INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 1

ACCOUNTING

MODULE – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This study material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

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A WORD ABOUT STUDY MATERIAL

Accounting constitutes a very significant area of core competence for chartered accountants. The paper of 'Accounting' at Intermediate (IPC) level concentrates on conceptual understanding of the crucial aspects of accounting.

The Study Material has been designed having regard to the needs of home study and distance learning students. The students are expected to cover the entire syllabus and also practice solving the questions given in the practice manual on their own.

The main features of the Study Material are as under:

- The entire syllabus has been divided into fifteen chapters.
- The Study Material has been divided into two Modules for the easy handling and convenience of students.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and can tackle the exercises.
- Many illustrations have been included in each chapter of the Study Material.
- In this revised study material, sincere efforts and care has been taken to incorporate the relevant amendments.
- In this revised edition, all the practical problems have been revisited and efforts have been taken to standardize the format of the solutions as far as possible.
- Flow charts have been inserted in Chapters at appropriate places for quick reference of students.
- Any theoretical additions made in the chapters have been highlighted in bold and italics while practical illustrations have been highlighted with grey shading in the Study Material for easy identification and quick reference.
- The Study Material has been revised in line with the relevant sections of the Companies Act, 2013 which have come into force.
- Feedback form is given in this study material wherein students are encouraged to give their feedback/suggestions.

These features would add value to the study material and aid the students in the learning process. In case you need any further clarification/guidance, you may send your queries at bosnoida@icai.in.

SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2018 EDITION OVER 2015 EDITION

Chapter no./unit no.	Name of Chapter/	Name of Unit	Section/ Sub-section	Changes
Chapter 1: Unit 1	Accounting Standards	Introduction to Accounting Standards	Para 1.8 Convergence to IFRS in India	Para amended.
Chapter 1: Unit 2		Overview of Accounting standards	2.1 Status of Accounting Standards	Para related to Accounting standards and Income Tax Act, amended.
			2.2 Applicability of Accounting Standards	Para amended
			2.4.2 Valuation of Inventories	Disclosures amended
			Para on Depreciation Accounting as per AS 6	Entire para on AS 6 deleted.
			2.4.6 Property, Plant and Equipment	Newly added by deleting the old para on 'Accounting for Fixed Assets'
			2.4.7 Accounting for investments	Matter relating to Investment Property amended.
			2.4.8 Accounting for Amalgamations	Matter relating to Treatment of Reserves on Amalgamation

			Miscellaneous Illustrations	Illustrations on AS 10 PPE added
Chapter 2-Unit 1	Financial Statements of Companies	Preparation of Financial Statements	Related illustrations	The presentation of dividend declared revised in line with the revision in Accounting Standards.
Chapter 6	Amalgamation		4. Methods of Accounting for Amalgamations	Matter related with presentation of Amalgamation Adjustment Reserve amended. This was also amended in relevant illustrations.

SYLLABUS

PAPER 1: ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge : Working Knowledge

Objectives :

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

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

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

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

Contents :

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

2. Accounting Standards

Working knowledge of:

AS	1	:	Disclosure of Accounting Policies
AS	2	:	Valuation of Inventories
AS	3	:	Cash Flow Statements
AS	7	:	Construction Contracts
AS	9	:	Revenue Recognition
AS	10	:	Property, Plant and Equipment
AS	13	:	Accounting for Investments

AS 14 : Accounting for Amalgamations

3. **Company Accounts**

   (a) Preparation of financial statements – Profit and Loss Account, Balance Sheet and Cash Flow Statement, Statement of changes in Equity and Explanatory Notes.

   (b) Profit (Loss) prior to incorporation

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

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

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

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

6. **Accounts from Incomplete Records**

7. **Accounting for Special Transactions**

   (a) Hire purchase and instalment sale transactions

   (b) Investment accounts

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

8. **Issues in Partnership Accounts**

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

9. **Accounting in Computerised Environment**

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

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

STUDY PLAN – KEY TO EFFECTIVE LEARNING

The paper of Accounting at Intermediate (IPC) level aims to lay a foundation for the preparation and presentation of financial statements of sole proprietors, partnerships and companies and also expects students to have working knowledge of the principles and procedures of accounting and their application to different practical situations.

Know your syllabus

The study material of Paper 1 'Accounting' is divided in fifteen chapters/topics based on the curriculum. The topics covered under this paper include Accounting Standards; Financial Statements of Companies, Profit or Losses Prior to Incorporation, Bonus issue, Amalgamation and Internal Reconstruction (excluding problems on inter- company holding); Average Due Date, Account Current; Self Balancing Ledgers; Financial Statements of Not for Profit Organizations; Accounts from Incomplete Records; Hire Purchase and Instalment Sale Transactions; Investment Accounts; Insurance Claims for Loss of Stock and Loss of Profit; Issues in Partnership Accounts; Accounting in Computerized Environment.

The syllabus of Accounting has an appropriate mix of various topics of sole proprietorship, partnership and companies as the objective of the paper is to gain ability to solve simple problems related to different businesses entities.

Be familiar with the Knowledge inputs provided by the BoS

Once you are aware of the syllabus, the next step is to find and assimilate the knowledge inputs which have been provided by the ICAI / Board of Studies, to study the paper. For better understanding of the paper, Board of Studies has provided following knowledge inputs:

1. Study Material
2. Practice Manual
3. Suggested Answers
4. Revision Test Papers
5. Mock Test Papers
6. Students' Journal for academic updates

Now, after knowing the various knowledge inputs provided by the Board of Studies, you should plan your studies.

Planning – Time Management

You are advised to plan your studies on the basis of availability of time and the course contents. Planning for study of the paper 'Accounting' should be done in a manner which makes you go through the subject at least three times.

In Accounting, examination paper is purely practical based. Therefore, one has to do written practice of good number of questions on each topic. So, at the time of planning the study for accounting you should keep into mind the written practice of practical questions also. Considering the practical nature of the paper, start your studies from the day you receive the course material. As at Intermediate (IPC) level you do not have to undergo articleship training, therefore, it is suggested that you should study at least two hours a day. By doing so, you will be able to manage first round of complete study and two rounds of revision well before time. Your first round of study should be completed well in advance, that is, at least 3 months before your exam.

This is macro level planning about how to study but you should also plan at micro level i.e. time planning for each and every chapter in detail - when to start and by what time the chapter should be completed. Keep some time leverage as assimilation of the chapters may take more time than expected or planned.

Your second round of study i.e. your first revision should be over before one month of your exam. Your second revision should be in the last month before exam so that you will be in the position to remember all the concepts. These three rounds of study will help in boosting the confidence level for the subject and will make you mentally prepared to appear in the examination.

First round of study

As you are aware that the syllabus of ‘Accounting' covers Accounting Standards as well as other topics, so your planning should be divided in two parts namely-

1. Accounting Standards
2. Other chapters of the course curriculum.

Every day when you start your study, first go through the concepts which you have read last day then start learning new concepts. Remember, out of sight, out of mind. Ideally your first study should be within 24 hours of initial reading, the second within 1 week of reading.

Part I- Accounting Standards

As accounting standards have been introduced to you for the first time in detail at this level, therefore, it is felt that we should give you an insight on accounting standards and how to study them.

Accounting standards are written policy documents issued by the ICAI. It covers the aspects of

- recognition,
- measurement,
- presentation and
- disclosure

of accounting transactions in the financial statements.

It is not necessary that each accounting standard deals with all the above aspects. There are some standards which deal only with disclosure part like AS 1, while AS 3 deals with the presentation aspect only. However, AS 2, 7, 9, 10, 13 and 14 as specified in the syllabus deal with recognition and measurement principles in specific along with certain disclosure requirements.

Note: The examples mentioned above are with reference to accounting standards which form part of the syllabus of Intermediate (IPC) Paper 1 'Accounting'. Only eight accounting standards are included at Intermediate (IPC) level even though there are in effect 27 accounting standards.

Each accounting standard has certain paragraphs in bold and italics which deal with the main provisions. Other paragraphs which are not in bold and italics are explanation to the paragraphs in bold and italics. Together the bold and italics paragraphs and normal paragraphs constitute an Accounting standard.

Some accounting standards are generally applied to any business like AS 1, 2, 9, 10 and 13 while some are industry/segment specific for example AS 7 (which will be applied only in case of construction contracts) and some situational like AS 14 'Accounting for Amalgamation' which states set of procedures to be followed at the time the company opt for merger.

In unit 2 of chapter 1 of our study material of 'Accounting', we have given the explanation/interpretation of the accounting standards specified in your syllabus. Also at the end of the study material, we have reproduced the bare text of these accounting standards for your reference. It is advised that after studying each standard explained in chapter 1 refer the bare text of accounting standard for building strong conceptual knowledge on the accounting standards specified in the syllabus.

Part II- Other Chapters

Once you study your accounting standard portion, you may study those chapters which are purely based on accounting standard. Such chapters are

Chapter 2 unit 2: Cash Flow Statement

Chapter 6: Amalgamation

Studying these chapters will revise your concepts on accounting standards which you have already studied in chapter 1 and will also make you understand and apply the provisions in the questions dealing with such standards.

Since, Intermediate (IPC) level is the second level of chartered accountancy course and we have a paper on 'Fundamentals of Accounting' at CPT level also, therefore, the chapters which apply the provisions studied at CPT level (to an extent) may be studied next. Such chapters are:

Chapter 9: Financial Statements of Not-for-Profit Organisations

Chapter 10: Accounts from Incomplete Records

Chapter 14: Issues in Partnership Accounts

You can then proceed studying other important chapters on company's accounts viz Preparation of financial statements of companies, Profit or loss prior to incorporation, Accounting for bonus issue and Internal reconstruction; one question on which is generally asked in the question paper. At the end, study small chapters on which question ranging from 4 to 8 marks are generally asked in the examination. Such chapters include average due date, account current, self balancing ledgers, hire-purchase and installment sale transactions, investment accounts, insurance claims for loss of stock and loss of profit and lastly accounting in computerized environment.

Chapter on 'Accounting in Computerized Environment' is a theory based chapter but question asked in the question paper is not a straight forward question. Your study should be application based so that you may analyze the requirements of the question and answer them in a desired manner.

Use of BoS Knowledge inputs in a systematic pattern

Step 1 Study material

To lay a strong foundation of the understanding of any particular topic, study material explains the concepts of each and every topic in detail with adequate illustrations. Study the underlying concepts and accounting treatment specified therein analytically before proceeding towards illustrations. Keep questioning yourself until you are absolutely clear on the topic. Solve the illustrations after understanding the topic. For example, in the chapter of Profit or loss prior to incorporation, one has to understand the reason why profit prior to incorporation is transferred to capital reserve and not to profit and loss account, what will be the treatment of loss prior to incorporation etc.

Step 2 Practice Manual

After solving the illustrations given in the study material, solve the questions given in the practice manual. Practice Manual is highly useful for the students appearing in the examination as it includes questions from past examinations which would facilitate in thorough understanding of the chapters explained in the study material. In accounting paper, it is very necessary that one should practice a good number of questions dealing with different adjustments. Practice Manual will help serve this purpose. Your first round of study should cover both Study Material and Practice Manual.

Second round of study

Step 3 Suggested answers

Your second round of study i.e. your first revision should cover practice of suggested answers of recent two to three examinations. Suggested answers of past few examinations give you an idea of what type of questions are asked in the examination and how to solve and present the solution for such questions in the examination. Solving the question paper in the examination situation will help you, not only in time management but will also give you the confidence to attempt different types of questions in the examination.

Step 4 Revision Test Papers (RTP)

After you complete revision of whole syllabus at least once, you should solve the questions given in the RTP. For every examination, Board of Studies comes out with a Revision Test Paper. Revision Test Paper is issued for every attempt containing a fresh set of questions which will help you to evaluate your preparation level. RTP of Accounting is divided into two parts namely Part I: Recent amendments, notifications and announcements which are relevant for that particular examination and is not given in the study material or was not applicable in the immediate past examination. You will be able to know all such relevant information applicable for the exam at one place. Part II carries questions and answers for your practice. In Accounting, questions on each topic are given with full solution to enable you to get an insight on how to present the solutions in an orderly manner. In Accounting paper, RTP of past few attempts can also be referred subject to amendments for which you have to refer the latest Study Material and RTP.

Third round of study

Step 5 Mock Test Papers

After second revision of the complete syllabus, you may assess your preparation by taking mock tests conducted by various branches at their end. Also Mock test papers are hosted on the institute's website www.icai.org which you may download and solve within a time period of three hours.

Important points to be kept in mind:

1. Preparation of notes

Prepare concise notes in the first round of study itself. Your notes should be prepared in a manner, which supplements your understanding of the concept and the illustrations you have solved. You may either make a separate copy where you write down the important concepts of the chapter or can underline the important concepts in the book itself and read those underlined portion at the time of revision. You should also shortlist the illustrations to be revised again in your second and third round of study. Short listing of illustrations should be based on the difficulty you faced while solving the question. Besides preparation of important points of the topic (which will help you to recapitulate the whole concepts), a summary of tricky points and adjustments gathered from the practice of various good illustrations may also be prepared which will help in grasping the intricate practical aspects. Such tricky points or adjustments should be cross linked with the concerned illustration number so that at the time of revision you not only study the accounting treatment but also refer the whole solution again. These notes may also be accompanied by the proforma of relevant accounts and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and efforts without going through a number of books again.

2. Use of proper and prescribed format for presentation of accounts

There are some chapters which require the solution or financial statements to be presented in particular format. You should make it a practice to adopt the prescribed formats while solving and presenting the accounts of particular topics. For example: Financial Statements of companies should be in the format prescribed in the Schedule III to the Companies Act, 2013.

3. Recapitulation of previously read topics

The chapter of Partnership accounts was also there in the paper of 'Fundamentals of Accounting' at CPT level. Therefore, here at Intermediate (IPC) level, you are required to whet your skills on this topic. Also the concepts and provisions read at CPT level lays down the foundation for studying and understanding the topics specified at the Intermediate (IPC) level. For example, concept of revenue and capital receipt and expenditure is applied in every topic while preparing the financial statements of an entity. Similarly, valuation of inventory, accounting for depreciation etc. are some of the topics the concepts of which are applied in general to all entities.

4. Keep yourself continuously updated

We at Board of studies endeavor to update you with the latest amendments or notifications as and when they are issued. One of the sections in the Students' Journal is on 'Academic Update' which contains recent amendments in accounting also. You should develop a habit to read this continuously as it will help you in avoiding last moment pressure to acquaint yourself with all the relevant amendments. Also list of publication comprising of all relevant accounting standards and guidance notes are published well in time in the Students' Journal and the institute's website to apprise you with the applicability part of the same in the particular examination.

5. Keep in mind the inter-linking of various topics

The provisions of accounting standards have to be kept in mind and applied while studying the related chapter based on the particular accounting standard. If your concepts are clear relating to a particular standard, you should not face any problem in applying the same to solve problems in an inter-connected chapter. Sometimes even though the chapter may not directly relate to an accounting standard, it may contain adjustments involving application of one or more standards.

We have made an attempt to explain with the help of tabular format given here under the manner in which concepts contained in the particular chapter of the study material have to be interlinked with the related provision in another chapter of the study material and read together:

Chapter / Unit No.	Name of the chapter/unit	Inter-linking
Chapter 1	Accounting standards	• Nine Accounting standards have been specified in this paper viz AS 1, 2, 3, 7, 9, 10, 13 and 14. • AS 3 is on Cash Flow Statement. There is a separate unit in chapter 2 which deals with Cash Flow Statement. All the provisions of AS 3 will be applied while preparing the cash flow statement of a company. • Similarly, provisions of AS 14 'Accounting for Amalgamations' will be applied in chapter 6 'Amalgamation'. • Provisions of AS 13 'Accounting for Investments' will be applied to an extent in chapter 12 Investment Accounts. For example value of closing balance of investment at the end of the accounting period will be cost or fair value whichever is less is as per para 14 of AS 13.
Chapter 2	Financial statements of companies	• Format of Schedule III to the Companies Act explained in this chapter is to be applied in the financial statements of companies required to be prepared in chapter 4 'Accounting for Bonus Issue', chapter 5 'Internal Reconstruction' and chapter 6 'Amalgamation'. • Cash flow statement is to be prepared as per AS 3 explained in chapter 1

Chapter 3	Profit or loss prior to incorporation	This chapter applies the principle of periodicity read at CPT level in the paper of Fundamentals of Accounting.
Chapter 6	Amalgamation	Provisions of AS 14 should be kept in mind while studying this chapter.
Chapter 9 and 10	Financial Statements of Not - for - Profit organizations and Accounts from Incomplete Records	These chapters apply the provisions studied in the chapter 'Preparation of Final Accounts for Sole Proprietors' at CPT level.
Chapter 12	Investment Accounts	Provisions of AS 2 and 13 should also be remembered while valuing the closing balance of investment at the end of the accounting period.
Chapter 14	Issues in Partnership Accounts	In 'Fundamentals of Accounting' at CPT level, we had a chapter on partnership which dealt with profit and loss appropriation account of partnership firm, admission, retirement and death of a partner.

Other chapters though not specifically interlinked with any chapter but still apply the provisions already read earlier.

Tips for examination

General tips are already given in the first part of this booklet. However, we would like to also focus on following accounting related examination tips which you should keep in mind at the time of appearing for the examination:

1. Use of proper formats

Certain statutes prescribe specific formats for presentation of the accounts. You should take care of the same at the time of solving the questions in the exam. Accounts presented in the prescribed manner will help you in scoring due marks.

2. Adequate Working Notes

In accounts, your solution is generally divided in two parts viz- main solution and working notes. Working notes form part of your solution and carries marks. Therefore, it is advised that calculations made on your calculator should also be written in your answer sheet as working note, wherever required, neatly and precisely. Also your working note should be cross referenced with the figure used in the main solution so that examiner can easily understand that how you have arrived at the particular figure.

3. Answer the questions with due emphasis on the provisions of Accounting Standards

Support your answers/conclusions with proper reasoning. Answers for questions based on accounting standards should be supported with provisions of that accounting standard rather than a mere common sense or guess work. It is not required to quote paragraph number of Accounting standard but you are expected to quote accounting standard number alongwith the name of the standard. However, if you state, paragraph number of accounting standard, then it will add value to the solution and will also help create a good impression in the mind of the examiner. You should quote number of accounting standard or name only when you are sure. It is better not to quote than to misquote the accounting standard number.

4. State the assumption clearly

In case a question leaves room for making an assumption and there is a possibility of more than one assumption, it is important to clearly state the assumption you have taken and solve the question accordingly.

Happy Reading and Best Wishes!

FEEDBACK FORM

(1)	Name of the Student					
(2)	Registration No.					
	Contact detail with e-mail id, mobile number, etc.					
(3)	Subject & Paper No.	Paper: 1: Accounting				
(4)	Name of Publication	Study Material				
(5)	Edition	July, 2018				
(6)	Do you find the publication student-friendly?					
(7)	Do the illustrations in the Study Material assist in understanding of the provisions contained in the Study Material?					
(8)	Does the Practice Manual contain adequate and sufficient questions to help in better understanding of the concepts explained in the Study Material?					
(9)	Are there any errors which you have noticed in the publication? If yes, give the specific details :					
	Type of Error (Specify nature of error)	**Chapter No. (Unit No., if applicable)**	**Page No.**	**Para No. & line of the para**	**Text or problem (containing the error) as per the publication**	**Suggested Correction**
	Typographical/ Printing/ Computational/ Conceptual/ Updation					
(10)	Do you feel that the publication can be made more value additive? If so, please give your specific suggestions. ____ ____					

Note: Use separate sheet, if necessary. You are also encouraged to send your response by e-mail at feedbackbos@icai.in

Please send feedback form to :

Director, Board of Studies
The Institute of Chartered Accountants of India
A-29, Sector-62, Noida- 201 309.

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Accounting Standards

Unit 1 : Introduction to Accounting Standards

Learning objectives

After studying this unit you will be able to:

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

1.1 Introduction

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

Accounting Standards deal with the issues of

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

(ii) measurement of these transactions and events,

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

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

Accounting Standards standardize diverse accounting policies with a view to

(i) Eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements, to the maximum possible extent, and

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

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

In addition to improving credibility of accounting data, standardisation of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise. Such comparisons are very effective and most widely used tools for assessment of enterprise performances by users of financial statements for taking economic decisions, e.g. whether or not to invest, whether or not to lend and so on.

The intra-enterprise comparison involves comparison of financial statements of same enterprise over number of years. The intra-enterprise comparison is possible if the enterprise uses same accounting policies every year in drawing up its financial statements. For this reason, AS 1 requires disclosure of changes in accounting policies.

The inter-enterprise comparison involves comparison of financial statements of different enterprises for same accounting period. This is possible only when comparable enterprises use same accounting policies in preparation of respective financial statements. The disclosure of accounting policies allows a user to make appropriate adjustments while comparing the financial statements.

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

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

1.2 Standards Setting Process

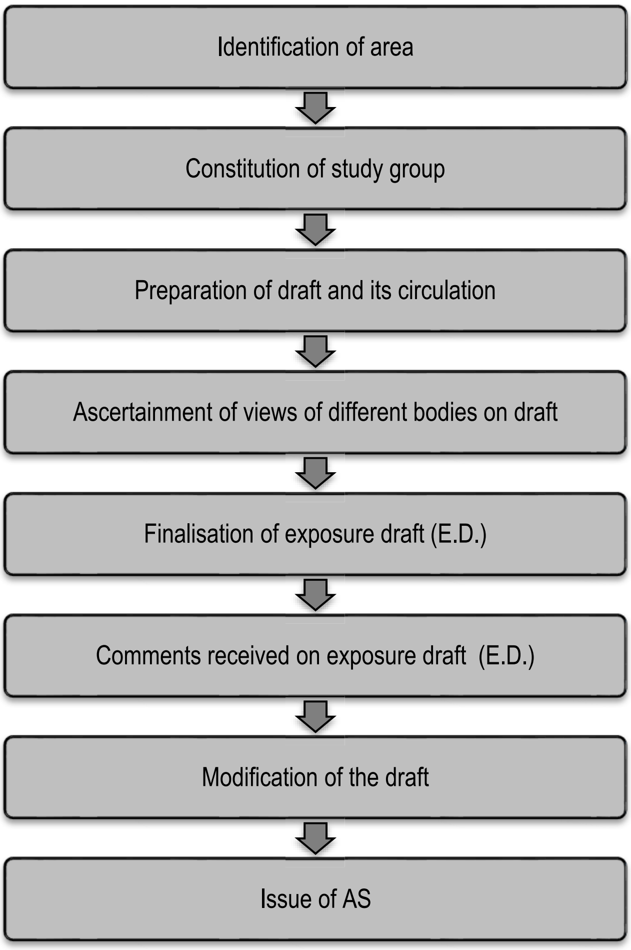
The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards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

The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:

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

- Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities, the accounting standards are issued by The Central Government of India.

Standard – Setting Process


Identification of area
Constitution of study group
Preparation of draft and its circulation
Ascertainment of views of different bodies on draft
Finalisation of exposure draft (E.D.)
Comments received on exposure draft (E.D.)
Modification of the draft
Issue of AS

Earlier, ASB used to issue Accounting Standard Interpretations which address questions that arise in course of application of standard. These were, therefore, issued after issuance of the relevant standard. Authority of the accounting standard interpretation (ASIs) was same as that of the accounting standard (AS) to which it relates. However, after notification of accounting standards by the Central government for the companies, where the consensus portion of ASI was merged as 'Explanation' to the relevant paragraph of the accounting standard, the council of ICAI also decided to merge the consensus portion of ASI as 'Explanation' to the relevant paragraph of the accounting standard issued by them. This initiative was taken by the council of the ICAI to harmonise both the set of standards i.e. accounting standards issued by the ICAI and accounting standards notified by the central government.

It may be noted that as per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Advisory Committee on Accounting Standards (NACAS).

1.3 Benefits and Limitations

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

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

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

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

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

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

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

(iii) ***Restricted scope***: Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

1.4 How many Accounting Standards?

The Council of the Institute of Chartered Accountants of India has, so far, issued ***twenty nine Accounting Standards. However, AS 6 on 'Depreciation Accounting' has been withdrawn on revision of AS 10 'Property, Plant and Equipment*' and*** AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are now only 27 notified accounting standards as per the Companies (Accounting Standards) Rules, 2006 (as amended in 2016).

The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

1.5 Need for Convergence towards Global Standards

The last decade has witnessed a sea change in the global economic scenario. The emergence of trans-national corporations in search of money, not only for fuelling growth, but to sustain on going activities has necessitated raising of capital from all parts of the world, cutting across frontiers.

Each country has its own set of rules and regulations for accounting and financial reporting. Therefore, when an enterprise decides to raise capital from the markets other than the country in which it is located, the rules and regulations of that other country will apply and this in turn will require that the enterprise is in a position to understand the differences between the rules governing financial reporting in the foreign country as compared to its own country of origin. Therefore translation and re-statements are of utmost importance in a world that is rapidly globalising in all ways. In themselves also, the accounting standards and principle need to be robust so that the larger society develops degree of confidence in the financial statements, which are put forward by organizations.

International analysts and investors would like to compare financial statements based on similar accounting standards, and this has led to the growing support for an internationally accepted set of accounting standards for cross-border filings. The harmonization of financial reporting around the world will help to raise confidence of investors generally in the information they are using to make their decisions and assess their risks.

Also a strong need was felt by legislation to bring about uniformity, rationalization, comparability, transparency and adaptability in financial statements. Having a multiplicity of accounting standards around the world is against the public interest. If accounting for the same events and information produces different reported numbers, depending on the system

* ***Earlier AS 10 was on 'Accounting for Fixed Assets'.***

of standards that are being used, then it is self-evident that accounting will be increasingly discredited in the eyes of those using the numbers. It creates confusion, encourages error and facilitates fraud. The cure for these ills is to have a single set of global standards, of the highest quality, set in the interest of public. Global Standards facilitate cross border flow of money, global listing in different bourses and comparability of financial statements.

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

1.6 International Accounting Standard Board

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

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

1.7 International Financial Reporting Standards as Global Standards

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

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

1.8 Convergence to IFRS in India

In the scenario of globalisation, India cannot insulate itself from the developments taking place worldwide. In India, so far as the ICAI and the Government authorities such as the National Advisory Committee on Accounting Standards established under the Companies Act, 2013, and various regulators such as Securities and Exchange Board of India and Reserve Bank of India are concerned, the aim is to comply with the IFRS to the extent possible with the objective to formulate sound financial reporting standards for the purpose of preparing globally accepted financial statements. The ICAI, being a member of the International Federation of Accountants (IFAC), considered the IFRS and tried to integrate them, to the extent possible, in the light of the laws, customs, practices and business environment prevailing in India.

Also, the recent stream of overseas acquisitions by Indian companies makes a compelling case for adoption of high quality standards to convince foreign enterprises about the financial standing as also the disclosure and governance standards of Indian acquirers.

In India, the Institute of Chartered Accountants of India (ICAI) has worked towards convergence by considering the application of IFRS in Indian corporate environment of Indian Accounting Standards with Global Standards. Recognising the growing need of full convergence of Indian Accounting Standards with IFRS, ICAI constituted a Task Force to examine various issues involved. Full convergence involves adoption of IFRS in the same form as that issued by the IASB. While formulating the Accounting

Standards, ICAI recognises the legal and other conditions prevailing in India and makes deviations from the corresponding IFRS.

For convergence of Indian Accounting Standards with International Financial Reporting Standards (IFRS), the Accounting Standard Board in consultation with the Ministry of Corporate Affairs (MCA)), has decided that there will be two separate sets of Accounting Standards viz. (i) Indian Accounting Standards converged with the IFRS – standards which are being converged by eliminating the differences of the Indian Accounting Standards vis-à-vis IFRS (known as Ind AS) and (ii) Existing Notified Accounting Standards.

History of IFRS-Converged Indian Accounting Standards (Ind AS)

First Step towards IFRS

The Institute of Chartered Accountants of India (ICAI) being the accounting standards-setting body in India, way back in 2006, initiated the process of moving towards the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) with a view to enhance acceptability and transparency of the financial information communicated by the Indian corporates through their financial statements. This move towards IFRS was subsequently accepted by the Government of India.

The Government of India in consultation with the ICAI decided to converge and not to adopt IFRS issued by the IASB. The decision of convergence rather than adoption was taken after the detailed analysis of IFRS requirements and extensive discussion with various stakeholders. Accordingly, while formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as, various terminology related changes have been made to make it consistent with the terminology used in law, e.g., ‘statement of profit and loss’ in place of ‘statement of profit and loss and other comprehensive income’ and ‘balance sheet’ in place of ‘statement of financial position’. Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS.

Government of India - Commitment to IFRS Converged Ind AS

Consistent, comparable and understandable financial reporting is essential to develop a robust economy. With a view to achieve international benchmarks of financial reporting, the Institute of Chartered Accountants of India (ICAI), as a proactive role in accounting, set out to introduce Indian Accounting Standards (Ind AS) converged with the International Financial

Reporting Standards (IFRS). This endeavour of the ICAI is supported by the Government of India.

Initially Ind AS were expected to be implemented from the year 2011. However, keeping in view the fact that certain issues including tax issues were still to be addressed, the Ministry of Corporate Affairs decided to postpone the date of implementation of Ind AS.

In July 2014, the Finance Minister of India at that time, Shri Arun Jaitely ji, in his Budget Speech, announced an urgency to converge the existing accounting standards with the International Financial Reporting Standards (IFRS) through adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies.

Pursuant to the above announcement, various steps have been taken to facilitate the implementation of IFRS-converged Indian Accounting Standards (Ind AS). Moving in this direction, the Ministry of Corporate Affairs (MCA) has issued the Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 covering the revised roadmap of implementation of Ind AS for companies other than Banking companies, Insurance Companies and NBFCs and Indian Accounting Standards (Ind AS). As per the Notification, Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS) shall be implemented on voluntary basis from 1st April, 2015 and mandatorily from 1st April, 2016. Separate roadmaps have been prescribed for implementation of Ind AS to Banking, Insurance companies and NBFCs respectively.

Unit 2: Overview of Accounting Standards

Learning objectives

After studying this unit you will be able to:

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

2.1 Status of Accounting Standards

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

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

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

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

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

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

Enterprises to which the accounting standards apply

Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

Implication of mandatory status

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. (See Scheme of Applicability of Accounting Standards given in para 2.3) In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

Section 129 (1) of the Companies Act, 2013 requires companies to present their financial statements in accordance with the accounting standards notified under Section 133 of the Companies Act, 2013 (See Note 1). Also, the auditor is required by section 143(3)(e) to report whether, in his opinion, the financial statements of the company audited, comply with the accounting standards referred to in section133 of the Companies Act, 2013. Where the financial statements of a company do not comply with the accounting standards, the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviations as per Section 129(5) of the Companies Act, 2013. Provided also that the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—-

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Note: As per the Companies Act, 2013, the Central Government may prescribe standards of accounting or addendum thereto, as recommended by the Institute of Chartered Accountants of India, in consultation with NACAS. Till date, the Central Government has notified all the existing accounting standards.

Financial items to which the accounting standards apply

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

Accounting Standards and Income tax Act, 1961

Accounting standards intend to reduce diversity in application of accounting principles. They improve comparability of financial statements and promote transparency and fairness in their presentation. Deductions and exemptions allowed in computation of taxable income on the other hand, is a matter of fiscal policy of the government.

Thus, an expense required to be charged against revenue by an accounting standard does not imply that the same is always deductible for income tax purposes. For example, depreciation on assets taken on finance lease is charged in the books of lessee as per AS 19 but depreciation for tax purpose is allowed to lessor, being legal owner of the asset, rather than to lessee. Likewise, recognition of revenue in the financial statements cannot be avoided simply because it is exempted under section 10 of the Income Tax Act, 1961.

Income Computation and Disclosure Standards

Section 145(2) empowers the Central Government to notify in the Official Gazette from time to time, income computation and disclosure standards to be followed by any class of assessees or in respect of any class of income. Accordingly, the Central Government has, in exercise of the powers conferred under section 145(2), notified ten income computation and disclosure standards (ICDSs) to be followed by all assessees (other than an individual or a Hindu undivided family who is not required to get his accounts of the previous year audited in accordance with the provisions of section 44AB) following the mercantile system of accounting, for the purposes of computation of income chargeable to income-tax under the head "Profit and gains of business or profession" or " Income from other sources", from A.Y. 2017-18. The ten notified ICDSs are:

ICDS I : Accounting Policies

ICDS II : Valuation of Inventories

ICDS III : Construction Contracts

ICDS IV : Revenue Recognition

ICDS V : Tangible Fixed Assets

ICDS VI : The Effects of Changes in Foreign Exchange Rates

ICDS VII : Government Grants

ICDS VIII : Securities

ICDS IX : Borrowing Costs

ICDS X : Provisions, Contingent Liabilities and Contingent Assets

2.2 Applicability of Accounting Standards

For the purpose of compliance of the accounting Standards, the ICAI had already issued an announcement on 'Criteria for Classification of Entities and Applicability of Accounting Standards' in year 2003. As per the announcement, entities were classified into three levels. Level II entities and Level III entities as per the said Announcement were considered to be Small and Medium Entities (SMEs).

However, when the accounting standards were notified by the Central Government in consultation with the National Advisory Committee on Accounting Standards[1], the Central Government also issued the 'Criteria for Classification of Entities and Applicability of Accounting Standards' for the companies. It is pertinent to note that the accounting standards notified by the government were mandatory for the companies since it was notified under the Act.

According to the 'Criteria for Classification of Entities and Applicability of Accounting Standards' as issued by the Government, there are two levels, namely, Small and Medium-sized Companies (SMCs) as defined in the Companies (Accounting Standards) Rules, 2006 and companies other than SMCs. Non-SMCs are required to comply with all the Accounting Standards in their entirety, while certain exemptions/ relaxations have been given to SMCs.

Consequent to certain differences in the criteria for classification of the levels of entities as issued by the ICAI and as notified by the Central Government for companies, the Accounting Standard Board of the ICAI decided to revise its ''Criteria for Classification of Entities and Applicability of Accounting Standards' and make the same applicable only to non-corporate entities. Though the classification criteria and applicability of accounting standards has been largely aligned with the criteria prescribed for corporate entities, it was decided to continue

[1] *The Companies Act, 1956 is being replaced by the Companies Act 2013 in a phased manner. Now, as per Section 133 of the Companies Act, 2013, the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority (NFRA). Section 132 of the Companies Act, 2013 deals with constitution of NFRA. It may be noted that this section is not notified till 30th November, 2016.*

However, the Ministry of Corporate Affairs has, vide clarification dated 13th September, 2013, announced that the existing Accounting Standards notified under the Companies Act, 1956 shall continue to apply till the Standards of Accounting or any addendum thereto are prescribed by Central Government in consultation and recommendation of the National Financial Reporting Authority.

with the three levels of entities for non-corporate entities vis-à-vis two levels prescribed for corporate entities as per the government notification.

'Criteria for Classification of Entities and Applicability of Accounting Standards' for corporate entities and non-corporate entities have been explained in the coming paragraphs.

No relaxation was given to Level II and III enterprises in respect to recognition and measurement principles. Relaxations were provided with regard to disclosure requirements.

2.2.1 Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees one crore but does not exceed rupees fifty crore in the immediately preceding accounting year.

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard: Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, *Employee Benefits*, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

2.2.2 Criteria for classification of Companies as per the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

"Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non- SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:-

   1.1 The SMC which does not disclose certain information pursuant to the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

   "The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

   1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instruction

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

"5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

2.2.3 Applicability of Accounting Standards to Companies

2.2.3.1 Accounting Standards applicable to all companies in their entirety for accounting periods commencing on or after 7th December, 2006

AS 1	Disclosures of Accounting Policies
AS 2 (Revised)	Valuation of Inventories
AS 4 (Revised)	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts
AS 9	Revenue Recognition

AS 10 (Revised)	Property, Plant and Equipment∗∗
AS 11	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13 (Revised)	Accounting for Investments
AS 14 (Revised)	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

2.2.3.2 Exemptions or Relaxations for SMCs as defined in the Notification

(A) *Accounting Standards not applicable to SMCs in their entirety:*

AS 3 Cash Flow Statements.

AS 17 Segment Reporting

Revised AS 10 is on 'Property, Plant and Equipment' which is applicable for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.

AS 6 has been withdrawn by the MCA on 30.3.2016 for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards. Provisions with respect to Depreciation has been incorporated in revised AS 10.

(B) *Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs*:*

(i) AS 21 (Revised), Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) *Accounting Standards** in respect of which relaxations from certain requirements have been given to SMCs:*

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(ii) AS 19, Leases

(iii) AS 20, Earnings Per Share

(iv) AS 28, Impairment of Assets

(v) AS 29(Revised), Provisions, Contingent Liabilities and Contingent Assets

(D) *AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.*

2.2.4 Applicability of Accounting Standards to Non-corporate Entities

2.2.4.1 Accounting Standards applicable to all Non-corporate Entities in their entirety (Level I, Level II and Level III)

AS 1	Disclosures of Accounting Policies
AS 2 (Revised)	Valuation of Inventories
AS 4 (Revised)	Contingencies and Events Occurring After the Balance Sheet Date

* AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

** The exemption provisions contained in these standards have not been detailed since these standards do not form part of syllabus of Intermediate (IPC) Paper-1 Accounting.

AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7	Construction Contracts
AS 9	Revenue Recognition
AS 10 (Revised)	Property, Plant and Equipment**
AS 11	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13 (Revised)	Accounting for Investments
AS 14 (Revised)	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 22	Accounting for Taxes on Income
AS 26	Intangible Assets

2.2.4.2 Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) *Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:*

AS 3	Cash Flow Statements
AS 17	Segment Reporting

(B) *Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:*

AS 3	Cash Flow Statements

*****Revised AS 10 is on 'Property, Plant and Equipment' which is applicable for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.***

AS 6 has been withdrawn by the MCA on 30.3.2016 for corporate entities and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2016 while for non-corporate entities the same has been withdrawn and will come into effect prospectively in respect of accounting periods commencing on or after April 1, 2017 onwards.

AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 24	Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities[*]*:*

(i)	AS 21 (Revised), Consolidated Financial Statements
(ii)	AS 23, Accounting for Investments in Associates in Consolidated Financial Statements
(iii)	AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards[**] *in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):*

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(ii) AS 19, Leases

(iii) AS 20, Earnings Per Share

(iv) AS 28, Impairment of Assets

(v) AS 29(Revised), Provisions, Contingent Liabilities and Contingent Assets

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

2.3 List of Accounting Standards

Following is the list of Accounting Standards with their respective date of applicability:

The following is the list of Accounting Standards with their respective date of applicability:

[*] AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

[**] The exemption provisions contained in these standards have not been detailed since these standards do not form part of syllabus of Intermediate (IPC) Paper-1 Accounting.

AS No.	*AS Title*	*Date*
1	Disclosure of Accounting Policies	01/04/1993
2	Valuation of Inventories (Revised)	01/04/1999
3	Cash Flow Statement	01/04/2001
4	Contingencies and Events Occurring after the Balance Sheet Date (Revised)	01/04/1998
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	01/04/1996
6	Depreciation Accounting	*Withdrawn w.e.f 1.4.2016 after issuance of revised AS 10 on PPE*
7	Construction Contracts	01/04/2002
8	Research & Development	Now included in AS 26
9	Revenue Recognition	01/04/1993
10	*Property, Plant and Equipment (Revised)*	*01/04/2016*
11	The Effects of Changes in Foreign Exchange Rates	01/04/2004
12	Accounting for Government Grants	01/04/1994
13	Accounting for Investments (Revised)	01/04/1995
14	Accounting for Amalgamations (Revised)	01/04/1995
15	Employee Benefits	01/04/2006
16	Borrowing Costs	01/04/2000
17	Segment Reporting	01/04/2001
18	Related Party Disclosures	01/04/2001
19	Leases	01/04/2001
20	Earnings Per Share	01/04/2001
21	Consolidated Financial Statements (Revised)	01/04/2001
22	Accounting for Taxes on Income	01/04/2006
23	Accounting for Investments in Associates in Consolidated Financial Statements	01/04/2002

24	Discontinuing Operations	01/04/2004
25	Interim Financial Reporting	01/04/2002
26	Intangible Assets	01/04/2003
27	Financial Reporting of Interests in Joint Ventures	01/04/2002
28	Impairment of Assets	01/04/2008
29	Provisions, Contingent Liabilities and Contingent Assets (Revised)	01/04/2004

***Note:** Accounting Standards 1, 2, 3, 7, 9, 10, 13 and 14 are covered in the Intermediate (IPC) Course (Gr-I) syllabus and have been discussed in detail in the later paras.*

2.4 Overview

2.4.1 Disclosure of Accounting Policies (AS 1)

Irrespective of extent of standardization, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard.

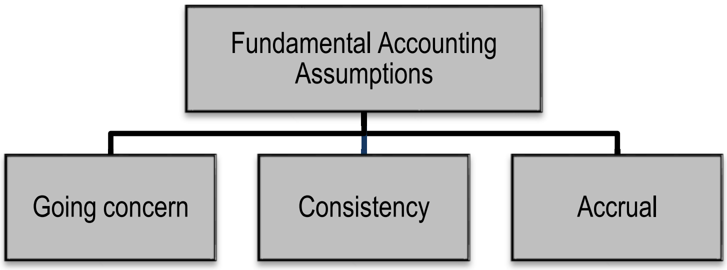
Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time.

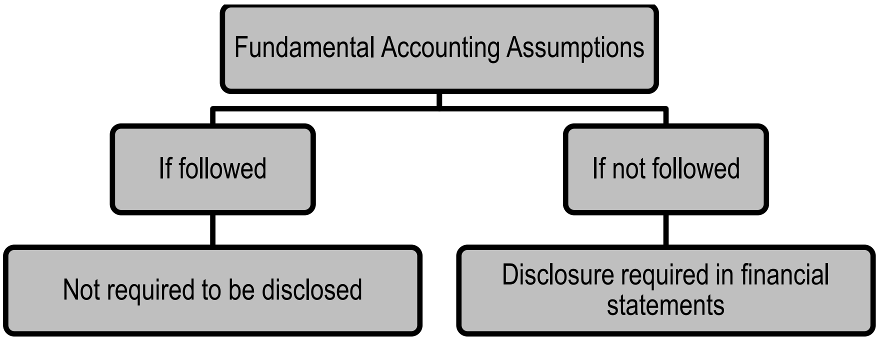
The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

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

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

Fundamental Accounting Assumptions (Paragraph 10)




Fundamental Accounting Assumptions
If followed
If not followed
Not required to be disclosed
Disclosure required in financial statements

Going Concern: The financial statements are normally prepared on the assumption that an enterprise will continue its operations in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities.

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

Accrual basis of accounting: Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it.

While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain.

Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting as illustrated below. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Accounting Policies

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.

Accountant has to make decisions from various options for recording or disclosing items in the books of accounts e.g.

Items to be disclosed	Method of disclosure or valuation
Inventories	FIFO, Weighted Average etc.
Cash Flow Statement	Direct Method, Indirect Method
Depreciation	Straight Line Method, Reducing Balance Method, Depletion Method etc.

This list is exhaustive i.e. endless. For every item right from valuation of assets and liabilities to recognition of revenue, providing for expected losses, for each event, accountant need to form principles and evolve a method to adopt those principles. This method of forming and applying accounting principles is known as accounting policies.

As we say that accounts is both science and art. It is a science because we have some tested accounting principles, which are applicable universally, but simultaneously the application of these principles depends on the personal ability of each accountant. Since different accountants may have different approach, we generally find that in different enterprise under same industry, different accounting policy is followed. Though ICAI along with Government is trying to reduce the number of accounting policies followed in India but still it cannot be reduced to one. Accounting policy adopted will have considerable effect on the financial results disclosed by the financial statements; it makes it almost difficult to compare two financial statements.

Selection of Accounting Policy

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

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

Example 1

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

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

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

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

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

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

Example 2

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

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

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

(a) A company shall disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or ₹1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).

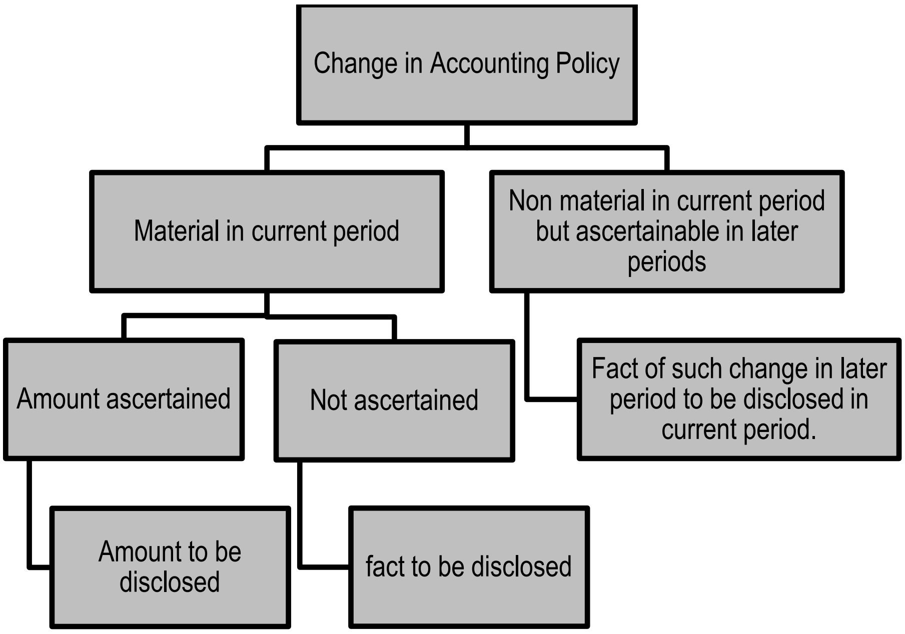
(b) A company shall disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held. (Refer general Instructions for Balance Sheet in Schedule III to the Companies Act, 2013).

Manner of disclosure: All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed

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. **Note:** Being a part of the financial statement, the opinion of auditors shall cover the disclosures of accounting policies.

Disclosure of Changes in Accounting Policies

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


Change in Accounting Policy
Material in current period
Non material in current period but ascertainable in later periods
Amount ascertained
Not ascertained
Fact of such change in later period to be disclosed in current period.
Amount to be disclosed
fact to be disclosed

Example 3

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

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

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

The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 2014-15 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 2014-15 is not significant, the change in policy will not have any material effect on financial statements of 2014-15. Yet, the company must disclose the change in accounting policy in 2014-15 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 2014-15, then no disclosure in future years will be required. This is because an enterprise has to disclose changes in accounting policies in the year of change only.

Disclosure of deviations from fundamental accounting assumptions

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

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

2.4.2 Valuation of Inventory (AS 2)

The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period.

Since inventories are assets, and assets are resources expected to cause flow of future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs of acquisition and costs that change either (i) the location of the inventory, e.g. freight incurred to carry the materials to factory or (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock.

The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and therefore should not be included in inventory costs.

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

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

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

Part I of Schedule III to the Companies Act prescribes that valuation mode shall be disclosed for inventory held by companies. AS 2 "Valuation of Inventories" was first issued in June 1981 to supplement the legal requirements. It was revised and made mandatory for all enterprises in respect of accounting periods commencing on or after April 1, 1999.

Paragraph 3 of AS 2 defines inventories as assets held

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

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

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

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

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

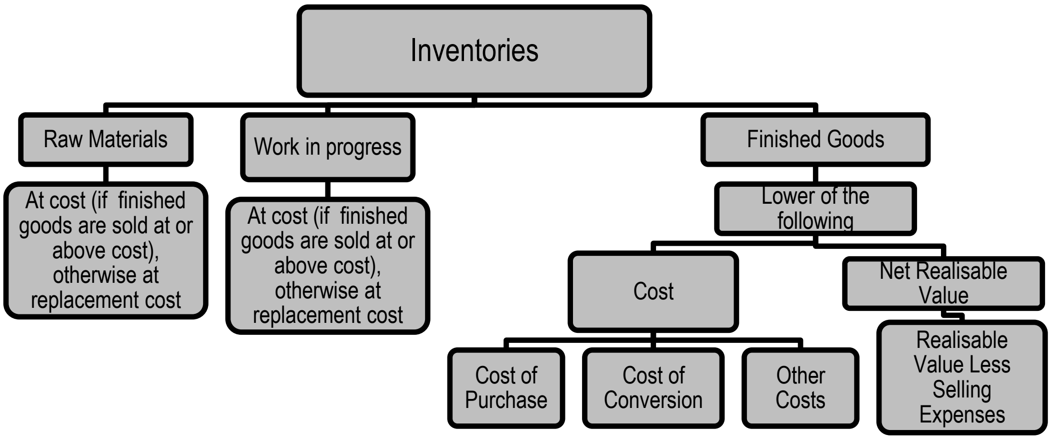
(b) Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise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

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

(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, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

Measurement of Inventories

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


Inventories
Raw Materials
Work in progress
Finished Goods
At cost (if finished goods are sold at or above cost), otherwise at replacement cost
At cost (if finished goods are sold at or above cost), otherwise at replacement cost
Lower of the following
Cost
Net Realisable Value
Cost of Purchase
Cost of Conversion
Other Costs
Realisable Value Less Selling Expenses

Example 1

Cost of a partly finished unit at the end of 2009-10 is ₹ 150. The unit can be finished next year by a further expenditure of ₹ 100. The finished unit can be sold at ₹ 250, subject to payment of 4% brokerage on selling price. The value of inventory is determined below:

	₹
Net selling price	*250*
Less: Estimated cost of completion	*(100)*

	150
Less: Brokerage (4% of 250)	*(10)*
Net Realisable Value	*140*
Cost of inventory	*150*
Value of inventory (Lower of cost and net realisable value)	*140*

Costs of inventory

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

Costs of purchase

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.

Example 2

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

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

(Normal cost per Kg.)

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

Allocation of material cost

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

Note: Abnormal losses are recognised as separate expense.

Costs of Conversion

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

The fixed production overheads should be absorbed systematically to units of production over normal capacity. Normal capacity is the production the enterprise expects to achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates the normal capacity. The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) 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.

Example

ABC Ltd. has a plant with the capacity to produce 1 lac unit of a product per annum and the expected fixed overhead is ₹ 18 lacs. Fixed overhead on the basis of normal capacity is ₹ 18 (18 lacs/1 lac).

Case 1: ***Actual production is 1 lac units. Fixed overhead on the basis of normal capacity and actual overhead will lead to same figure of ₹ 18 lacs. Therefore it is advisable to include this on normal capacity.***

Case 2: ***Actual production is 90,000 units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 20 (18 lacs/ 90 thousands). Hence by valuing inventory at ₹ 20 each for fixed overhead purpose, it will be overvalued and the losses of ₹ 1.8 lacs will also be included in closing inventory leading to a higher gross profit then actually earned. Therefore, it is advisable to include fixed overhead per unit on normal capacity to actual production (90,000 x 18) ₹ 16.2 lacs and rest ₹ 1.2 lacs shall be transferred to Profit & Loss Account.***

Case 3: ***Actual production is 1.2 lacs units. Fixed overhead is not going to change with the change in output and will remain constant at ₹ 18 lacs, therefore, overheads on actual basis is ₹ 15 (18 lacs/ 1.2 lacs). Hence by valuing inventory at ₹ 18 each for fixed overhead purpose, we will be adding the element of cost to inventory which actually has not been incurred. At ₹ 18 per unit, total fixed overhead comes to ₹ 21.6 lacs whereas, actual fixed overhead expense is only ₹ 18 lacs. Therefore, it is advisable to include fixed overhead on actual basis (1.2 lacs x 15) ₹ 18 lacs.***

Joint or By-Products

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

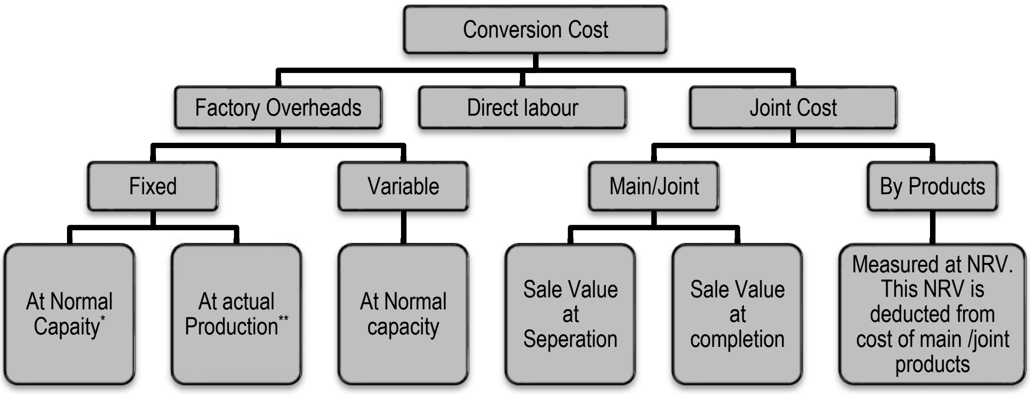
Other Costs

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

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

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

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


Conversion Cost
Factory Overheads
Direct labour
Joint Cost
Fixed
Variable
Main/Joint
By Products
At Normal Capaity*
At actual Production**
At Normal capacity
Sale Value at Seperation
Sale Value at completion
Measured at NRV. This NRV is deducted from cost of main /joint products

*When actual production is almost equal or lower than normal capacity.

** When actual production is higher than normal capacity.

Exclusions from the cost of inventories

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

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

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

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

(d) Selling and distribution costs.

Cost Formula

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

Other techniques of cost measurement

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

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

Example 4

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

Cost of closing inventory is shown below:

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

Estimates of Net Realisable Value

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

Comparison of Cost and Net Realisable Value

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

Example 5

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

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

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

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

NRV of materials held for use or disposal

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

Review of net realisable value at each balance sheet date

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

Disclosures

Paragraph 26 of AS 2 requires financial statements to disclose:

(a) accounting policies adopted in measuring inventories, including the cost formula used

(b) total carrying amount of inventories and its classification appropriate to the enterprise.

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:

(1) raw materials and components,

(2) work in progress,

(3) finished goods,

(4) Stock-in-trade (in respect of goods acquired for trading),

(5) stores and spares,

(6) loose tools, and

(7) Others (specify nature).

2.4.3 Cash Flow Statement (AS 3)

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

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

Status of AS 3

The standard is mandatory for Level 1 enterprises in respect of accounting periods commencing on or after April 1, 2001. The Level II and Level III non-corporate entities and Level II corporate entities are encouraged but not required to apply the standard.

Meaning of the term cash for cash flow statements

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

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

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

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

Meaning of the term cash flow

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

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

Types of cash flow

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

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

The investing cash flows are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to /

recovered from other entities (other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

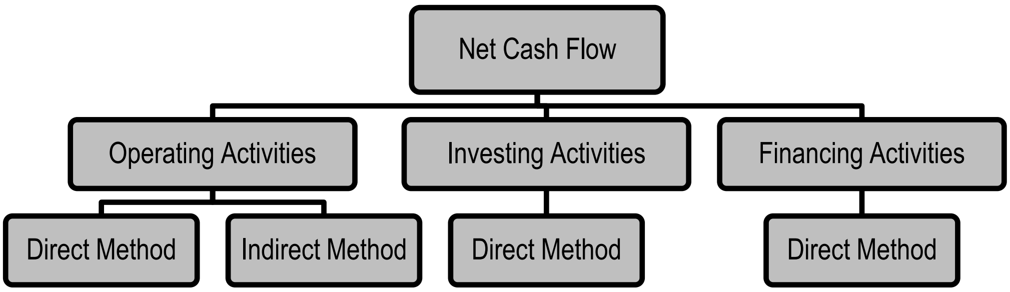
The financing cash flows are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue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

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

Identifying type of cash flows

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

Classification Cash Flows



Loans/Advances given and Interests earned

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

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

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

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

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

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

Loans/Advances taken and interests paid

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

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

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

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

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

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

Investments made and dividends earned

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

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

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

Dividends Paid

Dividends paid are financing cash outflows for all enterprises.

Income Tax

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

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

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

Insurance claims received

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

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

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

Profit or loss on disposal of fixed assets

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

Fundamental techniques of cash flow preparation

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

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

Reporting Cash Flows on Net Basis

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

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

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

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

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

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

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

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

Non-Cash transactions

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

Business Purchase

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

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

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

   (i) The total purchase or disposal consideration; and

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

Treatment of current assets and liabilities taken over on business purchase

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

Exchange gains and losses

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

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

Disclosures

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

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

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

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

Example 1

Classify the following activities as (a) Operating Activities, (b) Investing Activities, (c) Financing Activities (d) Cash Equivalents.

a. Purchase of Machinery.

b. Proceeds from issuance of equity share capital

c. Cash Sales.

d. Proceeds from long-term borrowings.

e. Proceeds from Trade receivables.

f. Cash receipts from Trade receivables.

g. Trading Commission received.

h. Purchase of investment.

i. Redemption of Preference Shares.

j. Cash Purchases.

k. Proceeds from sale of investment

l. Purchase of goodwill.

m. Cash paid to suppliers.

n. Interim Dividend paid on equity shares.

o. Wages and salaries paid.

p. Proceed from sale of patents.

q. Interest received on debentures held as investment.

r. Interest paid on Long-term borrowings.

s. Office and Administration Expenses paid

t. Manufacturing Overheads paid.

u. Dividend received on shares held as investments.

v. Rent Received on property held as investment.

w. Selling and distribution expense paid.

x. Income tax paid

y. Dividend paid on Preference shares.

z. Underwritings Commission paid.

aa. Rent paid.

bb. Brokerage paid on purchase of investments.

cc. Bank Overdraft

dd. Cash Credit

ee. Short-term Deposits

ff. Marketable Securities

gg. Refund of Income Tax received.

Solution

(a) Operating Activities: c, e, f, g, j, m, o, s, t, w, x, aa & gg.

(b) Investing Activities: a, h, k, l, p, q, u, v, bb & ee.

(c) Financing Activities: b, d, i, n, r, y, z, cc & dd.

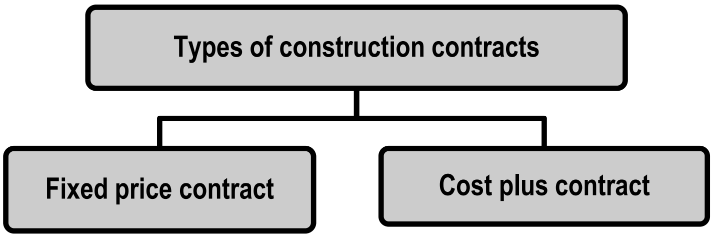
(d) Cash Equivalent: ff.

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

2.4.4 Construction Contracts (AS 7)

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

A construction contract is one, by which a contractor agrees to build some asset for his customer. The contractor's profit is the excess of contract price over construction costs. The contract price may or may not be fixed.



Types of construction contracts

Fixed price contract

Cost plus contract

In a **fixed price contract**, the price is agreed as fixed sum. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations.

In a **cost plus contract,** the customer undertakes to reimburse specified costs together with a fee calculated as percentage on reimbursable costs. The fee is the contractor's margin of profit.

Percentage completion method

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

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

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

(i) total contract revenue can be measured reliably;

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

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

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

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

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

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

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/13. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 2013-14 for 45% work and received ₹ 79,000 as progress payment from the customer. The cost incurred in 2014-15 was ₹ 89,000 to complete the rest of work.

Solution:

Profit & Loss Account

Year		*₹ 000*	*Year*		*₹ 000*
2013-14	*To Construction Costs (for 45% work)*	*81*	*2013-14*	*By Contract Price (45% of Contract Price)*	*90*
	To Net profit (for 45% work)	*9*			
		90			*90*
2014-15	*To Construction costs (for 55% work)*	*89*	*2014-15*	*By Contract Price (55% of Contract Price)*	*110*
	To Net Profit (for 55% work)	*21*			
		110			*110*

Customer Account

Year		*₹ 000*	*Year*		*₹ 000*
2013-14	*To Contract Price*	*90*	*2013-14*	*By Bank*	*79*
				By Balance c/d	*11*
		90			*90*

2014-15	*To Balance b/d* *To Contract Price*	*11* *110*	*2014-15*	*By Bank*	*121*
		121			*121*

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

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

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

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

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

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

Example 2

X Ltd. commenced a construction contract on 01/04/13. The contract price agreed was reimbursable cost plus 20%. The company incurred ₹ 1,00,000 in 2013-14, of which ₹ 90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹ 5,000. The other costs to complete the contract could not be estimated reliably.

The Profit & Loss A/c extract of X Ltd. for 2013-14 is shown below:

Profit & Loss Account

	₹ 000		*₹ 000*
To Construction Costs *To Provision for loss*	*100* *5*	*By Contract Price* *By Net loss*	*90* *15*
	105		*105*

Treatment of costs relating to future activity (Para 26)

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

Uncollectable Contract Revenue (Para 27)

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

Stage of Completion (Para 29)

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

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

(b) surveys of work performed; or

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

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

Example 3

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

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

Solution

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

Profit & Loss A/c

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

Combining and Segmenting Construction Contracts

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

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

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

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

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

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

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

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

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

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

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

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

Example 4

Mr. Shyam, a construction contractor undertakes the construction of an industrial complex. He has separate proposals raised for each unit to be constructed in the *industrial complex. Since each unit is subject to separate negotiation, he is able to identify the costs and revenues attributable to each unit. Should Mr. Shyam treat construction of each unit as a separate construction contract according to AS 7?*

Solution

As per AS 7 'Construction Contracts', 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.

Therefore, Mr. Shyam is required to treat construction of each unit as a separate construction contract.

Contract Revenue and costs

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

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

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

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

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

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

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

Note:

1. Direct costs can be reduced by incidental income, e.g. sale of surplus material, not included in contract revenue. (Paragraph 16)
2. The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16. (Paragraph 17)

Changes in Estimates (Para 37)

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

Disclosure

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

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

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

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

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

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

(i) the amount of advances received; and

(ii) the amount of retentions.

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

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

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

2.4.5 Revenue Recognition (AS 9)

This Standard is mandatory for all enterprises.

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

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

i. Revenue arising from construction contracts;

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

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

iv. Revenue of insurance companies arising from insurance contracts.

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

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

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

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

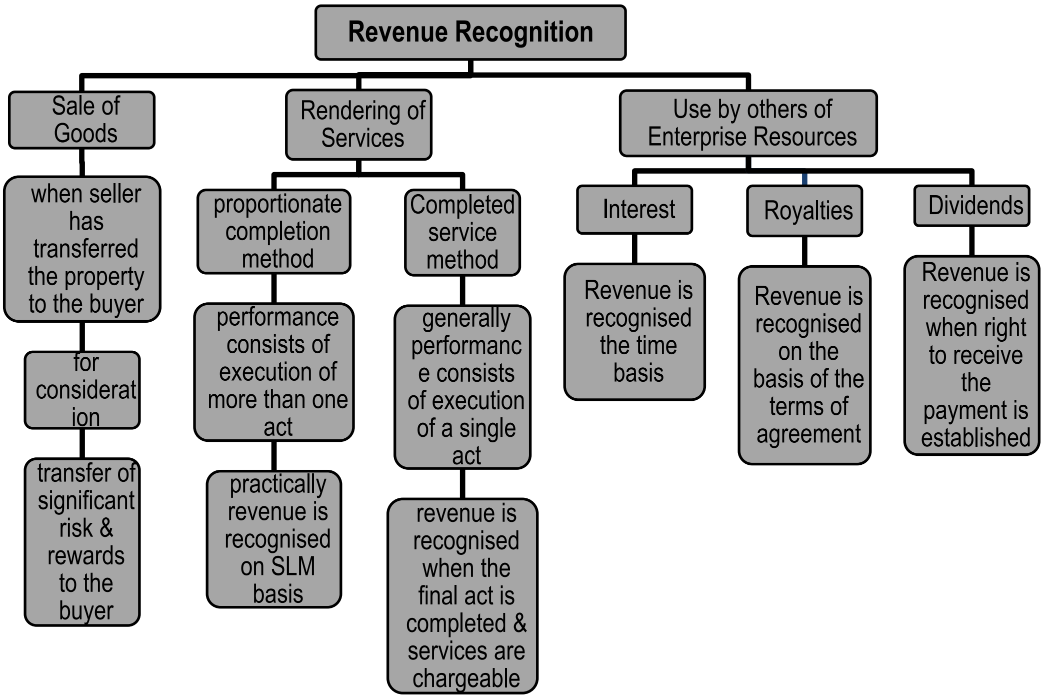
iv. Realised gains resulting from the discharge of an obligation at less than its carrying amount;

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

Sale of Goods

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

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


Revenue Recognition
Sale of Goods
when seller has transferred the property to the buyer
for consideration
transfer of significant risk & rewards to the buyer
Rendering of Services
proportionate completion method
performance consists of execution of more than one act
practically revenue is recognised on SLM basis
Completed service method
generally performance consists of execution of a single act
revenue is recognised when the final act is completed & services are chargeable
Use by others of Enterprise Resources
Interest
Revenue is recognised the time basis
Royalties
Revenue is recognised on the basis of the terms of agreement
Dividends
Revenue is recognised when right to receive the payment is established

Example 1

The stages of production and sale of a producer are as follow:

Date	Activity	Costs to date	Net Realisable Value
		₹	₹
20.1.12	Raw Materials	10,000	8,000
25.1.12	WIP 1	12,000	13,000
27.1.12	WIP 2	15,000	19,000
25.2.12	Finished Product	17,000	30,000
12.3.12	Ready for Sale	17,000	30,000
27.3.12	Sale Agreed and invoice raised	19,000	30,000
02.4.12	Delivered and paid for	19,000	30,000

Explain the stage on which you think revenue will be recognized and state how much would be net profit on a unit of this product according to AS 9?

Solution

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

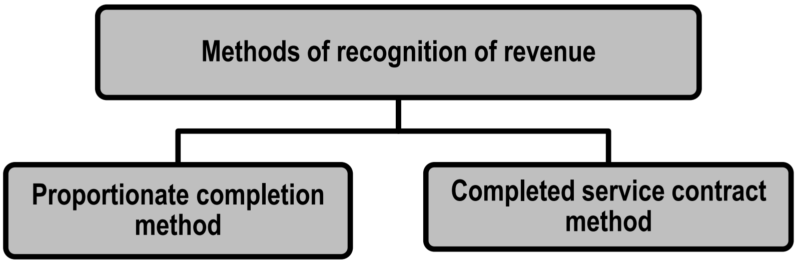
(i) The sale value is fixed and determinable.

(ii) Property of the goods is transferred to the customer.

Both these conditions are satisfied only on 27.3.2012 when sales are agreed upon at a price and goods are allocated for delivery purpose. The amount of net profit ₹ 11,000 (30,000 – 19,000) would be recognized in the books for the year ending 31st March, 2012.

Rendering of Services

Revenue from service transactions is usually recognised as the service is performed. There are two methods of recognition of revenue from service transaction, viz,


Methods of recognition of revenue
Proportionate completion method
Completed service contract method

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

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

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

Use by others of such enterprise resources gives rise to:

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

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

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

Effect of Uncertainties on Revenue Recognition

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

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

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

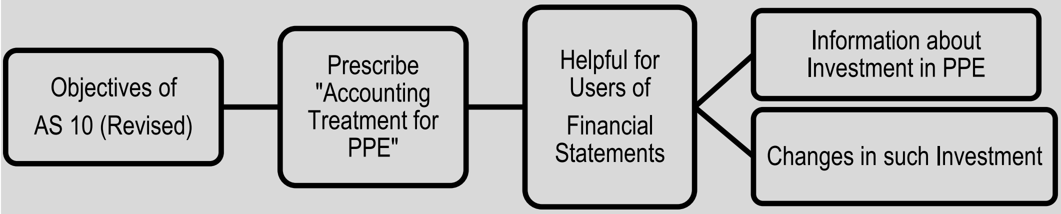
Disclosure

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

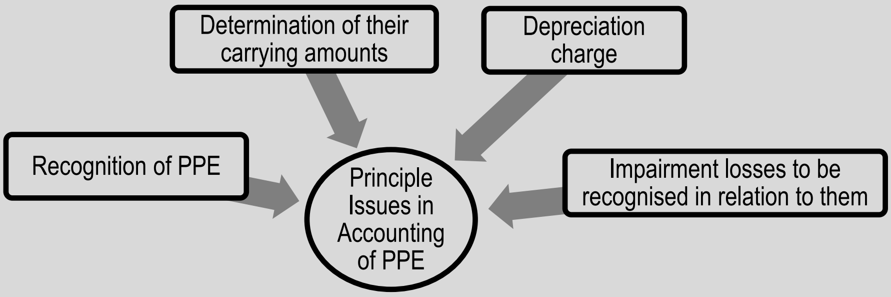
2.4.6 Property, Plant and Equipment (AS 10)

INTRODUCTION

The objective of this Standard is to prescribe accounting treatment for Property, Plant and Equipment (PPE).


Objectives of AS 10 (Revised)
Prescribe "Accounting Treatment for PPE"
Helpful for Users of Financial Statements
Information about Investment in PPE
Changes in such Investment

The principal issues in Accounting for PPE are:


Determination of their carrying amounts
Depreciation charge
Recognition of PPE
Principle Issues in Accounting of PPE
Impairment losses to be recognised in relation to them

SCOPE OF THE STANDARD

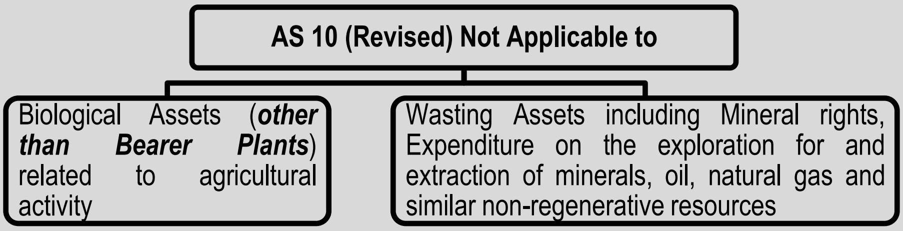
As a general principle, AS 10 (Revised) should be applied in accounting for PPE.

Exception:

When another Accounting Standard requires or permits a different accounting treatment.

Example: AS 19[2] on Leases, requires an enterprise to evaluate its recognition of an item of leased PPE on the basis of the transfer of risks and rewards. However, it may be noted that in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

This Standard does not apply to:



AS 10 (Revised) Not Applicable to

Biological Assets (***other than Bearer Plants***) related to agricultural activity

Wasting Assets including Mineral rights, Expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources

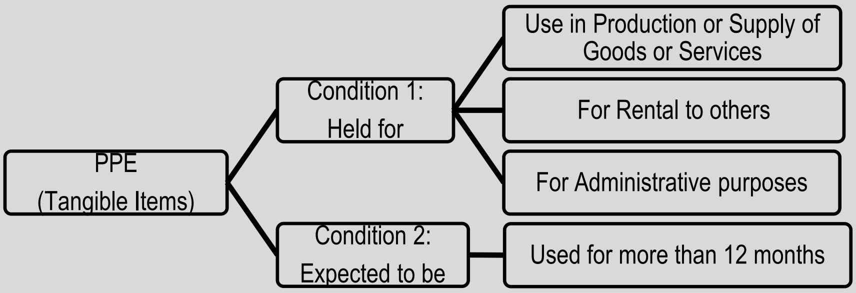
Note: **AS 10 (Revised) applies to Bearer Plants but it does not apply to the produce on Bearer Plants.**

Clarifications:

1. AS 10 (Revised) applies to PPE used to develop or maintain the assets described above.
2. Investment property (defined in AS 13 (Revised)), should be accounted for only in accordance with the Cost model prescribed in this standard.

DEFINITION OF PROPERTY, PLANT AND EQUIPMENT(PPE)

There are 2 conditions to be satisfied for a TANGIBLE item to be called PPE. PPE are *tangible items* **that:**



PPE (Tangible Items)

Condition 1: Held for

Use in Production or Supply of Goods or Services

For Rental to others

For Administrative purposes

Condition 2: Expected to be

Used for more than 12 months

[2] ***The students may note that AS 19 on Leases is not covered in syllabus of Intermediate Paper 1: Accounting syllabus.***

Note: **Intangible items are covered under AS 26.**

“Administrative purposes”: **The term ‘Administrative purposes’ has been used in** wider sense **to** *include all business purposes.* Thus, PPE would include assets used for:

- Selling and distribution
- Finance and accounting
- Personnel and other functions of an Enterprise.

Items of PPE may also be acquired for safety or environmental reasons.

The acquisition of such PPE, although not directly increasing the future economic benefits of any particular existing item of PPE, may be necessary for an enterprise to obtain the future economic benefits from its other assets.

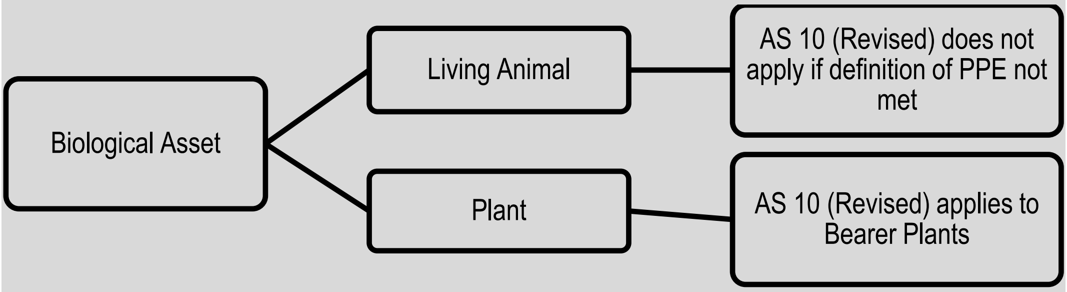
Such items of PPE qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired.

Example*: A chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals.*

The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28 (Impairment of Assets)[3].

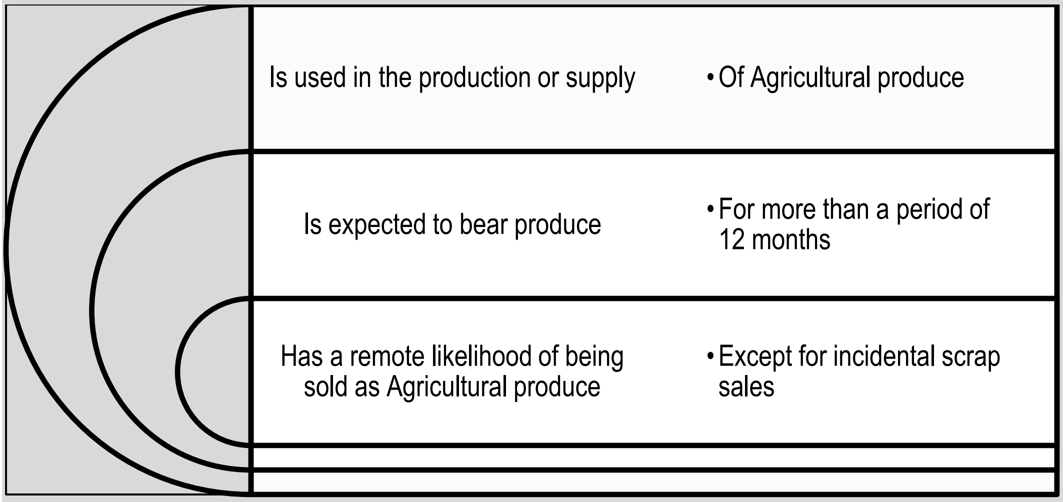
OTHER DEFINITIONS

1. **Biological Asset**: An Accounting Standard on “Agriculture” is under formulation, which will, inter alia, cover accounting for livestock. Till the time, the Accounting Standard on “Agriculture” is issued, accounting for livestock meeting the definition of PPE, will be covered as per AS 10 (Revised).


Biological Asset
Living Animal
Plant
AS 10 (Revised) does not apply if definition of PPE not met
AS 10 (Revised) applies to Bearer Plants

[3] *The students may note that AS 28 on Impairment of Assets is not covered in syllabus of Intermediate Paper 1: Accounting syllabus.*

2. **Bearer Plant:** Is a plant that (satisfies all 3 conditions):


Is used in the production or supply
• Of Agricultural produce
Is expected to bear produce
• For more than a period of 12 months
Has a remote likelihood of being sold as Agricultural produce
• Except for incidental scrap sales

Note: When bearer plants are no longer used to bear produce they might be cut down and sold as scrap. For example - use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a Bearer Plant.

The following are not Bearer Plants:

(a) Plants cultivated to be *harvested as* Agricultural produce

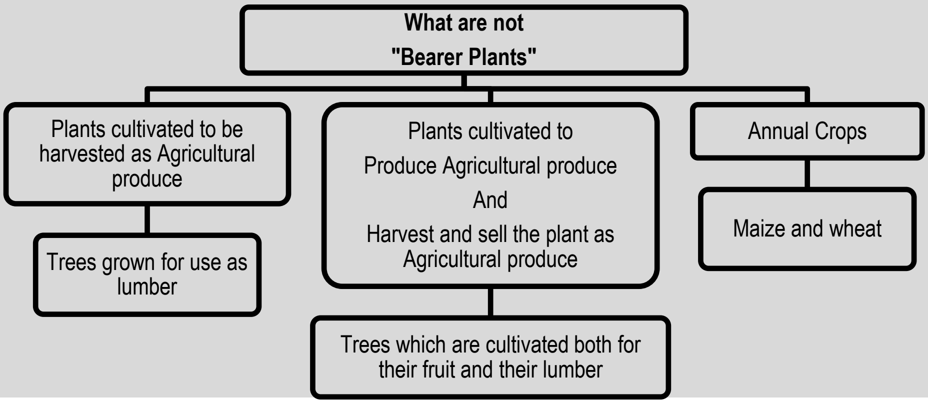
Example: Trees grown for use as lumber

(b) Plants cultivated *to produce* Agricultural produce when there is more than a remote likelihood that the entity will *also harvest and sell* the plant as agricultural produce, other than as incidental scrap sales

Example: Trees which are cultivated both for their fruit and their lumber

(c) Annual crops

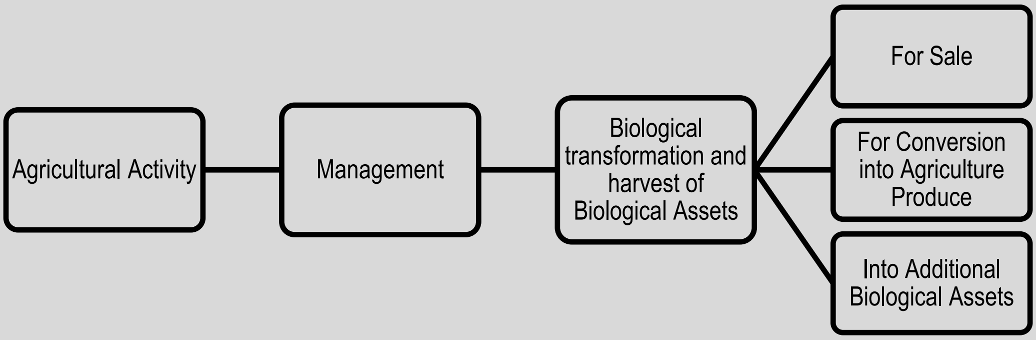
Example: **Maize and wheat**


What are not "Bearer Plants"
Plants cultivated to be harvested as Agricultural produce
Trees grown for use as lumber
Plants cultivated to Produce Agricultural produce And Harvest and sell the plant as Agricultural produce
Trees which are cultivated both for their fruit and their lumber
Annual Crops
Maize and wheat

Agricultural Produce is the harvested product **of** Biological Assets **of the enterprise.**

3. **Agricultural Activity**: Is the management by an Enterprise of:

- Biological transformation; and
- Harvest of Biological Assets
- For sale, Or
- For conversion into Agricultural Produce, Or
- Into additional Biological Assets


Agricultural Activity
Management
Biological transformation and harvest of Biological Assets
For Sale
For Conversion into Agriculture Produce
Into Additional Biological Assets

RECOGNITION CRITERIA FOR PPE

The *cost of an item of PPE* **should be recognised as an asset** *if, and only if*:

(a) It is probable that future economic benefits associated with the item will flow to the enterprise, and

(b) The cost of the item can be measured reliably.

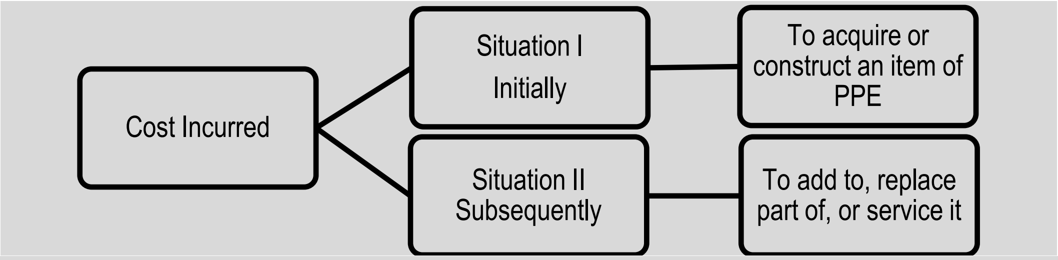
Notes:

1. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value.
2. An enterprise may decide to expense an item which could otherwise have been included as PPE, because the amount of the expenditure is not material.

When do we apply the above criteria for Recognition?

An enterprise evaluates under this recognition principle all its costs on PPE at the time they are incurred.

These costs include costs incurred:


Cost Incurred
Situation I
Initially
To acquire or construct an item of PPE
Situation II
Subsequently
To add to, replace part of, or service it

TREATMENT OF SPARE PARTS, STAND BY EQUIPMENT AND SERVICING EQUIPMENT

Case I If they meet the definition of PPE as per AS 10 (Revised):

- **Recognised as PPE as per AS 10 (Revised)**

Case II If they do not meet the definition of PPE as per AS 10 (Revised):

- **Such items are classified as Inventory as per AS 2 (Revised)**

Illustration 1 (Capitalising the cost of "Remodelling" a Supermarket)

Entity A, a supermarket chain, is renovating one of its major stores. The store will have more available space for in store promotion outlets after the renovation and will include a restaurant. Management is preparing the budgets for the year after the store reopens, which include the cost of remodelling and the expectation of a 15% increase in sales resulting from the store renovations, which will attract new customers. State whether the remodelling cost will be capitalised or not.

Solution

The expenditure in remodelling the store will create future economic benefits (in the form of 15% of increase in sales) and the cost of remodelling can be measured reliably, therefore, it should be capitalised.

TREATMENT OF SUBSEQUENT COSTS

Cost of day-to-day servicing

Meaning:

Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of such expenditures is often described as for the 'Repairs and Maintenance' of the item of PPE.

Accounting Treatment:

An enterprise does not recognise in the carrying amount of an item of PPE the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the Statement of Profit and Loss as incurred.

Replacement of Parts of PPE

Parts of some items of PPE may require replacement at regular intervals.

Examples:

1. A furnace may require relining after a specified number of hours of use.
2. Aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe.
3. Major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system.
4. Replacing the interior walls of a building, or to make a non-recurring replacement.

Accounting Treatment:

An enterprise recognises in the carrying amount of an item of PPE the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met.

Note: The carrying amount of those parts that are replaced is derecognised in accordance with the de-recognition provisions of this Standard.

9.7.3 Regular Major Inspections - Accounting Treatment

When each major inspection is performed, its cost is recognised in the carrying amount of the item of PPE as a replacement,if the recognition criteria are satisfied.

Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

Illustration 2

What happens if the cost of the previous part/inspection was/ was not identified in the transaction in which the item was acquired or constructed?

Solution

De-recognition of the carrying amount occurs regardless of whether the cost of the previous part/inspection was identified in the transaction in which the item was acquired or constructed.

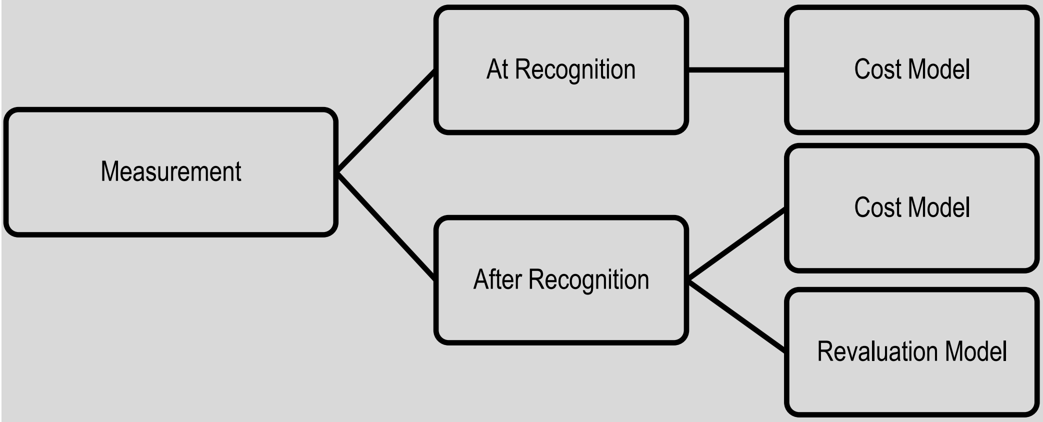
Illustration 3

What will be your answer in the above question, if it is not practicable for an enterprise to determine the carrying amount of the replaced part/inspection?

Solution

It may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/existing inspection component was when the item was acquired or constructed.

MEASUREMENT OF PPE

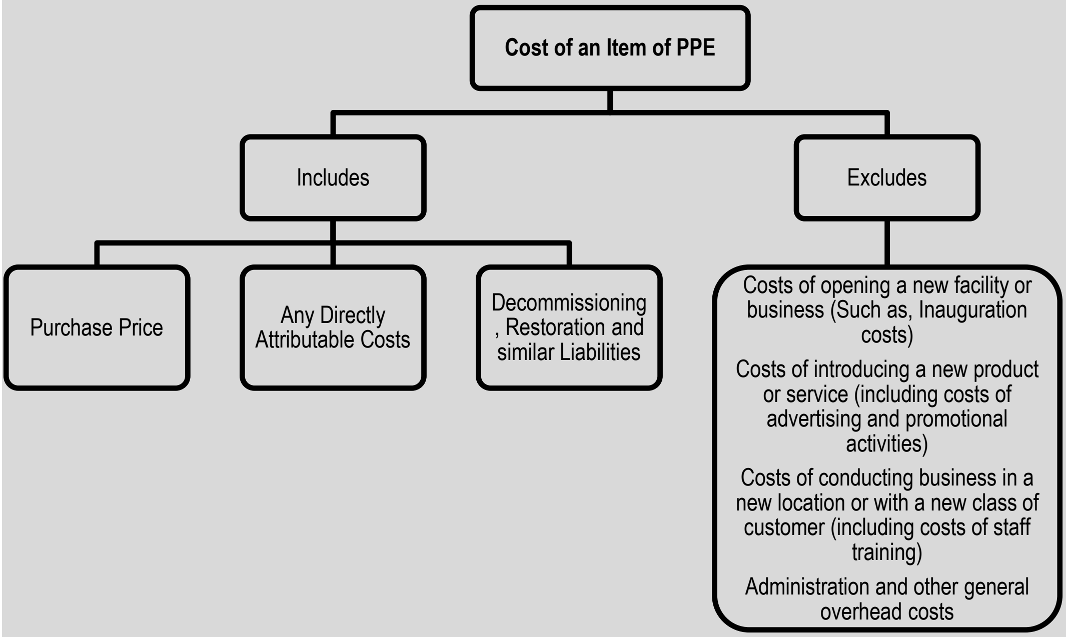

Measurement
At Recognition
After Recognition
Cost Model
Cost Model
Revaluation Model

Measurement at Recognition

An item of PPE that qualifies for recognition as an asset should be measured at its cost**.**

What are the elements of Cost?

Cost of an item of PPE comprises:


Cost of an Item of PPE
Includes
Excludes
Purchase Price
Any Directly Attributable Costs
Decommissioning , Restoration and similar Liabilities
Costs of opening a new facility or business (Such as, Inauguration costs)
Costs of introducing a new product or service (including costs of advertising and promotional activities)
Costs of conducting business in a new location or with a new class of customer (including costs of staff training)
Administration and other general overhead costs

Let us understand the above in detail.

A. **Purchase Price:**

- It includes import duties and non –refundable purchase taxes.
- It requires deduction of Trade discounts and rebates

B. **Directly Attributable Costs:**

Any costs directly attributable to bringing the asset to the 'location and condition' necessary for it to be capable of operating in the manner intended by management

Recognition of costs in the carrying amount of an item of PPE ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management.

The following costs are not included in the carrying amount of an item of PPE:

1. Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
2. Initial operating losses, such as those incurred while demand for the output of an item builds up. And
3. Costs of relocating or reorganising part or all of the operations of an enterprise.

Examples of directly attributable costs are:

1. Costs of employee benefits (as defined in AS 15) arising directly from the construction or acquisition of the item of PPE
2. Costs of site preparation
3. Initial delivery and handling costs
4. Installation and assembly costs
5. Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment)
6. Professional fees

Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility or business, such as, inauguration costs

(b) costs of introducing a new product or service (including costs of advertising and promotional activities)

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training)

(d) administration and other general overhead costs

Note: Some operations occur in connection with the construction or development of an item of PPE, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities.

Example*: Income may be earned through using a building site as a car park until construction starts because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in the Statement of Profit and Loss and included in their respective classifications of income and expense.*

Illustration 4

Entity A has an existing freehold factory property, which it intends to knock down and redevelop. During the redevelopment period the company will move its production facilities to another (temporary) site. The following incremental costs will be incurred:

1. *Setup costs of ₹ 5,00,000 to install machinery in the new location.*
2. *Rent of ₹ 15,00,000*
3. *Removal costs of ₹ 3,00,000 to transport the machinery from the old location to the temporary location.*

Can these costs be capitalised into the cost of the new building?

Solution

Constructing or acquiring a new asset may result in incremental costs that would have been avoided if the asset had not been constructed or acquired. These costs are not to be included in the cost of the asset if they are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. The costs to be incurred by the company are in the nature of costs of relocating or reorganising operations of the company and do not meet the requirement of AS 10 (Revised) and therefore, cannot be capitalised.

Illustration 5 (Capitalisation of directly attributable costs)

Entity A, which operates a major chain of supermarkets, has acquired a new store location. The new location requires significant renovation expenditure. Management expects that the renovations will last for 3 months during which the supermarket will be closed.

Management has prepared the budget for this period including expenditure related to construction and remodelling costs, salaries of staff who will be preparing the store before its opening and related utilities costs. What will be the treatment of such expenditures?

Solution

Management should capitalise the costs of construction and remodelling the supermarket, because they are necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management. The supermarket cannot be opened without incurring the remodelling expenditure, and thus the expenditure should be considered part of the asset.

However, if the cost of salaries, utilities and storage of goods are in the nature of operating expenditure that would be incurred if the supermarket was open, then these costs are not necessary to bring the store to the condition necessary for it to be capable of operating in the manner intended by management and should be expensed.

Illustration 6 (Operating costs incurred in the start-up period)

An amusement park has a 'soft' opening to the public, to trial run its attractions. Tickets are sold at a 50% discount during this period and the operating capacity is 80%. The official opening day of the amusement park is three months later. Management claim that the soft opening is a trial run necessary for the amusement park to be in the condition capable of operating in the intended manner. Accordingly, the net operating costs incurred should be capitalised. Comment.

Solution

The net operating costs should not be capitalised, but should be recognised in the Statement of Profit and Loss.

Even though it is running at less than full operating capacity (in this case 80% of operating capacity), there is sufficient evidence that the amusement park is capable of operating in the manner intended by management. Therefore, these costs are specific to the start-up and, therefore, should be expensed as incurred.

C. Decommissioning, Restoration and similar Liabilities:

Initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'Decommissioning, Restoration and similar Liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Exception: *An enterprise applies AS 2 (Revised) "Valuation of Inventories", to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period.*

Note: The obligations for costs accounted for in accordance with AS 2 (Revised) or AS 10 (Revised) are recognised and measured in accordance with AS 29 (Revised) "Provisions, Contingent Liabilities and Contingent Assets".

COST OF A SELF-CONSTRUCTED ASSET

Cost of a self-constructed asset is determined using the same principles as for an acquired asset.

1. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale. Therefore, any internal profits are eliminated in arriving at such costs.
2. Cost of abnormal amounts of wasted material, labour, or other resources incurred in self constructing an asset is not included in the cost of the asset.

