

Bank Reconciliation Statement

PRACTICAL QUESTIONS

1. Messer's Tall & Short, Faiz Bazar, Mumbai-110002 in account with Punjab National Bank, Daryaganj, Mumbai-110002

PASS-BOOK

Date		Particulars	Withdrawals ₹	Deposits ₹	Dr. or Cr.	Balance ₹
2021						
Jan.	2	By Cash		4,00,000	Cr.	4,00,000
"	4	To Furniture Dealers Ltd.	60,000		Cr.	3,40,000
"	4	To Das & Co.	1,25,000		Cr.	2,15,000
"	10	By J. Johnson & Co.'s cheque		35,000	Cr.	2,50,000
"	12	To Roy & James	1,00,000		Cr.	1,50,000
"	15	By B. Babu & Co's cheque		76,000	Cr.	2,26,000
"	16	By Cash		30,000	Cr.	2,56,000
"	20	To Cash	50,000		Cr.	2,06,000
"	26	By J. Rai & Bros cheque		43,000	Cr.	2,49,000
"	31	To Premium paid as per standing-instructions	25,000		Cr.	2,24,000
	31	To Bank Charges	1,000		Cr.	2,23,000
	31	By Interest collected on Government Securities		20,000	Cr.	2,43,000

CASH-BOOK (Bank column only)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2021			2021		
Jan. 1	To Cash	4,00,000	Jan. 2	By Furniture Dealers Ltd.	60,000
Jan. 2	To J. Johnson & Co.	35,000			

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
Jan. 8	To B. Babu & Co.	76,000	Jan. 2	By Roy & James	1,00,000
Jan. 10	To Cash	30,000	Jan. 2	By Das & Co.	1,25,000
Jan. 16	To J. Rai & Bros.	43,000	Jan. 4	By K. Nagpal & Co.	73,000
Jan. 20	To M. Mohan & Co.	1,05,000	Jan. 17	By Cash	50,000
Jan. 22	To N. Nandy & Sons	34,000	Jan. 20	By B. Babu & Co.	78,000
		7,23,000	Jan. 31	By Balance c/d	2,37,000
		2,37,000			7,23,000
Feb. 1	To Balance b/d	2,37,000			

(ICAI Study Material)

Sol. As per Balance Presentation:

Reconciliation Statement (BRS) as on 31st January, 2021

Particulars	Details (₹)	Amount (₹)
Balance as per Pass Book		2,43,000
Add: Cheques deposited but not yet credited : M. Mohan & Co. N. Nandy & Sons	1,05,000 34,000	1,39,000
Add: Premium paid and bank charges recorded in the Pass- Book but not yet recorded in the Cash-Book		26,000
		4,08,000
Less: Cheques issued but not presented for payment by bank K. Nagpal & Co. B. Babu & Co.	73,000 78,000	1,51,000
Less: Interest credited by bank but not yet recorded in the Cash Book		20,000
Balance as per Cash Book		2,37,000

Particulars	Details (Rs.)	Amount (Rs.)
Balance as per Cash Book		2,37,000
Add : Cheques issued but not yet presented by bank K. Nagpal & Co. B. Babu & Co	73,000 78,000	1,51,000
Add : Interest credited by bank but not yet recorded in the Cash Book		20,000
		4,08,000

Particulars	Details (Rs.)	Amount (Rs.)
Less : Cheques deposited but not credited by the bank: M. Mohan & Co. N. Nandy & Sons	 1,05,000 34,000	 1,39,000
Less : Premium paid and bank charges recorded in the Pass-Book but not recorded in the Cash-Book		26,000
Balance as per Pass Book		2,43,000

(ICAI Study Material)

As per Plus-Minus Presentation:

Bank Reconciliation Statement (BRS) as on 31st January, 2021

Particulars	Plus Amount (₹)	Minus Amount (₹)
Balance as per Cash Book	2,37,000	
Cheques issued but not yet presented:		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	
Interest recorded in pass-book but not yet entered into cash-book	20,000	
Cheques deposited but not yet credited:		
M. Mohan & Co.		1,05,000
N. Nandy & Sons		34,000
Premium paid and bank charges entered in pass book but not entered in cash-book		26,000
Balance as per pass book		2,43,000
	4,08,000	4,08,000

2. Based on the following extracts from the Cash-book and Pass-book for the month of Jan., 2017, prepare Bank Reconciliation Statements as on 31st Jan., 2017.

Cash-book (Bank Columns Only)

Date	Particulars	Rs.	Date	Particulars	Rs.
2017			2017		
Jan 3	To Cash	300	Jan 1	By Balance b/d	5,000
Jan 4	To Ram	1,300	Jan 16	By Cash	300
Jan 5	To Shyam	250	Jan 17	By Bharat	1,350
Jan 6	To Krishna	500	Jan 18	By Charat	500
Jan 10	To Bill of Exchange (Discount of Rs.100)	1,900			
Jan 31	To Balance c/d	2,900			
		7,150			7,150

Bank Reconciliation Statement

Pass Book

Date	Particulars	Withdrawal	Deposits	Dr./Cr.	Balance
2017		Rs.	Rs.		Rs.
Jan 1	To Balance b/d	--	--	Dr.	5,000
Jan 3	By Cash	--	300	Dr.	4,700
Jan 8	By Shyam	--	250	Dr.	4,450
Jan 9	By Krishna	--	500	Dr.	3,950

Date	Particulars	Withdrawal	Deposits Rs.	Dr./Cr.	Balance Rs.
2017					
Jan 10	To Krishna's Cheque Dishonoured	500	--	Dr.	4,450
	By Bills of Exchange (Discounted)	100	2,000	Dr.	2,550
	To Bills of Exchange (Dishonoured)	2,000	--	Dr.	4,550
	To Cash				
Jan 16	To Bharat	300	--	Dr.	4,850
Jan 18	To Bank-charges	500	--	Dr.	5,350
Jan 31	To Life Insurance premium as per standing-instructions	20	--	Dr.	5,370
Jan 31	By Dividend and interest collected as per instruction	250	--	Dr.	5,620
Jan 31		--	1,050	Dr.	4,570

Sol. Bank Reconciliation Statement (BRS) as on 31st Jan., 2017

Particulars	Plus	Minus
(A) Unfavourable Balance as per Cash-book (Cr.)		2,900
Plus : (a) Cheque issued but not yet presented for payment (To Bharat)	1,350	
(b) Dividend and Interest Collected directly by Bank	1,050	
Minus:		
(a) Cheque deposited but not yet realized (From Ram)		1,300
(b) Bank-charges debited		20
(c) Insurance Premium as per instruction		250
(d) Cheque dishonoured not entered in cash book		500
(e) Bill of Exchange dishonoured		2,000
	2,400	6,970
(B) Unfavourable Balance as per Pass-book (Dr.)	4,570	
	6,970	6,970

3. The following are the bank column of the cash book and Pass Book of Shri for the months of March, 2021 and April, 2021:

Cash Book (Bank Column only)

Date	Particulars	Amount Dr. ₹	Date	Particulars	Amount Cr. ₹
01/3/2021	To Balance b/d	60,000	03/3/2021	By Cash A/c	2,00,000
06/3/2021	To Sales A/c	3,00,000	07/3/2021	By Modi	60,000
10/3/2021	To Ram	65,000	12/3/2021	By Patil	30,000
18/3/2021	To Singhal	2,70,000	18/3/2021	By Suresh	40,000
25/3/2021	To Goyal	33,000	24/3/2021	By Ramesh	1,50,000
31/3/2021	To Patel	65,000	30/3/2021	By Balance c/d	3,13,000
		7,93,000			7,93,000

Pass Book

Date	Particulars	Amount Dr. ₹	Amount Cr. ₹	Dr. or Cr.	Balance ₹
1/4/2021	By Balance b/d		3,65,000	Cr.	3,65,000
3/4/2021	By Goyal		33,000	Cr.	3,98,000
5/4/2021	By Patel		65,000	Cr.	4,63,000
7/4/2021	To Naresh	2,80,000		Cr.	1,83,000
12/4/2021	To Ramesh	1,50,000		Cr.	33,000
15/4/2021	To Bank Charges	200		Cr.	32,800
20/4/2021	By Usha		17,000	Cr.	49,800
25/4/2021	By Kalpana		38,000	Cr.	87,800
30/4/2021	To Sunil	6,200		Cr.	81,600

Reconcile the balance of cash book on 31/3/2021.

(ICAI Study Material)

Sol. On scrutiny of the debit side of Cash-Book of March 2021 and receipt side of the Pass Book of April, 2021 reveals that two cheques deposited in the Bank (Goyal Rs 33,000 and Patel Rs 65,000) in March were not credited by the Bank till 31/3/2021.

On scrutiny of credit side of the cash-book and payment side of the pass-book reveals that a cheque issued to Ramesh for Rs 1,50,000 in March 2021, had not been presented for payment in Bank till 31/3/2021. Therefore the Bank Reconciliation statement on 31/3/2021 will appear as follows :

Bank Reconciliation Statement(BRS) as on 31st March, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per the Cash Book	3,13,000	
Cheque issued but not yet presented for payment by bank	1,50,000	
Cheque deposited but not yet credited by bank		98,000
Balance as per the Pass Book		3,65,000
	4,63,000	4,63,000

4. Prepare a Bank Reconciliation Statement (BRS) from the following particulars as on 31st Dec. 2017:

- (a) On 31st Dec.,2017 the Cash-book of a firm showed deposit with bank Dr. Balance of Rs.7, 000.
 - (b) Cheque has been issued for Rs.5, 000, out of which Cheque of Rs.4, 000 only were presented for payment.
 - (c) Cheque of Rs.1, 500 were deposited in bank on 28th Dec. 2017 but have not been credited by bank. Additionally, a cheque for Rs.500 was entered in the Cash-book on 30th Dec. 2017 but was banked on 3-1-2017.
 - (d) A cheque from Ushant for Rs.400 was deposited in the bank on 26th Dec.2017 but was dishonoured and theno information was received on 2-1-2017.
- Pass-book showed bank-charges of Rs.30 debited by bank.
- (e) One of the debtor deposited sum of Rs.500 in bank account of the firm on 20th Dec.,2017 but intimation in this respect was received from bank on 2-1-2017.
 - (f) Bank Pass-book showed a favourable balance of Rs.6,070 on 31st Dec.,2017.

Sol.

Bank Reconciliation Statement (BRS)as on 31st Dec., 2017

Particulars	Plus	Minus
Unfavourable Balance as per Cash-book	7,000	
Plus:		
(a)Cheque issued but not yet paid	1,000	
(b)Cheque directly deposited in Bank	500	
Minus:		
(a)Cheque deposited but not yet realized		1,500
(b)Cheque received and entered but not yet deposited		500
(c)Cheque deposited and dishonoured		400
(d)Bank-charges charged by Bank		30
	8,500	2,430
favourable Balance as per Pass-book		6,070
	8,500	8,500

5. The cash-book of a firm showed an Unfavourable Balance (Cr) of Rs.40,000 on 31st Mar.,2017. A comparison of entries in cash-book and Pass-book revealed that -

- (i) On 22nd Mar. , 2017 , Cheque totalling Rs.6,000 were sent to bank for collection. Out of these, a cheque for Rs.2,000 was wrongly entered on credit side of cash-book and Cheque amounting to Rs.300 couldn't be collected by bank before 1st Apr. , 2017 .
- (ii) A cheque for Rs.5,000 was issued to a supplier on 28th Mar.,2017. The cheque was presented to bank on 4th Apr. , 2017 .
- (iii) There were debit of Rs.2,700 in the Pass-book for interest on Unfavourable Balance and bank-charges, but the same has not been recorded in cash-book.
- (iv) A cheque for Rs.1,000 was issued to a creditor on 27th Mar.,2017 but by mistake same was not recorded in cash-book. The cheque was, however, duly encashed by 31st Mar.,2017.
- (v) As per standing instruction, the bank collected dividend of Rs.600 on behalf of firm and credited the same to its account by 31st Mar.,2017. The fact was, however, intimated to firm on 3rd Apr.,2017.

You are required to prepare a Bank Reconciliation Statement (BRS) as on 31st Mar.,2017.

Sol.

Bank Reconciliation Statement (BRS) as on 31.3.16

Particulars	Plus	Minus
Unfavourable Balance as per Cash-book (Cr.)		40,000
Plus :		
a) Cheque deposited but wrongly credited in cash book	2,000	
b) Cheque issued but not yet paid	5,000	
c) Dividend directly collected by Bank	600	
Minus:		
a) Cheque deposited but not realised		300
b) Bank-charges and interest debited by Bank		2,700
c) Dividend directly collected by Bank		1,000
	7,600	44,000
Unfavourable Balance as per Pass-book (Dr.)	36,400	
	44,000	44,000

Note: While converting Bank reconciliation statement in add-less form see that starting balance is Unfavourable Balance hence add all minus items and deduct all plus items.

6. Perfect Pvt. Ltd., has two accounts with Ever Bank Limited the account were known as 'Account-I' and 'Account-II'. As at Dec. , 31, 2016 the balance as per A/c books reflected following:

Account-I Rs.1, 26,000 Regular balance. Account-II Rs.1, 12,250 Unfavourable Balance. The accountant failed to tally the balance with Pass-book and the following information was available:

- (i) The Bank has debited Interest on Account-II, Rs.11, 375 and credited Interest on Account-I, Rs.1, 350. These were not entered by the accountant.
- (ii) Rs.12, 500 drawn on Dec.10, 2016, from Account-I was recorded in the books of Account-II.
- (iii) Bank-charges of Rs.250 and Rs.1, 225 for Account-I and Account-II were not entered in the books.
- (iv) A deposit of Rs.17, 500 in Account-I was wrongly entered in Account-II in the books.
- (v) Two Cheque of Rs.12,500 and Rs.13,750 deposited in Account-I, but entry made in Account-II in books, were dishonoured. The entries for dishonoured Cheque were entered correctly in Account-II.
- (vi) Cheque issued for Rs.1,50,000 and Rs.16,000 from Accounts-I and II respectively, were not presented for payment till 5th Jan. , 2017 .
- (vii) Cheque deposited Rs.1, 26,000 and Rs.1, 17,500 in Account-I and Account- II respectively, were credited by bank only on February 2, 2017.

You are required to prepare Bank Reconciliation Statement (BRS) for Account-I and Account- II.

Sol.

Bank reconciliation statement: Account – I

Particulars	Plus	Minus
Balance as per cash-book (Dr.)	1,26,000	
Plus :		
(a) Interest credited by bank	1,350	
(b) Cheque deposited but not yet entered in our book		
(c) Cheque issued but not yet paid	17,500	12,500
Minus:	1,50,000	250
(a) Withdrawal from bank not yet recorded by us		1,26,000
(b) Bank-charges charged by bank		
(c) Cheque deposited but not yet realised	2,94,850	1,38,750
Balance as per Pass-book (Cr.)		1,56,100
	2,94,850	2,94,850

Bank reconciliation statement: Account – II

Particulars	Plus	Minus
Unfavourable Balance as per cash-book (Cr.)		1,12,250
Plus :		
(a) Withdrawal from A/c-I wrongly recorded in A/c-II	12,500	
(b) Cheque issued but not yet paid	16,000	
Minus:		
(a) Interest charged by bank		11,375
(b) Bank-charges charged by bank		1,225
(c) Deposit in A/c-I is wrongly entered in A/c-II		17,500
(d) Cheque deposited but not yet realised		1,17,500
	28,500	2,59,850
Unfavourable Balance as per Pass-book (Dr.)	2,31,350	
	2,59,850	2,59,850

Note: In both the Bank Reconciliation Statement (BRS) no effect has come for item (5) because entry for deposit as well as its dishonour both has come in Account -II. That means it had nil effect everywhere.

Entry in our books for items (2) and (4) will be as follows:

Entry for (2)	Entry for (4)
Bank a/c II Dr. 12500	Bank a/c I Dr. 17500
To Bank a/c I 12500	To Bank a/c II 17500

7. Prepare a bank reconciliation statement from the following information as on 31st December 2021:

- (i) On 31st December, 2021 the cash-book of a firm showed a bank balance of ₹60,000 (debit balance).
- (ii) Cheques had been issued for ₹ 15,00,000, out of which cheques worth ₹4,00,000 only were presented for payment by bank .
- (iii) Cheques worth ₹11,40,000 were deposited in the bank on 28th December, 2021 but had not been credited by the bank. In addition to this, one cheque for ₹5,00,000 was entered in the cash-book on 30th December, 2021 but was banked on 3rd January, 2022.
- (iv) A cheque from Sushant for ₹4,00,000 was deposited in the bank on 26th December 2021 but was dishonoured and the advice was received on 2nd January, 2022.
- (v) Pass-book showed bank charges of ₹2000 debited by the bank.
- (vi) One of the debtors deposited a sum of ₹5,00,000 in the bank account of the firm on 20th December, 2021 but the intimation in this respect was received from the bank on 2nd January, 2022.

- (vii) Bank pass-book showed a unfavourable balance of ₹3,82,000 on 31st December, 2021. (ICAI Study Material)

Sol.

Bank Reconciliation Statements on 31st December, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Bank balance as per cash book	60,000	
Cheques issued but not yet presented for payment by bank	11,00,000	
Cheques directly deposited by a customer not yet recorded in cash book	5,00,000	
Cheques deposited but not yet credited by the bank		11,40,000
Cheque received and recorded in cash book but not yet banked		5,00,000
Cheque dishonoured by the bank; the dishonour entry not yet passed in cash book		4,00,000
Bank charges not recorded in Cash book		2,000
Bank balance (Dr.) as per pass book	3,82,000	
	20,42,000	20,42,000

8. Prepare a bank reconciliation statement from the following information as on 30th September, 2021:

Particulars	₹
Bank balance as per pass-book	10,00,000
Cheque deposited in the bank, but no entry was passed in the Cash-Book	5,00,000
Cheque received, but not sent to bank for collection	11,20,000
Credit side of the bank column of cash book cast short	2,000
Payment of Insurance premium made directly by bank under the standing advice	60,000
Bank charges entry made twice in the cash-book	2,000
Cheque issued, but not presented to bank	5,00,000
Cheque received recorded twice in the cash book	10,000
Bills discounted dishonoured not recorded in the cash book.	5,00,000

(ICAI Study Material)

Sol.

Bank Reconciliation Statement (BRS) as on 30th September, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Bank balance as per pass book	10,00,000	
Cheque received recorded in cash-book but not sent to bank	11,20,000	

Particulars	Plus (Rs.)	Minus (Rs.)
Credit side of the bank column of cash-book undercast	2,000	
Insurance premium paid directly by the bank not recorded in the cash book	60,000	
Cheque received entered twice in the cash book	10,000	
Bills dishonoured not entered in cash-book	5,00,000	
Cheque deposited into bank but no entry was made in cash-book		5,00,000
Bank charges recorded twice in the cash-book		2,000
Cheque issued but not yet presented		5,00,000
Bank balance as per cash book		16,90,000
	26,92,000	26,92,000

9. From the following information prepare a bank reconciliation statement on 31st March, 2021:

Particulars	₹
Favourable balance as per bank column of the cash book	37,20,000
Cheque issued to creditors but not yet presented to bank for payment	7,20,000
Dividend received by bank but not yet recorded in cash-book	5,00,000
Interest allowed by the bank	12,500
Cheques deposited into bank for collection but not collected by bank up to this date.	15,40,000
Bank charges	2,000
A cheque deposited into bank was dishonoured	3,20,000
Bank paid house tax on our behalf, but no information received from bank in this connection.	3,50,000

(ICAI Study Material)

Sol.

Bank Reconciliation Statement (BRS) as on 31st March, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Debit balance as per cash book	37,20,000	
Cheque issued but not yet presented to bank for payment	7,20,000	
Dividend received by bank not recorded in cash book	5,00,000	
Interest allowed by bank	12,500	
Cheques deposited into bank but not yet collected by bank		15,40,000

Particulars	Plus (Rs.)	Minus (Rs.)
Bank charges		2,000
A cheque deposited into bank was dishonoured , no intimation received		3,20,000
House tax paid by bank		3,50,000
Credit balance as per pass book		27,40,500
	49,52,500	49,52,500

10. From the following particulars , prepare a bank reconciliation statement on 31st March, 2021, and show the balance as per cash book:

- (i) Overdraft as per passbook on March 31, 2021, is Rs 3,00,000.
- (ii) Interest on overdraft debited by bank not entered in the cash book Rs. 36,500
- (iii) Insurance premium of Rs. 17,950 was due and paid by the bank but same has not been entered in the books.
- (iv) Cheques drawn in last week of March,2021, but not cleared till date for ₹13,000 and Rs. 23,500.
- (v) Cheques deposited into bank on February,2021, but yet to be credited on dated March 31, 2021 Rs. 56,000.
- (vi) Amount of Rs. 20,500 is wrongly charged by the bank
- (vii) Interest on Investment Rs. 83,800 collected and credited by bank but the same has not been entered in the Cash Book.

(ICAI Study Material)

Sol.

Bank Reconciliation Statement(BRS) as on 31st March, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per bank statement (Overdraft)		3,00,000
Cheques drawn but not cleared		36,500
Interest collected on investments directly by bank but not entered in cash-book		83,800
Interest on overdraft debited by bank not entered in the cash book	36,500	
Cheques deposited but not yet cleared	56,000	
Insurance premium paid by bank	17,950	
Amount wrongly debited by bank	20,500	
Overdraft as per cash book	2,89,350	
	4,20,300	4,20,300

11. The Bank Pass-book of Account No. 5678 of Miss. Rani showed an Unfavourable Balance of Rs.33, 575 as on 31st Mar., 2019. On going through Pass Book, the accountant found the following:

- (i) A Cheque of Rs.1,080 credited in Pass-book on 28th Mar. 2019 being dishonoured is debited again in the Pass-book on 1st Apr. 2019. There was no entry made in cash-book about the dishonour of the cheque until 15th Apr., 2019.
- (ii) Bank has credited her account with Rs.2,800 for interest collected by them on her behalf, but the same had not been entered in her cash-book.
- (iii) Out of Rs.20,500 paid in by Miss. Rani in cash and by Cheque on 31st Mar., 2019 Cheque amounting to Rs.7,500 were collected on 7th Apr., 2019.
- (iv) Out of Cheque amounting to Rs.7,800 drawn by her on 27th Mar., 2019 a cheque for Rs.2,500 was encashed on 3rd Apr., 2019.
- (v) Banker seems to have given her wrong credit for Rs.500 paid in by her in Account No. 8745 and a wrong debit in respect of a cheque for Rs.300 against her account No. 8745.
- (vi) A cheque for Rs.1,000 recorded in Cash-book but omitted to be banked on 31st Mar., 2019.
- (vii) A Bill Receivable for Rs.5,200 previously discounted (Discount Rs.200) with the Bank has been dishonoured but no information was received on 1st Apr., 2019.
- (viii) A Bill for Rs.10,000 was retired/paid by bank under a rebate of Rs.175 but the full amount of bill was credited in bank column of the Cash-book.
- (ix) A Cheque for Rs.2,400 deposited into bank but not recorded in Cash-book and were collected by bank on 31st Mar., 2019.

Prepare Bank Reconciliation Statement (BRS) as on 31st Mar., 2019.

[May 2018, 10 Marks]

Sol.

Bank Reconciliation Statement (BRS) as on 31st Mar., 2019

Particulars	Plus	Minus
(A) Debit Balance as per Pass Book		33,575
Plus :		
a) Amount debited in cash-book for pending Cheque in collection but not credited in Pass Book	7,500	
b) Reversal of wrong debit	300	
c) Cheque of Rs.1,000 entered in cash-book but omitted to be banked	1,000	
d) Discounted bill dishonoured but no entry in Cash book	5,200	
Minus:		
a) No entry in Cash-book for interest collection by Bank		2,800
b) Cheque credited in cash-book but not debited in pass book		2,500
c) Reversal of wrong Credit		500
d) Rebate on bill retired not entered in cash book		175
e) Cheque deposited in bank not yet recorded in cash book		2,400

Particulars	Plus	Minus
	14,000	41,950
(B) Balance (Cr. i.e. Unfavourable Balance) as per Cash book	27,950	
	41,950	41,950

Note: A cheque of Rs.1,080 credited in Pass-book on 28th Mar. , 2019 and later debited in Pass-book on 1st Apr., 2019 has no effect on Bank Reconciliation Statement (BRS) as at 31st Mar., 2019.

12. Prepare a Bank Reconciliation Statement (BRS) from the following particulars as on 31st Mar. 2019:
[Nov. 2018, 10 Marks]

Particulars	(Rs.)
Balance as per cash-book	18,60,000
Cheque issued to creditors but not yet presented to Bank for payment	3,60,000
Dividend received by bank but not recorded in Cash book	2,50,000
Interest credited by the Bank	6,250
Cheque deposited into bank but not collected by bank up to this date	7,70,000
Bank-charges not entered in Cash Book	1,000
A cheque deposited into bank was dishonoured, but no intimation received	1,60,000
Bank paid house tax on our behalf, but no intimation received from bank in this connection	1,75,000

Sol.

Bank Reconciliation Statement (BRS)
(As on Mar. 31, 2019)

Particulars	Plus	Minus
Favourable Balance as per cash-book (Dr.)	18,60,000	
Plus:		
(a) Cheque Issued but not yet presented by bank	3,60,000	
(b) Dividend received by the Bank	2,50,000	
(c) Interest Allowed by the Bank	6,250	
Minus:		
(a) Cheque deposited but not collected		7,70,000
(b) Bank-charges debited by bank but not entered in cash book		1,000
(c) Cheque deposited into bank but dishonoured		1,60,000
(d) House Tax Paid By Bank		1,75,000
	24,76,250	11,06,000
		13,70,250
Balance as per Pass-book (Cr.)	24,76,250	24,76,250

13. Prepare Bank Reconciliation Statement (BRS) of M/s. R.K. Brothers on 30th June, 2019 from the particulars given below:

- (i) The Bank Pass-book has a unfavourable balance of Rs.25, 000 on 30th June, 2019.
- (ii) A cheque of Rs.400 was directly deposited into Bank by a customer but no entry was made in the Cash-book.
- (iii) Out of Cheque issued of Rs.34, 000, Cheque amounting to Rs. 20,000 only was presented for payment till 30th June, 2019.
- (iv) A cheque for Rs.4, 000 received and recorded in the Cash-book but it was not sent to the Bank.
- (v) Cheque of Rs.20,000 has been sent to Banker for collection but the collection was reported by the Banker as under:
 - (1) Cheque collected before 30th June, 2019, Rs.14, 000
 - (2) Cheque collected on 10th July, 2019, Rs.4, 000
 - (3) Cheque collected on 12th July, 2019, Rs.2, 000.
- (vi) The Bank made a direct payment of Rs.600 which was not recorded in Cash-book.
- (vii) Interest on debit balance charged by bank Rs.1, 600 was not recorded in the Cash-book.
- (viii) Bank-charges of Rs. 80 have been entered twice in the cash-book whereas Insurance charges for Rs.70 directly paid by Bank were not at all entered in the Cash-book.
- (ix) The credit side of bank column of Cash-book was under cast by Rs.2, 000.

[May 2019, 10 Marks]

Sol.

Bank Reconciliation Statement (BRS) of M/s R.K. Brothers as on 30th June, 2019

Particulars	Plus	Minus
Unfavourable Balance as per Pass-book (Dr.)		25,000
Plus :		
(a) Cheque entered in Cash-book but not sent to the Bank	4,000	
(b) Cheque sent but not collected by Bank (4,000 + 2,000)	6,000	
(c) Direct payment made by Bank, not recorded in Cash Book	600	
(d) Interest on Unfavourable Balance charged by Bank, not recorded in Cash Book	1,600	
(e) Insurance Charges directly paid by Bank	70	
(f) Credit side of bank column of Cash-book under cast	2000	
Minus:		400
(a) Cheque directly deposited into Bank, but not entered in Cash Book		14,000
(b) Cheque issued but not presented for the payment till 30th June, 2019		80
(c) Bank-charges charged by Bank, recorded twice.	14,270	39,480
	25,210	
Unfavourable Balance as per Cash-book (Cr.)	39,480	39,480

14. On 31-3-2020, Mahesh's Cash-book Unfavourable Balance of Rs.98, 700. On comparison he finds the following rectification :

- (i) Out of the total Cheque of Rs.8, 900 issued on 27th Mar. , one cheque of Rs.7,400 was presented for payment on 4th Apr. And the other cheque of Rs.1, 500 handed over to the customer, was returned by him and in lieu of that a new cheque of the same amount was issued to him on 1st Apr. . . . No entry for the return was passed.
- (ii) Out of total cash and Cheque of Rs.6, 800 deposited in the Bank on 24th. In Mar. , one cheque of Rs.2,600 was realized on 3rd Apr. And the other cheque of Rs.500 was returned dishonoured by bank on 4th Apr. .
- (iii) Bank-charges Rs.35 and Bank interest Rs.2, 860 debited by the bank appearing in the passbook are not yet entered in the cash-book.
- (iv) A cheque deposited in his another account of Rs.1, 550 wrongly credited to this account by the bank.
- (v) A cheque of Rs.800, drawn on this account, was wrongly debited in another account by bank.
- (vi) A debit of Rs.3,500 appearing in the bank statement for an unpaid cheque returned for being 'out of date' has been re-dated and deposited in the bank account again on 5th Apr. 2020.
- (vii) The bank allowed interest on deposit Rs.1, 000 credited by bank.
- (viii) A customer who received a cash discount of 4% on his account of Rs.1, 00,000 paid a cheque on 20th Mar. , 2020. The cashier erroneously recorded the gross amount in the bank column of the Cash-book.

Prepare Bank Reconciliation Statement (BRS) as on 31-3-2020.

[Nov. 2020, 10 Marks]

Sol.

Bank Reconciliation Statement (BRS) as on 31st Mar., 2020

Particulars	Plus	Minus
Unfavourable Balance as per Cash-book (Cr.)		98,700
Plus :		
(a) Cheque issued but not presented [Rs.7400 + Rs.1500]	8,900	
(b) Cheque wrongly credited to account by Bank	1,550	
(c) Interest allowed by bank	1,000	
(d). Cheque wrongly debited by bank to another account	800	
Minus:		
(a) Cheque deposited with bank but not credited [Rs.2,600 + Rs.500]		3,100
(b) Bank-charges not entered in the Cash-book		35
(c) Bank interest not entered in the Cash-book		2,860
(d) Cheque returned 'out of date'		3,500
(e) Discount allowed wrongly entered in bank column		4,000

Particulars	Plus	Minus
	12,250	1,12,195
	99,945	
Unfavourable Balance as per Pass-book (Dr.)	1,12,195	1,12,195

15. Prepare a Bank Reconciliation Statement (BRS) from the following particulars as on 31st Dec. , 2020:

Particulars	Rs.
Balance as per Cash-book (Dr.)	1,97,000
Bank-charges charged by the bank not recorded in Cash Book	33,000
Received from debtors vide RTGS on 31st Dec. , 2020 not recorded in Cash Book	1,00,000
Cheque issued but not presented for payment	
Cheque deposited but not realized	46,000
Cheque received and deposited but dishonoured. Entry for dishonour not entered in the Cash Book	25,000
	6,000
Instruction for payment given to the banker on 31st Dec. , 2020 but the same affected by the Banker on 1st Jan. , 2021	4,000

Sol.

Bank Reconciliation Statement (BRS) as at 31st Dec. , 2020

Particulars	Plus	Minus
Balance as per Cash-book (Dr.)	1,97,000	
Plus :		
(a) Received from Debtors vide RTGS	1,00,000	
(b) Cheque issued but not presented	46,000	
(c) Instructions given to bank for payment on 31 st but bank made payment on 1st Jan. , 2021	4,000	
Minus:		
(a) Bank-charges debited by bank		33,000
(b) Cheque deposited but not realized		25,000
(c) Dishonour of cheque not recorded in Cash book		6,000
	3,47,000	64,000
		2,83,000
Balance as per Pass-book (Cr.)	3,47,000	3,47,000

16. From the following information, ascertain the Cash-book balance of Mr Bajaj as on 31st Mar., 2021:

- (i) Unfavourable balance as per Bank Pass-book Rs.3, 500.
- (ii) A cheque amounting to Rs.2, 500 deposited on 15th Mar., but the same was returned by the Bank on 24th Mar. for which no entry was entered in the Cash-book.
- (iii) During Mar. two bills amounting to Rs.2, 500 and Rs.500 were collected by the Bank but no entry was entered in the Cash-book.
- (iv) A bill for Rs.5, 000 due from Mr. Balaji previously discounted for Rs.4, 800 was dishonoured. The Bank debited the account, but no entry was made in Cash-book.
- (v) A Cheque for Rs.1, 500 was debited twice in the cash-book. [July 2021, 5 Marks]

Sol.

Bank Reconciliation Statement (BRS) as on 31st Mar. , 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Unfavourable Balance as per Pass-book (Dr.)		3,500
Plus:		
a) Cheque deposited but returned, not entered in Cash Book	2,500	
b) Bill discounted earlier but dishonoured, not entered in Cash Book		
c) A Cheque wrongly debited twice in the Cash Book	5,000	
	1,500	
Minus:		
a) Bills collected by bank but not entered in the Cash Book [Rs.2500 + Rs.500].	3000	
	9,000	6,500
Dr. Balance as per Cash Book		2,500
	9,000	9,000

17. From the following particulars, prepare a Bank Reconciliation Statement (BRS) on 31st Mar. , 2021:

Particulars	Rs.
Bank balance as per Passbook (Cr.)	25,00,000
Bills discounted dishonoured not recorded in Cash Book	12,50,000
Cheque received recorded twice in Cash Book	25,000
Bank-charges entered twice in Cash Book	5,000
Insurance premium paid directly by Bank understanding instruction	1,50,000
Cheque issued but not presented to Bank for payment	12,50,000
Cheque received, but not sent to Bank	28,00,000
Cheque deposited in Bank, but no entry made in the Cash Book	12,50,000
Credit side of the Bank column cast short	5,000

Bank Reconciliation Statement (BRS) as on 31st Mar., 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Favourable balance as per Passbook	25,00,000	
Plus:		
1. Bill discounted, dishonoured not recorded in cash book		
2. Cheque received entered twice in the cash book	12,50,000	
3. Insurance premium paid not recorded in Cash Book	25,000	
4. Cheque received but not sent to Bank	1,50,000	
5. Credit side of bank column cast short	28,00,000	
	5,000	
Minus:		
1. Bank-charges entered twice in cash book		5,000
2. Cheque issued but not presented		12,50,000
3. Cheque deposited but not recorded in cash book		12,50,000
	67,30,000	25,05,000
Dr. Balance as per Cash Book		42,25,000
	67,30,000	67,30,000

18. On 31st March 2021, the Bank Pass-Book of Namrit showed a balance of Rs 1,50,000 to her credit while balance as per cash-book was Rs 1,12,050. On scrutiny of the two books, she ascertained the following causes of difference:

- (i) She has issued cheques amounting to Rs 80,000 out of which only Rs 32,000 were presented for payment.
- (ii) She received a cheque of Rs 5,000 which she recorded in her cash-book but forgot to deposit in bank.
- (iii) A cheque of Rs 22,000 deposited by her has not been cleared yet.
- (iv) Mr. Kumar deposited an amount of Rs 15,700 in her bank which has not been recorded by her in Cash Book yet.
- (v) Bank has credited an interest of Rs 1,500 while charging Rs 250 as bank Charges. Prepare a bank reconciliation statement.

(ICAI Study Material)

Sol.

Bank Reconciliation Statement (BRS) as on 31st March, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per Pass Book (Cr.)	1,50,000	
Cheque deposited but not yet cleared	22,000	
Cheque recorded in Cash Book but not yet deposited into bank	5,000	
Bank Charges debited by bank	250	
Cheque issued but not yet presented		48,000
Amount deposited but not recorded in Cash Book		15,700
Interest allowed by bank		1,500
Balance as per Cash Book		1,12,050
	1,77,250	1,77,250

19. Ascertain the balance that would appear in the Bank Pass Book of B from the following particulars on 31st December, 2021.

- (1) The unfavourable balance as per Cash Book on 31st December, 2021 Rs 6,340.
- (2) Interest on unfavourable balance for 6 months ending 31st December, 2021 Rs 160 is entered in Pass Book.
- (3) Bank charges of Rs 400 are debited in the Pass Book only not recorded in cash book.
- (4) Cheques issued but not cashed prior to 31st December, 2021, amounted to Rs 11,68,000.
- (5) Cheques paid into bank but not cleared before 31st December, 2021 were for Rs 22,17,000.
- (6) Interest on investments collected by bank and credited in the Pass Book Rs 12,00,000 but not recorded in cash-book.

(ICAI Study Material)

Sol.

Bank Reconciliation Statement As on 31st December, 2021

Particulars	Amount (Rs.)
Overdraft as per Cash Book	6,340
Add: Interest debited in the Pass Book but not yet entered in the Cash Book	160
Add: Bank charges charged by bank but not entered in the Cash Book	400
Add : Cheques deposited but not yet credited in the Pass Book	22,17,000
	22,23,900

Particulars	Amount (Rs.)
Less: Cheques issued but not yet presented for payment by bank	(11,68,000)
Less: Interest collected and credited by bank but not yet recorded in Cash Book	(12,00,000)
Balance as per Pass Book (Cr.)	(1,44,100)

The above illustration can also be presented in “Plus” and “Minus” format.

Particulars	Plus Amount (Rs.)	Minus Amount (Rs.)
Overdraft as per Cash Book		6,340
Interest debited in Pass-Book but not yet recorded in Cash Book		160
Cheque issued but not yet presented	11,68,000	
Cheques paid in but not yet credited by the Bank		22,17,000
Bank charges		400
Interest collected and credited by the Bank in the Pass-Book but not yet recorded in Cash Book		
Balance as per Pass Book	12,00,000	
Total		1,44,100
	23,68,000	23,68,000

20. Prepare a Bank reconciliation statement from the following information, as at 31st December, 2021 for Messrs New Steel Limited :

		₹
(1)	Overdraft as per Cash Book on 31st December, 2021	22,45,900
(2)	Interest charged by Bank on 26th December, 2021 but no advice received	2,78,700
(3)	Cheque issued before 31st December, 2021 but not yet presented to Bank	6,60,000
(4)	Transport subsidy received from the State Government directly by the Bank but not advised to company	14,25,000
(5)	Draft deposited in the Bank, but not credited till 31st December, 2021	13,50,000
(6)	Bills for collection credited by the Bank till 31st December, 2021 but no advice received by the company	8,36,000
(7)	Amount wrongly debited to company account by the Bank, for which no details are available	7,40,000

(ICAI Study Material)

Sol.

M/s. New Steel Ltd.
Bank Reconciliation Statement as on 31st Dec, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Overdraft as per Cash Book		22,45,900
Interest charged by the bank		2,78,700
Draft deposited in bank but not yet credited		13,50,000
Wrong debit by the bank, under verification		7,40,000
Cheque issued but not yet presented	6,60,000	
Transport subsidy not yet recorded in the Cash Book	14,25,000	
Bills for collection credited in the bank not yet entered in the cash book	8,36,000	
Overdraft as per bank statement	16,93,600	
	46,14,600	46,14,600

21. When Nikki & Co. received a Bank Statement showing a credit balance of Rs. 10,39,200 for the period ended on 30th June, 2021, this did not agree with the balance in the cash-book.

An examination of the Cash-Book and Bank Statement disclosed the following :

1. A deposit of Rs 3,09,200 paid on 29th June, 2021 had not been credited by the Bank until 1st July, 2021.
2. On 30th March, 2021 the company had entered into hire purchase agreement to pay by bank order a sum of Rs 3,00,000 on the 10th of each month, commencing from April, 2021. No entries had been made in Cash-Book.
3. A customer of firm, who received a cash discount of 4% on his account of Rs 4,00,000 paid the firm a cheque on 12th June. The cashier erroneously entered the gross amount in the bank column of the Cash Book.
4. Bank charges amounting to Rs 3,000 has not been entered in Cash-Book.
5. On 28th June, a customer of the company directly deposited the amount in the bank Rs 4,00,000, but no entry had been entered in the Cash Book.
6. Rs 11,200 paid into the bank had been recorded twice in the Cash Book.
7. A debit of Rs 11,00,000 appeared in the Bank Statement for an unpaid cheque, which had been returned marked 'out of date'. The cheque had been re-dated by the customer and paid into Bank again on 5th July, 2021.

Prepare Bank Reconciliation Statement on 30 June, 2021.

(ICAI Study Material)

Sol.

Bank Reconciliation Statement (BRS) on 30th June, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per the Pass Book	10,39,200	
Deposited with bank but not credited	3,09,200	
Payment of Hire Purchase installments not entered in the Cash Book (Rs.3,00,000 x 3)	9,00,000	
Discount allowed wrongly entered in bank column	16,000	
Bank charges not entered in the Cash Book	3,000	
Deposit entered in the Cash Book twice	11,200	
Cheque returned 'out of date' entered in the Cash Book	11,00,000	
Direct deposit by customer not entered in the Cash Book		4,00,000
Balance as per the Cash Book		29,78,600
	33,78,600	33,78,600

22. On 30th September, 2021, the bank account of Y, according to the bank column of the Cash- Book, was overdrawn to the extent of Rs4,062. On the same date the bank statement showed a credit balance of Rs 20,758 in favour of X. An examination of the Cash Book and pass book reveals the following:

1. A cheque for Rs 13,14,000 deposited on 29th September, 2021 was credited by the bank only on 3rd October, 2021.
2. A payment by cheque for Rs 16,000 has been entered twice in the Cash Book.
3. On 29th Sept., 2021, the bank credited an amount of Rs 1,17,400 received from a customer of X, but the advice was not received by X until 1st October, 2021.
4. Bank charges amounting to Rs 580 had not been entered in the Cash Book.
5. On 6th Sept., 2021, the bank credited Rs20,000 to X in error.
6. A bill of exchange for Rs 1,40,000 was discounted by X with his bank. This bill was dishonoured on 28th September, 2021 but no entry had been made in the books of X.
7. Cheques issued upto 30th Sept., 2021 but not presented for payment upto that date totalled Rs 13,26,000.

You are required :

- (a) to show the appropriate rectifications required in the Cash Book of X, to arrive at the correct balance on 30th September, 2021 and
- (b) to prepare a bank reconciliation statement as on that date.

(ICAI Study Material)

Sol.

(a) Cash Book (Bank Column)

Date 2021	Particulars		Amount ₹	Date 2021	Particulars		Amount ₹
Sept. 30	To	Party A/c	16,000	Sept. 30	By	Balance b/d Bank	4,062
	To	Customer A/c			By	charges Customer	580
		(Direct deposit)	1,17,400		By	A/c	
	To	Balance c/d	11,242			(B/R dishonoured)	1,40,000
			1,44,642				1,44,642

(b) Bank Reconciliation Statement as on 30th September, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Overdraft as per Cash Book		11,242
Cheque deposited but not collected up to 30th Sep., 2022		13,14,000
Cheques issued but not presented for payment up to 30th September, 2022	13,26,000	
Credit by Bank erroneously on 6th September	20,000	
Credit balance as per bank statement		20,758
	13,46,000	13,46,000

Note: The bank wrongly credited X with 20,000 on September 6, 2021. If this error is rectified in the bank statement, it will not be subtracted in the previous statement, and as a result, a credit balance of Rs 758 will be reflected in the passbook.

23. On 30th Dec., 2021 the bank column of A. Philip's cash book showed a debit balance of Rs 4,610. On examination of the cash-book and bank statement you find that:

1. Cheques amounting to Rs 6,30,000 which were issued to trade payables and recorded in the cash book before 30th Dec., 2021 were not presented for payment until that date.
2. Cheques amounting to Rs 2,50,000 had been recorded in the cash book as having been paid into the bank on 30th December, 2021, but were entered in the bank statement on 1st January, 2023.
3. A cheque received for Rs 73,000 had been dishonoured prior to 30th Dec., 2021, but no record of this fact appeared in the cash book.
4. A dividend of Rs 3,80,000, paid directly to the bank had not been entered in the cash book.
5. Bank interest and charges amounting to Rs 4,200 had been charged in bank statement but not recorded in the cash book.

6. No entry had been made in the cash-book for a trade subscription of Rs 10,000 paid vide banker's order in November, 2021.
7. A cheque for Rs 27,000 drawn by B. Philip had been charged to A. Philip's bank account by mistake in December, 2021.

You are required:

- (a) to make appropriate adjustments in the cash-book bringing down the correct balance, and
 - (b) to prepare a statement reconciling adjusted balance in the cash-book with the balance shown in the bank statement.
- (ICAI Study Material)

Dr.			Cash Book (Bank column)			Cr.		
Date	Particulars	Amount ₹	Date	Particulars	Amount ₹			
2021 Dec. 30	To Balance b/d	4,610	2021 Dec. 30	By Trade receivables- (Cheque dishonoured)	73,000			
	To Dividend received	3,80,000		By Bank interest and charges	4,200			
				By Trade Subscription	10,000			
			Dec. 31	By Balance c/d	2,97,410			
		3,84,610			3,84,610			
2023 Jan. 1	To Balance b/d	2,97,410						

(b) Bank Reconciliation Statement (BRS) as at 30th December, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance per cash book	2,97,410	
Cheques not yet presented	6,30,000	
Lodgement not yet recorded by bank		2,50,000
Cheque wrongly charged		27,000
Balance as per the bank statement		6,50,410
	9,27,410	9,27,410

24. The Cash Book of Mr. Gadbad wala shows Rs 8,36,400 as the balance at Bank as on 31st Dec., 2021, but you find that it does not agree with the balances as per the Bank Pass-Book. On scrutiny, you find the following discrepancies

- (1) On 15th Dec., 2021 the payment side of the Cash Book was undercast by Rs 10,000.
- (2) A cheque for Rs 1,31,000 issued on 25th December, 2021 was not taken in the bank column.

- (3) One deposit of Rs 1,50,000 was recorded in the Cash-Book as if there is no bank column therein.
- (4) On 18th December, 2021 the debit balance of Rs 15,260 as on the previous day, was brought forward as credit balance in the Cash book.
- (5) Of the total cheques amounting to Rs 11,514 drawn in the last week of December, 2021, cheques aggregating Rs7,815 were encashed in December.
- (6) Dividends of Rs 25,000 collected by the Bank and subscription of Rs 1,000 paid by it were not recorded in the Cash Book.
- (7) One out-going Cheque of Rs 3,50,000 was entered twice in the Cash Book. Prepare Bank Reconciliation Statement. (ICAI Study Material)

Sol.

(When are not closed on 31st December, 2021)
Bank Reconciliation Statement of Mr. Gadbada wala as on 31st Dec., 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per the Cash Book	8,36,400	
Mistake in bringing forward Rs.15,260 debit balance as credit balance on 18th Dec., 2021	30,520	
Cheques issued but not presented : Issued Rs.11,514 Cashed (Rs.7, 815)		
Dividends directly collected by bank but not yet recorded in the Cash-Book	3,699	
Cheque recorded twice in the Cash Book	25,000	10,000
Deposit not recorded in the Bank column	3,50,000	1,31,000
Wrong casting in the Cash Book on 15th Dec.	1,50,000	1,000
Cheques issued but not entered in the Bank column		12,53,619
Subscription paid by the bank directly not yet recorded in the Cash Book		13,95,619
Balance as per the Pass Book		
	13,95,619	

25. Mr. Manuj is employed by Century Rayon and Carpets Pvt Ltd. as their cashier. The main responsibility of Mr. Manoj is to maintain the company's cash book and prepare a bank reconciliation statement at the end of each month. The cash-book (only bank column) is set out below together with a copy of the bank statement for the month of February 2021.

You are required to :

- Reconcile the cash book with the bank statement.
- Make necessary entries to update the cash book.
- Start with the bank balance as per cash book, list any unpresented cheques and sub-total on the reconciliation statement.

Century Rayon and Carpets Pvt Ltd Cash Book (Bank Column only)

Date	Particulars	Dr. ₹	Date	Particulars	Cr. ₹
01/02/2021	To Balance b/d	1,42,500	03/02/2021	By Bhagwandas	1,980
01/02/2021	To Blue and Co	1,570	07/02/2021	By Maruti Ltd (400460)	1,500
04/02/2021	To GM Ltd	2,430	12/02/2021	By Jackson Ltd (400461)	54,000
08/02/2021	To Robinson Ltd	910	18/02/2021	By PC computers (400462)	1,420
13/02/2021	To Donald	750	24/02/2021	By Shiv garage (400463)	49,000
20/02/2021	To Avenue Super mart	4,200	30/02/2021	By Petty cash (400465)	1,500
28/02/2021	To Sleep Well Ltd	940		By Shweta & Co (400464)	2,100
				By AV Partners (400466)	5,200
				By Balance c/d	36,600
		1,53,300			1,53,300

Customer: Century Rayon and Carpets Pvt Ltd Account No – xxxxx0439

Account Statement for the month of February 2021

Date	Particulars	Amount Dr.	Amount Cr.	Dr. or Cr.	Balance ₹
1/02/2021	Balance b/d				1,42,500
3/02/2021	Cheques		1,570	Cr.	1,44,070
5/02/2021	Maruti Ltd	1,500		Dr.	1,42,570
7/02/2021	Bhagwandas	1,980		Dr.	1,40,590
12/02/2021	GM Ltd		2,430	Cr.	1,43,020

Date	Particulars	Amount Dr.	Amount Cr.	Dr. or Cr.	Balance ₹
15/02/2021	Robinson Ltd		910	Cr.	1,43,930
20/02/2021	Premium of New India Insurance Ltd	3,800		Dr.	1,40,130
14/02/2021	Donald		750	Cr.	1,40,880
14/02/2021	400463	49,000		Dr.	91,880
23/02/2021	cheques		4,200	Cr.	96,080
26/02/2021	Savita 400465	1,030		Dr.	95,050
26/02/2021	Shreya	1,500		Dr.	93,550
27/02/2021			2,200	Cr.	95,750
28/02/2021	Bank charges	2,538		Dr.	93,212

(ICAI Study Material)

Sol. In the books of Century Rayon and Carpets Pvt Ltd

(a) Journal entries to be posted:

Debit	Credit
Bank A/c	Dr 2200
To Shreya A/c	2200
Bank Charges A/c	Dr 2538 Insurance premium A/c Dr 3800 Savita A/c Dr 1030
To Bank A/c	7368

Cash Book (Bank Column)

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	36,600	By bank charges	2,538
To direct receipt in bank	2,200	By insurance premium	3,800
		By direct payment to Savita	1,030
		By balance c/d	31,432
	38,800		38,800

Bank Reconciliation Statement as on February 28, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Updated Balance as per Cash book	31,432	
Cheques issued but not yet presented for payment : Jackson Ltd Rs.54,000 P C Computers Rs.1420 Shweta & Co Rs.2100 A.V. Partners Rs.5200	62,720	
Cheques deposited but not yet credited Sleep Well Ltd		940
Balance as per the bank statement		93,212
	94,152	94,152

- Without preparation of adjusted cash-book.
- Bank reconciliation statement (BRS) after the preparation of adjusted cash-book.

26. From the following information (as on 31.3.2017), prepare a Bank Reconciliation Statement (BRS) after making necessary amendments in the Cash-book.

Bank balance as per Cash-book (Dr.)	3,26,000
Cheque deposited, but not yet credited	4,48,500
Cheque issued but, not yet presented for payment by bank	3,56,200
Bank-charges debited by Bank but not recorded in Cash-book	1,350
Dividend directly collected by bank	12,600
Payment of insurance premium by bank as per standing instruction not intimated	15,900
Cash sales wrongly entered in the bank column of the Cash-book	26,500
Customer's cheque dishonoured by bank not entered in Cash-book	13,000
Wrong Credit given by bank	16,000

Also show bank balances that will appear in the Trial Balance as on 31.3.2017

Sol.

Cash-book as on 31.3.2017 (Bank Column)
(After making necessary amendments)

Particulars	Rs.	Particulars	Rs.
To Balance b/d	3,26,000	By Bank-charges a/c	1,350
To Dividend income a/c	12,600	By Insurance premium a/c	15,900
		By Cash Sales (wrongly recorded) a/c	26,500
		By Debtors (cheque dishonoured) a/c	13,000
		By Balance c/d (corrected/ final balance)	2,81,850
	3,38,600		3,38,600

Bank Reconciliation Statement (BRS) as on 31.3.2017

Particulars	Plus	Minus
Balance as per Cash-book (Dr.)	2,81,850	
Plus:		
(a) Cheque issued but not yet paid by Bank	3,56,200	
(b) Wrong Credit given by Bank	16,000	
Minus:		
(a) Cheque deposited but not yet realised by bank		4,48,500
	6,54,050	4,48,500
		205550
Balance as per Pass-book (Cr.)	6,54,050	6,54,050

Note: The bank balance of Rs.2,81,850 will appear in the trial balance as on 31st Mar., 2017 and consequently in Balance sheet.

27. On 30th Sept., 2019, the bank account of XYZ, according to the bank column of the cash book, was overdrawn to the extent of Rs.8,062. An examination of the Cash-book and Bank Statement reveals the following:

- (i) A cheque for Rs.11,14,000 deposited on 29th Sept., 2019 was credited by the bank only on 3rd Oct., 2019.
- (ii) A payment made by cheque for Rs.18,000 has been entered twice in the Cash-book.
- (iii) On 29th Sept., 2019, the banker credited an amount of Rs.1,15,400 received from a customer of XYZ, but the no information was not received by XYZ until 1st Oct., 2019.
- (iv) Bank-charges amounting to Rs.280 has not been entered in the cash book
- (v) On 6th Sept., 2019, the bank credited Rs.30,000 to XYZ in error.

- (vi) A bill of exchange for Rs.1, 60,000 was discounted by XYZ with his bar. The bill was dishonoured on 28th Sept. , 2019 but no entry has been made in books of XYZ.
- (vii) Cheque issued up to 30th Sept. , 2019 but not presented for payment up to that date totalled Rs.13, 46,000.
- (viii) A bill payable of Rs.2, 00,000 has been paid by bank but was not enter in the cash-book and bill receivable for Rs.60, 000 has been discounted, with the bank at a cost of Rs.1, 000 which has also not been recorded in the cash-book.

You are required:

To show the appropriate rectifications required in the cash-book of XYZ, arrive at the correct balance on 30th Sept. , 2019 and to prepare a Bank Reconciliation Statement as on that date.

[Nov. 2019, 10 Mark]

Sol.

Adjusted Cash-book (Bank Column)

Date	Particulars	Amount Rs.	Date	Particulars	Amount Rs.
	To Amount wrongly entered twice	18,000	2019 30 Sept.	By Bal. b/d	8,062
	To Customer (Direct Deposit)	1,15,400		By Bank-charges	280
	To Bills receivable (60000-1000)	59,000		By Customer (B/R dishonoured)	1,60,000
	To Bal.c/d	1,75,942		By Bills payable	2,00,000
	Total	368342		Total	368342

**Bank Reconciliation Statement (BRS)
As on 30th Sept., 2019**

Particulars	Plus	Minus
Unfavourable Balance as per adjusted cash-book (Cr.)		1,75,942
Plus :		
(a) Amount wrongly credited by bank	30,000	
(b) Cheque issued but not presented for payment	13,46,000	
Minus:		
(a) Cheque deposited but not credited by bank		11,14,000
	13,76,000	12,89,942
		86,058
Balance as per Pass-book (Cr.)	13,76,000	13,76,000

28. According to the cash-book of G, there was a debit balance of Rs.4, 45,000 in his bank on 30th June, 2021. On investigation you find that:

- (i) Cheque amounting to Rs.60, 000 issued to creditors has not been presented for payment till the date.
- (ii) Cheque deposited into the bank amounting to Rs.1,10,500, out of which Cheque amounting to Rs.55,000 were only collected by the bank up to 30th June, 2021.
- (iii) A dividend of Rs.4, 000 and rent amounting to Rs.60, 000 received by bank and entered in the passbook but not recorded in the cash-book.
- (iv) Insurance premium (up to 31st Dec., 2021) paid by the bank Rs.2, 700 not entered in the cash-book.
- (v) The payment side of the cash-book has been under cast by Rs.500.
- (vi) Bank-charges Rs.150 debited by bank shown in the Pass-book has not been entered in the cash-book.
- (vii) A bill payable of Rs.20, 000 has been paid by the bank but no entry was not made in the cash-book and bill receivable for Rs.6,000 has been discounted with the bank at a cost of Rs.100 which has also not been entered in the cash-book.

You are required:

- (1) To make appropriate adjustments in the cash-book, and
- (2) To prepare a statement reconciling it with the pass-book.

[Dec. 2021, 10 Marks]

Sol.

In the Books of G
Adjusted Cash-book (Bank Column)

Receipts	Rs.	Payments	Rs.
To Balance b/d	4,45,000	By Insurance premium a/c	2,700
To Dividend a/c	4,000	By Under casting of payment side	500
			150
To Rent a/c	60,000	By Bank-charges a/c	20,000
To Bills receivable a/c	5,900	By Bill payable a/c	4,91,550
		By Balance c/d	
Total	5,14,900	Total	5,14,900

Bank Reconciliation Statement (BRS) as on 30th June, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per Adjusted Cash-book (Dr.)	4,91,550	
Plus:		
Cheque issued but not presented for payment till 30th June, 2020	60,000	
Minus:		
Cheque paid into bank for collection but not collected till 30th June, 2021 (Rs.1,10,500 - Rs.55,000)	5,51,550	55,500
		55,500
		4,96,050
Balance as per Pass-book (Cr.)	5,51,550	5,51,550

29. On 30th September, 2021, the bank account of Y, according to the bank column of the Cash- Book, was overdrawn to the extent of Rs4,062. On the same date the bank statement showed a credit balance of Rs 20,758 in favour of X. An examination of the Cash Book and pass book reveals the following:

1. A cheque for Rs 13,14,000 deposited on 29th September, 2021 was credited by the bank only on 3rd October, 2021.
2. A payment by cheque for Rs 16,000 has been entered twice in the Cash Book.
3. On 29th September, 2021, the bank credited an amount of Rs 1,17,400 received from a customer of X, but the advice was not received by X until 1st October, 2021.
4. Bank charges amounting to Rs 580 had not been entered in the Cash Book.
5. On 6th September, 2021, the bank credited Rs20,000 to X in error.
6. A bill of exchange for Rs 1,40,000 was discounted by X with his bank. This bill was dishonoured on 28th September, 2021 but no entry had been made in the books of X.
7. Cheques issued upto 30th September, 2021 but not presented for payment upto that date totalled Rs 13,26,000

You are required :

- (a) to show the appropriate rectifications required in the Cash Book of X, to arrive at the correct balance on 30th September, 2021 and
- (b) to prepare a bank reconciliation statement as on that date.

(ICAI Study Material)

Sol.

(c) Cash Book (Bank Column)

Date 2021	Particulars		Amount ₹	Date 2021	Particulars		Amount ₹
Sept. 30	To	Party A/c	16,000	Sept. 30	By	Balance b/d	4,062
	To	Customer A/c (Direct deposit)			By	Bank charges	580
		Balance c/d	1,17,400		By	Customer A/c	
	To		11,242			(B/R dishonoured)	1,40,000
			1,44,642				1,44,642

(d) Bank Reconciliation Statement as on 30th September, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Overdraft as per Cash Book		11,242
Cheque deposited but not collected up to 30th September, 2022		13,14,000
Cheques issued but not presented for payment up to 30th September, 2022	13,26,000	
Credit by Bank erroneously on 6th September	20,000	
Credit balance as per bank statement		20,758
	13,46,000	13,46,000

Note: The bank wrongly credited X with 20,000 on September 6, 2021. If this error is rectified in the bank statement, it will not be subtracted in the previous statement, and as a result, a credit balance of Rs 758 will be reflected in the passbook.

30. On 30th Dec., 2021 the bank column of A. Philip's cash book showed a debit balance of Rs 4,610. On examination of the cash-book and bank statement you find that:

- I. Cheques amounting to Rs 6,30,000 which were issued to trade payables and entered in the cash book before 30th Dec., 2021 were not presented for payment until that date.
- II. Cheques amounting to Rs 2,50,000 had been recorded in the cash-book as having been paid into the bank on 30th
- III. Dec., 2021, but were entered in the bank statement on 1st January, 2023 .
- IV. A cheque received for Rs 73,000 had been dishonoured prior to 30th December, 2021, but no enter of this fact appeared in the cash book.
- V. A dividend of Rs 3,80,000, paid directly to the bank had not been entered in the cash book.

- VI. Bank interest and charges amounting to Rs 4,200 had been charged in the bank statement but not recorded in the cash book.
- VII. No entry had been made in the cash book for a trade subscription of Rs 10,000 paid vide banker's order in November, 2021.
- VIII. A cheque for Rs 27,000 drawn by B. Philip had been charged to A. Philip's bank account by mistake in December, 2021.

You are required:

- (a) To make appropriate adjustments in the cash-book bringing down the correct balance, and
- (b) To prepare a statement reconciling adjusted balance in the cash-book with the balance shown in the bank statement. (ICAI Study Material)

Cash Book (Bank Column)

Date 2021	Particulars	Amount ₹	Date 2021	Particulars	Amount ₹
Dec. 30	To Balance b/d	4,610	Dec. 30	By Trade receivables- (Cheque dishonoured)	73,000
	To Dividend received	3,80,000		By Bank interest and charges	4,200
			Dec. 31	By Trade Subscription	10,000
		3,84,610		By Balance c/d	2,97,410
					3,84,610
2023 Jan. 1	To Balance b/d	2,97,410			

Bank Reconciliation Statement (BRS) as at 30th December, 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance per cash book	2,97,410	
Cheques not yet presented	6,30,000	
Lodgement not yet recorded by bank		2,50,000
Cheque wrongly charged		27,000
Balance as per the bank statement		6,50,410
	9,27,410	9,27,410

31. The Cash Book of Mr. Gadbad wala shows Rs 8,36,400 as the balance at Bank as on 31st Dec., 2021, but you find that it does not agree with the balances as per the Bank Pass-Book. On scrutiny, you find the following differences

- On 15th Dec., 2021 the payment side of the Cash Book was undercast by Rs 10,000.
- A cheque for Rs 1,31,000 issued on 25th December, 2021 was not taken in the bank column of the cash-book.
- One deposit of Rs 1,50,000 was recorded in the Cash-Book as if there is no bank column.
- On 18th December, 2021 the debit balance of Rs 15,260 as on the previous day, was brought forward as credit balance in the Cash book.
- Of the total cheques amounting to Rs 11,514 drawn in the last week of December, 2021, cheques aggregating Rs7,815 were encashed in December.
- Dividends of Rs 25,000 collected by the Bank and subscription of Rs 1,000 paid by it were not recorded in the Cash Book.
- One out-going Cheque of Rs 3,50,000 was entered twice in the Cash Book. Prepare Bank Reconciliation Statement (ICAI Study Material)

Sol.

(When are not closed on 31st December, 2021)

Bank Reconciliation Statement of Mr. Gadbad wala as on 31st Dec., 2021

Particulars	Plus (Rs.)	Minus (Rs.)
Balance as per the Cash Book	8,36,400	
Error in bringing forward Rs.15,260 debit balance as credit balance on 18th Dec., 2021	30,520	
Cheques issued but not presented : Issued Rs.11,514 Cashed (Rs.7, 815)	3,699	
Dividends directly collected by bank but not yet recorded in the Cash-Book	25,000	
Cheque recorded twice in the Cash-Book	3,50,000	
Deposit not entered in the Bank column	1,50,000	
Wrong casting in the Cash-Book on 15th Dec.		10,000
Cheques issued but not recorded in the Bank column		1,31,000
Subscription paid by the bank directly not yet recorded in the Cash Book		1,000
Balance as per the Pass Book		12,53,619
	13,95,619	13,95,619

If the books are to be closed on 31st Dec., then adjusted cash-book will be prepared as given below:

Cash Book (Bank Column)

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	8,36,400	By wrong casting	10,000
To error for wrong posting	30,520	By cheques not entered	1,31,000
To dividends collected by bank	25,000	By subscription	1,000
To cheques recorded twice	3,50,000	By balance c/d	12,49,920
To deposit not recorded	1,50,000		
	13,91,920		13,91,920

Bank Reconciliation Statement

Particulars	Plus (Rs.)	Minus (Rs.)
Favourable Balance as per the Cash Book (corrected)	12,49,920	
Cheques issued but not yet presented	3,699	
Balance as per the Pass Book		12,53,619
	12,53,619	12,53,619

□□□

Bills of Exchange and Promissory Notes

BILLS OF EXCHANGE

It is common for sellers to offer a credit period to buyers. However, there are instances where immediate payment is not feasible for the buyer, and the seller may require a written promise from the buyer to pay on a specified future date. This written promise holds value as a credit instrument that can be used to generate immediate funds (i.e. Discounting of Bill).

The commercial practice treats these written promises as important instruments of credit. When a written promise is properly executed and duly stamped, it is expected to serve as a means for the buyer to settle their debt and for the seller to receive payment. Written promises, such as Bills of Exchange or promissory notes, are recognized and accepted by banks, which may provide advances against them. They can also be endorsed, allowing them to be transferred from one person to another.

A Bill of Exchange is a written instrument that includes an unconditional order, signed by the maker, directing a certain person to pay a specified sum of money to a particular person or to the bearer of the instrument. When this order is accepted in writing on the face of the document itself, it becomes a legally valid Bill of Exchange.

If X places an order with Y, requesting a payment of 20000 within a specified period of two months from the date mentioned, and Y accepts this order by signing the document, it would be referred to as a bill of exchange.

A Bill of Exchange possesses the following characteristics:

- 1. It should be documented in writing.*
- 2. It must have a specified date.*
- 3. It must include an instruction to pay a specific amount of money.*
- 4. The promise to pay should be absolute and unconditional*
- 5. The payment should be made to a specific person or their assigned order, or it may be payable to the bearer.*
- 6. The draft must receive acceptance from the party to whom the order is directed.*
- 7. It should have the required stamp duty affixed to it.*
- 8. The payment must be made in the legal currency of the respective country.*

The party who initiates the order is referred to as the drawer.

The party who accepts the order is known as the acceptor (drawee), and the recipient of the payment is called the payee.

“It is possible that the drawer and the payee can be the same individual or entity.”

A Bill of Exchange can be transferred to another person through endorsement. The endorsement process is similar to that of a cheque. The primary responsibility for payment lies with the acceptor (drawee). If the acceptor (drawee) fails to make the payment, the holder of the bill can seek recovery from any of the previous endorser or the drawee.

In certain cases, a bill of exchange may be utilized for international trade transactions. Such a bill is known as a “Foreign Bill of Exchange.” A foreign bill of exchange is created in one country but is payable in another.

Typically foreign Bill of exchange, is prepared in triplicate, with each copy sent separately to ensure at least one copy reaches the intended recipient. Only one of the copies will be honored for payment, rendering the other copies invalid.

Section 12 of the Negotiable Instruments Act states that any instrument not considered an inland instrument is classified as foreign.

Here is an example of a foreign bill of exchange:

₹400,000

Mumbai May, 2021

Eighty days after date of this First Bill of Exchange (Second and Third of the same tenure and date being unpaid) Pay to the order of M/s George Traders, Melbourne the sum of Rupees Four lakhs only, value received.

To,

Harry Sons

Accepted

(Harry sons) Stamp

Examples of foreign bills include:

1. A bill drawn in Country A on a person residing in Country B and made payable in Country B.
2. A bill drawn in Country B on a person residing in Country C.
3. A bill drawn in Country B and made payable in Country A.
4. A bill drawn in Country C and made payable in Country D.

These examples illustrate different scenarios of foreign bills, where the parties involved are located in different countries and the payment is to be made either within the same country or in another country. It is important to note that the specific details of a foreign bill may vary based on the specific circumstances and applicable regulations.

PROMISSORY NOTES

A promissory note is a written instrument that includes an unconditional promise, signed by the maker, to pay a specified sum of money to a particular person or their order.

It is important to note that a promissory note is distinct from a bank note or currency note. According to Section 31(2) of the Reserve Bank of India Act, a promissory note cannot be made payable to the bearer, meaning it must be payable to a specific person or their order.

“However Bill of Exchange can be paid to Bearer of Bill”

A promissory note possesses the following characteristics:

1. It must be in written form.
2. It should clearly state a promise to pay. Mere acknowledgment of a debt does not qualify as a promissory note.
3. The promise to pay must be unconditional. For instance, a statement like "I promise to pay ₹10,000 as soon as possible" is not considered an unconditional promise.
4. The promisor or maker of the note must sign it.
5. The maker of the note must be a definite and identifiable individual.
6. The payee, who is the recipient of the payment, must also be definite and identifiable.
7. The amount payable must be clearly specified and certain. An uncertain statement like "I promise to pay ₹10,000 plus any applicable fines" is not considered certain.
8. Payment must be made using the legal currency of the country.
9. It should not be made payable to the bearer.
10. The note should be appropriately stamped, as required by the relevant regulations.
11. It does not require any formal acceptance process.

Example of promissory note :

Specimen of a Promissory

₹20000/- only	Shyam 23, Sector-9, Delhi May 31, 2021
4 months after date I promise to pay Rajeev or his order the sum of ₹twenty thousand only, for value received. To,	
Rjeev	Stamp
K-20, Friends colony, Gurugram, (Shyam)	
Payee	Maker

DIFFERENCES - BILL OF EXCHANGE AND PROMISSORY NOTE

Bill of Exchange	Promissory Note
A bill represents a clear and unconditional order for payment.	A promissory note consists of a commitment (promise) to pay a specified amount of money.
Normally, a bill of exchange involves three main parties: Drawer, Drawee and the Payee	In a promissory note, two primary parties are involved: Maker and Payee
The payment for a bill of exchange is made by the party who accepts the bill (acceptor/ drawee).	The maker of a promissory note is responsible for making the payment
In the case of a bill of exchange, it is possible that the drawer and payee can be the same.	In a promissory note, the maker and payee are distinct and cannot be the same person.
In a bill of exchange, the liability of the drawer is of a secondary and conditional nature. (i.e drawer liable to pay if bill discounted or endorsed and drawee dishonours the Bill)	In a promissory note, the liability of the maker is of a primary and absolute nature.

In the case of a bill of exchange, it is necessary to provide notification of dishonor.	In the case of a promissory note, there is no requirement for a notice of dishonor to be given.
When a bill of exchange is dishonored, it is necessary to make a note of the dishonor and to have it protested.	Noting and protest are not necessary in the event of a promissory note being dishonored.

RECORD OF BILLS OF EXCHANGE AND PROMISSORY NOTES

When a party receives a Promissory Note or an accepted Bill of Exchange, it is recorded as a new asset called “Bills Receivable.” On the other hand, when a party issues a Promissory Note or accepts a Bill of Exchange, it is treated as a new liability categorized as “Bills Payable”.

In the subsequent discussion, we will address the entries in the books of the party receiving these instruments. (Please note that when referring to bills, we are including promissory notes as well.)

Upon receiving a Bill, the payee records the following entry in their accounting books:

Bills Receivable A/c	Dr.
To Drawee/Maker	

(1) When X accepts a Bill of Exchange drawn on him by Y, the entry in the books of Y will be as follows:

Bills Receivable A/c	Dr.
To X A/c	

(2) When X sends the acceptance of Z to Y, the entry in the books of Y will be as follows:

Bills Receivable Account	Dr.
To X A/c	

The recipient of the bill has three choices available:

- (i) They can retain the bill until its maturity date. In this scenario, no additional entry is recorded until the maturity date arrives.
- (ii) They can endorse the bill in favor of another party, such as Mr. P. In this case, the entry will involve debiting the receiving party and crediting the Bills Receivable Account.

