VIDYA SAGAR®

CAREER INSTITUTE LIMITED

FUNDAMENTALS OF ACCOUNTING

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CHAPTER # 1

ACCOUNTING AN INTRODUCTION

Unit - 1.1
Meaning and Scope of Accounting

Every Individual or group of individuals, performs some kind of economic activity. Such economic Activities are performed through "Transaction and events"

Transaction:-

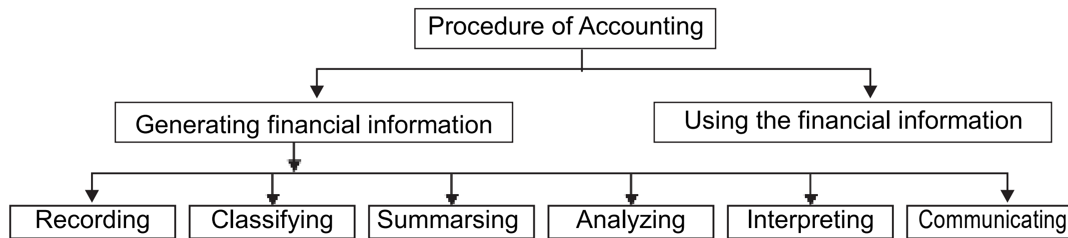
- A **transaction** is used to mean a Business, performance of an act, an agreement.
- A transaction is type of event which is generally external in nature and can be determined in terms of money.
- For e.g.
  - Started business with cash.
  - Rent paid
  - Salary received etc.

EVENT :-

- **Event** means a happing, as a consequence of transaction
  - A result or end result of transaction
  - for e.g. gross profit, net profit, closing stock etc.
- So every body wants to
- Keep records of all transactions and events and
- Io have adequate information about the economic activity as an aid to decision making.
- Accounting has universal application for recording transactions and events and presenting suitable information for decision making.
- The aim of accounting is to meet the information needs of the rational and sound decision makers.
  So it is called **Language of business.**

Meaning of Accounting :-

- The committee on terminology set up by the American institute of certified Public Accountants Formulated the following definition of accounting in **1961.**
  "Accounting is the Art of recording, classifying and Summarizing in a significant manner and in term of money, transactions and events which are in part at least of a financial character and interpreting the result there of"
- **According to above definition :**
  - Accounting is simply an art of record keeping
  - Process of accounting starts first identifying the transaction and events of financial character.
  - Recording is done in journal or subsidiary books known **as primary books.**
  - After recording in primary books transaction are transferred in secondary book, known as ledger,
  - In ledger transactions and events are classified in terms of income, exp. Assets and liabilities
  - Summarized in profit and loss a/c and balance sheet the above definition is not complete.
- So in modern world we can define "accounting as the process of recording, classifying, summarssing analyzing, and interpreting the financial transactions and communicating the results to the persons interested in such information".



Generating Financial Information:-

1. **Recording:-**
    a. **This is the basic function** of accounting.
    b. All business transaction of financial nature as evidenced by some documents as sales bill, passbook salary slip etc are Recorded in books of accounts.
    c. Recording is done in journal or in several subsidiary books.

2. **Classifying:-**
    a. Classification is concerned with systematic analysis of recorded data.
    b. Same nature transactions are put in one place so information in compact and usable from.
    c. Book Containing Classified Information is known as ledger

3. **Summarizing:-**
    a. It is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as external users of financial statement.
    b. This process leads to the preparation of the following financial statements.
        i. Trial balance
        ii. Profit and Loss account
        iii. Balance sheet
        iv. Cash flow statement

4. **Analyzing:-**
    a. It means methodical classification of the data given in the financial statements.
    b. Figures are put in simplified form.
    c. **It provides the basis for interpretation.**

5. **Interpreting:-**
    a. **This is the final function of accounting.**
    b. It is related with the explaining the meaning and significance of relationship as established by the analysis of accounting data.
    c. The recorded data are analysis and interpreting such a way which is useful for the end users of financial statement for sound decision making.

6. **Communicating:-**
    a. It is related with the transmission of summarized, analysed and interpreted information to the end user for sound and rational decision making.
    b. This is done through, **Preparation** and **distribution of accounting reports** which includes
    i. Profit & loss account
    ii. Balance sheet

iii. Additional information, inform of accounting ratios, graphs, diagram, fund flow statement etc.

Using the financial Information:-

There are following type of users of financial information.

1. Internal users
    a. Board of directors
    b. Partners
    c. Managers
    d. Officers
2. External users
    a. Investors
    b. Lenders
    c. suppliers
    d. Government agencies
    e. Customers
    f. Employees

Evolution of Accounting As a Social Science

i Stewardship accounting
- It is the first phase of accounting
- It is the Root of financial accounting
- It is the oldest form of Accounting
- Present system of Double entry system was developed in **15th Country**

ii Financial Accounting
- This is the second phase of accounting
- This is moulded by Law

iii Management Accounting
- This is the Third phase of Accounting
- To Aid in decision making to management

iv Social Responsibility Accounting
- It is in formative process
- It aim at accounting of social cost incurred by business and social benefit created by it.

Objective of Accounting

1. Systematic recording of transactions.
- Basic objective of Accounting is to systematically Recording of financial transaction.
- This step is called Book keeping
- These are then classified and summarized

2. Ascertainment of results
- Profit and Loss A/c is prepared for result of business operation

3. Ascertainment of financial position of business
- For this Balance sheet is prepared
- It is prepared at particular point of time (as on)
- It is a statement of Assets, Liabilities and Capital

4. Provide information to the users for rational decision making
- It provide information for sound Decisions making

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5. **To know the solvency position.**
   - **Balance sheet Disclose**
     Liquidity position: enterprises Ability to meet its Liability in the short Run
     Solvency position: Enterprises ability to meat its long term Liabilities in long Run.

Function of Accounting:-

a. **Measurement**
   - It measures past performance and financial position

b. **Forecasting**
   - Help in forecasting of future performance and financial position

c. **Decision making**
   - It provide information for decision making

d. **Comparison and evaluation**
   - Comparison from targets can be made to know about deviations

e. **Control**
   - Provide information for control

f. **Government regulation and Taxation**
   - Necessary information to government .

Book keeping:-

- Book keeping is an activity related with the recording of financial data relating to the business operation in a significant and orderly manner.
- It provides base for accounting.
- Financial statements do not form part of book keeping.
- It includes upto preparation of trial balance.
- Financial position of firm cannot be judged through book keeping.
- Management decisions cannot be taken with the help of book keeping.
- Working in book-keeping is clerical in nature.
- **There is no subfield of book keeping**
- Accounting starts where book keeping ends.

Objective of book keeping:-

- Complete and permanent record of all transaction in a systematic and logical manner.
- Ascertainment of financial effect on business.

Distinction between book keeping and accounting.

S.No.	Book-Keeping	Accounting
1.	It is a process concerned with recording of transactions	It is a process concerned with summarising of the recorded transactions
2.	It constitutes as a base for accounting	It is considered as a language of the business.
3.	Financial statements do not form part of this process	Financial statements are prepared in this process on the basis of book-keeping records.
4.	Managerial decisions cannot be taken with the help of these records	Management takes decisions on the basis of these records
5.	There is no sub-field of book-keeping	It has several sub-field like financial accounting, management accounting etc.

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6.	Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the accounting reports.

Subfield of accounting

1. **Financial accounting**
   - It deals with historical transaction
   - Final result is preparation of profit & Loss A/c and Balance sheet
2. **Management accounting**
   - Concerned with internal Reporting to the managers
3. **Cost accounting**
   - **It is a component of management accounting**
   - It deals with cost ascertainment and cost control
4. **Social responsibility accounting**
   - Accounting for social cost benefits
5. **Human resource accounting**
   - It records investment in human resources

Limitation of Accounting

1. **Non monetary transactions cannot be recorded** although they are very important e.g. loyalty of employee, quality of product, good relationship with customers.
2. Balance sheet show the financial position at particular date only, so it is not useful for decision makers as they want information in near future. To overcome this problem auditors disclose the events occurring after the balance sheet date but before approval of financial statements in the financial reports.
3. It does not consider inflation effect
4. Many occasions accounting principals conflict with each other.
5. Different accounting policies can be adopted for valuation of inventory, deprecation etc.
6. Accounting estimats depend on some personal judgement.

Role of accountant in the society:-

The following are the area of service.

1. Maintenance of books of accounts
2. Statutory audit
3. Internal audit
4. Taxation
5. Management accounting and consultancy service
6. Financial advice

Other Services

a. Secretarial work
b. Share registration work
c. Company formation
d. Receiverships, liquidations etc.
e. Arbitrations
f. As regards cost accountants
g. Accountant and information service

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Unit - 1.2
Accounting Concepts, Principal And Conventions

Introduction

- Accounting is a language of business.
- Financial statements prepared by the accountants communicate financial information for decision making.
- The term **'(GAAPs)'** is used to describe rules developed for preparation of financial statement and are called concepts, conventions, Postulates, principals etc.
- (GAAPs) are back bone of the accounting information system.
- **Purpose of (GAAPs):** To avoid confusion and achieve uniformity
- These conceptual frame works, (GAAPs) and accounting standards are considered as the theory base of accounting.

Accounting Concepts :-

- **Accounting concepts are:**
- Assumptions on the basis of which financial statements of a business entity are prepared.
- Concepts means **ideas or notion, which has universal application.**
- The accounting concepts lay the foundation on the basis of which the accounting principals are formulated

Accounting Principals:-

- **Body of doctrines commonly** associated with the theory and procedures of accounting.
- These principal are based on concepts.
- It is associated with explanation of current practice and as a guide for selection of conventions or proceedings where alternative exists

Accounting Conventions:-

- Convention are derived by usage and practice.
- Accounting conventions need not have universal applications.
- It emergs from accounting principals
- Accounting bodies of the world may change conventions to improve the quality of accounting information

Concepts, principles and conventions- an overview

1. **Entity concept**
   a. This concept is from accounting point of view, not from legal point of view.
   b. Business and owner both are different/separate identify.
   c. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of account.
   d. Because of this concept owner of business for his capital in the business treated as:
      i. Liability of business
      ii. Creditor of business
   e. Personal expenses of owner is treated as drawings in the business, not as a business expenses
   f. Interest of drawings is charged because of this concept.
   g. This concept is applied to all form of business like proprietorship, partnership and corporates

2. **Money Measurement Concept**
   a. Money is the medium of exchange and the standard of economic value.
   b. Transaction and events that expressed in term of money can only be recorded in the business books.
   c. Measurement unit for money is taken as the currency of the ruling country.(Rupee for India)
   d. Foreign currency is not considered as money.
   e. **Translations:**

Quantative : Not recorded
Qualitative : Not recorded
Monatery : Recorded

f. **Entity and money measurement are viewed as the basic concepts on which other procedural concepts hinge**

3. **Periodicity Concept:-**

- This is also called concepts of definite accounting period.
- According to this concept accounts should be prepared after every period and not at the end of the life of the entity.
- One year period is taken for performance measurement and appraisal of financial position, however it may also be 6 month or 9 month or 15 month.
- This concept facilitates in:
  - Comparing of financial statements of different periods.
  - Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
  - Matching periodic revenues with expenses for getting correct results of the business operations
- This concept makes the accounting system workable and the term accrual meaningful.
- Accrued revenue and accrued cost is due to this concept.

4. **Accrual Concept:-**

a. Transactions and other events are recognized on mercantile basis.
b. Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid.
c. As per accrual concept = revenue- expenses = profit.
d. Accrual concept provides the foundation on which the structure of present day accounting has developed.
e. Accured concept relates to measurement of income, Identifying assets and Liabilities

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5. **Matching Concept:-**

- This concept is based on accrual concept.
- According to this concept all expenses should be matched with the revenue of that period.
- In financial statements if any revenue is recognized then expenses related to earn that revenue should also be recognized.
- This concepts leads to adjustment of certain items like prepaid and outstanding expenses, unearned and accrued incomes.
- Some expenses are directly related with revenue and some expenses are time bound like rent, etc.
- Periodicity concept has also been followed while applying matching concept
- **Accrual, matching and periodcity concepts work together for income measurement and recognition of assets and liabilities**
- Effect:-
  - Prepaid expenses carry forward next year
  - Outstanding expenses shown in current profit & loss account although it is not paid.
  - Cost of closing stock carried over to next year as revenue of these goods, will be realized next year.

6. **Going Concern Concept:-**

- According to this concept business will continue in operation for the foreseeable future:-
- Financial statements are normally prepared on this assumption.
- It is assumed that enterprise has neither the intention nor the need to liquidate in near future.
- **The valuation of assets** of a business entirely depend on this assumption.

- Fixed assets are recorded at historical cost less depreciation till the date.
- If the business in intended to be closed shortly, fixed assets will be recognized at net relisable value.
- Prepaid expenses are shown in current year's balance sheet even these are basis for future.
- Outstanding expenses shown in current year's balance even not paid.
- As per this concept increase/decrease in the value of assets in shortrun is ignored.

7. <u>Cost Concept:-</u>

- According to this concept the value of an asset is to be determined on the basis of Historical as or Acquisition cost.
- Change in the market value of the assets afterward will not be considered.
- The concept is highly objective and free from all bias other measurement bases are not so objective.
- **This concepts have following limitations.**
    - In inflationary situation acquisition cost loses it's relevance
    - Historical cost based accounts may lose comparability.
    - Many assets do not have acquisition cost for e.g. Human assets.
    - In many cases cost concepts not followed for example conservative concept.

8. <u>Realization Concept:-</u>

- It closely follow the cost concept
- Any changes in the value an asset is to be recorded only when the business realizes it.
- If there is decrease in the value of asset then it should be considered.
- If there is any change in value is of permanent Nature it can be adjusted through creation of capital reserve.
- At thus **going concern, cost concept** and **realization concept gives the valuation criteria.**

9. <u>Dual Aspect concept:-</u>

- This concept is the core of double entry book keeping.
- According to this concept every transaction and event has two aspects.
- One is debited and other is credited.
- On the basis of this concept accounting equation is developed

    Assets = Capital (Equity) + Liabilities

    Or

    Capital (Equity) = Assets - Liabilities

    Equity+Long term Liabilities +Current Liabilities=Fixed Assets+Current Assets

    Equity+Long term Liabilities=fixed Assets+(Current Assets-Current Liabilities)

    Equity= fixed Assets +working capital -Long term Liabilities

    Capital +Income-Expenses +Net Profit =Assets - Liabilities

10. <u>Conservatism:-</u>

- According to this concept business should estimate profit on conservative basis.
- All anticipated losses should be recorded in the books of accounts.
- Anticipates and unrealized gain should be ignored.
- When there are many alternative value of an assets than accountant should choose the method which gives lesser value.
- On this concept golden role of current assets valuation “cost or market price” which ever is lower is based.
- This principle results in understatement of profits and assets and over statement of liabilities.
- **It creates secret reserves** in the balance sheet according to this concept.
- Closing stock is valued cost price or NRV whichever is less.
- Provision for bad debts, discount and estimated future liabilities is made.

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- No provision for discount on creditors is made.

  Example:-
  - Writing of 100% depreciation on Books or calculater etc. in the year of purchase
  - Stationary purchase but not fully consumed in current year but not carry forward.
- For this concepts there should be atleast three qualitative values
  - **Prudence:** Possible Loss to provide & ignore of future gains
  - **Neutrality:** unbised about possible Losses & uncertain gains
  - **Faithful representation** of alternative values.

11. <u>Consistency:-</u>

- According to this concept accounting policies adopted should be followed consistently form one period to another period.
- Due to this concept financial statements become **comparable through time.**
- If different accounting policies are followed by various organizations then results cannot be compared.
- **Accounting policies can be changed due to:**
  - To prepare financial statement according to accounting standards.
  - To company with law
  - For better presentation of financial statements.

12. <u>Materiality:-</u>

- This concept is exception of full disclosure concept.
- According to this concept only those facts should be disclosed in the financial statements which may effect the decision of users of the financial statement.
- Items have significant economic effect on business should be disclosed.
- Insignificant items which only increase the work of accountant and not relevant to the users should not be disclosed.
- However terms materiality is subjective form
- The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information level of the person making the decision etc.
- An item may be material for one person and can be immaterial for another person.
- **Example:**

  i Writing off 100% depreciation on books or calculator etc. in year of purchase.

  ii Stationary purchase but not fully consumed in current year and also not carry forward.

Fundamental Accounting Assumptions

- There are three :

  Going concern

  Consistency

  Accrual
- It is assumed that these are followed in preparation of financial statements.
- **If these are followed:** No disclosure is required
- **If these are not followed:** This fact should be specially disclosed.

<u>Qualitative Characteristics of Financial statements</u>

Meaning: These are the attributes that make the information provided in financial statement useful

<u>UnderStandability:-</u>

- Financial statements should be understandable by users.
- It is assumed that users have reasonable knowledge of business and economic activities.

Relevance:-

- Information provided in financial statements should be relevant for decision making for the user.
- Information regarding financial position and past performance should be in financial statements.
- Unusual, abnormal, infrequent item of income and expenses to be disclosed separately.

Reliability:-

- Information should be reliable and useful for decision makers in decision making.
- Information should be free from material error and bias.
- If information are not reliable then sound decision cannot be taken.

Comparability:-

- Users should be able to compare the financial statements of an enterprise through time in order to identify accounts, In it's financial position, performance and cash flow.

Materiality:-

- The relevance of information is affected by it's materiality.
- Information is material if it's misstatement could influence the economic decision of users taken on the basis of financial information.
- All material information should be disclosed.
- Materiality depends on the nature and size of the item or error in the particular circumstances.

FaithFull representation:-

- To be reliable the information, must be represent faithfully.
- With the help of information users should be able to judge financial position and profitability of firm.

Substance over form:-

- The information should be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. eg.

  Where rights and beneficial interest in an immovable property are transferred but the documentation and legal formality is pending. It's substance is that transaction completed.

Neutrality:-

- Reliable information disclosed in financial statements should be reliable that is free from bias.
- If information's are not netrual than sound decision cannot be taken by users.

Prudence:-

- Uncertainties should be disclosed in the financial statement.
- Their nature and extent may occur should also be disclosed.

Full, fair and adequate disclosure:-

- Financial statement should disclose all the reliable and relevant information about the enterprise.
- Disclosure should be full and final so that management and external users can correctly access the financial position of the firm.

Completeness:-

- All information in financial statements should be complete so that users can place reliability on the information.

Note:

i **Four principal qualitative characteristics are:**
understandability
Relevence
Reliability
Comparability

ii **Two principal qualitative characteristics are:**
Relevence
Realibility

Unit - 1.3
Accounting Standards: Concepts, Objective, Benefits

Introduction:-

- Accounting is a language of business.
- It communicates the financial result of a concern to the various users by means of financial statements.
- If financial accounting process is not property regulated then, financial statement will be misleading they will not show true and fair information.
- So it is essential **to standardize the accounting principles and policies.**
- Accounting standards **provide frame work and standard accounting policies so** that the financial statements of different enterprises become **comparable.**
- Purpose : To ensure transparency, consistency, comparability, adequacy and reliability of financial reporting

Concepts:-

- Accounting standards are **written policy documents** issued by expert accounting body or by government or other regulatory body
- In India accounting standards are issued by ICAI.
- So accounting standards deal with the issue of:-
  - **Recognition** of event and transactions in the financial statements.
  - **Measurement** of the transactions and events.
  - **Presentation** of these transaction and events in the financial statements in a manner that is meaningful and understandable to the reader.
  - **Disclosure** requirements of various users so that they may take rational decision.

Objective:-

The objective of accounting standards are:

- Harmonisation of accounting polices and practice followed by different business entity
- Eliminate the non comparability of financial statements.
- Improve the reliability of financial statements
- Provide a set of standard accounting policies; valuation norms and disclosure requirement.
- Accounting standard reduce the accounting alternative in the preparation of financial statements.
- Standardise diverse Accounting policies.

Benefits:-

- As seek to describe the accounting principles, the valuation techniques and methods of applying the accounting principles in the preparation and presentation of financial statements so that may give true and fair view.
- The main benefits of Accounting standards :
  - It reduce confusing variation in the accounting treatments used to prepare financial statements
  - Some information's are not required by law. To disclose standards **May call for disclosure beyond that required by law.**
  - Financial statements become comparable.

Limitations:-

- There may be trend towards rigidity.
- Accounting standards cannot override the statue.
- The choice between different alternative accounting treatment is difficult.

Tutorial note

- In Indian accounting standards are issued by institute of chartered accountants of India.
- For this purpose Accounting standard board (ASB) set up on 21st April 1977
- The main function of ASB is formulate accounting standard so that council of ICAI can established **AS**

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Total 32 as has been issued by ICAI

- out of which AS-8 on Accounting for research and Development has been with drawn due to issue of AS-26 on "intangible assets"
- Thus effectively there are 31 AS is at present

List of Accounting Standards

Sl.No.	Number of the Accounting Standard (AS)	TITLE OF THE ACCOUNTING STANDARD
1	As 1	Disclosure of Accounting policies
2	As 2(Revised)	Valuation of Inventories
3	As 3 (Revised)	Cash Flow Statements
4	As 4(Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5	As 5 (Revised)	Net profit of Loss for the period, prior period items and changes in Accounting policies
6	As 6(Revised)	Depreciation Accounting
7	As 7(Revised)	Accounting for Construction Contracts
8	As 8 (Withdrawn pursuant to As 26 becoming mandatory)	Accounting for Research and development
9	As 9	Revenue Recognition
10	As 10	Accounting for Fixed Assets
11	As 11(Revised)	The Effects of Changes in Foreign Exchange Rates
12	As 12	Accounting for Government Grants
13	As 13	Accounting for Investment
14	As 14	Accounting for Amalgamations
15	As 15 (Revised)	Employees Benefits
16	As 16	Borrowing Costs
17	As 17	Segment Reporting
18	As 18	Related Party Disclosures
19	As 19	Leases
20	As 20	Earnings per Share
21	As 21	Consolidated Financial Statements
22	As 22	Accounting for Taxes on Income
23	As 23	Accounting for Investments in Associates in Consolidated Financial Statements
24	As 24	Discontinuing Operations
25	As 25	Interim Financial Reporting
26	As 26	Intangible Assets
27	As 27	Financial Reporting of Interests in Joint Ventures
28	As 28	Impairment of Assets
29	As 29	Provisions, Contingent Liabilities & Contingent Assets
30	As 30	Financial Instruments : Recognition & Measurement
31	As 31	Financial Instruments: Presentation
32	As 32	Financial Instruments : Disclosures

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Unit - 1.4
Accounting Polices

- Accounting policy means: specific accounting principles and methods of applying these principles
- Accounting polices are based on various accounting concepts, principles and conventions.
- There is no single list of accounting polices which are applicable for all enterprises in all situations
- Different Enterprises adopts different Accounting policies
- Reason is that enterprises are operated in diverse and complex business environment so they have to adopt various policies.
- ICAI has been trying to reduce the number. of acceptable accounting policies through: **guidance notes and accounting standards.**

Following are the areas where different accounting policies can be adopted.

- Valuation of inventories
- Treatment of goodwill
- Valuation of investment
- Valuation of fixed assets
- Methods of depreciation, depletion and amortization.

  A selection of an inappropriate accounting policy decision may under state/over state the performance and financial position.

Selection of Accounting Policies:-

- Accounting policies are selected on the following basis.
  - Prudence
  - Substance over form
  - Materiality
- Selection of Accounting policy is the responsibility of management.

  For e.g. :- Finished goods are valued at cost or market prince which ever is lower as per prudence.

Policy for Valuation

i **Raw Material:** At cost, but if possibility of loss on finished goods is there then at lower value.

ii **By products:** At Net realisable value

iii **Finished goods:** At cost or Net Realisable value which ever is lower

iv **Long term investment** are valued at their acquisition cost but provision is made when there is permanent diminution in the value.

Change in Accounting policy:-

- Accounting policies ones selected should be used uniformly over year to year but in the following cases. It can be changed.
  - (i) To comply with law
  - (ii) To comply with accounting standard
  - (iii) To ensure that change would result in more appropriate presentation of financial statements.
- Effect of change in policy should be quantified and disclosed in financial statements.

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Unit 1.5
Accounting as a Measurement Discipline
Valuation Principles, Accounting Estimates

- Measurement is vital aspect of accounting
- Accounting can be treated as a measurement discipline
- Three elements of measurement are:-
  - Identification of object and events to be measured.
  - Selection of standard of scale to be used
  - Evaluation of dimension of measurement standard or scale.

Note:

i Money is the scale of measurement

ii It takes the shape of currency ruling in a country. i.e. Rupee in India

iii Although qualitative information are also given but such information are supplementary in nature

iv An ideal measurement of scale should be stable over time.

v Money as a measurement scale is not stable because its value changes.

Valuation Principal

- In Accounting there are four Measurement bases or valuation principal at which an asset or liability should be recorded in the books:-

1. **Historical cost or Acquisition Cost:-** According to this base-
   a. Assets are recorded at an amount:-
      i. Which is paid to acquire the asset or
      ii. In case any non-monatery consideration is given to acquire the asset, the fair value of the consideration given.
   b. Liabilities are recorded at the amount:-
      i. Which is received in exchange of obligation or
      ii. In some circumstances at the amount which is expected to be paid to satisfy the debt in the normal course of business.

2. **Current Cost:-** According to the base:-
   a. Assets are carried at the amount that would be paid, if the same or an equivalent asset is acquired currently and
   b. Liabilities are carried at the amount that would be required to settle the obligation currently.
   c. Current cost gives an Alternative measurement base.

3. **Realisable Value:- According to this base**
   a. Assets are carried at the amount that would be currently obtained by selling the assets in the ordinary course of business ie in an orderly disposal.
   b. Liabilities are carried at the amount that would be required to settle the obligation in the ordinary course of business.

4. **Present Value:- According to this base:-**
   a. Assets are carried at the present value of future net cash inflow, which is expected to be received form that assets in the ordinary course of business and
   b. Liabilities are carried at the present value of future net cash outflows that are expected to be required to settle the obligation in the ordinary course of business.

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Note: Economists often use **ordinal scale** to indicate the level of satisfaction. But accountants uses only cardinal scale.

Accounting Estimates:-

- The measurement of certain assets and liabilities is based on estimate of uncertain future events.
- The estimation process involves judgment based on the latest information available.
- An estimate may require revision if changes occur regarding circumstances on which the estimate was based.
- Changes in accounting estimate means difference arises between certain parameters estimated earlier and re-estimated during the current period or actual achieved during the current period.
  - Examples:-
    - Doubtful debts
    - Useful life of depreciable assets
    - Residual value
    - Accruals, Provisions
    - Employers Benefit obligations

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CHAPTER # 2
ACCOUNTING PROCESS

Unit - 2.1
BASICS ACCOUNTING PROCEDURES - JOURNAL ENTRIES

- **Double entry system** of book keeping is only scientific system of Accounting.
- **In double entry system**: each transaction has two fold aspects Debit and Credit, both aspects are recorded in the books of accounts.

Advantage of Double entry System
- By this system **accuracy of accounting** work can be established through a device, Which is known as Trial balance.
- **Profit and loss** earned during the period can be ascertained with details
- **Financial position** of a firm at the end of each period can be ascertained by preparing Balance Sheet
- In this system as much required details can be kept in Accounts so important **information for control** can be seen.
- Results of one year may be compared with previous years and reasons of changes can be ascertained.