3. AS 16 on Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of PPE.
4. Bearer plants are accounted for in the same way as self-constructed items of PPE before they are in the location and condition necessary to be capable of operating in the manner intended by management.

MEASUREMENT OF COST

Cost of an item of PPE is the cash price equivalent **at the recognition date.**

A. **If payment is deferred beyond normal credit terms:**

Total payment *minus* Cash price equivalent

- is recognised as an interest expense over the period of credit
- unless such interest is capitalised in accordance with AS 16

B. **PPE acquired in Exchange for a Non-monetary Asset or Assets or A combination of Monetary and Non-monetary Assets**:

Cost of such an item of PPE is measured at fair value unless:

(a) Exchange transaction lacks commercial substance; Or

(b) Fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable.

Note:

1. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up.
2. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.
3. An enterprise determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

   (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

   (b) the enterprise-specific value of the portion of the operations of the enterprise affected by the transaction changes as a result of the exchange;

   (c) and the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the enterprise-specific value of the portion of operations of the enterprise affected by the transaction should reflect post-tax cash flows. In certain cases, the result of these analyses may be clear without an enterprise having to perform detailed calculations.

Illustration 7 (Consideration received comprising a combination of non-monetary and monetary assets)

Entity A exchanges surplus land with a book value of ₹ 10,00,000 for cash of ₹ 20,00,000 and plant and machinery valued at ₹ 25,00,000. What will be the measurement cost of the assets received?

Solution

Since the transaction has commercial substance. The plant and machinery would be recorded at ₹ 25,00,000, which is equivalent to the fair value of the land of ₹ 45,00,000 less the cash received of ₹ 20,00,000.

Illustration 8 (Exchange of assets that lack commercial substance)

Entity A exchanges car X with a book value of ₹ 13,00,000 and a fair value of ₹ 13,25,000 for cash of ₹ 15,000 and car Y which has a fair value of ₹ 13,10,000. The transaction lacks commercial substance as the company's cash flows are not expected to change as a result of the exchange. It is in the same position as it was before the transaction. What will be the measurement cost of the assets received?

Solution

The entity recognises the assets received at the book value of car X. Therefore, it recognises cash of ₹ 15,000 and car Y as PPE with a carrying value of ₹ 12,85,000.

C. **PPE purchased for a Consolidated Price:**

Where several items of PPE are purchased for a consolidated price, the consideration is apportioned to the various items on the basis of their respective fair values at the date of acquisition.

Note: In case the fair values of the items acquired cannot be measured reliably, these values are estimated on a fair basis as determined by competent valuers.

D. **PPE held by a lessee under a Finance Lease:**

The cost of an item of PPE held by a lessee under a finance lease is determined in accordance with AS 19 (Leases).

E. **Government Grant related to PPE:**

The carrying amount of an item of PPE may be reduced by government grants in accordance with AS 12 (Accounting for Government Grants).

MEASUREMENTAFTER RECOGNITION

An enterprise should choose

- Either **Cost model,**
- Or **Revaluation model**

as its accounting policy and should apply that policy to an entire **class of PPE**.

Class of PPE: A class of PPE is a grouping of assets of a **similar nature and use** in operations of an enterprise.

Examples of separate classes:

(a) Land

(b) Land and Buildings

(c) Machinery

(d) Ships

(e) Aircraft

(f) Motor Vehicles

(g) Furniture and Fixtures

(h) Office Equipment

(i) Bearer plants

COST MODEL

After recognition as an asset, an item of PPE should be carried at:

Cost**-** Any Accumulated Depreciation**-** Any Accumulated Impairment losses

REVALUATION MODEL

After recognition as an asset, an item of PPE whose fair value can be measured reliably should be carried at a revalued amount.

Fair value at the date of the revaluation	-
Less: Any subsequent accumulated depreciation	(-)
Less: Any subsequent accumulated impairment losses	(-)
Carrying value	=

Revaluation for entire class of PPE

If an item of PPE is revalued, the entire class of PPE to which that asset belongs should be revalued.

Reason:

The items within a class of PPE are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the Financial Statements that are a mixture of costs and values as at different dates.

Illustration 9 (Revaluation on a class by class basis)

Entity A is a large manufacturing group. It owns a number of industrial buildings, such as factories and warehouses and office buildings in several capital cities. The industrial buildings are located in industrial zones, whereas the office buildings are in central business districts of the cities. Entity A's management want to apply the revaluation model as per AS 10 (Revised) to the subsequent measurement of the office buildings but continue to apply the historical cost model to the industrial buildings.

State whether this is acceptable under AS 10 (Revised) or not with reasons?

Solution

Entity A's management can apply the revaluation model only to the office buildings. The office buildings can be clearly distinguished from the industrial buildings in terms of their function, their nature and their general location.AS 10 (Revised) permits assets to be revalued on a class by class basis.

The different characteristics of the buildings enable them to be classified as different PPE classes. The different measurement models can, therefore, be applied to these classes for subsequent measurement.

However, all properties within the class of office buildings must be carried at revalued amount.

Frequency of Revaluations

Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using Fair value at the Balance Sheet date.

The frequency of revaluations depends upon the changes in fair values of the items of PPE being revalued.

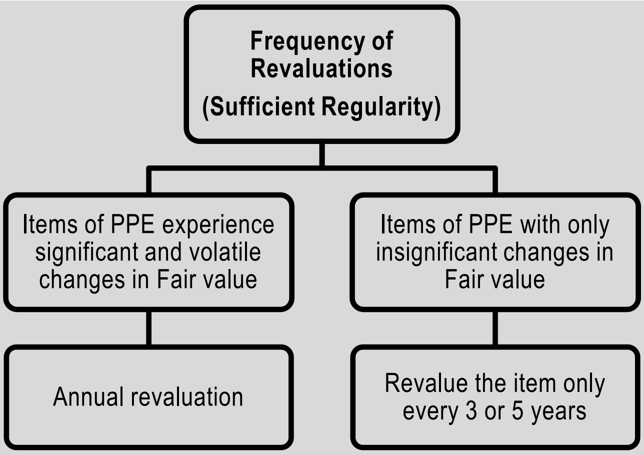
When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required.

A. **Items of PPE experience significant and volatile changes in Fair value**

Annual revaluation should be done.

B. **Items of PPE with only insignificant changes in Fair value**

Revaluation should be done at an interval of 3 or 5 years.


Frequency of Revaluations
(Sufficient Regularity)
Items of PPE experience significant and volatile changes in Fair value
Items of PPE with only insignificant changes in Fair value
Annual revaluation
Revalue the item only every 3 or 5 years

Determination of Fair Value

Fair value of items of PPE is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers.

If there is no market-based evidence of fair value because of the specialised nature of the item of PPE and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach.

Example:

Based on

- Discounted cash flow projections, Or
- A depreciated replacement cost approach

Which aims at making a **realistic estimate of the current cost** of acquiring or constructing an item that has the same service potential as the existing item.

Accounting Treatment of Revaluations

When an item of PPE is revalued, the carrying amount of that asset is adjusted to the revalued amount.

At the date of the revaluation, the asset is treated in one of the following ways:

A. **Technique 1**: Gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset.

Gross carrying amount

- May be restated by reference to observable market data, or
- May be restated proportionately to the change in the carrying amount.

Accumulated depreciation at the date of the revaluation is

- Adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses

Case Study on Technique I

PPE is revalued to ₹ 1,500 consisting of ₹ 2,500 Gross cost and ₹ 1,000 Depreciation based on observable market data.

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600
Fair Value			1,500
Revaluation Gain			900
Gain allocated proportionately to cost and depreciation	1,500	600	900
PPE after revaluation	2,500	1,000	1,500

The increase on revaluation is ₹ 900 (i.e., ₹ 1,500 – ₹ 600).

B. **Technique 2: Accumulated depreciation Is eliminated against the Gross Carrying amount of the asset**

Case Study on Technique II

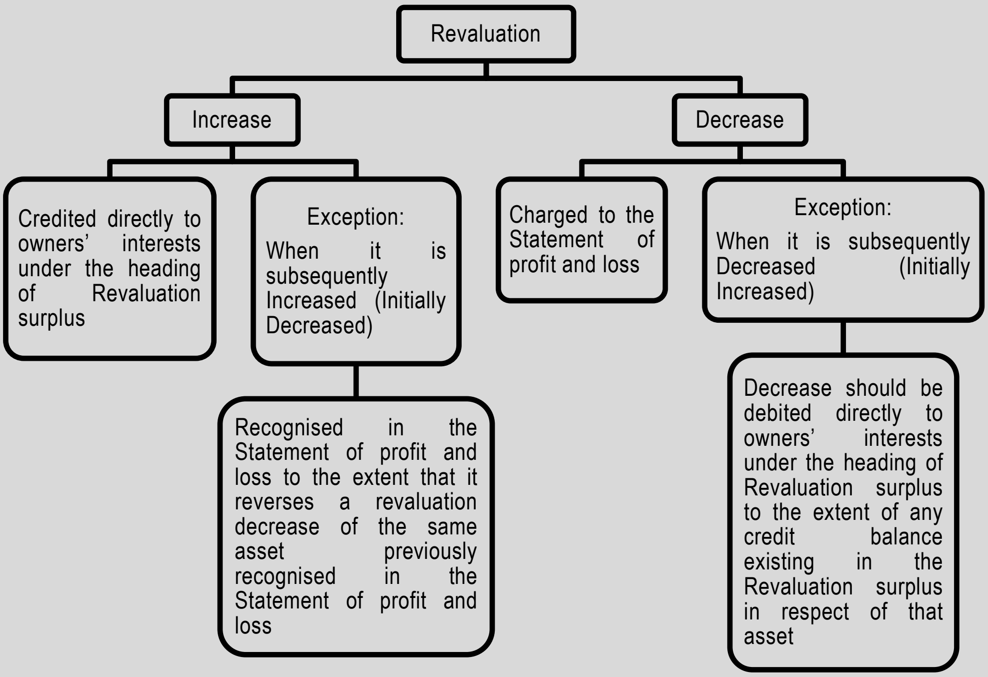
(Taking the information given in the above Example)

Details of the PPE before and after revaluation are as follows:

Particulars	Cost/Revalued Cost	Accumulated depreciation	Net book value
PPE before revaluation (assumed)	1,000	400	600
PPE after revaluation	1,500		1,500
Revaluation gain	500	400	

The increase on revaluation is ₹ 900 (i.e., ₹ 500 + ₹ 400).

Revaluation – Increase or Decrease


Revaluation
Increase
Decrease
Credited directly to owners' interests under the heading of Revaluation surplus
Exception: When it is subsequently Increased (Initially Decreased)
Charged to the Statement of profit and loss
Exception: When it is subsequently Decreased (Initially Increased)
Recognised in the Statement of profit and loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in the Statement of profit and loss
Decrease should be debited directly to owners' interests under the heading of Revaluation surplus to the extent of any credit balance existing in the Revaluation surplus in respect of that asset

Treatment of Revaluation Surplus

The revaluation surplus included in owners' interests in respect of an item of PPE may be transferred to the Revenue Reserves when the asset is derecognised.

Case I : When whole surplus is transferred:

When the asset is:

- Retired; Or
- Disposed of

Case II : Some of the surplus may be transferred as the asset is used by an enterprise:

In such a case, the amount of the surplus transferred would be:

Depreciation (based on Revalued Carrying amount) – Depreciation (based on Original Cost)

Transfers from Revaluation Surplus to the Revenue Reserves are not made **through the Statement of Profit and Loss.**

DEPRECIATION

Component Method of Depreciation:

Each part of an item of PPE with a cost that is significant in relation to the total cost of the item should be depreciated separately.

Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

Is Grouping of Components possible?

Yes.

A significant part of an item of PPE may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

Accounting Treatment:

Depreciation charge for each period should be recognised in the Statement of Profit and Loss unless it is included in the carrying amount of another asset.

Examples on Exception:

AS 2 (Revised): Depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories as per AS 2 (Revised).

AS 26: Depreciation of PPE used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26 on Intangible Assets.

DEPRECIABLE AMOUNT AND DEPRECIATION PERIOD

What is "Depreciable Amount"?

Depreciable amount is:

Cost of an asset (or other amount substituted for cost i.e. revalued amount) -Residual value

The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

Illustration 10

Entity A has a policy of not providing for depreciation on PPE capitalised in the year until the following year, but provides for a full year's depreciation in the year of disposal of an asset. Is this acceptable?

Solution

The depreciable amount of a tangible fixed asset should be allocated on a systematic basis over its useful life. The depreciation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

Useful life means the period over which the asset is expected to be available for use by the entity. Depreciation should commence as soon as the asset is acquired and is available for use. Thus, the policy of Entity A is not acceptable.

Review of Residual Value and Useful Life of an Asset

Residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with AS 5 ‘Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies’.

Illustration 11 (Change in estimate of useful life)

Entity A purchased an asset on 1st January 2013 for ₹ 1,00,000 and the asset had an estimated useful life of 10 years and a residual value of nil.

On 1st January 2017, the directors review the estimated life and decide that the asset will probably be useful for a further 4 years.

Calculate the amount of depreciation for each year, if company charges depreciation on Straight Line basis.

Solution

The entity has charged depreciation using the straight-line method at ₹ 10,000 per annum i.e (1,00,000/10 years).

On 1st January 2017, the asset's net book value is [1,00,000 – (10,000 x 4)] ₹ 60,000.

The remaining useful life is 4 years.

The company should amend the annual provision for depreciation to charge the unamortised cost over the revised remaining life of four years.

Consequently, it should charge depreciation for the next 4 years at ₹ 15,000 per annum i.e. (60,000 / 4 years).

Note: Depreciation is recognised even if the Fair value of the Asset exceeds its Carrying Amount. Repair and maintenance of an asset do not negate the need to depreciate it.

Commencement of period for charging Depreciation

Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management.

Illustration 12

Entity B constructs a machine for its own use. Construction is completed on 1st November 2016 but the company does not begin using the machine until 1st March 2017. Comment

Solution

The entity should begin charging depreciation from the date the machine is ready for use – that is, 1st November 2016.The fact that the machine was not used for a period after it was ready to be used is not relevant in considering when to begin charging depreciation.

Cessesation of Depreciation

I. **Depreciation ceases to be charged when asset’s residual value exceeds its carrying amount**

The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

Illustration 13 (Depreciation where residual value is the same as or close to Original cost)

A property costing ₹ 10,00,000 is bought in 2016. Its estimated total physical life is 50 years. However, the company considers it likely that it will sell the property after 20 years.

The estimated residual value in 20 years' time, based on 2016 prices, is:

Case (a) ₹ 10,00,000

Case (b) ₹ 9,00,000.

Calculate the amount of depreciation.

Solution

Case (a)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will equal the cost.

There is, therefore, no depreciable amount and depreciation is correctly zero.

Case (b)

The company considers that the residual value, based on prices prevailing at the balance sheet date, will be ₹ 9,00,000 and the depreciable amount is, therefore, ₹ 1,00,000.

Annual depreciation (on a straight line basis) will be ₹ 5,000 [{10,00,000 – 9,00,000} ÷ 20].

II. Depreciation of an asset ceases at the earlier of:

- The date that the asset is retired from active use and is held for disposal, and
- The date that the asset is derecognised

Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated.

However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

Land and Buildings

Land and buildings are separable assets and are accounted for separately, even when they are acquired together.

A. **Land**: Land has an unlimited useful life and therefore is not depreciated.

Exceptions: Quarries and sites used for landfill.

Depreciation on Land:

I. **If land itself has a limited useful life:**

It is depreciated in a manner that reflects the benefits to be derived from it.

II. If the cost of land includes the costs of site dismantlement, removal and restoration:

That portion of the land asset is depreciated over the period of benefits obtained by incurring those costs.

B. **Buildings:**

Buildings have a limited useful life and therefore are depreciable assets.

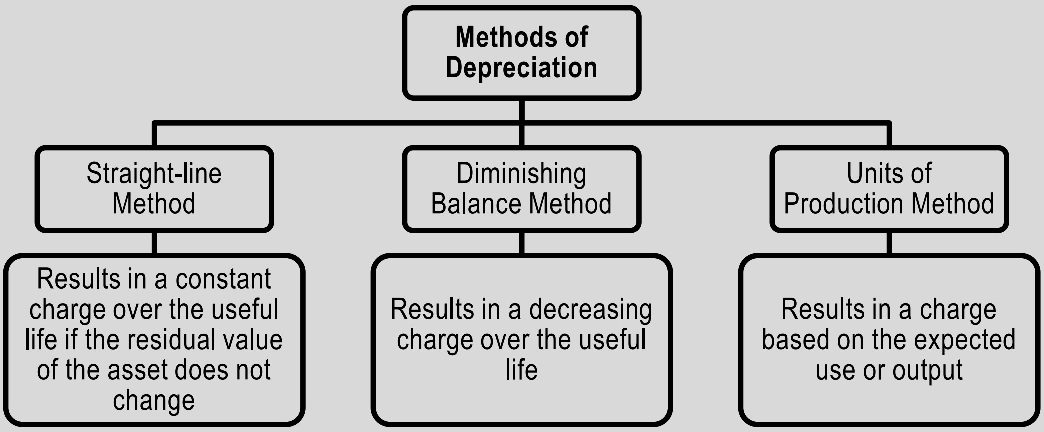
An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

Depreciation Method

The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

The method selected is applied consistently from period to period unless:

- There is a change in the expected pattern of consumption of those future economic benefits; Or
- That the method is changed in accordance with the statute to best reflect the way the asset is consumed.


Methods of Depreciation
Straight-line Method
Diminishing Balance Method
Units of Production Method
Results in a constant charge over the useful life if the residual value of the asset does not change
Results in a decreasing charge over the useful life
Results in a charge based on the expected use or output

Review of Depreciation Method:

The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern.

Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

Depreciation Method based on Revenue:

A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate.

Illustration 14 (Determination of appropriate Depreciation Method)

Entity B manufactures industrial chemicals and uses blending machines in the production process. The output of the blending machines is consistent from year to year and they can be used for different products.

However, maintenance costs increase from year to year and a new generation of machines with significant improvements over existing machines is available every 5 years. Suggest the depreciation method to the management.

Solution

The straight-line depreciation method should be adopted, because the production output is consistent from year to year.

Factors such as maintenance costs or technical obsolescence should be considered in determining the blending machines' useful life.

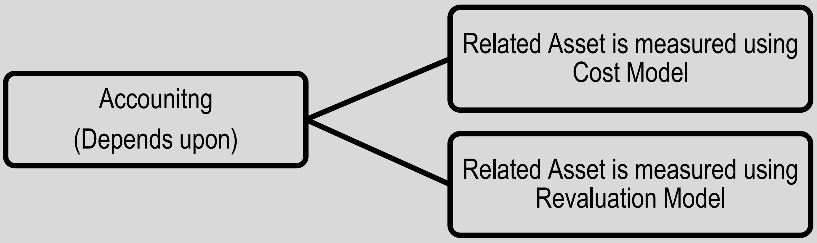
CHANGES IN EXISTING DECOMMISSIONING, RESTORATION AND OTHER LIABILITIES

The cost of PPE may undergo changes subsequent to its acquisition or construction on account of:

- Changes in Liabilities
- Price Adjustments
- Changes in Duties
- Changes in initial estimates of amounts provided for Dismantling, Removing, Restoration, and
- Similar factors

The above are included in the cost of the asset.

Accounting for the above changes:


Accounitng
(Depends upon)
Related Asset is measured using Cost Model
Related Asset is measured using Revaluation Model

A. **If the related asset is measured using the Cost model:**

Changes in the Liability should be added to, or deducted from, the cost of the related asset in the current period

Note: Amount deducted from the cost of the asset should not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in the Statement of Profit and Loss.

If the adjustment results in an addition to the cost of an asset:

- Enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable.

Note: If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with applicable Accounting standards.

B. **If the related asset is measured using the Revaluation model:**

Changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:

(i) Decrease in the liability credited directly to revaluation surplus in the owners' interest

Exception:

It should be recognised in the Statement of Profit and Loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in the Statement of Profit and Loss

Note: In the event that a decrease in the liability exceeds the carrying amount that would have been recognised had the asset been carried under the cost model, the excess should be recognised immediately in the Statement of Profit and Loss.

(ii) Increase in the liability should be recognised in the Statement of Profit and Loss

Exception:

It should be debited directly to Revaluation surplus in the owners' interest to the extent of any credit balance existing in the Revaluation surplus in respect of that asset

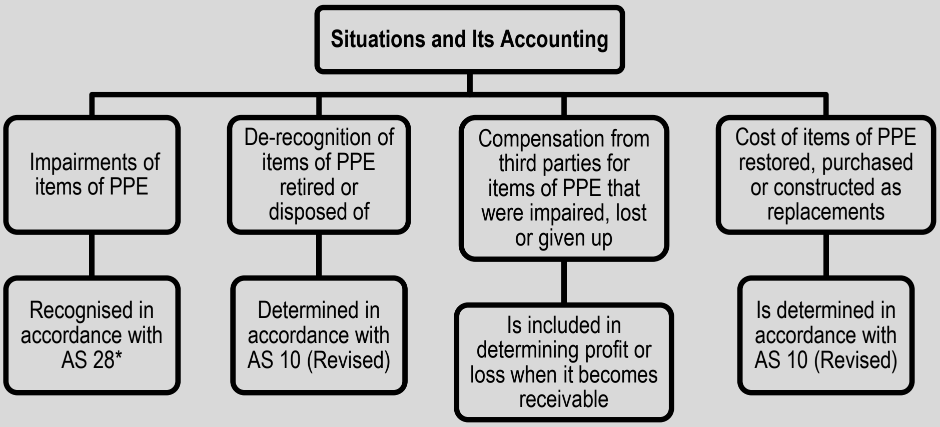
Caution:

A change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

What happens if the related asset has reached the end of its useful life?

All subsequent changes in the liability should be recognised in the Statement of Profit and Loss as they occur.

Note: This applies under both the cost model and the revaluation model.


Situations and Its Accounting
Impairments of items of PPE
Recognised in accordance with AS 28*
De-recognition of items of PPE retired or disposed of
Determined in accordance with AS 10 (Revised)
Compensation from third parties for items of PPE that were impaired, lost or given up
Is included in determining profit or loss when it becomes receivable
Cost of items of PPE restored, purchased or constructed as replacements
Is determined in accordance with AS 10 (Revised)

***Students may note that AS 28 is not covered in syllabus of Intermediate paper 1 Accounting.**

Illustration 15 (Gain on replacement of Insured Assets)

Entity A carried plant and machinery in its books at ₹ 2,00,000. These were destroyed in a fire. The assets were insured 'New for old' and were replaced by the insurance company with new machines that cost ₹ 20,00,000. The machines were acquired by the insurance company and the company did not receive the ₹ 20,00,000 as cash compensation. State, how Entity A should account for the same?

Solution

Entity A should account for a loss in the Statement of Profit and Loss on de-recognition of the carrying value of plant and machinery in accordance with AS 10 (Revised).

Entity A should separately recognise a receivable and a gain in the income statement resulting from the insurance proceeds under AS 29 (Revised) once receipt is virtually certain. The receivable should be measured at the fair value of assets that will be provided by the insurer.

RETIREMENTS

Items of PPE retired from active use and held for disposal should be stated at the lower of:

- Carrying Amount, and
- Net Realisable Value

Note: Any write-down in this regard should be recognised immediately in the Statement of Profit and Loss.

DE-RECOGNITION

The carrying amount of an item of PPE should be derecognised:

- On disposal
  - By sale
  - By entering into a finance lease, or
  - By donation, Or
- When no future economic benefits are expected from its use or disposal

Accounting Treatment:

Gain or loss arising from de-recognition of an item of PPE should be included in the Statement of Profit and Loss when the item is derecognised unless AS 19 on Leases, requires otherwise on a sale and leaseback (AS 19 on Leases, applies to disposal by a sale and leaseback.)

Where,

Gain or loss arising from de-recognition of an item of PPE

= Net disposal proceeds (if any) - Carrying Amount of the item

Note: Gains should not be classified as revenue, as defined in AS9 Revenue Recognition'.

Exception:

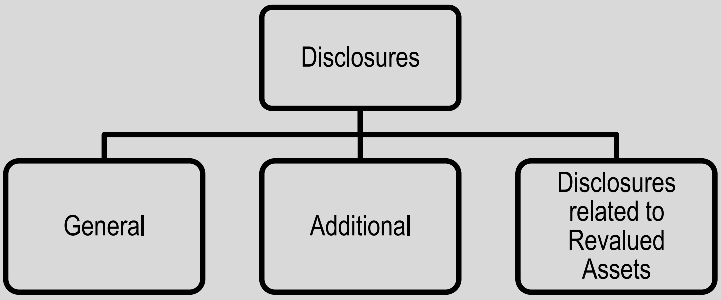
An enterprise that in the course of its ordinary activities, routinely sells items of PPE that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale.

The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9 on Revenue Recognition.

Determining the date of disposal of an item:

An enterprise applies the criteria in AS 9 for recognising revenue from the sale of goods.

DISCLOSURE



General Disclosures:

The financial statements should disclose, for each class of PPE:

(a) The measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;

(b) The depreciation methods used;

(c) The useful lives or the depreciation rates used.

In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;

(d) The gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

(e) A reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions

(ii) assets retired from active use and held for disposal

(iii) acquisitions through business combinations

(iv) increases or decreases resulting from revaluations and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28

(v) impairment losses recognised in the statement of profit and loss in accordance with AS 28

(vi) impairment losses reversed in the statement of profit and loss in accordance with AS 28

(vii) depreciation

(viii) net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11

(ix) other changes

Additional Disclosures:

The financial statements should also disclose:

(a) The existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;

(b) The amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;

(c) The amount of contractual commitments for the acquisition of property, plant and equipment;

(d) If it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and

(e) The amount of assets retired from active use and held for disposal.

Disclosures related to Revalued Assets:

If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

(a) The effective date of the revaluation;

(b) Whether an independent valuer was involved;

(c) The methods and significant assumptions applied in estimating fair values of the items;

(d) The extent to which fair values of the items were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and

(e) The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

TRANSITIONAL PROVISIONS

Previously Recognised Revenue Expenditure

Where an entity has in past recognised an expenditure in the Statement of Profit and Loss which is eligible to be included as a part of the cost of a project for construction of PPE in accordance with the requirements of this standard:

- It may do so retrospectively for such a project.

Note: The effect of such retrospective application, should be recognised net-of-tax in Revenue reserves.

PPE acquired in Exchange of Assets

The requirements of AS 10 (Revised) regarding the initial measurement of an item of PPE acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.

Spare parts

On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS 2 (Revised), and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts.

Note: The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

Revaluations

The requirements of AS 10 (Revised) regarding the revaluation model should be applied prospectively.

In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of items of PPE reflects any previous revaluation it should adjust the amount outstanding in the Revaluation reserve against the carrying amount of that item.

Note: The carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as Revaluation reserve over the carrying amount of that item should be adjusted in Revenue reserves.

2.4.7 Accounting for Investments (AS 13)

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

This Statement does not deal with:

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

b. Operating or finance leases.

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

d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 2013.

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

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

Forms of Investments

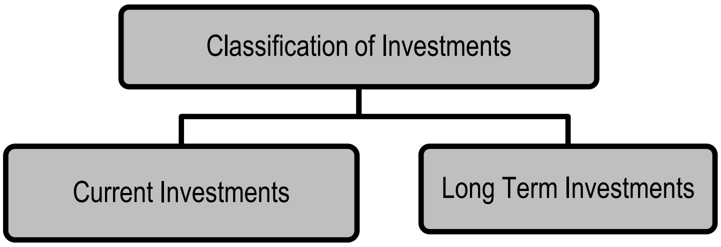
Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are not ‘investments’.

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

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

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

Classification of Investments



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

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

Cost of Investments

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

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

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

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

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

Carrying Amount of Investments

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

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

Investment Properties

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

An investment property is accounted for in accordance with cost model as prescribed in AS 10, 'Property, Plant and Equipment'. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

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

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

Reclassification of Investments

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

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

Disclosure

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

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

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

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

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

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

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

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

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

Example 1

X Ltd. on 1-1-2014 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realizable value of all such investment on 31-3-2014 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. From the given market conditions, it is apparent that the reduction in the value is permanent in nature. How will you recognize the reduction in financial statements for the year ended on 31-3-2014?

Solution

X Ltd. invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Ltd. only for 3 months (from 1.1.2014 to 31.3.2014), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2014 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

As per AS 13, 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realizable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be charged to the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Ltd. lost a case of copyright which drastically reduced the realisable value of its

shares to one third which is quiet a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and show the investments at ₹ 100 lakhs, since the downfall in the value of shares is other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will be charged to the Statement of profit and loss.

Note: Students are advised to refer 'chapter 12' for problems based on practical application of AS 13.

2.4.8 Accounting for Amalgamations (AS 14)

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

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

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

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

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

Types of Amalgamations

Amalgamations fall into two broad categories:

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

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

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

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

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

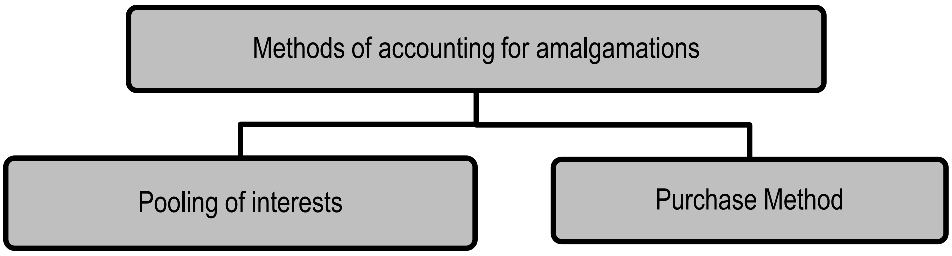
iv. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.

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

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

Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations, viz.,



Pooling of interests

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

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

The Purchase Method

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

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

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

Example

A Ltd. take over B Ltd. on April 01, 2015 and discharges consideration for the business as follows:

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

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

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

Solution:

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

Treatment of Reserves on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation.

Adjustments to reserves - Amalgamation in the Nature of Merger

When an amalgamation is accounted for using the pooling of interests method, the reserves of the transferee company are adjusted to give effect to the following:

- Conflicting accounting policies of the transferor and the transferee. A uniform set of accounting policies should be adopted following the amalgamation and, hence, the policies of the transferor and the transferee are aligned. The effects on the financial statements of this change in the accounting policies is reported in accordance with AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'

- 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.

Adjustments to reserves - Amalgamation in the Nature of Purchase

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

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

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 Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.***

The Standard gives a title, which reads as "Reserve". This gives rise to following requirements.

1. ***The corresponding debit is "also" to a Reserve Account***
2. ***That Reserve account will show a negative balance***
3. ***But it has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over".***

So the presentation will be as follows:

Notes to Accounts for "Reserves and Surplus"

Description	***Amount (Current year)***	***Amount (Previous Year)***
Statutory Reserve (taken over from transferor company)		
General Reserve		
Profit and Loss or Retained Earnings		
Amalgamation Adjustment Reserve (negative balance)	***(--)***	***(--)***

Treatment of Goodwill Arising on Amalgamation

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

Illustration

The following are the summarised balance sheets of A Ltd. and B Ltd. as on March 31, 2015:

Liabilities	*A Ltd. (₹)*	*B Ltd. (₹)*
Equity Shares, ₹ 10 each, fully paid up	*7,20,000*	*3,00,000*
14% Preference Share Capital, ₹ 100 each, fully paid up	*1,50,000*	*1,70,000*
Securities Premium	*1,50,000*	
Capital Reserve		*13,000*
General Reserve	*80,000*	*45,000*
Export Profit Reserve		*20,000*
Profit and Loss Account	*75,000*	*40,000*
Workmen Compensation Fund		*3,000*
13% Debentures, ₹ 100 each, fully paid up	*1,00,000*	*50,000*
Trade payables	*1,15,000*	*35,000*
Provision for Taxation	*15,000*	*10,000*
	14,05,000	*6,86,000*

Assets		
Goodwill	*2,00,000*	*60,000*
Land and Buildings	*2,50,000*	
Plant and Machinery	*3,25,000*	*2,70,000*
Furniture and Fixtures	*57,000*	*95,000*
Inventory	*2,15,000*	*1,75,000*
Trade receivables	*72,000*	*30,000*
Income Tax Refund Claim		*6,000*
Cash at Bank	*2,16,000*	*50,000*
Cash in Hand	*70,000*	
	14,05,000	*6,86,000*

A Ltd. take over B Ltd. on April 01, 2015 and discharges consideration for the business as follows:

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

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

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

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

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

Solution

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

Particulars		Dr. (₹)	Cr. (₹)
Goodwill Account	Dr.	60,000	
Plant & Machinery Account	Dr.	2,70,000	
Furniture & Fixtures Account	Dr.	95,000	
Inventory Account	Dr.	1,75,000	
Trade receivables Account	Dr.	30,000	
IT Refund Account	Dr.	6,000	
Bank Account	Dr.	50,000	
General Reserve Account (Balancing Figure)	Dr.	52,000	
To Capital Reserve Account			13,000
To Export Profit Reserve Account			20,000
To Workmen Compensation Fund Account			3,000
To 13% Debentures Account			50,000
To Trade payables Account			35,000
To Provision for Tax Account			10,000
To Business Purchase Account			6,07,000
Business Purchase Account	Dr.	6,07,000	
To B Ltd. Liquidator Account			6,07,000
B Ltd. Liquidator Account	Dr.	6,07,000	
To Equity Share Capital Account			4,20,000
To Preference Share Capital			1,87,000
13% Debentures Account (In B Ltd.)	Dr.	50,000	
To 13% Debentures Account (In A Ltd.)			50,000

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

Particulars		Dr. (₹)	Cr. (₹)
Goodwill Account (Balancing Figure)	Dr.	76,000	
Plant & Machinery Account	Dr.	2,70,000	
Furniture & Fixtures Account	Dr.	95,000	
Stock Account	Dr.	1,75,000	
Debtors Account	Dr.	30,000	
IT Refund Account	Dr.	6,000	
Bank Account	Dr.	50,000	
To 13% Debentures Account			50,000
To Creditors Account			35,000
To Provision for Tax Account			10,000
To Business Purchase Account			6,07,000
Business Purchase Account Dr.		6,07,000	
To B Ltd. Liquidator Account			6,07,000
B Ltd. Liquidator Account	Dr.	6,07,000	
To Equity Share Capital Account			4,20,000
To Preference Share Capital			1,87,000
13% Debentures Account (In B Ltd.)	Dr.	50,000	
To 13% Debentures Account (In A Ltd.)			50,000
Profit and Loss A/c	Dr.	15,000	
To Bank Account			15,000
Amalgamation Adjustment Reserve Account	Dr.	20,000	
To Export Profit Reserve Account			20,000

Disclosure

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

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

b. Effective date of amalgamation for accounting purposes;

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

d. Particulars of the scheme sanctioned under a statute.

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

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

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

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

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

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

Note: For problems based on practical application of AS 14, students are advised to refer 'chapter 6' of the study material.

Miscellaneous Illustrations

AS 1 Disclosure of Accounting Policies

Illustration 1

ABC Ltd. was making provision for non-moving stocks based on no issues for the last 12 months up to 31.3.2015.

The company wants to provide during the year ending 31.3.2015 based on technical evaluation:

Total value of stock	*₹ 100 lakhs*
Provision required based on 12 months issue	*₹ 3.5 lakhs*
Provision required based on technical evaluation	*₹ 2.5 lakhs*

Does this amount to change in Accounting Policy? Can the company change the method of provision?

Solution

The decision of making provision for non-moving stocks on the basis of technical evaluation does not amount to change in accounting policy. Requirement to provide for non-moving stocks may be said as accounting policy but the basis for making provision will not constitute accounting policy. It will be considered as an accounting estimate. Further, the method of estimating the amount of provision may be changed in case a more prudent estimate can be made**.**

In the given case, considering the total value of stock, the change in the amount of required provision of non-moving stock from ₹ 3.5 lakhs to ₹ 2.5 lakhs is also not material. The disclosure can be made for such change in the following lines by way of notes to the accounts in the annual accounts of ABC Ltd. for the year 2014-15:

"The company has provided for non-moving stocks on the basis of technical evaluation unlike preceding years. Had the same method been followed as in the previous year, the profit for the year and the corresponding effect on the year end net assets would have been higher by₹ 1 lakh."

Illustration 2

Jagannath Ltd. had made a rights issue of shares in 2012. In the offer document to its members, it had projected a surplus of ₹ 40 crores during the accounting year to end on 31st March, 2014. The draft results for the year, prepared on the hitherto followed accounting policies and presented for perusal of the board of directors showed a deficit of ₹ 10 crores. The board in consultation with the managing director, decided on the following:

(i) *Value year-end inventory at works cost (₹ 50 crores) instead of the hitherto method of valuation of inventory at prime cost (₹ 30 crores).*

(ii) *Provide depreciation for the year on straight line basis on account of substantial additions in gross block during the year, instead of on the reducing balance method, which was hitherto adopted. As a consequence, the charge for depreciation at ₹ 27 crores is lower than the amount of ₹ 45 crores which would have been provided had the old method been followed, by ₹ 18 cores.*

(iii) *Not to provide for "after sales expenses" during the warranty period. Till the last year, provision at 2% of sales used to be made under the concept of "matching of costs against revenue" and actual expenses used to be charged against the provision. The board now decided to account for expenses as and when actually incurred. Sales during the year total to ₹ 600 crores.*

(iv) *Provide for permanent fall in the value of investments - which fall had taken place over the past five years - the provision being ₹ 10 crores.*

As chief accountant of the company, you are asked by the managing director to draft the notes on accounts for inclusion in the annual report for 2013-2014.

Solution

As per AS 1, any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect 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. Accordingly, the notes on accounts should properly disclose the change and its effect.

Notes on Accounts:

(i) During the year inventory has been valued at factory cost, against the practice of valuing it at prime cost as was the practice till last year. This has been done to take cognizance of the more capital intensive method of production on account of heavy capital expenditure during the year. As a result of this change, the year-end inventory has been valued at ₹ 50 crores and the profit for the year is increased by ₹ 20 crores.

(ii) In view of the heavy capital intensive method of production introduced during the year, the company has decided to change the method of providing depreciation from reducing balance method to straight line method. As a result of this change, depreciation has been provided at ₹ 27 crores which is lower than the charge which would have been made had the old method and the old rates been applied, by ₹ 18 crores. To that extent, the profit for the year is increased.

(iii) So far, the company has been providing 2% of sales for meeting "after sales expenses during the warranty period. With the improved method of production, the probability of defects occurring in the products has reduced considerably. Hence, the company has decided not to make provision for such expenses but to account for the same as and when expenses are incurred. Due to this change, the profit for the year is increased by ₹ 12 crores than would have been the case if the old policy were to continue.

(iv) The company has decided to provide ₹ 10 crores for the permanent fall in the value of investments which has taken place over the period of past five years. The provision so made has reduced the profit disclosed in the accounts by ₹ 10 crores.

AS 2 Valuation of Inventories

Illustration 3

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2014-15, the Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

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

What will be the value of Closing Stock?

Solution

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

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

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

Illustration 4

The closing inventory at cost of a company amounted to ₹ 2,84,700. The following items were included at cost in the total:

(a) 400 coats, which had cost ₹ 80 each and normally sold for ₹ 150 each. Owing to a defect in manufacture, they were all sold after the balance sheet date at 50% of their normal price. Selling expenses amounted to 5% of the proceeds.

(b) 800 skirts, which had cost ₹ 20 each. These too were found to be defective. Remedial work in April cost ₹ 5 per skirt, and selling expenses for the batch totaled ₹ 800. They were sold for ₹ 28 each.

What should the inventory value be according to AS 2 after considering the above items?

Solution

Valuation of Closing Stock

Particulars	₹	₹
Closing Stock at cost		2,84,700
Less : Cost of 400 coats (400 x 80)	32,000	
Less: Net Realisable Value [400 x (75 – 5% of ₹75)]	28,500	3,500
Value of Closing Stock		2,81,200

Note: There is no adjustment for skirts because for skirts were sold at above cost.

Illustration 5

Calculate the value of raw materials and closing stock based on the following information:

Raw material X	
Closing balance	*500 units*
	₹ per unit
Cost price including GST	*200*
Input tax credit receivable	*10*
Freight inward	*20*
Unloading charges	*10*
Replacement cost	*150*
Finished goods Y	
Closing Balance	*1200 units*
	₹ per unit
Material consumed	*220*
Direct labour	*60*
Direct overhead	*40*

Total fixed overhead for the year was ₹ 2,00,000 on normal capacity of 20,000 units.

Calculate the value of the closing stock, when

(i) Net Realizable Value of the Finished Goods Y is ₹ 400.

(ii) Net Realizable Value of the Finished Goods Y is ₹ 300.

Solution

Statement showing valuation of Raw Material and Finished Goods at cost

Raw Material X	₹
Cost Price	200
Less: Input tax credit	(10)
	190
Add: Freight Inward	20
Unloading charges	10
Cost	220

Finished goods Y	₹
Materials consumed	220
Direct labour	60
Direct overhead	40
Fixed overheads (2,00,000/20,000)	10
Cost	330

(i) When Net Realisable Value (NRV) of the Finished Goods Y is ₹ 400

NRV is greater than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material and Finished Goods will be valued at cost

Accordingly, value of closing stock will be:

	Qty	*Rate*	*Amount (₹)*
Raw Material X	500	220	1,10,000
Finished Goods Y	1,200	330	3,96,000
Total cost of closing stock			5,06,000

(ii) When Net Realisable Value of the Finished Goods Y is ₹ 300

NRV is less than the cost of Finished Goods Y i.e. ₹ 330

Hence, Raw Material is to be valued at replacement cost and Finished Goods are to be valued at NRV.

Accordingly, value of closing stock will be:

	Qty	*Rate*	*Amount (₹)*
Raw Material X	500	150	75,000
Finished Goods Y	1,200	300	3,60,000
Total cost of closing stock			4,35,000

Note: It has been assumed that Raw Material X is used for production of Finished Goods Y.

AS 3 Cash Flow Statements

Illustration 6

Classify the following activities as (1) Operating Activities, (2) Investing Activities, (3) Financing Activities:

a. Purchase of Machinery.

b. Proceeds from issuance of equity share capital.

c. Cash Sales.

d. Proceeds from long-term borrowings.

e. Proceeds from Debtors.

f. Brokerage paid on purchase of investments.

Solution

As per para 5 of AS 3 (Revised) "Cash Flow Statements",

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.

Thus, the classification will be done as:

Operating Activities: c, e,

Investing Activities: a, f,

Financing Activities: b, d.

AS 7 Construction Contracts

Illustration 7

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2013.

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

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

Solution

(a)	*Amount of foreseeable loss*	*(₹ in lakhs)*
	Total cost of construction (500 + 105 + 495)	1,100

Less: Total contract price	(1,000)
Total foreseeable loss to be recognized as expense	100

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

(b)

Contract work-in-progress i.e. cost incurred to date are ₹ 605 lakhs	*(₹ in lakhs)*
Work certified	500
Work not certified	105
	605
This is 55% (605/1,100 × 100) of total costs of construction.	

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

55% of ₹ 1,000 lakhs = ₹ 550 lakhs

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

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

= [605 – 100 – 540] ₹ in lakhs

Amount due to customers = ₹ 35 lakhs

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

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

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

Illustration 8

On 1st December, 2014, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2015 the company found that it had already spent ₹ 64,99,000 on the construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. Calculate total estimated loss on contract and what amount should be charged *to revenue in the final accounts for the year ended 31st March, 2015 as per provisions of Accounting Standard 7 (Revised)?*

Solution

Calculation of estimated total loss and amount charged to revenue

	₹
Cost incurred till 31st March, 2015	64,99,000
Prudent estimate of additional cost for completion	32,01,000
Total cost of construction	97,00,000
Less: Contract price	(85,00,000)
Total foreseeable loss	12,00,000

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

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

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

= 67% of ₹ 85,00,000 = ₹ 56,95,000.

AS 9 Revenue Recognition

Illustration 9

Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received ₹ 10 lakhs and ₹ 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2014-15.

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

Solution

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

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

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

Illustration 10

SCL Ltd., sells agriculture products to dealers. One of the condition of sale is that interest is payable at the rate of 2% p.m., for delayed payments. Percentage of interest recovery is only 10% on such overdue outstanding due to various reasons. During the year 2013-2014 the company wants to recognise the entire interest receivable. Do you agree?

Solution

As per para 9.2 of AS 9 on Revenue Recognition, 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.

Thus, SCL Ltd. cannot recognise the interest amount unless the company actually receives it. 10% rate of recovery on overdue outstandings is also an estimate and is not certain. Hence, the company is advised to recognise interest receivable only on receipt basis.

AS 10 Property, Plant and Equipment

Illustration 11

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

Cost of the plant (cost per supplier's invoice plus taxes)	***₹25,00,000***
Initial delivery and handling costs	***₹2,00,000***
Cost of site preparation	***₹6,00,000***
Consultants used for advice on the acquisition of the plant	***₹7,00,000***
Interest charges paid to supplier of plant for deferred credit	***₹2,00,000***
Estimated dismantling costs to be incurred after 7 years	***₹3,00,000***
Operating losses before commercial production	***₹4,00,000***

Please advise ABC Ltd. on the costs that can be capitalised in accordance with AS 10 (Revised).

Solution

According to AS 10 (Revised), these costs can be capitalized:

Cost of the plant	***₹25,00,000***
Initial delivery and handling costs	***₹2,00,000***
Cost of site preparation	***₹6,00,000***
Consultants' fees	***₹7,00,000***

Estimated dismantling costs to be incurred after 7 years	*₹ 3,00,000*
	₹ 43,00,000

***Note:** Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalised. They should be written off to the Statement of Profit and Loss in the period they are incurred.*

Illustration 12

In the year 2016-17, an entity has acquired a new freehold building with a useful life of 50 years for ₹ 90,00,000. The entity desires to calculate the depreciation charge per annum using a straight-line method. It has identified the following components (with no residual value of lifts & fixtures at the end of their useful life) as follows:

Component	*Useful life (Years)*	*Cost*
Land	*Infinite*	*₹ 20,00,000*
Roof	*25*	*₹ 10,00,000*
Lifts	*20*	*₹ 5,00,000*
Fixtures	*10*	*₹ 5,00,000*
Remainder of building	*50*	*₹ 50,00,000*
		₹ 90,00,000

Calculate depreciation for the year 2016-17 as per componentization method.

Solution

Statement showing amount of depreciation as per Componentization Method

Component	*Depreciation (Per annum) (₹)*
Land	*Nil*
Roof	*40,000*
Lifts	*25,000*
Fixtures	*50,000*
Remainder of Building	*1,00,000*
	2,15,000

***Note:** When the roof requires replacement at the end of its useful life the carrying amount will be nil. The cost of replacing the roof should be recognised as a new component.*

AS 13 Accounting for Investments

Illustration 13

While preparing the financial statements of R Ltd. for the year ended 31st March, 2015, you come to know that an unquoted long term investment is carried in the books at a cost of ₹ 2 lakhs. The published accounts of the unlisted company received in May, 2015 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than ₹ 20,000. How you would deal with this in the financial statements?

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2015 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to ₹ 20,000 in the financial statements for the year ended 31st March, 2015.

Illustration 14

Saksham Ltd. wants to re-classify its Investment in accordance with AS 13. Decide on the treatment to be given in each of the following cases assuming that the market value has been determined in an arm's length transaction between knowledgeable and willing buyer and seller:

(i) A portion of Current Investments purchased for ₹ 10 lakhs to be reclassified as long-term Investments, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹ 12 lakhs.

(ii) Another portion of Current Investments purchased for ₹ 8 lakhs has to be re classified as Long-term Investments. The market value of these investments as on the date of Balance Sheet was ₹ 5 lakhs.

Solution

As per para 24 of AS 13 'Accounting for Investments', 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.

(i) In the first case, the market value of the investment is ₹ 12 lakhs, which is higher than its cost i.e. ₹ 10 lakhs. Therefore, the transfer to long term investments should be made at cost i.e. ₹ 10 lakhs.

(ii) In the second case, the market value of the investment is ₹ 5 lakhs, which is lower than its cost i.e. ₹ 8 lakhs. Therefore, the transfer to long term investments should be made in the books at the market value i.e. ₹ 5 lakhs. The loss of ₹ 3 (8 – 5) lakhs should be charged to profit and loss account.

Reference: ***The students are advised to refer the full text of AS 1, 2, 3, 7, 9, 10, 13 and 14 given in Appendix I.***

2

Financial Statements of Companies

Unit – 1: Preparation of Financial Statements

Learning Objectives

After studying this unit, you will be able to:

- Know how to maintain books of account of a company.
- Learn about statutory books of a company.
- Prepare and present the financial statements of a company as per Schedule III to the Companies Act, 2013 (Earlier Schedule VI to the Companies Act, 1956).
- Calculate managerial remuneration of managers in a company.
- Appreciate the term divisible profits and dividends.

1.1 Meaning of Company

As per Section 2(20) of the Companies Act, 2013, "Company" means a company incorporated under the Companies Act, 2013 or under any previous company law (e.g., the Companies Act, 1956). Different types of companies have been defined (under various sub-sections of the Companies Act, 2013) as follows:

2(21) "**company limited by guarantee**" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up;

2(22) "**Company limited by shares**" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them;

2(42) **"Foreign company"** means any company or body corporate incorporated outside India which –

(a) has a place of business in India whether by itself or through an agent physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

2(45) "**Government company**" means any company in which not less than 51% of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company;

2(62) "**One Person Company**" means a company which has only one person as a member;

2(68) "**Private company**" means a company having a minimum paid-up share capital as may be prescribed, and which by its articles,—

(i) restricts the right to transfer its shares;

(ii) except in case of One Person Company, limits the number of its members to two hundred:

Provided that where two or more persons hold one or more shares in a company jointly, they should, for the purposes of this sub-clause, be treated as a single member:

Provided further that—

(A) persons who are in the employment of the company; and

(B) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased, should not be included in the number of members; and

(iii) prohibits any invitation to the public to subscribe for any securities of the company;

2(71) **"Public Company"** mans a company which—

(a) is not a private company;

(b) has a minimum paid-up share capital as may be prescribed:

Provided that a company which is a subsidiary of a company, not being a private company, should be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles;

2(85) "**Small company**" means a company, other than a public company, -

(i) paid-up share capital of which does not exceed Rs. 50 lakhs or such higher amount as may be prescribed which should not be more than Rs. 5 crores; or

(ii) turnover of which as per its last profit and loss account does not exceed Rs. 2 crores or such higher amount as may be prescribed which should not be more than Rs. 20 crores:

Provided that nothing in this clause should apply to:

(A) a holding company or a subsidiary company

(B) a company registered under section 8

(C) a company or body corporate governed by any special Act

2(92) "**Unlimited company**" means a company not having any limit on the liability of its members;

2(46) "**Holding company**", in relation to one or more other companies, means a company of which such companies are subsidiary companies;

2(87) "**Subsidiary company**", or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company-

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies as may be prescribed should not have layers of subsidiaries beyond such numbers as may be prescribed.

Explanation – For the purposes of this clause, -

(a) a company should be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;

(b) the composition of a company's Board of Directors should be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

(c) the expression "company" includes any body corporate;

(d) "layer" in relation to a holding company means its subsidiary or subsidiaries;

1.2 Maintenance of Books of Account

As per Section 128 of the Companies Act, 2013, Every company should prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books should be kept on accrual basis and according to the double entry system of accounting:

Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

Maintenance at Place other than Registered Office

It is a duty of the company to inform the Registrar of Companies within seven days of the decision in case the Board of Directors decides to maintain books at the place other than the registered office.

In Case of Branch Office

Where a company has a branch office in India or outside India, it should be deemed to have complied with the provisions of the Act, if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or such other place as the Board of Directors has decided.

Section 128 (3) further lays down that the books of account and other books and papers maintained by the company within India should be open for inspection at the registered office of the company or at such other place in India by any director during business hours, and in the case of financial information, if any, maintained outside the country, copies of such financial information should be maintained and produced for inspection by any director subject to such conditions as may be prescribed. Section 128(5) further states that the books of account of every company relating to a period of not less than 8 financial years immediately preceding a financial year, or where the company had been in existence for a period less than 8 years, in respect of all the preceding years together with the vouchers relevant to any entry in such books of account should be kept in good order.

1.3 Statutory Books

The following statutory books are required to be maintained by a company under different sections of the Companies Act, 2013:

- Register of Investments of the company held in its own name (Section 187)
- Register of Charges (Section 85)
- Register of Members (Sections 88)
- Register of Debenture-holders and other Security holders (Section 88)
- Minute Books (Section 118)
- Register of Contracts, or arrangements in which directors are interested (Section 189)
- Register of directors and key managerial personnels and their shareholding (Section 170)
- Register of Loans and Investments by Company (Section 186)

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

- Registers and documents relating to the issue of shares are:
  - (i) Share Application and Allotment Book
  - (ii) Share Call Book
  - (iii) Certificate Book
  - (iv) Register of Members
  - (v) Share Transfer Book
  - (vi) Dividend Register

1.4 Annual Return

In accordance with Section 92 of the Companies Act, 2013, every company should prepare an annual return in the form prescribed by the Companies Act, 2013 signed by a director and the company secretary, or where there is no company secretary, by a company secretary in practice:

Provided that in relation to One Person Company and small company, the annual return should be signed by the company secretary, or where there is no company secretary, by the director of the company.

The annual return should be filed with the Registrar within 60 days from the day on which each of the annual general meeting (AGM) is held or where no AGM is held in any year, within 60 days from the date on which AGM should have been held along with a statement showing the reasons why AGM was not held.

1.5 Final Accounts

Under Section 129 of the Companies Act, 2013, at the annual general meeting of a company, the Board of Directors of the company should lay financial statements before the company:

Financial Statements as per Section 2(40) of the Companies Act, 2013, *inter-alia* include -

(i) a balance sheet as at the end of the financial year;

(ii) a profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;

(iii) cash flow statement for the financial year;

(iv) a statement of changes in equity, if applicable; and

(v) any explanatory note annexed to, or forming part of, any document referred to in (i) to (iv) above:

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Requisites of Financial Statements

It should give a true and fair view of the state of affairs of the company as at the end of the financial year.

Provisions Applicable

(1) Specific Act is Applicable

For instance, any

(a) insurance company

(b) banking company or

(c) any company engaged in generation or supply of electricity* or

(d) any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company

(2) In case of all other companies

Balance Sheet as per Form set out in Part I of Schedule III and Statement of Profit and Loss as per Part II of Schedule III

Points to be kept in mind while preparing final accounts:

- Requirements of Schedule III to the Companies Act;
- Other statutory requirements;
- Accounting Standards notified by Ministry of Corporate Affairs (MCA) (AS 1 to AS 29[1]);
- Statements and Guidance Notes issued by the Institute of Chartered Accountants of India (ICAI); which are necessary for understanding the accounting treatment/ valuation/ disclosure suggested by the ICAI.

Compliance with Accounting Standards

As per section 133 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time.

Schedule III of the Companies Act, 2013

As per section 129 of the Companies Act, 2013, Financial statements should give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under section133 and should be in the form or forms as may be provided for

**The Electricity Act, 2003 does not specify any format for presentation of Financial Statements. Therefore, Schedule III of the Companies Act, 2013 is followed by Electricity Companies in preparation of their financial statements.*

[1] AS 6 and AS 8 have been withdrawn

different class or classes of companies in Schedule III under the Act. Schedule III to the Companies Act, 2013 has been given as Appendix I at the end of this chapter.

Example 1

In the financial statements of the financial year 20X1-20X2, Alpha Ltd. has mentioned in the notes to accounts that during financial year, 24,000 equity shares of ₹ 10 each were issued as fully paid bonus shares. However, the source from which these bonus shares were issued has not been disclosed. Is such non-disclosure a violation of the Schedule III to the Companies Act? Comment.

Solution

Schedule III has come into force for the Balance Sheet and Profit and Loss Account prepared for the financial year commencing on or after 1st April, 20X1. As per Part I of the Schedule III, a company should, inter alia, disclose in notes to accounts for the period of 5 years immediately preceding the balance sheet date (31st March, 20X2 in the instant case) the aggregate number and class of shares allotted as fully paid-up bonus shares. Schedule III does not require a company to disclose the source from which bonus shares have been issued. Therefore, non-disclosure of source from which bonus shares have been issued does not violate the Schedule III to the Companies Act.

Example 2

The management of Loyal Ltd. contends that the work in process is not valued since it is difficult to ascertain the same in view of the multiple processes involved. They opine that the value of opening and closing work in process would be more or less the same. Accordingly, the management had not separately disclosed work in process in its financial statements. Comment in line with Schedule III.

Solution

Schedule III to the companies Act does not require that the amounts of WIP at the beginning and at the end of the accounting period to be be disclosed in the statement of profit and loss. Only changes in inventories of WIP need to be disclosed in the statement of profit and loss. Non-disclosure of such change in the statement of profit and loss by the company may not amount to violation of Schedule III if the differences between opening and closing WIP are not material.

Example 3

Futura Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31st March, 20X1:

	Amount ₹ in lakhs
Securities Premium Account	80
Capital Reserve	60
General Reserve	90

The company had an accumulated loss of ₹ 250 lakhs on the same date, which it has disclosed under the head "Statement of Profit and Loss" as asset in its Balance Sheet. Comment on accuracy of this treatment in line with Schedule III to the Companies Act, 2013.

Solution

Part I of Schedule III to the Companies Act, 2013 provides that debit balance of Statement of Profit and Loss (after all allocations and appropriations) should be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, should be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative. In this case, the debit balance of profit and loss i.e. ₹ 250 lakhs exceeds the total of all the reserves i.e. ₹ 230 lakhs. Therefore, balance of 'Reserves and Surplus' after adjusting debit balance of profit and loss is negative by ₹ 20 lakhs, which should be disclosed on the face of the balance sheet. Thus the treatment done by the company is incorrect.

Example 4

Sumedha Ltd. took a loan from bank for ₹ 10,00,000 to be settled within 5 years in 10 equal half yearly instalments with interest. First instalment is due on 30.09.20X1 of ₹ 1,00,000. Determine how the loan will be classified in preparation of Financial Statements of Sumedha Ltd. for the year ended 31st March, 20X1 according to Schedule III.

Solution

As per Schedule III, a liability should be classified as current when it satisfies any of the following criteria:

(i) it is expected to be settled in the company's normal operating cycle;

(ii) it is held primarily for the purpose of being traded;

(iii) it is due to be settled within twelve months after the reporting date; or

(iv) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date.

In the given case, instalments due on 30.09.20X1 and 31.03.20X2 will be shown under the head 'other current liabilities' as per criteria (c).

Therefore, in the balance sheet as on 31.3.20X1, ₹ 8,00,000 (₹ 1,00,000 x 8 instalments) will be shown under the heading 'Long term Borrowings' and ₹ 2,00,000 (₹ 1,00,000 x 2 instalments) will be shown under the heading 'Other Current Liabilities' as current maturities of loan from bank.

Note: Students may note that the questions based on preparation of Statement of Profit and Loss and Balance Sheet and explanatory notes as per Schedule III have been given in this Unit. However, questions requiring preparation of cash Flow statements have been separately given in the next unit of this chapter.

1.6 Managerial Remuneration

Managerial remuneration is calculated as a percentage of profit. Managerial remuneration payable by a company is governed by various sections of the Companies Act, 2013 and also Schedule V under the Companies Act, 2013.

The scope of the relevant sections is as below:

Section 197 prescribes the overall maximum managerial remuneration payable and also managerial remuneration in case of absence or inadequacy of profits.

As per Section 197 of the Companies Act, 2013, total managerial remuneration payable by a public company, to its directors, including managing director and whole-time director, and its manager in respect of any financial year should not exceed 11% of the net profits of that company for that financial year computed in the manner laid down in section 198 except that the remuneration of the directors should not be deducted from the gross profits. The company in general meeting may, with the approval of the Central Government, authorise the payment of remuneration exceeding 11% of the net profits of the company, subject to the provisions of Schedule V.

Provided further that, except with the approval of the company in general meeting,—

(i) the remuneration payable to any one managing director; or whole-time directoror manager should not exceed 5% of the net profits of the company and if there are more than one such director, remuneration should not exceed 10% of the net profits to all such directors and manager taken together;

(ii) the remuneration payable to directors who are neither managing directors nor whole-time directors should not exceed,—

(A) 1% of the net profits of the company, if there is a managing or whole-time director or manager;

(B) 3% of the net profits in any other case.

Section 198 lays down how the net profit of the company will be ascertained for the purpose of calculating managerial remuneration.

Schedule V consists of four parts. Part I lays down conditions to be fulfilled for the appointment of a managing or whole-time director or a manager without the approval of the Central Government. Part II deals with remuneration payable to managerial person by companies having profits and also by companies having no profits or inadequate profits. Part III specifies the provisions applicable to parts 1 and 2 of this schedule and Part IV deals with Central Government's power to relax any requirements in this Schedule.

The relevant details given under Part II of Schedule V are as follows:

Section I - Remuneration payable by companies having profits:

Subject to the provisions of section 197, a company having profits in a financial year may pay remuneration to a managerial person or persons not exceeding the limits specified in such section.

Section II - Remuneration payable by companies having no profit or inadequate profit without Central Government approval:

Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government approval, pay remuneration to the managerial person not exceeding the higher of the limits under *(A)* and *(B)* given below:-

(A)

	(1)	*(2)*
	Where the effective capital is*	Limit of yearly remuneration payable should not exceed (Rupees)
(i)	Negative or less than 5 crores	60 Lakhs
(ii)	5 crores and above but less than 100 crores	84 Lakhs
(iii)	100 crores and above but less than 250 crores	120 Lakhs
(iv)	250 crores and above	120 lakhs plus 0.01% of the effective capital in excess of Rs. 250 crores:

Provided that the above limits should be doubled if the resolution passed by the shareholders is a special resolution.

Explanation - It is hereby clarified that for a period less than one year, the limits should be pro-rated.

(B) In case of a managerial person who is functioning in a professional capacity, no approval of Central Government is required, if such managerial person is not having any interest in the capital of the company or its holding company or any of its subsidiaries directly or indirectly or through any other statutory structures and not having any, direct or indirect interest or related to the directors or promoters of the company or its holding company or any of its subsidiaries at any time during the last two years before or on or after the date

**Effective Capital has been explained after Section IV in the succeeding pages of this unit. Students are advised to please refer that definition of Effective Capital.*

of appointment and possesses graduate level qualification with expertise and specialised knowledge in the field in which the company operates:

Provided that any employee of a company holding shares of the company not exceeding 0.5% of its paid up share capital under any scheme formulated for allotment of shares to such employees including Employees Stock Option Plan or by way of qualification should be deemed to be a person not having any interest in the capital of the company;

Provided further that the limits specified under items (A) ant (B) of this section should apply, if-

(i) payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under Section 178(1) also by the Nomination and Remuneration Committee;

(ii) the company has not committed any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person and in case of a default, the company obtains prior approval from secured creditors for the proposed remuneration and the fact of such prior approval having been obtained is mentioned in the explanatory statement to the notice convening the general meeting;

(iii) an ordinary resolution or a special resolution, as the case may be, has been passed for payment of Remuneration as per the limits laid down in item (A) or a special resolution has been passed for payment of remuneration as per item (B), at the general meeting of the company for a period not exceeding 3 years.

(iv) a statement along with a notice calling the general meeting referred to in clause (iii) is given to the shareholders containing the following information, namely:-

I. General Information:

(1) Nature of industry

(2) Date or expected date of commencement of commercial production.

(3) In case of new companies, expected date of commencement of activities as per project approved by financial institutions appearing in the prospectus

(4) Financial performance based on given indicators

(5) Foreign investments or collaborations, if any.

II. Information about the appointee:

(1) Background details

(2) Past remuneration

(3) Recognition or awards

(4) Job profile and his suitability

(5) Remuneration proposed

(6) Comparative remuneration profile with respect to industry, size of the company, profile of the position and person (in case of expatriates the relevant details would be with respect to the country of his origin)

(7) Pecuniary relationship directly or indirectly with the company, or relationship with the managerial personnel, if any.

III. Other information:

(1) Reasons of loss or inadequate profits

(2) Steps taken or proposed to be taken for improvement

(3) Expected increase in productivity and profits in measurable terms.

IV. Disclosures:

The following disclosures should be mentioned in the Board of Director's report under the heading "Corporate Governance", if any, attached to the financial statement:-

(i) all elements of remuneration package such as salary, benefits, bonuses, stock options, pension, etc., of all the directors;

(ii) details of fixed component and performance linked incentives along with the performance criteria;

(iii) service contracts, notice period, severance fees;

(iv) stock option details, if any, and whether the same has been issued at a discount as well as the period over which accrued and over which exercisable.

Section III - Remuneration payable by companies having no profit or inadequate profit without Central Government approval in certain special circumstances

In the following circumstances a company may, without the Central Government approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:-

(a) where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of Section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under Section 197.

(b) where the company-

(i) is a newly incorporated company, for a period of seven years from the date of its incorporation, or

(ii) is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction for a period of 5 years from the date of sanction of scheme of revival,

(iii) is a company in relation to which a resolution plan has been approved by the National Company Law Tribunal under the Insolvency and Bankruptcy Code, 2016 for a period of 5 years from the date of such approval, it may pay remuneration up to two times the amount permissible under Section II.

(c) where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal:

Provided that the limits under this Section should be applicable subject to meeting all the conditions specified under Section II and the following additional conditions:-

(i) except as provided in para (a) of this Section, the managerial person is not receiving remuneration from any other company;

(ii) the auditor or Company Secretary of the company or where the company has not appointed a Secretary, a Secretary in whole-time practice, certifies that all secured creditors and term lenders have stated in writing that they have no objection for the appointment of the managerial person as well as the quantum of remuneration and such certificate is filed along with the return as prescribed under sub-section (4) of section 196.

(iii) the auditor or Company Secretary or where the company has not appointed a secretary, a secretary in whole-time practice certifies that there, is no default on payments to any creditors, and all dues to deposit holders are being settled on time.

(d) a company in a Special Economic Zone as notified by Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India, and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of thirty days in any financial year, may pay remuneration up to ₹2,40,00,000 per annum.

Section IV -Perquisites not included in managerial remuneration:

1. A managerial person should be eligible for the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II and Section III:-

   (a) contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income-tax Act, 1961;

   (b) gratuity payable at a rate not exceeding half a month's salary for each completed year of service; and

(c) encashment of/eave at the end of the tenure.

2. In addition to the perquisites specified in paragraph 1 of this section, an expatriate managerial person (including a non-resident Indian) should be eligible to the following perquisites which should not be included in the computation of the ceiling on remuneration specified in Section II or Section III-

   (a) Children's education allowance: In case of children studying in or outside India, an allowance limited to a maximum of ₹12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.

   (b) Holiday passage for children studying outside India or family staying abroad: Return holiday passage once in a year by economy class or once in two years by first class to children and to the members 'of the family from the place of their study or stay abroad to India if they are not residing in India, with the managerial person.

   (c) Leave travel concession: Return passage for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

Explanation I- For the purposes of Section II of this Part, "**Effective capital"** means the aggregate of the paid-up share capital (excluding share application money or advances against shares); amount, if any, for the time being standing to the credit of share premium account; reserves and surplus (excluding revaluation reserve); long-term loans and deposits repayable after one year (excluding working capital loans, over drafts, interest due on loans unless funded, bank guarantee, etc., and other short-term arrangements) as reduced by the aggregate of any investments (except in case of investment by an investment company whose principal business is acquisition of shares, stock, debentures or other securities), accumulated losses and preliminary expenses not written off.

Explanation II-(a) Where the appointment of the managerial person is made in the year in which company has been incorporated, the effective capital should be calculated as on the date of such appointment;

(b) In any other case the effective capital should be calculated as on the last date of the financial year preceding the financial year in which the appointment of the managerial person is made.

Explanation III - For the purposes of this Schedule, "family" means the spouse, dependent children and dependent parents of the managerial person.

Explanation IV-The Nomination and Remuneration Committee while approving the remuneration under Section II or Section III, should-

(a) take into account, financial position of the company, trend in the industry, appointee's qualification, experience, past performance, past remuneration, etc.;

(b) be in a position to bring about objectivity in determining the remuneration package while striking a balance between the interest of the company and the shareholders.

Explanation V–For the purposes of this Schedule, "negative effective capital" means the effective capital which is calculated in accordance with the provisions contained in Explanation I of this Part is less than zero.

Explanation VI -For the purposes of this Schedule:-

(A) "current relevant profit" means the profit as calculated under section 198 but without deducting the excess of expenditure over income referred to in sub-section 4 (I) thereof in respect of those years during which the managerial person was not an employee, director or shareholder of the company or its holding or subsidiary companies.

(B) "Remuneration" means remuneration as defined in clause 78 of section 2 and includes reimbursement of any direct taxes to the managerial person.

Section V - Remuneration payable to a managerial person in two companies:

Subject to the provisions of sections I to IV, a managerial person should draw remuneration from one or both companies, provided that the total remuneration drawn from the companies does not exceed the higher maximum limit admissible from anyone of the companies of which he is a managerial person.

Note: The appointment and remuneration referred to in Part I and Part II of this Schedule should be subject to approval by a resolution of the shareholders in general meeting.

Ascertainment of profit for managerial remuneration

As we have seen above that in case of a company having profits, managerial remuneration is calculated as a percentage on net profit. Such net profit is to be arrived in accordance with the provisions of Section 198 of the Companies Act, 2013.

As per Section 198 of the Companies Act, 2013,

(I) In making the computation aforesaid, credit should be given for the bounties and subsidies received from any Government, or any public authority constituted or authorised in this behalf, by any Government, unless and except in so far as the Central Government otherwise directs.

(II) In making the computation of the net profits, credit should not be given for the following sums, namely:—

(a) profits, by way of premium on shares or debentures of the company, which are issued or sold by the company

(b) profits on sales by the company of forfeited shares

(c) profits of a capital nature including profits from the sale of the undertaking or any of the undertakings of the company or of any part thereof

(d) profits from the sale of any immovable property or fixed assets of a capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling any such property or assets: Provided that where the amount for which any fixed asset is sold exceeds the written-down value thereof, credit should be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value

(e) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value

(III) In making the computation aforesaid, the following sums should be deducted, namely:—

(a) all the usual working charges

(b) directors' remuneration

(c) bonus or commission paid or payable to any member of the company's staff, or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis

(d) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits

(e) any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf

(f) interest on debentures issued by the company

(g) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets

(h) interest on unsecured loans and advances

(i) expenses on repairs, whether to immovable or to movable property, provided the repairs are not of a capital nature

(j) outgoings inclusive of contributions made under section 181 of the Act

(k) depreciation to the extent specified in section 123 of the Act

(l) the excess of expenditure over income, which had arisen in computing the net profits in accordance with this section in any year which begins at or after the commencement of this Act, in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained

(m) any compensation or damages to be paid in virtue of any legal liability including a liability arising from a breach of contract

(n) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in clause (m)

(o) debts considered bad and written off or adjusted during the year of account

(IV) In making the computation aforesaid, the following sums should not be deducted, namely:—

(a) income-tax and super-tax payable by the company under the Income-tax Act, 1961, or any other tax on the income of the company not falling under clauses (d) and (e) of sub-section (4)

(b) any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in clause (m) of sub-section (4)

(c) loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value

(d) any change in carrying amount of an asset or of a liability recognised in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value

Illustration 1

The following is the Draft Profit & Loss A/c of Mudra Ltd., the year ended 31st March, 20X1:

	₹		₹
To Administrative, Selling and		*By Balance b/d*	*5,72,350*
distribution expenses	*8,22,542*	*“ Balance from Trading A/c*	*40,25,365*
		“ Subsidies received from Govt.	*2,73,925*
” Directors fees	*1,34,780*		
” Interest on debentures	*31,240*		
” Managerial remuneration	*2,85,350*		
” Depreciation on fixed assets	*5,22,543*		
” Provision for Taxation	*12,42,500*		
” General Reserve	*4,00,000*		
” Investment Revaluation Reserve	*12,500*		
” Balance c/d	*14,20,185*		
	48,71,640		*48,71,640*

Depreciation on fixed assets as per Schedule II of the Companies Act, 2013 was ₹5,75,345. You are required to calculate the maximum limits of the managerial remuneration as per Companies Act, 2013.

Solution:

Calculation of net profit u/s 198 of the Companies Act, 2013

	₹	₹
Balance from Trading A/c		40,25,365
Add : Subsidies received from Government		2,73,925
		42,99,290
Less : Administrative, selling and distribution expenses	8,22,542	
Director's fees	1,34,780	
Interest on debentures	31,240	
Depreciation on fixed assets as per Schedule II	5,75,345	(15,63,907)
Profit u/s 198		27,35,383

Maximum Managerial remuneration under Companies Act, 2013= 11% of ₹27,35,383= ₹3,00,892

Illustration 2

The following extract of Balance Sheet of X Ltd. was obtained:

Balance Sheet (Extract) as on 31st March, 20X1

Liabilities	₹
Authorised capital:	
20,000, 14% preference shares of ₹100	*20,00,000*
2,00,000 Equity shares of ₹100 each	*2,00,00,000*
	2,20,00,000
Issued and subscribed capital:	
15,000, 14% preference shares of ₹100 each fully paid	*15,00,000*
1,20,000 Equity shares of ₹100 each, ₹80 paid-up	*96,00,000*
Share suspense account	*20,00,000*
Reserves and surplus	
Capital reserves (₹ 1,50,000 is revaluation reserve)	*1,95,000*
Securities premium	*50,000*
Secured loans:	
15% Debentures	*65,00,000*
Unsecured loans:	
Public deposits	*3,70,000*
Cash credit loan from SBI (short term)	*4,65,000*
Current Liabilities:	
Trade Payables	*3,45,000*
Assets:	
Investment in shares, debentures, etc.	*75,00,000*
Profit and Loss account(Dr.balance)	*15,25,000*

Share suspense account represents application money received on shares, the allotment of which is not yet made.

You are required to compute effective capital as per the provisions of Schedule V. Would your answer differ if X Ltd. is an investment company?

Solution

Computation of effective capital :

	Where X Ltd. is a non-investment company	*Where X Ltd. is an investment company*
	₹	₹
Paid-up share capital —		
15,000, 14% Preference shares	15,00,000	15,00,000
1,20,000 Equity shares	96,00,000	96,00,000
Capital reserves (1,95,000 – 1,50,000)	45,000	45,000
Securities premium	50,000	50,000
15% Debentures	65,00,000	65,00,000
Public Deposits	3,70,000	3,70,000
(A)	1,80,65,000	1,80,65,000
Investments	75,00,000	—
Profit and Loss account (Dr. balance)	15,25,000	15,25,000
(B)	90,25,000	15,25,000
Effective capital (A–B)	90,40,000	1,65,40,000

Illustration 3

Kumar Ltd., a non investment company has been incurring losses for the past few years. The company provides the following information for the current year:

	(₹ in lakhs)
Paid up equity share capital	120
Paid up Preference share capital	20
Reserves (including Revaluation reserve ₹ 10 lakhs)	150
Securities premium	40
Long term loans	40
Deposits repayable after one year	20
Application money pending allotment	720
Accumulated losses not written off	20
Investments	180

Kumar Ltd. has only one whole-time director, Mr. X. You are required to calculate the amount of maximum remuneration that can be paid to him as per provisions of Part II of Schedule XIII, if no special resolution is passed at the general meeting of the company in respect of payment of remuneration for a period not exceeding three years.

Solution

Calculation of effective capital and maximum amount of monthly remuneration

	(₹ in lakhs)
Paid up equity share capital	120
Paid up Preference share capital	20
Reserve excluding Revaluation reserve (150- 10)	140
Securities premium	40
Long term loans	40
Deposits repayable after one year	20
	380
Less: Accumulated losses not written off	(20)
Investments	(180)
Effective capital for the purpose of managerial remuneration	180

Since Kumar Ltd. is incurring losses and no special resolution has been passed by the company for payment of remuneration, managerial remuneration will be calculated on the basis of effective capital of the company, therefore maximum remuneration payable to the Managing Director should be @ ₹ 60,00,000 per annum.

Note: Revaluation reserve, and application money pending allotment are not included while computing effective capital of Kumar Ltd.

1.7 Divisible Profit

One of the important functions of company accounting is to determine the amount of profits which is available for distribution to the shareholders as dividend. This is necessary since the amount of profits disclosed by the Profit & Loss Account, in every case, is not available for distribution. The availability of profits for distribution depends on a number of factors, *e.g.*, their composition, the amount of provisions and appropriations that must be made out of them in priority, etc.

Meaning of Dividend

(a) A dividend is a distribution of divisible profit of a company among the members according to the number of shares held by each of them in the capital of the company and the rights attaching thereto.

(b) Such a distribution may or may not entail a release of assets; it would be where a distribution involves payment of cash.

(c) But when profits are capitalised and the amount distributed is applied towards payment of bonus shares, issued free to the shareholders, no part of the assets of the company can be said to have been released since, in such a case, profits are only capitalised, thereby increasing the paid up capital of the company. The company does not give up any asset.

As per Section 2 (35) of the Companies Act, 2013, term "Dividend" includes interim dividend also.

Under Section 123 (1) of the Companies Act, 2013, no dividend should be declared or paid by a company for any financial year except-

(a) Out of the profits of the company for that financial year arrived at after providing for depreciation in accordance with the provisions of section 123(2), or

(b) Out of the profits for any previous financial years arrived at after providing for depreciation in accordance with the provisions of that sub section and remaining undistributed; or

(c) Out of both the above;

(d) Out of the moneys provided by the Central Government or any State Government for the payment of dividend by the Company in pursuance of any guarantee given by that government

Provided that no dividend should be declared or paid by a company from its reserves other than free reserves.

Declaration of a dividend presupposes that there is a trading profit or a surplus available for distribution, arrived at after providing for depreciation on assets, not only for the year in which the profits were earned but also for any arrears of depreciation of the past years, calculated in the manner prescribed by sub-section (2) of Section 123.

Sub-section (3) of Section 124 further states that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared: Provided that in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

Dividends cannot be declared except out of profits.

Capital cannot be returned to the shareholders by way of dividend.

Dividend can be declared and paid by a company only out of the profits or free reserves (other than moneys provided by Central or State Govt.) as the payment of dividend from any other source will amount to payment of dividend from capital units.

Provision for Depreciation

Section 123(2) provides that depreciation must be to the extent specified in Schedule II to the Companies Act, 2013.Further, when the assets are sold, discarded, demolished or destroyed in any financial year, the excess of the written down value over its sale proceeds as scrap, if any should be written off in the same financial year.

Declaration and Payment of Dividend

For the purpose of second proviso to sub-section (1) of section 123, a company may declare dividend out of the accumulated profits earned by it in previous years and transferred by it to the reserves, in the event of inadequacy or absence of profits in any year, subject to the fulfillment of the following conditions as per Companies (Declaration and Payment of Dividend) Rules, 2014

(1) The rate of dividend declared should not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year: provided that this sub-rule should not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(2) The total amount to be drawn from such accumulated profits should not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The amount so drawn should first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(4) The balance of reserves after such withdrawal should not fall below 15% of its paid up share capital as appearing in the latest audited financial statement.

(5) No company should declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year the loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

Transfer to Reserves

I The Board of Directors are free and can appropriate a part of the profits to the credit of a reserve or reserves as per section 123 (1)of the Companies Act, 2013.

II Appropriation of a part of profit is sometimes made under law.

(a) For example, under the Banking Regulation Act, a fixed percentage of the profit of a banking company must first be transferred to the General Reserve before any dividend can be distributed.

(b) Transfer of a part of profit to a reserve is also necessary where the company has undertaken, at the time of raising of loan, that before any part of its profit is distributed, a specified percentage of the profit every year should be credited to a reserve for the repayment of the loan and until the time for repayment arrives, the amount should remain invested in a specified manner.

III Apart from appropriations aforementioned, it may also be necessary to provide for losses and arrears of depreciation and to exclude capital profit, as mentioned earlier, to arrive at the amount of divisible profit.

Declaration of Dividend

As per Section 123 of the Companies Act, 2013, Board of Directors of a company may declare dividend including interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared:

Provided that in case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend should not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

The amount of the dividend, including interim dividend, should be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend.

No dividend should be paid by a company in respect of any share therein except to the registered shareholder of such share or to his order or to his banker and should not be payable except in cash: Provided that nothing in Section 123 should be deemed to prohibit the capitalisation of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company:

Provided further that any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of the dividend.

Dividend on preference shares

(a) Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares.

(b) But such a right can be exercised subject to there being profits and the Directors recommending payment of the dividend.

Dividend on partly paid shares:

- A company may if so authorised by its Article, pay a dividend in proportion to the amount paid on each share (Section 51 of the Companies Act, 2013).

Calls in Advance

Calls paid in advance do not rank for payment of dividend.

Payment of Dividend

As per Section 124 of the Companies Act, 2013:

(1) Where a dividend has been declared by a company but has not been paid or claimed within thirty days from the date of the declaration to any shareholder entitled to the payment of the dividend, the company should, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account.

(2) The company should, within a period of ninety days of making any transfer of an amount under this section to the Unpaid Dividend Account, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

(3) If any default is made in transferring the total amount or any part thereof to the Unpaid Dividend Account of the company, it should pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of 12% per annum and the interest accruing on such amount should ensure to the benefit of the members of the company in proportion to the amount remaining unpaid to them.

(4) Any person claiming to be entitled to any money transferred to the Unpaid Dividend Account of the company may apply to the company for payment of the money claimed.

(5) Any money transferred to the Unpaid Dividend Account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer should be transferred by the company along with interest accrued, if any, thereon to the Fund "Investor Education and Protection Fund" established section 125 and the company should send a statement in the prescribed form of the details of such transfer to the authority which administers the said Fund and that authority should issue a receipt to the company as evidence of such transfer.

(6) All shares in respect of which unpaid or unclaimed dividend has been transferred to "Investor Education and Protection Fund" should also be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed:

Provided that any claimant of shares transferred above should be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.

(7) If a company fails to comply with any of the requirements of this section, the company will be punishable with fine which will not be less than five lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default will be punishable with fine which will not be less than one lakh rupees but which may extend to five lakh rupees.

Illustration 4

Due to inadequacy of profits during the year ended 31st March, 20X2, XYZ Ltd. proposes to declare 10% dividend out of general reserves. From the following particulars, ascertain the amount that can be utilised from general reserves, according to the Companies (Declaration of dividend out of Reserves) Rules, 2014:

	₹
17,500 9% Preference shares of ₹ 100 each, fully paid up	17,50,000
8,00,000 Equity shares of ₹ 10 each, fully paid up	80,00,000
General Reserves as on 1.4.20X1	25,00,000
Capital Reserves as on 1.4.20X1	3,00,000
Revaluation Reserves as on 1.4.20X1	3,50,000
Net profit for the year ended 31st March, 20X2	3,00,000

Average rate of dividend during the last five year has been 12%.

Solution

Amount that can be drawn from reserves for 10% dividend

10% dividend on ₹ 80,00,000		₹ 8,00,000
Profits available		
Current year profit	3,00,000	
Less: Preference dividend	(1,57,500)	(1,42,500)
Amount which can be utilised from reserves		6,57,500

Conditions as per Companies (Declaration of dividend out of Reserves) Rules, 20X1:

Condition I

Since 10% is lower than the average rate of dividend (12%), 10% dividend can be declared.

Condition II

Maximum amount that can be drawn from the accumulated profits and reserves should not exceed 10% of paid up capital plus free reserves ie. ₹ 12,25,000 [10% of (80,00,000+17,50,000+25,00,000)]

Condition III

The balance of reserves after drawl ₹18,42,500 (₹ 25,00,000 - ₹ 6,57,500) should not fall below 15 % of its paid up capital ie. ₹ 14,62,500 (15% of ₹ 97,50,000]

Since all the three conditions are satisfied, the company can withdraw ₹ 6,57,500 from accumulated reserves.(as per Declaration and Payment of Dividend Rules, 2014.)

Dividend Distribution Tax

1. Meaning

(a) The Finance Act, 1997, has introduced Chapter XIID (Sections 115O and 115Q) on "Special Provisions Relating to Tax on Distributed profits of Domestic Companies" [Hereinafter referred to as 'DDT' (Dividend Distribution tax)]. The ICAI has also issued Guidance Note on Accounting for Corporate Dividend Tax.

(b) The salient features of DDT are as below:

(i) DDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.

(ii) With effect from 1st Oct, 2014 dividend and income distribution tax is leviable on gross dividend / income and not on the net dividend / income distributed to shareholders and unit holders as per Income- tax Act, 1961.

(iii) The dividends chargeable to DDT may be out of the current profits or accumulated profits.

(iv) The rate of DDT is 15% (excluding surcharge of 12% plus secondary and higher education cess is (2+1) 3%).

(v) DDT should be payable even if no income-tax is payable by the domestic company on its total income.

(vi) DDT is payable to the credit of the Central Government within 14 days of

(a) declaration of any dividend,

(b) distribution of any dividend, or

(c) payment of any dividend.

whichever is the earliest.

(vii) DDT paid should be treated as the final payment of tax on the dividends and no further credit therefore should be claimed by the company or by any person in respect of the tax so paid.

(viii) The expression 'dividend' should have the same meaning as is given to 'dividend' in Section 2 of the Companies Act, 2013.

To make clear the understanding of the concept of grossing for calculation of CDT, an example has been given as follows:

Example

X Ltd., a domestic company, has distributed on 5th April 20X1, dividend of ₹230 lakh to its shareholders. Compute the Dividend Distribution tax payable by X Ltd.

Solution

Calculation of corporate dividend tax

Particulars	₹in lakh
Dividend distributed by X Ltd.	230
Add: Increase for the purpose of grossing up of dividend $\left[\frac{15}{100-15}\times 230\right]$	40.58
Gross dividend	270.59
Dividend distribution tax @ 15% [15% of ₹270.59 lakh]	40.59
Add: Surcharge@12%	4.88
	45.47
Add: Education cess@2% and SHEC@1%	1.36
Dividend Distribution tax	46.83

2. ***Accounting for DDT***

   ➢ ***As per AS 4 (Revised), Final dividend declared after the balance sheet date is recognised in the financial year in which it has been approved by the shareholder, i.e., there is no provision for dividend on the balance sheet date (to be disclosed by way of note only).In view of this, DDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year.***

3. ***Disclosure and Presentation of DDT in Financial Statements***

   ➢ ***Dividend on shares is an appropriation of profit which is not shown in the Statement of Profit and Loss as per the Schedule III to the Companies Act, 2013.***

It is shown as an appropriation or allocation of profit in the 'Notes to Accounts' of the 'Reserves and Surplus' item of the Balance sheet.

- ***Since dividends are appropriation to profits which is not the part of disclosure in the Statement of Profit and Loss, therefore, a question arises with regard to disclosure and presentation of DDT, as to whether the said tax should also be disclosed as appropriation or should be disclosed along with the normal income-tax provision for the year.***
- ***The liability in respect of DDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits***
- ***Since the DDT liability relates to distribution of profits as dividends which are disclosed as appropriation /allocation of profit in the 'Notes to Accounts' of 'Reserves and Surplus', it is appropriate that the liability in respect of DDT should also be disclosed therein.***
- ***It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.***
- ***DDT liability should be recognised in the accounts of the same financial year in which the dividend concerned is recognised.***
- ***DDT liability should be disclosed separately in the 'Notes to Accounts' of 'Reserves and Surplus', as follows:***

Dividend	***xxxxx***	
Dividend Distribution tax thereon	***xxxxx***	***xxxxx***

- ***The accounting treatment for Dividend Distribution tax in the financial statements of a company can be explained with the help of following:***

Example

On 31st March, 20X1 X Ltd. declared dividend amounting to ₹ 425 lacs for the year 20XX-20X1. The Dividend Distribution tax liability (15% of Corporate dividend tax including surcharge @ 12%, Education Cess @ 2% and SHEC @ 1% i.e. 17.304%) arises as per Income-tax Act,1961. In this case, calculate the grossing-up of dividend and separately disclosed the charge for DDT in the 'Notes to Accounts' of 'Reserves and Surplus'.

Solution

Calculation of grossing-up of dividend:

Particulars	*₹ in lacs*
Dividend distributed by X CO.	425

Add: Increase for the purpose of grossing up of dividend $\left[\frac{15}{100-15}\times 425\right]$	75
Gross dividend	500
Dividend distribution tax @ 17.304%	86.52

(An Extract)

- 'Notes to Accounts' of 'Reserves and Surplus'
- for the year ended 31st March, 20X1

	₹ (lacs)	*₹ (lacs)*
Dividend	425.00	
Dividend Distribution tax	86.52	511.52

The Dividend Distribution tax should be disclosed separately under, the head 'Other Current Liabilities'. The relevant extracts of the Balance Sheet of X Ltd. can be shown as follows:

Balance Sheet as on 31st March, 20X1

'Other Current Liabilities'	₹ (lacs)
Dividend declared	425.000
Declared Distribution tax	86.52

Illustration 5

The following is the Trial Balance of Omega Limited as on 31.3.20X2:

(Figures in ₹000)

	Debit		*Credit*
Land at cost	*220*	*Equity Capital (Shares of ₹ 10 each)*	*300*
Plant & Machinery at cost	*770*	*10% Debentures*	*200*
Trade Receivables	*96*	*General Reserve*	*130*
Inventories (31.3.X2)	*86*	*Profit & Loss A/c*	*72*
Bank	*20*	*Securities Premium*	*40*
Adjusted Purchases	*320*	*Sales*	*700*
Factory Expenses	*60*	*Trade Payables*	*52*
Administration Expenses	*30*	*Provision for Depreciation*	*172*
Selling Expenses	*30*	*Suspense Account*	*4*
Debenture Interest	*20*		
Interim Dividend Paid	*18*		
	1670		*1670*

Additional Information:

(i) The authorised share capital of the company is 40,000 shares of ₹ 10 each.

(ii) The company on the advice of independent valuer wish to revalue the land at ₹ 3,60,000.

(iii) Declared final dividend @ 10%.

(iv) Suspense account of ₹ 4,000 represents cash received for the sale of some of the machinery on 1.4.20X1. The cost of the machinery was ₹ 10,000 and the accumulated depreciation thereon being ₹ 8,000.

(v) Depreciation is to be provided on plant and machinery at 10% on cost.

You are required to prepare Omega Limited's Balance Sheet as on 31.3.20X2 and Statement of Profit and Loss with notes to accounts for the year ended 31.3.20X2 as per Schedule III. Ignore previous years' figures & taxation.

Solution

Omega Limited
Balance Sheet as at 31st March, 20X2

Particulars			*Note No.*	*(₹in 000)*
Equity and Liabilities				
1.	**Shareholders' funds**			
	a	Share capital	1	300
	b	Reserves and Surplus	2	500
2.	**Non-Current liabilities**			
	a	Long term borrowings	3	200
3.	**Current liabilities**			
	a	Trade Payables		52
	b	Other Current Liability	4	30
		Total		**1082**
Assets				
1.	**Non-current assets**			
	a	Fixed assets		
		i Tangible assets	5	880
2.	**Current assets**			
	a	Inventories		86
	b	Trade receivables		96
	c	Cash and bank balances		20
		Total		**1082**

Omega Limited

Statement of Profit and Loss for the year ended 31st March, 20X2

	Particulars	*Notes*	*(₹ in 000)*
I.	Revenue from operations		700
II.	Other Income	6	2
III	**Total Revenue**		**702**
IV	Expenses:		
	Purchases		320
	Finance costs	7	20
	Depreciation (10% of 760[2])		76
	Other expenses	8	120
	Total Expenses		**536**
V.	**Profit (Loss) for the period** (III – IV)		**166**

Notes to accounts

				(₹ in 000)
1.	**Share Capital**			
	Equity share capital			
	Authorised			
	40,000 shares of ₹ 10 each			400
	Issued & subscribed & called up			
	30,000 shares of ₹ 10 each			300
	Total			**300**
2.	**Reserves and Surplus**			
	Securities Premium Account			40
	Revaluation reserve (360 – 220)			140
	General reserve			130
	Profit & loss Balance			
	Opening balance	72		
	Profit for the period	166	238	
	Less: Appropriations			
	Interim Dividend		(18)	
	Final Dividend (300 x 10%)		(30)	190
				500
3.	**Long term borrowing**			
	10% Debentures			200

[2] 770 (Plant and machinery at cost) – 10 (Cost of plant and machinery sold)

4.	**Other Current Liability**		
	Dividend		30
5.	**Tangible assets**		
	Land		
	Opening balance	220	
	Add: Revaluation adjustment	140	
	Closing balance		360
	Plant and Machinery		
	Opening balance	770	
	Less: Disposed off	(10)	
		760	
	Less: Depreciation (172-8+76)	(240)	
	Closing balance		520
	Total		880
6.	**Other Income**		
	Profit on sale of machinery:		
	Sale value of machinery	4	
	Less: Book value of machinery (10-8)	(2)	2
7.	**Finance costs**		
	Debenture interest		20
8.	**Other expenses:**		
	Factory expenses	60	
	Selling expenses	30	
	Administrative expenses	30	120

Illustration 6

You are required to prepare Balance sheet and statement of Profit and Loss from the following trial balance of Haria Chemicals Ltd. for the year ended 31st March, 20X1.