P A/c	Dr.
To Bills Receivable Account	

- (iii) Alternatively, they can opt to discount the Bill of Exchange with a bank. The bank will deduct a small discount amount and provide the remaining funds.

Bank Account	Dr. (Amount received)
Discount Account	Dr. (Loss/discount)
To Bills Receivable Account	

When the date of maturity comes, there are two possibilities:-

- (a) The first scenario is that the bill will be paid and honored. The accounting entries for this will vary based on the actions taken regarding the bill during the maturity period. If the bill was held until maturity, the original recipient will receive the cash payment., following will be the entry:

Cash A/c	Dr.
To Bills Receivable A/c	

However, if the bill has already been endorsed in favor of a creditor or if it has been discounted with a bank, the original recipient will not receive the payment. Instead, the creditor or the bank will receive the funds. As a result, in these two scenarios, no entry will be recorded in the books of the party who initially received the bill.

- (b) The second scenario is that the bill will be dishonored, meaning it will not be paid. When a bill is dishonored, it becomes invalid, and the party who originally received the bill becomes responsible for paying the amount due, including any incurred expenses.

Following will be the journal entries :

1. If the bill is kept till the maturity :

Drawee / Maker	Dr.
To Bills Receivable A/c	

2. If the bill is endorsed in the favour of the creditor:

Drawee / Maker	Dr.
To Bills Receivable A/c	

3. If the bill is discounted (from the bank) :

Drawee / Maker	Dr.
To Bills Receivable A/c	

Therefore, in the event of dishonor, it is important to note that the party who issued the bill is debited since they have become liable to make the payment. The corresponding credit entry is made in the Bills Receivable Account if the bill was retained, or in the account of the creditor or the bank if the bill was endorsed or discounted in their favor.

TERM OF A BILL

The duration of a bill of exchange can vary, and it typically does not exceed 90 days from the date of the bill.

However, it's worth noting that the term of the bill depends on its specific conditions:

- ❑ If a bill is drawn after sight, the term starts running from the date of acceptance, which is when the bill is officially acknowledged.
- ❑ If a bill is drawn after the date, the term begins from the date the bill was initially created.

EXPIRY / DUE DATE OF A BILL

The date on which the term of the bill comes to an end is referred to as the “Expiry/Due Date of the bill.”

DAYS OF GRACE

A grace period of **three days** is granted to every instrument that is payable on a specific date, providing some additional time for payment.

DATE OF MATURITY OF BILL

The date after adding three days of grace to the expiry/due date of a bill is referred to as the maturity date. It is the point at which a promissory note or bill of exchange becomes due. Generally, promissory notes or bills of exchange mature on the third day following the specified payment date, unless they are indicated to be payable: on demand or at sight, or on presentment.

BILL AT SIGHT

Bill at Sight refers to instruments that do not specify a specific time for payment. A cheque, for instance, is always payable on demand. Similarly, a promissory note or bill of exchange is considered payable on demand in the following cases:

- (a) when no specific time for payment is mentioned, or
- (b) when it is explicitly stated to be payable on demand, at sight, or on presentment.

BILL AFTER DATE

Bill after date refers to an instrument where a specific time for payment is mentioned. A promissory note or bill of

exchange is considered a time instrument in the following cases:

- ☐ when it is expressed to be payable after a specified period,
- ☐ on a specific day,
- ☐ after sight,
- ☐ on the occurrence of an event that is certain to happen

Note: The duration of a Bill after sight begins from the date of acceptance, while the duration of a Bill after date begins from the date of its drawing.

- (i) The term “after sight” signifies the following:
 - (a) In the case of a promissory note, it refers to the period after the document has been presented for sight.
 - (b) In the case of a bill of exchange, it indicates the duration following acceptance, noting for non-acceptance, or protest for non-acceptance.
- (ii) A cheque is not considered a time instrument since it is always payable on demand. However, a cheque can be post-dated, indicating a future date on which it can be presented for payment or after that date. A cheque remains valid for a period of 90 days from its issuance, after which it becomes void. This is commonly referred to as a “Stale Cheque,” and banks will not honor such cheques.

HOW TO CALCULATE DUE DATE OF A BILL

The due date for each bill is calculated as follows:

Case	Due Date
(a) When the bill specifies a particular date for payment.	(a) The date mentioned in the bill will serve as the due date for payment..
(b) When the bill specifies a certain number of months after the date for payment.	(b) The day on which the term comes to an end will be the due date. Note: The due date of the bill is determined by matching the day of the month on which the bill is dated with the corresponding day in the month when the term expires. If there is no corresponding day in that month, the period is considered to end on the last day of that month. For instance, if a bill is dated on May 31st and is payable after 4 months, the due date will be September 30th.
(c) When the bill is to be paid after a specific number of days.	(c) The due date of the bill will be determined by adding the specified number of days to the date mentioned on the bill. Note: The date of Bill is not included while calculating the number of days.
(d) If the due date is a public holiday.	(d) Then the preceding business day is taken as the due date.
(e) If the due date coincides with an emergency or unforeseen holiday.	(e) The following business day will be considered as the new due date in such cases.

NOTING CHARGES

It is important to establish the occurrence of dishonour and its causes. If the acceptor (drawee) can demonstrate that the bill was not properly presented for payment, they may avoid liability. Therefore, in cases of dishonour or anticipated dishonour, the bill is handed over to a public official known as a "Notary Public."

These officials present the bill for payment, and if the payment is received, they return the money to the original party.

However, if the bill is dishonoured, they make a record of the dishonour along with the reasons and return the bill to their client. They charge a nominal fee for this service, known as "noting charges."

The party responsible for the dishonour is liable to

Suppose A received from B a bill for ₹500. On Maturity the bill is dishonoured and 20 is paid as noting charges. The entry in this case will be

		₹	₹
B A/c	Dr.	520	
To Bills Receivable A/c			500
To Bank A/c			20

Suppose X had endorsed this bill in favour of C. In that case entry for dishonoured bill would have been

B A/c To C A/c	Dr.	520	520

This is because C will claim ₹1,010 from A and A has the right of recovering ₹1,010 from B. Similarly, if the bill has been discounted with a bank, entry will be :

B A/c To Bank A/c	Dr.	520	520

RENEWAL OF BILL

In some cases, when the acceptor (drawee) is unable to pay the amount, they may request an extension of time "and" agree to bear interest for the extended period (calculated from the renewal date until the expected settlement date).

In such situations, a new bill is drawn, and the old bill is canceled. The cancellation of the old bill follows the same process as previously explained for dishonour. Upon receiving the new bill, entries are made to reflect the receipt of the bill. The amount of the new bill can represent the following scenarios:

- (i) If the drawee pays nothing: The total amount of the original bill plus the interest for the extended period.
- (ii) If the drawee pays the interest amount at the time of renewal: The amount of the original bill.
- (iii) If the drawee makes a partial payment of the original bill, interest amount, or both: The unpaid portion of the total amount of the original bill plus the interest for the extended period.

RETIREMENT OF BILLS OF EXCHANGE & REBATE

We have observed that the renewal of a bill of exchange occurs when an individual lacks sufficient funds to pay for the bill on the due date and requires an extended credit period. However, there are situations where the acceptor (drawee) of the bill has surplus funds well in advance of the maturity date. In such circumstances, the acceptor (drawee) approaches the payee and inquires whether they are willing to accept an early payment. In these cases, the acceptor (drawee) receives a certain discount, interest, or rebate for the premature payment. This discount represents income for the acceptor (drawee) and an expense for the payee. It serves as compensation for the early settlement.

INSOLVENCY

Insolvency refers to a situation where an individual is unable to fulfill their financial obligations, resulting in the dishonor of bills accepted by them.

When it becomes evident that a person has become insolvent, it is necessary to record the

dishonor of their acceptance through appropriate entries. Subsequently, any amount received from the insolvent estate should be accounted for. If an amount is received, the *Cash account is debited, and the personal account of the debtor is credited.*

However, any remaining amount that cannot be recovered should be written off as a bad debt. It is important for students to accurately calculate the amount received from the insolvent estate before deciding the extent of the write-off.

In the books of the drawee of the bill, the amount that remains unpaid due to insolvency should be credited to a *Deficiency Account.*

ACCOMMODATION BILLS

Bills of Exchange are typically used to facilitate trade transactions, serving as a means to finance the actual buying and selling of goods.

However, the mechanism of bills can also be employed for raising funds.

Example:

X requires finance for a period of four months,

- ❑ In this case, he can approach his friend Y and convince him to accept his draft.
- ❑ Subsequently, X can take the bill of exchange to his bank and have it discounted there, thus enabling him to access the funds.
- ❑ Once the four-month period elapses, X will send the necessary amount to Y, who will then settle the bill. This allows X to raise money for his personal use.
- ❑ Similarly, if both X and Y require funds, they can employ the same method.

Either X or Y can accept a bill of exchange, which will be discounted at the bank, and the resulting proceeds will be divided between them according to a mutual agreement. The costs associated with discounting must be shared by both parties in the same proportion as the proceeds.

- ❑ On the due date, the acceptor (drawee) will receive their respective share from the other party, and the bill will be settled. In such cases, these bills are referred to as accommodation bills.

However, there may be instances where the drawer (the party issuing the bill) is unable to remit the proceeds to the drawee (the party being paid) by the due date.

In such situations, the drawee may draw a bill on the drawer and have it discounted at the bank to honor the first bill. If the new drawer (the drawee of the first bill) also remits some proceeds from the new bill to the new drawee (the drawer of the first bill), the proportion of discount to be borne by the new drawee will depend on the remitted proceeds and the benefit obtained from not paying the amount due to the original drawee on the due date.

The accounting entries for both parties are recorded in the same manner as ordinary bills, with the additional entry being made for sending the remittance from one party to the other, and debiting the other party with their share of the discount.

BILLS OF COLLECTION

When an individual receives a bill of exchange, they have the option to hold onto the bill until its maturity date. However, to ensure its security, they may choose to send it to a bank with

specific instructions to retain the bill until maturity and realize the amount on that date. It's important to note that this process does not involve discounting because the bank will not credit the client until the actual amount is received. When the bill is sent to the bank with such instructions, it is referred to as a "bill sent for collection".

Following entries are passed: Bills for Collection A/c To Bills Receivable A/c	Dr.
When the amount is realised the entry will be Bank A/c To Bills for Collection A/c	Dr.
When the amount is not honoured, the entry will be Party A/c (from whom the bill was received) To Bills for collections A/c	Dr.

BILLS RECEIVABLE AND BILLS PAYABLE BOOKS

The books known as bills receivable and bills payable serve as chronological journals (Day Books) for recording the details of bills receivable and bills payable in an organized manner. These books are particularly useful when an organization deals with a significant number of bill transactions. Whenever a bill transaction occurs, it is promptly recorded in the Day Books as the primary entry. Subsequently, the individual debtor or creditor accounts are updated by posting the relevant information from the Day Books. Additionally, periodic postings of the total amount of bills received or accepted are made to the Bills Receivable Account and Bills Payable Account, respectively.

The bills receivable book and bills payable book provide valuable assistance in monitoring the status of outstanding bills. In situations where a large number of bills are involved, with varying due dates, it is possible that some of these bills may not be honored upon maturity due to various reasons. By referring to these Day Books, it becomes feasible to track the specifics of outstanding bills and identify the factors contributing to non-payment. Presented below are the sample formats of Day Books for both bills receivable and bills payable-

Bills Receivable Book

Date of receipt	Voucher No.	Party from whom Received	Acceptor (drawee)	Date of Bill	Due Date	Place of Payment	Amt. ₹	L.F.	Mode of Disposal

Bills Payable Book

Date of Acceptance	Drawer	Payee	Date of Bill	Due Date	Place of Payment	Amt. ₹	L.F.	Mode of Disposal

TEST YOUR KNOWLEDGE

True and False

1. Bills payable account is a Real account.
Sol. False, it's a personal account because bills payable represents a person to whom the amount is to be paid in future.
2. A bill of exchange includes a commitment (promise) to make payment.
Sol. False, A bill of exchange includes an instruction to make the necessary payment, rather than simply a promise to pay.
3. The maturity date of a bill is determined by adding the rebate days to the due date.
Sol. False, The maturity date of a bill is calculated by including a grace period of three days in addition to the due date.
4. Bills of exchange always involve the participation of two entities or parties.
Sol. False, In bills of exchange, it is possible to have more than two parties involved, including the drawer, acceptor (drawee), and the payee of the bill.
5. A foreign bill is issued within one country but is intended to be paid outside the borders of that country.
Sol. True, A bill that is created within a country but is intended to be paid outside the borders of that country is commonly referred to as a foreign bill.
6. A promissory note and a bill of exchange differ in terms of payment responsibility. In the case of a promissory note, the amount is paid by the maker, whereas in the case of a bill of exchange, the payment is made by the acceptor (drawee).
Sol. True, A promissory note and a bill of exchange differ in terms of payment responsibility.
7. Payment of promissory note can be made to the bearer.
Sol. False, A promissory note cannot be designated as payable to the bearer; instead, it must be made payable to a specific individual or to their order.
8. There is no need for a cancellation entry when renewing a bill.
Sol. False, Upon bill renewal, entries are made to cancel the previous bill and record the new one.
9. The maturity date of a bill labeled as 'after date' is determined based on the bill's date of issuance.
Sol. True, Indeed, the maturity date for an "after date" bill is computed starting from the bill's drawing date.
10. If a public holiday occurs, the bill's due date shifts to the following day.
Sol. False, If a public holiday occurs, the due date of the bill moves up by one day.
11. The primary responsibility for payment of the promissory note lies with the drawer.
Sol. True, Indeed, the drawer's liability for the payment of the promissory note is primary because they provide an unconditional commitment to make the payment.
12. Bill of Exchange includes a "conditional" order to pay.
Sol. False, Bill of Exchange includes an unconditional order to pay.

13. Creating a promissory note with a bearer payment option is not permissible.
Sol. True, A promissory note typically cannot be designated as payable to the bearer, with the exception being promissory notes issued by the RBI and/or Central Government.
14. A promissory note involves just two entities: the maker and the payee.
Sol. True, Indeed, a promissory note is characterized by the presence of only two parties, namely, the maker and the payee.
15. A promissory note is created and signed by the borrower.
Sol. True, Certainly, a promissory note is prepared and signed by the borrower, after which it is forwarded to the creditor.
16. In the context of a Bill of Exchange, it is possible for the drawer and payee to be same individual.
Sol. True, Indeed, it is permissible for the drawer and payee to be one and the same person in the context of a bill of exchange.
17. During the renewal of a bill, the drawee's books record a debit to the interest account.
Sol. True. During the renewal of a bill, the drawee debits the interest account in their books because it signifies an expenditure for them.
18. The term "bills payable" is used to describe a document provided to a creditor, signifying an outstanding financial obligation.
Sol. True, The term "bills payable" is used to describe a document provided to a creditor, signifying an outstanding financial obligation.
19. Rajesh has drawn a bill on Vikram. Vikram accepts the same and endorses the bill to Ritu.
Sol. False, Vikram cannot endorse the bill to Ritu because he is a drawee. Only Rajesh, the drawer, can do it.
20. Denying payment of the bill on the maturity date is termed as the Retirement of the bill.
Sol. False, Denying payment of the bill on the maturity date is referred to as the dishonour of the bill. The premature settlement of the bill is recognized as the Retirement of the bill.
21. Promissory Note needs acceptance.
Sol. False, It does not need acceptance, only bills receivable needs acceptance.
22. Obtaining a discount at the time of retiring a bill results in a gain for the drawee.
Sol. True, obtaining a discount at the time of retiring a bill results in a gain for the drawee.

MULTIPLE CHOICE QUESTIONS

1. On 1.3.2020, X draws a bill on Y for 25000, for 4 months' maturity date of the bill will be:
 (a) 4.7.2020 (b) 1.7.2020
 (c) 4.7.2020 (d) None of the above
Sol. (a) 4.7.2020
2. On 16.4.2021 M draws a bill on N for ₹330000 for 29 days. 18th May is a public holiday, maturity date of the bill will be:

(a) 19th May

(b) 18th May

(c) 17th May

(d) None of the above

Sol. (b) 18th May

3. Mr A draws a bill on Mr B for ₹99,000 on 1.4.2021. Mr B accepts the same on 1.4.2021 for period of 2 months after date. What will be the maturity date of the bill:

(a) 4.6.2021

(b) 1.6.2021

(c) 7.6.2021

(d) None of the above

Sol. (a) 4.6.2021

4. X draws a bill on Y. X endorsed the bill to Z. The payee of the bill will be

(a) X

(b) Z

(c) Y

(d) None of the above

Sol. (b) Z

5. The rebate on the bill indicates that it has been

(a) Endorsed

(b) Paid before maturity

(c) Paid after maturity

(d) None of the above

Sol. (b) Paid before maturity

6. The Notary Public is entitled to collect their fee from the

(a) Holder of the bill

(b) Drawer of the bill

(c) None of the above

(d) Both (a) and (b)

Sol. (a) Holder of the bill

7. On 1.1.2019, A draws a bill on B for ₹1,20,000 for 3 months' maturity date of the bill will be:

(a) 1.4.2019

(b) 3.4.2019

(c) 4.4.2019

(d) 2.4.2019

Sol. (c) 4.4.2019

8. On 16.6.2020 P draws a bill on Q for ₹1,25,000 for 30 days. 19th July is a public holiday, maturity date of the bill will be:

(a) 19th July

(b) 18th July

(c) 17th July

(d) 20th July

Sol. (b) 18th July

9. PQ draws a bill on XY for ₹130,000 on 1.1.2020. XY accepts the same on 4.1.2020 for a period of 3 months after the date. What will be the maturity date of the bill:-

(a) 4.4.2020

(b) 3.4.2020

(c) 7.4.2020

(d) 6.4.2020

Sol. (a) 4.4.2020

10. A bill of exchange contains

Bills of exchange and promissory note

- (a) An unconditional order (b) A promise
(c) A request to deliver the goods (d) None of the above

Sol. (a) An unconditional order

11. A promissory note contains

- (a) An unconditional order (b) A promise
(c) A request to deliver the goods (d) None of the above

Sol. (b) A promise

12. A promissory note is made by a

- (a) Seller (b) Purchaser
(c) Endorsee (d) None of the above

Sol. (b) Purchaser

13. At the time of drawing a bill, the drawer credits

- (a) Bills Receivables A/c (b) Bills Payable A/c
(c) Debtor's A/c (d) None of the above

Sol. (c) Debtor's A/c

14. A bill of exchange is drawn by a (POV - Purchaser)

- (a) Creditor (b) Debtor
(c) Debenture holder (d) None of the above

Sol. (a) Creditor

15. On 1.1.2020, XA draws a bill on YB for ₹1,00,000. At maturity YB request XA to renew the bill for 2 months at 12% p.a. interest. Amount of interest will be:

- (a) 2,000 (b) 1,500
(c) 1,800 (d) None of the above

Sol. (a) 2,000

16. XZ draws a bill on YZ for ₹2,00,000 for 3 months on 1.1.2020. The bill is discounted with banker at a charge of ₹1,000. At maturity the bill returns dishonoured. In the books of XZ, for dishonour, the bank account will be credited by:

- (a) 199000 (b) 200000
(c) 201000 (d) None of the above

Sol. (b) 200000

17. Mr. Jay draws a bill on Mr. John for ₹3,00,000 on 1.1.2020 for 3 months. On 4.2.2020, John got the bill discounted at 12% rate. The amount of discount will be

- (a) 9000 (b) 6000
(c) 3000 (d) None of the above

Sol. (b) 6000

18. _____ is written by the respective Debtor:

- (a) Promissory note (b) bill of exchange

(c) Demand draft

(d) None of the above

Sol. (a) Promissory note

19. A promissory note includes a _____ Promise:

(a) Conditional

(b) Unconditional

(c) Unconditional as well as conditional

(d) Conditional as well as unconditional

Sol. (a) Conditional

20. What distinguishes a promissory note from the others in the following list

(a) It must be signed by the drawer

(b) It must be signed by the acceptor

(c) It must be unconditional

(d) It is written by Debtor

Sol. (b) It must be signed by the acceptor

21. What are the merits associated with a bill of exchange?

(a) Legal document

(b) Discounting facility

(c) Endorsement Possible

(d) All of the above

Sol. (d) All of the above

22. Identify the feature that does not pertain to a bill of exchange from the options below.

(a) It must be in writing

(b) It must be signed by the drawer

(c) It must be signed by the acceptor (drawee)

(d) It must be signed by the payee

Sol. (d) It must be signed by the payee

THEORY QUESTIONS

1. Write a short note on:

(a) Accommodation bill.

(b) Renewal of bill.

(c) Noting charges.

Sol.

(a) **Accommodation bill** – Bills of Exchange are commonly utilized to facilitate trade transactions, serving as a means to finance the actual buying and selling of goods. However, it is worth noting that the mechanism of bills can also be employed to raise funds. In such cases, these bills are referred to as accommodation bills.

(b) **Renewal of bill** – In situations where the acceptor (drawee) of a bill faces financial difficulties in meeting the bill's payment on the due date, they have the option to approach

the drawer and propose the cancellation of the original bill. Subsequently, the drawer can create a fresh bill for an extended period, provided they agree to the arrangement. If the drawer agrees, the drawee then accepts the new bill in lieu of the original bill, but for a different duration. This process is commonly referred to as bill renewal.

- (c) **Noting charges** – The fees incurred for the notification of dishonored bills to the Notary P order, it becomes a valid bill of exchange. On the other hand, a promissory note is a **written instrument** (excluding bank notes or government currency notes) that includes an unconditional promise, signed by the maker, to pay a certain sum of money solely to a designated person, their order, or to the bearer of the instrument.

Unlike a bill of exchange, a promissory note does not require acceptance since the debtor themselves create the document, pledging to repay the specified amount. Both bills of exchange and promissory notes are negotiable instruments and can be transferred by endorsement. However, it's important to note that while the drawer and the payee can be the same person in a bill of exchange, the maker and the payee cannot be the same individual in a promissory note.

□□□



CHAPTER

Bills of Exchange

1. bhavna owes chetan a sum of ₹ 600 . On 1st April, 2016 he gives promissory note for the amount for 3 months to Chetan who gets it discounted with his bankers for ₹590. On the due date the bill is dishonoured the bank paying ₹ 5 as noting charges. bhavna then pays ₹ 200 in cash and accepts a bill of exchange drawn on him for the balance together with ₹ 10 as interest. This bill of exchanges is for 2 months and on the due date the bill is again dishonoured, Chetan paying ₹5 for noting charges. Draft the journal entries to be passed in the books of bhavna and Chetan.

Solution:

Date	Transaction	Journal of C	Dr.	Cr.	Journal of B	Dr.	Cr.
1.4	Promissory note given by bhavna to chetan	B.R.a/c Dr. To bhavna a/c	600	600	chetan a/c Dr. To B.P. a/c	600	600
	Bill disconuted with bank	Bank/cash a/c Dr. Discount a/c Dr. To B.R. a/c	590 10	600	No entry		
4.7	Bill dishonoured, bank recover from "chetan" bill amount + noting charges	bhavna a/c Dr. To bhavna a/c	605	605	B.P.a/c Dr. Noting charges Dr. To chetan a/c	600 5	605
	Interest due	bhavna a/c Dr. To Bank a/c	10	10	Interest a/c Dr. To Cash a/c	10	10
	Settlement partly in Cash & balance by new bill.	bhavna a/c Dr. B.R. a/c Dr. To Bank a/c	200 415	615	Interest a/c Dr. To B.P. a/c To Cash a/c	615	415 200
7.9	Second bill dishonoured & noting charges paid by "chetan"	bhavna a/c Dr. To B.R. a/c To cash a/c	420	415 5	B.P.a/c Dr. Noting charges Dr. To chetan a/c	415 5	420

2. Ayushi sends his promissory note for 3 months to Charu for ₹ 600 on May 1,2016. Charu gets it discounted with his bankers at 6 per cent per annum. On the due date the bill is dishonoured, the bank paying ₹ 10 as noting charges, Charu agrees to accept (₹225 in cash ₹25 for noting charges and interest) and another promissory note for ₹400 for 2 months. On the due date Ayushi approaches Charu again and asks for

renewal of the bill for a further period of 3 months. Charu agrees to the request, provided Ayushi pays ₹ 20 as interest in cash. This last bill is paid on maturity. Draft journal entries in the books of Ayushi and Charu.

Sol.

Date	Transaction	Journal of Charu	Dr.	Cr.	Journal of Ayushi	Dr.	Cr.
1.5	Promissory note given by Ayushi to Charu	B.R.a/c Dr. To Ayushi a/c	600	600	Charu a/c Dr. To B.P. a/c	600	600
	discounted with bank	Bank a/c Dr. Discount a/c Dr. To B.R. a/c	591 9	600	No entry		
4.8	Bill get dishonoured (bank recover from "Charu" Including noting charges) interest due (out of 25, 10 is noting charges & balance is interest) Settlement by interest amt. in cash & balance by bill.	Ayushi a/c Dr. To Bank a/c Ayushi a/c Dr. To Int. a/c (25-10 =25) B.R. a/c Dr. Cash a/c Dr. To Ayushi a/c	610 15 420 225	610 15 625	B.P.a/c Dr. Noting charge Dr. a/c To Charu a/c Interest a/c To Charu a/c Charu a/c Dr. To B.P. a/c To Cash a/c	600 10 15 625	610 15 400 225
7.10	(i) Cancellation of Bill	Ayushi Dr. To B.R. a/c	400	400	B.P. a/c Dr. To Charu	400	400
	(ii) Interest due	Ayushi Dr. To Interest a/c	20	20	Interest a/c Dr. To Charu	20	20
	(ii) Settlement	B.R. a/c Dr. Cash a/c Dr. TO Ayushi	400 20	420	Charu r. To B.P. a/c To Cash a/c	420	400 20
10.1	Bill Honoured	Cash a/c Dr. To B.R. a/c	400	400	B.P.a/c Dr. To Cash a/c	400	400

3. Mr. Dhruv draws two bills of exchange on 1-1-2016 for ₹ 6,000 and ₹ 10,000. The bills of exchange for ₹ 6,000 is for two months while the bill of exchange for ₹ 10,000 is for three months. These bills are accepted by Mr. Anuj. On 4-3-2016 Mr. Anuj requests Mr. Dhruv to renew the first bill with interest at 18% p.a. for a period of two months. Mr. Dhruv agrees to this proposal. On 20-3-2016 Mr. Anuj retires the acceptance for ₹10,000, the interest rebate ie. discount being ₹ 100. Before the due date of the

renewed bill, Mr. Anuj becomes insolvent and only 50 paise in a rupee could be recovered from his estate. You are to give the journal entries in the books of Mr. Dhruv.

Sol.

Transaction	Books of Dhruv			Books of Anuj		
1.1.2016						
Bill Drawn	B.R. a/c Dr. 6000 B.R. a/c Dr. 10000 To Anuj a/c		16000	Anuj a/c Dr. 16000 To B.P. a/c To B.P. a/c		6000 10000
Renewal of 1 st bill, old bill cancelled	Anuj a/c Dr. 6000 To B.R. a/c	6000	6000	To B.P. a/c Dr. 6000 To Dhruv/s a/c		6000
Interest due $\frac{18}{100} \times \frac{2}{12} \times 6000$	To Anuj a/c Dr. 180 To Int. a/c	180	180	B.P. a/c Dr. 180 To Dhruv a/c		180
Settlement by net will (3 rd bill)	B.R. a/c Dr. 6180 To Anuj a/c	6180	6180	Int. a/c Dr. 6180 To Dhruv/s a/c		6000
20.3.2016						
Retirement of 2 nd bill	Cash/Bank a/c Dr. 9900 Rebate a/c Dr. 100 To B.R. a/c	10000	10000	B.P. a/c Dr. 10000 To Cash/Bank a/c To Rebate a/c		9900 100
Anuj declared insolvent hence 3 rd bill dishonoured	Anuj a/c Dr. 6,180 To B.R. a/c					
Full and final settlement at 50%	Cash/Bank a/c Dr. 3090 Bad Debts a/c Dr. 3090 To Anuj a/c	6180	6180	Dhruv a/c Dr. 6180 To Cash/Bank a/c To Deficiency a/c		3090 3090

4. Journalise the following transactions in the books of Diksha:

Our acceptance to S. Chand for ₹ 5,000 retired before due date, rebate allowed ₹ 10.

- a. Ramu's acceptance for ₹ 400 renewed for a further period of 3 months, interest charged at 15 per cent.

Our acceptance to R.S Chopra for ₹ 800 renewed for 3 months on the condition that ₹ 200 is paid in cash immediately and the remaining balance to carry interest at 12 per cent.

- b. Amit's promissory note for ₹ 700 which we had endorsed in favour of Manoj dishonoured. Manoj paid ₹ 10 as noting charges. We pay. Manoj by cheque and accept from Amit another bill for the amount due plus interest ₹ 15.

Our promissory note for ₹ 500 in favour of Suraj returned unpaid due to lack of instructions to the bank. Suraj claim ₹ 510 which we pay by cheque.

Bill of Exchange

Our promissory note for ₹ 500 in favour of Sheetal settled by sending him Harshit's acceptance of ₹ 500.

Sol.

Particular	Transaction		Dr.	Cr.
(a) Our B.P. retired	B.P. a/c To Rebate To Cash/Bank a/c	Dr.	5000	10 4990
(b) Renewal of our B.R. old bill (cancelled)	Ramu's a/c To B.R. a/c	Dr.	400	400
Interest due	Ramu's a/c To Int. a/c	Dr.	15	15
Settlement by new bill	B.R. a/c To Int. a/c	Dr.	415	415
(c) Renewal of our B.P. Old bill cancelled	B.P. a/c To R.S Chopra a/c	Dr.	800	800
Part cash payment	To R.S Chopra a/c To Cash/Bank a/c	Dr.	200	200
Interest due	Int. a/c To R.S Chopra a/c	Dr.	18	18
2 nd bill accepted for balance amount	R.S Chopra a/c To B.P. a/c	Dr.	618	618
(d) B.R. which was endorsed renewed Old bill cancelled	Amit's a/c To Manoj's a/c	Dr.	710	710
We pay Manoj's	To Manoj a/c To Bank a/c	Dr.	710	710
Interest due	Amit's a/c To Int. a/c	Dr.	15	15
2 nd bill drawn on Amit	B.R. a/c To Amit's a/c	Dr.	725	725
(e) B.P. dishonoured	B.P. a/c To Suraj a/c	Dr.	500	500
Bank charges due	Bank charges a/c To Suraj a/c	Dr.	10	10
Paid	Suraj a/c To Bank a/c	Dr.	510	510
(f) B.P. settled by giving B.R.	B.P. a/c To Bill Receivable a/c	Dr.	500	500

5. Vipul draws on Anubhav a bill of ₹1500 on 1st April, 2015 for 3 months. Anubhav accepts the bill and send it to Vipul who gets it discounted for ₹1470. Vipul immediately remits ₹490 to Anubhav. On the due date, Vipul, being unable to remit the amount due, accepts a bill for ₹ 2100 for three months which is discounted by Anubhav

Anubhav for ₹2055. Anubhav sends ₹370 to Vipul. Before the maturity of the bill Vipul becomes bankrupt his estate paying fifty paise in the rupee. Give the journal entries in the books of Vipul and Anubhav. Also show Vipul's account in Anubhav's books.

Sol.

Date	Transaction	Journal of Vipul		Dr.	Cr.	Journal of Anubhav		Dr.	Cr.
1.4	Vipul draws on Anubhav a bill of ₹2055	B.R. a/c To Anubhav a/c	Dr.	1500	1500	Vipul a/c To B.P. a/c	Dr.	1500	1500
	Bill was discounted with bank	Bank/Cash a/c Discount a/c To B.R. a/c	Dr. Dr.	1470 30	1500	No entry	Dr.		
	Remittance by Anubhav Vipul to Anubhav with proportionate discount	Anubhav a/c To Cash a/c To Discount a/c	Dr.	500	490 10	Cash a/c Discount a/c To Vipul a/c	Dr. Dr.	490 10	500
4.7	2 nd bill drawn by Anubhav on Vipul	Anubhav a/c To B.P. a/c	Dr.	2100	2100	B.R. a/c To Vipul a/c	Dr.	2100	2100
	Second bill discounted	No entry				Bank/Cash a/c Discount a/c To B.R. a/c	Dr. Dr.	2055 45	2100
	1 st bill is honoured from the proceeds of 2 nd bill	No entry				B.P. a/c To cash a/c	Dr.	1500	1500
	Remittance to Vipul by Anubhav Dis = $45/2055 \times 1370 = 370$	Cash a/c Discount a/c To Anubhav a/c	Dr. Dr.	370 30	400	Vipul a/c To Cash a/c To discount a/c	Dr.	400	370 30
7.10	Second bill dishonoured & Anubhav Pays the	B.P. a/c To Anubhav a/c	Dr.	2100	2100	Vipul a/c To cash/bank a/c	Dr.	2100	2100
	Final Settlement	Anubhav a/c To Cash/Bank a/c To Deficiency A/c	Dr.	1400	710 710	Cash/Bank a/c Bad debts a/c To Vipul a/c	Dr. Dr.	700 700	1400

“Out of the proceeds of 2 nd bill ₹ 370 is used for Vipul (₹ 1000 for honouring 1st bill which ‘Vipul’ could not contribute & further ₹ 370 remitted to him) hence proportionate discount debited to him.

6. On 1st July, 2015 Ishaan drew a bill for ₹ 80,000 for 3 months on Shivani for mutual accommodation. He accepted the bill of exchange.

Ishaan had purchased goods worth ₹ 81,000 from Janvi on the same date. Ishaan endorsed Shivani's acceptance to Janvi in full settlement.

On 1st September, 2015 Janvi purchased goods worth ₹ 90,000 from Shivani. Janvi endorsed the bill of exchange received from Ishaan to Shivani and paid ₹ 9,000 in full settlement of the amount due to Shivani.

On 1st October, 2015 Shivani purchased goods worth ₹ 1,00,000 from Ishaan. He paid the amount due to Ishaan by cheque. Give the necessary Journal Entries in the books of Shivani and prepare necessary accounts in the books of Shivani, Ishaan & Janvi.

Sol.

Date 2015	Books of Shivani			Books of Janvi			Books of Ishaan		
1.7.	Ishaan a/c Dr. To B.P. a/c	80000	80000	—			B.R. a/c Dr. To Shivani a/c	80000	80000
1.7	—			Ishaan a/c Dr. To Sale a/c	81000	81000	Purchase a/c Dr. To Janvi a/c	81000	81000
1.7	—			B.R. a/c Dr. Discount Dr. To Ishaan a/c	80000 1000	81000	Janvi a/c Dr. To B.R. a/c To dis- count a/c	81000	81000 1000
1.9	Janvi a/c Dr. To Sale a/c	90000	90000	Purchase Dr. To Shivani a/c	90000	90000	—		
1.9	B.P. a/c Dr. Bank a/c Dr. Document a/c Dr. To Janvi a/c (Our B.P. is endorsed in our favour hence can- celled)	80000 9000 1000	90000	Shivani a/c Dr. To B.R. a/c To Bank a/c To Discount a/c	90000	80000 9000 1000	—		

1.10	Purchases a/c Dr. To Ishaan a/c	100000	-				Shivani a/c Dr. To sale a/c	100000	100000
1.10	Ishaan. a/c Dr. To bank a/c	20000	20000	-			To sale a/c Shivani a/c Dr.	20000	20000

IN THE BOOKS OF 'Shivani' Ishaan's A/c

1.7.2015	To B.P. a/c	80000	1.10.2015	By Purchases a/c	100000
9.10.2015	To Cash/Bank a/c	20000			
		100000			100000

B.P. A/c

1.9.2015	To Janvi's a/c	80000	1.7.2015	By Ishaan a/c	80000
		80000			80000

Janvi's A/c

1.9.2015	To Sales a/c	90000	1.9.2015	By B.P. a/c	80000
				By Bank/Cash a/c	9000
				By Discount a/c	1000
		90000			90000

IN THE BOOKS OF 'Janvi'

Ishaan's A/c

1.7.2015	To Sales a/c	81000	1.7.2015	By B'R a/c	80000
				By Discount a/c	1000
		81000			81000

B.R. A/c

1.7.2015	To Ishaan's a/c	80000	1.9.2015	By Shivani's a/c	80000
		80000			80000

Shivani's A/c

1.9.2015	To B.R.a/c	80000	1.9.2015	By Purchases a/c	90000
	To Cash/Bank a/c	9000			
	To Discount a/c	1000			
		90000			90000

IN THE BOOKS OF 'Ishaan'

Shivani's A/c

1.10.2015	To Sales a/c	100000	1.7.2015	By B'R a/c	80000
				By Cash/Bank a/c	20000
		100000	1.10.2015		100000

B.R. A/c

1.7.2015	To Shivani's a/c	80000	1.7.2015	By Janvi's a/c	80000
		80000			80000

Janvi's A/c

1.7.2015	To B.R.a/c	80000	1.7.2015	By Purchases a/c	81000
	To Discount a/c	1000			
		90000			81000

7. On 1st January 2018, Akshay draws two bills of exchange for ₹ 16,000 and ₹ 25,000. The bill of exchange for ₹ 16,000 is for two months while the bill of exchange for ₹ 25,000 is for three months. These bills are accepted by Vishal. On 4th March, 2018, Vishal requests Akshay to renew the first bill with interest @ 15% p.a. for a period of two months. Akshay agreed to this proposal. On 25th March, 2018, Vishal retires the acceptance for ₹ 25,000, the interest rebate i.e. discount being ₹ 250. Before the due date of the renewed bill, Vishal becomes insolvent and only 50 paise in a rupee could be recovered from his estate. Show the Journal Entries (with narrations) in the books of Akshay. [May 2019, 5 Marks]

Sol. In the Books of Akshay Journal Entries

Date	Particulars		₹	₹
2018	Bill Receivable a/c (I) Dr.		16000	
Jan-1	Bill Receivable a/c (II) Dr.		25000	
	To Vishal			41000
	(Being two bills accepted by Vishal 2 months & 3 months, respectively)			
Mar-4	Vishal Dr.		16000	
	To Bill Receivable a/c (I)			16000
	(Being bill receivable of ₹ 16000 drawn in favour of Vishal, cancelled)			
	Vishal Dr.		400	
	To Interest a/c ($16000 \times 15\% \times 2/12$)			400
	(Being interest receivable from Vishal on the out-standing balance due from him)			

	Bill Receivable a/c (III) To Vishal (Being new bills of ₹ 16400 Accepted by Vishal for a period of 2 months)	Dr.	16400	16400
Mar-25	Cash a/c Rebate a/c To Bills Receivable a/c (III) (Being Payment received and rebate allowed to Vishal)	Dr. Dr.	24750 250	25000
	Vishal To Bills Receivable a/c (III) (Being IIIrd bill of ₹ 16400 dishonoured on account of Vishal's insolvency)	Dr.	16400	16400
	Cash a/c Bad Debts a/c To Vishal (Being 50 paise in a rupee recovered from Vishal's estate)	Dr.	8200 8200	16400

8. Suresh draws a bill for ₹ 15,000 on Anup on 15 th April, 2020 for 3 months, which Anup returns to Suresh after accepting the same. Suresh gets it discounted with the bank for ₹14,700 on 18 th April, 2020 and remits one-third amount to Anup, On the due date Suresh fails to remit the amount due to Anup, but he accepts a bill of ₹ 17,500 for 3 months, which Anup discounts for Suresh becomes insolvent and only 50% was realized from his estate on 31st October, 2020.

Pass necessary Journal entries for the above transaction in the books of Suresh.

[Nov. 2020, 10 Marks]

Date	Particulars		₹	₹
15 April	Bill Receivable a/c To Anup a/c (Being accommodation bill drawn on Anup of ₹15,000)	Dr.	15000	15000

18*	Bank a/c Discounting Charges a/c To Bill Receivable a/c (Being bill discounted with bank)	Dr.	14700 300	15000
	Anup's a/c To Bank a/c To Discounting Charges a/c (Being 1/3rd amount remitted to him)	Dr.	5000	4900 100
18 July	Anup's a/c To Bank a/c (Being bills accepted in favour of Anup for 3 moths)	Dr.	17500	17500
	Bank a/c Discounting charges a/c To Anup's a/c (Being amount received with discount charges from anup)	Dr. Dr.	2825 300	3125
21 Oct	Bill payable a/c To Anup's a/c (Being bill payable accepted earlier, now dishonoured)	Dr.	17500	17500
31*	Anup's a/c ⁽²⁾ To Bank a/c To Dificiency a/c (Being amount paid as full and final settlement)	Dr.	13125	6562.50 6562.50

Sol.

Working Note :-

- Share of Suresh in discounting charges of Second Bill

$$= 400 \times \left(\frac{10000 + 2825}{171000} \right) = 300$$

-

Date	Particulars	₹	Date	Particulars	₹
18 April	To Bank a/c To Discounting charges	4900 100	15 April 18 July	By Bills Recivable a/c By Bank a/c	15000 2825
18 July 31 Oct	To Bill Payable a/c To Bank a/c To Deficiency a/c	17500 6562.50 6562.50	21 Oct	By Discounting charges By Bills Payable a/c	300 17500
		36625			35625

9. On 12th May, 2020 A sold goods to B for ₹ 36,470 and drew upon the later two bills one for ₹ 16,470 at one month and the other for ₹ 20,000 at three months. B accepted both the bills.

On 5th June, 2020 A sent both the bills to his banker for collection on the due dates. The first bill was duly met. But due to some temporary financial diffi. culties, B failed to honour the second bill on the due date and the bank had to pay ₹ 20 as noting charges.

However, on 16th August, 2020 it was agreed between A and B that B would immediately pay ₹ 8,020 in cash and accept a new bill at 3 months for ₹ 12,480 which included interest for postponement of the part payment of the dishonoured bill. A immediately sent new acceptance to its bank for collection on the due date. On 1st October, 2020 B approached A offering ₹ 12,240 for retirement of his acceptance. A accepted the request.

You are required to pass journal entries of all the above transactions in the books of A.

[Dec. 2021, 10 Marks]

Sol. In the books of A

Journal Entries

Date	Particulars	L.F	Amount (Dr.) ₹	Amount (Cr.) ₹
12 May	B's a/c Dr. To Sales a/c (Being goods sold to B on credit)		36470	36470
12 May	B/R No. 1 a/c Dr. B/R No. 2 a/c Dr. To B's a/c (Being 2 bill recivalbe received of 1 month & 3 month respectively from him)		16470 20000	36470
5 June	Bill sent for collection a/c Dr. To B/R No. 1 a/c To B/R No. 2 a/c (Being both Bill sent to bak for collection)		36470	16470 20,000
15 June	Bank a/c Dr. To Bill sent for collection a/c (Being the first bill sent for collection earlier, now collected)		16470	16470
14 Aug.	B's a/c Dr. To Bill sent for collection a/c To Bank a/c (Being the Second bill dishonoured by B & noting charges incurred ₹20)		20020	20000 20
16 Aug.	B's a/c Dr. To Interest a/c (1) (Being interest charged from him)		480	480

	Cash a/c To B's a/c (Being part payment received from B)	Dr.		8020	8020
	B/R No. 3 a/c To B's a/c (Being new bill accepted by B including interest)	Dr.		12480	12480
	Bill sent for Collection a/c To B/R No. 3 a/c (Being bill sent to bank for collection)	Dr.		12480	12480
1 Oct.	Bank a/c Rebate a/c To Bill sent for collection a/c (Being early payment made by B before due date)	Dr.		12240 240	12480

1. Interest = Cash ₹ 8,020 + B/R ₹ 12,480

= ₹20,500 – Amount due ₹ 20,200 = ₹ 480

10. T draws on J a bill of exchange for ₹ 1,80,000 on 1st April, 2022 for 3 months. J accepts the bill and sends it to T, who gets it discounted from his banker for ₹ 1,72,800. T immediately remits ₹ 57,600 to J. On the due date, T, being unable to remit the amount due, accepts a bill for ₹ 2,52,000 for three months, which is discounted by J from his banker for ₹ 2,40,660. J sends ₹ 40,440 to T. Before the maturity of the bill, T becomes bankrupt and his estate paying fifty paise in a rupee.

Give the journal entries in the books of T and J.

[Dec. 2022, 15 Marks]

Sol.

In the books of T
Journal Entries

Date	Particulars	L.F	Amount (Dr.) ₹	Amount (Cr.) ₹
1 April	B/R a/c To J a/c (Being bill on exchange drawn on J)	Dr.	180000	180000
	Bank a/c Discounting charges a/c To B/R a/c (Being Bill discounted with the Bank)	Dr. Dr.	172800 7200	180000
	J a/c To Bank a/c To Discounting charges a/c (Being amount remitted to J along with his share of discounting charges)	Dr.	60000	57600 2400

4 July	J a/c To B/P a/c (Being bill accepted due to non payment of earlier bill)	Dr.		252000	252000
	Bank a/c Discounting charges a/c To J a/c (Being amount received from J)	Dr.		40440 7560	48000
7 Oct	B/P a/c To J a/c (Being bill dishonoured due to bankruptcy)	Dr.		252000	252000
	J a/c To Bank a/c To Deficiency a/c (Being the amount due to J discharged by payment of 50 paise in a rupee)	Dr.		168000	84000 84000

In the books of J
Journal Entries

Date	Particulars	L.F	Amount (Dr.) ₹	Amount (Cr.) ₹
1 April	T a/c To B/P a/c (Being bill accepted and sent to T)	Dr.	180000	180000
	Bank a/c Discounting charges a/c To T a/c (Being amount received from T on account of the bills recivable)	Dr. Dr.	57600 2400	60000
4 July	B/R a/c To T a/c (Being Bill accepted by T)	Dr.	252000	252000
	Bank a/c Discounting charges a/c To B/R a/c (Being bill discounted with the bank)	Dr. Dr.	24660 11340	252000

4 July	B/P a/c To Bank a/c (Being B/P honoured on maturity date)	Dr.		180000	180000
	T a/c To Bank a/c To Discounting charges a/c (Being amount sent to T along with his share of discounting charges)	Dr.		48000	40440 7560
7 Oct	T a/c To Bank a/c (Being bill dishonoured due to T's bank-ruptcy)	Dr.		252000	252000
	Bank a/c Bad Debts a/c To T a/c (Being 50% amount received from T & balance being written off as bad debts)	Dr. Dr.		84000 84000	168000

Working Note :-

In the Books of J
T a/c

Particulars	₹	Particulars	₹
To B/P a/c	180000	By Bank a/c	57600
To Bank a/c	40440	By Discounting charges a/c	2400
To Discounting charge a/c	7560	By B/R a/c	252000
To Bank a/c	252000	By Bank a/c	84000
		By Bad debts a/c	84000
Total	480000	Total	480000

- Ms. Shakuntla receives 2 bills of exchange from Ms. Anupama dated 1st May 2021 for 3 months. The first bill is for ₹9500 and the second bill is for ₹7500. The second bill was endorsed in favour of Mr. Sushma on 3rd May 2021. And the First bill is discounted immediately with the bank for ₹9,000. Pass the necessary journal entries in the books of Ms. Sushma.

Sol.

In the books of Shakuntla

Date	Particulars	L.F.	DR. (in ₹)	CR. (in ₹)

01/05/2021	Bills receivables A/c	Dr.	17000	
	To Anupama A/c			17000
	(Being two bills receivable from Anupama)			
03/05/2021	Sushma A/c	Dr.	15,000	
	To Bills receivables A/c			15,000
	(Being the bill endorsed in favour of Ms. Sujata)			
01/05/2021	Bank A/c	Dr.	9000	
	Discount charges A/c	Dr.	500	
	To Bills receivable A/c			9500
	(Being the bills receivable discounted with the bank at a charge of 500)			

2. Vikram sold goods to Prajwal on 1st May, 2019 for ₹1,20,000. Prajwal immediately accepted a four month bill. On the due date Prajwal requested that the bill be renewed for a fresh period of one month. Vikram agrees to provide interest at 10% p.a. was paid immediately in cash. To this Prajwal was agreeable. The second bill was met on the due date. Give Journal entries in the books of Vikram and Prajwal.

Sol.

Books of Vikram

2021			₹	₹
1-May.	Prajwal	Dr.	1,20,000	
	To Sales Account			1,20,000
	(Sales of goods to Prajwal as per Invoice No...)			
	Bills Receivable Account	Dr.	1,20,000	
	To Prajwal			1,20,000
	(3 months acceptance received from Prajwal for the amount due from him)			
4 Sept	Prajwal	Dr.	1,20,000	
	To Bills Receivable Account			1,20,000
	(Prajwal acceptance cancelled because of renewal)			
	Prajwal	Dr.	1,000	
	To interest			1,000
	(Interest @ 10% on ₹1,20,000 due from Prajwal for 1 month because of renewal)			
	Bills Receivable Account	Dr.	1,20,000	
	Cash Account	Dr.	1,000	

2021		₹	₹
	To Prajwal		1,21,000
	[New acceptance for 2 months for ₹106,000 and Cash (for interest) received from Prajwal]		
7 Oct	Cash Account Dr.	1,20,000	
	To Bills Receivable Account		1,20,000
	(Cash received against Prajwal second acceptance)		

Books of Prajwal

2021		₹	₹
1 May	Purchase Account Dr.	1,20,000	
	To Vikram A/c		1,20,000
	(Purchase of goods from Vikram as per Invoice No...)		
	Vikram A/c Dr.	1,20,000	
	To Bills Payables Account		1,20,000
	(3 months acceptance given to Vikram for the amount)		
4 Sept	Bills Payable Account Dr.	1,20,000	
	To Vikram A/c		1,20,000
	(Cancellation of bill because of renewal)		
	Interest Account Dr.	1,000	
	To Vikram		1,000
	(Interest @ 10% on ₹1,20,000 due to Vikram for 1 month because of renewal)		
	Vikram Account Dr.	1,21,000	
	To Cash Account		1,000
	To Bills Payable Account		1,20,000
	[New acceptance for 1 months for ₹120,000 and Cash (for interest) paid to Vikram]		
2021			
7 Oct	Bills Payable Account Dr.	1,20,000	
	To Cash Account		1,20,000
	(Cash paid against second bill)		

3. On 1st June, 2021, Anjali sells goods for ₹3,50,000 to Bhanu and draws a bill at two

months for the amount. Bhanu accepts it and returns it to Anjali. On 1st July, 2021, Bhanu retires her acceptance under rebate of 10% per annum. Record these transactions in the journals of Anjali and Bhanu.

Sol.

Journal Entries in the books of Anjali

Date 2020	Particulars	₹	₹
June. 1	Bhanu's account Dr.	3,50,000	
	To Sales account (Being the goods sold to Bhavika on credit)		3,50,000
	Bills receivable account Dr.	350,000	
	To Bhanu's account (Being the acceptance of bill received)		3,50,000
July.1	Bank account Dr.	347084	
	Rebate on bills account Dr.	2916	
	To Bills receivable account (Being retired from the bill by Bhanu one month before maturity, the rebate being given to her at 10% p.a.)		350,000

Journal Entries in the books of Bhanu

Date 2020	Particulars	₹	₹
June. 1	Purchases account Dr.	350,000	
	To Anjali Account (Being the goods purchased from Anjali on credit)		350,000
	Anjali Account Dr.	5,00,000	
	To Bills Payable Account (Being the acceptance of bill)		5,00,000
July .1	Bills Payable Account Dr.	5,00,000	
	To Rebate Income Account To Bank Account (Being retirement of bill one month before maturity, the rebate being received at 10% p.a.)		5,000 4,95,000

4. On 1st Sept, 2021, Vijendra drew a bill of exchange for 25,000 due for payment after four months on Ekta. Ekta accepts this bill of exchange. On 4th December, 2021 Ekta retires the bill of exchange at a discount of 9% p.a. Prepare the journal for Ekta.

Sol.

Journal entries in the books of Ekta

Date	Particulars	L.F.	Debit ₹	Credit ₹
Sept. 1	Vijendra A/c To Bills Payable A/c (Being the bill draws by him accepted)	Dr.	25,000	25,000
Dec. 4	Bills Payable A/c To Bank A/c To Interest A/c (Discount A/c) (Being retirement of acceptance 1 month before maturity, interest allowed at 9% p.a.)	Dr.	25,000	24812.50 187.50

5. Mr. Dev draws two bills of exchange on 1.4.2021 for ₹8,000 and ₹9,000. The bills of exchange for ₹8,000 is for one month while the bill of exchange for ₹9,000 is for two months. These bills are accepted by Mr. Tanveer. On 4.May.2021, Mr. Tanveer requests Mr. Dev to renew the first bill with interest at 10% p.a. for a period of three months. Mr. Dev agrees to this proposal. On 20.5.2021, Mr. Tanveer retires the acceptance for ₹9,000, the interest rebate i.e. discount being Rs 90. Before the due date of the renewed bill, Mr. Tanveer becomes insolvent and only 40 paise in a rupee could be recovered from his estate.

You are to give the journal entries in the books of Mr. Dev.

Sol. *Journal Entries in the books of Mr. Dev*

2020			(₹)	(₹)
April. 1	Bills receivable (No. 1) A/c Bills receivable (No. 2) A/c To Mr. Tanveer's A/c (Being drawing of bills receivables)	Dr. Dr.	8,000 9,000	
			17,000	
4-May	Mr. Tanveer's A/c To Bills receivable (No.1) A/c (Being the reversal entry for bill No.1 on agreed renewal)	Dr.	8,000	8,000
4-May	Bills receivable (No. 3) A/c To Interest A/c To Mr. Tanveer A/c (Being the drawing of the bill of exchange no. 3 due for maturity on 7.8.2021 together with interest at 10%p.a. in lieu of the original acceptance of Mr. Tanveer)	Dr.	8200	200 8,000

2020		(₹)	(₹)
20-May	Bank A/c Discount A/c To Bills receivable (No. 2) A/c (Being the amount received on retirement of bills No.2 before the due date)	8,910 90	9,000
20-May	Mr. Tanveer's A/c Dr. To Bills receivable (No. 3) A/c (Being the amount due from Mr. Tanveer on dishonour of his acceptance on presentation on the due date)	8200	8200
20-May	Bank A/c Dr. To Mr. Tanveer's A/c (Being the amount received from official assignee of Mr. Tanveer at 40 paise per rupee against dishonoured bill)	3,280	3280
May 20	Bad debts A/c To Mr. Tanveer's A/c (Being the balance 60% balance in Mr. Tanveer's Account arising out of dishonoured bill written as bad)	4920	4920

6. On 1st June, 2020 Gautam drew a bill for 170000 for three months on Hemant for mutual accommodation. Hemant accepted the bill of exchange. Gautam had purchased goods worth 1,71,000 from Jayant on the same date. Gautam endorsed Hemant's acceptance to Jayant in full settlement. On 1st August, 2020, Jayant purchased goods worth ₹1,80,000 from Hemant. Jayant endorsed the bill of exchange received from Gautam to Hemant and paid ₹8,000 in full settlement of the amount due to Harry. On 1st September, 2020, Hemant purchased goods worth ₹190,000 from Gautam. Hemant paid the amount due to Gautam by cheque. Give the necessary Journal Entries in the books of Hemant and Gautam.

Sol.

In the books of Hemant

Date	Particulars	₹	₹
1.6.2020	Gautam's a/c To Bills payable a/c (Acceptance of bill drawn by Gautam)	170,000	170,000

1.8.2020	Jayant's a/c	1,80,000	
	To Sales a/c		1,80,000
	(Sales made to Jayant)		
1.8.2020	Bills receivable account	1,70,000	
	Bank account	8,000	
	Discount account	2,000	
	To Jayant's a/c		1,80,000
	(Acceptance received from Jayant's endorsement of bill received from Gautam for ₹1,70,000 and ₹ 8,000 received in full settlement of the amount due)		
1.8.2020	Bills payable account	1,70,000	
	To Bills receivable account		1,70,000
	(Own acceptance received from Jayant's endorsement, cancelled)		
1.9.2020	Purchase account	190,000	
	To Gautam's account		190,000
	(Purchases made from Gorge)		
	Gautam's account	20,000	
	To Bank account		20,000
	(Amount paid to Gautam after adjusting ₹170,000 for accommodation given to him)		

In the books of Gautam

Date	Particulars	₹	₹
1.6.2020	Purchases Account Dr.	171,000	
	To Jayant a/c		171,000
	(Purchase of goods from Jayant)		

1.6.2020	Bills Receivable Account	Dr.	1,70,000	
	To Hemant A/c			1,70,000
	(Acceptance by Hemant of bill drawn on him)			
1.6.2020	Jayant's account	Dr.	1,71,000	
	To Rebate Account			1,000
	To Bills Receivable A/c			1,70,000
	(Hemant's bill endorsed to Jayant)			
1.09.2020	Harry Account	Dr.	190,000	
	To Sales account			190,000
	(Sales to Harry)			
1.09.2020	Bank Account	Dr.	20,000	
	To Hemant a/c			20,000
	(Amount received from Gautam after adjusting ₹170,000 for accommodation extended by him)			

3. B purchased goods for ₹ 30,000 plus CGST and SGST @ 9% each on 1st June 2022 from A and on the same date accepted a bill payable after three months. Three Days later, A endorsed the Bill to C. On maturity, the bill was dishonoured for non payment and C had to pay ₹ 200 as noting charges.

Three days after the dishonour of the bill A made full payment to Z. 15 days after the dishonour of the bill, B paid ₹ 10,000 to A and requested him to draw a second bill for the balance plus ₹ 450 for the amount of interest, payable after two months. A accepted the proposal and drew the bill on B, which was accepted by B and was duly met on maturity.

Record the above transactions in the books of all the three parties.

Sol.

Journal of A

Date	Particulars	LF	Amount	Amount

2022	B A/c.	Dr.		35400	
June 1	To Sales A/c.				30,000
	To Output CGST A/c.				2700
	To Output SGST A/c.				2700
	(Being goods sold to Y, charged CGST and SGST @ 9% each)				
June 1	Bills Receivables A/c.	Dr.		35400	
	To B A/c.				35400
	(Being Acceptance Accepted)				
June 4	C A/c.	Dr.		35400	
	To Bills Receivables A/c.				35400
	(Being Bill endorsed to C)				
Sept 4	B A/c.	Dr.		35500	
	To C A/c				35500
	(Being bill dishonoured and noting charges paid by C)				
Sept 7	C A/c.	Dr.		35500	
	To Bank A/c				35500
	(Being cash paid to C)				
Sept 19	Bank A/c.	Dr.		10000	
	To B A/c				10000
	(Being cash received from B)				
Sept 19	B A/c.	Dr.		450	
	To Interest A/c.				450
	(Being interest receivable)				
Sept 19	Bills Receivables A/c.	Dr.		25950	
	To B A/c.				25950
	(Being new acceptance received)				
Nov 22	Bank A/c.	Dr.		25950	
	To Bills Receivable A/c.				25950

Journal of Y

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
2022				
June 1	Purchases A/c.	Dr.	60,000	
	Input CGST A/c.	Dr.	5,400	
	Input SGST A/c.	Dr.	5,400	
	To A A/c			70,800
	(Being goods purchased from A, paid CGST and SGST @ 9% each)			

June 1	A A/c. To Bills Payable A/c. (Being Acceptance given)	Dr.		70,800	70,800
Sept 4	Bills Payable A/c. Noting Charges A/c. To A A/c. (Being Bill dishonoured and noting charges payable)	Dr. Dr.		70,800 200	71,000
Sept 19	A A/c. To Bank A/c (Being cash paid to X)	Dr.		20,000	20,000
Sept 19	Interest A/c To A A/c (Being interest payable)	Dr.		900	900
Sept 19	A A/c. To Bills Payable A/c. (Being new acceptance given)	Dr.		51,900	51,900
Nov 22	Bills Payable A/c To Bank A/c (Being amount of bill paid)	Dr.		51,900	51,900

Journal of C

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
2018 June 4	Bills Receivable A/c To A A/c (Being bill received from A)	Dr.	35400	35400
Sept 4	A A/c. To Bills Receivable A/c. To Bank A/c. (Being bill dishonoured and noting charges paid)	Dr.	35500	35400 100
Sept 7	Bank A/c. To A A/c (Being cash received)	Dr.	35500	35500

4. A Bill receivable for ₹ 10,000, which had been discounted for ₹ 9750, is dishonoured and the bank paid ₹ 50 as noting charges.

Give journal entries to record the above in the books of

(i) The drawer and, (ii) Drawee.

Sol.

Journal of Drawer

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)

Bill of Exchange

	Drawee	Dr.	10050	
	To Bank A/c			10050
	(Dishnour of acceptance which was discounted with the bank and noting charges paid by bank)			

Journal of Drawer

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
	Bills Payable A/c. Dr.		10000	
	Noting Charges A/c. Dr.		50	
	To Drawer A/c.			10050
	(Acceptance dishnoured and noting charges due)			

5. Journalise the following transaction in the books of A :

B's acceptance of ₹ 25,000 which had been discounted with the bank for ₹ 24,000 was returned by the bank unpaid. Bank has notified that ₹ 100 has been paid as nothing.

Sol.

Journal of X

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
	Bank A/c Dr.		24000	
	Discounting charges A/c. Dr.		1000	
	To Bills receivable A/c.			25000
	(Being Bill discounted with bank of Rs.25,000 at a discount of Rs.1,000)			
	B A/c Dr.		25100	
	To Bank A/c			25100
	(Dishonour of B's acceptance which was discounted with the bank which claims ₹100 as noting charges)			

6. On Jan. 15, 2022 Gautam sold goods ₹ 15,000 to Namit and drew upon the later a bill for the same amount payable after three months. The bill was accepted by Namit. The bill was discounted by Gautam from his bank for ₹ 14625 on Jan. 31, 2022. On maturity the bill was dishonoured. He further agreed to pay ₹ 5,250 in cash including ₹ 250 interest and accept a new bill for two months for the remaining ₹ 10,000. The new bill was endorsed by Gautam in favour of his creditor Kusum for settling a debt of ₹ 10,400. The new bill was duly met by Namit on maturity. Record the necessary journal entries in the books of Gautam.

Sol.

In the Books of Sachin Journal Entry

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)

2022					
Jan 15	Namit	Dr.		15000	
	To Sales A/c				15000
	(Goods sold to Namit)				
Jan 15	Bills Receivable A/c	Dr.		15000	
	To Namit				15000
	(Acceptance received)				
Jan 31	Bank A/c	Dr.		14625	
	Discounting Charges A/c	Dr.		375	
	To Bills Receivable A/c				15000
	(B/R discounted)				
April 18	Namit	Dr.		15,000	
	To Bank A/c				15,000
	(Bill dishonoured)				
April 18	Namit	Dr.		250	
	To Interest received A/c				250
	(Interest Due)				
April 18	Cash/Bank A/c	Dr.		5250	
	To Namit				5250
	(Cash Received)				
April 18	Bills Receivable A/c	Dr.		10,000	
	To Namit				10,000
	(New acceptance received)				
April 18	Kusum	Dr.		10,400	
	To Bills Receivable A/c				10,000
	To Discount Received A/c				400

7. X sells goods for ₹ 20,000 to Y on 1st January, 2022 and on the same day draws a bill on Y at three months for the amount. Y accepts it and returns it to X, who discounts it on 4th January, 2022 with his bank at 6 % per annum. The acceptance is dishonoured on the due date and the noting charges were paid by the bank being ₹ 100.

On 4th April, 2022, Y accepted a new bill at three months for the amount then due to X together with interest at 12 % per annum.

Make Journal entries to record these transactions in the books of X and Y.

Sol.

Journal Entry

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
2022				
Jan 1	Y a/c	Dr.		
	To Sales A/c		20000	
	(Goods sold to Y)			20000
Jan 1	Bills Receivable A/c.	Dr.		
	To Y A/c.		20000	
				20000

	(Acceptance Received)			
Jan 4	Bank A/c. Dr. Discounting Charges A/c. Dr. To Bills Receivable A/c.		19700 300	20000
	(Bill discounted from the bank, i.e. $20,000 \times \frac{6}{100} \times \frac{3}{12} = 300$)			
Apr 4	Y A/c. Dr. To Bank A/c.		20100	20100
	(Bill dishonored and noting charges paid by bank)			
Apr 4	Y A/c. Dr. To Interest A/c.		603	603
	(Interest receivable from Y $20100 \times \frac{12}{100} \times \frac{3}{12} = 603$)			
Apr 4	Bills Receivable A/c. Dr. To B A/c.		20703	20703
	(New Acceptance received)			

Journal of Y

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
2022				
Jan 1	Purchases A/c. Dr. To X A/c.		20000	20000
	(Goods purchased from X)			
Jan 1	X A/c. Dr. To Bills Payable A/c.		20000	20000
	(Acceptance Given)			
Apr 4	Bills Payable A/c. Dr. Noting Charges A/c. Dr. To X A/c.		20,000 100	20100
	(Bill dishonored and noting charges due)			
Apr 4	Interest A/c. Dr. To X A/c.		603	603
	(Interest payable for three months)			

Apr 4	X A/c.	Dr.		20703	
	To Bills Payable A/c.				20703
	(New Acceptance given)				

8. What Journal entry will be passed in the books of drawer and drawee at the time of dishonour of bill of exchange in the following cases :

(i) If a bill of ₹ 5,000 was discounted from the bank and noting charges paid by the bank were ₹ 50.

(ii) If B/R of ₹ 5,000 was endorsed in favour of Z. Noting charges paid by C ₹ 50

(iii) If B/R is retained with a drawer and noting charges were ₹ 50.

Sol.

Entries in the Books of Drawer

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
(i)	Drawee Dr. To Bank		5050	5050
	(Bill dishonoured and noting charges paid by the bank)			
(ii)	Drawee Dr. To Z		5050	5050
	(Bill dishonoured and noting charges paid by the Z)			
(iii)	Drawee Dr. To Bills Receivable To Cash A/c		5050	5000 50
	(Bill dishonoured and noting charges paid)			

Entries in the Books of Drawee In case of (i), (ii) and (iii)

Date	Particulars	LF	Amount (Dr.)	Amount (Cr.)
	Bills Payable A/c. Dr.		5000	
	Noting Charges A/c. Dr. To Drawer		50	5050
	(Bill dishonoured and noting charges payable)			

CONCEPT OF DEPRECIATION

Tangible Assets are physical assets, meaning they can be seen, touched, and used in the production or provision of goods and services, for renting to others, or for administrative purposes. The useful life of a tangible asset is determined by its expected usage.

Property, plant, and equipment are examples of tangible assets that meet the following criteria:

- (a) They are used in the production or supply of goods and services, for rental, or administrative purposes.
- (b) They are expected to be used for more than twelve months.

These assets are commonly referred to as *fixed assets*. When a *fixed asset* is acquired, it is initially recorded in the accounting books at its *Cost of Acquisition*. However, *fixed assets* are expected to generate revenue or cost savings over several accounting periods, using the same acquisition cost and disclosing the same amount in Balance Sheet until the asset is sold or retired isn't justified.

Since the useful life of these assets extends beyond one year, it is necessary to allocate a portion of the acquisition cost as an expense in each accounting period in which the asset is used. This allocated amount is known as *depreciation*.

Why Does Value of Fixed Assets decreases over time..???

Various Factors are responsible for the same namely,

1. *Wear and tear* from business use.
2. The *passage of time*, even when not in use.
3. *Obsolescence* caused by technological or other changes.
4. *Decrease in market value*.
5. *Depletion*, primarily in the case of mines and other natural resources.

It's essential to recognize a portion of the asset's cost used in generating this income or cost savings to account during an accounting year to determine the true income.

As per Schedule II under the Companies Act, 2013,

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount is the asset's cost or another amount substituted for cost (e.g., in the case of asset revaluation), minus its residual value. The useful life of an asset is the period it is expected to be available for use by an entity, or the number of production or similar units the entity expects to obtain from the asset.

Therefore, there are **three key factors in calculating depreciation**:

- ❑ The estimated useful life of the asset.
- ❑ The cost of the asset.
- ❑ The asset's residual value at the end of its estimated useful life.

Depreciation of an asset commences when it is available for use, meaning it is in the necessary location and condition to operate as intended by management. **An asset doesn't have to be actively used, it just needs to be available for use.**

Example:

Fire extinguishers installed in Premises will be depreciated even though they are not used because to use them we need to intentionally fire up the premises

Depreciation for a given period helps to match a portion of the asset's cost against the revenues earned in that period, following the matching principle.

In other words, the **total cost of the asset is reflected as both "expired cost" (depreciation i.e. in PL A/c) and "unexpired cost," (i.e. Written Down Value) in the balance sheet.** Additionally, annual depreciation reduces distributable profits, ensuring funds are available when replacements are needed.

In essence, the cost of an asset used for business purposes must be gradually written off over its economic (not physical) life, which needs to be estimated. It's important to note that, typically, at the end of the asset's economic life, it may still have some residual value, such as scrap value. The annual write-off amount should be such that it reduces the asset's book value to its estimated scrap value at the end of its economic life.

Depreciation on components of an assets

It's worth mentioning that both **Accounting Standards and the Companies Act, 2013 mandate the practice of allocating depreciation on a component basis.** A business should **divide the initial amount recognized for an item of Property, Plant, and Equipment into its significant components and then apply separate depreciation for each of these components based on their individual useful life and residual value.**

Example:

An aircraft, which is a typical example of such an asset. The aircraft comprises distinct components like the airframe (the body of the aircraft), engines, and interiors, each having different expected useful lives. If the airframe has the longest useful life among these major components and is chosen as the basis for the aircraft's overall life, it's crucial to depreciate the other two major components, namely the engines and interiors, over their respective individual useful lives rather than using the airframe's life as a reference. Smaller, low-value components that require frequent replacement can be depreciated over the airframe's useful life, and the costs of their frequent replacements can be expensed as they occur.

It's important to note that, for a part of Property, Plant, & Equipment to be recognized as a separate component, it must meet two criteria:

- (a) Component should have a **significant cost compared to the total cost of the entire item of Property, Plant, and Equipment.**
- (b) It should have an **estimated useful life or depreciation method that differs from the other**

parts of the Property, Plant, and Equipment.

In some cases, a significant component of an item of Property, Plant, and Equipment may have the same useful life and depreciation method as another significant component of that same item. In such situations, these components may be grouped together when calculating the depreciation charge.

Objectives for Providing Depreciation

The primary goals of applying depreciation are as follows:

1. **Accurate income assessment (i.e. Net Profit or Net Loss)** : Depreciation is essential for the proper determination of periodic profit or loss. Without accounting for depreciation on Property, Plant & Equipment, a business would overlook the decline in the value of these assets resulting from their use in production or operations. This omission would fail to reflect the true profit or loss for the period.
2. **Genuine financial position representation (i.e. Networth)** : The value of Property, Plant & Equipment should be adjusted for the depreciation incurred to portray the actual financial status. Incorrect accounting for depreciation would lead to the disclosure of these assets in financial statements at a value higher than their true worth. It is crucial to present them at their remaining cost, which is the value after deducting the expired cost as depreciation.
3. **Provision for asset replacement (As Depn. is Non-Cash Expense)** : Depreciation aids in accumulating sufficient funds within the business for the replacement of assets at the end of their useful life. Depreciation serves as a useful indicator of the amount that an enterprise should reserve to replace a fixed asset when its economic utility is exhausted. Nevertheless, the replacement cost of a fixed asset may also be influenced by factors like inflation and technological advancements.
4. **Determining the actual production cost** : To ascertain the production cost, it is imperative to include depreciation as a component of the cost of production.

“You will understand impact of determination on production cost in CA-Inter”

Furthermore, it's important to note that depreciation is a non-cash expense, unlike other regular expenditures such as wages and rent, and it doesn't result in an immediate outflow of cash. Depreciation, by itself, doesn't generate funds but rather highlights the necessity to allocate a portion of gross revenue receipts for the replacement of assets used in business operations. This is achieved through the application of depreciation, which reduces distributable profits.