Transactions
- Transaction are recorded in the system of book keeping.
- A transaction is a type of event which can be determined in term of money and generally external in nature.
- **"End result by a transaction is known an event"**
- A transaction is a two way process in which value is transferred from one party to another.
- In transaction either a party receives a value in terms of goods etc. And passes the value in term of money.
- So every transaction should be recorded and they must be supported by substantial documents like purchase invoice bills, pay slips, cash memo, pass book etc.

To analysis the dual aspect of each transaction two approaches can be followed.

1. **Accounting Equation Approach**

- If the relationship of assets with that of liabilities and owner's equity is shown in the equation form that is known as "Accounting Equation"

  The Basic Accounting Equation is

  Assets = Equity + Liabilities

  Equity Capital = Assets- Liabilities

  Or

  Fixed Assets + Current Assets- Current Liabilities = Equity + Long term liabilities

  it is also known as Capital employed.

- So it is tradition that

  Increase in assets are recorded on the left hand side and decrease on the right hand side.

  Increase in liabilities and capital is recorded on right hand side and decrease in left hand side.

- **From the above following rules can be obtained.**
  - Debit if there is increase in amount of assets and credit if there is decrease.
  - Credit if there is increase in amount of liabilities and debit if there is decrease.
  - Income in owner's capital should be credited in capital A/c.
  - Profit will increase the capital so it will be credited directly in capital a/c.
  - Loss will reduce capital so it will be debited in capital a/c.

- Expenses and Losses are debited since it reduce capital.
- An increase in owner's capital is recorded by crediting capital a/c and reduction or withdrawal of capital will be recorded by debiting capital a/c.

(2) **Traditional Approach**

Under this approach transaction are classified in three groups

(a) Personal Accounts :-

- Personal accounts are related to persons, debtors and creditors.
- For example Ram & Co. , Capital A/c of Proprietor, also personal but adjustment on a/c of profit or loss are made in it.

Personal account can be further classified as.

(i) **Natural Personal A/c :-**

- Related with natural persons for example Ram, salim, etc.

(ii) **Artificial (Legal) Personal Accounts:-**

- Accounts related to government , companies (Private or limited), clubs, societies etc,
- Because business entities are treated as separate entity.
- They are recognised as person in the eye of law dealing with other persons.

(iii) **Representative Personal Accounts:-**

- These are not in the name of any person or organisation but are represented as personal accounts
- For example outstanding liabilities, prepaid a/c, capital a/c , Drawings A/c.

Note: Any nominal a/c to be shown in balance sheet become representative personal A/c

(b) Impersonal Accounts:-

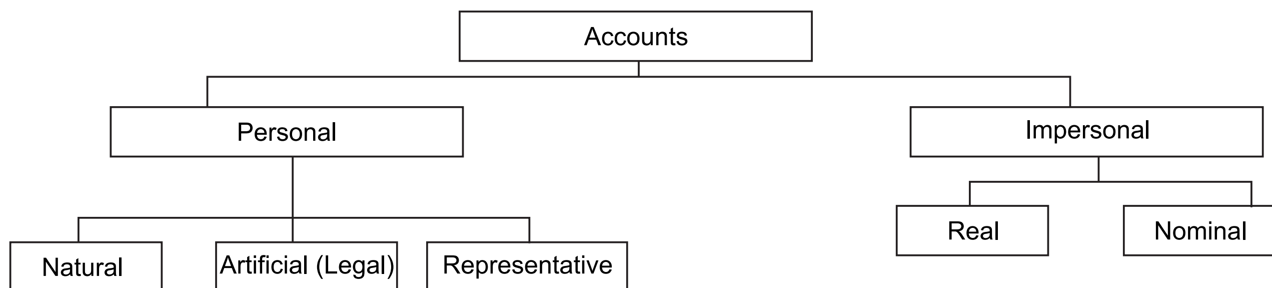
Accounts which are not personal in nature is known as impersonal account it ca be further classified

(i) **Real Accounts:-**

- Accounts related the assets of firm but not debt are real accounts
- For example land and building a/c, investment a/c, fixed deposit a/c, cash in hand and cash at bank.
- Bank is personal a/c but cash at bank is real a/c.

(ii) **Nominal Account:-**

- Accounts related to the expenses, losses, revenue and gain are nominal accounts.
- The net result of nominal accounts is known as profit or loss which is transferred in capital a/c.
- These accounts are temporary in nature



Nature of Account

Sl.No.	Title of Account	Traditional Approach
(a)	Building	Real
(b)	Purchase	Real
(c)	Cash	Real
(d)	Closing Stock	Real
(e)	Investment	Real
(f)	Bank Deposit	Personal
(g)	Rent Outstanding	Personal
(h)	Debtors	Personal
(i)	Sale Tax Payable	Personal
(j)	Capital	Personal
(k)	Drawings	Personal
(l)	Interest receivable	Personal
(m)	Rent received in advance	Personal
(n)	Prepaid Salary	Personal
(o)	Sales	Nominal (Revenue)
(p)	Rent	Nominal (Expense)
(q)	Depreciation	Nominal (Expense)
(r)	Adjusted Purchase	Nominal (Expense)
(s)	Discount Allowed	Nominal (Expense)
(t)	Bad Debts	Nominal (Expense)
(u)	Personal Income Tax	Personal (Drawing)
(v)	Bad debts recovered	Nominal (Gain)
(w)	Provision for Depreciation	Valuation (Real)
(x)	Stock reserve	Valuation (Real)
(y)	Provision for discount on creditors	Valuation (Personal)
(z)	Provision for bad and doubtful debts	Valuation (Personal)

Golden Rules of Accounting

1. **For Personal Accounts**

   Debit the receiver

   Credit the giver

2. **For Real Accounts**

   Debit what comes in

   Credit what goes out

3. **For Nominal Accounts**

   Debit all expenses & Losses

   Credit all incomes & gains.

Journal

- Journal is the first phase of accounting process

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- Transactions are first entered in this book.
- This is also known as **primary book of recording** transaction
- It is also called **subsidiary book**.
- Transaction of financial nature are recorded in Journal in **chronological order**
- There are 5 columes in journal

Performa

Date	Particulars	L.F Rs.	Debit Amount Rs.	Credit Amount Rs.
(1)	(2)	(3)	(4)	(5)

Advantage of Journal

- Complete information regarding business transaction can be obtained on time basis as there are recorded on chronological order.
- Entries are supported by narrations so one can properly and understand the transaction.
- It provides base for posting entries in ledger.

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Unit - 2.2
LEDGER

- Ledger is the second phase of accounting process.
- After recording the transaction in the Journal recorded entries are classified and grouped into by preparation of accounts.
- Book which contain all set of accounts is known as ledger.
- Ledger contains all type of accounts (Personal, Real, Nominal)
- **Ledger is known as principal book of accounts**
- By ledger account wise balance of each account can be determined
- A ledger account has two sides debit (left part) and Credit (right part)
- There are eight coloumn in Ledger, 4 column in debit side and 4 coloumn in credit side

Account

Debit Credit

Date	Particulars	L.F	Amount	Date	Particulars	L.F	Amount

Posting
- Process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.
- The word "To" is used with items written debit side in particulars column of account and word "By" is used with item written credit side in accounts.

  The word "To" represents debit and "By" represents credit

Balancing an account
- I t is necessary to ascertain the balance in an account.
- Balance can be ascertained at the end of each month or year or any particular day
- Difference of total of debit side and credit side of an account is known as balance of that account
- If debit side is bigger than it is called debit balance and difference is written in credit side as **"By balance C/d"**
- C/d means carried down
- Nominal accounts are not balanced.
- The balance of nominal accounts are transferred to the P&L a/c at the end.
- Only personal and real accounts shows balance
- Capital account is adjusted for profit and loss for the year.
- The technique of balance of each a/c is known as balancing an account.
- It credit side is bigger, it is called credit balance and difference is written in debit side as "To balance c/d.
- These balances will be carried forward to new period as opening balance as under.
  - Credit balance will be written on credit side as "By balance B/d"
  - Debit balance will be written on debit side as "To balance B/d" b/d means Brought down.
- L.F. in Journal and J.F. in ledger is entered at the time of posting.

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Unit - 2.3

TRIAL BALANCE

- Preparation of trial balance is the third phase in the accounting process.
- Trail balance is **a statement** which shows the balance of all accounts in the **ledger and cash and bank balance.**
- It is prepared with the ledger accounts
- Trial balance is a statement not an account
- Trial balance is prepared on particular date not for particular period .
- It can be prepared weekly, monthly, half, yearly or anytime.
- But it's preferable to prepare trial balance at the end of accounting year.
- To ensure the arithmetic accuracy of accounts
- The object of preparation of trial balance is to check arithmetical accuracy of accounting work.
- If two sides of trial balance is agreed it indicates **reasonable accuracy** of the accounting work.
- If two sides do not agree than there is simply an arithmetic errors.
- Trial balance has 5 columns

Objectives of preparing Trail Balance

- Trial balance helps to establish arithmetical accuracy of the books.
- Financial statements are normally prepared on the basis of agreed trial balance.
- Trial balance provide as a summary of ledger accounts. Ledger may be seen when details of particular account is required.

Performa

S.No.	Ledger Accounts	L.F	Dr.	Cr.
			(Total/Balance) Rs.	(Total/Balance) Rs.

Limitations of Trail Balance

- Trial balance is not a conclusive proof of accuracy.
- After agreeing trial balance some error may remain which are
    - Complete transaction is not entered in Journal
    - Wrong amount is written in both columns of the Journal
    - Wrong account has been mentioned in the Journal
    - An entry has not at all been posted in the ledger
    - Entry is twice posted in the Ledger
- Although above limitations preparation of Trial balance is useful otherwise it is difficult to prepare financial statement i.e Profit & Loss a/c and balance sheet

Methods of preparation of Trail Balance

1. **Total Method:-**
    - Under this method total of debit and credit of each ledger account is transferred to trial balance.
    - Trial balance can be prepared as soon as ledger accounts are totalled
    - Time of balancing ledger accounts can be saved. Balance can be found in the trial balance itself.
    - This method is not used commonly because it is not helpful in the preparation of financial statements

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2. **Balance Method:-**

- Under this method every ledger account is balanced
- Balancing of each ledger account is carry forwarded in trial balance
- **This method is commonly used by accountants because it helps in preparation of financial statements**
- Financial statements are prepared on the basis of the balance of the ledger accounts

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Unit - 2.4
SUBSIDIARY BOOKS

- In business a separate register for each class of transactions like receipts of cash, payments of cash, purchase of goods and sale of goods is maintained.
- Such type of register is called a book of original entry or of prime entry or also called subsidiary books.
- Then no need of journal entry for such transactions recorded in separate register.
- The system by which transactions of a class are first recorded and on basis ledger accounts are prepared is known as practical system of book keeping or even English system.
- In the system there is no departure from double entry system.
- These books of original or prime entry are also called subsidiary books, since Ledger accounts are prepared on their basis.

<u>Types of subsidiary Book :-</u>

Cash Book:- To record receipts and payments of cash and Bank.

Purchase Book:- To record all credit purchase of goods which is sold or used for manufacturing and stores required in the factory.

Purchase Return Book:- To record the returns of goods and material.(Only credit)

Sale Book:- To record sale of goods (Credit) by firm.

Sales Return Book:- To record the returns made by the customers. (Only credit)

Bills Receivable Book:- To record the receipts of promissory notes or hundies.

Bill Payable Book:- To record issue of the promissory notes or hundies.

Journal proper:- Transactions which can not be recorded in any of the above seven books is recorded in this book.

Note:-" Word Journal" may be used for all subsidiary books instead using books"

<u>Advantages of subsidiary Books:-</u>

1. **Division of work:-** Accounting work may be divided amongst a number of clerks.
2. **Specialization and Efficiency:-** A person do only some work and acquire specialization.
3. **Saving of the time:-** Due to specialization in same work, time consume less than others.
4. **Availability of information:-** For every transaction separate register is maintained, information will be available at one place.
5. **Facility in checking:-** Subsidiary books also helps to cheek error and even commission of error and frauds.

<u>Subsidiary Books and primary Books:-</u>

- Books in which transactions are first recorded for enable to ledger posting are called subsidiary books.
- Ledger and cash book are the principle books since they furnish information for preparation of the trial balance and financial statements.
- Ledger and cash Book is principal book.
- **Only subsidiary Books :** Purchase book, Sales book, Purchase return book, Sales return book, Bills receivable book, Bills payable book, Journal proper.
- **Only principal Book:** Ledger
- **Both subsidiary book and principal book: Cash book**

Note: Petty cash book is only subsidiary books not a principal book.

<u>Purchase Books or Purchase journal:-</u>

- To record the credit purchase of
  - * goods dealt in or

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* material and stores used in the factory

- Cash purchases not entered since these will be entered in the cash book.
- Credit purchase of things other than goods or materials like fixed assets are not entered, because they are entered in journal proper.
- Total of the amount column shows total purchase.
- Amount of purchase in purchase coloumn: purchase +packing +other charges -trade discount.
- Their accounts have to be credited for the respective amounts shown in the purchase book.
- The total of amount column shows the total purchase.
- The amount is debited to the purchase account to indicate receipt of goods.

Sale Book:-

- It records only credit sales of goods dealt in by firms.
- Cash sale not entered in sale book, they entered in Cash Book.
- Credit sale of things other than the goods dealt in by firm not recorded in sales book but they are journalized (Sale of fixed assest)
- Total credit sales means sale +packing charges -trade discounts.
- The total of amount column will shown the total credit sale for a period. It is posted in credit of sale account in Ledger .
- The name appearing in the Sale Book are of those parties which have received the goods. These a/c are posted in Ledger.

Sale Tax:-

- Charged at the time of sale.
- Current liability shown under liabilities side.
- Personal account in nature.
- Charged by seller form customers and have to deposit with sales tax department within 14 days from the end of month (ie. State government)
- Calculated after trade discount but before cash discount.
- Generally separate column is provided in the sales book.
- Sale tax rate vary from item to item and also on local sales and interstate sales.
- At the end of certain period total of sales tax column is credited to sales tax A/c.
- When sales tax deposited to government sales tax a/c is debited and Bank a/c credited.
- If there is credit balance in sales tax a/c it is liabilities and shown in liabilities side of balance sheet.
- In debtors total of sales and sale tax is debited.
- Journal Entry :-

▪ All the time of Sale:-

Debtors a/c Dr.
To sales
To sales tax

▪ Entry for sale tax deposit:-

Sale tax payable a/c Dr.
To Cash/ bank

Sales Return Book/ Returns Inward Book:-

- On goods being received and accepted from the customer a credit note is issued to the customers.
- In this book only return of credit sale is entered.
- Return of cash sale is entered in cash book.

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Purchase Returns or Returns Outward Book:-

- On goods returning to the supplier, debit note is being issued.
- In this book only return of credit purchase is entered.
- Return of goods purchase for cash entered in cash book.

Bills Receivable Books and Bill Payable Books:-

- It is a part of journal.
- Promissory notes or hundies are entered in B/R and B/P Book.

Journal Proper:-

In journal following entries is passed:-

1. **Opening entries:-** At beginning of the year opening balance of capital assets and liabilities are journalised.

2. **Closing entries:**- At the end of year, nominal account are transferred to the profit & loss account through journal entries called closing entries.

3. **Rectification entries:-E**ntry for rectification of error in journal .

4. **Transfer entries:- For** transfer one a/c to other a/c.

5. **Adjustment Entries:-**
   i Outstanding Expenses
   ii prepaid Expenses
   iii Accured Income
   iv Unearned Income
   v Interest on capital
   vi Depreciation
6. **Entries on dishonor of Bills:-** Entries is passed to record the non-payment.
7. **Misc. Entries:-** Credit purchase other than goods. (Plant and machinery)
   - An allowance to be given to the customers. After issue of invoice
   - Receipt of promissory notes or issue to them if separate bill books have not been maintained.
   - When customer become insolvent. (ie Bad debts)
   - Loss of property by fire. (ie earth quake etc.)
   - Transfer of net profit to capital account.

Unit - 2.5
CASH BOOK

- Cash transactions are recorded in the cash book and then ledger account are prepared therefore cash book is a subsidiary book.
- Cash book or Bank book directly entered in trial balance directly so cash book is a part of ledger hence also called as principal book.
- Cash book may be of three types:-
  1. Simple cash book;
  2. Two-Column Cash book;
  3. Three-Column Cash book;

  In addition to there books, a petty cash book is generally maintain which is purely a subsidiary book.

Simple Cash book:-

- Left side record receipts and right hand side payments
- Difference of cash book is written on credit side as “By balance C/d”
- In begining of next year "To balance b/d is written in debit side of cash book to show opening cash in hand
- It is like an ordinary account.
- Debit side always bigger than the credit side.

Two-Column Cash Book:-

- It has double column either **cash & discount** or **cash and Bank** column.
- Cash discount is allowed only if cash is paid so a column for discount is added on the receipt side and a column for discount received on the payment side
- Discount column are not balanced only totaled and posted to discount a/c.
- Discount column is not an account.
- The person to whom payment is made debited with the **sum of amount paid and discount.**
- The person who pays is credited **with sum of cash received and discount.**

Three Column Cash Book:-

- In this book another column is added to record cash deposited at bank (on receipt side of the cash book) and payments out of the bank (on payment side of the cash book)
- When cash is deposited with the bank, amount recorded in bank column on receipt side and in cash column on payment side and vice-versa.
- Letter “C” should be written in L.F. column for such type of transactions.
- If Cheque received and not deposited in bank on same date then first entry is passed in the cash column as under.

  Cash a/c Dr.
  To Ram a/c

  At the time of deposit the above cheque

  Bank a/c Dr.
  To cash a/c

  Entry for cheque dishonor when cheque is sent to the bank

  Party a/c Dr.
  To Bank a/c

  Entry for cheque endorsement to other party

  Party a/c Dr.

Or
Creditor a/c Dr.
To Bank a/c

- Bank Column balance on the credit side may be bigger than debit side in case of overdraft facility.
- The Discount column are memorandum column only provide information about the total discount allowed and total discount received.
- If more than one Bank a/c exist, seprate column should be for each Bank a/c

Petty Cash Book:-

- To recording the small payments in firm a "petty cashier" generally appointed. After some time he will be re-reimbursed for the payments made.
- At the beginning of the year/ month, a definite money is given to petty cashier and reimbursed for payments made at the end of the period.
- So he will have again the fixed amount in the beginning of the new period. Such a system is known as imprest system of petty cash.
- In Petty cash book, one column to record receipt of cash and other columns to records payment s of various type.
- Re-imbursement to petty cashier only when he prepares
  - A statement showing total payments.
  - Supported by vouchers i.e. documentary evidence and
  - Should be limited to the amount of actual re-imbursement
- Voucher should be filled in order.
- No payment should be made without proper authorization and payments above specified limit by only mains cashier.
- Petty cashier should not be allowed to receive any cash except for reimbursement
- Left hand Column:- Receipt of Cash
- Right hand Column:- Payments for various purpose.
- Petty cash Book is balanced as cash Book.
- Example: If imprest amount is given as Rs. 1000, out of this petty cashier expended Rs. 800, then at the end of period he will be given Rs. 800 (ie Amount equal to expenditure)
  : Journal Entry for petty cash given to petty cashier is
  Petty cash a/c Dr.
  To Cash a/c

Advantages of Petty Cash Book:-

- Saving of time of chief cashier.
- Saving in labour [In writing up the cash book, Posting into the ledger]
- Control over small payments.
- Balance of petty cash book is shown **in the Balance sheet as part of cash Balance.**
- Petty cash is asset.
- Now a days sales through Credit/Debit cards also done.

Accounting for Sale through Debit/Credit card

- **Credit card** **:** Issued by Banks to creditwrthy customer
- **Debit card** **:** Issued to customer who has account is Bank
- **ATM card** **:** ATM can be used As debit card
  It has 16 digit number

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- When sale is done through it is treated as cash sale
- Bank charges commission; it is a selling expenses
- **Entries**

  i Sale made: Bank a/c Dr.
  To Sales a/c

  ii Commission: Commission a/c Dr.
  To Bank a/c

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Unit - 2.6
CAPITAL AND REVENUE EXPENDITURE AND RECEIPTS

Introduction

- For ascertaining periodical Business results, the nature of transaction should be analysed whether they are capital or Revenue in Nature
- This Difference is made to placing them in Profit& Loss account or Balance sheet
- Revenue expenditure are shown in P&L a/c as their benefit are in one accounting period ie in which they are incurred
- Capital expenditure are placed on the asset side of balance sheet as they will generat benefit for more than one accounting period and will be transferred to P&L a/c of the year on the basic of utilization of benefit in particular year.
- Hence both capital and revenue expenditure are ultimately transferred P&L a/c but transfer is on different time.
- Revenue expenditure are transfer to P&L a/c in the year of spending while capital expenditure are transfered to P&L a/c in the year in which there benefit are utilized.
- Expenses are recognized in P&L a/c through matching concept.

Consideration in Determining capital and Revenue expenditure

1. **Nature of business:**
   - Purchase of item in which business is dealing is Revenue expenditure
   - **For example:** Purchase of furniture by trader is Revenue expenditure while furniture purchased by other business is capital expenditure.
   - While purchase of item for expenditure is Revenue for all business (purchase of stationary etc.) .

2. **Recurring Nature of expenditure :**
   - Normally Recurring expenditure are Revenue and.
   - Non recurring expenditure are capital
   - But item is not ultimate criterion.

3. **Purpose of expenses**
   - Normal repair and maintenance of fixed asset is Revenue expenditure.
   - Major repair of asset, so as to increase its productive capicity is capital expenditure

4. Effect on Revenue generating capacity of business
   - If Benefit of expenses received in one accounting year it is Revenue expenditure
   - If Benefit of expenditure will be received in more than one year is capital expenditure.

5. **Materiality of amount involved**
   - If expenditure is material and it increases the value of fixed asset is capital expenditure.

Capital & Revenue expenditures and receipts

Capital expenditure

- It is non-recurring by nature
- It's benefit arises for long period/medium term period.
- This expenditure belongs to fixed asset, either tangible or intangible, whether new purchased or old purchased or self constructed.
- Upto put to use all expenditure are known as capital expenditure.
- If any expenditure increase the efficiency/capacity of existing assets then this expenditure must be capitalised
- These are shown in asset side of balance sheet.

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- Any expenditure which reduce the cost of operation is also capital expenditure
- Any expenditure which is ancillary or essential for existence of the asset is known as capital expenditure
- Cost of improvement in the asset will be known as capital expenditure
- Example
  - Expenses on a foreign tour to purchase a machinery
  - Cost of machinery purchased
  - Insurance and freight on machinery purchased
  - Custom duty on imported machinery
  - Wages for erection of machinery
  - Installation charges of a machinery purchased.
  - Expenses incurred on trial run before the asset is put to use.
  - Cost of second hand machinery purchased
  - Repairs of second hand machinery before put to use
  - Interest on a term loan for the purchase of machinery. The commercial production has not been started till last day of the accounting year.
  - Money spent to reduce working expenses.
  - Overhead expenses of second hand machinery purchased.
  - Expenses for obtainly licence to start business is capital expenditure ie. Licence for new cinema hall.
  - Renovation expenses incurred for old Fixed Asset.
  - Transportation cost on purchase of fixed asset or material to be used on construction of fixed asset
  - Amount spent for replacement of a period driven by CNG engine.
  - Costs of rings & pistons of an engine changed to get fuel efficiency
  - Legal expenses to acquire a fixed asset.
  - Amount spent on repainting or white wash an old building for the first time on purchase. While repairing or white wash for existing building is Revenue.
  - Amount spent for the construction of temporary huts for construction of Building is capital expenditure.
  - Amount spent on demolition of building to construct a bigger building on the same site.
  - Purchase of a patent right, goodwill, licence
  - Travelling expenses for acquiring of fixed assets.

Revenue Expenditure

- It is recurring by nature.
- Its benefit is for a period not exceeding one year.
- It includes expenses which are incurred on operation of business activities and maintenance of existing assets
- These expense are only to run day to day Business.
- These are shown in either trading or P&L A/c.

Examples

- Depreciation on fixed asset
- Goods purchased for sale
- Maintenance & expenses of asset
- Expenses for removal of stock to a new site
- Fines Imposed
- White wash expenses
- Annual fire insurance
- Compensation for breach of contract

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- Legal expenses to recover dues from consumers
- Import duty on purchase of materials
- Advertisement expenses, inauguration expenses.
- Legal expenses to defend aganist plaintiffs claiming over asset that it belonging to him.
- To replacement of worn out part of machinery as it is maintenance cost.
- Renewal fees or expenses of license is Revenue.
- Loss arising out of obsolescence of machinery is revenue expenditure.

Deferred Revenue expenditure

- These expenses are primarily revenue nature but if complete the following two condition then will turn upto to deferred revenue expenditure .
  - Benefit of expense is for more than one accounting year.
  - Large amount
- Deferred Revenue expenditure written off in current year is debited in P&L a/c.
- So long as deferred Revenue expenditure not written of, it's shown on the asset side of balance sheet under "miscellaneous expenditure"

  Example:-
  - Heavy advertisement expenses
  - Heavy advertisement for new product launching.
  - Heavy advertisement to explore new market
  - Heavy compensation on voluntery retirement.
  - Heavy volume of free gift for new product

Note: If above expenses are not heavy then they are revenue

Types of Receipts

Capital Receipts	Revenue Receipts
It arises out of non recurring activities	It arises out of recurring activities
It is receipts from sale of fixed asset investment, loans, owner's capital etc	It is receipts against sale of stock, receipts of business recipt from debtor
It is not credited to P&L a/c but shown	It is credited to P&L a/c
in balance sheet	

Example

Insurance claim for machinery damaged	Bad debts recovered
Subsidy received for plant & machinery	General subsidy received
Premium received on issue of shares	Insurance claim for stock damaged by fire
Scrap value of machinery	Interest accrued on investment

Prepaid expenses VS deferred Revenue expenditure

- **Similarity:** Benefit of both will be received in future periods.
- **Difference:** Benefit of prepaid expenses is precisely estimated, whereas benefit of deferred revenue expenditure cannot precisely estimated.
- Security deposit with telephone department or electricity department to get connection is not expenses but known as assets

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Unit - 2.7
CONTINGENT ASSETS AND CONTINGENT LIABILITIES

- **Contingent liabilities** are those liabilities, which are not at present to be payable. But may be payable on happening of a contingency or future uncertain event.
- **For Example:-** there is a pending suit against a firm house and the businessman is expecting that the decision would be given against by the court in such a situation, at present, the liability is not certain to be payable, but there is only expectation that it would be payable in near future. So, this liability for payment is contingency liability.
- **A contingent liabilities can defined as** a possible obligation that arise from past events and existence of which will be confirmed only by the occurrence or non occurrence of one or more uncertain future events not wholly within control of the enterprise.
- **A present obligation** that arises from past events but is not recognized because:
  - i It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
  - ii A reliable estimate of the amount of the obligation cannot be made.
- Contingent liabilities are not recognized in financial statements. They are disclosed by way of note in financial statements. unless possibility of outflow of economic resource is remote.
- If possibility of outflow of economic resources is remote, no disclosing required.
- **Contingent liability includes:-**
  - Uncertain amount
  - Uncertain liability
- **Examples:-**
  - Claims against the enterprise not acknowledged as debts.
  - Guarantees gives in respect of third parties.
  - Liability in respect of bills discounted and statutory liability under dispute.