Haria Chemicals Ltd.
Trial Balance as at 31st March, 20X1

Particulars	*₹*	*Particulars*	*₹*
Inventory	*6,80,000*	*Equity Shares*	
Furniture	*2,00,000*	*Capital (Shares of ₹10 each)*	*25,00,000*
Discount	*40,000*	*11% Debentures*	*5,00,000*
Loan to Directors	*80,000*	*Bank loans*	*6,45,000*
Advertisement	*20,000*	*Trade payables*	*2,81,000*
Bad debts	*35,000*	*Sales*	*42,68,000*
Commission	*1,20,000*	*Rent received*	*46,000*
Purchases	*23,19,000*	*Transfer fees*	*10,000*
Plant and Machinery	*8,60,000*	*Profit & Loss account*	*1,39,000*

Rentals	*25,000*	*Depreciation provision:*	
Current account	*45,000*	*Machinery*	*1,46,000*
Cash	*8,000*		
Interest on bank loans	*1,16,000*	*:*	
Preliminary expenses	*10,000*		
Fixtures	*3,00,000*		
Wages	*9,00,000*		
Consumables	*84,000*		
Freehold land	*15,46,000*		
Tools & Equipments	*2,45,000*		
Goodwill	*2,65,000*		
Trade receivables	*4,40,000*		
Dealer aids	*21,000*		
Transit insurance	*30,000*		
Trade expenses	*37,000*		
Distribution freight	*54,000*		
Debenture interest	*55,000*		
	85,35,000		*85,35,000*

Additional information: Closing Inventory on 31-3-20X1: ₹8,23,000.

Solution

Haria Chemicals Ltd.

Balance Sheet as at 31st March, 20X1

	Schedule *No.* *(1)*	*Rupees as at* the *end of*31st March 20X1 *(2)*
Equity and Liabilities		
(1) Shareholders' funds :		
(a) Share Capital	1	25,00,000
(b) Reserves and Surplus	2	7,40,000
(2) Non Current Liabilities		
(a) Long term borrowings	3	11,45,000
(3) Current Liabilities		
(a) Trade payables		2,81,000
Total		**46,66,000**

Assets			
(1)	**Non current assets**		
	Fixed Assets:		
	(a) Tangible assets	4	30,05,000
	(b) Intangible assets (goodwill)		2,65,000
(2)	**Current assets**		
	(a) Inventories		8,23,000
	(b) Trade receivables		4,40,000
	(c) Cash and bank balances	5	53,000
	(d) Short term loans and advances	6	80,000
	Total		**46,66,000**

Haria Chemicals Ltd.
Statement of Profit and Loss for the year ended 31st March, 20X1

		Schedule	***Figures***	
Revenue from operations			42,68,000	
Other income	(A)	7	56,000	
			43,24,000	
Expenses				
Cost of materials consumed		8	23,19,000	
Change in inventory of finished goods		9	(1,43,000)	
Employee benefit expenses		10	9,00,000	
Finance cost		11	1,71,000	
Other expenses	(B)	12	4,76,000	
			37,23,000	
Profit before tax (A – B)				6,01,000
Provision for tax				—
Profit for the period				6,01,000

Notes to Accounts

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

2. Reserves and Surplus

Balance as per last balance sheet	1,39,000
Balance in profit and loss account	6,01,000
	7,40,000

3. Long term Borrowings

11% Debentures	5,00,000
Bank loans (assumed long-term)	6,45,000
	11,45,000

4. Tangible Assets

	Gross block	*Depreciation*	*Net Block*
Freehold land	15,46,000		15,46,000
Furniture	2,00,000		2,00,000
Fixtures	3,00,000		3,00,000
Plant & Machinery	8,60,000	1,46,000	7,14,000
Tools & Equipment	2,45,000		2,45,000
Total	31,51,000	1,46,000	30,05,000

5. Cash and bank balances

Cash and cash equivalents	
Current account balance	45,000
Cash	8,000
Other bank balances	Nil
	53,000

6. Short-term loans and Advances

Loan to directors	80,000

7. Other Income

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

8. Cost of materials consumed

Purchases	23,19,000

9. Changes in inventory of finished goods, WIP & Stock in trade

Opening inventory	6,80,000	
Closing inventory	8,23,000	(1,43,000)

10. Employee benefit expense

Wages	9,00,000

11. Finance cost

Interest on bank loans	1,16,000
Debenture interest	55,000
	1,71,000

12. Other Expenses

Consumables	84,000
Preliminary expenses	10,000
Bad debts	35,000
Discount	40,000
Rentals	25,000
Commission	1,20,000
Advertisement	20,000
Dealers' aids	21,000
Transit insurance	30,000
Trade expenses	37,000
Distribution freight	54,000
	4,76,000

Illustration 7

You are required to prepare a Statement of Profit and Loss and Balance Sheet from the following Trial Balance extracted from the books of the International Hotels Ltd., on 31st March, 20X2:

	Dr.	*Cr.*
	₹	*₹*
Authorised Capital-divided into 5,000 6% Preference Shares of ₹100 each and 10,000 equity Shares of ₹100 each		*15,00,000*
Subscribed Capital -		
5,000 6% Preference Shares of ₹100 each		*5,00,000*
Equity Capital		*8,05,000*
Purchases - Wines, Cigarettes, Cigars, etc.	*45,800*	
- Foodstuffs	*36,200*	
Wages and Salaries	*28,300*	
Rent, Rates and Taxes	*8,900*	
Laundry	*750*	
Sales - Wines, Cigarettes, Cigars, etc.		*68,400*
- Food		*57,600*

Coal and Firewood	*3,290*	
Carriage and Cooliage	*810*	
Sundry Expenses	*5,840*	
Advertising	*8,360*	
Repairs	*4,250*	
Rent of Rooms		*48,000*
Billiard		*5,700*
Miscellaneous Receipts		*2,800*
Discount received		*3,300*
Transfer fees		*700*
Freehold Land and Building	*8,50,000*	
Furniture and Fittings	*86,300*	
Inventory on hand, 1st April, 20X1		
Wines, Cigarettes. Cigars, etc.	*12,800*	
Foodstuffs	*5,260*	
Cash in hand	*2,200*	
Cash with Bankers	*76,380*	
Preliminary and formation expenses	*8,000*	
2,000 Debentures of ₹100 each (6%)		*2,00,000*
Profit and Loss Account		*41,500*
Trade payables		*42,000*
Trade receivables	*19,260*	
Investments	*2,72,300*	
Goodwill at cost	*5,00,000*	
General Reserve		*2,00,000*
	19,75,000	*19,75,000*

Wages and Salaries Outstanding	*1,280*
Inventory on 31st March, 20X2	
Wines, Cigarettes and Cigars, etc.	*22,500*
Foodstuffs	*16,400*

Depreciation :

Furniture and Fittings @ 5% p.a. : Land and Building @ 2% p.a.

The Equity capital on 1st April, 20X1 stood at ₹7,20,000, that is 6,000 shares fully paid and 2,000 shares ₹60 paid. The directors made a call of ₹40 per share on 1st October 20X1. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued @ ₹90 per share as fully paid. The Directors declare a dividend of 8% on equity shares, transferring any amount that may be required from General Reserve. Ignore Taxation.

Solution

Statement of Profit and Loss of International Hotels Ltd.
for the year ended 31st March, 20X2

	Particulars	*Notes*	*Amount*
I.	Revenue from operations	10	1,83,200
II.	Other income (Discount received)		3,300
III.	**Total Revenue (I + II)**		**1,86,500**
IV.	**Expenses:**		
	Cost of materials consumed	11	25,060
	Purchases of Inventory-in-Trade	12	45,800
	Changes in inventories of finished goods work-in-progress and Inventory-in-Trade	13	(9,700)
	Employee benefits expense	14	29,580
	Other operating expenses	15	18,000
	Selling and administrative expenses	16	14,200
	Finance costs	17	12,000
	Depreciation and amortisation expense	18	21,315
	Other expenses	9	8,000
	Total expenses		**1,64,255**
V.	**Profit (Loss) for the period (III - IV)**		**22,245**

Balance Sheet of International Hotels Ltd. as on 31st March, 20X2

Particulars	*Note No*	*₹*
Equity and Liabilities		
1 Shareholders' funds		
a Share capital	1	13,00,000
b Reserves and Surplus	2	1,74,745
2 Non-current liabilities		
a Long-term borrowings	3	2,00,000
3 Current liabilities		
a Trade Payables	4	42,000

	b	Other current liabilities		5	1,07,280
			Total		**18,24,025**
ASSETS					
1	**Non-current assets**				
	a	Fixed assets			
		i Tangible assets		6	9,14,985
		ii Intangible assets (Goodwill)			5,00,000
	b	Non-current investments			2,72,300
2	**Current assets**				
	a	Inventories		7	38,900
	b	Trade receivables			19,260
	c	Cash and bank balances		8	78,580
			Total		**18,24,025**

Notes to accounts

			₹
1	**Share Capital**		
	Equity share capital		
	Authorised		
	10,000 Equity shares of ₹ 100 each		10,00,000
	Issued & subscribed		
	8,000 Equity Shares of ₹100 each		8,00,000
	Preference share capital		
	Authorised		
	5,000 6% Preference shares of ₹ 100 each		5,00,000
	Issued & subscribed		
	5,000 6% Preference shares of ₹ 100 each		5,00,000
	Total		**13,00,000**
2	**Reserves and Surplus**		
	Capital reserve [100 x (90 – 40)]		5,000
	General reserve	2,00,000	
	Less : Amount used to pay dividend	(30,255)	1,69,745
	Surplus (Profit & Loss A/c)	22,245	
	Add: Balance from previous year	41,500	
	Transfer from General Reserve (94,000 – 41,500)	30,255	

	Appropriations		
	Dividend declared	(94,000)	-
	Profit (Loss) carried forward to Balance Sheet	**0**	0
	Total		**1,74,745**
3	**Long-term borrowings**		
	Secured		
	6% Debentures		2,00,000
	Total		**2,00,000**
4	**Trade Payables**		42,000
5	**Other current liabilities**		
	Wages and Salaries Outstanding	1,280	
	Interest on debentures	12,000	13,280
	dividend payable		
	Preference Dividend (5,00,000 x 6%)		30,000
	Equity Dividend (8,00,000 x 8%)		64,000
	Total		**1,07,280**
6	**Tangible assets**		
	Freehold land & Buildings	8,50,000	
	Less: Depreciation	(17,000)	8,33,000
	Furniture and Fittings	86,300	
	Less: Depreciation	(4,315)	81,985
	Total		**9,14,985**
7	**Inventories**		
	Wines, Cigarettes & Cigars, etc.		22,500
	Foodstuffs		16,400
	Total		**38,900**
8	**Cash and bank balances**		
	Cash and cash equivalents		
	Cash at bank		76,380
	Cash in hand		2,200
	Other bank balances		Nil
	Total		**78,580**
9	**Other expenses**		
	Preliminary Expenses*		8,000
	Total		**8,000**

* As per AS 26, preliminary expenses are not shown in the balance sheet.

10	**Revenue from operations**		
	Sale of products		
	Wines, Cigarettes, Cigars etc.	68,400	
	Food	57,600	1,26,000
	Sale of services		
	Room Rent	48,000	
	Billiards	5,700	
	Transfer fees	700	
	Miscellaneous Receipts	2,800	
			57,200
	Total		**1,83,200**
11	**Cost of materials consumed**		
	Opening Inventory	5,260	
	Add: Purchases during the year	36,200	
	Less: Closing Inventory	(16,400)	25,060
	Total		**25,060**
12	**Purchases of Inventory-in-Trade**		
	Wines, Cigarettes etc.		45,800
	Total		**45,800**
13	**Changes in inventories of finished goods work-in-progress and Inventory-in-Trade**		
	Wines, Cigarettes etc.		
	Opening Inventory	12,800	
	Less: Closing Inventory	(22,500)	(9,700)
	Total		**(9,700)**
14	**Employee benefits expense**		
	Wages and Salaries	28,300	
	Add: Wages and Salaries Outstanding	1,280	29,580
	Total		**29,580**
15	**Other operating expenses**		
	Rent, Rates and Taxes		8,900
	Coal and Firewood		3,290
	Laundry		750
	Carriage and Cooliage		810
	Repairs		4,250
	Total		**18,000**

16	**Selling and administrative expenses**		
	Advertising		8,360
	Sundry Expenses		5,840
	Total		**14,200**
17	**Finance costs**		
	Interest on Debentures (2,00,000 x 6%)		12,000
	Total		**12,000**
18	**Depreciation and amortisation expense**		
	Land and Buildings (8,50,000 x 2%)	17,000	
	Furniture & Fittings (86,300 x 5%)	4,315	21,315
	Total		**21,315**

Illustration 8

From the following particulars furnished by Pioneer Ltd., prepare the Balance Sheet as at 31st March, 20X1 as required by Schedule III of the Companies Act. Give notes at the foot of the Balance Sheet as may be found necessary -

		Debit	*Credit*
		₹	*₹*
Equity Capital (Face value of ₹100)			*10,00,000*
Calls in Arrears		*1,000*	
Land		*2,00,000*	
Building		*3,50,000*	
Plant and Machinery		*5,25,000*	
Furniture		*50,000*	
General Reserve			*2,10,000*
Loan from State Financial Corporation			*1,50,000*
Inventory :			
Finished Goods	*2,00,000*		
Raw Materials	*50,000*	*2,50,000*	
Provision for Taxation			*68,000*
Trade receivables		*2,00,000*	
Advances		*42,700*	
Dividend Payable			*60,000*
Profit and Loss Account			*86,700*
Cash Balance		*30,000*	
Cash at Bank		*2,47,000*	
Loans (Unsecured)			*1,21,000*
Trade payables (For Goods and Expenses)			*2,00,000*
		18,95,700	*18,95,700*

The following additional information is also provided :

(1) 2,000 equity shares were issued for consideration other than cash.

(2) Trade receivables of ₹52,000 are due for more than six months.

(3) The cost of assets:

Building	*₹4,00,000*
Plant and Machinery	*₹7,00,000*
Furniture	*₹62,500*

(4) The balance of ₹1,50,000 in the loan account with State Finance Corporation is inclusive of ₹7,500 for interest accrued but not due. The loan is secured by hypothecation of the Plant and Machinery.

(5) Balance at Bank includes ₹2,000 with Perfect Bank Ltd., which is not a Scheduled Bank.

(6) The company had contract for the erection of machinery at ₹1,50,000 which is still incomplete.

Solution

Pioneer Ltd.
Balance Sheet as on 31st March, 20X1

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	9,99,000
	b	Reserves and Surplus	2	2,96,700
2		**Non-current liabilities**		
	a	Long-term borrowings	3	2,63,500
3		**Current liabilities**		
	a	Trade Payables		2,00,000
	b	Other current liabilities	4	67,500
	c	Short-term provisions	5	68,000
		Total		**18,94,700**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	6	11,25,000
2		**Current assets**		
	a	Inventories	7	2,50,000

b	Trade receivables	8	2,00,000
c	Cash and bank balances	9	2,77,000
d	Short-term loans and advances		42,700
	Total		**18,94,700**

Notes to accounts

			₹.
1	**Share Capital**		
	Equity share capital		
	Issued & subscribed & called up		
	10,000 Equity Shares of ₹100 each	10,00,000	
	(Of the above 2,000 shares have been issued for consideration other than cash)		
	Less: Calls in arrears	(1,000)	9,99,000
	Total		**9,99,000**
2	**Reserves and Surplus**		
	General Reserve		2,10,000
	Surplus (Profit & Loss A/c)		86,700
	Total		**2,96,700**
3	**Long-term borrowings**		
	Secured		
	Term Loans		
	Loan from State Financial Corporation (1,50,000 – 7,500)		1,42,500
	(Secured by hypothecation of Plant and Machinery)		
	Unsecured loan		1,21,000
	Total		**2,63,500**
4	**Other current liabilities**		
	Interest accrued but not due on loans (SFC)		7,500
	Dividend Payable		60,000
	Total		**67,500**
5	**Short-term provisions**		
	Provision for taxation		68,000
	Total		**68,000**
6	**Tangible assets**		
	Land		2,00,000
	Buildings	4,00,000	
	Less: Depreciation	(50,000) (b.f.)	3,50,000

	Plant & Machinery	7,00,000	
	Less: Depreciation	(1,75,000) (b.f.)	5,25,000
	Furniture & Fittings	62,500	
	Less: Depreciation	(12,500) (b.f.)	50,000
	Total		**11,25,000**
7	**Inventories**		
	Raw Material		50,000
	Finished goods		2,00,000
	Total		**2,50,000**
8	**Trade receivables**		
	Debts outstanding for a period exceeding six months		52,000
	Other Debts		1,48,000
	Total		**2,00,000**
9	**Cash and bank balances**		
	Cash and cash equivalents		
	Cash at bank		
	with Scheduled Banks	2,45,000	
	with others (Perfect Bank Ltd.)	2,000	2,47,000
	Cash in hand		30,000
	Other bank balances		Nil
	Total		**2,77,000**

Note: Estimated amount of contract remaining to be executed on capital account and not provided for ₹1,50,000. It has been assumed that the company had given this contract for purchase of machinery.

Summary

- Meaning of Company has been defined Companies Act,2013.
- Books of accounts should be maintained at Registered office of company.
- Proper books are not deemed to be kept if they do not provide a true and fair view of state of affairs of company.
- A number of Statutory Books have been prescribed under Companies Act which is to be maintained along with statistical books to keep a record of all transactions.
- Annual Return is to be filed by every company within 60 days of holding Annual general meeting.

- Financial statements of a company should be as per schedule III and they should give true and fair view.
- Managerial Remuneration calculated as a percentage on profit and is governed by various sections of the Companies Act, 2013 (namely Section 197 and Section 198) and Schedule V to the Companies Act, 2013.
- Following things have been dealt with under various sections :
    - Overall maximum managerial remuneration payable
    - Managerial remuneration in case of absence or inadequacy of profits
    - Remuneration payable to whole-time directors and part-time directors
    - Ascertaining net profit of company
    - Remuneration of manager
- Determining amount of profits available for distribution is an important function and depends on a number of factors, like their composition, the amount of provisions and appropriations that must be made out of them in priority, etc.
- Capital cannot be returned to shareholders by way of dividend.
- Appropriating a part of profits may be done as a result of decision of Board of directors or as per law.
- Dividend may be declared out of reserves subject to certain conditions. Dividends cannot be declared except out of profits. Dividend Distribution Tax is the amount charged on amount declared as dividend distributed or paid by such company by way of dividends (whether interim or otherwise).
- Capital reserves include reserves which are not intended for distribution and include profit prior to incorporation, on sale of fixed assets, profit on reissue of forfeited shares, credit balance in capital reduction account. In short only profits or a surplus of a capital nature can be credited to such a reserve.
- Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares.

Unit – 2 : Cash Flow Statement

Learning Objectives

After studying this unit, you will be able to:

- Define cash flow statement as per AS 3
- Differentiate operating, investing and financing activities
- Learn the various elements of cash and cash equivalents
- Prepare cash flow statement both by direct method and indirect method.

2.1 Introduction

Accounting Standard 3, Cash Flow Statements, was issued in March, 2004. It is based on cash concept of profit. Cash Flow refers both cash and cash equivalents. This statement provides relevant information in assessing a company's liquidity, quality of earnings and solvency.

Benefits:

(a) Cash flow statement provides information about the changes in cash and cash equivalents of an enterprise.

(b) Identifies cash generated from trading operations.

(c) The operating cash surplus which can be applied for investment in fixed assets.

(d) Portion of cash from operations is used to pay dividend and tax and the other portion is ploughed back.

(e) Very useful tool of planning.

Purpose:

Cash flow statements are prepared to explain the cash movements between two points of time.

Sources of Cash:

1. Issue of shares and debentures and raising long-term loan.
2. Sale of investments and other fixed assets.
3. Cash from operations (Net Operating Profit)
4. Decrease in Cash.

Applications of Cash

1. Redemption of preference shares and debentures and repayment of long-term loan.

2. Purchase of investments and other fixed assets.
3. Payment of tax.
4. Payment of dividend.
5. Increase in cash.
6. Loss on Operation (Net Operating Loss)

Note – Cash includes Bank A/c also. Increase in cash or decrease in cash is put in the applications and the sources respectively just to balance the cash flow statement.

At this juncture students may note that in cash flow statement changes in all balance sheet items are to be taken into consideration separately for explaining movement of cash.

2.2 Elements of Cash

As per AS 3, issued by the Council of the ICAI, 'Cash' include:

(i) Cash in hand,

(ii) Demand deposits with banks, and

(iii) Cash equivalents.

(a) Components

- 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
- Securities with short maturity period of, say, three months or less from the date of acquisition

(b) Objective

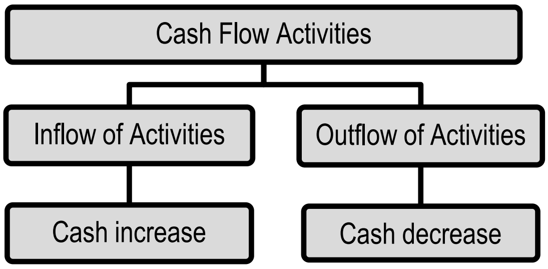
- Deploy, for a short period, idle cash required to meet short-term cash-commitments.

(c) Examples

- Acquisition of preference shares, shortly before their specified redemption date, bank deposits with short maturity period, etc.

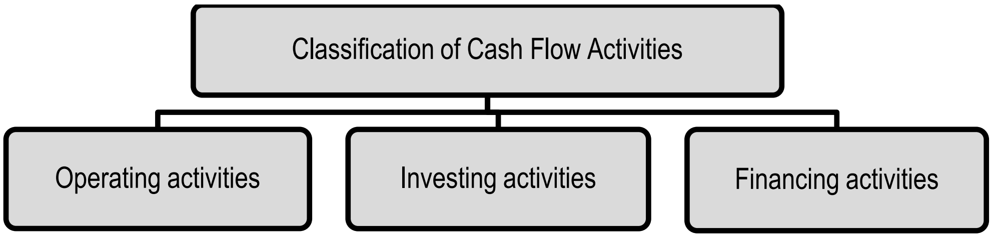
Conclusion: Thus, cash flow statement deals with flow of cash funds but does not consider the movements among cash, bank balance payable on demand and investment of excess cash in cash equivalents. Examples are cash withdrawn from current account, cash deposited in bank for 60 days, etc.

2.3 Classification of Cash Flow Activities


Cash Flow Activities
Inflow of Activities
Outflow of Activities
Cash increase
Cash decrease

AS 3 provides explanation for changes in cash position of the business entity.

As per Accounting Standard 3, cash flows during the period are classified as


Classification of Cash Flow Activities
Operating activities
Investing activities
Financing activities

2.3.1 Operating Activities

1. *Definition:* These are the principal revenue generating activities of the enterprise.
2. *Net Impact*: Net impact of operating activities on flow of cash is reported as 'Cash flows from operating activities' or 'cash from operation'.
3. *Key Indicator:* The amount of cash flows from operating activities is a key indicator of the extent to which the operations of the enterprises have generated sufficient cash flows to :

   (a) Maintain the operating capability of the enterprise,

   (b) Pay dividends, repay loans, and

   (c) Make new investments without recourse to external sources of financing.
4. *Information Provided:* It provides useful information about internal financing.
5. *Benefits:* Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

2.3.2 Investing activities

1. *Definition*: These are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

2. *Separate Disclosure*: Separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which the expenditures have been made for resources intended to generate future incomes and cash flows.

2.3.3 Financing activities

1. *Definition*: These are the activities that result in changes in the size and composition of the owner's capital (including preference share capital) and borrowings of the enterprise.
2. *Separate Disclosure*: The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

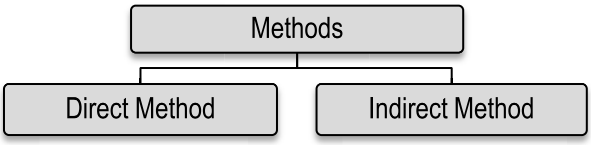
2.4 Calculation of Cash Flows from Operating Activities

1. *Components:* Cash flows from operating activities result from the transactions and other events that enter into the determination of net profit or loss.
2. *Examples*

   (a) cash receipts from the sale of goods and the rendering of services;

   (b) cash receipt from fees, commission and other revenue;

   (c) cash payments to suppliers for goods; cash payments to employees and so on.
3. *Methods*: An enterprise can determine cash flows from operating activities using either:



(a) Direct Method: The direct method, whereby major classes of gross cash receipts and gross cash payments are considered; or

(b) Indirect Method: The indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing activities.

2.4.1 Direct Method

1. Information Required

(a) Gross receipts and gross cash payments may be obtained from the accounting records to ascertain cash flows from operating activities.

(b) For example,

(i) information about cash received from trade receivables,

(ii) payment to trade payables, cash expenses etc., which may be obtained by an analysis of cash book.

(c) In actual practice, the relevant information is obtained by adjusting sales, cost of sales and other items in the profit and loss accounts for:

- Changes during the period in inventories and operating receivables and payables;
- Other non-cash items such as depreciation on fixed assets, goodwill written off, preliminary expenses written off, loss or gain on sale of fixed assets etc.; and
- Other items for which the cash effects are investing or financing cash flows. Examples are interest received and paid, dividend received and paid etc., which are related to financing or investing activities and are shown separately in the cash flow statement.
- This procedure of computation of cash flows from operating activities is also known as income statement method.

2. 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.

3. However, indirect method of determining the cash from operating activities is more popular in actual practice.

2.4.2 Indirect Method

Method of Determination

Under the indirect method, the net cash from operating activities is determined by adjusting net profit or loss instead of individual items appearing in the profit and loss account. Net profit or loss is also adjusted for the effect of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation; and

(c) all other items for which the cash effects are financing or investing cash flows.

(d) The indirect method is also known as 'reconciliation method'.

2.4.3 Conclusion

1. It is worth noting that both direct and indirect methods adjust current assets and current liabilities related to operating activities to determine cash from operating activities.
2. But direct method adjust individual items of profit and loss account and indirect method adjusts overall net profit (or loss) to determine cash from operation.

3. Therefore, indirect method fails to provide break-up of cash from operations.

Proforma of 'Cash Flow from Operating Activities' by indirect method

		₹
Net Profit for the year		-
Add: Non-Cash and Non-Operating Expenses:	-	
Depreciation	-	
Share Discount Written off	-	
Loss on Sale of Assets	-	
Provision for taxation, etc.	-	
Less: Non-Cash and Non-Operating Incomes:		
Profit on Sale of Assets	-	
Net Profit after Adjustment for Non-Cash Items	________	(-)

Cash from operation	=	Net Profit (after adjustment for Non-cash Items)
	-	Increase in Current Assets
	+	Decrease in Current Asset
	+	Increase in Current Liabilities
	-	Decrease in Current Liability

2.5 Calculation of Cash Flows from Investing Activities

1. These activities are related to the acquisition and disposal of long-term assets, non-operating current assets and investments which results in outflow of cash.
2. Disposal of the aforesaid assets results in inflow of cash.
3. Thus, inflows and outflows related to acquisition and disposal of assets, other than those related to operating activities, are shown under this category

2.6 Calculation of Cash Flows from Financing Activities

1. These activities are basically related to the changes in capital and borrowing of the enterprise which affect flow of cash.
2. Redemption of shares and repayment of borrowings results in outflow of cash.
3. Thus inflows and outflows related to the amount of capital and borrowings of the enterprise are shown under this head.

Students are advised to refer full text of revised Accounting Standard on Cash Flow Statements (AS 3) for the better understanding of the chapter.

2.7 Illustrations

Illustration 1

Following are the extracts of Balance Sheet of Ajay Ltd.:

Liabilities	*31.3.2014*	*31.3.2015*	*Assets*	*31.3.2014*	*31.3.2015*
	₹	₹			₹
Share Capital	*5,00,000*	*5,00,000*	*Discount on*		
15% Debentures	*5,00,000*	*7,50,000*	*issue of shares*	*1,15,000*	*90,000*
Unpaid Interest	*--*	*5,000*	*Discount on issue*		
Profit & Loss A/c	*50,000*	*90,000*	*of Debentures*	*90,000*	*1,15,000*

You are required to show the related items in Cash Flow Statement, if Discount on issue of Debentures amounting to ₹ 10,000 has been written off during the year.

Solution

An Extract of Cash Flow Statement for the year ending 31.3.2015

	₹
Closing balance as per Profit & Loss A/c	90,000
Less: Opening balance as per Profit & Loss Alc.	(50,000)
Add: Discount on issue of Shares	25,000
Add: Discount on issue of Debentures	10,000
Interest on Debentures	75,000
Net Cash from Operating Activities	1,50,000

Cash flows from financing activities:

Proceeds from debentures	2,15,000
Interest paid on Debentures [less unpaid]	(70,000)
Net Cash from Financing Activities	1,45,000

Working Note:

(i) Discount on issue of Debentures Account

Particulars	₹	*Particular*	₹
To Balance b/d	90,000	By Profit & Loss A/c (w/o)	10,000
To 15% Debentures A/c (Bal. fig.)	35,000	By Balance c/d	1,15,000
	1,25,000		1,25,000

(ii) 15% Debentures Account

Particulars	₹	Particular	₹
To Balance c/d	7,50,000	By Balance b/d	5,00,000
		By Bank A/c (Bal. fig.)	2,15,000
		By Discount on issue of Debentures A/c	35,000
	7,50,000		7,50,000

Illustration 2

From the following information, calculate cash flow from operating activities:

Summary of Cash Account
for the year ended March 31, 2015

Particulars	₹	*Particulars*	₹
To Balance b/d	*1,00,000*	*By Cash Purchases*	*1,20,000*
To Cash sales	*1,40,000*	*By Trade payables*	*1,57,000*
To Trade receivables	*1,75,000*	*By Office & Selling Expenses*	*75,000*
To Trade Commission	*50,000*	*By Income Tax*	*30,000*
To Sale of Investment	*30,000*	*By Investment*	*25,000*
To Loan from Bank	*1,00,000*	*By Repay of Loan*	*75,000*
To Interest & Dividend	*1,000*	*By Interest on loan*	*10,000*
		By Balance c/d	*1,04,000*
	5,96,000		*5,96,000*

Solution

Cash Flow Statement of ......
for the year ended March 31, 2015 (Direct Method)

Particulars	₹	₹
Operating Activities:		
Cash received from sale of goods	1,40,000	
Cash received from Trade receivables	1,75,000	
Trade Commission received	50,000	3,65,000
Less: Payment for Cash Purchases	1,20,000	
Payment to Trade payables	1,57,000	
Office and Selling Expenses	75,000	
Payment for Income Tax	30,000	(3,82,000)
Net Cash Flow used in Operating Activities		(17,000)

Illustration 3

The following summary cash account has been extracted from the company's accounting records:

Summary Cash Account

		(₹ '000)
Balance at 1.3.2014		*35*
Receipts from customers		*2,783*
Issue of shares		*300*
Sale of fixed assets		*128*
		3,246
Payments to suppliers	*2,047*	
Payments for fixed assets	*230*	
Payments for overheads	*115*	
Wages and salaries	*69*	
Taxation	*243*	
Dividends	*80*	
Repayments of bank loan	*250*	*(3,034)*
Balance at 31.12.2014		*212*

Prepare Cash Flow Statement of this company Hills Ltd. for the year ended 31st March, 2015 in accordance with AS-3 (Revised).

The company does not have any cash equivalents.

Solution

Hills Ltd.
Cash Flow Statement for the year ended 31st March, 2015
(Using direct method)

		(₹ '000)
Cash flows from operating activities		
Cash receipts from customers	2,783	
Cash payments to suppliers	(2,047)	
Cash paid to employees	(69)	
Other cash payments (for overheads)	(115)	
Cash generated from operations	552	
Income taxes paid	(243)	
Net cash from operating activities		309
Cash flows from investing activities		
Payments for purchase of fixed assets	(230)	
Proceeds from sale of fixed assets	128	

Net cash used in investing activities		(102)
Cash flows from financing activities		
Proceeds from issuance of share capital	300	
Bank loan repaid	(250)	
Dividend paid	(80)	
Net cash used in financing activities		(30)
Net increase in cash and cash equivalents		177
Cash and cash equivalents at beginning of period		35
Cash and cash equivalents at end of period		212

Illustration 4

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 2015:

Income Statement

		₹
Sales		*6,98,000*
Cost of Goods Sold		*(5,20,000)*
Gross Margin		*1,78,000*
Operating Expenses		
(including Depreciation Expense of ₹ 37,000)		*(1,47,000)*
		31,000
Other Income / (Expenses)		
Interest Expense paid	*(23,000)*	
Interest Income received	*6,000*	
Gain on Sale of Investments	*12,000*	
Loss on Sale of Plant	*(3,000)*	
		(8,000)
		23,000
Income tax		*(7,000)*
		16,000

Comparative Balance Sheets ₹

	31st March 2015	*31st March 2014*
Assets		
Plant Assets	*7,15,000*	*5,05,000*
Less: Accumulated Depreciation	*(1,03,000)*	*(68,000)*
	6,12,000	*4,37,000*

Investments (Long term)	*1,15,000*	*1,27,000*
Current Assets:		
Inventory	*1,44,000*	*1,10,000*
Accounts receivable	*47,000*	*55,000*
Cash	*46,000*	*15,000*
Prepaid expenses	*1,000*	*5,000*
	9,65,000	*7,49,000*
Liabilities		
Share Capital	*4,65,000*	*3,15,000*
Reserves and surplus	*1,40,000*	*1,32,000*
Bonds	*2,95,000*	*2,45,000*
Current liabilities:		
Accounts payable	*50,000*	*43,000*
Accrued liabilities	*12,000*	*9,000*
Income taxes payable	*3,000*	*5,000*
	9,65,000	*7,49,000*

Analysis of selected accounts and transactions during 2014-15

1. *Purchased investments for ₹ 78,000.*
2. *Sold investments for ₹ 1,02,000. These investments cost ₹ 90,000.*
3. *Purchased plant assets for ₹ 1,20,000.*
4. *Sold plant assets that cost ₹ 10,000 with accumulated depreciation of ₹ 2,000 for ₹ 5,000.*
5. *Issued ₹ 1,00,000 of bonds at face value in an exchange for plant assets on 31st March, 2015.*
6. *Repaid ₹ 50,000 of bonds at face value at maturity.*
7. *Issued 15,000 shares of ₹ 10 each.*
8. *Paid cash dividends ₹ 8,000.*

Prepare Cash Flow Statement as per AS-3 (Revised), using indirect method.

Solution

Ryan Ltd.
Cash Flow Statement
for the year ending 31st March, 2015

	₹	₹
Cash flows from operating activities		
Net profit before taxation	23,000	
Adjustments for:		

Depreciation	37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Interest expense	23,000	
Interest income	(6,000)	
Operating profit before working capital changes	68,000	
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Cash generated from operations	56,000	
Income taxes paid*	(9,000)	
Net cash generated from operating activities		47,000
Cash flows from investing activities		
Purchase of plant assets	(1,20,000)	
Sale of plant assets	5,000	
Purchase of investments	(78,000)	
Sale of investments	1,02,000	
Interest received	6,000	
Net cash used in investing activities		(85,000)
Cash flows from financing activities		
Proceeds from issuance of share capital	1,50,000	
Repayment of bonds	(50,000)	
Interest paid	(23,000)	
Dividends paid	(8,000)	
Net cash from financing activities		69,000
Net increase in cash and cash equivalents		31,000
Cash and cash equivalents at the beginning of the period		15,000
Cash and cash equivalents at the end of the period		46,000

***Working Note:**

	₹
Income taxes paid:	
Income tax expense for the year	7,000
Add: Income tax liability at the beginning of the year	5,000
	12,000
Less: Income tax liability at the end of the year	(3,000)
	9,000

Illustration 5

The balance sheets of Sun Ltd. for the years ended 31st March 2015 and 2014 were summarised as:

	2015 ₹	2014 ₹
Equity Share Capital	*60,000*	*50,000*
Reserves:		
Profit and Loss Account	*5,000*	*4,000*
Current Liabilities:		
Trade payables	*4,000*	*2,500*
Taxation	*1,500*	*1,000*
Dividends payable	*2,000*	*1,000*
	72,500	*58,500*
Fixed Assets (at w.d.v.)		
Premises	*10,000*	*10,000*
Fixtures	*17,000*	*11,000*
Vehicles	*12,500*	*8,000*
Short-term investments	*2,000*	*1,000*
Current Assets		
Inventory	*17,000*	*14,000*
Trade receivables	*8,000*	*6,000*
Bank and Cash	*6,000*	*8,500*
	72,500	*58,500*

The profit and loss account for the year ended 31st March, 2015 disclosed

	₹
Profit before tax	*4,500*
Taxation	*(1,500)*
Profit after tax	*3,000*
Declared dividends	*(2,000)*
Retained profit	*1,000*

Further information is available

	Fixtures ₹	Vehicles ₹
Depreciation for year	*1,000*	*2,500*
Disposals:		
Proceeds on disposal	—	*1,700*
Written down value	—	*(1,000)*
Profit on disposal		*700*

Prepare a Cash Flow Statement for the year ended 31st March, 2015.

Solution

Sun Ltd.
Cash Flow Statement
for the year ended 31st March, 2015

	₹	₹
Cash flows from operating activities		
Net Profit before taxation	4,500	
Adjustments for:		
Depreciation	3,500	
Profit on sale of vehicles	(700)	
Operating profit before working capital changes	7,300	
Increase in Trade receivables	(2,000)	
Increase in inventories	(3,000)	
Increase in Trade payables	1,500	
Cash generated from operations	3,800	
Income taxes paid	(1,000)	
Net cash generated from operating activities		2,800
Cash flows from investing activities		
Sale of vehicles	1,700	
Purchase of vehicles	(8,000)	
Purchase of fixtures	(7,000)	
Net cash used in investing activities		(13,300)
Cash flows from financing activities		
Issue of shares for cash	10,000	
Dividends paid	(1,000)	
Net cash from financing activities		9,000
Net decrease in cash and cash equivalents		(1,500)
Cash and cash equivalents at beginning of period (See Note 1)		9,500
Cash and cash equivalents at end of period (See Note 1)		8,000

Note to the Cash Flow Statement

Cash and Cash Equivalents

	31.3.2015	*31.3.2014*
Bank and Cash	6,000	8,500
Short-term investments	2,000	1,000
Cash and cash equivalents	8,000	9,500

Working Notes:

		₹
1.	Income taxes paid	
	Income tax expense for the year	1,500
	Add: Income tax liability at the beginning of the year	1,000
		2,500
	Less: Income tax liability at the end of the year	(1,500)
		1,000
2.	Dividend paid	
	Declared dividend for the year	2,000
	Add: Amount payable at the beginning of the year	1,000
		3,000
	Less: Amount payable at the end of the year	(2,000)
		1,000
3.	Fixed assets acquisitions	

	Fixtures ₹	*Vehicles* ₹
W.D.V. at 31.3.2015	17,000	12,500
Add back:		
Depreciation for the year	1,000	2,500
Disposals	—	1,000
	18,000	16,000
Less: W.D.V. at 31.12.2014	(11,000)	(8,000)
Acquisitions during 2014-2015	7,000	8,000

Illustration 6

Ms. Jyoti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year ended 31st March, 2015 :

	(₹ in lakhs)
Net Profit	*25,000*
Dividend (including dividend tax) paid	*8,535*
Provision for Income tax	*5,000*
Income tax paid during the year	*4,248*
Loss on sale of assets (net)	*40*
Book value of the assets sold	*185*

Depreciation charged to Profit & Loss Account	*20,000*
Profit on sale of Investments	*100*
Carrying amount of Investment sold	*27,765*
Interest income on investments	*2,506*
Interest expenses of the year	*10,000*
Interest paid during the year	*10,520*
Increase in Working Capital (excluding Cash & Bank Balance)	*56,081*
Purchase of fixed assets	*14,560*
Investment in joint venture	*3,850*
Expenditure on construction work in progress	*34,740*
Proceeds from calls in arrear	*2*
Receipt of grant for capital projects	*12*
Proceeds from long-term borrowings	*25,980*
Proceeds from short-term borrowings	*20,575*
Opening cash and Bank balance	*5,003*
Closing cash and Bank balance	*6,988*

Prepare the Cash Flow Statement for the year 2015 in accordance with AS 3. (Make necessary assumptions).

Solution

Star Oils Limited
Cash Flow Statement
for the year ended 31st March, 2015

(₹ in lakhs)

Cash flows from operating activities		
Net profit before taxation (25,000 + 5,000)	30,000	
Adjustments for :		
Depreciation	20,000	
Loss on sale of assets (Net)	40	
Profit on sale of investments	(100)	
Interest income on investments	(2,506)	
Interest expenses	10,000	

Operating profit before working capital changes	57,434	
Changes in working capital (Excluding cash and bank balance)	(56,081)	
Cash generated from operations	1,353	
Income taxes paid	(4,248)	
Net cash used in operating activities		(2,895)
Cash flows from investing activities		
Sale of assets	145	
Sale of investments (27,765 + 100)	27,865	
Interest income on investments	2,506	
Purchase of fixed assets	(14,560)	
Investment in joint venture	(3,850)	
Expenditure on construction work-in progress	(34,740)	
Net cash used in investing activities		(22,634)
Cash flows from financing activities		
Proceeds from calls in arrear	2	
Receipts of grant for capital projects	12	
Proceeds from long-term borrowings	25,980	
Proceed from short-term borrowings	20,575	
Interest paid	(10,520)	
Dividend (including dividend tax) paid	(8,535)	27,514
Net increase in cash and cash equivalents		1,985
Cash and cash equivalents at the beginning of the period		5,003
Cash and cash equivalents at the end of the period		6,988

Working note :

Book value of the assets sold	185
Less : Loss on sale of assets	(40)
Proceeds on sale	145

Assumption :

Interest income on investments ₹ 2,506 has been received during the year.

Illustration 7

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2015 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.

Summary Cash Account for the year ended 31.3.2015

	₹ '000		*₹ '000*
Balance on 1.4.2014	*50*	*Payment to Suppliers*	*2,000*
Issue of Equity Shares	*300*	*Purchase of Fixed Assets*	*200*
Receipts from Customers	*2,800*	*Overhead expense*	*200*
Sale of Fixed Assets	*100*	*Wages and Salaries*	*100*
		Taxation	*250*
		Dividend	*50*
		Repayment of Bank Loan	*300*
		Balance on 31.3.2015	*150*
	3,250		*3,250*

Solution

X Ltd.

Cash Flow Statement for the year ended 31st March, 2015

(Using direct method)

	₹ '000	*₹ '000*
Cash flows from operating activities		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	500	
Income tax paid	(250)	
Net cash generated from operating activities		250
Cash flows from investing activities		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	100	
Net cash used in investing activities		(100)
Cash flows from financing activities		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		(50)
Net increase in cash		100
Cash at beginning of the period		50
Cash at end of the period		150

Illustration 8

Given below is the Statement of Profit and Loss of ABC Ltd. and relevant Balance Sheet information:

Statement of Profit and Loss of ABC Ltd.
for the year ended 31st March, 2015

	₹ in lakhs
Revenue:	
Sales	*4,150*
Interest and dividend	*100*
Stock adjustment	*20*
Total (A)	*4,270*
Expenditure:	
Purchases	*2,400*
Wages and salaries	*800*
Other expenses	*200*
Interest	*60*
Depreciation	*100*
Total (B)	*3,560*
Profit before tax (A – B)	*710*
Tax provision	*200*
Profit after tax	*510*
Balance of Profit and Loss account brought forward	*50*
Profit available for distribution (C)	*560*
Appropriations:	
Transfer to general reserve	*200*
Declared dividend (including CDT)	*330*
Total (D)	*530*
Balance (C – D)	*30*

Relevant Balance Sheet information	*31.3.2015*	*31.3.2014*
	₹ in lakhs	*₹ in lakhs*
Trade receivables	*400*	*250*
Inventories	*200*	*180*

Trade payables	*250*	*230*
Outstanding wages	*50*	*40*
Outstanding expenses	*20*	*10*
Advance tax	*195*	*180*
Tax provision	*200*	*180*
Assessed tax liability		

Compute cash flow from operating activities using both direct and indirect method.

Solution

By direct method

Computation of Cash Flow from Operating Activities

	₹ in lakhs	*₹ in lakhs*
Cash Receipts:		
Cash sales and collection from Trade receivables		
Sales + Opening Trade receivables – Closing Trade receivables (A)	4,150 + 250 – 400	4,000
Cash payments:		
Cash purchases & payment to Trade payables		
Purchases + Opening Trade payables – Closing Trade payables	2,400 + 230 – 250	2,380
Wages and salaries paid	800 + 40 – 50	790
Cash expenses	200 + 10 – 20	190
Taxes paid – Advance tax		195
(B)		3,555
Cash flow from operating activities (A – B)		445
By indirect method		
Profit before tax		710
Add: Non-cash items : Depreciation		100
Add: Interest : Financing cash outflow		60
Less: Interest and Dividend : Investment cash inflow		(100)
Less: Tax paid		(195)
Working capital adjustments		
Trade receivables	250–400 (150)	

Inventories	180–200	(20)	
Trade payables	250–230	20	
Outstanding wages	50–40	10	
Outstanding expenses	20–10	10	(130)
Cash flow from operating activities			445

Illustration 9

Prepare Cash flow for Gamma Ltd., for the year ending 31.3.2014 from the following information:

(1) Sales for the year amounted to ₹ 135 crores out of which 60% was cash sales.

(2) Purchases for the year amounted to ₹ 55 crores out of which credit purchase was 80%.

(3) Administrative and selling expenses amounted to ₹ 18 crores and salary paid amounted to ₹ 22 crores.

(4) The Company redeemed debentures of ₹ 20 crores at a premium of 10%. Debenture holders were issued equity shares of ₹ 15 crores towards redemption and the balance was paid in cash. Debenture interest paid during the year was₹ 1.5 crores.

(5) Dividend paid during the year amounted to ₹ 11.7 crores(including Dividend distribution tax) was also paid.

(6) Investment costing ₹ 12 crores were sold at a profit of ₹ 2.4 crores.

(7) ₹ 8 crores was paid towards income tax during the year.

(8) A new plant costing ₹ 21 crores was purchased in part exchange of an old plant. The book value of the old plant was ₹ 12 crores but the vendor took over the old plant at a value of ₹ 10 crores only. The balance was paid in cash to the vendor.

(9) The following balances are also provided:

	₹ in crores *1.4.2013*	*₹ in crores* *31.3.2014*
Debtors	*45*	*50*
Creditors	*21*	*23*
Bank	*6*	

Answer

Gamma Ltd.

Cash Flow Statement for the year ended 31st March, 2014

(Using direct method)

Particulars	*₹ in crores*	*₹ in crores*
Cash flows from operating activities		
Cash sales (60% of 135)	81	
Cash receipts from Debtors [45+ (135x40%) - 50]	49	
Cash purchases (20% of 55)	(11)	
Cash payments to suppliers [21+ (55x80%) – 23]	(42)	
Cash paid to employees	(22)	
Cash payments for overheads (Adm. and selling)	(18)	
Cash generated from operations	37	
Income tax paid	(8)	
Net cash generated from operating activities		29
Cash flows from investing activities		
Sale of investments (12+ 2.40)	14.4	
Payments for purchase of fixed assets	(11)	
Net cash used in investing activities		3.4
Cash flows from financing activities		
Redemption of debentures (22-15)	(7)	
Interest paid	(1.5)	
Dividend paid	(11.7)	
Net cash used in financing activities		(20.2)
Net increase in cash		12.2
Cash at beginning of the period		6.0
Cash at end of the period		18.2

Summary

- Cash flow statement dealt under AS 3.
- Based on cash concept of profit.
- Benefits include providing information relating to changes in cash and cash equivalents of an enterprise.

- Useful tool of planning.
- Cash include :
  - (a) Cash in hand
  - (b) Demand deposits with banks
  - (c) Cash equivalents.
- Cash flow activities may be classified as inflow and outflow but as per AS-3 they are classified as Operating Activities, Investing activities, Financing activities.
- Operating activities are principal revenue generating activities.
- Investing Activities relate to acquisition and disposal of long-term assets and other investments.
- Financing Activities include the ones which result in changes in the size and composition of the owner's capital (including preference share capital) and borrowings of the enterprise.
- Methods to calculate cash flow from operating activities include:
  - (a) Direct Method
  - (b) Indirect Method also known as reconciliation method.
- In order to calculate cash flow from investing activities inflows and outflows related to acquisition and disposal of assets, other than those related to operating activities, are shown under this category.
- In order to calculate cash flow from financing activities inflows and outflows related to the amount of capital and borrowings of the enterprise are shown under this head.

3

Profit or Loss Pre and Post Incorporation

Learning Objectives

After studying this chapter, you will be able to:

- Understand the meaning of pre-incorporation profit or loss.
- Account for pre-incorporation profit or loss.
- Learn various methods for computing profit or loss prior to incorporation.

1. Introduction

When a running business is taken over by the promoters of a company, as at a date prior to the date of incorporation of company, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses. Such profits or losses, though belonging to the company or payable by it, are of capital nature; it is necessary to disclose them separately from trading profits or losses.

The general practice in this regard is that:

i. If there is a loss,

   a) it is either written off by debit to the Profit and Loss Account or to a special account described as "Loss Prior to Incorporation" and show as an "asset" in the Balance Sheet,

   b) Alternatively, it may be debited to the Goodwill Account.

ii. On the other hand, if a profit has been earned by business prior to the same being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to Capital Reserve Account or to the Goodwill Account, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.

2. Methods of Computing Profit or Loss Prior to Incorporation

The determination of such profit or loss would be a simple matter if it is possible to close the books and take the stock held by the business before the company came into existence. In such a case, the trial balance will be abstracted from the books and the profit or loss computed. Thereafter, the books will be either closed off or the balance allowed continuing undistributed; only the amount of profit or loss so determined being adjusted in the manner described above. When this is not possible, one or the other of the following methods will have to be followed for the purpose:

(1) The simplest, though not always the most expedient method is to close off old books and open new books with the assets and liabilities as they existed at the date of incorporation. In this way, automatically the result to that date will be adjusted, the difference between the values of assets and liabilities acquired and the purchase consideration being accounted for either as goodwill or as reserve.

The accounts, therefore, would relate exclusively to the post-incorporation period and any adjustment for the pre-incorporation period, whether an adjustment of profit or loss, would not be required.

(2) Since the decision to take over a business is usually reached long after the date from which it is agreed to be taken over it is normally not possible to follow any of the method aforementioned. The only alternative left, in the circumstances, is to split up the profit of the year of the transfer of the business to the company between 'pre' and 'post' incorporation periods. This is done either on the time basis or on the turnover basis or by a method which combines the two.

3. Basis of Apportionment

Item	***Basis of Apportionment between pre and Post incorporation period***
Gross Profit or Gross Loss	On the basis of turnover in the respective periods. Or On the basis of cost of goods sold in the respective periods in the absence of any information regarding turnover. Or On the basis of time in the respective periods in the absence of any information regarding turnover and cost of goods sold.
Variable expenses linked with Turnover [e.g. Carriage/Cartage outward, Selling and distribution expenses, Commission to selling agents/travelling agents, advertisement expenses, Bad debts (if actual bad debts for the two periods are not given), Brokerage, Sales Promotion.]	On the basis of Turnover in the pre and post incorporation.

Fixed Common charges [e.g. Salaries, Office and Administration Expenses, Rent, Rates and Taxes, Printing and Stationery, Telephone, Telegram and Postage, Depreciation, Miscellaneous Expenses]	On the basis of Time in the pre and post incorporation periods.
Expenses exclusively relating to pre-Incorporation period [e.g. Interest on Vendor's Capital]	Charge to pre-incorporation period but if the purchase consideration is not paid on taking over of business, interest for the subsequent period is charged to post incorporation period.
Expenses exclusively relating to post-incorporation period [e.g. Formation expenses, interest on debentures, director's fees, Directors' remuneration, Preliminary Expenses, Share issue Expenses, Underwriting commission, Discount on issue of securities.	Charge to Post-incorporation period
Audit Fees (i) For Company's Audit under the Companies Act. (ii) For Tax Audit under section 44AB of the Income tax Act, 1961	 Charge to Post-incorporation period On the basis of turnover in the respective periods.
Interest on purchase consideration to vendor: (i) For the period from the date of acquisition of business to date of incorporation. (ii) For the period from the date	 Charge to Pre-incorporation period Charge to Post-incorporation period

Let us take a small example for better understanding of apportionment on the basis of time ratio and sales ratio.

Example

Lion Ltd. was incorporated on 1.8.2014 to take over the running business of M/s Happy with assets from 1.4.2014. The accounts of the company were closed on 31.3.2015.

The average monthly sales during the first four months of the year (2014-15) was twice the average monthly sales during each of the remaining eight months.

Calculate time ratio and sales ratio for pre and post incorporation periods.

Solution

Time ratio:

Pre-incorporation period (1.4.2014 to 1.8.2015)	= 4 months
Post incorporation period (1.8.2015 to 31.3.2015)	= 8 months
Time ratio	= 4 : 8 or 1 : 2

Sales ratio:

Average monthly sale before incorporation was twice the average sale per month of the post incorporation period. If weightage for each post-incorporation month is x, then

Weighted sales ratio = 4 × 2x : 8 × 1x = 8x : 8x or 1 : 1

4. Pre-incorporation Profits & Losses

S. No	Pre-incorporation Profits	Pre-incorporation Losses
1.	It is transferred to **Capital Reserve Account** (i.e. capitalized).	It is treated as a part of **business acquisition cost** (Goodwill).
2.	It can be used for : • writing off Goodwill on acquisition • writing off Preliminary Expenses • writing down over-valued assets • issuing of bonus shares • paying up partly paid shares	It can be used for : • setting off against Post-incorporation Profit • addition to Goodwill on acquisition • writing off Capital Profit

Illustration 1

Bidyut Limited was incorporated on 1st July, 2014 to acquire from Bijli as and from 1st January, the individual business carried on by him. The purchase price of the fixed assets and goodwill was agreed to be the sum equal to 80% of the profits made each year on ascertainment of the sum due.

The following Trial Balance as on 31st Dec., 2014 is presented to you to enable you to prepare a Balance Sheet as at that date.

	Dr.	*Cr.*
	₹	₹
Share Capital - 1,500 equity shares of		
₹ 100 each, ₹ 80 paid up		*1,20,000*
Trade receivables	*82,000*	
Inventory on 31st Dec., 2014	*67,000*	
Cash at bank and on hand	*24,000*	

Directors' fee	*3,000*	
Preliminary expenses	*24,000*	
Trade Payables		*32,000*
Net Profit for the year after providing for all expenses under agreement entered into with Bijli		*48,000*
	2,00,000	*2,00,000*

Solution

Balance Sheet of M/s Bidyut Ltd. as on 31st Dec., 2014

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	1,20,000
	b	Reserves and Surplus	2	21,000
2		**Current liabilities**		
	a	Trade Payables		32,000
	b	Other Current liabilities		38,400
		Total		**2,11,400**
		Assets		
1		**Non-current assets**		
	a	Fixed assets	3	38,400
2		**Current assets**		
	a	Inventories		67,000
	b	Trade receivables		82,000
	c	Cash and cash equivalents		24,000
		Total		**2,11,400**

Notes to accounts

		₹
1	**Share Capital**	
	Equity share capital	
	Issued & Subscribed Capital	
	1,500 Equity Shares of ₹ 100 each, ₹ 80 paid up	1,20,000

2.	**Reserves and Surplus**			
	Capital Reserve (Pre incorporation profit)			24,000
	Profit and loss Account			
	Net Profit for the Year		24,000	
	Less: Directors' fee	3,000		
	Preliminary Expenses[*]	24,000	(27,000)	(3,000)
			Total	21,000
3.	**Fixed assets**			
	Goodwill and fixed assets (WN)			38,400

Working Note

	₹
Amount Payable to Bijli:	
Profit for the year	48,000
80% due as cost of goodwill, assets, etc.	38,400

Illustration 2

Inder and Vishnu, working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 2014 to take over their existing business. It was agreed that they would take over the assets of the partnership for a sum of ₹ 3,00,000 as from January 1st, 2014 and that until the amount was discharged they would pay interest on the amount at the rate of 6% per annum. The amount was paid on June 30, 2014. To discharge the purchase consideration, the company issued 20,000 equity shares of ₹ 10 each at a premium of ₹ 1 each and allotted 7% Debentures of the face value of ₹ 1,50,000 to the vendors at par.

The summarized Profit and Loss Account of the "Fellow Travellers Ltd." for the year ended 31st December, 2014 was as follows :

	₹		₹
To Purchase, including Inventory	*1,40,000*	*By Sales:*	
To Freight and carriage	*5,000*	*1st January to 31st May 2014*	*60,000*
To Gross Profit c/d	*60,000*	*1st June to 31st Dec., 2014*	*1,20,000*
		By Inventory in hand	*25,000*
	2,05,000		*2,05,000*
To Salaries and Wages	*10,000*	*By Gross profit b/d*	*60,000*

[*] As per para 56 of AS 26, "Intangible Assets" preliminary expenses should be charged fully to the statement of profit and loss of the year in which it is incurred. However this standard will be discussed in detail in Paper - 5: Advanced Accounting.

To Debenture Interest	*5,250*		
To Depreciation	*1,000*		
To Interest on purchase Consideration (up to 30-6-2014)	*9,000*		
To Selling commission	*9,000*		
To Directors' Fee	*600*		
To Preliminary expenses	*900*		
To Provision for taxes	*6,000*		
To Dividend on equity shares @ 5%	*5,000*		
To Balance c/d	*13,250*		
	60,000		*60,000*

Prepare statement apportioning the expenses and calculate profits/losses for the 'post' and 'pre-incorporation' periods and also show how these figures would appear in the Balance Sheet of the company.

Solution

Fellow Travellers Ltd.

Statement showing calculation of profit /losses for pre and post incorporation periods

		Ratio	*Pre-incorporation*	*Post-incorporation*
Gross profit allocated on the basis of sale		1:2	20,000	40,000
Less: Administrative Expenses allocated				
On time basis:				
(*i*) Salaries and wages	10,000			
(*ii*) Depreciation	1,000			
	11,000	5:7	4,583	6,417
Selling Commission on the basis of sales		1:2	3,000	6,000
Interest on Purchase Consideration				
(Time basis)		5:1	7,500	1,500
Expenses applicable wholly to the				
Post-incorporation period:				
Debenture Interest	5,250			
Director's Fee	600			5,850
Preliminary expenses				900
Balance c/d to Balance Sheet			4,917	19,333

Fellow Travellers Ltd.
Extract from the Balance Sheet as on 31st Dec., 2014

	Particulars	*Notes*	₹
	Equity and Liabilities		
1	**Shareholders' funds**		
a	Share capital	1	2,00,000
b	Reserves and Surplus	2	33,250
2	**Non-current liabilities**		
a	Long-term borrowings	3	1,50,000
3	**Current liabilities**		
a	Short term provisions	4	6,000
	Total		3,89,250

Notes to accounts

			₹
1.	**Share Capital**		
	20,000 equity shares of ₹ 10 each fully paid		2,00,000
2.	**Reserves and Surplus**		
	Profit Prior to Incorporation		4,917
	Securities Premium Account		20,000
	Profit and loss Account	19,333	
	Less: Provision for Tax[†]	(6,000)	
	Dividend on equity share[‡]	(5,000)	8,333
	Total		33,250
3.	**Long term borrowings**		
	Secured		
	7% Debentures		1,50,000
4.	**Other Current liabilities**		
	Provision for Taxes		6,000

[†] The entire amount of provision for tax has been considered to be related with company.

[‡] It is assumed that dividend has already been paid.

Illustration 3

The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 2014. The consideration was agreed at ₹ 1,17,00,000 based on the firm's Balance Sheet as at 31st December, 2013. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2014. Meanwhile the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of account were continued by the company which closed its account for the first time on 31st March, 2015 and prepared the following summarized profit and loss account.

			₹
Sales			*2,34,00,000*
Less:	*Cost of goods sold*	*1,63,80,000*	
	Salaries	*11,70,000*	
	Depreciation	*1,80,000*	
	Advertisement	*7,02,000*	
	Discounts	*11,70,000*	
	Managing Director's remuneration	*90,000*	
	Miscellaneous office expenses	*1,20,000*	
	Office-cum-show room rent	*7,20,000*	
	Interest	*9,51,000*	*2,14,83,000*
Profit			*19,17,000*

The company's only borrowing was a loan of ₹ 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.

The company was able to double the average monthly sales of the firm, from 1st April, 2014 but the salaries trebled from that date. It had to occupy additional space from 1st July, 2014 for which rent was ₹ 30,000 per month.

Prepare statement of apportioning cost and revenue between pre-incorporation and post-incorporation periods and calculation of profits/losses for such periods. Also, suggest how the pre-incorporation profits are to be dealt with.

Solution

MA (P) Ltd.

Statement showing calculation of profit/losses for pre and post incorporation periods

		Pre-inc.	*Post-inc.*
		₹	₹
Sales		26,00,000	2,08,00,000
Less:	Cost of goods sold	18,20,000	1,45,60,000
	Salaries	90,000	10,80,000
	Depreciation	36,000	1,44,000
	Advertisement	78,000	6,24,000
	Discounts	1,30,000	10,40,000
	M.D.'s remuneration	—	90,000
	Misc. Office Expenses	24,000	96,000
	Rent	90,000	6,30,000
	Interest	3,51,000	6,00,000
Net Profit/(Loss)		(19,000)	19,36,000

Working Notes:

(1) Calculation of ratio of sales:

Let the average sales per month in pre-incorporation period be x. Then the average sales in post-inc. period are 2x. Thus total sales are (3 × *x*) + (12 × 2*x*) or 27*x*. Ratio of sales will be 3*x* : 24*x* or 1:8.

Time ratio is 3 months : 12 months or 1:4

(2) Expenses apportioned on turnover ratio basis are cost of goods sold, advertisement, discounts.

(3) Expenses apportioned on time ratio basis are Depreciation, and misc. office expenses.

(4) Ratio for apportionment of Salaries:

If pre-incorporation monthly average is x, for 3 months 3x.

Average for balance 12 months 3x, for 12 months 36x.

Hence ratio for division, 1:12.

(5) Apportionment of Rent:

		₹
Total Rent		7,20,000
Additional rent for 9 months (From 1st July 2014 to 31st March, 2015)		(2,70,000)
Rent for old premises for 15 months at ₹ 30,000 p.m.		4,50,000
	Pre-inc.	Post-inc.
Old Premises	90,000	3,60,000
Additional rent	—	2,70,000
	90,000	6,30,000

Note on treatment

Since the profits prior to incorporation are in the negative, they would:

(*a*) Either be considered as a reduction from any capital reserve accruing in relation to the transaction, or

(*b*) Be treated as goodwill.

Illustration 4

ABC Ltd. was incorporated on 1.5.2014 to take over the business of DEF and Co. from 1.1.2014. The summarised Profit and Loss Account as given by ABC Ltd. for the year ending 31.12.2014 is as under:

Summarised Profit and Loss Account

	₹		₹
To Rent and Taxes	*90,000*	*By Gross Profit*	*10,64,000*
To Salaries including manager's salary of ₹ 85,000	*3,31,000*	*By Interest on Investments*	*36,000*
To Carriage Outwards	*14,000*		
To Printing and Stationery	*18,000*		
To Interest on Debentures	*25,000*		
To Sales Commission	*30,800*		
To Bad Debts (related to sales)	*91,000*		
To Underwriting Commission	*26,000*		
To Preliminary Expenses	*28,000*		
To Audit Fees	*45,000*		
To Loss on Sale of Investments	*11,200*		
To Net Profit	*3,90,000*		
	11,00,000		*11,00,000*

Prepare a Statement showing allocation of expenses and calculations of pre-incorporation and post-incorporation profits after considering the following information:

(i) G.P. ratio was constant throughout the year.

(ii) Sales for January and October were 1½ times the average monthly sales while sales for December were twice the average monthly sales.

(iii) Bad Debts are shown after adjusting a recovery of ₹ 7,000 of Bad Debt for a sale made in July, 2011.

(iv) Manager's salary was increased by ₹ 2,000 p.m. from 1.5.2014.

(v) All investments were sold in April, 2014.

(vi) The entire audit fees relates to company.

Solution

Pre-incorporation period is for four months, from 1st January, 2014 to 30th April, 2014. 8 months' period (from 1st May, 2014 to 31st December, 2014) is post-incorporation period.

Statement showing calculation of profit/losses for pre and post incorporation periods

	Pre-Inc ₹	*Post inc* ₹
Gross Profit	3,42,000	7,22,000
Interest on Investments	36,000	–
Bad debts Recovery	7,000	–
	3,85,000	7,22,000
Less : Rent and Taxes	30,000	60,000
Salaries		
Manager's salary	23,000	62,000
Other salaries	82,000	1,64,000
Printing and stationery	6,000	12,000
Audit fees	-	45,000
Carriage outwards	4,500	9,500
Sales commission	9,900	20,900
Bad Debts (91,000 + 7,000)	31,500	66,500
Interest on Debentures	–	25,000
Underwriting Commission	–	26,000
Preliminary expenses	–	28,000
Loss on sale of investments	11,200	–
Net Profit	1,86,900*	2,03,100

* Pre-incorporation profit is a capital profit and will be transferred to Capital Reserve.

Working Notes:

(i) Calculation of ratio of Sales

Let average monthly sales be *x*.

Thus Sales from January to April are 4½ *x* and sales from May to December are 9½ *x*.

Sales are in the ratio of 9/2*x* : 19/2*x* or 9 : 19.

(ii) Gross profit, carriage outwards, sales commission and bad debts written off have been allocated in pre and post incorporation periods in the ratio of Sales i.e. 9 : 19.

(iii) Rent, salaries, printing and stationery, audit fees are allocated on time basis.

(iv) Interest on debentures, underwriting commission and preliminary expenses are allocated in post incorporation period.

(v) Interest on investments, loss on sale of investments and bad debt recovery are allocated in pre-incorporation period.

Illustration 5

A company was incorporated on 1st July, 2014 to take over the business of Mr. M as and from 1st April, 2014. Mr. M's summarised Balance Sheet, as at that date was as under:

Liabilities	*₹*	*Assets*	*₹*
Trade Payables	*36,000*	*Building*	*80,000*
Capital	*1,94,000*	*Furniture and Fittings*	*10,000*
		Trade receivables	*90,000*
		Inventory	*30,000*
		Bank	*20,000*
	2,30,000		*2,30,000*

Trade receivables and Bank balances are to be retained by the vendor and Trade payables are to be paid off by him. Realisation of trade receivables will be made by the company on a commission of 5% on cash collected. The company is to issue M with 10,000 equity shares of ₹ 10 each, ₹ 8 per share paid up and cash of ₹ 56,000.

The company issued to the public for cash 20,000 equity shares of ₹ 10 each on which by 31st March, 2015 ₹ 8 per share was called and paid up except in the case of 1,000 shares on which the third call of ₹ 2 per share had not been realized. In the case of 2,000 shares, the entire face value of the shares had been realized. The share issue was underwritten for 2% commission, payable in shares fully paid up.

In addition to the balances arising out of the above, the following were shown by the books of accounts of the company on 31st March, 2015:

	₹
Discount (including ₹ 1,000 allowed on vendor's receivables)	*6,000*
Preliminary expenses	*10,000*
Directors' fee	*12,000*
Salaries	*48,000*
Trade receivables (including vendor's receivables)	*1,60,000*
Trade Payables	*48,000*
Purchases	*3,20,000*
Sales	*4,60,000*

Inventory on 31st March, 2015 was ₹ 52,000. Depreciation at 10% on Furniture and Fittings and at 5% on Building is to be provided. Collections from trade receivables belonging to the vendor were ₹ 60,000 in the period.

Prepare a Statement showing apportionment of expenses and calculation of profits for pre and post incorporation periods and balance sheet as on 31-3-2015.

Solution

Calculation of Gross Profit

		₹
Sales		4,60,000
Closing inventory		52,000
		5,12,000
Less: Opening inventory		30,000
Purchases		3,20,000
Gross Profit		1,62,000

Statement showing Calculation of profit/losses for pre and post incorporation periods

	Pre-Incorporation ₹	*Post-Incorporation* ₹
Gross Profit	40,500	1,21,500
Commission	-	3,000
	40,500	1,24,500
Less: Salaries	12,000	36,000
Directors' fee	-	12,000
Discount	1,250	3,750
Depreciation:		
Building	1,000	3,000

Furniture	250	750
Preliminary expenses*		10,000
Pre-incorporation Profit transferred to Capital Reserve Account	26,000	-
Net Profit	-	59,000

Note: Apportionment of expenses has been made in the Statement showing Profit and Loss for pre-incorporation and post-incorporation period using the following basis:

Item	*Base*	*Ratio*
Gross Profit	Time	1 : 3
Salaries	Time	1 : 3
Discount	Time	1 : 3
Directors' Fees		100% to post-incorporation period
Commission		100% to post-incorporation period

Balance Sheet as on 31.3.2015

	Particulars	*Notes*	*₹*
	Equity and Liabilities		
1	**Shareholders' funds**		
a	Share capital	1	2,42,000
b	Reserves and Surplus	2	69,000
2	**Current liabilities**		
a	Trade Payables	3	48,000
B	Other liabilities	4	4,000
	Total		**3,63,000**
	Assets		
1	**Non-current assets**		
a	Fixed assets		
	Tangible assets	5	85,000
2	**Current assets**		
a	Inventories		52,000
b	Trade receivables		1,31,000
c	Cash and cash equivalents		91,000
d	Other current assets	6	4,000
	Total		**3,63,000**

* As per para 56 of AS 26, preliminary expenses do not appear in the balance sheet.

Notes to accounts

			₹
1.	**Share Capital**		
	Equity share capital		
	30,000 equity shares of ₹ 10 each ₹ 8 called-up	2,40,000	
	(of the above 10,000 shares are allotted pursuant to a contract without payments being received in cash)		
	Less: Calls in Arrear	(2,000)	2,38,000
	Share Suspense A/c (400 shares to be issued to the underwriter in consideration of under-writing commission on completion of share issue)		4,000
	Total		**2,42,000**
2.	**Reserves and Surplus**		
	Capital reserve	26,000	
	Less: Goodwill written off	(16,000)	10,000
	Profit and loss Account		59,000
	Total		**69,000**
3.	**Trade payables**		48,000
4.	**Other current liabilities**		
	Calls in advance		4,000
5.	**Fixed assets**		
	Building	80,000	
	Less: Depreciation	(4,000)	76,000
	Furniture & Fittings	10,000	
	Less: Depreciation	(1,000)	9,000
	Total		**85,000**
6.	**Other current assets**		
	Underwriting Commission		4,000

Working Notes:

(1)	**Goodwill on acquisition**	₹	₹
	Purchase consideration:		
	10,000 equity shares of ₹ 10 each, ₹ 8 paid up		80,000
	Cash		56,000
			1,36,000
	Less: Assets taken over		
	Building	80,000	

Furniture and Fittings	10,000	
Inventory	30,000	(1,20,000)
Goodwill		16,000
(2) Cash Inflows from public issue of equity shares		₹
20,000 equity shares of ₹ 10 each ₹ 8 called up		1,60,000
Less: Calls in arrear on 1,000 shares @ ₹ 2 per share		(2,000)
		1,58,000
Add: Calls-in-advance on 2000 shares @ ₹ 2		4,000
		1,62,000
(3) Underwriting Commission 2% on face value ₹ 2,00,000		4,000

Underwriting Commission becomes due on completion of the job relating to shares underwritten. It appears that the job relating to public issue was not finished till 31st March, 2015. So a Share Suspense Account should be created showing the amount of shares to be issued to the underwriter in discharge of his claim for commission

(4) Cash collection from Company's receivables

Total Trade receivables Account

	Vendor's receivables	*Company's receivables*		*Vendor's receivables*	*Company's receivables*
	₹	₹		₹	₹
To Balance b/d	90,000	-	By Discount	1,000	5,000
To Sales		4,60,000[§]	By Cash	60,000	3,24,000[**]
			By Balance c/d	29,000	1,31,000[††]
	90,000	4,60,000		90,000	4,60,000

(5) Cash payment for purchases

Total Trade payables Account

	₹		₹
To Cash (Balancing figure)	2,72,000	By Purchases	3,20,000[‡‡]
To Balance c/d	48,000		
	3,20,000		3,20,000

[§] Assumed that all sales were on credit.

[**] Balancing figure.

[††] Total Trade receivables ₹ 1,60,000 minus Vendor's receivables ₹ 29,000.

[‡‡] Assumed that all purchases were on credit.

(6) **Summary Cash Book**

		₹			₹
To	Share Capital A/c	1,62,000	By	Total Trade Payables A/c	
To	Total Trade receivables A/c:			Payment to trade payables	2,72,000
	Collection from		By	Vendor's A/c:	
	company's receivables	3,24,000		Purchase consideration	56,000
	Collection from		By	Preliminary expenses	10,000
	vendor's receivables	60,000	By	Directors' Fee	12,000
			By	Salaries	48,000
			By	Vendor's A/c	
				(Collection less commission	
				₹ 3,000)	57,000
			By	Balance c/d	91,000
		5,46,000			5,46,000

5. Trade receivables and Trade Payables Suspense Accounts

As mentioned already, a company taking over a running business may also agree to collect its debts as an agent for the vendors and may further undertake to pay the trade payables on behalf of the vendors. In such a case, the trade receivables and trade payables of the vendors will be included in the accounts for the company by debit or credit to separate Total Accounts in the General Ledger to distinguish them from the trade receivables and trade payables of the business and contra entries will be made in corresponding Suspense Accounts. Also details of trade receivables' and trade payables' balance will be kept in separate ledgers. In order that the collections from trade receivables and payments of trade payables of vendors may not get mixed up with those of the company, it is a desirable procedure further to distinguish them by having separate columns for them in the Cash Book.

The book entries that should be passed for trade receivables in such a case are shown below:

1.	Debit Trade receivables A/c (or Total Debtors A/c) Credit trade receivables' Suspense A/c	for opening balance
2.	Debit Cash A/c	for cash received from trade receivables
	Debit Trade Receivables' Suspense A/c	for allowance etc. to trade receivables
	Credit Trade Receivables A/c	for cash and allowance etc.
3.	Debit Trade Receivables' Suspense A/c Credit Vendor A/c	for cash received from trade receivables for payable to vendors.

The vendor is thus treated as a trade payables for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his trade receivables and remitted the proceeds to the purchasing company.

For entries in respect of trade payables, the reverse of those outlined in respect of trade receivables will be passed. The vendor is considered a trade receivables in respect of cash paid to his trade payables by the purchasing company. The balance of the cash collected, less paid, will represent the amount due to or by the vendor, arising from trade receivables and trade payables' balances which have been taken over, subject to any collection expenses. The balance in the suspense accounts will be always equal to the amount of trade receivables and trade payables taken over remaining unadjusted at any time.

Illustration 6

Messrs. X, Y & Z, the balance sheet of whose business is given below transferred their business to a limited company with the same name on January 1, 2015. It was agreed that the company would take over the assets except cash and book debts at their book values, would pay ₹ 20,000 for the goodwill of business and would collect the book debts at a commission of 5%. Out of the collection from the trade receivables, the liabilities to trade payables would be first discharged as and when the amount is available, and the balance, if any, would be paid to vendors after six months. The partners undertook to pay off bank overdraft.

You are required to show the computation of the purchase consideration and the Vendors Collection Account, assuming that only ₹ 65,000 colected out of trade receivables' *balance and the remaining* trade receivables *were taken over by the vendors at the end of six months. Collection from* trade receivables *were : January, ₹ 30,000; February, ₹ 15,000; March, ₹ 10,000; April, ₹ 5,000; May, 5,000, June Nil.*

Summarised Balance Sheet of M/s X, Y, Z as on 31st December, 2014

Liabilities	*₹*	*₹*	*Assets*	*₹*
Capital Accounts of Partners:			*Land & Building*	*25,000*
X	*75,000*		*Machinery*	*1,50,000*
Y	*60,000*		*Inventory*	*60,000*
Z	*40,000*	*1,75,000*	*Trade receivables*	*75,000*
General reserve		*80,000*	*Cash*	*5,000*
Trade payables		*56,000*		
Bank overdraft		*4,000*		
		3,15,000		*3,15,000*

Solution

Purchase consideration payable:

		₹
Total of Assets		3,15,000
Add: Amount of Goodwill		20,000
		3,35,000
Less: Assets not taken over		
Cash balance	5,000	
Book debts	75,000	(80,000)
		2,55,000

Vendors Trade Receivables' (Debtors) Account

2015		₹	2015		₹
Jan. 1	To Balance of trade receivables taken over for collection	75,000	Jan.31	By Cash (Amount collected)	30,000
			Feb 28	By Cash (Amount collected)	15,000
			Mar. 31	By Cash (Amount collected)	10,000
			Apr. 30	By Cash (Amount collected)	5,000
			May 31	By Cash (Amount collected)	5,000
			June 30	By Balance transferred to Debtors' Suspense Account	10,000
		75,000			75,000

Trade Receivables' Suspense Account

2015		₹	2015		₹
Jan. 31	To Amount transferred to Vendors' Collection A/c	28,500	Jan. 1	By Balance of vendors' debtors taken over for collection	75,000
	To Commission A/c	1,500			
Feb. 28	To Amount transferred to Vendor's Collection A/c	14,250			
	To Commission A/c	750			
Mar. 31	To Amount transferred to Vendors' Collection A/c	9,500			
	To Commission A/c	500			
Apr. 30	To Amount transferred to	4,750			

	Vendors' Collection A/c				
	To Commission A/c	250			
May. 31	To Amount transferred to Vendors' Collection A/c	4,750			
	To Commission A/c	250			
June 30	To Amount transferred from Vendors' Debtors A/c	10,000			
		75,000			75,000

Trade Receivables' Suspense Account

2015		₹	*2015*		₹
Jan. 1	To Amount recoverable from vendors in respect of liabilities taken over	56,000	Jan. 31	By Vendors' Collection A/c	28,500
			Feb. 28	By Vendors' Collection A/c	14,250
			Mar. 31	By Vendors' Collection A/c	9,500
			Apr. 30	By Vendors' Collection A/c	3,750
		56,000			56,000

Vendors' Trade Payables (Creditors) Account

2015		₹	*2015*		₹
Jan. 31	To Cash	28,500	Jan. 1	By Amount payable on behalf of vendors	56,000
Feb. 28	To Cash	14,250			
Mar. 31	To Cash	9,500			
Apr. 30	To Cash	3,750			
		56,000			56,000

Vendors' Collection Account

2015		₹	*2015*		₹
Jan. 31	To Amount transferred to Creditors' Suspense A/c	28,500	Jan. 31	By Amount transferred from Debtors' Suspense A/c	28,500
Feb. 28	To Amount transferred to				
Feb. 28	To Creditors' Suspense A/c	14,250	Feb. 28	By Amount transferred from Debtors' Suspense A/c	14,250
Mar. 31	To Amount transferred to Creditors' Suspense A/c	9,500			
Apr. 30	To Amount transferred to Creditors' Suspense A/c	3,750	Mar. 31	By Amount transferred from Debtors' Suspense A/c	9,500

June 30	To	Cash (amt. paid to vendors)	5,750	Apr. 30	By	Amount transferred from Debtors' Suspense A/c	4,750
				May 31	By	Amount transferred from Debtors' Suspense A/c	4,750
			61,750				61,750

Summary

- Profit or loss of a business for the period prior to the date the company came into existence is referred to as Pre-Incorporation Profits or Losses.
- Generally there are two methods of computing Profit & Loss prior to Incorporation:
  i. One is to close off old books and open new books with the assets and liabilities as they existed at the date of incorporation. In this way, automatically the result to that date will be adjusted.
  ii. Other is to split up the profit of the year of the transfer of the business to the company between 'pre' and 'post' incorporation periods. This is done either on the time basis or on the turnover basis or by a method which combines the two.
- A company taking over a running business may also agree to collect its debts as an agent for the vendor and may further undertake to pay the creditor on behalf of the vendors. In such a case, the trade receivables and trade payables of the vendors will be included in the accounts for the company by debit or credit to separate total accounts in the General Ledger to distinguish them from the trade receivables and trade payables of the business and contra entries will be made in corresponding Suspense Accounts. Also details of debtors and creditors balance will be kept in separate ledger.
- The vendor is treated as a creditor for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he has himself collected cash from his debtors and remitted the proceeds to the purchasing company.
- The vendor is considered a debtor in respect of cash paid to his creditors by the purchasing company. The balance of the cash collected, less paid, will represent the amount due to or by the vendor, arising from debtors and creditors balances which have been taken over, subject to any collection expenses.
- The balance in the suspense accounts will be always equal to the amount of debtors and creditors taken over remaining unadjusted at any time.

4

Accounting for Bonus Issue

Learning Objectives

After studying this chapter, you will be able to:

- Understand the provisions relating to issue of bonus shares.
- Account for bonus shares.

1. Introduction

"Capitalisation of profits refers to the process of converting profits or reserves into paid up capital." A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to the members.

A bonus share may be defined as a free share of stock given to current shareholders in a company, based upon the number of shares that the shareholder already owns. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant. An issue of bonus shares is referred to as a bonus issue. Depending upon the constitutional documents of the company, only certain classes of shares may be entitled to bonus issues, or may be entitled to bonus issues in preference to other classes. No new funds are raised with a bonus issue. A bonus issue (or scrip issue) is a stock split in which a company issues new shares without charge in order to bring its issued capital in line with its employed capital (the increased capital available to the company after profits). This usually happens after a company has made profits, thus increasing its employed capital.

If the subscribed and paid up capital exceeds the authorised share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution authorising the issue of bonus shares is also required to be filed with the Registrar of Companies.

2. Provisions of the Companies Act, 2013

Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to Sub-section (1) of this section, a company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—

(i) its free reserves*;

(ii) the securities premium account; or

(iii) the capital redemption reserve account:

Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

As per Sections 52 (2) and 55 (4) of the Companies Act, the securities premium account and capital redemption reserve account may be applied by the company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares. Sub-section (2) of Section 63 provides that no company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless—

(a) it is authorised by its articles;

(b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(f) it complies with such conditions as may be prescribed.

Sub-section (3) of the Section also provides that the bonus shares shall not be issued in lieu of dividend.

As per Para 39 (i) of Table F given under Schedule I to the Companies Act, 2013, a company in general meeting may, upon the recommendation of the Board, resolve—

* *As per Section 2(43) of the Companies Act, 2013, "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend. Provided that—*

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

(i) (a) that it is desirable to capitalise any part of the amount for the time being standing to the credit of any of the company's reserve accounts, or to the credit of the profit and loss account, or otherwise available for distribution; and (b) that such sum be accordingly set free for distribution in the specified manner amongst the members who would have been entitled thereto, if distributed by way of dividend and in the same proportions.

(ii) The sum aforesaid shall not be paid in cash but shall be applied, subject to the provision contained in clause (iii), either in or towards— (a) paying up any amounts for the time being unpaid on any shares held by such members respectively; (b) paying up in full, unissued shares of the company to be allotted and distributed, credited as fully paid-up, to and amongst such members in the proportions aforesaid;

3. SEBI Regulations

A listed company or a company which intends to get its securities listed is also required to follow the provisions of the Securities and Exchange Board of India Act, 1992 and the rules and regulations made there under. Some of the important regulations regarding restrictions and conditions of bonus issue are as follows:

Conditions for Bonus Issue– Reg. 92 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

A listed company may issue bonus shares to its members if:

(a) it is authorised by its articles of association for issue of bonus shares, capitalisation of reserves, etc.:

Provided that if there is no such provision in the articles of association, the issuer shall pass are solution at its general body meeting making provisions in the articles of associations for capitalisation of reserve;

(b) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(c) it has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity and bonus;

(d) the partly paid shares, if any outstanding on the date of allotment, are made fully paid up

Restriction on bonus issue – Reg. 93 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

No issuer shall make a bonus issue of equity shares unless it has made reservation of equity shares of the same class in favour of the holders of outstanding [compulsorily] convertible debt instruments [,if any,] in proportion to the convertible part thereof. The equity shares [so] reserved for the holders of fully or partly [compulsorily] convertible debt instruments shall be issued at the time of conversion of such convertible debt instruments on the same terms or same proportion [at] which the bonus shares were issued.

Bonus shares only against reserves, etc. if capitalised in cash – Reg. 94 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

The bonus issue shall be made out of free reserves built out of the genuine profits or securities premium collected in cash only and reserves created by revaluation of fixed assets shall not be capitalised for the purpose of issuing bonus shares. The bonus share shall not be issued in lieu of dividend.

Completion of bonus issue – Reg. 95 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009

An issuer, announcing a bonus issue after the approval of its board of directors and not requiring shareholders' approval for capitalisation of profits or reserves for making the bonus issue, shall implement the bonus issue within fifteen days from the date of approval of the issue by its board of directors: Provided that where the issuer is required to seek shareholders' approval for capitalisation of profits or reserves for making the bonus issue, the bonus issue shall be implemented within two months from the date of the meeting of its board of directors wherein the decision to announce the bonus issue was taken subject to shareholders' approval.

Once the decision to make a bonus issue is announced, the issue can not be withdrawn.

4 Journal Entries

(A) **(1) Upon the sanction of an issue of bonus shares**

(a) Debit Capital Redemption Reserve Account

Debit Securities Premium Account

Debit Capital Reserve Account (realised in cash only)

Debit General Reserve Account

Debit Profit & Loss Account

(b) Credit Bonus to Shareholders Account.

(2) Upon issue of bonus shares

(a) Debit Bonus to Shareholders Account

(b) Credit Share Capital Account.

(B) **(1) Upon the sanction of bonus by converting partly paid shares into fully paid shares***

(a) Debit Capital Reserve Account (realised in cash only)

Debit General Reserve Account

Debit Profit & Loss Account

** As per Companies Act, 2013, the securities premium account and capital redemption reserve may be applied by the company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares.*

(b) Credit Bonus to Shareholders Account

(2) On making the final call due

(a) Debit Share Final Call Account

(b) Credit Share Capital Account.

(3) On adjustment of final call

(a) Debit Bonus to Shareholders Account

(b) Credit Share Final Call Account

Illustration 1

Following items appear in the trial balance of Bharat Ltd. (a listed company) as on 31st March, 2015:

	₹
40,000 Equity shares of ₹10 each	*4,00,000*
Capital Reserve (including 30,000 being profit on sale of machinery)	*75,000*
Capital Redemption Reserve	*25,000*
Securities Premium	*30,000*
General Reserve	*1,05,000*
Surplus i.e. credit balance of Profit and Loss Account	*50,000*

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

Solution

Journal Entries in the books of Bharat Ltd.

		Dr.	*Cr.*
		₹	₹
Capital Reserve A/c	Dr.	30,000	
Capital Redemption Reserve A/c	Dr.	25,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c	Dr.	15,000	
To Bonus to Shareholders A/c			1,00,000
(Bonus issue of one share for every four shares held, by utilising various reserves as per Board's resolution dated…….)			
Bonus to Shareholders A/c	Dr.	1,00,000	
To Equity Share Capital A/c			1,00,000
(Capitalisation of profit)			

Note: Capital reserve amounting ₹ 30,000 realised in cash can only be used for bonus issue.

Illustration 2

Following is the extract of the Balance Sheet of Solid Ltd. as at 31st March, 2015:

	₹
Authorised capital :	
10,000 12% Preference shares of ₹ 10 each	*1,00,000*
1,00,000 Equity shares of ₹ 10 each	*10,00,000*
	11,00,000
Issued and Subscribed capital:	
8,000 12% Preference shares of ₹ 10 each fully paid	*80,000*
90,000 Equity shares of ₹ 10 each, ₹ 8 paid up	*7,20,000*
Reserves and Surplus :	
General reserve	*1,60,000*
Revaluation reserve	*35,000*
Securities premium	*20,000*
Profit and Loss Account	*2,05,000*
Secured Loan:	
12% Debentures @ ₹ 100 each	*5,00,000*

On 1st April, 2015 the Company has made final call @ ₹ 2 each on 90,000 equity shares. The call money was received by 20th April, 2015. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue assuming that the company has passed necessary resolution at its general body meeting for increasing the authorised capital.

Solution

Solid Ltd.

Journal Entries

2015			Dr. ₹	Cr. ₹
April 1	Equity Share Final Call A/c	Dr.	1,80,000	
	To Equity Share Capital A/c			1,80,000
	(Final call of ₹ 2 per share on 90,000 equity shares due as per Board's Resolution dated....)			
April 20	Bank A/c	Dr.	1,80,000	
	To Equity Share Final Call A/c			1,80,000
	(Final Call money on 90,000 equity shares received)			

	Securities Premium A/c	Dr.	20,000	
	General Reserve A/c	Dr.	1,60,000	
	Profit and Loss A/c	Dr.	45,000	
	To Bonus to Shareholders A/c			2,25,000
	(Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated...)			
April 20	Bonus to Shareholders A/c	Dr.	2,25,000	
	To Equity Share Capital A/c			2,25,000
	(Capitalisation of profit)			

Balance Sheet (Extract) as on 30th April, 2015 (after bonus issue)

		Particulars	*Notes*	*Amount (₹)*
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	12,05,000
	b	Reserves and Surplus	2	1,95,000
2		**Non-current liabilities**		
	a	Long-term borrowings	3	5,00,000
		Total		**19,00,000**

Notes to Accounts

1	**Share Capital**	
	Equity share capital	
	Authorised share capital	
	1,25,000 Equity shares of ₹ 10 each	12,50,000
	Issued, subscribed and fully paid share capital	
	1,12,500 Equity shares of ₹ 10 each, fully paid (Out of above, 22,500 equity shares @ ₹ 10 each were issued by way of bonus) (A)	11,25,000
	Preference share capital	
	Authorised share capital	
	10,000 12% Preference shares of ₹ 10 each	1,00,000
	Issued, subscribed and fully paid share capital	
	8,000 12% Preference shares of ₹ 10 each (B)	80,000
	Total (A + B)	**12,05,000**
2	**Reserves and Surplus**	
	Revaluation Reserves	35,000

	Securities Premium	20,000	
	Less: Utilised for bonus issue	(20,000)	Nil
	General reserve	1,60,000	
	Less: Utilised for bonus issue	(1,60,000)	Nil
	Profit & Loss Account	2,05,000	
	Less: Utilised for bonus issue	(45,000)	1,60,000
	Total		**1,95,000**
3	**Long-term borrowings**		
	Secured		
	12% Debentures @ ₹ 100 each		5,00,000

SUMMARY

- Bonus Issue means an offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increasing the dividend payout.
- Bonus Issue is also known as a "scrip issue" or "capitalization issue".
- Bonus issue has following major effects :
  - ✓ Share capital gets increased according to the bonus issue ratio
  - ✓ Liquidity in the stock increases.
  - ✓ Effective Earnings per share, Book Value and other per share values stand reduced.
  - ✓ Markets take the action usually as a favourable act.
  - ✓ Market price gets adjusted on issue of bonus shares.
  - ✓ Accumulated profits get reduced.
- Bonus shares can be issued from following :
  - ✓ Free Reserves
  - ✓ Securities Premium
  - ✓ Capital Redemption Reserve.

5
Internal Reconstruction

Learning Objectives

After studying this chapter, you will be able to:

♦ Understand the meaning of term "reconstruction".

♦ Sub-divide and consolidate shares.

♦ Convert shares into stock and stock into shares.

♦ Account the adjustments made at the time of internal reconstruction.