FACTORS IN THE MEASUREMENT OF DEPRECIATION

Determining the precise amount of depreciation is a complex process that involves several estimates. Typically, the calculation of depreciation takes into account the following factors:

1. The **total cost of the asset**, which includes expenses for installation, commissioning, trial runs, and related costs.
2. The **estimated useful life of the asset**, considering both the duration in time and the anticipated utility or usage in units.

3. The **estimated scrap value**, if any, at the end of the asset's useful life.

Estimating the accurate depreciation amount involves a significant degree of estimation due to these factors.

The above mentioned factors can be explained, in detail, as follows:

- (a) The cost of a depreciable asset encompasses the financial expenditure associated with its acquisition, installation, commissioning, and any enhancements made to enhance its efficiency.
- (b) The concept of "Useful Life" can be defined as either
 - (i) the duration for which a depreciable asset is anticipated to be utilized by the enterprise or
 - (ii) the number of production units or similar measures that the enterprise expects to derive from the asset's use. The determination of an asset's useful life involves estimation and is typically based on a range of factors, including past experience with similar asset types. In certain cases, factors such as estimated working hours, production capacity, anticipated repairs and renewals, among others, are also taken into account.
- (c) Estimating the residual value can often be a challenging task. When the residual value is considered to be insignificant, it is typically treated as zero. However, if the residual value is expected to be significant, it is typically estimated either at the time of acquisition/ installation or during a subsequent revaluation of the asset.

The cost of Property, Plant, and Equipment includes:

- (a) The purchase price, which includes non-refundable import duties and purchase taxes, after accounting for trade discounts and rebates.
- (b) Any expenses directly related to preparing the asset for operation in the intended manner, including bringing it to the required location and condition.
- (c) The initial estimation of expenses associated with dismantling, removal of the item, and restoring the site where the asset is situated.

Examples of directly related costs include:

- (a) Employee benefits costs directly arising from the acquisition or construction of the property, plant, and equipment.
- (b) Costs of site preparation.
- (c) Initial delivery and handling costs.
- (d) Installation and assembly expenses.
- (e) Testing costs to ensure the asset functions correctly, net of any proceeds generated from items produced during testing, such as test samples.
- (f) Professional fees, such as fees for engineers hired to assist in machine installation.

In summary, any expenses that are essential to bring the asset into the desired condition and location for its intended use become part of the asset's cost.

However, certain expenses should not be considered part of the asset's cost, including:

- (a) Costs associated with opening a new facility or business, such as *inauguration expenses*.
- (b) Costs associated with introducing a new product or service, such as *advertising or promotional activities cost*.
- (c) Costs associated with conducting business in a new location or with a new class of customers, including *staff training costs*.
- (d) *General administration and other overhead expenses*.

Once an asset has been prepared for its intended use, no further costs should be recognized as part of the asset's cost, unless

- 1) a major repair or
- 2) addition significantly *extends the asset's useful life* or
- 3) *enhances its production capacity*.

Therefore, costs incurred while an item is capable of functioning as intended but is not yet in use or is used at less than full capacity should not be capitalized as part of the asset's cost. Similarly, the cost of relocating an asset should not be capitalized.

Maintaining an asset register with asset-specific details, such as cost, depreciation rate, and capitalization date, is crucial. This information is necessary for any additions to existing assets. Without adequate information, calculating annual depreciation expenses becomes challenging. It also becomes difficult to determine gains or losses upon disposal or retirement of a particular asset.

METHODS FOR PROVIDING DEPRECIATION

Usually, depreciation methods are formulated based on an analysis of how assets behave over several years, making it easier to calculate the depreciation incurred by various asset types. However, it's essential to apply each method thoughtfully, taking into account the asset's characteristics and its usage conditions. It's worth noting that, for income tax purposes, the Diminishing Balance Method is prescribed, except for assets of a power generation and distribution undertaking.

Straight Line Method

Under this approach, an identical sum is deducted each year throughout the operational life of an asset with the aim of ultimately reducing the asset's cost to either zero or its residual value by the end of its useful life. This method is known for its simplicity and precise outcomes, particularly when dealing with leases, as well as plant and machinery. It is also referred to as the "Fixed Installment Method."

$$\text{Straight line depreciation} = \frac{(\text{Cost of an asset} - \text{scrap value})}{\text{Useful life}}$$

$$\text{Straight line depreciation (in \%)} = \frac{\text{Depreciation Amount}}{\text{Cost of asset}} \times 100$$

This method assumes that a specific tangible asset provides consistent utility throughout its lifespan, although this may not always hold true.

In reality, repair and maintenance expenses tend to be lower in the earlier years and increase as the asset ages, just as the asset's capacity may vary over time. However, for assets

with minimal repair and maintenance costs, the straight-line method may still be suitable otherwise it should be ignored.

When employing this method, it's crucial to consider the period an asset is utilized in a given year. In the year of asset purchase, it may be available for use only for part of the year, so depreciation should be adjusted to reflect the period it was available for use. For instance, if an asset was acquired on March 1, 2022, and the enterprise's financial year ends on March 31, 2022, depreciation would be calculated for a period of just one month. A similar situation arises in the year when an asset is retired from its intended use or sold.

Reducing or Diminishing Balance Method or Written Down Value (WDV) Method

In this system, a fixed percentage of the diminishing value (WDV) of the asset is allocated each year to reduce the asset's value to its residual value at the end of its lifespan. Repairs and minor renewals are considered as regular expenses. This depreciation method is commonly applied to assets like plants and fixtures. It's important to note that under this method, the annual depreciation charge decreases from year to year, meaning that earlier years bear a larger depreciation burden compared to later years. Unlike the Straight Line Method, which results in a complete extinguishing of the asset's value, this method ensures that the asset retains some value.

The rationale behind this method lies in the assumption that repair costs tend to increase as an asset ages. Therefore, higher depreciation charges are incurred in the earlier years when repair expenses are expected to be lower, and lower depreciation charges in later years when higher repair costs are anticipated. This approach aims to distribute a nearly consistent burden over the asset's entire useful life, as depreciation decreases while repair costs increase over time. In contrast, the Straight Line Method maintains a constant depreciation charge while repair costs tend to rise with the asset's age.

However, there are drawbacks to this method, such as the risk of adopting a too low depreciation rate, which might result in insufficient depreciation over the asset's life. Additionally, when assets are grouped in a way that individual assets are hard to identify, there could be residual values remaining in the asset accounts even after the assets have been retired. This latter challenge can be mitigated by maintaining a Plant register.

The rate of depreciation for this method can be determined using the following formula.

$$\sqrt[n]{\frac{1 - n}{\text{Residual Value}}}$$

where, n = useful life

Much like the straight-line method, in this approach, it's also essential to take into account the period of usage in a given year, such as the year when an item of property, plant, and equipment is purchased or sold, when calculating the depreciation amount.

Accounting Treatment under Straight Line and Reducing Balance Methods:

There are two alternatives for accounting treatment of depreciation.

A depreciation provision or an Accumulated Depreciation account is established to aggregate the depreciation balance, and the assets are recorded at their historical cost. This method is favored by the majority of organizations as it provides a clear representation of both the original investment and the present value of the assets.

Depreciation Account Dr.
To Provision for Depreciation Account or Accumulated Depreciation
Profit and Loss Account Dr.
To Depreciation Account

Each year, the depreciation amount is recorded as a credit to the Asset Account, and the Asset Account is maintained at its historical cost, reduced by the accumulated depreciation.

Depreciation Account Dr.
To Asset Account
Profit and Loss Account Dr.
To Depreciation Account

This method is a modified version of the “Reducing Balance Method.” Under this approach, the annual depreciation is determined by multiplying the initial cost of the asset (excluding its expected scrap value) by the fraction represented by:

$$\frac{\text{The number of years (including the present year) of remaining life of the asset}}{\text{Total of all digits of the life of the asset (in years)}}$$

Suppose the estimated life of an asset is 9 years; the total of all the digits from 1 to 9 is 45 i.e., $9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1$, or by the formula:

$$\frac{n(n+1)}{2} = \frac{9 \times 10}{2} = 45$$

The depreciation expense for the initial year will be $\frac{9}{45}$ of the asset's cost (minus the expected scrap value), and in the second year, it will be $\frac{8}{45}$ of the asset's cost (excluding the estimated scrap value), and so forth. While this method is not widely adopted at the moment, its benefits align with those of the Reducing Balance Method.

Where it is feasible to maintain a record of the actual operating hours of each machine, depreciation can be calculated based on the number of hours the specific machine operates. The machine hour rate for depreciation is computed after estimating the total number of hours the machine is expected to work over its entire lifespan. However, it may need to

be adjusted periodically to account for changes in economic and technological conditions, ensuring that the depreciation provision aligns with the appropriate amount given the altered circumstances. This approach is a variation of the Straight Line Method, in which depreciation is determined annually. In contrast, under this method, depreciation is calculated for each hour the machine is in operation.

Schedule II to the Companies Act 2013, which specifies the estimated useful life of various assets for companies, also acknowledges this method to some extent. It recommends charging depreciation based on the estimated useful life it suggests. However, for certain categories of plant and machinery, it recommends a higher depreciation charge when these assets are used for 2 or 3 shifts. In a way, Schedule II combines elements of both the straight-line method and the machine hour method.

Production Units Method

In this method, the depreciation of the asset is ascertained by comparing the annual production to the estimated overall production. The depreciation amount is calculated using the following approach.

$$\text{Depreciable Amount} \times \frac{\text{Production during the period}}{\text{Estimated total production}}$$

This approach is suitable for machines that manufacture products with consistent specifications.

Depletion Method

Depletion is the allocation of the cost of wasting natural resources such as oil, gas, timber, and minerals to the production process. This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available to be extracted. Annual depreciation will be the quantity extracted multiplied by the rate per unit.

PROFIT OR LOSS ON THE SALE/DISPOSAL OF PROPERTY, PLANT AND EQUIPMENT

When a **depreciable asset** is sold during the year, depreciation is recorded for the period it was utilized within that year. The written down value, after accounting for this depreciation, is used to determine the profit or loss from the sale of the asset. **Any resulting profit or loss on the sale of the asset is then reflected in the profit and loss account. Consequently, all transactions related to the sale and the profit or loss from the asset sale are recorded in the corresponding asset account.**

Alternatively, an **alternative approach** is to create a new account titled “**Asset Disposal Account**” in the ledger to specifically track the profit or loss on the sale of the asset. In this scenario, the book value of the asset is transferred from the asset account to the Asset Disposal Account, and all sale-related entries, such as sale proceeds and profit or loss calculations, are documented within the Asset Disposal Account.

Example: The book value of the asset as on 1st January, 2022 is Rs 50,00,000. Depreciation is charged on the asset @10%. On 1st July 2022, the asset is sold for Rs 32,00,000.

Calculate Profit/loss

(ICAI Study Material)

Book value of asset as on 1st Jan., 2022	50,00,000
Less: Depreciation for six months @10% p.a. (from 1st Jan., 2022 to 30th June, 2022)	(2,50,000)
WDV as on 1st July, 2022	47,50,000
Less: Sale proceeds on 1st July, 2022	(32,00,000)
Loss on sale of asset	15,50,000

CHANGE IN THE METHOD OF DEPRECIATION

The depreciation method used for an asset should undergo an annual review, and if there's a substantial alteration in the anticipated pattern of utilizing the asset's future economic benefits, the method should be adjusted to align with the revised pattern. Whenever a change in the depreciation method occurs, it's treated as a modification in accounting estimate in accordance with Accounting Standards. The impact of this alteration should be quantified and disclosed separately. Such a change in an accounting estimate can have an impact on either the current period exclusively or on both the current period and future periods (i.e. Change in method of Depreciation will not have retrospective effect)

REVISION OF THE ESTIMATED USEFUL LIFE OF PROPERTY, PLANT AND EQUIPMENT

The residual value and the anticipated useful life of an asset should be evaluated annually, and if these expectations deviate from prior estimates, any adjustments should be treated as changes in accounting estimates in accordance with Accounting Standards.

In the event of a revision to the estimated useful life of the asset, the written down value or the remaining depreciable amount should be expensed over the updated estimated useful life of the asset.

REVALUATION OF PROPERTY, PLANT AND EQUIPMENT

(Refer Class Diagram for Better understanding)

Upon initially recognizing an asset, if its fair value can be reliably determined, it may be reported at the revalued amount, which is the fair value at the revaluation date, adjusted for accumulated depreciation and any accumulated impairment losses (in cases of a permanent decline in value), if applicable. If an entity chooses to revalue:

- Revaluations should occur at regular intervals, such as yearly, to ensure that the carrying amount does not substantially deviate from what would be determined using the fair value at the end of the reporting period.
- When one item of Property, Plant, and Equipment is revalued, the entire class to which the asset belongs should also be revalued.
- If the carrying amount of an asset increases due to revaluation, this increase should be credited to the revaluation surplus and accumulated in equity. However, this increase

should be recognized in the Profit and Loss statement to the extent of reversing a prior decrease in the asset that was previously recognized in the Profit and Loss statement.

- (d) If the carrying amount of an asset decreases due to revaluation, this decrease should be recognized in the Profit and Loss account. However, this decrease should be debited to the revaluation surplus to the extent of reversing a prior increase in the asset, which was previously recognized in the revaluation surplus.
- (e) The Revaluation Surplus can be transferred directly to retained earnings when the asset is derecognized. This may involve transferring the entire surplus when the asset is retired or disposed of. Such a transfer from Revaluation Surplus to Retained Earnings cannot be achieved through the Profit or Loss.
- (f) Alternatively, in the case of an upward revaluation, any excess depreciation due to such revaluation can be transferred from Revaluation Surplus to Retained Earnings. Again, this transfer from Revaluation Surplus to Retained Earnings cannot be made through the Profit or Loss.

It is essential to note that the revaluation of Property, Plant, and Equipment is an accounting policy choice and not mandatory under accounting standards or the Companies Act, 2013.

INTANGIBLE ASSETS

An *intangible asset* is a discernible, non-monetary asset that lacks physical substance, maintained for the purpose of contributing to the production or provision of goods or services, for leasing to others, or for administrative functions. Examples: -

- (a) Streaming rights of Films / songs on platforms like Netflix, Hotstar, Prime Video, Spotify, Gaana etc
- (b) Patents (e.g. patents of vaccines)
- (c) Trademarks (e.g. McDonaldsTM, DominozTM etc)
- (d) Copyright
- (e) Goodwill (purchased)
- (f) Computer Softwares like Tally, Windows

Intangible assets constitute a significant portion of a company's balance sheet. It's important to note that there are situations where intangible assets can hold more value for entities than their tangible counterparts.

For example, a multi-year customer contract guaranteeing over 75% of a company's revenue can be a substantial asset, at times surpassing the value of tangible assets. Likewise, during the acquisition of Air India, the tangible assets mainly comprised older planes requiring significant maintenance. However, one of the primary factors that made Air India an appealing target was its prime landing slots (an intangible asset) at various airports around the world.

Intangible assets can be included in financial statements if they meet the following criteria:

- (i) The *intangible asset* is *identifiable*, meaning the entity can rent, sell, exchange, or distribute the specific future economic benefits associated with the asset without compromising benefits from other assets used in the same revenue-earning activity.

- (ii) It is likely that the future economic benefits associated with the asset will accrue to the enterprise.
- (iii) The enterprise has control over the intangible asset, which means it has the ability to derive economic benefits from the asset while also being able to restrict others' access to those benefits.
- (iv) The cost of the intangible asset can be measured reliably.

When acquired separately, intangible assets are usually initially measured at cost since the cost can be reliably determined in such cases. The cost of the intangible asset comprises the purchase price, any import duties and taxes (except those subsequently recoverable from tax authorities), and any directly attributable expenditures related to making the asset ready for its intended use, such as professional fees for legal services. Trade discounts and rebates are subtracted when determining the cost, similar to how the cost of a tangible asset is calculated.

Intangible assets acquired as part of an acquisition, government grants, internally generated goodwill/intangible assets, or through asset exchanges are treated differently at an intermediate level.

Derecognition (removal from the balance sheet) of an intangible asset occurs upon disposal or when no future economic benefits are expected from its use and subsequent disposal. Gains or losses arising from the retirement or disposal of an intangible asset are determined as the difference between the net disposal proceeds and the carrying amount (book value) of the asset. These gains or losses should be recognized as income or expenses in the statement of profit and loss (i.e P&L A/c).

Difference between Tangible and Intangible Assets

Tangible Assets	Intangible Assets
Tangible assets are assets that possess a material form, meaning they can be visually perceived and physically touched. They are utilized in the production or provision of goods or services, for leasing to third parties, or for administrative functions.	These assets can be identified but lack physical form and are maintained for utilization in the production or provision of goods or services, for leasing to external parties, or for administrative purposes.
Tangible Assets have a limited lifespan determined by anticipated utilization.	Intangible Assets have a defined duration typically determined by contractual terms. However, in certain situations, intangible assets may possess an indefinite lifespan, like purchased goodwill.
The useful life is determined by anticipated usage, without any predefined assumptions.	The anticipated useful life of Intangible Assets is generally considered <u>not to exceed 10 years unless</u> there is evidence indicating a different timeframe.

Tangible Assets undergo depreciation throughout their useful life, which means the gradual reduction in the value of these assets each year is referred to as depreciation.	Intangible Assets are subject to amortization over their useful life. In simpler terms, the annual reduction in the value of intangible assets is referred to as amortization.
Examples- Furniture, Machinery, Computer for office use etc.	Examples- include softwares, purchased goodwill, trademarks, patents etc.

AMORTISATION

Amortization in the context of intangible assets is similar to the concept of depreciation for tangible assets. In essence, the process of reducing the value of an intangible asset annually is referred to as amortization.

Amortization can be defined as the systematic allocation of the depreciable amount of an intangible asset over its expected useful life. The depreciable amount is the asset's cost minus its anticipated residual value.

The useful life of an intangible asset is either:

- (a) the period during which the asset is anticipated to be utilized by the enterprise; or
- (b) the number of production units or similar measures expected to be derived from the asset by the enterprise.

Residual value represents the amount an enterprise expects to receive for an asset at the end of its useful life, after accounting for anticipated disposal costs.

Amortization begins when the asset is available for use. It is generally assumed that the useful life of an intangible asset does not exceed ten years from the asset's availability for use, unless contrary evidence exists.

Similar to depreciation, the method of amortization employed should mirror the consumption pattern of the asset's economic benefits by the enterprise. If this pattern cannot be reliably determined, the straight-line method should be utilized. The amortization expense for each period is recognized as an expenditure, unless there is permission or requirement to include it in the carrying amount of another asset.

Given the nature of intangible assets, it is typically assumed that the residual value is zero, unless:

- (a) a third party has committed to purchasing the asset at the end of its useful life; or
- (b) there is an active market for the asset, and:
 - (i) the residual value can be determined based on that market; and
 - (ii) it is probable that such a market will exist at the end of the asset's useful life.

The amortization period and method should be reviewed at least at the end of each financial year. If the expected useful life significantly differs from previous estimates, the amortization period should be adjusted accordingly. If there is a substantial change in the expected pattern of economic benefits from the asset, the amortization method should be modified to reflect the altered pattern.

TEST YOUR KNOWLEDGE

True and False

1. Increase in market value of a fixed asset is one of the reasons for depreciation being charged.

(ICAI Study Material)

Sol. False: Depreciation is associated with a reduction in an asset's market value, while an increase in market value can lead to the process of revaluation

2. Depreciation is a cash expenditure like other normal expenses.

(ICAI Study Material)

Sol. False: Depreciation differs from typical expenses as it does not involve a cash outflow.

3. Cost of property, plant and equipment includes purchase price, refundable taxes & import duties after deducting any discount or rebate.

(ICAI Study Material)

Sol. False: Non-refundable taxes & duties are included in the cost.

4. Cost of fixed asset should also include the cost of opening a new facility such as inauguration costs.

(ICAI Study Material)

Sol. False: Inauguration costs are not the part of the cost.

5. Depreciation is charged with a constant amount under straight line method and charged with a constant percentage under diminishing balance method.

(ICAI Study Material)

Sol. True: The Straight Line Method (SLM) yields a consistent depreciation amount, while the Diminishing Balance Method maintains a constant depreciation rate.

6. In case an item of Property, Plant & Equipment is revalued, whole class of assets to which that asset being revalued belongs should be revalued.

(ICAI Study Material)

Sol. True: Revaluation is done for the entire class of assets.

7. In case the carrying amount of an asset is decreased due to revaluation, such decrease should always be recognized in the Profit and Loss account.

(ICAI Study Material)

Sol. False: If an asset's value decreases due to revaluation, it should initially be charged to any existing Revaluation Reserve and then to the Profit & Loss account.

8. Akash purchased a machine for Rs 12,00,000. Estimated useful life is 10 years and scrap value is Rs 1,00,000. Depreciation for the first year using sum of the years digit method shall be Rs 2,00,000.

(ICAI Study Material)

Sol. True: The depreciation using the Sum of Years Digits method can be calculated as follows:
 $10/55 \times (12,00,000 - 1,00,000) = 2,00,000$.

9. Depreciation cannot be provided in case of loss, in a financial year.

(ICAI Study Material)

Sol. False: Depreciation is an expense that is deducted from revenue to calculate profit. Hence, it must be accounted for, even in instances where a financial year results in a loss.

10. Providing for depreciation also helps in providing for accumulation of funds to facilitate

the replacement at the end of its useful life.

(ICAI Study Material)

Sol. True: Depreciation, as a non-cash expense, lowers the amount of profits available for distribution, which, in turn, helps accumulate funds for asset replacement when necessary

11. If the equipment account has a balance of Rs 12,50,000 and the accumulated depreciation account has a balance of Rs 4,00,000, the written down value of same shall be ₹16,50,000.

(ICAI Study Material)

Sol. False: WDV will be = ₹8,50,000 (₹12,50,000 – ₹4,00,000)

12. Sum of the years digit method is an example of an accelerated method of charging depreciation.

(ICAI Study Material)

Sol. True: The sum of the years digit method results in a higher depreciation charge during the initial years.

13. Over the life of an asset subject to depreciation, the accelerated method will result in less Depreciation Expense in early years and more depreciation in later years of its life.

(ICAI Study Material)

Sol. False: Conversely, in the diminishing balance method, higher depreciation is applied in the initial years.

14. While depreciating land cost, Straight line method shall give more depreciation than the written down value.

(ICAI Study Material)

Sol. False: Land is not a depreciable asset.

15. Provision for depreciation account is debited at the time of recording the depreciation on an asset.

(ICAI Study Material)

Sol. False: The Provision for Depreciation account is attributed with a credit entry during the depreciation charge.

16. If adequate maintenance expenditure is incurred with relation to running repairs of an asset, we need not charge any depreciation.

(ICAI Study Material)

Sol. False: Depreciation entails distributing the asset's cost over its anticipated useful life. Routine maintenance and repairs, which may be necessary throughout its lifespan, are treated as expenses, and depreciation is applied regardless.

17. When a property, plant or equipment is sold then provision for depreciation account is debited, asset account is credited and any gain or loss is recorded to profit and loss account.

(ICAI Study Material)

Sol. True: When selling an asset, the respective asset account is credited, the provision for depreciation account is debited, and any resulting gain or loss is charged to the profit & loss account.

18. While calculating the depreciation as per diminishing balance method, the salvage value of the asset at the end of its life is reduced from its cost.

(ICAI Study Material)

Sol. False: Under the diminishing balance method, salvage value is not considered initially, as it assumes that at the end of the asset's life, the remaining value shall be its salvage value.

19. Any change in the estimated useful life of an asset should be accounted for as a change

in an accounting estimate in accordance with Accounting Standards.

(ICAI Study Material)

Sol. True: Any change in the useful life of an asset is accounted for as a change in estimate

20. An intangible asset is a non identifiable, non monetary asset.

(ICAI Study Material)

Sol. False: An intangible asset is an identifiable non-monetary asset used in the production and supply of goods and services

21. Land can be considered as an asset subject to depreciation.

Sol. False: Land is ineligible for depreciation under AS-10, as it does not meet the criteria for depreciation.

22. Depreciation, like regular expenses, involves a cash outflow.

Sol. False: Depreciation is considered a non-cash cost since it does not entail any actual cash disbursement.

23. Depreciation is an expense that is systematically allocated over time.

Sol. True: Depreciation is applied to the fixed asset's value throughout its useful life, allowing the gradual amortization of any initial capital investment over that period.

24. Depreciation cannot be recorded during a financial year if the company incurs a loss.

Sol. False: Depreciation is an expense deducted from profit, and it must be accounted for in the financial year of the business, regardless of whether there is a profit or a loss.

25. The depreciable amount is the variance between the asset's historical cost and its market value.

Sol. False: The depreciable amount is calculated as the historical cost minus the salvage value.

26. Depreciation represents a non-cash cost and does not lead to any cash disbursement.

Sol. True: Depreciation is a non-cash expenditure that does not involve any cash outflow within the business.

MULTIPLE CHOICE QUESTIONS

1. Original cost = Rs 12,60,000; Salvage value = Nil; Useful life = 6 years. Depreciation for the first year under sum of years digits method will be

(ICAI Study Material)

(a) Rs 3,60,000

(b) Rs 1,20,000

(c) Rs 1,80,000

(d) None of the above

Sol. (a) Rs 3,60,000

2. Obsolescence of a depreciable asset may be caused by:

I. Technological changes.

II. Improvement in production method.

III. Change in market demand for the product or service output.

IV. Legal or other restrictions.

(ICAI Study Material)

- (a) Only (I) above (b) Both (I) and (II) above
(c) All (I), (II), (III) and (IV) above (d) None of the above

Sol. (c) All (I), (II), (III) and (IV) above

3. The number of productions of similar units expected to be obtained from the use of an asset by an enterprise is called as

(ICAI Study Material)

- (a) Unit life (b) Useful life
(c) Production life (d) None of the above

Sol. (b) Useful life

4. If a concern proposes to discontinue its business from March 2018 and decides to dispose of all its plants within a period of 4 months, the Balance Sheet as on March 31, 2018 should indicate the plants at their

(ICAI Study Material)

- (a) Historical cost (b) Net realizable value
(c) Cost less depreciation (d) None of the above

Sol. (b) Net realizable value

5. In the case of downward revaluation of a plant which is for the first time revalued, the account to be debited is

(ICAI Study Material)

- (a) Plant account (b) Revaluation Reserve
(c) Profit & Loss account (d) None of the above

Sol. (c) Profit & Loss account

6. The portion of the acquisition cost of the tangible asset, yet to be allocated is known as

(ICAI Study Material)

- (a) Written down value (b) Accumulated value
(c) Realisable value (d) None of the above

Sol. (a) Written down value

7. The main objective of providing depreciation is to

(ICAI Study Material)

- (a) Create secret reserve (b) Reduce the book value of assets
(c) Allocate cost of the assets (d) None of the above

Sol. (c) Allocate cost of the assets

8. Original cost of a machine was Rs 25,20,000 salvage value was Rs 1,20,000, useful life was 6 years. Annual depreciation under Straight Line Method

(ICAI Study Material)

- (a) ₹4,20,000 (b) ₹4,00,000
(c) ₹3,00,000 (d) None of the above

Sol. (b) ₹4,00,000

9. The cost of a machine is Rs 20,00,000. Two years later the book value is Rs 10,00,000. The Straight-line percentage depreciation is

(ICAI Study Material)

- (a) 50% (b) 33-1/3%
(c) 25% (d) None of the above

Sol. (c) 25%

10. A machinery with original cost of Rs 10,00,000 and Nil Salvage value acquired on 1st April 2019 with 4 years useful life was depreciated using Straight Line Method. It was decided to sell the machinery on 1st October 2021 for Rs 1,20,000. What shall be the gain or (loss) on the sale of Machinery?

(ICAI Study Material)

- (a) Loss of Rs 1,30,000 (b) Gain of Rs 1,20,000
(c) Loss of Rs 5,000 (d) None of the above

Sol (c) Loss of Rs 5,000

11. Which of the following assets does not depreciate?

- (a) Machinery and equipment (b) Patents
(c) Land (d) None of the above

Sol. (c) Land

12. A company purchased a machinery on April 01, 2017, for Rs 15,00,000. It is estimated that the machinery will have a useful life of 5 years after which it will have no salvage value. The depreciation charged during the year 2021-22 was

- (a) ₹5,00,000 (b) ₹4,00,000
(c) ₹3,00,000 (d) None of the above

Sol. (c) ₹3,00,000

13. If the equipment account has a balance of Rs 22,50,000 and the accumulated depreciation account has a balance of Rs 14,00,000, the book value of the equipment is

- (a) ₹36,50,000 (b) ₹8,50,000
(c) ₹14,00,000 (d) None of the above

Sol. (b) ₹8,50,000

14. A plant with original cost of Rs 50,00,000 was revalued after 2 years resulting in credit to Revaluation Surplus account of Rs 4,00,000. Towards the year end of 2019-20, due to COVID-19 the plant value had gone down by Rs 5,00,000 and accordingly management decided to revalue the same. What shall be the impact of this downwards revaluation on the Profit & Loss Account?

- (a) Debit of Rs 5,00,000

- (b) Debit of Rs 1,00,000
- (c) Credit of Rs 5,00,000
- (d) None of the above

Sol. (b)

15. In respect of intangible assets, there is a presumption that the useful life of an intangible asset will not exceed

- (a) 2 years
- (b) 3 years
- (c) 10 years
- (d) None of the above

Sol. (c)

16. A company developed a technology to enhance the battery life of mobile phones. The cost of development have been capitalized as an intangible asset at 5,00,000. The company estimates the life of the technology developed to be 3 years. The company has forecasted that 50% of sales will be in year 1, 35% in year 2 and 15% in year 3. What should be the amortisation charge in third year?

- (a) 2,50,000
- (b) 75,000
- (c) 1,75,000
- (d) None of the above

Sol. (b)

17. An intangible asset is an asset

- (a) with no physical existence
- (b) generated internally by the business
- (c) cannot be sold
- (d) None of the above

Sol. (a)

THEORETICAL QUESTIONS

1. Distinguish between Straight line method of depreciation and Written down value method of depreciation.

Sol. The straight-line depreciation method evenly allocates depreciation expenses over the entire useful life of a depreciable tangible asset, ultimately reducing its book value to zero or its salvage value. In contrast, the reducing balance method applies a fixed percentage to the diminishing asset balance each year to reach its salvage value by the end of its useful life. The key differences between these methods are as follows:

1. The straight-line method maintains a consistent annual depreciation expense, while the reducing balance method reduces depreciation charges over time as the asset ages.
2. Under the straight-line method, it's possible to fully depreciate the asset, but with the reducing balance method, the asset can never reach a fully depreciated state.
3. In the straight-line method, depreciation expenses remain constant, while repair costs increase as the asset ages, resulting in non-uniform total expenses throughout the

asset's life. Conversely, the reducing balance method starts with higher depreciation charges in the initial years, generally accompanied by lower repair expenses. As the asset ages, depreciation charges decrease, while repair expenses increase, leading to a more balanced distribution of costs throughout the asset's life.

2. Write short note on Depletion method of depreciation

Sol. Natural resources includes tangible assets such as mineral deposits, oil and gas reserves, and timber. These resources diminish as they are utilized. The calculation of depletion per unit is determined by the following formula:

$$\frac{\text{Acquisition cost} - \text{residual Value}}{\text{Estimate life in terms of production units}}$$

3. What factors are considered for calculation of depreciation of a plant?

(ICAI Study Material)

Sol. The elements taken into account in the depreciation calculation encompass:

- (i) The total cost of the asset, which includes installation, commissioning, and trial run expenses.
- (ii) The estimated useful lifespan of the asset.
- (iii) The projected scrap value, if applicable, at the conclusion of the asset's useful life.

□□□

PRACTICAL QUESTIONS

1. A company purchased a machinery for ₹1,30,000 on 1st April, 2019 and paid ₹20,000 for freight & installation charges. On 1st October, 2021 another machine was purchased for ₹50,000 and sold old machinery for ₹1,00,000. The machine purchased on 1st October, 2021 was installed on 1st January, 2022.

Under existing practice, the company is charging depreciation @ 20% p.a. on the original cost. However, from 1st April, 2021 it decided to adopt WDV method and charge depreciation @15% p.a. You are required to prepare Machinery A/c from 1st April, 2019 to 31st March, 2022. [Dec. 2022, 4 Marks]

Sol.

Machinery A/c

Date	Particulars	Amount	Date	Particulars	Amount
1.4.2019	To Bank A/c-(M1)	1,30,000	31.3.2020	By Depn. A/c-(M1)	30,000
	To Bank A/c-(M1)	20,000		By Balance c/d-(M1)	1,20,000
	Total	1,50,000		Total	1,50,000
1.4.2020	To Bal. b/d-(M1)	1,20,000	31.3.2021	By Depn. A/c-(M1)	30,000
				By Balance c/d-(M1)	90,000
	Total	1,20,000		Total	1,20,000
1.4.2021	To Bal. b/d-(M1)	90,000	1.10.2021	By Depn. A/c -(M1)	6,750
1.10.2021	To P&L A/c (Profit)	16,750		By Bank A/c	1,00,000
1.01.2022	To Bank A/c -(M2)	50,000		(sale) -(M1)	
			31.3.2022	By Depn. A/c-(M2)	1,875
				By Balance c/d-(M2)	48,125
	Total	1,56,750		Total	1,56,750

Working Note:

I Machinery	₹	II Machinery	₹
1st April 2019	1,50,000	1st Jan, 2022	50,000
Less: Depreciation @ 20%		Less Depreciation @ 15%	

On 31st Mar. 2020	(30,000)	On 31st Mar 2021	(1,875)
1st April 2020	1,20,000	Balance on 31st Mar, 2022	₹48,125
Less Depreciation @ 20%			
On 31st Mar 2021	(30,000)		
1st April 2021	90,000		
Less Depreciation @ 15%			
On 1st Oct, 2021	(6,750)		
	₹83,250		
Less: Sold	1,00,000		
Profit on sale	₹16,750		

*Machinery purchased on 1 Oct. 2021 was put in use on 1 Jan, 2022 so depreciation has been charged from this date only.

2. A firm purchased second hand machinery on 1st January, 2019 for ₹3,00,000, subsequent to which ₹60,000 and ₹40,000 were spent on its repairs and installation, respectively. On 1st July, 2020 another machinery was purchased for ₹2,60,000. On 1st July, 2021, the first machinery having become outdated was auctioned for ₹3,20,000 and on the same date, another machinery was purchased for ₹2,50,000.

On 1st July, 2022, the second machinery was also sold off and it fetched ₹2,30,000.

Depreciation was provided on machinery @ 10% on the original cost annually on 31st December, under the straight line method.

Required:

Prepare the following A/cs in the books of the company: (i) Machinery A/c for the years ending Dec. 31, 2019 to 2022 and (ii) Machinery Disposal A/c. (ICAI Study Material)

Sol.

Machinery A/c					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.01.2019	To Bank A/c (A)	3,00,000	31.12.2019	By Depn. (A)	40,000
	– Cost			By Balance c/d (A)	3,60,000
	– Repairs	60,000			
	– Installation	40,000			
		4,00,000			4,00,000
01.01.2020	To Balance b/d	3,60,000	31.12.2020	By Depn.	
				(A) 40,000	
				(B) <u>13,000</u>	53,000
01.07.2020	To Bank A/c (B)	2,60,000		By Balance c/d	
				(A) 3,20,000	
				(B) <u>2,47,000</u>	5,67,000
		6,20,000			6,20,000

01.01.2021	To Balance b/d	5,67,000	01.07.2021	By Machinery Disposal A/c (A)	3,00,000
01.07.2021	To Bank A/c (C)	2,50,000		By Depn. A/c (A) 20,000	
				(B) 26,000	
				(C) <u>12,500</u>	58,500
				By Balance c/d (B) 2,21,000	
				(C) <u>2,37,500</u>	4,58,500
		8,17,000			8,17,000
01.01.2022	To Balance b/d	4,58,500	01.07.2022	By Machinery Disposal A/c (B)	2,08,000
				By Depn. A/c (B) 13,000	
				(C) <u>25,000</u>	38,000
				By Balance c/d	2,12,500
		4,58,500			4,58,500

Machinery Disposal A/c

Date	Particulars	₹	Date	Particulars	₹
01.07.2021	To Machinery A/c (A)	3,00,000	01.07.2021	By Bank A/c	3,20,000
	To Profit Loss A/c (Profit)	20,000			
		3,20,000			3,20,000
01.07.2022	To Machinery A/c (B)	2,08,000	01.07.2022	By Bank A/c	2,30,000
	To P & L A/c (Profit)	22,000			
		2,30,000			2,30,000

3. The LG Transport company purchased 10 trucks at ₹45,00,000 each on 1st April 2019. On October 1st, 2021, one of the trucks is involved in an accident and is completely destroyed and ₹27,00,000 is received from the insurance in full settlement. On the same date another truck is purchased by the company for the sum of ₹50,00,000. The company write off 20% on the original cost per annum. The company observe the calendar year as its financial year.

Give the motor truck A/c for two year ending 31 Dec, 2022. (ICAI Study Material)

Sol.

Date	Particulars	Amount	Date	Particulars	Amount
2021			2021		
Jan-01	To balance b/d	2,92,50,000	Oct-01	By bank A/c	27,00,000
Oct-01	To Profit & Loss A/c (Profit on settlement of Truck)	4,50,000	Oct-01	By Depn. on lost assets	6,75,000
Oct-01	To Bank A/c	50,00,000	Dec-31	By Depn. A/c	83,50,000
		3,47,00,000	Dec-31	By balance c/d	2,29,75,000
					3,47,00,000
2022			2022		
Jan-01	To balance b/d	2,29,75,000	Dec-31	By Depn. A/c	91,00,000
		2,29,75,000	Dec-31	By balance c/d	1,38,75,000
					2,29,75,000

Working Note:

- Profit on settlement of truck

	₹
Original cost as on 1.4.2019	45,00,000
Less: Depn. for 2019	(6,75,000)
	38,25,000
Less: Depn. for 2020	(9,00,000)
	29,25,000
Less: Depn. for 2021 (9 months)	(6,75,000)
	22,50,000
Less: Amount received from Insurance company	(27,00,000)
	4,50,000

- The Machinery A/c of a Factory showed a balance of ₹19,00,000 on 1st January, 2022. Its A/cs were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.

On 1st June 2022, a new machinery was acquired at a cost of ₹2,80,000 and installation charges incurred in erecting the machine works out to ₹8,920 on the same date. On 1st June, 2022 a machine which had cost ₹4,37,400 on 1st January 2020 was sold for

₹75,000. Another machine which had cost ₹4,37,000 on 1st January, 2021 was scrapped on the same date and it realised nothing.

Write a machinery A/c for the year 2022, allowing the same rate of depreciation as in the past, calculating depreciation to the nearest multiple of a Rupee.

Sol.

Plant and Machinery A/c

		₹			₹
2022			2022		
Jan. 1	To Balance b/d	19,00,000	June 1	By Bank (Sales)	75,000
June. 1	To Bank (2,80,000 + 8,920)	2,88,920		By Depn. (on sold machine)	14,762
				By Loss on sale	2,64,532
				By Loss on scrapping the machine	3,76,912
				By Depn. (on scrapped machinery)	16,388
				By Depn. (Note iii)	1,32,094
				By Balance c/d	13,09,232
		21,88,920			21,88,920

Working Note:

(i) Calculation of loss on sale of machine on 1-6-2022		₹
Cost on 1-1-2020		4,37,400
Less: Depreciation @ 10% on ₹4,37,400		(43,740)
W.D.V. on 31-12-2020		3,93,660
Less: Depreciation @ 10% on ₹3,93,660		(39,366)
W.D.V. on 31-12-2021		3,54,294
Less: Depreciation @ 10% on ₹3,54,294 for 5 months		(14,762)
		3,39,532
Less: Sale proceeds on 1-6-2022		(75,000)
Loss		2,64,532
(ii) Calculation of loss on scrapped machine		₹
Cost on 1-1-2021		4,37,000
Less: Depreciation @ 10% on ₹4,37,000		(43,700)
W.D.V. on 1-1-2022		3,93,300
Less: Depreciation @ 10% on ₹3,93,300 for 5 months		(16,388)
Loss		3,76,912
(iii) Depreciation		
Balance of machinery A/c on 1-1-2022		19,00,000
Less : W.D.V of machinery sold	3,54,294	

W.D.V. of machinery scrapped	3,93,300	(7,47,594)
W.D.V. of other machinery on 1-1-2022		11,52,406
Depreciation @ 10% on ₹11,52,406 for 12 months		1,15,240
Depreciation @ 10% on ₹2,88,920 for 7 months		16,854
		1,32,094

5. A firm's plant and machinery A/c at 31st December, 2021 and the corresponding depreciation provision A/c, broken down by year of purchase are as follows:

Year of Purchase	Plant and Machinery at cost ₹	Depn. Provision ₹
2005	2,00,000	2,00,000
2011	3,00,000	3,00,000
2012	10,00,000	9,50,000
2013	7,00,000	5,95,000
2020	5,00,000	75,000
2021	3,00,000	15,000
	30,00,000	21,35,000

Depreciation is at the rate of 10% per annum on cost. It is the Company's policy to assume that all purchases, sales or disposal of plant occurred on 30th June in the relevant year for the purpose of calculating depreciation, irrespective of the precise date on which these events occurred.

During 2022 the following transactions took place:

1. Purchase of plant and machinery amounted to ₹15,00,000
2. Plant that had been bought in 2011 for ₹170,000 was scrapped.
3. Plant that had been bought in 2012 for ₹90,000 was sold for ₹5,000.
4. Plant that had been bought in 2013 for ₹2,40,000 was sold for ₹15,000.

You are required to:

Calculate the provision for depreciation of plant and machinery for the year ended 31st December, 2022. In calculating this provision you should bear in mind that it is the company's policy to show any profit or loss on the sale or disposal of plant as a completely separate item in the Profit and Loss A/c. You are also required to prepare the following ledger A/cs during 2022.

- (i) Plant and machinery at cost;
- (ii) Depreciation provision;
- (iii) Sales or disposal of plant and machinery.

(ICAI Study Material)

Sol. Calculation of provision for depreciation of plant and machinery for the year ended 31st December,

2022.

Plant purchased in		₹	₹
2005		nil	
2011		nil	
2012			50,000
2013	1/2 year at 10% on ₹2,40,000	12,000	
	1 year at 10% on ₹4,60,000	46,000	58,000
2020	10% on ₹5,00,000		50,000
2021	10% on ₹3,00,000		30,000
2022	1/2 year at 10% on ₹15,00,000		75,000
			2,63,000

Plant and Machinery A/c (for 2022) at Cost

	₹		₹
To Balance b/d	30,00,000	By Disposals A/c:	
To Bank A/c	15,00,000	Scrapped	1,70,000
		Sold	3,30,000
		By Balance c/d	40,00,000
	45,00,000		45,00,000

Depreciation Provision A/c (for 2022)

		₹		₹
To Disposal A/c			By Balance b/d	21,35,000
Scrapped - 2011 assets	1,70,000		By Profit and Loss A/c	2,63,000
Sold - 2012 assets	90,000			
Sold - 2013 assets	2,16,000	4,76,000		
To Balance c/d		19,22,000		
		23,98,000		23,98,000

Disposal A/c (for 2022)

	₹		₹
To Plant and Machinery:		By Provision for Depn.	4,76,000
Scrapped	1,70,000	By Cash-Sales Proceeds	20,000
Sold	3,30,000	By Loss on sales	4,000

5,00,000

5,00,000

6. On 1.1.2020 machinery was purchased for ₹40,000. On 1.7.2021 addition were made to the amount of ₹20,000. On 31.3.2022 machine purchased on 1.7.2021 costing ₹6,000 was sold for ₹5,500 & on 30.6.2022 machinery purchased on 1.1.2020 costing ₹16,000 was sold for ₹13,350. On 1.10.2022 addition were made to the amount of ₹10,000.

Show Machinery A/c, Depreciation provision A/c, and Asset disposal A/c for 3 years 2020, 2021, 2022. Depreciate Machinery at 10% p.a. by W.D.V. method

Sol.

Machinery A/c

Date	Particulars	₹	Date	Particulars	₹
1.1.2020	To Bank A/c	40,000	31.12.2020	By Balance c/d	40,000
		40,000			40,000
1.1.2021	To Balance b/d	40,000	31.12.2021	By Balance c/d	60,000
1.7.2021	To Bank A/c	20,000			60,000
		60,000			60,000
1.1.2022	To Balance b/d	60,000	31.3.2022	By Asset disposal A/c	6,000
1.10.2022	To Bank A/c	10,000	30.6.2022	By Asset disposal A/c	16,000
			31.12.2022	By Balance c/d	48,000
		70,000			70,000

Provision for Depreciation A/c (WDV 10%)

Date	Particulars	₹	Date	Particulars	₹
31.12.2020	To Balance c/d	4,000	31.12.2020	By Depn. A/c	4,000
		4,000			4,000
31.3.2022	To Balance c/d	8,600	1.1.2021	By Balance b/d	4,000
		8,600	31.12.2021	By Depn. A/c	4,600
31.12.2021	To Asset disposal A/c	300			8,600
30.6.2022	To Asset disposal A/c	3040	1.1.2022	By balance b/d	8,600
31.12.2022	To Balance c/d	8,784	31.12.2022	By Depn. A/c	3,524
		12,124			12,124

Depreciation A/c

Date	Particulars	₹	Date	Particulars	₹
31.12.2020	To Depn. provision A/c	4,000	31.12.2020	By P&L A/c	4,000
		4,000			4,000

31.12.2021	To Depn. provision A/c	4,600	31.12.2021	By P&L A/c	4,600
		4,600			4,600
31.3.2022	To Asset disposal A/c	142	31.12.2022	By P&L A/c	4,314
30.6.2022	To Asset disposal A/c	648			
31.12.2022	To Depn. provision A/c	3,524			
		4,314			4,314

Asset Disposal A/c

Date	Particulars	₹	Date	Particulars	₹
31.3.2022	To Machinery A/c	6,000	31.12.2022	By Bank A/c (sale)	5,500
				By Depn. provision A/c	300
				By Depn. A/c	142
				By P&L A/c (loss)	58
30.6.2022	To Machinery A/c	16,000	30.6.2022	By Bank A/c (sale)	13,350
30.6.2022	To P&L A/c	1,038		By Depn. provision A/c	3,040
				By Depn. A/c	648
		23,038			23,038

- ❑ Depreciation upto the date of disposal is directly credited to asset disposal A/c alternatively it can be routed through depreciation provision A/c.
- ❑ Similarly asset sold can be A/c'd through asset Disposal A/c in earlier Question also

Working notes:

(1) Sold on 31.3.2022			(2) Sold on 30.6.2022			(3) Depreciation on 31.12.2022	
1.7.2021	Cost	6000	1.1.2020	Cost	1600.0	Balance of old machine on 1.1.2022	51400
31.12.2021	Depreciation	300	31.12.2020	Depreciation	1600	(-) sold	5700
1.1.2022	Balance	5700	1.1.2021	Balance	14400	(-) sold	12960
31.3.2022	Depreciation	142	31.12.2021	Depreciation	1440		
31.3.2022	Balance	5,558	1.1.2022	Balance	12960	Balance	32740
	Sold' for	5,500	30.6.2022	Depreciation	648	Depreciation @10%	3274
	Loss	58		Balance	12312	On new machine	250

				Sold for	13350	$10,000 \times 10 \div 100 \times 3 \div 12$	
				Profit	1038		3524

7. Shobhit purchased a machinery on 1st January 2017 for ₹4,80,000 and spent ₹20,000 on its installation. On July 1, 2017 another machinery costing ₹2,00,000 was purchased. On 1st July, 2018 the machinery purchased on 1st January, 2017 having become scrapped and was sold for ₹2,90,000 and on the same date fresh machinery was purchased for ₹5,00,000. Depreciation is provided annually on 31st December at the rate of 10% p.a. on written down value. Prepare Machinery A/c for the years 2017 and 2018. [Nov. 2019, 4 Marks]

Sol.

Machinery A/c

Date 2017	Particulars	Amount ₹	Date 2017	Particulars	Amount ₹
Jan 1	To Bank A/c(I)	4,80,000	31 Dec.	By Depreciation	
	To Bank A/c	20,000		I 50,000	
	(I) - Installation charges			II 10,000	60,000
July 1	To Bank A/c(II)	2,00,000	31 Dec.	By Balance c/d	
				I 4,50,000	
				II 1,90,000	6,40,000
	Total	7,00,000		Total	7,00,000
2018			2018		
1 Jan.	By Balance c/d		1 July	By Depreciation (I)	22,500
	I 4,50,000			By Bank A/c	2,90,000
	II 1,90,000	6,40,000		By Profit & Loss	1,37,500
				A/c(Loss)	
1 July	To Bank A/c (III)	5,00,000	31 Dec.	By Depreciation	
				I 19,000	44,000
				III 25,000	
			31 Dec.	By Balance c/d	
				I 1,71,000	6,46,000
				III 4,75,000	
	Total	11,40,000		Total	11,40,000

Working Note:

Format II (i.e. Direct Calculation - Pros: Time Effective, Cons: High Accuracy Needed)

I		II		III	
Year	Amount ₹	Year	Amount ₹	Year	Amount ₹
1 Jan. 2017	5,00,000	1 July. 2017	2,00,000	1 July 2018	5,00,000
31 Dec. 2017	-50,000	31 Dec. 2017	-10,000	31 Dec. 2018	-25,000

1 Jan. 2018	4,50,000	1 Jan. 2018	1,90,000		
1 July 2018	-22,500	31 Dec. 2018	-19,000		
Sold	4,27,500	Balance	1,71,000	Balance	4,75,000
	2,90,000				
(Loss)	1,37,500				

8. On 1st January, 2019 a firm purchased a Bus for ₹8,00,000. On 1st July, 2020 this bus was damaged due to fire and was completely destroyed and ₹6,00,000 were received by a cheque from the Insurance Company in full settlement on 1st October, 2020. On 1st July, 2020 another Bus was purchased by the firm for ₹10,00,000.

The firm charges Depreciation @ 20% per annum under the WDV Method. Calculate the amount of depreciation for the year ended 31st March, 2021 and gain or loss on the destroyed Bus.
[Dec. 2021, 5 Marks]

Sol.

Calculation of Depreciation on Buses

(i) On 1st Bus	₹
Cost on 1.1.2019	8,00,000
Less: Depreciation @ 20% upto 31.3.2019	40,000
WDV as on 31.03.2019 or WDV as on 1.4.2019	7,60,000
Less: Depreciation @ 20% upto 31.3.2020	1,52,000
WDV as on 31.03.2020 or WDV as on 1.4.2020	6,08,000
Less: Depreciation @ 20% upto 1.7.2020 for 3 months	30,400
WDV as on 1.7.2020 on date of Accident	5,77,600
Claim Recd. from Insurance Company	6,00,000
Gain Due to Accident of Bus	22,400
Cost On 1st July, 2020 on New Bus	10,00,000
Less: Depreciation @ 20% for 9 months	1,50,000
WDV as on 31.3.2021	8,50,000

Total Depreciation for the year ended 31st March, 2021 = 30,400 + 1,50,000 i.e ₹1,80,400

9. Jain Bros. acquired a machine on 1st July, 2021 at a cost of ₹14,00,000 and spent ₹1,00,000 on its installation. The firm writes off depreciation at 10% p.a. every year. The books are closed on 31st December every year.

Required:

Show the Machinery A/c on diminishing balance method for the year 2021 and 2022.

(ICAI Study Material)

Sol. As per Reducing Balance Method

Machinery A/c

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
July 1	To Bank A/c	14,00,000	Dec. 31	By Depn. A/c	75,000
July 1	To Bank A/c - Installation Expenses	1,00,000		(₹15,00,000 x 10% x 6/12) for 6 months	
			Dec. 31	By Balance c/d	14,25,000
		15,00,000			15,00,000
2022			2022		
Jan. 1	To Balance b/d	14,25,000	Dec. 31	By Depn. A/c	1,42,500
				(₹14,25,000 x 10%)	
			Dec. 31	By Balance c/d	12,82,500
		14,25,000			14,25,000

10. On 1.1.2020 machinery was purchased for ₹40,000. On 1.7.2021 addition were made to the amount of ₹20,000. On 31.3.2022 machine purchased on 1.7.2021 costing ₹6,000 was sold for ₹5,500 & on 30.6.2022 machinery purchased on 1.1.2020 costing ₹16,000 was sold for ₹13,350. On 1.10.2022 addition were made to the amount of ₹10,000.

Show Machinery A/c & Depreciation A/c for 3 years 2020, 2021, 2022. Depreciate Machinery at 10% p.a. by S.L.M.

Sol.

Machinery A/c (SLM 10%)

Date	Particulars	₹	Date	Particular	₹
1.1.2020	To Bank A/c	40,000	31.12.2020	By Depn. A/c	4,000
				By Balance c/d	36,000
		40,000			40,000
1.1.2021	To Balance b/d	36,000	31.12.2021	By Depn. A/c	5,000
1.7.2021	To Bank A/c	20,000		(4000 + 1000)	
		56,000		By Balance c/d	51,000
					56,000
1.1.2022	To Balance b/d	51,000	31.3.2022	By Bank A/c	5,500
30.6.2022	To Profit on sale of Machinery A/c	1,350		By Depn. A/c	150
1.10.2022	To Bank A/c	10,000		By Loss on sale of Machinery A/c	50
			30.6.2022	By Bank A/c	13,350
				By Depn. A/c	800

			By Depn. A/c (3800 + 250)	4050
			By Balance c/d	38,450
		62,350		62,350

Depreciation A/c

Date	Particulars	₹	Date	Particulars	₹
31.12.2020	To Machinery A/c	4,000	31.12.2020	By P&L A/c	4,000
		4,000			4,000
31.12.2021	To Machinery A/c	5,000	31.12.2021	By P&L A/c	5,000
		5,000			5,000
31.3.2022	To Machinery A/c	150	21.3.2022	By P&L A/c	5,000
30.6.2022	To Machinery A/c	800			
31.12.2022	To Machinery A/c	4,050			
		5,000			5,000

Working notes

(1) Sold on 31.3.2022			(2) Sold on 30.6 .2022		
1.7.2021	Cost	6,000	1.1.2020	Cost	16000
31.12.2021	Depreciation	300	31.12.2020	Depreciation	1600
1.1.2022	Balance	5,700	1.1.2021	Balance	14400
31.3.2022	Depreciation	150	31.12.2021	Depreciation	1600
31.3.2022	Balance	5,550	1.1.2022	Balance	12800
	Sold' for	5,500	30.6.2022	Depreciation	800
	Loss	50		Balance	12000
				Sold for	13350
				Profit	1350

(3) Deprecation on 31.12.2022

Original cost of remaining old machine	
40,000 - 16,000 =	24,000
20,000 - 6,000 =	14,000
	38,000
Depreciation @10%	3,800
One new machine	
10,000 × 10 ÷ 100 × 3 ÷ 12	250
	4050

11. On 1st January, 2020 Shankar purchased 6 machines for ₹7500 each. His Accounting year ends on 31st December. Depreciation at the rate of 10% on initial cost has been charged to profit and loss A/c and credited to a separate depreciation provision A/c.

On 1st January, 2021 one machine was sold for ₹6,250 and on 1st January, 2022 a second machine was sold for ₹6,250. An improved model which cost ₹14,000 was purchased on 1st July, 2021. The same rate of depreciation was decided for the new machine was well. You are required to show:

1. The asset A/c
2. The asset disposal A/c
3. The depreciation provision A/c.

Sol.

Ledger of Shankar

Dr.			Machinery A/c			Cr.		
Date	Particulars		₹	Date	Particulars		₹	
2020	To Bank A/c		45,000	2020	By Balance c/d		45,000	
Jan 1			45,000	Dec. 31			45,000	
2021	To Balance b/d		45,000	2021	By Machinery disposal A/c		7,500	
Jan 1	To Bank A/c		14,000	Jan. 1	By Balance c/d		51,500	
July 1			59,000	Dec. 31			59,000	
2022	To Balance b/d		51,500	2022	By Machinery disposal A/c		7,500	
Jan 1				Jan. 1	By Balance c/d		44,000	
			51,500	Dec. 31			51,500	

Note: The balance in the asset A/c at any time represents the cost of assets retained by the firm.

Machinery Disposal A/c

Date	Particulars	₹	2021	Particulars	₹
2021 Jan. 1	To Machinery A/c	7,500	2021 Jan. 31	By provision for Depn. A/c	750
			2021 Jan. 1	By Bank A/c	6,250
				By Profit and loss A/c (loss)	500
		7,500			7,500
		₹			₹
2022 Jan. 1	To Machinery A/c	7,500	2022 Jan. 1	By Provision for Depn. A/c	1,500
	To P&L A/c (profit)	250		By Bank A/c	6,250
		7,750	2022 Jan. 1		7,750

Note: Machinery disposal A/c is not a continuous A/c like machinery A/c. It must be prepared separately for each year.

Dr. Provision for Depreciation A/c (SLM 10%)			Cr.		
Date	Particulars	₹	Date	Particulars	₹
2020	To Balance c/d	4,500	2020	By Depn. A/c	4,500
Dec. 1		4,500	Dec. 31		4,500
2021	To Machinery disposal A/c (transfer)	750	2021	By Balance b/d	4,500
Jan 1			Jan. 1		
	To Balance c/d	8,200		By Depn. A/c (3750 + 700)	4,450
Jan 1		8,950	Dec. 31		8,950
2022	To Machinery disposal A/c transfer	1,500	2022	By Balance b/d	8,200
Jan 1			Jan. 1	By Depn. A/c (3000 + 1400)	4,400
	To Balance c/d	11,100	Dec. 31		
Dec. 31		12,600			12,600

Note: The balance in the provision A/c at any time shows the balance of accumulated depreciation in respect of retained assets.

	₹
Depreciation for 2021	
(1) On ₹37,500 (₹45,000 – ₹7,500) @ 10% per annum	3,750
On ₹14,000 @ 10% p.a. for 6 months	700
	4,450
Depreciation for the year 2022	
(2) On ₹30,000 (₹37,500 – ₹7,500) @ 10% p.a.	3,000
On ₹14,000 @ 10% p.a. for one year	1,400
	4,400

12. A firm purchased on 1st January, 2020 certain machinery for ₹5,82,000 and spent ₹18,000 on its erection. On July 1, 2020 another machinery for ₹2,00,000 was acquired. On 1st July, 2021 the machinery purchased on 1st January, 2020 having become obsolete was auctioned for ₹3,86,000 and on the same date fresh machinery was purchased at a cost of ₹4,00,000.

Depreciation was provided for annually on 31st December at the rate of 10 per cent p.a. on written down value.

Required Prepare machinery A/c.

(ICAI Study Material)

Sol.

Machinery A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2020			2020		
Jan. 1	To Bank A/c	5,82,000	Dec. 31	By Depn. A/c	70,000
Jan. 1	To Bank A/c – erection charges	18,000		By Balance c/d	7,30,000
July 1	To Bank A/c	2,00,000			
		8,00,000			8,00,000
2021			2021		
Jan. 1	To Balance b/d	7,30,000	July 1	By Depn. on sold machine	27,000
July 1	To Bank A/c	4,00,000		By Bank A/c	3,86,000
				By Profit and Loss A/c	1,27,000
			Dec. 31	By Depn. A/c	39,000
				By Balance c/d	5,51,000
		11,30,000			11,30,000

Working Note:-

Book Value of Machines

	Machine I ₹	Machine II ₹	Machine III ₹
Cost	6,00,000	2,00,000	4,00,000
Depreciation for 2020	(60,000)	(10,000)	
Written down value	5,40,000	1,90,000	
Depreciation for 2021	(27,000)	(19,000)	(20,000)
Written down value	5,13,000	1,71,000	3,80,000
Sale Proceeds	(3,86,000)		
Loss on Sale	1,27,000		

13. A machine of cost ₹12,00,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by ₹60,000 the remaining useful life was reassessed at 9 years.

(ICAI Study Material)

Required:

Calculate depreciation for the fourth year.

Sol. Depreciation per year charged for three years = ₹12,00,000 / 10 = ₹1,20,000

WDV of the machine at the end of third year = ₹12,00,000 – ₹1,20,000 × 3 = ₹8,40,000.

Depreciable amount after revaluation = ₹8,40,000 + ₹60,000 = ₹9,00,000

Remaining useful life as per previous estimate = 7 years Remaining useful life as per revised estimate = 9 years

Depreciation for the fourth year onwards = ₹9,00,000 / 9 = ₹1,00,000.

14. M/s Akash & Co. purchased a machine for ₹10,00,000. Estimated useful life and scrap value were 10 years and ₹1,20,000 respectively. The machine was put to use on 1.1.2017.

Required:

Show Machinery A/c and Depreciation A/c in their books for 2022 by using sum of years digits method. (ICAI Study Material)

Sol.

In the books of M/s Raj & Co.

Machinery A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2022 Jan. 1	To Balance b/d (w.n.2)	3,60,000	2022 Dec. 31	By Depn. A/c (w.n.3)	80,000
			Dec. 31	By Balance c/d	2,80,000
		3,60,000			3,60,000
2023 Jan. 1	To Balance b/d	2,80,000			

Depreciation A/c

Date	Particular	₹	Date	Particular	₹
2022 Dec. 31	To Machinery A/c	80,000	2022 Dec. 31	By Profit and Loss A/c	80,000
		80,000			80,000

15. A Machine costing ₹6,00,000 is depreciated on straight line basis, assuming 10 years working life and Nil residual value, for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Required:

Calculate depreciation for the fourth year.

Sol. Depreciation per year = ₹6,00,000 / 10 = ₹60,000

Depreciation on SLM charged for three years = ₹60,000 x 3 years = ₹1,80,000

Book value of the computer at the end of third year = ₹6,00,000 – ₹1,80,000 = ₹4,20,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation from the fourth year onwards = ₹4,20,000 / 5 = ₹84,000 per annum

16. A Machinery costing ₹10,00,000 is depreciated on straight line assuming 10 year working life and zero residual value, for four years. At the end of the fourth year, the machinery was revalued upwards by ₹40,000. The remaining useful life was reassessed at 8 years. Calculate Depreciation for the fifth year. [Nov. 2018, 4 Marks]

Sol.

$$\text{Depreciation per year} = \frac{10,00,000}{10} = ₹1,00,000$$

$$\text{Value of plant \& Machinery} = 10,00,000$$

$$\text{Less: Depreciation for 4 years } (1,00,000 \times 4) = 4,00,000$$

$$\text{WDV of the machine at the end of 4 th year} = 6,00,000$$

$$\text{Add: Upward Revaluation} = 40,000$$

$$\text{Depreciable amount after revaluation} = 6,40,000$$

Remaining useful life as per revised estimate = 8 years

$$\text{Depreciation for the fifth year onwards} = \frac{6,40,000}{8} = ₹80,000$$

17. Jain Bros. acquired a machine on 1st July, 2021 at a cost of ₹14,00,000 and spent ₹1,00,000 on its installation. The firm writes off depreciation at 10% p.a. of the original cost every year. The books are closed on 31st December every year.

Required:

Show the Machinery A/c and Depreciation A/c for the year 2021 and 2022.

(ICAI Study Material)

Machinery A/c

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
July 1	To Bank A/c	14,00,000	Dec. 31	By Depn. A/c	75,000
July 1	To Bank A/c - Installation	1,00,000		10% for 6 months SLM	
			Dec. 31	By Balance c/d	14,25,000
		15,00,000			15,00,000
2022			2022		
Jan. 1	To Balance b/d	14,25,000	Dec. 31	By Depn. A/c	1,50,000
			Dec. 31	10% for 12 months SLM	12,75,000
		14,25,000		By Balance c/d	14,25,000

Depreciation A/c

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
Dec. 31	To Machinery A/c	75,000	Dec. 31	By Profit & Loss A/c	75,000
2022			2022		
Dec. 31	To Machinery A/c	1,50,000	Dec. 31	By Profit & Loss A/c	1,50,000

18. A machine is purchased for ₹20,00,000. Its estimated useful life is 10 years with a residual value of ₹2,00,000. The machine is expected to produce 1.5 lakh units during its life time. Expected distribution pattern of production is as follows:

Year	Production
1-3	20,000 units per year
4-7	15,000 units per year
8-10	10,000 units per year

Required:

Determine the value of depreciation for each year using production units method.

(ICAI Study Material)

Sol. Statement showing Depreciation under Production Units Method

Year	Annual Depreciation
1-3	$\frac{20,000}{1,50,000} \times (\text{₹}20,00,000 - \text{₹}2,00,000) = \text{₹}2,40,000$
4-7	$\frac{15,000}{1,50,000} \times (\text{₹}20,00,000 - \text{₹}2,00,000) = \text{₹}1,80,000$
8-10	$\frac{10,000}{1,50,000} \times (\text{₹}20,00,000 - \text{₹}2,00,000) = \text{₹}1,20,000$

19. A Machinery costing ₹20,00,000 is depreciated on straight line assuming 10 years working life and nil salvage value for four years. At the end of the fourth year, the machinery was revalued upwards by ₹80,000. The remaining useful life of the machinery was also reassessed as 8 years at the end of the fourth year. Calculate the depreciation for 5th Year.

(ICAI Study Material)

Sol. Depreciation every year for first 4 years = ₹20,00,000 / 10 = ₹2,00,000

Thus, Written Down Value of the Machinery at end of the 4th year = ₹20,00,000 - (₹2,00,000 × 4) = ₹12,00,000

Revalued Amount i.e. New Depreciable Amount shall be = ₹12,00,000 + ₹80,000 = ₹12,80,000

Original remaining useful life is (10-4) = 6 Years whereas it is reassessed as 8 Years. Hence, depreciation for 5th Year = ₹12,80,000 / 8 = ₹1,60,000

20. M/s Surya & Co. took lease of a quarry on 1-1-2019 for ₹1,00,00,000. As per technical estimate the total quantity of mineral deposit is 2,00,000 tonnes. Depreciation was charged on the basis of depletion method. Extraction pattern is given in the following table:

Year Quantity of Mineral extracted

2019 2,000 tonnes

2020 10,000 tonnes

2021 15,000 tonnes

Required:

Show the Quarry Lease A/c and Depreciation A/c for each year from 2019 to 2021.

(ICAI Study Material)

Sol.

Quarry Lease A/c

Date		₹			₹
2019			2019		
Jan.	To Bank A/c	1,00,00,000	Dec. 31	By Depn. A/c [(2,000/2,00,000) × ₹1,00,00,000]	1,00,000
			Dec. 31	By Balance c/d	99,00,000
		1,00,00,000			1,00,00,000
2020			2020		
Jan. 1	To Balance b/d	99,00,000	Dec. 31	By Depn. A/c	5,00,000
			Dec. 31	By Balance c/d	94,00,000
		99,00,000			99,00,000
2021			2021		
Jan. 1	To Balance b/d	94,00,000	Dec. 31	By Depn. A/c	7,50,000
			Dec. 31	By Balance c/d	86,50,000
		94,00,000			94,00,000

Depreciation A/c

Date		₹			₹
2019			2019		
Dec. 31	To Quarry lease A/c	1,00,000	Dec. 31	By Profit & Loss A/c	1,00,000
		1,00,000			1,00,000
2020			2020		
Dec. 31	To Quarry lease A/c	5,00,000	Dec. 31	By Profit & Loss A/c	5,00,000
		5,00,000			5,00,000
2021			2021		
Dec. 31	To Quarry lease A/c	7,50,000	Dec. 31	By Profit & Loss A/c	7,50,000
		7,50,000			7,50,000

21. M/s Anshul & Co. commenced business on 1st January 2017, when they purchased plant and equipment for ₹7,00,000. They adopted a policy of charging depreciation at 15% per annum on diminishing balance basis and over the years, their purchases of plant have been:

On 1-1-2021 it was decided to change the method and rate of depreciation to straight line basis. On this date remaining useful life was assessed as 6 years for all the assets purchased before 1.1.2021 with no scrap value and 10 years for the asset purchased on 1.1.2021.

Required:

Calculate the difference in depreciation to be adjusted in the Plant and Equipment A/c for the year ending 31st December, 2021. (ICAI Study Material)

Sol.

Depreciation on WDV method

		Purchased on Jan. 1, 2017 ₹	Purchased on Jan. 1, 2018 ₹	Total Depreciation ₹
2017	Cost	7,00,000		
	Depn.	(1,05,000)		1,05,000
	Written Down Value (WDV)	5,95,000		
2018	Cost	-	1,50,000	
	Depn.	(89,250)	(22,500)	1,11,750
	W.D.V.	5,05,750	1,27,500	
2019	Depn.	(75,863)	(19,125)	94,988
	W.D.V.	4,29,887	1,08,375	
2020	Depn.	(64,483)	(16,256)	80,739
	W.D.V.	3,65,404	92,119	
2021	Depn.	(60,900)	(15,353)	76,253
		3,04,504	76,766	

Plant and Equipment A/c

Date		₹			₹
2021			2021		
Jan. 1	To Balance b/d	4,57,523	Dec. 31	By Depn.	96,253

	To Bank	2,00,000	(60,900 + 15,353 + 20,000)	
			By Balance c/d	5,61,270
		6,57,523		6,57,523
2022				
Jan. 1	To Balance b/d	5,61,270		

22. On 1.1.2020 Plant was purchased for ₹40,000. On 1.7.2021 addition were made to the amount of ₹20,000. On 31.3.2022 Plant purchased on 1.7.2021 costing ₹6,000 was sold for ₹5,500 & on 30.6.2022 Plant purchased on 1.1.2020 costing ₹16,000 was sold for ₹13,350. On 1.10.2022 addition were made to the amount of ₹10,000.

Show Plant A/c & Depreciation A/c for 3 years 2020, 2021, 2022. Depreciate Plant at 10 % p.a. by W.D.V. method

Sol.

Plant A/c (W.D.V. 10%)

Date	Particular	₹	Date	Particular	₹
1.1.2020	To Bank A/c	40,000	31.12.2020	By Depn. A/c	4000
				By Balance c/d	36000
		40,000			40,000
1.1.2021	To Balance b/d	36000	31.12.2021	By Depn. A/c	4600
1.7.2021	To Bank A/c	20000		By Balance c/d	51,400
		56,000			56,000
1.1.2022	To Balance b/d	51,400	31.3.2022	By Bank A/c	5,500
				By Depn. A/c	142
				By Loss on sale of Machinery	58
30.6.2022	To Profit on sale of machinery	1038	30.6.2022	By Bank A/c	13,350
1.10.2022	To Bank A/c	10,000		By Depn. A/c	648
				By Depn./c (3274 + 250)	3524
				By Balance c/d	39,216
		62,438			62,438

Depreciation A/c

Date	Particular	₹	Date	Particular	₹
31.12.2020	To Plant A/c	4,000	31.12.2020	By P & L A/c	4,000
		4,000			4,000

Date	Particular	₹	Date	Particular	₹
31.12.2021	To Plant A/c	4,600	31.12.2021	By P & L A/c	4,600
		4,600			4,600
31.3.2022	To Plant A/c	142	31.12.2022	By P & L A/c	4314
30.6.2022	To Plant A/c	648			
31.12.2022	To Plant A/c	3524			
		4314			4314

Working notes

(1) Sold on 31.3.2022			(2) Sold on 30.6.2022			(3) Depreciation on 31.12.2022	
1.7.2021	Cost	6000	1.1.2020	Cost	16000	Balance of old machine on 1.1.2022	51400
31.12.2021	Depreciation	300	31.12.2020	Depreciation	1600	(-) sold	5700
1.1.2022	Balance	5700	1.1.2021	Balance	14400	(-) sold	12960
31.3.2022	Depreciation	142	31.12.2021	Depreciation	1440	Balance	32740
31.3.2022	Balance	5,558	1.1.2022	Balance	12960	Depreciation @10%	3274
	Sold' for	5,500	30.6.2022	Depreciation	648	On new machine	
	Loss	58		Balance	12312	$10,000 \times 10 \div 100 \times 3 \div 12$	250
				Sold for	13350		
				Profit	1038		3524

23. A purchased on 1st January, 2020 certain machinery for ₹97,000 and spent ₹3,000 on its erection. On 1st July, 2020 additional machinery costing ₹50,000 was purchased. On 1st July, 2022 the machinery purchased on 1st January, 2020 having become obsolete was auctioned for ₹50,000 and on the same date new machinery was purchased at a cost of ₹75,000. Depreciation was provided for annually on 31st December at the rate of 10% per annum on the original cost of the machinery. No depreciation need be provided when a machinery is sold or auctioned, for that part of the year in which sale or auction took place. But for the above, depreciation shall be provided on time basis. In 2023, however, A changed this method of providing depreciation and adopted the method of writing off 15% p.a. on the written down value on the balance as appeared in machinery A/c on 1-1-2023.