Contingent Assets

1. A Contingent Assets can be defined As:
   a. Possible assets that arise from past events and
   b. Whose existence will be confirmed only on the Recurrence or non occurrence of one or more uncertain future events not wholly within the control of enterprises.
2. It is a possibility of an inflow of economic benefits to the business entity.
3. Example:- Claim against third party for compensation on Damage.
4. As enterprises should not recognize contingent assets due to conservative concept and present accounting standard 29.
5. A Contingent asset need not be disclosed in financial statement.
6. A Contingent asset is usually disclosed in the report of the approving authority if inflow of economic benefit is probable.
7. If inflow of Economic benefit is not probable it will not be disclosed in approving authority report.
8. Approving authority is board of Directors in case of company and corresponding governing body in other enterprises.
9. When the realization of inflow of contingent asset becomes virtually certain the asset and related income will be recognized in the year in which it become virtually certain.

Provision

Provision means:-

1. Any amount written off or
2. Retained by way of providing for depreciation, renewal or diminution in the value of Assets
3. Retained by way of providing for Any **Known Liability** of which the **Amount Cannot be determined with Substantial Accuracy.**

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Present obligation:-

An obligation is a present obligation it based on the evidence available, its existence at the balance date is considered probable, ie more likely than not.

Possible Obligation

An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not possible.

Difference between liability & contingent Liability

Sr. No.	Difference	Liability	Contingent Liability
1.	Obligation	Present Financial obligation of enterprises	Either possible obligation or present obligation for which outflow cannot reliably estimated
2	Result	Outflow of resources embodying economic benefit	No outflow of economic resources
3	Recognition	Recognized in financial statements	Not recognized in financial statements
4	Disclosure	Disclosed in Balance Sheet liability side	Disclosed as foot note to financial statements

Difference between contingent liability and provision.

Sr. No.	Deference	Provision	Contingent Liability
1.	Obligations	Present obligation+outflow of economic resource probable +reliable estimation can be made	Possible obligation or present obligation for which no outflow possible or if possible cannot reliably estimated
2. `	Recognition	Recognized in financial statements	Not recognized in financial statements
3.	Disclosure	Disclosed in Balance Sheet	Disclosed as foot note to financial statements

<u>Difference between liability provision</u>

Liability :- Amount of Liability is certain

Provision :- Amount of provision is Reliably Estimated

Example of contingent Liability, Provision, Liability

1. Excise department imposed a penalty on X ltd, For violation of excise Act. The company goes on an apeal :

. **If Management :-**

i. Estimate that company have to pay penalty and reliable estimate of penalty can be made will be treated as provision

ii. Estimate that decision will be in favour of company it is contingent liability.

iii Final Decision of Court came for certain amount: **it is liability.**

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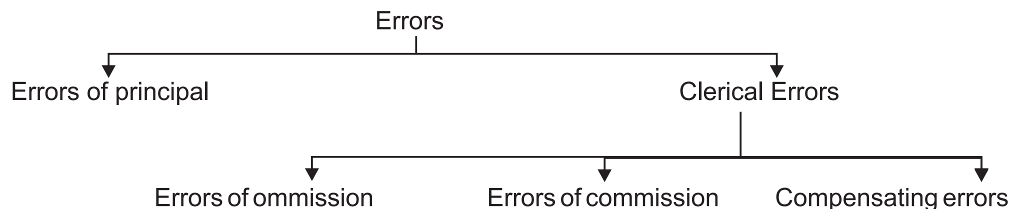
Unit - 2.8
RECTIFICATION OF ERRORS

Errors :-Unintentional ommission or commission of amount
Fraud :- Intentional omission or commission of amount

Basically errors are of two types:



a. **Error of principle**
   i. When a transaction is recorded in contravention of Accounting principle
   ii. For example treating capital expenditure as revenue or vice versa
   iii. No effect on trial Balance

b. **Clerical Errors :- There are three type**
   i. Error of Ommission :-
   1. A transaction Completely or partially omitted from book of Accounts.
   2. Example :-
      a. Furnishes purchased as credit but entry omitted.
      b. Furnishes purchased not posted to ledger.

   ii. Error of commission :-
   a. Amount posted is wrong account.
   b. It is written is wrong side of account
   c. Totals are wrong
   d. Wrong balance is struck

   iii. Compensating Errors :-
   a. Effect of one error compensated by other error
   b. Example:- From sale book Ram Account excess posted by Rs. 100 and shyam account short posted by Rs. 100

Note: A small Difference in trial balance may be result of a number of error

Error effecting Trial Balance
   i. Wrong casting of subsidiary Books
   ii. Wrong balancing of An account
   iii. Posting an Amount in wrong side
   iv. Wrong Amount posting
   v. Omitting to post an amount from subsidiary books
   vi. Omitting to post the total of subsidiary books
   vii. Omitting to write the cash book balance in the trial balance
   viii. Omitting to write the balance of an account in the trial balance

ix. Writing a balance in wrong column of trial balance.
x. Totaling the trial balance wrongly.

Errors not effecting trial balance.

i. Omitting an entry form subsidiary book
ii. Making an entry in wrong subsidiary book
iii. Posting an Amount in wrong account but on correct side
iv. Error of principal
v. Compensating errors

Rectification of Errors

i. Errors should never be corrected by overwriting
ii. If error occurred immediately after the error committed if may be corrected by neatly crossing the existing entry and making correct entry.
iii. If error detected after some time, A new entry called rectification entry should be passed to rectify it.

Rectification Can be made at three stages

i. Before preparing of trial balance.
ii. After preparing trial balance but before final accounts.
iii. After preparing Final Account ie in next accounting year.

Before preparing trial balance

i. If error in single account :-
  a. No journal entry required.
  b. Correction can be made in receptive account by putting difference amount.

ii. If Error in two accounts:-
  a. either correction in wrong account or passing of journal entry.

Ratification after preparing of trial balance

i. A Suspense account can be opened.
ii. If total of credit side is exceed suspense account is debited.
iii. If total of debit side is exceed suspense account is credited.
iv. Suspense account may be personal, real or nominal.
v. At this stage journal entry **is must for rectification of error.**

Correction in next account year

i. All amounts concerning nominal account i.e. expenses and incomes should be adjusted through **"prior period items" or Profit & loss adjustment account.**
ii. The balance in prior period items or profit & loss adjustment account is transferred to profit & loss account & not in capital account.
iii. Prior period items should be charged after Deriving net profit of current year.
iv. Prior period items are material, income or expenses which arise in current year **as a result of error or omission in the preparations** of periods financial statement of one or more prior
v. These are separately disclosed in Profit & loss account.
vi. Nature and amount of prior period items should be disclosed.

CHAPTER # 3

BANK RECONCILIATION STATEMENT (BRS)

- **Meaning:** Bank Reconciliation Statement is prepared to reconcile the difference between:-
  - (i) Bank balance as per Cash Book.
  - (ii) Balance as per Pass Book.
- It is a statement not an account
- It can be prepared at any date.
- It is prepared for current a/c or overdraft a/c and not for fixed deposit a/c

- **Importance of BRS-**

(1) it is a tool for internal control of cash flow.
(2) It helps in detecting frauds and errors in Cash Book or Pass Book.
(3) Any undue delay in clearance of cheques are shown by BRS
(4) It discourages the cashier and employees to engage in fraud.
(5) It helps in finding out actual Bank balance.

Bank pass book

i. The bank either send a periodical statement to customer or gives a pass book to customer.
ii. Both these are almost a copy of ledger account of the customer in the books of the bank
iii. Bank has duty to sent Bank statement to Customer,
iv. Customer has duty to send passbook to written up to date.
v. Passbook is binded book while bank statement is loose sheets.

- **Causes for disagreements between Cash book and Pass book**

(1) Timing Difference
(2) Errors in Cash book, committed by Accountant
(3) Errors in Pass Book, Committee by Bank

- **Preparation of Adjusted Cash book (CB)**

(1) In adjusted cash book, all cash book errors and omission are rectified.
(2) Timing difference and pass book errors are not considered in adjusted cash book.
(3) The object of adjusted cash book is to calculate the correct bank balance.
(4) If reconciliation is done at the end of financial year, the cash book must be adjusted.

Note: it BRS is prepared after adjusted cash book , then in BRS, cash book errors and omissions are not considered, In that case, only timing difference and pass book errors are considered.

Tips:-

(1) Overdraft as per Cash Book = Credit balance as per cash book
(2) Overdraft as per pass book = Debit balance as per pass book

	Debit side	**Credit Side**
Cash Book	Receipt Column	Payment Column
Pass Book	Withdrawal Column	Deposit Column

	Receipt	**Payment**
Cash Book	Dr. Side	Cr. Side
Pass Book	Cr. Side	Dr. Side

Note:-

(1) Pass book is the copy of customer's account maintained by bank.

(2) For the purpose of financial statement corrected balance of cash book is calculated.

(3) BRS is prepared by the business enterprises, it is not prepared by bank

(4) A cheque issued becomes a stale cheque after three months. Therefore if not presented to bank within three months, such cheque has to be cancelled.

(5) In balance sheet bank balance as per cash book is taken, not as per pass book.

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CHAPTER # 4
INVENTORIES

Meaning of inventories AS-2

Inventories are tangible current Assets:
(a) Held for sale in the ordinary course of business, or
(b) In the process of production for such sale or
(c) In the form of material or supplies to be consumed in the production process or in the rendering of services.

What to include?
- 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.
- Finished goods produced or work in progress being produced by the enterprise and
- include material, speareparts, maintenance supplies consumables and loose tools awaiting use in the productions process.

What not to include?
- **Machinery Spares:** 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 -10. As Fixed assets

Presentation of closing stock:
(i) If shown below trial balance: Dr side of trading a/c & asset side of balance sheet.
(ii) If shown in trial balance: Asset side of balance sheet
(iii) If adjusted purchase given in trial balance: Asset side of balance sheet

Significance of Inventory valuation
(a) To determine true Income
(b) To ascertain correct financial position
(c) To determine the correct liquidity position of business for example current ratio is affected by value of inventory
(d) For statutory compliance

(1) Schedule vi of companies Act 1956 require that detail of quantity of inventory along with method of valuation should be disclosed in financial statements.

(2) As per AS-2 financial statements should disclose the following information relating to inventories-
- Accounting policies for measuring of inventory
- Cost formula used for inventory valuation
- Total carrying amount of inventory
- Inventory classification etc ie raw material, work in progress, finished goods, stores & spares, loose tools

Effect of over/under valuation of Inventory
- When closing inventory is overstated, net profit will be overstated.
- When opening inventory is overstated, net profit will be understated.
- When closing inventory is understated, net profit will be understated.
- When opening inventory is understated, net profit will be overstated.

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Types of Inventory

For manufacturing concern

- Raw Material
- Work in Progress
- Finished Goods
- Basis of valuation of inventory

For Trading Concern

Finished goods

- **Based on conservatism/prudence concept**
  - Stock will be valued at cost or NRV, whichever is lower
  - Comparision of cos or NRV will be made by item wise, some time group wise but not on overall basis.

Note:- The term market value is now replaced with NRV

Calculation of NRV

	Estimated Selling Price	-------------
Less:-	Estimated costs of completion	-------------
	Estimated costs necessary to Make the sale	-------------

Net Realizable value		

Example

Item	Cost	NRV	Value
A	10	6	6
B	5	8	5
C	8	11	8
D	9	7	7
E	12	13	12
	44	**45**	**38**

Here - Value of Stock will be Rs. 38

Note: In the following cases, the inventory is not valued at cost or NRV, which ever is lower-

Consumable stores and supplies	- Ordinarily valued at cost
By products	- Net Realizable Value

Historical Cost Methods

It is the addition of following three costs:-

(1) Cost of Purchase

Purchase Price	------------------
Add:- Duties & Taxes on Purchase	------------------
Freight inward	------------------
Other Expenses directly Attributable to acquisition	------------------
Less:- Trade Discount	------------------
Duty draw back/refund of Duties	------------------
Subsidies/grants etc	------------------

(2) Conversion Cost

Direct production cost ------------------
Add:- Production overhead ------------------

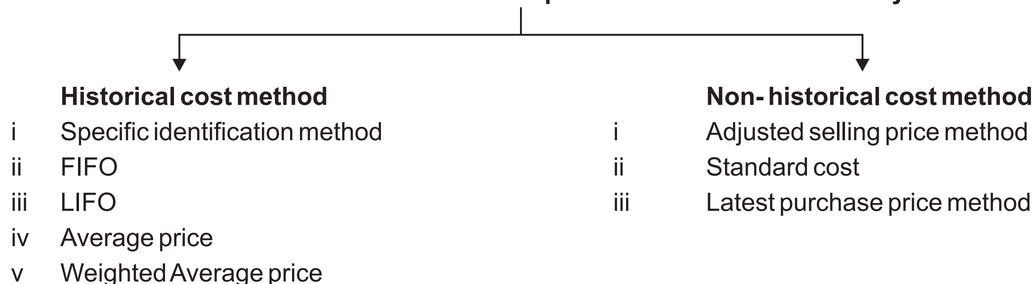
(3) Other costs, incurred in normal course of business in bringing the inventory in present condition and location

Historical cost of Inventory **------------------**

Note:- Expenses not included in cost of Inventory & written of in P&L a/c in same year.

- Abnormal Cost
- Storage Cost unless necessary in production process
- Administrative overhead
- Selling & Distribution costs
- Interest and borrowing cost normaly excluded

The different techniques for valuation of inventory :



Following methods are allowed by AS-2

i Specification identification method
ii FIFO
iii Weighted average
iv Adjusted selling price method

Specific Identification Method:

- This method is generally used to ascertain the cost of inventories of item that are not ordinarily interchangeable.
- Pricing under this method is based on actual physical flow of goods

FIFO Method

- Goods received first are issued first
- Cost of goods sold represent cost of earlier purchases
- Balance sheet shows the ending inventory at value nearer the current market value.
- Old costs are matched with current revenue as a result, Income Tax liability is increased.

LIFO Method

- Goods received last are issued first
- Cost of goods sold represents cost of recent purchase
- Ending inventory represents cost of earlier stock.

- Current cost are matched with current revenue so income tax liability is reduced.

Weighted Average Price Method

- It averages out the effect of price fluctuations.
- Weighted average price per unit = $\frac{\text{Total cost of goods available for sale during the period}}{\text{Total Number of units available for sale during the period}}$

Average Price Method

- All the different prices are added together and them divided by the number of prices.
- The closing stock is then valued according to the price ascertained.

Non Historical cost Method

- **Adjusted selling price Method**
    - this method is also called retail inventory method
    - **It is used in:**

      a. retail business or in business where the inventory comprises of items the individual cost of which are not readily ascertainable.

      b. Large number. of rapidly changing items subject to similar profit margin.
    - Value of inventry will be determined by "selling price of inventory --profit margin"
    - Calculations will be for individual item or group of item

Inventory Record System

S.No.	Periodic Inventory System/ physical inventory system	Perpetual Inventory System
1	This system is based on physical verification	It is based on book records
2	It require closure of business for counting of stock	Without affecting the operations of the business
3	Inventory control is not possible	Inventory control can be possible
4	This system provides information about stock at a particulars date	It provides continuous information updated
5	This is simple and less expensive	This is costier

Stock Taking: The Physical stock taking may take place on a different date like some days earlier as after the date of Balance sheet.

The condition is as under:

Computation of value of Inventory if an inventory is taken on a date (say 7th April 2011) after the balance sheet date.

Value of inventory as per books as on 7th April -------------------

Add:- Cost of goods sold and purchase return after 31st March, till stock taking -------------------

Add:- Cost of goods lying with other's on our behalf as on 31st March -------------------

ie- Cost of goods sent on consignment

Cost of goods sent on approval basis

Cost of goods sent to branch

Less:- Cost of sales return and purchase made after 31st March till stock taking ---------------------

ie- Cost of goods received on consignment
Cost of gods received on approval bases
Cost of goods received on hire purchase basis

Value of inventory as per books as on 31st March
Where inventory is taken on a date (Say 24 March prior to the balance sheet date

Value of physical inventory as on 24th March	
Add:- Cost of goods purchased after stock Taking till 31st March (whether received or not)	-----------
Add:- Cost of sales return after stock taking till 31st March (whether or not received)	-----------
Less:- Cost of goods sold after stock taking till 31st March (whether or not delivered)	----------
Less:- Cost of purchases return after stock takings till 31st March (whether or not delivered)	-----------
Value of inventory as on 31st March	-----------

Note:-

Cost of goods sold (COGS) = Sales - Gross Profit
Cost of goods sold = Opening stock+ Purchase+ Direct Exp. - Closing Stock

Change of rate of profit on different basis

Profit %on Cost		**Profit %on sale**	
50%	(1/2)	33.33%	(1/3)
33.33%	(1/3)	25%	(1/4)
25%	(1/4)	20%	(1/5)
20%	(1/5)	16.66%	(1/6)

CHAPTER # 5

DEPRECIATION

1. Depreciations is a measure of wearing out, consumption or other loss of value of a depreciable asset arising for use, effluxion of time or obsolesce thought technology and market changes.
2. Depreciation include amortization.
3. **External Depreciation is due to :-**
   a. Effluxion of twice
   b. Exhaustion of subject matter.
   c. Accident.
   d. Obsolescence.
4. Internal depreciation is due to natural wear and tear.
5. **Depreciable Assets:-** are assets which:
   a. Are expected to be used during more than are accounting year.
   b. Have a limited useful life and
   c. Held for use in production or supply of goods and service, rental to others or administrative purpose and.
   d. Not for sale in ordinary course of business
6. The amount of depreciation charged each year should be such amount which will reduce the book value of the asset at the end of economic life to **its estimated scrap value**
7. **Useful Life :-** is either
   a. The period over which a depreciable asset is expected to be used by the enterprise or.
   b. Number of production or similar units expected to be obtained from the use of asset by enterprises.
8. **Depreciable Amount** is Historical lost or other amount substituted less estimated scrap value.
9. Written down method and sum of year digit method are **accelerated method of depreciation.**
10. Depreciation is the process of allocation of cost over the useful life of asset
11. **Depreciation is:-**
    - Expenses
    - Revenue expenses
    - Non cash expenses (no cash outflow)
    - A source of fund
    - A charge on profit
12. Accounting standard -6 apply for Depreciation
13. **It may arise due to following reasons**
    - Use of asset
    - Effluxion of time
    - Obsolescence of asset, through market change or technology change
    - Natural wear & tear.
14. Depreciation is charged over the period of economic life of asset, instead of physical life of asset
15. Land is treated as Non-depreciable asset, However leasehold land is treated as depreciable asset.
16. **The term amortization is used for:**
    - Intangible assets
    - Deferred Revenue expenditure
17. The term depletion is used for wasting assets ie Natural resources

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18. Depreciation is charged to comply matching concept depreciation is charged even if market value of the assts has increased during the year.

19. **Amount of annual depreciation is equal under**
    - Straight line method
    - Annuity method
    - Sinking fund method

20. Depreciation charged on fixed asset , tangiable and depreciable asset

21. Depreciation is start when asset is ready to put to use.

22. **Objective of providing Depreciation:**
    - To ascertain correct income
    - True financial position
    - Funds for replacement
    - Ascertain true costs of production

23. **Factors in the measurement of depreciation**:
    - **Actual** cost of asset ie (Including all expenses upto ready for use.)
    - **Estimated** useful life
    - **Estimated** scrap value

Method of Providing Depreciation

(1) Straight line method/ Fixed installment method

- Depreciation $= \dfrac{\text{Cost of Asset Scrap Value}}{\text{Useful Life}}$
- Depreciation Rate $= \dfrac{\text{Straight line depreciation X 100}}{\text{Cost of asset}}$
- It's based on assumption that asset generate equal utility during lifetime

Suitability : This method is suitable for those assets in relation to which

(a) Repair charges are less, and
(b) The possibility of obsolescence is less
(c) This method is suitable for furniture, patent, copyright, trademark, lease, etc.
(d) This is most suitable and accurate method in most cases.

Note:- (i) An equal amount of depreciation is charged every year.
(ii) After the useful life value of asset becomes NIL.
(iii) Depreciation rate on book value increase every year
(iv) Total charge of using the asset increase because deprecitation same but repair increases over the year's.

(2) Reducing Balance Method

- Depreciation $= \left(\dfrac{\text{WDV x Depreciation Rate}}{100}\right)$

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- Depreciation Rate = $1 - \sqrt[n]{\frac{\text{Scrap Value x 100}}{\text{Cost of asset}}}$

  n = Useful life

Suitability: The method is suitable for those assets in relation to which

(a) The amount of repairs and renewals goes on increasing as the asset become older

(b) The possibilities of obsolescence are more.

(c) This method is suitable for plant and machineries, building etc.

Note:- (i) This method is recommended by Income Tax Act. Except undertaking engaged in generation and distribution of power

(ii) Book value never becomes ZERO.

(iii) The rate of depreciation on book value is same.

(iv) Total charge of using the asset is same because in earlier year's when repair is low, Depreciation is high & as repair increases depreciation decreases.

(3) Sum of years of digits method:-

- Depreciation = $\frac{\text{(Original Cost Scrap Value X Number of years of remaining life of assets (including current years)}}{\text{Sum of all digits of the use full life of assets in years}}$

Note:- (i) This method is not yet in vogue in India. Its advantages are same as those of reducing balance method.

(ii) Depreciation in first year is even highest in this method.

(4) Annuity method

- Depreciation Rate = (Original Cost Scrap Value) AF +(Scrap X Interest Rate/100)

AF(Annuity Factor) = $\frac{i}{1 - \frac{1}{(1+i)^n}}$

Where $i = \frac{\text{Rate of Interest}}{100}$; n = useful life

Suitability - This method is suitable for long term lease which involve considerable capital outlay

Note:- (i) Only method where interest element is included for depreciation

(ii) Though depreciations is every year constant but interest in earlier years will be higher and later year lower.

(iii) Asset A/c Dr
To Interest A/c

(iv) The amount of depreciation is same every year depreciation = (Original Cost Scrap value) x sff

(5) Sinking fund method -

(Sinking fund factor) = (Original cost - Scrap value) x SFF

AF(Annuity Factor) = $\frac{i}{(1+i)^n - 1}$

Where , $i = \frac{\text{Rate of Interest}}{100}$; n = Useful Life

- The amount of annual depreciation is credited to sinking fund account instead of fixed asset A/c
- An Equivalent amount invested in government securities.
- Interest received will be reinvested and credited to sinking fund account
- When asset is due for replacement, the securities are sold and new asset is purchased from the proceed of sale.
- The book value of old asset is transferred to sinking fund account
- Any amount realised on sale of old asset transfer to sinking fund account
- P&L on sale on securities is transfer to sinking fund account
- It is closed by transfer balance to P&L a/c or general reserve a/c

Suitability

- The main advantage of using this method is that this method not only provides depreciation on asset but simultaneously makes provision for the replacement of the asset at the end of its useful life.
- If the amounts were not invested outside the business, the withdraw of funds from regular business operation could have cripples the normal financial working of the business.

(6) **Machine Hour Method:-**

- $\text{Depreciation} = \frac{\text{Original cost - Scrap Value X (Actual hours run during the year)}}{\text{Useful life in terms of hours}}$
- $\text{Rate per Hour} = \frac{\text{Original Cost- Scrap Value}}{\text{Useful life in term of hours}}$

Suitability : This method is suitable when it is possible to keep the records of actual running hours of each machinery .

(7) **Production in unit method**

- $\text{Depreciation} = \frac{\text{Original Cost - Scrap Value X (Actual output during the year)}}{\text{Useful life in terms of productive output}}$
- $\text{Depreciation rate per unit} = \frac{\text{Original cost Scrap value}}{\text{Useful life in terms of productive output}}$

Suitability:- This method is suitable where

(a) The life of the asset can be estimated in terms of output
(b) The utility of the asset of output
(c) The utility of the asset is directly related to its productive life
(d) Obsolescence is not a primary factor.

(8) Depletion Method:-

(a) Suitable for mines, quarries etc. Containing only a certain quantity of product.
(b) Depreciation Rate = Cost of asset / Total Quantity to be extracted
(c) Depreciation of Current year = Quantity extracted x Depreciation rate

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Profit or loss on sale / Disposable of Depreciable Assets

(a) If asset is sold during the year calculate book value as on the date of sale is as under :-

Book value at the beginning for year	xx
Less :- Depreciation up to date of sale	xx
WDV / book value on sales date	xx

(b) If Book value is Higher than sale price this is loss and transferred to profit and loss accout.

(c) If book value is lower than sale price difference is profit. This profit may be capital or revenue

(d) If sale price is above cost then :-

Sale value above cost is capital profit & transferred to capital reserve.

Cost-WDV is revenue profit & transferred to profit and loss accout.

Change in the method of depreciation

- According to AS-6 issued by ICAI , the depreciation method selected would be applied consistently.
- A change from one method of providing depreciation to another be made only in following cases:
    - Adoption of new method is required by law.
    - Adoption of new method is required by Accounting standard.
    - Change is necessary for better presentation of financial Statements.
- When such a change of the method of depreciation is made, depreciation should be recalculated in accordance with the new method from **the date of assets coming into use.**
- The deficiency or surplus arising from retrospective calucation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed.
- In case the change in the method results deficiency in depreciation in past year's the deficiency should be charged in the statement of profit and loss.
- In case the change in the method results in surplus should be credited to the statement of profit and loss.
- Such a change should be treated as a change in the accounting policy and effect should be qualified and disclosed.

Revision of estimated useful life of depreciable asset

- In this case, the unamortised amount should be charged to asset over the revised remaining estimated useful life of asset.
- Such revision should be treated as change in accounting estimates.
- Change in method has **retrospective effect where as change in estimation has prospective effect.**

Revaluation of Depreciable asset

- In this case, the depreciation should be charged on the revalued amount on the basis of remaining estimated useful life of asset.
- If revaluation is made during the year then at first deduct depreciation on asset upto revaluation date to achieve at WDV on date of revaluation.
- Difference between WDV on revaluation date and revaluation amount is profit or loss on revaluation.
- If there is an upward revision in the value of asset, then the amount of appreciation is debited to asset account and credited to revaluation account.
- If there is downward revision in the value of asset then profit and loss account is debited and asset account is credited.

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Provision for repairs and renewals

- Total expenditure on repair and renewal over life of asset is estimated.
- On the above basis average expenses is calculated.
- Actual repair not transferred to P&L a/c but transferred to provision for repair a/c
- Purpose : to equalize cost of repair each year
- Average of this expenditure is debited to P&L a/c and credited to provision for repairs & renewals a/c irrespective of actual expenses incurred.
- For accrual expenses incurred provision for repair & renewal a/c is debited and repairs a/c is credited.
- The balance in provision for renewal a/c is carried forward and at the end on the sale of asset the a/c is closed by transfer the **balance to the asset a/c.**

Provision for depreciation method:-

- Two accounts open in this method
  - (a) Provision for depreciation account is opened to accumulate the balance of depreciation.
  - (b) Asset are carried at historical cost
  - (c) Provision for depreciation a/c is credited in place of fixed asset a/c while charging depreciation
  - (d) Depreciation a/c Dr.
    To provision for depreciation A/c
  - (e) P&L a/c Dr.
    To Depreciation a/c

Second Alternative:-

- Amount of depreciation is credited to the asset account every year and the asset account is carried at historical cost less depreciation.