1. Meaning of Reconstruction

When a company has been making losses for a number of years, the financial position does not present a true and fair view of the state of the affairs of the company. In such a company the assets are overvalued, the assets side of the balance sheet consists of fictitious assets, useless intangible assets and debit balance in the profit and loss account. Such a situation does not depict a true picture of financial statements and shows a higher net worth than what the real net worth ought to be. In short the company is over capitalized. Such a situation brings the need for reconstruction.

Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganize capital or to compound with creditors or to effect economies. Such a process is called ***internal reconstruction*** which is carried out without liquidating the company and forming a new one.

However, there may be external reconstruction. Wherever an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is external reconstruction. Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS-14.

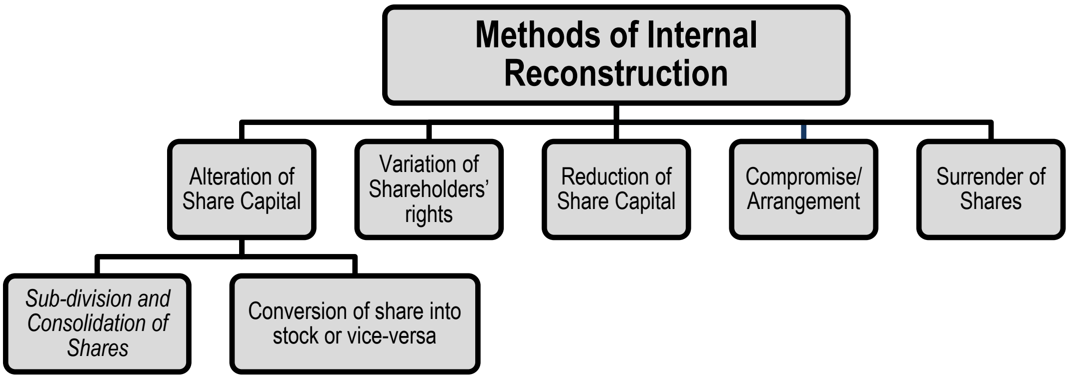
1.1 Difference Between Internal and External Reconstruction

Basis	Internal Reconstruction	External Reconstruction
Liquidation	The existing company is not liquidated.	The existing company is liquidated.
Formation	No new company is formed but only the rights of shareholders and creditors are changed.	A new company is formed to take over the liquidated company.
Reduction of capital	There is certain reduction of capital and sometimes the outside liabilities like debenture holders may have to reduce their claim.	There is no reduction of capital. In fact there is a fresh share capital of the company.
Legal position	Internal reconstruction is done as per provisions of section 100 of the Companies Act, 1956*.	External reconstruction is regulated by section 394 of the Companies Act, 1956*.

** The corresponding sections under Companies Act, 2013 related with these sections have been not been notified.*

2. Methods of Internal Reconstruction

For properly deploying the process of internal reconstruction following methods are generally employed or used simultaneously:


Methods of Internal Reconstruction
Alteration of Share Capital
Variation of Shareholders' rights
Reduction of Share Capital
Compromise/ Arrangement
Surrender of Shares
Sub-division and Consolidation of Shares
Conversion of share into stock or vice-versa

2.1 Alteration of Share Capital

Sub-division and Consolidation of Shares

If authorised by its Articles, a company may, in a general meeting by passing an ordinary resolution, decide to sub-divide or consolidate the shares into those of a smaller or higher denomination than that fixed by the Memorandum of Association, so long as the proportion between the paid up and unpaid amount, if any, on the shares continues to be the same as it was in the case of the original shares.

A notice specifying alteration made must be given to the Registrar within 30 days of alteration.

For example, a company with a capital of ₹ 10,00,000 divided into 10,000 equity shares of ₹ 100 each on which ₹ 75 is paid up decides to recognise its capital by splitting one equity share of ₹ 100 each into 10 such shares of ₹ 10 each. The consequential entry to be passed in such a case would be—

		Dr.	*Cr.*
		₹	₹
Equity Share Capital (₹ 100) A/c	Dr.	7,50,000	
To Equity Share Capital (₹ 10) A/c			7,50,000
(Being the sub-division of 10,000 shares of ₹ 100 each with ₹ 75 paid up thereon into 1,00,000 shares of ₹ 10 each with ₹ 7.50 paid up thereon as per the resolution of shareholders passed in the General Meeting held on...)			

Similar entries will be passed on consolidation of shares of a smaller amount into those of a larger amount.

Illustration 1

On 31-12-2012, B Ltd. had 20,000, ₹ 10 Equity Shares as authorised capital and the shares were all issued on which ₹ 8 was paid up. In June, 2013 the company in general meeting decided to *sub-divide* each share into two shares of ₹ 5 with ₹ 4 paid up. In June, 2014 the company in general meeting resolved to *consolidate* 20 shares of ₹ 5, ₹ 4 per share paid up into one share of ₹ 100 each, ₹ 80 paid up.

Pass entries and show how share capital will appear in notes to Balance Sheet as on 31-12-2012, 31-12-2013 and 31-12-2014.

Solution

Journal Entries

2013			₹	₹
June	Equity Share Capital (₹ 10) A/c	Dr.	1,60,000	
	To Equity Share Capital (₹ 5) A/c			1,60,000
	(Being the sub-division of 20,000 shares of ₹ 10 each with ₹ 8 paid up into 40,000 shares ₹ 5 each with ₹ 4 paid up by resolution in general meeting dated....)			

2014 June	Equity Share Capital (₹ 5) A/c Dr. To Equity Share Capital (₹ 100) A/c (Being consolidation of 40,000 shares of ₹ 5 with ₹ 4 paid up into 2,000 ₹ 100 shares with ₹ 80 paid up)	1,60,000	 1,60,000

Notes to Balance Sheet

Liabilities:	₹
As on 31-12-2012	
1. Share Capital	
Authorised:	
20,000 Equity Shares of ₹ 10 each	2,00,000
Issued and Subscribed:	
20,000 Equity Shares of ₹ 10 each ₹ 8 per share called up	1,60,000
As on 31-12-2013	
1. Share Capital	
Authorised:	
40,000 Equity Shares of ₹ 5 each	2,00,000
Issued and Subscribed:	
40,000 Equity Shares of ₹ 5 each ₹ 4 per share called up	1,60,000
As on 31-12-2014	*₹*
1. Share Capital	
Authorised:	
2,000 Equity Shares of ₹ 100 each	2,00,000
Issued and Subscribed:	
20,000 Equity Shares of ₹ 100 each ₹ 80 per share called up	1,60,000

Note: Some accountants prefer not to make any entry as the amount remains same. Even when an entry is passed it applies only to the called up portion, and not to uncalled or unissued portion of share capital.

Conversion of Fully Paid Shares into Stock and Stock into Shares

Stock is the consolidation of the share capital into one unit divisible into aliquot parts. While it is impossible of the share capital to be one share, any amount of stock may be transferred. In practice, however, companies restrict the transfer of stock to multiples of, say, ₹ 100. A company can convert its fully paid shares into stock. Upon the company converting its shares into stock, the book-keeping entries merely record the transfer from share capital account to stock account. A separate Stock Register is started in which details of members' holdings are entered and the annual return is modified accordingly.

Illustration 2

C Ltd. had ₹ 5,00,000 authorised capital on 31-12-2012 divided into shares of ₹ 100 each out of which 4,000 shares were issued and fully paid up. In June 22013 the Company decided to convert the issued shares into stock. But in June, 2014 the Company re-converted the stock into shares of ₹ 10 each, fully paid up.

Pass entries and show how Share Capital will appear in Notes to Balance Sheet as on 31-12-2012, 31-12-2013 and 31-12-2014.

Solution

Journal Entries

2013			₹	₹
June	Equity Share Capital A/c	Dr.	4,00,000	
	To Equity Stock A/c			4,00,000
	(Being conversion of 4,000 fully paid Equity Shares of ₹ 100 into ₹ 4,00,000 Equity Stock as per resolution in general meeting dated…)			
2014				
June	Equity Stock A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being re-conversion of ₹ 4,00,000 Equity Stock into 40,000 shares of ₹ 10 fully paid Equity Shares as per resolution in General Meeting dated...)			

Notes to Balance Sheet

Liabilities :	
As on 31-12-2012	₹
1. Share Capital	
Authorised	
5,000 Equity Shares of ₹ 100 each	5,00,000
Issued and Subscribed	
4,000 Equity Shares of ₹ 100 each fully called up	4,00,000
As on 31-12-2013	₹
1. Share Capital	
Authorised	

5,000 Equity Shares of ₹ 100 each	5,00,000
Issued and Subscribed	
Equity Stock-4,000 Equity Shares of ₹ 100 converted into Stock	4,00,000
As on 31-12-2014	₹
1. Share Capital	
Authorised	
50,000 Equity Shares of ₹ 10 each	5,00,000
Issued and Subscribed	
40,000 Equity Shares of ₹ 10 each fully called up	4,00,000

2.2 Variation of Shareholders Rights

When a company has issued different classes of shares with different rights or privileges attached to such shares e.g. rights as to dividend, voting rights etc. any of such right may be changed in any manner.

For example, the company may change rate of (a) dividend on preference shares or (b) convert cumulative preference shares into non-cumulative preference shares without changing the amount of share capital by passing the following journal entries:

(a) Debit (Old)% Cum. Pref. Share Capital Account
Credit (New)% Cum. Pref. Share Capital Account

(b) Debit ...% Cum. Pref. Share Capital Account
Credit ...% Non-cum. Pref. Share Capital Account

2.3 Reduction of Share Capital

Section 100 of the Companies Act, 1956[*] lays down the procedure in respect of reduction of share capital. One way of doing this is reducing the paid-up capital. The share capital of a company which has been suffering losses continuously for a long time, is not truly represented by its assets. In such a case, any scheme for capital reduction should write-off that portion of capital which is already lost.

This reduction is a sacrifice by the shareholders and the amount of reduction or sacrifice is credited to a new account called Capital Reduction Account (or Reconstruction Account). The accounting treatment is as follows:

Reduction in paid up value only- Here the nominal value of the share remains the same and only the paid value is reduced. For example, the shareholders may agree to reduce the paid capital of ₹ 100 per share to paid value of ₹ 10 per share. The sacrifice is ₹ 90 and the entry will be

[*] Corresponding Section 66 (Reduction of Share Capital) of the Companies Act, 2013 has not been notified.

Share Capital Account	Dr. (₹ 90 X No. of Shares)
To Capital Reduction Account	(₹ 90 X No. of Shares)

Reduction in both nominal and paid up values- In this case, both the paid up capital and nominal value of the shares are reduced. Continuing the above example, the entry will be:

Share Capital Account (₹ 100 Share)	Dr. (₹ 100 X No. of Shares)
To Share Capital (₹ 10 Share)	(₹ 10 X No. of Shares)
To Capital Reduction Account	(₹ 90 X No. of Shares)

Thus in such treatment we debit the original Share Capital Account so as to close it, credit new Share Capital Account with the amount treated as paid up; and credit Capital Reduction Account with the difference. A certified copy of Court's order and Minutes approved by the Court must be filed by the Registrar.

2.4 Compromise/Arrangements

A scheme of compromise and arrangement is an agreement between a company and its members and outside liabilities when the company faces financial problems. Such an arrangement therefore also involves sacrifices by shareholders, or creditors and debenture holders or by all.

Accounting treatment for some of the cases is as follows:

a) When equity shareholders give up there claim to reserves and accumulated profits:

Reserves Account	Dr.	(With the amount of
To Reconstruction Account		reserves)

b) Settlement of outside liabilities at lesser amount: Liabilities such as sundry creditors may agree to accept less amount in lieu of final settlement. Treatment will be as follows:

Outside Liabilities Account	Dr.	(With the amount of sacrifice
Provision Account, if any	Dr.	made by creditors, debenture
To Reconstruction Account		holders etc.)

2.5 Surrender of Shares

The shareholders are made to surrender their shares. These shares are then allotted to debenture holders and creditors so that their liabilities are reduced. The unutilized surrendered shares are then cancelled.

3. Entries in Case of Internal Reconstruction

On a scheme of reconstruction being adopted (through special resolution confirmed by the Court), the entries to be passed are:

1. An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to Capital Reduction Account (or Reconstruction Account).
2. Write off all fictitious assets (including Goodwill and Patents) and eliminate all over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account it should be transferred to the Capital Reserve Account.

While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:

(*a*) After the name of the company, the words **"and Reduced"** should be added *only* if the Court so orders.

(*b*) In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

Illustration 3

Following is the Draft Balance Sheet of ABC Ltd. Co. as at 31st March, 2015:

Liabilities	*₹*	*Assets*	*₹*
Share capital:		*Plant and machinery*	*9,00,000*
2,00,000 Equity shares of		*Furniture and fixtures*	*2,50,000*
₹ 10 each fully paid up	*20,00,000*	*Patents and copyrights*	*70,000*
6,000 8% Preference shares of ₹ 100 each	*6,00,000*	*Investments (at cost) (Market value ₹ 55,000)*	*68,000*
9% Debentures	*12,00,000*	*Inventory*	*14,00,000*
Bank overdraft	*1,50,000*	*Trade receivables*	*14,39,000*
Trade payables	*5,92,000*	*Cash and bank balance*	*10,000*
		Profit and Loss Account	*4,05,000*
	45,42,000		*45,42,000*

The following scheme of reconstruction was finalized:

(i) Preference shareholders would give up 30% of their capital in exchange for allotment of 11% Debentures to them.

(ii) *Debentureholders having charge on plant and machinery would accept plant and machinery in full settlement of their dues.*

(iii) Inventory *equal to ₹ 5,00,000 in book value will be taken over by trade payables in full settlement of their dues.*

(iv) *Investment value to be reduced to market price.*

(v) *The company would issue 11% Debentures for ₹ 3,00,000 to augment its working capital requirement after settlement of bank overdraft.*

Give necessary journal entries reflecting the above scheme of reconstruction in the books of the ABC Ltd. Co.

Solution

Journal Entries in the Books of ABC Ltd.

Particulars		₹	₹
8% Preference share capital A/c	Dr.	6,00,000	
To Preference shareholders A/c			4,20,000
To Capital reduction A/c			1,80,000
[Being 30% reduction in liability of preference share capital]			
Preference shareholders A/c	Dr.	4,20,000	
To 11% Debentures A/c			4,20,000
[Being the issue of debentures to preference shareholders]			
9% Debentures A/c	Dr.	12,00,000	
To Debenture holders A/c			12,00,000
[Being transfer of 9% debentures to debenture holders A/c]			
Debenture holders A/c	Dr.	12,00,000	
To Plant & machinery A/c			9,00,000
To Capital reduction A/c			3,00,000
[Settlement of debenture holders by allotment of plant & machinery]			
Trade payables A/c	Dr.	5,92,000	
To Inventory A/c			5,00,000
To Capital reduction A/c			92,000
[Being settlement of creditors by giving stocks]			
Bank A/c	Dr.	3,00,000	
To 11% Debentures A/c			3,00,000

[Being fresh issue of debentures]			
Bank overdraft A/c	Dr.	1,50,000	
To Bank A/c			1,50,000
[Being settlement of bank overdraft]			
Capital reduction A/c	Dr.	4,18,000	
To Investment A/c			13,000
To Profit and loss A/c			4,05,000
(Being decrease in investment and profit and loss account (Dr. bal.); transferred to capital reduction)			
Capital reduction A/c	Dr.	1,54,000	
To Capital reserve A/c			1,54,000
(Balance of capital reduction account transferred to capital reserve]			

Illustration 4

The Balance Sheet of A & Co. Ltd. as on 31-12-2014 is as follows:

Assets	₹	₹
Fixed Assets:		
Freehold property	*4,25,000*	
Plant	*50,000*	
Patent	*37,500*	
Goodwill	*1,30,000*	*6,42,500*
Traded Investments (at cost)		*55,000*
Current Assets:		
Trade receivables	*4,85,000*	
Inventory	*4,25,000*	*9,10,000*
Profit and Loss Account		*5,35,000*
Total		*21,42,500*

Liabilities		
Share Capital:		
4,000 6% Cumulative Preference Shares of ₹ 100 each	*4,00,000*	
75,000 Equity Shares of ₹ 10 each	*7,50,000*	*11,50,000*
6% Debentures (Secured on Freehold Property)	*3,75,000*	

Accrued Interest	*22,500*	*3,97,500*
Current Liabilities:		
Bank Overdraft	*1,95,000*	
Trade payables	*3,00,000*	
Directors' Loans	*1,00,000*	*5,95,000*
Total		*21,42,500*

The Court approved a Scheme of re-organisation to take effect on 1-1-2014, whereby:

(i) The Preference shares to be written down to ₹ 75 each and Equity Shares to ₹ 2 each.

(ii) Of the Preference Share dividends which are in arrears for four years, three fourths to be waived and Equity Shares of ₹ 2 each to be allotted for the remaining quarter.

(iii) Accrued interest on debentures to be paid in cash.

(iv) Debenture-holders agreed to take over freehold property, book value ₹ 1,00,000 at a valuation of ₹ 1,20,000 in part repayment of their holdings and to provide additional cash of ₹ 1,30,000 secured by a floating charge on company's assets at an interest rate of 8% p.a.

(v) Patents and Goodwill to be written off.

(vi) Inventory to be written off by ₹ 65,000.

(vii) Amount of ₹ 68,500 to be provided for bad debts.

(viii) Remaining freehold property to be re-valued at ₹ 3,87,500.

(ix) Trade Investments be sold for ₹ 1,40,000.

(x) Directors to accept settlement of their loans as to 90% thereof by allotment of equity shares of ₹ 2 each and as to 5% in cash, and balance 5% being waived.

(xi) There were capital commitments totalling ₹ 2,50,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.

(xii) Ignore taxation and cost of the scheme.

You are requested to show Journal entries reflecting the above transactions (including cash transactions) and prepare the Balance Sheet of the company after completion of the Scheme.

Solution

Journal of A & Co. Ltd.

			Dr.	*Cr.*
			₹	₹
2014	Equity Share Capital A/c (₹ 10)	Dr.	7,50,000	

Dec. 31	To Capital Reduction A/c			6,00,000
	To Equity Share Capital A/c (₹ 2)			1,50,000
	(Reduction of equity shares of ₹ 10 each to shares of ₹ 2 each as per Reconstruction Scheme dated...)			
	6% Cum. Preference Share Capital A/c (₹ 100)	Dr.	4,00,000	
	To Capital Reduction A/c			1,00,000
	To Pref. Share Capital A/c (₹ 75)			3,00,000
	(Reduction of preference shares of ₹ 100 each to shares of ₹ 75 each as per reconstruction scheme)			
2014	Freehold Property A/c	Dr.	82,500	
Dec. 31	To Capital Reduction A/c			82,500
	(Appreciation in the value of property:			
	Book value Revalued Figure			
	₹ 1,00,000 ₹ 1,20,000			
	₹ 3,25,000 ₹ 3,87,500			
	Total ₹ 4,25,000 ₹ 5,07,500			
	Profit on revaluation: ₹ 82,500)			
”	6% Debentures A/c	Dr.	1,20,000	
	To Freehold Property A/c			1,20,000
	(Claims of debenture-holders, in part, in respect of principal discharged by transfer of freehold property vide Scheme of Reconstruction)			
	Accrued Interest A/c	Dr.	22,500	
	To Bank A/c			22,500
	(Debenture interest paid)			
”	Bank A/c	Dr.	1,30,000	
	To 8% Debentures A/c			1,30,000
	(8% Debentures issued for cash)			
”	Bank A/c	Dr.	1,40,000	
	To Trade Investment A/c			55,000
	To Capital Reduction A/c			85,000
	(Sale of Trade Investment for ₹ 1,40,000 cost being ₹ 55,000; profit credited to Capital Reduction Account)			
”	Directors’ Loan A/c	Dr.	1,00,000	

	To Equity Share Capital A/c			90,000
	To Bank A/c			5,000
	To Capital Reduction A/c			5,000
	(Directors' loan discharged by issue of equity shares of ₹ 90,000, cash payments of ₹ 5,000 and surrender of ₹ 5,000, vide Scheme of Reconstruction)			
Dec. 31	Capital Reduction Account	Dr.	24,000	
	To Equity Share Capital Account			24,000
	(Arrears of preference dividends satisfied by the issue of equity shares, 25% of the amount due, ₹ 96,000)			
"	Capital Reduction A/c	Dr.	8,48,500	
	To Patents			37,500
	To Goodwill			1,30,000
	To Inventory			65,000
	To Provision for Doubtful Debts			68,500
	To Bank			12,500
	To Profit & Loss Account			5,35,000
	(Writing off patents, goodwill, profit and loss account and reducing the value of stock, making the required provision for doubtful debts and payment for cancellation of capital commitments)			

Balance Sheet of A & Co. Ltd. (And Reduced) as on 1st January, 2015

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	5,64,000
2		**Non-current liabilities**		
	a	Long-term borrowings	2	3,85,000
3		**Current liabilities**		
	a	Trade Payables		3,00,000
	b	Short term provision	**3**	68,500
		Total		**13,17,500**

		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	4	4,37,500
		Intangible assets	5	-
2		**Current assets**		
	a	Inventories		3,60,000
	b	Trade receivables	6	4,85,000
	c	Cash and cash equivalents		35,000
		Total		**13,17,500**

Notes to accounts

1	Share Capital		
	Equity share capital 1,32,000 Equity shares of ₹ 2 each (of the above 45,000 shares have been issued for consideration other than cash)		2,64,000
	Preference share capital		
	4,000 6% Preference shares of ₹ 75 each		3,00,000
	Total		**5,64,000**
2	**Long-term borrowings**		
	Secured		
	6% Debentures		2,55,000
	8% Debentures		1,30,000
	Total		**3,85,000**
3	**Short term provision**		
	Provision for doubtful debt		68,500
4	**Tangible assets**		
	Fixed assets		
	Tangible assets		
	Freehold property	4,25,000	
	Add: Appreciation under scheme of Reconstruction	82,500	
	Less: Disposed of	(1,20,000)	3,87,500
	Plant		50,000

	Patents	37,500	
	Less: Written off under scheme of Reconstruction	(37,500)	-
	Net carrying value		**4,37,500**
5	**Intangible assets**		
	Goodwill	1,30,000	
	Less: Written off under scheme of Reconstruction	(1,30,000)	
	Net carrying value	-	-
6	**Trade receivables**		
	Trade receivables		4,85,000

Illustration 5

Given below is the summarized balance sheet of Rebuilt Ltd. as on 31.3.2015:

Liabilities	*Amount* ₹	*Assets*	*Amount* ₹
Authorised and issued capital:		*Building at cost less depreciation*	*4,00,000*
12,000, 7% Preference shares of ₹ 50 each(Note: Preference dividend is in arrear for five years)	*6,00,000*	*Plant at cost less depreciation*	*2,68,000*
15,000 Equity shares of ₹ 50 each	*7,50,000*	*Trademarks and*	
	13,50,000	*goodwill at cost*	*3,18,000*
Loan	*5,73,000*	*Inventory*	*4,00,000*
Trade payables	*2,07,000*	*Trade receivables*	*3,28,000*
Other liabilities	*35,000*	*Profit and loss A/c*	*4,51,000*
	21,65,000		*21,65,000*

The Company is now earning profits short of working capital and a scheme of reconstruction has been approved by both the classes of shareholders. A summary of the scheme is as follows:

(a) The equity shareholders have agreed that their ₹ 50 shares should be reduced to ₹ 2.50 by cancellation of ₹ 47.50 per share. They have also agreed to subscribe for three new equity shares of ₹ 2.50 each for each equity share held.

(b) The preference shareholders have agreed to cancel the arrears of dividends and to accept for each ₹ 50 share, 4 new 5% preference shares of ₹ 10 each, plus 6 new equity shares of ₹ 2.50 each, all credited as fully paid.

(c) Lenders to the company for ₹ 1,50,000 have agreed to convert their loan into share and for this purpose they will be allotted 12,000 new preference shares of ₹ 10 each and 12,000 new equity shares of ₹ 2.50 each.

(d) The directors have agreed to subscribe in cash for 40,000, new equity shares of ₹ 2.50 each in addition to any shares to be subscribed by them under (a) above.

(e) Of the cash received by the issue of new shares, ₹ 2,00,000 is to be used to reduce the loan due by the company.

(f) The equity share capital cancelled is to be applied:

i. to write off the debit balance in the profit and loss A/c; and

ii. to write off ₹ 35,000 from the value of plant.

Any balance remaining is to be used to write down the value of trademarks and goodwill.

Show by journal entries how the financial books are affected by the scheme and prepare the balance sheet of the company after reconstruction. The nominal capital as reduced is to be increased to ₹ 6,50,000 for preference share capital and ₹ 7,50,000 for equity share capital.

Solution

In the books of Rebuilt Ltd.

Journal Entries

	Particulars		*Debit (₹)*	*Credit (₹)*
1.	Equity share capital A/c (₹ 50)	Dr.	7,50,000	
	To Equity share capital A/c (₹ 2.50)			37,500
	To Capital reduction A/c			7,12,500
	(Being equity capital reduced to nominal value of ₹ 2.50 each)			
2.	Bank A/c	Dr.	1,12,500	
	To Equity share capital			1,12,500
	(Being 3 right shares against each share was issued and subscribed)			
3.	7% Preference share capital A/c (₹ 50)	Dr.	6,00,000	
	Capital reduction A/c	Dr.	60,000	
	To 5% Preference share capital (₹ 10)			4,80,000
	To equity share capital (₹ 50)			1,80,000
	(Being 7% preference shares of ₹ 50 each converted to 5% preference shares of ₹ 10 each and also given to them 6 equity shares for every share held)			

4.	Loan A/c Dr.	1,50,000	
	To 5% Preference share capital A/c		1,20,000
	To Equity share capital A/c		30,000
	(Being loan to the extent of ₹ 1,50,000 converted into share capital)		
5.	Bank A/c Dr.	1,00,000	
	To Equity share application money A/c		1,00,000
	(Being shares subscribed by the directors)		
6.	Equity share application money A/c Dr.	1,00,000	
	To Equity share capital A/c		1,00,000
	(Being application money transferred to capital A/c)		
7.	Loan A/c Dr.	2,00,000	
	To Bank A/c		2,00,000
	(Being loan repaid)		
8.	Capital reduction A/c Dr.	6,52,500	
	To Profit and loss A/c		4,51,000
	To Plant A/c		35,000
	To Trademarks and Goodwill A/c (Bal.fig.)		1,66,500
	(Being losses and assets written off to the extent required)		

Balance sheet of Rebuilt Ltd. (and reduced)

as on 31.3.2015

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	10,60,000
2		**Non-current liabilities**		
	a	Long-term borrowings		2,23,000
3		**Current liabilities**		
	a	Trade Payables		2,07,000
	b	Other current liabilities		35,000
		Total		**15,25,000**

		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	2	6,33,000
		Intangible assets	3	1,51,500
2		**Current assets**		
	a	Inventories		4,00,000
	b	Trade receivables		3,28,000
	c	Cash and cash equivalents	4	12,500
		Total		**15,25,000**

Notes to accounts

			₹
1	**Share Capital**		
	Authorised capital:		
	65,000 Preference shares of ₹ 10 each	6,50,000	
	3,00,000 Equity shares of ₹ 2.50 each	7,50,000	14,00,000
	Issued, subscribed and paid up:		
	1,84,000 equity shares of ₹ 2.5 each	4,60,000	
	60,000, 5% Preference shares of ₹ 10 each	6,00,000	10,60,000
2	**Tangible assets**		
	Building at cost less depreciation	4,00,000	
	Plant at cost less depreciation	2,33,000	6,33,000
3.	**Intangible assets**		
	Trademarks and goodwill		1,51,500
4	**Cash and cash equivalents**		
	Bank (1,12,500+1,00,000-2,00,000)		12,500

Illustration 6

Repair Ltd. is in the hands of a receiver for debenture holders who holds a charge on all assets except uncalled capital. The following statement shows the position as regards creditors as on 30th June, 2015:

Liabilities	₹	Assets	₹
6,000 shares of ₹ 60 each,		Property, machinery	
₹ 30 paid up		and plant etc. (Cost	
First debentures	3,00,000	₹ 3,90,000)	
Second debentures	6,00,000	Estimated at	1,50,000
Unsecured trade payables	4,50,000	Cash in hand of	
		the receiver	2,70,000
		Charged under debentures	4,20,000
		Uncalled capital	1,80,000
			6,00,000
		Deficiency	7,50,000
	13,50,000		13,50,000

A holds the first debentures for ₹ 3,00,000 and second debentures for ₹ 3,00,000. He is also an unsecured creditor for ₹ 90,000. B holds second debentures for ₹ 3,00,000 and is an unsecured trade payables for ₹ 60,000.

The following scheme of reconstruction is proposed:

1. A is to cancel ₹ 2,10,000 of the total debt owing to him, to bring ₹ 30,000 in cash and to take first debentures (in cancellation of those already issued to him) for ₹ 5,10,000 in satisfaction of all his claims.
2. B is to accept ₹ 90,000 in cash in satisfaction of all claims by him.
3. In full settlement of 75% of the claim, unsecured creditors (other than A and B) agreed to accept four shares of ₹ 7.50 each, fully paid against their claim for each share of ₹ 60. The balance of 25% is to be postponed and to be payable at the end of three years from the date of Court's approval of the scheme. The nominal share capital is to be increased accordingly.
4. Uncalled capital is to be called up in full and ₹ 52.50 per share cancelled, thus making the shares of ₹ 7.50 each.

Assuming that the scheme is duly approved by all parties interested and by the Court, give necessary journal entries.

Solution

Journal Entries

Particulars		*Debit* *(₹)*	*Credit* *(₹)*
First debentures A/c	Dr.	3,00,000	
Second debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	90,000	
To A's A/c			6,90,000
(Being A's total liability ascertained)			
A's A/c	Dr.	2,10,000	
To Capital reduction A/c			2,10,000
(Being cancellation of debt upto ₹ 2,10,000)			
Bank A/c	Dr.	30,000	
To A's A/c			30,000
(Being cash received in course of settlement)			
A's A/c	Dr.	5,10,000	
To First debentures A/c			5,10,000
(Being liability of A, discharged against first debentures)			
Second debentures A/c	Dr.	3,00,000	
Unsecured creditors A/c	Dr.	60,000	
To B's A/c			3,60,000
(Being B's liability ascertained)			
B's A/c	Dr.	3,60,000	
To Bank A/c			90,000
To Capital reduction A/c			2,70,000
(Being B's liability discharged)			
Unsecured trade payables A/c	Dr.	3,00,000	
To Equity share capital A/c			1,12,500
To Loan (Unsecured) A/c			75,000
To Capital reduction A/c			1,12,500
(Being settlement of unsecured creditors)			

Share call A/c	Dr.	1,80,000	
To Share capital A/c			1,80,000
(Being final call money due)			
Bank A/c	Dr.	1,80,000	
To Share call A/c			1,80,000
(Being final call money received)			
Share capital A/c (Face value ₹ 60)	Dr.	3,60,000	
To Share capital (Face value ₹ 7.50)			45,000
To Capital reduction A/c			3,15,000
(Being share capital reduced to ₹ 7.50 each)			
Capital reduction A/c	Dr.	8,70,000	
To Profit and loss A/c			8,70,000
(Being reconstruction surplus used to write off losses)			

Working Notes:

1.	Settlement of claim of remaining unsecured creditors			₹
	75% of ₹ 3,00,000			2,25,000
	Considering their claim for share of ₹ 60 each			
	2,25,000/60 =3,750 shares			
	Less: Number of shares to be issued			
	3,750 x 4= 15,000 shares of ₹ 7.5 each			
	Total value= 15,000 x 7.50			(1,12,500)
	Transferred to Capital reduction A/c			1,12,500

2. **Ascertainment of profit and loss account's debit balance at the time of reconstruction.**

	₹	₹
Asset		
Fixed assets	3,90,000	
Cash	2,70,000	6,60,000
Less: Capital & Liabilities:		
Share capital	1,80,000	
1st Debenture	3,00,000	
2nd Debenture	6,00,000	
Unsecured *trade payables*	4,50,000	(15,30,000)
Profit and loss A/c (Debit balance)		(8,70,000)

Illustration 7

The Balance Sheet of Vaibhav Ltd. as on 31st March 2014 is as follows:

Liabilities	*₹*	*Assets*	*₹*
Equity Shares of ₹ 100 each	*2,00,00,000*	*Fixed Assets*	*2,50,00,000*
6%, Cumulative Preference Shares of ₹ 100 each	*1,00,00,000*	*Investments (Market Value ₹ 19,00,000)*	*20,00,000*
5% Debentures of ₹ 100 each	*80,00,000*	*Current Assets*	*2,00,00,000*
Sundry Creditors	*1,00,00,000*	*P & L A/c*	*12,00,000*
Provision for taxation	*2,00,000*		
TOTAL	*4,82,00,000*	*TOTAL*	*4,82,00,000*

The following scheme of Internal Reconstruction is sanctioned:

(i) All the existing equity shares are reduced to ₹ 40 each.

(ii) All preference shares are reduced to ₹ 60 each.

(iii) The rate of Interest on Debentures increased to 6%. The Debenture holders surrender their existing debentures of ₹ 100 each and exchange the same for fresh debentures of ₹ 70 each for every debenture held by them.

(iv) Fixed assets are to be written down by 20%.

(v) Current assets are to be revalued at ₹ 90,00,000.

(vi) Investments are to be brought to their market value.

(vii) One of the creditors of the company to whom the company owes ₹ 40,00,000 decides to forgo 40% of his claim. The creditor is allotted with 60000 equity shares of ₹ 40 each in full and final settlement of his claim.

(viii) The taxation liability is to be settled at ₹ 3,00,000.

(ix) It is decided to write off the debit balance of Profit & Loss A/c.

Pass journal entries and show the Balance Sheet of the company after giving effect to the above.

Solution

Journal Entries in the books of Vaibhav Ltd.

		₹	₹
(i)	Equity share capital (₹ 100) A/c Dr.	2,00,00,000	
	To Equity Share Capital (₹ 40) A/c		80,00,000

	To Capital Reduction A/c		1,20,00,000
	(Being conversion of equity share capital of ₹ 100 each into ₹40 each as per reconstruction scheme)		
(ii)	6% Cumulative Preference Share capital (₹ 100) A/c Dr.	1,00,00,000	
	To 6% Cumulative Preference Share Capital (₹ 60)A/c		60,00,000
	To Capital Reduction A/c		40,00,000
	(Being conversion of 6% cumulative preference shares capital of ₹ 100 each into ₹ 60 each as per reconstruction scheme)		
(iii)	5% Debentures (₹ 100) A/c Dr.	80,00,000	
	To 6% Debentures (₹ 70) A/c		56,00,000
	To Capital Reduction A/c		24,00,000
	(Being 6% debentures of ₹ 70 each issued to existing 5% debenture holders. The balance transferred to capital reduction account as per reconstruction scheme)		
(iv)	Sundry Creditors A/c Dr.	40,00,000	
	To Equity Share Capital (₹ 40) A/c		24,00,000
	To Capital Reduction A/c		16,00,000
	(Being a creditor of ₹ 40,00,000 agreed to surrender his claim by 40% and was allotted 60,000 equity shares of ₹ 40 each in full settlement of his dues as per reconstruction scheme)		
(v)	Provision for Taxation A/c Dr.	2,00,000	
	Capital Reduction A/c Dr.	1,00,000	
	To Liability for Taxation A/c		3,00,000
	(Being conversion of the provision for taxation into liability for taxation for settlement of the amount due)		
(vi)	Capital Reduction A/c Dr.	199,00,000	
	To P & L A/c		12,00,000
	To Fixed Assets A/c		50,00,000
	To Current Assets A/c		110,00,000
	To Investments A/c		1,00,000

	To Capital Reserve A/c (Bal. fig.)		26,00,000
	(Being amount of Capital Reduction utilized in writing off P & L A/c (Dr.) Balance, Fixed Assets, Current Assets, Investments and the Balance transferred to Capital Reserve)		
(vii)	Liability for Taxation A/c Dr.	3,00,000	
	To Current Assets (Bank A/c)		3,00,000
	(Being the payment of tax liability)		

Balance Sheet of Vaibhav Ltd. (After Reconstruction) as on 31st March, 2014

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	164,00,000
	b	Reserves and Surplus	2	26,00,000
2		**Non-current liabilities**		
		Long-term borrowings	3	56,00,000
3		**Current liabilities**		
		Trade Payables(1,00,00,000 less 40,00,000)		60,00,000
		Total		3,06,00,000
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	4	200,00,000
	b	Investments	5	19,00,000
2		**Current assets**	6	87,00,000
		Total		3,06,00,000

Notes to accounts

		₹
1. Share Capital		
Equity share capital		
Issued, subscribed and paid up		
2,60,000 equity shares of ₹ 40 each (of the above 60,000 shares have been issued for consideration other than cash)		1,04,00,000

	Preference share capital		
	Issued, subscribed and paid up		
	1,00,000 6% Cumulative Preference shares of ₹ 60 each		60,00,000
	Total		1,64,00,000
2.	**Reserves and Surplus**		
	Capital Reserve		26,00,000
3.	**Long-term borrowings**		
	Secured		
	6% Debentures		56,00,000
4.	**Tangible assets**		
	Fixed Assets	2,50,00,000	
	Adjustment under scheme of reconstruction	(50,00,000)	2,00,00,000
5.	**Investments**	20,00,000	
	Adjustment under scheme of reconstruction	(1,00,000)	19,00,000
6.	**Current assets**		
		2,00,00,000	
	Adjustment under scheme of reconstruction	110,00,000	
		90,00,000	
	Taxation liability paid	(3,00,000)	87,00,000

Working Note:

Capital Reduction Account

To Liability for taxation A/c	1,00,000	By Equity share capital	1,20,00,000
To P & L A/c	12,00,000	By 6% Cumulative preferences	
To Fixed Assets	50,00,000	Share capital	40,00,000
To Current assets	1,10,00,000	By 5% Debentures	24,00,000
To Investment	1,00,000	By Sundry creditors	16,00,000
To Capital Reserve (Bal. fig.)	26,00,000		
	2,00,00,000		2,00,00,000

Summary

1. Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares.
2. Reconstruction account is a new account opened to transfer the sacrifice made by the shareholders for that part of capital which is not represented by lost assets.
3. Reconstruction account is utilized for writing-off fictitious assets, writing down over-valued fixed assets, recording new liability etc.
4. If some credit balance remains in the reconstruction account, the same should be transferred to the capital reserve account.
5. Methods of Internal reconstruction :
    - Alteration of share capital :
        - ✓ Sub-divide or consolidate shares into smaller or higher Denomination
        - ✓ Conversion of share into stock or vice-versa
    - Variation of shareholders’ rights :
        - ✓ Only the specific rights are changed. There is no change in the amount of capital.
    - Reduction of share capital
    - Compromise, arrangements etc.
    - Surrender of Shares.

6

Amalgamation of Companies

Learning Objectives

After studying this chapter, you will be able to:

- Understand the term "Amalgamation" and the methods of accounting for amalgamations.
- Appreciate the concept of transferee Company and the transferor company.
- Calculate purchase consideration under both the methods of amalgamation as per AS 14.
- Pass the entries to close the books of the vendor company.
- Pass the journal entries in the books of purchasing company to incorporate the assets and liabilities of the vendor company and also giving effect to other adjustments..

1. Meaning of Amalgamation

In an amalgamation, two or more companies are combined into one by merger or by one taking over the other. Therefore, the term 'amalgamation' contemplates two kinds of activities:

(*i*) two or more companies join to form a new company or

(*ii*) absorption and blending of one by the other.

Thus, amalgamation include absorption.

The purpose of companies joining together is to secure various advantages such as economies of large scale production, avoiding competition, increasing efficiency, expansion etc.

The companies going into liquidation or merged companies are called vendor companies or transferor companies. The new company which is formed to take over the liquidated companies or the company with which the transferor company is merged is called transferee or vendee.

In the case of amalgamation the assets and liabilities of transferor company(s) are amalgamated and the transferee company becomes vested with all such assets and liabilities.

Wherever an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is **external reconstruction**. Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS (Accounting Standard) 14, Accounting for Amalgamations.

Basis	Amalgamation	Absorption	External Reconstruction
Meaning	Two or more companies are wound up and **a new company** is formed to take over their business.	In this case **an existing company** takes over the business of **one or more** existing companies.	In this case, **a newly formed company** takes over the business of an **existing company**.
Minimum number of Companies involved	At least three companies are involved.	At least two companies are involved.	Only two companies are involved.
Number of new resultant companies	Only one resultant company is formed. Two companies are wound up to form a **single** resultant company.	**No** new resultant company is formed.	Only one resultant company is formed. Under this case **a newly formed company** takes over the business of an existing company.
Objective	Amalgamation is done to cut competition & reap the economies in large scale.	Absorption is done to cut competition & reap the economies in large scale.	External reconstruction is done to reorganise the financial structure of the company.
Example	A Ltd. and B Ltd. amalgamate to form C Ltd.	A Ltd. takes over the business of another existing company B Ltd.	B Ltd. is formed to take over the business of an existing company A Ltd.

2. Types of Amalgamation

The Institute of Chartered Accountants of India has introduced Accounting Standard -14 (AS 14) on 'Accounting for Amalgamations'. The standard recognizes two types of amalgamation –

Amalgamation in the nature of merger is an amalgamation where there is a genuine pooling not merely of assets and liabilities of the transferor and transferee companies but also of the shareholders' interests and of the businesses of the companies. 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 respective figures of the transferor and transferee companies. *Amalgamation in the nature of merger* is an amalgamation, as per para 3(e) of AS-14, 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. For example, if transferor company is following straight line method of depreciation, the book value of the assets of the transferor company will be revised by applying the written down method of depreciation.

If any one or more of the above conditions are not satisfied in an amalgamation, such amalgamation is called ***amalgamation in the nature of purchase***.

Difference between amalgamation in the nature of merger and amalgamation in the nature of purchase.

Best of Distinction	**Amalgamation in the Nature of Merger**	**Amalgamation in the Nature of Purchase**
a) Transfer of Assets and Liabilities	There is transfer of all assets & liabilities.	There need not be transfer for all assets & liabilities.
b) Shareholders of transferor company	Equity shareholders holding 90% equity shares in transferor company become shareholders of transferee company.	Equity shareholders need not become shareholders of transferee company.
c) Purchase Consideration	Purchase consideration is discharged wholly by issue of equity shares of transferee company (except cash only for fractional shares)	Purchase consideration need not be discharged wholly by issue of equity shares.
d) Same Business	The same business of the transferor company is intended to be carried on by the transferee company.	The business of the transferor company need not be intended to be carried on by the transferee company.

e) Recording of Assets & Liabilities	The assets & liabilities taken over are recorded at their existing carrying amounts except where adjustment is required to ensure uniformity of accounting policies.	The assets & liabilities taken over are recorded at their existing carrying amounts or the basis of their fair values.
f) Method of Accounting	Journal entries for recording the merger are passed by pooling of interest method.	Journal entries for recording the purchase of business are passed by purchase method.

3. Purchase Consideration

For the purpose of accounting for amalgamations, we are essentially guided by AS-14 'Accounting for Amalgamations'. Para 3(g) of AS 14 defines the term purchase consideration as the "*aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company*". In simple words, it is the price payable by the transferee company to the transferor company for taking over the business of the transferor company.

It is notable that purchase consideration ***does not include*** the sum which the transferee company will directly pay to the debentureholders or creditors of the transferor company. If a certain liability of the transferor company has not been taken over by the transferee company it will be discharged by the transferor company.

The purchase consideration essentially depends upon the fair value of its elements. For example, when the consideration includes securities, the value fixed by the statutory authority may be taken as the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up or in the absence of market value, net book value of the assets (i.e. cost less accumulated depreciation) are considered.

Sometimes adjustments may have to be made in the purchase consideration in the light of one or more future events. When the additional payment is probable and can be reasonably estimated it is to be included in the calculation of purchase consideration.

Illustration 1

Let us consider the draft Balance Sheet of X Ltd. as on 31st March, 20X1:

Liabilities	*₹ ('000)*	*Assets*	*₹ ('000)*
Share Capital:		*Land & Buildings*	*50,00*
Equity Shares of ₹ 10	*75,00*	*Plant & Machinery*	*45,00*
each 14% Preference		*Furniture*	*10,50*
Shares of ₹ 100 each	*25,00*	*Investments*	*5,00*
General Reserve	*12,50*	*Inventory*	*23,00*
12% Debentures	*40,00*	*Trade receivables*	*24,00*

Trade payables and other		*Cash & Bank balance*	*15,00*
Current liabilities	*20,00*		
	172,50		*172,50*

Other Information:

(i) Y Ltd. takes over X Ltd. on 10th April, 20X1.

(ii) Debenture holders of X Ltd. are discharged by Y Ltd. at 10% premium by issuing 15% own debentures of Y Ltd.

(iii) 14% Preference Shareholders of X Ltd. are discharged at a premium of 20% by issuing necessary number of 15% Preference Shares of Y Ltd. (Face value ₹ 100 each).

(iv) Intrinsic value per share of X Ltd. is ₹ 20 and that of Y Ltd. ₹ 30. Y Ltd. will issue equity shares to satisfy the equity shareholders of X Ltd. on the basis of intrinsic value. However, the entry should be made at par value only. The nominal value of each equity share of Y Ltd. is ₹ 10.

Compute the purchase consideration.

Solution

Computation of Purchase consideration	*(₹ in '000)*	*Form*
For Preference Shareholders of X Ltd.	3,000	30,000 15% Preference shares in Y Ltd.
For equity shareholders of X Ltd. (2/3 × 7,50,000) × ₹ 10 of ₹ 10 each	5,000	5,00,000 Equity shares of Y Ltd.
Total Purchase consideration	8,000	

Note: Consideration for debenture holders should not be included above. Such debentures will be taken over by Y Ltd. and then discharged.

Illustration 2

S. Ltd. is absorbed by P. Ltd. The draft balance sheet of S. Ltd. is as under:

Balance Sheet

	₹		₹
Share Capital:			
2,000 7% Preference shares		*Sundry Assets*	*13,00,000*
of ₹ 100 each (fully paid-up)	*2,00,000*		
5,000 Equity shares of ₹ 100			
each (fully paid-up)	*5,00,000*		

Reserves	*3,00,000*		
6% Debentures	*2,00,000*		
Trade payables	*1,00,000*		
	13,00,000		*13,00,000*

P. Ltd. has agreed :

(i) to issue 9% Preference shares of ₹ 100 each, in the ratio of 3 shares of P. Ltd. for 4 preference shares in S. Ltd.

(ii) to issue to the debenture-holders in S. Ltd. 8% Mortgage Debentures at ₹ 96 in lieu of 6% Debentures in S. Ltd. which are to be redeemed at a premium of 20%;

(iii) to pay ₹ 20 per share in cash and to issue six equity shares of ₹ 100 each (market value ₹ 125) in lieu of every five shares held in S. Ltd.; and

(iv) to assume the liability to trade payables.

You are required to calculate the purchase consideration.

Solution

The purchase consideration will be

		₹	*Form*
Preference shareholders:	2,000 × 3/4 × 100	1,50,000	9% Pref. shares
Equity shareholders:	5,000 × 20	1,00,000	Cash
	5,000 × 6/5 × 125	7,50,000	Equity shares
		10,00,000	

According to AS 14, 'consideration' for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company. Therefore, debentures issued to the debenture holders will not be included in purchase consideration. Like trade payables, the liability in respect of debentures of S. Ltd. will be taken by P Ltd., which will then be settled by issuing new 8% debentures.

Illustration 3

Y Ltd. decides to absorb X Ltd. The draft Balance Sheet of X Ltd. is as follows:

	₹		₹
3,000 Equity shares of		*Net assets*	*2,90,000*
₹ 100 each (fully paid)	*3,00,000*	*Profit and Loss Account*	*70,000*
Preference shares	*60,000*		
	3,60,000		*3,60,000*

Y Ltd. agrees to take over the net assets of X Ltd. An equity share in X Ltd., for purposes of absorption, is valued @ ₹ 70. Y Ltd. agrees to pay ₹ 60,000 in cash for payment to preference shareholders equity shares will be issued at value of ₹ 120 each. Calculate purchase consideration to be paid by Y Ltd. and how will it be discharged?

Solution

Value of 3,000 shares of X Ltd. @ ₹ 70 = ₹ 2,10,000

The purchase consideration will be:

= ₹ 2,10,000 for equity shares + ₹ 60,000 for Liability towards preference shareholders

= ₹ 2,70,000

₹ 60,000 out of the above will be in cash and ₹ 2,10,000 in the form of equity shares of Y Ltd., issued at ₹ 120 per share; the number of shares that will be issued = 2,10,000/120 = 1,750 equity shares.

Illustration 4

Neel Ltd. and Gagan Ltd. amalgamated to form a new company on 1.04.20X1. Following is the Draft Balance Sheet of Neel Ltd. and Gagan Ltd. as at 31.3.20X1:

Liabilities	Neel	Gagan	Assets	Neel	Gagan
	₹	₹		₹	₹
Capital	7,75,000	8,55,000	Plant & Machinery	4,85,000	6,14,000
Current liabilities	6,23,500	5,57,600	Building	7,50,000	6,40,000
			Current assets	1,63,500	1,58,600
	13,98,500	14,12,600		13,98,500	14,12,600

Following are the additional information:

(i) *The authorised capital of the new company will be ₹ 25,00,000 divided into 1,00,000 equity shares of ₹ 25 each.*

(ii) *Liabilities of Neel Ltd. includes ₹ 50,000 due to Gagan Ltd. for the purchases made. Gagan Ltd. made a profit of 20% on sale to Neel Ltd.*

(iii) *Neel Ltd. had purchased goods costing ₹ 10,000 from Gagan Ltd. All these goods are included in the current asset of Neel Ltd. as at 31st March, 20X1.*

(iv) The assets of Neel Ltd. and Gagan Ltd. are to be revalued as under:

	Neel	*Gagan*
	₹	₹
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000

(v) The purchase consideration is to be discharged as under:

(a) Issue 24,000 equity shares of ₹ 25 each fully paid up in the proportion of their profitability in the preceding 2 years.

(b) Profits for the preceding 2 years are given below:

	Neel	*Gagan*
	₹	₹
1st year	*2,62,800*	*2,75,125*
IInd year	*2,12,200*	*2,49,875*
Total	*4,75,000*	*5,25,000*

(c) Issue 12% preference shares of ₹ 10 each fully paid up at par to provide income equivalent to 8% return on net assets in the business as on 31.3.20X1 after revaluation of assets of Neel Ltd. and Gagan Ltd. respectively.

You are required to compute the

(i) equity and preference shares issued to Neel Ltd. and Gagan Ltd.,

(ii) Purchase consideration.

Solution

(i) Calculation of equity shares to be issued to Neel Ltd. and Gagan Ltd.

Profits of	*Neel*	*Gagan*
	₹	₹
I year	2,62,800	2,75,125
II year	2,12,200	2,49,875
Total	4,75,000	5,25,000

No. of shares to be issued = 24,000 equity shares in the proportion of the preceding 2 years' profitability

	Neel	Gagan
24,000 x 475/1000	11,400 equity shares	
24,000 x 525/1000		12,600 equity shares

Calculation of 12% Preference shares to be issued to Neel Ltd. and Gagan Ltd.

	Neel	Gagan
	₹	₹
Net assets (Refer working note)	8,40,000	9,24,000
8% return on Net assets	67,200	73,920
12% Preference shares to be issued	56,000 shares	
$\left[67{,}200 \times \frac{100}{12}\right] = 5{,}60{,}000 @ ₹ 10 \text{ each}$		
$\left[73{,}920 \times \frac{100}{12}\right] = 6{,}16{,}000 @ ₹ 10 \text{ each}$		61,600 shares

(ii) Total Purchase Consideration

	Neel	*Gagan*
	₹	₹
Equity shares @ of ₹ 25 each	2,85,000	3,15,000
12% Preference shares @ of ₹ 10 each	5,60,000	6,16,000
Total	8,45,000	9,31,000

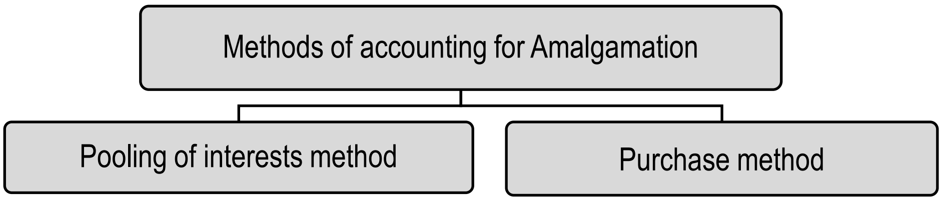
Working Note:

Calculation of Net assets as on 31.3.20X1

	Neel	*Gagan*
	₹	₹
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000
Current assets	1,63,500	1,58,600
Less: Current liabilities	(6,23,500)	(5,57,600)
	8,40,000	9,24,000

4. Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamation viz,


Methods of accounting for Amalgamation
Pooling of interests method
Purchase method

The first method is used in case of amalgamation in the nature of merger and the second method is used in case of amalgamation in the nature of purchase.

Pooling of Interest Method

Under pooling of interests method, the assets, liabilities and reserves of the Transferor Company will be taken over by Transferee Company at existing carrying amounts unless any adjustment is required due to different accounting policies followed by these companies. As a result the difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of Transferor Company should be adjusted in reserves.

Purchase Method

Assets and Liabilities: the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

Reserves: No reserves, other than statutory reserves, of the transferor company should be incorporated in the financial statements of transferee company.

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. Statutory reserves of the transferor company should be incorporated in the balance sheet of transferee company by way of the following journal entry.

Amalgamation Adjustment Reserve A/c Dr.

To Statutory Reserves

The balance of Profit and Loss account of the transferor company is not recorded at all.

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 Reserve') which is presented as a separate line item. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed. Amalgamation Adjustment Reserve' has to be shown as a separate line item - Which implies, that this debit "cannot be set off against Statutory reserve taken over" and therefore, the presentation will be as follows:

Reserves

Description	***Amount (Current year)***	***Amount (Previous Year)***
Statutory Reserve (taken over from transferor company)		
General Reserve		
Retained Earnings		
Amalgamation Adjustment Reserve (negative balance)	***(--)***	***(--)***

Difference between the Purchase Consideration and Net Assets transferred: Any excess of the amount of purchase consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised as goodwill in the financial statement of the transferee company. Any short fall should be shown as capital reserve. Goodwill should be amortised over period of five years unless a somewhat longer period can be justified.

Illustration 5

Consider the following summarized balance sheets of X Ltd. and Y Ltd.

Balance Sheet as on 31st March, 20X1

Liabilities	*X Ltd.*	*Y Ltd.*	*Assets*	*X Ltd.*	*Y Ltd.*
	₹'000	*₹'000*		*₹'000*	*₹'000*
Equity Share Capital	*50,00*	*30,00*	*Land & Building*	*25,00*	*15,50*
(₹ 10 each)			*Plant & Machinery*	*32,50*	*17,00*
14% Preference Share	*22,00*	*17,00*	*Furniture & Fittings*	*5,75*	*3,50*
Capital (₹ 100 each)			*Investments*	*7,00*	*5,00*
General Reserve	*5,00*	*2,50*	*Inventory*	*12,50*	*9,50*
Export Profit Reserve	*3,00*	*2,00*	*Trade receivables*	*9,00*	*10,30*
Investment Allowance		*1,00*	*Cash & Bank*	*7,25*	*5,20*
Reserve					
Profit & Loss A/c	*7,50*	*5,00*			
13% Debentures	*5,00*	*3,50*			

(₹100 each)					
Trade payables	*4,50*	*3,50*			
Other Current Liabilities	*2,00*	*1,50*			
	99,00	*66,00*		*99,00*	*66,00*

X Ltd. takes over Y Ltd. on 1st April, 20X1. X Ltd. discharges the purchase consideration as below:

(i) Issued 3,50,000 equity shares of ₹10 each at par to the equity shareholders of Y Ltd.

(ii) Issued 15% preference shares of ₹100 each to discharge the preference shareholders of Y Ltd. at 10% premium.

The debentures of Y Ltd. will be converted into equivalent number of debentures of X Ltd. The statutory reserves of Y Ltd. are to be maintained for 2 more years.

Show the balance sheet of X Ltd. after amalgamation on the assumption that:

(a) the amalgamation is in the nature of merger.

(b) the amalgamation is in the nature of purchase.

Solution:

(a) Amalgamation in the nature of merger:

Balance Sheet of X Ltd.

		Particulars	*Notes*	*₹ in '000*
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	12,570
	b	Reserves and Surplus	2	1,930
2		**Non-current liabilities**		
	a	Long-term borrowings	3	850
3		**Current liabilities**		
	a	Trade Payables		800
	b	Other current liabilities		350
		Total		**16,500**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	4	9,925
	b	Non-current investments		1,200

2		**Current assets**		
	a	Inventories		2,200
	b	Trade receivables		1,930
	c	Cash and cash equivalents		1,245
		Total		**16,500**

Notes to accounts

				₹ in '000
1	**Share Capital**			
	Equity share capital			
	85,00, Equity Shares of ₹ 10 each			8,500
	Preference share capital			
	18,700, 15% Preference Shares of ₹ 100 each			1,870
	22,000, 14% Preference Shares of ₹ 100 each			2,200
	Total			**12,570**
2	**Reserves and Surplus**			
	General Reserve of X Ltd.	500		
	Add: General reserve of Y Ltd.	250	750	
	Less: Adjustment for amalgamation*		(670)	80
	Export Profit Reserve of X Ltd.		300	
	Add: Export Profit Reserve of Y Ltd.		200	500
	Investment Allowance Reserve			100
	Profit & Loss A/c of X Ltd.		750	
	Add: Profit & Loss A/c of Y Ltd.		500	1,250
	Total			**1,930**
3	**Long-term borrowings**			
	Secured			
	8,500 13% Debentures of ₹ 100 each			850
	Total			**850**
4	**Tangible assets**			
	Land & Buildings			4,050
	Plant & Machinery			4,950
	Furniture & Fittings			925

Total		9,925

*The difference between the amount recorded as share capital issued and the amount of share capital of transferor company should be adjusted in reserves. Thus,

Adjustment for amalgamation = ₹ ’000 (53,70 – 47,00) = ₹ (’000) 670

(b) Amalgamation in the nature of purchase:

Balance Sheet of X Ltd.

		Particulars	*Notes*	*₹ in'000*
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	12,570
	b	Reserves and Surplus	2	1,930
2		**Non-current liabilities**		
	a	Long-term borrowings	3	850
3		**Current liabilities**		
	a	Trade Payables		800
	b	Other current liabilities		350
		Total		**16,500**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	4	9,925
	b	Non-current investments		1,200
2		**Current assets**		
	a	Inventories		2,200
	b	Trade receivables		1,930
	c	Cash and cash equivalents		1,245
		Total		**16,500**

Notes to accounts

		₹ in'000
1 Share Capital		
Equity share capital		

	85,00, Equity Shares of ₹ 10 each		8,500
	Preference share capital		
	18,700, 15% Preference Shares of ₹ 100 each		1,870
	22,000, 14% Preference Shares of ₹ 100 each		2,200
	Total		**12,570**
2	**Reserves and Surplus**		
	Capital Reserve		380
	General Reserve		500
	Amalgamation adjustment reserve		(300)
	Export Profit Reserve		500
	Investment Allowance Reserve		100
	Surplus (Profit & Loss A/c)		750
	Total		**1,930**
3	**Long-term borrowings**		
	Secured		
	8,500 13% Debentures of ₹ 100 each		850
	Total		**850**
4	**Tangible assets**		
	Land & Buildings		4,050
	Plant & Machinery		4,950
	Furniture & Fittings		925
	Total		**9,925**

Workings Notes: Capital Reserve arising on Amalgamation:

(A)	Net Assets taken over:	₹ ('000)	₹ ('000)
	Sundry Assets		66,00
	Less : 13% Debentures	3,50	
	Trade payables	3,50	
	Other current liabilities	1,50	(8,50)
			57,50
(B)	Purchase consideration :		
	To Equity Shareholders of Y Ltd.		35,00
	To Preference Shareholders of Y Ltd.		18,70
			53,70
(C)	Capital Reserve (A – B)		3,80

5. Journal Entries to close the books of Vendor Company

The journal entries will be illustrated with the following case.

Wye Ltd. acquires the business of Zed Ltd. whose summarised balance sheet on 31st December, 20X1 is as under :

Liabilities	`	*Assets*	`
Share capital divided into		*Goodwill*	*2,00,000*
shares of ₹ 100 each		*Land & Buildings*	*4,00,000*
6% Preference share capital	*4,00,000*	*Plant and Machinery*	*6,00,000*
Equity share capital	*8,00,000*	*Patents*	*50,000*
Capital Reserve	*1,00,000*	*Inventory*	*1,50,000*
Profit & Loss A/c	*50,000*	*Trade receivables*	*1,80,000*
6% Debentures	*2,00,000*	*Cash at bank*	*70,000*
Interest outstanding on above	*12,000*	*Underwriting commission*	*40,000*
Workmen's compensation reserve			
(Expected liability ₹ 5,000)	*8,000*		
Trade payables	*1,20,000*		
	16,90,000		*16,90,000*

Wye Ltd. was to take over all assets (except cash) and liabilities (except for interest due on debentures) and to pay following amounts:

(i) ₹ 2,00,000 7% Debentures (₹ 100 each) in Wye Ltd. for the existing debentures in Zed Ltd.; for the purpose, each debenture of Wye Ltd. is to be treated as worth ₹ 105.

(ii) For each preference share in Zed Ltd. ₹ 10 in cash and one 9% preference share of ₹ 100 each in Wye Ltd.

(iii) For each equity share in Zed Ltd. ₹ 20 in cash and one equity share in Wye Ltd. of ₹ 100 each having the market value of ₹ 140.

(iv) Expense of liquidation of Zed Ltd. are to be reimbursed by Wye Ltd. to the extent of ₹ 10,000. Actual expenses amounted to ₹ 12,500.

Wye Ltd. valued Land and building at ₹ 5,50,000 Plant and Machinery at ₹ 6,50,000 and patents at ₹ 20,000.

Purchase Consideration:

			₹	*Form*
(i)	*Preference Shares: ₹ 10 per share*	*40,000*		*Cash*
	Preference shares	*4,00,000*	*4,40,000*	*Preference shares*

(ii)	*Equity shares: ₹20 per share*	*1,60,000*		*Cash*
	8,000 equity shares in			
	Wye Ltd. @ ₹140	*11,20,000*	*12,80,000*	*Equity shares*
			17,20,000	

Steps to close the Books of the Vendor Company

1. *Open Realisation Account and transfer all assets at book value.*

Exception: If cash is not taken over by the purchasing company, it should not be transferred.

Note: Profit and Loss Account (Dr.) and expenses not written off are not assets and should not be transferred to the Realisation Account.

The journal entry in the above case is:		*₹*	*₹*
Realisation A/c	*Dr.*	*15,80,000*	
To Sundries —			
Goodwill			*2,00,000*
Land & Building			*4,00,000*
Plant & Machinery			*6,00,000*
Patents			*50,000*
Inventory			*1,50,000*
Trade receivables			*1,80,000*
(Transfer of assets to Realisation Account on sale of business to Wye Ltd.)			

2. *Transfer to the Realisation Account the liabilities which the purchasing company is to take over. In case of the provisions, the portion which represents liability expected to arise in future should be so transferred and the portion which is not required (i.e., the reserve portion) should be treated as profit. Accordingly, the following entry will be recorded:*

		₹	*₹*
6% Debentures in Wye Ltd.	*Dr.*	*2,00,000*	
Workmen's Compensation Reserve	*Dr.*	*5,000*	
Trade payables	*Dr.*	*1,20,000*	
To Realisation A/c			*3,25,000*
(Transfer of liabilities taken over by Wye Ltd. to Realisation A/c)			

For liabilities not take over by the purchasing company, the profit or loss on discharge of such liabilities shall be transferred to Realisation Account.

3. *Debit purchasing company and credit Realisation Account with the purchase consideration.*

Wye Ltd.-	*Dr.*	*17,20,000*	
To Realisation A/c			*17,20,000*
(Amount receivable from Wye Ltd. for sale of business)			

4. *On receipt of the purchase consideration debit what is received (cash, debentures, shares etc.) and credit the purchasing company. Thus —*

Cash	*Dr.*	*2,00,000*	
9% Preference shares in Wye Ltd.	*Dr.*	*4,00,000*	
Equity shares in Wye Ltd.	*Dr.*	*11,20,000*	
To Wye Ltd.			*17,20,000*
(Receipt of purchase consideration from the purchase company)			

5. *Expenses of liquidation have to be dealt with according to the circumstances of each case.*

(a) *If the vendor company has to bear and pay them:*

Realisation Account should be debited and Cash Account credited.

(b) *If the expenses are to be borne by the purchasing company, the question may be dealt within one of the two ways mentioned below:*

(*i*) *It may be ignored in the books of the vendor company.*

(ii) *If the expenses are to be paid first by the vendor company and afterwards reimbursed by the purchasing company, the following two entries will be passed :*

(a) *Debit Purchasing company and credit Cash Account when expenses are paid by the vendor company; and*

(b) *Debit Cash Account and credit purchasing company (on the expenses being reimbursed).*

In the above mentioned case Wye Ltd. has to pay maximum of ₹ 10,000 only whereas, the amount spent is ₹ 12,500. Hence ₹ 2,500 is to be borne by Zed Ltd.; the entries required will be :

		₹	₹
Wye Ltd.	*Dr.*	*10,000*	
Realisation A/c	*Dr.*	*2,500*	
To Cash A/c			*12,500*
(Liquidation expenses out of which ₹ 10,000 is payable by Wye Ltd.)			

Cash A/c	*Dr.*	*10,000*	
To Wye Ltd.			*10,000*
(Account reimbursed by Wye Ltd. for expense)			

6. *Liabilities not assumed by the purchasing company, have to be paid off. On payment, debit the liability concerned and credit cash. Any difference between the amount actually paid and the book figure must be transferred to the Realisation Account. Zed Ltd. shall pass the following entries in this respect :*

		₹	₹
Interest Outstanding	Dr.	12,000	
To Debentureholders A/c			12,000
(Amount due to debenture holders for debentures interest)			
Debentureholders	Dr.	12,000	
To Cash A/c			12,000
(Debentureholders paid cash ₹ 12,000 for outstanding interest)			

7. *Credit the preference shareholders with the amount payable to them, debiting Preference Share Capital with the amount shown in the books, transferring the difference between the two, if any, to the Realisation Account. Thus —*

6% Pref. Share Capital A/c	*Dr.*	*4,00,000*	
Realisation A/c	*Dr.*	*40,000*	
To Preference Shareholders A/c			*4,40,000*
(The amount due to preference shareholders for capital and the extra amount payable under the scheme of absorption)			

***Note** : In the absence of any indication to the contrary, preference shareholders will be entitled only to the capital contributed by them. But if funds available after paying off creditors are not sufficient to satisfy the claim of preference shareholders fully, they will have to suffer a loss to the extent of the deficit.*

8. *Pay off preference shareholders by debiting them and crediting whatever is given to them. The entry in the above case is :*

		₹	₹
Preference shareholders A/c	*Dr.*	*4,40,000*	
To Cash A/c			*40,000*
To 9% Preference shares in Wye Ltd.			*4,00,000*
(Cash and preference shares in Wye Ltd. given to preference shareholders)			

9. *Transfer equity share capital and account representing profit or loss (including the balance in Realisation Account) to Equity Shareholders Account. This will determine the amount receivable by the equity shareholders. Zed Ltd. shall pass the following entries in this regard :*

		₹	₹
Equity Share Capital A/c	Dr.	8,00,000	
Capital Reserve A/c	Dr.	1,00,000	
Profit and Loss A/c	Dr.	50,000	
Workmen's Compensation Reserve A/c	Dr.	3,000	
Realisation A/c	Dr.	4,22,500*	
To Sundry Equity Shareholders A/c			13,75,500
(Various accounts representing capital and profit transferred to Equity Shareholders Account)			
Equity Shareholders A/c	Dr.	40,000	
To Underwriting Commission A/c			40,000
(Underwriting Commission A/c closed by transfer to Equity Shareholders A/c)			

10. On satisfaction of the claims of the equity shareholders, debit their account and credit whatever is given to them. Hence:

Equity Shareholders A/c	Dr.	13,35,500	
To Equity Shares in Wye Ltd.			11,20,000
To Cash A/c**			2,15,500

*The Realisation Account will appear as follows :

Realisation Account

	₹		₹
To Sundry Assets	15,80,000	By Sundry Liabilities	3,25,000
To Cash (excess expenses of liquidation)	2,500	By Wye Ltd.	17,20,000
To Preference Shareholders	40,000		
To Equity Shareholders A/c - profit transferred	4,22,500		
	20,45,000		20,45,000

** The Cash Account will appear as follows :

Cash Account

	₹		₹
To Balance b/d	70,000	By Realisation	2,500
To Wye Ltd. (consideration for amalgamation)	2,00,000	By Wye Ltd.	10,000
To Wye Ltd. (liquidation expenses reimbursed)	10,000	By Debentureholder	12000
		By Preference shareholder	40000
		By Equity Shareholder (B/F)	215500
	280000		280000

6. Entries in the books of Purchasing Company

1. Debit Business Purchase Account and Credit Liquidator of the vendor company with the account of the purchase consideration. Thus -

		₹	₹
Business Purchase A/c	Dr.	17,20,000	
To Liquidator of Zed Ltd.			17,20,000
(Amount payable to Zed Ltd. as per agreement dated....)			

2. (i) Debit assets acquired (except goodwill) at the value placed on them by the purchasing company;

   (ii) Credit liabilities taken over at agreed values and credit Business Purchase Account with the amount of purchase consideration; and

   (iii) Credit the account showing shares held in the company, if any, with the cost of such shares.

   (iv) If the creditors as per (ii) and (iii) above exceed debits as per (i) above, the difference should be debited to Goodwill Account, in the reverse case, the difference should be credited to Capital Reserve.

   Note : The amount of Goodwill or Capital Reserve that shall be included will be the amount as has been arrived at only in foregoing manner.

   In the above case the entry to be passed shall be:

		₹	₹
Land and Building A/c	Dr.	5,50,000	
Plant and Machinery A/c	Dr.	6,50,000	
Patents A/c	Dr.	20,000	
Inventory A/c	Dr.	1,50,000	
Trade receivables	Dr.	1,80,000	
Goodwill	Dr.	5,05,000	
To			
Provision for Workmen's Compensation A/c		5,000	
Trade payables			1,20,000
Debentures in Z Ltd.			2,10,000
Business Purchases Account			17,20,000
(Various assets and liabilities taken over from Zed Ltd. Goodwill ascertained as a balancing figure)			

3. On the payment to the vendor company the balance at its credit, the entry to be made by Wye Ltd. shall be:

			₹	₹
	Liquidator of Zed Ltd.	Dr.	17,20,000	
	To Cash			2,00,000
	To 9% Preference Share Capital A/c			4,00,000
	To Equity Share Capital A/c			8,00,000
	To Securities Premium A/c			3,20,000
	(Payment of cash and issue of shares in satisfaction of purchase consideration)			
4.	Debentures in Z Ltd. A/c	Dr.	2,10,000	
	To 7% Debentures A/c			2,00,000
	To Premium on Debentures A/c			10,000

5. If the purchasing company is required to pay the expenses of liquidation of the vendor company, the amount should be debited to the Goodwill or Capital Reserve Account, as the case may be. In the instant case, the entry shall be:

Goodwill Account	Dr.	10,000	
To Cash Account			10,000
(Amount paid towards liquidation expenses on Zed Ltd.)			

Entries at par value - The students will note that purchasing company is left with a large debit in the Goodwill Account (Step No. 2) accompanied by quite a large amount in the Securities Premium Account (Step No. 3). The two cannot be adjusted. However, it would be permissible to negotiate on the basis to the market value of the shares but to make entries only on the basis of par of shares of purchasing company. This will mean that Goodwill Account (or Capital Reserve) will be automatically adjusted for the securities premium.

Inter Company-owing - Should the purchasing company owe an amount to the vendor company or *vice versa,* the amount will be included in the book debts of one company and trade payables of the other. This should be adjusted by the entry:

Trade payables	Dr.
To Trade receivables	

The entry should be made after the usual acquisition entries have been passed. At the time of preparing the Realisation Account and passing the business purchase entries, no attention need be paid to the fact that the two companies involved owed money mutually.

Adjustment of the value of stock - Inter-company owings arise usually from purchase and sale of goods; it is likely, therefore, that at the time, of the sale of business, the debtor company also has goods in stock which it purchased from the creditor company - the cost of the debtor company will include the profit made by the creditor company. After the takeover of the business it is essential that such a profit is eliminated. The entry for this will be made by the purchasing company. If it is the vendor company which has such goods in stock, at the time of passing the acquisition entries, the value of the stock should be reduced to its cost to the company which is acquiring the business; automatically goodwill or capital reserve, as the case may be, will be adjusted. But if the original sale was made by the vendor company and the stock is with the company acquiring the business, the latter company will have to debit Goodwill (or Capital Reserve) and credit stock with the amount of the profit included in the stock.

Illustration 6

The following draft Balance Sheets are given as on 31st March, 20X1:

	(₹ in lakhs)			*(₹ in lakhs)*	
	Best Ltd.	*Better Ltd.*		*Best Ltd.*	*Better Ltd.*
	₹	*₹*		*₹*	*₹*
Share Capital:			*Fixed Assets*	*25*	*15*
Shares of ₹100, each			*Investments*	*5*	*–*
fully paid	*20*	*10*	*Current Assets*	*20*	*5*
Reserve and Surplus	*10*	*8*			
Other Liabilities	*20*	*2*			
	50	*20*		*50*	*20*

The following further information is given —

(a) *Better Limited issued bonus shares on 1st April, 20X1, in the ratio of one share for every two held, out of Reserves and Surplus.*

(b) *It was agreed that Best Ltd. will take over the business of Better Ltd., on the basis of the latter's Balance Sheet, the consideration taking the form of allotment of shares in Best Ltd.*

(c) *The value of shares in Best Ltd. was considered to be ₹150 and the shares in Better Ltd. were valued at ₹100 after the issue of the bonus shares. The allotment of shares is to be made on the basis of these values.*

(d) *Liabilities of Better Ltd., included ₹1 lakh due to Best Ltd., for purchases from it, on which Best Ltd., made profit of 25% of the cost. The goods of ₹50,000 out of the said purchases, remained in stock on the date of the above Balance Sheet.*

Make the closing ledger in the Books of Better Ltd. and the opening journal entries in the Books of Best Ltd., and prepare the Balance Sheet as at 1st April, 20X1 after the takeover.

Solution

LEDGER OF BETTER LIMITED

Fixed Assets Account

	₹		₹
To Balance b/d	15,00,000	By Realisation A/c (transfer)	15,00,000

Current Assets Account

	₹		₹
To Balance b/d	5,00,000	By Realisation A/c (transfer)	5,00,000

Liabilities Account

	₹		₹
To Realisation A/c	2,00,000	By Balance b/d	2,00,000

Realisation Account

	₹		₹
To Fixed Assets A/c	15,00,000	By Liabilities A/c	2,00,000
” Current Assets A/c	5,00,000	” Best Limited (Purchase Consideration)	15,00,000
		” Shareholders’ A/c (Loss on Realisation)	3,00,000
	20,00,000		20,00,000

Share Capital Account

	₹		₹
To Sundry shareholders A/c - (transfer)	15,00,000	By Balance b/d	10,00,000
		” Reserves & Surplus A/c (Bonus issue)	5,00,000
	15,00,000		15,00,000

Reserves & Surplus Account

	₹		₹
To Share Capital (Bonus issue)	5,00,000	By Balance b/d	8,00,000
” Sundry Shareholders	3,00,000		
	8,00,000		8,00,000

Best Ltd.

	₹		₹
To Realisation A/c - Purchase Consideration	15,00,000	By Shares in Best Ltd	15,00,000
	15,00,000		15,00,000

Shares in Best Ltd.

	₹		₹
To Best Ltd.	15,00,000	By Sundry Shareholders A/c	15,00,000

Sundry Shareholders Account

	₹		₹
To Realisation A/c (Loss)	3,00,000	By Share Capital A/c	15,00,000
		” Reserves & Surplus A/c	3,00,000
” Share in Best Ltd.	15,00,000		
	18,00,000		18,00,000

Journal of Best Ltd.

			Dr.	Cr.
20X1			₹	₹
Apr. 1	Fixed Assets A/c	Dr.	15,00,000	
	Current Assets A/c	Dr.	5,00,000	
	To Liabilities A/c			2,00,000
	To Liquidator of Better Ltd.			15,00,000
	To Capital Reserve A/c			3,00,000
	(Assets & Liabilities of Better Ltd. taken over for an agreed purchase consideration of ₹ 15,00,000 as per agreement dated....)			
	Liquidator of Better Ltd.	Dr.	15,00,000	
	To Share Capital A/c			10,00,000
	To Securities Premium A/c			5,00,000
	(Discharge of Purchase consideration by the issue of equity shares of ₹ 10,00,000 at a premium of ` 50 per share as per agreement)			
	Trade payables A/c	Dr.	1,00,000	
	To Trade receivables A/c			1,00,000
	(Amount due from Better Ltd., and included in its creditors taken over, cancelled against own Trade receivables)			

Capital Reserve A/c	Dr.	10,000	
To Current Asset (Stock) A/c			10,000
(Unrealized profit on stock included in current assets of Better Ltd. written off to Reserve Account)			

Working Note :

Calculation of Purchase consideration:

Issued Capital of Better Ltd. (after bonus issue) at ₹ 100 per share ₹ 15,00,000

Purchase consideration has been discharged by Best Ltd. by the issue of shares for ₹ 10,00,000 at a premium of ₹ 5,00,000. This gives the value of ₹ 150 per share.

Balance Sheet of Best Ltd. (After absorption)

		Particulars	*Notes*	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	30,00,000
	b	Reserves and Surplus	2	17,90,000
2		**Current liabilities**		21,00,000
		Total		**68,90,000**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets	3	40,00,000
	b	Non-current investments		5,00,000
2		**Current assets**		23,90,000
		Total		**68,90,000**

Notes to accounts

			₹
1	**Share Capital**		
	Equity share capital		
	Issued & Subscribed		
	30,000 shares of ₹ 100 (of the above 10,000 shares have been issued for consideration other than cash)		30,00,000
	Total		**30,00,000**
2	**Reserves and Surplus**		
	Capital Reserve (3,00,000 – 10,000)		2,90,000
	Securities Premium		5,00,000

	Other reserves and surplus		10,00,000
	Total		**17,90,000**
3	**Tangible assets**		
	Fixed Assets	25,00,000	
	Acquired during the year	15,00,000	40,00,000
	Total		**40,00,000**

Illustration 7

K Ltd. and L Ltd. amalgamate to form a new company LK Ltd. The financial position of these two companies on the date of amalgamation was as under:

	K Ltd. *₹*	*L Ltd.* *₹*		*K Ltd.* *₹*	*L Ltd.* *₹*
Share Capital			*Goodwill*	*80,000*	
Equity Shares			*Land & Building*	*4,50,000*	*3,00,000*
of ₹100 each	*8,00,000*	*3,00,000*	*Plant & Machinery*	*6,20,000*	*5,00,000*
7% Preference Share			*Furniture and*		
of ₹100 each	*4,00,000*	*3,00,000*	*Fittings*	*60,000*	*20,000*
5% Debentures	*2,00,000*	*—*	*Trade receivables*	*2,75,000*	*1,75,000*
General Reserve	*—*	*1,00,000*	*Stores & inventory*	*2,25,000*	*1,40,000*
Profit and Loss			*Cash at Bank*	*1,20,000*	*55,000*
Account	*3,71,375*	*97,175*	*Cash in hand*	*41,375*	*17,175*
Trade payables	*1,00,000*	*2,10,000*			
Secured Loan	*—*	*2,00,000*			
	18,71,375	*12,07,175*		*18,71,375*	*12,07,175*

The terms of amalgamation are as under:

(A) (1) The assumption of liabilities of both the Companies.

(2) Issue of 5 Preference shares of ₹20 each in LK Ltd. @ ₹18 paid up at premium of ₹ 4 per share for each preference share held in both the Companies.

(3) Issue of 6 Equity shares of ₹20 each in LK Ltd. @ ₹18 paid up at a premium of ₹4 per share for each equity share held in both the Companies. In addition, necessary cash should be paid to the Equity Shareholders of both the Companies as is required to adjust the rights of shareholders of both the Companies in accordance with the intrinsic value of the shares of both the Companies.

(4) Issue of such amount of fully paid 6% debentures in LK Ltd. as is sufficient to discharge the 5% debentures in K Ltd. at a discount of 5% after takeover.

(B) (1) The assets and liabilities are to be taken at book values inventory and trade receivables for which provisions at 2% and 2 ½ % respectively to be raised.

(2) The trade receivables of K Ltd. include ₹ 20,000 due from L Ltd.

(C) The LK Ltd. is to issue 15,000 new equity shares of ₹ 20 each, ₹ 18 paid up at premium of ₹ 4 per share so as to have sufficient working capital. Prepare ledger accounts in the books of K Ltd. and L Ltd. to close their books.

Solution

Books of K Ltd.

Realisation Account

	₹		₹
To Goodwill	80,000	By 5% Debentures	2,00,000
To Land & Building	4,50,000	By Trade payables	1,00,000
To Plant & Machinery	6,20,000	By LK Ltd.	15,60,000
To Furniture & Fitting	60,000	(Purchase consideration)	
To Trade receivables	2,75,000	By Equity shareholders A/c	51,375
To Stores & inventory	2,25,000	(loss)	
To Cash at Bank	1,20,000		
To Cash in hand	41,375		
To Preference shareholders			
(excess payment)	40,000		
	19,11,375		19,11,375

Equity Shareholders Account

	₹		₹
To Realisation A/c (loss)	51,375	By Share capital	8,00,000
To Equity Shares in LK Ltd.	10,56,000	By Profit & Loss A/c	3,71,375
To Cash	64,000		
	11,71,375		11,71,375

7% Preference Shareholders Account

	₹		₹
To Preference Shares in LK Ltd.	4,40,000	By Share capital	4,00,000
		By Realisation A/c	40,000
	4,40,000		4,40,000

LK Ltd. Account

	₹			₹
To Realisation A/c	15,60,000	By Equity Shares in LK Ltd.		
		For Equity	10,56,000	
		Pref.	4,40,000	14,96,000
		By Cash		64,000
	15,60,000			15,60,000

Books of L Ltd.
Realisation Account

	₹		₹
To Land & Building	3,00,000	By Trade payables	2,10,000
To Plant & Machinery	5,00,000	By Secured loan	2,00,000
To Furniture & Fittings	20,000	By LK Ltd. (Purchase consideration)	7,90,000
To Trade receivables	1,75,000		
To Inventory of stores	1,40,000	By Equity shareholders A/c— Loss	37,175
To Cash at bank	55,000		
To Cash in hand	17,175		
To Pref. shareholders	30,000		
	12,37,175		12,37,175

Equity Shareholders Account

	₹		₹
To Equity shares in LK Ltd.	3,96,000	By Share Capital	3,00,000
To Realisation	37,175	By Profit & Loss A/c	97,175
To Cash	64,000	By Reserve	1,00,000
	4,97,175		4,97,175

7% Preference Shareholders Account

	₹		₹
To Preference Shares in LK Ltd.	3,30,000	By Share capital	3,00,000
		By Realisation A/c	30,000
	3,30,000	3,30,000	

LK Ltd. Account

	₹			₹
To Realisation A/c	7,90,000	By Equity shares in LK Ltd.		
		For Equity	3,96,000	
		Preference	3,30,000	7,26,000
		By Cash		64,000
	7,90,000			7,90,000

Working Notes:

(i) Purchase consideration

	K Ltd. ₹	*L Ltd.* ₹
Payable to preference shareholders:		
Preference shares at ₹ 22 per share	4,40,000	3,30,000
Equity Shares at ₹ 22 per share	10,56,000	3,96,000
Cash [See W.N. (*ii*)]	64,000	64,000
	15,60,000	7,90,000

(ii) Value of Net Assets

		K Ltd. ₹		*L Ltd.* ₹
Goodwill		80,000		
Land & Building		4,50,000		3,00,000
Plant & Machinery		6,20,000		5,00,000
Furniture & Fittings		60,000		20,000
Trade receivables less 2.5%		2,68,125		1,70,625
Inventory less 2%		2,20,500		1,37,200
Cash at Bank		1,20,000		55,000
Cash in hand		41,375		17,175
		18,60,000		12,00,000
Less : Debentures	2,00,000		–	
Trade payables	1,00,000		2,10,000	
Secured Loans	–	(3,00,000)	2,00,000	(4,10,000)
		15,60,000		7,90,000
Payable in shares		14,96,000		7,26,000
Payable in cash		64,000		64,000

Illustration 8

The following are the summarized Balance Sheets of A Ltd. and B Ltd. as on 31.3.20X1:

		(₹ in thousands)
Liabilities	*A Ltd.*	*B Ltd.*
Share capital:		
Equity shares of 100 each fully paid up	*2,000*	*1,000*
Reserves	*1,000*	*---*
10% Debentures	*500*	*---*

Loans from Banks	*250*	*450*
Bank overdrafts	*---*	*50*
Trade payables	*300*	*300*

Total	*4,050*	*1,800*
Assets		
Tangible assets/fixed assets	*2,700*	*850*
Investments	*700*	*---*
Trade receivables	*400*	*150*
Cash at bank	*250*	*---*
Accumulated loss	*---*	*800*
Total	*4,050*	*1,800*

B Ltd. has acquired the business of A Ltd. The following scheme of merger was approved:

(i) Banks agreed to waive off the loan of ₹ 60 thousands of B Ltd.

(ii) B Ltd. will reduce its shares to ₹ 10 per share and then consolidate 10 such shares into one share of ₹ 100 each (new share).

(iii) Shareholders of A Ltd. will be given one share (new) of B Ltd. in exchange of every share held in A Ltd.

(iv) Trade payables of B Ltd. includes ₹ 100 thousands payable to A Ltd.

Pass necessary entries in the books of B Ltd. and prepare Balance Sheet after merger.

Solution

Calculation of purchase consideration

One share of B Ltd. will be issued in exchange of every share of A Ltd. (i.e. 20,000 equity shares of B Ltd. will be issued against 20,000 equity shares of A Ltd.)	20,000 shares

Journal Entries in the books of B Ltd.

Date			*(₹ in thousands)*	
20X1			*Dr.*	*Cr.*
March,31	Loan from bank A/c	Dr.	60	
	To Capital reduction A/c			60
	(Being loan from bank waived off to the extent of ₹ 60 thousand)			

	Equity share capital A/c (₹ 100)	Dr.	1,000	
	To Equity share capital A/c (₹ 10)			100
	To Capital reduction A/c			900
	(Being equity shares of ₹ 100 each reduced to ₹ 10 each)			
	Equity share capital A/c (₹ 10)	Dr.	100	
	To Equity share capital A/c (₹ 100 each)			100
	(Being 10 equity shares of ₹ 10 each consolidated to one share of ₹ 100 each)			
	Capital reduction A/c	Dr.	960	
	To Profit and loss A/c			800
	To Capital reserve A/c			160
	(Being accumulated losses set off against reconstruction A/c and balance transferred to capital reserve account)			
	Business purchase A/c	Dr.	2,000	
	To Liquidator of A Ltd.			2,000
	(Being purchase of business of A Ltd.)			
	Fixed asset A/c	Dr.	2,700	
	Investment A/c	Dr.	700	
	Trade receivables A/c	Dr.	400	
	Cash at bank A/c	Dr.	250	
	To Trade payables A/c			300
	To Loans from bank A/c			250
	To 10% Debentures A/c			500
	To Business purchase A/c			2,000
	To Reserves A/c			1,000
	(Being assets, liabilities and reserves taken over under pooling of interest method)			
	Liquidator of A Ltd. A/c	Dr.	2,000	
	To Equity share capital A/c			2,000
	(Being payment made to liquidators of A Ltd. by allotment of 20,000 new equity shares)			

	Trade payables A/c	Dr.	100	
	To Trade receivables A/c			100
	(Being mutual owing cancelled)			

Balance Sheet of B Ltd. after merger as on 31.3.20X1

		Particulars	Notes	₹ in '000
		Equity and Liabilities		
1		**Shareholders' funds**		
	a	Share capital	1	2,100
	b	Reserves and Surplus	2	1,160
2		**Non-current liabilities**		
	a	Long term borrowings	3	1,140
3		**Current liabilities**		
	a	Trade payables		500
	b	Short term borrowings	4	50
		Total		**4,950**
		Assets		
1		**Non-current assets**		
	a	Fixed assets		
		Tangible assets		3,550
	b	Non-current investments		700
2		**Current assets**		
	a	Trade receivables		450
	b	Cash and cash equivalents		250
		Total		**4,950**

Notes to accounts

			₹ in '000
1	**Share Capital**		
	21,000, Equity shares of ₹ 100 each fully paid		2,100
	(Out of the above, 20,000 shares have been issued for consideration other than cash)		
2	**Reserves and Surplus**		
	Capital reserve	160	

	General reserve	1,000	
	Total		**1,160**
3	**Long Term Borrowings**		
	10% Debentures	500	
	Loan from Bank (250+450-60)	640	1,140
4	**Short term borrowings**		
	Bank overdraft		250

Illustration 9

The following are the summarized Balance Sheets of P Ltd. and Q Ltd. as on 31st March, 20X1:

Liabilities	*P Ltd.* *₹*	*Q Ltd.* *₹*	*Assets*	*P Ltd.* *₹*	*Q Ltd.* *₹*
Share Capital			*Fixed Assets*	*7,00,000*	*2,50,000*
Equity Shares of ₹ 10 each	*6,00,000*	*3,00,000*	*Investment*	*80,000*	*80,000*
			Current Assets:		
10% Pref. Shares of ₹ 100 each	*2,00,000*	*1,00,000*	*Inventory*	*2,40,000*	*3,20,000*
			Trade receivables	*4,20,000*	*2,10,000*
Reserves and Surplus	*3,00,000*	*2,00,000*	*Cash at Bank*	*1,10,000*	*40,000*
Secured Loans:					
12% Debentures	*2,00,000*	*1,50,000*			
Current Liabilities:					
Trade payables	*2,50,000*	*1,50,000*			
	15,50,000	*9,00,000*		*15,50,000*	*9,00,000*

Details of Trade receivables and trade payables are as under:

	P Ltd. (₹)	*Q Ltd. (₹)*
Trade receivables		
Debtors	*3,60,000*	*1,90,000*
Bills Receivable	*60,000*	*20,000*
	4,20,000	*2,10,000*
Trade payables		
Sundry Creditors	*2,20,000*	*1,25,000*
Bills Payable	*30,000*	*25,000*
	2,50,000	*1,50,000*

Fixed Assets of both the companies are to be revalued at 15% above book value. Inventory in Trade and Debtors are taken over at 5% lesser than their book value. Both the companies are to pay 10% Equity dividend, Preference dividend having been already paid.

After the above transactions are given effect to, P Ltd. will absorb Q Ltd. on the following terms:

(i) 8 Equity Shares of ₹ 10 each will be issued by P Ltd. at par against 6 shares of Q Ltd.

(ii) 10% Preference Shareholders of Q Ltd. will be paid at 10% discount by issue of 10% Preference Shares of ₹ 100 each at par in P Ltd.

(iii) 12% Debenture holders of Q Ltd. are to be paid at 8% premium by 12% Debentures in P Ltd. issued at a discount of 10%.

(iv) ₹ 30,000 is to be paid by P Ltd. to Q Ltd. for Liquidation expenses. Sundry Creditors of Q Ltd. include ₹ 10,000 due to P Ltd.

Prepare:

(a) Journal entries in the books of P Ltd.

(b) Statement of consideration payable by P Ltd.

Solution

(a) Journal Entries in the Books of P Ltd.