Show the machinery A/c for the calendar years 2020 to 2023.

Sol.

Date	Particulars	₹	Date	Particulars	₹
2020			2020		
Jan 1	To Bank A/c	97,000	Dec 31	By Depn. A/c (10000 + 2500)	12,500
	To Bank A/c - erection	3,000		By Balance c/d	1,37,500
July 1	To Bank A/c	50,000			
		1,50,000			1,50,000
2021			2021		
Jan 1	To Balance b/d	1,37,500	Dec 31	By Depn. A/c (10000 + 5000)	15,000
				By Balance c/d	1,22,500
		1,37,500			1,37,500
2022			2022		
Jan 1	To Balance b/d	1,22,500	July 1	By Bank A/c	50,000
July 1	To Bank A/c	75,000		By P & L A/c (loss on sale machine)	25,000
				By Depn. A/c (on asset sold)	5,000
			Dec 31	By Depn. A/c (5000 + 3750)	8,750
				By Balance c/d	1,08,750
		1,97,500			1,97,500
2023			2023		
Jan 1	To Balance b/d	1,08,750	Dec 31	By Depn. A/c (15% of 108750)	16,312
				By Balance c/d	92,438
		1,08,750			1,08,750

New method to be applied on the balance appearing as on 1.1.2023, as prospective change.

24. On April 1, 2019 Shubra Ltd. purchased a machinery for ₹12,00,000. On Oct 1, 2021, a part of the machinery purchased on April 1, 2019 for ₹80,000 was sold for ₹45,000 and a new machinery at a cost of ₹1,58,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the written down value of the machinery.

Required: Show the necessary ledger A/cs for the years ended 31st March, 2020 to 2022 assuming that (a) 'Provision for Depreciation A/c' is not maintained (b) Provision for Depreciation A/c is maintained.
(ICAI Study Material)

Sol. (a) If 'Provision for Depreciation A/c' is not maintained.

Dr. Machinery A/c			Cr.		
Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
01.04.2019	To Bank A/c	12,00,000	31.03.2020	By Depn. A/c	1,20,000
		12,00,000		By Balance c/d	10,80,000
01.04.2020	To Balance b/d	10,80,000	31.03.2021	By Depn. A/c	1,08,000
		10,80,000		By Balance c/d	9,72,000
01.04.2021	To Balance b/d	9,72,000	01.10.2021	By bank A/c	45,000
01.10.2021	To Bank A/c	1,58,000		By Profit & Loss A/c	16,560
				By Depn. A/c	3,240
			31.3.2021	By Depn. A/c (7,900 + 90,720)	98,620
				By Balance c/d (8,16,480 + 1,50,100)	9,66,580
		11,30,000			11,30,000

(b) If 'Provision for Depreciation A/c' is maintained

Dr. Machinery A/c (at original cost)			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.04.2019	To Bank A/c	12,00,000	31.03.2020	By Balance c/d	12,00,000
01.04.2020	To Balance b/d	12,00,000	31.03.2021	By Balance c/d	12,00,000
01.04.2021	To Balance b/d	12,00,000	01.10.2021	By Machinery Disposal A/c	80,000
01.10.2021	To Bank A/c	1,58,000	31.03.2022	By Balance c/d	12,78,000
		13,58,000			13,58,000

Dr. Provision for Depreciation A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	1,20,000	31.03.2020	By Depn. A/c	1,20,000
31.03.2021	To Balance c/d	2,28,000	1.04.2020	By Balance b/d	1,20,000
		2,28,000	31.03.2021	By Depn. A/c	1,08,000
					2,28,000

01.10.2021	To Machinery Disposal A/c	18,440	01.04.2021	By Balance b/d	2,28,000
31.03.2022	To Balance c/d	3,11,420	01.10.2021	By Depn. A/c	3,240
		3,29,860	31.03.2022	By Depn. A/c	98,620
					3,29,860

Dr.			Machinery Disposal A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
01.10.2021	To Machinery Disposal A/c	80,000	01.10.2021	By Provision for Depn. A/c	18,440			
				By Bank A/c	45,000			
				By Profit and Loss A/c	16,560			
		80,000			80,000			

Working Notes:

(1) Calculation of Profit/Loss on Sale of Machinery

Particulars	₹
A. Original Cost	80,000
B. Less: Depreciation @ 10% WDV p.a. for 2 ½ years	18,440
C. Book Value as on date of Sale (A – B)	61,560
D. Less: Sale proceeds	45,000
E. Loss: on Sale (C – D)	16,560

(2) Calculation of Depreciation for Current Year on Machines (other than sold)

Particulars	₹
A. On Old Machines of ₹9,07,200 for 1 year (10% WDV)	90,720
B. On New Machine of ₹1,58,000 for ½ year	7,900
	98,620

25. Kumar R&D Co. registered a patent (the patent meets the criteria of an intangible asset) on 1st July, 2021 developed at a cost of ₹28,00,000 and spent ₹2,00,000 towards legal fees and registration. The patent is granted for a period of 10 years. The books are closed on 31st December every year.

Required:

Show the Patent A/c and Amortisation A/c for the year 2021 and 2022.

(ICAI Study Material)

Sol. Useful Life: 10 years from 1 July, 2021 Residual Value: NIL

Value of patent will be = ₹30,00,000 (₹28,00,000 + ₹2,00,000)

Therefore, annual depreciation: ₹30,00,000 ÷ 10 years = ₹3,00,000

Patent A/c

Date	Particular	₹	Date	Particular	₹
2021			2021		
July 1	To Bank A/c	28,00,000	Dec. 31	By Amortisation A/c:	1,50,000
July 1	To Bank A/c - Legal & Reg. Exp.	2,00,000		₹3,00,000 x 6/12	
			Dec. 31	By Balance c/d	28,50,000
		30,00,000			30,00,000
2022			2022		
Jan. 1	To Balance b/d	28,50,000	Dec. 31	By Amortisation A/c	3,00,000
			Dec. 31	By Balance c/d	25,50,000
		28,50,000			28,50,000

Amortisation A/c

Date	Particular	Amount ₹	Date	Particular	Amount ₹
2021			2021		
Dec. 31	To Patent A/c	1,50,000	Dec. 31	By Profit & Loss A/c	1,50,000
2022			2022		
Dec. 31	To Patent A/c	3,00,000	Dec. 31	By Profit & Loss A/c	3,00,000

26. Amazing group had Property, Plant & Equipment (PP&E) with a book value of ₹35,00,000 on 31st December, 2022. The balance in Revaluation Surplus on that date was ₹3,00,000. As part of their practice of revaluing the assets on yearly basis, another revaluation was carried out on 31st December, 2022. Evaluate the impact of Revaluation if the Fair Value as a result of Revaluation done on 31st December, 2022 was (a) ₹37,00,000 (b) ₹33,00,000 and (c) ₹31,00,000. Also, give the journal entries. (ICAI Study Material)

Sol. (a) Fair Value: ₹37,00,000

Given that this represents an upward revaluation and the group previously experienced an increase in revaluation surplus (indicating a prior upward adjustment), it will lead to an additional credit of 2,00,000 to the Revaluation Surplus A/c. Consequently, the cumulative balance of Revaluation Surplus (an element of other comprehensive income within Equity) will rise to 5,00,000. Here's the corresponding Accounting journal entry:

Property, Plant & Equipment A/c	Dr	2,00,000
To Revaluation Surplus A/c		2,00,000

(b) Fair Value: ₹33,00,000

As this involves a downward revaluation, and the group previously had a balance in the revaluation surplus (indicating a prior upward adjustment), this will result in a reduction or a debit to the Revaluation Surplus A/c equal to the existing balance. Any remaining excess will be debited to the Profit & Loss A/c. In this particular instance, there is a decrease in fair value amounting to ₹2,00,000 (₹35,00,000 - ₹33,00,000), and this entire sum will be debited to the Revaluation Surplus A/c. Consequently, the total balance of Revaluation Surplus (a component of other comprehensive income within Equity) will decrease to ₹1,00,000. Here's the corresponding Accounting journal entry:

Revaluation Surplus A/c	Dr.	2,00,000
To Property, Plant & Equipment A/c		2,00,000

(c) Fair Value: ₹31,00,000

Given that this also involves a downward revaluation, and the group previously held a balance in the revaluation surplus (indicating a prior upward adjustment), this will lead to a reduction or a debit to the Revaluation Surplus A/c up to the amount of the existing balance. Any excess will be debited to the Profit & Loss A/c. In this scenario, there is a decrease in fair value of ₹4,00,000 (₹35,00,000 - ₹31,00,000), resulting in a debit of ₹3,00,000 to the Revaluation Surplus A/c, and the remaining ₹1,00,000 will be debited to the Profit & Loss A/c. Consequently, the total balance of the Revaluation Surplus (a component of other comprehensive income in Equity) will be reduced to zero. Here's the corresponding Accounting journal entry:

Revaluation Surplus A/c	Dr.	3,00,000
Profit & Loss A/c	Dr.	1,00,000
To Property, Plant & Equipment A/c		4,00,000

27. The balance of Machinery A/c of a company on 1st April, 2020 was ₹28,54,000. Out of this, a plant having book value of ₹2,16,000 as on 1st April, 2020 was sold on 1st July, 2020 for ₹82,000. On the same date a new plant was purchased for ₹4,58,000 and ₹22,000 was spent on its erection. On 1st November, 2020 a new machine was purchased for ₹5,60,000. Depreciation is Written off @ 15% per annum under the diminishing balance method. Calculate the total amount debited to depreciation for the year ended 31st March, 2021. [July 2021, 4 Marks]

Sol.

Calculation of Depreciation for the year ended 31st March, 2021:

Particulars	Amount ₹
Depreciation on:	
1. Opening Balance (1.4.2020)	
(a) Machine Sold 1.7.2020 $\left(2,16,000 \times \frac{15}{100} \times \frac{3}{12} \right)$	8,100
(b) Other Machine $(28,54,000 - 2,16,000) \times \frac{15}{100}$	3,95,700

2. Machine Purchased on 1.7.2020	
$(4,58,000 + 22,000) \times \frac{15}{100} \times \frac{9}{12}$	54,000
3. Machine Purchased on 1.11.2020	
$5,60,000 \times \frac{15}{100} \times \frac{5}{12}$	35,000
Total Depreciation for the year	4,92,800

28. A machine was purchased for ₹30,00,000 having an estimated total working of 24,000 hours. The scrap value is expected to be ₹2,00,000 and anticipated pattern of distribution of effective hours is as follows :

Year

1 – 3 3,000 hours per year

4 – 6 2,600 hours per year

7 – 10 1,800 hours per year

Required:

Determine Annual Depreciation under Machine Hour Rate Method.

(ICAI Study Material)

Sol. Statement of Annual Depreciation under Machine Hours Rate Method

Year	Annual Depreciation
1 – 3	$\frac{3,000}{24,000} \times (\text{₹}30,00,000 - \text{₹}2,00,000) = \text{₹}3,50,000$
4 – 6	$\frac{2,600}{24,000} \times (\text{₹}30,00,000 - \text{₹}2,00,000) = \text{₹}3,03,333$
7 – 10	$\frac{1,800}{24,000} \times (\text{₹}30,00,000 - \text{₹}2,00,000) = \text{₹}2,10,000$

29. Cost of Machine = ₹40,000

Scrap Value = ₹4,000

Estimated life = 5 years

Calculate depreciation of all the years on the basis of Sum of Years of Digits Method.

Sol.

$$\text{Depreciation of the Year} = \text{Depreciable value} \times \frac{\text{Number of years (including the present year) of remaining life of the asset}}{\text{Number of years (including the present year) of remaining life of the asset}}$$

1st Year depreciation = $(40,000 - 4,000) \times \frac{5}{1 + 2 + 3 + 4 + 5} = 36,000 \times \frac{5}{15} = ₹12,000$
2nd Year depreciation = $36,000 \times \frac{4}{15} = ₹9,600$
3rd Year depreciation = $36,000 \times \frac{3}{15} = ₹7,200$
4th Year depreciation = $36,000 \times \frac{2}{15} = ₹4,800$
5th Year depreciation = $36,000 \times \frac{1}{15} = ₹2,400$

30. On April 1, 2019 a firm purchased a machinery for ₹2,00,000. On 1st October in the same Accounting year, additional machinery costing ₹1,00,000 was purchased. On 1st October, 2020, the machinery purchased on 1st April 2019, having become obsolete was sold off for ₹90,000. On October 1, 2021, new machinery was purchased for ₹2,50,000 while the machinery purchased on 1st October 2019 was sold for ₹85,000 on the same day. The firm provides depreciation on its machinery @ 10% per annum on original cost on 31st March every year. Show Machinery A/c, Provision for Depreciation A/c and Depreciation A/c for the period of three Accounting years ending March 31, 2022. (ICAI Study Material)

Sol.

Dr.			Machinery A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
01.04.2019	To Bank A/c	2,00,000	31.03.2020	By Balance c/d	3,00,000			
01.10.2019	To Bank A/c	1,00,000						
		3,00,000			3,00,000			
01.04.2020	To Balance b/d	3,00,000	01.10.2020	By Bank A/c	90,000			
				By Provision for Depn. A/c	30,000			
				By Profit and Loss A/c	80,000			
			31.3.2021	By Balance c/d	1,00,000			
		3,00,000			3,00,000			
01.04.2021	To Balance b/d	1,00,000	01.10.2021	By Bank A/c	85,000			
01.10.2021	To Bank A/c	2,50,000		By Provision for Depn. A/c	20,000			
	To Profit and Loss A/c	5,000	31.3.2022	By Balance c/d	2,50,000			
		3,55,000			3,55,000			

Depreciation A/c

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To provision for Depn. A/c	25,000	31.03.2020	By Profit and Loss A/c	25,000
		25,000			25,000
01.10.2020	To Provision for Depn. A/c	10,000	31.03.2021	By Profit and Loss A/c	20,000
31.03.2021	To Provision for Depn. A/c	10,000			20,000
		20,000			20,000
01.10.2021	To Provision for Depn. A/c	5,000	31.03.2022	By Profit and Loss A/c	17,500
31.03.2022	To Provision for Depn. A/c	12,500			17,500
		17,500			17,500

Dr.

Provision for Depreciation A/c

Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	25,000	31.03.2020	By Depn. A/c (₹20,000 + ₹5,000)	25,000
		25,000			25,000
01.12.2020	To Machinery A/c (₹20,000 + ₹10,000)	30,000	01.04.2020	By Balance b/d	25,000
31.03.2021	To Balance c/d	15,000	01.10.2020	By Depn. A/c	10,000
		45,000	31.03.2021	By Depn. A/c	10,000
01.10.2021	To Machinery A/c (₹5,000 + ₹10,000 + ₹5,000)	20,000	01.04.2021	By Balance b/d	15,000
31.03.2022	To Balance c/d	12,500	01.10.2021	By Depn. A/c	5,000
		32,500	31.03.2022	By Depn. A/c	12,500
					32,500

31. The Machinery A/c of a firm showed a balance of ₹95 Lakhs on 1st April, 2020. The Books of A/c of the firm are closed on 31st March every year and Depreciation is written off @ 10% per annum under the Diminishing Balance Method. On 1st September, 2020 a new machine was acquired at a cost of ₹14 Lakhs and ₹44,600 was incurred on the same day as installation charges for erecting the machine. On 1st September, 2020 a machine which had cost ₹21,87,000 on 1st April, 2018 was sold for ₹3,75,000. Another machine which had cost ₹21,85,000 on 1st April, 2019 was scrapped on 1st September, 2020 and it realized nothing.

Prepare the Plant and Machinery A/c for the year ended 31st March, 2021. Allow the same rate of depreciation as in the past and calculate depreciation to the nearest multiple of a rupee. Also show all the necessary working notes. [June 2022, 10 Marks]

Sol.

Plant and Machinery A/c (1st April 2020 to 31st March 2021)

Date	Particulars	Amount	Date	Particulars	Amount
2020			2020		
1 April	To Balance b/d :-		1 Sept.	By Depn. on:	
	M1 - WDV 1771470			Machinery 1 - 73811	
	M2 - WDV 1966500			Machinery 2 - <u>81938</u>	1,55,749
	Bal. - WDV <u>5762030</u>	95,00,000		By Bank A/c (Sale M1)	3,75,000
				By P&L A/c (Loss M1)	13,22,659
1 Sept.	To Bank A/c (New Machine)			By P&L A/c (Loss M2)	18,84,562
	Cost - 14,00,000		2021		
	Installation - <u>44,600</u>	14,44,600	31 Mar.	By Depn. On :	
				Op. Unsold - 576203	
				New Machine - <u>84268</u>	6,60,471
				By Balance c/d	
				Op. Unsold - 5185827	
				New Machine - <u>1360332</u>	65,46,159
	Total	1,09,44,600		Total	1,09,44,600

Working Note:-

Machinery 1	₹
Cost as on 1.4.2018	21,87,000
- Depreciation @ 10%	(2,18,700)
W.D.V. as on 31.3.2019	19,68,300
- Depreciation @ 10%	<u>(1,96,830)</u>
W.D.V. as on 31.3.2020	<u>17,71,470</u>
Cost as on 1.4.2019	21,85,000
Depreciation @ 10%	<u>(2,18,500)</u>
W.D.V. as on 31.3.2020	<u>19,66,500</u>

32. Mr. Bhuvan purchased a Plant costing ₹30,000 on 1st January, 2020. He purchased another Plant for ₹25,000 on 1st July in the same year. On 1st October 2021, he sold 1/3rd part of 1st Plant for ₹5,500 and purchased another Plant for ₹15,000 on the same date. Prepare Plant A/c for three years in the following cases:

Case I - If rate of depreciation is 10% p.a. on SLM

Case II - If rate of depreciation is 10% p.a. on WDV

Sol. Case I:-

Working Note:

Plant-I		Plant-II		Plant-III	
On Jan .1, 2020	30,000	On July 1, 2020	25,000	On Oct 1, 2021	15,000
Part I		Less: Dep.	1,250	Less: Dep. for 3M	375
COA $30,000 \times 1/3 =$	10,000	Balance as on 31/12/20	23,750	Balance as on 31/12/21	14,625
Less: Dep.	1,000	Less: Dep.	2,500	Less: Dep.	1,500
Balance as on 31/12/20	9,000	Balance as on 31/12/21	21,250	Balance as on 31/12/22	13,125
Less: Dep. for 9M	750	Less: Dep.	2,500		
Balance on date of sale	8,250	Balance as on 31/12/22	18,750		
Sale Value	5,500				
Loss:	2,750				
Part II					
COA $30,000 \times 2/3 =$	20,000				
Less: Dep.	2,000				
Balance as on 31/12/20	18,000				
Less: Dep.	2,000				
Balance as on 31/12/21	16,000				
Less: Dep.	2,000				
Balance as on 31/12/22	14,000				

Plant A/c

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2020				2020			
Jan. 1	To Bank: Plant I		30,000	Dec. 31	By Depn. on		
July 1	To Bank: Plant II		25,000		Plant I 3000		
					Plant II 1,250		4,250
					By Balnace c/d		
					Plant I 27,000		
					Plant II 23,750		50,750
	Total		55,000		Total		55,000
2021				2021			
Jan. 1	To Bal b/d			Oct. 1	By Depreciation on		
	Plant I 27,000				Plant I 1/3		750
	Plant II 23,750		50,750		By Bank		5,500
					By P& L A/c (Loss)		2,750
Oct. 1	To Bank -Plant III		15,000	Dec. 31	By Depn. on		
					Plant I (2/3) 2,000		
					Plant II 2,500		

					Plant III	<u>375</u>	4,875
					By Balance c/d		
					Plant I (2/3)	16,000	
					Plant II	21,250	
					Plant III	<u>14,625</u>	51,875
	Total		65,750		Total		65,750
2022				2022	By Depn. on		
Jan. 1	To Balance b/d			Dec. 31	Plant (2/3)	2,000	
	Plant I 16,000				Plant II	2,500	
	(2/3)				Plant III	<u>1,500</u>	6,000
	Plant II 21,250				By Balance c/d		
	Plant III <u>14,625</u>		51,875		Plant I (2/3)	14,000	
					Plant II	18,750	
					Plant III	<u>13,125</u>	45,875
	Total		51,875		Total		51,875

33. M/s. Tyagi & Sons purchased 10 trucks @ ₹50,00,000 each on 1st July 2017. On 1st October, 2019, one of the trucks is involved in an accident and is completely destroyed and ₹35,00,000 is received from the insurance in full settlement. On the same date, another truck is purchased by the company for the sum of ₹60,00,000. The company writes off 20% of the original cost per annum. The company observes the calendar year as its financial year.

Give the motor truck A/c for two years ending 31st December, 2020.

[Jan. 2021, 10 Marks]

Sol.

In the Books of M/s. Tyagi & Sons
Trucks A/c

Date	Particulars	Amount	Date	Particulars	Amount
2019			2019		
1 Jan.	To Balance b/d (WN-1)	3,50,00,000	1 Oct.	By Depn. A/c	7,50,000
1 Oct.	To Profit on destroyed Truck (WN-2)	7,50,000		[50,00,000 × 20% × (9/12)]	
	To Bank A/c	60,00,000	31 Dec.	By Bank A/c	35,00,000
				By Depn. A/c	
				(a) On 9 old trucks	90,00,000
				(b) On 1 new truck	<u>3,00,000</u>
				By Balance c/d	93,00,000
				(a) 9 old trucks	2,25,00,000
				(b) 1 new truck	<u>57,00,000</u>
	Total	4,17,50,000		Total	2,82,00,000
					4,17,50,000

2020			2020		
1 Jan.	By Balance c/d		31 Dec.	By Depn. A/c	
	(a) 9 old trucks 2,25,00,000			(a) On 9 old trucks 90,00,000	
	(b) 1 new truck <u>57,00,000</u>	2,82,00,000		(b) On 1 new truck <u>12,00,000</u>	1,02,00,000
				By Balance c/d	
				(a) 9 old trucks 1,35,00,000	
				(b) 1 new truck <u>45,00,000</u>	1,80,00,000
	Total	2,82,00,000		Total	2,82,00,000

Working Notes:

(1) Calculation of Balance as on 1st Jan., 2019:-

	₹
Cost of 10 trucks	5,00,00,000
Less: Dep. for 6 months of Year 2017	(50,00,000)
Less: Dep. of Year 2018	<u>(1,00,00,000)</u>
	<u>3,50,00,000</u>

(2) Calculation of Profit or Loss on destroyed truck:-

Balance of 10 trucks as on 1st Jan., 2019	= $\frac{3,50,00,000}{10}$
Balance of destroyed truck	= 35,00,000
Less: Depreciation of Year 2019	<u>(7,50,000)</u>
	27,50,000
Less: Insurance Claim	<u>35,00,000</u>
Profit	7,50,000

Case II:

Working Note:

Plant-I	Plant-II	Plant-III
On Jan 1, 2020 30,000	On July 1, 2020 25,000	On Oct 1, 2021 15,000
Part I-	Less: Dep. 1,250	Less: Dep. for 3M 375
COA $30,000 \times \frac{1}{3} =$ 10,000	Balance as on 31/12/20 23,750	Balance as on 31/12/21 14,625
Less: Dep. 1,000	Less: Dep. 2,375	Less: Dep. 1463
Balance as on 31/12/20 9,000	Balance as on 31/12/21 21,375	Balance as on 31/12/22 13,162
Less: Dep for 9M 675	Less: Dep. 2,137	
Balance on date of sale 8,325	Balance as on 31/12/22 19,238	
Less: Dep. 5,500		
Loss 2,825		

Part II-		
COA	$30,000 \times 2/3 =$	20,000
Less: Dep.		2,000
Balance as on 31/12/20 18,000		
Less: Dep.		1,800
Balance as on 31/12/21 16,200		
Less: Dep.		1,620
Balance as on 31/12/22 14,580		

Plant A/c

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2020				2020			
Jan. 1	To Bank: Plant I		30,000	Dec. 31	By Depn. on		
July 1	To Bank: Plant II		25,000		Plant I 3000		
					Plant II <u>1,250</u>		4,250
					By Balance c/d		
					Plant I 27,000		
					Plant II 23,750		50,750
	Total		55,000		Total		55,000
2021				2021			
Jan. 1	To Balance b/d			Oct. 1	By Depn. on		
	Plant I 27,000				Plant I (1/3)		675
	Plant II <u>23,750</u>		50,750		By Bank		5,500
Oct. 1	To Bank - Plant III		15,000		By P& L A/c (Loss)		2,825
				Dec. 31	By Depn. on		
					Plant I (2/3) 2,000		
					Plant II 2,500		
					Plant III <u>375</u>		4,550
					By Balance c/d		
					Plant I (2/3) 16,200		
					Plant II 21,375		
					Plant III <u>14,625</u>		52,200
	Total		65,750		Total		65,750
2022				2022			
Jan. 1	To Balance b/d			Dec. 31	By Depn. on		
	Plant I 16,200				Plant (2/3) 1,620		
	(2/3)				Plant II 2,137		
	Plant II 21,375				Plant III <u>1,463</u>		5,220
	Plant III <u>14,625</u>		52,200		By Balance c/d		

				Plant(2/3)	14,580		
				Plant II	19,238		
				Plant III	<u>13,162</u>		46,980
	Total		52,200	Total			52,200

34. On 1.1.20 machinery was purchased for ₹40,000. On 1.7.21 addition were made to the amount of ₹20,000. On 31.3.22 machine purchased on 1.7.21 costing ₹6,000 was sold for ₹5,500 & on 30.6.22 machinery purchased on 1.1.20 costing ₹16,000 was sold for ₹13,350. On 1.10.22 addition were made to the amount of ₹10,000.

Show Machinery A/c & Depreciation provision A/c for 3 years 2020, 2021, 2022. Depreciate Machinery at 10% p.a. by S.L.M.

Sol.

Dr.			Machinery A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
1.1.20	To Bank A/c	40,000	31.12.20	By Balance c/d	40,000			
		40,000			40,000			
1.1.21	To Balance b/d	40,000	31.13.21	By Balance c/d	60,000			
1.1.21	To Bank A/c	20,000			60,000			
		60,000						
1.1.22	To Balance b/f	60,000	31.3.22	By Bank A/c	5500			
30.6.22	To P&L A/c (profit)	1,350		By Depn. provision A/c	450			
1.10.22	To Bank A/c	10,000		By P&L (loss) A/c	50			
			30.6.22	By Bank A/c	13,350			
				By Depn. provision A/c	4,000			
			31.12.22	By Balance c/d	48,000			
		71,350			71,350			

Alternatively sale of asset can be routed through asset disposal A/c as done in earlier question.

Dr.			Provision for Depreciation A/c (SLM 10%)			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
31.12.20	To Balance c/d	4,000	31.12.20	By Depn. A/c	4,000			
		4,000			4,000			
31.12.21	To Balance c/d	9,000	1.1.21	By Balance b/d	4,000			
		9,000	31.12.21	By Depn. A/c	5,000			
					9,000			
31.3.22	To Machinery A/c	450	1.1.22	By balance b/d	9,000			
30.6.22	To Machinery A/c	4,000	31.3.22	By Depn. A/c	150			

31.12.22	To Balance c/d	9,550	30.6.22	By Depn. A/c	800
			31.12.22	By Depn. A/c	4050
		14,000			14,000

Depreciation A/c

Date	Particulars	₹	Date	Particulars	₹
31.12.20	To Depn. provision A/c	4,000	31.12.20	By P&L A/c	4,000
		4,000			4,000
31.12.21	To Depn. provision A/c	5,000	31.12.21	By P&L A/c	5,000
		5,000			5,000
31.3.22	To Depn. provision A/c	150	31.12.22	By P&L A/c	5,000
30.6.22	To Depn. provision A/c	800			
31.12.22	To Depn. provision A/c	4050			
		5,000			5,000

Working notes

(1) Sold on 31.3.2022			(2) Sold on 30.6.2022		
1.7.2021	Cost	6,000	1.1.2020	Cost	16000
31.12.2021	Depreciation	300	31.12.2020	Depreciation	1600
1.1.2022	Balance	5,700	1.1.2021	Balance	14400
31.3.2022	Depreciation	150	31.12.2021	Depreciation	1600
31.3.2022	Balance	5,550	1.1.2022	Balance	12800
	Sold' for	5,500	30.6.2022	Depreciation	800
	Loss	50		Balance	12000
				Sold for	13350
				Profit	1350

(3) Deprecation on 31.12.2022	
Original cost of remaining old machine	
40,000 - 16,000 =	24,000
20,000 - 6,000 =	14,000
	38,000
Depreciation @10%	3,800
One new machine	
10,000 × 10 ÷ 100 × 3 ÷ 12	250
	4050

35. A Trader purchased an old Machinery for ₹37,000 on 1st January, 2015 and spent ₹3,000 on its overhauling. On 1st July 2016, another machine was purchased for ₹10,000. On 1st July 2017, the machinery which was purchased on 1st January 2015, was sold for ₹28,000 and the same day a new machinery costing ₹25,000 was purchased. On 1st July, 2018, the machine which was purchased on 1st July, 2016 was sold for ₹2,000.

Depreciation is charged @ 10% per annum on straight line method. He changed the method and adopted diminishing balance method with effect from 1st January, 2016 and the rate was increased to 15% per annum. The books are closed on 31st December every year.

Prepare Machinery A/c for four years from 1st January, 2015.

[May 2019, 10 Marks]

Sol.

Machinery A/c

Date	Particulars	Amount	Date	Particulars	Amount
2015			2015		
Jan. 1	To Bank A/c (M1)	37,000	Dec. 31	By Depn. A/c	4,000
	To Bank A/c (M1) - overhauling	3,000		By Balance c/d	36,000
	Total	40,000		Total	40,000
2016			2016		
Jan. 1	To Balance b/d (M1)	36,000	Dec. 31	By Depn. A/c	
July 1	To Bank A/c (M2)	10,000		M1 5400	
				M2 750	6,150
				By Balance c/d	
				M1 30600	
				M2 9250	39,850
	Total	46,000		Total	46,000
2017			2017		
Jan. 1	By Balance c/d		July 1	By Depn. A/c	2,295
	M1 30600			By Bank A/c	28,000
	M2 9250	39,850		By Profit & Loss A/c (1)	305
July 1	To Bank A/c (M3)	25,000	Dec. 31	By Depn. A/c	
				M2 1388	
				M3 1875	3,263
				By Balance c/d	
				M1 7862	
				M3 23125	30,987
	Total	64,850		Total	64,850

2018 Jan. 1	By Balance c/d		2018 July 1	By Depn. A/c	590
	M2	7862		By Bank A/c	2,000
	M3	<u>23125</u>	Dec. 31	By Profit & Loss A/c (2)	5,272
		30,987		By Depn. A/c	3,469
				By Bank c/d	19,656
	Total	30,987		Total	30,987

Working Note:-

(1)	Calculation of Loss on 1st Machinery:	₹
	Balance of Machinery as on 1 Jan, 2017	36,600
	Less: Depreciation upto 1 July, 2017 $\left(30,600 \times \frac{15}{100} \times \frac{6}{12}\right)$	2,295
	Balance of Machine on date of Sale	28,305
	Less: Sale value of Machinery	28,000
	Loss on sale of asset	305
(2)	Calculation of Loss on 2nd Machinery:	
	Balance of Machinery as on 1 Jan, 2018	7,860
	Less: Depreciation upto 1 July, 2018 $\left(7,862 \times \frac{15}{100} \times \frac{6}{12}\right)$	590
	Balance of Machine on date of Sale	7,272
	Less: Sale value of Machinery	2,000
	Loss on sale of asset	5,272

36. Prime Streaming Co. acquired the streaming rights of a movie for ₹18,00,000 with the contracted duration of the streaming period being 10 years. At the beginning of the fourth year, based on the decline in viewership, Prime Streaming Co. decided to stream the movie only for the next 5 years.

Required:

Calculate amortisation for the fourth year.

(ICAI Study Material)

Sol. Amortisation every year will be = ₹18,00,000 / 10 = ₹1,80,000

Amortisation on SLM charged for 3 years = ₹1,80,000 × 3 = ₹5,40,000

Balance Amount of the Streaming Rights at the end of third year

= ₹18,00,000 – ₹5,40,000 = ₹12,60,000.

Balance useful life as per previous estimate = 7 years

Balance useful life as per revised estimate = 5 years

Amortisation from the 4th year onwards = ₹12,60,000 / 5 = ₹2,52,000 per annum



PRACTICAL QUESTIONS

1. Mr. Dravid. has provided following details related to his financials. Find out the missing figures:

Particulars	(₹in'000)
Profits carved during the year	5,000
Assets at the beginning of year	A
Liabilities at the beginning of year	12,000
Assets at the end of the year	B
Liabilities at the end of the year	C
Closing capital	35,000
Total liabilities including capital at the end of the year	50,000

(ICAI Study Material)

Sol.

Computing opening capital: (All figure in ₹' 000) Closing capital - profits earned during the year

$$= 35,000 - 5,000$$

$$= 30,000$$

We also know:

Assets = liabilities + capital

$$\begin{aligned} \text{Therefore, opening assets (A)} &= 12,000 + 30,000 \\ &= 42,000 \end{aligned}$$

Computation of liabilities at the end of the year:

$$\text{Total liabilities including capital} = 50,000$$

$$\text{Less: closing capital} = \underline{(35,000)}$$

$$\text{Liabilities at the end of the year (C)} = 15,000$$

$$\begin{aligned} \text{Also assets at the end of the year (B)} &= \text{closing capital} + \text{liabilities at the end of the year} \\ &= 35,000 + 15,000 \\ &= 50,000 \end{aligned}$$

2. Given below is a ledger extract relating to the business of A and Co. as on March, 31, 2022. You are required to prepare the Trial Balance by the Total Amount Method.

Dr.		Cash A/c		Cr.	
Particulars	₹	Particulars	₹		
To Capital A/c	10,000	By Furniture A/c	3,000		
To Shyam's A/c	25,000	By Salaries A/c	2,500		
To Cash Sales	500	By Ram's A/c	21,000		
		By Cash Purchases	1,000		
		By Capital A/c	500		
		By Balance c/d	7,500		
	35,500		35,500		

Dr.		Furniture A/c		Cr.	
Particulars	₹	Particulars	₹		
To Cash A/c	3,000	By Balance c/d	3,000		
	3,000		3,000		

Dr.		Salaries A/c		Cr.	
Particulars	₹	Particulars	₹		
To Cash A/c	2,500	By Balance c/d	2,500		
	2,500		2,500		

Dr.		Ram's A/c		Cr.	
Particulars	₹	Particulars	₹		
To Cash A/c	21,000	By Purchases A/c	25,000		
To Purchase Returns A/c	500	(Credit Purchase)			
To Balance c/d	3,500		—		
	25,000		₹		

Dr.		Purchases A/c		Cr.	
Particulars	₹	Particulars	₹		
To Cash A/c (Cash Purchases)	1,000	By Balance c/d	26,000		
To Sundries as per Purchases Book					
(Credit Purchases)	25,000		—		
	26,000		26,000		

Dr. Purchases Returns A/c		Cr.	
Particulars	₹	Particulars	₹
To Balance c/d	500	By Sundries as per Purchases Return Book	500
	500		500

Dr. Shyam's A/c		Cr.	
Particulars	₹	Particulars	₹
To Sales A/c (Credit Sales)	30,000	By Sales Returns A/c	100
		By Cash A/c	25,000
		By Balance c/d	4,900
	30,000		30,000

Dr. Sales A/c		Cr.	
Particulars	₹	Particulars	₹
To Balance c/d	30,500	By Cash A/c (Cash Sales)	500
		By Sundries as per Sales Book (Credit Sales)	30,000
	30,500		30,500

Dr. Sales Returns A/c		Cr.	
Particulars	₹	Particulars	₹
To Sundries as per Sales Returns Book	100	By Balance c/d	100
	100		100

Dr. Capital A/c		Cr.	
Particulars	₹	Particulars	₹
To Cash A/c	500	By Cash A/c	10,000
To Balance c/d	9,500		
	10,000		10,000

(ICAI Study Material)

Sol.

Trial Balance of X and Co. on 31 March 2022

Sl. No.	A/c	Dr ₹	Cr ₹
1.	Cash A/c	35,500	28,000
2.	Furniture A/c	3,000	

Sl. No.	A/c	Dr ₹	Cr ₹
3.	Salaries A/c	2,500	
4.	Ram's A/c	21,500	25,000
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Shyam's A/c	30,000	25,100
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c	500	10,000
		1,19,100	1,19,100

3. Taking the same information as given in Question 1, prepare the Trial Balance by Balance Method.
(ICAI Study Material)

Sol.

Trial Balance of X and Co. on 31 March 2022

Sl. No.	A/c	Dr ₹	Cr ₹
1.	Cash A/c	7,500	
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Ram's A/c		3,500
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	4,900	
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c		9,500
		44,000	44,000

4. Show the classification of the following A/cs under traditional and Accounting equation approach:
(ICAI Study Material)

a	Rent outstanding	g	Capital
b	Closing Inventory	h	Sales Tax Payable
c	Sales	i	Trade receivables

d	Bank Fixed Deposit	j	Depreciation
e	Cash	k	Drawings
f	Bad Debts		

Sol.

Nature of A/c

Sl. No.	Title of A/c	Traditional Approach	Accounting Equation Approach
a	Rent Outstanding	Personal	Liability
b	Closing Inventory	Real	Asset
c	Sales	Nominal	Revenue
d	Bank Fixed Deposit	Personal	Asset
e	Cash	Real	Asset
f	Bad Debts	Nominal (Expense)	Temporary Capital (Expense)
g	Capital	Personal	Capital
h	Sales Tax Payable	Personal	Liability
i	Trade receivables	Personal	Asset
j	Depreciation	Nominal (Expense)	Temporary Capital (Expense)
k	Drawings	Personal	Temporary Capital (Drawings)

5. Show the effect of increase = (+), decrease = (-) and no change=(0) on the assets of the following transactions:

- Purchased office furniture, payment to be made next month.
- Collected cash for repair services
- Goods sold on credit.
- Withdrawal of cash by the owner for personal use.
- Hired an employee as sales manager of the north wing.
- Returned goods worth ₹50,000.
- One of our debtor agreed to pay his dues to Mr. C who is a creditor of the company with the same amount being due to him.
- Entered into an agreement with Mehta & Co. to purchase all raw materials from their company from next year.

Also give reasons for your answers.

(ICAI Study Material)

Sol.

S.No.	Increase (+) / Decrease (-) / No Change (0) in Assets	Reasons
(a)	+	Furniture has been purchased making it an increase in assets and also it being purchased on credit it increases liability and there is no outflow of assets like cash or bank.
(b)	+	Cash has flowed in for services provided making it an increase in assets.
(c)	+	Here with goods sold there is a decrease in inventory (assets) but given there is an increase in debtors there will be a net increase in assets. Though if goods are sold at cost it will result in no change whereas sale at below cost will result in decrease in assets.
(d)	-	Here cash has been withdrawn from business resulting in decrease in assets and capital.
(e)	0	Only hiring of employee has been done resulting in no change in assets.
(f)	-	Outflow of goods has resulted in decrease in assets while money owed to creditors reduce on the liability side.
(g)	-	Here both assets and liabilities reduce by same amounts meaning a decrease in assets.
(h)	0	Only a purchase agreement has been entered into with no transaction taking place yet.

6. Shri Ram maintains a Columnar Petty Cash Book on the Imprest System. The imprest amount is ₹500. From the following information, show how his Petty Cash Book would appear for the week ended 12th September, 2023:

		₹
7-9-2022	Balance in hand	134.90
	Received Cash reimbursement to make up the imprest	365.10
	Stationery	49.80
8-9-2022	Miscellaneous Expenses	20.90
9-9-2022	Repairs	156.70
10-9-2022	Travelling	68.50
11-9-2022	Stationery	71.40
12-9-2022	Miscellaneous Expenses	6.30
13-9-2022	Repairs	48.30

(ICAI Study Material)

Sol.

Petty Cash Book

Date 2023	Receipts	Amount ₹	Date 2023	Payments	Total Amount ₹	Stationery ₹	Travelling ₹	Misc Exps. ₹	Repairs ₹
Sept. 7	To Balance b/d	134.90	7	By Stationery	49.80	49.80			
	To Reim- bursement	365.10	8	By Misc. Expenses	20.90			20.90	
			9	By Repairs	156.70				156.70
			10	By Travelling	68.50		68.50		
			11	By Stationery	71.40	71.40			
			12	By Misc. Expenses	6.30			6.30	
			13	By Repairs	48.30				48.30
					421.90	121.20	68.50	27.20	205.00
				By Balance c/d	78.10				
		500.00			500.00				
	To Balance b/d	78.10							

7. The following Trail balance as on 31st March, 2022 was drawn from the books of fintech traders:

Particulars	L.F.	Dr. Balance (₹)	Cr. Balance (₹)
Building		60,000	-
Machinery		17,000	-
Return Outward		2,600	-
Bad Debts		2,800	-
Cash		400	-
Discount Received		3,000	-
Bank Overdraft		10,000	-
Creditors		50,000	-
Purchases		1,00,000	-
Capital		-	73,600
Fixtures		-	5,600
Sales		-	1,04,000
Debtors		--	60,000
Interest Received		-	2,600

Particulars	L.F.	Dr. Balance (₹)	Cr. Balance (₹)
Input CGST A/c		-	3,000
Input SGST A/c		-	3,000
Input IGST A/c		-	4,800
Output CGST A/c		5,400	-
Output SGST A/c		5,400	-
Total		2,56,600	2,56,600

Even though the debit and credit sides agree, the trial Balance contains certain errors.
Check the accuracy of trial balance. (ICAI Study Material)

Sol.

Trial Balance as at 31/03/2022 (After correction)

Particulars	L.F.	Debit (₹)	Credit (₹)
Building		60,000	-
Machinery		17,000	-
Return Outward		-	2,600
Bad Debts		2,800	-
Cash		400	-
Discount Received		-	3,000
Bank Overdraft		-	10,000
Creditors		-	50,000
Purchases		1,00,000	-
Capital		-	73,600
Fixtures		5,600	-
Sales		-	1,04,000
Debtors		60,000	-
Interest Received		-	2,600
Input CGST A/c		3,000	-
Input SGST A/c		3,000	-
Input IGST A/c		4,800	-
Output CGST A/c		-	5,400
Output SGST A/c		-	5,400
		2,56,600	2,56,600

8. Transactions of Ramesh for April are given below. Journalise them.

2020			₹
April	1	Ramesh started business with	10,00,000
"	3	Bought goods for cash	50,000
"	5	Drew cash from bank	10,000
"	13	Sold to Krishna - goods on credit	1,50,000
"	20	Bought from Shyam goods on credit	2,25,000
"	24	Received from Krishna	1,45,000
"		Allowed him discount	5,000
"	28	Paid Shyam cash	2,15,000
"		Discount allowed	10,000
"	30	Cash sales for the month	8,00,000
		Paid Rent	50,000
		Paid Salary	1,00,000

(ICAI Study Material)

Sol.

JOURNAL

Date 2020	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
April 1	Bank A/c Dr. To Capital A/c (Being the amount invested by Ramesh in the business as capital)	1 4	10,00,000	10,00,000
" 3	Purchases A/c Dr. To Bank A/c (Being goods purchased for cash)	7 1	50,000	50,000
" 5	Cash A/c Dr. To Bank A/c (Being cash withdrawn from bank)	5 1	10,000	10,000
" 13	Krishna Dr. To Sales A/c (Being goods sold to Krishna on credit)	9 11	1,50,000	1,50,000
" 20	Purchases A/c Dr. To Shyam (Being goods bought from Shyam on credit)	7 10	2,25,000	2,25,000

“ 24	Bank A/c	Dr.	1	1,45,000	1,50,000
	Discount A/c	Dr.	12	5,000	
	To Krishna		9		
	(Being cash received from Krishna and discount allowed to him)				
“ 28	Shyam	Dr.	10	2,25,000	2,15,000 10,000
	To Bank A/c		1		
	To Discount A/c		12		
	(Being cash paid to Shyam and discount allowed by him)				
“ 30	Bank A/c	Dr.	1	8,00,000	8,00,000
	To Sales A/c		11		
	(Being goods sold for cash)				
“ 30	Rent A/c	Dr.	15	50,000	1,50,000
	Salaries A/c	Dr.	14	1,00,000	
	To Bank A/c		1		
	(Being the amount paid for rent and salary)				
	Rent A/c	Dr.	15	50,000	1,50,000
	Salaries A/c	Dr.	14	1,00,000	
	To Bank A/c		1		
	(Being the amount paid for rent and salary)				
	Total			27,60,000	27,60,000
	(Ledger Folio imaginary)				

9. Enter the following transactions in Cash Book with Discount and Bank Columns. Cheques are first treated as cash receipt.

		₹
Jan.1	Chandni commences business with Cash	20,000
“ 3	He paid into Current A/c	19,000
“ 4	He received cheque from Kirti & Co. on A/c	600
“ 7	He pays in bank Kirti & Co.'s cheque	600
“ 10	He pays Rattan & Co. by cheque and is allowed discount ₹20	330
“ 12	Tripathi & Co. pays into his Bank A/c	475
“ 15	He receives cheque from Warshi and allows him discount ₹35	450
“ 20	He receives cash ₹75 and cheque ₹100 for cash sale	
“ 25	He pays into Bank, including cheques received on 15th and 20th	1,000
“ 27	He pays for cash purchase	275
“ 30	He pays sundry expenses in cash	50

(ICAI Study Material)

Sol.

Dr.

Cash Book

Cr.

Date	Receipts	L.F.	Dis- count ₹	Cash ₹	Bank ₹	Date	Payments	L.F.	Dis- count ₹	Cash ₹	Bank ₹
2022						2022					
Jan. 1	To Capital A/c			20,000		Jan. 3	By Bank A/c	C		19,000	
3	To Cash	C			19,000	7	By Bank A/c	C		600	
4	To Kirti & Co.			600		10	By Ratan & Co.		20		330
7	To Cash	C			600	25	By Bank A/c	C		1,000	
12	To Tripathi & Co.				475	27	By Purchases A/c			275	
15	To Warshi		35	450		30	By S. Exp. A/c			50	
20	To Sales A/c			175							
25	To Cash	C			1,000						
						31	By Balance c/d			300	20,745
			35	21,225	21,075				20	21,225	21,075
Feb. 1	To Balance b/d			300	20,745						

10. Enter the following transaction in Cash Book with Discount and Bank columns. Cheques are first treated as cash receipts –

2022		₹
March 1	Cash in Hand	15,000
	Overdraft in Bank	500
2	Cash Sales	3,000
3	Paid to Sumesh Bros. by cheque	3,400
	Discount received	100
5	Sales through credit card	2,800
6	Received cheque from Srijan	6,200
7	Endorsed Srijan's cheque in favour of Adit	
9	Deposit into Bank	6,800
10	Received cheque from Aviral and deposited the same into Bank by allowing discount of ₹50	3,600
12	Adit informed that Srijan's cheque is dishonoured. Now cash is received from Srijan and amount is paid to Adit through own cheque	

2022		₹
15	Sales through Debit Card	3,200
24	Withdrawn from Bank	1,800
28	Paid to Sanchit by cheque	3,000
30	Bank charged 1% commission on sales through Debit/Credit Cards	

(ICAI Study Material)

Sol.

Dr.

Cash Book

Cr.

Date	Particulars	L.F.	Dis- count ₹	Cash ₹	Bank ₹	Date	Particulars	L.F.	Dis- count ₹	Cash ₹	Bank ₹
2022						2022					
March 1	To Balance b/d			15,000		March 1	By Balance b/d				500
2	To Sales			3,000		3	By Sumesh Bros.		100		3,400
5	To Sales				2,800	7	By Adit			6,200	
6	To Srijan			6,200		9	By Bank	C		6,800	
9	To Cash A/c	C			6,800	12	By Adit				6,200
10	To Aviral		50		3,600	24	By Cash A/c	C			1,800
12	To Srijan			6,200		28	By Sanchit				3,000
15	To Sales A/c				3,200	30	By Commission				60
24	To Bank A/c	C		1,800		31	By Balance c/d			19,200	1,440
			50	32,200	16,400				100	32,200	16,400

Note: If a received check is promptly endorsed to another party on the same day, there is no need for an entry. Nevertheless, in the scenario described above, the entry was made via the cash column due to the endorsement occurring on the subsequent day.

11. The following are some of the transactions of M/s. Ramesh & Sons for the year ended 31st March, 2020. You are required to make out their Sales Book.

(i) Sold to M/s. Geeta & Seeta on Credit:

40 Shirts @ ₹900 per shirt

30 trousers @ ₹1,000 per trouser

Less: Trade discount @ 10%

(ii) Sold furniture to M/s. Pankaj & Co. on credit ₹8,000

(iii) Sold 15 shirts to Bhavna @ ₹750 each for cash.

(Nov, 2020, 4 Marks)

Sol.

In the books of M/s. Ramesh & Sons
Sales Book

Date	Particular	Invoice No.	L.F.	Details (₹)	Amount (₹)
2020	M/s. Geeta & Seeta				
	40 Shirts @ ₹900			36,000	
	30 Trousers @ ₹1000			30,000	
				66,000	
	Less: 10 % Trade discount			(6600)	59,400
	Total				59,400

12. Calculate the missing amount for the following.

(ICAI Study Material)

	Assets	Liabilities	Capital
(a)	15,00,000	2,50,000	?
(b)	?	1,50,000	75,000
(c)	14,50,000	?	13,75,000
(d)	57,00,000	- 2,80,000	?

Sol.

(a) 12,50,000

(b) 2,25,000

(c) 75,000

(d) 59,80,000

These have been solved using the Accounting Equation: Assets = Capital + Liabilities

13. Prepare a Petty Cash Book on the imprest System from the following:

2022		₹
Jan. 1	Received ₹100 for petty cash	
" 2	Paid bus fare	.50
" 2	Paid cartage	2.50
" 3	Paid for Postage	5.00
" 3	Paid wages for casual labourers	6.00
" 4	Paid for stationery	4.00
" 4	Paid Bus charges	2.00
" 5	Paid for the repairs to chairs	15.00
" 5	Bus fare	1.00
" 5	Cartage	4.00
" 6	Postage	7.00
" 6	Bus charges	3.00

2022		₹
" 6	Cartage	3.00
" 6	Stationery	2.00
" 6	Refreshments to customers	5.00

(ICAI Study Material)

Sol.

Petty Cash Book

R e - ceipts ₹	Date 2022	V. No.*	Particulars	Total ₹	Con- veyance ₹	Cart- age ₹	Statio- nery ₹	Postage ₹	Wages ₹	Sun- dries ₹
100	Jan.1		To Cash							
	2	1	By Conveyance	.50	.50					
		2	By Cartage	2.50		2.50				
	3	3	By Postage	5.00				5.00		
		4	By Wages	6.00					6.00	
	4	5	By Stationery	4.00			4.00			
		6	By Conveyance	2.00	2.00					
	5	7	By Repairs to Furniture	15.00						15.00
		8	By Conveyance	1.00	1.00					
		9	By Cartage	4.00		4.00				
	6	10	By Postage	7.00				7.00		
	"	11	By Conveyance	3.00	3.00					
	"	12	By Cartage	3.00		3.00				
	"	13	By Stationery	2.00			2.00			
	"	14	By General Expenses	5.00						5.00
				60.00	6.50	9.50	6.00	12.00	6.00	20.00
			By Balance c/d	40.00						
100			To Balance b/d To Cash	100.00						
40.00										
60.00	8									

14. One of your clients Mr. Vikas asked you to finalize his A/c for the year ended 31st March, 2022. As a basis for audit, Mr. Vikas furnished you with the following statement:

Particular	Dr. (₹)	Cr. (₹)
Vikas's Capital		4,668
Vikas's Drawings	1,692	

Particular	Dr. (₹)	Cr. (₹)
Leasehold Premises	2,250	
Sales		8,250
Due from customers		1,590
Purchases	3,777	
Purchase Return	792	
Loan from Bank		768
Trade Expense	2,100	
Trade Payable	1,584	
Bills Payable	300	
Salaries and Wages	1,800	
Cash at Bank	678	
Opening Inventory		792
Rent and Rates	1,389	
Sales Return		294
	16,362	16,362

The closing inventory was ₹1,722. Mr. Vikas claims that he has recorded every transaction correctly as the trial balance is tallied. Check the accuracy of the above trial balance and give reasons for the errors, if any. [June 2022, 4 Marks]

Sol.

In the Books of Mr. Vikas
Corrected Trial Balance as on 31st March, 2022

Name of A/cs	Dr. (₹)	Cr. (₹)
X's Capital	-	4,668
X's Drawings	1,692	-
Leasehold Premises	2,250	-
Sales	-	8,250
Due from customers	1,590	-
Purchases	3,777	-
Purchase return	-	792
Loan from Bank	-	768
Trade Expense	2,100	-
Trade Payable	-	1,584
Bills Payable	-	300
Salaries and Wages	1,800	-
Cash at Bank	678	-
Opening Inventory	792	-
Rent and Rates	1,389	-
Sales Return	294	-
Total	16,362	16,362

Reasons:-

1. Due from customer & opening inventory are treated as assets of the business so they are recorded in the debit side of trial balance.
2. Trade payable & Bills Payable are treated as liabilities so they are recorded on a credit side of trial balance.
3. Purchase return & Sales return always show the credit balance & debit balance respectively.

15.

Enter the following transactions in a Simple Cash Book:

2022		Amount ₹
Jan.1	Cash in hand	1,200
"5	Received from Shyam	300
"7	Paid Rent	30
"8	Sold goods for cash	300
"10	Paid to Ram	700
"27	Purchased Furniture	200
"31	Paid Salaries	100
"31	Rent due, not yet paid, for January	30

(ICAI Study Material)

Sol.

Dr.

Cash Book in the books of.....

Cr.

Date 2022	Receipts	L.F.	Amount ₹	Date 2022	Payments	L.F.	Amount ₹
Jan. 1	To Balance b/d		1,200	Jan. 07	By Rent A/c		30
" 5	To Shyam A/c		300	" 10	By Ram A/c		700
" 8	To Sales A/c		300	" 27	By Furniture A/c		200
					By Salaries A/c		100
					By balance c/d		770
			1800				1800

Note: The basic cash book exclusively documents cash receipts and cash payments, since Rent due for January, which remains unpaid, will not be recorded in the cash book It will be documented through a journal entry (i.e. Rent A/c Dr. To Rent Payable A/c).

16. Following are the transactions entered into by R after he started his business. Show how various A/cs will be affected by these transactions:

2020 April		(₹in 000)
1.	R started business with	5,000
2.	He purchased furniture for	1,200

2020 April		(₹in 000)
3.	Paid salary to his clerk	1,100
4.	Paid rent	1,150
5.	Received interest	2,000

(ICAI Study Material)

Sol.

2020 April	Explanation	A/cs Involved	Nature of A/cs	How affected	Debit (₹in 000)	Credit (₹in 000)
1.	₹5,000 cash invested in business	Bank and R's Capital	Asset Capital	Increased Increased	5,000	5,000
2.	Purchased furniture for ₹1,200	Furniture and Bank	Asset Asset	Increased Decreased	1,200	1,200
3.	Paid ₹1,100 to employee for salary	Salary & Bank	Expense Asset	Increased Decreased	1,100	1,100
4.	Paid Rent ₹1,150	Rent & Bank	Expense Asset	Increased Decreased	1,150	1,150
5.	Received interest ₹2,000	Cash & Interest	Asset Income	Increased Increased	2,000	2,000

17. From the following transactions prepare the purchase book of Ashok for September 2023.

- 1 Purchased on credit from Keshav & Co.: 60 Electric Irons @ ₹35, 10 Toasters @ ₹30
- 6 Purchased for Cash from Amit & Bros.: 25 Table Lamps @ ₹15
- 10 Purchased from Praveen & Sons on credit: 30 Electric Stoves @ ₹30, 20 Heaters @ ₹40.
- 16 Purchased on credit from Sheena & Co.: 25 Heaters @ ₹30.
- 20 Purchased on credit one typewriter from Reena and for 1,600

Sol.

Purchase Book of Ashok

Date	Particular	Invoice No.	L.F.	Details	₹Net Invoice
1.9.2023	Keshav & Co, 60 Electric Irons @ ₹35 10 Toasters @ ₹30			2100 300	2400
10.9.2023	Harsh & Sons 30 Electric Stoves @ ₹30 20 Heaters @ ₹40			900 800	1700

Date	Particular	Invoice No.	L.F.	Details	₹Net Invoice
16.9.2023	Sheena & Co. 25 Heaters @ ₹30				750
				Total	4,850

Note: Total of ₹4,850 shall be debited to purchase A/c & individual Party account will be credited with respective amount.

18. From the following transactions prepare the Cash Book with cash and discount columns:

Oct. 2017	₹
1 Opening cash balance	2600
3 Received from D & Co. ₹1,450 in full settlement of ₹1,500	
4 Received for cash sales	1250
5 Paid to Ramesh & Co. ₹875 in full settlement of his A/c for	900
7 Purchased office furniture	770
13 Paid for postal stamps	35
15 Paid for office rent for month of Sept., 2017 in Oct. 2017	130
17 Used office cash for meeting personal expenses	160
19 Sold goods on credit to Mr. Faheem	1700
20 Paid to Rani ₹770 in full settlement of his A/c for	₹800
20 Deposited in the Bank all cash in excess of	₹1,300.

Sol.

Double Column Cash Book

Dr.

Cr.

Date	Particulars	LF	Dis	Cash	Date	Particulars	LF	Dis	Cash
1.10.2017	To Opening b/d			2600	5.10.2017	By Ramesh & Co.		25	875
3.10.2017	To D & Co. a/c		50	1450	7.10.2017	By Furniture a/c			770
4.10.2017	To Sales a/c.			1250	13.10.2017	By Postage exp. a/c			35
					15.10.2017	By Rent payable a/c			130
					17.10.2017	By Drawings a/c			160
					20.10.2017	By Rani a/c		30	770
					20.10.2017	By Bank a/c			1260
					20.10.2017	By Balance c/d			1300
			50	5300				55	5300

Note: The discount columns in the cash book are subjected to totaling and doesn't require balancing, However, totals are subsequently recorded in the ledger under the 'Discount Received/Paid' A/c.

19. From the following transactions, prepare the Purchases Returns Book of ABC & Co., a Cloth dealer :

Date	Debit Note No.	Particulars
05.06.2021	303	Returned to Gupta & sons, Mumbai - 5 Shirts @ ₹800.
10.06.2021		Returned to us by Mishra wholesales, Jaipur - goods which were purchased for cash 5 Trousers @ ₹500.
17.06.2021	304	Returned to Ambika brothers, Ghaziabad - 5 Jeans @ ₹1800.
29.06.2021		Returned 1 office furniture because it was defective worth ₹50000 to FGB Furnitures.

Purchase Returns Book

Date	Debit Note No.	Name of supplier	L.F.	Amount
2021				
June. 5	303	Gupta & Sons, Mumbai		4,000
June. 17	304	Ambika brothers, Ghaziabad		9,000
June 30		Purchases Returns A/c (Cr.)		13,000

20. Analyse transactions of M/s Sahil & Co. for the month of March, 2020 on the basis of double entry system by adopting the following approaches:

(A) Accounting Equation Approach.

(B) Traditional Approach.

Transactions for the month of March, 2020 were as follows (figures are in '000):

1. Sahil introduced capital through bank of ₹4,000.
2. Cash withdrawn from the City Bank ₹200.
3. Loan of ₹500 taken from Mr. Y.
4. Salaries paid for the month of "dcMarch, 2020, ₹300 and ₹100 is still payable for the month of March, 2020.
5. Furniture purchased ₹500. Required

What conclusions one can draw from the above analysis? (ICAI Study Material)

Sol.

(A) Analysis of Business Transaction: Accounting Equation Approach.

The Accounting equation is Assets = Liabilities + Capital (₹in '000)

ASSETS						=	CAPITAL	+	LIABILITIES
	CASH	+	BANK	+	FURNITURE	=	CAPITAL	+	LIABILITIES
(a)	-	+	4,000	+	-	=	4,000	+	-
(b)	+200	+	-200	+	-	=	-	+	-
(c)	-	+	500	+	-	=	-	+	500

ASSETS						=	CAPITAL	+	LIABILITIES
	CASH	+	BANK	+	FURNITURE	=	CAPITAL	+	LIABILITIES
(d)	-	+	-300	+	-	=	-400	+	100
(e)	-	+	-500	+	500	=	-	+	-
Balance	200	+	3,500	+	500	=	3,600	+	600
			4,200				4,200		

(B) Analysis of Business Transactions: Traditional Approach

Transaction	Analysis	A/c Affected and Nature of A/c	Rule	Entry
Introduction of ₹4,000 through bank by the proprietor	Bank has received money; Owner has given money	Bank–Personal Capital–Personal	Debit the receiver Credit the giver	Dr Bank Cr Capital
Cash Withdrawn from Bank Rs. 200	Cash comes inside the business; Bank gives out cash	Cash–Real Bank–Personal	Debit what comes in Credit the giver	Dr Cash Cr Bank
Loan from Y ₹500	Bank receives the money :Y pays through bank	Bank–Personal Y's Loan–Personal	Debit the receiver Credit the giver	Dr Bank Cr Y's Loan
Salary paid ₹300 and still payable ₹100	Cost of services ₹400; Bank gives ₹300; Still payable amount or outstanding amount for services received ₹100	Salary Nominal Bank–Personal Salary Outstanding–Personal	Debit all expenses Credit the giver Credit the giver	Dr Salary (₹400) Cr. Bank (₹3,00) Cr Salary outstanding (₹100)
Furniture purchased ₹500	Furniture purchased; Bank gives the money	Furniture Real Bank–Personal	Debit what comes in Credit the giver	Dr Furniture Cr Bank

Conclusion:

The examination above highlights that the process for scrutinizing transactions, categorizing A/cs, and guidelines for documenting business transactions differ between the Accounting equation approach and the traditional approach. Despite these variances in analysis methodology, the A/cs impacted and the entries made in those A/cs remain consistent under both approaches. In essence, the act of recording transactions in affected A/cs using the double-entry system is unaffected by the analytical method chosen by a business enterprise. In simpler terms, the A/cs designated for debiting and crediting to document the dual aspect remain unchanged across both approaches.

21. From the following ledger balances, prepare a trial balance of Anirudh Traders as on 31st March, 2022:

A/c Head	₹
Capital	1,00,000
Sales	1,66,000
Purchases	1,50,000
Sales return	1,000
Discount allowed	2,000
Expenses	10,000
Trade receivables	75,000
Trade payables	25,000
Investments	15,000
Cash at bank and in hand	37,000
Interest received on investments	1,500
Insurance paid	2,500

(ICAI Study Material)

Sol.

Trial Balance of Anirudh Traders as at 31 March 2022

A/c	Debit balance ₹	A/c	Credit balance ₹
Purchases	1,50,000	Capital	1,00,000
Sales return	1,000	Sales	1,66,000
Discount allowed	2,000	Trade payables	25,000
Expenses	10,000	Interest received on investments	1,500
Trade receivables	75,000		
Investments	15,000		
Cash at bank and in hand	37,000		
Insurance paid	2,500		
Total	2,92,500		2,92,500

22. From the following information prepare the Purchase Book of M/s. Radha & Co.

(i) Purchased from Vishnu & Co. on credit:

- 10 pair of black shoes @ ₹800 per pair

- 5 pair of brown shoes @ 900 per pair

Less: Trade Discount@10%

(ii) Purchased Computer from M/s. Gaurav & Co. on credit for ₹40,000.

- (iii) Purchased from Bhavesh & Co. in cash :
 - 5 pair of black shoes @ ₹700 per pair
 - 15 pair of brown shoes @ 100 per pair
 Less: Trade Discount @15%

[July 2021, 5 Marks]

Sol.

In the Books of M/s. Radha & Co.
Purchase Book

Date	Particular	L.F.	Details (₹)	Amount (₹)
(i)	Vishnu & Co. 10 pair of Black Shoes @ ₹800 per pair 5 pair of Brown shoes @ ₹900 per pair Less: 10 % Trade Discount		8,000 4,500 12,500 (1,250)	 11,250
	Total			11,250

23. Pass Journal Entries for the following transactions in the books of Gamma Bros.

- (i) Employees had taken inventory worth ₹1,00,000 (Cost price ₹75,000) on the eve of Deepawali and the same was deducted from their salaries in the subsequent month.
 (ii) Wages paid for erection of Machinery ₹18,000.
 (iii) Income tax liability of proprietor ₹1,17,000 was paid out of petty cash.
 (iv) Purchase of goods from Naveen of the list price of ₹2,00,000. He allowed 10% trade discount, ₹5,000 cash discount was also allowed for quick payment.

Sol.

Journal Entries in the books of Gamma Bros.

	Particulars		Dr. Amount ₹	Cr. Amount ₹
(i)	Salaries A/c To Purchase A/c (Being entry made for inventory taken by employees)	Dr.	75,000	75,000
(ii)	Machinery A/c To Bank/Cash A/c (Being wages paid for erection of machinery)	Dr.	18,000	18,000
(iii)	Drawings A/c To Petty Cash A/c (Being the income tax of proprietor paid out of business money)	Dr.	1,17,000	1,17,000

	Particulars		Dr. Amount ₹	Cr. Amount ₹
(iv)	Purchase A/c To Naveen A/c (Being goods purchased from Naveen)	Dr.	1,80,000	1,80,000
	Naveen A/c To Cash To Discount Received A/c (Being cash received from the goods purchased from Naveen for ₹2,00,000. 10% trade discount and cash discount of ₹5,000 allowed to him)	Dr.	1,80,000	1,75,000 5,000

Note:

- Here wages paid on erection of machinery have been capitalised therefore machinery A/c has been debited directly instead of wages being recorded as an expenditure.
- The students may also note that trade discount is allowed on the list price of goods. It is deducted to find out the invoice amount of the goods to be recorded in the books. Cash discount is a discount allowed in case of early payments to the seller. The entry is made in the books of A/cs for cash discount.

24. An inexperienced book keeper has drawn up a Trial balance for the year ended 31st March, 2019.

Particular	Debit (₹)	Credit (₹)
Provision for Doubtful Debts	250	-
Cash Credit A/c	1654	-
Capital	-	4591
Trade payables	-	1637
Due from customers	2983	-
Discount Received	252	-
Discount Allowed	-	733
Drawings	1200	-
Office Furniture	2155	-
Carriage Inward	-	829
Purchases	10923	-
Returns Inward	-	330
Rent & Rates	314	-
Salaries	2520	-
Sales	-	16882
Inventory	2418	-
Provision for Depreciation on Furniture	364	-
Total	25,033	25,002

Draw up a corrected Trial Balance by debiting or crediting any residual errors to a Suspense A/c. [Nov. 2019, 5 Marks]

Sol.

Trial Balance as on 31st March, 2019

Name of A/c	L.F.	Dr. Bal.	Cr. Bal.
Provision for Doubtful Debts			250
Cash Credit A/c			1654
Capital			4591
Trade Payables			1637
Due from Customers		2983	
Discount Received			252
Discount Allowed		733	
Drawings		1200	
Office Furniture		2155	
Carriage Inward		829	
Purchases		10923	
Returns Inward		330	
Rent & Rates		314	
Salaries		2520	
Sales			16,882
Inventory		2418	
Provision for Depreciation on Furniture			364
Suspense A/c (bal. Fig.)		1225	
Total		25,630	25,630

25. From the following information, draw up a Trial Balance in the books of Shri Tanuj as on 31st March, 2021:

Particular	Amount (₹)	Particular	Amount (₹)
Purchases	36,000	Capital	1,40,000
Carriage Inward	8,700	Discount Allowed	1,200
Sales	60,000	Carriage Outwards	2,300
Return Outwards	700	Return Inward	300
Plant and Machinery	80,700	Rent and Taxes	1,200
Sundry Debtors	20,200	Stock on 1st April, 2020	15,500
Investments	3,600	Sundry Creditors	12,000
Cash in Hand	100	Commission Received	1,800
Motor Cycle	34,600	Cash at Bank	10,100
		Stock on 31st March, 2021	20,500

[Dec. 2021, 5 Marks]

Sol.

In the Books of Shri Tanuj
Trial Balance as on 31st March, 2021

Name of A/c	L.F.	Debit Bal. (₹)	Credit Bal. (₹)
Capital		-	1,40,000
Purchases		36,000	-
Discount Allowed		1,200	-
Carriage Inward		8,700	-
Carriage Outward		2,300	-
Sales		-	60,000
Return Inward		300	-
Return Outward		-	700
Rent & Taxes		1,200	-
Plant & Machinery		80,700	-
Stock on 1st April, 2020		15,500	-
Sundry Debtors		20,200	-
Sundry Creditors		-	12,000
Investments		3600	-
Commission Received		-	1,800
Cash in Hand		100	-
Cash at Bank		10,100	-
Motor Cycle		34,600	-
Total		2,14,500	2,14,500

IMP Information: Closing Stock as on 31st March, 2021 is ₹20,500.

26. Prepare the Stationery A/c of a firm running Business of Supplying Stationery to School for the year ended 31.12.2022 duly balanced off, from the following details:

2020		₹
Jan. 7	Inventory of stationery	210
April 1	Purchase of stationery by cheque	655
Nov. 8	Purchase of stationery on credit from Ramesh	940

Sol.

Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
7.1	To Balance b/d	210	31.12	By Balance c/d	1805
1.4	To Bank A/c	655			
8.11	To Ramesh A/c	940			
		1805			1805

Note: Stationery is Asset in the current question based on Business Type

27. One of your clients, Mr. Maheshwari has asked you to finalise his A/cs for the year ended 31st March, 2022. Till date, he himself has recorded the transactions in books of A/cs. As a basis for audit, Mr. Maheshwari furnished you with the following statement.

	Dr. Balance (₹)	Cr. Balance (₹)
Maheshwari's Capital		1,556
Maheshwari's Drawings	564	
Leasehold premises	750	
Sales		2,750
Dues from customers		530
Purchases	1,259	
Purchases return	264	
Loan from bank		256
Trade payables	528	
Trade expenses	700	
Cash at bank	226	
Bills payable	100	
Salaries and wages	600	
Inventories (1.4.2021)		264
Rent and rates	463	
Sales return		98
	5,454	5,454

The closing inventory on 31st March, 2022 was valued at ₹574. Mr. Singhania claims that he has recorded every transaction correctly as the trial balance is tallied. Check the accuracy of the above trial balance. (ICAI Study Material)

Sol.