Depreciation A/c Dr.
To Asset A/c

Profit & Loss A/c Dr.
To depreciation A/c

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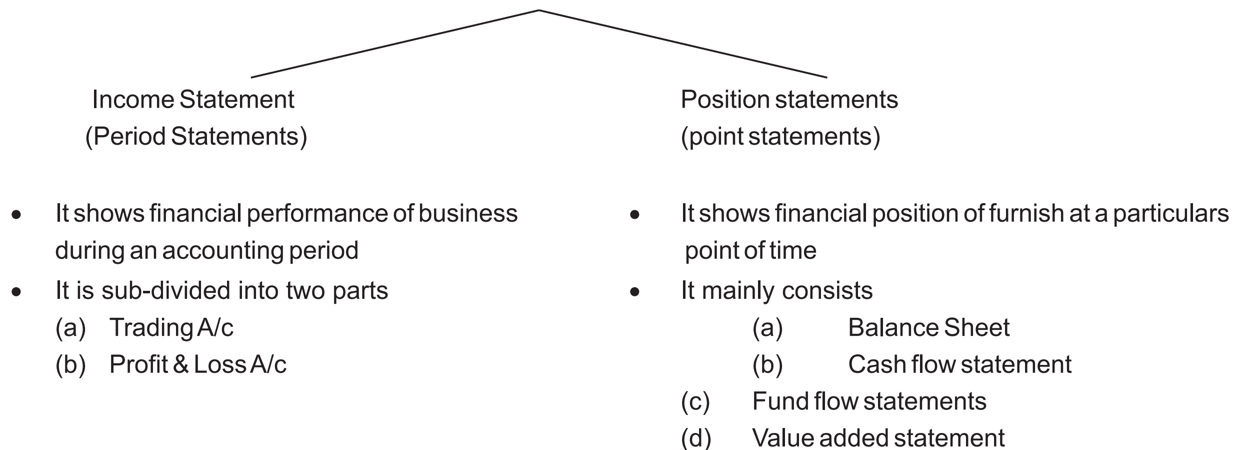
CHAPTER # 6
FINAL ACCOUNT OF SOLE PROPRIETORS

Unit - 6.1
FINAL ACCOUNTS OF NON MANUFACTURING ENTITIES

1. Introduction :-

- Financial statements are the part of summarisation activity of accounting process.
- They are organised summary of detailed information about financial performance and financial position of an enterprises.

Part of financial statements



What is matching concept?

According to this principal, revenue and the expenses incurred to earn the revenue should be properly matched, as under:

- If a certain revenue is entered in the trading and P&L a/c, then all the expenses relating to it, whether paid or not, should be debited to the trading/profit and loss account. This is why, at the end of the year, the entry for outstanding expenses are made.

- If some expenses have been incurred but against it, income will be received in next year, the expenses should not be debited to the current year's trading and P&L a/c but should be carried forward as on asset and shown in the balance sheet and debited to the trading and P&L a/c, when the relevant income will also be credited. This is why, at the end of the year, the entry for prepaid expense are made.

- If a revenue is received in the current year, but the work against it has to be done and the cost in respect of it has to be incurred in next year, the income or the revenue is considered to be of next years. It should be shown in the balance sheet on the liabilities side as " Income received in advance" and should be credited to profit & loss account of the next year.

Exception to matching concept

- Sometimes cost is incurred but no revenue is to be received against it in such a case, the cost is debited to P&L a/c. In the year of it incurred
- For example,
  (i) a fire has occurred and has damaged the firm's property, the loss must be debited to the profit and loss account to the extent is not covered by insurance.

(ii) Bad debts

(iii) Fall in the value of stock

Trading A/c

- It is a nominal a/c in nature
- It is prepared to ascertain the gross profit or gross loss during the accounting period.
- It reflects cost of goods sold.
- It includes only direct expense.
- Gross profit or gross loss is transfer to P&L a/c

Contents of Trading Accounting

- **Opening stock**
  - It is Closing stock of the last year
  - In the first year of a business there will be no opening stock
  - It will be entered on trading account **via opening entry.**

- **Purchase:-**
  - It includes cash as well as credit purchase
  - It goods are received but the relevant invoice is not received from the supplier on the date of closing of the account, an entry must be passed.

    Purchase a/c Dr.

    To Supplier A/c
  - **Purchase a/c is real a/c but adjusted purchase a/c is nominal a/c**

    i Net purchase = purchase - purchase return

    ii Adjusted purchase = Net purchase - closing stock+ opening stock

    iii Cost of goods sold = Opening stock + net purchase + direct expenses - closing stock

- **Carriage and Freight inwards:-**
  - It is incurred to bring the materials to the firms godown and make them available for use.

- **Wages & Salaries:-**
  - Wages & salaries is direct expenses
  - Salaries & wages is indirect expenses

- **Closing stock and its valuation**
  - According to prudence principle stock is valued at cost or NRV whichever is lower
  - If the closing stock appears outside the trial balance then it will be reflected on two side

    i Trading A/c credit side and

    ii Asset side of balance sheet
  - If the closing stock appears inside then it will be shown only in the balance sheet at asset side

- **Sales Tax**
  - Sales Tax is an indirect Tax
  - It's collected by the seller from customer and deposited into government account.
  - Sales Tax liability is shown as current liabilities in the balance sheet, until deposited.
  - Sales tax a/c is personal in nature

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- **Closing entries in respect of trading a/c**

  Trading Account Dr.
  To opening stock account
  To purchase account
  To wages account
  To freight on purchase account etc.

  Sales Account Dr.
  Closing Stock Account Dr.
  To trading Account

Closing entries in respect of profit & loss account:

(a) For items to be debited to the Profit and Loss account this account will be debited and the various accounts concerned will be credited. For example,

  Profit and Loss account
  To Salaries account
  To Rent account
  To Interest account
  To Other Expenses account

(b) Items of income or gain such as interest received or miscellaneous income will be debited and credited to Profit and Loss account.

  Discount Received account Dr.
  Bad debts Recovered account Dr.
  To Profit and Loss account

(c) At this stage, the Profit and Loss account will show net profit or net loss. Both have to be transferred to the Capital Account. In case of net profit, i.e. when the credit side is bigger than the debit side, the entry is:

  Profit and Loss account Dr.
  To Capital account

In the case of net loss, the entry will be

  Capital account
  To Profit and Loss account

Balance sheet

- The balance sheet may be defined as " a statement which sets out the assets and liabilities of a firm or an institution as at a certain date"
- A balance sheet is only a statement and not an account
- It is prepared at a particular point of time and not for a particulars period & shown "as act ---------"
- In balance sheet only personal and real a/c are shown, nominal a/c cannot be shown
- Balance sheet is based on marshalling technique.
- Marshalling : Arrangement of asset and liability in liquidity or permance order
- If assets are arranged in the order of their liquidity then cash in hand is shown at first in asset side of balance sheet and goodwill is shown at last.
- In permanency order cash in hand is shown at last and goodwill is shown at first.

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- It's prefered after preparation of p&L a/c
- Il reflect liquidity/solvency/financial position of the business.
- Balance sheet is based on accounting equation.
- Share holder, fund, proprietary fund, owner's equity is calculated by the help of balance sheet
- Soleproprietors general present balance sheet in horizontal form

Opening Entry

- First Entry passed at the beginning of accounting year to bring assets, liabilities and capital from last year to current year.
- **Posting :-** Asset account opened and debited as "To balance b/d" Liabilities account and capital account opened and credited "By balance B/d"

Closing Entry :-

- Entries passed in journal for preparing the trading and profit and loss account ie. Transferring various account in trading or profit & loss account are known as closing entries.
- For transferring nominal account into trading, profit & loss account.
- For transferring gross profit / loss to profit & loss account.
- For transferring net profit to capital account.

Adjustment Entry

- Adjustment for matching concept ie prepaid, accrued, outstanding unearned etc.
- These are passed at the end of accounting year.
- These are **reversed at the beginning of next year.**

Accrued :-

- It signifies that an account has been incurred as expenses or earned as income, the due date of which fall in next trading period.
- If due date fall in current period the term used should be 'outstanding' or 'Accrued and Due'
- **Accrued & Accruing :-** Signifies items which though not due for payments but pertain to the period of account, a provision for which has been made.

Drawing Account

- It is not expenses for the business.
- It is not debited to profit & loss account.
- It is debited to capital account.

Discount Received and allowed:-

- **Trade Discount.**
  1. **It is allowed when order for goods is not below a certain figure**
  2. It is deducted from invoice.
  3. Only net amount of invoice entered.
  4. No further treatment of trade discount.

- **Cash Discount.**
  1. It is allowed to a customer if he makes the payment before a certain date.
  2. It is allowed for prompt payment.

3. Cash discount received is like a interest received and credited to profit & loss account.
4. Cash discount allowed is like a interest expenses and debited to profit & loss account.

Rebate

- It is allowance given to a customer when his purchases during a period say one year total up to a certain figure.
- The entry for rebate is made only at the end of the year.

- **Entries for rebate given.**

  a. Rebate Account Dr.
  To Customer account

  b. Profit & loss account Dr.
  To Rebate account.

- **Entry for Rebate taken**

  a. Supplier account Dr.
  To Rebate account.

  b. Rebate account Dr.
  To Profit and loss account

Bad Debts:-

- When a customer does not pay and no hope of recovery, it is bad debts
- Entry :-

  a. Bad Debts. Account. Dr.
  To customer account.

  b. Profit & Loss account. Dr.
  To Bad Debts account

- If later on amount is recovered it should be treated as a gain.
- It should not be credited to the party paying it
- It should be credited to Bad Debts recovered account.
- Entry :-

  a. Bank account Dr.
  To Bad Debts Recovered account.

  b. Bad Debts Recovered account Dr.
  To Profit & loss account

Sequence of Accounting Procedure or Accounting cycle

- Recording the transaction in journal or journalising
- Posting into Ledger
- Trial Balance to cheek Arithmetical accuracy

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- Trading and Profit & loss account for profit or loss earned.
- Balance sheet for Financial Position.

TREATMENT OF ITEMS OF ADJUSTMENTS APPEARING OUTSIDE THE TRIAL BALANCE

Item of Adjustment	Adjusting Entry	Treatment in Trading A/c	Treatment in Profit & Loss A/c	Treatment in Balance Sheet
(a) Closing Stock	Closing Stock Dr. To Trading A/c	Shown on the credit Side	X	Shown on the s asset side as a Current Asset
(b) Outstanding Expense `	Respective Expense A/c Dr To Outstanding Exp. A/c	Added to The respective expense on the debit side	Added to the respective expense on the debit side	Shown on the liabilities side as a Current Liabilities
(c) Prepaid expenses (unexpired expenses)	Prepaid Expenses A/c Dr. To Respective Expenses A/c	Deducted from the respective expenses on the debit side	Deducted from the respective expense on the debit side	Shown on the assets side as a Current Asset
(d) Accrued Income (or Income earned but not received)	Accrued Income A/c Dr. To Respective Income A/c	X	Added to the respective Incomes on the credit side	Shown on the Assets side as a Current Asset
(e) Unearned Income (or Income received in balance)	Respective Income A/c Dr. To Unearned Income A/c	X	Deducted from the respective incomes on the credit side	Shown on the liabilities side as Current Liability
(f) Depreciation	Depreciation A/c Dr. To Asset A/c	X	Shown on the debit side	Shown on the assets side by way of deduction from the value of concerned fixed assets.
(g) Additional Bad Debts	Bad Debts A/c Dr. To Sundry Debtors A/c	X	Shown on the debit side by way of addition to Bad Debts (Inside the Trail Balance)	Shown on the assets side by way of deduction from the amount of Sundry Debtors.
(h) Provision for Doubtful debts	P&L A/c Dr. To Provision for Doubtful Debts A/c	X	Shown o n the debit side	Shown on the asset side by way of deduction from the amount of Sundry Debtors

				(Net of additional bad debts)
(i) Provision for Discount on debtors	P & L A/c Dr. To Provision for Discount on Debtors A/c	X	Shown on the debit side	Shown on the asset side by way of deduction from the amount of Sundry Debtors (net of additional bad debts & Provisions for doubtful debts)
(j) Provision for Discount on Creditors	Reserve for Discount on Creditors A/c Dr. To P&L A/c	X	Shown on the Credit side	Shown on the liabilities side by way of deduction from the amount of Sundry Creditors
(k) Interest on Capital	Interest on Capital A/c Dr. To Capital a/c	X	Shown on the debit side	Shown on the liabilities side by way of addition to the Capital
(i) Interest on Drawings	Capital A/c Dr. To Interest on Drawings	X	Shown on the Credit side	Shown on the liabilities side by way of deduction from the Capital
(m) Manager's Commission on Profit	Manager's Commission Dr. To Outstanding Commission A/c	X	Shown on the debit side	Shown on the liabilities side as a Current Liability
(n) Abnormal Loss of stock	Loss of Stock a/c Dr. To Trading A/c	Total value of abnormal loss of stock (Whether or not received) is shown on the credit side as a separate item.	Total value of irrecovered loss of stock is shown on the debit side as a separate item	The amount due from the insurance company is shown on the asset side as a current asset
(o) Goods sent on approval	(i) Sales A/c Dr. To Debtors A/c (ii) Stock with customers A/c Dr. To Trading A/c	Shown on the credit side by way of deduction from sales	X X	Shown on the assets side by way of deduction from debtors Shown on the

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		Shown on the credit side by way of addition to Closing Stock in hand		assets side by way of addition to Closing Stock in hand

Treatment of Adjustments appearing in Trial Balance

Item given in Trail Balance	Treatment in Profit & Loss A/c or Other Account	Treatment in Balance Sheet
(a) Closing Stock	-----	Shown on the Assets side as a Current Asset
(b) Outstanding Expense	-----	Shown on the Liabilities side as a Current Liabilities
(c) Prepaid Expense	-----	Shown on the Assets side as a Current Asset
(d) Accrued Expense	-----	Shown on the Assets side as a Current Asset
(e) Unearned Income	-----	Shown on the Liabilities side as a Current Liabilities
(f) Depreciation	Shown on the debit side of P & L A/c	-----
(g) Bad Debts	Shown on the debit side of P & L A/c	-----
(h) Discount allowed	Shown on the debit side of P & L A/c	-----
(i) Discount Received	Shown on the credit side of P & L A/c	-----
(j) Interest on Capital	Shown on the debit side of P & L A/c as a separate item	-----
(k) Interest on Drawings	Shown on the credit side of P & L A/c as a separate item.	-----

Distinction between provision & Reserve

Basic of Distinction	Provision	Reserve
(1) Meaning	Provision Means (i) Any Amount written off (ii) Any amount retained by way of providing for Depreciation, renewal or diminution in value of Assets. (iii) Any Provision for known Liability, of which amount cannot be determined with substantial accuracy.	Profit retained in the business not having any of the attributes of a 'provision' is to be treated as a reserve. Also provisions in excess of the amount considered necessary for the purposes these were originally made are to be considered as reserves.
(2) Purpose	It is created for a particular purpose and can only be used for that particular purpose	It need not necessarily be created for a particular purpose. e.g General Reserve is not for nay particular purpose.
(3) Charge Vs Appropriation	It is a charge against the profit	It is an appropriation out of profit
(4) Disclosure in Balance Sheet	Usually a provision is shown by way of deduction from the amount of the	Reserve is shown as a separate item under the head **"Reserve and Surplus"**

	items for which it is created e.g. Provision for Doubtful Debts.	on the liabilities side of the Balance Sheet.
(5)Investment outside the business	There is no question of investment of the amount of provisions.	The amount of a reserve can be invested outside business, it is called 'FUND'
(6) Utilisation for dividends	It cannot be utilised for distribution by way of dividends.	It can be utilised for distribution by way of dividends.
(7) Examples	Provision for Tax, Provision for Doubtful Debts	General Reserve, Contingency Reserve, Worker's Welfare Reserve

Adjustments:-

(1) **Sales Tax :**

- it is deducted from sale in trading A/c.
- Shown as liability until paid

(2) **Trading Expenses :** it is shown in debit side of profit & loss account.

(3) **Income Tax:**

- In case of sole proprietor ship income tax is personal expenses, So it is deducted from capital
- In case of companies, this is expenses and debited to P&L a/c
- In case of partnership firms
  (i) Tax on firms is income: is expenses and debited to P&L a/c
  (ii) Tax on partners income: is personal expenditure and debited to drawings a/c

(4) **Provision on Debtors:**

- There are two provision on Debtors
  (i) Provisions for Bad &Doubtful debts
  (ii) Provisions for Discount on Debtors
- Both of them are made because of conservatism concept
- If both provision are given in the question then first calculate provision for bad & doubtful debts, then calculate provision for discount on debtors.
- If provision for bad debts is maintained then bad debt is debited to provision for bad debt a/c and not to P&L a/c
- If no provision is maintained then bad debt a/c is debited to P&L a/c
- Provisions for Bad & Doubtful Debts is created on Closing Debtors.
- Closing debtor is calculated with the help of debtors account as under

Debtors Account

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance B/d To Sales To B/R(Dishonoured)			By Cash By Bank By B/R By Bad Debts By Discount Allowed By Balance C/d	

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Disclosure:

Provision for Bad & Doubtful Debt:-

In Profit & Loss account

Total Bad Debts (Old + Further Bad debts)	--------------
Add:- New Bad Debt Provision	--------------
Less:- Old Bad Debt Provision	---------------

Note : if resultant figure is positive then accounting entry will be

P & L A/c Dr.
To Provision for Bad Debts

If Negative

Provision for Bad Debt A/c Dr.
To P & L A/c

In Balance Sheet

Assets Side

Closing Debtors	-----------
Less: Provision for Bad & Doubtful Debts	------------
Good Debtors	------------
Less: Provision for Discount on Debtors	------------
Net Debtors	-----------

Provision for Discount :

- To be calculating after deducting the provision for Bad & Doubtful Debts from the total Debtors.

Provision for Depreciation:

- Depreciation a/c is debited and provision account is credited, in place of fixed asset a/c
- Abnormal loss of stock by accident or fire: Difference is between stock loss and insurance claim amount transfer to P&L a/c
- Abnormal loss account is to be debited and purchase account is to be credited.
- Abnormal loss account is to be transferred to profit & loss account

If fully insured :

Insurance company a/c Dr.
To Purchase a/c

If no insurance cover

Loss by Fire a/c Dr.
To purchase a/c

P&L a/c Dr
To Loss by fire a/c

Partly Insured

Insurance company A/c Dr. (Claim amount)
Loss by Fire A/c Dr. (Stock Loss- claim amount)
To Purchase A/c
Profit & Loss A/c Dr.
To Loss by fire a/c

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Goods sent on approval basis

- When goods were sold we have passed the entry for actual sale.
- At the year end if the goods are still with the customers for approval following entries are to be raised

(i) Sales A/c Dr. (invoice value)
To Sundry Debtors A/c

(ii) Stock with customers A/c Dr. (Cost)
To Trading A/c

Goods used other than for sale

Donation A/c Dr. (Goods as Charity)
Drawing A/c Dr. (Personal use)
Free Sample A/c Dr. (Distribution as sample)
Building A/c Dr. (Construction Use)
Repairs A/c Dr. (used for asset maintenance)
To Purchase A/c

Note:

Particular	Effect on G.P.	Effect on net profit	Effect on capital
Donation	No	Reduce	Reduce
Drawing	No	No	Reduce
Free sample	No	Reduce	Reduce
Building	No	No	No
Reapir	No	Reduce	Reduce

Commission based on Profit

- Sometimes commission is payable to manager based on net profit.
- **If commission on net profit before charging such commission.**

$$\frac{\text{Profit before commission x Rate of commission}}{100}$$

- **Commission on net profit after charging such commission**

$$\frac{\text{Profit before commission x Rate of commission}}{100 + \text{Rate of commission}}$$

- Entry will be:

Commission A/c Dr.
To commission payable a/c

Unit - 6.2
FINAL ACCOUNTS OF MANUFACTURING ENTITIES

Introduction

- Manufacturing entities generally prepare a separate manufacturing account as a part of final accounts in addition to trading accounts.

Purpose

- It shows cost of production
- It includes stock of raw material, work in progress but not include stock of finished goods.
- It facilities reconciliation of financial books with cost records
- Manufacturing cost is transferred from manufacturing a/c to trading a/c

Computation of manufacturing cost

Direct material consumed	----------------------
Add:- Direct Labour	----------------------
Add:- Direct manufacturing expenses	----------------------
Prime Cost	----------------------
Indirect manufacturing expenses	---------------------
Total manufacturing expenses	**---------------------**
Note :- Raw material consumed	
Opening stock of raw material	----------------
Add:- Purchases	----------------
Less:- Closing stock of raw material	----------------

Direct material expenses

Cost other than material or wages, which are incurred for a specific product of sale after service

For Example:-

- Royalties for using license or technology (if based on unit produced)
- Hire charge of the plant and machinery used on hire (if based on units produced)

Indirect manufacturing expenses

- Overhead is total of Indirect material
- Overhead is total of Indirect wages
- Overhead is total of Indirect expenses
- It is also called manufacturing overhead, works overhead, or production overhead

Note:

- Indirect expenses are those which cannot be directly linked to the units produce.
- For example:- Training expenses, depreciation of plant and machinery, depreciation of factory shed, insurance premium for plant & machinery, factory shed.

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By Product:

- It is a subsidiary product, which is produced along with main product
- It can also be treated as secondary product

Examples

- Molasses in sugar manufacturing
- Butter milk in butter and cheese production

Valuation :

- it is generally valued at net realisable value if there cost cannot seperatly identified
- Treatment :it is credited to manufacturing account
- It reduce manufacturing cost of good units
- It is often treated as miscellaneous income
- Sale value of the by product is credited in manufacturing a/c
- By product have insignificiant value compared to main product

The following rules may be observed

- The manufacturing account should have column the **quantities and values**.
- **The manufacturing account will show**
  (i) **Regarding raw-material:** Opening stock, closing stock & purchase
  (ii) **Regarding WIP:** Opening and closing stock
  (iii) **Regarding finished stock:** only quantities manufactured
- Trading account will never show opening or closing value of raw material and work in progress.
- Sale have been assumed on **"first in first out"** basis if no specific information

Tutorial Note

- Final accounts are prepared after preparation of trial balance
- Trading account and profit and loss account are period statements.
- Balance sheet is a position statement
- Manufacturing account is a period statement
- Manufacturing account, trading account profit & loss account are nominal account
- Balance sheet is not a ledger account
- Manufacturing account, trading account and profit & loss account show result of the operation of business.
- Gross profit is transferred to profit & loss account via this entry

  Trading A/c Dr.
  To Profit & Loss A/c

- Net profit is transferred to capital account

  Profit & Loss A/c Dr
  To capital a/c

- Drawing account is transferred to capital a/c

  Capital a/c Dr.
  To Drawings A/c

- Closing stock given in the trial balance is shown only in balance sheet.
- Sale of scrap is credited to manufacturing a/c.
- Cost of production is transferred from manufacturing account to trading account.

Entry:

Trading a/c Dr.

To manufacturing a/c

Limitation of Financial Statements :-

- Fixed assets are shown at historical lost irrespective of Current Value.
- Only financial information given not qualitative in formations.
- Writing off long term item is arbitrary
- Different errors follow different accounting retires
- Management may manipulate Results.

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CHAPTER # 7

ACCOUNTING FOR SPECIAL TRANSACTIONS

Unit - 7.1

CONSIGNMENT

- When a person sends goods to his agent to sell those goods on behalf of first person, then such transaction is called consignment.
- Here, sender of goods is known as consignor and the receiver of goods is known as consignee.
- The legal relationship between consignor and consignee is governed by law of principal and agent.
- In consignment risk remains with consignor.
- In consignment, only possession of goods is transferred to consignee, the ownership of goods remains with consignor.
- The profit or loss on sale of goods sent belongs to consignor.
- Expenses incurred by consignee are borne by consignor.
- The principal does not send an invoice to the agent, He send only a Performa Invoice.
- Account sale has to be submitted by the consignee to the consignor from time to time.
- Principal can accept advance from the agent in the form of cash or a bill of exchange, it is adjusted against the sale proceeds of the goods.
- Consignment a/c is just like profits & loss account or say **nominal account.**

Difference between consignment & sale

Sr. No.	Distinction	Consignment	Sale
1.	Ownership of goods	Rest with consigner until sold	Ownership transferred from seller to buyer at the time of sale
2.	Return of goods	Consignee can return the goods to consignee	Buyer can return the goods if seller agree
3.	Risk of Loan	Consignor bear risk until sale	Buyer bear risk after sale
4.	Relationship	Relationship between consigner and consignee is that of principal and agent	Relation between seller and buyer is that of debtor & creditor
5.	Expenses	All expenses of goods received and safety of goods is borne by consignee	Expenses after delivery borne by buyer

Commission

- It is remuneration paid by consignor to consignee for service rendered.
- Three types of commission can be given jointly or separately:

1. **Ordinary Commission:-**
   a. This is normal commission for service rendered by consignee
   b. If commission " word" given it means ordinary commission.
   c. It is based on fixed percentage of the gross sales proceeds made by the consignee.
   d. It is given regardless of cash sale or credit sale.
   e. This commission not give protection against Bad Debts.
   f. It is provided on **total sale**.

2. **Del-credere commission**
   a. It is given:
      i. To increase the sale and
      ii. To encourage the consignee to make credit sale
   b. It protect the consigner form bad debts i.e. bad debts will be borne by consignee
   c. It is calculated on **total sale unless an agreement** between consignor and consignee to provide on credit sale.
   d. If del-credere commission is paid :-
      - Consignees account is debited for both cash and credit sale because bad debts risk will be borne by consignee

        i.e.:- Consignee a/c Dr. (Cash +credit sale)
        To Consignment A/c (Cash +credit sale)
   e. **If no Del-credere commission is paid:-**
      i. Consignor account will be debited for cash sale and consignment debtor account will be debited for credit sale.

         ie.:- Consignment debtor a/c Dr. (Credit sale)
         To Consignment a/c (Credit sale)

         Consignee a/c Dr. (Cash sale)
         To consignment a/c (Cash sale)

3. **Over-Riding Commission**
   a. It is an extra commission allowed by consignor to consignee to:-
      i. Promote sale at higher price then specified or
      ii. Encourage the consignee to put hard work in introducing new product in the market
   b. Depending on agreement it is calculated on :-
      i. Total sales or
      ii. Difference between actual sales and invoice price or
      iii. Any specified price

<u>Valuation of Stock</u>

- Valuation of stock is based on the location of stock.
- The principal of valuation is cost or NRV, Whichever is lower.
- In the case of consignment, **cost means** effective cost which includes some adjustment of expenses.

Example:

Consignor cost	Rs. 100	
Consignor Exp.	Rs. 2	
Consignee Non Recurring Exp.	Rs. 3	
Consignee Recurring Exp.	Rs. 1	
Valuation of unsold stock with agent is:	100 + 2 + 3 =	Rs. 105

Valuation of stock for abnormal loss in transit is: 100 + 2 = Rs. 102

Valuation of stock for abnormal loss in consignees godwn is: 100 + 2 + 3 = Rs. 105

Note :- (A) Examples of consignors expenses

- Carriage outward, Cartage
- Freight, Insurance in transit
- Packing
- Octori

B. **Non Recurring Nature Expenses**

- Clearing charges, custom duty, octopi, carriage inward / transport charges upto godown.

C. **Recurring Nature Expenses**

- Warehouse charges, insurance of godown, selling & distribution expenses, godown rent.