		Dr. ₹	*Cr.* ₹
Fixed Assets	Dr.	1,05,000	
To Revaluation Reserve			1,05,000
(Revaluation of fixed assets at 15% above book value)			
Reserve and Surplus	Dr.	60,000	
To Equity Dividend			60,000
(Declaration of equity dividend @ 10%)			
Equity Dividend	Dr.	60,000	
To Bank Account			60,000
(Payment of equity dividend)			
Business Purchase Account	Dr.	4,90,000	
To Liquidator of Q Ltd.			4,90,000
(Consideration payable for the business taken over from Q Ltd.)			
Fixed Assets (115% of ₹ 2,50,000)	Dr.	2,87,500	
Inventory (95% of ₹ 3,20,000)	Dr.	3,04,000	

Debtors	Dr.	1,90,000	
Bills Receivable	Dr.	20,000	
Investment	Dr.	80,000	
Cash at Bank	Dr.	10,000	
(₹ 40,000 –₹ 30,000 dividend paid)			
To Provision for Bad Debts (5% of ₹ 1,90,000)			9,500
To Sundry Creditors			1,25,000
To 12% Debentures in Q Ltd.			1,62,000
To Bills Payable			25,000
To Business Purchase Account			4,90,000
To Capital Reserve (Balancing figure)			80,000
(Incorporation of various assets and liabilities taken over from Q Ltd. at agreed values and difference of net assets and purchase consideration being credited to capital reserve)			
Liquidator of Q Ltd.	Dr.	4,90,000	
To Equity Share Capital			4,00,000
To 10% Preference Share Capital			90,000
(Discharge of consideration for Q Ltd.'s business)			
12% Debentures in Q Ltd. (₹ 1,50,000 × 108%)	Dr.	1,62,000	
Discount on Issue of Debentures	Dr.	18,000	
To 12% Debentures			1,80,000
(Allotment of 12% Debentures to debenture holders of Q Ltd. at a discount of 10%)			
Sundry Creditors of Q Ltd.	Dr.	10,000	
To Sundry Debtors of P Ltd.			10,000
(Cancellation of mutual owing)			
Goodwill	Dr.	30,000	
To Bank			30,000
(Being liquidation expenses reimbursed to Q Ltd.)			
Capital Reserve	Dr.	30,000	
To Goodwill			30,00
(Being goodwill set off)			

(b) Statement of Consideration payable by P Ltd. for 30,000 shares (payment method)

Shares to be allotted $\frac{30,000}{6} \times 8$ = 40,000 shares of P Ltd.

Issued 40,000 shares of ₹ 10 each i.e.	₹ 4,00,000	(i)
For 10% preference shares, to be paid at 10% discount		
₹ $\frac{1,00,000 \times 90}{100}$	₹ 90,000	(ii)
Consideration amount [(i) + (ii)]	₹ 4,90,000	

Illustration 10

The financial position of two companies Hari Ltd. and Vayu Ltd. as on 31st March, 20X1 was as under:

Assets	*Hari Ltd. (₹)*	*Vayu Ltd. (₹)*
Goodwill	*50,000*	*25,000*
Building	*3,00,000*	*1,00,000*
Machinery	*5,00,000*	*1,50,000*
Inventory	*2,50,000*	*1,75,000*
Trade receivables	*2,00,000*	*1,00,000*
Cash at Bank	*50,000*	*20,000*
	13,50,000	*5,70,000*
Liabilities	*Hari Ltd. (₹)*	*Vayu Ltd. (₹)*
Share Capital:		
Equity Shares of ₹ 10 each	*10,00,000*	*3,00,000*
9% Preference Shares of ₹ 100 each	*1,00,000*	*–*
10% Preference Shares of ₹ 100 each	*–*	*1,00,000*
General Reserve	*70,000*	*70,000*
Retirement Gratuity fund	*50,000*	*20,000*
Trade payables	*1,30,000*	*80,000*
	13,50,000	*5,70,000*

Hari Ltd. absorbs Vayu Ltd. on the following terms:

(a) 10% Preference Shareholders are to be paid at 10% premium by issue of 9% Preference Shares of Hari Ltd.

(b) Goodwill of Vayu Ltd. is valued at ₹ 50,000, Buildings are valued at ₹ 1,50,000 and the Machinery at ₹ 1,60,000.

(c) *Inventory to be taken over at 10% less value and Provision for Doubtful Debts to be created @ 7.5%.*

(d) *Equity Shareholders of Vayu Ltd. will be issued Equity Shares @ 5% premium.*

Prepare necessary Ledger Accounts to close the books of Vayu Ltd. and show the acquisition entries in the books of Hari Ltd. Also draft the Balance Sheet after absorption as at 31st March, 20X1.

Solution

In the Books of Vayu Ltd.
Realisation Account

		₹			₹
To	Sundry Assets	5,70,000	By	Retirement Gratuity Fund	20,000
To	Preference Shareholders (Premium on Redemption)	10,000	By	Trade payables	80,000
To	Equity Shareholders (Profit on Realisation)	50,000	By	Hari Ltd. (Purchase Consideration)	5,30,000
		6,30,000			6,30,000

Equity Shareholders Account

		₹			₹
To	Equity Shares of Hari Ltd.	4,20,000	By	Share Capital	3,00,000
			By	General Reserve	70,000
			By	Realisation Account (Profit on Realisation)	50,000
		4,20,000			4,20,000

Preference Shareholders Account

		₹			₹
To	9% Preference Shares of Hari Ltd.	1,10,000	By	Preference Share Capital	1,00,000
			By	Realisation Account (Premium on Redemption of Preference Shares)	

			10,000
	1,10,000		1,10,000

Hari Ltd. Account

	₹		₹
To Realisation Account	5,30,000	By 9% Preference Shares	1,10,000
		By Equity Shares	4,20,000
	5,30,000		5,30,000

In the Books of Hari Ltd.
Journal Entries

		Dr.	Cr.
		₹	₹
Business Purchase A/c	Dr.	5,30,000	
To Liquidators of Vayu Ltd. Account			5,30,000
(Being business of Vayu Ltd. taken over)			
Goodwill Account	Dr.	50,000	
Building Account	Dr.	1,50,000	
Machinery Account	Dr.	1,60,000	
Inventory Account	Dr.	1,57,500	
Trade receivables Account	Dr.	1,00,000	
Bank Account	Dr.	20,000	
To Retirement Gratuity Fund Account			20,000
To Trade payables Account			80,000
To Provision for Doubtful Debts Account			7,500
To Business Purchase A/c			5,30,000
(Being Assets and Liabilities taken over as per agreed valuation).			
Liquidators of Vayu Ltd. A/c	Dr.	5,30,000	
To 9% Preference Share Capital A/c			1,10,000
To Equity Share Capital A/c			4,00,000
To Securities Premium A/c			20,000
(Being Purchase Consideration satisfied as above).			

Balance Sheet of Hari Ltd. (after absorption)
as at 31st March, 20X1

		Particulars	Notes	₹
		Equity and Liabilities		
1		**Shareholders' funds**		
	A	Share capital	1	16,10,000
	B	Reserves and Surplus	2	90,000
2		**Non-current liabilities**		
	A	Long-term provisions	3	70,000
3		**Current liabilities**		
	A	Trade Payables		2,10,000
	B	Short term provision		7,500
		Total		**19,87,500**
		Assets		
1		**Non-current assets**		
	A	Fixed assets		
		Tangible assets	4	11,10,000
		Intangible assets	5	1,00,000
2		**Current assets**		
	A	Inventories		4,07,500
	B	Trade receivables	6	3,00,000
	C	Cash and cash equivalents		70,000
		Total		**19,87,500**

Notes to accounts

			₹
1	**Share Capital**		
	Equity share capital		
	1,40,000 Equity Shares of ₹ 10 each fully paid (Out of above 40,000 Equity Shares were issued in consideration other than for cash)		14,00,000
	Preference share capital		
	2,100 9% Preference Shares of ₹ 100 each (Out of above 1,100 Preference Shares were issued in consideration other than for cash)		2,10,000
	Total		**16,10,000**
2	**Reserves and Surplus**		

	Securities Premium		20,000
	General Reserve		70,000
	Total		**90,000**
3	**Long-term provisions**		
	Gratuity fund		70,000
	Total		**70,000**
4	**Short term Provisions**		
	Provision for Doubtful Debts		**7,500**
5	**Tangible assets**		
	Buildings		4,50,000
	Machinery		6,60,000
	Total		**11,10,000**
6	**Intangible assets**		
	Goodwill		1,00,000
	Total		**1,00,000**
7	**Trade receivables**		3,00,000

Working Notes:

Purchase Consideration:	₹
Goodwill	50,000
Building	1,50,000
Machinery	1,60,000
Inventory	1,57,500
Trade receivables	92,500
Cash at Bank	20,000
	6,30,000
Less: Liabilities:	
Retirement Gratuity	(20,000)
Trade payables	(80,000)
Net Assets/ Purchase Consideration	5,30,000
To be satisfied as under:	
10% Preference Shareholders of Vayu Ltd.	1,00,000
Add: 10% Premium	10,000

1,100 9% Preference Shares of Hari Ltd.	1,10,000
Equity Shareholders of Vayu Ltd. to be satisfied by issue of 40,000	
Equity Shares of Hari Ltd. at 5% Premium	4,20,000
Total	5,30,000

Summary

1. Amalgamation means joining of two or more existing companies into one company, the joined companies lose their identity and form themselves into a new company.
2. In absorption, an existing company takes over the business of another existing company. Thus there is only one liquidation and that is of the merged company.
3. A company which is merged into another company is called a transferor company or a vendor company.
4. A company into which the vendor company is merged is called transferee company or vendee company or purchasing company.
5 In amalgamation in the nature of merger there is genuine pooling of:

   (a) Assets and liabilities of the amalgamating companies,

   (b) Shareholders' interest,

   Also the business of the transferor company is intended to be carried on by the transferee company.
6. In amalgamation in the nature of purchase, one company acquires the business of another company.
7. Purchase Consideration can be defined as the aggregate of the shares and securities issued and the payment made in form of cash or other assets by the transferee company to the share holders of the transferor company.
8. There are two main methods of accounting for amalgamation:

   (a) The pooling of interests method, and

   (b) The purchase method.
9. Under pooling of interests method, the assets, liabilities and reserves of the transferor company will be taken over by transferee company at existing carrying amounts.
10. Under purchase method, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

APPENDIX I

AS 1 : Disclosure of Accounting Policies*

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard sho uld be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with the disclosure of significant accounting policies followed in preparing and 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 the 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 Standards 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.

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 forms part of accounts in some cases while in others it is given as supplementary information.

8. The purpose of this Standard 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.

* Issued in November, 1979

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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 standard.)

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 judgement by the management of the enterprise.

13. The various standards 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.

(a) Methods of depreciation, depletion and amortisation

(b) Treatment of expenditure during construction

(c) Conversion or translation of foreign currency items

(d) Valuation of inventories

(e) Treatment of goodwill

(f) Valuation of investments

(g) Treatment of retirement benefits

(h) Recognition of profit on long-term contracts

(i) Valuation of fixed assets

(j) 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 the 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.

Main Principles

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 : Valuation of Inventories*

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

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 Standard 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 Standard 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, Construction Contracts);

(b) work in progress arising in the ordinary course of business of service providers;

(c) shares, debentures and other financial instruments held as stock-in-trade; and

(d) producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

*.Revised in 1999.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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 Standard.

Definitions

3. The following terms are used in this Standard with the meanings specified:

3.1. 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.

3.2. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

4. Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and 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.

Measurement of Inventories

5. Inventories should be valued at the lower of cost and net realisable value.

Cost of Inventories

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

Costs of Purchase

7. The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

Costs of Conversion

8. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

9. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in 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 cost are necessary in the production process prior to a further production stage;

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

(d) selling and distribution costs.

Cost Formulas

14. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

15. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large numbers of items of inventory which are ordinarily 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[2].

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:

(a) Raw materials and components

(b) Work-in-progress

(c) Finished goods

(d) Stock-in-trade (in respect of goods acquired for trading)

(e) Stores and spares

(f) Loose tools

(g) Others (specify nature)".

[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, 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 Accounting Standards.

AS 3 : Cash Flow Statements*

Cash Flow Statements

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards*[1] *and the 'Applicability of Accounting Standards to Various Entities'.]*

This Accounting Standard is not mandatory for Small and Medium Sized Companies and non-corporate entities falling in Level II and Level III as defined in 'Applicability of Accounting Standards to Various Entities.' Such entities are however encouraged to comply with this 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 Standard 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 a 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.

*Revised in 1997

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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 Standard with the meanings specified:

5.1. Cash comprises cash on hand and demand deposits with banks

5.2 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.

5.3. Cash flows are inflows and outflows of cash and cash equivalents.

5.4. Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

5.5. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

5.6. 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, 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 a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities and includes the differences, if any, had those cash flows been reported at the end-of-period exchange rates.

Extraordinary Items

28. The cash flows associated with extraordinary items should be classified as arising from operating, investing or financing activities as appropriate and separately disclosed.

29. The cash flows associated with extraordinary items are disclosed separately as arising from operating, investing or financing activities in the cash flow statement, to enable users to understand their nature and effect on the present and future cash flows of the enterprise. These disclosures are in addition to the separate disclosures of the nature and amount of extraordinary items required by Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Interest and Dividends

30. Cash flows from interest and dividends received and paid should each be disclosed separately. Cash flows arising from interest paid and interest and dividends received in the case of a financial enterprise should be classified as cash flows arising from operating activities. In the case of other enterprises, cash flows arising from interest paid should be classified as cash flows from financing activities while interest and dividends received should be classified as cash flows from investing activities. Dividends paid should be classified as cash flows from financing activities.

31. The total amount of interest paid during the period is disclosed in the cash flow statement whether it has been recognised as an expense in the statement of profit and loss or capitalised in accordance with Accounting Standard (AS) 10, Accounting for Fixed Assets.

32. Interest paid and interest and dividends received are usually classified as operating cash flows for a financial enterprise. However, there is no consensus on the classification of these cash flows for other enterprises. Some argue that interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of net profit or loss. However, it is more appropriate that interest paid and interest and dividends received are classified as financing cash

flows and investing cash flows respectively, because they are cost of obtaining financial resources or returns on investments.

33. Some argue that dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows. However, it is considered more appropriate that dividends paid should be classified as cash flows from financing activities because they are cost of obtaining financial resources.

Taxes on Income

34. Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

35. Taxes on income arise on transactions that give rise to cash flows that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities, the related tax cash flows are often impracticable to identify and may arise in a different period from the cash flows of the underlying transactions. Therefore, taxes paid are usually classified as cash flows from operating activities. However, when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities, the tax cash flow is classified as an investing or financing activity as appropriate. When tax cash flow 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 by 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.

Illustration I

Cash Flow Statement for an Enterprise other than a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration 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 illustration 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

(₹ '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

	(₹ '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)]

		(₹ '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	
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

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 ₹'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	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

Illustration II

Cash Flow Statement for a Financial Enterprise

This illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

1. The illustration shows only current period amounts.
2. The illustration is presented using the direct method.

		(₹ '000)
		1996
Cash flows from operating activities		
Interest and commission receipts	28,447	
Interest payments	(23,463)	
Recoveries on loans previously written off	237	
Cash payments to employees and suppliers	(997)	
Operating profit before changes in operating assets	4,224	
(Increase) decrease in operating assets:		
Short-term funds	(650)	
Deposits held for regulatory or monetary control purposes	234	
Funds advanced to customers	(288)	
Net increase in credit card receivables	(360)	
Other short-term securities	(120)	
Increase (decrease) in operating liabilities:		
Deposits from customers	600	
Certificates of deposit	(200)	
Net cash from operating activities before income tax	3,440	
Income taxes paid	(100)	
Net cash from operating activities		3,340
Cash flows from investing activities		
Dividends received	250	
Interest received	300	
Proceeds from sales of permanent investments	1,200	
Purchase of permanent investments	(600)	
Purchase of fixed assets	(500)	
Net cash from investing activities		650
Cash flows from financing activities		

Issue of shares	1,800	
Repayment of long-term borrowings	(200)	
Net decrease in other borrowings	(1,000)	
Dividends paid	(400)	
Net cash from financing activities		200
Net increase in cash and cash equivalents		4,190
Cash and cash equivalents at beginning of period		4,650
Cash and cash equivalents at end of period		8,840

AS 7*: Construction Contracts

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards*[1] *and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

The objective of this Standard 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 Standard 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 Standard should be applied in accounting for construction contracts in the financial statements of contractors.

Definitions

2. The following terms are used in this Standard with the meanings specified:

2.1 A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

2.2 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.

* Revised in 2002 and came 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.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2.3 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 Standard, 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 Standard, 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 Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard 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:

(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[2]. Contingencies may arise from such items as warranty costs, penalties or possible losses.

Illustration

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

Disclosure of Accounting Policies

The following are illustrations 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.

[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, 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 Accounting Standards.

The Determination of Contract Revenue and Expenses

The following illustration 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 hereinbelow 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 revenue	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:

	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
Expenses	8,200	6,068	2,132
Profit	1,000	740	260

Contract Disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance upto the reporting date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

Contract

(amount in Rs. lakhs)

	A	*B*	*C*	*D*	*E*	*Total*
Contract Revenue recognised in accordance with paragraph 21	145	520	380	200	55	1,300
Contract Expenses recognised in accordance with paragraph 21	110	450	350	250	55	1,215
Expected Losses recognised in accordance with paragraph 35	—	—	—	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract Costs incurred in the period	110	510	450	250	100	1,420
Contract Costs incurred recognised as contract expenses in the period in accordance with paragraph 21	110	450	350	250	55	1,215
Contract Costs that relate to future activity recognised as an asset in accordance with paragraph 26	—	60	100	—	45	205
Contract Revenue (see above)	145	520	380	200	55	1,300
Progress Billings (paragraph 40)	100	520	380	180	55	1,235
Unbilled Contract Revenue	45	—	—	20	—	65
Advances (paragraph 40)	—	80	20	—	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period [paragraph 38(a)]	1,300
Contract costs incurred and recognised profits (less recognised losses) upto the reporting date [paragraph 39(a)]	1,435
Advances received [paragraph 39(b)]	125

Gross amount due from customers for contract work —

presented as an asset in accordance with paragraph 41(a) 220

Gross amount due to customers for contract work —

presented as a liability in accordance with paragraph 41(b) (20)

The amounts to be disclosed in accordance with paragraphs 39(a), 41(a) and 41(b) are calculated as follows:

					(amount in Rs. lakhs)	
A	B	C	D	E	Total	
Contract Costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	—	15	220
Due to customers	—	—	—	(20)	—	(20)

The amount disclosed in accordance with paragraph 39(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

AS 9* : Revenue Recognition[1]

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The Standard 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 Standard does not deal with the following aspects of revenue recognition to which special considerations apply:

* Issued in 1985

[1] It is reiterated that this Accounting Standard (as is the case of other accounting standards) 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.

[2] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(i) Revenue arising from construction contracts[3]

(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 Standard 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 Standard with the meanings specified:

4.1 Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise[4] 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.

[3] Refer to AS 7 on 'Construction Contracts'.

[4] The Institute has issued an Announcement in 2005 titled 'Treatment of Inter-divisional Transfers'. As per the Announcement, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with Accounting Standard 9.

6. Sale of Goods

6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

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

Main Principles

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.

Explanation :

The amount of revenue from sales transactions (turnover) should be disclosed in the following manner on the face of the statement of profit or loss :

Turnover (Gross)	*XX*	
Less: Excise Duty	*XX*	
Turnover (Net)		*XX*

The amount of excise duty to be deducted from the turnover should be the total excise duty for the year except the excise duty related to the difference between the closing start and opening stock. The excise duty related to the difference between the closing stock and opening stock should be recognised separately in the statement of profit or loss, with an explanatory note in the notes to accounts to explain the nature of the two amounts of excise duty.

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 the 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.***
(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.

Illustrations

These illustrations do not form part of the Accounting Standard. Their purpose 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 notwithstanding 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 and 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 order 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 deferred and recognised either on a straight line basis over time or, where the items delivered vary in value from period to 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;

(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 fee 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 : Property, Plant and Equipment

(This Accounting Standard includes paragraphs set in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the General Instructions contained in part A of the Annexure to the Notification.)

Objective

1. The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about investment made by an enterprise in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Scope

2. This Standard should be applied in accounting for property, plant and equipment except when another Accounting Standard requires or permits a different accounting treatment.

3. This Standard does not apply to:

(a) biological assets related to agricultural activity other than bearer plants. This Standard applies to bearer plants but it does not apply to the produce on bearer plants; and

(b) wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (a) and (b) above.

4. Other Accounting Standards may require recognition of an item of property, plant and equipment based on an approach different from that in this Standard. For example, AS 19, Leases, requires an enterprise to evaluate its recognition of an item of leased property, plant and equipment on the basis of the transfer of risks and rewards. However, in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

5. Investment property, as defined in AS 13, Accounting for Investments, should be accounted for only in accordance with the cost model prescribed in this standard.

Definitions

6. The following terms are used in this Standard with the meanings specified:

Agricultural Activity is the management by an enterprise of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce or into additional biological assets.

Agricultural Produce is the harvested product of biological assets of the enterprise.

Bearer plant is a plant that

(a) ***is used in the production or supply of agricultural produce;***

(b) ***is expected to bear produce for more than a period of twelve months; and***

(c) ***has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.***

The following are not bearer plants:

(i) plants cultivated to be harvested as agricultural produce (for example, trees grown for use as lumber);

(ii) plants cultivated to produce agricultural produce when there is more than a remote likelihood that the entity will also harvest and sell the plant as agricultural produce, other than as incidental scrap sales (for example, trees that are cultivated both for their fruit and their lumber); and

(iii) annual crops (for example, maize and wheat).

When bearer plants are no longer used to bear produce they might be cut down and sold as scrap, for example, for use as firewood. Such incidental scrap sales would not prevent the plant from satisfying the definition of a bearer plant.

Biological Asset is a living animal* or plant.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Accounting Standards.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Enterprise -specific value is the present value of the cash flows an enterprise expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Gross carrying amount of an asset is its cost or other amount substituted for the cost in the books of account, without making any deduction for accumulated depreciation and accumulated impairment losses.

An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. Property, plant and equipment are tangible items that:

(a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) are expected to be used during more than a period of twelve months. Recoverable amount is the higher of an asset's net selling price and its value in use.

* An Accounting Standard on Agriculture is under formulation, which will, inter alia, cover accounting for livestock. Till the time, the Accounting Standard on Agriculture is issued, accounting for livestock meeting the definition of Property, Plant and Equipment, will be covered as per AS 10 (Revised), Property, Plant and Equipment.

The residual value of an asset is the estimated amount that an enterprise would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Useful life is:

(a) the period over which an asset is expected to be available for use by an enterprise; or

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

Recognition

7. The cost of an item of property, plant and equipment should be recognised as an asset if, and only if:

(a) ***it is probable that future economic benefits associated with the item will flow to the enterprise; and***

(b) ***the cost of the item can be measured reliably.***

8. Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this Standard when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

9. This Standard does not prescribe the unit of measure for recognition, i.e., what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to specific circumstances of an enterprise. An example of a 'unit of measure' can be a 'project' of construction of a manufacturing plant rather than individual assets comprising the project in appropriate cases for the purpose of capitalisation of expenditure incurred during construction period. Similarly, it may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies and to apply the criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as property, plant and equipment, because the amount of the expenditure is not material.

10. An enterprise evaluates under this recognition principle all its costs on property, plant and equipment at the time they are incurred. These costs include costs incurred:

(a) initially to acquire or construct an item of property, plant and equipment; and

(b) subsequently to add to, replace part of, or service it.

Initial Costs

11. The definition of 'property, plant and equipment' covers tangible items which are held for use or for administrative purposes. The term 'administrative purposes' has been used in wider sense to include all business purposes other than production or supply of goods or services or for rental for others. Thus, property, plant and equipment would include assets used for selling and distribution, finance and accounting, personnel and other functions of an enterprise. Items of property, plant and equipment may also be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an enterprise to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an enterprise to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the enterprise is unable to manufacture and sell chemicals. The resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with AS 28, *Impairment of Assets*.

Subsequent Costs

12. Under the recognition principle in paragraph 7, an enterprise does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in the statement of profit and loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of such expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

13. Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Similarly, major parts of conveyor system, such as, conveyor belts, wire ropes, etc., may require replacement several times during the life of the conveyor system. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an enterprise recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 74-80).

14. A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised.

15. The derecognition of the carrying amount as stated in paragraphs 13-14 occurs regardless of whether the cost of the previous part / inspection was identified in the transaction in which the item was acquired or constructed. If it is not practicable for an enterprise to determine the carrying amount of the replaced part/ inspection, it may use the cost of the replacement or the estimated cost of a future similar inspection as an indication of what the cost of the replaced part/ existing inspection component was when the item was acquired or constructed.

Measurement at Recognition

16. An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.

Elements of Cost

17. The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as 'decommissioning, restoration and similar liabilities', the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

18. Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

19. An enterprise applies AS 2, Valuation of Inventories, to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period. The obligations for costs accounted for in accordance with AS 2 or AS 10 are recognised and measured in accordance with AS 29, Provisions, Contingent Liabilities and Contingent Assets.

20. Examples of costs that are not costs of an item of property, plant and equipment are:

(a) costs of opening a new facility or business, such as, inauguration costs;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

21. Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) initial operating losses, such as those incurred while demand for the output of an item builds up; and

(c) costs of relocating or reorganising part or all of the operations of an enterprise.

22. Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in the statement of profit and loss and included in their respective classifications of income and expense.

23. The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an enterprise makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see AS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self- constructing an asset is not included in the cost of the asset. AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

24. Bearer plants are accounted for in the same way as self-constructed items of property, plant and equipment before they are in the location and condition necessary to be capable of operating in the manner intended by management. Consequently, references to 'construction' in this Standard should be read as covering activities that are necessary to cultivate the bearer plants before they are in the location and condition necessary to be capable of operating in the manner intended by management.

Measurement of Cost

25. The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is capitalised in accordance with AS 16.

26. One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset(s) received nor the asset(s) given up is reliably measurable. The acquired item(s) is/are measured in this manner even if an enterprise cannot immediately derecognise the asset given up. If the acquired item(s) is/are not measured at fair value, its/their cost is measured at the carrying amount of the asset(s) given up.

27. An enterprise determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the enterprise-specific value of the portion of the operations of the enterprise affected by the transaction changes as a result of the exchange;

(c) and the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.

For the purpose of determining whether an exchange transaction has commercial substance, the enterprise - specific value of the portion of operations of the enterprise affected by the transaction should reflect post-tax cash flows. In certain cases, the result of these analyses may be clear without an enterprise having to perform detailed calculations.

28. The fair value of an asset is reliably measurable if (a) the variability in the range of reasonable fair value measurements is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used when measuring fair value. If an enterprise is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

29. Where several items of property, plant and equipment are purchased for a consolidated price, the consideration is apportioned to the various items on the basis of their respective fair values at the date of acquisition. In case the fair values of the items acquired cannot be measured reliably, these values are estimated on a fair basis as determined by competent valuers.

30. The cost of an item of property, plant and equipment held by a lessee under a finance lease is determined in accordance with AS 19, Leases.

31. The carrying amount of an item of property, plant and equipment may be reduced by government grants in accordance with AS 12, Accounting for Government Grants.

Measurement after Recognition

32. An enterprise should choose either the cost model in paragraph 33 or the revaluation model in paragraph 34 as its accounting policy and should apply that policy to an entire class of property, plant and equipment.

Cost Model

33. After recognition as an asset, an item of property, plant and equipment should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation Model

34. After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

35. The fair value of items of property, plant and equipment is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers.

36. If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an enterprise may need to estimate fair value using an income approach (for example, based on discounted cash flow projections) or a depreciated replacement cost approach which aims at making a realistic estimate of the current cost of acquiring or constructing an item that has the same service potential as the existing item.

37. The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

38. When an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or

(b) the accumulated depreciation is eliminated against the gross carrying amount of the asset.

The amount of the adjustment of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with paragraphs 42 and 43.

39. If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs should be revalued.

40. A class of property, plant and equipment is a grouping of assets of a similar nature and use in operations of an enterprise. The following are examples of separate classes:

(a) land;

(b) land and buildings;

(c) machinery;

(d) ships;

(e) aircraft;

(f) motor vehicles;

(g) furniture and fixtures;

(h) office equipment; and

(i) bearer plants.

41. The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

42. An increase in the carrying amount of an asset arising on revaluation should be credited directly to owners' interests under the heading of revaluation surplus However, the increase should be recognised in the statement of profit and loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in the statement of profit and loss.

43. A decrease in the carrying amount of an asset arising on revaluation should be charged to the statement of profit and loss. However, the decrease should be debited directly to owners' interests under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

44. The revaluation surplus included in owners' interests in respect of an item of property, plant and equipment may be transferred to the revenue reserves when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an enterprise. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on its original cost. Transfers from revaluation surplus to the revenue reserves are not made through the statement of profit and loss.

Depreciation

45. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately.

46. An enterprise allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates each such part separately. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.

47. A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

48. To the extent that an enterprise depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an enterprise has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

49. An enterprise may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.

50. The depreciation charge for each period should be recognised in the statement of profit and loss unless it is included in the carrying amount of another asset.

51. The depreciation charge for a period is usually recognised in the statement of profit and loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see AS 2). Similarly, the depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with AS 26, *Intangible Assets*.

Depreciable Amount and Depreciation Period

52. The depreciable amount of an asset should be allocated on a systematic basis over its useful life.

53. The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

54. Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

55. The depreciable amount of an asset is determined after deducting its residual value.

56. The residual value of an asset may increase to an amount equal to or greater than its carrying amount. If it does, depreciation charge of the asset is zero unless and until its residual value subsequently decreases to an amount below its carrying amount.

57. Depreciation of an asset begins when it is available for use, *i.e.*, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is retired from active use and is held for disposal and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use (but not held for disposal) unless the asset is fully depreciated. However, under usage methods of depreciation, the depreciation charge can be zero while there is no production.

58. The future economic benefits embodied in an asset are consumed by an enterprise principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the expected capacity or physical output of the asset.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset. Expected future reductions in the selling price of an item that was produced using an asset could indicate the expectation of technical or commercial obsolescence of the asset, which, in turn, might reflect a reduction of the future economic benefits embodied in the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

59. The useful life of an asset is defined in terms of its expected utility to the enterprise. The asset management policy of the enterprise may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the enterprise with similar assets.

60. Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

61. If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

Depreciation Method

62. The depreciation method used should reflect the pattern in which the future economic benefits of the asset are expected to be consumed by the enterprise.

63. The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Such a change should be accounted for as a change in an accounting estimate in accordance with AS 5.

64. A variety of depreciation 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 units of production method. Straight-line depreciation results in a constant charge over the useful life if the residual value of the asset does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The enterprise selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits or that the method is changed in accordance with the statute to best reflect the way the asset is consumed.

65. A depreciation method that is based on revenue that is generated by an activity that includes the use of an asset is not appropriate. The revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of the economic benefits of the asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

Changes in Existing Decommissioning, Restoration and Other Liabilities

66. The cost of property, plant and equipment may undergo changes subsequent to its acquisition or construction on account of changes in liabilities, price adjustments, changes in duties, changes in initial estimates of amounts provided for dismantling, removing, restoration and similar factors and included in the cost of the asset in accordance with paragraph 16. Such changes in cost should be accounted for in accordance with paragraphs 67–68 below.

67. If the related asset is measured using the cost model:

(a) ***subject to (b), changes in the liability should be added to, or deducted from, the cost of the related asset in the current period.***

(b) ***the amount deducted from the cost of the asset should not exceed its carrying amount. If a decrease in the liability exceeds the carrying amount of the asset, the excess should be recognised immediately in the statement of profit and loss.if the adjustment results in an addition to the cost of an asset, the enterprise should consider whether this is an indication that the new carrying amount of the asset may not be fully recoverable. If it is such an indication, the enterprise should test the asset for impairment by estimating its recoverable amount, and should account for any impairment loss, in accordance with AS 28.***

68. If the related asset is measured using the revaluation model:

(a) ***changes in the liability alter the revaluation surplus or deficit previously recognised on that asset, so that:***

(i) ***a decrease in the liability should (subject to (b)) be credited directly to revaluation surplus in the owners' interest, except that it should be recognised in the statement of profit and loss to the extent that it reverses a revaluation deficit on the asset that was previously recognised in the statement of profit and loss;***

(ii) ***an increase in the liability should be recognised in the statement of profit and loss, except that it should be debited directly to revaluation surplus in the owners' interest to the extent of any credit balance existing in the revaluation surplus in respect of that asset.***

(b) ***in the event that a decrease in the liability exceeds the carrying amount that would have***

been recognised had the asset been carried under the cost model, the excess should be recognised immediately in the statement of profit and loss.

(c) ***a change in the liability is an indication that the asset may have to be revalued in order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Any such revaluation should be taken into account in determining the amounts to be taken to the statement of profit and loss and the owners' interest under (a). If a revaluation is necessary, all assets of that class should be revalued.***

69. The adjusted depreciable amount of the asset is depreciated over its useful life. Therefore, once the related asset has reached the end of its useful life, all subsequent changes in the liability should be recognised in the statement of profit and loss as they occur. This applies under both the cost model and the revaluation model.

Impairment

70. To determine whether an item of property, plant and equipment is impaired, an enterprise applies AS 28, Impairment of Assets. AS 28 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 the recognition of, an impairment loss.

Compensation for Impairment

71. Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up should be included in the statement of profit and loss when the compensation becomes receivable.

72. Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

(a) impairments of items of property, plant and equipment are recognised in accordance with AS 28;

(b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

(c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

(d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

Retirements

73. Items of property, plant and equipment retired from active use and held for disposal should be stated at the lower of their carrying amount and net realisable value. Any write-down in this regard should be recognised immediately in the statement of profit and loss.

Derecognition

74. The carrying amount of an item of property, plant and equipment should be derecognised

(a) ***on disposal; or***

(b) ***when no future economic benefits are expected from its use or disposal.***

75. The gain or loss arising from the derecognition of an item of property, plant and equipment should be included in the statement of profit and loss when the item is derecognised (unless AS

19, Leases, requires otherwise on a sale and leaseback). Gains should not be classified as revenue, as defined in AS 9, Revenue Recognition.

76. However, an enterprise that in the course of its ordinary activities, routinely sells items of property, plant and equipment that it had held for rental to others should transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets should be recognised in revenue in accordance with AS 9, Revenue Recognition.

77. The disposal of an item of property, plant and equipment may occur in a variety of ways (e.g. by sale, by entering into a finance lease or by donation). In determining the date of disposal of an item, an enterprise applies the criteria in AS 9 for recognising revenue from the sale of goods. AS 19, Leases, applies to disposal by a sale and leaseback.

78. If, under the recognition principle in paragraph 7, an enterprise recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an enterprise to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

79. The gain or loss arising from the derecognition of an item of property, plant and equipment should be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

80. The consideration receivable on disposal of an item of property, plant and equipment is recognised in accordance with the principles enunciated in AS 9.

Disclosure

81. The financial statements should disclose, for each class of property, plant and equipment:

(a) ***the measurement bases (i.e., cost model or revaluation model) used for determining the gross carrying amount;***

(b) ***the depreciation methods used;***

(c) ***the useful lives or the depreciation rates used. In case the useful lives or the depreciation rates used are different from those specified in the statute governing the enterprise, it should make a specific mention of that fact;***

(d) ***the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and***

(e) ***a reconciliation of the carrying amount at the beginning and end of the period showing:***

(i) additions;

(ii) assets retired from active use and held for disposal;

(iii) acquisitions through business combinations;

(iv) increases or decreases resulting from revaluations under paragraphs 34, 42 and 43 and from impairment losses recognised or reversed directly in revaluation surplus in accordance with AS 28;

(v) impairment losses recognised in the statement of profit and loss in accordance with AS 28;

(vi) ***impairment losses reversed in the statement of profit and loss in accordance with AS 28;***

(vii) ***depreciation;***

(viii) ***the net exchange differences arising on the translation of the financial statements of a non-integral foreign operation in accordance with AS 11, The Effects of Changes in Foreign Exchange Rates; and***

(ix) ***other changes.***

82. The financial statements should also disclose:

(a) ***the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;***

(b) ***the amount of expenditure recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;***

(c) ***the amount of contractual commitments for the acquisition of property, plant and equipment;***

(d) ***if it is not disclosed separately on the face of the statement of profit and loss, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in the statement of profit and loss; and***

(e) ***the amount of assets retired from active use and held for disposal.***

83. Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other enterprises. For similar reasons, it is necessary to disclose:

(a) depreciation, whether recognised in the statement of profit and loss or as a part of the cost of other assets, during a period; and

(b) accumulated depreciation at the end of the period.

84. In accordance with AS 5, an enterprise discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

(a) residual values;

(b) the estimated costs of dismantling, removing or restoring items of property, plant and equipment;

(c) useful lives; and

(d) depreciation methods.

85. If items of property, plant and equipment are stated at revalued amounts, the following should be disclosed:

(a) ***the effective date of the revaluation;***

(b) ***whether an independent valuer was involved;***

(c) ***the methods and significant assumptions applied in estimating fair values of the items;***

(d) ***the extent to which fair values of the items were determined directly by reference to***

observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques; and

(e) ***the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.***

86. In accordance with AS 28, an enterprise discloses information on impaired property, plant and equipment in addition to the information required by paragraph 81 (e), (iv), (v) and (vi).

87. An enterprise is encouraged to disclose the following:

(a) the carrying amount of temporarily idle property, plant and equipment;

(b) the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

(c) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model;

(d) the carrying amount of property, plant and equipment retired from active use and not held for disposal.

Transitional Provisions

88. Where an entity has in past recognized an expenditure in the statement of profit and loss which is eligible to be included as a part of the cost of a project for construction of property, plant and equipment in accordance with the requirements of paragraph 9, it may do so retrospectively for such a project. The effect of such retrospective application of this requirement, should be recognised net-of-tax in revenue reserves.

89. The requirements of paragraphs 26-28 regarding the initial measurement of an item of property, plant and equipment acquired in an exchange of assets transaction should be applied prospectively only to transactions entered into after this Standard becomes mandatory.

90. On the date of this Standard becoming mandatory, the spare parts, which hitherto were being treated as inventory under AS 2, Valuation of Inventories, and are now required to be capitalised in accordance with the requirements of this Standard, should be capitalised at their respective carrying amounts. The spare parts so capitalised should be depreciated over their remaining useful lives prospectively as per the requirements of this Standard.

The requirements of paragraph 32 and paragraphs 34 – 44 regarding the revaluation model should be applied prospectively. In case, on the date of this Standard becoming mandatory, an enterprise does not adopt the revaluation model as its accounting policy but the carrying amount of item(s) of property, plant and equipment reflects any previous revaluation it should adjust the amount outstanding in the revaluation reserve against the carrying amount of that item. However, the carrying amount of that item should never be less than residual value. Any excess of the amount outstanding as revaluation reserve over the carrying amount of that item should be adjusted in revenue reserves.

AS 13*: Accounting for Investments

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards*[1] *and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with accounting for investments in the financial statements of enterprises and related disclosure requirements.[2]

2. This Standard 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 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 Standard with the meanings assigned:

3.1 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'.

3.2 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.

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

3.4 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.

3.5 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.

* This standard was issued in 1993. A limited revision to this Standard was made in 2003, pursuant to which paragraph 2 (d) of this Standard has been revised to include 'and venture capital funds'.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] 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 Standard. 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 Standard, 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 Standard.

3.6 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 they 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

[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'.

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

Carrying Amount of Investments

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. An investment property is accounted for in accordance with cost model as prescribed in Accounting Standard (AS) 10, Property, Plant and Equipment. The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

Disposal of Investments

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;

 (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.

Main Principles

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:

[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 Accounting Standard (AS) 2, in respect of Valuation of Inventories.

***(a)* Government or Trust securities**

***(b)* Shares, debentures or bonds**

***(c)* Investment properties**

***(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

Investment Properties

30. An enterprise holding investment properties should account for them in accordance with cost model as prescribed in AS 10, Property, Plant and Equipment.

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

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities').]*

Introduction

1. This standard deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This Standard is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

2. This standard does not deal with cases of acquisitions which arise when there is a purchase by one company (referred to as the acquiring company) of the whole or part of the shares, or the whole or part of the assets, of another company (referred to as the acquired company) in consideration for payment in cash or by issue of shares or other securities in the acquiring company or partly in one form and partly in the other. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Definitions

3. The following terms are used in this standard with the meanings specified:

* Issued in 1994. A limited revision to this Standard was made in 2004, pursuant to which paragraphs 23 and 42 of this Standard were revised.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

(a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies and includes 'merger'.

(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) Pooling of interests is a method of accounting for amalgamations the object of which is to account for the amalgamation 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 of 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, 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. 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 Reserve') which is presented as a separate line item. 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, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

20. Factors which may be considered in estimating the useful life of goodwill arising on amalgamation include:

(a) the foreseeable life of the business or industry;

(b) the effects of product obsolescence, changes in demand and other economic factors;

(c) the service life expectancies of key individuals or groups of employees;

(d) expected actions by competitors or potential competitors; and

(e) 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 Standard 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 Standard.

(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 Standard 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 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.

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 goodwill arising on amalgamation.

Amalgamation after the Balance Sheet Date

27. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure is made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation is not incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

Main Principles

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 of 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 policies 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 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

35. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves.

The Purchase Method

36. In preparing the transferee company's financial statements, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or, alternatively, the consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. The reserves (whether capital or revenue or arising on revaluation) of the transferor company, other than the statutory reserves, should not be included in the financial statements of the transferee company except as stated in paragrap h 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 on 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. . The corresponding debit should be given to a suitable account head (e.g., 'Amalgamation Adjustment Reserve') which should be presented as a separate line item. 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 Standard 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 reasons for following the treatment different from that prescribed in this Standard.

(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 Standard that would have been followed had no treatment been prescribed by the scheme.

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

Disclosure

43. For all amalgamations, the following disclosures should be made in the first financial statements following the amalgamation:

(a) names and general nature of business of the amalgamating companies;

(b) effective date of amalgamation for accounting purposes;

(c) the method of accounting used to reflect the amalgamation; and

(d) particulars of the scheme sanctioned under a statute.

44. For amalgamations accounted for under the pooling of interests method, the following additional disclosures should be made in the first financial statements following the amalgamation:

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

(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 amalgamation:

(a) consideration for the amalgamation and a description of the consideration paid or contingently payable; and

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

Amalgamation after the Balance Sheet Date

46. When an amalgamation is effected after the balance sheet date but before the issuance of the financial statements of either party to the amalgamation, disclosure should be made in accordance with AS 4, 'Contingencies and Events Occurring After the Balance Sheet Date', but the amalgamation should not be incorporated in the financial statements. In certain circumstances, the amalgamation may also provide additional information affecting the financial statements themselves, for instance, by allowing the going concern assumption to be maintained.

APPENDIX – II

SCHEDULE III

(See section 129)

General Instructions for preparation of Balance Sheet and Statement of Profit and Loss of A Company

General Instructions

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes *inter se*, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.

2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or disaggregations of items recognized in those statements and (b) information about items that do not qualify for recognition in those statements.

   (ii) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

4. (i) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:

Turnover	**Rounding off**
(a) less than one hundred crore rupees	to the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(b) one hundred crore rupees or more	to the nearest, lakhs, millions or crores, or decimals thereof.

   (ii) Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.

5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

6. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note: This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I – BALANCE SHEET

Name of the Company…………………….

Balance Sheet as at ………………………

(Rupees in…………)

			Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of previous reporting period*
			1	*2*	*3*	*4*
			EQUITY AND LIABILITIES			
1.			**Shareholders' funds**			
	a		Share capital			
	b		Reserves and Surplus			
	c		Money received against share warrants			
2.			**Share application money pending allotment**			
3.			**Non-current liabilities**			
	a		Long-term borrowings			
	b		Deferred tax liabilities (Net)			
	c		Other long term liabilities			
	d		Long-term provisions			

4.			**Current liabilities**			
	a		Short-term borrowings			
	b		Trade Payables			
	c		Other current liabilities			
	d		Short-term provisions			
			Total			
			ASSETS			
1			**Non-current assets**			
	a		Fixed assets			
		i	Tangible assets			
		ii	Intangible assets			
		iii	Capital Work-in-progress			
		iv	Intangible assets under development			
	b		Non-current investments			
	c		Deferred tax assets (Net)			
	d		Long-term loans and advances			
	e		Other non-current assets			
2			**Current assets**			
	a		Current investments			
	b		Inventories			
	c		Trade receivables			
	d		Cash and cash equivalents			
	e		Short-term loans and advances			
	f		Other current assets			
			Total			

See accompanying notes to Financial Statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within twelve months after the reporting date; or

(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the notes to accounts:

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) the number and amount of shares authorized;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

  (A) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.

  (B) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

  (C) Aggregate number and class of shares bought back.

(j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(l) forfeited shares (amount originally paid up)

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

  (a) Capital Reserves;

  (b) Capital Redemption Reserve;

  (c) Securities Premium Reserve;

  (d) Debenture Redemption Reserve;

  (e) Revaluation Reserve;

  (f) Share Options Outstanding Account;

  (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

  (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) A reserve specifically represented by earmarked investments shall be termed as a ‘fund’.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head ‘Surplus’. Similarly, the balance of ‘Reserves and Surplus’, after adjusting negative balance of surplus, if any, shall be shown under the head ‘Reserves and Surplus’ even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures.

(b) Term loans

(A) From banks.

(B) From other parties

(c) Deferred payment liabilities.

(d) Deposits.

(e) Loans and advances from related parties.

(f) Long term maturities of finance lease obligations

(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long Term Liabilities

Other Long term Liabilities shall be classified as:

(a) Trade payables

(b) Others

E. Long-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

F. Short-term borrowings

(i) Short-term borrowings shall be classified as:

(a) Loans repayable on demand

(A) From banks

(B) From other parties

(b) Loans and advances from related parties.

(c) Deposits.

(d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

FA. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:

(a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;

(b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

(c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;

(d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and

(e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'

(h) Unpaid matured deposits and interest accrued thereon

(i) Unpaid matured debentures and interest accrued thereon

(j) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Tangible assets

(i) Classification shall be given as:

(a) Land.

(b) Buildings.

(c) Plant and Equipment.

(d) Furniture and Fixtures.

(e) Vehicles.

(f) Office equipment.

(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible assets

(i) Classification shall be given as:

(a) Goodwill.

(b) Brands /trademarks.

(c) Computer software.

(d) Mastheads and publishing titles.

(e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms

(h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;

(b) Security Deposits;

(c) Loans and advances to related parties (giving details thereof);

(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

(i) Long Term Trade Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature)

(iii) Long term Trade Receivables, shall be sub-classified as:

(a) (A) Secured, considered good;

(B) Unsecured considered good;

(C) Doubtful

(b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

R. Short-term loans and advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

(a) Claims against the company not acknowledged as debt;

(b) Guarantees;

(c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

(a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

(b) Uncalled liability on shares and other investments partly paid

(c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company……………………..

Profit and loss statement for the year ended ………………………

(Rupees in…………)

Particulars		*Note No.*	*Figures for the current reporting period*	*Figures for the previous reporting period*
1		*2*	*3*	*4*
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Revenue (I + II)		xxx	xxx

IV.	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of finished goods			xxx		xxx
	work-in-progress			xxx		xxx
	and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and amortization expense			xxx		xxx
	Other expenses			xxx		xxx
	Total expenses			xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)			xxx		xxx
VI.	Exceptional items			xxx		xxx
VII.	Profit before extraordinary items and tax (V - VI)			xxx		xxx
VIII.	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII- VIII)			xxx		xxx
X	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)			xxx		Xxx
XII	Profit/(loss) from discontinuing operations			xxx		Xxx
XIII	Tax expense of discontinuing operations			xxx		Xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)			xxx		Xxx
XV	Profit (Loss) for the period (XI + XIV)			xxx		xxx
XVI	Earnings per equity share:					
	(1) Basic			xxx		xxx
	(2) Diluted			xxx		xxx

See accompanying notes to the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (ii) of Clause (40) of Section 2 in like manner as they apply to a statement of profit and loss.

2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from

(a) Sale of products;

(b) Sale of services;

(c) Other operating revenues;

Less:

(d) Excise duty.

(B) In respect of a finance company, revenue from operations shall include revenue from

(a) Interest; and

(b) Other financial services

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as:

(a) Interest expense;

(b) Other borrowing costs;

(c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as:

(a) Interest Income (in case of a company other than a finance company);

(b) Dividend Income;

(c) Net gain/loss on sale of investments

(d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

(i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortization expense;

(c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000, whichever is higher;

(d) Interest Income;

(e) Interest Expense;

(f) Dividend Income;

(g) Net gain/ loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(j) Payments to the auditor as

(a) auditor,

(b) for taxation matters,

(c) for company law matters,

(d) for management services,

(e) for other services,

(f) for reimbursement of expenses;

(k) In case of companies covered u/s 135, amount of expenditure incurred on corporate social responsibility activities.

(l) Details of items of exceptional and extraordinary nature;

(m) Prior period items;

(ii) (a) In the case of manufacturing companies,-

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

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

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

(iii) In the case of all concerns having works in progress, works-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(vi) Expenditure incurred on each of the following items, separately for each item:-

(a) Consumption of stores and spare parts.

(b) Power and fuel.

(c) Rent.

(d) Repairs to buildings.

(e) Repairs to machinery.

(f) Insurance.

(g) Rates and taxes, excluding, taxes on income.

(h) Miscellaneous expenses,

(vii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(viii) The profit and loss account shall also contain by way of a note the following information, namely:-

(a) Value of imports calculated on C.I.F basis by the company during the financial year in respect of –

I. Raw materials;

II. Components and spare parts;

III. Capital goods;

(b) Expenditure in foreign currency during the financial year on account of royalty, know-how, professional and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings in foreign exchange classified under the following heads, namely:-

I. Export of goods calculated on F.O.B. basis;

II. Royalty, know-how, professional and consultation fees;

III. Interest and dividend;

IV. Other income, indicating the nature thereof

Note: **Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.**

INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 1

ACCOUNTING

MODULE – 2

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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7

Average Due Date and Account Current

Unit 1 : Average Due Date

Learning Objectives

After studying this unit, you will be able to:

- Understand what is average due date and how to choose 0 (zero) day for calculating average due date.
- Learn the technique of calculating due date
- Learn calculation of average due date where amount is lent in various instalments.
- Calculate average due date for determining interest on drawings.
- Familiarize with the steps involved in calculation of average due date where amount is lent in one instalment but repayment is done in various instalments. Also understand days of grace and learn the technique of maturity date by counting the days of grace.

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. Average Due Date is one on which the net amount payable can be settled without causing loss of interest either to the borrower or the lender. 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 Due Date

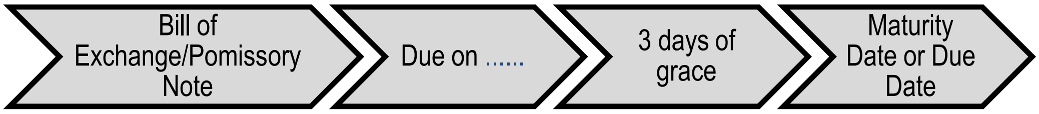
The due date of a bill of exchange/invoice is the date when the amount of a bill/invoice is payable by the drawee/ creditor to drawer/ debtor.

1.2.1Calculation 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.

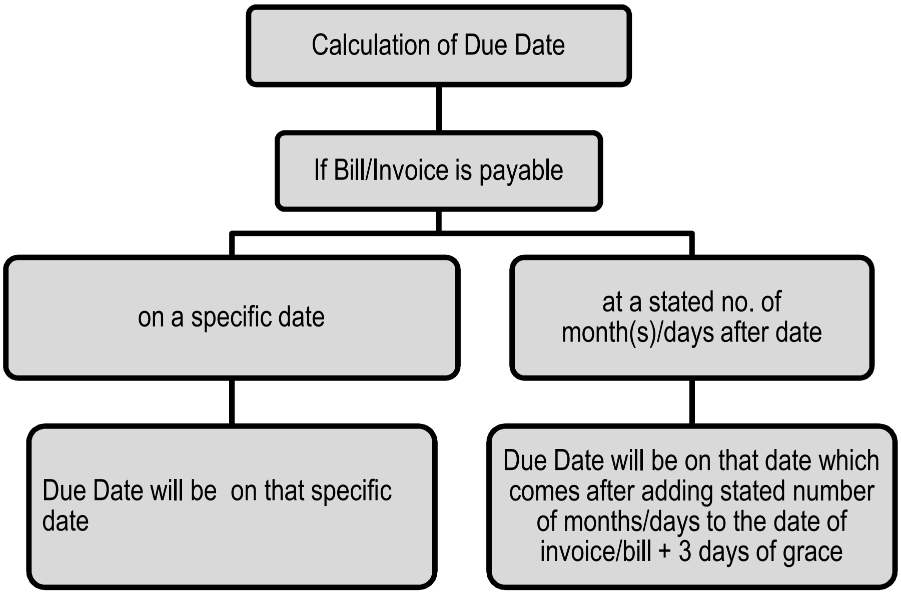
(ii) A note dated 1st January is payable one month after sight. It falls due on 4th February.


Bill of Exchange/Pomissory Note
Due on ......
3 days of grace
Maturity Date or Due Date

1.2.2 Calculating Due Date of Bill or Note Payable Few Months after Date or Sight

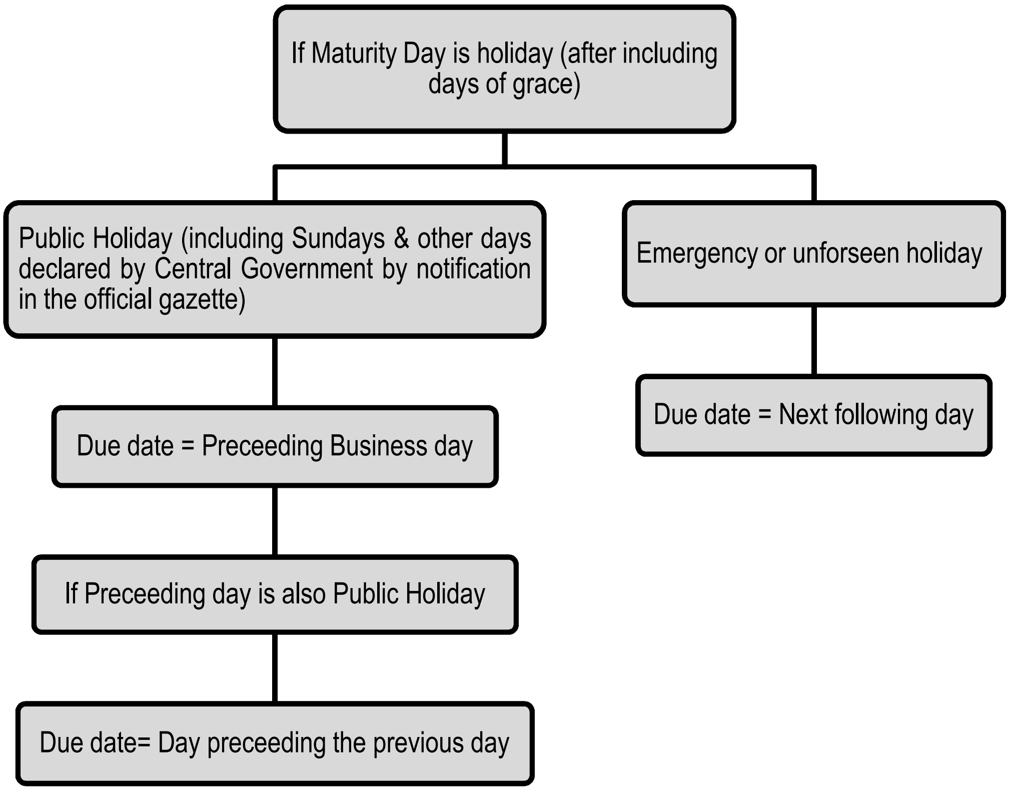
When the bill is made payable at a stated number of months after date or after sight or after certain events, then the period stated shall be held to terminate on the date of the month which corresponds with the day on which the instrument is dated. If the month in which the period would terminate has no corresponding day, the period shall be held to terminate on the last day of such month.

Example: A Bill due on 29th January, 2011 is made payable at one month after date. The due date of instrument is 3rd day after 28th February, i.e., 3rd March (in 2011, February is of 28 days only).


Calculation of Due Date
If Bill/Invoice is payable
on a specific date
at a stated no. of month(s)/days after date
Due Date will be on that specific date
Due Date will be on that date which comes after adding stated number of months/days to the date of invoice/bill + 3 days of grace

1.2.3 Calculation of Due Date when the Maturity Day is a Holiday

When the day on which a promissory note or bill of exchange is at maturity (after including days of grace) is a public holiday, the instrument shall be deemed to be due on the preceding business day. The expression "public holiday" includes Sundays and other days declared by the Central Government by notification in the official gazette, to be a public holiday. And now if the preceding day is also a public holiday, it will fall on the day preceding the previous day. But if the holiday happens to be emergency or unforeseen holiday then the date shall be the next following day.

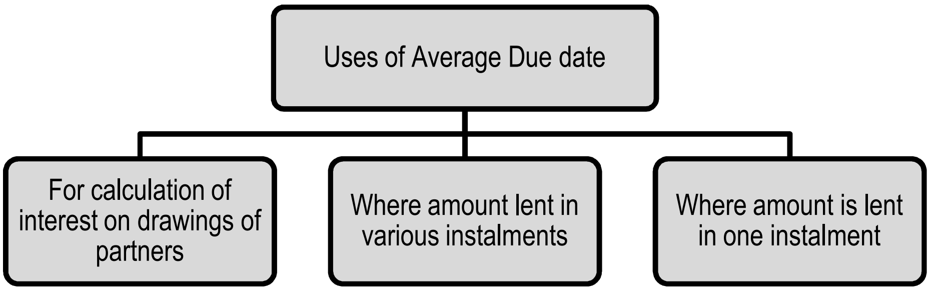

If Maturity Day is holiday (after including days of grace)
Public Holiday (including Sundays & other days declared by Central Government by notification in the official gazette)
Emergency or unforseen holiday
Due date = Preceeding Business day
Due date = Next following day
If Preceeding day is also Public Holiday
Due date= Day preceeding the previous day

1.3 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.


Uses of Average Due date
For calculation of interest on drawings of partners
Where amount lent in various instalments
Where amount is lent in one instalment

1.3.1 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 base date or “O” day for convenience. Any date whatsoever, may also be taken as “O” day.

b. Consider the number of days from base date up to 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” by “Amount total” and get result approximately upto a whole number.

f. This number is added in the base date to find the average due date.

Thus the formula for the average due date can be under.

$$\text{Average due date} = \text{Base date} \pm \frac{\text{Total of products}}{\text{Total amounts}}$$

Note: For calculation of no. of days, no. of days in each respective month involved are to be considered individually.

Illustration 1

The followings are the amounts due on different dates in between the same parties:

Amount	*Due Date*
₹	
500	*3rd July*
800	*2nd August*
1,000	*11th September*

Suggest a date on which all the bills may be paid out without any loss of interest to either party.

Solution

Considering 3rd July as the starting day the following table is prepared:

Due Dates	*Amount*	*No. of Days from 3rd July*	*Products*
3rd July	500	0	0
2nd August	800	30	24,000
11th September	1,000	70	70,000
	2,300		94,000

$$\text{Average Due Date} = \text{3rd July} + \frac{94{,}000}{2{,}300}$$

= 3rd July + 41 days = 13th August

Assuming 5% is interest rate, the debtor loses interest due to early payment of ₹ 1,000 for 29 days (from 13th August to 11th September) i.e., ₹ 4. He however, gains interest, due to late payment on ₹ 500 for 41 days from 3rd July to 13th August and on ₹ 800 for 11 days i.e. ₹ 2.80 + ₹1.20, i.e., ₹ 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*
	₹		*₹*
April 18	*60.00*	*April 23*	*52.00*
May 15	*70.00*	*May 24*	*50.00*
June 16	*80.00*		

Calculate the date upon which the balance should be paid so that no interest is due either to X or Y.

Solution

Taking May 18th as the zero or base date:

For Y's payments:

Date of Transactions	*Due Date*	*Amount*	*No. of days from the base date*	*Products*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
April 18	May 18	60	0	0
May 15	June 15	70	28	1,960
June 16	July 16	80	59	4,720
Amount Due to X		210	Sum of products	6,680

For X's payments

The students should note that the same base date should be taken. Therefore, the base date will be May 18th in this case also.

Date of Transactions	*Due Date*	*Amount*	*No. of days from the base date*	*Products*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
April 23	May 23	52	5	260
May 24	June 24	50	37	1,850
Amount Due to Y		102	Total products	2,110

Excess of Y's products over X's = 6,680 – 2,110

= 4,570

Excess amount due to X ₹ 210 – 102 = ₹ 108.

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

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

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

Calculation of interest on drawings

In the case of drawings also, amount is drawn by the owners of business on various dates but it may settled on one day. It should be noted that, 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 basis given above. An illustration is given below to help in understanding the same:

Illustration 3

A and B, two partners of a firm, have drawn the following amounts from the firm in the year ending 31st March, 2015:

Date	*A*	*Date*	*B*
	₹		*₹*
1st July	*500*	*12th June*	*1,000*
30th September	*800*	*11th august*	*500*
1st November	*1,000*	*9th February*	*400*
28th February	*400*	*7th March*	*900*

Interest at 6% p.a. is charged on all drawings. Calculate interest chargeable by using (i) ordinary system (ii) Average due date system. (assume 1 year = 365 days)

Solution

(i)	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
		=	₹ 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

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

(ii) Average Due Date System:

(a) Taking 1st July as the base date (*O-day)*

	Dates	*₹*	*Days from O-day*	*Products*
	1st July	500	0	0
	30th September	800	3	2,400
A	*1st November*	1,000	4	4,000

	28th February	400	8	3,200
		2,700		9,600

Average Due Date = $\frac{9,600}{2,700}$ months from 1st July. 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 x $\frac{6}{100}$ x $\frac{5.444}{12}$ = ₹ 73.49

Or,

Taking 1st April as the base date (*O-day)*:

	Dates	*₹*	*Months from O-day*	*Products*
A	1st July	500	3	1,500
	30th September	800	6	4,800
	1st November	1,000	7	7,000
	28th February	400	11	4,400
		2,700		17,700

Average Due Date = $\frac{17,700}{2,700}$ months from 1st April. 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 x $\frac{6}{100}$ x $\frac{5.444}{12}$ = ₹ 73.49

(b) Taking 12th June as the base date (Zero-day)

	Dates	*₹*	*Days from O-day*	*Products*
B :	*12th June*	1,000	0	0
	11th August	500	60	30,000
	9th February	400	242	96,800
	7th March	900	268	2,41,200
		2,800		3,68,000

Average Due Date = $\frac{3,68,000}{2,800}$ days from 12th June . i.e. 131 days.

June 18

July 31

Aug. 31
Sept. 30
110

131 days -110 days i.e. 21st October

So, interest is chargeable from 21st October to 31st March i.e. for 161 days.

$$2{,}800 \times \frac{6}{100} \times \frac{161}{365} = ₹\ \ 74.10$$

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 18th March or (b) on 14th July. Interest rate of 8% p.a. is taken into consideration.

Due Dates	*₹*
10th January	*500*
26th January (Republic Day)	*1,000*
23rd March	*3,000*
18th August (Sunday)	*4,000*

Determine the amount to be paid in (a) and in (b).

Solution

Taking 10th January as the base date

Due Date (Normal)	*Due Date (Actual)*	*No. of days from 10th January. . .*	*Amount ₹*	*Product*
10th January	*10th January*	0	500	0
26th January	*25th January*	15	1,000	15,000
23rd March	*23rd March*	72	3,000	2,16,000
18th August	*17th August*	219	4,000	8,76,000
			8,500	11,07,000

$$\text{Average Due Date} = \text{10th Jan.} + \frac{11{,}07{,}000}{8{,}500} = \text{10th Jan} + 130 \text{ days} = \text{20th May}$$

January	21
February	28

March	31
April	30
	110

(a) If the payment is made on 18th March rebate will be allowed for unexpired time from 18th March to 20th May i.e., 13 + 30 + 20 i.e. for 63 days. He has to pay the discounted value of the total amount.

$$\text{Discount} = 8{,}500 \times \frac{8}{100} \times \frac{63}{365} = 680\times \frac{63}{365} = ₹\ 117.37$$

Amount to be paid on 18th March= ₹ (8,500 – 117.37) = ₹ 8,382.63

(b) If the payment is deferred to 14th July, interest is to be paid from 20th May to 14th July i.e., for 11 + 30 + 14 = 55 days.

$$\text{Interest} = 8{,}500 \times \frac{8}{100} \times \frac{55}{365} = 680 \times \frac{55}{365} = ₹\ 102.47$$

The amount to be paid on 14th July.

₹ 8,500 + 102.47 = 8,602.47

Illustration 5

Manoj 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	*Bills Receivable*	*Tenure*	*Date*	*Bills Payable*	*Tenure*
	₹			*₹*	
01/06/2014	*3,000*	*3 month*	*29/05/2014*	*2,000*	*2 month*
05/06/2014	*2,500*	*3 month*	*03/06/2014*	*3,000*	*3 month*
09/06/2014	*6,000*	*1 month*	*9/06/2014*	*6,000*	*1 month*
12/06/2014	*1,000*	*2 month*			
20/06/2014	*1,500*	*3 month*			

15 August, 2014 was a Public holiday. However, 6 September, 2014 was also declared as sudden holiday.

Solution:

Let us take 12.07.2014 as Base date.

Bills receivable

Due date	*No. of days from 12.07.2014*	*Amount*	*Product*
04/09/2014	54	3,000	1,62,000

08/09/2014	58	2,500	1,45,000
12/07/2014	0	6,000	0
14/08/2014	33	1,000	33,000
23/09/2014	73	1,500	1,09,500
		14,000	4,49,500

Bills payable

Due date	*No. of days from 12.07.2014*	*Amount*	*Product*
01/08/2014	20	2,000	40,000
07/09/2014	57	3,000	1,71,000
12/07/2014	0	6,000	0
		11,000	2,11,000

Excess of products of bills receivable over bills payable = 4,49,500 -2,11,000= 2,38,500

Excess of bills receivable over bills payable = 14,000 – 11,000 = 3,000

Number of days from the base date to the date of settlement is 2,38,500/3,000 = 79.5 (appox.)

Hence date of settlement of the balance amount is 80 days after 12th July i.e. 30th September.

On 30th September, 2014 Sohan has to pay Manoj ₹ 3,000 to settle the account.

1.3.2 Case 2: Where amount is lent in one Instalment

Calculation of average due date in a case where the amount is lent in one instalment and repayment is done in various instalments (opposite to what we have done in the first case). The problem takes a different shape. The procedure for calculating average due date can be summarised as under:

Step 1: Calculate number of days/monthly/years from the date of lending money to the date of each repayment.

Step 2: Find the total of such days/months/years.

Step 3: Quotient will be the number of days/months/years by which average due date falls away from date of commencement of loan.

Thus, the formula for the average due date can be written as under:

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

Illustration 6

₹ 10,000 lent by Dass Bros. to Kumar & Sons on 1st January, 2008 is repayable in 5 equal annual instalments commencing on 1st January, 2009. Find the average due date and calculate interest at 5% per annum, which Dass Bros. will recover from Kumar & Sons.

Solution

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

$$= \text{Jan. 1, 2008} + \frac{1+2+3+4+5}{5}$$

= Jan. 1, 2008+ 3 years

= 1st Jan., 2011

Interest at a certain rate on the instalments paid from the date of payment to any fixed date will be the same as on ₹ 10,000 (if lent on 1st Jan., 2011 to that fixed date). There will be no loss to either party. Supposing rate of interest is 5% p.a. and date of settlement is 31st Dec., 2009 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. 2013*	*Product*
₹			₹
2,000	1st Jan. 2009	5 Years	10,000
2,000	1st Jan. 2010	4 Years	8,000
2,000	1st Jan. 2011	3 Years	6,000
2,000	1st Jan. 2012	2 Years	4,000
2,000	1st Jan. 2013	1 Year	2,000
			30,000

Interest at 5% p.a. on ₹ 30,000 for one year. $= \frac{₹\ 30{,}000 \times 5}{100} = ₹\ 1{,}500$

Dass Bros. will receive interest (if given on 1st Jan., 2011 on ₹ 10,000 from average due date to 31st Dec., 2013, i.e., for 3 years at 5% p.a. $= \frac{5 \times 3 \times ₹\ 10{,}000}{100} = ₹\ 1{,}500$

From the above, it can be concluded that if the borrower pays ₹ 2,000 yearly from 1st Jan., 2009 for 5 years and if the lender gives ₹ 10,000 on 1st Jan., 2011 then both will charge same interest from each other. There is no loss to any of the parties. But actually lender gives ₹ 10,000 on 1st Jan., 2008, therefore, he has given loan 3 years in advance and will charge interest on ₹ 10,000 for 3 years.

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

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 2014*	*400*	*2 months*
2	*10th March 2014*	*300*	*3 months*
3	*5th April 2014*	*200*	*2 months*
4	*20th April 2014*	*375*	*1 month*
5	*10th May 2014*	*500*	*2 months*

You are required to find the said average due date.

Solution

Calculation of the average due date

Taking 4th May as the base date

Sl. No.	*Date of bill*	*Due Date of Maturity*	*Amount ₹*	*No. of days from starting date (4th May)*	*Product*
1	1st March 2014	4th May	400	0	0
2	10th March 2014	13th June	300	40	12,000
3	5th April 2014	8th June	200	35	7,000
4	20th April 2014	23rd May	375	19	7,125
5	10th May 2014	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, 2014. The new bill should be for ₹ 1,775 payable on June 7th, 2014.

Illustration 8

A owes B ₹ 890 on 1st January, 2015. From January to March, the following further transactions took place between A and B:

January 16	*A buys goods*	*₹ 910*
February 2	*A receives Cash loan*	*₹ 750*
March 6	*A buys goods*	*₹ 810*

A pays the whole amount on 31st March, 2015 together with interest at 5% per annum. Calculate the interest by the average due date method.

Due Date	*Amount*	*No. of days from Jan. 1*	*Product*
2015	*₹*		
Jan. 1	890	0	0
Jan. 16	910	15	13,650
Feb. 2	750	32	24,000
March 6	810	64	51,840
	3,360		89,490

Solution

Calculation of average due date

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

Jan. 1 + $\left[\dfrac{89{,}490}{3{,}360}\right]$ i.e., 27 days or Jan. 28

Interest therefore has been calculated on ₹ 3,360 from 28th Jan. to 31st March, i.e., for 63 days.

$$3{,}360 \text{ x } \frac{5}{100} \text{ x } \frac{63}{365} = ₹\ 29$$

Illustration 9

Radheshyam purchased goods from Hariram. The due dates for payment is cash, being as follows:

March 15	*₹ 400 Due on 18th April*
April 21	*₹ 300 Due on 24th May*
April 27	*₹ 200 Due on 30th June*

May 15 ₹ 250 Due on 18th July

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

Solution

Taking 18th April as the base date

Due Date	*Amount*	*No. of days*	*Product*
	₹	*from 18th April*	
18th April	400	0	
24th May	300	36	10,800
30th June	200	73	14,600
18th July	250	91	22,750
	1,150		48,150

Average Due Date is $\frac{48,150}{1,150}$ or 42 days after the base date.

18th April, i.e. 30 May.

Illustration 10

Calculate Average Due date from the following information:

Date of the bill	*Term*	*Amount*
		₹
August 10, 2013	*3 months*	*6,000*
October 23, 2013	*60 days*	*5,000*
December 4, 2013	*2 months*	*4,000*
January 14, 2014	*60 days*	*2,000*
March 08, 2014	*2 months*	*3,000*

(Assume February of 28 days)

Solution

Calculation of Average Due Date
Taking 10th August as the base date

Date of bill	*Term*	*Due date*	*No. of days from 10th August 2013*	*Amount ₹*	*Product ₹*
August 10, 2013	3 months	Nov. 13, 2013	95	6,000	5,70,000
October 23,2013	60 days	Dec. 25, 2013	137	5,000	6,85,000

December 04, 2013	2 months	Feb. 07, 2014	181	4,000	7,24,000
January 14, 2014	60 days	Mar. 18, 2014	220	2,000	4,40,000
March 08, 2014	2 months	May 11, 2014	274	3,000	8,22,000
				20,000	32,41,000

Average due date= $\frac{\text{Total of product}}{\text{Total of amount}} = \frac{32{,}41{,}000}{20{,}000}$ = 162 days

= 162 days after August 10, 2013 i.e. January 19, 2014.

Illustration 11

Mr. Green and Mr. Red had the following mutual dealings and desire to settle their account on the average due date:

Purchases by Green from Red:	₹
6th January, 2015	*6,000*
2nd February, 2015	*2,800*
31st March, 2015	*2,000*

Sales by Green to Red:

6th January, 2015	*6,600*
9th March, 2015	*2,400*
20th March, 2015	*500*

You are asked to ascertain the average due date.

Solution

Calculation of Average Due Date

Taking 6th January, 2015 as base date

For Green's payments

Due date	*Amount*	*No. of days from the base date i.e. 6th Jan. 2015*	*Product*
2015	₹		
6th January	6,000	0	0
2nd February	2,800	27	75,600
31st March	2,000	84	1,68,000
Total	10,800		2,43,600
For Red's payment			
2015			

6th January	6,600	0	0
9th March	2,400	62	1,48,800
20th March	500	73	36,500
Total	9,500		1,85,300

Excess of Green's products over Red's =₹ 2,43,600 – ₹ 1,85,300 = ₹ 58,300

=₹ 10,800 – ₹ 9,500 =₹ 1,300

Number of days from the base date to the date of settlement is 58,300/1,300=45 days (approx.)

Hence, the date of settlement of the balance amount is 45 days after 6th January i.e. on 20th February.

On 20th February, 2015, Green has to pay Red ₹ 1,300 to settle the account.

Summary

- Average Due Date is one on which the net amount payable can be settled without causing loss of interest either to the borrower or the lender.
- It is used in various cases like:
  - (i) Calculation of interest on drawings of partners.
  - (ii) Cancellation of various bills of exchange due on different dates and issuance of a Single bill.
  - (iii) Amount lent in one instalment and repayable in various instalments.
- When the amount is lent in various instalments then average due date can be calculated as :

$$\text{Average due date = Base date} \pm \frac{\text{Total [Amount} \times \text{No. of days from base date to due date}}{\text{Total amounts}}$$

- 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.
- Average due date in a case where the amount is lent in one instalment and repayment is done in various instalments will be:

$$\text{Average due date = Date of Loan} + \frac{\begin{array}{c}\text{Sum of days/months/years from the date of lending to the date of}\\ \text{repayment of each instalments}\end{array}}{\text{Total amounts}}$$

- 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. This exempted period of three days is called days of grace.
- When due date is a public holiday, then the preceding business day will be the due date.
- When due date is an emergency/ unforeseen holiday, then the next following day will be the due date.

Unit 2 : Account Current

Learning Objectives

After studying this unit, you will be able to:

- Understand the meaning of Account Current.
- Learn the methods of preparing Account Current, namely preparation of Account Current with the help of interest tables, by means of product and by means of balances.
- Grasp the calculation procedure involved in the preparation of Account Current.

2.1 Introduction

An Account Current is a running statement of transactions between parties for a given period of time and includes interest allowed or charged on various items. It takes the form of an ledger account.

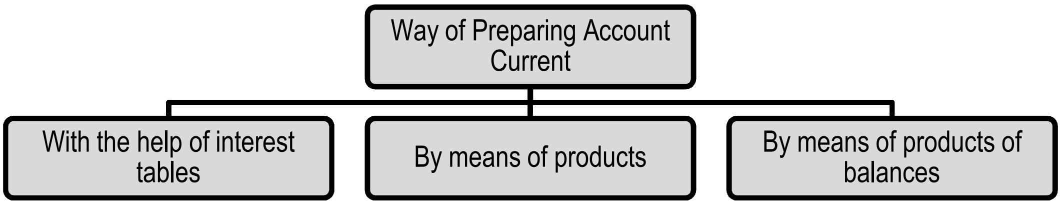
Some of the situations when account current is prepared are:

1. 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.
2. A consignee of goods can also prepare an Account Current, if the latter is to settle the account at the end of the consignment & interest is chargeable on outstanding balance.
3. An Account Current also is frequently prepared to set out the transactions taking place between a banker and his customer.
4. It is prepared when two or more persons are in joint venture and ech co-venture is entitled to interest on their investment. Also, no separate set of book is maintained for it.

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:


Way of Preparing Account Current
With the help of interest tables
By means of products
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 columns 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:

2013		₹	
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.*
2014			
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. (1 year = 365 days)

Solution

Shyam in Account Current with Nath Brothers
(Interest to 1st February, 2014 @ 6% p.a.)

Date	Particulars	Due	Amount	Days	Interest	Date	Particulars	Due	Amount	Days	Interest
2013		date	₹			2013		date	₹		
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
2014						2014					
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 2013	*Due Date*	*Oct.*	*Nov.*	*Dec.*	*Jan.*	*Feb.*	*Total* Days
16th Sept.	1st Oct.	30+	30+	31+	31+	1 =	123
1st Oct.	1st Oct.	30+	30+	31+	31+	1 =	123
21st Oct.	1st Dec.	-	-	30+	31+	1 =	62
1st Nov.	1st Nov.	-	29+	31+	31+	1 =	92
1st Dec.	1st Dec.	-	-	30+	31+	1 =	62
5th Dec.	1st Jan.	-	-	-	30+	1 =	31
10th Dec.	1st Jan.	-	-	-	30+	1 =	31

2014							
1st Jan.	1st Feb.	-	-	-	30+	1 =	31
9st Jan.	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. In this method is only the method of calculating interest 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, 2014 @ 6% p.a.)

Date	*Particulars*	*Due*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Due*	*Amount*	*Days*	*Product*
2013		*date*	₹	₹	₹	2013		*date*	₹	₹	₹
Sept. 16	To Sales A/c	1st Oct	200	123	24,600	Oct. 1	By Cash A/c	Oct.1	90	123	11,070
1 Nov.	To Cash A/c	1st Nov	330	92	30,360	Oct.21	By Purchase A/c	Dec.1	500	62	31,000
1 Dec.	To Cash A/c	1st Dec	330	62	20,460	Dec.5	By Purchase A/c	Jan. 1	500	31	15,500
						Dec.10	By Purchase A/c	1 Jan	200	31	6,200
2014						2014					
Jan.1	To Cash A/c	1 Jan	600	31	18,600	Feb.1	By Balance of products				30,250
Jan.9	To Sales A/c	1 Feb	20			Feb.1	By Balance c/d		194.97		
Feb.1	To Interest		4.97								

	$\frac{30,250}{365}\times\frac{6}{100}$									
		1,484.97		94,020				1,484.97		94,020
2014										
Feb	To Balance b/d	194.97								

2.2.3 Method of Computing the numbers of Days

Usually any of the following two methods is used for calculating the number of days.

1. Forward Method- Under this method the number of days are calculated from the due date of the transaction to the date of closing the account.
2. Backward (or Epoque Method)- Under this method, the number of the days are calculated from the opening date of statement to the due date of transaction.

Example

From the following particulars, make up an Account Current to be rendered by Mr. X to Mr. Y on 31st December, 2014 taking interest into account at the rate of 18% p.a.

01.07. 2014	*Balance owing by Mr. Y*	*₹ 600*
30.07. 2014	*Goods sold to Mr. Y (Credit Period allowed 1 month)*	*₹ 300*
01.08. 2014	*Good purchased from Mr. Y (Credit Period received 1 month)*	*₹ 200*
01.09. 2014	*Cash received from Mr. Y*	*₹ 100*
01.09. 2014	*Mr. Y accepted Mr. X's Draft at 3 Months date*	*₹ 400*

You are required to prepare the Account Current according to interest on individual transaction under the Forward and Backward methods.

Solution

(a) Product of individual Transaction Method (Forward Method)

Mr. Y in Account Current with Mr. X (interest to 31st Dec. 2014 @ 18% p.a.)

Date	Particulars	Due date	Am ₹	Days	Product ₹	Date	Particulars	Due date	Amt. ₹	Days	Product ₹
01.07.2014	To Balance b/d		600	184	1,10,400	01.08.2014	By Purchase A/c	Sep. 1	200	121	24,200
30.07.2014	To Sales A/c	Aug 30	300	123	36,900	01.09.2014	By Cash A/c	Sep. 1	100	121	12,100
31.12. 2014	To Interest on Balance for 1 day @ 18% $\left[\frac{1,00,200 \times 18 \times 1}{100 \times 365}\right]$		49			01.09.2014	By B/R A/c	Dec. 4	400	27	10,800
						31.12.2013	By Balance of Products				1,00,200
						31.12.2013	By Balance c/d		249		
			949		1,47,300				949		1,47,300

(b) Product of individual Transaction Method (Epoque Method)

Mr. Y in Account Current with Mr. X (interest to 31st Dec. 2014 @ 18% p.a.)

Date	*Particulars*	*Due date*	*Amt. ₹*	*Days*	*Product ₹*	*Date*	*Particulars*	*Due date*	*Amt. ₹*	*Days*	*Product ₹*
01.07.2014	To Balance b/d		600			01.08.2014	By Purchase A/c	Sep. 1	200	63	12,600
30.07.2014	To Sales A/c	Aug 30	300	61	18,300	01.09.2014	By Cash A/c	Sep. 1	100	63	6,300
31.12.2014	To Balance of Product				1,00,200	01.09.2014	By B/R A/c	Dec. 4	400	157	62,800
31.12.2014	To Interest on Balance for 1 day @ 18% $\left[\frac{1{,}00{,}200 \times 18 \times 1}{100 \times 365}\right]$		49			31.12.2014	By Balance of Products [200 x 184]				36,800
						31.12.2014	By Balance c/d		249		
			949	-	1,18,500				949		1,18,500

Illustration 2

From the following particulars prepare the account current to be rendered by Mr. Singh to Mr. Paul as on 31st August, 2014. Interest must be calculated @ 10% p.a. (1 year = 365 days)

2014		*₹*
June 11	*Goods sent to Mr. Paul*	*1,020*
June 15	*Cash received from Mr. Paul*	*500*
June 20	*Goods sent to Mr. Paul*	*650*
July 7	*Goods sent to Mr. Paul*	*700*
Aug 8	*Cash received from Mr. Paul*	*1,100*

Solution

Mr. Paul in Account Current with Mr. Singh
(Interest to 31st August, 2014 @ 10% p.a.)

Dr.											*Cr.*
Date	*Particulars*	*Due*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Due*	*Amount*	*Days*	*Product*
2014		Date	₹			2014		Date	₹		
June 11	To Sales A/c	June 11	1,020	81	82,620	June 15	By Cash A/c	June 15	500	77	38,500
June 20	To Sales A/c	June 20	650	72	46,800	Aug.8	By Cash A/c	Aug.8	1,100	23	25,300
July 7	To Sales A/c	July 7	700	55	38,500	Aug.31	By Balance of product				1,04,120
Aug.31	To Interest A/c $\frac{1,04,120}{365}\times\frac{10}{100}$		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								

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. (assume 1 year = 365 days)

2014		*₹*
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, 2014 @ 5% p.a.)

Date	*Particulars*	*Due*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Due*	*Amount*	*Days*	*Product*
2014		*Date*	*₹*			*2014*		*Date*	*₹*		
June 30	To Balance b/d		520	185	96,200	Aug.1	By Cash A/c	Aug.1	500	152	76,000
July 17	To Sales A/c	July 17	40	167	6,680	Sep.1	By Cash A/c	Sep.1	400	121	48,400
Aug.19	To Sales A/c	Aug.19	720	134	96,480	Sep.1	By Bills Receivable A/c (Note : 1)	Dec.4	300	27	8,100
Aug.30	To Sales A/c	Aug.30	50	123	6,150	Oct.22	By Purchases A/c	Oct.22	20	70	1,400
Nov.12	To Sales A/c	Nov.12	14	49	686	Dec.14	By Cash A/c	Dec.14	50	17	850
						Dec. 31	By Balance of product				71,446
31 Dec.	To Interest A/c $\frac{71,446\times5\%}{365}$		9.79			Dec. 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

Note: While counting the number of days, for opening balances, the opening date as well as date upto which the account is prepared, is counted.

Illustration 4

From the following prepare an account current, as sent by A to B on 30th June, 2014 by means of products method charging interest @ 6% p.a:

2014		*₹*
Jan. 1	*Balance due from B*	*600*
Jan.11	*Sold goods to B*	*520*
Jan. 18	*B returns Goods*	*125*
Feb 11	*B Paid by cheque*	*400*
Feb 14	*B accepted a bill drawn by A for one month*	*300*
Apr. 29	*Goods sold to B*	*615*
May 15	*Received cash from B*	*700*

Solution

B in Account Current with A
for the period ending on 30th June, 2014

Date	*Particulars*	*Amount*	*Days*	*Products*	*Date*	*Particulars*	*Amount*	*Days*	*Products*
2014		₹			2014		₹		
Jan.1	To Balance b/d	600	182	1,09,200	Jan.18	By Sales Returns	125	164	20,500
Jan. 11	To Sales A/c	520	171	88,920	Feb. 11	By Bank A/c	400	140	56,000
Apr. 29 June 30	To Sales A/c To Interest A/c	615 15.75	62	38,130	Feb. 14	By B/R A/c (due date: March 17)	300	105	31,500
					May 15	By Cash A/c	700	46	32,200
					June 30	By Balance of products			96,050
						By Balance c/d	225.75		
		1,750.75		2,36,250			1,750.75		2,36,250

Calculation of interest:

$$\text{Interest} = \frac{96{,}050}{366} \times \frac{6}{100} = ₹\ 15.75$$

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 5

Following transaction took place between X and Y during the month of April, 2014.

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 7.2.2014 is honoured on this due date*	
10	*X sold goods to Y (invoice dated 10.5.2014)*	*15,000*
12	*X received cheque form Y dated 15.5.2014*	*7,500*
15	*Y sold goods to X (invoice dated 15.5.2014)*	*6,000*
20	*X returned goods sold by Y on 15.4.2014*	*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 30.4.2014, taking interest into account @ 10% p.a. (assume 1 year = 365 days)

Solution

'Y' In Account Current with 'X'
(Interest to 30th April, 2014 @ 10% p.a.)

Dr. *Cr.*

Date	*Particulars*	*Due*	*Amount*	*Days*	*Product*	*Date*	*Particulars*	*Due*	*Amount*	*Days*	*Product*
		Date	*₹*					*Date*	*₹*		
2014		*2014*				*2014*		*2014*			
April 7	To Bills Payable	June 10	5,000	-	-	April 1	By Balance b/d		10,000	30	3,00,000
April 10	To Sales A/c	May 10	15,000	-	-	April 12	By Bank A/c (Cheque received dated 15.5.2014)	May 15	7,500	-	-
April 20	To Purchase Returns	May 15	1,000	-	-	April 15	By Purchase A/c (invoice dated 15.5.2014)	May 15	6,000	-	-
April 20	To Bill Receivable A/c	April 20	5,000	10	50,000						
April 30	To Red Ink Product (₹ 7,500 x 15) as per contra	May 15		15	1,12,500	April 30	By Red Ink Product as per contra (5,000 x 41)	June 10	-	41	2,05,000

April 30	To Red Ink Product (₹ 6,000 x 15) as per contra	May 15		15	90,000	April 30	By Red Ink Product as per contra (15,000 x 10)	May 10	-	10	1,50,000
April 30	To Balance of product				4,17,500	April 30	By Red Ink Product as per contra (1,000 x 15)	May 15	-	-	15,000
						April 30	By Interest A/c $4,17,500 \times \frac{10}{100} \times \frac{1}{365}$		114.38		
						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.

2.2.4 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 6

On 2nd January, 2014 Vinod opened a current account with the Allahabad Bank Limited; and deposited a sum of ₹ 30,000.

He further deposited the following amounts:	*₹*
15th January	*12,000*
12th March	*8,000*
10th May	*16,000*
His withdrawals were as follows :	
15th February	*26,000*
10th April	*30,000*
15th June	*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 to be prepared as on 30th June, 2014. 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*
2014								
Jan. 2	By Cash Account	–	30,000	Cr.	30,000	13	–	3,90,000
Jan. 15	By Cash Account	–	12,000	Cr.	42,000	31	–	13,02,000
Feb. 15	To Self	26,000	–	Cr.	16,000	25	–	4,00,000
Mar. 12	By Cash Account	–	8,000	Cr.	24,000	29	–	6,96,000
April 10	To Self	30,000	–	Dr.	6,000	30	1,80,000	-
May 10	By Cash Account	-	16,000	Cr.	10,000	36	-	3,60,000
June 15	To Self	14,000	-	Dr.	4,000	16	64,000	-
June 30	By Interest A/c	-	140	Dr.	3,860		-	-
June 30	By Balance c/d		3,860	-				
		70,000	70,000				2,44,000	31,48,000
July 1	To Balance b/d	3,860						

* Interest is calculated as follows:

On ₹ 31,48,000 @ 2% for 1 day = ₹ 172.49

On ₹ 2,44,000 @ 5% for 1 day = ₹ 33.42

Net Interest = ₹ 139.07 (₹ 172.49- ₹ 33.42)

Summary

- When interest calculation becomes an integral part of the account. The account maintained is called "Account Current".

  Some examples where it is maintained are:

  (i) Frequent transactions between two parties.

  (ii) Goods sent on consignment

  (iii) Frequent transactions between a banker and his customers

  (iv) In case of Joint venture when no separate set of books is maintained for joint venture

- There are three ways of preparing an Account Current :

  (i) With the help of interest tables

  (ii) By means of products

  (iii) By means of products of balances

8

Self Balancing Ledgers

Learning Objectives

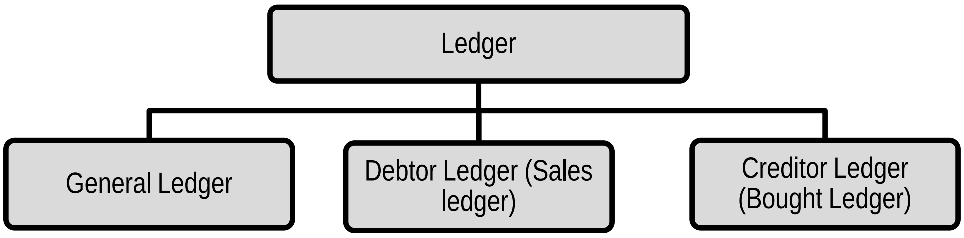
After studying this chapter, you will be able to:

- Define and understand the significance of self-balancing ledger system and sectional balancing system.
- Be familiar with the three ledgers generally maintained in a self-balancing ledger system.
- Observe that in self balancing system total debtors and total creditors accounts kept in the general ledger are called sales ledger adjustment account and bought ledger adjustment account respectively.
- Learn the technique of maintaining total debtors and total creditors accounts under sectional balancing system.
- Note the technique of recording transactions involving transfer from one ledger to another ledger under both the systems.

1. Introduction

One ledger is maintained for all accounts when the volume of transactions of business is small and number of accounts is limited. But for a big business, with rise in the number of transactions, size of the ledger becomes hefty due to large number of accounts. When large number of ledgers is kept by a concern and if their balances do not tally, the accountant would have to face great difficulty in tracing book-keeping errors, responsible for the non-agreement of the trial balance. In order to reduce to a minimum the trouble and time involved in locating the errors, sometimes the system of multiple ledgers (self-balancing or sectional balancing) is employed.

Under multiple ledger system, ledger is usually divided into three parts viz.



In this chapter, we shall discuss the concept and significance of Self-balancing and Sectional balancing systems with the hep of suitable illustrations.

2. Self-Balancing System

Self Balancing Ledger System implies a system of ledger keeping which classifies ledgers as per nature of transactions, namely, Sales ledger, Bought ledger, General ledger, etc. and also makes them to balance independently. The objective of this system is to identify errors and to facilitate their quick detection with the minimum efforts. In order to make each ledger self-balancing, an extra account called general ledger adjustment account is opened in each of the sales ledger and bought ledger. The maintenance of various ledgers under this system will be discussed in detail in para 2.3.

2.1 Working of the Self-Balancing system

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.

2.2 Advantages of Self-Balancing system

(i) Fixation of responsibility of ledger keeper: Self-balancing system fixes the responsibility of the ledger keeper, as to the balancing of the 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) Arithmetical accuracy: Arithmetical accuracy of each ledger can be proved independently.

(iii) Preparation of interim accounts: It enables preparation of interim accounts without personal ledgers having to be balanced.

(iv) Availability of total figures: The figures of total debtors or creditors is readily available.

(v) Internal check: It is instrumental in strengthening the internal check.