Trial Balance as at 31/03/2022 (After correction)

Particulars	Debit ₹	Credit ₹
Singhanian's Capital		1,556
Singhanian's Drawings	564	
Leasehold premises	750	
Sales		2,750
Dues from customers (refer note 1 below)	530	
Purchases	1,259	
Purchases returns (refer note 2 below)		264
Loan from Bank		256
Trade payables (refer note 3 below)		528
Trade expenses	700	

Particulars	Debit ₹	Credit ₹
Cash at Bank	226	
Bills payable (refer note 4 below)		100
Salaries and Wages	600	
Inventory (1.4.2021) (refer note 5 below)	264	
Rent and rates	463	
Sales return (refer note 6 below)	98	
	5,454	5,454

Notes:

1. Outstanding customer dues are categorized as assets, therefore, they carry a debit balance.
2. The Purchases Return A/c consistently displays a credit balance, as it reflects the outflow of assets.
3. The Trade Payables balance is considered a liability, leading to a credit balance.
4. Bills Payable is also a liability, resulting in a credit balance.
5. The Opening Inventory represents assets and consequently holds a debit balance.
6. The Sales Return A/c invariably exhibits a debit balance, signifying the inflow of assets.

28. An inexperienced bookkeeper has drawn up a Trial Balance for the year ended 30th June, 2022.

	Debit (₹)	Credit (₹)
Provision for Doubtful Debts	200	—
Bank Overdraft	1,654	—
Capital	—	4,591
Trade payables	—	1,637
Trade receivables	2,983	—
Discount Received	252	—
Discount Allowed	—	733
Drawings	1,200	—
Office Furniture	2,155	—
General Expenses	—	829
Purchases	10,923	—
Returns Inward	—	330
Rent & Rates	314	—
Salaries	2,520	—
Sales	—	16,882
Inventory	2,418	—
Provision for Depreciation on Furniture	364	—
Total	24,983	25,002

Required:

Draw up a 'Corrected' Trial Balance, debiting or crediting any residual errors to a Suspense A/c. (ICAI Study Material)

Sol.

Trial Balance as at 30/06/2022

Heads of A/cs	Debit ₹	Credit ₹
Provision for Doubtful Debts	—	200
Bank overdraft	—	1,654
Capital	—	4,591
Trade payables	—	1,637
Trade receivables	2,983	—
Discount Received	—	252
Discount allowed	733	—
Drawings	1,200	—
Office furniture	2,155	—
General Expenses	829	—
Purchases	10,923	—
Returns Inward	330	—
Rent & Rates	314	—
Salaries	2,520	—
Sales	—	16,882
Inventory	2,418	—
Provision for Depreciation on Furniture	—	364
Suspense A/c (Balancing figure)	1,175	—
Total	25,580	25,580

29. Show the classification of the following A/cs under traditional and Accounting equation approach:

(a) Building; (b) Purchases; (c) Sales; (d) Bank Fixed Deposit; (e) Rent; (f) Rent Outstanding; (g) Cash; (h) Adjusted Purchases; (i) Closing Inventory; (j) Investments; (k) Trade receivables; (l) Sales Tax Payable; (m) Discount Allowed; (n) Bad Debts; (o) Capital; (p) Drawings; (q) Interest Receivable A/c; (r) Rent received in advance A/c; (s) Prepaid salary A/c; (t) Bad debts recovered A/c; (u) Depreciation A/c, (v) Personal income-tax A/c. (ICAI Study Material)

Sol.

Nature of A/c			
Sl. No.	Title of A/c	Traditional Approach	Accounting Equation Approach
(a)	Building	Real	Asset
(b)	Purchases	Nominal	Asset
(c)	Sales	Nominal	Revenue
(d)	Bank Fixed Deposit	Personal	Asset
(e)	Rent	Nominal (Expense)	Expense
(f)	Rent Outstanding	Personal	Liability
(g)	Cash	Real	Asset
(h)	Adjusted Purchases	Nominal (Expense)	Expense
(i)	Closing Inventory	Real	Asset
(j)	Investment	Real	Asset
(k)	Trade receivables	Personal	Asset
(l)	Sales Tax Payable	Personal	Liability
(m)	Discount Allowed	Nominal (Expense)	Temporary Capital (Expense)
(n)	Bad Debts	Nominal (Expense)	Temporary Capital (Expense)
(o)	Capital	Personal	Capital
(p)	Drawings	Personal	Temporary Capital (Drawings)
(q)	Interest receivable	Personal	Asset
(r)	Rent received in advance	Personal	Liability
(s)	Prepaid salary	Personal	Asset
(t)	Bad debts recovered	Nominal (Gain)	Temporary Capital (Gain)
(u)	Depreciation	Nominal (Expense)	Temporary Capital (Expense)
(v)	Personal Income Tax	Personal (Drawing)	Temporary Capital (Drawings)

30. Enter the following transactions in a three column cash book of M/s. Chander & Co.
May, 2017

- 1 Cash on hand ₹337; Balance at bank ₹6,594.
- 2 Received from Verma cash ₹690, allowed him discount ₹10.
- 4 Paid salaries for March by cash ₹300 and Cash sales of ₹134.
- 5 Paid D.P Sharma by cheque ₹300 and Cash Purchases of ₹60.
- 7 Paid Anshu by cheque ₹585 and discount received ₹15.
- 8 Cash Sales ₹112. Paid cartage and coolie ₹6.
- 10 Paid rent in cash ₹50
- 14 Cash Sales ₹212. Received from R.S Chopra ₹194 after discount of 3%.

- 16 Deposited into Bank ₹600. Purchased a motor car for ₹5,800 and drawn a cheque for the amount.
- 23 Received a cheque from Tripti & Co. for ₹291; after discount of 3%.
- 28 Cash Sales ₹298.
- 29 Bank notifies that Tripti & Co.'s cheque has been dishonoured.
- 30 Deposited with Bank ₹300. Paid wages ₹172. Bank charges as shown in Pass Book ₹5.

Sol.

Triple Column Cash Book

Date	Particular	LF	Dis	Cash	Bank	Date	Particular	LF	Dis	Cash	Bank
1.5.17	To Bal. b/d			337	6594	4.5.17	By Salary payable A/c			300	
2.5.	To Verma A/c		10	690							300
4.5	To Sales A/c			134		5.5.	By D.P Sharma A/c			60	
8.5.	To Sales A/c			112		5.5.	By Purchase A/c		15	6	585
14.5	To Sales A/c			212		7.5	By Anshu A/c			50	
14.	To R.S Chopra A/c		6		194		By Cartage & coolie			600	
					600		By Rent A/c				
16.5.	To Cash A/c	C			291	8.5.	By Bank A/c				5800
23.5.	To Tripti & Co.		9			10.5.	By Motor car A/c		9		291
28.5.	To Sales A/c			298	300		By Tripti & Co. A/c	C			
30.5.	To Cash A/c	C				16.5.	By Bank A/c	C		300	
						16.5.	By Wages A/c.			172	
						29.5.	By Bank charges				5
						30.5.	By balance c/d			295	998
						30.5.					
						30.5.					
						30.5.					
				1783	7979					1783	7979

Note: The discount columns in the cash book are subjected to totaling and doesn't require balancing, However, totals are subsequently recorded in the ledger under the 'Discount Received/Paid' A/c.

31. Record the following transactions in a columnar Petty Cash Book kept on the Imprest System and balance the cash book. Also post the transaction to the respective ledger A/cs.

Mar. 2017	Particular	₹
1	The Petty Cash received by cheque	400.00
2	Carriage	5.00
3	Carriage	6.50
6	Postal stamps	18.75

Mar. 2017	Particular	₹
8	Revenue stamps	5.50
10	Bought stationery for office use	15.90
13	Bought envelopes	10.40
17	Safety pin box	6.00
19	Printing bill	26.00
23	Travelling expenses to salesman	46.25
25	Subscription to Economic Times	11.50
26	Paid to Waikar on A/c	18.00
27	Railway fare for sale executive	36.60
28	Tea to office staff	32.40
30	Paid advertising bill	11.25

Sol.

Petty Cash Book (Analytical Cash Book)

Date	Particular	Receipt	Pay- ment	Car- riage	Post- age	Office exp.	Sta- tio- nery	Travel. elling exp.	Adver- tisement	Ad- vance
Mar. 2017										
1	To Cash A/c (Recd.)	400.00								
2	By Carriage		5.00	5.00						
3	By Carriage		6.50	6.50						
6	By Postage exp.		18.75		18.75					
8	By Revenue stamp		5.50			5.50				
10	By Stationery		15.90				15.90			
13	By Stationery(envelop)		10.40				10.40			
17	By Stationery (Pins)		6.00				6.00			
19	By Stationery(Printing)		26.00				26.00			
	By Travelling exp,		46.25					46.25		
23	By Office exp.		11.50			11.50				
25	By Advance (Waikar)		18.00							
26	By Travelling exp.		36.60					36.60		18.00
27	By Office exp. (Tea)		32.40			32.40				
28	By Advertisement		11.25						11.25	
30			250.05	11.50	18.75	49.40	58.30	82.85	11.25	18.00
	Total		149.95							
	By Balance	400.00	400.00							

Posting from above petty cash book to ledger A/cs will be made as follows:

Carriage A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		11.50				

Postage A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		18.75				

Office Expenses A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		49.40				

Stationery Expenses A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		58.30				

Travelling Expenses A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		82.85				

Advertisement A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		11.25				

Advance A/c

Date	Particular		₹	Date	Particular		₹
31.3.2017	To Petty Cash		18.00				

Note: Since it's Year End, so in examination kindly balance the account. All the A/c's being Nominal balance will be transferred to Trading A/c or P&L A/c

32. The transactions provided below are extracted from the Book of Vikas & Co. for the year 2021. Based on this information, prepare their Sales Book.

Sold to M/s. Ram on credit:

20 pen @ ₹20 per pen.

10 pencils @ ₹10 per pencil

Less : Trade Discount @ 5%

Sold office computer to M/s. Bhushan & Co. on credit ₹12,000.

Sold 10 registers to M/s. Arora & Sons @ ₹70 per register on credit

Sold 5 registers to Atul for Cash @ 90

Sol.

Sales Book

Date	Particulars	Details ₹	L.F.	Amount ₹
2021	M/s. Ram			
	20 pen @ ₹20 per pen	400		
	10 pencils @ 10 per pencil	100		
		500		
	Less : 5%	(25)		475
	M/s. Arora & Sons			
	10 registers @ 70 per register			700
		Total		1175

Note : The Sales Book does not include entries for cash sales or sales of Office furniture.

33. Journalise the following transactions. Also state the nature of each A/c involved in the Journal entry. Following figures are given in ('00)

1. December 1, 2020, Ajit started business with capital ₹4,00,000
2. December 3, he withdrew cash for business from the Bank ₹2,000.
3. December 5, he purchased goods making payment through bank ₹15,000.
4. December 8, he sold goods ₹16,000 and received payment through bank.
5. December 10, he purchased furniture and paid by cheque ₹2,500.
6. December 12, he sold goods to Arvind ₹2,400.
7. December 14, he purchased goods from Amrit ₹10,000.
8. December 15, he returned goods to Amrit ₹500.
9. December 16, he received from Arvind ₹2,300 in full settlement.
10. December 18, he withdrew goods for personal use ₹1,000.
11. December 20, he withdrew cash from business for personal use ₹2,000.
12. December 24, he paid telephone charges ₹110.
13. December 26, amount paid to Amrit in full settlement ₹9,450.
14. December 31, paid for stationery ₹200, rent ₹5,000 and salaries to staff ₹2,000.
15. December 31, goods distributed by way of free samples ₹2,000

(ICAI Study Material)

Sol.

Dr.

JOURNAL

(₹ in '00) Cr.

Sl. No	Date	Particulars	Nature of A/c	L.F.	Debit (₹)	Credit (₹)
1.	Dec. 1	Bank A/c To Capital A/c (Being commencement of business)	Dr. Personal A/c Personal A/c		4,00,000	4,00,000
2.	Dec. 3	Cash A/c To Bank A/c (Being cash withdrawn from the Bank)	Dr. Real A/c Personal A/c		2,000	2,000
3.	Dec. 5	Purchases A/c To Bank A/c (Being purchase of goods for cash)	Dr. Real A/c Personal A/c		15,000	15,000
4.	Dec. 8	Bank A/c To Sales A/c (Being goods sold for cash)	Dr. Personal A/c Real A/c		16,000	16,000
5.	Dec. 10	Furniture A/c To Bank A/c (Being purchase of furniture, paid by cheque)	Dr. Real A/c Personal A/c		2,500	2,500
6.	Dec. 12	Arvind To Sales A/c (Being sale of goods)	Dr. Personal A/c Real A/c		2,400	2,400
7.	Dec. 14	Purchases A/c To Amrit (Being purchase of goods from Amrit)	Dr. Real A/c Personal A/c		10,000	10,000
8.	Dec. 15	Amrit To Purchases Returns A/c (Being goods returned to Amrit)	Dr. Personal A/c Real A/c		500	500

9.	Dec. 16	Bank A/c Discount A/c To Arvind (Being cash received from Arvind in full settlement and allowed him ₹ 100 as discount)	Dr. Dr.	Personal A/c Nominal A/c Personal A/c	2,300 100	2,400
10.	Dec. 18	Drawings A/c To Purchases A/c (Being withdrawal of goods for personal use)	Dr.	Personal A/c Real A/c	1,000	1,000
11.	Dec. 20	Drawings A/c To Cash A/c (Being cash withdrawal from the business for personal use)	Dr.	Personal A/c Real A/c	2,000	2,000
12.	Dec. 24	Telephone Expenses A/c To Bank A/c (Being telephone expenses paid)	Dr.	Nominal A/c Personal A/c	110	110
13.	Dec 26	Amrit To Bank A/c To Discount A/c (Being cash paid to Amrit and he allowed ₹50 as discount)	Dr.	Personal A/c Personal A/c Nominal A/c	9,500	9,450 50
14.	Dec. 31	Stationery Expenses Rent A/c Salaries A/c To Bank A/c (Being expenses paid)	Dr. Dr. Dr.	Nominal A/c Nominal A/c Nominal A/c Personal A/c	200 5,000 2,000	7,200
15.	Dec. 31	Advertisement Expenses A/c To Purchases A/c (Being distribution of goods by way of free samples)	Dr.	Nominal A/c Real A/c	2,000	2,000

34. From the transactions given below prepare the Sales Book of Salman, a furniture shopkeeper:

July, 2017

5 Sold on credit to Shivaji College less 10% trade discount : 20 tables @ ₹30
20 chairs @ ₹20

8 Sold Chandan Bros.; 5 stools @ ₹20

10 Sold on credit M/s. Vinay & Co.: 4 tables @ ₹75, 6 chairs @ ₹30

20 Sold to M/s. Om & Sons for cash 6 tables @ ₹50

27 Sold on credit to Rajpal & Co. old typewriter for ₹400

Sol.

Sales Book of Salman

Date	Particular	Invoice No.	L.F.	Details	₹Net Invoice
5.7.2017	Shivaji College 20 tables @ ₹30 20 chairs @ ₹20			600	
				400	
				1000	
	Less : 10 % Trade Discount			100	900
8.7.2017	Chandan Bros. 5 stools @ ₹20				100
10.7.2017	M/s Vinay & Co. 4 tables @ ₹75 6 chairs @ ₹30			300	
				180	480
				Total	1480

Note:

1. Additional columns can be made as per requirement of the question.
2. Total of Sales book will be posted to the Credit side of sales A/c and respective party A/c will be debited

Shivaji College A/c

Date	Particular	J.F	Amount	Date	Particular	J.F.	Amount
5.7	To Sales A/c	11	900				

Chandan Bros. A/c

Date	Particular	J.F	Amount	Date	Particular	J.F.	Amount
8.7	To Sales A/c	11	100				

Vinay & Co. A/c

Date	Particular	J.F	Amount	Date	Particular	J.F.	Amount
10.7	To Sales A/c	11	480				

Sales A/c

Date	Particular	J.F	Amount	Date	Particular	J.F.	Amount
				20.7	By Cash A/c		300
				30.7	By Sundry debtors	11	1480

Note: Since it's not Year End A/c's are not Balanced

35. Prepare a three column cash book from the following:

October. 2017

1	Cash balance	₹	1,800
	Bank overdraft		5,700
5	Received from Dinesh cash ₹750 and a cheque of full settlement of	₹860 in	₹1650
7	Paid for office rent by cheque		600
8	Paid for wages in cash		₹350
9	Sold goods for cash ₹1500 and received half the amount in cash and half by cheque which is deposited in the bank		
10	Bank pass book states that the bank has collected interest on investment	660	
12	Cheque received on 5th paid into bank		
15	Transferred ₹3000 from fixed deposit to Current A/c		
20	Drew for personal use cash ₹250 and a cheque of ₹375		
25	Made cash purchase and paid by cheque ₹1595		
30	Paid Disha ₹800 by cheque		

Sol.

Dr.

Triple Column Cash Book

Cr.

Date	Particular	LF	Dis	Cash	Bank	Date	Particular	LF	Dis	Cash	Bank
1 Oct.	To Opening Balance			1800	—	1 Oct.	By Opening bal, (O.D.)			—	5700
5	To Dinesh a/c (cash + cheque)		40	1610	—	7	By Rent a/e				600
9	To Sales a/c.			750	750	8	By Wages a/c			350	
10	To Interest a/ c				660	12	By Bank (ch deposit)	C		860	
12	To Cash (ch. Deposited)	C			860	20	By Drawings a/c			250	375
15	To Fixed deposit a/c				3000	25	By Purchase a/c				1595
30	To Balance c/d. (OD)				3800	30	By Disha a/c				800
						30	By Balance c/d			2700	
				4160	9070		Total			4160	9070

Cheque received but not deposited in bank – The usual practice in the books on Accounting is to show such amount as cash and when the same is deposited in bank then cash a/c is credited and bank a/c debited (As done for cheques amount to ₹860 above).

36. Develop the Accounting equation from following information available at the beginning of Accounting period:

Particulars	(₹in '000)
Capital	51,000
Loan	11,500
Trade payables	5,700
Fixed Assets	12,800
Inventory	22,600
Trade receivables	17,500
Cash and Bank	15,300

At the end of the Accounting period the balances appear as follows:

	₹
Capital	?
Loan	11,500
Trade payables	5,800
Fixed Assets	12,720
Inventory	22,900
Trade receivables	17,500
Cash at Bank	15,600

(a) Reset the equation and find out profit.

(b) Prepare Balance Sheet at the end of the Accounting period.

(All the figures in solution are in ₹000)

(ICAI Study Material)

Sol. The Accounting equation, expressed as $\text{Equity} + \text{Liabilities} = \text{Assets}$, can be represented using E, L, and A to denote the initial values of equity, liabilities, and assets at the start of the Accounting period..

$$E = ₹51,000$$

$$L = \text{Loan} + \text{Trade payables}$$

$$= ₹11,500 + ₹5,700$$

$$= ₹17,200$$

$$A = \text{Fixed Assets} + \text{Inventories} + \text{Trade receivables} + \text{Cash at Bank}$$

$$= 12,800 + 22,600 + 17,500 + 15,300$$

$$= 68,200$$

So, at the start of Accounting period

$$E + L = A$$

$$\text{i.e., } 51,000 + 17,200 = 68,200$$

We can utilize E1, L1, and A1 to represent equity, liabilities, and assets, respectively, at the conclusion of the Accounting period.

$$L1 = \text{Loan} + \text{Trade payables}$$

$$= 11,500 + 5,800$$

$$= 17,300$$

$$A1 = \text{Fixed Assets} + \text{Inventories} + \text{Trade receivables} + \text{Cash at Bank}$$

$$= 12,720 + 22,900 + 17,500 + 15,600$$

$$= 68,720$$

$$E1 = A1 - L1 = 68,720 - 17,300 = 51,420$$

$$\text{Profit will be} = E1 - E0 = 51,420 - 51,000 = 420$$

(a)

Balance Sheet

Liabilities	₹	₹	Assets	₹
Capital	51,000		Fixed Assets	12,720
Balance Add: Profit	420		Inventories	22,900
		51,420	Trade receivables	17,500
Loan		11,500	Cash at Bank	15,600
Trade payables		5,800		
		68,720		68,720

37. Prepare a Triple Column Cash book from the following transactions of M/s. Raj Agencies and bring down the balance for the start of next month: [Dec. 2022, 5 Marks]

2022		Particular	(₹)
March	1	Cash in hand	30,000
	1	Cash at bank	1,20,000
	2	Paid into bank	10,000
	5	Bought furniture and issued cheque	15,000
	8	Purchased goods for cash	5,000
	12	Received cash from Mohan	9,800
		Discount, allowed to him	200
	14	Cash sales	50,000
	16	Paid to Lata by cheque	14,500
		Discount received	500
	19	Paid into Bank	5,000
	23	Withdrawn from Bank for Private expenses	6,000
	24	Received cheque from Gupta	14,300
		Allowed him discount	200

2022		Particular	(₹)
	26	Deposited Gupta's cheque into Bank	
	28	Withdrew cash from Bank for Office use	20,000
	30	Paid rent by cheque	8,000

Sol.

In the books of M/s Raj Agencies
Triple Column Cash Book

Date	Particular	LF	Dis	Cash	Bank	Date	Particular	LF	Dis	Cash	Bank
2022						2022					
Mar 1	To Balance b/d		-	30,000	1,20,000	Mar 2	By Bank (c)			10000	-
			-	-						-	
2	To Cash (c)				10000	5	By Furniture				15000
											-
12	To Mohan	200		9,800	-	8	By Purchases			5000	
14	To Sales		-	50000	-	16	By Lata	500		-	14500
											-
19	To Cash (c)		-	-	5000	19	By Bank (c)			5000	-
24	To Gupta	200			-	23	By Drawings			-	6000
				14300							
26	To Cash (c)		-		14300	26	By Bank (c)			14300	-
28	To Bank (c)		-	20000	-	28	By Cash (c)			-	20000
						30	By Rent			-	8000
						31	By Balance c/d			89800	85800
	Total		400	124100	149300		Total			124100	149300

38. The following entries can be found in the Rough Book of M/s. XYZ & Co :

2021

March.

- Purchased from ABC & Co. on credit :
5 Units of Product A @ 500 per product,
Less : Trade Discount @ 20%
- Purchased for cash from Ramesh & Sons;
10 units of product A @ ₹450 per product.

3. Purchased mobile phone for office from Z Electronics. on credit for ₹40,000.
4. Purchase of Product B from V Ltd on credit
50 units @ 50 ₹

Prepare Purchase Book of M/s. XYZ & Co.

Sol.

Purchases Book

Date	Particulars		L.F.	Amount
2021		₹		₹
March. 1	M/s. ABC & Co.			
	5 Units @ 500	2500.00		
	Less : 20% trade discount	<u>(500)</u>		2000
"4	V Ltd.			
	Product B			
	50 units @ ₹50 per unit	2500		2500
		Total		4500

Note : Purchases goods for cash and purchase of mobile phone will not be recorded in the Purchase Book.

39. Gyanendra commenced business on 1st April, 2022 with ₹2,000 as capital. He had the following cash transactions in the month of April 2022:

		₹			₹
April 1	Purchased furniture and	250	April 7	Paid for petty expenses	15
"2	paid cash				
"4	Purchased goods	500	" 8	Cash purchases	150
	Sold goods for cash	950		Paid for labour	1,000
				Paid Ali & Sons	400
"5	Paid cash to Ram Mohan	560	13	They allowed discount	8
	He allowed discount	10			
"6	Received cash from	600	" "		
	Krishna & Co.	20			
	Allowed discount		" "		

Make out the two-column Cash Book (Cash and discount column) for the month of April, 2022.

(ICAI Study Material)

Sol.

Cash Book

Dr. Date 2022	Receipts	L.F.	Discount ₹	Amount ₹	Date 2022	Payments	L.F.	Discount ₹	Cr. Amount ₹
April 1	To Capital A/c			2,000	April	By Furniture A/c			250
" 4	To Sales A/c			950	2	By Purchases A/c			500
" 6	To Krishna A/c		20	600	" 5	By Ram Mohan		10	560
					" 7	By Petty Expenses A/c			15
					" 8	By Purchases A/c			150
					" 13	By wages A/c			1,000
					" 13	By Ali & Sons		8	400
					" 30	By Balance c/d			675
			20	3,550				18	3,550

Note: The discount columns in the cash book are subjected to totaling and doesn't require balancing, However, totals are subsequently recorded in the ledger under the 'Discount Received/Paid' A/c.

UNIT - 1 INTRODUCTION TO COMPANY ACCOUNTS**1.1 INTRODUCTION**

The unceasing human aspiration for continual growth has led to the rapid increase in the number of businesses. Consequently, there arises a demand to increase operational scales in order to meet the escalating requirements of an expanding consumer base. This expansion necessitates substantial resources such as

- (a) financial investments,
- (b) advanced technology, and
- (c) extensive human involvement.

Accommodating these requirements proves challenging under proprietorship or partnership structures as the amount of funds needed cannot be met by 1 or 50 people .

In response to this challenge, the idea of a 'Company' or 'Corporation' emerged.

Simultaneously, the necessity to distinguish management from ownership led to the establishment of an organizational form now recognized as the 'Company.'

The organizational structure known as the company is a remarkable product of human ingenuity, facilitating businesses in conducting wealth creation activities through the efficient utilization of resources. Over time, the company structure has evolved into a significant institutional form for business enterprises, establishing a prominent role in both business operations and the wealth-generating functions of society.

1.2 MEANING OF COMPANY

The term 'Company,' in everyday usage, commonly refers to a gathering of individuals for social, companionship, or fellowship purposes. In an organizational context, 'company' signifies a collective of individuals who voluntarily agree to establish a company.

The term 'company' has its roots in the Latin words 'com,' meaning with or together, and 'pany,' meaning bread.

Originally, it denoted an association of individuals or merchants discussing matters and sharing meals.

According to this legal definition, a company is formed when a group of individuals agrees to establish it under the law. Once formed, it becomes a distinct legal entity with perpetual succession, its own unique name, and a common seal. Its existence remains unaffected by changes in its membership.

The concept of a company, rooted in law, denotes an organization comprising individuals, known as shareholders by virtue of holding company shares. These shareholders are legally authorized to elect a board of directors, allowing the company to function as a separate legal entity. Typically, a company's capital is represented by transferable shares, and its members have limited liabilities.

1.3 SALIENT FEATURES OF A COMPANY

Here are the distinctive features of a company

1. **Incorporated Association:** A company is brought into existence through legal processes, requiring registration under the Companies Act. Without such registration, a company cannot be formed. As a creation of law, it is considered an artificial legal entity.
2. **Separate Legal Entity:** A company possesses a distinct legal identity and remains unaffected by changes in its membership. As a separate business entity, it can enter into contracts, initiate legal actions, and be subject to legal actions in its registered name and capacity.
3. **Perpetual Existence:** Due to its independent existence from its members, a company continues to exist despite changes in membership, including deaths, insolvencies, or other alterations.
4. **Common Seal:** As a non-natural entity, a company cannot sign documents in the manner of a natural person. To address this, a legal instrument known as the 'Common Seal' is provided. Originally, the Companies Act, 2013 mandated the use of the common seal on certain documents (e.g., bills of exchange, share certificates). However, recent changes have made the use of the common seal optional. Documents that previously required the common seal can now be signed by two directors or one director and a company secretary. Additionally, every registered company in India is required to obtain a unique Corporate Identification Number (CIN) assigned by the Registrar of Companies.
5. **Limited Liability:** The responsibility of each shareholder in a company is confined to the agreed-upon amount payable on the shares allocated to them. When shares are fully paid-up, shareholders bear no further liability.
6. **Distinction between Ownership and Management:** Due to the extensive number of shareholders, often spread across different locations, managing the day-to-day operations becomes challenging. This necessitates the separation of ownership and management.
7. **Not a Citizen:** Despite being created by legal processes, a company does not hold citizenship rights and duties comparable to those enjoyed by natural persons. It exists legally but lacks the citizenship attributes of individuals.
8. **Transferability of Shares:** Shareholders contribute capital through share subscriptions, and these shares are generally transferable, with the exception of certain restrictions imposed on transferability in the case of a private limited company.
9. **Maintenance of Books:** Legal requirements mandate a limited company to maintain a specific set of accounting books. Failure to comply with this obligation results in penalties.

10. **Periodic Audit:** A company is obligated to undergo periodic audits conducted by chartered accountants appointed for this purpose by shareholders upon the recommendation of the board of directors.
11. **Right of Access to Information:** Shareholders have the right to inspect the company's account books, as governed by the Articles of Association. This right extends to participating in company meetings and accessing periodic reports to obtain information from the directors.

1.4 TYPES OF COMPANIES

1. Government Company

As per the definition provided in Section 2(45) of the Companies Act, 2013, a "Government company" is defined as a company wherein at least fifty-one percent of the paid-up share capital is owned by either the Central Government (CG) or a State Government (SG), or multiple State Governments (SG), or in a combination of the Central Government (CG) and one or more State Governments (SG). This definition includes a company that functions as a subsidiary of such a Government company.

2. Foreign Company

As outlined in Section 2 (42) of the Companies Act, 2013, a "Foreign company" is defined as any company or body corporate incorporated outside India that meets the following criteria:

- (a) Possesses a place of business in India, either directly or through an agent, whether physically or via electronic means; and
- (b) Engages in any business activity in India through any other method.

3. Private Company

In accordance with Section 2(68) of the Companies Act, 2013, a 'Private company' is delineated as a company whose articles:

- (a) Impose limitations on the right to transfer its shares;
- (b) Set a restriction on the number of its members limited to 200, with the exception of a One Person Company (OPC),.
- (c) Prohibits any public invitation for the subscription of the company's securities. Additionally, shares of a Private Company are not publicly listed on the Stock Exchange.

Note: w.r.t to Point No. ii

that in cases where two or more individuals jointly hold shares in a company, they are considered a single member for the purposes of this provision.

Furthermore, it is stipulated that:

- (i) Individuals currently employed by the company; and
- (ii) Individuals who, having been previously employed by the company, were members of the company during their employment and have continued as members after their employment ceased, are not to be counted in the total number of members;

4. Public Company

Section 2(71) of the Companies Act, 2013 defines a Public Company as a company that:

- (a) which is not a private company; and
- (b) Possesses a minimum paid-up share capital as stipulated by regulations.

However, it is important to note that a company, which is a subsidiary of a public company, is considered a public company under this Act, even if the subsidiary continues to be classified as a private company in its articles.

A company classified as a listed public company, if it becomes unlisted, will still be considered a public company.

Note wrt to point (b)

The Companies Act, 2013 has eliminated the previous minimum paid-up share capital requirements of INR 1,00,000 (for private companies) and INR 5,00,000 (for public companies). Consequently, there are no longer minimum paid-up capital prerequisites for the incorporation of both private and public companies in India.

5. One Person Company

According to Section 2(62) of the Companies Act, 2013, a “One Person Company” is characterized as a company that comprises only one individual as a member.

6. Small Company

As per Section 2(85) of the Companies Act, 2013, a “Small company” is defined as a company, excluding a public company, meeting the following criteria:

- (A) The paid-up share capital does not surpass four crore rupees (4Cr.) or the prescribed higher amount, not exceeding ten crore rupees (10 Cr.).
- (B) The turnover, based on the last profit and loss account for the immediately preceding financial year, does not exceed forty crore (40 Cr.) rupees or the prescribed higher amount, not surpassing hundred crore rupees (100 Cr.).

However, the provisions of this clause do not apply to:

- (i) A holding company or a subsidiary company.
- (ii) A company registered under section 8.
- (iii) A company or body corporate governed by any special Act.

7. Listed Company

In accordance with Section 2(52) of the Companies Act, 2013, a “listed company” is defined as a company that has its securities listed on any recognized stock exchange.

Conversely, a company whose shares are not listed on any recognized stock exchange is referred to as an “Unlisted Company.”

It's important to note that an unlisted company can fall into either the category of a public company or a private company.

8. Unlimited Company

As per Section 2(92) of the Companies Act, 2013, an “Unlimited company” is characterized as a company where there is no restriction on the liability of its members.

9. Company limited by Shares

According to Section 2(22) of the Companies Act, 2013, a “Company limited by shares” is described as a company wherein the liability of its members is restricted by the memorandum to the amount, if any, unpaid on the shares they hold.

10. Company limited by Guarantee

As outlined in Section 2(21) of the Companies Act, 2013, a “company limited by guarantee” is defined as a company where the liability of its members is restricted by the memorandum to the amount that the members individually commit to contributing to the company’s assets in the event of its winding up.

11. Holding Company

As per Section 2(46) of the Companies Act, 2013, the term “Holding company,” controlling one or more other companies, refers to a company of which those companies are considered subsidiary companies.

12. Subsidiary Company

According to Section 2(87) of the Companies Act, 2013, a “subsidiary company” is defined as a company where the holding company:

- (i) Governs the composition of the BOD; or
- (ii) Exercises or controls more than half of the total share capital either on its own or collectively with one or more of its subsidiary companies.

A company is considered a subsidiary of the holding company even if there is indirect control through subsidiary companies.

The control over the composition of the subsidiary company’s Board of Directors implies the exercise of authority to appoint or remove all or a majority of the directors of the subsidiary company.

1.5 MAINTENANCE OF BOOKS OF ACCOUNT

As outlined in Section 128 of the Companies Act, 2013, each company is required to create and maintain, at its registered office, books of account, along with other pertinent books, papers, and financial statements for every financial year. These records must present an accurate and comprehensive depiction of the company’s state of affairs, including any branch office(s), elucidating transactions conducted both at the registered office and its branches. The accounting entries in these books should adhere to the accrual basis and be in accordance with the double-entry system.

Additionally, the company is permitted, as specified further, to maintain these books of account or relevant papers in electronic format, following the prescribed manner.

1.6 PREPARATION OF FINANCIAL STATEMENTS

As per Section 129 of the Companies Act, 2013, the financial statements are required to present an accurate and comprehensive depiction of the company's state of affairs. They must comply with the notified accounting standards and be presented in the format as prescribed in Schedule III, which may vary for different classes of companies. It is the responsibility of the Board of Directors to present these financial statements at each annual general meeting of the company.

In accordance with Section 2(40) of the Companies Act, 2013, Financial Statements includes various components, including but not limited to:

- i. A balance sheet reflecting the financial position at the end of the financial year;
- ii. A statement of profit and loss ,or in the case of a company engaged in non-profit activities, an income and expenditure account for the financial year;
- iii. A cash flow statement (CFS) for the financial year;
- iv. A statement of changes in equity, where applicable; and
- v. Notes to A/c forming part of any document mentioned in sub-clauses (i) to (iv).

Note: FST for a One Person Company (OPC), small company, and dormant company may, under the provided condition, exclude the cash flow statement.

REQUISITES OF FINANCIAL STATEMENTS

It is required to present an accurate and comprehensive depiction of the company's state of affairs as of the conclusion of the financial year.

1. Provisions Applicable

Specific class of company such as –

- (a) Insurance companies
- (b) Banking companies
- (c) Companies involved in the generation or supply of electricity
- (d) Any other class of company prescribed

The above mentioned company shall follow prescribed Form of balance sheet or Profit and loss account is mandated under the relevant Act governing them.

(2) For all other companies:

The Balance Sheet should adhere to the format outlined in Part I of Schedule III, and the Statement of Profit and Loss should follow the guidelines set out in Part II of Schedule III.

COMPLIANCE WITH ACCOUNTING STANDARDS

In accordance with Section 129 of the Companies Act, adherence to the accounting standards notified by the Central Government on a periodic basis is obligatory.

Schedule III of the Companies Act, 2013

According to Section 129 of the Companies Act, 2013, it is required that financial statements provide an accurate and comprehensive depiction of the state of affairs of the company or companies. They must also adhere to the accounting standards notified under Section 133 and be presented in the form or forms as specified for different classes of companies in Division I of Schedule III under the Act.

PART I – FORMAT OF BALANCE SHEET

Name of the Company.....

Balance Sheet as at.....

Particulars		Notes No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
EQUITY AND LIABILITIES				
1.	Shareholders' funds			
a.	Share capital (A)		xxx	xxx
b.	Reserves and Surplus (B)		xxx	xxx
c.	Money received against share warrants		xxx	xxx
2.	Share application money pending allotment		xxx	xxx
3.	Non-current liabilities			
a.	Long-term borrowings (C)		xxx	xxx
b.	Deferred tax liabilities (Net)		xxx	xxx
c.	Other long term liabilities		xxx	xxx
d.	Long-term provisions (D)		xxx	xxx
4.	Current liabilities			
a.	Short-term borrowings (E)		xxx	xxx
b.	Trade Payables total outstanding dues of micro enterprises and small enterprises; and total outstanding dues of creditors other than micro enterprises and small enterprises.]		xxx xxx	xxx xxx
c.	Other current liabilities (F)		xxx	xxx
d.	Short-term provisions		xxx	xxx
	Total		xxx	xxx

	ASSETS				
1.	Non-current assets				
	a.	i. Property, Plant and Equipment		xxx	xxx
		ii. Intangible assets (H)		xxx	xxx
		iii. Capital Work-in-progress		xxx	xxx
		iv. Intangible assets under development		xxx	xxx
	b.	Non-current investments (I)		xxx	xxx
	c.	Deferred tax assets (Net)		xxx	xxx
	d.	Long-term loans and advances (J)		xxx	xxx
	e.	Other non-current assets		xxx	xxx
2.	Current assets				
	a.	Current investments (K)		xxx	xxx
	b.	Inventories (L)		xxx	xxx
	c.	Trade receivables		xxx	xxx
	d.	Cash and cash equivalents (M)		xxx	xxx
	e.	Short-term loans and advances		xxx	xxx
	f.	Other current assets		xxx	xxx
	Total			xxx	xxx

Some items are to be clarified as follows (the list is not exhaustive):

A. SHARE CAPITAL

For every category of share capital, the following considerations should be taken into account:

- The authorized number and amount of shares.
- The number of shares that are issued, subscribed, and fully paid, as well as those issued, subscribed but not fully paid.
- The par value per share.
- Reconciliation of shares outstanding at the beginning and end of the reporting period.
- Unpaid calls.
- Forfeited shares.

B. RESERVES AND SURPLUS

Reserves and surplus may be allocated among the subsequent sub-headings:

- Capital reserves
- Capital redemption reserves
- Securities Premium
- Debenture Redemption reserve

- v. Revaluation reserve
- vi. Surplus; the balance as per profit and loss statement
- vii. Other reserves (specify the nature and purpose)

C. LONG TERM BORROWINGS

Long-term borrowings can be categorized within the subsequent sub-headings::

- i. Bonds/Debentures
- ii. Term loans
- iii. Deferred payment liabilities
- iv. Deposits
- v. Long term maturities of finance lease obligations
- vi. Loans and advances from related parties
- vii. Other loans and advances (specify nature)

D. LONG TERM PROVISIONS

This can be categorized as follows:

- i. Provisions for employee benefits such as gratuity, provident fund, etc.
- ii. Other provisions (please specify the nature).

E. SHORT TERM BORROWINGS

Short-term borrowings can be categorized within the subsequent sub-headings::

- i. Loans repayable on demand
- ii. Loans and advances from related parties
- iii. Deposits
- iv. Other loans and advances (specify the nature)

F. OTHER CURRENT LIABILITIES

Some of the additional current liabilities can be organized as follows::

- i. Interest accrued but not/and due on borrowings
- ii. Income received in advance
- iii. Unpaid dividends
- iv. Application money received for allotment of securities and due for refund and interest accrued thereon
- v. Other current liabilities (specify the nature)

G. PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment can be categorized in the following manner :

- i. Land
- ii. Buildings
- iii. Plant and Equipment

- iv. Furniture and Fixtures
- v. Vehicles
- vi Office equipment
- vii. Others (specify the nature)

A comprehensive report detailing additions, disposals, acquisitions through business combinations, and other adjustments, along with amounts related to depreciation, impairment losses, revaluation, etc., must be furnished for each category of asset.

H. INTANGIBLE ASSETS

Intangible assets can be categorized as follows:

- i. Goodwill
- ii. Brands/trademarks
- iii. Computer software
- iv. Mining rights
- v. Publishing titles
- vi. Copyrights, patents and other intellectual property rights, services and operating rights.
- vii. Licence and franchise
- viii. Recipes, models, designs, formulae and prototypes
- ix. Others (specify the nature)

An in-depth report illustrating additions, disposals, acquisitions through business combinations, and other adjustments, along with amounts associated with depreciation, impairment losses, revaluation, etc., is required for each category of asset.

I. NON-CURRENT INVESTMENTS

Investments can be categorized as under:

- i. Investments in property
- ii. Investments in equity instruments
- iii. Investments in preference shares
- iv. Investments in governments or trust securities
- v. Investments in debentures or bonds
- vi. Investments in mutual funds
- vii. Investments in partnership firms
- viii. Other non-current investments (specify the nature)

J. LONG TERM LOANS AND ADVANCES

It may be categorized within the subsequent sub-groups::

- i. Capital advances
- ii. Security deposits

- iii. Loans and advances to related parties
- iv. Other loans and advances (specify nature) \

The aforementioned shall also be further classified as follows:

- i. Secured, considered goods
- ii. Unsecured, considered goods
- iii. Doubtful

K. CURRENT INVESTMENTS

It may be categorized as follows:

- i. Investments in equity instruments
- ii. Investments in preference shares
- iii. Investments in government or trust securities
- iv. Investments in bonds or debentures
- v. Investments in mutual funds
- vi. Investments in partnership firms
- vii. Other investments (specify the nature)

L. INVENTORIES

Inventories may be categorized as follows:

- i. Raw materials
- ii. Work-in-progress
- iii. Stores and spares
- iv. Finished goods
- v. Loose tools
- vi. Stock in trade
- vii. Goods in transit
- viii. Others (specify the nature)

L. CASH AND CASH EQUIVALENTS

The following head may be categorized as follows :

- i. Balances with banks
- ii. Cheques, drafts in hand
- iii. Cash in hand
- iv. Others (specify the nature)

PART II – FORMAT OF STATEMENT OF PROFIT AND LOSS

Name of the Company.....

Profit and Loss Statement for the year ended

(in...)

Company Accounts

Particulars		Note No.	Figures for the current reporting period		Figures for the previous reporting period	
I.	Revenue from operations			xxx		xxx
II.	Other income			xxx		xxx
III.	Total Revenue (I + II)			xx		xx
IV.	Expenses:			x		x
	Cost of materials consumed			xx		xx
	Purchases of Stock-in-Trade			x		x
	Changes in inventories of finished goods, Work-in-Progress and Stock-in-Trade			xx		xx
	Employee benefits expense			x		x
	Finance costs			xx		xx
	Depreciation and amortization expense			x		x
	Other expenses			xxx		xxx
				xx		xx
				x		x
				xx		xx
				x		x
				xx		xx
				x		x
				xxx		xxx
Total expenses				xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)		xx	xxx	xx	xxx
VI.	Exceptional items		x		x	
VII.	Profit before extraordinary items and tax (V-VI)		xx	xxx	xx	xx
VIII.	Extraordinary Items			xxx		xx
IX.	Profit before tax (VII-VIII)			xxx		x xxx
X.	Tax expense:			xxx		xxx
	1. Current tax					
	2. Deferred tax					

Xi.	Profit (Loss) for the period from continuing operations (VII-VIII)			xxx		xxx
XII.	Profit/(Loss) from discontinuing operations			xxx xxx		xxx xx x
XIII.	Tax expense of discontinuing operations			xxx		xx x
XIV.	Profit/(Loss) from discontinuing operations (after tax) (XII-XIII)			xxx		xx
XV.	Profit (Loss) for the period (XI + XIV)			xxx		x
XVI.	Earnings per equity share: (1) Basic (2) Diluted			xxx xxx		xx x xx x xx x

TEST YOUR KNOWLEDGE

True and False

- Every public company is a listed company. (ICAI Study Material)
Sol. False . Listed companies are those that have their shares listed on a stock exchange, making them accessible to the general public. While every listed company is considered a public company, it's important to note that not every public company is necessarily listed.
- Shares of a private company are not listed on the stock exchange. (ICAI Study Material)
Sol. True . Shares of a company become listed on the stock exchange only if it is a public company. Therefore, every listed company is, by definition, a public company.
- It is not mandatory to incorporate a company under the companies act. (ICAI Study Material)
Sol. False . Under the Companies Act, it is obligatory to formally establish a company through incorporation. Without undergoing this process, a company cannot be brought into existence.
- Company is an artificial, legal person created by law. (ICAI Study Material)
Sol True . A company is brought into existence through the legal process and is recognized as a distinct entity separate from its members.

3. Which of the following statements is true in case of a Foreign Company? (ICAI Study Material)
- (a) A Company incorporated in India and has place of business outside India.
 - (b) A Company incorporated outside India and has a place of business in India.
 - (c) A Company incorporated in India and has a place of business in India.
 - (d) None of the Above

Sol. (b) A Company incorporated outside India and has a place of business in India.

4. Which of the following statements is not a feature of a private company? (ICAI Study Material)
- (a) Restricts the rights of members to transfer its shares.
 - (b) Does not restrict the number of its members to any limit.
 - (c) Does not involve participation of the public in general.
 - (d) None of the Above

Sol. (b) Does not restrict the number of its members to any limit.

5. Under Schedule III of the Companies Act, assets and liabilities are to be disclosed based on: (ICAI Study Material)
- (a) Current/ non-current.
 - (b) Financial /non-financial.
 - (c) Owned /not-owned.
 - (d) All of the Above

Sol. (a) Current/ non-current.

6. Schedule III of the Companies Act prescribes the format and content of : (ICAI Study Material)
- (a) Balance sheet and statement of profit and loss
 - (b) Auditors' report.
 - (c) Directors' report.
 - (d) None of the Above

Sol. (a) Balance sheet and statement of profit and loss

7. A company is required to maintain its books of accounts at : (ICAI Study Material)
- (a) its registered office.
 - (b) its largest branch office.
 - (c) Managing Director's residence.
 - (d) All of the above

Sol. (a) its registered office.

8. Cash flow statements are not required for: (ICAI Study Material)
- (a) Private company.
 - (b) One person company.
 - (c) Public company.
 - (d) All of the Above

Sol. (b) One person company.

9. The presentation and disclosure requirements of a company are prescribed by : (ICAI Study Material)

- (a) Schedule III. (b) Schedule II.
- (c) Schedule I. (d) None of the Above

Sol. (a) Schedule III.

10. Following is an example of current assets: (ICAI Study Material)

- (a) Inventories.
- (b) Property, Plant & Equipment.
- (c) Intangible Assets.
- (d) All of the Above

Sol. (a) Inventories.

11. Earnings per share (EPS) is to be disclosed in which of the following sections of the financial statements ? (ICAI Study Material)

- (a) Balance Sheet.
- (b) Statement of Profit and Loss.
- (c) Cash Flow Statements.
- (d) All of the above

Sol. (b) Statement of Profit and Loss.

12. Following is NOT an example of a company under Companies Act, 2013 : (ICAI Study Material)

- (a) Small company.
- (b) Private company.
- (c) Large company.
- (d) All of the Above

Sol. (c) Large company.

THEORY QUESTIONS

1. Explain salient features of a company in brief. (ICAI Study Material)

Sol. Here are the distinctive features of a company:

Incorporated Association: A company is brought into existence through legal processes, requiring registration under the Companies Act. Without such registration, a company cannot be formed. As a creation of law, it is considered an artificial legal entity.

Separate Legal Entity: A company possesses a distinct legal identity and remains unaffected by changes in its membership. As a separate business entity, it can enter into contracts, initiate legal actions, and be subject to legal actions in its registered name and capacity.

Perpetual Existence: Due to its independent existence from its members, a company continues to exist despite changes in membership, including deaths, insolvencies, or other alterations.

Common Seal: As a non-natural entity, a company cannot sign documents in the manner of a natural person. To address this, a legal instrument known as the 'Common Seal' is provided. Originally, the Companies Act, 2013 mandated the use of the common seal on certain documents (e.g., bills of exchange, share certificates). However, recent changes have made the use of the common seal optional. Documents that previously required the common seal can now be signed by two directors or one director and a company secretary. Additionally, every registered company in India is required to obtain a unique Corporate Identification Number (CIN) assigned by the Registrar of Companies.

Limited Liability: The responsibility of each shareholder in a company is confined to the agreed-upon amount payable on the shares allocated to them. When shares are fully paid-up, shareholders bear no further liability.

Distinction between Ownership and Management: Due to the extensive number of shareholders, often spread across different locations, managing the day-to-day operations becomes challenging. This necessitates the separation of ownership and management.

Not a Citizen: Despite being created by legal processes, a company does not hold citizenship rights and duties comparable to those enjoyed by natural persons. It exists legally but lacks the citizenship attributes of individuals.

Transferability of Shares: Shareholders contribute capital through share subscriptions, and these shares are generally transferable, with the exception of certain restrictions imposed on transferability in the case of a private limited company.

Maintenance of Books: Legal requirements mandate a limited company to maintain a specific set of accounting books. Failure to comply with this obligation results in penalties.

Periodic Audit: A company is obligated to undergo periodic audits conducted by chartered accountants appointed for this purpose by shareholders upon the recommendation of the board of directors.

Right of Access to Information: Shareholders have the right to inspect the company's account books, as governed by the Articles of Association. This right extends to participating in company meetings and accessing periodic reports to obtain information from the directors.

2. Write short note on:

(i) Foreign company.

(ii) Small company.

(iii) Company limited by guarantee. (ICAI Study Material)

Sol. (i) Foreign Company

As outlined in Section 2 (42) of the Companies Act, 2013, a "Foreign company" is defined as any company or body corporate incorporated outside India that meets the following criteria:

(a) Possesses a place of business in India, either directly or through an agent, whether physically or via electronic means; and

(b) Engages in any business activity in India through any other method.

(ii) Small Company

As per Section 2(85) of the Companies Act, 2013, a “Small company” is defined as a company, excluding a public company, meeting the following criteria:

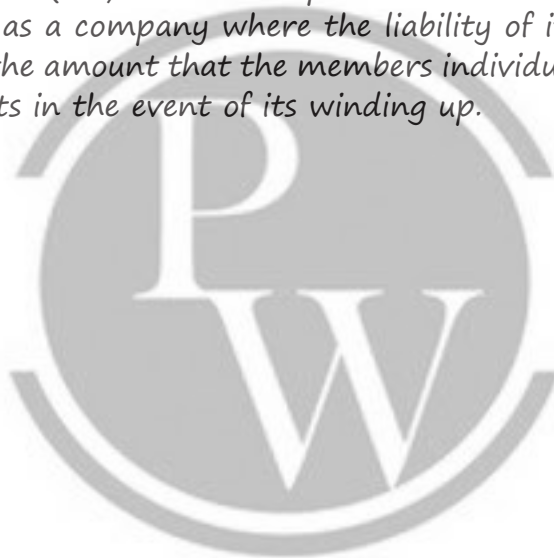
- (i) The paid-up share capital does not surpass four crore rupees or the prescribed higher amount, not exceeding ten crore rupees.
- (ii) The turnover, based on the last profit and loss account for the immediately preceding financial year, does not exceed forty crore rupees or the prescribed higher amount, not surpassing hundred crore rupees.

However, the provisions of this clause do not apply to:

- (A) A holding company or a subsidiary company.
- (B) A company registered under section 8.
- (C) A company or body corporate governed by any special Act.

(iii) Company limited by Guarantee

As outlined in Section 2(21) of the Companies Act, 2013, a “company limited by guarantee” is defined as a company where the liability of its members is restricted by the memorandum to the amount that the members individually commit to contributing to the company’s assets in the event of its winding up.



Issue, Forfeiture and Reissue of Shares Updated

INTRODUCTION

Funds injected by the owner(s) into a business are known as capital.

In a sole proprietorship business, the proprietor contributes capital. In contrast, in a partnership where there are multiple proprietors known as partners, the partners infuse capital into the firm.

Given that the number of members in a partnership is limited, the capital available is also restricted in such business forms. Additionally, the liability of the proprietor / partner is unlimited (exception LLP)

Capital funding process for different types of business forms can be summarised as follows:

Business Organisation	Ownership	Type of Capital	Liability of Owners
Sole - Proprietorship	Proprietor - He alone is the owner of business	Capital	Unlimited
Partnership	Partners	Partners' Capital	Unlimited
Company	Shareholders	Share Capital	Limited to issue price of shares held

Non-corporate entities (Sole-Proprietorship / Partnership) found it challenging to manage the intensified capital requirements and high risk levels of business. Consequently, this gave rise to the adoption of the corporate form of organization known as company.

SHARE CAPITAL

The company's entire capital is divided into numerous small units, each of a predetermined amount, referred to as shares.

The printed value on the share certificate, known as nominal/par/face value, represents the fixed value of a share. It is important to note that a company has the option to offer shares at a price distinct from the face value .

The liability of shareholders, who are the holders of shares, is confined to the acquisition price of the shares they own.

How are shares priced in an IPO..???

The issue price is not mandated to align with the market price of the share. In contemporary practices, shares are commonly priced using the book-building process.

In this method, the company establishes a price range for its shares, and the issue price is ultimately determined based on bids received from prospective investors within this price band.

(Book building is a process by which a company establishes its share prices.)

The company's capital is distributed into shares, collectively known as 'Share Capital.' During the issue of shares, it is mandatory for every company to comply with SEBI Regulations.

The share capital of a company is categorized as follows:

(i) **Authorized Share Capital or Nominal Capital:** This represents the maximum capital requirements estimated by a company, specified in the 'Capital Clause' of the 'Memorandum of Association' registered with the Registrar of Companies. It imposes a limit on the amount of capital authorized to be raised during the company's lifetime, known as 'Authorized Capital.' It is presented in the Share Capital schedule in the financial statements following the prescribed format at face value.

(ii) **Issued Share Capital:** A company is not obligated to issue its entire authorized capital. The portion of the share capital actually issued out of Authorized by the company is termed 'Issued Capital.' Issued capital encompasses the nominal value of shares issued for cash and consideration other than cash to promoters and others. It is also presented in the balance sheet at nominal value.

The remaining portion of the authorized capital that is not issued, either in cash or consideration, may be termed as 'Unissued Capital.' This is not disclosed in the balance sheet.

(iii) **Subscribed Share Capital:** This is the part of the issued share capital subscribed by the public, i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.

(iv) **Called-up Share Capital:** Companies usually receive the issue price of shares in installments. The portion of the issue price of shares that a company has demanded or called from shareholders is known as 'Called-up Capital,' and the balance, which the company has decided to demand in the future, may be referred to as **Uncalled Capital**.

(v) **Paid-up Share Capital:** This is the portion of called-up capital paid by the shareholders. Installments in arrears refer to the amount not paid, although it has been demanded by the company as payment towards the issue price of shares. To calculate paid-up capital, the amount of installments in arrears is deducted from called-up capital. Call-in-advance is the portion of capital yet to be called by the company but has already been paid by the shareholder. In the financial statements, called-up and paid-up capital are shown together.

(vi) **Reserve Share Capital:** According to Section 65 of the Companies Act, 2013, a company may decide, through a reSol., that a certain portion of its subscribed uncalled capital shall not be called up except in the event of winding up of the company. This portion of the uncalled capital, which a company has decided to call only in the case of liquidation, is termed **Reserve Capital**.

Reserve Capital is distinct from Capital Reserve, as Capital reserves are part of 'Reserves and Surplus' and refer to those reserves not available for the declaration of dividends.

Reserve Capital, on the other hand, is a portion of the uncalled capital to be called up only in the event of the company's winding up, and it differs in nature from Capital Reserve, which is created out of capital profits only.

TYPES OF SHARES

Shares issued by a company can be categorized as follows:

- *Preference Shares: As per Section 43 of the Companies Act, 2013, individuals holding preference shares, known as preference shareholders –*
- *are guaranteed a preferential dividend at a fixed rate throughout the company's existence.*
- *They also hold a preferential right over equity shareholders to receive payment first in the event of the company's winding up.*

Typically, holders of these shares do not have voting rights.

Companies opt for this financing method as it is more cost-effective than raising debt. The dividend is usually cumulative and may not be paid every year in the case of a deficiency in profits.

Preference shares are typically Redeemable, Cumulative, Non-Convertible and Non-Participating unless expressly stated otherwise.

Types of Preference Shares

Preference shares can assume various types, including:

- (a) *Cumulative Preference Shares: These shares entitle the holder to a fixed dividend or a dividend at a fixed rate.*
If the current year's profits are insufficient, then unpaid dividend accumulates, and if arrears exist for a continuous two years, holders gain the right to participate and vote on reSols in general body meetings.
- (b) *Non-cumulative Preference Shares: These shares grant the right to a fixed dividend, but if no dividend is declared in a year, the right to receive it expires.*
- (c) *Participating Preference Shares: Despite having a fixed dividend, these shares allow the holder to participate in surplus profits after equity shareholders are paid a stipulated rate of dividend. They also confer a predetermined proportion of surplus in the event of the company's winding up.*
- (d) *Non-participating Preference Shares: These shares only receive a fixed rate of dividend without additional rights in profits or surplus on winding-up, unless otherwise specified.*
- (e) *Redeemable Preference Shares: These shares are issued with the condition that the company will repay them after a fixed period or earlier at the company's discretion, governed by Section 55 of the Companies Act, 2013.*
- (f) *Non-redeemable Preference Shares: Preference shares without a redemption arrangement are termed Non-redeemable Preference Shares. Section 55 prohibits companies from*

issuing irredeemable preference shares or preference shares redeemable after 20 years, except for specified infrastructure projects.

(g) **Convertible Preference Shares:** These shares give the holder the option to convert them into equity shares according to the terms and conditions of their issue.

(h) **Non-convertible Preference Shares:** Shares without the right to convert into equity shares are termed Non-convertible Preference Shares.

□ **Equity Shares:** Equity shares refer to those shares that are distinct from preference shares, lacking preferential rights in terms of dividend payment or capital repayment.

The dividend rate on equity shares is determined by the Board of Directors and is subject to change based on the company's dividend policy and available profits after meeting the references of preference shareholders. Equity shares come with voting rights.

The Companies Act, 2013 allows the issuance of equity share capital with varying rights concerning dividend, voting, or other aspects in accordance with specified regulations.

A company has the option to issue shares either –

- for cash or
- for consideration other than cash.

ISSUE OF SHARES FOR CASH

To issue shares, private companies rely on 'Private Placement' of shares, while public companies issue a 'Prospectus' to invite the general public for share subscriptions.

For the purpose of discussing accounting treatment, the focus will be on public companies that invite the general public to subscribe to equity shares. The same accounting treatment is applicable in other scenarios. However, when recording journal entries for the issue of preference shares, the term 'Equity' is replaced with 'Preference'.

Process in Issue of Share to Public by the company:

1st Step: Issue of prospectus to invite the general public to subscribe to its shares

2nd Step: Interested parties deposit applications, along with the cash amount payable at the time of application.

Note: The initial installment paid with the application is termed as 'Application Money'. As per Section 39 of the Companies Act, 2013, application money must be at least 5% of the Face Value (i.e. Nominal Value) of shares.

However, SEBI regulations stipulate that the minimum application money, along with the application money, shall not be less than 25% of the issue price.

Matters related to the issue and transfer of securities, as per Section 24 of the Companies Act, 2013, are administered by SEBI, not the Company Law Board.

Following the closing date of the issue (the last date for submitting applications), the company, in consultation with SEBI and the relevant stock exchange, determines the allotment of shares. According to the Companies Act, 2013, a company is not permitted to proceed with the allotment of shares unless it has received the minimum subscription (i.e. 90%).

The minimum subscription amount disclosed in the prospectus by the Board of Directors

is determined by considering various factors, including:

- (a) Preliminary expenses of the company,
- (b) Commission payable on the issue of shares,
- (c) Cost of fixed assets already purchased or intended to be purchased,
- (d) Working capital requirements of the company, and
- (e) Any other expenditure necessary for the day-to-day operation of the business.

However, In accordance with the Securities Exchange Board of India (SEBI) guidelines, the minimum subscription amount to be received in an issue must not be less than 90% of the offer through the offer document.

If the company fails to secure the minimum subscription of 90% of the issue, all application funds received will be refunded to the applicants within:

- (a) fifteen days of the closure of the issue for non-underwritten issues, and
- (b) seventy days of the closure of the issue for underwritten issues where the minimum subscription, including devolvement obligations paid by the underwriters, is not received within sixty days of the issue's closure.

The company typically receives the issue price of shares in installments, and these installments are commonly referred to as:

First installment		Application Money
Second Installment		Allotment Money
Third Installment		First Call Money
Fourth Instalment		Second Call Money and so on.
Last Installment		Final Call Money

JOURNAL ENTRIES FOR ISSUE OF SHARES FOR CASH

Upon the issuance of share capital by a company, the following entries are recorded in the financial records:

- Upon the receipt of the application money

Bank Account Dr. (With the actual amount received.)

To Share Application Account

(Being received application money)

- On allotment of share

Share Allotment Account Dr. (With the amount due on allotment.)

Share Application Account Dr. (With the application amount received on allotted shares.)

To Share Capital Account (With the amount due on allotment and application.)

(Being the amount payable on allotment and the transfer of application funds to the capital

Retirement of A Partner

account)

- On receipt of allotment money

Bank Account

Dr. (With the amount actually received on allotment.)

To Share Allotment A/c

(Being allotment money received)

- On a call being made

Share Call Account

Dr. (With the amount due on the call)

To Share Capital Account

(Being share call made due at ₹...)

- On receipt of call money

Bank Account

Dr. (With the due amount actually received on call)

- To Share Call Account

(Being share call money received)

SUBSCRIPTION OF SHARES

The accounting treatment for the issuance of shares varies based on the subscription type. When a company opts to offer shares to the public, it solicits subscriptions by publishing a prospectus. It is not mandatory for the company to receive applications matching the number of shares issued.

Three scenarios may arise:

Full Subscription

The issue is considered fully subscribed when the quantity of shares presented for subscription matches the number of shares actually subscribed by the public. To initiate the discussion on the accounting treatment for share issuance, let's assume that the issue is fully subscribed.

Under Subscription

It implies that the quantity of shares issued exceeds the number of shares subscribed by the public subject to 90% as discussed in "Minimum Subscription Para".

Over Subscription

In practice, share issue are often either under-subscribed or over-subscribed. In cases of oversubscription, certain applications may be declined, resulting in the refund of application money. For other applications, only a portion of the requested shares may be allotted, and any surplus funds received can be utilized for allotment or upcoming call payments. The entries are:

- On refund of application money to applicants to whom shares have not been allotted: Share Application A/c Dr.

To Bank Account

(Being application money refunded to the applicants)

- When only a part of shares applied for are allotted. Share Application A/c Dr.

To Share Allotment* A/c (With the application money accepted for allotment)

To Share Calls-in-Advance* A/c (With the amount received in advance)

To Bank A/c (With any excess amount to be refunded) (Being excess application money adjusted)

*Credited to Share Capital A/c subsequently.

(Note: This type of share allotment is termed as Pro-rata allotment discussed later)

SHARES ISSUED AT DISCOUNT

Shares are considered to be issued at a discount when the issue occurs at an amount lower than the nominal or par value or face value of the shares. The difference between the nominal value and the issue price represents the discount on the shares.

Section 53 of the Companies Act, 2013 stipulates that a company is not allowed to issue shares at a discount, except in the case of the issuance of sweat equity shares (shares issued to employees and directors). Consequently, any issuance of shares at a discount is considered void.

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SHARES ISSUED AT PREMIUM

When a company issues its securities at a price higher than the face value, it is termed as an issue at a premium. Premium represents the surplus of the issue price over the face value of the security.

It is a common practice for financially robust and well-managed companies to issue shares at a premium, i.e., at an amount exceeding the nominal or par value of the shares.

Example: if a share with a face value

In cases where the issue is at a premium, the premium amount may technically be called at any stage of share capital transactions. However, in practice, premium is usually called along with the amount due on allotment, occasionally with the application money, and rarely with the call money.

ACCOUNTING TREATMENT

When shares are issued at a premium, the premium amount is recorded in a distinct account known as the "Securities Premium Account," as it does not constitute a part of the share capital. Instead, it signifies a "capital gain" for the company.

As a credit balance, the Securities Premium Account is presented under the "Reserves and Surplus" category. However, 'Reserves and Surplus' is classified as 'shareholders' funds' in the Balance Sheet according to Schedule III.

Section 52 of the Companies Act, 2013, specifies that the Securities Premium Account can be utilized by the company for the following purposes:

(a) Issuing unissued shares of the company as fully paid bonus shares to its members.

- (b) Writing off preliminary expenses incurred by the company.
- (c) Writing off expenses, commission, or discounts related to any share or debentures of the company.
- (d) Adjusting premium on the redemption of redeemable preference shares or debentures.
- (e) Purchasing the company's own shares or other securities. (Buy-Back of Shares)

When shares are issued at a premium, the following journal entries are passed :

□ **Premium amount called with Application money**

Bank A/c Dr. [Total Application money + Premium Amount]

To Share Application A/c [Amount received] (Being Application Money received on Shares @ ₹ per share including premium)

Share Application A/c Dr. [No. of Shares Applied for x Application Amount per share]

To Securities Premium A/c [No. of Shares allotted x Premium Amount per share]

To Share Capital A/c [No. of Shares allotted x Nominal value per share for capital]

□ **Premium Amount called with Allotment Money**

Share Allotment A/c Dr. [No. of Shares Allotted x Allotment and Premium Money per share]

To Share Capital A/c [No. of Shares Allotted x Allotment Amount per share]

To Securities Premium A/c [No. of Share Allotted x Premium Amount per share]

(Allotment money due of shares @ ₹ per share including premium)

Bank A/c Dr.

To Share Allotment A/c (Allotment Money received including premium).

OVER SUBSCRIPTION AND PRO-RATA ALLOTMENT

Over subscription occurs when the application money received exceeds the number of shares issued to the public by a company.

This typically happens with well-received issues and is influenced by factors such as investor confidence, economic conditions, and issue pricing.

In the event of oversubscription, the company faces the challenge of deciding how to allocate the shares among the applicants. The company has the discretion to reject some applicants entirely, refunding their application money. Multiple applications from the same individuals are usually not considered. Alternatively, the company may choose to allot shares in full to some applicants based on their requested quantity.

Another option is to allocate shares on a pro-rata basis, meaning in proportion to the shares applied for. For instance, if a company offers 10,000 shares and receives applications for 12,000 shares, the pro-rata ratio might be 12,000:10,000 or 6:5. In this scenario, an applicant who applied for 6 shares would be allotted 5 shares.

Under pro-rata allotment, any excess application money received is adjusted against the amount due on allotment or future calls. Surplus funds, after adjusting for future calls, are

returned to the applicants. The details of the allotment process are communicated to the applicants through advertisements in prominent newspapers.

In cases of pro-rata allotment, an applicant's total application money exceeds the exact amount due on application. The excess amount is considered an advance against allotment or any forthcoming calls. The net amount due on allotment or future calls is the difference between the amount due on allotment or future calls and the excess amount received during the application process.

Accounting Entries

□ For rejected applications:

Share Application Account Dr.

To Bank Account

(Being application money refunded for rejected applications)

□ For pro-rata allotment:

Share Application Account Dr.

To Share Allotment Account

(Being excess application money adjusted against allotment money)

ALLS-IN-ARREARS AND CALLS-IN-ADVANCE

Calls-in-Arrears

On occasion, shareholders may default on payment for allotment or calls. The aggregate unpaid sum for one or more installments is referred to as Calls-in-Arrears or Unpaid Calls. This amount signifies the outstanding capital yet to be collected from shareholders. Therefore, it is reflected as a deduction from the 'called-up capital' to determine the paid-up value of the share capital.

The following journal entry is recorded for recording 'Calls-in-Arrears' :

Calls-in-Arrears A/c	Dr.	[Amount of Unpaid Calls]
Bank A/c	Dr.	[Amount received]
To Share Allotment A/c		[Total allotment money due]
To Share Calls A/c		[Total Call money due]

(Being call money/ allotment money received on shares at ₹ per share.)

Note: Call in arrears cannot happen on Application Stage

Calls-in-Advance

Occasionally, certain shareholders may remit a portion or the entirety of the uncalled amount. This sum is referred to as Calls-in-advance.

The following entry is recorded for recording 'Calls-in-Advance' :

Bank A/c Dr. [Call amount received in advance] To Call-in-Advance A/c

When calls become actually due, the calls-in-advance account is adjusted at the time of the

call. For this the following journal entry is recorded:

Calls-in-Advance A/c Dr. [Call amount received in advance]

Bank A/c Dr. [Remaining call money received, if any] To Particular Call A/c [Call money due]

(Being call in advance adjusted and call money duly received)

INTEREST ON CALLS-IN-ARREARS AND CALLS- IN-ADVANCE

Interest on overdue calls is collectible, while for advance calls, it is payable, in accordance with the stipulations outlined in the company's articles. The rates are either specified in the articles or determined by the directors within the boundaries set by the Articles. Table F designates 10% and 12% per annum as the maximum rates for call-in-arrears and call-in-advance calls, respectively.

Interest on Calls in Arrears	Interest on Calls in Advance
It is payable by shareholders to company (i.e. receivable for company) on the calls due that are Outstanding and unpaid.	It is payable by the Company to Shareholders for the call money received in advance that is not yet due.
As per Table F , the maximum prescribed rate is 10%.	As per Table F, the maximum prescribed rate is 12%.
Time Frame considered : From the due date of call money to the date when the funds are received.	Time Frame considered: From the day the money was received to the day the call was ultimately deemed due.
Directors have authority to waive such interest on a case-by-case basis at their own discretion.	Shareholders are not eligible for any dividends on advance calls because dividend is calculated on Paid Up Capital which is called by the company
It is a nominal account and is credited to the income statement as revenue.	It is a nominal account in nature with interest being an expense for the company.

The following journal entries are passed for calls-in-arrears :

□ For interest receivable on calls-in-arrears

Shareholders' A/c Dr.

To Interest on calls-in-arrears A/c

(Being interest on calls in arrears made due at the rate of ...%)

□ For receipt of interest

Bank A/c Dr.

To Shareholders' A/c (Being interest on calls in arrears received)

The following is the accounting treatment of interest on Calls-in-Advance:

❑ Interest Due

Interest on Calls-in-Advance A/c Dr. [Amount of interest due for payment]

To Shareholder's A/c

(Being interest on calls in advance made due)

❑ Payment of Interest

Shareholder's A/c Dr. [Amount of interest paid]

To Bank A/c

(Being interest on calls-in-advance paid)

FORFEITURE OF SHARES

The term 'forfeit' essentially refers to the confiscation of property due to a breach of a condition.

It is not uncommon for one or more shareholders to default on the payment of their allotment and/or calls on the scheduled dates. Non-payment of allotment and/or calls money leads to the forfeiture of shares. Forfeiture of shares involves the company taking action to cancel the shares.

Typically, the Articles of Association (AOA) empower the directors to forfeit such shares by issuing proper notice to the defaulting shareholder(s). When shares are forfeited, the ownership rights of the shareholder are terminated, also the amount paid to date is not refunded. The shareholder then loses any further claim on the company.

The power to forfeit must be exercised strictly in accordance with the rules outlined in the Articles of Association (AOA), and it should be done in good faith for the benefit of the company.

Directors also retain the right to cancel such forfeiture before the forfeited shares are re-issued.

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❑ Forfeiture of Shares which were issued at Par

In this scenario, the Share Capital Account will be debited with the called-up value of the forfeited shares. The Allotment or Calls Account will be credited with the amount due but not paid by the shareholder(s). Alternatively, the Calls-in-Arrears Account can be credited for the entire amount due if it was transferred to the Calls-in-Arrears Account. The Forfeited Shares Account or Shares Forfeiture Account will be credited with the amount already received for those shares.