Treatment of abnormal loss

- Abnormal loss is an avoidable loss, usually caused due to fire, theft, abnormal spoilage, pilferage etc.
- It is not treated as a part of cost.
- Entries for abnormal loss

i. If no Insurance Exist:-

Profit & loss a/c	Dr.	(Cost of goods sold)
To consignment a/c		(Cost of goods sold)

ii. If Full insurance exist

Insurance company	Dr.	(Cost of goods sold)
To Consignment a/c		(Cost of goods sold)

iii. If part insurance cover

Insurance company	Dr.	(Insurance claim)
Profit & loss a/c	Dr.	(Amount of Loss)
To Consignment a/c		(Cost of good sold)

- **It is clear that the cost of abnormal loss is credited to consignment account whether claim is received or not.**
- Net abnormal loss = cost of abnormal loss- claim received known as unrecovered loss and shown in profit & loss account.
- If goods lost in transit :- Only consignors expenses are considered
- If goods lost at consignees godown:- Expenses of consignor and not recurring expenses of consignee are considered.

Normal Loss

- It is an unavoidable loss, caused due to inherent features, of the goods.
- It is treated as a part of cost.
- No Journal entry is passed to account for such loss.
- Its value is adjusted by inflating the cost per unit as under:

$$\text{Effective Cost per unit} = \frac{\text{Total Cost}}{\text{Total Qty.-Normal Loss (in qty.)}}$$

Goods invoiced above cost:-

i. If goods are sent on invoice price then excess of invoice price above cost is loading.

ii. If consignment account is debited with sale price, an adjustment entry will be passed to remove the load ie:-

Goods sent on consignment a/c	Dr.	(Amount of Profit)
To consignment account		(Amount of Profit)

iii. In this case closing stock will be credited with invoice value and an additional entry to remove the load on stock will be as under:-

Consignment a/c	Dr.
To stock reserve a/c	

iv. Closing stock in balance sheet of consigner will be shown as under:-

Stock on consignment	xx
Less:- stock reserve	xx
Value of stock	xx

v. **Consignment stock is not recorded in the financial books of consignee**

Consignment Account :

- It is Prepared by consignor
- It is Nominal account like trading and profit & loss account.
- **It is Debited with:**
  - i Cost of goods consigned
  - ii Expenses incurred by consignor
  - iii Expenses incurred by consignee
  - iv Commission due to consignee
- **It is Credited with**
  - i Sale Proceeds
  - ii Abnormal loss
  - iii Closing stock
  - iv Cost of goods returned by consignee

Consignment account is closed by transferring the profit or loss on consignment to the Profit & loss account.

Return of Goods from the consignee

- Consigned goods returned by the consignee to the consignor are valued at the price at which it was consigned to the consignee.
- All expenses borne by consignor and consignee shall be ingnored

Performa Invoice

- A statement that looks like an invoice but is really not one.
- Object of Performa invoice is to convey information to the agent regarding particulars of goods.
- It is sent by consignor to consignee at the time of goods sent

Accounts Sales

- Periodical summary statement sent by the consignee to the consignor.
- It is different from sales account

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- **It contain/ detail regarding:**
  - i Sales made
  - ii Expenses incurred on behalf of the consignor
  - iii Commission earned
  - iv Unsold stock left with the consignee
  - v Advance payment or security deposited with the consignor and the extent to which it has been adjusted.
  - vi Balance payment due or remitted.

Note :- Amount remitted by agent is calculated as under;

sales made		xx
Less : Consignee's all expenses		
i	Recurring expenses	xx
ii	Non recurring expenses	xx
Consignee commission		xx
Advance given by consignee		
o	If as advance: full amount	xx
o	If as security **: proportionate amount**	xx
Bill of exchange given		xx
Amount of final payment		**xx**

Advance by the consignee vs security against the consignment :-

- **Advance payment for goods :** Adjusted full at the time of payment
- **Advance payment in the form of security deposit :** Adjusted proportionately to goods sold & unsold
  - o For Example:- If Rs. 5,00,000 given as security deposit for goods costing Rs. 20,00,000. If 50% goods sold then only 50% security ie. Rs. 2,50,000 will be adjusted at the time of remittance by consignee to consignor.

Accounting Books of consignee

- Consignee debits to consigner for advance payment, bill given, bad debts, commission earned and final payment.
- He credits consignor for cash or credit sale.
- If Del-creder commission is received then bad debits will be borne by consignee hence consignor will not be debited but commission earned will be debited for bad debts.
- Commission earned net of Bad debts will be transferred to profit & loss account.
- Consignment stock is not the stock of consigner hence it is not shown or entered in the books of consignee.
- No entry is passed in the books of consignee to account for
  - i Receipt of goods from consignor
  - ii Expenses incurred by consignor
  - iii Abnormal loss / normal loss in the godown transit.
  - iv B/R discounted by the consignor
  - v Return of goods by consigne
  - vi Unsold stock lying with him
- Loss of consignment stock is borne by consignor unless such loss occurs due to negligence of consignee.
- Abnormal loss is debited in the General Profits loss account of the consignor.

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Unit - 7.2
JOINT VENTURES

- It is short duration partnership between two or more persons without firm name.
- This partnership is formed for some specific object, like construction of bridge, dam, etc.
- Parties of Joint Ventures are known as co-venturers or joint venturers.
- Co-venturers share profit/loss of ventures in an agreed ratio, like partnership.
- **Going concern assumption :** It is not followed in joint venture, accounting. So no distinction is made between capital and revenue expenditure.
- There is no specific law to regulate the affairs of joint venture. So Indian partnership act 1932 and Indian contract act 1872 are used to regulate joint venture.
- Joint Venture automatically dissolves after completion of venture.
- Nature of Joint Venture account is Nominal Account.
- Joint Venture account is prepared to find out profit or loss of the business.
- If Agreement is silent then co-ventures enjoy equal ratio.
- Plant, Machinery and other fixes assets when used in venture are first charged to joint venture account at cost. On completion of venture such assets are revalued and shown as revenue of the joint venture if taken by ventures.
- Generally profit or loss on venture is computed on completion of the venture.

Distinction of Joint Venture Account with Partnership

S.No.	Basis	Joint Venture	Partnership
1.	Scope	Limited to a specific venture	Not Limited to a specific venture
2.	Person Involved	Called co-ventures	Called partners
3.	Ascertainment of profit / loss	The Profit / losses are ascertained at the end of venture if short duration venture if long durations venture then interim basis	The Profit / losses are ascertained on annual basis
4.	Act governing	No specific act is there	Governed by Indian Partnership Act 1932
5.	Name	There is no need for firm name	A partnership firm always has a name
6.	Separate set of books	There is no need for a separate set of books. The accounts can be maintained even in one of the co-venture's books only	A partnership firm has to maintain separate books of accounts.
7.	Admission of minor	A minor cannot be a co-venture as he is Incompetent to contract	A minor can be admitted to the benefits of the firm.
8.	Accounting	Accounting for joint venture is done on **liquidation basis**	Accounting for partnership is done on **going concern basis.**
9.	Competition	Chances of co-ventures in the competing business are very high	Partners generally do not involve in competing business

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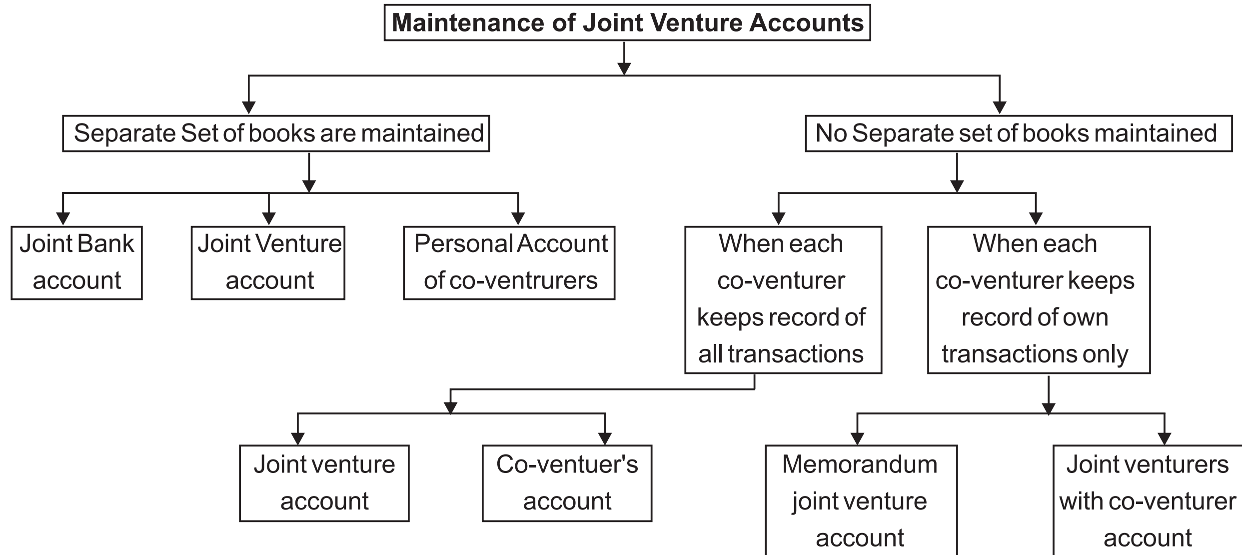
Methods of Maintaining Joint Venture Accounts

Generally there are two ways to keep records of Joint Venture :

1. When Separate Set of Books are maintained
2. When no separate set of books are maintained



When Separate Set of Books are Maintained

- When size of the venture is fairly big.
- In the Joint Venture books the following accounts are opened.

(i) **Joint Bank a/c**

- It is personal a/c in nature
- Open with initial contributions of co-venturers
- All cash bank transactions are recorded here.
- On completion of the venture the joint bank a/c is closed by paying the balance to co-venturers.

(ii) **Joint Venture a/c**

- It is nominal in nature
- Used to calculate the profit / loss on joint venture
- Venture profit / loss is transferred to co-venturers a/c

(iii) **Co-venturer a/c**

- It is personal in nature
- Used to record dealings with the joint business and to ascertain the amount due to / from them.
- This a/c is also closed simultaneously with the closure of joint bank a/c

Journal Entries

1. For Initial contribution by the co-venturers in joint bank a/c

Joint Bank a/c Dr.

To co-venturers a/c

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2. **For Expenses paid out of joint bank account**

   Joint venture a/c Dr.

   To joint bank a/c

3. **For material supplied by venturers or direct payment made by venturers**

   Joint Venture a/c Dr.

   To co-venturers /ac

4. **For sale or payment received**

   Joint bank a/c Dr.

   To Joint venture a/c

5. **For sale or payment directly received by venturers**

   Co-ventures a/c Dr.

   To Joint venture a/c

6. **For profit on joint venture**

   Joint venture a/c Dr.

   To co-venturers a/c

7. **For loss on joint venture**

   Co-venturers a/c Dr.

   To joint venture a/c

8. **For closing the joint bank a/c**

   Co-venturers a/c Dr.

   To joint bank a/c

<u>When no separate set of books are maintained</u>

(A) **<u>When each co-venturer keeps record of all transaction</u>**

(i) For supply of goods to venture out of business stock :-

Joint Venture a/c Dr.

To purchasea/c

(ii) For meeting expenses of venture

Joint Venture a/c Dr.

To Bank a/c

(iii) When co-venture supplies goods and incurs expenses for venture

Joint Venture A/c Dr.

To co-venture a/c

(iv) For venture sale

Bank a/c Dr.

To Joint venture /ac

(v) For Venture sale made by the co-venturer

Co-venturer a/c Dr.
  To joint venture a/c

(vi) For venture profit

Joint venture a/c Dr.
  To Profit & loss a/c

(v) **For Venture loss**

Profits loss a/c Dr.
Co-venturer a/c Dr.
  To Joint venture /ac
  To co-venturers a/c

(vi) **For settlement of claim (payment is due to venture)**

Co-ventuer a/c Dr.
  To Bank

When payment is due from co-venturer

Bank a/c Dr.
  To Co-venturer a/c

When each co-venturer keep records of their own transaction only

- It is necessary to open "Joint Venture with co-venturer a/c it is personal account
- For determination of profit & loss Memorandum Joint Venture account is prepared.
- Venturers usually pass the following journal entries

(a) For supply of material from stores

Joint venture with "x" a/c Dr.
  To purchase a/c

(b) For payment of expenses

Joint venture with "x" a/c Dr.
  To Bank / cases a/c

(c) For Sale on venture

Bank a/c Dr.
  To Joint venture with x a/c

(d) For Profit on venture

Joint venture with x a/c Dr.
  To Profit & loss a/c

.

(e) For final payment to co-venturer

Joint venture with x a/c Dr.
  To Bank a/c

Memorandum Joint Ventures Account

- It is rough statement prepared by the venturers for determination of venture profit when they do not maintain full records of venture transaction in the books of accounts.
- It is nominal account

Other tutorial note

- When bill of exchange is drawn by one co-venturer on the other and such bill is discounted, discount charges are debited in joint venture a/c
- No accounting is made when goods are transferred by one co-venturer to the other.
- No accounting is made for loss of stock, however amount of claim is credited to joint venture a/c

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Unit - 7.3
BILLS OF EXCHANGE & PROMISSORY NOTES

BIILS OF EXCHANGE:-

When goods are sold on credit, the seller would like that purchaser should give a promise in written.

- When a written promise is made in **proper form and is properly stamped,** It is supposed that buyer has discharged his debt and seller has received payment.
- And such written promise is either in the form of **Bills of Exchange** or in the form of a **promissory note.**

Bill of Exchange:-

Meaning

Bills of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of certain person or to the bearer of instrument.

Characteristics of bills of exchange

- Must be in writing and
- containing an unconditional order signed by the maker.
- Must be dated.
- Must contain an order to pay a certain sum of money.
- Must be payable to a definite person or to the order of a certain person or to the bearer.
- Must be accepted by the party making payment.
- When such order is accepted in writing on the face of the order itself, it becomes a valid bill of exchange.
- When such order is sent to buyer it is known as **Draft.** After acceptance it becomes a proper bill of exchange.
- **parties to bills of exchange :**
  - **Drawer:-** Which makes the order.
  - **Acceptor or Drawee:-**Which accepts the order.
  - **Payee:-**To whom amount has to be paid so drawer and payee can be same.
- A bills of exchange can be passed on to another person by **endorsement**.
- Primary liability on a bill of exchange is on the **Acceptor**.
- In case, he does not pay, a holder can recover the amount from any of the previous endorsers or the drawee.

FOREIGN BILLS OF EXCHANGE:-

According to Section 12 of the Negotiable Instrument Act, all instruments which are not inland instrument are foreign.

These are:

- Drawn up in triplicate;
- Each copy is sent by separate post so that at least one copy reaches to intended party
- Payment will be for one copy then other copies become useless.

Following are examples of foreign bills.

1. A bill drawn in India **on a person resident outside India** and **made payable outside India.**
2. **A bill drawn outside India;**
   - o On a person resident outside India or
   - o Made payable in India or
   - o Made payable outside India.

PROMISSORY NOTES:-

A promissory note is an instrument in writing ,not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person

FEATURES OF PROMISSORY NOTES:-

- Is must be in writing and **signed** by the maker to pay a certain sum of money only to or to the order of a certain person.
- Bank note or currency note are not promissory notes;
- It must contain a clear promise to pay. Mere acknowledgment of a debt is not a promissory note.
- The promise to pay must be unconditional "I promise to pay Rs.500 as soon as I Can" is not an unconditional promise.
- The maker and payee must be a certain person.
- The sum payable must be certain. "I promise to pay Rs.500 plus all fine" is not certain.
- Payment must be in legal currency of the country.
- Under section 31(2) of RBI Act- It should not be made payable to the bearer.
- It should be properly stamped.

RECORD OF BIILS OF EXCHANGE AND PROMISSORY NOTES:

A party who receives a Promissory Note or receives an accepted bill of exchange is as a new asset under the name of Bills Receivable.

A party which issues a Promissory Note or accepts a bill of exchange is as New Liability under the heading of Bills Payable.

Journal Entries in the books of party which receives promissory notes or bills:-

1. On receipt of Bill:-

Bills Receivable Account Dr.
To Drawee or [In case of bills of exchange]
To Maker [In case of promissory note]

2. The person who receives the bill has three options: - These are;

- He can hold the bill till maturity. **No further entry is passed.**
- Bill can be endorsed to another person;-

Endorsee's Account Dr.
To Bills Receivable Account

- Bill can be discounted with Bank.

Bank Account Dr. [with the amount actually received]
Discount Account Dr. [with the amount of loss or discount]
To Bills Receivable Account

3. On the date of maturity:- There will be two possibility:-

i. Bill will be paid:-

a. If the bill was kept

Cash Account Dr.
To Bill Receivable Account

b. If the bill was endorsed or discounted no entry will be passed by the party which origionally received the bill because payment will not be received by him

ii. Bill will be dishonored;- In this case following entries will be made according to following situations:-

- **If the bill was kept till maturity then:**

Drawee Account Dr.
To Bills Receivable Account

- **If the bill was endorsed in favour of a creditor:**
  Drawee Account Dr.
  To creditor

- **If the bill was discounted with the bank:**
  Drawee Account Dr.
  To Bank Account

In case of dishonor, always debit the party which gave the bill

BILL AT SIGHT/DEMAND BILL:-

- Meaning:-
  - o Cheque is always payable on Demand
  - o A bill of exchange or promissory note is payable on demand if:
  - - No time of payment is mentioned;
  - - To be payable **on demand**, or **at sight** or **on presentation**
- It can be presented for payment at any time.
- **Days of grace is not added to calculate maturity** of such types of bills.

BILL AFTER DATE:-

- Meaning**:- Instrument in which**
  - - Time of payment is mentioned;
- A bill of exchange or promissory note is a time bill if payable
  - - After a specified period.
  - - On a specific day
  - - **After sight**
  - - On the happening of event which is certain to happen.

Notes:-

(i.) The expression 'after sight' means:-
  b. In a **promissory note**, after presentment for sight.
  c. In a **bill of exchange**, after acceptance or noting for non-acceptance or protest for non-acceptance.
(ii.) A cheque cannot be time instrument because the cheque is always payable on demand.

TERM OF BILL.

Term of Bill may be of any duration usually upto 90 days.

Term of bill when start:

- A bill which is drawn "**after sight**", its term commences from the date of '**SIGHTING**' i.e. when the **bill is accepted.**
- A Bill which is drawn" **after date**" the term of the bill begins to run from **the date of drawing the bill.**

DUE DATE OF A BILL.

The date on which the term of the bill expires is called as **"Due Date of the Bill".**

DAYS OF GRACE:-

Every instrument payable **otherwise than on demand** is entitled to three days of grace. i.e

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Demand Bill: -No grace period.

Term Bill: - 3 Days

DATE OF MATURITY OF BILL.

The date which comes after adding three days to the due date of a bill, called the date of maturity. i.e.

Term Bill: - Due Date +3 Days.

Demand Bill: -Due Date is maturity date

HOW TO CALCULATE DUE DATE OF A BILL.

S.No.	Case	Due Date
1.	Payable on a specific date.	That Specific date.
2.	Payable after certain months	That date on which the term of the bill shall expire. i.e. Corresponding date of month or if there is no corresponding date then last date of such a month.
3.	Payable after No.of days	That date which comes after adding number of days. **The date of Bill is excluded.**
4.	Due date is public holiday	The preceding business day
5.	Due date is an emergency/ unforeseen holiday	The next following day

Noting Charges

- The amount of noting charges is recoverable from the party **which is responsible for dishonor**
- If the acceptor can prove that the bill was not properly presented to him, he may escape liability
- If there is dishonor, or fear of dishonor, the bill will be given to a **public official known** as **"Notary Public".**
- Notary public then present bill for payment and if money is received, hand over to original party.
- If bill is dishonored, after noting fact they give the bill back to their client for this service they charge a small fee known as **noting charges.**

Journal Entries:-

E.g. K received from L a bill for Rs.5000. On maturity the bill is dishonoured and Rs.50 is paid as noting charges.

A. If bill was kept till maturity.

		Dr.	Cr.
L Account	Dr.	5050	
To Bill Receivable Account			5000
To Bank Account			50

B. If bill was endorsed in favour of creditor.

		Dr.	Cr.
L Account	Dr.	5050	
To M			5050

C. If bill was discounted with the Bank.

		Dr.	Cr.
L Account	Dr.	5050	
To Bank A/c			5050

Renewal of Bill:-

- When acceptor is unable to pay the amount then he himself moves for extension of time period.
- Then old bill get cancelled and entry will be same as passed for dishonor.
- In this case new bill is drawn and entry will be same as passed at the time of receipt of the bill.
- In addition one interest entry more passed which is charged from acceptor for the extension period.

Accommodation Bills;-

To satisfy financial need these bills are drawn.

The discounting charges must also be borne by the two parties in the same ratio in which the proceeds are divided.

INSOLVENCY:-

- Means he is unable to pay his liabilities.
- When a person becomes insolvent then entry for dishonor must be passed **when it is known about insolvency even before due date**
- Later on something may be received from his estate, then cash account debit and debtor account credit entry is passed. Remaining amount will be irrecoverable and should be written as **Bad Debt.**
- In the books of drawee, the amount not ultimately paid by him due to insolvency should be credited to deficiency account.

BIILS OF COLLECTION:-

To ensure safety, bill is sent to bank till maturity to collect the bill known as "Bill sent for collection".

It is not discounting with the Bank because the bank will not credit the client until the amount is actually is realized.

Journal Entry:-

1. Bills for collection account Dr.
   To Bills Receivable Account
2. **When bill is realized;-**
   Bank Account Dr.
   To Bills for Collection Account
3. **When amount is not honoured, entry will be:-**
   Party account Dr. [from whom bill was received]
   To Bills for Collection

Retirement of Bills of Exchange

- made when acceptor has spare funds much before the maturity.
- In such a case the acceptor gets a certain rebate on interest on discount for premature payment.
- The interest becomes the income of the acceptor and expenses of the payee.
- It is a consideration of premature payment.

BIILS RECEIVABLE AND BILLS PAYABLE BOOKS;-

- These books are journal (Day Books).
- To record in a chronological order the details of B/R and B/P.
- Bills Receivable and Bills payable books are useful for following up the status of outstanding bills
- From maintaining these books, it is possible to trace the details of the outstanding bills and to identify the reasons for not honoring the bills.

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Unit - 7.4
SALE OF GOODS ON APPROVAL OR RETURN BASIS

INTRODUCTION:-

- Mean the delivery of the goods to the customers with the option to retain or return them within a specified period.
- Purpose:
  - o Pushing up the sales or
  - o For introducing the new product in the market
- Generally these transaction take place between a manufacturer (or a wholesaler) and a retailer.
- Goods transferred from the wholesaler to the retailer, under a sale or return basis, **change in the possession of goods only and not a transfer of the ownership of goods.**
- Ownership is transferred as and when approval comes from retailer or goods are not returned within specified period.
- There is **no liability of retailer (customer)** merely that goods sent to him.

As per definition given under the **Sale of Goods Act, 1983 ,** the sale will take place or the property in the goods pass to the buyer:

i. When retailer gives his approval or acceptance to the seller Or

ii. When he does some act adopting the transaction Or

iii. Retains the goods without giving notice of rejection:-

- On the expiry of the specified time (if a time has been fixed) Or
- On the expiry of a reasonable time (if no time has been fixed)

ACCOUNTING RECORDS:-

Depends on the fact whether the business sends goods on sale or approval basis

i. Casually

ii. Frequently

iii. Numerously

WHEN GOODS SENDS CASUALLY ON SALES OR RETURN:-

- Transactions is treated as Ordinary Sale;
- If goods are accepted or not returned, No extra entry is required to be passed;
- If goods are returned within a specified time limit, a reverse entry is passed to cancel previous transaction;
- **At year end, goods are still lying with the customers and the specified time limit is yet to expire**
  - i Sale entry is cancelled and
  - ii Value of the goods lying with the customers must be reduced from selling price to the cost price and
  - iii Treated ordinary stock for Balance Sheet purposes.

JOURNAL ENTRIES:-

1. When goods are sent on approval or on sale or return basis

Sundry Debtors Account	Dr.	[Invoice Price]
To Sales Account		

2. When goods are rejected or returned within the specified time

Sale/Return Inwards Account	Dr.	[Invoice Price]
To Customers/Sundry Debtors Account		

3. When goods are accepted at invoice price

No Entry

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4. When goods are accepted at a higher price than invoice price

Sundry Debtors Account Dr. [Difference in Price]
To Sales Account

5. When goods are accepted at a lower price than invoice price

Sales Account Dr. [Difference in Price]
To Sundry Debtors Account

6. (i) At the year end, goods are lying with the customers and specified time limit is yet to expire

Sales Account Dr. [Invoice Price]
To Sundry Debtors Account

(ii) Treated stock with customers and adjustment entry is to be passed:-

Stock with customers on Sale or Return Account Dr.
To Trading Account [Cost price or market price whichever is less]

WHEN GOODS SENDS FREQUENTLY ON SALE OR RETURN BASIS;-

- As long as the property does not pass to the buyer, the seller should not record it as a sale.
- Therefore, **should not debit the customer with the sales price.**
- In this case a specially ruled sale or return journal / Day Book shall be maintained.
- This day book is divided in **four main columns**
  - i. Goods sent on approval- **Sale price of good entered.**
  - ii Goods returned- **The price of goods returned.**
  - iii Goods approved- **The price of good approved.**
  - iv Balance- Calculated as under:-
    = Value of goods sent on Sale or Return **Less** Value of Goods returned **Less** Value of Goods Approved.

Note that:-

When goods are sent :

entered in sale or return journal
the sale price also posted to debit of individual customers in goods on approval ledger
periodically total of all such sales is credited to goods on approval ledger

when goods are returned

entered in sale or return journal
the sale price also posted to credit of individual customers in goods on approval ledger
periodically total of all such sales returns is dedited to goods on approval ledger

when goods are retained

entered in sale or return journal
the sale price also posted to credit of individual customers in goods on approval ledger
periodically total of all such retention is dedited to goods on approval ledger

balance

balance is written in sales or return journal
total of this column will show stock with customers at selling price

- Information relating to **goods delivered and goods returned** is kept on **Memorandum Basis.**
- However, information relating to **goods approved and balance** is duly accounted for by passing journal entries to sales and stock on approval basis.

i. At the time of approval:-

Customers Account Dr.
   To Sales Account

ii. At the time of preparing of Final Accounts

Like an ordinary closing stock, such goods are considered as stock lying with customers on behalf of seller **are valued at cost or net realizable value whichever is less.**

Goods with Customers on Sale or Return Account Dr.
   To Sales Account

WHEN GOODS SENDS NUMEROUSLY ON SALE OR RETURN:-

The business maintains (a) Sale or Return Day Book (b) Sale or return Ledger. Ledger contains the account of the customers and the "Sale or Return" Total Account.

- Both the books treated as **"Memorandum Books"**

In this case, when the goods are sent to the customers on a sale or return basis, they are recorded in the Sale or Return day book.

In the sale or return ledger, all the customers are individually debited and the Sale or Return Account is credited with the periodical total of the Sale or Return Day Book.

When the goods are returned by the customers within specified time, **they are initially recorded in the Sale or Return Day Book.** Thereafter, **in the Sale or Return Ledger**, the Sale or Return Account is debited with the periodical total of the Sale or Return Day Book and the individual customers are credited. These records are all memorandum and hence cannot find a place in the regular books.

When acceptance of the goods or no intimation is received within the specified time, they are recognized as sales and are recorded in the Sales Day Book. Periodically, the total of the Sales Day Book is credited to Sales Account and debited to the Individual Customers Account.