(vi) Secrecy: Where it is desired not to reveal the content of the private ledger to the clerical staff, the balances on this ledger can be directly incorporated in total figure in the trail balance.

2.3 Various Ledgers to be Maintained in Self-balancing Ledger System

In the Sales or Bought ledgers double entry is not completed as in the system outlined above, a separate trial balance cannot be taken out from these ledgers. If these ledgers are maintained in such a way as to offer separate trial balances, the system would be known as "Self-balancing". In such a case "General Ledger Adjustment Account" is prepared in each of the subsidiary ledgers. The General ledger would have:

(i) Bought Ledger Adjustment Account
(in reality, Total Creditors Account) and

(ii) Sales Ledger Adjustment Account
(in reality, Total Debtors Account)

These accounts are known as Control Accounts. The system on which entries are made in the adjustment account is described below:

2.3.1 **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.

Similarly entries can be made in case of bills payable, discount 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.

2.3.2 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.

Similarly entries can be made in case of bills receivable, dishonoured bills etc.

2.3.3 General Ledger: As stated above, each time an entry is made in the Bought and Sales Ledger for self-balancing, the contra effect of the entries is shown in the Bought Ledger or Sales Ledger Adjustment Account set up in the General Ledger. The accounts represent the Total Debtors and Creditors Accounts in a summarised form and thus serve to self-balance the General Ledger. As a result no additional entries are required to make the General Ledger self-balancing.

It may be mentioned that in regard to several other accounts, which do not relate either to customers or suppliers, no additional entry is necessary under the self-balancing scheme since, both aspects of every transaction already exist in one or other of the accounts contained in the General Ledger such as cash sales, discounting of bills, recovery of bad debts written off, creating provision for bad debts etc.

Illustration 1

Dinesh & Co. have three ledgers in use viz, a Debtors Ledger, a Creditors Ledger and a Normal Ledger which are all kept on the system of self-balancing. From the following particulars prepare the adjustments account that would appear in each of these ledgers.

2015		*₹*
Jan. 1	*Balance of Sundry Debtors*	*16,000*
	Balance of Sundry Creditors	*18,500*

Jan. 31	*Credit Purchases*	*4,500*
	Credit Sales	*9,800*
	Cash Sales	*1,500*
	Paid to Creditors	*9,875*
	Discount allowed by them	*325*
	Cash received from debtors	*7,800*
	Allowed them discount	*200*
	Bills payable accepted	*1,500*
	Bills receivable received	*3,000*
	Returns inwards	*875*
	Returns outwards	*600*
	Rebates allowed to debtors	*275*
	Rebates allowed by creditors	*150*
	Provision for Doubtful Debts	*320*
	Bad Debts	*450*
	Bills Receivable dishonoured	*375*

Solution

In the Debtors Ledger
General Ledger Adjustment Account

Dr.					*Cr.*
2015		*₹*	*2015*		*₹*
Jan. 31	To Debtors Ledger		Jan. 1	By Balance b/d	16,000
	Adjustment Account :		Jan. 31	Debtor Ledger	
	Bank	7,800		Adjustment A/c:	
	Discount	200		Sales	9,800
	Bills Receivable	3,000		Bills Receivable dishonoured	375
	Returns Inwards	875			
	Allowances	275			
	Bad Debts	450			
	To Balance c/d	13,575			
		26,175			26,175
			Feb. 1	By Balance b/d	13,575

Entries for cash sales and provision for doubtful debts will not affect Debtors Ledger.

In the Creditors Ledger
General Ledger Adjustment Account

2015		₹	2015		₹
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
	Purchases	4,500		Discount	325
				Bills Payable	1,500
				Return outwards	600
				Allowances	150
				By Balance c/d	10,550
		23,000			23,000
Feb. 1	To Balance b/d	10,550			

In General Ledger
Debtors Ledger Adjustment Account

2015		₹	2015		₹
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

2015		₹	2015		₹
Jan. 31	To Nominal Ledger		Jan. 1	By Balance b/d	18,500
	Adjustment A/c:		Jan. 31	By Nominal Ledger	
	Bank	9,875		Adjustment A/c:	

		Discount	325		Purchases	4,500
		Bills Payable	1,500			
		Return Outwards	600			
		Allowances	150			
	To	Balance c/d	10,550			
			23,000			23,000

Transfer from one ledger to another: Whenever a balance is transferred from an account in one ledger to that in another e.g., from the Bought Ledger to the Sales Ledger, the entry is recorded through the Journal. Also an additional entry is made in the Control Accounts for recording the corresponding effect.

3. Sectional Balancing

A really simple way to prove the accuracy of say, the Sales Ledger would be to maintain a Total Debtors account in the General Ledger. It would mean that whereas accounts of Individual customer would be maintained in the Sales Ledger, in the General Ledger the Total Debtors account would be posted by the (monthly) totals of various transactions with total credit sales, total amount received from credit customers, total discount allowed to them, total returns inwards, total bills receivable received; etc. The balance in the Total Debtors Account should be equal to the total of balances shown by the accounts of individual customers. If it is so, the Total Debtors Account as well as individual customers' account may be taken as correct. A difference would show that there is some error somewhere.

In the same way, the accuracy of individual supplier account may be checked by comparing total of their balances with the balance in the Total Creditors Account.

The double entry would be complete in the General Ledger itself. For instance, for credit sales– Total Debtors Account would be debited and Sales Account credited. For goods returned to suppliers– Total Creditors Account would be debited and Return Outward Account credited.

The "total accounts" are also known as adjustment accounts or control accounts since they prove the accuracy of the subsidiary (Sales or Bought) ledgers.

To sum up, under sectional balancing system, only the total account for each of the subsidiary ledgers is opened in the general ledger and no control/ adjustment account/ self-balancing account is opened in the subsidiary ledger.

3.1 Advantages of sectional balancing system

Advantages of using control accounts under the system are as follows:

1. Check on accuracy of entries: Control accounts provide a check on accuracy of entries made in personal accounts in debtors ledger as well as creditors ledger.

2. Location of errors: A regular comparison of balances of control accounts with individual balances will quickly fix up the errors.
3. Preparation of final accounts: Control accounts assist in preparation of final accounts by providing the total balances.
4. Calculation of missing figures: Control accounts help in computation of missing figures.
5. Internal check: Control accounts provide an interim check over postings in different accounts.

4. Distinction between Self Balancing and Sectional Balancing systems

		Self Balancing	Sectional Balancing
1.	Classification of ledgers	Separate ledger is maintained for different type of transactions.	Only total account for each of the subsidiary ledgers is opened in the general ledger.
2.	Double entry	Under this system, a general ledger adjustment account is prepared in the debtors' ledger as well as in creditors' ledger to complete double entry.	A separate trial balance can't be made from these ledger as double entry is not completed.
3.	Accuracy of accounts	Correctness of individual account balances in each ledger will be verified by extracting its balances by agreeing them with balance of control accounts.	Accuracy of individual customer's/supplier's account can be checked by comparing the total of their balances with balances of total debtors' /creditors' account in general ledger.

5. Rectification of Errors

5.1 Rectification of errors before opening Suspense Account

5.1.1 Sectional Balancing System: If the error affects the accounts of Debtors or Creditors without affecting their total, it is rectified by adjusting the accounts of Debtors or Creditors itself. However, if it affects the totals of Debtors or Creditors, the additional entries are to be made in the main ledger through Total Debtors and Total Creditors Account. The same is discussed with the following examples:

1. If goods sold to X and wrongly posted in the account of Y, trial balance of main ledger will tally. This error can be rectified in Debtors' ledgers by debiting X's account and crediting Y's account.
2. If goods sold to X are not recorded in the Sales Book, it means under reporting of Sales. It means sectional balancing entry will be passed with lower amount of sales and Total debtors. The error can be rectified by debiting the total debtors account and crediting the sales account in the main ledger.
3. If goods sold to X are omitted to be recorded in his account only in the debtors' ledger, main ledger will tally. This error is rectified by debiting X's account by writing "to error in omitting to record sales".
4. If goods sold to X are recorded in the debtors ledger and sales account is properly credited at the end of the period, but omitted to debit the total debtors account. The error can be rectified by writing in debit side of total debtors account "To error in omitting to record sales".

5.1.2 Self Balancing System: The rectification of errors will be done in the usual manner as in single ledger system but there is one difference that is, whenever the totals of Debtors or Creditors are affected, rectification will be done by making additional self balancing entries. In this case, rectification of errors in the above examples will be done as follows:

1. For rectification of errors in Debtors ledger - X's account will be debited and Y's account will be credited.
2. The rectification of error will be made by crediting sales account by writing 'By error in omitting the sales' and additional entry of self balancing with the same amount will be made, namely,

Debtor Ledger Adjustment A/c	Dr	(In main ledger)
To General Ledger Adjustment A/c		(In debtors ledger)

3. The error is rectified by debiting X's account by writing 'To error in omitting to record sales.'

4 This can be rectified by self balancing entry with the same amount, namely,

Debtor Ledger Adjustment A/c	Dr	(In main ledger)
To General Ledger Adjustment A/c		(In debtors ledger)

5.2 Rectification of errors after opening Suspense Account

5.2.1 Sectional Balancing System: The method of rectification of error will be same, 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 :

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)

5.2.2 **Self Balancing System:** The method of rectification of error will be same, with the exception that the entries which were corrected unilaterally will be corrected through suspense account. In the above examples rectification of errors will be done as follows:

1. Same as above.
2. (a) Suspense A/c Dr. (In Debtors ledger)
   To Sales A/c
   (b) Debtors ledger Adjustment A/c Dr. (In main ledger)
   To General Ledger Adjustment A/c (In Debtors Ledger)
3. X's A/c Dr. (In Debtors Ledger)
   To Suspense A/c (In Debtors Ledger)
4. (a) Debtors ledger Adjustment A/c Dr. (In main ledger)
   To Suspense A/c (In main ledger)
   (b) Suspense A/c Dr. (In Debtors ledger)
   To General Ledger Adjustment A/c (In Debtors Ledger)

Illustration 2

Prepare journal entries in the books of Exe. Ltd. for the following:

(a) The Sales Book was found under cast by ₹ 1,000.

(b) Discount allowed to Rao ₹ 50 correctly, entered in the Cash Book was not posted to his account.

(c) Credit balance of ₹ 310 in Murty's account in the Purchase Ledger was to be transferred to his account in Sales Ledger.

Give Journal entries both under the self-balancing system and the sectional balancing system.

Solution

Journal of Exe. Ltd.

Self-Balancing System:

(a)	Sales Ledger Adjustment Account (In General Ledger) To General Ledger Adjustment Account (In Sales Ledger) (The error because of the under-casting of Sales Books, rectified)	Dr.	1,000	 1,000
	Suspense Account (In Sales Ledger) To Sales Account	Dr.	1,000	 1,000

	(Rectification of the error resulting from under casting of the Sales Book)			
(b)	Suspense Account (In Sales Ledger)	Dr.	50	
	To Rao (In Sales Ledger)			50
	(Rectification of the error by which Rao was not credited, accounts in the general ledger are not affected)			
(c)	Murty (In Purchase Ledger)	Dr.	310	
	To Murty (In Sales Ledger)			310
	(Transfer of Murty's credit balance in the Purchase Ledger to his account in the Sales Ledger)			
	Bought Ledger Adjustment Account (In General Ledger)	Dr.	310	
	To General Ledger Adjustment A/c			310
	(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 (In Sales Ledger)	Dr.	310	
	To Sales Ledger Adjustment A/c (In General Ledger)			310
	(Correction of the adjustment account relating to the Sales Ledger because of the transfer of Murty's account)			

Note : It is assumed that if a ledger is not balanced, a Suspense Account has been opened.

Sectional Balancing System

(a)	Total Debtors Account	Dr.	1,000	
	To Sales Account			1,000
	(Rectification of the consequence of the under- casting the Sales Book)			
(b)	Credit Rao with ₹ 50 (In Sales Ledger)			
(c)	1. Murty (In Purchase Ledge)	Dr.	310	
	To Murty (In Sales Ledger)			310
	(Transfer of Murty's credit balance ₹ 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.

	₹
Debtors' Balance on 1st January, 2014	91,500
Creditors' Balance on 1st January, 2014	1,09,800
Transactions for the year 2014 :	
Credit purchases	41,000
Credit sales	45,400
Returns Inwards	800
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)

2014		₹	*2014*		₹
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
			2015		
			Jan. 1	By Balance b/d	64,000

General Ledger Adjustment A/c (in Purchases Ledger)

2014		₹	*2014*		₹
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
2015					
Jan. 1	To Balance b/d	67,020			

6. Ruling of Subsidiary Books

Whenever there are several Bought or Sales Ledgers in use, various books of original entry, e.g., Purchases Books, Sales Books, Cash Book and Journal are suitably ruled in a manner that they readily show the monthly total of the transactions posted in various ledgers, on the basis of which the self-balancing entries, can be recorded.

7. Secret Account

At time it may be considered necessary to keep the operation of certain accounts, e.g., partners' capitals, loans, deposits etc., secret from members of the staff except the senior officials. In such a case, these accounts would be segregated into a Private Ledger and posting will be made in the ledger by a confidential clerk, under the direct supervision of the Chief Accountant. Also a General Ledger Adjustment Account will be set up in the Private Ledger and a Private Ledger Adjustment Account in the General Ledger. In this way, though the individual entries in the accounts kept in the Private Ledger will be revealed to the accounting staff, their total effect will be kept secret. In case individual accounts also are desired to be kept secret separate Cash Book and Bank Account would be maintained; this would ensure complete secrecy.

When such a system is first started, the assets and other debit balances are transferred to the Private Ledger by crediting the respective accounts in the General Ledger and the Private Ledger Adjustment Account is debited with their total. The opposite are the entries made when credit balances are transferred. Also, if it is desired to transfer a part of the Bank Balance to Private Bank Account, Bank Account is credited and the Private Ledger Adjustment Account is debited. From the Private Bank Account, partners will be able to draw amounts required by them and to pay interest on deposits and loans at whatever rates they may please without the fact being disclosed to the staff.

When accounts are closed at the end of the year, the revenue accounts are closed off by transfer of the Private Ledger Adjustment Account and corresponding entries are made in the Private Ledger by debit or credit to the General Ledger Adjustment Account. Afterwards all the balances so transferred, along with those already in the Private Ledger, are transferred to the Profit & Loss Account in the Private Ledger. In this way, complete secrecy is maintained regarding the operation of accounts in the Private Ledger; also the amount of profit made by the concern is not disclosed to the staff.

Students may note that the procedure followed for making the Private and General Ledgers self-balancing is somewhat different from that described above in so far as entries in the Adjustment Accounts are not made at the time an expense is paid or an income is collected, but only at the end of the year. This is done only to avoid making book keeping too cumbersome.

Illustration 4

M. Govind keeps self-balancing ledgers. Record the following transactions in the General Ledger Adjustment Account in the Sales Ledger :

1.4.2015 Received ₹ 475 from Mr. X in full settlement. He was allowed a discount of ₹ 25.

2.4.2015 Received ₹ 2,000 from Mr. Y towards his dues in full.

3.4.2015 Goods supplied to Mr. T ₹ 700 and received ₹ 300 after adjustment of the advance of ₹ 400.

4.4.2015 Bad debts recovered from Mr. Q ₹ 1,000.

5.4.2015 Goods sold to the following :

Mr. A	*₹ 1,000*
Mr. B	*₹ 1,500*
Mr. C	*₹ 2,000*

15.4.2015 Mr. P paid ₹ 750 towards dues. Balance thereafter due was ₹ 250.

25.4.2015 Amount received from the following :

Mr. A	*₹ 750*
Mr. B	*₹ 1,000*
Mr. C	*₹ 2,000*

30.4.2015 Advance received from Mr. R for supply ₹ 2,000.

Solution

Sales Ledger

General Ledger Adjustment Account

2015		₹	*2015*		₹
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 (Sales)	700
April 30	To " " (P, X & Y)	3,250	April 30	By Sales Ledger	
	To " " (A, B, C)	3,750		Adjustment A/c	4,500
	To " " R	2,000	April 30	By Balance c/d	2,000
April 30	To Balance c/d				
	(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 :

	₹
X	500
Y	2,000
P	1,000
	3,500

(ii) Opening debit balance ₹ 400, is advance from T.

(iii) Closing debit balance represents advance from R ₹ 2,000.

(iv) Closing balance of ₹ 1,000 includes the following debts :

	₹
A	250
B	500
P	250
	1,000

Illustration 5

The following information is available from the book of a trader from January 1 to March 31, 2013:

(1) Total sales amounted to ₹ 60,000 including the sale of old furniture for ₹ 1,200 (book value ₹ 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 ₹ 2,600.

(3) Bills Receivable drawn during three months totalled ₹ 6,000 of which bills amounting to ₹ 3,000 were endorsed in favour of suppliers. Out of these endorsed B/R, a B/R for ₹ 600 was dishonoured for non-payment, as the party became insolvent, his estate realising nothing.

(4) Purchases totalled ₹ 16,000 of which 10% was for cash.

(5) A cheque received from a customer for ₹ 6,000 was dishonoured; a sum of ₹ 500 is irrecoverable: Bad Debts written off in the earlier years realised ₹ 2,500.

(6) Sundry debtors, as on 1st January, 2013 stood at ₹ 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.*
	₹		₹

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 ₹ 100, cash sales will be ₹ 20. Total credit sales shall be 5/6th of ₹ 58,800, i.e., ₹ 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, 2015:

Date	*Particulars*
1	*Purchase from Mr. X ₹ 2,000*
2	*Paid ₹ 1,600 after adjusting the initial advance in full to Mr. X.*
13	*Paid ₹ 1,000 to Mr. R towards the purchases made in February in full.*
13	*Paid advance to Mr. Y ₹ 3,000*
14	*Purchased goods from Mr. A ₹ 4,000*
25	*Returned goods worth ₹ 500 to Mr. A.*
26	*Settled the balance due to A at a discount of 10 per cent.*
27	*Goods purchased from Mr. Y ₹ 2,500 against advance paid on 13th.*
28	*Received at bank the advance from Mr. P paid on 28 February, 2015, ₹ 2,000.*
29	*Purchased from B ₹ 2,000.*
30	*Goods returned to Q ₹ 750.*

Solution

Creditors Ledger Adjustment Account

2015		₹	*2015*		₹

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:

1.3.2015	X	2,000
14.3.2015	A	4,000
27.3.2015	Y	2,500
30.3.2015	B	2,000
		10,500

(2) Payments:

2.3.2015	X	1,600
13.2.2015	R	1,000
13.2.2015	Y	3,000
26.3.2015	A ₹ 3,500 - 10%	3,150
		8,750

Illustration 7

From the following information prepare a Total Debtors Account as appearing in the General ledgers in the Books of M/s Shukla and Company.

Debit balance as on 1.7.2014, ₹ 87,200; Credit balance as on 1.7.2014 in Debtors Account ₹ 600.

Transactions during 6 months ended on 31.12.2014:

Total sales were ₹ 94,000 including cash sales of ₹ 4,000. Debtors whose balances were in credit were paid off ₹ 600. Payments received by cheques from Debtors ₹ 60,000. Payments received by cash from Debtors ₹ 48,000. Payment received by bills receivable ₹ 26,000.

Bills receivable received from Debtors were dishonoured for ₹ 6,000 and noting charges of ₹ 60 were paid. Cheques received from customers were dishonoured for ₹ 800.

Out of bills receivable received and included in ₹ 26,000 above, bills of ₹ 5,000 were endorsed to suppliers.

Bad debts written-off during the period were ₹ 1,000. Discount allowed for prompt payment were ₹ 700 and bad debts written off in 2013 and now recovered from debtors amounted to ₹ 900.

Interest debited for delay in payments were ₹ 1,250. On 31.12.2014 provision for doubtful debts was created for ₹ 2,100. M/s Trial & Co.'s account appeared in Debtors Ledger and also in Creditors Ledger. The balance in Creditors Ledger was ₹ 900 and the same was transferred to Debtors Ledger. Goods of ₹ 2,760 were rejected by the customers.

Solution

In the General Ledger of M/s. Shukla & Company

Dr.	Total Debtors Account				*Cr.*
Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.7.2014	To Balance b/f	87,200	1.7.2014	By Balance b/f	600
1.7.2014 to 31.12.2014	To Sales (₹ 94,000 - ₹ 4,000)	90,000	1.7.2014 to 31.12.2014	By Bank	60,000
"	To Cash	600	"	By Cash	48,000
"	To Bills Receivable (dishonoured)	6,000	"	By Bills receivable	26,000
"	To Bank (noting charges)	60	"	By Bad debts	1,000
"	To Bank (cheque dishonoured)	800	"	By Discount allowed	700
"	To Interest	1,250	"	By Total Creditors A/c-Transfer	900
			"	By Sales Return	2,760
			"	By Balance c/d	45,950
		1,85,910			1,85,910

Notes:

(1) Bad debts of 2013 recovered in 2014 will not appear in the Total Debtors Account. It should be credited to Profit and Loss Account.

(2) Bills Receivable of ₹ 5,000 endorsed to suppliers has nothing to do with Total Debtors Account because at the time of endorsement Suppliers Account is debited and Bills Receivable Account is credited.

Illustration 8

The following particulars are obtained from books of a Self Ltd. for the year ended 31st March, 2015:

	₹		₹
Cash Sales	*25,000*	*Bills Receivable dishonoured*	*2,500*
Credit Purchases	*2,80,000*	*Return Inward*	*8,500*
Collection from Debtors	*4,25,000*	*Payments to creditors*	*1,62,000*
Bills Receivable drawn	*20,000*	*Discount allowed*	*3,000*
Discount Received	*2,500*	*Debtors' cheque returned dishonoured*	*7,500*
Cash Purchases	*12,000*	*Credit Sales*	*4,90,000*
Bills Payable paid	*6,500*	*Bills Receivables collected*	*10,000*
Recovery of Bad Debts	*1,500*	*Return outward*	*3,700*
Bills Receivable discounted with Bank	*8,000*	*Bills Receivable endorsed to creditors*	*7,900*
Interest charged on overdue Customer's Accounts	*1,200*	*Overpayments refunded by suppliers*	*600*
Endorsed Bills Receivable dishonoured (noting charges ₹ 75)	*5,500*	*Bad Debts* *Opening Balances*	*1,000*
Bills Payable accepted	*16,000*	*Sundry Debtors*	*78,000*
		Sundry Creditors	*85,000*

You are required to prepare the Total Debtors Account and Total Creditors Account.

Solution

In the books of Self Ltd.

Total Debtors Account

	₹		₹
To Balance b/d	78,000	By Cash	4,25,000
To Bank (Cheque dishonoured)	7,500	By Discount Allowed	3,000
To B/R (Dishonoured)	2,500	By B/R	20,000
To Interest	1,200	By Returns Inward	8,500
To Sales	4,90,000	By Bad Debts	1,000
To Sundry Creditors (endorsed bill dishonoured with noting charges)	5,575	By Balance c/d	1,27,275
	5,84,775		5,84,775

Total Creditors Account

	₹		₹
To Cash	1,62,000	By Balance b/d	85,000
To B/R (endorsed)	7,900	By Purchases	2,80,000
To Discount received	2,500	By Sundry Debtors A/c (endorsed B/R	
To Bills Payable	16,000	dishonoured with noting charges)	5,575
To Return outward	3,700	By Cash (over payments refunded)	600
To Balance c/d	1,79,075		
	3,71,175		3,71,175

Note: Transactions relating to cash sales or purchases; honour of bills receivable or payable; and discount or endorsement of bill will not be entered in Total Debtors and Total Creditors A/c.

Illustration 9

The following particulars are obtained from books of Z Ltd. for the year ended 31st March, 2015:

	₹		₹
Cash Sales	*75,000*	*Bills Receivable dishonoured*	*2,500*
Credit Purchases	*2,80,000*	*Returns Inward*	*10,500*
Collection from Debtors	*5,00,000*	*Payment to creditors*	*2,62,000*
Bills Receivable drawn	*20,000*	*Discount allowed by creditors*	*3,000*
Discount Received	*5,000*	*Debtors' cheque returned dishonoured*	*7,000*
Cash Purchases	*72,000*	*Credit Sales*	*5,25,000*
Bills Payable paid	*6,500*	*Bills Receivables collected*	*10,000*
Recovery of Bad Debts	*1,500*	*Returns outward*	*3,700*
Bills Receivable disounted with Bank	*8,000*	*Bills Receivable endorsed to creditors*	*7,900*
Interest charged on overdue Customer's Accounts	*1,200*	*Overpayments refunded by suppliers*	*600*
Endorsed Bills Receivable		*Bad Debts*	*1,000*
dishonoured	*5,500*		
Bills Payable accepted	*16,000*	*Opening Balances*	
		Sundry Debtors	*78,000*
		Sundry Creditors	*85,000*

You are required to prepare the Total Debtors Account and Total Creditors Account.

Solution:

In the books of Z Ltd.

Total Debtors Account

	₹		₹
To Balance b/d	78,000	By Cash	5,00,000
To Sales	5,25,000	By B/R	20,000
To B/R (Dishonoured)	2,500	By Returns Inward	10,500
To Bank (Cheque dishonoured)	7,000	By Bad Debts	1,000
To Interest	1,200	By Balance c/d	87,700
To Total Creditors (Endorsed bill dishonoured)	5,500		
	6,19,200		6,19,200

Total Creditors Account

	₹		₹
To Discount received (5,000 + 3,000)	8,000	By Balance b/d	85,000
To Cash	2,62,000	By Purchases	2,80,000
To Bills Payable	16,000	By Total Debtors A/c (endorsed B/R dishonoured)	5,500
To Return outward	3,700	By Cash (overpayments refunded)	600
To B/R (endorsed)	7,900		
To Balance c/d	73,500		
	3,71,100		3,71,100

Note:

1. Transactions relating to cash sales or cash purchases; collection/payment of bills receivable/payable, discounting of bills and recovery of bad debts will not be entered in Total Debtors or Total Creditors A/c.
2. It is assumed that endorsed bills receivable dishonoured of ₹ 5,500 were earlier endorsed to creditors only.

Summary

- Self Balancing Ledger System implies a system of ledger keeping which classifies ledgers as per nature of transactions.
- 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.
- In self-balancing system, generally three ledgers, namely debtor ledger, creditor ledger and main ledger (containing remaining accounts) are prepared.
- In self-balancing system "General Ledger Adjustment Account" is prepared in each of the subsidiary ledgers. The General ledger would have Bought Ledger Adjustment Account

(in reality, Total Creditors Account) and Sales Ledger Adjustment Account (in reality, Total Debtors Account). These accounts are known as Control Accounts

- Under Sectional balancing system, if the error affects the accounts of Debtors or Creditors without affecting their total, it is rectified by adjusting the accounts of Debtors or Creditors itself. However, if it affects the totals of Debtors or Creditors, the additional entries are to be made

9

Financial Statements of Not-For-Profit Organisations

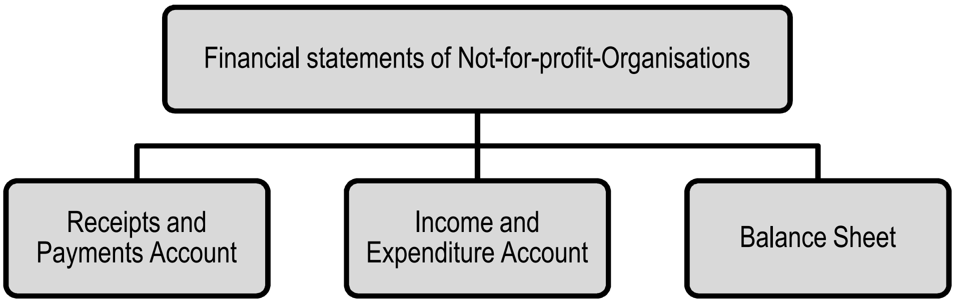
Learning Objectives

After studying this unit, you will be able to:

- Understand the meaning of Not-for-profit-Organisations and distinction between a profit making organisation and a Not-for-profit-Organisation.
- Accounting for Not-for-profit-Organisations.
- 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 of Not-for-profit-Organisation including an educational institution.
- Understand various sources of income and avenues of expenses in an educational institution.

1. Introduction

A non profit organization is a legal and accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. 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 not-for-profit 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 deficit. In non-profit making organisations, total cash receipts and total cash payments are highlighted through Receipts and Payments Account.


Financial statements of Not-for-profit-Organisations
Receipts and Payments Account
Income and Expenditure Account
Balance Sheet

2. Nature of Receipts and Payments Account

A Receipts and Payments Account is a summary of the cash book. It 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.

Features:

- It is the summary of the cash and bank transactions like cash book, all the receipts (capital or revenue) are debited, similarly, all the expenditures (capital or revenue) are credited.
- It starts with opening cash and bank balances and also ends with their closing balances.
- This account is usually not a part of the double entry system.
- It includes all cash and bank receipts and payments, whether they are related to current, past or future periods.
- Surplus or deficit for an accounting period cannot be ascertained from this account, since, it shows only the cash position an excludes all non cash items.

Illustration 1

The receipts and payments for the Swaraj Club for the year ended December 31, 2014 were: Entrance fees ₹ 300; Membership Fees ₹ 3,000; Donation for Club Pavilion ₹ 10,000, Foodstuff sales ₹ 1,200; Salaries and Wages ₹ 1,200 Purchase of Foodstuff ₹ 800; Construction of Club Pavilion ₹ 11,000; General Expenses ₹ 600; Rent and Taxes ₹ 400; Bank Charges ₹ 160.

Cash in hand–Jan. 1st ₹ 200, Dec. 31st ₹ 350

Cash in Bank–Jan. 1st ₹ 400; Dec. 31st ₹ 590

Solution

Swaraj Club
Receipts and Payments Accounts
for the year ended 31st December, 2014

	Receipts	₹		Payments	₹
To	Cash in hand b/d	200	By	Salaries and Wages	1,200
To	Cash with bank b/d	400	By	Purchase of Foodstuff	800
To	Entrance Fees	300	By	Club Pavilion (Expenditure	
To	Membership Fees	3,000		on its construction)	11,000
To	Donation of Account		By	General Expenses	600
	of Club Pavilion	10,000	By	Rent and Taxes	400
To	Sales of foodstuff	1,200	By	Bank Charges	160
			By	Cash in hand c/d	350
			By	Cash in bank c/d	590
		15,100			15,100

2.1 Limitations of Receipts and Payments Account

From a study of the above account, it will be apparent that the increase in the cash and bank balances at the end of the year, as compared to those in beginning, does not truly represent the surplus for the year since it does not take into account the cost of construction of the pavilion, which is in excess of the donation received, the outstanding subscription or those which were collected in advance, etc. Ordinarily one must ascertain whether for a current year income is sufficient to meet the current expenses. Since the Receipts and Payments Account includes items relating to all periods or of all types, it does not serve the purpose mentioned above. On account of these drawbacks, the preparation of Receipts and Payments Account is not favoured except where the activities of the organization, 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.

3. Income and Expenditure Account

The income and expenditure account is equivalent to the Profit and Loss Account of a business enterprise. It is an account which is widely adopted by non-profit making concerns and is prepared by following accrual principle. Only items of revenue nature pertaining to the period of account are included therein. The preparation of the account, therefore, requires adjustment in relevant accounts of outstanding items of income and expenditure as also exclusion of amounts paid in advance before these are included in Income and Expenditure Account. In so far as this, it resembles a Profit and Loss Account and serves the same function in respect of a non-profit making concern as the later account does for a firm, carrying on business or trade.

Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.

Features:

- It is a revenue account prepared at the end of the financial period for finding out the surplus or deficit of that period.
- It is prepared by matching expenses against the revenue of that period concerned.
- Both cash and non-cash items, such as depreciation, are taken into consideration.
- All capital expenditures and incomes are excluded.
- Only current years' income and expenses are considered.

3.1 Main Sources of Income

These are subscriptions, ordinary donations, membership fees or entrances fees (if the amount is normal or provided according to bye-laws of the society), recurring grants from local authorities and 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.

Examples:

Hospital - medicines and cost of tests and investigations.

Sports Club - sports materials, tournament expenses, etc.

Drama Club - expenses of staging plays, rent of the hall, payment to artists, etc.

Educational Societies - award of scholarships, organisation of seminars, etc.,

Library Societies - newspapers and magazines.

Any expenditure for acquisition of a fixed asset will be capitalised, though the amount of annual depreciation shall be debited to revenue expenditure.

It may be noted that after various accounts have been adjusted as is considered necessary and all the revenue accounts have been closed off by transfer to the Income and Expenditure Account, there will still be a number of balances left over. These are included in the balance sheet. A balance sheet is thus a complement to such an account. If a regular Trial Balance is available, the preparation of the Income and Expenditure Account and the Balance Sheet is on the lines of final accounts.

3.2 Distinction between Receipts and Payments Account and Income and Expenditure Account

Non profit organizations such as public hospitals, public educational institutions, clubs, etc., conventionally prepare Receipt and Payment Account and Income and Expenditure Account to show periodic performance for a particular accounting period. The distinguishing features of both the accounts can be summarized as:

Receipt and Payment Account is an elementary form of account consisting of a classified summary of cash receipts and payments over a certain period together with 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. All the receipts and payments whether of revenue or capital nature are included in this account. The balance of the account at the end of a period represents the difference between the amount of cash received and paid up. It is always in debit since it is made up of cash in hand and at bank.

Income and Expenditure Account resembles a Profit and 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. Income and Expenditure Account is drawn up in the same form as the Profit and Loss Account. Expenditure of revenue nature is shown on the debit side, income and gains of revenue nature are shown on the credit side. Income and Expenditure Account contains all the items of income and expenditure relevant to the period of account, whether received or paid out as well as that which have fallen due for recovery or payment. Capital Receipts, prepayments of income and capital expenditures, prepaid expenses are excluded. It does not start with any opening balance. The closing balance represents the amount by which the income exceeds the expenditure only or vice versa.

3.3 Preparation of Income and Expenditure Account from Receipts and Payments Account

Often problems set in examinations require compilation of Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account after making adjustments in respect of Income accrued but not collected and expenses outstanding. The preparation of Balance Sheet in such a case in also necessary since an Income and Expenditure Account must always be accompanied by a Balance Sheet. The procedure which should be followed in this regard is briefly outlined below.

(i) Compute the opening balance of the Accumulated Fund, or Capital Fund of the Institution. It will be excess of the total value of the assets over that of the liabilities at the commencement of the period.

(ii) Open ledger accounts in respect of various items of income and expenditure (e.g. subscription, rents, printing, purchase of sports materials etc.) in which accruals or outstanding at the beginning or at the end of period have to be adjusted. Enter therein any accrual or outstanding at the end of the period as well as amounts which relate to an earlier period or the following period. The balance of the ledger accounts, therefore will represent the amounts or income or expenditure pertaining to the period. These should be transferred to the Income and Expenditure Account.

(iii) Post from the debit of the Receipts & Payments Account to the credit of the Income and Expenditure Account other items of income wherein accruals and outstanding amount have to be adjusted. Likewise, post item of expenses in which no adjustment is to be made directly to debit of income and Expenditure Account.

(iv) Transfer the balance of Income and Expenditure Account to the Accumulated Fund Account.

(v) Post the receipts and payments of capital nature from the Receipts and Payments Account to the appropriate asset or liability account for incorporating in the Balance Sheet. If a part or whole of an asset has been sold, the capital profit/loss, if any, is credited / debited in the Income and Expenditure Account. The balance of Income and Expenditure Account should be transferred to the Accumulated Fund Account.

(vi) Prepare a Balance Sheet by including therein all the balances left over after transfers to the Income and Expenditure Account have been made.

Illustration 2

During 2014, subscription received in cash is ₹ 42,000. It includes ₹ 1,600 for 2013 and ₹ 600 for 2015. Also ₹ 3,000 has still to be received for 2014. Calculate the amount to be credited to Income and Expenditure Account in respect of subscription.

Solution

			₹
Amount received			42,000
Add : Outstanding on 31st Dec., 2014			3,000
			45,000
Less : Received on account of	2013	1,600	
	2015	600	(2,200)
			42,800

The various accounts will appear as under :

Subscription Outstanding Account

2014		₹	2014		₹
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

2015 Jan. 1	To Balance b/d	3,000			

Subscription Account

2014		₹	2014		₹
Dec. 31	To Subscription Outstanding A/c (transfer)	1,600	Dec. 31	By Cash A/c	42,000
Dec. 31	To Subscription received in advance A/c	600	Dec. 31	By Subscription Outstanding A/c	3,000
Dec. 31	To Income and Expenditure A/c (transfer)	42,800			——
		45,000			45,000

Subscription received in Advance Account

2014		₹	2014		₹
Dec. 31	To Balance c/d	600	Dec. 31	By Subscription A/c	600
			2015 Jan. 1	By Balance b/d	600

Subscription outstanding ₹ 3,000 and Subscription received in advance ₹ 600 will be shown in the balance sheet on the assets and liabilities side respectively.

Illustration 3

Suppose salaries paid during 2014 were ₹ 23,000. The following further information is available:

Salaries unpaid on 31st Dec. 2013	*1,400*
" prepaid on " " 2013	*400*
" unpaid on " " 2014	*1,800*
" prepaid " " 2014	*600*

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

Solution

Salaries Account

2014		₹	*2014*		₹
Jan. 1	To Prepaid	400	Jan. 1	By Salaries Outstanding	1,400

	Salaries A/c			A/c	
Dec. 31	To Cash	23,000	Dec. 31	By Salaries Prepaid A/c	600
	To Salaries			By Transfer to Income	
	Outstanding A/c	1,800		& Expenditure A/c	23,200
		25,200			25,200

Salaries Outstanding Account

2014		₹	2014		₹
Jan. 1	To Salaries A/c	1,400	Jan. 1	By Balance b/d	1,400
Dec. 31	To Balance c/d	1,800	Dec. 31	By Salaries A/c	1,800
		3,200			3,200
			2015		
			Jan 1	By Balance b/d	1,800

Salaries Prepaid Account

2014		₹	2014		₹
Jan. 1	To Balance b/d	400	Jan. 1	By Salaries A/c	400
Dec. 31	To Salaries A/c	600		(transfer)	
			Dec. 31	By Balance c/d	600
		1,000			1,000
2015					
Jan. 1	To Balance b/d	600			

4. Balance Sheet

A Balance Sheet is the statement of assets and liabilities of an accounting unit at a given date. It is generally prepared at the end of an accounting period after the Income and Expenditure Account has been prepared. 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. In not for profit organizations, the excess of total assets over total outside liabilities is known as Capital 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.

Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.

4.1 Accounting Treatment of Some Special Items

4.1.1 Donations

These may have been raised either for meeting some revenue or capital expenditure; those intended for the first mentioned purpose are credited directly to the Income and Expenditure Account but others, if the donors have declared their specific intention, are credited to special fund account and in the absence thereof, to the Capital Fund Account. If any investments are purchased out of a special fund or an asset is acquired there from, 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.

4.1.2 Entrance and Admission Fees

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

4.1.3 Subscription

Subscriptions being an income, should be allocated over the period of their accrual. For testing the knowledge of candidates of this important accounting principle, questions are often set in examinations wherein figures of subscription collected by a society during the year as well as those outstanding at the beginning of the year and at its close are given. If some subscriptions have been received in advance, their amount is also indicated. In such cases, it is always desirable to set up a Subscription Account for determining the amount of subscription pertaining for the period for which accounts are being prepared. For example, if it is stated that subscriptions collected by a society during the year 2012 amounted to ₹ 1,850 out of which ₹ 200 represented subscription for the year 2011; ₹ 100 were subscriptions collected in advance for the year 2013, and subscriptions amounting to ₹ 500 were outstanding for recovery at the end of 2012, the adjusting journal entries and the Subscription Account should be set up as follows :

		₹	₹
Subscription Outstanding Account	Dr.	500	
To Subscriptions Account			500
(The amount outstanding for this year credited to Subscription Account)			
Subscription A/c	Dr.	300	
To Outstanding Subscription A/c			200
To Subscriptions Received in Advance A/c			100
(Subscription received ₹ 200 for the previous year and ₹ 100 for the next year, adjusted)			

Subscription Account

Dr.					*Cr.*
2014		₹	*2014*		₹
Jan 1	To Outstanding Subscriptions	200	Dec.	By Cash A/c	1,850
Dec. 31	To Subscriptions received in advance	100		By Subscriptions outstanding	500
	To Income and Expenditure Account, transfer	2,050			
		2,350			2,350

The amount of outstanding subscription is adjusted in the Subscription Account by debit to Outstanding Subscription Account and that balance is shown as an asset in Balance Sheet. The Subscription Account is closed off by transferring its balance at the end of the year to the Income and Expenditure Account.

4.1.4 Life Members

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

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

(1) The entire amount may be carried forward in a special account until the member dies, 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.

4.2 Preparation of Balance Sheet

- **Preparation of opening balance sheet and calculation of surplus:** If capital fund or accumulated surplus in the beginning of the year is not given, it is calculated by deducting liabilities from assets in the beginning of year. While calculating opening capital fund, care should be taken to include prepaid expenses and accrued incomes as assets and outstanding expenses and advance incomes as liabilities. Any surplus earned during the year is added to the opening capital fund and deficit suffered during the year is deducted from the opening capital fund.
- **Cash and bank balance:** Closing cash and bank balance as disclosed in Receipt and Payment Account is shown in the assets side of Balance Sheet. If there is a bank overdraft, it is to be shown on the liabilities side of the balance sheet.
- **Fixed assets:** Opening balances of Fixed Assets (Furniture, building, equipment, etc.) are increased by the amount of purchases and reduced by sales of the same and depreciation on the same.
- **Liabilities:** Opening balances of liabilities should be adjusted for any increase or decrease in the same.

Note: The illustrations explained in the chapter comprise of clubs not registered under the Companies Act, 2013. Therefore, Income & Expenditure A/c and Balance Sheet are not prepared as per Schedule III of the Companies Act, 2013.

Illustration 4

The following was the Receipts and Payments Account of Exe Club for the year ended Dec. 31, 2014

Receipts	₹	*Payments*	₹
Cash in hand	*100*	*Groundsman's Fee*	*750*
Balance at Bank as per Pass Book:		*Moving Machine*	*1,500*
Deposit Account	*2,230*	*Rent of Ground*	*250*
Current Account	*600*	*Cost of Teas*	*250*
Bank Interest	*30*	*Fares*	*400*
Donations and Subscriptions	*2,600*	*Printing & Office Expenses*	*280*
Receipts from teas	*300*	*Repairs to Equipment*	*500*
Contribution to fares	*100*	*Honoraria to Secretary*	
Sale of Equipment	*80*	*and Treasurer of 2013*	*400*
Net proceeds of Variety		*Balance at Bank as per Pass Book:*	
Entertainment	*780*	*Deposit Account*	*3,090*
Donation for forth		*Current Account*	*150*
coming Tournament	*1,000*	*Cash in hand*	*250*
	7,820		*7,820*

You are given the following additional information:

	Jan. 1, 2014	*Dec. 31, 2014*
	₹	₹
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, 2014, the honoraria to the Secretary and Treasurer are to be increased by a total of ₹ 200.

Prepare the Income and Expenditure Account for 2014 and the relevant Balance Sheet.

Solution

Income and Expenditure Account of Exe Club

for the year ending 31st Dec. 2014

		₹		₹
To Groundsman's fee		750	By Donations and Subscription	2,550
To Rent of Ground		250	By Receipts from teas	50
To Fares' Expenses	400		(Fares) less expenses (300 - 250)	
Less : Contribution	(100)	300	By Proceeds of Variety	
To Printing & Office Expenses		260	Entertainment	780
To Repairs		460	By Interest (30 + 20)	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 Grounds man		300		
To Excess of Income over				

Expenditure		40		
		3,430		3,430

Balance Sheet of Exe Club as on 31st Dec. 2014

Liabilities		₹	*Assets*	₹
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 &	
Add: Surplus for the year	40	3,120	Equipments	1,750
Tournament Fund (Donation)		1,000		
		5,210		5,210

Opening Balance Sheet

	₹		₹
Outstanding Expenses		Cash in hand	100
and Honoraria (100 + 400)	500	Cash in Deposit A/c	2,230
Capital Fund (Balancing Figure)	3,080	Cash in Current A/c	300
		Subscription Due	150
		Machinery	800
	3,580		3,580

Illustration 5

The Income and Expenditure Account of the Youth Club for the Year 2014 is as follows:

	₹		₹
To Salaries	*4,750*	*By Subscription*	*7,500*
To *General Expenses*	*500*	*By Entrance Fees*	*250*
To *Audit Fee*	*250*	*By Contribution for*	
To *Secretary's Honorarium*	*1,000*	*annual dinner*	*1,000*
To *Stationery & Printing*	*450*	*By Profit on Annual*	
To *Annual Dinner Expenses*	*1,500*	*Sport meet*	*750*
To *Interest & Bank Charges*	*150*		
To *Depreciation*	*300*		

To *Surplus*	*600*		
	9,500		*9,500*

This account had been prepared after the following adjustments:

	₹
Subscription outstanding at the end of 2013	*600*
Subscription received in Advance on 31st December, 2013	*450*
Subscription received in advance on 31st December, 2014	*270*
Subscription outstanding on 31st Dec., 2014	*750*

Salaries Outstanding at the beginning and the end of 2014 were respectively ₹ 400 and ₹ 450. General Expenses include insurance prepaid to the extent of ₹ 60. Audit fee for 2014 is as yet unpaid. During 2014 audit fee for 2013 was paid amounting to ₹ 200.

The Club owned a freehold lease of ground valued at ₹ 10,000. The club had sports equipment on 1st January, 2014 valued at ₹ 2,600. At the end of the year, after depreciation, this equipment amounted to ₹ 2,700. In 2013, the Club has raised a bank loan of ₹ 2,000. This was outstanding throughout 2014. On 31st December, 2014 cash in hand amounted to ₹ 1,600.

Prepare the Receipts and Payments Account for 2014 and Balance Sheet as at the end of the year.

Solution

The Youth Club
Receipts and Payments Account
for the year ended 31st Dec., 2014

	₹	₹		₹	₹
To Balance b/d(balancing figure)		1,390	By Salaries	4,750	
To Subscriptions As per Income & Expenditure Account			*Add:* Paid for 2013	400	
				5,150	
Add: 2013's Received	7,500		*Less:* Unpaid for 2014	(450)	4,700
2015's Received	270		By General Expenses	500	
	8,370		*Add :* Paid for 2015	60	560
Less: 2014's Received in 2013	(450)		By Audit fee (2014)		200
	7,920		By Secy. Honorarium		1,000
Less: 2014's Outstanding	(750)	7,170	By Stationery & Printing		450
To Entrance Fees		250	By Annual Dinner Expenses		1,500
To Contribution for annual dinner		1,000	By Interest & Bank Charges		150
To Profit on Sport meet :			By Sports Equipments		
Receipt less expenses		750	[2700-(2600-300)]		400
			By Balance c/d		1,600
		10,560			10,560
To Balance b/d		1,600			

Balance Sheet of Youth Club as at December 31, 2014

Liabilities	₹	₹	*Assets*	₹	₹
Subscription received			Freehold Ground		10,000
in advance		270	Sport Equipment:		
Audit Fee Outstanding		250	As per last		
Salaries Outstanding		450	Balance Sheet	2,600	
Bank Loan		2,000	Additions	400	
Capital Fund :				3,000	
Balance as per previous			*Less :* Depreciation	(300)	2,700
Balance Sheet	11,540				
Add : Surplus for 2014	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, 2013

Liabilities	₹	*Assets*	₹
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, 2015:

Income & Expenditure Account for the year 2014-15

	₹		₹
To Upkeep of Ground	10,000	By Subscriptions	17,320
To Printing	1,000	By Sale of Newspapers (Old)	260
To Salaries	11,000	By Lectures	1,500
To Depreciation on Furniture	1,000	By Entrance Fee	1,300

To Rent	600	By Misc. Income	400
		By Deficit	2,820
	23,600		23,600

Balance Sheet as at 31st March, 2015

Liabilities		₹	*Assets*	₹
Subscription in Advance			Furniture	9,000
(2015-16)		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 (2014-15)	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 adjustments have been made in the above accounts:

(1) Upkeep of ground ₹ 600 and Printing ₹ 240 relating to 2013-2014 were paid in 2014-15.

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

(3) Subscription outstanding in 2013-14 was ₹ 800 and for 2014-15 ₹ 700.

(4) Subscription received in advance in 2013-14 was ₹ 200 and in 2014-15 for 2015-16 ₹ 100.

Solution

Receipts and Payments Account
for the year ending 31st March, 2015

Receipts	₹	*Payments*	₹
To Balance b/d		By Upkeep of Ground	
(Balancing figure)	4,660	(10,000+600)	10,600
To Subscription	17,320	By Printing (1,000+240)	1,240
To Interest on Prize Fund Investments	1,000	By Salaries	11,000
To Lecture (fee)	1,500	By Rent	600
To Entrance Fee	2,600	By Prizes	2,000

To Sale of Newspapers (old)	260	By Balance c/d	2,300
To Misc. Income	400		
	27,740		27,740

Working note: ₹ 600 paid for upkeep of ground for 2013-14 and ₹ 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

2014		₹	*2014*		₹
April	To Subscription Outstanding (2011-12)	800	April 1	By Cash (Balancing figure)	17,320
	To Subscription In Advance (2013-14)	100		By Subscription Outstanding (2014-15)	700
				By Subscription in Advance (2013-14)	200
2015					
March	To 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, 2015 :

Receipts and Payments Acount

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

Figures of other assets and liabilities are furnished as follows:

	as at March 31	
	₹	*₹*
	2014	*2015*
Salaries outstanding	*710*	*170*
Outstanding rent & electricity	*864*	*973*
Outstanding for magazines and newspapers	*226*	*340*
Fixed Deposit (10%) with bank	*20,000*	*20,000*
Interest accrued thereon	*500*	*500*
Subscription receivable	*1,263*	*1,575*
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, 2015 was ₹ 5,250.

From the above information you are required to prepare:

(a) The Club's Balance Sheet as at March 31, 2014;

(b) The Club's Income and Expenditure Account for the year ended March 31, 2015.

(c) The Club's Closing Balance Sheet as at March 31, 2015.

Solution

(a)

Sportswriters Club
Balance Sheet as on 31st March, 2014

Liabilities	*₹*	*₹*	*Assets*	*₹*
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
Capital Fund (Balancing figure)		47,000	Cash in hand & at Bank	4,820

			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, 2015

	Expenditure		₹		*Income*	₹
To	Salaries		11,460	By	Subscription	28,912
To	Rent & Electricity		7,329	By	Interest	2,000
To	Magazines & Newspapers		2,286	By	Misc. Income	700
To	Sundry Expenses		10,075	By	Excess of expenditure over income	2,888
To	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, 2015

Liabilities	₹	₹	*Assets*	₹	₹
Outstanding Expenses:			Furniture		
Salaries	170		Cost	9,600	
Rent & Electricity	973		*Less* : Depreciation	(960)	8,640
Newspapers	340	1,483	Magazines &		
Capital Fund:			Sport Equipment:		
Opening balance	47,000		Opening balance	7,200	
Less : Excess of			Addition	1,000	
exp. over income	(2,888)	44,112		8,200	
			Less : Depreciation	(1,640)	6,560
			Library Books :		
			Opening Balance	5,000	
			Addition	1,000	
				6,000	
			Less : Depreciation	(750)	5,250

			Fixed Deposit		20,000
			Cash in hand & at bank		2,450
			Prepaid Expenses		620
			Subscription Receivable		1,575
			Interest accrued		500
		45,595			45,595

Working Notes:

(i)	*Expenses*	*Salaries*	*Rent & Electricity Papers*	*Magazines & News-*	*Sundry Expenses*
		₹	₹	₹	₹
	Paid during the year	12,000	7,220	2,172	10,278
	Add : Outstanding on 31.3.2015	170	973	340	—
	Prepaid on 31.3.2014	—	—	—	417
		12,170	8,193	2,512	10,695
	Less : Outstanding on 31.3.2014	(710)	(864)	(226)	—
	Less : Prepaid on 31.3.2015	—	—	—	(620)
	Expenditure for the year	11,460	7,329	2,286	10,075
					₹
(ii)	*Depreciation*				
	(a) Furniture @10% on ₹ 9,600				960
	(b) Sports Equipment @ 20% on ₹ 8,200				1,640
	(c) Library books-book value			6,000	
	Revalued at			(5,250)	750
(iii)	*Subscription*				
	Received in cash				28,600
	Add : Receivable on 31.3.2015				1,575
					30,175
	Less: Receivable on 31.3.2014				(1,263)
					28,912

Illustration 8

From the following data, prepare an Income and Expenditure Account for the year ended 31st December, 2014, and a statement of affairs as at that date of the Mayura Hospital :

Receipts and Payments Account for the year ended 31 December, 2014

	₹				₹
To Balances			*By Salaries :*		
Cash	*400*		*(₹ 3,600 for 2013)*		*15,600*
Bank	*2,600*	*3,000*	*By Hospital Equipment*		*8,500*
To Subscriptions :			*By Furniture purchased*		*3,000*
For 2013		*2,550*	*By Additions to Building*		*25,000*
For 2014		*12,250*	*By Printing and Stationery*		*1,200*
For 2015		*1,200*			
To Government Grant :			*By Diet expenses*		*7,800*
For building		*40,000*	*By Rent and rates*		
For maintenance		*10,000*	*(₹ 150 for 2015)*		*1,000*
Fees from sundry			*By Electricity and water*		
patients		*2,400*	*charges*		*1,200*
To Donations (not to be		*4,000*	*By office expenses*		*1,000*
capitalised)			*By Investments*		*10,000*
To Net collections from			*By Balances :*		
benefit shows		*3,000*	*Cash*	*700*	
			Bank	*3,400*	*4,100*
		78,400			*78,400*

Additional information :	₹
Value of building under construction as on 31.12.2014	*70,000*
Value of hospital equipment on 31.12.2014	*25,500*
Building Fund as on 1.1. 2014	*40,000*
Subscriptions in arrears as on 31.12.2013	*3,250*
Investments in 8% Govt. securities were made on 1st July, 2014.	

Solution

Mayura hospital
Income & Expenditure Account
for the year ended 31 December, 2014

Expenditure	₹	*Income*	₹
To Salaries	12,000	By Subscriptions	12,250
To Diet expenses	7,800	By Govt. Grants (Maintenance)	10,000
To Rent & Rates	850	By Fees, Sundry Patients	2,400
To Printing & Stationery	1,200	By Donations	4,000
To Electricity & Water-charges	1,200	By Benefit shows (net collections)	3,000
To Office expenses	1,000	By Interest on Investments	400
To Excess of Income over expenditure transferred to Capital Fund	8,000		
	32,050		32,050

Statement of Affairs as on 31st Dec., 2014

Liabilities	₹	₹	*Assets*	₹	₹
Capital Fund :			Building :		
Opening balance	24,650		Opening balance	45,000	
Excess of Income			Addition	25,000	70,000
Over Expenditure	8,000	32,650	Hospital Equipment :		
Building Fund :			Opening balance	17,000	
Opening balance	40,000		Addition	8,500	25,500
Add : Govt. Grant	40,000	80,000	Furniture		3,000
Subscriptions			Investments-		
received in advance		1,200	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., 2013

Liabilities	₹	*Assets*	₹
Capital Fund		Building	45,000
(Balancing Figure)	24,650	Equipment	17,000
Building Fund	40,000	Subscription Receivable	3,250
Creditors for Expenses :		Cash at Bank	2,600
Salaries payable	3,600	Cash in hand	400
	68,250		68,250

	₹
(2) Building	
Balance on 31st Dec. 2014	70,000
Paid during the year	25,000
Balance on 31st Dec. 2013	45,000
(3) Equipment	
Balance on 31st Dec. 2014	25,500
Paid during the year	(8,500)
Balance on 31st Dec. 2013	17,000
(4) Subscription due for 2013	
Receivable on 31st Dec. 2013	3,250
Received in 2014	2,550
Still Receivable for 2013	700

Illustration 9

The receipts and payments account and the income and expenditure account of a Club for the year ended 31st December, 2014 were as follows:

Receipts and Payments Account

Receipts	₹	₹	*Payments*	₹
To Balance c/d		*2,500*	*By Books purchased*	*1,000*
To Subscriptions:			*By Printing and Stationery*	*200*
2013	*600*		*By Salary*	*1,500*
2014	*4,300*	*4,900*	*By Advertisement*	*200*
To Interest		*500*	*By Electric Charge*	*400*
To Donation for special fund		*300*	*By Balance c/d*	*7,350*

To Rent:				
2013	*150*			
2014	*300*	*450*		
To Govt. Grants		*2,000*		
		10,650		*10,650*

Income and Expenditure Account

Expenditure	*₹*	*Income*	*₹*
To Salary	*2,800*	*By Interest*	*400*
To Tent Hire	*200*	*By Subscription*	*4,800*
To Electric charges	*400*	*By Rent*	*2,300*
To Depreciation on Building	*750*	*By Govt. Grant*	*2,000*
To Printing and Stationery	*200*		
To Advertisement	*150*		
To Surplus	*5,000*		
	9,500		*9,500*

The club's assets as on 1st January 2014 were :

Building ₹ 15,000; Books ₹ 10,000

Furniture ₹ 4,000; Investments ₹ 10,000

Liabilities as on that date were ₹ 50 for advertisement and ₹ 100 for salary.

You are required to prepare the balance sheet of the club on 31st December, 2013 and 31st December, 2014.

Solution:

Balance Sheet
As at 31st December, 2013

Liabilities	*₹*	*Assets*	*₹*
Capital fund(Bal. fig.)	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
		Furniture Purchased	4,000
		Investments	10,000
	42,350		42,350

Balance Sheet

As at 31st December, 2014

Liabilities		₹	*Assets*		₹
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 31/12/13	42,200				
Add: Surplus	5,000	47,200	Buildings	15,000	
			Less: Dep.	(750)	14,250
			Furniture		4,000
			Investments		10,000
			Accrued Rent		2,000
		49,100			49,100

Note: In the above solution, it is assumed that ₹ 100(₹ 500-₹ 400) excess interest received during the year is in relation to the outstanding interest of the last year.

Illustration 10

The following is the Receipts and Payments Account of Lion Club for the year ended 31st March, 2014.

Receipts	₹	*Payments*	₹
Opening balance		Salaries	1,20,000
Cash	10,000	Creditors	15,20,000
Bank	3,850	Printing and stationary	70,000
Subscription received	2,02,750	Postage	40,000
Entrance donation	1,00,000	Telephones and telex	52,000
Interest received	58,000	Repairs and maintenance	48,000
Sale of assets	8,000	Glass and table linen	12,000
Miscellaneous income	9,000	Crockery and cutlery	14,000
Receipts at		Garden upkeep	8,000
Coffee room	10,70,000	Membership fees	4,000
Wines and spirits	5,10,000	Insurance	5,000
Swimming pool	80,000	Electricity	28,000
Tennis court	1,02,000	Closing balance	
		Cash	8,000
		Bank	2,24,600
	21,53,600		21,53,600

The assets and liabilities as on 1.4.2013 were as follows:

	₹
Fixed assets (net)	5,00,000
Stock	3,80,000
Investment in 12% Government securities	5,00,000
Outstanding subscription	12,000
Prepaid insurance	1,000
Sundry creditors	1,12,000
Subscription received in advance	15,000
Entrance donation received pending membership	1,00,000
Gratuity fund	1,50,000

The following adjustments are to be made while drawing up the accounts:

(i) Subscription received in advance as on 31st March, 2014 was ₹ 18,000.

(ii) Outstanding subscription as on 31st March, 2014 was ₹ 7,000.

(iii) Outstanding expenses are salaries ₹ 8,000 and electricity ₹ 15,000.

(iv) 50% of the entrance donation was to be capitalized. There was no pending membership as on 31st March, 2014.

(v) The cost of assets sold net as on 1.4.2013 was ₹ 10,000.

(vi) Depreciation is to be provided at the rate of 10% on assets.

(vii) A sum of ₹ 20,000 received in October 2013 as entrance donation from an applicant was to be refunded as he has not fulfilled the requisite membership qualifications. The refund was made on 3.6.2014.

(viii) Purchases made during the year amounted ₹ 15,00,000.

(ix) The value of closing stock was ₹ 2,10,000.

(x) The club as a matter of policy, charges off to income and expenditure account all purchases made on account of crockery, cutlery, glass and linen in the year of purchase.

You are required to prepare an Income and Expenditure Account for the year ended 31st March, 2014 and the Balance Sheet as on 31st March, 2014 along with necessary workings.

Solution

Income and Expenditure Account of Lion Club

for the year ended 31st March, 2014

Expenditure	₹	*Income*	₹
To Salaries	1,28,000	By Subscription	1,94,750
To Printing and stationary	70,000	By Entrance donation	90,000
To Postage	40,000	By Interest	60,000
To Telephone and telex	52,000	By Miscellaneous income	9,000
To Repairs and maintenance	48,000	By Profit from operations	92,000
To Glass and table linen	12,000	By Excess of expenditure over income transferred to capital fund	30,250
To Crockery and cutlery	14,000		
To Garden upkeep	8,000		
To Membership fees	4,000		
To Insurance	6,000		
To Electricity charges	43,000		
To Loss on sale of assets	2,000		
To Depreciation	49,000		
	4,76,000		4,76,000

Balance Sheet of Lion Club as on 31st March, 2014

Liabilities	₹	*Assets*	₹
Capital fund	10,89,600	Fixed assets	4,41,000
Gratuity fund	1,50,000	Stock	2,10,000
Sundry creditors	92,000	Investments	5,00,000
Subscription received in advance	18,000	Subscription outstanding	7,000
Entrance donation refundable	20,000	Interest accrued	2,000
Outstanding expenses	23,000	Bank	2,24,600
		Cash	8,000
	13,92,600		13,92,600

Working Notes:

1. **Opening Balance Sheet**

Balance Sheet of Lion Club as on 1st April, 2013

Liabilities	₹	*Assets*	₹
Sundry creditors	1,12,000	Fixed assets	5,00,000
Subscription received		Stock	3,80,000
in advance	15,000	Investments	5,00,000
Entrance donation received in advance	1,00,000	Subscription outstanding	12,000
		Prepaid expenses	1,000
Gratuity fund	1,50,000	Cash	10,000
Capital fund (balance figure)	10,29,850	Bank	3,850
	14,06,850		14,06,850

2. **Subscription**

	₹
Subscription received during the year	2,02,750
Add: Outstanding subscription on 31.3.2014	7,000
	2,09,750
Add: Received in advance as on 1.4.2013	15,000
	2,24,750
Less: Outstanding subscription as on 1.4.2013	(12,000)
	2,12,750
Less: Received in advance as on 31.3.2014	(18,000)
	1,94,750

3. **Entrance donation**

	₹
Entrance donation received during the year	1,00,000
Add: Received in advance as on 1.4.2013	1,00,000
	2,00,000
Less: Entrance donation in respect of ineligible member	(20,000)
	1,80,000
Less: 50% capitalized	(90,000)
Taken to income and expenditure account	90,000

4. **Loss on sale of asset**

	₹
Cost of asset sold	10,000
Less: Sale proceeds	(8,000)
Loss on sale of asset	2,000

5. **Depreciation**

	₹
Fixed asset as per trial balance	5,00,000
Less: Cost of asset sold	(10,000)
	4,90,000
Depreciation on ₹ 4,90,000 @ 10%	49,000

6. **Salaries**

	₹
Salary paid during the year	1,20,000
Add: Outstanding as on 31.3.2014	8,000
	1,28,000

7. **Electricity charges**

	₹
Electricity charges paid during the year	28,000
Add: Outstanding as on 31.3.2014	15,000
	43,000

8. **Interest**

	₹
Interest on 12% Government security investment (₹ 5,00,000 @ 12 % p.a.)	60,000
Less: Interest received during the year	(58,000)
Interest accrued	2,000
Interest credited to Income and Expenditure Account	60,000

9. **Profit from operations:**

	₹
Cost of goods sold:	
Opening stock	3,80,000
Add: Purchases	15,00,000
	18,80,000

Less: Closing stock	(2,10,000)
Cost of goods sold (A)	16,70,000
Receipts from operations:	
Receipts from coffee room	10,70,000
Receipts from wines and spirits	5,10,000
Receipts from swimming pool	80,000
Receipts from tennis court	1,02,000
Total receipts (B)	17,62,000
Profits from operations (B-A)	92,000

10. Insurance

	₹
Insurance paid during the year	5,000
Add: Prepaid insurance as on 1.4.2013	1,000
	6,000

11. Sundry creditors

	₹
Opening balance as on 1.4.2013	1,12,000
Add: Purchases made during the year	15,00,000
	16,12,000
Less: Payments made during the year	(15,20,000)
Closing balance as on 31.3.2014	92,000

12. Outstanding expenses

	₹
Outstanding salaries	8,000
Outstanding electricity charges	15,000
Outstanding expenses	23,000

13. Fixed assets

	₹
Fixed assets as on 1.4.2013	5,00,000
Less: Cost of assets sold	(10,000)
	4,90,000
Less: Depreciation	(49,000)
Fixed assets as on 31.3.2014	4,41,000

14. Capital fund

	₹
Capital fund as on 1.4.2013	10,29,850
Add: Entrance donation capitalised	90,000
	11,19,850
Less: Excess of expenditure over income	(30,250)
Balance as on 31.3.2014	10,89,600

5. Educational Institution

Registration

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 Maharashtra, all the Societies have simultaneously been registered under the Bombay Public Trust Act, 1950.

Organisational Pattern

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.

Salient Features

The basic tenets pre-suppose, that part of the expenses of the educational institutions are 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.

5.1 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 form of annual tuition fees, term fees, admission fees, laboratory fee etc., and

(3) Grants received from the Government.

The Government grants are of four kinds namely Maintenance Grant, Equipment grant, Building Grant and such other grants as may be sanctioned by the Government from time to time.

5.2 Specific items

5.2.1 Donation from Public

These are received either for recurring or non-recurring purposes. Donations are received either in cash or in kind. The 'in kind' donations are in the form of land and building, shares and securities, utensils, furniture and fixtures and the like, generally with a desire to perpetuate the memory of a distinguished member of the family of the donor.

5.2.2 Capitation fee or admission fee

Amounts are collected from parents/guardians of the students who seek admission in the educational institution. These are either in the form of capitation fees or admission fees and are generally collected by the Parent Body which runs the institution. In recent times, such collections have been a matter of severe attack and ban.

5.2.3 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.

5.2.4 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.

5.2.5 Recurring grants

Recurring grants in the form of Maintenance Grants are received in instalments spread out throughout the year.

5.2.6 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: expenditure of printing and stationery, conveyance expenditure, expenditure on purchase of books and furniture equipment.

(11) Current repairs.

(12) Miscellaneous Expenses: e.g. 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.

(24) Sales-tax and General tax on purchase of the school requirements.

(25) Payments for merit scholarships.

Illustration 11

From the following Trial Balance of Education Society as on 31st Dec., 2014; prepare an Income & Expenditure Account and a Balance Sheet:

	Dr.	*Cr.*
	₹	₹
Furniture & Fittings	*12,500*	
Additions to Furniture (during the year)	*3,200*	
Library Books	*17,500*	
Addition to Library (during the year)	*4,300*	
Building	*2,75,000*	
General Investment	*1,50,000*	
Investment Reserve fund		*15,000*
Sundry Debtors and Creditors	*5,000*	*14,500*

Entrance Fee		*15,200*
Examination Fee		*2,400*
Subscription Received		*20,000*
Certificate fee		*500*
Hire of Society's Hall		*6,500*
Interest on Investment		*5,500*
Sundry receipts		*600*
Staff Salaries	*10,200*	
Printing, Stationery & Advertising	*1,000*	
Taxes & Insurance	*800*	
Examination Expenses	*600*	
Subscription of Periodicals	*1,200*	
Prize Trust Fund		*16,000*
Prize Trust Investment	*15,800*	
Prize Trust Income		*650*
Prize Awarded	*450*	
Prize Fund Bank	*275*	
Donations received (to be capitalised)		*18,000*
General Expenses	*375*	
Capital Fund		*3,89,150*
Cash at Bank	*5,500*	
Cash in hand	*300*	
	5,04,000	*5,04,000*

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

	₹
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. 2014 was ₹ 1,30,000. You are not required to make any provision for this fall in value.

Solution

Bharat Education Society
Income and expenditure Account
for the year ended at 31st Dec., 2014

	₹	₹		₹	₹
To Staff salaries	10,200		By Subscription	20,000	
Add: Outstanding	1,800	12,000	*Add:* Outstanding	4,500	
To Printing, Stationery				24,500	
& Advertising		1,000	*Less:* Received		
To Taxes & Insurance	800		in advance	(500)	
Less: Prepaid	(500)	300			24,000
To Examination Expenses		600	By Entrance Fee		15,200
To Subscription to			By Examination Fee		2,400
Periodicals		1,200	By Certificate Fee		500
To General expenses		375			
To Depreciation :			By Hire of Society's Hall		6,500
Library Books	3,270				
Furniture & Fittings	785		By Interest on Investment		
Building	13,750	17,805	Received	5,500	
To Excess of Income			*Add:* Accrued	450	5,950
Over Expenditure		21,870	By Sundry Receipts		600
		55,150			55,150

Balance Sheet of Bharat Education Society as on 31st Dec., 2014

Liabilities	₹	₹	*Assets*	₹	₹
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. ₹ 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 12

From the following balances and particulars of Republic College prepare Income & Expenditure Account for the year ended March, 2015 and a Balance Sheet as on the date :

	₹	₹
Seminars & Conference Receipts		*4,80,000*
Consultancy Receipts		*1,28,000*
Security Deposit-Students		*1,50,000*
Capital fund		*16,06,000*

Research Fund		*8,00,000*
Building Fund		*25,00,000*
Provident Fund		*5,10,000*
Tuition Fee received		*8,00,000*
Government Grants		*5,00,000*
Donations		*50,000*
Interest & Dividends on Investments		*1,85,000*
Hostel Room Rent		*1,75,000*
Mess Receipts (Net)		*2,00,000*
College Stores-Sales		*7,50,000*
Outstanding expenses		*2,25,000*
Stock of-stores and Supplies	*3,00,000*	
Purchases-Stores & Supplies	*8,00,000*	
Salaries-Teaching	*8,50,000*	
Research	*1,20,000*	
Scholarships	*80,000*	
Students Welfare expenses	*38,000*	
Repairs & Maintenance	*1,12,000*	
Games & Sports Expenses	*50,000*	
Misc. Expenses	*65,000*	
Research Fund Investments	*8,00,000*	
Other Investments	*18,50,000*	
Provident Fund Investment	*5,10,000*	
Seminar & Conference Expenses	*4,50,000*	
Consultancy Expenses	*28,000*	
Land	*1,00,000*	
Building	*16,00,000*	
Plant and Machinery	*8,50,000*	
Furniture and Fittings	*6,00,000*	
Motor Vehicle	*1,80,000*	
Provision for Depreciation		
Building		*4,80,000*
Plant & Equipment		*5,10,000*

Furniture & Fittings		*3,36,000*
Cash at Bank	*6,42,000*	
Library	*3,60,000*	
	1,03,85,000	*1,03,85,000*

Adjustments:

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

Solution

Republic College
Income and Expenditure Account
for the year ending 31st March, 2015

	₹	₹	₹	₹	₹
To Salaries: Teaching		8,50,000	By Tuitions & other fee		8,80,000
Research		1,20,000	By Govt. Grants		5,00,000
To Material & Supplies Consumed			By Income from Investments By Hostel room		1,85,000
Teaching		50,000	Rent		1,75,000
Research		1,50,000	By Mess Receipts		2,00,000
To Repairs &		1,12,000	By profit-stores		75,000

	Maintenance				sales		
To	Sports & Games Expenses			By	Seminar and Conferences		
	Cash	50,000			Income	4,80,000	
	Materials	25,000	75,000		*Less :* Expenses	(4,50,000)	30,000
To	Students Welfare Expenses			By	Consultancy charges :		
	Cash	38,000			Income	1,28,000	
	Materials	75,000	1,13,000		*Less :* Expenses	(28,000)	1,00,000
To	Misc. Expenses		65,000	By	Donations		50,000
To	Scholarships		80,000				
To	Depreciation						
	Building		80,000				
	Plant & Equipment		85,000				
	Furniture		60,000				
	Motor Vehicle		36,000				
To	Excess of Income over						
	Expenditure		3,19,000				
			21,95,000				21,95,000

Republic College
Balance Sheet as on 31st March, 2015

Liabilities	₹	₹	*Assets*	₹	₹
			Fixed Assets:		
Capital Fund			Land		1,00,000
Opening balance	16,06,000		Building Cost	16,00,000	
Add: Excess of Income			*Less:* Dep.	(5,60,000)	10,40,000
over Expenditure	3,19,000	19,25,000	Equipment Cost	8,50,000	
Other Funds			*Less :* Dep.	(5,95,000)	2,55,000
Research Fund		8,00,000	Furniture &		
Building Fund		25,00,000	Fittings:		
			Cost	6,00,000	
Current Liabilities :			*Less :* Dep.	(3,96,000)	2,04,000
Outstanding Expenses		2,25,000	Motor Vehicles		
Provident Fund		5,10,000	Cost :	1,80,000	

Security Deposit		1,50,000	*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*
		₹	₹	₹
	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

5.3 Technique of Maintaining Fund Accounts

Non-business organizations, particularly educational institutions, sometimes, maintain separate accounts/funds for any specific activity of the organization such as sports, prizes, refreshments, etc. and in that case, presentation of information in financial statements is made fund-wise. 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 13

Noida School maintains separate building fund. As on 31.3.2014, balance of building fund was ₹ 10,00,000 and it was represented by fixed deposit (15% per annum) of ₹ 6,00,000 and current account balance of ₹ 4,00,000. During the year 2014-15, the school collected as donations towards the building fund ₹ 5,60,000 and transferred 40% of developmental fees collected ₹ 22,56,500 to building fund. Capital work progress as on 31st March, 2014 was ₹ 8,25,000 for which contractors' bill upto 75% was paid on 14.4.2014. The extension of building was finished on 31.12.2014 costing ₹ 7,25,000 for which contractors' bill was fully met. It was decided to transfer the cost of completed building (₹ 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 2014-15 and show the trial balance of building fund ledger.

Solution

Journal Entries for Building Fund Ledger

			₹	₹
(1)	Bank A/c	Dr.	5,60,000	
	To Building fund A/c			5,60,000
	(On collection of donations)			
(2)	Bank A/c	Dr.	9,02,600	
	To Building fund A/c			9,02,600
	(40% of the development fees directly transferred to building fund)			
(3)	Fixed deposit A/c	Dr.	90,000	

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

Trial Balance of Building Fund as on 31st March, 2015

	Dr.	*Cr.*
	₹	₹
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

Summary

- A non profit organization is a legal and accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. Financial Statements of such organizations consists of:
  1. Receipts and Payments Account
  2. Income and Expenditure Account
  3. Balance Sheet
- A Receipts and Payments Account is a summary of the cash book.

- The income and expenditure account is equivalent to the Profit and Loss Account of a business enterprise. 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.
- ***Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.***
- It may be noted that after various accounts have been adjusted as is considered necessary and all the revenue accounts have been closed off by transfer to the Income and Expenditure Account, there will still be a number of balances left over. These are included in the balance sheet. A balance sheet is thus a complement to such an account.
- Donations, Entrance and Admission Fees, Subscription, Life Membership Fee are some of the sources of incomes for the non-profit organizations. These items have separate treatments with some being capitalized while others being treated on accrual basis, as told before.
- Educational institutions are quite different from other not-for-profit organisations in terms of sources of finance and items of expenditure.

10

Accounts from Incomplete Records

Learning Objectives

After studying this chapter, 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 inventory.
- ♦ Learn how to find out sales, applying gross profit ratio and adjusting for trend.

1. Introduction

Very often the small sole proprietorship and partnership businesses do not maintain double entry book keeping system. Sometimes they keep record only of the cash transactions and credit transactions. Sometimes they maintain no record of many transactions. But at the end of the accounting period they want to know the performance and financial position of their businesses. This creates some special problems to the accountants. This study 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.

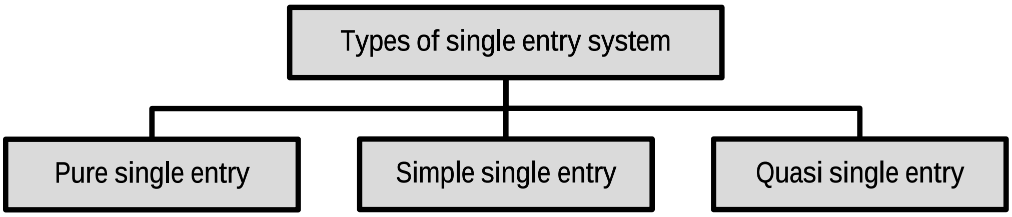
1.1 Features

- It is an inaccurate, unscientific and unsystematic method of recording business transactions.

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

2. Types

A scrutiny of many procedures adopted in maintaining records under single entry system brings forth the existence of following three types:



(i) Pure single entry: In this, only personal accounts are maintained with the result that no information is available in respect of cash and bank balances, sales and purchases, etc.. In view of its failure to provide even the basic information regarding cash etc., this method exists only on paper and has no practical application.

(ii) Simple single entry: In this, only: (a) personal accounts, and (b) cash book are maintained. Although these accounts are kept on the basis of double entry system, postings from cash book are made only to personal accounts and no other account is to be found in the ledger. Cash received from debtors or cash paid to creditors is simply noted on the bills issued or received as the case may be.

(iii) Quasi single entry: In this: (a) personal accounts, (b) cash book, and (c) some subsidiary books are maintained. The main subsidiary books kept under this system are Sales book, Purchases book and Bills book. No separate record is maintained for discounts which are entered into the personal accounts. In addition, some scattered information is also available in respect of few important items of expenses like wages, rent, rates, etc.. In fact, this is the method which is generally adopted as a substitute for double entry system.

3. Ascertainment of Profit by Capital Comparison

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

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.

3.1 Methods of Capital Comparison

Capital is increased if there is profit, while capital is reduced if there is loss. However, if the proprietor/partners made fresh investments in the business, capital is increased; if they make withdrawal capital is reduced. So while determining the profit by capital comparison, the following rules should be followed.

Particulars	₹
Capital at the end (a)	....
Add: Drawings	....
Less: Fresh capital introduced	.....
Capital at the beginning (b)	.....
Profit (a-b)	.....

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 utilizes the following sources for the purpose of finding out the assets and liabilities of a business enterprise:

(i) Cash book for cash balance

(ii) Bank pass book for bank balance

(iii) Personal ledger for debtors and creditors

(iv) Inventory by actual counting and valuation.

(v) As regards fixed assets, he prepares a list of them. The proprietor would help him by disclosing the original cost and date of purchase. After deducting reasonable amount of depreciation, the written down or depreciated value would be included in the Statement of Affairs.

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	₹	*Assets*	₹
Capital (Bal. Fig.)	xx	Building	xx
Loans, Bank overdraft	xx	Machinery	xx
Sundry creditors	xx	Furniture	xx
Bills payable	xx	Inventory	xx
Outstanding expenses		Sundry debtors	xx
		Bills receivable	xx
		Loans and advances	xx
		Cash and bank	xx
		Prepaid expenses	xx
	xx		xx

Now from the statement of affairs prepared for two different dates, opening and closing capital balances can be obtained.

3.2 Difference between Statement of Affairs and Balance Sheet

Basis	Statement of affairs	Balance sheet
Reliability	It is prepared on the basis of transactions partly recorded on the basis of double entry book keeping and partly on the basis of single basis. Most of the assets are recorded on the basis of estimates, assumptions, information gathered from memory rather than records.	It is based on transactions recorded strictly on the basis of double entry book keeping; each item in the balance sheet can be verified from the relevant subsidiary books and ledger. Hence the balance sheet is not only reliable, but also dependable.
Capital	In this statement, capital is merely a balancing figure being excess of assets over capital. Hence assets need not be equal to liabilities.	Capital is derived from the capital account in the ledger and therefore the total of assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared on the basis of incomplete records, it is very difficult, to locate the assets and liabilities, if they are omitted from the books.	There is no possibility of omission of any item of asset and liability since all items are properly recorded. Moreover, it is easy to locate the missing items since the balance sheet will not agree.

Basis of Valuation	The valuation of assets is generally done in an arbitrary manner; therefore no method of valuation is disclosed.	The valuation of assets is done on scientific basis, that is original cost in the case of new assets and depreciated amount on the basis of cost minus depreciation to date for used assets. Any change in the method of valuation is properly disclosed.
Objects	The object of preparing this statement in the calculation of capital figures in the beginning and at the end of the accounting period respectively.	The object of preparing the balance sheet is to ascertain the financial position on a particular date.

3.3 Preparation of Statement of Affairs and Determination of Profit

It has been discussed in Para 3.1 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 31-12-2013 and 31-12-2014 are as follows:

	31-12-2013	*31-12-2014*
	₹	₹
Assets		
Building	*1,00,000*	-
Furniture	*50,000*	-
Inventory	*1,20,000*	*2,70,000*
Sundry debtors	*40,000*	*90,000*
Cash at bank	*70,000*	*85,000*
Cash in hand	*1,200*	*3,200*
Liabilities		
Loans	*1,00,000*	*80,000*
Sundry creditors	*40,000*	*70,000*

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

Prepare Statement of Affairs.

Solution

Statement of Affairs
as on 31-12-2013 & 31-12-2014

Liabilities	*31-12-2013*	*31-12-2014*	*Assets*	*31-12-2013*	*31-12-2014*
	₹	₹		₹	₹
Capital	2,41,200	4,40,700	Building	1,00,000	97,500
(Bal. Fig.)			Furniture	50,000	45,000
Loans	1,00,000	80,000	Inventory	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

	₹
Capital Balance as on 31-12-2014	4,40,700
Less : Fresh capital introduced	(40,000)
	4,00,700
Add : Drawings (₹ 2000 × 12)	24,000
	4,24,700
Less : Capital Balance as on 31-12-2013	(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:

	31-3-2014	31-3-2015
	₹	₹
Furniture	1,20,000	-
Advances	70,000	50,000
Creditors	32,000	30,000
Debtors	40,000	45,000
Inventory	60,000	74,750
Loan	80,000	—
Cash at Bank	50,000	1,40,000

The partners are entitled to salary @ ₹ 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
	₹	₹
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 ₹ 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 ₹ 10,000 may be depreciated for 1/4th of a year.

Current account as on 31-3-2014: A ₹ 5,000 (Cr.), B ₹ 2,000 (Dr.)

Prepare Statement of Profit, Current Accounts of partners and Statement of Affairs as on 31-3-2015.

Solution

Statement of Affairs
As on 31-3-2014 and 31-3-2015

Liabilities	31-3-2014	31-3-2015	Assets	31-3-2014	31-3-2015
	₹	₹		₹	₹
Capital A/c's			Furniture	1,20,000	1,17,750
A	1,50,000	75,000	Advances	70,000	50,000
B	75,000	75,000	Inventory	60,000	74,750
C	—	75,000	Debtors	40,000	45,000
Loan	80,000	—	Cash at bank	50,000	1,40,000
Creditors	32,000	30,000	Current A/c		

			B	2,000	—
Current A/c's					
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 ₹ 1,20,000	12,000
	10% on ₹ 10,000 for 1/4 year	250
		12,250
(*ii*)	*Furniture as on 31-3-2015*	
	Balance as on 31-3-2014	1,20,000
	Add: new purchase	10,000
		1,30,000
	Less: Depreciation	(12,250)
		1,17,750
(*iii*)	*Total of Current Accounts as on 31-3-2015*	
	Total of Assets	4,27,500
	Less : Fixed Capital + Liabilities	(2,55,000)
		1,72,500

This is after adding salary, interest on capital and deducting drawings and interest on drawings.

(*iv*)	*Interest on Capital* :				₹
	A :	on	1,50,000	@ 6% for 3 months	2,250
		on	75,000	@ 6% for 9 months	3,375
					5,625
	B :	on	75,000	@ 6% for 1 year	4,500
	C :	on	75,000	@ 6% for 9 months	3,375
					7,875
(*v*)	*Interest on Drawings* :				
	A :	on	2,000	@ 10% for 11 months	183
		on	4,000	@ 10% for 9 months	300
		on	2,000	@ 10% for 3 months	50
					533

	B :	on	2,000	@ 10% for 10 months	167
		on	6,000	@ 10% for 6 months	300
		on	8,000	@ 10% for 1 month	67
					534

Allocation of Profit	₹ 1,15,067	
3 months Profit	₹ 28,767	
9 months Profit	₹ 86,300	
A : 2/3 × ₹ 28,767 + 1/3 × ₹ 86,300		= ₹ 47,944
B : 1/3 × ₹ 1,15,067		= ₹ 38,356
C: 1/3 × ₹ 86,300		= ₹ 28,767
		₹ 1,15,067

Current Accounts

		A	*B*	*C*			*A*	*B*	*C*
To	Balance b/d	—	2,000	—	By	Balance b/d	5,000	—	—
To	Drawings	8,000	16,000	—	By	Salary	24,000	24,000	18,000
To	Interest on drawings	533	534	—	By	Interest on capital	5,625	4,500	3,375
To	Balance c/d	74,036	48,322	50,142	By	Share of Profit	47,944	38,356	28,767
		82,569	66,856	50,142			82,569	66,856	50,142

Statement of Profit

				₹
Current Account Balances as on 31-3-2015				1,72,500
Less: Salary	A ₹ 2,000 × 12	=	24,000	
	B ₹ 2,000 × 12	=	24,000	
	C ₹ 2,000 × 9	=	18,000	(66,000)
Less: Interest on Capital	A		5,625	
	B		4,500	
	C		3,375	(13,500)
Add: Drawings	A		8,000	
	B		16,000	24,000
Add: Interest on Drawings	A		533	
	B		534	1,067
				1,18,067
Less: Current A/c Balances as on 31-3-2012 (₹ 5,000 – ₹ 2,000)				(3,000)
				1,15,067

Illustration 4

The Income Tax Officer, on assessing the income of Shri Moti for the financial years 2013-2014 and 2014-2015 feels that Shri Moti has not disclosed the full income. He gives you the following particulars of assets and liabilities of Shri Moti as on 1st April, 2013 and 1st April, 2015.

				₹
1-4-2013	*Assets*	*:*	*Cash in hand*	*25,500*
			Inventory	*56,000*
			Sundry debtors	*41,500*
			Land and Building	*1,90,000*
			Wife's Jewellery	*75,000*
	Liabilities	*:*	*Owing to Moti's Brother*	*40,000*
			Sundry creditors	*35,000*
1-4-2015	*Assets*	*:*	*Cash in hand*	*16,000*
			Inventory	*91,500*
			Sundry debtors	*52,500*
			Land and Building	*1,90,000*
			Motor Car	*1,25,000*
			Wife's Jewellery	*1,25,000*
			Loan to Moti's Brother	*20,000*
	Liabilities	*:*	*Sundry creditors*	*55,000*

During the two years the domestic expenditure was ₹ 4,000 p.m. The declared income of the financial years were ₹ 1,05,000 for 2013-2014 and ₹ 1,23,000 for 2014-2015 respectively.

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

Solution

Capital Account of Shri Moti

		1-4-2013		*1-4-2015*
	₹	₹	₹	₹
Assets				
Cash in hand		25,500		16,000
Inventory		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
Capital		3,13,000		5,65,000
Income during the two years:				
Capital as on 1-4-2015				5,65,000
Add: Drawings – Domestic Expenses for the two years (₹ 4,000 × 24 months)				96,000
				6,61,000
Less: Capital as on 1-4-2013				(3,13,000)
Income earned in 2013-2014 and 2014-2015				3,48,000
Income declared (₹ 1,05,000 + ₹ 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 ₹ 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 to the bank, the following profit figures:

Year ending 31st December	*Profits (₹)*
2010	*20,000*
2011	*32,000*
2012	*35,000*
2013	*48,000*
2014	*55,000*

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

(a) Position as on 31st December, 2009: Sundry debtors ₹ 20,000; Inventory in trade (at 95% of the cost) ₹ 47,500; Cash in hand and at bank ₹ 12,600; Trade creditors ₹ 6,000; Expenses due ₹ 1,600.

(b) He had borrowed ₹ 5,000 from his wife on 30th September, 2009 on which he had agreed to pay simple interest at 12% p.a. The loan was repaid alongwith interest on 31st December, 2011.

(c) In December, 2010, he had advanced ₹ 8,000 to A for purchase of a vacant land. The property was registered in March, 2012 after payment of balance consideration of ₹ 32,000. Costs of registration incurred for this were ₹ 7,500.

(d) Suresh purchased jewellery for ₹ 15,000 for his daughter in October, 2012. Marriage expenses incurred in January were ₹ 24,000.

(e) A new VCR was purchased by him in March 2014 for ₹ 18,000 and presented by him to his friend in November, 2014.

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

(g) The position of assets and liabilities as on 31st December 2014 was found to be Overdraft with bank (secured against property) ₹ 12,000; Trade creditors ₹ 10,000. Expenses payable ₹ 600; Sundry debtors (including ₹ 600 due from a peon declared insolvent by Court) ₹ 28,800; Inventory in trade (at 125% of cost to reflect market value) ₹ 60,000 and Cash in hand ₹ 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 31-12-2009

Liabilities	₹	₹	*Assets*	₹
Loan from Mrs. Suresh	5,000		Sundry debtors	20,000
Add: Interest outstanding	150	5,150	Inventory on trade-at cost	
Trade creditors		6,000	$\left(47,500\times\frac{100}{95}\right)$	50,000
Outstanding expenses		1,600	Cash in hand & at bank	12,600
Capital (Bal. fig.)		69,850		
		82,600		82,600

Statement of Affairs as on 31-12-2014

Liabilities	₹	*Assets*	₹
Bank overdraft-secured against property	12,000	Sundry Debtors	28,800
Trade Creditors	10,000	Inventory in trade at cost	
Outstanding expenses	600	(₹ 60,000 × 100/125)	48,000
Capital Balancing figure	54,450	Cash in hand	250
	77,050		77,050

Statement of Profit for the period 1-1-2010 to 31-12-2014

	₹
Capital as on 31-12-2014 as per statement	54,450

Add:	Drawings during the period (₹ 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
		2,78,950
Less:	Capital as on 31-12-2009 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 31-12-2014	(600)
	Net profit over the five-year period	2,08,500

Statement showing annual profits and their differences with reported profits: 2010-2014

Year ended	*Apportionment Ratio*	*Annual profit*	*Profit reported*		*Difference to bank*
		₹	₹		₹
31-12-2010	3	25,020	20,000	(+)	5,020
31-12-2011	4	33,360	32,000	(+)	1,360
31-12-2012	4	33,360	35,000	(–)	1,640
31-12-2013	6	50,040	48,000	(+)	2,040
31-12-2014	8	66,720	55,000	(+)	11,720
		2,08,500	1,90,000	(+)	18,500

4. 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.

4.1 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. 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.

4.2 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*
	₹	₹		₹	₹
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 debtors	-	10,000	By Sundry creditors	-	5,000
			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 2014.

	₹
Cash Balance on 1st Jan., 2014	250

Bank overdraft on 1st Jan., 2014	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., 2014	310
Bank balance on 31st Dec., 2014	1,180

Now prepare the cash and Bank Summary.

Cash and Bank Summary

Dr.			*Cr.*
	₹		₹
Cash Balance as on 1-1-2014	250	Bank overdraft	5,400
Collection from Sundry debtors	45,600	Cash purchases	3,000
Sale of old furniture	750	Purchase of Machinery	12,000
Fresh Capital brought in	5,000	Payment to Sundry creditors	26,370
Balancing figure	8,340	Expenses	8,450
		Drawings	3,230
		Cash balance on 31-12-2014	310
		Bank balance on 31-12-2014	1,180
	59,940		59,940

See that debit side is short by ₹ 8,340. What may be the possible source of cash inflow?

May be cash sales.

4.3 Analysis of Sales Ledger and Purchase Ledger

Sales Ledger: It would disclose information pertaining to the opening balance of the debtors, the goods sold to them on credit during the year, bills receivable dishonoured, if any; cash received from them in the accounting period, discount, rebate or any other concession allowed to them, receipts of bills receivable, returns inwards, bad debts written off and transfers. Journal entries must be made by debiting or crediting the impersonal accounts concerned with contra credit or debit given to total debtors account.