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Share Capital Account Dr. [No. of shares x 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 Share First Call Account [If amount due, but not paid]

Retirement of A Partner

To Share Final Call Account [If amount due, but not paid]

If all amounts due on allotment, first call, and final call have been transferred to the Calls-in-Arrears Account, the entry will be:

Share Capital Account Dr. [No. of shares x 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 Premium

In this scenario, the Share Capital Account will be debited with the called-up value of forfeited shares. If the shareholder has not paid the premium on such shares, the Securities Premium Account will be debited to nullify it (if it was credited previously). The Allotment, Calls, and Forfeited Accounts will be credited as usual.

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If the company has already received the premium, it cannot be nullified even in the event of future forfeiture of shares.

If premium not received

Share Capital A/c Dr. [Called-up value]

Securities Premium A/c Dr. [Amount of Security premium not received]

To Share Allotment Account [If amount due, but not paid]

To Share First Call Account [If amount due, but not paid]

To Share Final Call Account [If amount due, but not paid]

To Forfeited Shares Account [Amount received on forfeited shares]

If premium received		
Share Capital A/c	Dr.	[Called-up value]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

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❑ Forfeiture of Fully Paid-Up Shares

The forfeiture of shares can occur due to various reasons, including non-payment of calls, premium, or the outstanding portion of the face value. However, in cases where shares are fully paid-up, forfeiture may take place as allowed by the Articles for the purpose of recovering the shareholder's debts.

RE-ISSUE OF FORFEITED SHARES

A forfeited share is essentially a share that the company can sell and is retained by the

company for this specific purpose. The reissuance of forfeited shares is not an allotment but rather a sale. Following forfeiture, the company is obligated to sell these shares. Typically, forfeited shares are sold through an auction. These shares can be reissued at any price, provided that the total amount received (from both the initial allottee and the subsequent purchaser) for those shares is not less than the amount in arrears on those shares.

Accounting Entries :

Bank Account Dr. [Actual amount received] Forfeited Shares Account Dr. [Loss on re-issue]

To Share Capital Account

(Being re-issue of....shares @ ₹ Each)

Forfeited Shares Account Dr.

To Capital Reserve Account

(Being transfer of profit on re-issue to capital reserve).

□ Points for Consideration

In relation to the re-issuance of forfeited shares, the following considerations are significant:

- The loss on re-issuance should not surpass the forfeited amount.
- If the loss on re-issuance is less than the forfeited amount, the surplus should be transferred to Capital Reserve.
- The forfeited amount on shares (originally paid-up) not yet reissued should be indicated under the heading 'share capital.'
- When only a portion of the forfeited shares is re-issued, the profit from the re-issuance of that specific portion of shares should be transferred to Capital Reserve.
- In the case of shares being re-issued at a loss, the loss should be debited to the "Forfeited Shares Account."
- If the shares are re-issued at a price exceeding the face value, the excess amount will be credited to the Securities Premium Account.
- If the combined re-issued and forfeited amount surpasses the face value of the shares re-issued, there is no obligation to transfer such an amount to the Securities Premium Account.

□ Calculation of Profit on Re-Issue of Forfeited Shares

Students should understand that the credit balance in the Forfeited Shares Account is not considered a surplus until the re-issued shares have been successfully re-issued.

This is because, during re-issuance, the company may offer a discount to the new purchaser equal to the amount credited in the Forfeited Shares Account.

To illustrate, if 120 shares with a nominal value of Rs.10 were forfeited, with Rs.5 per share paid up and transferred to the Forfeited Shares Account, and later 50 shares were re-issued with Rs.6 per share collected to make them fully paid up, Rs.200 (50 shares x Rs.10 - 50 shares x Rs.6) would be credited to the Share Capital Account to cover the deficiency on re-issued shares.

Additionally, Rs.50 (50 shares x Rs.5 - Rs.200) would be transferred to the Capital

Reserve Account as the surplus on the re-issuance of the 50 shares. The remaining balance in the Forfeited Shares Account, equivalent to the amount collected on the remaining 70 forfeited shares (i.e., Rs.350), would be carried forward until these shares are re-issued.

It's important to note that the example assumes a uniform amount paid up on all 120 forfeited shares. In practice, shares may be forfeited with varying amounts outstanding. For instance, if in the given case, 70 shares were forfeited with Rs.5 paid up and 50 shares with Rs.7.50 paid up, the calculation would be adjusted accordingly.

$$\begin{aligned}\text{Share Forfeited Account Balance} &= (70 \times 5) + (50 \times 7.50) \\ &= \text{Rs.725}\end{aligned}$$

Thus if 50 shares with Rs.7.50 paid up are re-issued for Rs.6 per share then Capital Reserve balance will be as follows:

$$\text{Rs.}(7.50 + 6 - 10) \times 50 \text{ shares} = \text{Rs.175}$$

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Public limited companies typically issue shares for cash and utilize the proceeds to acquire various types of assets required for their business operations. However, there are instances where a company may opt to issue shares directly in exchange for assets such as land, buildings, or other resources.

Additionally, shares might be issued as compensation for services provided by promoters or legal professionals involved in the formation of the company.

“It is essential to present these shares separately under the ‘Share Capital’ category”

According to accounting standards, when an asset is acquired, either wholly or partly, through the issuance of shares or other securities, the cost of acquisition is determined by the fair value of the securities issued.

This fair value, in relevant cases, may be indicated by the issue price as determined by statutory authorities and may not necessarily align with the nominal or par value of the securities issued.

□ Accounting Entries

When assets are purchased in exchange of shares Assets Account Dr.

To Share Capital Account

TEST YOUR KNOWLEDGE

True and False

1. Liability of a holder of shares is limited to the face value of shares acquired by them. (ICAI Study Material)

Sol.– False. The shareholder's liability is limited to the acquisition price of the shares they hold.

2. Authorized capital appears in the balance sheet at face value. (ICAI Study Material)

Sol. – True. Authorized capital is the capital amount specified in the 'capital clause' of the 'Memorandum of Association.' Authorized capital is considered a representation and is not included in the total balance sheet.

3. The rate of dividend on preference shares may vary From year to year. (ICAI Study Material)

Sol. – False. The rate of preference dividend is not always fixed.

4. A company may issue shares at a discount to the public in general. (ICAI Study Material)

Sol. – False. According to Section 53 of the Companies Act, 2013, issuing shares at a discount is allowed in the case of sweat equity shares (issued to employees and directors).

5. Sweat equity shares are those which are issued to employees & directors at a discount. (ICAI Study Material)

Sol. – True. According to Section 53 of the Companies Act, 2013, issuing shares at a discount is generally not allowed, except in the case of sweat equity shares.

6. As per table F, rate of interest on calls in arrears is 12%.(ICAI Study Material)

Sol. – False. As per Table F, the rate of interest on calls in arrears is typically 10%.

7. As per Table F, rate of interest on calls in advance is 10%.(ICAI Study Material)

Sol. – False. As per Table F, the rate of interest on calls in advance is usually 12%.

8. Non-participating preference shareholders enjoy voting rights. (ICAI Study Material)

Sol. – False . A share that receives a fixed rate of dividend without additional rights in profits or surplus on winding-up is termed 'Non-participating Preference Shares.' Non-participating preference shareholders usually lack voting rights.

9. Forfeited shares are available to the company for the purpose of resale. (ICAI Study Material)

Sol. – True . Reissue of forfeited shares is considered a sale rather than an allotment of shares.

10. Loss on reissue should exceed the forfeited amount. (ICAI Study Material)

Sol. – False . Loss on re-issue should not surpass the forfeited amount.

11. Reserve Capital and Capital Reserve have identical definitions.

Sol. False: Reserve Capital pertains to the uncalled up portion of share capital, only accessible in the event of winding up. Capital Reserve, on the other hand, is a reserve generated from capital gains.

12. In accordance with Table F, the minimum interest rate permissible for Calls-in-arrears is 10% per month, and the minimum interest rate allowed for calls-in-advance is 12% per month.

Sol. – False: According to Table F, the highest interest rate that can be levied on Calls-in-Arrears is 10% per annum, while the highest interest rate permitted on calls-in-advance is 12% per annum.

13. Re-issue of forfeited shares is allotment of shares but not a sale. [May 2018, 2 Marks]

Sol. – False: A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale as they have already been allotted earlier.

14. Since company has existence independent of its members, it continues to be in existence despite the death, insolvency or change of members. [Nov. 2019, 2 Marks]

Sol. – True: A company has a separate legal entity i.e. its existence is independent of its members. The company is consequently able to enjoy perpetual succession and continues in existence irrespective of death/insolvency/change of members, until it is wound up by law.

15. In the balance sheet of X Limited, preliminary expenses amounting to ₹ 5 lakhs and securities premium account of ₹ 35 lakhs are appearing. The accountant can use the balance in securities premium account to write off preliminary expenses.

[Nov. 2020, 2 Marks]

Sol. – True: Section 52 of the Companies Act, 2013 allows that preliminary expenses may be written off through Securities Premium Account.

16. Re-issue of forfeited shares is allotment of shares but not a sale. [Jan. 2021, 2 Marks]

Sol. – False: Reissue of forfeited shares is treated as sale of shares not as allotment of shares.

17. A Company is not allowed to issue shares at a discount to the public in general.

[July 2021, 2 Marks]

Sol. – True: According to Section 53 of the Companies Act, 2013, a company cannot issue shares at a discount to general public.

18. A person holding preference shares of a company cannot hold equity shares of the same company. [July 2021, 2 Marks]

Sol. – False: A person can hold both equity and preference shares of the same company as per Companies Act, 2013.

19. Non-participating preference shareholders enjoy voting rights. [Dec. 2021, 2 Marks]

Sol. – False: No voting rights are conferred on Preference Shares irrespective of whether participating or non-participating

Multiple Choice Questions

1. The excess price received over the par value of shares, should be credited to ____.

(ICAI Study Material)

- (a) Calls-in-advance account
- (b) Share capital account
- (c) Securities premium account
- (d) None of the Above

Sol. – (c) Securities premium account

2. The Securities Premium amount may be utilized by a company for ____.

(ICAI Study Material)

- (a) Writing off any loss on sale of fixed asset
- (b) Writing off any loss of revenue nature
- (c) Writing off the expenses/discount on the issue of debentures
- (d) All of the Above

Sol. – (C) Writing off the expenses/discount on the issue of debentures

3. When shares are forfeited, the share capital account is debited with _____ and the share forfeiture account is credited with _____. *(ICAI Study Material)*

- (a) Paid-up capital of shares forfeited; Called up capital of shares forfeited
- (b) Called up capital of shares forfeited; Calls in arrear of shares forfeited
- (c) Called up capital of shares forfeited; Amount received on shares forfeited
- (d) None of the Above

Sol. – (C) Called up capital of shares forfeited; Amount received on shares forfeited

4. T Ltd. proposed to issue 6,000 equity shares of Rs.100 each at a premium of 40%. The minimum amount of application money to be collected per share as per the Companies Act, 2013 *(ICAI Study Material)*

- (a) Rs.5.00
- (b) Rs.6.00
- (c) Rs. 7.00
- (d) None of the Above

Sol. – (a) Rs.5.00

5. Dividends are usually paid as a percentage of _.

(ICAI Study Material)

- (a) Authorized share capital
- (b) Net profit
- (c) Paid-up capital
- (d) All of the Above

Sol. – (c) Paid-up capital

6. As per the SEBI guidelines, on issue of shares, the application money should not be less than :

(ICAI Study Material)

- (a) 2.5% of the nominal value of shares
- (b) 2.5% of the issue price of shares
- (c) 25.0% of the issue price of shares
- (d) 5% of the nominal value of shares

Sol. – (c) 25.0% of the issue price of shares

7. G Ltd. acquired assets worth ₹ 7,50,000 from H Ltd. by issue of shares of ₹ 100 at a premium of 25%. The number of shares to be issued by G Ltd. to settle the purchase consideration = ?

(ICAI Study Material)

- (a) 6,000 shares
- (b) 7,500 shares
- (c) 9,375 shares
- (d) 6,500 Shares

Sol. – (a) 6,000 shares

8. Securities Premium is presented as a part of :

(ICAI Study Material)

- (a) Reserves & Surplus
- (b) Share Capital
- (c) Liabilities
- (d) None of the Above

Sol. – (a) Reserves & Surplus

9. Schedule III of Companies Act 2013 prescribes the format for : (ICAI Study Material)

- (a) Financial statements
- (b) Directors' Report
- (c) Auditors' Report
- (d) All of the Above

Sol. – (a) Financial statements

10. Dividend on _____ shares have to be paid before dividend on shares.

(ICAI Study Material)

- (a) Equity, Preference
- (b) Preference, Equity
- (c) Convertible, Non-Cumulative
- (d) None of the Above

Sol. – (b) Preference, Equity

11. Preference shares are unless expressly stated otherwise.

(ICAI Study Material)

- (a) Non-participating
- (b) Convertible
- (c) Interest-bearing
- (d) None of the Above

Sol. – (a) Non-participating

Theory Questions

1. Write short notes on:

Utilization of securities premium account

Re-issue of forfeited shares.

(ICAI Study Material)

Sol. –

- (i) When shares are issued at a premium, the premium amount is recorded in a distinct account known as the “Securities Premium Account,” as it does not constitute a part of the share capital. Instead, it signifies a capital gain for the company.

As a credit balance, the Securities Premium Account is presented under the “Reserves and Surplus” category. However, ‘Reserves and Surplus’ is classified as ‘shareholders’ funds’ in the Balance Sheet according to Schedule III.

Section 52 of the Companies Act, 2013, specifies that the Securities Premium Account can be utilized by the company for the following purposes:

- (a) Issuing unissued shares of the company as fully paid bonus securities to its members.
- (b) Writing off preliminary expenses incurred by the company.
- (c) Writing off expenses, commission, or discounts related to any securities or debentures of the company.
- (d) Providing for the premium on the redemption of redeemable preference shares or debentures. (e) Purchasing the company’s own shares or other securities.
- (ii) A forfeited share is essentially a share that becomes available for the company to sell and is

retained by the company for this specific purpose. The reissue of forfeited shares does not constitute an allotment of shares; rather, it is regarded as a sale. Once forfeited, the share held by the company comes with the responsibility to be sold. Typically, forfeited shares are auctioned in practice. These shares can be reissued at any price, as long as the total amount received (from both the original allottee and the second purchaser) for those shares is not less than the outstanding amount on those shares.

2. Distinguish between:

Calls-in-Arrears and Calls-in-advance

Issue of shares for cash and Issue of Shares for Consideration other than Cash

(ICAI Study Material)

Sol. –

- (i) *Calls-in-Arrears: On occasions, shareholders may neglect to fulfill the payment obligations on allotment or calls. The aggregate outstanding amount on one or more installments is referred to as Calls-in-Arrears or Unpaid Calls. This sum signifies the unreceived portion of capital from the shareholders and is displayed as a deduction from the 'called-up capital' to determine the paid-up value of the share capital.*

Calls-in-advance: In certain instances, shareholders may choose to make a partial or full payment of the yet-to-be-called-up amount. This sum is termed Calls-in-advance.

- (ii) *A company has the option to issue shares either in exchange for cash or for consideration other than cash. Typically, public limited companies opt to issue shares for cash, utilizing the proceeds to acquire diverse assets essential for their business operations. Nevertheless, there are instances where a company may choose to issue shares directly in exchange for assets such as land, buildings, or other non-monetary considerations.*

3. Can a company issue shares at discount?

(ICAI Study Material)

Sol. – *In adherence to Section 53 of the Companies Act, 2013, a company is prohibited from issuing shares at a discount, except in the scenario of issuing sweat equity shares, which are allocated to employees and directors. Consequently, any attempt to issue shares at a discount is deemed void.*

UNIT – 3 ISSUE OF DEBENTURES**3.1 INTRODUCTION**

Due to the escalating and ongoing demands for corporate expansion and development, depending solely on equity financing proves insufficient. As a result, companies resort to debt financing through various channels. One such avenue involves issuing debt instruments to the public for subscription, serving as a means to fund business activities.

Debt financing contributes to shaping the company's optimal capital structure. Among the commonly employed debt instruments for fundraising is the issuance of debentures by companies.

3.2 MEANING

The primary method of increasing a company's available capital involves the issuance of debentures.

A debenture, is a bond issued by a company under its seal, acknowledges a debt and includes provisions for the repayment of principal and interest.

3.3 FEATURES OF DEBENTURES

1. It is a written record that signifies a loan extended to a company.
2. It is a secure, interest-bearing financial instrument with interest payments due on specific dates.
3. The interest is payable at a predetermined fixed rate, irrespective of the company's profit levels.
4. The principal amount is repaid at a designated future date, or it is converted into shares.
5. It may or may not establish a claim on the company's assets as collateral.
6. Typically, it is tradable on the stock exchange, with the option to buy or sell at a price either above or below its nominal value.

3.4 DISTINCTION BETWEEN DEBENTURES AND SHARES

Debentures	Shares
1. Debenture holders function as the company's creditors.	1. Shareholders of the company are the owners of the business.
2. Debenture holders lack voting rights, thereby posing no threat to the existing control structure of the company.	2. Shareholders possess voting rights, thereby exercising control over the overall affairs of the company.
3. Debenture interest is typically paid at a predetermined fixed rate, regardless of the company's profitability. Debentures take precedence over all types of shares for the payment of due interest.	3. Dividends on equity shares fluctuate based on company profits (while dividends on preference shares are fixed).
4. Interest on debentures constitutes charges against profits and is deductible as an expense when determining the company's taxable profit.	4. Dividends represent an appropriation of profits and are not deductible when calculating the taxable profit of the company.
5. On the Company's Balance Sheet, debentures are categorized under "Term Borrowings."	5. The company's Balance Sheet includes shares categorized under "Shareholder's Fund," detailed in the 'Share Capital' section of the Notes to Accounts.
6. Debentures have the option to be converted into other debentures or shares based on the terms specified during the debenture issuance.	6. Shares are not convertible into other shares under any circumstances.
7. Debentures cannot be forfeited due to non-payment of call moneys.	7. Shares may be forfeited if allotment and call moneys are not paid.
8. Upon maturity, debenture holders receive their invested capital in accordance with the stipulated terms and conditions of redemption.	8. Equity shareholders cannot reclaim their investment before the company undergoes liquidation (unlike preference shareholders who have that privilege).
9. In the event of liquidation, debenture holders are repaid before shareholders.	9. During liquidation, shareholders receive payment last, after settling obligations to debenture holders, trade payables, and other liabilities.

3.5 TYPES OF DEBENTURES

The following are the types of debentures issued by a company. They can be classified on the basis of:

1. Security

- (a) **Secured Debentures:** These debentures are backed by a charge (claim on asset if amount is not paid) on some or all of the company's assets.

There are two categories of charges:

- (i) **Fixed charge:** A fixed charge represents a mortgage on specific assets, and these assets cannot be sold without the consent of the debenture holders
- (ii) **Floating charge:** A floating charge typically includes all of the company's assets, including those acquired in the future.
- (b) **Unsecured or "Naked" Debentures:** These debentures lack security through any charge on assets. The company simply commits to paying interest on specified dates and repaying the principal amount on the maturity date. Such debentures carry a high level of risk from the perspective of investors.

2. Convertibility

- (a) **Convertible Debentures:** These represent debentures that undergo conversion into equity shares, either at par, premium, or discount, after a specified period from the date of their issuance. Convertible debentures may be fully or partially convertible, providing debenture holders with an opportunity to become shareholders of the company in the future.
- (b) **Non-Convertible Debentures:** In contrast, non-convertible debentures are not eligible for conversion into shares in the future. According to the terms of issuance, these debentures are repaid without the option of conversion.

3. Permanence

- (a) **Redeemable Debentures:** These debentures are scheduled for repayment in accordance with the terms specified during issuance, such as after 8 years from the date of their release.
- (b) **Irredeemable Debentures:** Irredeemable debentures, also known as perpetual debentures, do not have a repayment schedule during the company's lifetime. They are only repaid at the time of liquidation.

4. Negotiability

- (a) **Registered Debentures:** These debentures are repayable to a registered holder whose details, including name, address, and holding particulars, are documented in the Register of Debenture holders. They are not easily transferable, and compliance with the provisions of the Companies Act, 2013 is necessary for the transfer of these debentures.

However, Debenture interest is disbursed either to the order of the registered holder, as indicated in the warrant issued by the company, or to the bearer of the interest coupons.

- (b) **Bearer Debentures:** These debentures can be transferred by delivery and are negotiable instruments payable to the bearer. The company does not maintain any record of the holders of such debentures. Consequently, interest is paid to the holder without consideration of identity, and no transfer deed is required for the transfer of such debentures.

5. Priority

- (a) **First Mortgage Debentures:** Payment of these debentures takes precedence over other claims on the charged property.
- (b) **Second Mortgage Debentures:** Payment of these debentures occurs after satisfying the claims of the first mortgage debentures

3.6 ISSUE OF DEBENTURES

3.6.1 Accounting entries for issue of redeemable debentures

The categorization of redeemable debentures encompasses the following scenarios:

1. Debentures issued at par and redeemable either at par or at a discount.
2. Debentures issued at a discount and redeemable either at par or at the same discount.
3. Debentures issued at a premium and redeemable either at par or at a discount.
4. Debentures issued at par and redeemable at a premium.
5. Debentures issued at a discount and redeemable at a premium.
6. Debentures issued at a premium and redeemable at the same premium.

Note: Redemption at a discount is an uncommon occurrence in practical situations.

Journal entries in each of the above cases are discussed below:

1. Debentures issued at par redeemable at par: When debenture are issued at par i.e the issue price is equal to par value, the following entries are recorded:

- (a) For receipt of application money:

Bank A/c	Dr.
To Debenture Application A/c	

- (b) For transfer of application money to debentures account :

Debenture Application A/c	Dr.
To % Debenture A/c	

2. Debentures issued at Discount and Redeemable at par or at discount : In the case of debentures issued at a discount, the issue price is lower than the par value. The variance between the two is recognized as a loss on debenture issuance and is amortized over the lifespan of the debentures. In this scenario , the following entries are given passed :

- (a) For receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

(b) At the time of making allotment

Debenture Application A/c Dr.

Discount on issue of debentures A/c Dr.

To ...% Debentures A/c

3. Debentures Issued at Premium and Redeemable at par or at discount

In instances where debentures are issued at a premium, the issue price exceeds the par value. The surplus amount is then transferred to the securities premium account. In this case, the journal entries are recorded as follows :

When premium amount is received at the time of application;

(a) For receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) For transfer of application of money at the time of allotment

Debenture application A/c Dr.

To ...% Debentures A/c

To Securities Premium A/c

When debentures are issued at par or a premium but redeemed at a discount, it implies that the company will benefit by making a lesser payment.

This gain is not acknowledged in the books during the debenture issuance in adherence to the conservatism concept. The utilization of debenture premium is guided by the provisions outlined in Section 52 of the Companies Act, 2013.

4. Debentures issued at par and redeemable at a premium

When debentures are set to be redeemed at a premium, an additional entry is required during the debenture issue and allotment. This supplementary entry is made to account for the premium due upon redemption.

The Debenture Redemption Premium Account serves as a personal account, indicating a liability for the company concerning the premium payable upon redemption.

In such instances, where the issue price is equal to the par value but the redemption value exceeds the par value, the redemption premium is recorded as a loss during the allotment of debentures.

Following journal entries are passed in this regard:

(a) For application money received

Bank A/c Dr.

To Debenture application A/c

(b) For making allotment

(i) Application money transferred to debenture account

Debenture Application A/c Dr.

To ...% Debenture A/c

(ii) Call made on 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

Instead of passing the separate entries, a compound entry can also be passed:

Bank A/c	Dr.

Loss on issue of debenture A/c	Dr.

To ...% Debenture A/c

To Debenture redemption premium A/c

5. Debentures Issued at discount and redeemable at premium

In this scenario, the issue price is lower than the par value, while the redemption value exceeds the par value. The disparity between the redemption price and the issue price is considered as a discount or loss on the debenture issuance.

For example, if a 10% debenture with a face value of Rs.1,000 is issued at a discount of Rs. 100 and redeemable at a premium of Rs. 5 per debenture, the calculated loss would be Rs. 1,005 – Rs. 900 = Rs. 105. This amount is recognized as a loss on the issue. It is important to note that the premium on the redemption of debentures is also offset by Rs. 5.

(a) For application money received

Bank A/c	Dr.

To Debenture Application A/c

(b) For making allotment

(i) Application money transferred to debenture account

Debenture Application A/c	Dr.

To % Debentures A/c

(ii) Allotment money due of debentures at

Discount and redeemable at premium

Debenture Allotment A/c	Dr.

Discount/Loss on issue of debenture A/c	Dr.	[Amount equal to the discount on issue of debenture plus Premium on redemption]

To ...% Debenture A/c

(c) For allotment money received

Bank A/c	Dr.

To Debenture Allotment A/c

Instead of passing the separate entries, a compound entry can also be passed:

Bank A/c Dr.

Discount/Loss on issue of debentures A/c Dr.

To ...% Debentures A/c

To Debenture redemption premium A/c

6. Debentures Issued at premium and redeemable at premium

In this scenario, both the issue price and redemption value surpass the par value. The premium received during the debenture issuance is acknowledged in the Securities Premium Account, and the premium paid upon redemption represents a loss to be accounted for during the debenture issue.

For instance, if a 10% debenture with a face value of Rs.1,000 is issued at a premium of Rs.100 and redeemable at a premium of Rs.50 per debenture, in this case, Rs.100 is credited to the Securities Premium Account, and Rs.50 is recognized as a loss to be provided for at the time of the debenture issue. It is important to note that the premium on the redemption of debentures is also credited by Rs.50.

(a) For application money received

Bank A/c Dr.

To Debenture Application A/c

(b) For making allotment

(i) Application money transferred to debenture account

Debenture Application A/c Dr.

To % Debentures A/c

(ii) Allotment money due of debenture at premium and Redeemable at premium

Debenture Allotment A/c Dr.

Loss on issue of debenture A/c Dr. [Amount equal to the Premium on redemption]

To ...% Debenture A/c

To Securities Premium A/c [Amount equal to premium on issue]

To Premium on Redemption of Debentures [Amount equal to Debentures A/c premium on redemption]

Instead of passing the separate entries, a compound entry can also be passed:

Bank A/c Dr.

Loss on issue of Debentures A/c Dr.

To ...% Debentures A/c

To Securities Premium A/c

To Premium on redemption of debentures A/c

3.6.2 Accounting for issue of debentures payable in instalments

Similar to shares, the payment for debentures can be made either in full with the application or in instalments. The accounting entries will vary to some extent in each scenario.

Debentures Payable in Full on Application

When the amount owed on debentures is payable in full upon application, it is customary to establish distinct Debentures Application Accounts for each debenture class, such as the 10% Debentures Application Account or 12% Debentures Application Account.

These accounts document the funds received from debenture applicants. In cases of oversubscription, these accounts can be utilized to record the repayment of funds to unsuccessful applicants.

During the debenture allotment process, the sum in the Debentures Application Account is transferred to the corresponding Debentures Account.

As previously discussed, debentures may be issued at par, at a premium, or at a discount.

Debentures Issued at Par

Debentures issued at par are priced at their nominal value, meaning that if a debenture with a face value of Rs.100 is issued at par, the company receives Rs.100.

The accounting entries would be recorded as follows:

- (a) When Application money is received

Bank A/c	Dr.
To Debentures Application A/c	
(Being money received on.... debentures @` each)	

- (b) When excess Application money is refunded or adjusted for future calls

Debentures Application A/c	Dr.
To Bank A/c (Amount refunded)	
To Debenture Allotment A/c (Amount adjusted for allotment)	
(Being excess money...debentures adjusted)	

- (c) When the debentures are allotted

Debentures Application A/c	Dr.
To % Debentures A/c	
(Being the allotment of...debentures of ` each.)	

- (d) When Allotment money becomes due

Debenture Allotment A/c	Dr.
To % Debentures A/c	
(Being Allotment Money due)	

- (e) When Allotment money is received

Bank A/c	Dr.
To Debenture Allotment A/c (Being Allotment money received)	

(f) On Debenture Call money being due

Debenture Calls A/c

Dr.

To % Debentures A/c (Being Debentures Call money made due)

(g) On Debenture Call money being received

Bank A/c

Dr.

To Debenture Calls A/c (Being Debentures Call money received)

Debentures Issued at a Premium

A company opts to issue debentures at a premium when the market interest rate is lower than the debenture's stated interest rate. Debentures issued at a premium are priced higher than their nominal value.

For instance, if a debenture with a face value of Rs.100 is issued at a 10% premium, the company receives Rs.110, and the investor receives slightly less interest than indicated in the debenture. Consider 12% Debentures with a face value of Rs.100 issued at a premium of 10%. The investor receives Rs.12 annually for the investment of Rs.110. Consequently, the effective rate of interest on the investment is calculated as $(12/110 \times 100) = 10.91\%$.

The following accounting entries would be recorded:

(a) When Application money is received

Bank A/c

Dr.

[Nominal value plus premium]

To Debentures Application A/c

(Being Application money received on....debentures @ ` ..... each including premium of `)

(b) When Application money is refunded

Debentures Application A/c

Dr.

To Bank A/c

(Being refund of money on....debentures @ ` Each)

(c) When the debentures are allotted

Debentures Application A/c

Dr.

To % Debentures A/c

To Securities Premium A/c

(Being the allotment of....debentures, premium transferred to Securities Premium A/c)

Debentures Issued at a Discount

- The Companies Act does not impose any limitations on the price at which debentures can be issued, unlike shares.
- There is no specified limit for the discount on the issue of debentures, making it quite common for debentures to be issued at a discount. Debentures issued at a discount are priced below their nominal value.

- For instance, if a debenture with a nominal value of Rs.100 is issued at a 10% discount, the company receives only Rs.90. Issuing debentures at a discount slightly increases the effective rate of interest payable. Consider 12% Debentures with a face value of Rs.100 issued at a discount of 10%. The company has to pay Rs.12 for a loan of Rs.90. Therefore, the effective rate of interest is calculated as $(12/90 \times 100) = 13.33\%$.
- When the market rate of interest exceeds the debenture interest rate, the company issues debentures at a discount, similar to shares.
- The Debentures Account is credited with the nominal value, and the difference between the nominal value of debentures and the cash received is transferred to the "Discount on Issue of Debentures" Account.
- In the subsequent years, the Discount on Issue of Debentures is gradually written off proportionately by charging it to the Statement of Profit and Loss. It is customary to amortize the discount on the issue of debentures over the period of benefit, typically 3 to 5 years, but not exceeding the tenure of the debentures.

The Following accounting entries would be recorded:

- (a) When Application money is received

Bank A/c	Dr.	
To Debentures Application A/c		[Actual cash received]
(Being Application money received on....debentures @ ` each)		

- (b) When excess Application money is refunded

Debentures Application A/c	Dr.	
To Bank A/c		
(Being excess money on....debentures refunded as per Board's Resolution No.....dated....)		

- (c) When the debentures are allotted

Debentures Application A/c	Dr.	
		[Actual cash received]

- (d) Discount on Issue of Debentures A/c

Discount on Issue of Debentures A/c	Dr.	
To % Debentures A/c		[Discount on debentures]
		[Nominal value of debentures]
(Being the allotment of...debentures of ` ....each @ ` each)		

Indeed, the discount on the issue of debentures is viewed as an additional interest expense. The actual cost (net borrowing cost) for a specific accounting period is, consequently, the sum of the total interest payment and the amortized discount.

3.7 ISSUE OF DEBENTURES AS COLLATERAL

SECURITY

Collateral security refers to an additional or supportive security provided for a loan, which the lender can utilize if the original loan is not repaid by the due date. In this arrangement, the borrower agrees that a specific asset or a set of assets will be liquidated, and the proceeds will be used to settle the loan if the amount due cannot be paid.

In such instances, the holder of these debentures is eligible to receive interest solely on the loan amount, and not on the debentures themselves.

Occasionally, companies use their own debentures as collateral security for a loan or a revolving overdraft. When the loan is repaid as scheduled, these debentures are promptly released along with the primary security.

However, if the company is unable to repay the loan and the associated interest on time, the lender assumes the role of the debenture holder and can exercise all the rights associated with being a debenture holder.

Accounting Entries

There are two methods of recording these types of debentures in the accounts of a company.

Method 1

With this approach, there is no recording of entries in the company's accounting books during the issuance of these debentures. Instead, the acknowledgment of the debentures being issued and outstanding is disclosed in the 'Notes to Accounts' section of the Balance Sheet, specifically noted under the secured liabilities.

3.8 ISSUE OF DEBENTURES IN CONSIDERATION OTHER THAN FOR CASH

Similar to shares, debentures can be issued in exchange for considerations other than cash, such as for the acquisition of land, machinery, and so on. In this scenario, the subsequent entries are recorded :

(a) Sundry Assets Account	Dr.	[Assets taken over]
To Sundry Liabilities Account		[Liabilities assumed]
To Vendors Account		[Purchase consideration]
(Being the assets and liabilities taken over)		
(b) Vendors Account	Dr.	
To Debentures Account		
(Being the issue of debentures as purchase consideration)		

Additionally, it is important to observe that these debentures can be issued at par, premium, or at a discount. In each instance, the second entry for the issuance of debentures should be made accordingly. The calculation for the number of debentures to be issued is as follows :

1. When debentures are issued at par

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value}}$$

2. When debentures are issued at premium

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} + \text{Premium}}$$

3. When debentures are issued at discount

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} - \text{Discount}}$$

3.9 TREATMENT OF DISCOUNT/LOSS ON ISSUE OF DEBENTURES

The discount on the issuance of debentures is amortized over the period between the date of issuance and the date of redemption.

The write-off should be done in the following manner based on the terms of redemption:

- (a) If the debentures are redeemable after a specific period (i.e. in One go), for example, at the end of 5 years, the entire discount amount should be evenly written off over the debentures' lifespan (employing the straight-line method).

This method offers the advantage of distributing the discount burden equally over the years.

- (b) If the debentures are redeemable on different dates (i.e. In Installment), the total discount amount should be written off in proportion to the benefit derived from the debenture loan in any given year (utilizing the sum of the year's digit method).

This method is suitable when debentures are redeemed through uneven installments.

The Following accounting entries would be passed :

Profit and Loss Account

Dr.

To Discount on Issue of Debentures Account

(Being the amount of discount on issue of debentures written-off)

The loss incurred on the issuance of debentures is also considered a capital loss and should be amortized in a manner similar to the discount on issued debentures. In the balance sheet, both items (Discount and Loss) are presented as non-current or current assets, depending on the period over which they are to be written off.

3.10 INTEREST ON DEBENTURES

Interest due on coupon debentures is recognized as an expense against the company's profits. The interest on debentures is paid regularly, calculated at the coupon rate on the nominal value of the debentures.

The company disburses interest to debenture holders after deducting taxes (i.e. TDS). The deducted tax is then deposited by the company with the income tax authorities.

In this case , following accounting entries are to be recorded:

1. For making interest due

Interest A/c

Dr.

To Debenture holders' A/c

2. For interest paid and deduction of tax at source (TDS)

Debenture holders A/c

Dr.

To TDS Payable A/c

To Bank A/c

3. For tax deducted at source (TDS) paid

TDS payable A/c

Dr.

To Bank A/c

4. For interest transferred to profit and loss account

Profit and Loss A/c

Dr.

To Interest A/c

TEST YOUR KNOWLEDGE

True and False

1. Debenture holders are the owners of the company. (ICAI Study Material)

Sol. False. Debenture holders are considered creditors of the company.

2. Perpetual debentures are payable at the time of liquidation of the company. (ICAI Study Material)

Sol. True. Perpetual debentures, also referred to as irredeemable debentures, are not repayable during the lifetime of the company.

3. Registered debentures are transferable by delivery. (ICAI Study Material)

Sol. False. Registered debentures are not easily transferable through delivery, while bearer debentures are transferable by delivery.

4. When companies issue their own debentures as collateral security for a loan, the holder of such debenture is entitled to interest only on the amount of loan and not on the debentures. (ICAI Study Material)

Sol. True. If the company fails to repay its loan and interest on the due date, the lender assumes the role of a debenture holder and is entitled to interest on the debentures.

5. Debentures suspense account appears on liability side of balance sheet. (ICAI Study Material)

Sol. False. Debentures Suspense Account is listed on the liabilities side of the balance sheet under non-current liabilities.

6. If a company incurs loss, then it does not pay interest to the debenture holders. (ICAI Study Material)

Sol. False, Regardless of whether the company incurs a loss or earns a profit, it is obligated to pay interest on debentures.

7. At the time of liquidation, debenture holders are paid off after the shareholders. (ICAI Study Material)

Sol. False, During liquidation, debenture holders are repaid before shareholders on a priority basis.

8. Convertible debentures can be converted into equity shares. (ICAI Study Material)

Sol. True. Convertible debentures can be converted into equity shares after a certain period from the date of issuance.

9. Redeemable debentures are not payable during the life time of the company. (ICAI Study Material)
- Sol. False.** These debentures are repayable based on the terms of issue, for instance, after 8 years from the date of issue.
10. Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc. (ICAI Study Material)
- Sol. Correct.** Debentures can be issued in exchange for considerations other than cash, such as for purchasing land, machinery, etc.
11. Debenture Redemption Premium Account and Discount on issue of debentures Account are Nominal Accounts.
- Sol. False:** The Debenture Redemption Premium Account is classified as a Personal Account, while the Discount on Issue of Debentures Account is categorized as a Nominal Account.
12. Now Debentures can be issued at Par/Premium but not at discount.
- Sol. False.** Debentures can be issued at par, premium, or discount, as there are no limitations on issuing debentures at a discount.
13. Like Shares a Company can issue debentures with voting rights.
- Sol. False.** A company is not permitted to issue debentures with voting rights.
14. A fixed charge generally covers all the assets of the company including future one.
- Sol. False .** A fixed charge is established on specific, identifiable assets (whether movable or immovable), while a floating charge encompasses the entire class of assets, including both existing and future assets.

MULTIPLE CHOICE QUESTIONS

1. Premium on redemption of debentures account appearing in the balance sheet is. (ICAI Study Material)
- (a) A nominal account – expenditure
 (b) A nominal account – income
 (c) A personal account_
 (d) None of the Above
- Sol. (c) A personal account.**
2. Debenture interest– (ICAI Study Material)
- (a) Is payable before the payment of any dividend on shares
 (b) Accumulates in case of losses or inadequate profits
 (c) Is payable after the payment of preference dividend but before the payment of equity dividend _.
- Sol. (a) Is payable before the payment of any dividend on shares**

3. F Ltd. purchased Machinery from G Company for a book value of Rs.4,00,000. The consideration was paid by issue of 10% debentures of Rs.100 each at a premium of 25%. The debenture account was credited with _.

(ICAI Study Material)

- (a) Rs. 4,00,000
- (b) Rs. 5,00,000
- (c) Rs. 3,20,000
- (d) Rs. 3,50,000

Sol. (c) Rs. 3,20,000

4. Which of the following is not a characteristic of Bearer Debentures? (ICAI Study Material)

- (a) They are treated as negotiable instruments
- (b) Their transfer requires a deed of transfer
- (c) They are transferable by mere delivery
- (d) None of the Above

Sol (b) Their transfer requires a deed of transfer

5. When debentures are issued as collateral security, the final entry for recording the collateral debentures in the books is.

(ICAI Study Material)

- (a) Credit Debentures A/c and debit Cash A/c.
- (b) Debit Debenture suspense A/c and credit Cash A/c.
- (c) Debit Debenture suspense A/c and credit Debentures A/c.
- (d) None of the Above

Sol. (c) Debit Debenture suspense A/c and credit Debentures A/c.

6. When debentures are redeemable at different dates, the total amount of discount on issue of debentures should be written off.

(ICAI Study Material)

- (a) Every year by applying the sum of the year's digit method
- (b) Every year by applying the straight line method
- (c) To profit and loss account in full in the year of final or last redemption
- (d) None of the Above

Sol. (a) Every year by applying the sum of the year's digit method

7. Debentures are issued at discount when - (ICAI Study Material)

- (a) Market interest rate is higher than debenture interest rate
- (b) Market interest rate is lower than debenture interest rate
- (c) Market interest rate is equal debenture interest rate
- (d) All of the Above

Sol. - (b) Market interest rate is lower than debenture interest rate

8. Interest payable on Debentures attract - (ICAI Study Material)

- (a) Tax deducted at source
- (b) Goods and Service tax
- (c) Fringe benefit tax
- (d) Entertainment tax

Sol. (a) Tax deducted at source

THEORETICAL QUESTIONS

1. Distinguish between debentures and shares.

Sol.

Debentures	Shares
1. Debenture holders function as the company's creditors.	1. Shareholders of the company are the proprietors of the business.
2. Debenture holders lack voting rights, thereby posing no threat to the existing control structure of the company.	2. Shareholders possess voting rights, thereby exercising control over the overall affairs of the company.
3. Debenture interest is typically paid at a predetermined fixed rate, regardless of the company's profitability. Debentures take precedence over all types of shares for the payment of due interest.	3. Dividends on equity shares fluctuate based on company profits (while dividends on preference shares are fixed).
4. Interest on debentures constitutes charges against profits and is deductible as an expense when determining the company's taxable profit.	4. Dividends represent a distribution of profits and are not deductible when calculating the taxable profit of the company.
5. On the Company's Balance Sheet, debentures are categorized under "Term Borrowings."	5. The company's Balance Sheet includes shares categorized under "Shareholder's Fund," detailed in the 'Share Capital' section of the Notes to Accounts.
6. Debentures have the option to be converted into other debentures or shares based on the terms specified during the debenture issuance.	6. Shares are not convertible into other shares under any circumstances.
7. Debentures cannot be forfeited due to non-payment of call moneys.	7. Shares may be forfeited if allotment and call moneys are not paid.
8. Upon maturity, debenture holders receive their invested capital in accordance with the stipulated terms and conditions of redemption.	8. Equity shareholders cannot reclaim their investment before the company undergoes liquidation (unlike preference shareholders who have that privilege).
9. In the event of liquidation, debenture holders are repaid before shareholders.	9. During liquidation, shareholders receive payment last, after settling obligations to debenture holders, trade payables, and other liabilities.

2. Explain the purpose for raising of debenture by the company. Also give the main features of debentures.
- Sol.** The debenture is a frequently utilized debt instrument issued by companies to secure funds for their business operations. The primary approach for enhancing a company's available capital is through the issuance of debentures, which can be either simple or naked, lacking any charge on assets, or mortgage debentures with either a fixed or floating charge on some or all of the company's assets.
1. It is a written record that signifies a loan extended to a company.
 2. It is a secure, interest-bearing financial instrument with interest payments due on specific dates.
 3. The interest is payable at a predetermined fixed rate, irrespective of the company's profit levels.
 4. The initial amount is reimbursed at a designated future date, or it is converted into shares or alternative debentures.
 5. It may or may not establish a claim on the company's assets as collateral.
 6. Typically, it is tradable on the stock exchange, with the option to buy or sell at a price either above or below its nominal value.



ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

UNIT – 4: ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

4.1 ISSUE OF BONUS SHARES

4.1.1 Introduction

A bonus share can be described as the issuance of shares to existing shareholders in a company without any cost, determined by the number of shares already held by them.

To clarify, a bonus issue does not involve raising new funds. While it increases the total number of issued and owned shares, it does not impact the company's net worth. Despite the increase in the total number of shares, the proportion (%) of shares held by each shareholder remains constant.

Example – to understand above mentioned para

A Ltd. issued and subscribed shares are 5000, out of which 10% (i.e. 500 shares) is with Mr. X, A Ltd

gave an offer of 1 share as bonus for every 2 share held.

After giving the effect company share increase to 7500 (i.e. 5000 + 2500 bonus issue) and Mr. X now

own 750 share (i.e. 500 + 250 bonus)

However, % owned by Mr. X after bonus issue will remain same i.e. 10%

The term “bonus issue” is also referred to as ‘capitalization of profits.’ This process involves converting profits or reserves (“which are otherwise available for distribution as dividends”) into paid-up capital by issuing fully paid bonus shares to the members.

In the event that the subscribed and paid-up capital surpasses the authorized share capital due to a bonus issue, the company must in a general meeting pass a reSol. for the increase of the authorized capital.

Additionally, it is necessary to submit a return of the bonus issue, along with a copy of the reSol. authorizing the issuance of bonus shares, to the Registrar of Companies.

4.1.2 Provisions of the Companies Act, 2013

Section 63 of the Companies Act, 2013 addresses the issuance of bonus shares. As outlined

in Sub-section (1) of Section 63, a company is permitted to distribute fully paid-up bonus shares to its members using any method,:

- (i) its free reserves;
- (ii) the securities premium account; or
- (iii) the capital redemption reserve account

However, it is important to note that the capitalization of reserves resulting from the revaluation of assets or reassessment of liability is not allowed for the purpose of issuing bonus shares.

Sub-section (2) of Section 63 stipulates that a company cannot capitalize its profits or reserves for the issuance of fully paid-up bonus shares under sub-section (1) unless the following conditions are met:

- (a) it is duly authorized by its articles;
- (b) it has received authorization in a general meeting of the company on the recommendation of the Board;
- (c) it has not defaulted in the payment of interest or principal related to fixed deposits or debt securities issued by the company;
- (d) it has not defaulted in meeting statutory obligations to employees, such as contributions to provident fund, gratuity, and bonus;
- (e) any partly paid-up shares outstanding on the date of allotment are converted to fully paid-up shares; and

Once a company has publicly announced the decision of its Board recommending a bonus issue, it is not allowed to draw-back the decision.

Also, Sub-section (3) of the section also explicitly states that bonus shares cannot be issued as a substitute for dividend.

According to Para 39 (i) of Table F under Schedule I to the Companies Act, 2013, during a general meeting, a company may, based on the Board's recommendation, pass a resolution:

- (i)
 - (a) expressing the desirability to capitalize a portion of the amount currently credited to any of the company's reserve accounts, the profit and loss account, or otherwise available for distribution; and
 - (b) specifying that the said amount should be released for distribution among the members in the designated manner, as if it were distributed as a dividend, and in the same proportions.
- (ii) The aforementioned amount is not to be disbursed in cash but is to be utilized, subject to the conditions in clause (iii), either for:
 - (a) clearing any outstanding amounts on shares held by the respective members;
 - (b) fully paying up unissued company shares to be allotted and distributed, credited as fully paid-up, among the members in the specified proportions, either wholly as per (a) or partly as per (a) and partly as per (b) above.

It is important to note that a securities premium account and a capital redemption reserve account can exclusively be utilized for paying up unissued shares to be issued as fully paid bonus shares to members of the company. To clarify, these accounts cannot be used to settle unpaid amounts on shares held by current shareholders.

Question 1. Alpha Company announced bonus issue to its shareholders in the ratio of 2:3 ie. 2 shares for every 3 shares held. Shareholder X has 6.000 shares before announcement of bonus issue. How much shares would he have after bonus issue? (ICAI Study Material)

Sol. Company announced bonus issue in ratio of 2:3

Shareholder X will be entitled to have 4.000 bonus shares ($6.000 \text{ shares} / 3 \times 2$) Total number of shares X has after bonus issue 10.000 ($6.000 + 4.000$)

In accordance with Section 63(2) of the Companies Act, 2013, issuance of bonus shares is contingent upon the conversion of partly paid-up shares into fully paid-up status. Meanwhile, Para 39(ii) of Table F under Schedule I to the Companies Act, 2013 permits the utilization of free reserves to settle outstanding amounts on shares held by current shareholders.

By examining both provisions together, it can be concluded that free reserves are permissible for addressing unpaid amounts on shares held by existing shareholders, while it is important to note that the securities premium account and capital redemption reserve cannot be employed for this purpose.

4.1.3 Journal Entries

(A) (1) At the time of the sanction of an issue of bonus shares

Capital Redemption Reserve Account Dr.

Securities Premium Account¹ Dr.

General Reserve Account Dr.

Profit & Loss Account Dr.

To Bonus to Shareholders Account.

(2) At the time of issue of bonus shares

Bonus to Shareholders Account Dr.

To Share Capital Account.

(B) (1) At the time of the sanction of bonus by converting partly paid shares into fully paid shares

General Reserve Account Dr.

Profit & Loss Account Dr.

To Bonus to Shareholders Account

(2) For making the final call due

Share Final Call Account Dr.

To Share Capital Account.

(3) At the time of adjustment of final call

Bonus to Shareholders Account Dr.
To Share Final Call Account

4.1.4 Effects of Bonus Issue

Bonus issue has following major effects:

- Increase In share capital
- Reduction In EPS and other per share values
- Favorable act considered by market
- Adjustment In market price.
- Reduction In accumulated profits

4.2 RIGHT ISSUE

4.2.1 Introduction

Section 62(1)(a) of the Companies Act, 2013 applies to both public and private companies seeking to increase their subscribed share capital through the issuance of additional shares

When a company plans to issue new shares, there is a potential for dilution of voting and governance rights among existing shareholders if they are not provided the means to safeguard these rights. This scenario arises because new shareholders may subscribe to the issued share capital. The Companies Act, 2013 addresses this concern by granting existing shareholders the opportunity to maintain their position through the initial offering of newly issued shares, exclusive to them.

Existing shareholders have the right to subscribe to these shares if they so choose. Alternatively, if they opt not to subscribe, they are also afforded the right to renounce these shares in favor of another party, unless the company's articles prohibit such a right to renounce.

In summary, existing shareholders possess the right to subscribe to any fresh issuance of shares by the company in proportion to their existing holdings. They also have the implicit right to renounce this subscription in favor of someone else or reject it altogether.

In other words, existing shareholders enjoy a right of first refusal, entitling them to either subscribe for these shares, sell their rights, or decline the offer.

$$\text{VALUE OF RIGHT} = \text{CUM-RIGHT VALUE OF SHARE} - \text{EX-RIGHT VALUE OF SHARE}$$

Question 6. Let's consider a scenario where a company initiates a right issue of 10,000 shares while its existing issued and subscribed capital stands at 100,000 shares. This allows any shareholder holding 10 shares to subscribe to 1 new share. Consequently, X, an existing shareholder with 1,000 shares, has the option to subscribe to 100 shares as a matter of right. At the outset, X's existing share percentage is 1% ($1,000 / 100,000$). If X chooses to subscribe to these shares, his percentage ownership in the company will remain at 1% ($1,100 / 110,000$). However, if X is comfortable with a slight dilution to 0.91% ($1,000 / 110,000$), he has the option to renounce the right in favor of

[* These questions are not complete *]

A company intending to issue new shares must, in accordance with Section 62(1)(a) of the Companies Act, 2013, extend an offer to existing equity shareholders through a letter of

offer, subject to the following conditions:

- ❑ The offer should be presented through a notice specifying the number of shares offered, setting a timeframe not less than fifteen days (15 Days) and not exceeding thirty days (30 Days) from the date of the offer. If the offer is not accepted within this period, it will be considered as declined.
- ❑ Unless the company's articles state otherwise, the aforementioned offer is deemed to include a right that can be exercised by the concerned individual to renounce the shares offered to them in favor of another person. The notice, as mentioned above, must explicitly state this right.
- ❑ Following the expiration of the specified time in the notice or upon earlier intimation from the recipient that they decline the offered shares, the Board of Directors has the authority to dispose of the shares in a manner that is not detrimental to the existing shareholders and the company.

EXCEPTIONS TO THE RIGHTS OF EXISTING EQUITY SHAREHOLDERS

Section 62 recognizes four scenarios under which a company may issue further shares, and in these situations, there is no obligation to offer them to existing shareholders.

The shares can be offered, bypassing existing shareholders, if the company has passed a special reSol. and complies to the prescribed procedures.

Situation 1

Shares may be issued to employees under an employees' stock option scheme, subject to specific conditions.

Situation 2

Shares may be offered to any individuals, either for cash or for a consideration other than cash, provided that the share price is determined by the valuation report of a registered valuer and subject to certain specified conditions.

Situation 3

In some instances, companies raise funds through debentures or loans, granting creditors the option to purchase equity shares at a predetermined price on a future date.

Section 62(3) specifies that the increase in the subscribed capital due to the exercise of such options is exempted from the provisions of this section.

However, this exemption is dependent upon the terms of issuing such debentures or loans with options being approved by a special reSol. in a general meeting before their issuance.

Situation 4

In a unique scenario where a loan is obtained from the government, and the government, in the public interest, directs the conversion of debentures or loans into equity shares. Section 62(4) comes into play.

This section empowers the government to issue an order directing such conversion, even if the terms of the debenture or loan do not inherently include a provision for this conversion, provided the government deems it reasonable under the circumstances and the order is

issued in the public interest.

FINANCIAL EFFECTS OF A FURTHER ISSUE

The balance sheet encapsulates the financial status of a business. Issuing additional shares enhances both the equity (net worth) and the liquid assets (Bank). The equity amount is determined by multiplying the number of additional shares issued by the issue price. It's noteworthy that the issue price can surpass the face value, a scenario known as issuing shares at a premium. However, it's essential to mention that the Companies Act prohibits the issuance of shares at a discount, with the exception of sweat equity shares under Section 53.

BOOK VALUE OF A SHARE

Book value of a share = Net worth (as per books) / Number of shares

In a scenario where there are 10,000 shares with a net worth of ₹ 1.25.000. the book value per share is calculated as ₹ 12.50 (₹ 125,000 divided by 10,000 shares). It's important to note that the market value of shares may deviate from their book value.

The market value reflects the current worth of a company's shares, considering anticipated future cash flows in the form of dividends and expected capital gains from future share price appreciation.

The market price existing before a rights issue is referred to as the Cum-right Market Price of the share. The decision to issue additional shares can impact the market value of the share. In theory, the post-rights issue value of a company's shares should be the sum of the market capitalization just before the rights issue and the cash inflows generated from the rights issue.

Typically, further public issues to existing shareholders are offered at a discounted price from the market value to encourage a positive response and reward existing shareholders.

For instance, consider a company with a net worth of ₹ 250,000. If 1,000 shares are issued in a rights issue at a price of ₹ 14 per share (in a ratio of 1:10, i.e., 1 new share for every 10 existing shares held), the total worth of tangible assets held by the business after the issue would be ₹ 264,000 (Existing net worth ₹ 250,000 + Fresh Issue ₹ 14,000). The equity shares would consequently be valued at ₹ 264,000.

The market price of shares after the further issue of shares (rights issue) is termed as the Ex-right Market Price of the shares. The Theoretical Ex-Rights Price is a hypothetical value assigned to a company's share immediately after a rights issue transaction. This price is expected to prevail after the completion of the further share issuance.

E.g.:- Right value of the shares = [Cum-right value of existing shares + (Right shares X Issue Price)] / (Existing Number of Shares + Number of Right shares)

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According to Section 2(57) of the Companies Act, 2013, the term 'net worth' refers to the total value of the paid-up share capital, along with all reserves generated from profits and the securities premium account. This calculation involves subtracting the combined value of accumulated losses, deferred expenditure, and miscellaneous expenditure not written off, as

indicated in the audited balance sheet. However, the definition excludes reserves resulting from the revaluation of assets, the write-back of depreciation, and amalgamation.

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RIGHT OF RENUNCIATION

The right of renunciation pertains to a shareholder's ability to relinquish their entitlement to purchase securities and transfer this right to another individual.

Shareholders who have received right shares have three options regarding their rights -

- (a) They can exercise the rights by acquiring additional shares in accordance with the details of the rights issue or
- (b) Sell the rights in the market, or
- (c) choose not to capitalize on their rights, essentially declining the right offer.

In well-functioning capital markets, the renunciation of rights holds value and can be converted into monetary gain by existing shareholders.

The monetary value accessible to existing shareholders as a result of a rights issue is termed the 'value of right.'

If a shareholder opts to renounce some or all of the right shares in favor of a nominee, the value of right is confined to the sale price of renouncing the right in favor of the nominee.

If an existing shareholder chooses to avail the right issue offer, the value of right is determined as outlined below:

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Value of right = Cum-right value of share - Ex-right value of share

EX- right value of the shares = [Cum-right value of the existing shares + (Rights shares × Issue Price)] / (Existing Number of shares + Number of right shares)

In our previous example. Ex-right value of share = $[\text{₹ } 250,000 + (\text{₹ } 14 \times 1,000 \text{ shares})] / 10,000$

+ 1,000 shares = ₹ 24

Value of right = ₹ 25 - ₹ 24 = ₹ 1 per share.

Question 7. Continuing the previous case, consider an individual shareholder Mr. Narain holding 100 shares of Prosperous Company before rights issue.

Current worth of holding = No. of shares × Cum-right Market Price = $100 \times 25 = \text{₹ } 2,500$

(a) If Narain exercises his right, he will pay ₹ 14 × 10 shares = ₹ 140.

His total investment in the company including right is ₹ 2.640 (₹ 2.500 + ₹ 140).

On a per share basis, it is ₹ 2.640 / 110 shares = ₹ 24. Which is the Ex-right Market value of the share.

(b) If Narain does not exercise his right to further issue, his holding's worth will decline to ₹ 24 × 100 shares = ₹ 2400. The law allows him to compensate for this dilution of shareholding by renouncing this right in favour of, say, Mr. Murthy.

Narain can charge Murthy, in well-functioning capital markets, this dilution of ₹ 100 by renouncing his right to acquire 10 shares. Hence Murthy will be charged ₹ 10 per share ($\text{₹ } 100 / 10 \text{ shares}$), in return for a confirmed allotment of 10 shares at ₹ 14 each.

For every share to be offered to Murthy, Narain must have ten shares at the back. Hence his holding of 10 shares fetches him right money of ₹ 10 or ₹ 1 per share held. This is exactly equal to the difference between Cum-right and Ex-right value of the share. It is termed as the Value of Right. (ICAI Study Material)

In a well-functioning capital market, this mechanism works in a fair manner to all the participants.

- Murthy's total investment will be ₹ 140 (payable to Company) + ₹ 100 (payable to Narain, by way of value of right), or ₹ 240. He will end up holding ten shares at an average cost of ₹ 24, which is the Ex-right Market Price of the share.
- Narain will have a final holding of ten shares worth ₹ 2400 + ₹ 100 by way of value of right received from Murthy. It matches with his cum-right holding valuation.

4.2.2 Accounting for Right issue

The accounting treatment of rights share is the same as that of issue of ordinary shares and the journal entry will be made as follows :

Bank A/c Dr.

To Equity shares capital A/c

If rights shares are being offered at a premium, the premium amount is credited to the securities premium account.

The accounting entry is as follows –

Bank A/c Dr.

To Equity Share Capital A/c

To Securities Premium A/c

Question 9 A Company having 70,000 shares of ₹10 each as its issued share capital and having market value of ₹21 issues rights shares in the ratio of 1:10 at an issue price of ₹ 10. Pass journal entry for issue of right shares. (ICAI Study Material)

Sol. The entry at the time of subscription of right shares by the existing shareholders will be:

Bank A/c Dr. 70,000

To Equity Share Capital A/c

70,000 (Being issue of 7,000 right shares at price of ₹ .10)

Working Note – Number of rights shares to be issued – $70,000 / 10 \times 1 = 7000 \text{ shares}$.

Question 10 A company having 1,00,000 shares of ₹10 each as its issued share capital, and having a market value of ₹ 46, issues rights shares in the ratio of 1:10 at an issue price of ₹ 31. Pass journal entry for issue of right shares. (ICAI Study Material)

Sol. The entry at the time of subscription of right shares by the existing shareholders will be:

Bank
 A/c Dr. 3,10,000
 To Equity Share Capital A/c 1,00,000
 To Securities Premium A/c
 2,10,000 (Being issue of 10,000 right shares @ ₹31 offered)

4.2.3 Advantages and Disadvantages of Right Issue

Advantages of Right Issue

1. A rights issue allows existing shareholders to preserve their proportionate ownership in the company, safeguarding their financial and governance rights. It discourages management issuing shares to known individuals to exercise greater control over the company's affairs.
2. In well-operating capital markets, a right issue inevitably results in the dilution of share value. However, existing shareholders are insulated from this impact by acquiring new shares at a discounted value compared to their cum-right value, effectively compensating for the decrease in share value. The cum-right value is maintained even if existing shareholders renounce their rights in favor of a third party.
3. A rights issue serves as a natural hedge against the issuance expenses typically associated with a public offering (IPO or FPO)
4. A right issue positively enhances the company's image, garnering approval from the public and shareholders.
5. The probability of success for a rights issue surpasses that of a general public offering and is considerably more logistically manageable.

DISADVANTAGES OF RIGHT ISSUE

1. A right issue inevitably results in a reduction of the market value of the company's shares.
2. The appealing price of the rights issue must be objectively evaluated in comparison to its actual value to guarantee a favorable deal.

EFFECTS OF RIGHT ISSUE

- Maintenance of existing shareholders' proportional holding in company and retain their financial and governance rights
- Dilution in the value of share.
- Image enhancement
- Convenience in handling issue

TEST YOUR KNOWLEDGE

True and false

1. Earning per share gets increased after bonus issue

(ICAI Study Material)

ADMISSION OF A NEW PARTNER

Sol. False Earnings per share decrease following a bonus issue.

2. Issued share capital including issue of rights shares and bonus shares may be more than the Authorised capital (ICAI Study Material)

Sol False The issued share capital, which includes rights shares and bonus shares, is always less than or equal to the authorized capital

3. Rights issue of shares results in decrease of market value of per share in comparison to market price before rights issue. (ICAI Study Material)

Sol True A rights issue of shares leads to a decrease in the market value per share compared to the market price before the rights issue.

4. Right shares are normally offered at a price more than the cum-right value of the share, causing dilution in its value post-right issue (ICAI Study Material)

Sol. False Right shares are typically offered at a price lower than the cum-right value of the share, resulting in a dilution in its value after the rights issue

MULTIPLE CHOICE QUESTIONS

1. Which of the following cannot be used for issue of bonus shares as per the Companies Act? (ICAI Study Material)

- (a) Securities premium account
- (b) Revaluation reserve
- (c) Capital redemption reserve
- (d) All of the above

Sol. (b) Revaluation reserve

2. Which of the following statements is true with regard to declaring and issuing of Bonus Shares? (ICAI Study Material)

- (a) Assets are transferred from the company to the shareholders
- (b) A Bonus issue results in decrease in reserves and surplus
- (c) A Bonus issue is same as declaration of dividends
- (d) None of the Above

Sol. (b) A Bonus issue results in decrease in reserves and surplus

3. Which of the following statement is true in case of bonus issue? (ICAI Study Material)

- (a) Convertible debenture holders will get bonus shares in same proportion as to the existing shareholders
- (b) Bonus shares may be issued to convertible debenture holders at the time of conversion of such debentures into shares
- (c) Both (a) and (b).
- (d) None of the Above

Sol

Sol. (c) Both (a) and (b)

4. Bonus issue is also known as

(ICAI Study Material)

- (a) Scrip issue
- (b) Capitalisation issue
- (c) Both (a) and (b)
- (d) None of the Above

Sol (c) Both (a) and (b)

5. The bonus issue is not made unless

(ICAI Study Material)

- (a) Partly paid shares are made fully paid up.
- (b) It is provided in its articles of association
- (c) Both (a) and (b).
- (d) None of the Above

Sol - (c) Both (a) and (b)

6. Bonus issue has the following effect

(ICAI Study Material)

- (a) Market price gets adjusted on issue of bonus shares
- (b) Effective Earnings per share. Book Value and other per share values stand increased
- (c) Markets generally take the action as an unfavourable act
- (d) All of the above

Sol. (a) Market price gets adjusted on issue of bonus shares

7. ABC Co Ltd resolved to issue bonus shares Which of the following is not a pre-requisite for issuance of bonus shares?

(ICAI Study Material)

- (a) Authorization in Articles of Association
- (b) Timely Payment of statutory dues of employees such as PF. Gratuity etc
- (c) Sufficient balance in bank account of company
- (d) None of the Above

Sol. (c) Sufficient balance in bank account of company

8. In case of further issue of shares, the right to renounce the shares in favour of a third party

(ICAI Study Material)

- (a) Must include a right exercisable by the person concerned to renounce the shares;
- (b) Should include a right exercisable by the person concerned to renounce the shares;
- (c) Is deemed to include a right exercisable by the person concerned to renounce the shares (subject to the provisions under the articles of the company).
- (d) All of the above

Sol. (c) Is deemed to include a right exercisable by the person concerned to renounce the shares (subject to the provisions under the articles of the company)

9. A company 's share 's face value is ₹10. book value is ₹ 20. Right issue price is ₹ 30 and Market price is ₹ 40. while recording the issue of right share, the securities premium will be credited with

(ICAI Study Material)

- (a) ₹ 10
- (b) ₹ 20

(c) ₹ 30

(d) ₹ 40

Sol. (b) ₹ 20

10. A. Right shares enable existing shareholders to maintain their proportional holding in the company (ICAI Study Material)

B. Right share issue does not cause dilution in the market value of the share

Which of the option is correct? (ICAI Study Material)

(a) A-Correct; B Correct

(b) A - Incorrect; B Correct

(c) A - Correct. B - Incorrect

(d) None of the above

Sol. (c) A - Correct; B - Incorrect

11. Ex-Rights price can be calculated by which of these formulas ? (ICAI Study Material)

(a) $(\text{Cum rights value of the existing shares} + \text{Rights share issue proceeds}) / (\text{existing number of shares} + \text{No of right shares})$

(b) $(\text{Cum rights value of the existing shares} + \text{Rights share issue proceeds}) \times (\text{existing number of shares} + \text{No of right shares})$

(c) $(\text{Cum rights value of the existing shares} - \text{Rights share issue proceeds}) / (\text{existing number of shares} - \text{No of right shares})$

(d) None of the Above

Sol - (a) $(\text{Cum rights value of the existing shares} + \text{Rights share issue proceeds}) / (\text{existing number of shares} + \text{No of right shares})$.

THEORETICAL QUESTIONS

1. What is meant by Bonus issue? Explain its related provisions as per the Companies Act, 2013 (ICAI Study Material)

Sol. A Bonus Issue refers to the provision of complimentary additional shares to current shareholders. A company might opt to allocate additional shares as an alternative method to enhance dividend distribution. For details, refer para 41.1 & 41.2

2. Explain the financial effects of a further issue of equity shares on the market value of the share. (ICAI Study Material)

Sol. The financial status of a business is outlined in its balance sheet. The issuance of additional shares augments both the share capital and the liquid resources (Bank). The total share capital issued results from multiplying the additional number of shares by the issue price, which can surpass the face value, indicating an issuance at a premium.

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3. What are the advantages and disadvantages of a rights issue? (ICAI Study Material)

Sol. A rights issue entails the granting of privileges to a company's current shareholders, allowing them to purchase additional shares directly from the company in proportion to their existing holdings within a specified timeframe. For advantages and disadvantages

of right issue, refer para 4.2 3

4. What is meant by renunciation of rights shares by existing shareholder?.

(ICAI Study Material)

Sol. In a scenario where a current shareholder does not plan to participate in a company's rights issue, they have the option to relinquish their entitlement in favor of another individual in exchange for consideration. This act of surrendering rights is referred to as the renunciation of rights.



6.1 INTRODUCTION

A debenture is a financial instrument issued by a company under its official seal, acknowledging a financial obligation and outlining terms for the repayment of both principal and interest.

In accordance with Section 71(1) of the Companies Act, 2013, a company has the authority to issue debentures with an option to convert them into shares, either in full or in part, during the redemption process.

However, this issuance, specifically debentures with a conversion option, must receive approval through a special resolution passed at a properly convened general meeting.

As specified in Section 71(2), it is prohibited for any company to issue debentures with voting rights.

Basic provisions

In the event when charge has been established on a specific asset or the entirety of a company's assets, the document should describe:

The characteristics of the charge (i.e Fixed or Floating)

A description of the asset(s) subject to the charge. (in case of fixed charge) are described therein.

As registration with the Registrar is a prerequisite for the validity of the charge, the bond includes a certificate from the Registrar confirming the registration of the charge.

In the case of mortgage debentures, it is a common practice to establish a trusteeship in favor of one or more individuals. The trustees holding the debentures possess the authority equivalent to that of a property mortgage, enabling them to take any necessary actions to protect the interests of debenture holders.

6.2 REDEMPTION OF DEBENTURES

Debentures typically possess a redeemable nature, indicating that they are either repaid in cash or can be converted into equity shares after a specified duration.

The redemption of these debentures may occur through various methods, including:

Completion of a fixed number of years (i.e. One Shot Repayment)

Any time subsequent to a specific duration from their issuance
Providing a designated notice period
Annual drawing (i.e In Instalments)

Moreover, a company retains the option to acquire its debentures at its convenience in the open market. In situations where the debentures are traded at a discount on the Stock Exchange, it can be advantageous for the company to purchase and subsequently cancel them.

6.3 DEBENTURE REDEMPTION RESERVE

When a company issues debentures, it may be obligated (required) to establish a debenture redemption reserve account using profits available for dividend distribution.

The funds credited to this account must be exclusively designated for the redemption of debentures and cannot be employed by the company for any purpose other than the debenture redemption. This structure ensures that the company maintains adequate liquid funds to meet debenture redemption obligations when they become due.

Annually, a suitable portion of profits is allocated to the Debenture Redemption Reserve, and the corresponding investment is referred to as Debenture Redemption Reserve Investment or Debenture Redemption Fund.

In the final year or at the time of debenture redemption, the investments in the Debenture Redemption Reserve are liquidated, and the proceeds are utilized for the redemption of debentures.

63.1 Requirement to create Debenture Redemption Reserve

The Companies Act 2013, specifically outlined in Section 71, addresses the necessity of establishing a debenture redemption reserve account. The provisions of Section 71 are detailed as follows:

- (1) In instances where a company issues debentures under this section, it is mandated to establish a debenture redemption reserve (DRR) A/c using its profits available for dividend distribution each year until the said debentures are duly redeemed.
- (2) The sums credited to the debenture redemption reserve are strictly reserved for the stipulated purpose and may not be utilized by the company for any other objective beyond the aforementioned purpose.
- (3) The company is required to comply with the T & C of the debentures' issuance, including the payment of interest and the redemption of debentures.
- (4) In instances where a company neglects to redeem debentures upon maturity or defaults in paying the interest when due, the Tribunal (Type of Court) has the authority, upon the application of debenture holders or the debenture trustee, and subsequent to a hearing involving all concerned parties, to issue an order compelling the company to promptly redeem the debentures by settling the principal and the accrued interest.

6.3.2 Balance in Debenture Redemption Reserve (DRR)

When the company establishes the Debenture Redemption Reserve (DRR) A/c the designated amount from the credit to the Debenture Redemption Reserve (DRR) A/c and a debit to the

Statement of P & L. This signifies the company's intent to allocate funds for the creation of a reserve intended for debenture redemption.

Concurrently, the company should acquire investments. The corresponding entry for this purpose would naturally involve Dr. DRR Investment A/c and Cr. the Bank A/c.