To cancel the earlier entries, individual customers are credited and the Sale or Return Account is debited. The entries for the approved goods are shown as below:-

In the Memorandum Sale or Return Ledger:-

Sale or Return Account Dr.
   To Individual Customers Account

In the regular General Ledger

Individual Customers Account Dr.
   To Sales Account

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CHAPTER # 8
PARTNERSHIP ACCOUNTS

Unit - 8.1
INTRODUCTION TO PARTNERSHIP ACCOUNTS

INTRODUCTION

- Defined in section 4 (1) of the Indian partnership act 1932

  Definition:- Partnership is a relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all

Features of Partnership

- Association of two or more persons.
- The carrying on of business by all or any of them acting for all.
- Sharing of profit of the business (including losses)
- Unlimited liability of all partners.
- At the time of formation of firm minor cannot be included.
- Minor can only included in firm for profit only, he will not contribute in the losses.
- Registration of a firm is optional and not compulsory.
- Partnership is created by Agreement, not by law.
- Partnership firm has no separate legal entity.
- Minimum partners limit is 2 either banking or non banking business.
- **Maximum partners limit is given in companies act 1956 ar:**

  Maximum Limit For banking business: 10 and

  For non banking: 20.
- A partner is the agent of a firm.
- Existence of business called 'firm'.

LIMITED LIABILITY PARTNERSHIP

- **Short comings of existing form of partnership**
  - i. Unlimited liability of all partner for business debts and legal consequences regardless of their holding.
  - ii. General partners are also jointly and severely liable for tortous Act of co-partners.
  - iii. Each partners has exposure of their personal assets being appropriated and liquidated to meet partnership dues.

- **Purpose of Limited liability Partnership**
  - i. To encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability.
  - ii. To enable professional expertise and entrepreneurial initiative to combine recourses.

- **Characteristics**
  - i. It is an alternative corporate business proposal that provide benefit of limited liability but allow its members the flexibility of organizing their internal structure based on mutually agreement.
  - ii. It is separate Legal Entity.
  - iii. **Liability of :**

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LLP: To the full extent of its assets.

Partners: Limited to their agreed contribution in LLP which may be of tangible or intangible or both in nature.

iv. No partner is liable an account of the independent or un-authorize Act of other partners or their misconduct.

- **Unlimited Liability of LLP and partners if :-**
  i. Who are found to have acted with intention to defraud creditors or
  ii. **For any fraudulent purpose:** In above cases liability will be unlimited for all or any of the debts or other liability of LLP.

- **Main Advantage:-**
  i. Main advantage is that it is taxed as a partnership but has a benefit of being corporate; a Juristic entity with limited liability.
  ii. Separate legal personality distinct from its partners.

MAIN CLAUSES OF PARTNERSHIP DEED :

- There must be an agreement to form a partnership.
- Agreement may be express (whether written or oral) or implied.
- Partnership is voluntary and contractual in nature.
- The written agreement is known as partnership deed.
- Deed shall be properly stamped.
- Registration of deed is not compulsory.
- Partnership deed is registered in the court of law whereas partnership agreement is not registered.
- Non registration restricts the partners or firm from taking any legal action.
- If there is no partnership deed or if there is one but it may be silent on a particular point in that case relevant sections of the partnership act will apply.
- In absence of any partnership deed / agreement
  A. No partner has the right to salary.
  B. No interest allowed on capital
  C. No interest charged on drawings
  D. Interest on partners loan allowed at 6% (simple interest)
  E. Profits and losses are shared equally

Note: 1. In absence of agreement, the interest and salary payable to a partner will be paid only if there is a profit.
2. If in the question it is stated to calculate as per partnership act 1932 it means there is no deed or deed is silent.

ACCOUNTS

- If partner takes money / goods for personal use either his **capital a/c** or **drawings a/c** will be debited.
- Drawings a/c is also known as current a/c
- At last drawing a/c may be transferred to capital a/c or may be kept separate.

Profit & Loss Appropriation A/c :

- It is nominal a/c is nature.
- It is not prepared by sole proprietor.
- It is prepared as per partnership deed.
- In the absence of partnership deed, it will be prepared as per **clause** of partnership act.
- It included appropriation of profit only not charge against profit.

Fixed Capital A/c

- The capital normally remains unchanged except:-
  - i. Introduction of long term capital
  - ii. Permanent Reduction in capital
- Two accounts are maintained for each partner.
  - A. Fixed capital A/c
  - B. Current A/c or drawing a/c
- All adjustments for drawings, Interest on drawings, Interest on capital, salary, share of profit / loss are made in current account.
- Fixed capital account can never show a negative balance means always show a credit balance.
- Under this method interest on capital will be only on fixed capital account.

Fluctuating Capital Method

- The capital fluctuates quite frequently from period to period.
- Only on account (capital a/c) is mainted fo each year.
- All adjustments for drawings. Interest on capital, salary, share of profit / loss are made in capital a/c
- Fluctuating capital a/c can show a negative balance.
- Interest is calculated on capital used, times basis

Interest on Capital

- Interest on capital is to be calculated when there is a clause in partnership deed.
- **Interest on capital is Appropriation of profit, not charge on profit.**
- If there is no clause in deed/agreement then there is no question above interest on capital.
- In Fixed capital method interest will be on fixed capital a/c and no interest is payable on the balance of current a/c
- Full interest is paid on opening balance of capital and on the additional capital introduced during the year, interest for the relevant period of utilization is calculated.
- If date of introduction of capital not given then interest will be for six months.
- Interest on capital will be allowed only if there are profit.
- In case of loss, no interest on capital will be allowed.
- In case profit before interest is less than interest, profit will be distributed in the **ratio of capital of each partners.**

Interest on Drawings

- Interest on drawing is income for firm.
- Interest on drawing is to be charged from partners only when the partnership agreement provides for the same and **accepted by partner.**
- Where drawing made at different dates then interest on drawings should be calculated with the help of product method.
- When dates of drawings are not given the interest on drawing is calculated on the total amount of drawings for an **average period of 6 months.**
- The entry to record interest on Drawings is to debit capital or current account and credit to profit and loss appropriation account.

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Table for interest on drawings.

	Monthly	Quarterly	Half Yearly
Beginning	$\frac{12+1}{2}$ = 6.5 months	$\frac{12+3}{2}$ = 7.5 months	$\frac{12+6}{2}$ = 9 months
Middle	$\frac{11.5+.5}{2}$ = 6 months	$\frac{10.5+1.5}{2}$ = 6 months	$\frac{9+3}{2}$ = 6 months
End	$\frac{11+0}{2}$ = 6.5 months	$\frac{9+0}{2}$ = 4.5 months	$\frac{6+0}{2}$ = 3 months

Guarantee of Minimum Profit

- It means assurance to give a minimum amount of profit to partner.
- If the question is silent about the nature of guarantee . The burden of guarantee is borne by the remaining partner in their profit sharing ratio.
- If share of guaranteed partner in profit is higher than guaranteed profit than guarantee is meaningless and profit will be distributed in normal way.
- If the share of partner is less than the guaranteed amount than he will take minimum profit and shortfall will be born by remaining partners as per agreement, and if there is no agreement than in profit sharing ratio.
- Minor partner and guaranteed (profit) partner are shared only profit hence it is proved that they are not contributing in case of loss.

Methods of carrying out part adjustment

- If after the final a/c have been prepared and the profit have already been distributed, some omission or commission are found than adjustment can be made.
  1. Either through profit & loss adjustment a/c or
  2. Directly through the capital a/c of concerned partners.

Unit - 8.2
TREATMENT OF GOODWILL IN PARTNERSHIP ACCOUNTS

1. Goodwill

- The value of reputation of a firm which makes it earn over and above the normal rate of profits.
- Goodwill is regarded as an intangible asset and not a fictitious asset, it will be valuable right for organization.
- As per AS 10 only purchased goodwill is recorded in the books means self generated goodwill is Ignored.
- Valuation of goodwill due to following mentioned reaons.
  A. The profits sharing ratio among partners changed.
  B. A new partner is admitted
  C. A old partner retires or dies
  D. The business is dissolved or sold
- The partner who gains will pay for goodwill and who scarifies will receive share of goodwill.

2. Methods for goodwill valuation

A. Average profit method
B. Super profit method
C. Annuity method
D. Capitalization of super profit method.

A. Average Profit Method :

- Average profit is calculated as under :

	Year 1	Year 2	Year 3
Profit before tax	xx	xx	xx
Past years Adjustments :-			
Add : Abnormal loss	xx	xx	xx
Less : Abnormal gain			
non recurring income	xx	xx	xx
speculation income	xx	xx	xx
Non trade Income	xx	xx	xx
Add / less rectification of error	xx	xx	xx
Adjusted profit	xx	xx	xx

Search the trends in this profit :

- If there is clear increasing or decreasing trend of profits then use weighted average otherwise use simple average of these profits
- Weights are assigned on years not on profit
- After being averaging the profit whether simple or weighted

Simple or weighted profit :	xx
Future Adjustment	
Add : Future expected income	xx
Reduction in expenses	xx
Less : Increase in expenses	xx
Reduction in income	xx

Appropriate managerial commission	xx
Profit before tax	xx
Less : Income Tax	xx
Future maintainable profit	xx

Goodwill = Future maintainable profit x number of years

2. **Super Profit Method :**

- Excess profit over and above normal profit is known as super profit.
- In this method time value of money is not considered.
- If there is no super profit, there will be no goodwill.
- Goodwill = Annual super profit x number of years of purchase

Note : A. Super profit = Average profit - Normal profit

B. Normal Profit = Capital employed x normal rate of return

C. Normal Rate of Return:

a. Normal profit is usually profit earned by similar firms under similar circumstances

b. If only interest rate or market rate of return is given it can be taken as normal rate.

c. If risk premium also given with market rate or interest rate then this premium will be added in interest rate or market rate to arrive normal rate.

d. Normal rate of return is also known as expected rate or reasonable rate of return

3. **Annuity Method**

- Time value is considered
- In Annuity method value of goodwill will be lower than super profit method.
- Goodwill = Super profits X annuity factor.

4. **Capitalization Method**

- Time value of money considered
- Goodwill = Value of Business -- Capital Employed
- Value of Business = $\frac{\text{Average / Future maintainable profit}}{\text{Normal Rate of Return}}$
- **Steps for Goodwill Value**

i. Determine normal Rate of Return.

ii. Calculate Average profit of Firm.

iii. Calculate Capital Employed.

iv. Calculate Value of Business.

v. Deduct Average capital Employed form value of business to find goodwill.

Alternative Method

i. Calculate super profit.

ii. Goodwill = Super profit / Normal rate of return

Note:

- **Undisclosed value of goodwill** = total value of goodwill - book value of goodwill.

Valuation of goodwill in case of admission of new partners

- Only purchased goodwill should be recorded in the books of the firm.
- Amount brought by new partner over and above his capital contribution is known as premium / goodwill.
- Goodwill is compensation to old partners for their sacrifice so it is credited in their profit sacrificing ratio.
- Profit sacrificing ratio = old ratio new ratio.
- Adjustment of goodwill should be through partners capital a/c instead to raise goodwill.
- Payment of any premium for goodwill privately to the existing partners then no entry is required in the books of the firm.
- When incoming partner is unable to bring cash for goodwill then goodwill should not be raised in the books since it is inherent goodwill and should be adjusted through partners Capital a/c by this adjustment entry =

  Gaining partners capital a/c Dr.
  To Sacrificing partners capita a/c

Journal Entries of Goodwill

1. **When goodwill is brought in cash :**

Bank a/c	Dr.	(Capital + goodwill)
To Incoming partners capital a/c		(capital amount)
To existing partners capital a/c		(goodwill amount)
Or		
Bank a/c	Dr.	(goodwill amount)
To sacrificing existing partners capital a/c		(sacrificing ratio)
Or		
Bank a/c	Dr.	(Capital + goodwill)
To Incoming partners capital a/c		(Capital + goodwill)
Incoming partners Capital a/c	Dr.	(goodwill)
To existing partners capital a/c		(sacrificing ratio)

2. **When goodwill not brought in cash**

- Adjusted through partners capital a/c

Incoming partners capital a/c	Dr.	(goodwill)
To existing partners capital a/c		(sacrificing partner)

Or

- By opening goodwill a/c with the old partners capital and then closing goodwill a/c with the new partners capital.

Goodwill a/c	Dr.	
To old partners capital a/c		(old profit sharing ratio)
All partner including new partners	Dr.	
To goodwill a/c		(New profit sharing ratio)

When Amount of goodwill withdrawn

Partners Capital a/c	Dr.
To Bank a/c	

Accounting Treatment of Goodwill in case of change in profit sharing ratio

a. Value of goodwill (full value) should be determined.
b. Distribute this goodwill in old profit sharing ratio.
c. Distribute again the goodwill in new profit sharing ratio.

d. After making the difference between step (B) and (C) pass a adjustment entry by capital a/c

Gaining partners capital a/c Dr.

To sacrificing partners capital a/c

Accounting treatment of goodwill in case of retirement or death of a partners :

- Continuing partners gain in terms of profit sharing ratio. Therefore they have to pay to retiring partner.
- For this goodwill is valued at date of retirement or death and adjusted through capital a/c of the partner.

Adjustment for hidden goodwill

Incoming partners capital X reciprocal of share of incoming partner.	xx
Less : Total capital after taking into consideration the capital brought in by incoming partner.	xx
Value of goodwill	xx

Unit - 8.3
ADMISSION OF NEW PARTNER

- Admission of a partner is one of the mode of reconstituting the firm.
- Old partnership comes to an end and a new partnership comes into existence (including new partner)
- A person can be admitted as new partner only with the consent of all the existing partners unless otherwise agreed.
- Adjustment required at the time of admission of a new partner.
  - A. Adjustment of profit / loss arising from revaluation of asset and liabilities.
  - B. Adjustment in profit sharing ratio.
  - C. Adjustment of goodwill
  - D. Adjustment of capital.

Revaluation account or profit & loss adjustment a/c

- Nominal a/c
- Prepared at the time of admission, retirement and death, but not prepared at the time of dissolution / liquidity of firm.
- This a/c is debited with decrease in asset and increase in the liabilities.
- This a/c is credited with increase in value of asset and decrease in the liabilities.
- The balance of revaluation a/c is transferred to old partners capital a/c in their old profit sharing ratio.
- After revaluation assets and liabilities appear in the balance sheet at their revised figures.
- If partners may agree that revalued figures will not be shown in the balance sheet and they will shown on old value then there are two way.
- By memorandum revaluation a/c
  - i. Prepare memorandum Revaluation account as normal revaluation account :

  If Profit

  - Memorandum Revaluation a/c Dr. (old profit sharing Ratio)
    - To Old Partners capital a/c (old profit sharing Ratio)

    All partners capital a/c Dr. (new profit sharing ratio)
    - To Memorandum Revaluation a/c (new profit sharing ratio)
- **Adjustment entry by capital a/c:**

  Gaining partners capital a/c Dr.
  - To Sacrificing partners capital a/c

Adjustment of accumulated profits / loss in the balance sheet

- Belongs to old partners and distributes them in old profit sharing ratio, even no information is given in the question.
- For reserves and profits, partners capital a/c is credited and for accumulated losses partners capital a/c is debited.

Adjustment in profit sharing ratio condition if new profit sharing ratio is not given

Ex. 1. A, B are partners in the ratio of 3 : 2, they admitted C for 1/6 share in the firm, calculate sacrificing ratio and new ratio.

- In this situation old profit sharing ratio is sacrificing ratio also.

For C = $\frac{1}{6}$

Remaining Firm = $\frac{1}{6} = \frac{5}{6}$

A (New) = $\frac{5}{6} \times \frac{3}{5} = \frac{15}{30}$

Before admission

Firm	A	B
600	360	240

After Admission

Firm	A	B	C
600	300	200	100

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<table>
<tr><td>B (New) = $\frac{5}{6} \times \frac{2}{5} = \frac{10}{30}$

C = $\frac{1}{6} \times \frac{5}{5} = \frac{5}{30}$

New Ratio = 15 : 10 : 5
Or say
3 : 2 : 1</td><td>For = $\frac{1}{6} \times \frac{100}{500}$

Sacrifice 60 40
Or say
3 : 2</td></tr>
</table>

Ex. 2. A and B are partners in a firm sharing profits and losses in the ratio of 3 : 2, C is admitted in the firm and the new ratio is 4 : 3 : 1. Calculate sacrificing Ratio and New ratio.

<table>
<tr><th>Option A</th><th>Option B</th></tr>
<tr><td>Sacrificing = Old Ratio - New Ratio

A = $\frac{3}{5} - \frac{4}{8}$
$\frac{24 - 20}{40} = \frac{4}{40}$
B = $\frac{2}{5} - \frac{3}{8}$
$\frac{16 - 15}{40} = \frac{1}{40}$

Sacrifice = 4 : 1</td><td>Before
Firm A B
800 480 320

After
Firm A B C
800 400 300 100
Sacrifice 80 : 20
New Rates = 4 : 3 : 1

Sacrifice = 4 : 1</td></tr>
</table>

Ex. 3. A and B are partners in a firm sharing profits and losses in the ratio of 3 : 2. C is admitted for 1/6th share in the firm which he receives equally from A and B.

Calculate Sacrificing Ration and New Ratio

<table>
<tr><td>Option A

C Ratio = $\frac{1}{6}$
A Sacrifice = $\frac{1}{6} \times \frac{1}{2} = \frac{1}{12}$

B Sacrifice = $\frac{1}{6} \times \frac{1}{2} = \frac{1}{12}$

Sacrifice 1 : 1
A's New Ratio
$= \frac{3}{5} - \frac{1}{12}$ $\frac{36 - 5}{60} = \frac{31}{60}$

B's New Ratio
$= \frac{2}{5} - \frac{1}{12}$ $\frac{24 - 6}{60} = \frac{19}{60}$</td><td>Option B

Before
Firm A B
600 360 240

After
Firm A B C
600
- 100 - 50 - 50 100
310 190 100
New Ratio 31 : 19 : 10
Sacrifice 1 : 1</td></tr>
</table>

Eg. 4. A and B are partners in a firm sharing profit and losses in the ratio of 3 : 2. C is admitted for 1/5 share in the firm. Which he receives entirely from A.

Calculate sacrificing ratio and new ratio.

Option A	**Option B**
$A = \frac{3}{5} - \frac{1}{5} = \frac{2}{5}$ $B = \frac{3}{5} - 0 = \frac{2}{5}$ $C = \frac{2}{5}$ $\frac{3}{5} : \frac{2}{5} : \frac{1}{5}$ New Ratio 2 : 2 : 1	Before Firm A B 500 300 200 After Firm A B C 500 - 100 - 100 0 + 100 400 200 200 100 Only A sacrificing New Ratio = 2 : 2 : 1

Eg. 5. A and B are partner in a firm sharing profit and losses in the ratio of 3 : 2. C is admitted in the firm. A surrenders 2/5th of his share in favour of C and. B surrenders 1/5th of his share in favour of C.

Option A	**Option B**
A sacrifice = $\frac{3}{5} - \frac{2}{5} = \frac{6}{25}$ B sacrifice = $\frac{2}{5} \times \frac{1}{5} = \frac{2}{25}$ $\frac{6}{25} : \frac{2}{25}$ means 6 : 2 or 3 : 1 New Ratio $A = \frac{3}{5} - \frac{6}{25} = \frac{9}{25}$ $B = \frac{2}{5} - \frac{2}{25} = \frac{8}{25}$ $C = \frac{6}{25} - \frac{2}{25} = \frac{8}{25}$	Before Firm A B 500 300 200 After Firm A B C 500 - 120 - 40 + 160 180 160 160 New 9 : 8 : 8

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Unit - 8.4
RETIREMENT OF A PARTNER

INTRODUCTION:-

- Generally the business of the partnership firm does not affect due to retirement of a partner.
- Other partners may continue to run the business of the firm.
- Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio.
- Re-adjustment take place like revaluation of assets and recomputation of liabilities, valuation of goodwill and surrender value of joint life policy if any taken.
- Revaluation of profit and reserve and surplus transferred to capital or current account of partners
- Lastly, final amount due to retiring partner is determined and discharges.

Gaining Ratio: - On retirement the continuing partner will gain in the term of profit sharing ratio.

Gaining Ratio = New Ratio - Old Ratio

E.g. A, B and C were sharing profits and losses in the ratio of 5:3:2 and B retires then A and C has decided will share profits and losses in future at the ratio of 3:2 then A gains 1/10 (3/5-5/10) and C gains 2/10 (2/5-2/10). Gaining ratio between A and C is 1:2.

REVALUATION OF ASSETS AND LIABILITES ON RETIREMENT OF A PARTNER:-

Case 1: When revalued figures will appear in the Balance Sheet.

- **Assets and Liabilities are** revalued at the time of retirement and any profit/loss on revaluation shall be distributed to all the partners including the retiring partner at the existing profit sharing ratio.
- To arrive at profit /loss, a **Revaluation Account or Profit and Loss Adjustment** is opened.

Journal Entry is as under:-

Revaluation Account	Dr.	[For profit on revaluation]
To Partners Capital Account		
	Or	
Partners Capital Account	Dr.	[For loss on revaluation]
To Revaluation Account		

Case 2: When revalued figures will not appear in the Balance Sheet.

Three methods

a) Through partners capital account
b) Through asset and liabilities
c) Memorandum revaluation a/c

Through partners capital account

- If continuing partner is decided that revalued figures of assets and liabilities will not appear in the balance sheet then for revaluation profit/loss entry will be adjusted through partner's capital account.

E.g. Ram, Shyam & Mohan sharing profit and losses equally and revaluation profit is Rs.60000 at the time of retirement of Ram. Then Rs.20000 becomes due to Ram then the journal entry will be as follows:

Shyam Account	Dr.	10000	
Mohan Account	Dr.	10000	
To Ram Account			20000

Through asset and liabilities

- First journal entry passed for the increase in the value of assets or decrease in the value of liabilities by debiting assets or liability account and crediting partner's capital at **existing profit sharing ratio.**
- Simultaneously the partner's capital accounts are debited for such gain at **new profit sharing ratio** and assets or liabilities account is credited.

  E.g. Increase in sundry fixed assets Rs.20000 and decrease in sundry creditors Rs.4000. In this case journal entry will be as under:-

A.

Particulars		Dr.	Cr.
Sundry fixed assets account	Dr.	20000	
Sundry Creditors account	Dr.	4000	
To Ram's Capital Account			8000
To Shyam's Capital Account			8000
To Mohan's Capital Account			8000

B.

Particulars		Dr.	Cr.
Shyam Capital Account	Dr.	12000	
Mohan Capital Account	Dr.	12000	
To Sundry Fixed Assets Account			20000
To Sundry Creditors Account			4000

- In this case an entry is passed just like in the case of goodwill without showing goodwill in balance sheet at the time of admission of partner.

RESERVE:-

A. Any undistributed profit or reserve in the Balance Sheet shall be credited to partner's Capital Accounts in the **Old Profit Sharing Ratio.**

Journal Entry:-

Reserve Account Dr.
To All partners Account including retiring partner.

OR

B. If others partner continue at their same profit sharing ratio then only retiring partner's share may be transferred to his capital account.

Journal Entry:-

Reserve Account Dr.
To Retiring Partner Capital Account. (share of retiring partner in reserve)

C. But if profit sharing ratio is changed after retirement of a partner then entry for reserve will be as same as done in case **A.**

D. If the continuing partner want to show reserve in the Balance Sheet, reserve shall be adjusted through the Journal Entry as under :-

Continuing Partner Capital A/c Dr. (**In Gaining Ratio)**
To Retiring Partners Capital A/c (Share of retiring partner.)

E.g. K, L and M are partners sharing equally. M decided to retire. K and L decided to continue at ratio of 3:2. Reserve at the time of retirement was Rs.12000.

K's Gain: 3/5-1/3=4/15

L's Gain: 2/5-1/3=1/15

Gaining Ratio=4:1

Journal Entry:-

Particulars		Dr.	Cr.
K's Capital Account	Dr.	9600	
L's Capital Account	Dr.	2400	
To M's Capital Account			12000

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FINAL PAYMENT TO A RETIRING PARTNER:-

After adjustment of reserve , goodwill , profit or loss on revaluation, balance lying to the credit of the retiring partner is to be paid to him.

Journal entry will be as under:-

- **When whole payment is made:-**

  Retiring partner's capital A/c Dr.

  To Bank Account

- **When some portion is retained as a loan:-**

  Retiring partner's capital A/c Dr.

  To Retiring partners loan A/c

  To Bank Account

PAYING A PARTNERS LOAN IN INSTALMENT:-

- In this case loan is to be paid off in equal installments otherwise additional information is given.
- Loan is being carried on interest on outstanding balance.
- It is an only a matter of arranging **Finance.**

JOINT LIFE POLICY:-

- Firm generally take a joint life policy for partners for which firm pays the premium amount.
- The purpose of taking such policy is to minimize the financial hardship at the time of payment to the legal representatives of a deceased partner or to the retiring partner.
- Amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. Amount of policy is in the nature of **Gain.**
- Share of value of JLP of deceased partner & surrender value of other partners is considered

The accounting treatment for the premium paid and the joint life policy may be on any of the following ways:-

➢ **When premium paid is treated as an expense:-**

- Entry will be passed just like passing an entry of expenses.
- At the end of the year, premium transferred to profit and loss account.

Accounting Entry:-

(a) On payment of premium.

JLP insurance premium A/c Dr.

To Bank Account

(b) Transfer to Profit and Loss Account

Profit and Loss Account Dr.

To JLP insurance premium

(c) On maturity of policy

Insurance Company/Bank Account Dr.

To Partner's Capital Account [Including representative of a deceased partner]

➢ **When premium paid is treated as an asset:-**

Accounting Entry:-

- **At the time of payment of insurance premium:-**

  JLP Account Dr.

  To Bank Account.

- **At the end of the year, amount in excess of surrender value:-**
  Treated as a loss and is transferred to Profit and Loss Account.

- **At the time of amount received from the insurance company in excess of surrender value :-**
  Treated as a gain and amount received in excess of surrender value is transferred to capital accounts of the partners in the profit sharing ratio.

E.g. A, B and C are partners sharing profit and losses 5:3:2. Took a JLP in 2007 for Rs.100000, premium of Rs.5000 paid annually on 10th June.

The surrender value of the policy on 31st December of various year was as under;-

2007 **NIL** **- to be transferred to profit and loss account Rs.5000**

2008 Rs.2000 **- to be transferred to profit and loss account Rs.3000, Balance Rs.2000**

2009 Rs.4500 **- to be transferred to profit and loss account Rs.2500, Balance Rs.4500**

At the time of maturity, amount received was Rs.15000/- in 2009 then Rs.10500 is to be transferred to capital account in the profit sharing ratio.

➢ **Creation of Joint Policy Reserve Account:-**

In this method,

- Premium paid is debited to JLP a/c and credited to bank account
- At the end of the year amount equal to premium is transferred from profit and loss appropriation account to JLP reserve account.
- After this JLP a/c brought down to surrender value by debiting JLP Reserve and crediting JLP account
- Thus Policy account appears on the assets side and joint life policy reserve account appears on the liabilities side of the Balance Sheet until it is realized.
- Both these accounts appear in the Balance Sheet at the surrender value of the policy.
- On the death of a partner, Joint Life Policy Reserve Account is transferred to Joint Life policy.
- Then the balance is transferred to partner's capital account
- **At the time of payment of insurance premium:-**
  JLP Account Dr.
  To Bank Account.