Analysis of Sales Ledger of the year

Op. Customer Balance	Sales	Bills Disho-noured	Total Debits	Cash Recd.	Dis-counts Alld.	Bills Recd.	Sales Returns	Bad Debts	Total Credit	Balance (cl.)

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)

	₹		₹
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 ₹ 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. The information is available in respect of opening balance of the creditors, goods purchased on credit, bills payable dishonored; cash paid to the creditors during the year, discount and other concessions obtained, returns outwards and transfers. Here also, journal entries must be made by debiting or crediting the respective impersonal accounts. Contra credit or debit being given to total creditor's account.

If a proper record of return to creditors, discount allowed by them etc., has not been kept, it will not be possible to write up the Total Creditors A/c. In such a case, net credit purchase will be ascertained as follows:

Cash paid to Creditors including on account of Bills	
Payable during the period	....
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	*Amount Bank Payment*	*Paid out of Accrued*	*Total Private Fund*	*Pre Payment*	*Expenses for the period*
1	*2*	*3*	*4*	*5*	*6*	*7*
	₹	*₹*	*₹*	*₹*	*₹*	*₹*
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 4.2. Given some other information, how to compute credit purchase and credit sale is discussed below:

Opening balance (1-1-2014)	₹
Inventory	20,000
Sundry creditors	12,300
Sundry debtors	15,000
Closing Balance (31-12-2014)	
Inventory	15,000
Sundry creditors	13,800
Sundry debtors	25,600
Discount received during 2014	1,130
Discount allowed	1,870

What are the purchases for 2014? Let us prepare the Sundry Creditors Account.

Sundry Creditors Account

	₹		₹
To Cash	26,370	By Balance b/d	12,300
To Discount	1,130	(opening)	
To Balance c/d (closing)	13,800	By Purchases (balancing figure)	29,000
	41,300		41,300

The credit purchases are ₹ 29,000; cash purchases are ₹ 3,000: hence total purchases are ₹ 32,000.

Likewise prepare the Sundry Debtors Account:

Sundry Debtors Account

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

So total sales = credit sales + cash sales

= ₹ 58,070 + ₹ 8,340 = ₹ 66,410

4.4 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.

4.5 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 of personal investment of the proprietors collected and put in the business;
- 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, 2015 and a Balance Sheet as on that date:

(a)		*Balance as on 31st March, 2014* ₹	*Balance as on 31st March, 2015* ₹
	Building	*3,20,000*	*3,60,000*
	Furniture	*60,000*	*68,000*
	Motorcar	*80,000*	*80,000*
	Inventorys	*–*	*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:

	₹		₹
Sale of old papers and miscellaneous income	*20,000*	*Cash purchases* *Payment to creditors*	*48,000* *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 ₹ 20,000 and Bills payable accepted ₹ 16,000.*
- *Some items of old furniture, whose written down value on 31st March, 2014 was ₹ 20,000 was sold on 30th September, 2014 for ₹ 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 ₹ 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, 2014 was ₹ 8,000 and on 31st March, 2015 was ₹ 10,000 on 31st March, 2014. Profit and Loss Account had a credit balance of ₹ 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, 2015

	₹		₹
To Opening inventory		By Sales(3,20,000x 100/80)	4,00,000
(balancing figure)	80,000	By Closing inventory	40,000
To Purchases (1,92,000x100/80)	2,40,000		
To Gross profit c/d @ 30% on sales	1,20,000		
	4,40,000		4,40,000
To Miscellaneous expenses		By Gross profit b/d	1,20,000
(₹ 80,000 – ₹ 8,000 +		By Miscellaneous receipts	20,000
₹ 10,000)	82,000	By Net loss transferred to Capital A/c	25,840
To Depreciation: Building ₹ 36,000 Furniture ₹ 7,800 (₹ 6,800+₹ 1,000) Motor Car ₹ 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, 2015

Liabilities	₹	₹	*Assets*	₹	₹
Capital as on 1st April, 2014		7,16,000	Building	3,20,000	
			Add: Addition during the year	40,000	
Profit and Loss A/c			*Less:* Provision for	3,60,000	
Opening balance	40,000		depreciation	(36,000)	3,24,000
Less: Loss for the			Furniture	60,000	
year	(25,840)	14,160	*Less:* Sold during		
Sundry creditors		1,12,000	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
			Inventory 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:

(i) Sundry Debtors Account

	₹		₹
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 (bal. fig.)	2,52,000
	4,80,000		4,80,000

(ii) Sundry Creditors Account

	₹		₹
To Cash/Bank A/c	1,84,000	By Balance b/d	1,20,000
To Bills Payable A/c	16,000	By Purchases A/c	1,92,000
To Balance c/d (bal. fig.)	1,12,000		
	3,12,000		3,12,000

(iii) Bills Receivable Account

	₹		₹
To Balance b/d	32,000	By Cash/ Bank A/c (bal. fig.)	24,000
To Sundry Debtors A/c	20,000	By Balance c/d	28,000
	52,000		52,000

(iv) Bills Payable Account

	₹		₹
To Cash/Bank A/c (bal. fig.)	28,000	By Balance b/d	28,000
To Balance c/d	16,000	By Sundry Creditors A/c	16,000
	44,000		44,000

(v) Furniture Account

	₹		₹
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

(vi) Cash/Bank Account

	₹		₹
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 (bal. fig.)	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

(vii) Opening Balance Sheet of Mr. Shivkumar as on 31st March, 2014

Liabilities	₹	*Assets*	₹
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	Inventory in trade	80,000
Outstanding salary	8,000	Sundry Debtors	1,60,000
		Bills Receivable	32,000
		Cash in hand and at bank	1,80,000
	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, 2014 is given below:

Receipts	₹	*Payments*	₹
Bank Balance as on 1st January, 2014	*2,800*	*Payments to Sundry creditors*	*35,000*
Received from Sundry Debtors	*48,000*	*Salaries*	*6,500*
Cash Sales	*11,000*	*General expenses*	*2,500*
Capital brought during the year	*6,000*	*Rent and Taxes*	*1,500*
Interest on Investments	*200*	*Drawings*	*3,600*
		Cash purchases	*12,000*
		Balance at Bank on 31st Dec., 2014	*6,400*
		Cash in hand on 31st Dec., 2014	*500*
	68,000		*68,000*

Particulars of other assets and liabilities are as follows:

	1st January, 2014	*31st December, 2014*
Sundry debtors	*14,500*	*17,600*
Sundry creditors	*5,800*	*7,900*
Machinery	*7,500*	*7,500*
Furniture	*1,200*	*1,200*
Inventory	*3,900*	*5,700*
Investments	*5,000*	*5,000*

Prepare final accounts for the year ending 31st December, 2014 after providing depreciation at 10 percent on machinery and furniture and ₹800 against doubtful debts.

Solution

A. Adamjee

Trading and Profit & Loss Account for the year ended 31-12-2014

	₹	₹		₹
To Opening Inventory		3,900	By Sales	62,100
To Purchases		49,100	By Closing Inventory	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	750			
Furniture	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, 2014

Liabilities	₹	₹	*Assets*	₹	₹
A. Adamjee's Capital			Machinery	7,500	
on 1st January, 2014	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	Inventory-in-trade		5,700
			Sundry debtors	17,600	
Sundry creditors		7,900	*Less :* Provision for		
			doubtful debts	(800)	16,800
			Investment		5,000
			Cash at bank		6,400
			Cash in hand		500
		42,230			42,230

Working Notes:

1. Statement of Affairs of A. Adamjee as on 1-1-2014

	₹		₹
Sundry creditors	5,800	Machinery	7,500
A. Adamjee's capital	29,100	Furniture	1,200
(balancing figure)		Inventory	3,900
		Sundry debtors	14,500
		Investments	5,000
		Bank balance (from Cash statement)	2,800
	34,900		34,900

2. Ledger Accounts

A. Adamjee's Capital Account

		₹			₹
Dec. 31	To Drawings	3,600	Jan. 1	By Balance	29,100
Dec. 31	To Balance c/d	31,500	Dec. 31	By Cash	6,000
		35,100			35,100

Sales Account

		₹			₹
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

		₹			₹
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			

Purchases Account

		₹			₹
Dec. 31	To Cash A/c	12,000			
	To Total Creditors A/c	37,100	Dec. 31	By Trading Account	49,100
		49,100			49,100

Total Creditors Account

		₹			₹
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

Illustration 8

From the following data, you are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, 2015 and a Balance Sheet as at that date. All workings should form part of your answer.

Assets and Liabilities	*As on 1st April 2014*	*As on 31st March 2015*
	₹	₹
Creditors	*15,770*	*12,400*
Sundry expenses outstanding	*600*	*330*
Sundry Assets	*11,610*	*12,040*
Inventory in trade	*8,040*	*11,120*
Cash in hand and at bank	*6,960*	*8,080*
Trade debtors	*?*	*17,870*
Details relating to transactions in the year:		
Cash and discount credited to debtors		*64,000*

Sales return		*1,450*
Bad debts		*420*
Sales (cash and credit)		*71,810*
Discount allowed by trade creditors		*700*
Purchase returns		*400*
Additional capital-paid into Bank		*8,500*
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 31-3-2015		*1,200*
Cheques issued to trade creditors		*60,270*

Solution

Trading and Profit & Loss Account
for the year ending 31st March, 2015

	₹	₹		₹	₹
To Opening Inventory		8,040	By Sales		
			Cash	4,600	
To Purchases	59,030		Credit	67,210	
Less : Returns	(400)	58,630		71,810	
To Gross profit c/d		14,810	*Less :* Returns	(1,450)	70,360
			By Closing inventory		11,120
		81,480			81,480
To Sundry expenses (W.N.v)		9,300	By Gross profit b/d		14,810
To Discount		1,500	By Discount		700
To Bad Debts		420			
To Net Profit transfer to Capital		4,290			
		15,510			15,510

Balance Sheet of M/s ....
as on 31st March, 2015

Liabilities	₹	₹	*Assets*	₹
Capital			Sundry assets	12,040
Opening balance	26,770		Inventory in trade	11,120
Add: Addition	8,500		Sundry debtors	17,870
Net Profit	4,290		Cash in hand & at bank	8,080
	39,560			
Less : Drawings	(3,180)	36,380		
Sundry creditors		12,400		
Outstanding expenses		330		
		49,110		49,110

Working Notes:

(i) Cash sales

Combined Cash & Bank Account

	₹		₹
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-Balancing Figure)	4,600	By Sundry expenses	9,570
		By Purchases	1,030
		By Balance c/d	8,080
	96,800		96,800

(ii) Total Debtors Account

	₹		₹
To Balance b/d (Balancing figure)	16,530	By Bank	62,500
		By Discount(64,000 - 62,500)	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

	₹		₹
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, 2014

Liabilities	₹	*Assets*	₹
Capital (balancing figure)	26,770	Sundry Assets	11,610
Sundry Creditors	15,770	Inventory in Trade	8,040
Outstanding Expenses	600	Sundry Debtors	16,530
		Cash in hand & at bank	6,960
	43,140		43,140

(v)

Expenses paid in Cash	9,570
Add : Outstanding on 31-3-2015	330
	9,900
Less : Outstanding on 1-4-2014	(600)
	9,300

(vi) Due to lack of information deprecation has not been provided on fixed assets.

Illustration 9

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

	31-12-2013	*31-12-2014*
Sundry debtors	*70,000*	*92,000*
Bills receivable	*15,000*	*6,000*
Bills payable	*12,000*	*14,000*
Sundry creditors	*40,000*	*56,000*
Inventory	*1,10,000*	*1,90,000*
Bank	*90,000*	*87,000*
Cash	*5,200*	*5,300*

Summary of cash transactions during the year 2014:

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

(ii) Withdrawals ₹ 1,21,000.

(iii) Cash payment to suppliers ₹ 77,200 for supplies and ₹ 25,000 for furniture.

(iv) Cheques collected from customers but dishonoured ₹ 5,700.

(v) Bills accepted by customers ₹ 40,000.

(vi) Bills endorsed ₹ 10,000.

(vii) Bills discounted ₹ 20,000, discount ₹ 750.

(viii) Bills matured and duly collected ₹ 16,000.

(ix) Bills accepted ₹ 24,000.

(x) Paid suppliers by cheque ₹ 3,20,000.

(xi) Received ₹ 20,000 on maturity of one LIC policy of the proprietor by cheque.

(xii) Rent received ₹ 14,000 by cheque for the premises owned by proprieter.

(xiii) A building was purchased on 30-11-2014 for opening a branch for ₹ 3,50,000 and some expenses were incurred on this building, details of which are not maintained.

(xiv) Electricity and telephone bills paid by cash ₹ 18,700, due ₹ 2,200.

Other transactions:

(i) Claim against the firm for damage ₹ 1,55,000 is under legal dispute. Legal expenses ₹ 17,000. The firm anticipates defeat in the suit.

(ii) Goods returned to suppliers ₹ 4,200.

(iii) Goods returned by customers ₹ 1,200.

(iv) Discount offered by suppliers ₹ 2,700.

(v) Discount offered to the customers ₹ 2,400.

(vi) The business is carried on at the rented premises for an annual rent of ₹ 20,000 which is outstanding at the year end.

Prepare Trading and Profit & Loss Account of Mr. Anup for the year ended 31-12-2014 and Balance Sheet as on that date.

Solution

Trading and Profit & Loss Account of Mr. Anup
for the year ended 31-12-2014

	₹	₹		₹	₹
To Opening Inventory		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 Inventory		1,90,000
To Gross Profit		5,88,650			
		11,48,550			11,48,550
To Wages (9,200 x12)		1,10,400	By Gross Profit		5,88,650
To Electricity & Tel. Charges(18,700+2,200)		20,900	By Discount		2,700
To Legal expenses		17,000			
To Discount (2,400+ 750)		3,150			
To Shop exp. (600 x12)		7,200			
To Provision for claims for damages		1,55,000			
To Shop Rent		20,000			
To Net Profit		2,57,700			
		5,91,350			5,91,350

Balance-Sheet as on 31-12-2014

Liabilities	₹		*Assets*	₹
Capital A/c (W.N.vi)	2,38,200		Building	3,72,000
Add : Fresh capital introduced			Furniture	25,000
Maturity value from LIC	20,000		Inventory	1,90,000
Rent	14,000		Sundry debtors	92,000
Add : Net Profit	2,57,700		Bills receivable	6,000
	5,29,900		Cash at Bank	87,000
Less : Drawing(14,00 x12)	(16,800)	5,13,100	Cash in Hand	5,300
Rent outstanding		20,000		
Sundry creditors		56,000		

Bills Payable		14,000		
Outstanding expenses				
Legal 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 :

(i) Sundry Debtors Account

	₹		₹
To Balance b/d	70,000	By Bill Receivable A/c-	
To Bill receivable A/c-Bills dishonoured	3,000	Bills accepted by customers	40,000
To Bank A/c- Cheque dishonoured	5,700	By Bank A/c -	
To Credit sales (Balancing Figure)	9,59,750	Cheque received	5,700
		By Cash	8,97,150
		By Return inward A/c	1,200
		By Discount A/c	2,400
		By Balance c/d	92,000
	10,38,450		10,38,450

(ii) Bills Receivable Account

	₹		₹
To Balance b/d	15,000	By Sundry creditors A/c	
To Sundry Debtors A/c	40,000	(Bills endorsed)	10,000
(Bills accepted)		By Bank A/c	19,250
		By Discount A/c (Bills discounted)	750
		By Bank	
		Bills collected on maturity	16,000
		By Sundry debtors	
		Bills dishonoured (Bal. Fig)	3,000
		By Balance c/d	6,000
	55,000		55,000

(iii) Sundry Creditors Account

	₹		₹
To Bank	3,20,000	By Balance c/d	40,000
To Cash	77,200	By Credit purchase	
		(Balancing figure)	4,54,100
To Bill Payable A/c	24,000		
To Bill Receivable A/c	10,000		
To Return Outward A/c	4,200		
To Discount Received A/c	2,700		
To Balance b/d	56,000		
	4,94,100		4,94,100

(iv) Bills Payable A/c

	₹		₹
To Bank A/c (Balance figure)	22,000	By Balance b/d	12,000
To Balance c/d	14,000	By Sundry creditors A/c	
		Bills accepted	24,000
	36,000		36,000

(v) Summary Cash Statement

	Cash	Bank		Cash	Bank
	₹	₹		₹	₹
To Balance b/d	5,200	90,000	By Bank	7,62,750	
To Sundry debtors			By Cash		1,21,000
(Bal. Fig)	8,97,150		By Shop exp.	7,200	
To Cash		7,62,750	By Wages	1,10,400	
To Bank	1,21,000		By Drawing A/c	16,800	
			By Bills Payable		22,000
To S. Debtors		5,700	By Sundry creditors	77,200	3,20,000
To Bills receivable		19,250	By Furniture	25,000	
To Bills receivable		16,000	By Sundry Debtors		5,700
To Capital (maturity			By Electricity		
value of LIC policy)		20,000	& Tel. Charges	18,700	
To Capital (Rent			By Building (Bal.		
received)		14,000	fig)		3,72,000
			By Balance c/d	5,300	87,000
	10,23,350	9,27,700		10,23,350	9,27,700

(vi) Statement of Affairs as on 31-12-2013

Liabilities	₹	*Assets*	₹
Sundry Creditors	40,000	Inventory	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 ₹ 500 p.m. he decided to start his own typewriting institute. He approached U.B.C. Bank which sanctioned him a loan of ₹ 20,000 on 1-1-2014. His father gifted him ₹ 5,000 on 1-1-2014. He purchased 6 typewriters worth ₹ 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 31-12-2014. His Pass Book reveals the following:

		₹
(a)	*Expenses of the Institute*	*8,400*
(b)	*Salary to self*	*4,000*
(c)	*Monthly Fee Collected*	*32,700*
(d)	*Examination Fee Collected*	*4,200*

The following are the additional details available:

(1) During the year AVL purchased a second-hand cycle costing ₹ 400 from a student who owed monthly fees of ₹ 100. The balance was paid. The cycle is used for the institute only.

(2) AVL helped a friend by encashing a cheque for ₹ 1,000 which was dishonoured. The friend has so far repaid only ₹ 400.

(3) AVL has taken ₹ 600 per month for his personal expenses in addition to his salary.

(4) AVL runs the institute from his house for which a rent of ₹ 600 p.m. is paid. 50% may reasonably be allocated for his own living.

(5) The following are outstanding as at end of 31-12-2014

		₹
(a)	*Fees Receivable*	*2,200*
(b)	*Expenses Payable*	*1,000*

(c)	*Salary to Self for Nov. and Dec.,*	
(d)	*Inventory of stationery on hand*	*200*

(6) Provide Depreciation 20% on typewriters and cycle.

(7) The loan from Bank is repayable at ₹ 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, 2014

	₹	₹		₹
To Sundry expenses	8,400		By Fees earned	35,000
Add : Outstanding	1,000	9,400	By Examination fee	4,200
To Rent		3,600	By Inventory of stationery	200
To Depreciation				
Typewriters	4,800			
Cycle	80	4,880		
To Interest on Loan		2,295		
To Net Profit transferred to Capital A/c		19,225		
		39,400		39,400

Balance Sheet of Mr. AVL as on 31st Dec., 2014

Liabilities	₹	₹	*Assets*	₹	₹
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	Inventory of stationery		200
Expenses payable		1,000	Fees receivable		2,200
			Loan to friend		600
			Cash and 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 :

		₹
(i)	Fees earned	32,700
	Add : Due on the closing date	2,200
	Adjustment in payment for cycle purchased	100
		35,000
(ii)	Interest on Bank Loan @ 12% p.a. on	₹
	₹ 20,000 for January to June	1,200
	₹ 19,500 for July	195
	₹ 19,000 for August	190
	₹ 18,500 for September	185
	₹ 18,000 for October	180
	₹ 17,500 for November	175
	₹ 17,000 for December	170
		2,295

(iii) Cash and Bank Account

	₹		₹
To Capital A/c (Gift)	5,000	By Typewriters	24,000
To Bank Loan	20,000	By Sundry Expenses	8,400
To Students' fees	32,700	By Drawings (salary)	4,000
To Exam. fees	4,200	By Cycle (Purchase)	300
To Sundries (friend's Cheque)	1,000	By Advance (friend's)	1,000
To Advance (Recovered)	400	By Sundries (friend's cheque dishonoured)	1,000
		By Drawings(7,200 +3,600)	10,800
		By Rent	3,600
		By Bank loan (500 × 6)	3,000
		By Bank Interest	2,295
		By Balance c/d	4,905
	63,300		63,300

(iv) Drawings Accounts

	₹		₹
To Rent	3,600	By Balance c/d	14,800
To Bank - Cash withdrawal	7,200		
To Bank - Taken as salary	4,000		
	14,800		14,800

(vi) Salaries to proprietor is not considered as an item of expense. Profit is believed to be the product of capital, labour and management.

Illustration 11

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

(a) Assets and liabilities as on

	1.1.2014 ₹	*31.12.2014* ₹
Furniture (w.d.v)	*12,000*	*12,700*
Inventory at cost	*16,000*	*14,000*
Sundry Debtors	*32,000*	*?*
Sundry Creditors	*22,000*	*30,000*
Prepaid expenses	*1,200*	*1,400*
Unpaid expenses	*4,000*	*3,600*
Cash in hand and at bank	*2,400*	*1,250*

(b) Receipts and payments during 2014 :

Collections from debtors, after allowing discount of ₹3,000 amounted to ₹1,17,000.

Collections on discounting of bills of exchange, after deduction of discount of ₹250 by the bank, totalled to ₹12,250.

Creditors of ₹80,000 were paid ₹78,400 in full settlement of their dues.

Payment for freight inwards ₹6,000.

Amount withdrawn for personal use ₹14,000.

Payment for office furniture ₹2,000.

Investment carrying annual interest of 4% were purchased at ₹ 192 (face value ₹200) on 1st July, 2014 and payment made there for.

Expenses including salaries paid ₹29,000.

Miscellaneous receipts ₹1,000.

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

(d) *Goods costing ₹ 1,800 were used as advertising materials.*

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

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

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

Rashmi asks you to prepare trading and profit and loss account for the year ended 31st December, 2014 and the balance sheet as on that date.

Solution:

Trading and Profit and Loss Account of Ms. Rashmi

for the year ended 31st December, 2014

		₹		₹
To Opening Inventory		16,000	By Sales	1,46,100
To Purchases	91,200		By Closing inventory	14,000
Less : For advertising	(1,800)	89,400		
To Freight inwards		6,000		
To Gross profit c/d		48,700		
		1,60,100		1,60,100
To Sundry expenses		28,400	By Gross profit b/d	48,700
To Advertisement		1,800	By Interest on investment	4
To Discount allowed –			(200 x 4/100 x ½)	
Debtors	3,000		By Discount received	1,600
Bills Receivable	250	3,250	By Miscellaneous income	1,000
To Depreciation on furniture		1,300		
To Provision for doubtful debts		972		
To Net Profit		15,582		
		51,304		51,304

Balance Sheet as on 31st December, 2014

Liabilities	*Amount*		*Assets*		*Amount*
	₹	₹		₹	₹
Capital as on 1.1.2014	37,600		Furniture (w.d.v.)	12,000	
Less: Drawings	(15,808)		Additions during the year	2,000	
	21,792		*Less :* Depreciation	(1,300)	12,700
Add : Net Profit	15,582	37,374	Investment		192
Sundry creditors		30,000	Interest accrued		4
Outstanding expenses		3,600	Closing Inventory		14,000
			Sundry debtors	38,900	
			Less : Provision for doubtful debts	972	37,928
			Bills receivable		3,500
			Cash in hand and at bank		1,250
			Prepaid expenses		1,400
		70,974			70,974

Working Notes :

(1) Capital on 1st January, 2014

Balance Sheet As On 1st January, 2014

Liabilities	₹	*Assets*	₹
Capital (Bal.fig.)	37,600	Furniture (w.d.v.)	12,000
Creditors	22,000	Inventory at cost	16,000
Outstanding expenses	4,000	Sundry debtors	32,000
		Cash in hand and at bank	2,400
		Prepaid expenses	1,200
	63,600		63,600

(2) Purchases made during the year

Sundry Creditors Account

	₹		₹
To Cash and bank A/c	78,400	By Balance b/d	22,000
To Discount received A/c	1,600	By Sundry debtors A/c	800

To Bills Receivable A/c	4,000	By Purchases A/c	91,200
To Balance c/d	30,000	(Balancing figure)	
	1,14,000		1,14,000

(3) Sales made during the year

		₹
Opening inventory		16,000
Purchases	91,200	
Less : For advertising	(1,800)	89,400
Freight inwards		6,000
		1,11,400
Less : Closing inventory		(14,000)
Cost of goods sold		97,400
Add : Gross profit (@ 50% on cost)		48,700
		1,46,100

(4) Debtors on 31st December, 2014

Sundry Debtors Account

	₹		₹
To Balance b/d	32,000	By Cash and bank A/c	1,17,000
To Sales A/c	1,46,100	By Discount allowed A/c	3,000
To Sundry creditors A/c		By Bills receivable A/c	20,000
(bill dishonoured)	800	By Balance c/d (Bal.fig.)	38,900
	1,78,900		1,78,900

(5) Additional drawings by Ms. Rashmi

Cash and Bank Account

	₹		₹
To Balance b/d	2,400	By Freight inwards A/c	6,000
To Sundry debtors A/c	1,17,000	By Furniture A/c	2,000
To Bills Receivable A/c	12,250	By Investment A/c	192
To Miscellaneous income A/c	1,000	By Expenses A/c	29,000
		By Creditors A/c	78,400
		By Drawings A/c	15,808

		[₹ 14,000 + ₹ 1,808 (Additional drawings)]	
		By Balance c/d	1,250
	1,32,650		1,32,650

(6) Amount of expenses debited to Profit and Loss A/c

Sundry Expenses Account

	₹		₹
To Prepaid expenses A/c (on 1.1.2014)	1,200	By Outstanding expenses A/c (on 1.1.2014)	4,000
To Bank A/c	29,000	By Profit and Loss A/c (Balancing figure)	28,400
To Outstanding expenses A/c (on 31.12.2014)	3,600		
		By Prepaid expenses A/c	1,400
	33,800		33,800

(7) Bills Receivable on 31st December, 2014

Bills Receivable Account

	₹		₹
To Debtors A/c	20,000	By Creditors A/c	4,000
		By Bank A/c	12,250
		By Discount on bills receivable A/c	250
		By Balance c/d (Balancing figure)	3,500
	20,000		20,000

Summary

- Single entry system is generally found in sole trading concerns or even in partnership firms to some extent but never in case of limited liability companies on account of legal requirements.
- There are basically 3 types of single entry systems:
  (i) Pure Single Entry
  (ii) Simple Single Entry
  (iii) Quasi Single Entry
- Single entry system ignores the concept of duality and therefore, transactions are not recorded in their two-fold aspects.
- Closing Capital = Opening Capital + Additional Capital – Drawings + Profits
- Many techniques are possible for obtaining complete accounting information.

11

Hire Purchase and Instalment Sale Transactions

Learning Objectives

After studying this chapter, you will be able to:

- Understand the salient features and nature of Hire purchase transactions.
- Journalise the Hire purchase entries both in the books of hire purchaser and the hire vendor.
- Learn various methods of accounting for hire purchase transactions.
- 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.
- Understand the instalment payment system and also how it is different from hire purchase transactions.

1. Introduction

With an increasing demand for better life, the consumption of goods has been on the expanding scale. But, this has not been backed up by adequate purchasing power, transforming it into effectual demand, i.e., actual sale at set or settled prices. This has created the market for what is called **hire purchase.**

When a person wants to acquire an asset but is not sure to make payment within a stipulated period of time he may pay in instalments if the vendor agrees. This enables the purchaser to use the asset while paying for it in instalments over an agreed period of time. This type of a business deal is known as hire purchase transaction. Here, the customer pays the entire amount either in monthly or quarterly or yearly instalments, while the asset remains the property of the seller until the buyer squares up his entire liability. For the seller, the agreed instalments include his interest on the assets given on credit to the purchaser. Therefore, when the total amount is paid in instalments over a period of time is certainly higher than the cash down price of the article because of interest charges. Obviously, both the parties gain in the bargain. By virtue of this, the purchaser has the right of immediate use of the asset without making down right payment from his own, by this, he gets both credit and product from the same seller. From seller's view point, he derives the benefit by increase in sale and also he recovers his own cost of credit.

2. Nature of Hire Purchase Agreement

Under the Hire Purchase System the Hire Purchaser gets possession of the goods at the outset and can use it, while paying for it in instalments over a specified period of time as per the agreement. However, the ownership of the goods remains with the Hire Vendor until the hire purchaser has paid all the instalments. Each instalment paid by the hire purchaser is treated as hire charges for using the asset. In case he fails to pay any of the instalments (even the last one) the hire vendor will take back his goods without compensating the buyer, i.e., the hire vendor is not going to pay back a part or whole of the amount received through instalments till the date of default from the buyer.

3. Special Features of Hire Purchase Agreement

1. ***Possession:*** The hire vendor transfers only possession of the goods to the hire purchaser immediately after the contract for hire purchase is made.
2. ***Installments:*** The goods are 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 i.e an amount on signing the agreement.
4. ***Constituents of Hire purchase instalments:*** Each instalment consists partly of a finance charge (interest) and partly of a capital payment.
5. ***Ownership:*** The property in goods is to pass to the hire purchaser on the payment of the last instalment and exercising the option conferred upon him under the agreement.
6. ***Repossession:*** In case of default in respect of payment of even the last instalment, the hire vendor has the right to take the goods back without making any compensation.

4. Terms used in Hire Purchase Agreements

1. ***Hire Vendor:*** Hire vendor is a person who delivers the goods alongwith its possession to the hire purchaser under an hire purchase agreement.
2. ***Hire Purchaser:*** Hire purchaser is a person who obtains the goods and rights to use the same from hire vendor under an hire purchase agreement.
3. ***Cash Price:*** Cash price is the amount to be paid by the buyer on outright purchase in cash.

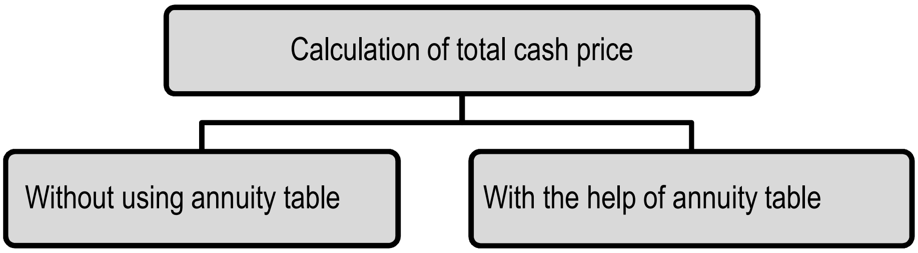
4. ***Down Payment:*** Down payment is the initial payment made to the hire vendor by the hire purchaser at the time of entering into hire purchase agreement.

5. ***Hire Purchase Instalment:*** Hire purchase instalment is the amount which the hire purchaser has to pay after a reguler interval upto certain period as specified in the agreement to obtain the ownership of the asset purchased under a hire purchase agreement. It comprises of principal amount and the interest on the unpaid amount.

6. ***Hire purchase price:*** It means the total sum payable by the hire purchaser to obtain the ownership of the asset purchased under hire purchase agreement. It comprises of cash price and interest on outstanding balances.

5. 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.


Calculation of total cash price
Without using annuity table
With the help of annuity table

5.1. Calculation of Total Cash Price without using Annuity Table

In this method, the interest included in the last instalment is to be calculated first with the help of the appropriate formula (explained below).

For example in a hire purchase transaction, apart from down payment, four other instalments are payable. The interest will be calculated first on the 4th instalment, then on the 3rd instalment, then on the 2nd instalment and lastly on the 1st instalment. Interest on down payment will be nil.

In this connection, it should be noted that the amount of interest will go on increasing from the 4th instalment to the 3rd instalment, from the 3rd instalment to the 2nd instalment and from the 2nd instalment to the 1st instalment.

We know that interest is to be calculated on the outstanding balance of cash price.

In this case, we will have to calculate the interest with the help of the total amount due on hire purchase price since the cash price is not known. For the purpose of calculating the interest, the following steps should be followed:

Step 1: Calculate the ratio between interest and the amount due with the help of the following formula:

$$\text{Ratio of interest and amount due} = \frac{\text{Rate of interest}}{100 + \text{Rate of interest}}$$

Step 2: Calculate the interest included in the last instalment by applying the following formula:

Interest = Total amount due at the time of instalment x Ratio of interest and amount due (as calculated in step 1)

Step 3: Subtract the interest (as calculated in step 2) from this instalment to get the amount of outstanding cash price at the time of last instalment.

Step 4: Add the cash price calculated in Step 3 to the amount of instalment due at the end of the third year.

Step 5: Calculate the interest on the entire sum (cash price included in the 4th instalment + amount of 3rd instalment). Deduct this interest from the total amount due at the end of 3rd year to get the outstanding cash price at the time of 3rd instalment.

Step 6: Add the cash price calculated in step 5 to the amount of instalment due at the end of 2nd year.

Step 7: Calculate the interest on the entire sum so obtained in Step 6. Deduct this interest from the total amount due at the end of 2nd year to get the outstanding cash price at the time of 2nd instalment.

Step 8: Add the cash price calculated in Step 7 to the amount of instalment due at the end of 1st year.

Step 9: Calculate the interest on the entire sum so obtained in Step 8. Deduct this interest from the total amount due at the end of 1st year to get the outstanding cash price at the time of 1st instalment.

Step 10: Add the cash price calculated in Step 9 to the amount of down payment, if any. The sum so obtained will be the total cash price.

Illustration 1

Asha purchased a truck on hire purchase system. As per terms he is required to pay ₹ 70,000 down, ₹ 53,000 at the end of first year, ₹ 49,000 at the end of second year and ₹ 55,000 at the end of third year. Interest is charged @ 10% p.a.

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

Solution

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

(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 of ₹ 55,000 =₹ 5,000	50,000
2nd	*99,000	1/11 of ₹ 99,000 = ₹ 9,000	90,000
1st	**1,43,000	1/11of ₹ 1,43,000 = ₹ 13,000	1,30,000

Total cash price = ₹ 1,30,000+ 70,000 (down payment) =₹ 2,00,000.

*₹ 50,000 + 2nd instalment of ₹ 49,000 = ₹ 99,000.

** ₹ 90,000 + 1st instalment of ₹ 53,000 = ₹ 1,43,000.

Illustration 2

A acquired on 1st January, 2012 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of ₹ 6,000 each, the first instalment being due on 1st July, 2012. 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)
	₹	₹	₹
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 ₹ 25,977.

5.2 Calculation of Total Cash Price with the help of Annuity Table

Cash price = Down payment + Present value of instalments

Present value of instalments is calculated as follows:

(a) If present value of an annuity of ₹ 1 for a given period, at given rate of interest, is given Present value of instalments = Annual instalments x Present value of an annuity of ₹ 1 for a given period at given rate of interest

$$= \text{Annual instalment x } \frac{(1+r)^n - 1}{r(1+r)^n}$$

(b) If annuity to recover ₹ 1 during a given period at given rate of interest is given

$$= \text{Annual instalment x } \frac{r(1+r)^n}{(1+r)^n - 1}$$

6. 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 amount of interest from the hire purchase price.

Interest is charged on the amount outstanding. Therefore, if the hire purchaser makes a down payment on signing the contract, it will not include any amount of interest. It should be noted that though the instalments of a hire purchase agreement may be equal, the interest element in each instalment is not the same.

At the time of calculating interest, students may face the following two situations:

(a) When the cash price, rate of interest and the amount of instalments are given; and

(b) When the cash price and the amount of instalments are given, but the rate of interest is not given.

Now, let us consider the above two situations.

6.1 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.

Illustration 3

Om Ltd. purchased a machine on hire purchase basis from Kumar Machinery Co. Ltd. on the following terms:

(a) Cash price ₹ 80,000

(b) Down payment at the time of signing the agreement on 1.1.2013 ₹ 21,622.

(c) 5 annual instalments of ₹ 15,400, the first to commence at the end of twelve months from the date of down payment.

(d) Rate of interest is 10% p.a.

You are required to calculate the total interest and interest included in cash instalment.

Solution:

Calculation of interest

	Total (₹)	*Interest in each instalment (1)*	*Cash price in each instalment (2)*
Cash Price	80,000		
Less : Down Payment	(21,622)	Nil	₹ 21,622

Balance due after down payment	58,378		
Interest/Cash Price of 1st instalment	-	₹ 58,378 x10/100 = ₹ 5,838	₹ 15,400 – ₹ 5,838= ₹ 9,562
Less : Cash price of 1st instalment	(9,562)		
Balance due after 1st instalment	48,816		
Interest/cash price of 2nd instalment	-	₹ 48,816 x 10/100 = ₹ 4,882	₹ 15,400 - ₹ 4,882= ₹ 10,518
Less: Cash price of 2nd instalment	(10,518)		
Balance due after 2nd instalment	38,298		
Interest/Cash price of 3rd instalment	-	₹ 38,298 10/100 = ₹ 3,830	₹ 15,400 - ₹ 3,830= ₹ 11,570
Less: Cash price of 3rd instalment	(11,570)		
Balance due after 3rd instalment	26,728		
Interest/Cash price of 4th instalment	-	₹ 26,728 x10/100 = ₹ 2,672	₹ 15,400 - ₹ 2,672 = ₹ 12,728
Less : Cash price of 4th instalment	(12,728)		
Balance due after 4th instalment	14,000		
Interest/Cash price of 5th instalment	-	₹14,000 x10/100 =₹ 1,400	₹ 15400– ₹ 1,400= 14,000
Less : Cash price of 5th instalment	(14,000)		
Total	Nil	₹ 18,622	₹ 80,000

Total interest can also be calculated as follow:

(Down payment + instalments) – Cash Price = ₹ [21,622 +(15400 x 5)] – ₹ 80,000 = ₹ 18,622

6.2 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 installments are given, we have to find interest rate implicit in the transaction by bifurcating the installments between reduction in liability and finance charges (interest).

Internal rate of return (IRR) is the discount rate that equates the present value of the expected net cash flows with the initial cash outflow. When the net cash flows are not uniform over the life of the investment, the determination of the discount rate can involve trial and error and interpolation between interest rates.

Internal Rate of Return Method (IRR)[•] method considers the time value of money, the initial cash investment, and all cash flows from the investment. IRR method does not use the desired rate of return but estimates the discount rate that makes the present value of subsequent net cash flows equal to the initial investment.

Illustration 4

Happy Valley Florists Ltd. acquired a delivery van on hire purchase on 01.04.2010 from Ganesh Enterprises. The terms were as follows:

Particulars	*Amount (₹)*
Hire Purchase Price	*180,000*
Down Payment	*30,000*
1st installment payable after 1 year	*50,000*
2nd installment after 2 years	*50,000*
3rd installment after 3 years	*30,000*
4th installment after 4 years	*20,000*

Cash price of van ₹ 150,000 You are required to calculate Total Interest and Interest included in each instalment.

Solution:

Calculation of total Interest and Interest included in each installment

Hire Purchase Price (HPP) = Down Payment + instalments

= 30,000 + 50,000 + 50,000 + 30,000 + 20,000 = 1,80,000

Total Interest = 1,80,000 – 1,50,000 = 30,000

Computation of IRR (considering two guessed rates of 6% and 12%)

Year	*Cash Flow*	*DF @6%*	*PV*	*DF @12%*	*PV*
0	30,000	1.00	30,000	1.00	30,000
1	50,000	0.94	47,000	0.89	44,500
2	50,000	0.89	44,500	0.80	40,000
3	30,000	0.84	25,200	0.71	21,300
4	20,000	0.79	15,800	0.64	12,800
		NPV	1,62,500	NPV	1,48,600

[•] *For detailed understanding of IRR, students are advised to refer Chapter 6 "Investment Decisions" of Financial Management Study Material.*

Interest rate implicit on lease is computed below by interpolation:

Interest rate implicit on lease = *6%* + $\frac{1{,}62{,}500-1{,}50{,}000}{1{,}62{,}500-1{,}48{,}600}\times(12-6)=11.39\%$

= *6%* + $\frac{12{,}500}{13{,}900}\times 6=11.39\%$

Thus repayment schedule and interest would be as under:

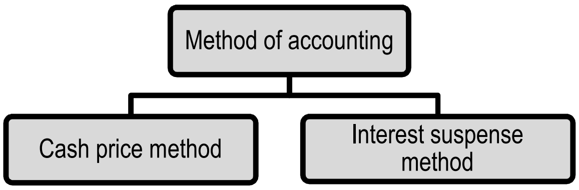
Installment no.	*Principal at beginning*	*Interest included in each installment*	*Gross amount*	*Installment*	*Principle at end*
Cash down	1,50,000		1,50,000	30,000	1,20,000
1	1,20,000	13,668	1,33,668	50,000	83,668
2	83,668	9,530	93,198	50,000	43,198
3	43,198	4,920	48,118	30,000	18,118
4	18,118	2,064	20,182	20,000	182*
		30,182*			

7. Accounting Arrangements of Hire Purchase Transaction

7.1 In the Books of Hire Purchaser

There are following two methods of recording the hire purchase transactions in the books of the hire-purchaser:

1. Cash price method
2. Interest suspense 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.

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, therefore, it is also called Full Cash Price Method. 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).

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.	*On entering into the agreement* Asset Account To Hire Vendor Account	Dr. [Full cash price]
2.	*When down payment is made* Hire Vendor Account To Cash/Bank Account	Dr. [Down payment]
3.	*When an instalment becomes due* Interest Account To Hire Vendor Account	Dr. [Interest on outstanding balance]
4.	*When an instalment is paid* Hire Vendor Account To Bank Account	Dr. [Amount of instalment]
5.	*When depreciation is charged on the asset* Depreciation Account To Asset Account	Dr. [Calculated on cash price]
6.	*For closing interest and depreciation account* Profit and Loss Account To Interest Account To Depreciation Account	Dr.

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 5

On January 1, 2010 HP M/s acquired a Pick-up Van on hire purchase from FM M/s. The terms of the contract were as follows:

(a) The cash price of the van was ₹ 1,00,000.

(b) ₹ 40,000 were to be paid on signing of the contract.

(c) The balance was to be paid in annual instalments of ₹ 20,000 plus interest.

(d) Interest chargeable on the outstanding balance was 6% p.a.

(e) Depreciation at 10% p.a. is to be written-off using the straight-line method.

You are required to:

(a) Give Journal Entries and show the relevant accounts in the books of HP M/s from January 1, 2010 to December 31, 2012; and

(b) Show the relevant items in the Balance Sheet of the purchaser as on December 31, 2010 to 2012.

Solution

In the books of HP M/s
Journal Entries

Date	*Particulars*		*Dr.*	*Cr.*
			₹	₹
2010	Pick-up Van A/c	Dr.	1,00,000	
Jan. 1	To FM M/s A/c			1,00,000
	(Being the purchase of a pick-up van on hire purchase from FM M/s)			
"	FM M/s 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 M/s A/c			3,600
	(Being the interest payable @ 6% on ₹ 60,000			
"	FM M/s A/c (₹ 20,000+₹ 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 ₹ 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)			
2011	Interest A/c	Dr.	2,400	
Dec. 31	To FM M/s A/c			2,400
	(Being the interest payable @ 6% on ₹ 40,000)			
	FM M/s A/c (₹ 20,000 + ₹ 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)			
2012	Interest A/c	Dr.	1,200	
Dec. 31	To FM M/s A/c			1,200
	(Being the interest payable @ 6% on ₹ 20,000)			
	FM M/s A/c (₹ 20,000 + ₹ 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 ₹ 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)			

Ledgers in the books of HP M/s

Pick-up Van Account

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
1.1.2010	To FM M/s A/c	1,00,000	31.12.2010	By Depreciation A/c	10,000
			31.12.2011	By Balance c/d	90,000
		1,00,000			1,00,000
1.1.2011	To Balance b/d	90,000	31.12.2011	By Depreciation A/c	10,000
			31.12.2011	By Balance c/d	80,000
		90,000			90,000
1.1.2012	To Balance b/d	80,000	31.12.2012	By Depreciation A/c	10,000
			31.12.2012	By Balance c/d	70,000
		80,000			80,000

FM M/s Account

Date	Particulars	₹	Date	Particulars	₹
1.1.10	To Bank A/c	40,000	1.1.10	By Pick-up Van A/c	1,00,000
31.12.10	To Bank A/c	23,600	31.12.10	By Interest c/d	3,600
31.12.10	To Balance c/d	40,000			
		1,03,600			1,03,600
31.12.11	To Bank A/c	22,400	1.1.11	By Balance b/d	40,000
31.12.11	To Balance c/d	20,000	31.12.11	By Interest A/c	2,400
		42,400			42,400
31.12.12	To Bank A/c	21,200	1.1.12	By Balance b/d	20,000
			31.12.12	By Interest A/c	1,200
		21,200			21,200

Depreciation Account

Date	Particulars	₹	Date	Particulars	₹
31.12.2010	To Pick-up Van A/c	10,000	31.12.2010	By Profit & Loss A/c	10,000
31.12.2011	To Pick-up Van A/c	10,000	31.12.2011	By Profit & Loss A/c	10,000
31.12.2012	To Pick-up Van A/c	10,000	31.12.2012	By Profit & Loss A/c	10,000

Interest Account

Date	Particulars	₹	Date	Particulars	₹
31.12.2010	To FM M/s A/c	3,600	31.12.2010	By Profit & Loss A/c	3,600
31.12.2011	To FM M/s A/c	2,400	31.12.2011	By Profit & Loss A/c	2,400
31.12.2012	To FM M/s A/c	1,200	31.12.2012	By Profit & Loss A/c	1,200

Balance Sheet of HP M/s as at 31st December, 2010

Liabilities	₹	Assets	₹
FM M/s	40,000	Pick-up Van	90,000

Balance Sheet of HP M/s as at 31st December, 2011

Liabilities	₹	Assets	₹
FM M/s	20,000	Pick-up Van	80,000

Balance Sheet of HP M/s as at 31st December, 2012

Liabilities	₹	Assets	₹
		Pick-up Van	70,000

Interest suspense method

Under this method, at the time of transfer of possession of asset, the total interest unaccrued is transferred to interest suspense account. At latter years, as and when interest becomes due, interest account is debited and interest suspense account is credited.

Journal Entries

1.	*When the asset is acquired on hire purchase* Asset Account To Hire Vendor Account	 Dr. [Full cash price]
2.	*For total interest payment is made* H.P. Interest Suspense Account To Hire Vendor Account	 Dr. [Total interest]
3.	*When down payment is made* Hire Vendor Account To Bank Account	 Dr.
4.	For Interest of the relevant period Interest Account To H.P. Interest Suspense Account	 Dr. [Interest of the relevant period]
5.	When an instalment is paid Hire Vendor Account To Bank Account	 Dr.
6.	*When depreciation is charged on the asset* Depreciation Account To Asset Account	 Dr. [Calculated on cash price]
7.	*For closing interest and depreciation account* Profit and Loss Account To Interest Account To Depreciation Account	 Dr.

Illustration 6

In illustration 5 assume that the hire purchaser adopted the interest suspense method for recording his hire purchase transactions. On this basis, prepare H.P. Interest Suspense Account, Interest Account and FM M/s Accounts and Balance Sheets in the books of hire purchaser.

Solution

H.P. Interest Suspense Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.1.2010	To FM M/s A/c (W.N.)	7,200	31.12.2010	By Interest A/c	3,600
			31.12.2010	By Balance c/d	3,600
		7,200			7,200
1.1.2011	To Balance b/d	3,600	31.12.2011	By Interest A/c	2,400
			31.12.2011	By Balance c/d	1,200
		3,600			3,600
1.1.2012	To Balance b/d	1,200	31.12.2012	By Interest A/c	1,200

Interest Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
31.12.2010	To H.P. Interest Suspense A/c	3,600	31.12.2010	By Profit & Loss A/c	3,600
31.12.2011	To H.P. Interest Suspense a/c	2,400	31.12.2011	By Profit & Loss A/c	2,400
31.12.2012	To H.P. Interest Suspense A/c	1,200	31.12.2012	By Profit & Loss A/c	1,200

FM M/s Account

Date	*Particulars*	₹	*Date*	*Particulars*	₹
1.1.2010	To Bank A/c	40,000	1.1.2010	By Pick-up Van A/c	1,00,000
31.12.2010	To Bank A/c	23,600	1.1.2010	By H.P. Interest Suspense A/c	7200
31.12.2010	To Balance c/d	43,600			
		1,07,200			1,07,200
31.12.2011	To Bank A/c	22,400	1.1.2011	By Balance b/d	43,600
31.12.2011	To Balance c/d	21,200			
		43,600			43,600
31.12.2012	To Bank A/c	21,200	1.1.2012	By Balance b/d	21,200

Balance Sheet of HP M/s as at 31st December, 2010

Liabilities		₹	*Assets*		₹
FM M/s	43,600		Pick-up Van	1,00,000	
Less: H.P. Interest Suspense	(3,600)	40,000	*Less*: Depreciation	(10,000)	90,000

Balance Sheet of HP M/s as at 31st December, 2011

Liabilities		₹	*Assets*	₹	
FM M/s	21,200		Pick-up Van	90,000	
Less: H.P. Interest Suspense	(1,200)	20,000	Less: Depreciation	(10,000)	80,000

Balance Sheet of HP M/s as at 31st December, 2012

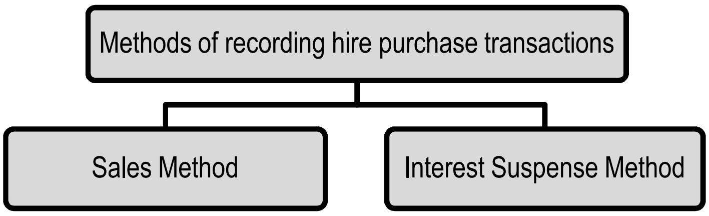
Liabilities	₹		*Assets*		₹
			Pick-up Van	80,000	
			Less: Depreciation	(10,000)	70,000

Working Note:

Total Interest = ₹ 3,600 + ₹ 2,400 + ₹ 1,200 = ₹ 7,200.

7.2 In the 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



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 To H.P. Sales Account	Dr. [Full cash price]

2.	*When the down payment is received* Bank Account To Hire Purchaser Account	 Dr.
3.	*When an instalment becomes due* Hire Purchaser Account To Interest Account	 Dr.
4.	*When the amount of instalment is received* Bank Account To Hire Purchaser Account	 Dr.
5.	*For closing interest Account* Interest Account To Profit and Loss Account	 Dr.
6.	*For closing Hire Purchase Sales Account* H.P. Sales Account To Trading Account	 Dr.

It is worth noting that

(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; and

(ii) Interest pertaining to each accounting period is credited to the Profit and Loss Account of that year.

Interest Suspense Method

This method is almost similar to the sales method, except the accounting for interest. Under this method, the hire purchaser is debited with full cash price and interest (total) included in the hire selling price. Credit is given to the H.P. Sales Account and Interest Suspense Account. When the instalment is received, the Bank Account is debited and the Hire Purchaser Account is credited. At the same time an appropriate amount of interest (i.e., interest for the relevant accounting period) is removed from the Interest Suspense Account and credited to the Interest Account. At the time of preparation of Final Accounts, interest is transferred to the credit of the Profit and Loss Account. The balance of the Interest Suspense Account is shown in the Balance Sheet as a deduction from Hire Purchase Debtors.

Journal Entries

1.	When goods are sold and delivered under hire purchase	
	Hire Purchase Account	Dr. [Full cash price + total interest]
	To H.P. Sales Account	[Full cash price]

	To Interest Suspense Account	[Total Interest]
2.	When down payment/instalment is received	
	Bank Account	Dr.
	To Hire Purchaser Account	
3.	For interest of the relevant accounting period	
	Interest Suspense Account	Dr.
	To Interest Account	
4.	For closing interest Account	
	Interest Account	Dr.
	To Profit and Loss Account	
5.	For closing Hire Purchase Sales Account	
	H.P. Sales Account	Dr.
	To Trading Account	

The disclosure in balance sheet of the respective parties will be:

Balance Sheet of Hire Purchaser

Assets

Fixed assets :

Asset on Hire purchase

Less : Depreciation

Liabilities

Amount payable to Vendor

Less: Balance in Interest suspense A/c

Balance Sheet of Vendor

Assets

Current assets :

Hire purchase debtors

Less : Balance in Interest suspense A/c

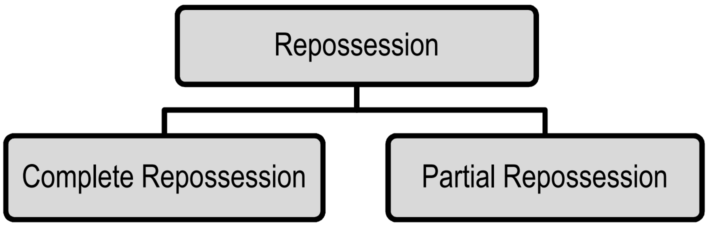
Liabilities

8. 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".



8.1 Complete Repossession

The hire vendor closes Hire Purchaser's Account by transferring balance of Hire Purchaser Account to Goods Repossessed Account.

The hire purchaser closes the Hire Vendor's Account by transferring the balance of Hire Vendor Account to Hire Purchase Asset and then finding the profit and loss on repossession in Asset Account.

After repossession, the vendor may incur expenses on repossessed stock and may sell the same in due course of time.

Particulars	*Books of hire purchaser*	*Books of hire vendor*
Purchase/Sales	Asset A/c ...Dr. To Hire Vendor A/c	Hire Purchaser A/c ...Dr. To Sales A/c
Installment	Hire Vendor A/c ...Dr. To Cash A/c	Cash A/c ...Dr. To Hire Purchaser A/c
Interest	Interest A/c ...Dr. To Hire Vendor	Hire Purchaser A/c ...Dr. To Interest A/c
Repossession	Hire Vendor A/c ...Dr. To Asset A/c	Goods Repossessed A/c Dr. To Hire Purchaser

8.2 Partial Repossession

In case of a partial repossession, only a part of the asset is taken back by the hire vendor and other part is left with the hire purchaser. 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.

Miscellaneous Illustrations

Illustration 7

X Ltd. purchased 3 milk vans from Super Motors costing ₹ 75,000 each on hire purchase system. Payment was to be made: ₹ 45,000 down and the remainder in 3 equal instalments together with interest @ 9%. X Ltd. writes off depreciation @ 20% on the diminishing balance. It paid the instalment at the end of the 1st year but could not pay the next. Super Motor agreed to leave one milk van with the purchaser, adjusting the value of the other two milk vans against the amount due. The milk vans were valued on the basis of 30% depreciation annually on written down value basis. X Ltd. settled the seller's dues after three months.

You are required to give necessary journal entries and the relevant accounts in the books of X Ltd.

Solution

In the Books of X Ltd.
Journal Entries

		Dr. (₹)	*Cr. (₹)*
I Year			
Milk Vans purchased:			
Milk Vans A/c	Dr.	2,25,000	
To Vendor A/c			2,25,000
On down payment:			
Vendor A/c	Dr.	45,000	
To Bank			45,000
I Year end			
Interest A/c (₹ 1,80,000 @ 9%)	Dr.	16,200	
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
Profit & Loss A/c	Dr.	61,200	
To Depreciation			45,000
To interest all			16,200

II Year end			
Depreciation @ 20%			
Depreciation A/c	Dr.	36,000	
To Milk Vans A/c			36,000
Interest A/c	Dr.	10,800	
(1,20,000 @ 9%)			
To Vendor A/c			10,800
For Loss in Repossession:			
Super Motors A/c	Dr.	73,500	
Profit/Loss A/c	Dr.	22,500	
To Milk Vans A/c			96,000
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		₹	*Year*		₹
1	To Super Motors A/c	2,25,000	1 end	By Depreciation A/c	45,000
			”	By Balance c/d	1,80,000
		2,25,000			2,25,000
2	To Balance b/d	1,80,000	2 end	By Depreciation	36,000
				By Super Motors (value of 2 vans after depreciation for 2 years @ 30%)	73,500
				By P & L A/c (balancing figure)	22,500
				By Balance c/d (one van less depre- ciation for 2 years) @ 20%	48,000
		1,80,000			1,80,000

Super Motors Account

Year		₹	*Year*		₹
1	To Bank A/c	45,000	1	By Milk Vans A/c	2,25,000

	To Bank A/c	76,200		By Interest @ 9% on ₹ 1,80,000	16,200
	To Balance c/d	1,20,000			
		2,41,200			2,41,200
2	To Milk Van A/c	73,500	2	By Balance b/d	1,20,000
	To Balance c/d	57,300		By Interest A/c	10,800
		1,30,800			1,30,800
3	To Bank A/c	57,300	3	By Balance b/d	57,300

Illustration 8

A firm acquired two tractors under hire purchase agreements, details of which were as follows:

	Tractor A	*Tractor B*
Date of Purchase	*1st April, 2011(₹)*	*1st Oct., 2011 (₹)*
Cash price	*14,000*	*19,000*

Both agreements provided for payment to be made in twenty-four monthly instalments (of ₹ 600 each for Tractor A and Rs. 800 each for Tractor B), commencing on the last day of the month following purchase, all instalments being paid on due dates.

On 30th June, 2012, Tractor B was completely destroyed by fire. In full settlement, on 10th July, 2012 an insurance company paid ₹ 15,000 under a comprehensive policy out of which ₹ 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, 2011 and 31st December, 2012:

(a) Tractors on hire purchase.

(b) Provision for depreciation of tractors.

(c) Disposal of tractors.

Solution

Hire Purchase accounts in the buyer's books

(a) **Tractors on Hire Purchase Account**

2011				₹	*2011*				₹
April 1	To	HP Co. - Cash price			Dec. 31	By	Balance c/d		
		Tractor A		14,000			Tractor A	14,000	
Oct. 1	”	HP Co. - Cash price					Tractor B	19,000	33,000
		Tractor B		19,000					
				33,000					33,000
2012				₹	*2012*				₹
Jan. 1	To	Balance b/d			June 30	By	Disposal of Tractor A/c - Transfer		19,000
		Tractor A	14,000			By	Balance c/d		14,000
		Tractor B	19,000	33,000	Dec. 31				33,000
				33,000					
2013									
Jan. 1	To	Balance b/d		14,000					

(b) **Provision for Depreciation of Tractors Account**

2011		₹	*2011*				₹
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

2012			₹	*2012*			₹
June30	To	Disposal of Tractor account—Transfer	2,850	Jan. 1	By	Balance b/d	3,050
				Jun. 30	By	P & L A/c	
Dec. 31	To	Balance c/d	4,900			(Depn. for Tractor B)	1,900
				Dec. 31	By	P & L A/c	
						(Depn. for Tractor A)	2,800
			7,750				7,750
				2013			₹
				Jan.	1	By Balance b/d	4,900

(c) **Disposal of Tractor Account**

2012		₹	2012		₹
June30	To Tractors on hire purchase—Tractor B	19,000	June 30	By Provision for Depn. of Tractors A/c	2,850
			July 10	By Cash : Insurance	15,000
			Dec. 31	By P & L A/c : Loss	1,150
		19,000			19,000

Illustration 9

A machinery is sold on hire purchase. The terms of payment is four annual instalments of ₹ 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 ₹ 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

		₹			₹
I Yr.	To Hire Vendor A/c	15,533	I Yr.	By Depreciation A/c	1,553
				By 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
				By 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
				By Hire Vendor	11,000
				By 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

		₹			₹
I Yr.	To Bank A/c	6,000	I Yr.	By Machinery A/c	15,533
	To Balance c/d	12,639		By 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
	To Balance c/d	9,167		By 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
				By Interest A/c	1,833
		11,000			11,000

Note : Alternatively, total interest could have been debited to Interest Suspense A/c and credited to Hire Vendor A/c with consequential changes.

Working Notes:

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

Interest	$18{,}639 \times \frac{20}{120}$	3,106	3,106	2,894
		15,533	8,467	15,533

Illustration 10

X Transport Ltd. purchased from Delhi Motors 3 Tempos costing ₹ 50,000 each on the hire purchase system on 1-1-2010. Payment was to be made ₹ 30,000 down and the remainder in 3 equal annual instalments payable on 31-12-2010, 31-12-2011 and 31-12-2012 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. 31-12-2010 but could not pay the next on 31-12-2011. Delhi Motors agreed to leave one Tempo with the purchaser on 1-1-2012 adjusting the value of the other 2 Tempos against the amount due on 31-12-2011. 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 2010, 2011 and 2012.

Solution

X Transport Ltd.
Tempo Account

2010		₹	*2010*		₹
Jan. 1	To Delhi Motors	1,50,000	Dec. 31	By Depreciation A/c:20% on 1,50,000	30,000
				By Balance c/d	1,20,000
		1,50,000			1,50,000
2011			2011		
Jan 1.	To Balance b/d	1,20,000	Dec.31.	By Depreciation A/c	24,000
				By Delhi Motors A/c (Value of 2 tempos taken away)	49,000
				By Profit and Loss A/c (balancing figure)	15,000
				By Balance c/d (Value of one tempo left)	32,000
		1,20,000			1,20,000
2012			2012		
Jan. 1	To Balance b/d	32,000	Dec. 31	By Depreciation A/c	6,400
				By Balance b/d	25,600
		32,000			32,000

Delhi Motors Account

2010		₹	*2010*		₹
Jan. 1	To Bank (Down Payment)	30,000	Jan. 1	By Tempos A/c	1,50,000
Dec. 31	To Bank	50,800	Dec. 31	By Interest (9% on ₹ 1,20,000)	10,800
	To Balance c/d	80,000			
		1,60,800			1,60,800
2011			2011		
Jan. 1	To Tempo	49,000	Jan. 1	By Balance b/d	80,000
Dec. 31	To Balance c/d	38,200	Dec. 31	By Interest (9% on ₹ 80,000)	7,200
		87,200			87,200
2012		₹	2012		₹
Dec. 31	To Bank	41,638	Jan. 1	By Balance b/d	38,200
			Dec. 31	By Interest (9% on ₹ 38,200)	3,438
		41,638			41,638

Working Notes :

(1) Value of a Tempo left with the buyer:

	₹
Cost	50,000
Depreciation @ 20% p.a. under WDV method for 2 years [i.e. ₹ 10,000 + ₹ 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

	₹
Cost ₹ 50,000 × 2 =	1,00,000
Depreciation @ 30%	
Under WDV method for 2 years [i.e. ₹ 30,000 + ₹ 21,000]	(51,000)
Value of tempos taken away at the end of 2nd year	49,000

9. 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.

10. 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 pass 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.

Summary

- **Under Hire Purchase System**, hire purchaser will pay cost of purchased asset in installments. The ownership of the goods will be transferred by the Hire Vendor only after payment of outstanding balance.
- **Under installment system**, ownership of the goods is transferred by owner on the date of delivery of goods.
- **Accounting Method**
  - ✓ Cash price Method
  - ✓ Interest suspense method

12

Investment Accounts

Learning Objectives

After studying this chapter, you will be able to:

- Understand the meaning of the term ‘investments’.
- Learn the classification of investments.
- Compute the acquisition cost and carrying amounts of investments.
- Calculate the profit/loss on disposal of investments.

1. Introduction

Investments are assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise. Investment Accounting is done as per AS-13 which deals with all kind of investments except:

(i) interest, dividends and rentals earned on investments

(ii) operating or financial leases

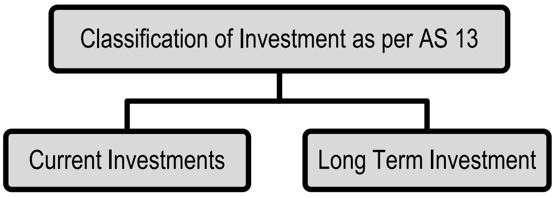
(iii) investment of retirement benefit plans and life insurance enterprises

(iv) mutual funds

(v) assets held as Stock-in-trade are not ‘Investments’.

2. Classification of Investments

The investments are classified into two categories as per AS 13, *viz.*, Current Investments and Long-term Investments.

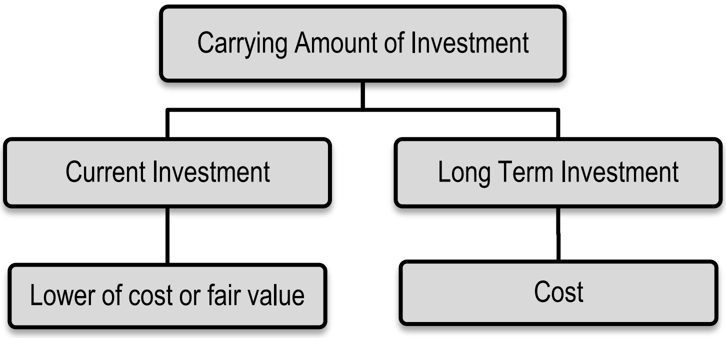


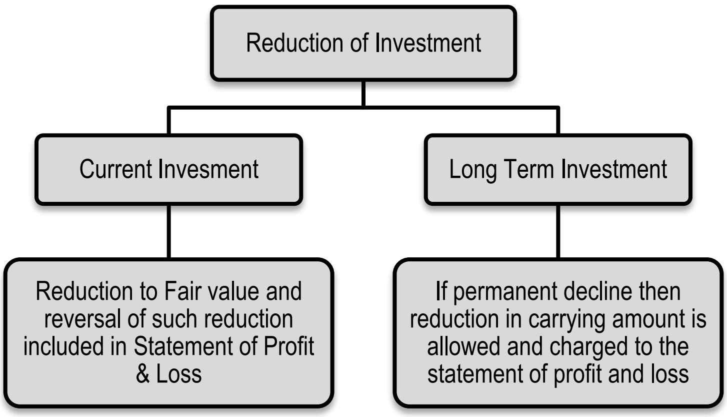
2.1 Current Investments

- A current Investment is an investment that is by its nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.
- **The carrying amount** for current investments is the lower of 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.
- Any reduction to fair value and any reversals of such reductions are included in the statement of profit and loss.

2.2 Long Term Investments

- A long-term investment is an investment other than a current investment.
- Long term investments are usually carried at cost.
- If there is a permanent decline in the value of a long term investment; the carrying amount is reduced to recognize the decline.
- The reduction in carrying amount is charged to the statement of profit and loss.
- 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.



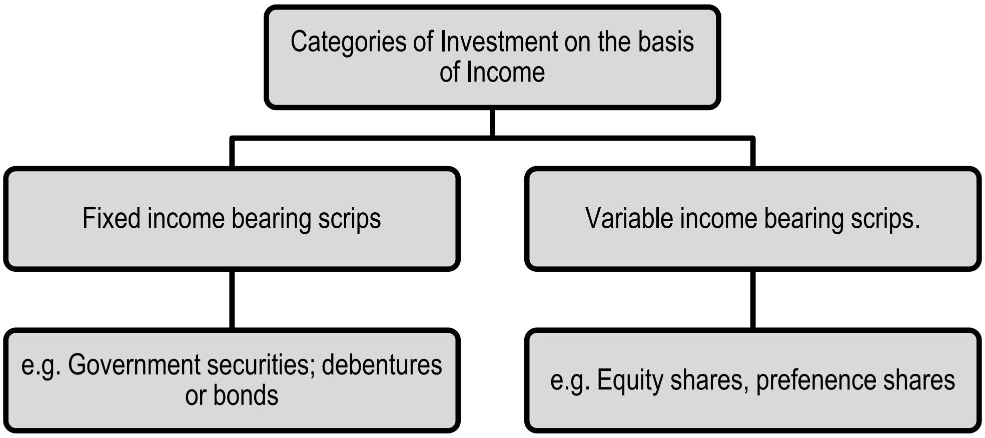

Reduction of Investment
Current Invesment
Long Term Investment
Reduction to Fair value and reversal of such reduction included in Statement of Profit & Loss
If permanent decline then reduction in carrying amount is allowed and charged to the statement of profit and loss

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 or asset issued.

   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.,


Categories of Investment on the basis of Income
Fixed income bearing scrips
Variable income bearing scrips.
e.g. Government securities; debentures or bonds
e.g. Equity shares, prefenence shares

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:

Investment Account	Dr.	(With the price settled on ex- interest basis)*
Interest accrued Account	Dr.	(Accrued interest till the date of transaction)**
To Bank A/c		(With total amount paid)

* This amount will appear in Capital Column of 'Investment A/c'.

**This amount will appear in Income Column of 'Investment A/c'.

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:

Investment Account	Dr.	(With the price settled on cum- interest less Interest Accrued)*
Interest accrued Account	Dr.	(Accrued interest till the date of transaction)**
To Bank A/c		(With total amount paid)

* This amount will appear in Capital Column of 'Investment A/c'.

**This amount will appear in Income Column of 'Investment A/c'.

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:

Investment Account	Dr.	(With the entire purchase price)*
To Bank A/c		(With total amount paid)

* This amount will appear in Capital Column of 'Investment A/c'.

The adjustment with respect to dividend is made when the dividend is actually received as under:

Bank A/c	Dr	(with total dividend received)
To Investment A/c		(with the amount of dividend for the period for which the investor did not hold the share)*
To Investment A/c		(with the amount of dividend for the post – acquisition period)**

* This amount will appear in Capital Column of 'Investment A/c'.

**This amount will appear in Income Column of 'Investment A/c'.

- 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 as per para 13 of AS 13 "Accounting for Investment".

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 ₹ 50,000. He subsequently receives an offer of right to acquire fresh shares in the company in the proportion of 1:1 at ₹ 110 each. X subscribes for the right issue. Thus, the total cost of X's holding of 400 shares would amount to ₹ 72,000 (50,000 + 22,000).

Suppose, he does not subscribe but sells the rights for ₹ 15,000. The ex-right market value of 200 shares bought by X immediately after the rights falls to ₹ 40,000. In this case out of sale proceeds of ₹ 15,000, ₹ 10,000 may be applied to reduce the carrying amount to the market value ₹40,000 and ₹ 5,000 would be credited to the profit and loss account.

5. Where an investment is acquired by way of issue of bonus shares, no amount is entered in the capital column of investment account since the investor has not to pay anything.

4. 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.

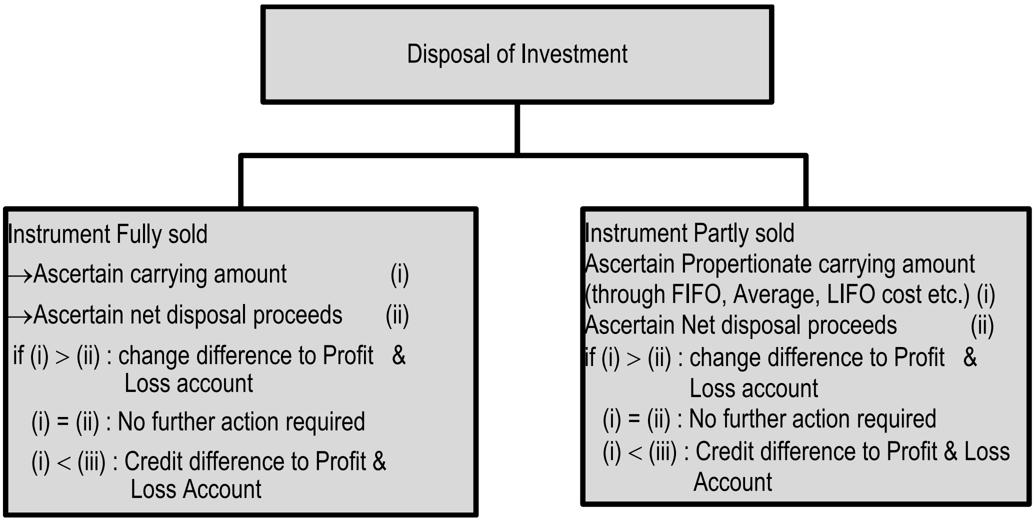

Disposal of Investment
Instrument Fully sold
→Ascertain carrying amount (i)
→Ascertain net disposal proceeds (ii)
if (i) > (ii) : change difference to Profit & Loss account
(i) = (ii) : No further action required
(i) < (iii) : Credit difference to Profit & Loss Account
Instrument Partly sold
Ascertain Propertionate carrying amount (through FIFO, Average, LIFO cost etc.) (i)
Ascertain Net disposal proceeds (ii)
if (i) > (ii) : change difference to Profit & Loss account
(i) = (ii) : No further action required
(i) < (iii) : Credit difference to Profit & Loss Account

Illustration 1

On 1.4.2014, Sundar had 25,000 equity shares of 'X' Ltd. at a book value of ₹ 15 per share (Face value ₹ 10). On 20.6.2014, he purchased another 5,000 shares of the company at ₹16 per share. The directors of 'X' Ltd. announced a bonus and rights issue. No dividend was payable on these issues. The terms of the issue are as follows:

Bonus basis 1:6 (Date 16.8.2014).

Rights basis 3:7 (Date 31.8.2014) Price ₹ 15 per share.

Due date for payment 30.9.2014.

Shareholders were entitled to transfer their rights in full or in part. Accordingly Sundar sold 33.33% of his entitlement to Sekhar for a consideration of ₹ 2 per share.

Dividends: Dividends for the year ended 31.3.2014at the rate of 20% were declared by X Ltd. and received by Sundar on 31.10.2014. Dividends for shares acquired by him on 20.6.2014 are to be adjusted against the cost of purchase.

On 15.11.2014, Sundar sold 25,000 equity shares at a premium of ₹ 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 31.12.2014and shares are valued at average cost.

Solution

Books of Sundar
Investment Account
(Scrip: Equity Shares in X Ltd.)

		No.	*Amount*			*No.*	*Amount*
			₹				*₹*
1.4.201420. 6.2014	To Bal b/d To Bank	25,000 5,000	3,75,000 80,000	31.10.2014	By Bank (dividend on shares acquired on 20/6/2014)	—	10,000
16.8.2014 30.9.2014	To Bonus To Bank (Rights Shares)	5,000 10,000	— 1,50,000				
15.11.2014	To Profit (on sale of shares)		44,444	15.11.2014	By Bank (Sale of shares)	25,000	3,75,000
				31.12.2014	By Bal. c/d	20,000	2,64,444
		45,000	6,49,444			45,000	6,49,444

Profit and Loss Account (An extract)

To Balance c/d	1,04,444	By Profit transferred By Sale of rights By Dividend	44,444 10,000 50,000
	1,04,444		1,04,444

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% = ₹ 50,000

Dividend on shares purchased on 20.6.2014= 5,000×10×20% = ₹ 10,000 is adjusted to Investment A/c

(5) Profit on sale of 25,000 shares

= Sales proceeds – Average cost

Sales proceeds = ₹ 3,75,000

Average cost = $\frac{(3{,}75{,}000+80{,}000+1{,}50{,}000-10{,}000)}{45{,}000}\times 25{,}000$ = ₹ 3,30,556

Profit = ₹ 3,75,000– ₹ 3,30,556= ₹44,444.

(6) Cost of shares on 31.12.2014

$$\frac{(3{,}75{,}000 + 80{,}000 + 1{,}50{,}000 - 10{,}000)}{45{,}000} \times 20{,}000 = ₹\ 2{,}64{,}444$$

Illustration 2

On 1.4.2014, Mr. Krishna Murty purchased 1,000 equity shares of ₹ 100 each in TELCO Ltd. @ ₹ 120 each from a Broker, who charged 2% brokerage. He incurred 50 paise per ₹ 100 as cost of shares transfer stamps. On 31.1.2015 Bonus was declared in the ratio of 1 : 2. Before and after the record date of bonus shares, the shares were quoted at ₹ 175 per share and ₹ 90 per share respectively. On 31.3.2015 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 Murty
Investment Account
for the year ended 31st March, 2015
(Scrip: Equity Shares of TELCO Ltd.)

Date	*Particulars*	*Nominal Value (₹)*	*Cost (₹)*	*Date*	*Particulars*	*Nominal Value (₹)*	*Cost (₹)*
1.4.2014	To Bank A/c	1,00,000	1,23,000	31.3.2015	By Bank A/c	50,000	44,100
31.1.2015	To Bonus shares	50,000	–	31.3.2015	By Balance c/d	1,00,000	82,000
31.3.2015	To Profit & loss A/c (W.N.(iii)	–	3,100				
		1,50,000	1,26,100			1,50,000	1,26,100

Working Notes:

(i) Cost of equity shares purchased on 1.4.2014= 1,000 ×₹ 120 + 2% of ₹ 1,20,000 + ½% of ₹ 1,20,000 = ₹ 1,23,000

(ii) Sale proceeds of equity shares (bonus) sold on 31st March, 2015= 500 ×₹ 90 – 2% of ₹ 45,000 = ₹ 44,100.

(iii) Profit on sale of bonus shares on 31st March, 2015

= Sales proceeds – Average cost

Sales proceeds = ₹ 44,100

Average cost = ₹ (1,23,000 × 50,000)/1,50,000= ₹ 41,000

Profit = ₹ 44,100 – ₹ 41,000 = ₹ 3,100.

(iv) Valuation of equity shares on 31st March, 2015

Cost = (₹ 1,23,000 × 1,00,000)/1,50,000 = ₹ 82,000)

Market Value = 1,000 shares × ₹ 90 = ₹ 90,000

Closing balance has been valued at ₹ 82,000 being lower than the market value.

Illustration 3

Mr. X purchased 500 equity shares of ₹ 100 each in Omega Co. Ltd. for ₹ 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 ₹ 175 per share. After the capitalisation, the shares were quoted at ₹ 92.50 per share. Mr. X. sold the bonus shares and received at ₹ 90 per share.

Prepare the Investment Account in X's books on average cost basis.

Solution

In the books of A
Investment Account
[Scrip: Equity shares in Omega Co. Ltd.]

	Nominal Value	*Cost*		*Nominal Value*	*Cost*
	₹	₹		₹	₹
To Cash	50,000	62,500	By Cash Sale	50,000	45,000
To Bonus shares	50,000	-	By Balance c/d (W.N. 3)	50,000	31,250
To P & L A/c (W.N. 2)	-	13,750			
	1,00,000	76,250		1,00,000	76,250
To Balance b/d	50,000	31,250			

Working Notes:

1. Bonus shares do not have any cost.
2. Profit on sale of bonus shares

   = Sales proceeds – Average cost

   Sales proceeds = ₹ 45,000

   Average cost = $\frac{500}{1,000} \times 62,500$ = ₹ 31,250

   Profit = ₹ 45,000 – ₹31,250 = ₹ 13,750.
3. The total cost of 1,000 share including bonus is ₹62,500

   Therefore, cost of 500 shares (carried forward) is $\frac{500}{1,000} \times 62,500$ = ₹ 31,250

   Market price of 500 shares = 92.50 x 500 = ₹ 46,250

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

Illustration 4

On 1st January 2014, Singh had 20,000 equity shares in X Ltd. Face value of the shares was ₹10 each but their book value was ₹ 16 per share. On 1st June 2014, Singh purchased 5,000 more equity shares in the company at a premium of ₹ 4 per share.

On 30th June, 2014, 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, 2014.

The terms of the rights issue were:

(a) Rights shares to be issued to the existing holders on 10th August, 2014.

(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 ₹ 15 per share-the whole sum being payable by 30th September, 2014.

(c) Existing shareholders were entitled to transfer their rights to outsiders, either wholly or in part.

(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 ₹ 1.50 per share.

(e) Dividends for the year ended 31st March, 2014, at the rate of 15% were declared by the Company and received by Singh on 20th October, 2014.

(f) On 1st November, 2014, Singh sold 20,000 equity shares at a premium of ₹ 3 per share.

The market price of share on 31-12-2014 was ₹ 14. Show the Investment Account as it would appear in Singh's books on 31-12-2014and the value of shares held on that date.

Solution

Investment Account-Equity Shares in X Ltd.

Date		*No. of shares*	*Dividend*	*Amount*	*Date*		*No. of shares*	*Dividend*	*Amount*
			₹	₹				₹	₹
2014					2014				
Jan. 1	To Balance b/d	20,000	-	3,20,000	Oct. 20	By Bank (dividend)		30,000	7,500
June 1	To Bank	5,000	-	70,000	Nov. 1	By Bank	20,000		2,60,000
Aug. 2	To Bonus Issue	5,000		—	Nov. 1	By P & L A/c			1,429
Sep. 30	To Bank (Right)	5,000	-	75,000	Dec. 31	By Balance c/d	15,000		1,96,071
Nov. 1	To Profit & Loss A/c (Dividend income)		30,000						
		35,000	30,000	4,65,000			35,000	30,000	4,65,000
Jan. 1, 2015	To Balance b/d	15,000		1,96,071					

Working Notes:

1. **Cost of shares sold — Amount paid for 35,000 shares**

	₹
(₹3,20,000 + ₹ 70,000 + ₹ 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 on sale	1,429

2. **Value of investment at the end of the year**

Assuming investment as current investment, closing balance will be valued based on lower of cost or net realizable value.

Here, Net realizable value is ₹14 per share i.e. 15,000 shares x ₹ 13= ₹ 2,10,000 and cost = $\frac{4,57,500}{35,000} \times 15,000 =$ ₹ 1,96,071. Therefore, value of investment at the end of the year will be ₹ 1,96,071.

Illustration 5

The following transactions of Nidhi took place during the year ended 31st March 2014:

1st April	*Purchased ₹ 12,00,000, 8% bonds at ₹ 80.50 cum-interest. Interest is payable on 1st November and 1st May.*
12th April	*Purchased 1,00,000 equity shares of ₹ 10 each in X Ltd. for ₹ 40,00,000*
1st May	*Received half-year's interest on 8% bonds.*
15th May	*X Ltd. made a bonus issue of three equity shares for every two held. Nidhi sold 1,25,000 bonus shares for ₹ 20 each.*
1st October	*Sold ₹ 3,00,000, 8% bonds at ₹ 81 ex-interest.*
1st November	*Received half-year's bond interest.*
1st December	*Received 18% dividend on equity shares in X Ltd.*

Prepare the relevant investment account in the books of Nidhi for the year ended 31st March, 2014.

Solution:

In the books of Nidhi
8% Bonds Account
[Interest Payable: 1st November & 1st May]

Date	Particulars	Nominal	Interest	Cost	Date	Particulars	Nominal	Interest	Cost
		Value (₹)	(₹)	(₹)			Value (₹)	(₹)	(₹)
1.4.14	To Bank A/c (W.N.1)	12,00,000	40,000	9,26,000	1.5.14	By Bank A/c	-	48,000	-
31.3.15	To Profit & Loss A/c (W.N 6)		84,000	11,500	1.10.14	By Bank A/c (W.N 2)	3,00,000	10,000	2,43,000
					1.11.14	By Bank A/c (W.N 3)	-	36,000	-
					31.3.15	By Balance c/d (W.N.4)	9,00,000	30,000	6,94,500
		12,00,000	1,24,000	9,37,500			12,00,000	1,24,000	9,37,500

Investment in Equity Shares of X Ltd. Account

Date	Particulars	No.	Dividend	Cost	Date	Particulars	No.	Dividend	Cost
			(₹)	(₹)				(₹)	(₹)
12.4.14	To Bank A/c	1,00,000		40,00,000	15.5.14	By Bank A/c	1,25,000		25,00,000
15.5.14	To Bonus Issue	1,50,000			1.12.14	By Bank A/c		2,25,000	
31.3.15	To Profit & Loss A/c (W.N 5)		2,25,000	5,00,000	31.3.15	By Balance c/d	1,25,000		20,00,000
		2,50,000	2,25,000	45,00,000			2,50,000	2,25,000	45,00,000

Working Notes:

1. On 1st April, 2014, 12,000, 8% bonds were purchased @ ₹ 80.50 cum-interest. Total amount paid 12,000 bonds x ₹ 80.50 = 9,66,000 which includes accured interest for 5 months. i.e. 1stNovember, 2013 to 31stMarch, 2014. Accrued interest will be ₹ 12,00,000 x 8/100x 5/12 = ₹ 40,000. Therefore, cost of investment purchased = ₹ 9,66,000 – 40,000 = ₹9,26,000.

2. On 1st October, 2014, 3,000 bonds were sold@ ₹ 81 ex-interest. Total amount received = 3,000 x 81 + accrued interest for 5 months =₹ 2,43,000 +₹10,000 (3,00,000 x 8/100 x5/12)

3. On 1st November, 2014, interest will be received for 9,000 bonds @ 8% for 6 months, i.e., ₹ 9,00,000 x 8/100x1/2 = ₹ 36,000.

4. Cost of bonds on 31.3.2014 will be ₹ 9,26,000/12,000 x 9,000 = ₹ 6,94,500.

   Interest accrued on bonds on 31.3.2014 = 9,00,000 x 8% x 5/12 = ₹30,000

5. Profit on sale of bonus shares:

   Cost per share after bonus = ₹ 40,00,000/2,50,000 = ₹ 16

   Profit per share sold (₹ 20 – ₹ 16) = ₹ 4.

   Therefore, total profit on sale of 1,25,000 shares = ₹ 4 x 1,25,000 = ₹ 5,00,000.

6. Profit on sale of bonds

		₹
Sale value	=	2,43,000
Cost of ₹3,00,0008% bonds = 9,26,000/12,00,000 x 3,00,000 =		2,31,500
Profit	=	11,500

Illustration 6

Smart Investments made the following investments in the year 2013-14:

12% State Government Bonds having face value ₹100

Date	Particulars
01.04.2013	Opening Balance (1200 bonds) book value of ₹ 126,000
02.05.2013	Purchased 2,000 bonds @ ₹ 100 cum interest
30.09.2013	Sold 1,500 bonds at ₹ 105 ex interest

Interest on the bonds is received on 30th June and 31st Dec. each year.

Equity Shares of X Ltd.	
15.04.2013	Purchased 5,000 equity shares @ ₹ 200 on cum right basis Brokerage of 1% was paid in addition (Face Value of shares ₹ 10)
03.06.2013	The company announced a bonus issue of 2 shares for every 5 shares held.
16.08.2013	The company made a rights issue of 1 share for every 7 shares held at ₹ 250 per share. The entire money was payable by 31.08.2013.
22.8.2013	Rights to the extent of 20% was sold @ ₹ 60. The remaining rights were subscribed.
02.09.2013	Dividend @ 15% for the year ended 31.03.2013 was received on 16.09.2013
15.12.2013	Sold 3,000 shares @ ₹ 300. Brokerage of 1% was incurred extra.
15.01.2014	Received interim dividend @ 10% for the year 2013-14
31.03.2014	The shares were quoted in the stock exchange @ ₹ 220

Prepare Investment Accounts in the books of Smart Investments. Assume that the average cost method is followed.

Solution

In the books of Smart Investments

12% Govt. Bonds for the year ended 31st March, 2014

Date	Particulars	Nos.	Interest	Amount	Date	Particulars	Nos.	Interest	Amount
1.4.13	To Opening balance b/d	1,200	3,600	1,26,000	30.6.13	By Bank A/c (Interest) (3,200 x 100 x 12% x 6/12)	-	19,200	-
2.5.13	To Bank A/c	2,000	8,000	1,92,000	30.9.13	By Bank A/c	1,500	4,500	1,57,500
31.3.14	To P & L A/c (Interest)		27,400		31.12.13	By Bank A/c (Interest) (1,700 x 100 x 12% x 6/12)	-	10,200	-
	To P & L A/c (Profit on Sale)			8,437.50	31.3.14	By Bal. c/d	1,700	5,100	1,68,937.50
		3,200	39,000	3,26,437.50			3,200	39,000	3,26,437.50

Investments in Equity shares of X Ltd. for year ended 31.3.2014

Date	Particulars	Nos.	Dividend	Amount	Date	Particulars	Nos.	Dividend	Amount
15.4.13	To Bank A/c	5,000		10,10,000					
3.6.13	To Bonus Issue	2,000	-	-	16.9.13	By Bank (Dividend)	-	-	7,500
31.8.13	To Bank A/c	800		2,00,000	15.12.13	By Bank (Sale)	3,000	-	8,91,000
31.3.14	To P & L A/c		4,800	4,28,500	15.1.14	By Bank (interim dividend)		4,800	
					31.3.14	By Bal. c/d	4,800		7,40,000
		7800	4,800	16,38,500			7800	4,800	16,38,500

Working Notes:

1. **Profit on sale of bonds on 30.9.13**

   = Sales proceeds – Average cost

   Sales proceeds = ₹1,57,500

   Average cost = ₹ [(1,26,000+1,92,000) ×1,500/3,200] = 1,49,062.50

   Profit = 1,57,500– ₹ 1,49,062.50=₹8,437.50

2. **Valuation of bonds on 31st March, 2014**

   Cost = ₹3,18,000/3,200 x1,700 = 1,68,937.50

3. **Cost of equity shares purchased on 15/4/2013**

   = Cost + Brokerage

   = (5,000 ×₹ 200) + 1% of (5,000 ×₹ 200) =₹ 10,10,000

4. **Sale proceeds of equity shares on 15/12/2013**

   = Sale price – Brokerage

   = (3,000 ×₹ 300) – 1% of (3,000 ×₹ 300) =₹ 8,91,000.

5. **Profit on sale of shares on 15/12/2013**

   = Sales proceeds – Average cost

   Sales proceeds = ₹ 8,91,000

   Average cost = ₹ [(10,10,000+2,00,000-7,500) × 3,000/7,800]

   = ₹ [12,02,500 × 3,000/7,800] = 4,62,500

   Profit = ₹ 8,91,000 – ₹4,62,500=₹ 4,28,500.

6. **Valuation of equity shares on 31st March, 2014**

   Cost =₹ [12,02,500× 4,800/7,800]=₹ 7,40,000

   Market Value = 4,800 shares ×₹220 =₹ 10,56,000

   Closing stock of equity shares has been valued at ₹ 7,40,000 i.e. cost being lower than the market value.

Note:

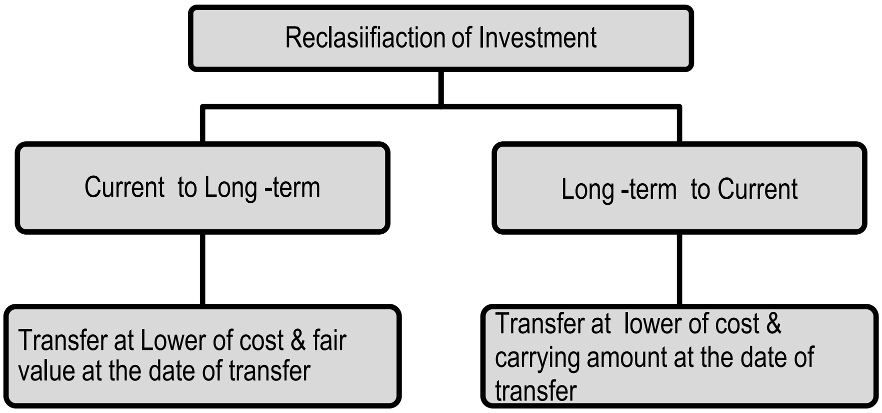
1. It is presumed that no dividend is received on bonus shares as bonus shares are declared on 3.6.2013 and dividend pertains to the year ended 31.03.2013.

2. The amount of dividend for the period, for which shares were not held by the investor, has been treated as capital receipt.

5. Valuation in case of Reclassification of Investment

When Investments are classified from Current Investment to Permanent Investment, Permanent Investment is valued at Cost Price or Fair Value, whichever is less.

When Investments are classified from Permanent Investment to Current Investment, Current Investment is valued at Cost Price or Carrying Amount, whichever is less.


Reclasiifiaction of Investment
Current to Long -term
Long -term to Current
Transfer at Lower of cost & fair value at the date of transfer
Transfer at lower of cost & carrying amount at the date of transfer

Summary

- Investment Accounting is done as per Accounting Standard-13.
- **Two type of Investments :**
  - ✓ Long Term Investments
  - ✓ Current Investments
- **Valuation of Current investment** – Lower of Cost or Fair Value/net Realizable Value
- **Valuation of Long Term investment** – At cost
- **Reclassification :**
  - ✓ From Current to Permanent → Valuation at Cost or Fair value, whichever is lower
  - ✓ From Permanent to Current → Valuation at Cost or Carrying Amount, whichever is lower
- **Disposal of Investment:**
  - ✓ Difference between carrying amount and disposal proceeds is transferred to Profit & Loss A/c.

  In case of partial sale, weighted average method to be used.

13

Insurance Claims for Loss of Stock and Loss of Profit

Learning Objectives

After studying this chapter, you will be able to compute:

- Claim for loss of stock.
- Claim for loss of profit.