6.3.3 Adequacy of Debenture Redemption Reserve (DRR)

In accordance with Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, the company is required to adhere to the stipulations concerning the Debenture Redemption Reserve (DRR) and the investment or deposit of funds related to debentures maturing in the year ending on the 31st day of March of the subsequent year (refer to paragraph 6.4 below), based on the conditions outlined below —

The creation of the Debenture Redemption Reserve must be sourced from the company's profits available for dividend payment; the prescribed limits pertaining to the sufficiency of DRR and investment or deposits, as applicable, are as follows:

S. No	Debentures issued by	Adequacy of Debenture Redemption Reserve (DRR)
1	All India Financial Institutions (AIFIs), under the supervision of the Reserve Bank of India and Banking Companies, are overseen in their issuance of debentures, whether publicly or privately placed.	The creation of a Debenture Redemption Reserve (DRR) is not obligatory (i.e. optional to create)
2	Other financial institutions (FIs) as defined in clause (72) of section 2 of the Companies Act, 2013.	(DRR) will be applicable to Non-Banking Financial Companies (NBFCs) registered with the RBI, as per the provision outlined in (3) below.
3	Regarding listed companies (other than AIFIs and Banking Companies as indicated in Sr. No. 1 above):	
	a. All listed NBFCs (registered with RBI under (Housing Finance Companies registered with National Housing Bank) for both public as well as privately placed debentures	No DRR is required section 45-IA of the RBI Act,) and listed HFCs
	b. Other listed companies for both public as privately placed debentures	No DRR is required well
4	Regarding unlisted companies (other than AIFIs and Banking Companies as indicated in Sr. No. 1 above	
	a. All unlisted NBFCs (registered with RBI under section 45-IA of the RBI (Amendment) Act, 1997) and unlisted HFCs (Housing Finance Companies registered with National Housing Bank) for privately placed debentures	No DRR is required
	b. Other unlisted companies	DRR shall be 10% of the value of the outstanding debentures issued

6.3.4 Investment of Debenture Redemption Reserve (DRR) Amount

Moreover, in accordance with Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, the subsequent categories of entities are subject to the following regulations:

- (a) All publicly listed NBFCs
- (b) All publicly listed HFCs
- (c) All other publicly listed companies (excluding AIFs, Banking Companies, and other Financial Institutions); and
- (d) All unlisted companies that are neither NBFCs nor HFCs

Shall, by the 30th day of April each year, concerning the issued debentures, deposit or invest, as applicable, an amount not less than 15% of the total debentures maturing in the year ending on the 31st day of March of the subsequent year, utilizing one or more of the following methods:

- (a) In deposits with any scheduled bank, clear of any charge or lien;
- (b) In unencumbered securities of the Central Government or any State Government;
- (c) In unencumbered securities listed in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
- (d) In unencumbered bonds issued by any other company specified under clause (f) of Section 20 of the Indian Trusts Act, 1882.

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The deposited or invested amount, as applicable, must be exclusively utilized for the redemption of debentures maturing in the specified year.

However, it is imperative that the remaining deposited or invested amount never falls below 15% of the total debentures maturing by the 31st day of March of that particular year.

In the case of partly convertible debentures, the creation of the Debenture Redemption Reserve (DRR) is required for the non-convertible portion of the debenture issue.

The funds credited to the DRR are reserved solely for the purpose of debenture redemption and cannot be employed for any other use by the company.

Note: While it is permissible to allocate to the DRR at any time before redemption and to invest in specified securities mentioned above before the 30th of April for debentures maturing in that year, for the sake of simplicity, it is advisable to perform the allocation and investment promptly after the debentures are allotted, assuming the company has adequate profits (if the allotment date is not provided in the question). Additionally, in cases where the date of allotment is missing, the appropriation and investments should be executed on the first day of the year for which ledger accounts are to be prepared.

6.3.5 Journal Entries

The required journal entries recorded in a company's accounts are as follows::

1. After allotment of debentures

- (a) For setting aside the fixed amount of profit for redemption

Profit and Loss A/c Dr.

To Debenture Redemption Reserve A/c

- (b) For investing the amount set aside for redemption

Debenture Redemption Reserve Investment A/c Dr.

To Bank A/c

- (c) For receiving interest on Debenture Redemption Reserve Investments Bank A/c Dr.

To Interest on Debenture Redemption Reserve Investment A/c

- (d) For transfer of interest on Debenture Redemption Reserve Investments (DRRI)

Interest on Debenture Redemption Reserve Investment A/c Dr.

To Profit and loss A/c*

* Taking into account the circumstance where interest is annually received through the cash/bank account and is not reinvested, this aspect has been acknowledged in the examples provided in the chapter. Consequently, the interest on DRR investment is not credited to the DRR Account but is instead accounted for in the Profit and Loss Account.

2. At the time of redemption of debentures

- (a) For encashment of Debenture Redemption Reserve Investments

Bank A/c Dr.

To Debenture Redemption Reserve Investment A/c

- (b) For amount due to debentureholders on redemption

Debentures A/c Dr.

To Debentureholders A/c

- (c) For payment to debentureholders

Debentureholders A/c Dr.

To Bank A/c

- (d) After redemption of debentures, DRR should be transferred to general reserve

DRR A/c Dr.

To General Reserve

6.4 METHODS OF REDEMPTION OF DEBENTURES

The redemption of debentures should adhere to the terms outlined in the debenture issuance, and any deviation from these terms will be regarded as a default by the company.

The settlement of the debt associated with the issued debentures can be accomplished through one of the three methods, namely:

6.4.1 By payment in lumpsum

In the lump-sum payment method, the complete redemption of the debenture occurs either at its maturity or before the designated period's expiration, with the entire amount settled in a single payment.

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8.1.1 By payment in Instalments

In the installment payment method, specified portions of the debenture are paid in installments at designated intervals.

8.1.2 Purchase of Debentures in Open Market

The acquisition of debentures in the open market is occasionally practiced. However, it's important to note that this topic is not addressed in the chapter as it has been deliberately excluded from the Foundation level syllabus.

TEST YOUR KNOWLEDGE

TRUE AND FALSE

1. Amounts credited to the debenture redemption reserve may be utilised by the company for any purpose. .(ICAI Study Material)
Sol. False: The funds credited to the debenture redemption reserve should only be utilized for the specific purpose of debenture redemption and not for any other purpose.
2. All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures need not create any Debenture Redemption Reserve (DRR). .(ICAI Study Material)
Sol. True: All India Financial Institutions (AIFIs) regulated by the Reserve Bank of India and Banking Companies for both publicly and privately placed debentures are not obligated to create any Debenture Redemption Reserve (DRR).
3. Under payment in instalments method, the payment of entire debenture is made in one lot. (ICAI Study Material)
Sol. False: In the installment payment method, specified portions of debentures are paid in installments at specified intervals.
4. At redemption of debentures, DRR should be transferred to general reserve. . (ICAI Study Material)
Sol. True: The Debenture Redemption Reserve (DRR) is transferred to the general reserve at the time of debenture redemption.

MULTIPLE CHOICE QUESTIONS

1. Which of the following statements is true? .(ICAI Study Material)

- (a) A debenture holder is an owner of the company.
- (b) A debenture holder can get his money back only on the liquidation of the company.
- (c) A debenture issued at a discount can be redeemed at a premium.
- (d) All of the Above

Sol. (c) A debenture issued at a discount can be redeemed at a premium.

2. Which of the following statements is false?

(ICAI Study Material)

- (a) Debentures can be redeemed by payment in lump sum at the end of a specified period.
- (b) Debentures cannot be redeemed during the life time of the company.
- (c) Debentures can be redeemed by payments in annual instalments.
- (d) None of the Above

Sol. (b) Debentures cannot be redeemed during the life time of the company.

3. For debentures issued by unlisted companies (other than AIFs, Banking companies, NBFCs and HFCs), Debentures Redemption reserve will be considered adequate if it is: (ICAI Study Material)

- (a) 25% of the value of debentures issued through public issue.
- (b) 10% of the value of debentures issued through public issue.
- (c) 5% of the value of debentures issued through public issue.
- (d) 15% of the value of debentures issued through public issue

Sol. (b) 10% of the value of debentures issued through public issue

5. A company has issued 6% debentures for ₹ 10,00,000, interest being payable on 31st March and 30th September. The company redeems ₹ 10,000 debentures at ₹ 96 (ex-interest) on 1st August 2021. The amount of Profit/loss on cancellation of debentures will be - (ICAI Study Material)

- (a) Profit of ₹ 600.
- (b) Profit of ₹ 400.
- (c) Loss of ₹ 400
- (d) Loss of ₹ 500

Sol. (b) Profit of ₹ 400

THEORETICAL QUESTIONS

1. What is meant by redemption of debentures? Explain.

(ICAI Study Material)

Sol. Debentures are typically redeemable, meaning they are either repaid in cash or convertible after a specific period. The redemption of these debentures can occur through various methods:

- After a fixed number of years
- Any time after a certain number of years has passed since their issuance

- Upon providing a specified notice
- Through an annual drawing.

For details, refer para 6.2 of this chapter .

2. Write short note on Debenture Redemption Reserve.

(ICAI Study Material)

Sol. A company issuing debentures might need to establish a debenture redemption reserve account using profits allocated for dividend distribution. The amounts credited to this account should solely be earmarked for debenture redemption and cannot be utilized by the company for any purpose other than the redemption of debentures. This structure ensures that the company maintains adequate liquid funds for the timely redemption of debentures when they become due for payment. For details , refer para 6.3 of the chapter .



Redemption of Preference Shares

INTRODUCTION

Redemption involves the systematic repayment of an obligation in predetermined amounts and schedules. It constitutes a contractual agreement stipulating the redemption of preference shares within or at the end of a specified period at a predetermined price.

These shares are issued with the understanding that shareholders will, at a later date, receive a repayment equivalent to their initial investment in the company, in addition to periodic payments of specified dividends as a return on investment during the tenure of the preference shares.

The redemption date, denoting the scheduled repayment, is typically indicated on the preference share certificate. The redemption process also allows a company to adjust its financial structure, such as eliminating preference shares and substituting them with other securities if the company's future growth makes such a change advantageous.

PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

A company might opt to release redeemable preference shares for the following reasons:

- ❑ It serves as an appropriate means of raising funds in a sluggish primary market.
- ❑ A company facing challenges in raising share capital, particularly if its shares are not actively traded on the stock exchange, might find redeemable preference shares tempting to potential investors. The redeemable feature can offer assurance to investors who may be hesitant to invest in shares that lack liquidity.
- ❑ Redemption of preference shares becomes viable when there is a surplus of capital, and the excess funds cannot be effectively utilized for profitable business purposes.
- ❑ In situations of loss or no profit, redeemable preference shares offer the advantage of not requiring dividend payments, unlike debentures or loans where interest is payable even in the absence of profits.
- ❑ Essentially, the declared/paid preference dividend remains classified as an appropriation of profits, similar to the treatment for equity shares, in contrast to the treatment of debenture interest, which is considered a charge against profits.

In India, the issuance and redemption of preference shares are regulated by Section 55 of the Companies Act, 2013.

PROVISIONS OF THE COMPANIES ACT (SECTION 55)

A company limited by shares, if authorized by its Articles, has the discretion to release preference shares that are subject to redemption, typically within a period not exceeding 20 years from the date of their issuance. It is important to observe that:

- (a) The redemption of shares is permissible solely from divisible or distributable profit, i.e., the company's profit available for dividends, or from the proceeds of a fresh issue of shares specifically generated for the purpose of redemption.
- (b) Redemption of such shares is only allowed if they are fully paid.
- (c) (i) For companies falling within the prescribed class and whose financial statements comply with the accounting standards specified for that class under Section 133, any premium payable on redemption must be accounted for; from the profits of the company before the redemption of shares:
Provided also that any premium payable on the redemption of preference shares issued on or before the commencement Companies Act, 2013 by any such company shall be accounted for; from the profits of the company or from the company's securities premium account before such shares are redeemed.
(ii) For other companies not included by the provisions in (i) above, any premium payable on redemption shall be accounted for from the profits of the company or from the company's securities premium account before the redemption of such shares.
- (d) In the event that such shares are intended to be redeemed from the company's profits, a sum equivalent to the nominal amount (face value) of the redeemed shares Less proceeds from a fresh issue for redemption purpose shall be transferred from the divisible profits, i.e., the profits otherwise available for dividends, to a reserve account named the Capital Redemption Reserve Account.

The provisions of the Act concerning the reduction of the share capital of a company shall apply, with the exception as provided in the Section, as if the Capital Redemption Reserve (CRR) Account were the paid-up share capital of the company. The utilization of the CRR Account is further constrained to the issuance of fully paid-up bonus shares exclusively.

The objective behind transfer to CRR A/c is to ensure that the security for creditors/bankers, etc., is not diminished with the repayment of redeemable preference shares.

METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

The redemption of preference shares involves the company repaying its obligation related to the issued shares. As per the Companies Act, 2013, preference shares must be redeemed within the maximum period allowed under the Act, usually not exceeding 20 years. Consequently, the issuance of irredeemable preference shares by a company is prohibited.

In the case of redeeming preference shares from the proceeds of a fresh share issue, the replacement of capital and tangible assets is evident.

If redemption is carried out from distributable profits, the replacement of capital occurs indirectly through the retention of profit transferred to the Capital Redemption Reserve. In this scenario, the amount that would have been distributed to shareholders as dividends is

retained in the business and utilized to settle the claims of preference shareholders.

Consequently, there is no additional depletion from the net assets of the company. The transfer of divisible profits to the Capital Redemption Reserve (CRR) renders them non-divisible profits. As the Capital Redemption Reserve can only be used for issuing fully paid bonus shares, profits retained in the business ultimately convert into share capital.

The protection afforded to external stakeholders relies on both the called-up capital and the uncalled capital that the company can demand as per its requirements. In order to safeguard the interests of outsiders, Section 55 stipulates the redemption of solely fully paid-up shares.

From the preceding paragraphs, it can be inferred that the 'impact' resulting from the redemption of redeemable preference shares in the company's capital needs to be addressed by:

- (a) the proceeds from a fresh issuance of shares; or
- (b) the capitalization of undistributed profits (accomplished by establishing a Capital Redemption Reserve); or
- (c) a combination of both (a) and (b) as mentioned above.

Redemption of Preference Shares by Fresh Issue of Shares

Utilizing the funds generated from a new share issuance is one of the approaches for redeeming preference shares. The company has the option to issue fresh shares, whether they are equity shares or preference shares, and the funds derived from this new issuance can be employed for the redemption of preference shares.

However, funds derived from the issuance of debentures cannot be allocated for this redemption of Preference Share.

An issue arises when a new share offering is conducted with the intention of redeeming preference shares at a premium. The crucial consideration is whether the fresh share issuance shall be a premium or not for the amount needed for the redemption of preference shares.

Because as per Section 52 of the Companies Act, 2013 the securities premium account, permissible uses include –

- (a) Utilization for the issuance of unissued shares of the company, provided to members as fully paid bonus securities.
- (b) Writing off preliminary expenses of the company. (Use Not Allowed for Companies covered Under Sec 133)
- (c) Writing off expenses or commissions paid, or discounts allowed on the company's securities or debentures.
- (d) Provision for premium on the redemption of redeemable preference shares or debentures. (Use Not Allowed for Companies covered Under Sec 133)
- (e) Purchasing its own shares or other securities.

Note: It is important to highlight that certain categories of companies whose financial statements comply with the Accounting Standards specified under Section 133 of the Companies Act, 2013, are restricted from applying the securities premium account for the purposes mentioned in (b) and (d) above.

Reasons for issue of New Equity Shares

A company may opt to release new equity shares for the following reasons:

- (a) When the company acknowledges the need for permanent capital, and it is more beneficial to issue Equity Shares instead of Redeemable Preference Shares, as Preference Shares entail a fixed rate of dividend.
- (b) When the remaining profit, typically available for dividends, is inadequate.
- (c) In situations where the company's liquidity position is not sufficiently robust.

Advantages of redemption of preference shares by issue of fresh equity shares

The benefits of redeeming preference shares through the issuance of fresh equity shares are as follows:

- (1) There is no immediate or future cash outflow.
- (2) The new equity shares can be issued at a premium value.
- (3) Shareholders maintain their equity stake.

Disadvantages of redemption of preference shares by issue of fresh equity shares

The drawbacks include:

- (1) Future earnings may face dilution.
- (2) If the fresh issue is extended to external parties, there is a shift in shareholding. However, if the fresh issue is offered to existing shareholders proportionally (as in a rights issue), the alteration in the shareholding structure can be avoided.

ACCOUNTING ENTRIES

- ❑ When new shares are issued at par

Bank Account

Dr.

To Share Capital Account

(Being the issue of shares of `.....each for the purpose of redemption of preference shares)

- ❑ When new shares are issued at a premium

Bank Account

Dr.

To Share Capital Account

To Securities Premium Account

(Being the issue of shares of `.....each at a premium of `.....each for the purpose of redemption of preference shares)

- ❑ When preference shares are redeemed at par

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

- ❑ When preference shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr. Premium on Redemption of
Preference Shares Account Dr.

To Preference Shareholders Account

- ☐ When payment is made to preference shareholders

Preference Shareholders Account	Dr.

To Bank Account

- ❑ For adjustment of premium on redemption

Profit and Loss Account Dr.

To Premium on Redemption of Preference Shares Account

CALCULATION OF MINIMUM FRESH ISSUE OF SHARES

Occasionally, exam questions omit the quantity of shares to be issued for redeeming preference shares, mandating the issuance of the minimum shares to comply with Section 55 of the Companies Act, 2013. This process involves four steps outlined below:

- ❑ In such scenarios, the utmost amount of reserves and surplus available for redemption is determined, considering the balances presented in the balance sheet pre-redemption and any supplementary details provided in the problem. For instance, if the general reserve balance in the balance sheet is Rs.1,00,000 and additional information states that the Board of Directors has decided it should not fall below Rs.40,000 under any circumstances, then the maximum amount of general reserve available for redemption is Rs.60,000.
- ❑ Following the determination of the maximum amount of reserves and surplus available for redemption, adjustments for the premium on redemption payable from profits are applied. This adjusted figure is then juxtaposed with the nominal value of the shares slated for redemption. This comparison yields the minimum proceeds from a fresh share issue, as Section 55 allows redemption from either the proceeds of a fresh issue or divisible profits.

Therefore, Minimum Proceeds from Fresh Share Issue:

Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

- After the calculation of the minimum proceeds, the minimum number of shares to be issued is established by dividing the minimum proceeds by the value of one share. The procedure is as follows:

Minimum Number of Shares = Minimum proceeds to comply with Section 55 / Face value of one share

The term "proceeds of one share" refers to the par value of a share issued, whether at par or at a premium. However, in the case of shares issued at a discount, it pertains to the discounted value.

- ❑ The minimum number of shares computed as per (3) above requires adjustment for various reasons. Primarily, shares cannot be issued in fractions. Therefore, if the minimum

number of shares as per (3) includes a fraction, it must be rounded up to the next higher whole number to ensure compliance with the provisions of Section 55. Additionally, if the exam question stipulates that the proceeds/number of shares should be a multiple of, for example, 10, 50, or 100, then the next higher multiple should be considered.

FRESH ISSUE AT A PREMIUM AND MINIMUM FRESH ISSUE

The calculation of the minimum number of shares, especially when a fresh issue is at a premium, requires careful consideration. It cannot be determined without knowledge of the profits available for replacing preference shares, and the available profit for replacement cannot be established without knowing the portion of profit allocated for the redemption, including the premium.

To address this, one may assume that the profits available for redemption are not needed for paying the premium on the redemption of preference shares. Essentially, this assumption implies that the securities premium, including the premium on the fresh issue, exceeds the premium on redemption.

If this assumption holds true, the minimum number of shares can be computed straightforwardly without resorting to the use of equations. However, if the stated condition does not hold true, an equation is employed to ascertain the minimum number of shares.

MINIMUM FRESH ISSUE TO PROVIDE FUNDS FOR REDEMPTION

Moreover, in addition to ensuring adherence to Section 55, the issuance of fresh shares is undertaken to generate funds for satisfying payment obligations to preference shareholders. To determine the minimum number of fresh shares required for fund provision, the amount payable to preference shareholders is juxtaposed with the available redemption funds, and the remaining funds to be raised through the issuance of fresh shares are computed. This amount to be raised is then divided by the issue price of a share (comprising the amount payable by the shareholder, including any premium on the fresh issue) to calculate the minimum number of shares to be issued.

REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED DIVISIBLE PROFITS

Another approach for redeeming preference shares, in accordance with the Companies Act, involves utilizing distributable profits instead of issuing new shares. When shares are redeemed using distributable profit, an amount equivalent to the face value of the redeemed shares is moved to the Capital Redemption Reserve Account by debiting the distributable profit. Essentially, a portion of the distributable profits is set aside to ensure it cannot be distributed to shareholders as dividends.

Profit, or a segment of profit, that is legally available for distribution to shareholders as dividends is referred to as Divisible or Distributable Profit.

The Companies Act specifies that “When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall, out of profits which would otherwise have been available for dividend (i.e., out of divisible profits), be transferred to a reserve called

the Capital Redemption Reserve Account a sum equal to the nominal amount of the shares redeemed.”

Note: Only Divisible Profits can be utilized to establish the Capital Redemption Reserve; Non-Divisible Profits cannot be employed for this purpose.

Advantages of redemption of preference shares by capitalisation of undistributed divisible profits

The benefits of redeeming preference shares through the capitalization of undistributed divisible profits include:

- ❑ Maintaining the existing percentage of equity shareholding in the company.
- ❑ Utilizing surplus funds effectively.

Disadvantages of redemption of preference shares by capitalisation of undistributed divisible profits

The drawback of redeeming preference shares through the capitalization of undistributed profits is that it may result in decreased liquidity, requiring potential asset sales, such as divesting investments..

Accounting Entries

- ❑ For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account

General Reserve Account Dr.

Profit and Loss Account Dr.

any other Divisible Profits Dr.

To Capital Redemption Reserve Account

(Being the transfer of amount to Capital Redemption Reserve Account as per the requirement of the Act).

- ❑ When shares are redeemed at par

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

(Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)

- ❑ When shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr. Premium on Redemption of Preference Shares AccountDr.

To Preference Shareholders Account

(Being the amount payable on redemption transferred to Preference Shareholders Account)

- ❑ When payment is made to preference shareholders

Preference Shareholders Account Dr.

To Bank Account

(Being the payment to preference shareholders as per terms)

❑ **For adjustment of premium of redemption**

Divisible Profit Account Dr.

To Premium on Redemption of Preference Shares Account (Being the premium on redemption adjusted against Profit and Loss Account)

Redemption of Preference Shares by combination of Fresh Issue and Capitalisation of Undistributed divisible Profits

A corporation has the option to partially redeem preference shares using funds from a fresh issue and partly from profits. To bridge the difference between the face value of the redeemed shares and the proceeds from the new issue, a transfer must be executed from distributable profits (Profit & Loss Account, General Reserve, and other Free Reserves) to the Capital Redemption Reserve Account..

Formula:

❑ **Amount to be Transferred to Capital Redemption Reserve `**

Face value of shares redeemed ***

Less: Proceeds from new issue ***

❑ **Proceeds to be collected from New Issue ` Face value of shares redeemed *** Less:**

Profits available for distribution as dividend ***

The term “proceeds from a fresh/new issue” shall be construed as:

(a) The sum credited to Share Capital in the case of an issue at par.

(b) The sum credited to Share Capital in the case of an issue at a premium. Although the premium is received and credited to the Securities Premium A/c, it shall not be considered as ‘proceeds.’ Treating it as such would result in a lower transfer of distributable profits to the Capital Redemption Reserve by the premium amount received.

(c) The amount received (i.e., debited to Cash/Bank) in the case of an issue at a discount.

Note: Section 53 of the Companies Act, 2013 prohibits the issuance of shares at a discount, except for the issuance of Sweat Equity Shares as outlined in Section 54.

Sale of Investments to Provide Sufficient Funds for Redemption

Companies might possess ample investments that can be liquidated in the market to generate funds for the redemption of preference shares..

REDEMPTION OF PARTLY CALLED-UP PREFERENCE SHARES

One of the requirements for redemption is that a company can only redeem fully paid-up preference shares. Therefore:

- ❑ If the scenario indicates the redemption of partly called-up preference shares, it is assumed that the final call on these shares has been demanded and received before initiating the redemption process.

- ❑ When information about both fully paid and partly paid preference shares is provided, it is presumed that only fully paid shares are intended for redemption, while partly paid shares remain outstanding.
- ❑ In the event of non-receipt of call money despite reminders, the company has the option to forfeit the shares.

REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

The issue of unpaid calls on fully called-up shares can be examined within the following classifications:

Upon the receipt of Calls-in-Arrears

If the Company receives the unpaid calls amount before redemption, the corresponding entry is as follows:

Bank A/c Dr.

To Calls-in-Arrears A/c

Upon receiving the arrears of calls, the shares attain full payment status, enabling the company to proceed with the redemption process as usual..

In case of Forfeited Shares

If shareholders neglect to fulfill their unpaid calls obligations, even after receiving a formal notice from the company, the Board of Directors holds the authority to opt for forfeiture. Rather than reissuing the forfeited shares, which is impractical due to the impending redemption, the company cancels these shares. The corresponding journal entry for forfeiture is made in the customary manner, as outlined below:

Preference Share Capital A/c # Dr (#Called up share capital only relating to the shares to be forfeited)

To Calls In Arrears A/c To Shares Forfeited A/c *

(*Amount actually collected on shares forfeited. This will be equal to the balancing amount)

NOTE: However, it is crucial to recognize that, in this scenario, the quantity of shares slated for redemption will be diminished by the count of shares subject to forfeiture. Additionally, as the preference shares are slated for redemption, the forfeited shares will not undergo reissuance. Consequently, the remaining balance in the Shares Forfeited Account needs to be transferred to Capital Reserve, which is executed through the subsequent journal entry:

Shares Forfeited A/c Dr.

To Capital Reserve A/c

TEST YOUR KNOWLEDGE

True and False

1. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Reserve account by debiting the

distributable profit.

(ICAI Study Material)

Sol. False . Transferring an amount equivalent to the face value of redeemed shares to the Capital Redemption Reserve account by debiting distributable profit occurs when shares are redeemed.

2. A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing for premium on the redemption of Redeemable Preference shares of the Company. . (ICAI Study Material)

Sol. True . If a company, in accordance with Accounting Standards under Section 133 of the Companies Act, 2013, prepares financial statements, it is not permitted to utilize securities premium for redeemable preference shares' premium on redemption.

3. The balance in forfeited shares account can be used for transfer to capital redemption reserve account. . (ICAI Study Material)

Sol. False . Utilizing the balance in the Forfeited shares account for transferring to the capital redemption reserve account is not allowed.

4. Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses . . (ICAI Study Material)

Sol. True . The utilization of capital redemption reserve for the write-off of miscellaneous expenses and losses is not permissible.

Multiple Choice Questions

1. Securities premium cannot be used to . . (ICAI Study Material)

- (a) Issue bonus shares
- (b) Redeem preference shares
- (c) Write-off preliminary expenses
- (d) All of the Above

Sol. (b) Redeem preference shares

2. S Ltd. issued 2,000, 10% Preference shares of ` 100 each at par on 1.4.2021, which are redeemable at a premium of 10%. For the purpose of redemption, the company issued 1,500 Equity Shares of ` 100 each at a premium of 20% per share. At the time of redemption of Preference Shares, the amount to be transferred by the company to the Capital Redemption Reserve Account = ? . (ICAI Study Material)

- (a) ` 50,000
- (b) ` 40,000
- (c) ` 2,00,000
- (d) ` 1,00,000

Sol. (a) ` 50,000

HINT = 2,00,000 – 1,50,000

3. Which of the following cannot be used for the purpose of creation of capital redemption reserve account? . (ICAI Study Material)

- (a) Profit and loss account (credit balance)
- (b) General reserve account
- (c) Unclaimed dividend account
- (d) None of the Above

Sol. (c) Unclaimed dividend account

4. According to Section 52 of the Companies Act, 2013, the amount in the Securities Premium A/c cannot be used for the purpose of - . (ICAI Study Material)

- (a) Issue of fully paid bonus shares
- (b) Writing off losses of the company
- (c) For purchase of own securities
- (d) All of the Above

Sol. (b) Writing off losses of the company

5. Which of the following can be utilized for redemption of preference shares? . (ICAI Study Material)

- (a) The proceeds of fresh issue of equity shares
- (b) The proceeds of issue of debentures
- (c) The proceeds of issue of fixed deposit
- (d) All of the above

Sol. (a) The proceeds of fresh issue of equity shares

6. Preference shares amounting to ` 2,00,000 (already issued on 1.4.2021) are redeemed at a premium of 5%, by issue of shares amounting to ` 1,00,000 at a premium of 10%. The amount to be transferred to capital redemption reserve = ? . (ICAI Study Material)

- (a) ` 1,05,000
- (b) ` 1,00,000
- (c) ` 2,00,000
- (d) ` 2,50,000

Sol. (b) ` 1,00,000

HINT = 2,00,000 – 1,00,000

Theoretical Questions

1. What is the purpose of issuing redeemable preference shares?

Sol. To secure funds in a lackluster primary market, a company has the option to issue redeemable preference shares. These shares can be repurchased when there is an excess of capital, and the surplus funds cannot be effectively employed for profitable business purposes. For details , refer para 5.2 of this chapter .

2. What are the provisions of the Companies Act, 2013 related with redemption of preference shares? Explain in brief.

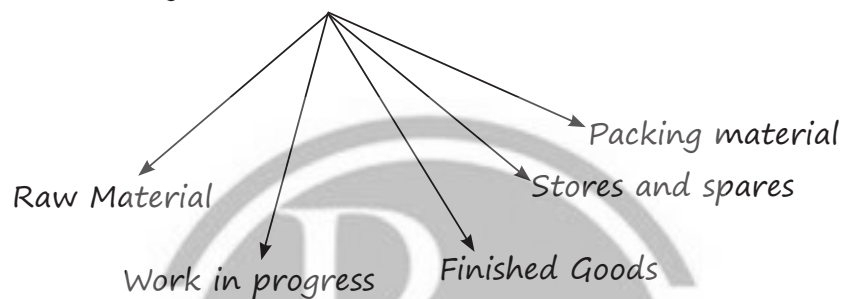
Sol. Provisions regarding the redemption of preference shares are addressed in Section 55 of the Companies Act, 2013. This section safeguards against any reduction in shareholders' funds resulting from redemption, thereby preserving the interests of external stakeholders. For details , refer para 5.3 of this chapter .



UNIT - 1 INVENTORY

TYPE OF INVENTORY

(i) In case of Manufacturing concerns



(ii) In case of Trading concerns



Traded Goods

MEANING

Inventory can be defined as assets held for various purposes within a business entity. It encompasses items

- (i) that are **intended for sale** (i.e. Finished Goods) in the normal course of business,
- (ii) those in the **process of production** (i.e. Work-in-Progress or Semi-Finished Goods) being converted into Finished Goods for sale and
- (iii) those **utilized in the production of goods or services** (i.e. Raw Material) for sale, including **maintenance supplies and consumables** (excluding machinery spares, servicing equipment, and standby equipment).

Different types of inventory exist based on the nature of the enterprise's operations.

For a trading concern, inventory primarily comprises products acquired for resale (i.e. Purchase of FG and Sale of FG) in their current state. Additionally, it may include supplies like wrapping paper, cartons, and stationery.

In the case of a manufacturing concern, inventory consists of several inventories:

- (a) **Raw Materials** (which will be transformed into finished goods),
- (b) **Work-in-Progress** (partially completed products in the factory), and

(c) *Finished products.*

Manufacturing concerns also include maintenance supplies, consumables, loose tools, and spare parts within their inventory.

However, inventory does not encompass spare parts, servicing equipment, and standby equipment that are exclusively used with fixed assets and are expected to have irregular usage. Such machinery spares are typically treated as fixed assets. Similarly, construction businesses consider projects under construction as part of their inventory.

At the end of the fiscal year, every business entity must determine the closing balance of its inventory, which includes raw materials, work-in-progress, finished goods, and other consumable items.

The value of the closing inventory is recorded on the credit side of the Trading Account and the BS Asset side. Therefore, before preparing the final accounts, the accountant needs to ascertain the value of the inventory. However, for the purpose of our discussion, we will focus on the inventory valuation of manufacturing concerns and goods of trading concerns.

INVENTORY VALUATION

An important aspect of accounting for inventories revolves around determining their appropriate valuation for inclusion in the financial statements until the corresponding revenues are recognized. Inventories typically represent the largest portion of current assets held by trading or manufacturing enterprises.

It is widely acknowledged that inventory is a crucial asset that directly impacts operational efficiency. Both excessive inventory levels and inventory shortages can have adverse effects on production activities and the overall profitability of a business, regardless of whether it is engaged in manufacturing or trading operations. Therefore, accurately valuing inventory is essential for ensuring the reliability and accuracy of FST.

The importance of inventory valuation can be attributed to several reasons, as outlined below:

- (i) **Determination of Income:** Inventory valuation is crucial for accurately calculating the income earned by a business during a specific period. The cost of goods sold is matched with the revenue to determine the gross profit.

The formula for calculating the cost of goods sold is as follows:

Cost of goods sold = Opening inventory + Purchases + Direct expenses – Closing inventory.

The valuation of inventory significantly impacts income determination, especially when the cost of goods sold represents a substantial portion of the sales price.

Misstatements in inventory valuation can affect net income:

Particulars	Overstated	Under- Stated
Closing Inventory	Leads to Overstated Net Income	Leads to Understated Net Income
Opening Inventory	Leads to Understated Net Income	Leads to Overstated Net Income

Thus, accurate valuation of inventory is essential for determining the correct income.

(ii) **Ascertainment of Financial Position:**

Inventories are classified as current assets, and their value on the balance sheet date is crucial for determining the financial position of a business.

Proper valuation of inventory ensures that the balance sheet reflects the true financial position of the business.

(iii) **Liquidity Analysis:**

As inventory is classified as a current asset, it is a component of net working capital, which provides insights into the liquidity position of the business. The value of inventory significantly affects the current ratio, which measures the relationship between current assets and current liabilities.

(iv) **Statutory Compliance:**

Under Schedule III of the Companies Act, 2013, the valuation of each class of goods, including raw Materials, work-in-progress, and finished goods, must be disclosed in the financial statements.

Accounting standards also require the disclosure of the accounting policies used for measuring inventories and the total carrying amount of inventories, along with appropriate classification based on the enterprise's requirements. The common classifications of inventories include raw materials, work-in-progress, finished goods, stores-in-trade (for trading goods), and spares and loose tools.

BASIS OF INVENTORY VALUATION (COST OR NRV W.E.L)

The valuation of inventories is guided by the principle of conservative accounting, which states that expenses or losses should be recognized immediately while gains or profits should only be recognized when they become due or realized. The general rule is to value inventories at the lower of cost or net realizable value, considering the following principles:

Cost:

According to accounting standards, the cost of inventories should include:

- (i) All purchase costs, such as the purchase price, duties, taxes (excluding those recoverable from taxing authorities), and directly attributable acquisition expenses. Trade discounts, rebates, and duty drawbacks are deducted from the purchase cost.*
- (ii) Costs of conversion, primarily for finished goods and work-in-progress. This includes direct labor costs and a systematic allocation of fixed and variable overheads.*
- (iii) Other costs incurred in bringing the inventories to their present location and condition, such as administrative overheads or specific costs related to a customer's inventory.*

Certain expenses are excluded from the cost of inventories, including abnormal amounts of wasted materials, labor, or production overheads, storage costs (unless necessary in the production process), administrative overheads unrelated to bringing the inventories to their present state, and selling and distribution costs.

Net Realizable Value:

Net realizable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the costs necessary to make the sale. For finished goods and traded goods, net realizable value typically considers selling price minus selling and distribution expenses. In the case of work-in-progress, it also includes expenses and overheads required to convert it into finished goods ready for sale. For raw materials, the net realizable value is generally considered the replacement cost.

The assessment of net realizable value is done at each balance sheet date, and inventories are written down to net realizable value on an item-by-item basis. In certain circumstances, similar or related items may be grouped together, such as interchangeable items where it may not be feasible to identify the cost and net realizable value of each item separately.

The proper valuation of inventories at the lower of cost or net realizable value ensures that financial statements reflect a conservative approach and provide an accurate representation of the business's financial position.

INVENTORY RECORD SYSTEMS

Two main systems are employed to determine the physical quantities and monetary value of inventories sold and remaining on hand. These systems are known as the “**Periodic Inventory System**” and the “**Perpetual Inventory System**.” While the periodic system is more cost-effective, the perpetual system provides more valuable information despite its higher implementation costs. These systems differ in terms of the records maintained to calculate the cost of goods sold and the valuation of closing inventory.

PERIODIC INVENTORY SYSTEM

The **periodic inventory system** is a method used to **determine inventory by physically counting** (or measuring or weighing) all the inventory items on hand at a specific date for valuation purposes.

This system is often referred to as the **physical inventory system** due to the actual physical count involved. The cost of goods sold is calculated as follows:

Opening inventory (known) + Purchases (known) – Closing inventory (physically counted) = Cost of goods sold.

The **periodic inventory system** is straightforward and less costly compared to the perpetual system. In this system, the inventory account is adjusted at the end of the accounting period to calculate the cost of goods sold. However, the **periodic inventory system** has several limitations:

- (i) Physical inventory counts may be required multiple times a year for the preparation of quarterly or semi-annual financial statements, making it more expensive.
- (ii) **Conducting a physical count** of goods necessitates temporarily suspending normal business operations.
- (iii) Since the cost of goods sold is derived as a residual figure, it is challenging to identify losses due to pilferage, damage, or fraud.

- (iv) *Inventory control is not proper under this system.*
- (v) *The books of accounts do not provide real-time visibility of the inventory on hand and its value, making it difficult to plan operations such as determining when and how much to order or manufacture.*

The periodic inventory system is commonly used by small enterprises where physical inventory control is more manageable. However, it is generally not considered suitable for medium or larger enterprises, which typically employ the perpetual inventory system.

PERPETUAL INVENTORY SYSTEM

The perpetual inventory system is a method of recording inventory balances after each receipt and issue. To ensure the accuracy of perpetual inventory records, physical inventory should be checked and compared with the recorded balances. In this system, the cost of goods issued is directly determined, and the inventory of goods is derived as a residual figure using the inventory ledger, which records the flow of goods continuously. The key feature of this system is the maintenance of an inventory ledger that provides ongoing records of goods.

Under the perpetual inventory system, the closing inventory is calculated as follows:

Opening inventory (known) + Purchases during the period (known) – Cost of Goods Sold (known) = Closing Inventory (balancing figure)

The perpetual inventory system helps overcome the limitations of the periodic system. As the inventory is derived as a residual figure, it accounts for losses of goods. However, the main drawback of this system is the associated cost of implementation and maintenance.

DISTINCTION BETWEEN PERIODIC INVENTORY SYSTEM AND PERPETUAL INVENTORY SYSTEM

The Periodic Inventory System and Perpetual Inventory System are not mutually exclusive; rather, they complement each other and serve different purposes in inventory management. The distinction between these two systems can be explained as follows:

Sr.No.	Periodic Inventory System	Perpetual Inventory System
1.	<i>This system relies on conducting physical inspections or verifications.</i>	<i>This system is dependent on the records maintained in books or accounting documentation.</i>
2.	<i>This system furnishes specific details regarding the inventory and COGS as of a particular date.</i>	<i>It offers uninterrupted updates regarding inventory and the cost of sales.</i>
3.	<i>This system calculates the inventory and considers the COGS as the remaining amount.</i>	<i>It calculates the COGS directly and calculates the inventory as the balancing figure.</i>
4.	<i>The COGS includes any loss of goods, as it assumes that goods not present in the inventory has been sold.</i>	<i>The closing inventory accounts for any loss of goods, as it assumes that all unsold goods are included in the inventory.</i>
5.	<i>Inventory control cannot be effectively maintained using this method.</i>	<i>This system allows for effective inventory control to be exercised.</i>
6.	<i>This system offers a straightforward and cost-effective approach.</i>	<i>This method incurs higher.</i>

7.	Counting the inventory under the periodic system necessitates temporary business closure.	Inventory can be determined without disrupting the normal business operations.

FORMULAE/METHODS TO DETERMINE COST OF INVENTORY

HISTORICAL COST METHODS

There is no single formula for determining the historical cost of inventories. Various techniques for inventory valuation are discussed below:

Specific Identification Method:

This method assigns costs to specific goods based on their actual physical flow. It requires keeping separate records for different lots of purchased goods to identify the specific lot from which the remaining units in inventory are taken. The historical cost of such specifically identified inventories can be determined based on their purchase price or production cost.

The specific identification method is typically used to determine the cost of inventories for items that are not interchangeable and have high value, such as expensive medical equipment. Otherwise, it may be necessary to use other methods like FIFO (First In, First Out) or weighted average price/average price formula.

(i) FIFO (First in first out) Method

The FIFO (First-In, First-Out) method is based on the principle that costs should be assigned to revenue in the order in which they were incurred. According to this method, it is assumed that the **earliest inventory items purchased or produced are the first ones to be consumed or sold**. Therefore, the **closing inventory consists of the most recently acquired or produced items**, and they are valued at the price paid for those specific items.

Using the FIFO formula ensures that inventory is accounted for based on the order of **acquisition**, which is particularly important for perishable goods or items with frequent technological changes. It aligns with the common business practice of using goods in the order they were acquired. It's important to note that this assumption of cost flow does not necessarily reflect the actual physical movement of goods; it is a method of accounting.

To better understand how the FIFO method is applied, let's consider the following example.

(ii) LIFO (Last in first out) Method

The LIFO (Last-In, First-Out) formula is based on the principle of **assigning the cost of goods sold to the most recently purchased or produced goods, even if the actual issues are made from the earliest lot on hand to preserve their value**. According to this method, the **closing inventory is assumed to comprise earlier consignments**, and its value is calculated accordingly based on those consignments. Under the LIFO basis, the goods issued are valued at the price paid for the most recent lot of goods on hand, while the inventory of goods remaining is valued at the price paid for the earlier lot of goods. When

there are no details available regarding the specific issues, the price paid for the earliest consignments is used to determine the value of the closing inventory. The LIFO method ensures that the current costs are matched with the corresponding current revenue, as the cost of recently purchased or produced goods is attributed to each sale. By using this method, the cost of goods sold reflects the cost of the most recent purchases, allowing for a better alignment of current costs with current sales.

The LIFO (Last-In, First-Out) method is based on the assumption that the most recent inventories entering the stores are issued or consumed first, which is considered irrational and contrary to the observed flow of goods in business entities. It is important to note that when applying LIFO, there may be a discrepancy between the cost of goods sold and the value of the closing inventory, particularly if the entity follows the periodic method of inventory valuation as opposed to the perpetual method (which will be explained later in this chapter). As a result, the usage of the LIFO method for valuing inventories is no longer adopted and is not permitted by Accounting Standards. In practice, FIFO (First-In, First-Out) and Weighted Average Price Method are commonly used among business entities, and both of these methods are permitted by Accounting Standards.”

(iii) Simple Average Price Method

The Simple Average price method for valuing inventory is a straightforward approach. It involves adding up all the different prices and then dividing the total by the number of prices. The resulting average price is used to determine the value of the closing inventory. This method is commonly used by entities that employ the periodic inventory method, as it does not require the effort of identifying which consignments or lots the closing inventory belongs to.

(iv) Weighted Average Price Method

The calculation of a simple average price does not take into account the quantities purchased in different lots. However, a more appropriate approach would be to calculate a weighted average price by considering the quantities purchased in each lot as weights. With the weighted average price method, the total cost of goods available for sale during a specific period is combined, and then divided by the total number of units available for sale during that period. This enables the calculation of the weighted average price per unit, which provides a more accurate representation.

$$p.u = \text{Weighted average price} \frac{\text{Total cost of goods (which are available for sale during the period)}}{\text{Total no. of units (which are available for sale during the period)}}$$

$$\text{Closing inventory} = \text{No. of units in inventory} \times \text{Weighted average p.u}$$

$$\text{Cost of goods sold} = \text{No. of units sold} \times \text{Weighted average price p.u.}$$

Perpetual and Periodic Inventory System and Average Methods of Cost of Inventory

The Simple Average Method and Weighted Average Method are implemented differently depending on whether the entity adopts periodic inventory taking or perpetual inventory taking. When periodic inventory taking is used, the inventory available for sale over a period is combined, and an average rate is calculated to determine the valuation of the closing inventory. On the other hand, under perpetual inventory taking, the average rate of the

inventory is recalculated with each new purchase, and the subsequent issue is recorded using the updated average rate.

NON-HISTORICAL COST METHODS

Non-historical cost methods do not rely on the historical cost incurred to acquire goods. Two examples of non-historical cost methods are the Adjusted Selling Price method and the Standard Cost method. Let's discuss the Adjusted Selling Price method:

Adjusted Selling Price method–, also known as the retail inventory method, is commonly employed in retail businesses or in cases where the inventory consists of items with unascertainable individual costs. This method is suitable for measuring inventories that involve a large number of rapidly changing items with similar profit margins, making it impractical to use other costing methods. The cost of the inventory is determined by subtracting an appropriate percentage of the gross margin from the sales value of the inventory.

To calculate the estimated gross margin of profit, a percentage is applied, considering any inventory that has been marked down from its original selling price. Typically, an average percentage is used for each retail department. The estimation of gross margin can be done for individual items, groups of items, or by departments, depending on the specific circumstances.

This method is employed when there is frequent fluctuation in the price per unit of goods and the business makes frequent purchases of those goods, such as in the case of crude oil. A standard cost is determined based on the accumulated experience of price changes, and the inventory is valued using this predetermined cost per unit.

INVENTORIES TAKING

Typically, a temporary halt in operations occurs for a day or two within the financial year to conduct a comprehensive physical inventory count of all items in the warehouse or store. For year-end inventory valuation, the physical inventory count is conducted during the final week of the financial year or the initial week of the following year. If the inventory count is completed on March 26th, while the accounting year ends on March 31st, any purchases and sales between March 26th and March 31st are separately adjusted. Subsequently, a value is assigned to each item based on the principle of utilizing the lower of cost or net realizable value, either for the entire inventory or on an item-by-item basis.

Ideally, enterprises prefer to conduct inventory counts on the closing day. However, there are instances where inventory counts cannot be performed on the closing day. In such cases, the actual inventory value must be adjusted to relate it to the specific year-end. This adjustment requires taking into account incoming goods (purchases and sales returns) and outgoing goods (sales and purchase returns) during the period between the end of the year and the actual inventory count date. Additionally, all adjustments for goods must be based on their respective costs. Let's consider a scenario where a company's financial year ends on March 31st. However, the inventory count takes place on March 5th of the following year, and the actual inventory value is determined to be ₹550000. Between March 1st and March 5th, the company made purchases totaling ₹90000 and recorded sales amounting to ₹120000. The mark-up on cost is 20%. The inventory on 31st March would be ₹8,32,000 as shown below:

	₹
Inventory ascertained on March 5	550000
Less: Goods purchases during March. 1 to 5	90000
Add: Cost of goods sold during March 1 to 5 $120,000 \times (100/120)$	100000
	560000

TEST YOUR KNOWLEDGE

TRUE AND FALSE

- Inventories refer to the stocks of goods and materials held by a business entity primarily for the purpose of generating revenue.
Sol. True: Inventories are stocks of goods and materials that businesses maintain with the primary intention of generating revenue
- In a construction business, a building is classified as part of the inventory.
Sol. True, In the context of a construction business, a building under construction is categorized as inventory. This building is part of the ongoing business operations and is intended to be sold as inventory once completed.
- Inventory is assessed by subtracting the percentage decrease from the carrying cost.
Sol. False, Inventory is assessed based on the lower of its cost or net realizable value for valuation purposes.
- Under the physical inventory system, management has access to up-to-date information on the quantity and valuation of the closing stock on a daily basis.
Sol. False, With the Perpetual Inventory System, management has access to up-to-date information on the closing stock on a daily basis.
- The Periodic Inventory System is often considered more suitable for small enterprises, as it provides a simpler approach to inventory management.
Sol. True, a periodic inventory system is well-suited for small and micro enterprises, particularly when the physical counting of inventory is not a burdensome task.
- If the closing inventory is inaccurately overstated, it will result in an understatement of the net income for the accounting period.
Sol. False, If the closing inventory is inaccurately overstated, it will result in an overstatement of the net income for the accounting period.
- The cost of inventories should include all the expenses incurred during the purchase process
Sol. False, The cost of inventories should include not only the expenses related to the purchase, but also the costs of conversion and other expenses incurred in transporting and preparing the inventories in their current state and location.

8. The costs of converting inventories includes expenses that are specifically associated with the production units, which may involve the allocation of fixed overheads.
- Sol. False,** Costs of conversion of inventories encompass expenses that are directly associated with the production process of units. These costs comprise not only the direct materials and labor involved but also entail the systematic allocation of both fixed and variable overheads.
9. The costs of inventories include abnormal amounts of wasted materials, labor, or other production overhead expenses.
- Sol. False,** The costs of inventories do not include abnormal amounts of wasted materials, labor, or other production overhead expenses.
10. Counting inventory under a perpetual system can be conducted without the need to close the business operations.
- Sol. False,** Under the periodic system, business closure is necessary to conduct inventory counting.
11. The periodic inventory system is an approach to determining inventory levels through the process of conducting a physical count of items.
- Sol. True,** Under the periodic inventory system, an actual physical count of inventory is conducted on a specific date to determine the quantity of inventory on hand.
12. The ending inventory's valuation using the simple average price method is considered more realistic when compared to the Last-In, First-Out (LIFO) method.
- Sol. True,** In the simple average price method for inventory valuation, both the earlier cost and the most recent cost of purchases are considered. However, in the LIFO method, only the latest cost is taken into account. Consequently, it can be argued that the simple average provides a more realistic assessment compared to LIFO.
13. The inventory's value is presented on the assets side of the Balance Sheet under the category of fixed assets.
- Sol. False,** The inventory's value is represented in the Balance Sheet under current assets, rather than as a fixed asset, since it can be realized within a twelve-month period.
14. During inflationary periods, FIFO (First-In, First-Out) may not reflect the lowest cost of goods sold.
- Sol. False,** During periods of inflation, both the LIFO (Last-In, First-Out) and weighted average methods may not yield the lowest cost of goods sold.
15. In the LIFO method, inventory is valued under the assumption that expenses are allocated against revenue in the order in which they occur.
- Sol. False,** The FIFO method operates under the assumption that costs are allocated against revenue in the order in which they occur.
16. Value of inventory, is based on the Principle of conservatism.
- Sol. True,** When applying the principle of conservatism, we prioritize recognizing potential losses over expected profits when valuing inventory. Therefore, we base our inventory valuation on the lower of cost or net realizable value.

17. Inventory that has suffered damage should be appraised at the lesser of its cost or market value.
- Sol. False,** in accordance with Accounting Standards, if inventory is impaired, obsolete, or valued higher than its market value, it is necessary to reduce its value to the net realizable value.
18. The expense related to renting a warehouse for the storage of finished inventory should be included into the cost of the finished inventory.
- Sol. False,** The cost of renting a warehouse should typically not be factored into the valuation of finished inventory; instead, such expenses are generally categorized as part of selling and distribution expenses.
19. If the closing inventory is underestimated, it will lead to a decrease in the reported net income.
- Sol. True,** If the closing inventory is understated, this will lead to an understatement of net income. This occurs because when expenses are overstated, specifically the cost of goods sold, they reduce net income, resulting in an understatement of overall net income.
20. LIFO is not the preferred choice when unit costs decrease as production decreases.
- Sol. False,** LIFO is less advantageous when production levels rise and unit costs tend to decrease. Under the LIFO method, the cost of goods sold (COGS) is calculated using the current inventory items first, meaning the older and less expensive inventory is sold later. In an inflationary economy, this leads to a higher COGS, resulting in lower earnings or net income for the company. However, the lower reported profit also leads to reduced tax liabilities. LIFO assumes that the most expensive inventory items will be sold first in anticipation of rising prices, which reduces the recorded inventory value but increases the COGS. In summary, the LIFO method tends to result in higher COGS and lower reported earnings.
21. The chosen cost flow assumption should align with the real movement of the goods.
- Sol. False,** The cost flow assumption is not obligated to mirror the precise physical movement of goods in order to comply with accounting standards. A cost flow assumption refers to the method used to subtract costs from a company's inventory and present them as the cost of goods sold. It encompasses various methods like FIFO, LIFO, and average. These methods focus on the cost flow process rather than mirroring the exact physical removal of goods from inventory.
22. Businesses involved in both merchandising and production often manage multiple inventory accounts.
- Sol. False,** The quantity and nomenclature of inventory accounts are subject to change depending on the corporate structure. Inventory is categorized as a current asset on the balance sheet. It encompasses items either intended for direct sale to customers or those in the process of production that

will eventually reach consumers.

In the case of retail businesses, they typically maintain a single inventory account, referred to as the merchandising inventory account.

However, manufacturing companies typically manage three distinct inventory accounts: one for raw materials, one for work-in-progress, and one for finished goods.

24. Typically, finished goods are valued at the higher of cost or market price.

Sol. False: According to AS-2, finished goods are typically valued at the lower of cost or net realizable value

25. Under AS-2, inventory is valued based on either its cost price or the current replacement cost, choosing the lower of the two.

Sol. False: In accordance with AS-2, Valuation of Inventories, inventory is valued at the lower of cost and net realizable value.

26. The cost of storing finished inventory in a warehouse, in terms of rent, should be incorporated into the total cost of the finished inventory. [July 2021, 2 Marks]

Sol. False, The cost of warehouse rent for storing finished inventory should be excluded from the cost of finished inventory, as it is categorized as part of selling and distribution expenses.

27. The periodic inventory system is a method for determining inventory levels by conducting a physical count of items on hand. [Dec. 2022, 2 Marks]

Sol. True, The periodic inventory system involves determining inventory levels by physically counting, measuring, or weighing all inventory items on hand at a specific date when inventory valuation occurs.

MULTIPLE CHOICE QUESTIONS

1. Calculate the amount purchases

Cost of goods sold = 20000

Opening stock = 2000

Closing stock = 2200

(a) ₹19800

(b) ₹20000

(c) ₹20400.

(d) ₹20200

Sol. (d) ₹20200

2. Average Inventory = ₹10,000. Closing Inventory is ₹4000 more than opening Inventory. Find out the value of closing Inventory.

(a) ₹20000

(b) ₹8000

(c) ₹12000.

(d) ₹4000

Sol. (c) ₹12000

3. If the profit is 20% of the sales price then it is

- (a) 20% of the cost price
- (c) 25% of the cost price

- (b) 33% of the cost price
- (d) None of the above

Sol. (c) 25% of the cost price

4. The cost of goods sold =

- (a) Opening stock + purchases
- (b) Purchases - Closing stock
- (c) Opening stock + purchases - closing stock
- (d) None of the above

Sol. (c) Opening stock + purchases - closing stock

5. How is inventory presented in financial statements?

- (a) Under Fixed Assets
- (b) Under Current Assets
- (c) Under Current Liabilities
- (d) Under Investments

Sol. (b) Under Current Assets

6. Accounting Standards prohibit the usage of which inventory valuation method?

- (a) FIFO
- (b) Average cost
- (c) LIFO
- (d) None of the above

Sol. (c) LIFO

7. Which inventory costing method calculates the value of the closing inventory by assuming that the most recently purchased inventory remains unsold??

- (a) FIFO
- (b) LIFO
- (c) Weighted average cost
- (d) None of the above

Sol. (a) FIFO

8. On which principle is the valuation of inventory based when it is valued at cost or net realizable value?

- (a) Consistency
- (b) Conservatism
- (c) Going concern
- (d) None of the above

Sol. (b) Conservatism

9. In an inflationary trend, which of the methods will reflect the highest inventory value?

- (a) FIFO
- (b) Weighted average
- (c) LIFO
- (d) None of the above

Sol. (a) FIFO

10. Which of the following methods does not take into account the historical cost of inventory?

- (a) Weighted average
- (b) FIFO
- (c) Retail price method
- (d) None of the above

Sol. (c) Retail price method

11. During the process of concluding the current year's profit assessment, the company identified an error in the valuation of the closing inventory from the prior year. In the

previous year, the closing inventory had been overvalued by an amount exceeding Rs. 40,000 leading to_____

- (a) The profit from the preceding year has been inflated, and the profit for the current year is similarly overstated
- (b) The profit reported for the previous year is inflated, while the profit for the current year is understated.
- (c) The profit for the preceding year is reported lower than its actual value, and the profit for the current year is similarly understated.
- (d) None of the above

Sol. (b) The profit reported for the previous year is inflated, while the profit for the current year is understated.

12. Consider the following for the Q co. for the year 2021-22

Cost of goods available for sale Rs.1,00,000

Total sales Rs. 50,000

Opening inventory of goods Rs. 10,000

Gross profit margin on sales 20%

Closing inventory of goods for the year

2021-22 as:

(a) 40,000	(b) 60,000
(c) 50,000	(d) None of the above

Sol. (b) 60,000

13. A company is following the weighted average cost method for valuing its inventory. The details of its purchase and issue of raw materials during the 1st week of November are as follows:

01.11.2021 opening inventory 40 units value Rs. 2,000

02.11.2021 purchased 90 units @ Rs.45

04.11.2021 issued 40 units

05.11.2021 purchased 150 units @ Rs.48

The value of the inventory at the end of the week and the unit weighted average cost is-

(a) Rs. 11388 - 47.45	(b) Rs. 14300 - 47
(c) Rs. 13600 - 46.30	(d) None of the above

Sol. (a) Rs. 11388 - 47.45

14. Cost of sales =

- (a) Opening stock + Purchases
- (b) Purchases - Closing inventory
- (c) Opening stock + Purchases - closing inventory
- (d) None of the above

Sol. (c) Opening stock + Purchases - closing inventory

15. Inventory is presented in financial statements under:

- (a) Fixed Assets
- (b) Current Assets
- (c) Current liabilities
- (d) None of the above

Sol. (b) Current Assets

16. What is the inventory costing method that determines the closing inventory value by assuming that the most recently acquired inventory remains unsold?

- (a) FIFO
- (b) LIFO
- (c) Weighted average
- (d) None of the above

Sol. (a) FIFO

17. Among the following methods, which one does not take into account the historical cost of inventory?

- (a) FIFO
- (b) LIFO
- (c) Weighted average
- (d) Retail price method

Sol. (d) Retail price method

18. In Perpetual Inventory System

- (a) There is no need to prepare a purchase a/c
- (b) A COGS a/c is prepared
- (c) Two entries are needed to record a sale
- (d) All of the above

Sol. (d) All of the above

19. Which of the following items must be accounted for in a company's inventory at the close of the fiscal year?

- (a) Goods in transit shipped with "freight on board" (FOB) Destination
- (b) Goods in transit acquired at a "f.o.b. shipping point"
- (c) Products sold to a customer and retained for the buyer to collect at their own convenience
- (d) Products received under a consignment arrangement from another organization

Sol. (b) Goods in transit acquired at a "f.o.b" shipping point

20. Regarding inventories, which of the following is a "product cost"?

- (a) Selling and distribution expenses
- (b) Interest expenses
- (c) Raw materials
- (d) Abnormal wastage

Sol. (c) Raw materials

21. Among the following, which item cannot be individually recorded when calculating the Cost of Goods Sold using the Periodic inventory system?

- (a) Discounts applied to cash purchases made during the span of time
- (b) Trade discounts for purchases during the time
- (c) The cost associated with importing goods acquired during the duration

(d) Allowances and returns of products acquired during the period

Sol. (b) Trade discounts for purchases during the time

22. According to the accounting standards, the cost of inventories include-

(a) Cost of purchase

(b) Cost of conversion

(c) Additional expenses involved in transporting inventories to their current state and location

(d) All of the above

Sol. (d) All of the above

THEORY QUESTIONS

1. Describe:

(i) Adjusted Selling Price method.

(ii) primary methods used to determine the cost of inventory.

Sol.

Adjusted selling price method-

The adjusted selling price method, also known as the retail inventory method, is commonly utilized in retail businesses or when dealing with inventory that consists of items with unknown individual costs. This approach allows for estimating the historical cost of inventory by initially determining it based on the selling price and subsequently subtracting an estimated gross margin of profit on those particular stocks. It is a practical way to assess inventory value when detailed cost information for individual items is not readily available.

Primary methods used to determine the cost of inventory- The determination of inventory cost is commonly achieved through the use of three principal methods: specific identification, First-In-First-Out (FIFO), and weighted average cost formulae. The specific identification method involves assigning costs to inventory items based on their individual identification, which is particularly suitable for non-interchangeable items and goods or services allocated to specific projects. On the other hand, FIFO assumes that the first items acquired or produced are the first ones to be sold, while the weighted average cost formula calculates the average cost of inventory based on the total cost and quantity of goods. These methods provide businesses with different approaches to ascertain inventory cost based on their specific needs and circumstances.

2. Write down the differences between:

(i) LIFO and FIFO.

(ii) FIFO and weighted average price method.

Sol.

(i) Under the FIFO (First-In-First-Out) method of inventory valuation, the assumption is that the items of inventory that were purchased or produced first are the ones that are consumed or sold first. As a result, the closing inventory is valued using the

most recent purchase prices, while inventory issues are valued using the corresponding older purchase prices. In simpler terms, the costs are assigned to the units issued in the same order as they were entered in the inventory records. In periods when prices are rising, following the FIFO method results in reporting higher profits because the cost of goods sold is based on older and lower prices.

On the other hand, the LIFO (Last-In-First-Out) method of inventory valuation values the units of inventory issued at the prices paid for the most recent purchases, while the closing inventories are valued at the prices paid for earlier purchases. This means that the closing inventories are valued using older purchase prices, and the issues are valued using the corresponding latest purchase prices.

- (ii) Under the FIFO (First-In-First-Out) method of stock valuation, the assumption is that the goods issued are typically from the earliest batch received. Therefore, the remaining stock on hand consists of the most recent consignments. The closing stock is valued based on the price paid for these recent consignments.

On the other hand, the weighted average price method is different from a simple average price method. With this method, a stock ledger is maintained to track daily receipts and issues. Whenever a new consignment is received, a new average price is calculated by taking into account the previous stock value and the cost of the new consignment. This average price is determined by dividing the total value of the preceding stock and the new consignment by the total units of the preceding stock and the new consignment. This results in a weighted average price.

3. Define inventory. Explain the importance of proper valuation of inventory in the preparation of statements of the business entity.

Sol. Inventory can be defined as the assets held by a business entity that meet one of the following criteria:

Items held for sale in the regular course of business.

Items in the process of being produced for sale.

Items consumed in the production of goods or services for sale, including maintenance supplies and consumables (excluding machinery spares).

The valuation of inventory holds significance for several reasons:

- (i) **Determination of Income:** Proper valuation of inventory is crucial for accurately determining the cost of goods sold and calculating the gross profit or loss, which ultimately impacts the determination of income.
- (ii) **Ascertainment of Financial Position:** The value of inventory directly affects the balance sheet by impacting the calculation of assets, specifically the current assets. Proper valuation helps in presenting an accurate financial position of the business.
- (iii) **Liquidity Analysis:** Inventory valuation plays a role in assessing the liquidity of a business. It provides insights into the availability of stock that can be converted into cash through sales.
- (iv) **Statutory Compliance:** Compliance with accounting standards and legal requirements necessitates proper inventory valuation. Accurate reporting ensures adherence to

regulations and facilitates transparency in financial statements.

4. Write a Short note on Periodic Inventory System

Sol. This approach is commonly known as the Physical Inventory System, characterized by the following:

- (1) Absence of inventory record keeping.
- (2) Year-end inventory assessment is conducted through physical counting and subsequent valuation.
- (3) Small businesses often opt for this simple method.

Unless specified otherwise, we can assume that inventory or closing stock is determined through physical counting and valuation for the annual financial statement.

5. Write a short note on Perpetual Inventory System.

Sol. Inventory information for each item is systematically documented in what are commonly known as inventory records, often referred to as store records.

These records may take the form of either value-only documentation or quantity-related data (referred to as the priced ledger).

Any changes in balance, as well as the particulars of receipts and withdrawals, are promptly recorded. Consequently, real-time inventory balances for all items are continuously accessible. This year-end balance is typically employed for preparing final financial statements in accounting.

6. Write a short note on stock taking.

Sol. Stock taking, the practice of physically counting and examining each item within an inventory, plays a pivotal role in inventory management.

Stocktaking can be conducted either on scheduled occasions or unannounced, with no advance notice provided to the store staff. Companies may opt to validate all their products at once or choose a periodic sampling approach. Essential or high-value items are subject to more frequent verification than others.

In perpetual inventory systems, stocktaking is employed to validate the precision of stock records.

In contrast, for periodic inventory systems, stocktaking is typically conducted at the conclusion of the fiscal year.



PRACTICAL QUESTIONS

1. M/s. Subhash Traders find out the following historical cost and net realisable value for various types of inventories. Find out value of Closing Stock in accordance with AS-2 (Revised) – Valuation of Inventories issued by ICAI.

Inventory Categories	01	02	03	04	05	06	
Historical Cost	17,400	20,100	18,200	16,500	15,400	21,400	= 1,09,000
Net Realisable Value	12,200	27,400	19,100	17,200	16,800	20,900	= 1,13,600

Sol. As per AS-2 (Revised), valuation of inventories must be at the lower of historical cost and Net Realisable value. Comparison between cost and net realisable value can be done individually on item-by-item basis or in the aggregate i.e. group-wise of similar and interchangeable items. But comparison by global basis is to be avoided. That is to say, total cost of all dissimilar items with their total net realisable value is not permitted. Hence, as per category-by-category comparison, we can determine value of inventories as under.

Inventory Categories	Lower of historical cost & net realisable value
01	12,200
02	20,100
03	18,200
04	16,500
05	15,400
06	20,900
	1,03,300

Thus, value of closing stock is ₹1,03,300

2. A firm has two products C and D. It analyses its costs for the products as follows:

	C (₹)	D (₹)
Materials	1,20,000	1,40,000
Labour	80,000	1,00,000
Production Expenses	70,000	70,000
Administration Expenses	50,000	50,000
Advertising	30,000	30,000
	3,50,000	3,90,000

Production was 20,000 units of A and 30,000 units of B. The selling price was ₹ 20 per unit of A but the price of B was only ₹ 10; agents in both cases received commission @ 5 % of the selling price. The closing stock was 2,000 units and 3,000 units of C and D respectively. What is the value that should be put on the closing stock?

Sol. Statement Showing Valuation of Stock as on

		A	B
Cost of Production write above material		₹	₹
		1,20,2000	1,40,000
Labour		80,000	1,00,000
Production Expenses		70,000	70,000
Total	(i)	2,70,000	3,10,000
No. of units produced	(ii)	20,000	30,000
Cost per unit [(i) - (ii)]		₹ 13.50	10.33
Net Realisable value (NRV) (Selling price less 5% selling comm.)		₹ 19.00	9.50
Valued at Lower of Cost or NRV		₹ 13.50	9.50
No. of units in Stock		2,000	3,000
Value of Stock (at cost or net realisable value which-ever is lower)		₹ 27,000	28,500
Total Value: 55,500			

FIFO, LIFO AND WEIGHTED AVERAGE

3. The following are the details of a spare part of Sriram Mills:

1-1-2016	Opening Stock	Nil
1-1	Purchases	100 units @ ₹ 30 per unit
15-1	Issued for consumption	50 unit
1-2	Purchases	200 unit @ ₹ 40 per unit
15-2	Issued for consumption	100 units
20-2	Issued for consumption	100 units
1-3	Purchases	150 units @ ₹ 50 per unit
15-3	Issued for consumption	100 units

Find out the value of stock as on 31-3-2016 if the company follows:

1. First in First Out basis
2. Last in First Out basis
3. Weighted Average basis

Sol.

Stores card/Stores ledger

FIFO METHOD

Item - Spare parts → Method of Valuation of Issues → FIFO

Date			Receipt			Issue			Balance		
2016	Particulars	V.No.	Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Rate	Amt.
1.1	Opening Bal.								—	—	—
1.1	Purchase	100		30	3000				100	30	3000
15.1	Issue					50	30	1500	50	30	1500
1.2	Purchase		200	40	8000				50	30	1500
									200	40	8000
15.2	Issue					100	50×30 50×40	1500 2000	150	40	6000
20.2	Issue					100	100×40	4000	50	40	2000
1.3	Purchase		150	50	7500				50	40	2000
									150	50	7500
15.3	Issue					100	50×40 50×50	2000 2500	100	50	5000
	Total		450		18500	350		13500	100		5000

	Qty.	Value
Purchase	450	18,500
Consumption	350	13,500
Closing Stock (Cost by FIFO method)	100	5,000

Without making stores card, if we simply value the stock of 100 units from the last lot because the earlier lots have been issued, we get the same valuation 100 units @ ₹ 50 = ₹ 5,000.

LIFO METHOD

Item - Spare parts → Method of Valuation of Issues → LIFO

Date			Receipt			Issue			Balance		
2016	Particulars	V.No.	Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Rate	Amt.
1.1	Opening Bal.								—	—	—
1.1	Purchase		100	30	3000				100	30	3000
15.1	Issue					50	30	1500	50	30	1500
1.2	Purchase		200	40	8000				50	30	1500
									200	40	8000
15.2	Issue					100	40	4000	50	30	1500
									100	40	4000
20.2	Issue					100	40	4000	50	30	1500
1.3	Purchase		150	50	7500				50	30	1500
									150	50	7500
15.3	Issue					100	50	5000	50	30	1500
									50	50	2500
	Total		450		18500	350		14500	100		4000

	Qty.	Value
Purchases	450	18,500
Consumption	350	14,5000
Closing Stock (Cost by LIFO method)	100	4,000

Alternatively: The shortcut valuation of closing stock by LIFO i.e. without preparing stores card, would have been 100 units @30 = 3,000. It differs from the above valuation which is more correct if datewise issue is known.

WEIGHTED AVERAGE METHOD

Item - Spare parts → Method of Valuation of issues → Weighted Average Method

Date			Receipt			Issue			Balance		
2016	Particulars	V.No.	Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Rate	Amt.
1.1	Opening Bal.								—	—	—
1.1	Purchase		100	30	3000				100	30	3000
15.1	Issue					50	30	1500	50	30	1500
1.2	Purchase		200	40	8000				250	38	9500
15.2	Issue					100	38	3800	150	38	5700

20.2	Issue					100	38	3800	50	38	1900
1.3	Purchase		150	50	7500				200	47	9400
15.3	Issue					100	47	4700	100	47	4700
	Total		450		18500	350		13800	100		4700

	Qty.	Value
Purchases	450	18,500
Consumption	350	13,800
Closing Stock (Cost by weighted method)	100	4,700

Alternatively periodic weighted average can be applied

Say quarterly weighted average = $3000 + 8000 + 7500/100 + 200 + 150 = 41.11$

Closing stock = $41.11 \times 100 = 4111$

	Qty.	Value
Purchases	450	18,500
Consumption	350	14,389
Closing Stock (Cost by weighted method)	100	4,111

4. A manufacturer has the following record of purchase of a condenser which he uses while manufacturing radio sets:

Purchases were as follows

Date	Quantity (Units)	Price per (Unit)
Dec-4	900	5.00
Dec-10	400	5.50
Dec-11	300	5.50
Dec-19	200	6.00
Dec-28	800	4.75
	2600	

Value the closing stock under different methods

Issues were made as follows

Date	Quantity (Units)
Dec-5	600
Dec-12	400
Dec-29	600

Sol.

FIFO METHOD*Item - Condenser → Method of Valuation of Issues → FIFO*

Date	Particulars	V.No.	Receipt			Issue			Balance		
			Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Rate	Amt.
01.12	Opening Bal.								—	—	—
04.12	Purchase		900	5	4500				900	5	4500
05.12	Issue					600	5	3000	300	5	1500
10.12	Purchase		400	5.50	2200				300	5	1500
									400	5.50	2200
11.12	Purchase		300	5.5	1650				300	5	1500
									700	5.50	3850
12.12	Issue					400	300×5 100×5.5	1500 550	600	5.50	3300
19.12	Purchase		200	6	1200				600	5.50	3300
									200	6	1200
28.12	Purchase		800	4.75	3800				600	5.50	3300
									200	6	1200
									800	4.75	3800
29.12	Issue					600	5.50	3300	200	6	1200
									800	4.75	3800
	Total		2600		13350	1600		8350	1000		5000

	Qty.	Value
Purchases	2600	13,350
Consumption	1600	8,350
Closing Stock (Cost by FIFO method)	1000	5,000

Without making stores card, if we simply value the stock of 1000 units from the last lots because the earlier lots have been issued, we get the same valuation 800 units @ 4.75 = ₹ 3,800 and 200 units @ 6 = ₹ 1,200.