- **At the end of the year:-**
  Profit and Loss Appropriation Account Dr. [Equal to premium amount]
  To JLP Reserve Account

  JLP Reserve Account Dr. [Amount which exceeds the surrender value of the policy]
  To Joint Life Policy Account

Unit - 8.5
DEATH OF PARTNER

INTRODUCTION:-

- The problems faced at the time of death of a partner are same as retirement that is revaluation of assets and liabilities, goodwill valuation, joint life policy.
- Death of retirement ends partnership not the partnership firm/business.
- Deceased partner's share in profit calculated on the basis of normal profit.
- The only additional situation is that the firm would receive the joint life policy value.
- The **representative 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 **Executors Account.**
- The amount due to decreased partner carried interest as mutually agreed or
- in absence of agreement:-
- The representatives of the deceased partner can receive, at their option, **interest @6% per annum** or **the share of profits earned for the amount due to the deceased partner**.

SPECIAL TRANSACTIONS IN CASE OF DEATH: JOINT LIFE POLICY

- If Joint Life Policy appearing in the Balance Sheet at Surrender Value, then the firm will gain on the death of a partner.

SPECIAL TRANSACTIONS IN CASE OF DEATH: PAYMENT OF DECEASED PARTNER'S SHARE:-

- The basic difference between retirement and death of a partner relates to finalization 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.
- Journal Entry of transfer of profit is as under:-

  Profit and Loss **Suspense** Account Dr. [Upto the date of death]

  To A's Capital Account.

At the end of the year, the profit and loss suspense account will be transferred to Profit and loss account.

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CHAPTER # 9
COMPANY ACCOUNTS

Unit - 9.1
INTRODUCTION TO COMPANY ACCOUNTS

As PER THE LAW “Company” is termed as Company which is formed and registered under the companies Act 1956 or an existing company formed and registered under any of the previous law.

Large amount of money, modern technology, large human contribution etc. is required for formation of company which is not possible to arrange under partnership or proprietorship.

The word 'company' is derived from the Latin word 'com' i.e. with or together and 'panis' i.e. bread.

Generally, the capital of the company consists of transferable shares, and members have limited liabilities.

Lord Justice Hanay has defined a company as “an artificial person created by law with a perpetual succession and a common seal.

A company is an **Artificial Person:-**

- Created by law
- Having a separate Legal entity
- With a perpetual succession and a common seal (According to lord justice hanay).
- The work 'company' is derived from the Latin word 'com' ie. with or together and 'panis' i.e. bread

Features of Company:-

i **Incorporated Association**
- Incorporation is must under company act.
- Created by law not as per agreement
- Created by law so known as artificial legal person

ii **Separate legal entity**
- Members may come, members may go. But a company goes on forever.
- Company can sue and be sued in its incorporated name and capacity.

iii **Perpetual Existence**
- It's continuity not affected by death, insolvency or change of members.

iv **Limited Liability**
- Liability of shareholder's of a company is limited to the amount he has agreed to pay on shares allotted to him.
- Company limited by shares, then upto unpaid value
- If fully paid share there is no any liability.
- Company limited by guarantee upto committed amount to contribute as asset at the time of winding up.

v **Not a citizen** : Like any other natural person, though it is created by the process of law.

vi **Transferability of shares**

In public company: Freely transferable

In private company: Certain restrictions

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vii **Common seal:**

- Company can not sign on documents as natural person.
- To enable to sign a legal tool is provided called "common seal".

viii Maintenance of book:

- A company is required to maintain it books of
- In private company: Certain restrictions

ix Right or access to information of share holders

- By participating in the meeting
- By periodic reports
- Governed by articles of association.

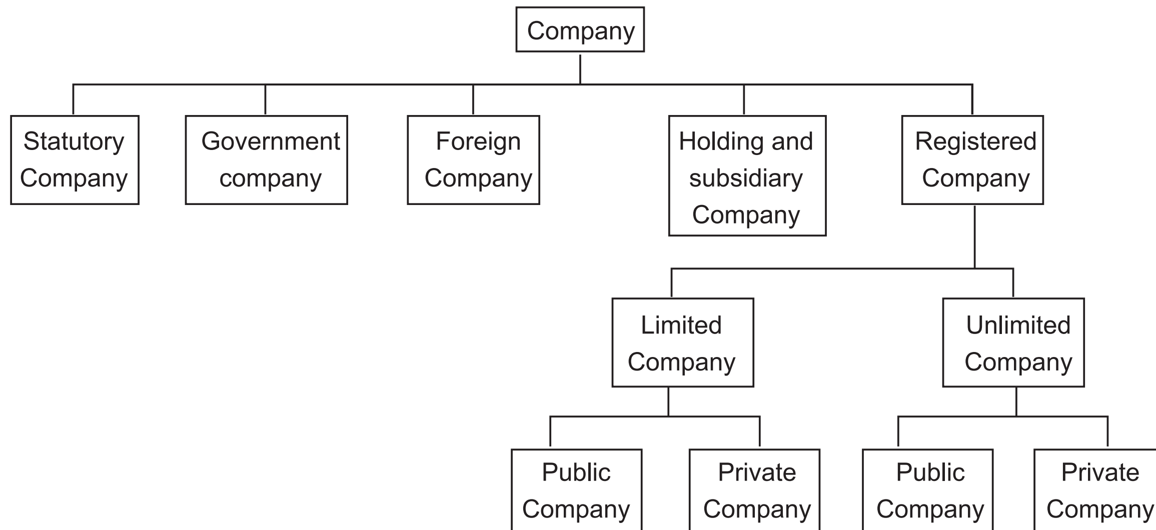
x Periodic audit by CA is mandatory

- Appointment on the recommendations of board of directors.

xi Separate of management and ownership

- Due to large members, management is different from ownership

Types of companies



A. Statutory Companies

These Companies are formed under special Act passed by the state legislature or parliament.

- These companies are not required to use “Limited” word
- Account of such companies are audited by CAG (Comptroller and auditor general of India)
- Example UTI, LIC, RBI, SBI and so on.

B. Government Companies (SEC 617)

- **51% or more paid up capital held**
  - by central government

- Or by any state government
- Partly by central government and partly by one or more sate govt.

Note : A subsidiary of a govt. company shall also be treated as a government company.

C. Foreign company

- These companies are incorporated outside India, But has place of business in India.

D. Holding Company (Sec 4 (4)

- A Company is known as the holding company if other company is its subsidiary.

E. Subsidiary company (Sec 4(1)

A company is known as the subsidiary in the following cases.

- If holding company controls the composition of board of directors of subsidiary company.
- Holding company holds more than 50% of the nominal value of equity shares.
- **Indirect subsidiary** Means subsidiary of subsidiary.

F. Limited Liability Company

- Where the liability of share holder is restricted to the amount of unpaid calls on shares.

G. Unlimited Liability Company

- In this case every member of the company is liable for the debts of company (like a partnership firm)

H. Public company (3 (i) (iv))

- Public company means a company which is not a private company.
- Minimum paid up capital is **Rs. 500000** or such higher amount as prescribed according to companys (amendment) act, 2000.
- Can Invite public to subscribe to its shares, or debentures
- No restrictions on transfer of shares
- Minimum **member 7**, and no limit for maximum
- Minimum directors 3
- Must use “Limited” word with it's name
- May be listed or unlisted
- Right to issue prospectus
- Any private company which is subsidiary of public company.

I. Private Company (3 (i) (iii))

- **A private company is a company:**
  - which has Minimum paid up capital **Rs. 100000** or such higher capital as prescribed.
  - Restricts the right of members to transfer its shares
  - Cannot invite public in shares, debenture.
  - Prohibits acceptance of deposits from persons other than its member, director and relatives.
  - Limit the number of its members to 50 excluding:-
    (a) Preson who are in employment of the company.
    (b) Past employes who were members of company and still continue.

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Note: Joint hoders of shares will be counted as single members.

- Minimum directors 2
- Cannot issue prospectus
- Must disclose "private limited"
- Private company is always unlisted

Note : As per the companies Bill 2003, if any company private or public, fails to maintain its minimum capital requirement the director or manager or share holder will have unlimited liability.

J. Listed company :

- A public company which has its securities listed in any recognized stock exchange.

K. Unlisted companies :

- Any company whose securities are not listed on any recognized stock exchange for trading.
- In case of private companies shares are not listed in any stock exchange.

L. Registered company:

- All companies registered under companies act 1956.

Books of Account (Sec 209)

A **Books are necessary to give:**

- True and fair view of the state of affairs.
- Are kept on accrual basis
- According to double entry system.

B. **Every company maintain proper books of account in relation to :**

- All receipts and payment
- All sales and purchase of goods
- All assets and liability
- In case of manufacturing companies, records for utilization of material or labour and other items of cost.

Financial statements (Sec 210)

- BOD of the company shall lay before AGM:

A. Balance Sheet as at the end of period.

B. **A profit & loss a/c for that period/ income and expenditure account for for those company not carrying business for profit**.

- Section 211 and schedule VI deals with the preparation and presentation of profit & loss A/c and the balance sheet
- Schedule VI does not prescribe any form in which profit and loss A/c to be prepared, but should be according to part II to schedule VI.
- Balance sheet of a company should be in form set out in Part I of schedule VI
- It prescribe two alternative forms of balance sheet HORIZONTAL AND VERTICAL

Underwriting commission/ brokerage for sale of shares and debentures:

- Maximum Rate for Underwriting :
  For Shares 5 % of issue price
  For Debentures 2.5% of issue price

Share holder's fund

Paid up equity Capital	xx
Paid up preference capital	xx
Reserve & Surplus	xx
Less :- Miscellaneous Expenditure and fictitious assets	xx
Owners equity	**xx**

Note: Under **"Miscellaneous Expenditure"** Heads in asset side of balance sheets:

1. Profit and loss /ac Dr. Balance
2. Discount on issue of shares
3. Discount on issue of debentures
4. Preliminary expenses
5. Deferred revenue expenditure
6. Loss on issue of debentures
7. Underwriting commission

Important Notes for New Company Act & Schedule Change

	Old	New Replace
1.	Company Act, 1956	Company Act, 2013
2.	Sec. 617 (Government Company)	Sec. 2 (45)
3.	Sec. 4 (4) Holding Company	Sec. 2 (46)
4.	Sec. 4 (1) Subsidiary Company	Sec. 2 (37)
5.	Sec. 3 (1) (iv) Public Company	Sec. 2 (71)
6.	Sec. 3 (1) (iii) Private Company	Sec. 2 (68)
7.	Sec. 209 Books of Account	Sec. 128
8.	Sec. 210 Preparation of financial statement	Sec. 129
9.	Sec. 211 Along with schedule VI to the Company Act, 1956 (Prepare & presentation of P & L & B/s)	Sec. 129 along with schedule III to the Company Act, 2013
10.	B/S - Part I Schedule VI P & L - Part II Schedule VI	Now Schedule III to the Company Act, 2013
11.	(Reserve Capital) Sec. 99 of Company Act, 1956	Sec. 65 of Company Act, 2013
12.	(Preference Share) Sec. 85 of Company Act, 1956	Sec. 43 of Company Act, 2013
13.	(Redemption of Preference Share) Sec. 80 of Company Act, 1956	Sec. 55 of Company Act, 2013
14.	(Minimum Application Money) Sec. 69 (3) of Company Act, 1956	Sec. 39 of Company Act, 2013

15.	Shares issued at Discount Sec. 79 of Company Act, 1956	Sec. 53 of Company Act, 2013 No. Shares can be issued at Discount but till date This Sec. is not notified by Central Government
16.	(Reserve & Surplus shown as "Shareholder's fund in B/s as per Revised Schedule VI)	Now Schedule III of Company Act, 2013
17.	(Use of Security Premium Sec. 78 of Company Act, 1956	Sec. 52 of Company Act, 2013
18.	Revised Schedule VI	Schedule III of Company 2013

Note : New name of profit and loss account is statement of profit and loss, Balance Sheet will be prepare as per vertical form and miscellaneous expenses head is removed.

1. Reserve and Surplus will be shown in shareholder's fund head.
2. Discount on issue of share A/c is shown in other Current/Non-current Assets head.
3. Calls in arrear will be shown by way of deduction from called up capital for the calculating paid share capital

4.	Forfeited account balance	Share capital head
5.	Unclaimed Dividend	Current Liabilities head
6.	Proposed Dividend	Current Liabilities head
7.	Interest accured & due	Current Liabilities head
8.	Interest accured but not due	Current Liabilities head
9.	Calls in Advance	Current Liabilities head
10.	Provision for Tax	Current Liabilities head
11.	Discount on issue of Debenture	Other Non-current Assets
12.	Security Premium	Reserve & Surplus (Share fund)
13.	Bank Overdraft	Cash & Cash Equivalent
14.	Schedule VI	New schedule III

Note: As per new Section 53 of the Companies Act, 2013, no shares can be issue at discount. However, till date this section has not been notified by the Central Government. Therefore, section 79 of the Companies Act, 1956 will be applicable till the time new Section 53 of the Companies Act, 2013 is notified.

Balance Sheet

Name of the Company..................................

Balance Sheet as at......................................

(Rs. in.................)

Particulars	**Notes No.**	**Figures for the current reporting period**	**Figures for the previous reporting period**
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			

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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

Profit and Loss

Name of the Company..
Profit and loss statement for the year ended.......................................

(Rs. in....................)

Particulars	Notes No.	Figures for the current reporting period	Figures for the previous reporting period
I. Revenue from operations			
II. Other income			
III. Total Revenue (I+II)			
IV. Expenses :			
Cost of materials consumed			
Purchases of Stock-in-Trade			
Changes in inventories of finished goods			
Work-in-progress and Stock-in-trade			

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Employee benefits expense
Finance costs
Depreciation and amortization expense
Other expenses

Total Expenses

V. Profit before exceptional and extraordinary items and tax (III-IV)
VI. Exceptional items
VII. Profit before extraordinary items and tax (V-VI)
VIII. Extraordinary Items
IX. Profit before tax (VII-VIII)
X. Tax expense:
   1. Current tax
   2. Deferred tax
XI. Profit (Loss) for the period from continuing operations (VII-VIII)
XII. Profit/(Loss) from discontinuing operations
XIII. Tax expense of discontinuing operations
XIV. Profit/ (Loss) from Discontinuing operations (after tax) (XII-XIII)
XV. Profit (Loss) for the period (XI+XIV)
XVI. Earnings per equity share:
   1. Basic
   2. Diluted

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Unit - 9.2
ISSUE, FORFEITURE AND REISSUE OF SHARES

INTRODUCTION

- Funds provided by the owners in business are recorded as capital.
- Liability of proprietors and partnership remains unlimited and only limited capital source is available
- Because of these limitations company came into existence.

Share Capital

- The capital of company is divided into small units of a fixed amount. Each unit is called shares.
- Fixed value of share printed on the share certificate is called nominal / par / face value of share.
- A company can issue shares at a price different from the face value of a shares.
- Holder of shares is called as shareholders and their liability is to the extent of issue price of shares.
- **As per SEBI guideline a company is free to price its issue if it has:**
    - Three years track record of consistent profitability.
    - New company is free to price its issue, If it promoted by company with a five years track record of consistent profitability.
- Calls in advance, calls in arrears, shares application, allotment, calls are personal a/c
- Total capital of the company is divided into shares, is called "share capital".

CATEGORIES OF SHARE OF CAPITAL

1. **AUTHORISED SHARE CAPITAL:**

- Also called registered or nominal capital
- It is the maximum share capital, which the company can issue during the lifetime.
- It is mentioned in the capital clause of memorandum of company.
- It is shown in the balance sheet at nominal value/ face value.
- It is not considered in total of balance sheet.

2. **ISSUED SHARE CAPITAL:**

- That part of authorized capital which are offered to the public. Called issued capital.
- remaining portion of authorised which is not issued called unissued capital and this will not shown in balance sheet.
- Issued share capital will shown in balance sheet at nominal value. This can be issued by company for
    - A. Cash
    - B. Consideration other than cash
        - Issued to promoter and others.

3. **Subscribed Share Capital**

- The portion of the issue price which is subscribed i.e. applied by the investor company and allotted by company investor .
- Also included face value shares issued by the company for consideration other than cash.

4. Called up share capital

- Portion of the issue price of the shares which is called
- And balance which is decided to demand in future called "uncalled capital".

5. **Paid up share capital**

- It is the part of the called up capital, which has been paid by the share holders
- **In the balance sheet called up and paid up capital are shown together as under.**

Called up capital	xx	
Less : Calls in Arrear	xx	
Paid up capital		xx

- Equity dividend is normally paid on paid up capital.
- Unpaid calls or installment will known as calls in Arrear i.e. demanded by company but not paid by shareholder.
- Only paid up capital is considered for liability side of balance sheet.
- Divided is not paid on calls in advance.

Reserve Capital(Sec 99)

- This is that part of subscribed uncalled capital of a company. Which can be called up only on the winding up of the company
- This will not shown in balance sheet
- Decided by special resolution

Note:

i **Details of authorised, issued and subscribed capital shown but not counted in total of balance sheet.**

ii **Only paid up capital is taken in account while totaling the liability side of balance sheet.**

Capital Reserve

- Which are not freely available for distribution as dividend and part of reserve and surplus.
- Reserve capital is different from capital reserve.
- **Example of capital reserve:**
  Profit prior to incorporation
  Profit on acquisition of business
  Profit on re issue of forfeited shares.
- May be used to write off capital losses like discount on issue shares.
- May be used to issue bonus shares, if received in cash.

Types of Shares :

Preference Shares(sec. 85) :_ Having two preferential right of :

A. Payment of dividend during the lifetime of the company at fixed rate before paying to equity shareholder.

B. Repayment of capital on winding up of the company before paying to equity shareholder.

- Generally holders of these shares do not get voting right
- It is cheapest than raising debt.
- The companies act 1956 prohibits the issue of irredeemable preference shares.
- **Preference shares are cumulative and non participating and non convertible unless expressly stated otherwise.**

Note: Dividend need not be paid every year, in case of deficiency of profits or loss.

Preference shares can be of various types:

A. **Cumulative Preference Shares:-**

- The fixed dividend keeps on accumulating until it is fully paid.
- Arrear of dividend is shown in balance sheet as contingent liability.

- If dividend is unpaid for two year then such holders will be entitled to take voting right on every resolution of AGM
- Dividend payable out of future profit if current year profit are insufficient.

B. Non cumulative preference shares

- If dividend is not declared due to any reason, right to receive is expires.
- Not entitled to arrears of dividend in future.
- If dividend not paid for two years or not paid atleast three years out of six years then they have right to vote in AGM.

C. Participating preference shares : Are those shares which

- Are entitled to a fixed preferential dividend and
- Carry a right to participate in the surplus profit after equity share holders dividend at a stipulated rate.
- Also have right in case of winding up of the company.

D. Non participating preference shares :

- The preference shares, which are not entitle to receive any additional right in profit and in the surplus on winding up.

E. Redeemable preference share (Sec 80)

- A company limited by shares may issue redeemable preference shares, which are to be redeemed

a. After the fixed period or even earlier at company discretion.
b. During the life time of companies (Subject to maximum 20 years)
c. **In India** company can only issue this type of preference shares.

F. Irredeemable Preference Shares(80 (5A))

A company limited by shares cannot issue any preference shares, which

a. Is irredeemable
b. Is redeemable after the expiry of period of 20 years from the date of its issue.

G. Convertible preference shares

- The holders has a right to convert his shares **into equity** shares at a later date.
- i.e. Convertible only in equity share

H. Non convertible preference shares

- The holders do not have a right to convert his shares into equity share .

I. Equity Shares

- Shares other than preference shares will known as equity shares
- Equity capital is also known as **Risk Capital**
- Equity holders are Real owners of company.
- Companies (Amendment) Act 2000 permits issue of equity share capital with differential right as to dividend, voting or otherwise.
- The shares can be issued by a company either

1. For cash
2. For consideration other than cash

- There are no fixed rate of dividend .
- Dividend payment is not compulsory even high profit exist.

Issue of Shares for cash

1. **Modes of issue of shares:**
   a. Private placement for private and public companies.
   b. Issue prospectus and invite the public for public companies
   Note:- Private companies depends upon price placement

2. **Application money:**
   As per companies Act = 5% of **face value** of shares
   As per SEBI = 25% of **issue price** of the shares
   Note: (if size of the issue is upto 500 crore)

3. In public issue company decides about allotment with consultation of SEBI and stock exchange.
4. Minimum time gap between the due dates of two calls is **one month.**

5. **Time limit to make the share fully paid up :** as per sebi the shares are to be made fully paid up within 12 months of the date of allotment if size of the issue is upto 500 crores
6. **Minimum Subscription**
   - It is stated in prospectus issued by public company.
   - It is 90% of issue or such higher amount as specified in the prospectus.
   - If the minimum subscription is not received , the entire subscription shall be refunded within 15 days after date of closure of issue w.e.f 28-08-2008.
   - Othewise interest will have to be paid.
   - **The minimum subscription is taking into account the following**
     a. Preliminary expenses of the company
     b. Commission payable on issue of shares
     c. Cost of fixed assets purchased or to be purchased
     d. Working capital requirement of the company
     e. Any other expenditure for the day to day operation of the business

- **It is applicable for public and right issue. but not applicable for offer for sale.**
- **It is applicable both for equity and preference shares and debentures.**
- Matters related to issue and transfer shall be administered **by SEBI and not by company law board.**
- In case of delay in refunding the money company, the company becomes liable to pay interest ranging from 4% to 15% as per section 73 of companies act.
- Company has the right to accept or reject **the application fully or partially.**

Subscription of Shares

A. **Full Subscription**
   - If the numbers of shares offered for subscription and the number of shares actually subscribed i.e. applied by the public are same.

B. **Under subscription**

- Shares offered for subscription is more than the number of shares subscribed i.e. applied by the public.
- It must be ensure that the company has received the minimum subscription.
- Accounting will not be passed for total offered shares but for shares actually applied and allotted.

C. **Oversubscription**

- In case number of shares applied for is more than the number of shares offered
- Company can reject entire application or may allot share proportionately.
- Excess money may be kept to appropriate further calls.
- Entry on refund of application money to applicants to whom shares have not been allotted.

  Share Application A/c Dr.

  To Bank A/c

D. When only a part of shares applied for are allowed.

Share application A/c or (with the amount received in advance for allotment)

To Share Allotment

To Share calls in advance A/c

Issue of Shares at Discount (Sec 79)

A Company may issue shares at issue price lower than nominal value/ par value only if.

- It is authorised by resolution in AGM +permission of central government.
- Shares must be issued within two months from receiving sanction from central govt.
- The shares to be issued at discount must be of the same class already issued.
- Discount must not exceed 10% or such higher rate as the central government may permit in special circumstances.
- The company must have working for at least **one year from the date of commencement of business. i.e. not from in corporation date.**
- **A new company** cannot issue shares at a discount.
- **A new class** of shares cannot be issued at a discount.
- Discount on the issue of share account is in the nature of capital loss to the company.
- Entry of discount is made at the time of allotment while premium can be with application, allotment or calls, but normally with allotment.
- Discount on issue of shares is shown under "Misc. expenditure " heading in asset side of balance sheet.
- It can be set off against security premium a/c or may be write off over a period from P&L a/c
- In case discount :
  (i) Call money/ allotments money debited with net of discount
  (ii) Amount of discount debited in discount a/c
  (iii) capital a/c credited by (call money + discount).

Shares issued at premium (Sec 78)

- Premiun is generally is called with allotment money, sometimes with application money and rarely with call money.
- It is the capital nature Receipt for the company and not a part of share capital.
- It is shown under the heading “Reserve & Surplus”
- Excess price over face value is credited to securities premium A/c
- The securities premium A/c may be used for
  A. To issue fully paid up Bonus shares
  B. Writing off the preliminary expenses of the company. Pr

C. To pay premium on the redemption of preference shares or debenture

D. Writing off the commission paid or discount allowed or expenses incurred on any issue of shares or debentures of the company.

When shares are issued at a premium, the journal entries are as under:-

(A). **Premium amount called with Application Money.**

(i) Bank Account Dr. (Total Application Money + Premium Amount)
To Share Application A/c (Amount Received)

(ii) Share Application A/c Dr. (No. of shares applied for * Application amount per Share)
To Securities Premium A/c (No. of share allotted* Premium amount per Share)
To Share Capital A/c (No. of share allotted* per share for capital)

(B). **Premium amount called with Application Money.**

(i) Share Allotment A/c Dr. (No. of shares Allotted * Allotment and Premium Money per share)
To Securities Premium A/c (No. of share allotted* Premium amount per Share)
To Share Capital A/c (No. of share allotted* Allotment Amount per share)

(ii) Bank Account Dr.
To Share Allotment A/c

Oversubscripition and pro-rata allotment:-

- **Over subscription** is the application money received for more than the number of shares offered to the public by a company.
- In this situation a alternative is that a company may allot shares to the applicants on **pro-rata** basis.
- **'Pro-rata allotment'** means allotment in proportion of shares applied for.
- For example, a company offers to the public 5000 shares for subscription and company received applications for 6000 shares. If the shares are to be allotted on pro-rata basis, applicants for 6000 shares are to be allotted 5000 shares i.e. in 6:5 ratio. Applicant who has applied for 6 shares will be allotted 5 shares.

ACCOUNTING ENTRY:-

A. For rejected application:-

Share Application A/c Dr.
To Bank A/c

B. For pro-rata allotment:-

Share Application A/c Dr.
To Share Allotment Account

Calls in- arrears and calls- in -advance-

Calls in arrears:-

- The total unpaid amount on one or more installments is known as Calls-in-Arrears or Unpaid Calls.
- Shown by way of deduction from “called up Capital” to arrive at paid up capital.
  - Articles of Association empower the directors to charge interest on calls in arrears at a predetermined rate. however the directors may waive off the interest or ever charge higher.
  - As per the Table A, Interest @5% p.a. is charged,

Journal Entry is as under:-

There are two methods for treatment of calls in arrier:

FIRST : no journal entry to be passed for transfer of unpaid balance of allotment and calls in calls in arrier account .these unpaid balances represent calls in arrier

SECOND: pass a journal entry for transfer of above balances in calls in arrier a/c

Calls-in-Arrears A/c Dr. (Amount of Unpaid Calls)
To Share Allotment A/c (unpaid amount)
To Share Calls A/c (unpaid amount)

Interest on calls in arrears is paid for the period from between the due date of the call and the time of actual payment.

Journal Entry for interest on calls in arrears is as under:-

i. **For interest receivable on calls-in-arrears:-**
Shareholder A/c Dr.
To Interest on calls-in-arrears A/c

ii. **For Receipt of interest:-**
Bank A/c Dr.
To Shareholder A/c

Calls in Advance:

- **Amount paid by shareholders fully or in part before demanded is calls in advance**
- According to Table A, interest at the rate of 6% is to be paid compulsory
- **for the period from the date of receipt of calls in advance to the date of appropriation of the call.**
- **Journal Entry is as under:-**
  Bank Account Dr.
  To Calls in Advance A/c
- **Entry for adjustment of calls in advance to Calls money :-**
  Calls-in-advance A/c Dr. (Call Amount Due)
  To Particular Call A/c
- **The balance in Calls-in-Advance account is shown as a separate item on the liabilities side in Balance Sheet under the heading "Share Capital" and is not added to the amount of paid up capital.**
- Journal Entry for interest on Calls-in-Advance is as under:-
  i. For Interest Due:-
  Interest on Calls-in-Advance A/c Dr. (Amount of interest due for payment)
  To Shareholder A/c
  ii. Payment of Interest:-
  Shareholder A/c Dr. (Amount of interest paid)
  To Bank A/c
- Sundry members account or shareholders account (not the individual members account) is credited or debited for For interest on calls in advance and calls in arrears.