1. Introduction

Business enterprises get insured against the loss of stock on the happening of certain events such as fire, flood, theft, earthquake etc. Insurance being a contract of indemnity, the claim for loss is restricted to the actual loss of assets. Sometimes an enterprise also gets itself insured against consequential loss of profit due to decreased turnover, increased expenses etc.

If loss consequential to the loss of stock is also insured, the policy is known as loss of profit or consequential loss policy.

Insurance claim can be studied under two parts as under:-

- Claim for loss of stock
- Claim for loss of profit

2. 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.

3. 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:

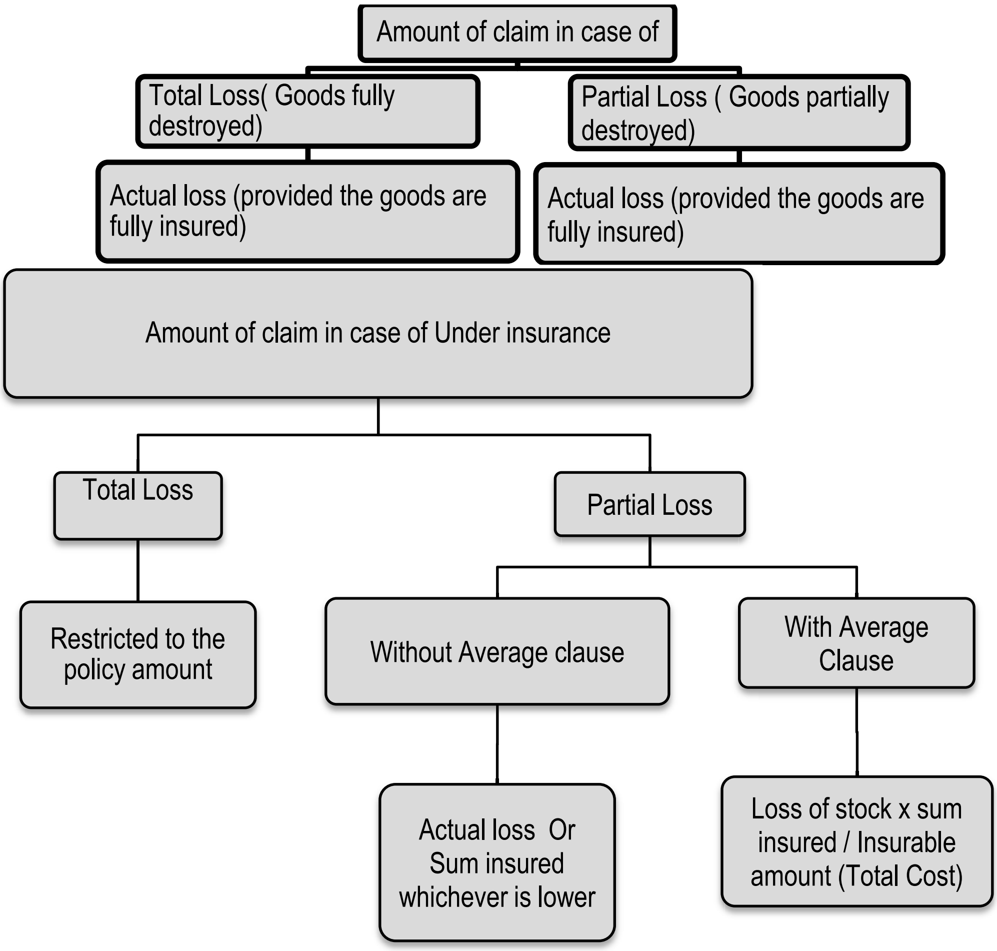
a. **Total Loss:** If the goods are totally destroyed, the amount of claim is equal to the actual loss, provided the goods are fully insured. However, in case of under insurance (i.e. insurable value of stock insured is more than the sum insured),the amount of claim is restricted to the policy amount.

b. **Partial Loss:** If the goods are partially destroyed, the amount of claim is equal to the actual loss provided the goods are fully insured. However in case of under insurance, the amount of claim will depend upon the nature of insurance policy as follows:

   I) Without Average clause:- Claim is equal to the lower of actual loss or the sum insured.

   II) With Average Clause:- Amount of claim for loss of stock is proportionately reduced, considering the ratio of policy amount (i.e. insured amount) to the value of stock as on the date of fire (i.e insurable amount) as shown below:

Amount of claim = Loss of stock x sum insured / Insurable amount (Total Cost)


Amount of claim in case of
Total Loss(Goods fully destroyed)
Partial Loss (Goods partially destroyed)
Actual loss (provided the goods are fully insured)
Actual loss (provided the goods are fully insured)
Amount of claim in case of Under insurance
Total Loss
Partial Loss
Restricted to the policy amount
Without Average clause
With Average Clause
Actual loss Or Sum insured whichever is lower
Loss of stock x sum insured / Insurable amount (Total Cost)

One should note that the average clause applies only where the insured value is less than the total cost and not vice-versa.

3.1 Relevant points

(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.

Loss of Stock

Amount of loss of stock is calculated as under:

Value of stock on the date of fire	XXXX
Less:- Value of Salvaged stock	XXXX
Amount of loss of stock	XXXX

Illustration 1

On 12th June, 2014 fire occurred in the premises of N.R. Patel, a paper merchant. Most of the stocks were destroyed, cost of stock salvaged being ₹ 11,200. In addition, some stock was salvaged in a damaged condition and its value in that condition was agreed at ₹ 10,500. From the books of account, the following particulars were available.

1. *His stock at the close of account on December 31, 2013 was valued at ₹ 83,500.*
2. *His purchases from 1-1-2014 to 12-6-2014 amounted to ₹ 1,12,000 and his sales during that period amounted to ₹ 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 ₹ 60,000. Compute the amount of the claim.

Solution

Computation of claim for loss of stock

	₹	₹
Opening Stock on 1-1-2014		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 = $\frac{60,000}{87,700} \times 66,000$ = ₹ 45,154		

Illustration 2

On 1st April, 2015 the stock of Shri Ramesh was destroyed by fire but sufficient records were saved from which following particulars were ascertained:

	₹
Stock at cost-1st January, 2014	*73,500*
Stock at cost-31st December, 2014	*79,600*
Purchases-year ended 31st December, 2014	*3,98,000*
Sales-year ended 31st December, 2014	*4,87,000*
Purchases-1-1-2015 to 31-3-2015	*1,62,000*
Sales-1-1-2015 to 31-3-2015	*2,31,200*

In valuing the stock for the Balance Sheet at 31st December, 2014 ₹ 2,300 had been written off on certain stock which was a poor selling line having the cost ₹ 6,900. A portion of these goods were sold in March, 2015 at loss of ₹ 250 on original cost of ₹ 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 ₹ 5,800. The policy was for ₹ 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 2014
(to determine the rate of gross profit)

	₹		₹	₹
To Opening Stock	73,500	By Sales A/c		4,87,000
To Purchases	3,98,000	By Closing Stock :		
To Gross Profit	97,400	As valued	79,600	
		Add : Amount written off to restore stock to full cost	2,300	81,900
	5,68,900			5,68,900

The (normal) rate of gross profit to sales is = $\frac{97,400}{4,87,000} \times 100$ = 20%

Memorandum Trading Account upto March 31, 2015

	Normal items	*Abnormal items*	*Total*		*Normal*	*Abnormal items*	*Total items*
	₹	₹	₹		₹	₹	₹
To Opening Stock	75,000	6,900*	81,900	By Sales	2,28,000	3,200	2,31,200
				By Loss	—	250	250
To Purchases	1,62,000	—	1,62,000	By Closing Stock (bal. fig.)	54,600	3,450	58,050
To Gross Profit (20% on ₹ 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 ₹ 4,600

Calculation of Insurance Claim

	₹
Value of Stock on March 31, 2015	58,050
Less : Salvage	(5,800)
Loss of stock	52,250

Claim subject to average clause:

$$= \frac{\text{Amount of Policy}}{\text{Value of Stock}} \times \text{Actual Loss of Stock}$$

$$= ₹\ \frac{50,000}{58,050} \times 52,250 = ₹\ 45,004$$

4. 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 or consequential Policy normally covers the following items:

(1) Loss of net profit

(2) Standing charges.

(3) Any increased cost of working *e.g.,* renting of temporary premises.

In every business, there is some standard by which its activity or progress can be accurately judged: it may be sales affected or the quantity of goods (or services) produced. To measure the loss suffered by a firm due to fire, it is necessary to set up some standard expressed in such units to represents the volume of work. There should be a direct relation between the amount of standard and the amount of profit raised. A comparison between the amount of the standard before and after the fire will give a reliable indication of the loss of profit sustained. The most satisfactory unit of measuring the prosperity (and therefore profits) is usually turnover:

A claim for loss of profits can be established only if :

(i) the insured's premises, or the property therein, are destroyed or damaged by the peril defined in the policy; and

(ii) the insured's business carried on the premises is interrupted or interfered with as a result of such damage.

A claim for loss of profits cannot arise if the claim for loss of property as a result of the fire is not also admitted. This is very convenient as it avoids independent investigation into loss of property for purposes of loss of profits policy. It is possible that the business of the insured may suffer because of fire in the neighbourhood, not causing damage to the property of the insured, say by closing the street for some time. Such eventualities may be covered by agreement with the insurer on payment of extra premium. If fire does not affect the volume of business, there can be no claim for loss of profits.

Also, it does not follow that if there is a large property claim, there will be necessarily a large claim for loss of profit or vice versa.

4.1 Terms Defined

The following terms should be noted:

Gross Profit is 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 is 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].

4.2 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 ₹ 2,00,000

(iii) Turnover, last financial year ended Dec. 31, 2014 ₹ 12,00,000.

(iv) Gross Profit, i.e., Net profit plus insured standing charges, ₹ 2,00,000 giving a gross profit rate of 20%.

(v) Net profit plus all standing charges, ₹ 2,50,000 i.e., 50,000 of the standing charges are not insured.

(vi) Fire occurs on 31st March, 2015, and affects business for 6 months.

(vii) Turnover for 12 months ended 31st March, 2015, ₹ 11,70,000.

(viii) Turnover: 1-4-2014 to 30-9-2014	5,00,000
1-4-2015 to 30-9-2015	3,00,000
Reduction in turnover	2,00,000

(ix) Sales amounting ₹ 1,60,000 generated in period 1.4.2015 to 30.9.2015 by incurring additional expenses of ₹ 30,000.

(x) Saving in insured charges in the indemnity period ₹ 10,000.

The claim in respect of profit will be calculated as follows:

(a)	Short Sales :	₹
	Reduction in Turnover 1-4-2014 to 30-9-2014	5,00,000
	Less : Turnover 1-4-2015 to 30-9-2015	(3,00,000)
		2,00,000
	Down-trend:	₹
	Quarterly sales in 2014 $\left[\dfrac{\text{₹ } 12,00,000}{12}\times 3\right]$	3,00,000
	Sales of first quarter in 2015 : ₹ 11,70,000 - $\left[\dfrac{\text{₹ } 12,00,000}{12}\times 9\right]$	2,70,000
		30,000
	Adjusted Annual Turnover :	₹
	Sales for the period 1-4-2014 to 31-12-2014(11,70,000—2,70,000)	9,00,000
	Add: Sales from 1-1-2015 to 31-3-2015	2,70,000
		11,70,000
(*b*)	Gross Claim: Gross Profit @ 20% on (*a*)	40,000
	Add: Claim for increase in cost of working	24,718
		64,718
	Less: Saving in insured standing charges	(10,000)
		54,718

Claim for increased cost of working is subject to two tests

(*i*) $$\text{Increased cost of working}\times\frac{\text{G.P. on Annual Turnover}}{\text{G.P. as above } + \text{ Uninsured Standing Charges}}$$

$$= \text{₹ } 30,000\times\frac{\text{₹ } 11,70,000\times\dfrac{20}{100}}{\text{₹ } 11,70,000\times\dfrac{20}{100}+\text{₹ } 50,000} = \text{₹ } 24,718.$$

(*ii*) Gross Profit on sales generated by increased cost of workings

$= 1{,}60{,}000 \times \frac{20}{100} =$ ₹ 32,000

Lower of the two, *i.e.,* ₹ 24,718 is allowable

		₹
(*c*)	Application of average clause :	
	Gross Profit of annual turnover, 20% on ₹ 11,70,000	2,34,000
	Sum insured	2,00,000
	Hence claim limited to $54{,}718 \times \frac{₹\ 2{,}00{,}000}{₹\ 2{,}34{,}000}$	46,768

Illustration 3

A fire occurred on 1st February, 2014, in the premises of Pioneer Ltd., a retail store and business was partially disorganised upto 30th June, 2014. The company was insured under a loss of profits for ₹ 1,25,000 with a six months period indemnity. From the following information, compute the amount of claim under the loss of profit policy.

	₹
Actual turnover from 1st February to 30th June, 2014	*80,000*
Turnover from 1st February to 30th June, 2013	*2,00,000*
Turnover from 1st February, 2013 to 31st January, 2014	*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 ₹ 6,700 and but for this expenditure, there would have been negligible turnover during the dislocation period. There was also a saving during the indemnity period of ₹ 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	₹
Turnover from 1st Feb. 2013 to 30th June, 2013	2,00,000
Add: 15% expected increase	30,000

	2,30,000
Less: Actual Turnover from 1st Feb., 2014 to 30th June, 2014	(80,000)
Short Sales	1,50,000
Gross Profit on reduction in turnover @ 30% on ₹ 1,50,000 (see working note 1)	45,000
Add: Additional Expenses Lower of	
(i) Actual = ₹ 6,700	
(ii) Additional Exp. × $\frac{\text{G.P. on Annual Turnover}}{\text{G.P. on Annual Turnover} + \text{Uninsured Standing Charges}}$	
$6{,}700 \times \frac{1{,}55{,}250}{1{,}63{,}250} = 6{,}372$	
(iii) G.P. on sales generated by additional expenses — 80,000 x 30% = 24,000 Therefore, lower of above is	6,372
	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 = ₹ 39,390	

Working Notes:

(*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., 2013 to 31st January, 2014	4,50,000
Add: 15% expected increase	67,500
	5,17,500

Gross Profit on ₹ 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, 2014 and as a result, the business was practically disorganised upto 31st August, 2014. The company is insured under a loss of profits policy for ₹ 1,65,000 having an indemnity period of 6 months.

From the following information, prepare a claim under the policy:

		₹
(i)	*Actual turnover during the period of dislocation (1-3-2014 to 31-8-2014)*	*80,000*
(ii)	*Turnover for the corresponding period (dislocation) in the 12 months immediately before the fire (1-3-2013 to 31-8-2013)*	*2,40,000*
(iii)	*Turnover for the 12 months immediately preceding the fire (1-3-2013 to 28-2-2014)*	*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 ₹ 9,300 immediately after the fire and but for this expenditure, the turnover during the period of dislocation would have been only ₹ 55,000. There was also a saving during the indemnity period of ₹ 2,700 in insured standing charges as a result of the fire.

Solution

Computation of loss of profit Insurance claim

		₹
(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 = $\left[\frac{₹\ 1{,}50{,}000}{₹\ 5{,}00{,}000}\times 100\right]$ = 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 (1-3-2013 to 23-2-2014)	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 ₹ 55,000 which is more than the claim computed in Para (5). So the Insurance Company would insist on trend adjusted on annual turnover.

(4) Additional Expenses:

		₹
(i)	Actual Expenses	9,300
(ii)	Gross profit on sales generated by additional expenses 30/100× (₹ 80,000 – ₹ 55,000)	7,500
(iii)	$\frac{\text{Gross Profit on Annual (Adjusted) Turnover}}{\text{Gross Profit shown in the numerator} + \text{Uninsured standing charges}}\times\text{Additional Expenses}$	
	$\frac{30\%\ \text{on}\ ₹\,6{,}60{,}000}{30\%\ \text{on}\ ₹\,6{,}60{,}000 + ₹\,5{,}000}\times ₹\,9{,}300$	
	$\frac{₹\ 1{,}98{,}000}{₹\ 2{,}03{,}000}\times ₹\,9{,}300 =$	9,071

Least of the above three figures, *i.e.* ₹ 7,500 allowable.

(5) Claim*:*

	₹
Loss of profit on short sales (30% on ₹ 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

$\left[\text{₹}\,60{,}000\times\frac{\text{₹}\,1{,}65{,}000}{\text{₹}\,1{,}98{,}000}\right]$ 50,000

Illustration 5

S & M Ltd. give the following Trading and Profit and Loss Account for year ended 31st December, 2014:

Trading and Profit and Loss Account for the year ended 31st December, 2014

	₹			₹
To Opening Stock	50,000	By Sales		8,00,000
To Purchases	3,00,000	By Closing stock		70,000
To Wages (₹ 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 ₹ 80,000 and ₹ 1,72,000. A fire occurred on 1st May, 2015 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 2015 were ₹ 1,00,000, ₹ 50,000 and ₹ 36,000 respectively.

(b) Sales for the same period were ₹ 2,40,000.

(c) Other sales figures were as follows :

	₹
From 1st January 2014 to 30th April, 2014	3,00,000
From 1st May 2014 to 31st August, 2014	3,60,000

From 1st May, 2015 to 31st August, 2015	*60,000*

(d) Due to rise in wages, gross profit during 2015 was expected to decline by 2% on sales.

(e) Additional expenses incurred during the period after fire amounted to ₹ 1,40,000. The amount of the policy included ₹ 1,20,000 for expenses leaving ₹ 20,000 uncovered. Ascertain the claim for stock and for loss of profit.

All workings should form part of your answers.

Solution

Claim for loss of stock

Memorandum Trading Account for the period 1st January to 1st May, 2015

	₹		₹
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 ₹ 80,000 which is the amount of Insurance policy.

Working Notes:

(1) Rate of Gross Profit in 2014

$$\frac{\text{Gross Pr ofit}}{\text{Sales}} \times 100$$

$$\frac{2{,}40{,}000}{8{,}00{,}000} \times 100 = 30\%$$

In 2015, 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, 2014 to 31st August, 2014	3,60,000
Less: 20% decline observed in 2015 over 2014	
(Jan - April ₹ 2,40,000 instead of ₹ 3,00,000)	72,000
	2,88,000
Less: Sales from 1st May, 2015 to 31st August, 2015	60,000

	Short-Sales		2,28,000
(b)	Gross profit ratio		
	$\frac{\text{Net Profit} + \text{Insured standing charges (2014)}}{\text{Sales (2014)}} \times 100$		
	$\frac{56{,}000 + 1{,}20{,}000}{8{,}00{,}000} \times 100 =$	22%	
	Less: Expected decrease due to increase in wages	2%	20%
(*c*)	Loss of Gross Profit:		
	20% on short sales ₹ 2,28,000 =		₹ 45,600
(*d*)	Annual turnover: (12 months to 1st May, 2015) :		
			₹
	Sales for Jan-Dec., 2014		8,00,000
	Less: From 1-1-2014 to 30-4-2014		(3,00,000)
			5,00,000
	Less: 20% downward trend		(1,00,000)
			4,00,000
	Add: From 1-1-2015 to 30-4-2015		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 20% of ₹ 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.* ₹ 12,000 is admissible.

****Total claim for Loss of Profit:** 45,600 + 12,000= ₹ 57,600

Note.: On the amount of final claim, the average clause will not apply since the amount of the policy ₹ 1,72,000 is higher than Gross Profit on annual turnover ₹ 1,28,000.

Illustration 6

Sony Ltd.'s. Trading and profit and loss account for the year ended 31st December, 2013 were *as follows:*

Trading and Profit and Loss Account for the year ended 31.12.2013

		₹			₹
To	*Opening stock*	*20,000*	*By*	*Sales*	*10,00,000*
To	*Purchases*	*6,50,000*	*By*	*Closing stock*	*90,000*
To	*Manufacturing expenses*	*1,70,000*			
To	*Gross profit*	*2,50,000*			
		10,90,000			*10,90,000*
To	*Administrative expenses*	*80,000*	*By*	*Gross profit*	*2,50,000*
To	*Selling expenses*	*20,000*			
To	*Finance charges*	*1,00,000*			
To	*Net profit*	*50,000*			
		2,50,000			*2,50,000*

The company had taken out a fire policy for ₹ 3,00,000 and a loss of profits policy for ₹ 1,00,000 having an indemnity period of 6 months. A fire occurred on 1.4.2014 at the premises and the entire stock were gutted with nil salvage value. The net quarter sales i.e. 1.4.2014 to 30.6.2014 was severely affected. The following are the other information:

Sales during the period	*1.1.14 to 31.3.14*	*2,50,000*
Purchases during the period	*1.1.14 to 31.3.14*	*3,00,000*
Manufacturing expenses	*1.1.14 to 31.3.14*	*70,000*
Sales during the period	*1.4.14 to 30.6.14*	*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 1.1.2014 to 31.3.2014

	₹		₹
To Opening stock	90,000	By Sales	2,50,000
To Purchases	3,00,000	By Closing stock	2,60,000
To Manufacturing expenses	70,000	(balancing figure)	
To Gross profit (20%* of ₹ 2,50,000)	50,000		
	5,10,000		5,10,000
			₹
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:

	₹	
Average sales for the period 1.4.2013 to 30.6.2013 (W.N.1) (₹ 7,82,610/3)	2,60,870	
Add: Increasing trend of sales (15%)	39,130	(Approx.)
	3,00,000	
Less: Sales during the period 1.4.2014 to 30.6.2014	87,500	
Short sales	2,12,500	

Computation of G.P. Ratio:

$$\text{Gross profit ratio} = \frac{\text{Net profit} + \text{Insured standing charges}}{\text{Sales}} \text{ x } 100$$

$$=- \frac{₹\ 50{,}000 + ₹\ 50{,}000}{₹\ 10{,}00{,}000} \text{ x } 100 \quad = \quad 10\%$$

Less: Decreasing trend in G. P. 5%

5%

Loss of profit = 5% of ₹ 2,12,500 = ₹ 10,625

Amount allowable in respect of additional expenses:

* G.P. of 2013	25%	
Less: Decrease in trend	5%	20%

Least of the following:-

(i) Actual expenditure	₹ 60,000
(ii) G.P. on sales generated by additional expenses 5% of ₹ 87,500	₹ 4,375

(assumed that entire sales during disturbed period is due to additional expenses)

(iii) Additional expenses x $\dfrac{G.P. on \ \ annual \ \ turnover}{G.P. \ on \ \ annual \ \ turnover + Uninsured \ standing \ charges}$

$₹ 60,000 \text{ x} \dfrac{57,500}{57,500 + 1,30,000}$ = ₹ 18,400 (approx.)

least i.e. ₹ 4,375 is admissible.

G.P. on annual turnover:

Adjusted annual turnover:

	₹
Average turnover for the period 1.4.2013 to 31.12.2013 (W.N.1)	7,82,610
Turnover for the period 1.1.2014 to 31.3.2014	2,50,000
	10,32,610
Add: Increase in trend (15% of ₹ 7,82,610) (W.N.2)	1,17,390
	11,50,000
Gross profit on annual turnover (5% of ₹ 11,50,000)	57,500

As the gross profit on annual turnover (₹ 57,500) is less than policy value (₹ 1,00,000), average clause is not applicable.

Insurance claim to be submitted:

	₹
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 (₹ 80,000) and finance charges (₹ 1,00,000). Insured standing charges being ₹ 50,000, uninsured standing charges would be ₹ 1,30,000.

Working Note:

		₹
1.	**Break up of sales for the year 2013:**	

	Sales of the first quarter of 2013 (₹ 2,50,000 x 100/115)	2,17,390* (approx.)
	Sales for the remaining three quarters of 2013 ₹ (10,00,000-2,17,390)	7,82,610

* Sales for the first quarter of 2013 is computed on the basis of sales of the first quarter of 2014.

2. The increase in trend of sales has been applied to the sales of 2013 only, as the sales figure of the first quarter of 2014 was already trend adjusted.

Illustration 7

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

Sum insured (from 31st December 2013)	*₹ 4,00,000*
Period of indemnity	*12 months*
Date of damage	*1st January, 2014*
Date on which disruption of business ceased	*31st October, 2014*

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

The books of account revealed:

(a) The gross profit for the financial year 2013 was ₹ 3,60,000.

(b) The actual turnover for financial year 2013 was ₹ 12,00,000 which was also the turnover in this case.

(c) The turnover for the period 1st January to 31st October, in the year preceding the loss, was ₹ 10,00,000.

During dislocation of the position, it was learnt that in November-December 2013, there has been an upward trend in business done (compared with the figure of the previous years) and it was stated that had the loss not occurred, the trading results for 2014 would have been better than those of the previous years.

The Insurance company official appointed to assess the loss accepted this view and adjustments were made to the pre-damaged figures to bring them up to the estimated amounts which would have resulted in 2014.

The pre-damaged figures together with agreed adjustments were:

Period	*Pre-damaged figures*	*Adjustment to be added*	*Adjusted standard turnover*
	₹	*₹*	*₹*
January	*90,000*	*10,000*	*1,00,000*

Feb. to October	*9,10,000*	*50,000*	*9,60,000*
November to December	*2,00,000*	*10,000*	*2,10,000*
	12,00,000	*70,000*	*12,70,000*
Gross Profit	*3,60,000*	*46,400*	*4,06,400*

Rate of Gross Profit 30% (actual for 2013), 32% (adjusted for 2014).

Increased cost of working amounted to ₹ 1,80,000.

There was a clause in the policy relating to savings in insured standard charges during the indemnity period and this amounted to ₹ 28,000.

Standing Charges not covered by insurance amounted to ₹ 20,000 p.a. The annual turnover for January was nil and for the period February to October 2014 ₹ 8,00,000

Solution

1. **Short sales**

Period	*Adjusted Standard Turnover*	*Actual Turnover*	*Shortage*
	₹	*₹*	*₹*
January	1,00,000	-	1,00,000
Feb. to October	9,60,000	8,00,000	1,60,000
	10,60,000	8,00,000	2,60,000

2. Gross profit ratio for the purpose of insurance claim on loss of profit

Gross profit - Insured Standing Charges - Uninsured standing charges = Net profit

Or

Gross profit - Uninsured standing charges = Net profit +Insured Standing Charges

= 4,06,400 – 20,000 = 3,86,400

$$\frac{₹\ 3{,}86{,}400}{₹\ 12{,}70{,}000} \times 100 = 30.425\%$$

3. Amount allowable in respect of additional expenses

Least of the following:

(i) Actual expenses = 1,80,000

(ii) Gross profit on sales during 10 months period = 8,00,000 x 30.425% =2,43,400

(iii) $\frac{\text{Gross Profit on Annual Adjusted Turnover}}{\text{Gross Profit on Annual Adjusted Turnover} + \text{uninsured standing charges}}$ x Additional expenses

$$\frac{3{,}86{,}400}{3{,}86{,}400+20{,}000} \times 1{,}80{,}000 = 1{,}71{,}142 \text{ (approx.)}$$

Least i.e. = ₹ 1,71,142 is admissible.

4. Amount of Claim

	₹
Gross profit on short sales = ₹ 2,60,000 x $\frac{30.425}{100}$	79,105
Add: Amount allowable in respect of additional expense	1,71,142
	2,50,247
Less: Savings in Insured Standing Charges	(28,000)
	2,22,247

On the amount of final claim, the average clause will not apply since the amount of the policy ₹ 4,00,000 is higher than gross profit on annual adjusted turnover ₹ 3,86,400.

Therefore, insurance claim will be ₹ 2,22,247.

Summary

1. Claim for Loss of Stock

- **Loss of Stock:**

  Amount of loss of stock is calculated as under:

Value of stock on the date of fire	XXXX
Less :- Value of Salvaged stock	XXXX
Amount of loss of stock	XXXX

- **Claim for loss of stock can be studied under two heads:**

  a. Total Loss:

  Amount of claim = Actual loss (If goods are fully insured but the amount of claim is restricted to the policy amount).

  b. Partial Loss:

  I) Without Average clause:-

  Claim =Lower of actual Loss or Sum Insured

  II) With Average Clause:-

  Claim = Loss of stock x sum insured / Insurable amount (Total Cost)

- **Other Points:**

  i. Stock records are maintained and not destroyed by fire, the value of the stock as at the date of the fire can be easily arrived at.

  ii. Stock records are not available or destroyed by the fire, the value of stock at the date of the fire has to be estimated.

iii. Where books of account are destroyed, the Trading Account to be prepared.

iv. Insurance company makes payment for total loss.

v. 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.

2. Claim for Loss of Profit

- The Loss of Profit Policy normally covers the following items:

  (1) Loss of net profit

  (2) Standing charges.

  (3) Any increased cost of working

  - ***Gross Profit****:*

    Net profit +Insured Standing charges *OR*

    Insured Standing charges – Net Trading Loss (If any) X Insured Standing charges/All standing charges of 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].

  - ***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

  - ***Indemnity Period***:

    The period beginning with the occurrence of the damage and ending not later than twelve months

- 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.
- ***Amount of Indemnity Payable***: Gross Profit Lost + Claim for increased cost of working Capital – Saving in Insured standing Charges.

14

Issues in Partnership Accounts

Learning Objectives

- After studying this unit, you will be able to:
- Understand the features of a partnership firm and the need for a Partnership Deed.
- Understand the points to be covered in a Partnership Deed regarding accounts.
- Learn the technique of maintaining Profit and Loss Appropriation Account.
- Familiarise with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- Learn where to show interest on capital and drawings, salaries/commissions to partners etc. Also learn that drawings by partners will not appear in the Appropriation Account.
- Learn the accounting of goodwill and see when valuation of goodwill becomes essential in partnership accounts.
- Deal with change in profit sharing ratio without any change in the constitution of partnership.
- Understand the reasons for which revaluation of assets and recomputation of liabilities is required in case of admission of a new partner. Also understand the logic of revaluation of assets and recomputation of liabilities at the time of admission, retirement of a partner and death of a partner.
- Learn the treatment of balance of reserves on admission, retirement or death of a partner.
- Know how to arrive at new profit-sharing ratio after admission, retirement or death of a partner.
- Learn how to keep records if the balance due to the retiring partner is transferred to loan account.
- Understand the accounting implications if death of a partner takes place at any date during the accounting period.
- Learn to record accounting required at the time of death of partner and how to record payment of profit to the Executor of the deceased partner for part of the accounting year.

1. Definition and Features of Partnership Accounts

The Indian Partnership Act defines partnership as the relationship between persons who have agreed to share the profit or loss of a business carried on by all or any of them acting for all. Such persons are individually known as partners and they do business in the name of their firm. Generally, partners agree among themselves as regards terms and conditions on which the business of the firm will be carried on. But often they carry on business on the basis of a verbal agreement.

The essential features of partnership are:

(i) Association of two or more persons;

(ii) An agreement entered by all persons concerned;

(iii) Existence 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 circumstance 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.

In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding and the provisions of the Act relating to the question will apply. In case of a trading firm, the implied powers of partners are the following:

(a) Buying and selling of goods;

(b) Receiving payments on behalf of the firm and giving valid recepit;

(c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

(d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

(e) Engaging servants for the business of the firm.

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are :

(a) Submitting a dispute relating to the firm arbitration;

(b) Opening a bank account on behalf of the firm in the name of a partner;

(c) Compromise or relinquishment of any claim or portion of claim by the firm;

(d) Withdrawal of a suit or proceeding filed on behalf of the firm;

(e) Admission of any liability in a suit or proceedings against the firm;

(f) Acquisition of immovable property belonging to the firm;

(g) Entering into partnership on behalf of the firm.

The rights, duties and power of partners can be changed by mutual consent.

Students should remember that in the absence of any agreement to the contrary;

1. no partner has the right to a salary,
2. no interest is to be allowed on capital,
3. no interest is to be charged on the drawings,
4. interest at the rate of 6% is to be allowed on a partner’s loan to the firm, and
5. profits and losses are to be shared equally.

Note : In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

2. Partners' Capital and Current Accounts

From the point of view of accounting, maintenance of the partners' capital accounts and current accounts is very important. The relevant accounting transactions and events are:

- Initial contribution by partners towards capital of the firm.
- Fresh capital contributed by partners.
- Interest entitlements (if agreed in the partnership deed) on capital so contributed;
- Amount withdrawn by the partners from time to time;
- Interest liability of partners on such drawings (if agreed in the partnership deed);
- Salary to partners for services rendered to run the partnership business;
- Rent of premises let out to partnership by the partners;
- Share of profit or loss of the partnership business.

How to account for all such transactions and events in the partnership accounts should be understood properly.

There are two methods of accounting –

i) fixed capital method and

ii) 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.

In 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, 2014, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 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 2014 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes. Show the capital accounts of the partners following fluctuating capital method.

Solution

A's Capital Account

2014		₹	*2014*			₹
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
			2015			
			Jan. 1	By	Balance b/d	33,800

B's Capital Account

2014			₹	*2014*			₹
Dec.31	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
				2015			
				Jan. 1	By	Balance b/d	23,200

Illustration 2

Ram and Rahim started business with capital of ₹ 50,000 and ₹ 30,000 on 1st January, 2014. Rahim is entitled to a salary of ₹ 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 ₹ 8,000 and Rahim withdrew ₹ 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹ 30,000. Assuming the capitals to be fixed, prepare the Capital and Current Accounts of the partners.

Solution

Ram's Capital Account

2014			₹	*2014*			₹
Dec.31	To	Balance c/d	50,000	Jan. 1	By	Cash	50,000

			2015		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2014		₹	*2014*		₹
Dec. 31.	To Balance c/d	30,000	Jan. 1	By Cash	30,000
			2015		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2014		₹	*2014*		₹
	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
			2015		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2014		₹	*2014*		₹
	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	
				1/2 Profit	10,470
		17,070			17,070
			2015		
			Jan. 1	By Balance b/d	6,770

3. Profit and Loss Appropriation Account

- Profit and Loss Appropriation Account is prepared by a partnership firm to distribute the net profit among the partners in accordance with the partnership deed.
- Any interest on drawing is added to the net profit and thereafter out of such total profit, interest on partners' capital, salaries, commission, rent etc. are distributed as per agreement.
- The balance of profit is distributed among the partners at the profit sharing ratio.
- One partner may have the right to have minimum amount of profits in a year as per terms of partnership agreement.

Net loss and Interest on Capital: Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only

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 ₹ 5,00,000 each. The business is run at the premises of Mr. X who is further entitled to get a monthly rent of ₹ 2,000 to be adjusted against his current account. They share profits and losses equally. Net profit during the year 2014 was ₹ 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 1-10-2014 and to change the profit sharing ratio to 1:2:2 with effect from the same date and Y and Z would not get any commission. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

	₹	₹		₹
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. 2014 @ 8%* ₹	*Oct-Dec. 2014 @ 12%* ₹	*Total* ₹
	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 ₹ 7,00,000) = ₹ 78,750

(3)	*Share of Profit*	*Jan-Sept. 2014* ₹	*Oct-Dec. 2014* ₹	*Total* ₹
	Profit for the period	5,25,000	1,75,000	7,00,000
	Less: Commission	(78,750)	-	(78,750)
	Less : Interest	(90,000)	(45,000)	(1,35,000)
	Less : Rent	(18,000)	(6,000)	(24,000)
	Profit available for distribution in the profit sharing ratio	3,38,250	1,24,000	4,62,250
	X	1,12,750	24,800	1,37,550
	Y	1,12,750	49,600	1,62,350
	Z	1,12,750	49,600	1,62,350

4. Treatment of Goodwill in Partnership Accounts

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits. The implication of the above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partners or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

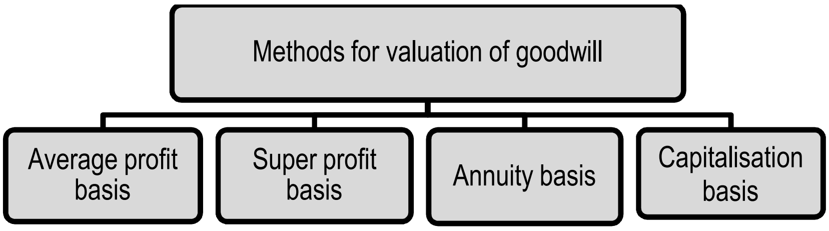
(a) When the profit sharing ratio amongst the partners is changed;

(b) When a new partner is admitted;

(c) When a partner retires or dies, and

(d) When the business is dissolved or sold.

There are four methods for valuation of goodwill, viz:



Methods for valuation of goodwill

Average profit basis

Super profit basis

Annuity basis

Capitalisation basis

4.1 Methods for Goodwill Valuation

1. Average Profit Basis: In this case the profits of the past few years are averaged and adjusted for any expected change in future. For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

Let us suppose profits of a partnership firm for the last five years were ₹ 30,000, ₹ 40,000, ₹ 50,000, ₹ 60,000 and ₹ 70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weight as shown below:

Year	*Profit*	*Weight*	*Weighted Profit*
	₹		₹
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

$$\text{So Weighted Average Profit} = \frac{₹\ 8,50,000}{15} = ₹\ 56,667$$

If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is ₹ 56,667 × 3 = ₹ 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 ₹ 30,000, ₹ 25,000, ₹ 20,000, ₹ 30,000 and ₹ 28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to ₹ 26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' purchase of profit, value of goodwill becomes ₹ 79,800.

2. Super Profit Basis: In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years. The implication is that such profit will be maintained for so many numbers of years and the partner(s) who gains in terms of profit sharing ratio should contribute for such gains in profit to the partners who make the sacrifice. On the other hand, super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because he can earn normal profit by joining any partnership. Under super profit method, what excess profit a partnership firm can earn is to be determined first. The steps to be followed are given below:

(a) Identify the capital employed by the partnership firm;

(b) Identify the average profit earned by the partnership firm based on past few years' figures;

(c) Determine normal rate of return prevailing in the locality for similar firms;

(d) Apply normal rate of return on capital employed to arrive at normal profit;

(e) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose total capital employed by a partnership firm was ₹ 1,00,000 and its average profit was ₹ 25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So normal profit is ₹ 22,000 and average profit is ₹ 25,000. The partnership firm earns ₹ 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 ₹ 3,000 × 5 = ₹ 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*
	₹	₹	₹
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
			10,056.60

So under the annuity method, discounted value of super profit becomes ₹ 10,056.60 and not ₹ 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 ₹ 3000 × 3.3522 = ₹ 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 ₹ 1,00,000, its average profit is ₹ 20,000, Normal rate of return is 15%.

Normal Value of business = $\frac{20,000}{15}$ x 100 = ₹ 1,33,333

Value of goodwill = ₹ 1,33,333 – ₹ 1,00,000 = ₹ 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 2011-2014 as follows:

Year	*Profit*
	₹
2011	*1,20,000*
2012	*1,25,000*
2013	*1,30,000*
2014	*1,50,000*

On 31.12.2014 capital employed in M/s Lee and Lawson was ₹ 5,00,000. Rate of normal profit is 20%.

Find out the value of goodwill following various methods.

Solution

Average Profit:

Year	*Profit (₹)*	*Weight*	*Weighted Profit (₹)*
2011	1,20,000	1	1,20,000
2012	1,25,000	2	2,50,000
2013	1,30,000	3	3,90,000
2014	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = ₹ 1,36,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Value of Goodwill: ₹ 1,36,000 × 3 = ₹ 4,08,000

Method (2): Super Profit Basis

	₹
Average Profit	1,36,000
Normal Profit (20% on ₹ 5,00,000)	1,00,000
	36,000

Assumption: Goodwill is valued at 3 years purchase.

Value of Goodwill: ₹ 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: ₹ 36,000 × 2.1065 (Annuity factor at 20% for 3 years) = ₹ 75,834

Method (4): Capitalisation Basis

Normal Value of Capital employed: ₹ 1,36,000 x 100/ 20	=	₹ 6,80,000
Capital Employed in M/s Lee and Lawson	=	₹ 5,00,000
Goodwill	=	₹ 1,80,000

4.2 Accounting Treatment

Para 16 of AS 10 'Accounting for Fixed Assets' states that goodwill can be recorded in the books only when some consideration in money or money's worth has been paid for it.

Para 35 of AS 26 'Intangible Assets' also states that internally generated goodwill* should not be recognized as an asset. Internally generated (self generated) goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Therefore, only purchased goodwill should be recorded in the books.

In case of admission/retirement/death of a partner or in case of change in profit sharing ratio

* 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.

among partners, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth' is paid for it. If any partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners.

Sometimes at the time of any change in the constitution of the firm (by way of admission/ retirement/death/change in profit sharing ratio) goodwill of the firm is evaluated. In that situation the value of the goodwill should not be brought to books since it is inherent goodwill. Rather the value of goodwill should be adjusted through partners' capital accounts.

Accounting treatment of goodwill in case of admission of a partner

When a new partner is admitted in the firm, the value of evaluated goodwill is adjusted through concerned partners' capital accounts. The treatment is explained through following examples:

Example 1

A and B are equal partners. They wanted to take C as third partner and for this purpose goodwill was valued at ₹ 1,20,000. The journal entry for adjustment of value of goodwill through partners' capital accounts will be:

C's Capital A/c	Dr.	₹ 40,000	
To A's Capital A/c			₹ 20,000
To B's Capital A/c			₹ 20,000
(Adjustment for goodwill)			

The net effect in partner's capital accounts is shown on the basis of profit sacrificing ratio (Difference between old profit sharing ratio and new profit sharing ratio):

A	$= \frac{1}{6} \times$ ₹ 1,20,000 =	₹ 20,000(Cr.)
B	$= \frac{1}{6} \times$ ₹ 1,20,000 =	₹ 20,000(Cr.)
C	$= \frac{2}{6} \times$ ₹ 1,20,000=	₹ 40,000(Dr.)

Example 2

A and B are equal partners. They wanted to admit C as 1/6th partner who brought ₹ 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows:

Partners	*Old share*	–	*New share*	=	*Share sacrificed*	*Share gained*
A	$\frac{1}{2}$	–	$\frac{1}{2}$	=	0	
B	$\frac{1}{2}$	–	$\frac{2}{6}$	=	$\frac{1}{6}$	
C			$\frac{1}{6}$			$\frac{1}{6}$

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c	Dr.	₹ 60,000	
To B's Capital A/c			₹ 60,000
(Goodwill brought in by C credited to B's Capital A/c in full)			

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 or gaining ratio.

Example 3

A, B and C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. The goodwill was valued as ₹ 90,000. Make the necessary journal entry.

Solution

Journal Entry

		₹	₹
A's Capital	Dr.	10,000	
To C's Capital A/c			10,000
(Being adjusting entry passed for change in profit ratio for ₹10,000 (1/9 x 90,000)			

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.

₹ 90,000 × 1/9 = ₹ 10,000

Example 4

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at ₹ 20,000. Calculate the sacrifice/gain by the partners and make the necessary journal entry.

Solution

Partners	*New share*		*Old share*	*Difference*	
				Sacrifice	*Gain*
A	$\frac{7}{20}$	–	$\frac{4}{10}$	$\frac{1}{20}$	
B	$\frac{7}{20}$	–	$\frac{3}{10}$		$\frac{1}{20}$
C	$\frac{6}{20}$	–	$\frac{3}{10}$	-	-

Thus, B gained 1/20th share while A sacrificed 1/20th share. For C there was no loss no gain.

Journal Entry

B's Capital A/c	Dr.	1,000	
To A's Capital A/c			1,000
(Being adjusting entry passed for change in profit sharing ratio for ₹1,000 (1/20 x 20,000)			

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 ₹ 20,000, A and B should pay @ ₹ 1,000 each as (i.e., ₹ 20,000 × 1/20) compensation to C and D respectively for their sacrifice.

Journal Entry

		₹	₹
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	

To C’s Capital Account		1,000
To D’s Capital Account		1,000

It is only when there is amalgamation, conversion or sale of partnership firms, the question of recording goodwill will arise. If an existing partnership firm acquires another firm, and if the purchase consideration exceeds the net assets acquired, the difference will be shown as goodwill in the books of the transferee firm.

Accounting treatment of goodwill in case of retirement or death of a partner

In case of retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. Therefore they have to pay to retiring partner for his share of goodwill in the firm in the gaining ratio.

Similarly, in case of death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is valued on the date of the retirement of death and adjusted through the capital accounts of the partners.

Example 6

A, B and C are equal partners. C wanted to retire for which value of goodwill is considered as ₹ 90,000. The necessary journal entry will be

A's Capital A/c	Dr.	₹ 15,000	
B's Capital A/c	Dr.	₹ 15,000	
To C's Capital A/c			₹ 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, 2014, 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 ₹ 15,000 per annum and that the capital employed would be ₹ 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.

	₹
2011	*67,200*
2012	*75,600*
2013	*72,000*
2014	*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:		
	Year ending 30th June, 2012 :	₹	₹
	1/2 of 2011 profits	33,600	
	1/2 of 2012 profits	37,800	71,400
	Year ending 30th June, 2013 :		
	1/2 of 2012 profits	37,800	
	1/2 of 2013 profits	36,000	73,800
	Year ending 30th June, 2014 :		
	1/2 of 2013 profits	36,000	
	1/2 of 2014 profits	31,200	67,200
	Total		2,12,400
	Average		70,800
(ii)	Super Profit :		₹
	Average profits earned		70,800
	Less : Partner's remuneration	45,000	
	Less : 8% on capital employed	12,480	(57,480)
			13,320
	Super Profits		
(iii)	Goodwill @ three years' purchase (13,320 x 3)		39,960

Adjustment entries for Goodwill

Journal Entries

		Dr. ₹	Cr. ₹
Clever's Capital Account	Dr.	7,992	
Dull's Capital Account	Dr.	7,992	
To Wise's Capital Account			15,984
(Being Wise's share of goodwill adjusted in the capital accounts of partners on the death of Mr. Wise in their gaining 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 31.12.2014 was as follows:

Balance Sheet of M/s Vasudevan, Sunderarajan & Agrawal

Liabilities	*₹*	*Assets*	*₹*
Capital A/cs		*Sundry fixed assets*	*5,00,000*
Vasudevan	*85,000*	*Inventory*	*1,00,000*
Sunderarajan	*3,15,000*	*Trade receivables*	*50,000*
Agrawal	*2,25,000*	*Bank*	*5,000*
Trade payables	*30,000*		
	6,55,000		*6,55,000*

The partnership earned profit ₹ 2,00,000 in 2014 and the partners withdrew ₹ 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:		₹
(1)	*Average Capital Employed*	
	Total Assets *less* Trade receivables as on 31.12.2014	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 2014	(1,00,000)
		6,00,000

(2)	*Super Profit :*	
	Profit of M/s Vasudevan, Sunderarajan & Agrawal	2,00,000
	Normal profit @ 30% on ₹ 6,00,000	1,80,000
	Super Profit	20,000
(3)	*Value of Goodwill*	
	5 Years' Purchase of Super profit (₹ 20,000 × 5) = ₹ 1,00,000	

5. Change in Profit Sharing Ratio

Sometimes, change in profit sharing ratio takes place without any change in the number of patners (i.e. admission, retirement or death) of the firm.

When such a change takes place, one or more partners purchase interest in the business from the other partner(s). Therefore, the aggregate amount of gain by one or more partner(s) is equal to the aggregate amount of sacrifices made by the other partner(s). The required adjustments in regard to the profit-sharing ratio, revaluation of assets and liabilities, treatment of goodwill or reserves or partners' capitals are same as what is done in case of admission or retirement or death of a partner.

The only exception is that neither a partner is coming into the business nor a partner is going out. Sometimes a single entry is passed through partners' capital accounts in gaining/sacrificing ratio, when such changes are not to be incorporated in the balance sheet, as is passed for adjustment of goodwill.

Illustration 7

P, Q and R are partners sharing profits and losses in the ratio of 3:2:1. The goodwill of the firm is valued at ₹ 12,000. They have decided to change the profit-sharing ratio to 2:2:1. Pass necessary Journal Entries.

Solution

Journal Entries Dr. Cr.

Date	*Particulars*		₹	₹
	Q's Capital A/c (Refer Working Note)	Dr.	800	
	R's Capital A/c	Dr.	400	
	To P's Capital A/c			1,200
	(Being the adjustment for goodwill through the Partners' Capital Accounts)			

Working Note:

Calculation of share of sacrifice/gain

	P	*Q*	*R*
Old ratio (3:2:1)	$\frac{3}{6}$	$\frac{2}{6}$	$\frac{1}{6}$
New ratio (2:2:1)	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
	(Sacrifice) $\frac{1}{10}$	(Gain) $\frac{2}{30}$	(Gain) $\frac{1}{30}$
	12,000 x 1/10	12,000 x 2/30	12,000 x 1/30

Illustration 8

The following is the Balance sheet of Anil and Bimal, who are equal partners as on 31.12.2014:

Liabilities		*₹*	*Assets*	*₹*
Capital Accounts:	Anil	12,000	Sundry Assets	28,000
	Bimal	6,000		
Reserves		6,000		
Account payables		4,000		
		28,000		28,000

From 1.1.2015, the partners decided to share profits and losses in the ratio of 2:1. For this purpose, the goodwill of the firm is valued at ₹ 6,000 which will not be shown in the Balance Sheet.

Pass necessary Journal Entries and re-draft the Balance Sheet.

Solution

In the books of the firm

Journal Entry

Particulars		*Dr.* *₹*	*Cr.* *₹*
Reserves A/c	Dr.	6,000	
To Anil's Capital A/c			3,000
To Bimal's Capital A/c			3,000
(Being reserve transferred to the Partners' Capital Accounts in the old ratio before change in the constitution)			

Anil's Capital A/c (Refer W.N.) To Bimal's Capital A/c (Being the adjustment for goodwill made through the Partners' Capital Accounts)	1,000	 1,000

Balance Sheet of Anil and Bimal as at 1.1.2015

Liabilities	*₹*	*Assets*	*₹*
Capital Accounts:		Sundry Assets	28,000
Anil: ₹ (12,000+3,000-1,000)	14,000		
Bimal: ₹ (6,000+3,000+1,000)	10,000		
Account Payables	4,000		
	28,000		28,000

Working Note:

Calculation of share of sacrifice/gain

	Anil	Bimal
Old ratio (1:1)	$\frac{1}{2}$	$\frac{1}{2}$
New ratio (2:1)	$\frac{2}{3}$	$\frac{1}{3}$
	(Gain) $\frac{1}{6}$	(Sacrifice) $\frac{1}{6}$
	6,000 x 1/6	6,000 x 1/6

Illustration 9

Any and Many are partners sharing profits as to ¾ and ¼ and their capitals are ₹ 90,000 and ₹ 30,000 respectively. It is decided that with effect from 1st April, 2015 the profit-sharing ratio will be: Any 5/8 and Many 3/8. The Deed states that goodwill is to be valued at 2 years' purchase of three years' profits and capitals of the two partners should be proportionate to the profit-sharing ratio. The profits for the years ended 31st March, 2013, 31st March, 2014 and 31st March, 2015 were ₹ 42,000, ₹ 39,000 and ₹ 45,000 respectively. Make necessary journal entries.

Solution

		₹
Value of Goodwill: Total profits for 3 years -	2012-13	42,000
	2013-14	39,000
	2014-15	45,000
	Total	1,26,000

Average profit		42,000
Goodwill at 2 years' purchase		84,000

Calculation of share of sacrifice/gain

	Any	Many
Old ratio (3:1)	$\frac{3}{4}$	$\frac{1}{4}$
New ratio (5:3)	$\frac{5}{8}$	$\frac{3}{8}$
	(Sacrifice) $\frac{1}{8}$	(Gain) $\frac{1}{8}$
	84,000 x 1/8 = 10,500	84,000 x 1/8=10,500

New capital required after the change in ratio-

		₹
Total Capital	(90,000 + 30,000)	1,20,000
Any's capital	1,20,000 x 5/8	75,000
Many's capital	1,20,000 x 3/8	45,000

Journal Entries

		₹	₹
Many's Capital Account	Dr.	10,500	
To Any's Capital Account			10,500
[The value of 1/8 share of goodwill (total value ₹ 84,000) which Many acquires from Any]			
Bank Account	Dr.	25,500	
To Many's Capital Account			25,500
[The sum required to make up Many's capital upto ₹ 45,000 after the debit of ₹ 10,500, i.e., ₹ 45,000 – (30,000 – 10,500)]			
Any's Capital Account	Dr.	25,500	
To Bank Account			25,500
[The sum to be returned to Any to bring his capital down to ₹ 75,000 i.e., ₹ (90,000 + 10,500 – 75,000)]			

6. Admission of a Partner

When a new partner is admitted into the partnership, new profit sharing ratio and sacrificing ratio of old partners is calculated, assets are revalued and liabilities are reassessed. A Revaluation Account (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 assets.
	Liabilities Account (Individually)		
	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 profit in the new profit sharing ratio.
To Revaluation A/c		
Or		
Revaluation A/c	Dr.	With the amount of revaluation loss in the new profit sharing ratio.
To Capital A/cs (of all partners including newly admitted partners)		

In this case entries 1 and 2 are not required.

Whenever a new partner is admitted, any reserve etc. which may be lying in the Balance

Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio. (In examination problems, it should be done even if there are no instructions on this point).

Illustration 10

Messers Dalal, Banerji and Mallick is a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2015 is as below :

Liabilities		*₹*	*Assets*	*₹*
Trade Payables		*12,850*	*Land and Buildings*	*25,000*
Outstanding liabilities		*1,500*	*Furniture*	*6,500*
General reserve		*6,500*	*Inventory*	*11,750*
Capital Account :			*Trade Receivable*	*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, 2015 on the following terms :

(1) Mr. Mistri shall bring 5,000 towards his capital.

(2) The value of Inventory should be increased by ₹ 2,500 and Furniture should be depreciated by 10%.

(3) Provision for bad and doubtful debts should be made at 10% of the trade receivables.

(4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at ₹ 15,000.

(5) The value of the goodwill be fixed at ₹ 15,000.

(6) General Reserve will be transferred to the partner's Capital Accounts.

(7) The new profit sharing ratio shall be : Mr. Dalal 5/15, Mr. Banerji 5/15,Mr. Mallick 3/15 and Mr. Mistri 2/15.

(8) The goodwill account shall be written back to the Partner's accounts in accordance with the new profit sharing proportion.

The outstanding liabilities include ₹ 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

2015			₹	2015		₹
April1	To Provision for bad and doubtful debts		550	April 1	By Inventory	2,500
"	To Furniture and fittings		650	"	By Land and Building	5,000
	To 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

Particulars	Dalal	Banerji	Mallick	Mistri	Particulars	Dalal	Benerji	Mallick	Mistri
	₹	₹	₹	₹		₹	₹	₹	₹
To Dalal & Benerjii	–	–	–	2,000	By Balance b/d	12,000	12,000	5,000	–
To Balance c/d	19,120	18,120	7,560	3,000	By General Reserve	2,600	2,600	1,300	–
					By Cash	–	–	–	5,000
					By Mistri*	1,000	1,000	–	–
					By Out-standing Liabilities	1,000	-	-	–
					By Revaluation A/c	2,520	2,520	1,260	–
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

Balance Sheet of M/s Dalal, Banerji, Mallick and Mistri as on 1-4-2015

Liabilities		₹	Assets		₹
Trade payables		12,850	Land and Buildings		30,000
Outstanding Liabilities		500	Furniture		5,850
Capital Accounts of			Inventory		14,250

* Goodwill adjustment for Mistri's share of goodwill through Dalal and Banerji in their sacrificing ratio.

partners :					
Mr. Dalal	19,120		Trade Receivables	5,500	
Mr. Banerji	18,120		*Less:* Provision	550	4,950
Mr. Mallick	7,560		Cash in hand		140
Mr. Mistri	3,000	47,800	Cash at Bank		5,960
		61,150			61,150

6.1 Proportionate capital and goodwill inference

'Proportionate Capital' means Capital Account balances of partners in accordance with the profit sharing ratio. In other words, ratio of Capital Account balances is equal to profit sharing ratio. Proportionate capital is maintained generally following 'fixed capital method'.

For example, A and B are in partnership, sharing profit or loss at the ratio of 3:2. If total capital is ₹ 1,00,000, A should contribute ₹ 1,00,000 × 3/5 *i.e.,*₹ 60,000 and B should contribute ₹ 1,00,000 × 2/5 *i.e.,* ₹ 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 ₹ 60,000 and ₹ 40,000. Now they want to admit C giving him 1/5th share for which C agrees to bring ₹ 30,000. Since total capital is ₹ 1,00,000, C should contribute ₹ 20,000 (₹ 1,00,000 × 1/5) for 1/5th share. Instead he agrees to pay ₹ 30,000. So for 1/5th share he is paying ₹ 10,000, for goodwill. Thus total value of goodwill is ₹ 10,000 × 5 *i.e.,* ₹ 50,000.

Illustration 11

A and B are in partnership sharing profits and losses equally. The Balance Sheet of M/s A and B as on 31-12-14 was as follows :

Liabilities	*₹*	*Assets*	*₹*
Capital A/cs :		*Sundry Fixed Assets*	*60,000*
A	*45,000*	*Inventory*	*30,000*
B	*45,000*	*Bank*	*20,000*
Trade Payables	*20,000*		
	1,10,000		*1,10,000*

On 1-1-15 they agreed to take C as 1/3rd partner to increase the capital base to ₹ 1,35,000. C agrees to pay ₹ 60,000. Show the necessary journal entries, Partners' Capital A/cs and Balance Sheet as on 1-1-15.

Solution

In the Books of M/s A, B and C
Journal Entries

		₹	₹
Bank A/c	Dr.	60,000	
To C's Capital A/c			60,000
(Cash brought in by C for 1/3rd share)			
C's Capital A/c	Dr.	15,000	
To A's Capital A/c			7,500
To B's Capital A/c			7,500
(Inferred value of goodwill adjusted in the books through capital accounts)			
A's Capital A/c	Dr.	7,500	
B's Capital A/c	Dr.	7,500	
To Bank			15,000
[To keep capital intact by ₹ 1,35,000, excess capital (due to goodwill adjustment) withdrawn]			

Working Notes :

(1) Old profit sharing ratio - 1:1

(2) New profit sharing ratio - 1:1:1

(3) C's share of Capital = ₹ 1,35,000 × $\frac{1}{3}$ = ₹ 45,000

(4) Goodwill : ₹ 60,000 — ₹ 45,000 = ₹ 15,000 for 1/3rd share.

Total Goodwill : ₹ 15,000 × 3 = ₹ 45,000

Partner's Capital Accounts

Dr. *Cr.*

Particulars	*A*	*B*	*C*	*Particulars*	*A*	*B*	*C*
	₹	₹	₹		₹	₹	₹
To A & B	-	-	15,000	By Balance b/d	45,000	45,000	-
To Bank	7,500	7,500	-	By Bank	-	-	60,000
To Balance c/d	45,000	45,000	45,000	By C	7,500	7,500	-
	52,500	52,500	60,000		52,500	52,500	60,000

Balance Sheet of M/s A, B & C as on 1-1-2015

Liabilities		₹	*Assets*	₹
Capital A/cs :			Sundry Fixed Assets	60,000
A	45,000		Inventory	30,000
B	45,000		Bank	65,000
C	45,000	1,35,000		
Trade Payables		20,000		
		1,55,000		1,55,000

7. Retirement of a Partner

- On retirement of a partner, it is required to revalue assets and liabilities and to calculate new profit sharing and sacrificing/gaining ratios of the existing partners 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.
- 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 ₹ 30,000 calculated on A's retirement, then ₹ 10,000 becomes due to A which is to be borne by B and C equally. So the journal entry will be as follows :

		₹	₹
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 in the new profit sharing ratio and the respective asset's/liabilitie's account is to be credited again. So the following journal entries are necessary for ₹ 10,000 increase in sundry fixed assets and ₹ 2,000 decrease in Trade payables :

			₹	₹
(1)	Sundry Fixed Assets A/c	Dr.	10,000	
	Trade payables A/c	Dr.	2,000	
	To A's Capital A/c			4,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	(Distribution of Revaluation Profit amongst the existing partners at the profit sharing ratio)			
(2)	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	6,000	
	To Sundry Fixed Assets A/c			10,000
	To Trade payables 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 ₹ 10,000. In this case either of the following two (any one) journal entries can be passed :

		₹	₹
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		
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 second alternative 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 ₹ 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 first alternative is to be followed in this case.

	₹	₹
Reserve A/c Dr.	9,000	
To X's Capital A/c		3,000
To Y's Capital A/c		3,000
To Z's Capital A/c		3,000
(Transfer of Reserve on Z's retirement)		

If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be :

	₹	₹
X's Capital A/c Dr.	2,400	
Y's Capital A/c Dr.	600	
To Z's capital A/c		3,000
(Adjustment entry for Z's share of reserve)		

7.1 Final payment to retiring partner

The following adjustments are necessary in the Capital Accounts :

(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	

7.2 Liability of Retiring partner

In the absence of an agreement, 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.

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.

Points to be remembered :

(1) 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) 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].

8. Joint Life Policy

A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimise the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

The accounting treatment for the premium paid and the Joint Life Policy may be in any of the following ways:

1. **When premium paid is treated as an expense:** When premium is treated as an expense then it is closed every year by transferring to profit and loss account. In this case complete amount received from the insurance company either on a surrender of policy or on the death of the partner becomes a gain.

Accounting entries are:

(a) On payment of premium

Joint Life Policy Insurance Premium A/c Dr.

To Bank A/c

(b) On charging to Profit and Loss Account

Profit and Loss Account Dr.

To Joint Life Policy Insurance Premium A/c

(c) On maturity of the Policy

Insurance Company/ Bank Account Dr.

To Partners' Capital A/cs (individually)

(Including the account of the representative

of a deceased partner)

2. **When premium paid is treated as an asset:** In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value

results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.

3. **Creation of Joint Policy Reserve Account:** Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realised. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

On the death of a partner Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and then the balance is transferred to Partners' Capital Accounts.

Example

A, B and C are in partnership sharing profits and losses at the ratio of 5 : 3 : 2. The balance sheet of the firm on 31.12.2014 was as follows:

Balance Sheet

Liabilities	*₹*	*Assets*	*₹*
Capital A/cs		*Sundry Fixed Assets*	*80,000*
A	*50,000*	*Inventories*	*50,000*
B	*40,000*	*Trade receivables*	*30,000*
C	*30,000*	*Joint Life Policy*	*20,000*
Bank Loan	*40,000*	*Bank*	*10,000*
Trade payables	*30,000*		
	1,90,000		*1,90,000*

On 1.1.2015, A wants to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2009 for ₹ 1,00,000 and its surrender value as on 31.12.2014 was ₹ 25,000. For the purpose of A's retirement goodwill was raised for ₹ 1,00,000. Sundry Fixed Assets was revalued for ₹ 1,10,000. But B and C did not prefer to show such increase in assets in the Balance Sheet. Also they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹ 25,000 and to make their capital proportionate.

Prepare necessary journal entries.

Solution

Journal Entries

			₹	₹
1.	B's Capital A/c	Dr.	49,500	
	C's Capital A/c	Dr.	18,000	
	To A's Capital A/c			67,500
	(Share of revaluation profit ₹ 67,500 including good will due to A borne by B and C at the gaining ratio 11 : 4)			
2.	A's Capital A/c	Dr.	1,17,500	
	To A's Loan A/c			58,750
	To Bank A/c			58,750
	(Settlement of A's claim on his retirement by payment of 50% in case and transferring the balance to his Loan A/c).			
3.	Bank A/c	Dr.	73,750	
	To A's Capital A/c			60,333
	To A's Capital A/c			13,417
	(Cash brought in by the continuing partners).			

Working Notes :

1. **Revaluation Profit**

	₹
Goodwill	1,00,000
Sundry Fixed Assets	30,000
Joint Life Policy	5,000
	1,35,000

A's Share ₹ 1,35,000 × 5/10 = ₹ 67,500.

2. **Gaining Ratio**

B : 2/3 - 3/10 = 11/30

C : 1/3 - 2/10 = 4/30

Gaining Ratio :	B	:	C
	11	:	4

3. Total Capital

		₹
Assets as per Balance Sheet		1,90,000
Additional Bank Balance		15,000
		2,05,000
Less : Bank Loan	40,000	
Trade Payables	30,000	
A's Loan	58,750	(1,28,750)
		76,250
B's Share		50,833
C's Share		25,417

Illustration 12

F, G and K were partners sharing profit and losses at the 2:2:1. K wants to retire on 31-12-2014. Given below the Balance Sheet of the partnership as well as other information:

Balance Sheet as on 31-12-2014

Liabilities	₹	*Assets*	₹
Capital A/cs:		*Sundry Fixed Assets*	*1,50,000*
F	*1,20,000*	*Inventory*	*50,000*
G	*80,000*	*Trade Receivables*	*70,000*
K	*60,000*	*Bank*	*50,000*
Reserve	*10,000*		
Trade Payables	*50,000*		
	3,20,000		*3,20,000*

F and G agree to share profits and losses at the ratio of 3:2 in future. Value of goodwill is taken to be ₹ 50,000. Sundry Fixed Assets are revalued upward by ₹ 30,000 and inventory by ₹ 10,000. Trade receivables were valued at ₹ 65,000 on 31.12.2014. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also they wanted to maintain ₹ 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 F and G.

Solution

Journal Entries

		₹	₹
(1) Reserve A/c	Dr.	10,000	

	To F's Capital A/c			4,000
	To G's Capital A/c			4,000
	To K's Capital A/c			2,000
	(Transfer of Reserve to Partners' Capital A/cs on K's retirement).			
(2)	Sundry Fixed Assets A/c	Dr.	30,000	
	Inventory A/c	Dr.	10,000	
	To Profit and Loss Adjustment A/c			40,000
	(Increase in the value of Sundry Fixed Assets and Stock recorded).			
(3)	Profit and Loss Adjustment A/c	Dr.	5,000	
	To Trade Receivable A/c			5,000
	(Being loss arising on trade receivables recorded).			
(4)	Profit and Loss Adjustment A/c	Dr.	35,000	
	To F's Capital A/c			14,000
	To G's Capital A/c			14,000
	To K's Capital A/c			7,000
	(Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)			
(5)	F's Capital A/c	Dr.	10,000	
	To K's Capital A/c			10,000
	(Adjusting the share of K in value of goodwill to F)			
(6)	Bank A/c	Dr.	1,04,000	
	To F's Capital A/c			70,000
	To G's Capital A/c			34,000
	(Cash brought in by F and G as per agreement).			
(7)	K's Capital A/c	Dr.	79,000	
	To Bank A/c			79,000
	(Payment made to K on retirement)			

Balance Sheet
(After K's retirement)

Liabilities	₹	*Assets*	₹
Capital A/cs:		Sundry Fixed Assets	1,80,000
F	1,98,000	Inventory	60,000

G	1,32,000	Trade Receivables	65,000
Trade Payables	50,000	Bank	75,000
	3,80,000		3,80,000

Working Notes :

1. **Partner's Capital Accounts**

	F	G	K		F	G	K
	₹	₹	₹		₹	₹	₹
To K	10,000	-	-	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By F	-	-	10,000
				By P & L Adj. A/c	14,000	14,000	7,000
	–	–		By Reserve	4,000	4,000	2,000
			–				
	1,38,000	98,000	79,000		1,38,000	98,000	79,000
To Bank	–	–	79,000	By Balance b/d	1,28,000	98,000	79,000
To Balance c/d	1,98,000	1,32,000	–	By Bank	70,000	34,000	–
	1,98,000	1,32,000	79,000		1,98,000	1,32,000	79,000

2.

Total capital	₹
Sundry Fixed Assets (₹ 1,50,000 + 30,000)	1,80,000
Inventory (₹ 50,000 + ₹ 10,000)	60,000
Trade Receivables	65,000
Bank	75,000
	3,80,000
Less: Trade Payables	(50,000)
	3,30,000
F's Share (₹ 3,30,000 × 3/5)	1,98,000
G's Share (₹ 3,30,000 × 2/5)	1,32,000

3. **Bank Account**

	₹		₹
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

Illustration 13

Glad and Happy, who make up their accounts to 30 September in each year, carried on business in partnership under the firm name of Feelings.

Their partnership agreement provided:

(1) Profits and losses should be shared Glad - two-third and Happy - one-third.

(2) Interest on capital accounts should be allowed at the rate of 6% per annum but no interest should be allowed or charged on current accounts.

(3) On the retirement or admission of a partner:

(i) If the change takes place during any accounting year, such partner's share of profits or losses for the period up to retirement or from admission is to be arrived at by apportionment on a time basis except where otherwise agreed.

(ii) No account for goodwill is to be maintained in the firm's books, any adjusting entries for transactions between the partners being made in their capital accounts.

(iii) Any balance due to an outgoing partner is to carry interest at 8% per annum from the date of his retirement to the date of payment.

Glad retired from the firm on 31st March 2014 and, on the same day, Happy took into partnership Joy, an employee of the firm. It was agreed that the terms of the previous partnership agreement should apply in all respects except that, as from the date, profits or losses are to be shared: Happy - three-fifth, Joy - two-fifth.

The trial balance extracted from the books of the firm as on 30th September 2014 was as follows:

Particulars	*₹*	*₹*
Capital Accounts – 30th September 2013		
Glad	*-*	*8,000*
Happy	*-*	*6,000*
Current Accounts – 30th September 2013		
Glad	*-*	*2,400*
Happy	*-*	*1,600*
Joy – Cash introduced 31st March, 2014	*-*	*3,000*
Plant and machinery at cost	*14,000*	*-*
Plant and machinery: Provision for depreciation -30th September, 2013	*-*	*2,800*
Motor vehicles at cost	*6,200*	*-*
Motor vehicles: provision for depreciation – 30th September 2013	*-*	*3,400*
Purchases	*62,000*	*-*

Inventory – 30th September 2013	*12,400*	*-*
Wages	*14,600*	*-*
Salaries	*10,800*	*-*
Trade Receivable	*4,600*	*-*
Sales	*-*	*96,000*
Expenses	*1,600*	*-*
Trade Payables	*-*	*6,200*
Rent and rates	*1,400*	*-*
Bad debts	*600*	*-*
Balance at bank	*1,200*	*-*
	1,29,400	*1,29,400*

You are given the following further information:

(1) The value of the firm's goodwill as on 31st March 2014 was agreed to be ₹ 12,000.

(2) On 31st March, 2014, Joy had paid Glad ₹ 5,000 on account of the balance due to him on retirement. But no entry had been made in the books in respect of this payment. The balance due to Glad after taking into account this payment remained unpaid as on 30th September, 2014.

(3) Glad on retirement had taken over one of the firm's motor vehicles and it was agreed that he should be charged for it at its written down value on the date of his retirement. The vehicle had cost ₹ 1,400 and up to 30th September, 2013 depreciation of ₹ 625 had been provided on it.

(4) The inventory as on 30th September 2014 was valued at ₹ 14,200.

(5) Partners' drawings which are included in salaries were as follows:

Glad ₹ 1,800; Happy ₹ 2,400; Joy ₹ 900.

(6) Salaries also included ₹ 1,200 paid to Joy prior to his being admitted as a partner and which is to be charged against the half-year profits of the firm ended on 31st March, 2014.

(7) Professional charges of ₹ 250 included in trade expenses are specifically attributable to the second half of the year.

(8) The whole of the charge of ₹ 600 for bad debts related to the period upto 31st March, 2014.

(9) A bad debts provision specifically, attributable to the second half of the year of 5% of the total debtors is to be made as on 30th September 2014.

(10) As on 30th September 2014, rent paid in advance amounted to ₹ 400 and trade expenses accrued amounted to ₹ 180.

(11) Provision is to be made for depreciation on plant and machinery and on motor vehicles at the rates of 10% and 25% per annum respectively, calculated on cost.

You are required to prepare:

(a) The Trading and profit and loss account for the year ended 30th September 2014.

(b) Partner's capital and current accounts for the year ended 30th September 2014; and

(c) The balance sheet as on that date.

Solution:

(a) Trading and Profit and Loss A/c

for the year ended 30th September, 2014

	₹	₹
Sales		96,000
Less: Cost of goods sold:		
Opening Inventory	12,400	
Purchase	62,000	
	74,400	
Less: Closing Inventory	(14,200)	(60,200)
Less: Wages		(14,600)
Gross Profit		21,200

	Half year to 31st March 2014		*Half year to 30th September 2014*	
	₹	₹	₹	₹
Gross profit allocated on time basis		10,600		10,600
Less: Expenses				
Salaries (W.N.1)	3,450		2,250	
Expenses (W.N.2)	765		1,015	
Rent and rates (W.N.3)	500		500	
Bad debts	600		-	
Provision for doubtful debts	-		230	
Depreciation: (W.N.4)				
Plant and machinery	700		700	
Motor vehicles	775		600	
Interest on loan	-	(6,790)	540	(5,835)
		3,810		4,765
Appropriation of profits:				
Interest on Capital:				

Glad	240			
Happy	180	420	84	
Joy			96	180
Remaining profits				
Glad	2,260			
Happy	1,130	3,390	2,751	
Joy			1,834	4,585
		3,810		4,765

(b) Partners' Capital Accounts

	Glad	Happy	Joy		Glad	Happy	Joy
	₹	₹	₹		₹	₹	₹
To Glad (goodwill)[*]		3,200	4,800	By Balance b/d	8,000	6,000	
To Glad's Loan A/c	16,000			By Cash			3,000
To Balance c/d		2,800	3,200	By Happy (goodwill)	3,200		
				By Joy (goodwill)	4,800		
				By Cash			5,000
	16,000	6,000	8,000		16,000	6,000	8,000

Partners' Current Accounts

	Glad	Happy	Joy		Glad	Happy	Joy
	₹	₹	₹		₹	₹	₹
To Car taken over	600	-	-	By Balance b/d	2,400	1,600	
To Drawings	1,800	2,400	900	By Interest on capital	240	264	96
To Transfer to loan account	2,500			By Profit	2,260	3,881	1,834
To Balance c/d		3,345	1,030				
	4,900	5,745	1,930		4,900	5,745	1,930

(c) Balance Sheet as at 30th September 2014

Assets	Cost	Depreciation	Net
	₹	₹	₹
Fixed assets:			
Plant and machinery	14,000	4,200	9,800
Motor vehicles	4,800	3,975	825
	18,800	8,175	10,625
Other assets:			
Inventory		14,200	

[*] Goodwill will be credited to Glad for his share and Joy and Happy will be debited in their gaining ratio of 3:2.

Trade Receivables		4,370	
Prepaid Rent		400	
Balance at bank		1,200	
		20,170	
Less: Liabilities			
Outstanding Trade expenses		(180)	
Trade payables		(6,200)	
			13,790
			24,415
Financed by	*Happy*	*Joy*	*Total*
	₹	₹	₹
Capital accounts	2,800	3,200	6,000
Current accounts	3,345	1,030	4,375
Loan – Glad			14,040
			24,415

Working Notes

		₹	₹
1.	**Salaries**		
	Total as per trial balance		10,800
	Less: Partners' Drawings - Glad	1,800	
	Happy	2,400	
	Joy	900	(5,100)
			5,700
	Allocation		
	Half-year to 31st March, 2014:		
	½ × (₹ 5,700 – ₹ 1,200) + Joy's salary of ₹ 1,200		3,450
	Half-year to 30 September 2014:		
	½ × (₹ 5,700 – ₹ 1,200)		2,250
			5,700
2.	**Expenses**		
	Total as per trial balance		1,600
	Add: Accrual		180
			1,780
	Allocation		
	Half-year to 31 March 2014:		
	½ × (₹ 1,780 – ₹ 250)		765
	Half-year to 30th September 2014:		
	½ × (₹ 1,780 – ₹ 250) + professional charges of ₹ 250		1,015
			1,780

3.	**Rent and rates**		
	Total as per trial balance		1,400
	Less: Rent paid in advance		(400)
	Allocation: 50 : 50		1,000

4. **Depreciation**

Plant and machinery:
10% per annum on ₹ 14,000 = ₹ 1,400; Allocated 50:50

Motor vehicles:
Half-year to 31st March 2014: 25% per annum on ₹ 6,200 = ₹ 775
Half-year to 30th September 2014: 25% per annum on ₹ 4,800 = ₹ 600

5. **Glad's Loan Account**

	₹		₹
To Cash from Joy	5,000	By Transfer from capital account	16,000
To Balance c/d	14,040	By Transfer from current account	2,500
		By Profit and loss account:	
		Interest at 8% p.a. on	
		₹ 13,500 for six months	540
	19,040		19,040
		By Balance b/d	14,040

6.	**Car taken over by Glad**	₹	₹
	Cost		1,400
	Depreciation – upto 30th September 2013	625	
	upto 31st March, 2014	175	800
			600
7.	**Motor vehicles**	*Cost*	*Depreciation*
	Per trial balance	6,200	3,400
	Less: Vehicle sold	(1,400)	(800)
		4,800	2,600
	Charge for year to 30th September 2014		1,375
			3,975
8.	**Trade Receivables**		
	Balance per trial balance		4,600
	Less: Provision for bad debts		(230)
			4,370

9. 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, 2015. 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 2014 can be taken as base for calculating 3½ months profit in 2015. If M/s. A, B & C earned ₹ 96,000 in 2014, then 3½ months profit is ₹ 28,000. A's share comes to ₹ 28,000 × 2/5 *i.e.,* ₹ 11,200.

Journal entry is :

Profit and Loss Suspense A/c	Dr.	₹ 11,200	
To A's Capital A/c			₹ 11,200
(Share of A in 3½ months profit in 2015 is transferred to his Capital Account on death)			

10. Special Transactions in case of Death : Joint Life Policy and Separate Life Policy

If Joint Life Policy appears in the Balance Sheet at surrender value, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000,. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

			₹	₹
(i)	Bank A/c	Dr.	1,00,000	
	To Joint Life Policy A/c			1,00,000
	(Policy value received from the insurance company on A's death)			
(ii)	Joint Life Policy A/c	Dr.	90,000	
	To A's Capital A/c			45,000
	To B's Capital A/c			27,000
	To C's Capital A/c			18,000

However, if joint life policy does not appear in the Balance Sheet, then entry (ii) is to be passed for ₹ 1,00,000 and it would appear as follows :

Joint Life Policy A/cs	Dr.	1,00,000	
To A's Capital A/c			50,000
To B's Capital A/c			30,000
To C's Capital A/c			20,000

In the event of death of a partner, the policy of the deceased partner will get mature and the firm will receive the assured value of the policy. In this case, the legal representative of the deceased partner is entitled to get the proportionate share of (a) assured value of the matured policy of the deceased partner (b) surrender values of other life policies of the remaining partners taken by the firm.

Bank A/c Dr. (Assured value)

To Separate Life Policy of Deceased partner A/c

(Policy value received on death of a partner)

Separate Life Policy of Deceased Partner A/c Dr. (Assured value)

Separate Life Policy of Remaining Partners A/c Dr (Surrender value)

To Executor's A/c (Total value distributed in profit sharing ratio)

To Remaining partners A/c (Total value distributed in profit sharing ratio)

(Being the total of assured value of deceased partner's life policy and surrender value of other partners' life policy(s) distributed in the profit and loss sharing ratio)

11. 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 whereby 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, 2014. The capitals of the partners, after all necessary adjustments stood at ₹ 50,000, ₹ 75,000 and ₹ 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, 2015. The profit made during the period of three months amounts to ₹ 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—₹ 28,000

C's share – $28{,}000 \times \frac{1{,}20{,}000}{2{,}45{,}000}$ = ₹ 13,714

(ii) Interest at 6% p.a.

$1{,}20{,}000 \times \frac{6}{100} \times \frac{3}{12}$ = ₹ 1,800

Since, (*i*) option is beneficial for C, he will necessarily go for his proportionate share in profits.

Illustration 14

Rohan, Sohan and Mohan were partners sharing profits and losses in the ratio of 2:2:1. Their Balance Sheet as on 1-1-2014 stood as follows :

Liabilities	*₹*	*₹*	*Assets*	*₹*
Capital Accounts :			*Fixed Assets*	*1,00,000*
Rohan	*50,000*		*Inventory*	*25,000*
Sohan	*40,000*		*Trade Receivable*	*35,000*
Mohan	*30,000*	*1,20,000*	*Cash and bank*	*10,000*
Reserves		*10,000*		
Trade Payables		*40,000*		
		1,70,000		*1,70,000*

On 1st July, 2014 Mohan died. His representatives agreed that :

(i) Goodwill of the firm be valued at ₹ 50,000;

(ii) Fixed Assets be written down by ₹ 10,000; and

(iii) In lieu of profits, Mohan should be paid at the rate of 25% per annum on his capital as on 1-1-2014.

Current years (2014) profit after charging depreciation of ₹ 9,500 (₹ 5,000 related to the 1st half) was ₹ 40,500. The year-end figures of Inventory, Trade receivables and Trade payables and Cash and Bank Balances were respectively ₹ 23,000, 19,000, 35,000 and 4,377. The particulars regarding their drawings are given below:

	Upto1-7-2014	*After 1-7-2014*
	₹	*₹*
Rohan	*4,125*	*5,000*
Sohan	*4,125*	*5,000*
Mohan	*1,750*	

Prepare the balance sheet of the firm as on 31st December, 2014 assuming, that final settlement to Mohan's executors was made on 31st December, 2014.

Solution

		₹
(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.* ₹
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 1-7-2014**

	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
				By Reserves	4,000	4,000	2,000
To Drawings	4,125	4,125	1,750	By Rohan &			
To Mohan	5,000	5,000	—	Sohan (goodwill adj.)	—	—	10,000
To Executor's A/c	–	–	42,000	By Profit and Loss			
To Balance c/d	49,000	39,000	–	Appn. A/c	8,125	8,125	3,750
	62,125	52,125	45,750		62,125	52,125	45,750

(f) **Application of Section 37 of the Partnership Act**

Either

(i) Interest of 42,000 $\times \frac{6}{100} \times \frac{6}{12}$ = ₹ 1,260

Or

(ii) Profit earned out of unsettled capital

$$20{,}500 \times \frac{42{,}000}{(49{,}000 + 39{,}000 + 42{,}000)} = ₹\ 6{,}623$$

(g) In the absence of specific agreement amongst partners on the above subject matter, the representatives of the deceased partner can receive at their option, interest at the rate of 6% p.a. or the share of profit earned for the amount due to the decease partner.

In the above case, it would be rational to assume that the representatives would opt for ₹ 6,623.

(h)

Profit and Loss Appropriation A/c for the second half

Dr.					*Cr.*
			₹		₹
To	Executors A/c		6,623	By Net Profit	20,500
To	Rohan	6,938			
	Sohan	6,939	13,877		
			20,500		20,500

(i)

Capital Accounts as on 31-12-2014

Dr.					*Cr.*
	Rohan	*Sohan*		*Rohan*	*Sohan*
	₹	₹		₹	₹
To Drawings	5,000	5,000	By Balance b/d	49,000	39,000
To Balance c/d	50,938	40,939	By Profit & Loss Appn. A/c	6,938	6,939
	55,938	45,939		55,938	45,939

(j)

Executors Account

Dr.			*Cr.*
	₹		₹
To Bank	48,623	By Mohan's Capital A/c	42,000
		By Profit & Loss Appn. A/c	6,623
	48,623		48,623

(k)

Balance Sheet as on 31-12-2014

Liabilities	₹	₹	*Assets*	₹	₹
Capital Accounts			Fixed Assets	1,00,000	
Rohan	50,938		*Less* : Written down	(10,000)	
Sohan	40,939	91,877		90,000	
Trade Payables		35,000	*Less* : Depreciation	(9,500)	80,500
			Trade Receivables		19,000
			Inventory		23,000
			Cash and Bank		4,377
		1,26,877			1,26,877

Summary

- **Partnership** is defined 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.
- **Two methods of accounting**
  - ✓ Fixed capital method
  - ✓ Fluctuating capital method.
- **Goodwill** is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.
- **Necessity for valuation of goodwill in a firm arises in the following cases:**
  - ✓ When the profit sharing ratio amongst the partners is changed;
  - ✓ When a new partner is admitted;
  - ✓ When a partner retires or dies, and
  - ✓ When the business is dissolved or sold.
- **Methods for valuation of goodwill**:-

  (1) Average profit basis :

  $$\text{Average Profit} = \frac{\text{Total profit}}{\text{Number of Years}}$$

  Goodwill = Average Profit x No. of Years' purchased

  The profits taken into consideration are adjusted with abnormal losses, abnormal gains, return on non-trade investments and errors.

  (2) Super profit basis :

  Calculate Capital Employed

Assets	…….
Less: Liability	…….
Capital Employed	……..

  - ✓ Find the normal Rate of Return(NRR)
  - ✓ Find Normal Profit=Capital Employed X Normal rate of Return
  - ✓ Find Average Actual Profit
  - ✓ Find Super Profit=Average Actual Profit-Normal Profit
  - ✓ Find Goodwill=Super Profit X Number of Years Purchased

  (3) Annuity basis :

  Goodwill=Super Profit x Annuity Number

  (4) Capitalization basis:

  $$\text{Goodwill} = \frac{\text{Super profit}}{\text{Normal Rate of Return}}$$

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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.
- Understand the outsourcing of accounting function

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. Now, we look 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. Fast, Powerful, Simple and Integrated: Computerized accounting is designed to automate and integrate all the business operations, such as sales, finance, purchase, inventory and manufacturing. With computerized accounting, accurate, up-to-date business information is literally at the fingertips. Computerized accounting has user-definable templates which provides fast, accurate data entry of the transactions.

   Computerized accounting has the ability to handle huge volumes of transactions without compromising on speed or efficiency.

2. Complete Visibility & Scalability: With Computerized accounting the company will have greater visibility into the day-to-day business operations and access to vital information. Computerized accounting adapts to the current and future needs of the business, irrespective of its size or style.

3. Customised: Computerized accounting allows the company to enter data in a variety of ways which makes work a pleasure. Adapting to the specific business needs is possible. Hence, a software can be tailor-made accordingly to the need of the business.

4. For quick decision making & improved Business Performance: Computerized accounting is a highly integrated application that transforms the business processes with its performance enhancing features which encompass accounting, inventory, reporting and statutory processes. This helps the company access information faster, and takes quicker decisions. Computerized accounting also guarantees real-time optimization of operations and enhanced communication.It generates real-time, comprehensive MIS reports and ensures access to complete and critical information, instantly.

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 have 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.

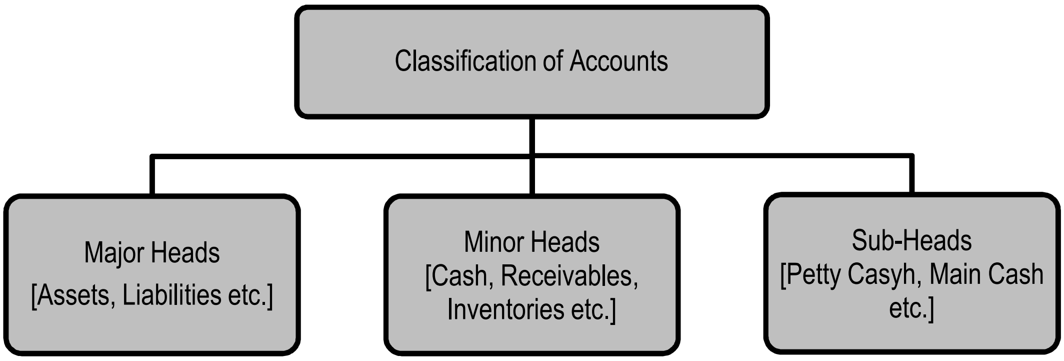
(a) The main unit of classification in accounts should be the major head which should be divided into minor heads, each of which should have a number of subordinate heads, generally shown as sub-heads. The sub-heads are further divided into detailed heads. Sometimes major heads may be divided into 'sub-major 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.


Classification of Accounts
Major Heads
[Assets, Liabilities etc.]
Minor Heads
[Cash, Receivables, Inventories etc.]
Sub-Heads
[Petty Casyh, Main Cash etc.]

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

Accounting software is an invaluable resource for modern business. Software allows detailed tracking of financial transactions and near instantaneous reporting and analysis.

Selection of the accounting software dependents upon the requirement of business. If you have small organization that makes only a few basic transactions a month—deposits, withdrawals and invoices, you can even use a spread sheet package like Microsoft Excel.

If your business is growing fast you should consider using pre-packaged accounting software like, Sage, Tally, or, FACT or any other billing software. At the higher end if you are in service industry or your business has some specific requirements which are not available in common pre-packaged software, you will have to go for customised accounting software.

Larger organisations go often for an ERP package where finance comes as module. An ERP is an integrated software package which manages the business process across the entire enterprise.

6.1 Spread Sheets

Account can be maintained in a computerised environment even by using a spread sheet package. 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.

Advantages of 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.

Disadvantages of a spreadsheet as an accounting tool are:

1. It has data limitations. Depending upon the package they can accept data only up to 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.

6.2 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 (customer master file) 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 prepackaged 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

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.

6.2.1 Advantages of Pre-Packaged Accounting Software

Pre-packaged Accounting Software has many advantages. The significant advantages are as follows:

1. ***Easy to install***: The CD or floppy disk is to be inserted and the setup file should be run to complete the installation.
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.
5. ***Flexibility:*** Certain flexibility of report formats provided by some of the softwares: 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.

6.2.2 Disadvantage of Pre-packaged Accounting Software

Some of the important Disadvantages of Pre-packed Accounting Software are as follows:

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.

6.2.3 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.

6.3 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.

6.3.1 Advantages of a Customised Accounting Package

Advantages of a customised accounting package are the following:

1. The functional areas which are not in pre-packaged software 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.

6.3.2 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.

7. Accounting Software as Part of Enterprise Resource Planning (ERP)

An ERP is an integrated software package that manages the business process across the entire enterprise.

7.1 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. ***No Redundancy*****:** Duplication of data entry is avoided as it is an integrated package.
4. **Better Information**: Greater information is available through the package.

7.2 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.

7.3 Choice of an ERP

Choice of an ERP depends upon the following factors:

1. ***Functional requirements 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.

8. 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.

8.1 Advantages of Outsourcing the Accounting Functions

The advantages of outsourcing the accounting functions are the following:

1. ***Saving of time:*** The organisation that outsources is able to save time to concentrate on the core area of business activity.
2. ***Utilisation of expertise of the third party: The*** organisation is able to utilise the expertise of the third party in undertaking the accounting work.
3. ***Data management by professional:*** Storage and maintenance of the data is in the hand of professional people.
4. ***Less dependence on key accounting positions:*** The organisation is not bothered about people leaving the organisation in key accounting positions.
5. ***Economical:*** The proposition often proves to be economically more sensible.

8.2 Disadvantages of Outsourcing the Accounting Functions

The disadvantages of outsourcing are as follows:

1. ***Lack of security & confidentiality:*** 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. ***High cost:*** 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.

8.3 Choice of outsourcing vendor

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.

9. Consideration for choice of different alternatives of accounting softwares

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 requirement:.*** 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.

10. 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 are 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.

Summary

Significance of computerised accounting:

- Increase the speed, Accuracy, Security
- Reduce the error
- Remove the duplicacy of work
- Immediate information

Accounting Package:

- Maintained by using a spread sheet package,
- Pre-Packaged Accounting Software
- Customised Accounting Software
- ERP

Role of Computer in accountancy:

- Controlling operations
- Deciding sequence of operations
- Accounting operations

Advantages of Pre-Packaged Accounting Software:

- Easy to install
- Relatively inexpensive
- Easy to use
- Backup procedure is simple
- Certain flexibility of report formats provided by some of the softwares
- Very effective for small and medium size businesses

Disadvantage of Pre-packaged Accounting Software:

- Does not cover peculiarities of specific business
- Does not cover all functional area
- Customisation may not be possible in most such softwares
- Reports generated is not sufficient or serve the purpose
- Lack of security
- Bugs in the software

Consideration for Selection of Pre-Packaged Accounting Software:

- Fulfilment of business requirements
- Completeness of reports
- Ease of use
- Cost
- Reputation of the vendor
- Regular updates

Customised Accounting Software: where the software is developed on the basis of requirement specifications provided by the organisation

ERP : Integrated software package manages the business process across the entire enterprise.

Advantages of ERP

- Standardised processes and procedures
- Standardised reporting
- Avoided Duplication of data entry
- Availability of Greater information

Disadvantages of an ERP

- Lesser flexibility
- Implementation hurdles
- Very expensive :
- Complexity of the software

Choice of an ERP:

- Functional requirement of the organisation
- Reports available in the ERP
- Background of the vendors
- Cost comparisons

Outsourcing of accounting function:

Accounting function done by the third party.

Advantages

- Time saving
- Use of the expert knowledge
- Maintenance of the data is in the hand of professional people
- Economically

Disadvantages

- The data of the organisation is handed over to a third party
- Inadequate services provided
- Higher cost
- Delay in obtaining services