Forfeiture of shares:-

- Shares can be forfeited for non payment of allotment /calls or premium or interest thereon
- The Directors are empowered by the Articles to forfeit the shares of defaulting share holders after giving a **notice of 14 days.**
- But it should be bonafide in the interest of the company

- In forfeiture right of the shareholders is extinguished but amount paid by shareholders is not refunded
- In case of forfeiture of shares originally issued at premium, if the premium has been received, it cannot be forfeited/cancelled.
- Fully paid shares can be forfeited for realization of debts if the articles specifically provide so.
- **Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.**
- These Shares can be reissued at par or at a discount or at a premium.

Journal entries would be according to the situations:-

- **forfeiture of shares which issued at par:-**

Share Capital Account	Dr.	[No. of Shares*called up value per share]
To Forfeited Shares Account		[Amount already received on forfeited shares]
To Share Allotment Account		[If amount due, but not paid]
To Shares First Call Account		[If amount due, but not paid]
To Shares Final Call Account		[If amount due, but not paid]

OR

Share Capital Account	Dr.	[No. of Shares*called up value per share]
To Calls-in-Arrears Account		[Total amount due, but not paid]
To Forfeited Shares Account		[Amount received]

- **forfeiture of shares which were issued at a discount:-**

When shares are issued at a discount, the Discount Account is debited. Therefore, at, the time of forfeiture of such share, Discount Account will be credited to cancel it.

Share Capital Account	Dr.	[No. of Shares*called up value per share]
To Forfeited Shares Account		[Amount already received on forfeited shares]
To Discount on Issue of Shares Account		[No. of shares*discount per share]
To Share Allotment Account		[If amount due, but not paid]
To Shares First Call Account		[If amount due, but not paid]
To Shares Final Call Account		[If amount due, but not paid]

- **FORFEITURE OF SHARES WHICH WERE ISSUED AT A PREMIUM:-**

Share capital account is debited with the called up value of shares forfeited.

If the premium has already received by the company, it cannot be cancelled even if the shares are forfeited in the future.

Re-issue of forfeited shares:-

- Re-issue of a forfeited share is not allotment but only a sale.
- So When shares are re-issued, return of the forfeited shares need not be filed under Section75(1) of the Companies Act 1956.
- The loss on re-issue should not exceed the forfeited amount.
- Profit on Re-issue shall be transferred to capital reserve.
- Loss on re-issue shall be debited to "**forfeited Shares Account".**

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- If the shares are re-issued at a price more than the face value of the shares, the excess amount is credited to **securities premium account**.
- When a company issues shares for consideration other than cash, the same shall produce before the registrar a written contract of Sale of Service within one month of allotment.

Accounting Entries:-

Bank Account Dr. [Actual Amount Received]
Forfeited Shares Account Dr. [Loss on re-issue]
To Share Capital A/c

Forfeited Shares Account Dr.
To Capital Reserve A/c
(Being the profit on re-issue, transferred to capital reserve)

Prospectus :

1. **Meaning** : Prospectus of company is an invitation to make an offer to subscribe the shares or debentures of company.
2. **Registration** : A copy of prospectus is required to be delivered to the registrar for registration on or before date of publication thereof.
3. **Issue :** Prospectus must be issued within 90 days of its registration.

Miscellaneous worth Noting Points:-

1. If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.
2. The **forfeited amount** on shares not yet reissued should be shown in the Balance Sheet as an **addition to the share capital**.
3. If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to securities premium account.
4. When shares, originally issued at a discount, are reissued at a loss, the loss to the extent of original discount is debited to Discount on Issue of Shares Account and the balance loss is debited to Forfeited Shares Account.
5. Dividend is usually paid on paid up capital**. Dividend is not paid on calls in advance**.
6. Proposed dividend is **provision** where as declared dividend is a **current liability**.
7. The right shares u/s 81 are offered to the existing shareholders in proportion to equity shares held by them.
8. Registration fees is payable on basis of Authorized Capital.
9. Any change in amount of authorized capital amounts to alteration of memorandum clause
10. Surrender of shares is a voluntary surrender of shares by the shareholder for the purpose of cancellation of shares.
11. There is no difference between the Forfeiture of Shares and Surrender of Shares so far as accounting treatment is concerned.

Issue of Shares for consideration Other than Cash:-

Company has to file a return with ROC within **one month** of allotment in relation to contract of sale of sale of service in respect of which shares have been allotted.

Accounting Entries:-

(a) For Purchase of Assets

Assets A/c Dr.
To Share Capital

(b) Issue to Promoters

Good will A/c Dr.
To Share Capital

Unit - 9.3
REDEMPTION OF PREFERENCE SHARES

INTRODUCTIONS:-

Redemption is the process of repaying obligation of preference shareholders;.

PURPOSES OF ISSUING REDEEMABLE PREFERNCE SHARES:-

- Easy to raise finance in dull market.
- There are many difficulties to raise share capital, may encouraged to invest in redeemable preference shares.
- When there is a surplus of capital, preference share may be redeemed.
- It is a **medium term** source of finance

PROVISIONS UNDER SECTION 80 OF THE COMPANIES ACT 1956.

This section deals with rules relating to redemption of preferences shares.

A company limited by shares, if authorized by its articles may issue redeemable preference shares, subject to

a) No shares can be redeemed except out of profit available for dividend or proceeds of fresh issue
b) Only fully paid up shares can be redeemed.
c) Premium on redemption can only be providing out of profits or security premium account.
d) If redemption is made out of accumulated profits a sum equal to face value less proceeds of fresh issue shall be transferred to Capital redemption reserve account.
e) Capital Redemption Reserve account can be used only for issue of fully paid up bonus shares resulting profits get converted into share capital.
e) Reason is that the security for creditors should not be reduced.
f) **After Companies Act 1996**, a company cannot issue any preference share
   - which is irredeemable or
   - is redeemable after the expiry of a period of 20 years from the date of its issue.
g) proceed of debenture is not treated as proceed for redemption

REDEMPTION OF IRREDEEMABLE PREFERNCE SHARES UNDER SECTION 80A.

1. Every preference shares issued before commencement of Companies (Amendment) Act 1988:-

   A. If it is irredeemable:-

   Shall be redeemed within a period of 5 years from such commencement.

   B. If it is not redeemable before expiry of 10 years from date of issue and not redeemed before such commencement of act.

   - Shall be redeemed on due date for redemption or within 10 years from such commencement whichever is earlier.
   - If company could not redeem any such share within period as mentioned above and dividend due, if any, then with the consent of CLB, can issue further redeemable preference shares equal to the amount due including dividend due.
   - After such issue of redeemable preference shares, the unredeemed shares shall be deemed to have been redeemed.
2. No provision of this section can modify by any class of shareholders by resolution or any court or the Central Government.

METHODS OF REDEMPTION OF FULLY PAID UP SHARES:-

(i) By proceeds of a fresh issue of equity or preference shares.
   - Redemption cannot be made out of securities premium account or fresh issue of debentures.

(ii) By Capitalization of undistributed profits.

(iii) By combination of above (i) & (ii) methods

- In case of redemption of preferences shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious.
- Where in case of redemption out of distributable profits, replacement of capital is ensured by retention of profit by transfer to CRR Account in indirect manner.
- Transfer of divisible profits to CRR Account makes them non-distributable profits.

1 REDEMPTION OF PREFERNCE SHARES BY FRESH ISSUE OF SHARES:-

Premium on redemption of preferences shares to be adjusted against Securities Premium Account but the redemption itself cannot be financed out of the Securities Premium Account.

Number of shares of fresh issue = face value of preference shares to be redeemed/ proceed per share

Meaning of Proceeds of one share:-

- If it is issued at par then **par value** of share issued.
- If it is issued at premium then **par value** of share issued
- If it is issued at discount then **discounted value** of share.
- **If new shares are partly paid up then proceed amount will be taken only received amount upto date of redemption excluding security premium**

Reason for issue of New Equity Shares:-

1. When capital is needed is permanently and to avoid a fixed rate of dividend.
2. Liquidity position is not good enough.

Advantages:-

1. No cash outflow of money.
2. May be issued at a premium.
3. No Capital gain tax liability in the hand of shareholders.

Disadvantages:-

1. Dilution of earnings.
2. Shareholding pattern are changed.

2 REDEMPTION OF PREFERNCE SHARES BY CAPITALISATION OF UNDISTRUBUTED PROFITS:-

If redemption is made out of accumulated profits then an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting distributable profit.

Following profits are available for redemption

- General reserve
- Reserve fund
- Profit and loss a/c
- Dividend equalization fund/reserve
- Building reserve
- Capital reserve received in cash(if no information available assumed not received in cash)

Following profits are not available for redemption

- Capital reserve if not received in cash
- Revaluation reserve

- Security premium
- Capital redemption reserve
- Profit prior to incorporation
- Forfeited shares
- Debenture sinking fund
- Sinking fund
- Proposed dividend/un claimed dividend
- Workmen compensation fund(but excess of fund over liability can be taken for redemption)

Advantages:-

1. No change in shareholding pattern.
2. Future earnings are not diluted.
3. Surplus funds can be used.

Disadvantages:-

1. Reduction in liquidity.
2. Capital gain tax liability for preference shareholders.

3 REDEMPTION OF PREFERNCE SHARES BY COMBINATION OF FRESH ISSUE AND CAPITALISATION OF UNDISTRUBUTED PROFITS:-

(1) Amount to be transferred to Capital Redemption Reserve:-

Face value of shares to be redeemed	Rs…….
Less: - Proceeds from new issue	Rs…….

	Rs……..
	-----------

(2) Proceeds to be collected from New Issue

Face value of shares to be redeemed	Rs…….
Less: - Profit available for distribution	Rs…….

	Rs……..

Minimum Number of Shares:-

Minimum proceeds required to comply with section 80

Proceeds of one share

Meaning of Proceeds of one share:-

- If it is issued at par then **par value** of share issued.
- If it is issued at premium then **par value** of share issued
- If it is issued at discount then **discounted value** of share

Followings points must be keept in mind during calculation of minimum fresh issue of shares:-

- If in question it is said that certain sum of profit should be maintained then only remaining profit can be transferred to CRR

  Example:- Balance in Balance Sheet of General Reserve Rs.200000/-

  Additional information;- Balance of general reserve should not be less than Rs.60000/-

In this situation maximum amount available for redemption is Rs.140000/-

- Minimum number of shares needs to adjust due to fraction as shares cannot be issued in fractions. It must be approximated to the **next higher figure** and
- if in examination it is provided that proceeds/numbers of shares should be a multiple i.e. 10 or 50 or 100 shares then again the next higher multiple should be considered.

Minimum issue of shares if shares to be redeemed at premium and fresh issue also at premium

Step 1

If existing security premium is sufficient to pay premium on redemption of preference shares

Minimum fresh issue =total nominal value of preference shares to be redeemed -profit available

Example:

Preference capital to be redeemed	Rs 10,00,000
Preference capital to be redeemed @ 10% premium	
Profits available for redemption	Rs 4,00,000
Securities premium	Rs 1,50,000

Fresh shares of Rs 100 shall be issued @ 10% premium

Here existing security premium is sufficient hence

fresh issue will be Rs 10,00,000-400000=Rs 6,00,000

Number of share=600000/100=6000

Step 2

If existing security premium is not sufficient to pay premium on redemption of preference shares but:

(A) If existing and new premium is sufficient to pay premium on redemption of preference shares

Minimum fresh issue =Total nominal value of preference shares--profit available

If in above example balance of security premium is Rs 80,000 then existing premium is not sufficient but existing and new premium is sufficient ie 80000+60000=140000,fresh issue will be 100000-400000=600000

Step 3

If existing and new premium is not sufficient to pay premium on redemption of preference shares

Fresh issue shall be calculated by an equation

i.e profit available +security premium available + paid up value of new share +security premium on new share = nominal value to be redeemed +premium on redemption (assuming paid up value of share as X)

If in above example existing security premium is 30000,

Then **existing and new premium is not sufficient I e Rs 30000 + 60000= 90000** whereas required premium is Rs 100000 hence equation will be

400000 + 30000 + X + .10X =1000000+100000

X =609090.91

Hence fresh issue will be 609090.91

Premium on new issue =609090.91X.10 =60909.09

Number of fresh issue of share =609090.91/100 = 6090.909 share

Transfer to CRR =1000000-609090.91 =390909.09

Accounting Entries:-

1. **When shares are redeemed at par**

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

2. **When shares are redeemed at a premium**

Redeemable Preference Share Capital Account	Dr.
Premium on Redemptions of Preference Shares Account	Dr.
To Preference Shareholders Account	

3. **Payment Entry:-**

Preference Shareholders Account	Dr.
To Bank Account	

4. **For adjustment of premium on redemption:-**

Securities Premium Account	Dr.
Profit & Loss Account	Dr.
To Premium on Redemption of Preference Shares Account	

5. **For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account:-**

General Reserve Account	Dr.
Profit and Loss Account	Dr.
To Capital Redemption Reserve Account	

Note: - Securities premium cannot be utilized for transfer to CRR Account as dividend cannot be paid out of Securities Premium Account.

REDEMPTION OF PARTLY CALLED UP PREFERNCE SHARES:-

- it is assumed that final call on partly called up shares is demanded and received before redemption.
- If information about both fully paid and partly paid preferences shares is provided, then, **only fully paid shares are redeemed.**

REDEMPTION OF FULLY CALLED BUT PARTLY PAID UP PREFERNCE SHARES:-

- **When calls in arrears is received by the company.**

  Entry is passed as under:-

Bank Account	Dr.
To Calls in Arrears Account	

  Then shares become fully paid up and company can now redeem in the normal course.
- **In case of forfeited shares.**
- Total preference shares capital including the shares forfeited and cancelled should be considered to ensure replacement of capital out of proceeds of a fresh issue or out of divisible profits.
- However for arranging funds for redemption, amount actually payable to shareholders is taken into consideration.

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Unit - 9.4
ISSUE OF DEBENTURES

- **FEATURES OF DEBENTURES:-**
- **The most common method of supplementing the capital** available to a company is debentures
- Debentures are creditor/loan for a company'
- It is fixed interest bearing security where interest fall due at particular dates
- They do not carry voting right
- These are issued under common seal of the company
- Dedentures are shown under **'secured loan'** in liability side of balance sheet whether secured or not
- Debentures are the bonds issued by a company under its seal, acknowledging a debt and mentioning the terms of repayment of Principal and interest.
- Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business.
- Charge created on assets of the company described in bond is not valid unless registered with Registrar of companies and charge is printed on the bond.
- In case of mortgage debentures, it is expected to create a trusteeship in favour of one or more persons.
- “Interest accrued and due on debentures” should be shown under **“Debenture”** Head.
- Preference shares cannot be irredeemable while debentures can be irredeemable.
- **Preference of payment: -** 1. Debenture holder 2. Preference shareholders 3. Equity shareholders.
- Premium on redemption of debenture/debenture redemption premium is liability and shown under “Secured Loan” its nature is personal account.
- Debenture Premium is treated as security premium.
- Fixed interest will be paid irrespective of level of profits or even loss also
- interest is paid on paid up value ignoring discount/premium.
- Original sum is repaid at specified date or converted into shares or other debentures.
- May or May not create a charge on the assets.
- It can generally be bought or sold through the stock exchange

DISTINCTION BETWEEN DEBENTURES AND SHARES

S.No.	Debentures	Shares
1.	Creditors of the Company	Owners of the Company
2.	No voting rights and control on the affairs of the company	Voting rights and control on the affairs of the company
3.	Interest is paid at a pre-determined fixed rate whether there is profit or not	Dividend on equity share Paid at a variable rate depending upon profit and **however dividend on preference shares is paid at a fixed rate if sufficient profit earned**
4.	Interest are charges on profits and expenses which is deductible to calculate taxable profit	Appropriation of profits and not deductible
5.	There are different kinds of debentures ie. Secured/unsecured, redeemable/ irredeemable, registered/bearer, Convertible/non convertable	Only two kinds of shares equity and preference

6.	Shown under "Secured Loans"	Shown under "Share Capital"
7.	**Can be converted in shares (Equity Shares)**	Cannot be converted into debentures.
8.	**Cannot be forfeited**	Can be forfeited
9.	At maturity, get back their money	Cannot get back except in liquidation **however preference shareholder can get back without liquidation.**
10.	At the time of liquidation, debenture holders are paid off before the shareholders	At liquidation time, Paid after paying debenture holders, creditors etc.

TYPES OF DEBENTURES:-

1. **Security**
   (a) **Secured Debentures:-** Having a charge on assets of the company.
      (i) **Fixed Charge: -** Having a charge over specific assets and such assets cannot be sold without the consent of the debenture holders.
      (ii) **Floating Charge: -** Having a charge over all the assets and not particular assets and including future one.

   (b) **Unsecured or "Naked Debentures":-** Having no charge over assets. These debentures are very risky from the view point of investors. Merely promises to pay interest on due dates and to repay the amount due on maturity date.

2. **Convertibility**
   (a) **Convertible Debentures: -**
      i To be converted into equity shares after a future specified date.
      ii Conversion can be at par, at premium or discount
      iii These are fully or partly convertable
   (b) Non Convertible Debentures: - Not to be converted into shares.

3. **Permanence**
   (a) **Redeemable Debentures**:- Repayable as per terms of issue.
   (b) **Irredeemable Debentures:-** repaid only at the time of liquidation. Also called **perpetual debentures.** Not repayable during life time of the company.

4. **Negotiability**
   (a) **Registered debentures:** - Payable only to the registered holder; whose name appears in the
      i Register of debenture holders.
      ii Not easily transferable.
      iii Provisions of the Companies Act 1956 are to be complied.
   (b) **Bearer Debentures:** - Transferable by delivery. These are negotiable instrument payable to
   Bearer. No record is kept by the company in respect of debenture holder. Interest is paid to the holder without any identity. No transfer deed is required for transfer of such debentures.

5. **Priority**
   (i) **First Mortgage Debentures** : Payable first out of property charged
   (ii) **Second Mortgage Debentures** :Payable after satisfying the first mortgage debentures

ISSUE OF DEBENTURES:-

Issue of **redeemable** debentures can be divided into the following:

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1. Issued at par and redeemable at par or at a discount;
2. Issued at a discount and redeemable at par or at discount;
3. Issued at a premium and redeemable at par or at discount;
4. Issued at par and redeemable at premium;
5. Issued at a discount and redeemable at premium.
6. Issued at premium and redeemable at premium.

Journal Entries for every cases are as under;-

1. Issued at par and redeemable at par.

- **For receipt of application money:**

  Bank Account Dr.
  To Debenture Application A/c

- **For transfer to debenture account:**

  Debenture Application A/c Dr.
  To -------%Debenture A/c

2. Issued at Discount and redeemable at par.

- **For receipt of application money:**

  Bank Account Dr.
  To Debenture Application A/c

- **For transfer to debenture account/making allotment:**

  Debenture Application A/c Dr.
  Discount on issue of debenture A/c
  To -------%Debenture A/c

3. Issued at Premium and redeemable at par.

- **For receipt of application money:**

  Bank Account Dr.
  To Debenture Application A/c

- **For transfer to debenture account/making allotment:**

  Debenture Application A/c Dr.
  To -------%Debenture A/c
  To Securities Premium A/c

4. Issued at par and redeemable at a premium.

- **For receipt of application money:**

  Bank Account Dr.
  To Debenture Application A/c

- **For transfer to debenture account/making allotment:**

  Debenture Application A/c Dr.
  To -------%Debenture A/c

- **Call made upon allotment:**

  Debenture Allotment A/c Dr.
  Loss on issue of debenture A/c Dr. [Equal to Debenture Redemption Premium]
  To -------% Debenture A/c
  To Debenture redemption premium A/c

Note: - An extra entry is to be made at the time of issue/allotment of debentures when debentures are redeemed at premium. This is passed for providing premium payable on redemption.

5. Issued at discount and redeemable at a premium.

- In this case issue price is less than par value but redemption value is more than par value which is treated as loss on issue. E.g. a 15% debenture of Rs.100 is issued at discount of Rs.10 and redeemable at a premium of Rs. 5 per debenture. Loss amount will be Rs.90-105=Rs.15/-
- Premium on redemption of debenture is also credited by Rs.5.

- **For receipt of application money:**

  Bank Account Dr.
  To Debenture Application A/c

- **For transfer to debenture account/making allotment:**

  Debenture Application A/c Dr
  To -------%Debenture A/c

- **Call made upon allotment:**

  Debenture Allotment A/c Dr.
  Discount/Loss on issue of debenture A/c Dr. [Equal to the discount on issue of debenture Plus Premium on redemption]
  To -------% Debenture A/c
  To Debenture redemption premium A/c

- **Receipt of Call made on allotment:-**

  Bank A/c Dr.
  To Debenture Allotment A/c

6. Issued at premium and redeemable at a premium.

- In this case issue price is more than par value but redemption value is more than par value E.g. a 15% debenture of Rs.100 is issued at premium of Rs.10 and redeemable at a premium of Rs. 5 per debenture. Rs.10 to be credited to Debenture premium account and Rs.5 will be loss to be provided at the time of issue of debentures.
- Premium on redemption of debenture is also credited by Rs.5.

- **For receipt of application money:**

  Bank Account Dr.
  To Debenture Application A/c

- **For transfer to debenture account/making allotment:**

  Debenture Application A/c
  To -------%Debenture A/c

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- **Call made upon allotment:**

  Debenture Allotment A/c Dr.
  Loss on issue of debenture A/c Dr. [Equal to the premium on redemption]
  To -------% Debenture A/c
  To Debenture premium A/c
  To Premium on Redemption of Debentures A/c

➢ **Accounting for issue of debentures payable in installments:-**

Money payable on debentures may be paid either in full with application or by installments.
Accounting entries will differ to some extent in either case.

- **Debentures payable in full on Application**:- Debenture may also issued at par, at a premium, or at a discount.

Debentures Issued at Par:-

A. When cash is received

Bank Account Dr.
To Debenture Application Account

B. When excess money is refunded

Debenture Application Account Dr.
To Bank Account

C. When the debentures are allotted

Debenture Application Account Dr.
To Debenture Account

- **Debentures Issued at a premium**:
  - **A company rarely issue debenture at premium**
  - - A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate.

For example, 10% debentures of Rs.100 issued at a premium of 10%. The investor will get Rs.1 p.a. for his investment of 110. Therefore, the effective rate of interest on investment is (12/111 *100)=10.91%

There is no restriction for utilization of debenture premium as this is different from share premium.

It can be used to write off:-

a. Discount on issue of shares or debentures;
b. Premium on redemption of shares or debentures;
c. Capital Losses;
d. Intangible Assets like goodwill;

After write off, any balance remaining in the Debenture Premium Account should be transferred to **Capital Reserve Account.**

Accounting Entries:-

Debentures Issued at premium:-

A. When cash is received

Bank Account Dr. [Nominal value plus premium]
To Debenture Application Account

B. When excess money is refunded

Debenture Application Account Dr.
To Bank Account

C. When the debentures are allotted

Debenture Application Account Dr.
To Debenture Account
To Debenture Premium Account

D. When Debenture premium is transferred:-

Debenture Premium Account Dr.
To Capital Reserve Account

- **Debentures Issued at a Discount**: -
  - No maximum limit for discount on issue of debenture but in case of shares limit is 10%
  - In this case, true rate of interest is slightly increases. E.g. 12% debentures of Rs.100 issued at discount of 10%. Company will have to pay Rs.1 for a loan of Rs.90. Therefore the true rate of interest is (12/90*100) =13.33%.
  - Issued when market rate of interest is higher than debenture interest rate.
  - Discount on issue of debentures is written off proportionately by charging to the Profit and Loss Account.
  - "Discount on Issue of Debentures" is shown on the Asset side of Balance Sheet under the head "Miscellaneous Expenditure".

  Discount on issue of debentures is considered as **incremental interest expenses**.

  The borrowing cost for a particular accounting period is total interest payment plus the discount written off.

Accounting Entries:-

Debentures Issued at discount:-

A. When cash is received

Bank Account Dr. [Actual cash received]
To Debenture Application Account

B. When excess money is refunded

Debenture Application Account Dr.
To Bank Account

C. When the debentures are allotted

Debenture Application Account Dr. [Actual cash received]
Discount on Issue of debentures Account Dr. [Discount on debentures]
To Debenture Account [Nominal value of debentures]

ISSUE OF DEBENTURES AS COLLATERAL SECURITY:-

- Secondary or supporting security for a loan;
- Can be used by lender when original loan not paid;
- Sometimes, company issue their own debentures as collateral security for a loan and in case company not pay its loan and interest thereon, the lender becomes the debenture holder and have all the rights of debenture holder.
- The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

There are two methods of showing such types of debentures in the accounts of a company.

Method 1

No entry is made at the time of issue.

In the balance sheet, the fact of the debentures being issued and outstanding is **shown by a note under the liability secured**.

Method 2

Following entry is made:-

Debenture Suspense Account Dr.
  To Debentures Account

The debenture suspense account is shown on the assets side of the Balance Sheet and Debentures on the liabilities side of the Balance Sheet.

Entry is reversed when loan is repaid.

However method 1 is more logical from the accounting point of view.

ISSUE OF DEBENTURES IN CONSIDERATION OTHER THAN FOR CASH:-

Just like shares, debentures can also be issued for consideration other than for cash.

Accounting Entry:-

a. Sundry Assets Account Dr. [Assets taken over]
  To Sundry Liabilities Account [Liabilities assumed]
  To Vendors Account [Purchase consideration]

b. Vendors Account Dr.
  To Debentures Account

TREATMENT OF DISCOUNT ON ISSUE OF DEBENTURES:-

(a) If debentures are redeemable after a certain period says 5 or 10 years, discount should be written-off **equally** throughout the life of debentures applying SLM Method.
- Advantage is to spread the burden of discount equally over the years.

(b) If debentures are redeemable at different dates, discount should be written off applying **Sum of the year's digit method.** This method should be use when debentures are redeemed by unequal installments.

(c) If debentures are irredeemable, the discount should be written off **gradually over a long period.**

(d) Capital loss to be written off over the tenure of the debentures.

Accounting Entry:-

Profit and Loss Account Dr.
  To Discount on Issue of Debentures Account

INTEREST ON DEBENTURES:-

(a) Interest payable on debentures is treated at a charge against the profit of the company.

(b) Interest is paid net of tax to debenture holders as company is liable to deduct TDS.

(c) Interest is always calculated at the nominal value of debentures @ coupon date.

Accounting Entry:-

1. For making interest due:-

Interest A/c Dr.
  To Debenture holders Account

2. For making payment of interest and TDS;-

Debenture holders account	Dr.
To TDS payable Account	[Shown under duties and taxes head under liabilities Side of the Balance Sheet]
To Bank Account	

3. For making payment of TDS.

TDS Payable Account	Dr.
To Bank Account	

4. For transferring interest to profit and loss account

Profit and loss account	Dr.
To Interest Account	

Tutorial notes:

- There is no restriction on issue of debenture at discount whereas there are restriction for issue of shares
- No maximum limit of discount in debenture whereas in case of shares it is 10% limit
- Maximum underwriting commission or brokerage on :
  - Issue of debentures is 2.50% of issue amount
  - Issue of debentures is 5% of issue amount
- Nature of premium on redemption of debenture account is personal a/c
- Tds on debenture interest is liability until paid
- Nature of debenture is personal a/c

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