LIFO METHOD*Item→ Condenser → Method of Valuation of issues → LIFO*

Date	Particulars	V.No.	Receipt			Issue			Balance		
			Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Rate	Amt.
01.12	Opening Bal.								—	—	—

04.12	Purchase		900	5	4500				900	5	4500
05.12	Issue					600	5	3000	300	5.5	1500
10.12	Purchase		400	5.5	2200				300	5	1500
									400	5.50	2200
11.12	Purchase		300	5.5	1650				300	5	1500
									700	5.50	3850
12.12	Issue					400	5.50	2200	300	5	1500
									300	5.50	1560
19.12	Purchase		200	6	1200				300	5	1500
									300	5.50	1650
									200	6	1200
28.12	Purchase		800	4.75	3800				300	5	1500
									300	5.50	1650
									200	6	1200
										4.75	3800
29.12	Issue					600	4.75	2850	300	5	1500
									300	5.50	1650
									200	6	1200
									200	4.75	950
	Total		2600		13350	1600		8050	1000		5300

	Qty.	Value
Purchases	2600	13,350
Consumption	1600	8,050
Closing Stock (Cost by LIFO method)	1000	5,000

The shortcut valuation of closing stock by LIFO i.e, without preparing stores card, would have been 900 units @ 5 = 4,500 and 100 units @5.50 = 550. It differs from the above, which is more correct if date wise issue is known.

WEIGHTED AVERAGE METHOD

Item → Condenser → Valuation of issues → Weighted Average

Date	Particulars	V.No.	Receipt			Issue			Balance		
			Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Rate	Amt.
01.12	Opening Bal.								—	—	—
04.12	Purchase		900	5	4500				900	5	4500
05.12	Issue					600	5	4500	300	5.	1500

10.12	Purchase		400	5.50	2200				700	5.286	3700
11.12	Purchase		300	5.50	1650				1000	5.35	5350
12.12	Issue					400	5.35	2140	600	5.35	3210
19.12	Purchase		200	6	1200				800	5.5125	4410
28.12	Purchase		800	4.75	3800				1600	5.131	8210
29.12	Issue					600	5.131	3079	1000	5.131	5131

	Qty.	Value
Purchases	2600	13,350
Consumption	1600	8,219
Closing Stock (Cost by LIFO method)	1000	5,131

Alternatively periodic weighted average can be applied. It can be monthly, quarterly etc.

$$\text{Monthly Weighted Average} = \frac{5 \times 900 + 5.5 \times 400 + 5.5 \times 300 + 6 \times 200 + 4.75 \times 800}{900 + 400 + 300 + 200 + 800}$$

$$= \frac{4500 + 2200 + 1650 + 1200 + 3800}{2600} = \frac{13350}{2600} = 5.135$$

Therefore closing stock will be $1000 \times 5.135 = 5135$

	Qty.	Value
Purchases	2,600	13,350
Consumption	1,600	8,215
Closing Stock (Cost by LIFO method)	1,000	5,135

Ascertaining closing stock by preparing trading account

5. From the following particulars for the years 2014 and 2015 determine the value of the closing stock at the end of 2015.

	2014 (₹)	2015 (₹)
Opening stock	20,000	30,000
Purchases	1,20,000	1,90,000
Sales	2,00,000	2,40,000

Uniform rate of gross profit may be assumed.

At the end of 2015, goods purchased were received, but no entry was made for this credit purchase invoice was not received. These goods cost ₹ 20,000.

- Sol.** Closing stock of 2015 can be ascertained by preparing Trading a/c but gross profit ratio for 2015 is not given hence the same is ascertained by preparing Trading a/c of 2014. For this remember the closing stock of this year is the opening stock of next year.

Trading Account
For the year ending 31st December, 2014

Particulars	₹	Particulars	₹
To Opening stock	30,000	By Sales	2,00,000
To Purchases	1,20,000	By Closing Stock	30,000
To Gross Profit (Balancing figure)	90,000		
	2,30,000		2,30,000

Calculation of Rate of Gross Profit

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{90,000}{2,00,000} \times 100 = 45\%$$

Trading Account
For the year ending 31st December, 2015

Particulars		₹	Particulars	₹
To Opening stock		30,000	By Sales	2,40,000
To Purchases	1,90,000		By Closing Stock	1,08,000
+ unrecorded purchase	20,000	2,10,000	(Balancing figure)	
To Gross Profit (45% of 2,40,000)		1,08,000		2,30,000
		3,48,000		3,48,000

Uniform rate of gross profit = 45% is taken from 2004. Stock as on 31-12-2005 including goods for which invoice was not accounted is ₹ 1,08,000

Ascertaining Stock, when stock of different date is known (Stock of latter date is known)

6. X who was closing his books on 31-3-2016 failed to take the actual Stock which he did only on 9th April, 2016, when it was ascertained by him to be worth ₹ 25,000.

It was found that sales are entered in the sales book on the same day of dispatch and return inwards in the return book as and when the goods are received back. Purchases are entered in the purchases day book once the invoices are received.

It was found that sales between 31-3-2016 and 9-4-2016 as per the sales day book are ₹ 1,720. Purchases between 31-3-2016 and 9-4-2016 as per purchases day book are ₹ 120, out of these goods amounting to ₹ 50 were not received until after the stock was taken.

Goods invoiced during the month of March, 2016 but goods received only on 4th April, 2016 amounted to ₹ 100. Rate of gross profit is 33 1/3% on cost.

Ascertain the value of physical stock as on 31-3-2016.

Sol.

Stock on 9-4-2016	25,000
Add: Cost of goods sold $(1720/100) \times 75$	+ 1,290
Note: Profit 33 $\frac{1}{3}$ % on cost = 25% on sale	
Less: Goods purchased and received (120-50)	- 70
Less: Goods purchased in March but received on 4-4-2016	- 100
Physical stock on 31-3-2016	26120
Add: Stock in transit (purchased but not received till 31-3-2016)	+ 100
Closing stock for final a/c.	26,220

**Ascertaining Stock, when stock of different date is known
(Stock of earlier date is known)**

7. A trader prepared his accounts on 31st March, each year. Due to some unavoidable reasons, stock taking was done on 15th March, 2016 on which date the total cost of goods in his godown came to ₹ 50,000. The following facts were established between 15th March and 31st March, 2016.

- (a) Sales ₹ 41,000 (including cash sales ₹ 10,000)
- (b) Purchases ₹ 5,034 (including cash purchases ₹ 1,990)
- (c) Sales Returns ₹ 1,000

Goods are sold by the trader at a profit of 20% on sales.

You are required to ascertain the value of stock on hand on 31st March 2016.

Sol. Statement showing the Valuation of Stock as on 31st March, 2016

	₹
A. Stock in godown (Physical inventory) as on 15-3-2016	50,000
B. Less: (a) Cost of sales between 15.3 to 31.3 net of return 80% of (₹ 41,000 - ₹ 1,000)	- 32,000
C. Add: (a) Purchases during the period	+ 5,034
D. Stock as on March 31, 2016 (at cost)	23,034

8. Karan Ltd. prepared their accounts for financial year ended on 31st March 2019. Due to unavoidable circumstances actual stock has been taken on 10th April 2019, when it was ascertained at ₹ 1,25,000. It has been found that;
- (i) Sales are entered in the Sales Book on the day of dispatch and return inwards in the Returns Inward Book on the day of the goods received back.
 - (ii) Purchases are entered in the Purchase Book on the day the Invoices are received.
 - (iii) Sales between 1st April 2019 to 9th April 2019 amounting to ₹ 20,000 as per Sales Day Book.

- (iv) Free samples for business promotion issued during 1st April 2019 to 9th April 2019 amounting to ₹ 4,000 at cost.
- (v) Purchases during 1st April 2019 to 9th April 2019 amounting to ₹ 10,000 but goods amounting to ₹. 2,000 not received till the date of stock taking.
- (vi) Invoices for goods purchased amounting to Rs. 20,000 were entered on 28th March 2019 but the goods were not included in stock.

Rate of Gross Profit is 25% on cost.

Ascertain the value of Stock as on 31st March 2019.

[May 2019, 5 Marks]

Sol.

	₹
Stock as on 10th April, 2019	1,25,000
Add: Cost of Goods sold $\left(\frac{20,000}{100} \times 80 \right)$	16,000
[Note:- Profit 25% on cost = 20% on sale]	
Add: Free samples distributed	4,000
Less: Goods purchased & received (10,000-2,000)	8,000
Add: Invoices entered but goods not included in stock	20,000
Stock as on 31st March, 2019	1,57,000

9. Physical verification of stock in a business was done on 23rd February, 2020. The value of the stock was ₹ 28,00,000. The following transactions took place from 23rd February to 29th February, 2020:

- (1) Out of the goods sent on consignment, goods at cost worth ₹ 2,30,000 were unsold.
- (2) Purchases of ₹ 3,00,000 were made out of which goods worth ₹ 1,20,000 were delivered on 5th March, 2020.
- (3) Sales were ₹ 13,60,000 which include goods worth ₹ 3,20,000 sent on approval. Half of these goods were returned before 29th February, 2020, but on information is available regarding the remaining goods.
- (4) Goods are sold at cost plus 25%. However goods costing ₹ 2,40,000 had been sold for ₹ 1,50,000.

Determine the value of stock on 29th February, 2020.

[Nov. 2020, 10 Marks]

Sol. Statement of Valuation of Stock on 29th Feb., 2020

	₹	₹
Value of stock as on 23rd Feb, 2020		28,00,000
Add: Unsold stock out of the goods sent on consignment	2,30,000	
Purchases during the period from 23 Feb., 2020 to 29Feb., 2020	1,80,000	

Goods in transit on 29 Feb, 2020	1,20,000	5,30,000
		33,30,000
Less: Cost of sales during the period from 23 Feb, 2020 to 29 Feb., 2020 (W.N.1)		(9,52,000)
		23,78,000

Working Notes:

1. Calculation of Cost of Sales:

Total Sales	₹ 13,60,000
Less: Goods sent on Approval*	
(a) ½ returned	(1,60,000)
(b) No intimation received for approval of ½ goods	(1,60,000)
	<u>10,40,000</u>

₹ 10,40,000	
Abnormal Sales	Normal Sales
₹ 1,50,000	(₹ 10,40,000 – ₹ 1,50,000)
	₹ 8,90,000
	Less: Gross Profit ₹ 1,78,000
	(25% on cost or 20% on Sales)
<u>COGS ₹ 2,40,000</u>	<u>COGS ₹ 712,000</u>

Total COGS is ₹ 9,52,000 (₹ 2,40,000 + ₹ 7,12,000)

* This stock is already included in stock taking made on 23rd Feb., 2020.

10. From the following particulars ascertain the value of inventories as on 31st March, 2020:

Inventory as on 1st April, 2019	– ₹ 3,50,000
Purchase made during the year	– ₹ 12,00,000
Sales	– ₹ 18,50,000
Manufacturing Expenses	– ₹ 1,00,000
Selling and Distribution Expenses	– ₹ 50,000
Administration Expenses	– ₹ 80,000

At the time of valuing inventory as on 31st March, 2019, a sum of ₹ 20,000 was written off on a particular item which was originally purchased for ₹ 55,000 and was sold during the year for ₹ 50,000.

Except the above mentioned transaction, gross profit earned during the year was 20% on sales.

[Jan. 2021, 5 Marks]

Sol.

Particulars	Normal	Abnormal	Total	Particulars	Normal	Abnormal	Total
To Opening Stock a/c (3,50,000 + 20,000)	3,15,000	55,000	3,70,000	By Sales a/c	18,00,000	50,000	18,50,000
To Purchases a/c	12,00,000	--	12,00,000	By Closing stock a/c (bal. fig.)	1,75,000	--	1,75,000
To Manufacturing exp.	1,00,000	--	1,00,000	By Gross Loss	--	5,000	5,000
to Gross Profit	3,60,000	--	3,60,000				
Total	19,75,000	55,000	20,30,000	Total	19,75,000	55,000	20,30,000

So, value of Stock on the date of fire ₹ 1,75,000.

Note: Selling & Distribution expenses and Administration expenses will not be considered for the purpose of preparing Trading a/c.

11. From the following information, calculate the historical cost of closing inventories using adjusted selling price method:

Purchase during the year	– ₹ 5,00,000
Sales during the year	– ₹ 75,50,000
Opening Inventory	Nil
Closing Inventory at selling price	– ₹ 1,00,000

[July 2021, 5 Marks]

Sol.

(i) Calculation of Gross Margin of Profit:	₹
Sales during the year	75,00,000
Add: Closing Inventory (at selling price)	1,00,000
	8,50,000
Less: Purchases during the year	(5,00,000)
Gross Margin	3,50,000

$$(ii) \text{ Rate of Gross Margin} = \frac{3,50,000}{8,50,000} \times 100 = 41.176\%$$

$$(iii) \text{ Cost of Closing Inventory} = ₹ 1,00,000 - 41.176\% \text{ of } ₹ 1,00,000$$

$$= ₹ 1,00,000 - ₹ 41,176$$

$$= ₹ 58,824$$

12. A trader prepared his accounts on 31st March, each year. Due to some unavoidable

1-1-2021	Opening Inventory	Nil
1-1-2021	Purchases	10 units @ ₹ 300 per unit
15-1-2021	Issues for consumption	5 units
1-2-2021	Purchases	20 units @ ₹ 400 per unit
15-2-2021	Issues for consumption	10 units
20-2-2021	Issues for consumption	10 units

Find out the value of Inventory as on 31-2-2021, if the company follows Weighted Average Method. [Dec, 2021, 4 Marks]

Sol.

STOCK LEDGER

Date 2021	Receipt			Issue			Balance		
	Qty. (Units)	Rate ₹	Amt. ₹	Qty. (Units)	Rate ₹	Amt. ₹	Qty. (Units)	Rate ₹	Amt. ₹
1st Jan.	--	--	--	--	--	--	Nil	--	Nil
1st Jan.	10	300	3000	--	--	--	10	300	3000
15th Jan.	--	--	--	5	300	1500	5	300	1500
1st Feb.	20	400	8000	--	--	--	25	380	9500
15th Feb.	--	--	--	10	380	3800	15	380	5700
20th Feb.	--	--	--	10	380	3800	5	380	1900
31st Mar.	--	--	--	--	--	--	5	380	1900

Value of inventory as on 31st March, 2021 is ₹ 1900.

13. Jack Enterprises furnishes the following information for the year ended 31st March, 2021.

Particulars	Amount (₹)
Value of Stock as on 1st April, 2020	28,00,000
Purchases during the year	1,38,40,000
Manufacturing Expenses during the year	28,00,000
Sales during the year	2,08,80,000

The following further information is also provided:

- At the time of valuing stock on 31st March, 2020 a sum of ₹ 2,40,000 was written off for a particular item which was originally purchased for ₹ 8,00,000. This item was sold during the year ended 31st March, 2021 for ₹ 6,40,000.
- Except for the above transaction, the Rate of Gross Profit during the year was 1/3rd on cost.

Ascertain the value of Stock as on 31st March, 2021.

[June 2022, 5 Marks]

Sol.

Trading a / c for the year ended 31st March, 2021

Particulars	₹	Particulars	Amount (₹)
To Opening Stock 28,00,000		By Sales 2,08,80,000	
+ Written off 2,40,000	22,40,000	Less: Sale of (6,40,000) abnormal item	2,02,40,000
– Abnormal item (80,00,000)	1,38,40,000	By Closing Stock (Bal. fig.)	37,00,000
To Purchases	28,00,000		
To Manufacturing exp.	5060000		
To Gross Profit (1/3 on Cost Or 1/4 on sales)			
Total	2,39,40,000	Total	2,39,40,000

So, Value of stock as on 31 March, 2021 is ₹ 37,00,000.

- Vik ikram Ltd is engaged in the trading of three distinct products: X, Y, and Z. These products are dissimilar and cannot be interchanged. At the conclusion of the financial year, the company has provided the historical cost and net realizable value (NRV) for each item in the closing stock. We need to determine the value of the closing stock.

Items	Historical Cost (in ₹ Lakhs)	Net Realisable Value (in ₹ Lakhs)
X	20	18
Y	36	33
Z	15	16

- Sol. When valuing inventories, the principle of lower of cost and Net Realizable Value (NRV) is applied. It means that inventories are recorded at the lower of their cost or NRV. The determination of the value of closing stocks is done according to the following approach:

Items	Historical Cost (in ₹ Lakhs)	Net Realisable Value (in ₹ Lakhs)	Valuation = Least of Cost or NRV
X	20	18	18
Y	36	33	33
Z	15	16	15
Total			66

- B Ltd. has a record of purchases of light bulbs that are used in the manufacturing of lamps:

Date	Quantity (units)	Price per unit
May. 1	700	40
May. 3	300	50
May. 11	400	60
May. 20	300	40
May. 30	600	30
	2,300	

1,200 units were issued during the month of May till 16th May.

Sol. The closing inventory of B Ltd. consists of 1100 units, which are determined using the FIFO (First-In, First-Out) method. Specifically, it includes:

600 units received on May 30th,
300 units received on May 20th, and
200 units received on May 11th.

	₹
Value of 600 units @ ₹30	18000
Value of 300 units @ ₹40	12000
Value of 200 units @ 60	12000
Total	42,000

3. Prepare store ledger from the following records May:

Record of issues

Date	Quantity (units)
May. 5	700
May. 18	200
Total	900

Sol. Computation of closing stock under perpetual inventory system

Record of receipts

Date	Quantity (units)	Price per unit
May. 1	700	40
May. 3	300	50
May. 11	400	60
	1400	

Using LIFO method, following will be stock ledger:

Date	Receipts			Issues			Balance inventory		
May	Qty.	Rate	Amount	Qty	Rate	Amount	Qty.	Rate	Amount
1	700	40	28,000	-	-	-	700	40	28,000
3	300	50	15,000	-	-	-	700	40	28,000
							300	50	15,000
5	-	-	-	300	50	15000			
				400	40	16000			
							300	40	12,000
11	400	60	24,000	-	-	-	300	40	12,000
							400	60	24,000
18	-	-	-	200	60	12000			
							300	40	12000
							200	60	12,000

4. Calculate value of closing stock using simple average price method by using data of question 2.:

Sol. The simple average in this question is:

$$[(40 + 50 + 60 + 40 + 30)/5] = 220/5 = ₹44$$

1100 units valued at ₹44

So value of closing stock will be $44 * 1100 = 48400$

5. On the basis of the data given in illustration 2 and 3, calculate the weighted average price and also the value of closing inventory by weighted average price method.

Sol. The computation of weighted average price in the referred example is shown below:

A new average rate would be calculated on receiving a fresh consignment. Answer on that basis would be as under:

Date	Receipts			Issues			Balance inventory		
	Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
May 1	700	40	28,000	-	-	-	700	40	28,000
May 3	300	50	15000	-	-	-	1000	43	43000
May 5	-	-	-	700	43	30100	300	43	12900
May 11	400	60	24000	-	-	-	700	52.71	36900
May 18	-	-	-	200	52.71	10542	500	52.71	26358

6. M/s A, B and C are in a partnership, from the following information find out the historical cost for the year ending 31 march 2021 (using adjusted selling price method).

Goods received from suppliers

(without deducting trade discount and adding GST)	₹	1230000
Trade discount 5% and GST 10%		
Packaging and transportation charges	₹	87,500
Sales during the year 2020-21	₹	1850000
Sales value of closing inventories	₹	190000

Sol.

Determination of cost of purchases:

Goods received from suppliers	1230000
Less: Trade discount 5%	(61500)
	1168500
Add: Sales Tax 10%	₹116850
	₹128535
Add: Packaging and transportation charges	₹75000
	₹1360350

Determination of estimated gross profit margin:

Sales during the year	₹1850000
Closing inventory at the selling price	₹190000
	1660000
Less: Purchases	₹(1360350)
Gross profit	₹299650
Gross profit margin	16.19%
Inventory valuation:	
Selling price of closing inventories	₹190000
Less: Gross profit margin 16.19%	₹(30761)
	₹159239

This method is employed when there is frequent fluctuation in the price per unit of goods and the business makes frequent purchases of those goods, such as in the case of crude oil. A standard cost is determined based on the accumulated experience of price changes, and the inventory is valued using this predetermined cost per unit.

7. Calculate the value of Inventories as on 31st March, 2021:

	₹
Inventory as on 1.4.2020	138000
Purchases	805000
Manufacturing Expenses	140000
Selling Expenses	60,500
Administrative Expenses	30,000
Financial Charges	21,500
Sales	1050000

During the inventory valuation on March 31st, 2020, a write-off of 15,000 was made for a specific item. This item was originally purchased for 40,000 and was later sold for ₹50,000 within the year. Excluding this particular transaction, the gross profit earned during the year amounted to 15% of the sales.

Sol.

Statement of Inventory in trade as on 31st March, 2021

	₹	₹
Inventory as on 1st April, 2020	138000	
Less: Book value of abnormal inventory (₹40,000 - ₹15000)	25,000	113000
Add: Purchases		805000
Manufacturing Expenses		140000
		1058000
Less: Cost of goods sold:		

Sales as per books	1050000	
Less: Sales of abnormal item	50000	
	1000000	
Less: Gross Profit @ 15%	150000	850000
Inventory on 31st March, 2021		208000

8. Anita typically finalizes their accounts on March 31st each year. However, due to unforeseen circumstances, it was not feasible to conduct an inventory count until April 10th, 2021. On this particular date, it was determined that the total cost of goods in the Anita's premises amounted to ₹450000. During the period between March 31st and April 10th, 2021, several pertinent facts were discovered.

(i) Sales ₹380000 (including cash sales ₹80,000)

(ii) Purchases ₹70,500 (including cash purchases ₹19,900)

(iii) Sales Return ₹20,000.

Goods are sold at profit of 25% on sales.

Ascertain the value of inventory as on 31st March, 2021.

Sol.

Statement of valuation of Inventory on 31st March, 2021

	₹	₹
Value of Inventory as on 10th April, 2021		450,000
Add: Cost of goods sold during the period	360,000	270,000
between 31st March, 2021 to 10th April, 2021	90,000	
Sales (380,000 - 20,000)		
Less: Gross Profit (25% of ₹4,00,000)		7,20,000
Less: Purchases during the period from		
31st March, 2021 to 10th April, 2021		70500
		649500

9. Inventory taking for the year ended 31st March, 2021 was completed by 12th April 2020, the valuation of which showed a inventory figure of ₹1500000 at cost as on the completion date. After the end of the accounting year and till the date of completion of inventory taking, sales for the next year were made for ₹50000, profit margin being 25% percent on cost. Purchases for the next year included in the inventory amounted to ₹80,000 at cost less trade discount 12 percent. During this period, goods were added to inventory at the mark up price of ₹4,000 in respect of sales returns. After inventory taking it was found that there were certain very old slow-moving items costing ₹12000, which should be taken at ₹8000 to ensure disposal to an interested customer. Due to heavy flood, certain goods costing ₹16000 were received from the supplier beyond

the delivery date of customer. As a result, the customer refused to take delivery and net realizable value of the goods was estimated to be ₹11000 on 31st March. Compute the value of inventory for inclusion in the final accounts for the year ended 30th March, 2021.

Sol.

Statement showing the valuation of Inventory as on 31st March, 2021

	₹
Value of Inventory as on 12th April	1500000
Add: Cost of goods sold after 31st March till Inventory taking	45000
(₹50000 – ₹15000)	
Less: Purchases for the next period (80000-12%)	(70400)
Less: Cost of Sales Returns (4000- 20%)	(3200)
Less: Loss on revaluation of slow moving inventories	(4,000)
Less: Reduction in value on account of default	(5,000)
Value of Inventory on 31st March	112400

Note- 25% markup on cost means 20% markup on sales

PRACTICAL QUESTIONS

1. X who was closing his books on 31.3.2020 failed to take the actual stock which he did only on 9th April, 2020, when it was ascertained by him to be worth ₹2,50,000.

It was found that sales are entered in the sales book on the same day of dispatch and return inwards in the returns book as and when the goods are received back. Purchases are entered in the purchases day book once the invoices are received.

It was found that sales between 31.3.2020 and 9.4.2020 as per the sales day book are ₹17,200. Purchases between 31.3.2020 and 9.4.2020 as per purchases day book are ₹1,200, out of these goods amounting to ₹500 were not received until after the stock was taken.

Goods invoiced during the month of March, 2020 but goods received only on 4th April, 2020 amounted to ₹1,000. Rate of gross profit is $33\frac{1}{3}\%$ on cost.

Ascertain the value of physical stock as on 31.3.2020.

(ICAI Study Material)

Sol.

Statement of Valuation of Physical Stock as on 31st March, 2020

Particulars	₹	₹
Value of stock as on 9th April, 2020		2,50,000
ADD : Cost of sales during the intervening period: Sales made between 31.3.2020 and 9.4.2020	17,200	
LESS : Gross profit @25% on sales	(4,300)*	12,900
		2,62,900
LESS : Purchases actually received during the intervening period: Purchases from 1.4.2020 to 9.4.2020	1,200	
Goods not received up to 9.4.2020	(500)	(700)
		2,62,200
Purchases during March, 2020 received on 4.4.2020		(1,000)
Value of physical stock as on 31.3.2020		2,61,200

$$* 17,200 \times \frac{25}{100}$$

$$\left(\frac{1}{3} \text{ of cos or } 33\frac{1}{3}\% - \frac{1}{4} \text{ of sales or } 25\% \right)$$

2. From the following information, ascertain the value of stock as on 31.3.2020:

Particulars	₹
Value of stock on 1.4.2019	7,00,000
Purchases during the period from 1.4.2019 to 31.3.2020	34,60,000
Manufacturing expenses during the above period	7,00,000
Sales during the same period	52,20,000

At the time of valuing stock on 31.3.2019 a sum of ₹60,000 was written off a particular item which was originally purchased for ₹2,00,000 and was sold for ₹1,60,000. But for the above transaction the gross profit earned during the year was 25% on cost.

(ICAI Study Material)

Sol.

Statement of Valuation of Stock as on 31st March, 2020

Particulars	₹	₹
Value of stock as on 1st April, 2019		7,00,000
ADD : Purchases during the period from 1.4.2019 to 31.3.2020	34,60,000	
Manufacturing expenses during the above period	7,00,000	41,60,000
		48,60,000

Inventory Valuation

LESS : Cost of sales during the period: Sales	52,20,000	
Gross profit (WN1)	10,32,000	41,88,000
Value of stock as on 31.3.2020		6,72,000

Working Notes

CALCULATION OF GROSS PROFITS

	₹
Gross Profit on Normal Sales $(52,20,000 - 1,60,000) \times \frac{25}{125} *$	10,12,000
Gross Profit on the abnormal item $\{1,60,000 - (2,00,000 - 60,000)\}$	20,000
	10,32,000

*25% on cost

3. The Profit and loss account of Hanuman showed a net profit of ₹6,00,000, after considering the closing stock of ₹3,75,000 on 31st March, 2020. Subsequently the following information was obtained from scrutiny of the books:

- (1) Purchases for the year included ₹15,000 paid for new electric fittings for the shop.
- (2) Hanuman gave away goods valued at ₹40,000 as free samples for which no entry was made in the books of accounts.
- (3) Invoices for goods amounting to ₹2,50,000 have been entered on 27th March, 2020, but the goods were not included in stock.
- (4) In March, 2020 goods of ₹2,00,000 sold and delivered were taken in the sales for April, 2020.
- (5) Goods costing ₹75,000 were sent on sale or returned in March, 2020 at a margin of profit of $33\frac{1}{3}\%$ on cost. Though approval was given in April, 2020 these were taken as sales for March, 2020.

Calculate the value of stock on 31st March, 2020 and the adjusted net profit for the year ended on that date. (ICAI Study Material)

Sol.

PROFIT AND LOSS ADJUSTMENT ACCOUNT

PARTICULARS	AMOUNT	PARTICULARS	AMOUNT
To Advertisement (Samples)	40,000	By Net Profit	6,00,000
To Sales (Goods approved in April to be taken as April sales)	1,00,000*	By electric fittings (purchase)	15,000

To Adjusted Net profit	10,40,000	By samples	40,000
		By stock (Goods not included in stock)	2,50,000
		By sales (Goods wrongly taken as April sales)	2,00,000
		By stock (Goods sent on approval basis not included in stock)	75,000
	11,80,000		11,80,000

$$* \left\{ 75,000 + 25,000 \left(33\frac{1}{3}\% \times 75,000 \right) \right\}$$

CALCULATION OF VALUE OF INVENTORY AS ON 31st MARCH, 2020

PARTICULARS	AMOUNT
Closing Stock on 31st March, 2020 (already given)	3,75,000
ADD : Purchases not included in stock of March, 2020	2,50,000
Goods lying with customers for approval	75,000
	7,00,000

□□□

Introduction to partnership accounts

1.1 INTRODUCTION: WHY PARTNERSHIP?

In today's complex business environment, a sole proprietor may find it challenging to handle the financial and managerial aspects alone. Consequently, multiple individuals may choose to combine their financial and non-financial resources to operate a business together.

1.2 DEFINITION AND FEATURES OF PARTNERSHIP

According to Section 4 of the Partnership Act, 1932, a partnership is defined as the relationship between individuals who have agreed to jointly share the profits of a business conducted by any or all of them acting on behalf of the group.

The key features of a partnership are as follows:

- (i) **Agreement Existence:** As outlined in Section 5 of the Indian Partnership Act, 1932, the partnership relationship arises from a contract between parties, unlike the status-based formation seen in Hindu Undivided Families (HUF). A formal or written agreement is not mandatory for the creation of a partnership.
- (ii) **Business Involvement:** A partnership is exclusive to business activities. Merely having an agreement is not sufficient; a partnership comes into existence when partners begin conducting business in accordance with their agreement. Section 2(b) of the Indian Partnership Act, 1932 defines business to include every trade, occupation, and profession.
- (iii) **Profit Sharing:** The involved parties must mutually agree to share the business profits. Being a partner requires the right to share in the business's profits, according to Section 4 of the Indian Partnership Act, 1932. However, there is no requirement for sharing losses as per the same section.
- (iv) **Mutual Agency:** This implies that the business is conducted by any or all partners acting for the entire group. If an individual operates the business not only for themselves but also for others, creating a principal-agent relationship, they are considered partners.
- (v) **Minor as a Partner:** It is permissible to include a minor in a partnership firm, but the condition is that the minor can only share in the profits and cannot be made partner to share the firm's losses.

In case of a loss, other major partners bear the responsibility based on their profit-sharing ratio.

- (vi) **Number of Partners:**

- (i) **Minimum Partners:** 2

- (ii) *Maximum Partners:* As per Section 464 of the Companies Act, 2013, an association or partnership cannot have more than 100 persons (or as prescribed by government) for carrying on any business.

However Rule 10 of Companies (Incorporation) Rules 2014 also specifies the limit as 50. Therefore, the maximum number of members in a partnership firm is limited to 50 (as of now).

1.3 MAIN CLAUSES IN A PARTNERSHIP DEED

The partnership's internal dynamics are guided by a mutual agreement referred to as the partnership deed, which is crucial for preventing future disputes.

Typically, the partnership deed, whether registered or not, includes the following clauses:

1. Name of the firm and details of the partners.
2. Commencement and duration of the business.
3. Capital contributions from each partner.
4. Drawings allowed to each partner and the associated timing.
5. Interest rates on capital, partner loans, and drawings.
6. Profit or loss-sharing ratios among partners.
7. Provision for partner salary, if applicable.
8. Any alterations in the mutual rights and duties of partners.
9. Method for valuing goodwill during changes in the firm's structure.
10. Partner retirement process and payment methods for dues.
11. Executors' basis for determining a deceased partner's share and the payment method.
12. Treatment of losses stemming from a partner's insolvency.
13. Dispute settlement procedures among partners.
14. Guidelines for the preparation and audit of accounts.

While firm registration is optional, non-registration limits the partners or the firm from pursuing legal action.

In cases where there is no written partnership deed or if it is silent on a specific matter, the relevant sections of the Indian Partnership Act, 1932 will apply. Any clause present in the partnership deed will take precedence over the Act's provisions in relation to the respective issues.

Rules in the the absence of Partnership Deed

1. Partners are not entitled to receive a salary.
2. No interest will be permitted on the capital.
3. Interest is not to be levied on the drawings.
4. Interest at a rate of 6% per annum will be granted on a partner's loan to the firm.

5. Profits and losses will be distributed equally among the partners.

Note:

Without a formal agreement, the payment of interest and salary to a partner will only occur in the presence of profits (i.e. all these will be appropriation of Profit)

Question

A and B commenced business in partnership on 1 January 2022. No partnership agreement was made either oral or written. They contributed ₹ 40,000 and ₹ 10,000 respectively as capital. In addition, A also advanced ₹ 20,000 on 1 July 2022. A met with an accident on 1 April 2022 and could not attend to the partnership business upto 30 June 2022. The profits for the year ended on 31 December 2022 amounted to ₹ 50,600. Disputes having been arisen between them for sharing the profits.

A claims: (i) He should be given interest at 10% p.a. on capital and loan (ii) Profit should be distributed in proportion of capital.

B claims: (i) Net profit should be shared equally. (ii) He should be allowed remuneration of ₹ 1,000 p.m. during the period of A's illness. (iii) Interest on capital and loan should be given @ 6% p.a. You are required to settle the dispute between them and distribute the profits according to law. State reasons for your answer. (ICAI Study Material)

Answer

(a) Given the absence of a written or oral partnership agreement, the following rules under the Indian Partnership Act, 1932, apply:

(b) (a) No interest is permissible on capital. (b) A 6% per annum interest is sanctioned on the advanced loan. (c) Profits and losses are to be equally shared. (d) No remuneration is authorized for any partner participating in the business.

(c) Consequently: (a) Neither A nor B will receive interest on capital. (b) Both A and B will be entitled to a 6% interest. (c) Profit and losses will be evenly shared between A and B. (d) No remuneration will be granted to B.

(d)

Net profit for the year	=	50,600
Less: Int. on A's loan $20,000 \times 6\% \times 6/12$	=	600
Net Profit	=	50,000
A's 50%	25,000	
B's 50%	25,000	

Example

A, B and C are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capitals were ₹ 15,00,000, ₹ 30,00,000 and ₹ 60,00,000 respectively. For the year 2022 interest on capital was credited to them @ 12% instead of 10%. (ICAI Study Material)

Particulars	A	B	C	Firm
Interest that should have been credited @ 10%	1,50,000	3,00,000	6,00,000	10,50,000
Interest already credited @ 12%	1,80,000	3,60,000	7,20,000	12,60,000
Excess credit in partners account	(30,000)	(60,000)	(1,20,000)	(2,10,000)
By recovering the extra amount paid, the share of profits will increase and it will be credited in the ratio of 2:3:5	42,000	63,000	105,000	2,10,000
Net effect	12,000	3,000	(15,000)	-

The necessary journal entry will be:

Particulars	Debit (₹)	Credit (₹)
C's Current A/c	15,000	
To A's Current A/c		12,000
To B's Current A/c		3,000
(Interest less charged now rectified)		

1.4 POWERS OF PARTNERS

Partners possess the authority to make decisions in specific matters while lacking such powers in others.

Unless a contrary public notice is given, contracts initiated by a partner on behalf of the partnership, without consultation with other partners, are legally binding on the firm, subject to the relevant provisions of the Act.

For trading firms, the implied powers of partners are as follows:

- Buying and selling goods.
- Receiving payments on behalf of the firm and providing valid receipts.
- Issuing cheques and endorsing bills of exchange and promissory notes in the firm's name.
- Borrowing money for the firm, with or without pledging inventories.
- Employing staff for the firm's business.

However, there are instances where an individual partner lacks the authority to bind the firm, meaning third parties cannot bind the firm unless all partners agree.

Such cases include:

- (a) Submitting a dispute concerning the firm to arbitration.
- (b) Opening a bank account in a partner's name on behalf of the firm.
- (c) Compromising or relinquishing any claim on behalf of the firm.
- (d) Withdrawing a suit or proceeding filed on behalf of the firm.
- (e) Admitting liability in a suit or proceedings against the firm.
- (f) Acquiring immovable property owned by the firm.
- (g) Entering into partnerships on behalf of the firm.

It is crucial to note that the rights, duties, and powers of partners can be altered through mutual consent.

1.5 ACCOUNTS

The Partnership Act does not prescribe a specific format for preparing accounts of a Partnership Firm, and therefore, accounts are structured in accordance with basic accounting principles. The accounting structure for a partnership firm closely resembles that of a sole proprietorship, provided there is no alteration in the firm itself.

The primary distinction lies in the presence of multiple Capital Accounts, corresponding to the number of partners.

For instance, if there are three partners (A, B, and C), each partner will have a dedicated Capital Account, credited with the capital contributed by them individually.

When a partner withdraws funds from the firm for personal use, the approach involves either debiting the partner's Capital Account or creating a distinct account known as the Drawings Account in the partner's name, which is then debited.

In the Trial Balance of a partnership firm, one may encounter both Capital Accounts and Drawings Accounts. Ultimately, the Drawings Account of a partner may be transferred to their Capital Account, consolidating the figures.

1.6 PROFIT AND LOSS APPROPRIATION

In the course of conducting business, a partnership firm routinely prepares a Trading Account and a Profit and Loss Account at the close of each fiscal year. The final accounts of a sole proprietorship closely align with those of a partnership firm. The Profit and Loss Account elucidates the firm's earned profit or incurred loss. This financial outcome is subsequently transferred to the Capital Accounts of partners in accordance with the clause in the Partnership Deed or as per the provisions of the Indian Partnership Act (in the absence of a Partnership Deed or if it remains silent on specific matters).

For instance, if the Profit and Loss Account reveals a profit of ₹90,000 and there are two

partners, A and B, without a Partnership Deed, the profit would be divided equally between them, irrespective of the variations in their contributions. However, if the Partnership Deed specifies a salary for A and interest on capital, the profit must first accommodate A's salary deduction and interest on the Capital Accounts of both partners before being equally divided. Additionally, if the Partnership Deed designates a specific profit-sharing ratio, such as three-fourths to A and one-fourth to B, that ratio governs the distribution.

In the context of partnership accounting, the division of profit among partners, following necessary adjustments stated in the partnership deed like

- (a) Interest on capitals,
- (b) Interest on drawings,
- (c) Salaries, or commissions to partners etc

This account, termed the Profit and Loss Appropriation Account, is prepared by transferring net profit from the debit side of the Profit and Loss Account to its credit side.

Before the profit is distributed among partners, these adjustments are recorded in the Profit and Loss Appropriation Account.

To illustrate, if a partner is entitled to a salary, the Profit and Loss Appropriation Account will be debited, while the Partner's Capital Account will be credited. Similarly, if interest is to be allocated on capital, the Profit and Loss Appropriation Account will be debited, and the respective Capital Accounts will be credited.

1.7 FIXED AND FLUCTUATING CAPITAL

In the example provided earlier, it is observed that A's Capital Account has undergone a change from ₹30,000 at the beginning to ₹33,800, while B's Capital Account has transitioned from ₹20,000 to ₹23,200. This alteration is a result of recording entries related to interest, salary, profits earned during the year, and withdrawals by the partners directly in the Capital Account itself. When Capital Accounts are prepared using this method, they are considered fluctuating. However, certain firms opt to maintain the Capital Accounts of partners at the original figures without incorporating entries for interest, salary, profit, and withdrawals. Instead, a separate account is established for these transactions, commonly known as the Current Account or Drawings Account. In this approach, if interest on capital is permitted, it is computed solely on the fixed capital amount. When Capital Accounts are prepared following this method, they are classified as fixed.

So, there are 2 methods of accounting –

- (i) Fixed capital method and
- (ii) Fluctuating capital method.

In Fixed capital method, Typically, the initial capital contributions made by partners are recorded as credits in their respective capital accounts. All subsequent transactions and

events are then managed through current accounts. Unless a deliberate decision is made to alter this practice, the initial balance in the capital accounts remains unchanged.

In Fluctuating capital method, In this system, there is no utilization of a current account; instead, all transactions and events are processed directly through the capital accounts. Consequently, the capital account balances of the partners experience fluctuations with each occurrence. In contrast, the fixed capital method adheres to maintaining a consistent capital balance over a specified period, while the fluctuating capital method witnesses continual variations in the capital account balances.

1.7.1 Interest on Capital:

A partner does not inherently have the right to receive interest on their capital.

However, if an agreement stipulates that a partner is entitled to interest on their capital, such interest is disbursed at the agreed-upon rate, funded exclusively from profits. Typically, interest on capital is computed based on the opening balance, factoring in any capital additions or withdrawals during the accounting period.

The calculated interest amount is debited to the interest on capital accounts and credited either to the capital accounts (in the case of fluctuating capitals) or the current accounts (in the case of fixed capitals). Subsequently, the interest on capital account is closed by transferring it to the profit and loss appropriation account.

Alternatively, the partner's relevant capital (or current) account can be credited, with a corresponding debit to the profit and loss appropriation account.

Interest on capital- Journal Entry-

Profit and Loss Appropriation Account	Dr.
To (Individual) Capital (or Current) Accounts of Partners	

Interest is commonly granted on the partners' capital, calculated based on the duration for which the capital amount has been utilized in the business. Typically, interest is computed for the entire year on the opening balance of the capital unless there is an injection of fresh capital during the year. In such cases, interest is calculated on the additional capital introduced for the relevant period of utilization.

For instance, let's consider A, who begins the year with a capital of ₹30,000 and introduces an additional ₹10,000 during the year. Assuming an annual interest rate on capital of 20%, the interest on A's capital is determined as follows:

$$30,000 \times 20/100 + 10,000 \times 20/100 \times 6/12 = \text{Rs } 6,000 + \text{Rs } 1,000 = \text{Rs } 7,000$$

For fixed capital accounts, interest computation is limited to the balance within the capital accounts, and there is no obligation for interest on the balance within current accounts.

Regarding net loss and interest on capital: Unless specified otherwise in the partnership agreement, interest on capital is allocated exclusively from profits. Consequently, in the event of a loss, no provision is made for interest. However, when profits are insufficient (i.e., net profit falls short of covering the interest on capital), the available profit is distributed based

on the capital ratio, as partners derive profit through interest on capital exclusively.

Question

Shilpa and Sanju are partners with a capital of 1,00,000 and 1,60,000 on January 1, 2022 respectively. Shilpa introduced additional capital of 30,000 on July 1, 2022 and another 20,000 on October 31, 2022. Calculate interest on capital for the year ending 2022. The rate of interest is 9% p.a. (ICAI Study Material)

Solution

Interest on Capital (Shilpa):

$$\text{On 1,00,000 for 12 month @ 9\%} = 1,00,000 \times 9/100 \times 12/12 \\ = 9,000$$

$$\text{On 30,000 for 6 month @ 9\%} = 30,000 \times 9/100 \times 6/12 \\ = \text{`1,350}$$

$$\text{On 20,000 for 2 month @ 9\%} = 20,000 \times 9/100 \times 2/12 \\ = \text{`300}$$

$$\text{Total interest on Shilpa capital} = 9,000 + 1,350 + 300 \\ = 10,650$$

By product method

Amount (₹)	Months	Product
1,00,000	12	12,00,000
30,000	6	1,80,000
20,000	2	40,000
Total product		14,20,000

Interest on capital of Sanju:

$$\text{On `1,60,000 for month @ 9\%} = 1,60,000 \times 09/100 \times 12/12 = \text{`14,400}$$

$$\text{By product method:} = 1,60,000 \times 12 = 19,20,000 \\ = 19,20,000 \times 9/100 \times 1/12 = 14,400$$

1.7.2 Interest on Drawings

Occasionally, interest is not solely granted on the capitals but is also levied on drawings. In such instances, interest is assessed based on the duration between the withdrawal of funds and the year's conclusion.

Method 1: Product Method – Applied when varying sums are withdrawn at different intervals.

Let's consider X, a partner, who has made the following withdrawals:

On 29th February, 2023 250

On 31st March, 2023 200

On 30th June, 2023 300

On 31st October, 2023 400

The financial accounts are settled annually on December 31st. An interest rate of 6% per annum is applicable to drawings. The calculation of interest on X's drawings is demonstrated below:

1.	On 250 for 10 months, i.e.	12.5
2.	On 200 for 9 months, i.e.	9
3.	On 300 for 6 months, i.e.	9
4.	On 400 for 2 months, i.e.	4
	Total	34.5

Alternatively, it can also be calculated as follows:

Amount (₹)	Number of months	Product
250	10	2500
200	9	1800
300	6	1800
400	2	800
1150		6900

Interest on 6900 for one month at 6% per annum is Rs 34.5.

If the specific dates of the withdrawals are not provided, it is advisable to calculate interest for six months on the entire amount, assuming an even distribution of withdrawals throughout the year. Using the example above, with total drawings amounting to Rs 1150 and an interest rate of 6% for 6 months, the interest is computed as 34.5. The entry to document interest on drawings involves debiting the Capital Account of the relevant partner (or their Current Account if the capital is fixed) and crediting the Profit and Loss Appropriation Account.

In scenarios where withdrawals occur evenly at the beginning of each month, interest can be effortlessly calculated for the entire amount over 6-1/2 months. For withdrawals at the end of each month, interest should be computed for 5-1/2 months. If withdrawals happen at the commencement of each quarter, interest can be determined using the formula: Total drawings × Rate × 100 × 7.5/12. However, for withdrawals at the end of each quarter, the formula: Total drawings × Rate × 100 × 4.5/12 is applicable.

1.8 Guarantee of Minimum Profit

In certain scenarios outlined by the partnership agreement, a partner may be entitled to a minimum guaranteed profit for a given year. If the partner's share exceeds the guaranteed profit, the profit allocation is executed in the usual manner. However, if the partner's share falls below the guaranteed amount, they receive the minimum guaranteed profit, and the surplus of the guaranteed profit over the actual share is collectively shouldered by the other partners according to the agreement.

There are three potential scenarios regarding the distribution of the deficiency by other partners:

- The excess is paid by a specific remaining partner.
- The excess is distributed among at least two or all partners based on an agreed ratio.
- The excess is shared by the remaining partners in their agreed-upon mutual profit-sharing ratio.

In cases where the agreement is silent about the nature of the guarantee, the remaining partners bear the burden of the guarantee in their mutually agreed profit-sharing ratio.

1.8.1 Capital ratio

Partners have the option to mutually decide on sharing profits and losses based on their capital ratios. In situations where capitals are static, the profit-sharing follows the ratio of the specified capitals. However, when capitals are subject to fluctuations due to partners introducing or withdrawing capital throughout the year, the ratio is determined based on the time-weighted average method.

Example

A and B formed a partnership with a capital contribution of ₹50,000 and ₹30,000 respectively on 1st January 2022. The profits were to be shared in the capital ratio. Calculate the capital ratio on the basis of following details:

	Capital Introduced		Capital Withdrawn	
	A (₹)	B (₹)	A (₹)	B (₹)
31 March	5,000	—	—	2,000
1 July	—	9,000	3,000	—
1 September	5,500	—	—	1,000
1 November	—	4,000	4,500	—

(ICAI Study Material)

Answer

Total Capital Employed by A for one Month

Capital (₹)	Months for which capital has been used in the business	Product (₹)
50,000	3	1,50,000
55,000	3	1,65,000
52,000	2	1,04,000
57,500	2	1,15,000
53,000	2	1,06,000
Total		6,40,000

Total Capital Employed by B for one Month

Capital (₹)	Months for which capital has been used in the business	Product (₹)
30,000	3	90,000
28,000	3	84,000
37,000	2	74,000
36,000	2	72,000
40,000	2	80,000
Total		4,00,000

On the basis of products of both the partners, the capital ratio between A and B is 64: 40 or 8 : 5.

1.9 LIMITED LIABILITY PARTNERSHIP

The Indian Partnership Act of 1932 establishes a conventional form of partnership with inherent drawbacks, notably the unlimited liability of all partners for business debts and legal consequences.

This liability is irrespective of their ownership or profit-sharing ratios, given that the firm lacks legal entity status. General partners also face joint and several liability for the wrong acts of co-partners, and in the event of liquidation, personal assets of partners can be utilized to meet the firm's obligations.

Recognizing the need for a corporate structure that offers an alternative to the traditional partnership's unlimited personal liability and the statute-based governance of a limited liability company, the Limited Liability Partnership (LLP) Act of 2008 was introduced.

The LLP, provides the benefits of limited liability while allowing members the flexibility to organize their internal structure based on mutual agreements.

The LLP operates as a separate legal entity and is liable to the extent of its assets in LLP, with partner liability limited to their agreed contributions, whether tangible or intangible.

Partners are not personally liable for the independent or unauthorized actions of others, except in cases of intentional fraud or misconduct, where liabilities become unlimited for debts or other obligations.

One of the primary advantages of an LLP is its taxation as a partnership, coupled with the benefits of corporate status and limited liability. However, challenges include the public disclosure of financial statements, absence of an option for equity investments, and extensive penal provisions for non-compliance.

The introduction of Limited Liability Partnerships (LLPs) in India occurred through the Limited Liability Partnership Act, 2008, with subsequent amendments made by the LLP (Amendment) Act, 2021, under the Ministry of Law and Justice.

1.9.1 Definition of LLP

In Section 2 of the Limited Liability Partnership (LLPs) Act, 2008, a “limited liability partnership” is defined as a partnership that is formed and registered under this Act.

Additionally, a “limited liability partnership agreement” refers to any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners. This agreement outlines the mutual rights and duties of the partners, as well as partner rights and duties in relation to that LLP (as a separate legal entity)

Furthermore,

“Small limited liability partnership (LLP)” is partnership that meets the following criteria:

- (i) The capital contribution of which does not exceed twenty-five lakh rupees (25L) or such higher amount, not exceeding five crore rupees (5 Cr), as may be prescribed.
- (ii) The turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees (40L) or such higher amount, not exceeding fifty crore rupees (50 Cr), as may be prescribed.

Nature of Limited Liability Partnership

- (1) The Limited Liability Partnership (LLP) is a corporate entity established and incorporated in accordance with this LLP Act, possessing a distinct separate legal identity independent of its partners.
- (2) The LLP enjoys perpetual succession, ensuring its continuous existence.
- (3) Modifications in the composition of partners within an LLP should not impact the ongoing existence, rights, or liabilities of the limited liability partnership.

Non-applicability of the Indian Partnership Act, 1932

Unless stated otherwise, the regulations outlined in the Indian Partnership Act, 1932, do not apply to a limited liability partnership.

Minimum number of partners in case of LLP

As per the LLP Act, any individual or corporate entity is eligible to be a partner in a limited liability partnership.

However, certain restrictions apply to individuals, preventing them from becoming a partner if:

- (a) They have been declared of unsound mind by a Court of competent jurisdiction, and the declaration is currently in force.
- (b) They are an undischarged insolvent. (That means discharged insolvent can become partner)
- (c) They have applied for insolvency adjudication, and the application is pending.

Every limited liability partnership (LLP) must have a minimum of two partners. If, at any point, the number of partners falls below two, and the limited liability partnership (LLP) continues its operations for more than six months under such conditions, the individual who becomes the sole partner during this period, with the knowledge that the business is being conducted solely by them, will be personally liable for the obligations incurred by the limited liability partnership during that time frame.

Designated partners

As per Section 7 of the LLP Act, each limited liability partnership must have a minimum of two designated partners, both of whom must be individuals.

Furthermore, at least one of these designated partners must be a resident in India. However, if all the partners in a limited liability partnership are corporate bodies, or if the partners include both individuals and corporate bodies, the requirement is that at least two individuals, either partners or nominees of the corporate bodies, act as designated partners.

For the purpose of this section, the term “resident in India” refers to an individual who has spent not less than 120 days in India during the immediately preceding one year.

In accordance with the Act:

- (1) If the incorporation document specifies designated partners, those individuals should assume the role upon incorporation. Alternatively, if the document states that every partner, from time to time, is to be a designated partner, each partner will hold the designation.
- (2) Any partner may assume or cease to be a designated partner based on the terms outlined in the limited liability partnership agreement.
- (3) An individual can only become a designated partner in a limited liability partnership after providing prior consent in the prescribed form and manner.
- (4) Every limited liability partnership (LLP) is required to submit, within thirty days (30 Days) of appointment, the details of every individual who has given consent to act as a designated partner, in the manner prescribed, to the registrar.
- (5) Individuals eligible to be designated partners must comply with the conditions and requirements as prescribed by law.

Liabilities of designated partners

As outlined by the LLP Act, unless expressly mentioned otherwise:

- (a) A designated partner is obligated to oversee the execution of all essential acts, matters, and tasks vital for the limited liability partnership's adherence to the provisions of this Act. This includes the submission of specified documents, returns, statements, and reports as outlined in the limited liability partnership agreement.
- (b) The designated partner is accountable for any penalties imposed on the limited liability partnership in case of violations of these provisions.

Limitation of Liability of an LLP and its partners

In accordance with the LLP Act, 2008, any obligation arising from a contract or otherwise for an LLP is exclusively the responsibility of the LLP itself. • The liabilities of an LLP must be satisfied using the assets owned by the LLP. •

A partner is not personally, directly, or indirectly liable for an obligation mentioned above solely due to their status as a partner in the LLP. •

An LLP is not bound by actions taken by a partner in interactions with a third party if:

(i.e. in these scenarios partner will be liable to compensate to third parties no obligation on LLP

- The partner lacks the authority to act on behalf of the LLP for a specific action and
- other party is aware that the partner lacks authority or is unaware or does not believe them to be a partner in the LLP.

The LLP and partners involved in fraudulent activities will bear unlimited liability for all or any debts or other liabilities of the LLP.

However, if such actions are carried out by a partner, the LLP is liable to the same extent as the partner unless the LLP can demonstrate that the act occurred without its knowledge or authorization. • The LLP is liable if a partner is accountable to any person due to wrongful acts or omissions within the scope of the LLP's business or with the partner's authorization.

Financial Disclosures & Returns

- Each LLP is obligated to maintain accurate books of accounts, as per the prescribed standards, detailing its activities for every year of its existence. These accounts should follow either a cash or accrual basis and comply with the double-entry system of accounting. The LLP is required to keep these records at its registered office for the specified duration.
- Within six months of the conclusion of each financial year (i.e. on or before 30th sept.), an LLP must compile a Statement of Account and Solvency for that period, as of the last day of the financial year, in the format prescribed. It is mandatory for every LLP to submit the Statement of Account and Solvency to the Registrar signed by designated partners of the LLP accompanied by the specified fee.
- The accounts of an LLP must undergo an audit in accordance with the rules as prescribed. However, the CG reserves the right to exempt specific classes of limited liability partnerships from this requirement, as notified in the Official Gazette.

1.10 DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Basis	LLP	Partnership firm
1.	Act	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	Body corporate	Yes	No
3.	Separate legal entity in eyes of law	LLP is a legal entity which is separate from its partners.	It is a group of partners and it is not a separate legal entity.
4.	Creation	To form an LLP it is registered under the LLP Act, 2008.	To form a partnership an agreement is done between the partners.
5.	Power	LLP can sue others and can be sued in its own name.	The partnership firm which is registered can sue the 3rd parties.
6.	Perpetual succession	The perpetuity of an LLP remains unaffected by events such as the death, insanity, retirement, or insolvency of its partner(s). While members have the flexibility to join or depart, the existence of the LLP endures indefinitely.	The perpetual existence of the LLP might be impacted by events such as the death, insanity, retirement, or insolvency of its partner(s). Unlike entities with perpetual succession, an LLP does not possess this characteristic.
7.	Name	The name of the LLP must incorporate the term "limited liability partners (LLP)" as a suffix.	No such guidelines. Any name can be chosen by partnership.
8.	Liability	The liability of each partner is restricted to the extent of their agreed contribution, except in situations involving deliberate fraud.	The liability of each partner is not capped; it can extend to their personal assets.
9.	Mutual agency	Each partner has the authority to legally obligate the LLP through their own actions, but this authority does not extend to other partners.	Every partner has the ability to legally commit the firm and other partners through their individual actions.
10.	Designated partners	A minimum of two designated partners is required, with at least one of them being a resident in India.	The Partnership Act of 1932 does not include any provisions for partners of this nature.

11.	Number of Partners	Minimum 2 partners but no maximum limit	Minimum 2 partners and maximum 50 partners.
12.	Legal compliances	The designated partners bear sole responsibility for adhering to all compliance requirements and facing penalties as outlined in this Act.	Every partner is accountable for adhering to all compliance obligations and facing penalties under the Act.
13.	Foreign partnership	Individuals from foreign countries are eligible to be partners in an LLP.	Individuals from foreign countries are not permitted to be partners in a partnership firm.
14.	Minor as partner	Admission of minors to the advantages of the LLP is not allowed.	Admitting a minor to the advantages of the partnership requires the prior consent of the existing partners.

True and False

1. In absence of any agreement partners share profits of the business in the ratio of their capital contribution. (ICAI Study Material)
- Sol.** False, Without a specific agreement, partners divide profits equally rather than based on their capital contributions
2. Profit sharing ratio and capital contribution ratio need not be same. (ICAI Study Material)
- Sol.** True, Profit distribution may not align with individual capital contributions. It's not necessary for a partner contributing more capital to receive a higher profit-sharing ratio and vice versa.
3. Every partnership firm must register itself with Registrar of firms. (ICAI Study Material)
- Sol.** False, Registration of firms is not a mandatory requirement according to the Indian Partnership Act, 1932
4. A partner can advance loan to the partnership firm in addition to capital contributed by him. (ICAI Study Material)
- Sol.** True, In the absence of a partnership deed, interest on loans to partners should be paid at a rate of 6% per annum
5. A partner can demand interest on capital even if it is not provided in the partnership deed. (ICAI Study Material)
- Sol.** False, Interest on capital is not restricted to the provisions of the partnership deed
6. If a partner does not take part in day to day business activities of the firm then he is not entitled to any share of profit. (ICAI Study Material)
- Sol.** False, Partners are entitled to their share of profits even if they don't actively participate in the business

7. Interest should be paid @ 6% p.a. on partners' loan even if it is not provided in the partnership deed. (ICAI Study Material)
- Sol. False, Without a partnership deed, a partner's loan to the firm incurs interest at a rate of 6% per annum.
8. Husband and wife cannot be partners in the same firm. (ICAI Study Material)
- Sol. False, Husband and wife are allowed to be partners in the same firm.
9. One senior partner is Principal and other partners are his agents. (ICAI Study Material)
- Sol. False,; There is no distinction between senior and junior partners; each partner acts as both agent and principal to other partners.
10. Partners are the agents of the firm and each other. (ICAI Study Material)
- Sol. True, The concept of agency applies to every partner and the firm, making each partner both a principal and agent to every other partner and to the firm.

MULTIPLE CHOICE QUESTIONS

1. If a firm prefers Partners' Capital Accounts to be shown at the amount introduced by the partners as capital in firm then entries for salary, interest, drawings, interest on capital and drawings and profits are made in (ICAI Study Material)
- (a) Trading Account
 - (b) Profit and Loss Account
 - (c) Partners' Current Account
 - (d) None of the above
- Sol. (c)
2. In the absence of any agreement, partners are liable to receive interest on their Loans @ (ICAI Study Material)
- (a) 12% p.a.
 - (b) 10% p.a.
 - (c) 6% p.a.
 - (d) None of the above
- Sol. (c)
3. The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as (ICAI Study Material)
- (a) Partnership.
 - (b) Joint Venture.
 - (c) Association of Persons.
 - (d) None of the above

Sol. (a)

4. Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in

(ICAI Study Material)

- (a) Profit sharing of the partners.
- (b) Calculation of the goodwill.
- (c) Both.
- (d) None of the above

Sol. (b)

5. In the absence of an agreement, partners are entitled to

(ICAI Study Material)

- (a) Interest on Loan and Advances.
- (b) Commission.
- (c) Salary.
- (d) None of the above

Sol. (a)

6. Partners are supposed to pay interest on drawings only when by the

(ICAI Study Material)

- (a) Provided, Agreement.
- (b) Agreed, Partners
- (c) Both (a) & (b) above.
- (d) None of the above

Sol. (c)

7. When a partner is given a guarantee by the other partner, loss on such guarantee will be borne by

(ICAI Study Material)

- (a) Partner who gave the guarantee
- (b) All the other partners.
- (c) Partnership firm.
- (d) None of the above

Sol. (a)

8. A, B and C had capitals of ` 50,000; ` 40,000 and ` 30,000 respectively for carrying on business in partnership. The firm's reported profit for the year was ` 80,000. As per provisions of the Indian Partnership Act, 1932, find out the share of each partner in the above amount after taking into account that no interest has been provided on an advance by A of ` 20,000, in addition to his capital contribution. (ICAI Study Material)

- (a) ` 26,267 for Partner B and C & ` 27,466 for partner A.
- (b) ` 26,667 each partner.
- (c) ` 33,333 for A, ` 26,667 for B and ` 20,000 for C.

(d) None of the above

Sol. (a)

9. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and X wanted interest on capital @ 20% as his capital contributions was ₹ 1,00,000 as compared to that of Y and Z which was ₹ 75,000 and ₹ 50,000 respectively.

(ICAI Study Material)

- (a) Profits of ₹ 6,000 will be distributed equally with no interest on either Capital.
(b) X will get the interest of ₹ 20,000 and the loss of ₹ 14,000 will be shared equally.
(c) All the partners will get interest on capital and the loss of ₹ 39,000 will be shared equally.
(d) None of the above

Sol. (a)

10. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Y determined interest @ 24% p.a. on his loan of ₹ 80,000. There was no agreement on this point.

(ICAI Study Material)

Calculate the amount payable to X, Y and Z respectively.

- (a) ₹ 2,000 to each partner.
(b) Loss of ₹ 4,400 for X and Z & Y will take home ₹ 14,800.
(c) ₹ 400 for X, ₹ 5,200 for Y and ₹ 400 for Z.
(d) None of the above

Sol. (c)

11. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Z demanded minimum profit of ₹ 5,000 as his financial position was not good. However, there was no written agreement. Profits to be distributed to X, Y and Z will be

(ICAI Study Material)

- (a) Other partners will pay Z the minimum profit and will suffer loss equally.
(b) Other partners will pay Z the minimum profit and will suffer loss in capital ratio.
(c) ₹ 2,000 to each of the partners.
(d) None of the above

Sol. (c)

THEORY QUESTIONS

1. Write short notes on:

- (a) Features of Partnership
(b) Powers of Partners

Sol. (a) The essential characteristics defining a partnership include the following:

- (i) **Agreement Basis:** Partnership arises from a contractual agreement, emphasizing that the partnership is formed through a mutual understanding, not by inherent status.
 - (ii) **Business Focus:** Partnerships are exclusive to business activities, existing only within a business context.
 - (iii) **Profit Sharing:** The individuals involved must explicitly agree to distribute the profits generated by the business among themselves.
 - (iv) **Mutual Agency:** The business operations are conducted by any or all of the partners on behalf of the entire group. When a person conducts business not just for themselves but also for others, establishing a relationship where they act as both principals and agents, they are considered partners.
- (b) In terms of powers granted to partners, they include:
- (i) Facilitating the buying and selling of goods;
 - (ii) Handling receipts on behalf of the firm and issuing valid receipts;
 - (iii) Managing financial instruments such as drawing cheques, and endorsing bills of exchange and promissory notes in the firm's name;
 - (iv) Securing loans for the firm, with or without using the firm's inventories as collateral;
 - (v) Employing staff for the firm's business operations.

2. Distinguish between fixed capital and fluctuating capital.

Sol. In the fixed capital approach, the primary capital contributions of partners are typically recorded in their respective capital accounts. Subsequent transactions and events are managed through current accounts, unless a deliberate decision is made to alter this practice. The initial balance in the capital account remains unchanged unless a specific decision is made to modify it.

Conversely, the fluctuating capital method operates without the use of current accounts. All transactions and events are directly recorded in capital accounts, resulting in constant fluctuations in the partners' capital account balances. Therefore, the fixed capital method maintains a stable capital balance over time, while the fluctuating capital method sees continual changes in capital account balances.

2.1 GOODWILL

Goodwill in business refers to the intangible value associated with a firm's reputation (i.e. Intangible Asset), representing the anticipation of future profits exceeding the standard rate.

To put it simply, it reflects the likelihood that previous customers will continue patronizing the business. Despite being intangible and imperceptible, goodwill holds significant substance. While it lacks physical presence, its accounting recognition necessitates a measurable or marketable value.

Valuation of goodwill (self-generated) becomes imperative in specific scenarios:

- (a) Change in PSR
- (b) Admission of a new partner,
- (c) Retirement or death of a partner,
- (d) and the dis Sol. (if any of the partner will be using firm name after dis Sol.) or sale of the business.

Example:

A small business owned by a firm with a net worth of 120,000 (assets minus liabilities). If a buyer is willing to pay 135,000, the additional ₹15,000 is classified as goodwill in accounting.

Reason behind this payment (i.e. Rs.15000) might be the business's future potential to generate profits surpassing the normal profit, which may be possibly attributable to a favorable location or other favorable factors.

Several factors significantly influence the valuation of goodwill, and while the following list is not exhaustive, it provides fundamental criteria for consideration:

- (i) Quality of the goods sold.
- (ii) Personal reputation of the owners, including their ability to attract customers.
- (iii) Location of the business premises, such as a prime position in a crowded market.
- (iv) Possession of near-monopoly rights, like being the main agent for specific vehicles such as Maruti cars or Bajaj scooters.

- (v) Ownership of trademarks and patents.
- (vi) Presence of managerial skills.
- (vii) Cost of research and development, facilitating cost-effective production of high-quality goods.
- (viii) Possession of special contracts ensuring the availability of materials.

RECOMMENDATION OF ACCOUNTING STANDARD

Accounting Standards mandate the recognition of an intangible asset by an enterprise only under specific conditions, which include:

- (i) The intangible asset must exhibit the characteristics of an asset, possessing clear value and identifiability, allowing it to be sold independently without disposing of other assets or their future benefits.
- (ii) Recognition of an intangible asset is contingent on the assurance that future economic benefits, such as increased revenue from sales, etc. This necessitates management's ability to make reasonable estimates of future benefits.
- (iii) The cost of the intangible asset must be reliably measurable, ensuring objective verifiability. If the cost cannot be measured reliably, it cannot be acknowledged as an asset.

Internally generated (i.e. self-generated) goodwill fails to meet any of these conditions hence not recorded in Book of Account.

Reasons:

- (a) Assessing its future benefits proves challenging, and
- (b) the cost of internally generated goodwill cannot be reliably measured without any consideration in money or money's worth
- (c) lacking documentary evidence to support its value as a resource.

Goodwill should only be recorded in the books when a consideration in money or money's worth has been exchanged for it.

Therefore, during events such as the admission, retirement, death of a partner, or changes in profit-sharing ratios among existing partners, goodwill should not be recorded in the partnership firm's accounts if no consideration in money or money's worth has been paid for it.

Purchased goodwill, whether paid in cash or money's worth, is the only type valid for recording in the books.

For instance, if 'A' and 'B' purchase the net assets of 'C' for 2,00,000 in cash, with a 25,000 additional payment for goodwill, it qualifies as purchased goodwill and can be recorded in the books.

Conversely, internally generated or inherent goodwill, without any payment, cannot be recorded as per Accounting Standards. In cases of reconstitution due to admission, retirement, death of a partner, or changes in profit-sharing ratios, the value of goodwill should not be brought into the books, and adjustments should be made through the capital accounts of the

partner(s).

Goodwill, whether internally generated or purchased, is subject to gradual write-off over time. If the goodwill account exists at the time of a firm's reconstitution, it should be promptly written off, irrespective of its origin, whether internally generated or purchased for consideration.

2.2 METHODS FOR GOODWILL VALUATION (Self-Generated)

There are 3 methods for the valuation of goodwill

1. Average profit method, - (Simple as well as Weighted average method)
2. Super profit method- (Number of Years Purchase, Annuity basis, and Capitalization of Super Profit)
3. Capitalization basis- Average Profits

2.3 NEED FOR VALUATION OF GOODWILL

Whenever there is a modification in the existing partnership dynamics, some partners are required to sacrifice their prospective profits while others stand to gain. It becomes necessary to compensate those sacrificing future profits by those benefiting from the change.

This adjustment of partnership rights may arise due to various circumstances –

- (a) Change in Profit Sharing Ratio
- (b) Admission of a new partner
- (c) Retirement or Death of a partner, or the dissolution of the partnership.

Partners who experience gain in their profit-sharing ratio are obligated to contribute proportionately to the value of goodwill to offset their gain. Conversely, partners who undergo a reduction in their profit-sharing ratio receive compensation for their sacrifice in proportion to the value of goodwill.

True and False

1. Goodwill is intangible asset therefore it cannot be valued. (ICAI Study Material)

Sol. False, Goodwill, despite being intangible, is assessable in terms of monetary value.

2. Goodwill is valued whenever there is change in the profit-sharing ratio among the partners. (ICAI Study Material)

Sol. True, Valuation of goodwill is necessary whenever there is a reorganization.

3. Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits. (ICAI Study Material)

Sol. True, Goodwill represents the firm's market brand, providing it with a competitive edge over other market player

4. At the time of admission or retirement of a partner, goodwill can be raised in the

books of accounts and shown as an asset.

(ICAI Study Material)

Sol. False, during a partner's admission or retirement, goodwill is not typically raised in the partnership firm's books unless a monetary or equivalent consideration has been provided.

5. Only simple average method can be used for valuation of goodwill. (ICAI Study Material)

Sol. False, Various methods, such as the weighted average profit method, capitalization method, and super profits method, can be employed for the valuation of goodwill

6. Super profit means excess of actual average profit over normal profit.

(ICAI Study Material)

Sol. – True, Super profit denotes the surplus profit that a firm can generate beyond the normal profit commonly earned by similar firms in comparable circumstances

7. Normal profit means profit earned by similar companies in the same industry.

(ICAI Study Material)

Sol. True, the rate of return is calculated as an industry average, applied to the capital employed in the relevant firm.

8. Normal profit depends upon Normal Rate of Return and past profits.

(ICAI Study Material)

Sol. False, Normal profit relies on the normal rate of return & capital employed and is not solely based on past profits.

9. At the time of admission/retirement of a partner, since goodwill cannot be raised in the books of accounts is recorded through capital accounts of the partners.

(ICAI Study Material)

Sol. True, Generally, goodwill at the time of admission is adjusted through the capital accounts and may not be explicitly shown in the firm's books

10. At the time of admission of a partner, goodwill brought in by the new partner is shared equally by old partners. (ICAI Study Material)

Sol. False, Goodwill brought in by a new partner is shared by old partners in the sacrificing ratio, not equally.

11. Goodwill is considered a notional or intangible asset.

Sol. True: Goodwill is categorized as an intangible asset

12. Goodwill is characterized as a personal account in its nature.

Sol. False: Although intangible, goodwill is considered to have the nature of a real account

MULTIPLE CHOICE QUESTIONS

1. Goodwill brought in by incoming partner in cash for joining in a partnership firm is taken away by the old partners in their.....ratio. (ICAI Study Material)

(a) Capital (b) New Profit Sharing.
(c) Sacrificing. (d) None of the above

Sol. (c)

2. A & B are partners sharing profits and losses in the ratio 5:3. On admission, C brings ₹ 70,000 cash and ₹ 48,000 against goodwill. New profit sharing ratio between A, B and C are 7:5:4. Find the sacrificing ratio of A:B. (ICAI Study Material)

(a) 3:1. (b) 4:7.
(c) 5:4. (d) None of the above

Sol. (a)

3. Following are the factors affecting goodwill except: (ICAI Study Material)

(a) Nature of business. (b) Efficiency of management.
(c) Location of the customers. (d) None of the above

Sol. (c)

4. Weighted average method of calculating goodwill should be followed when:

(ICAI Study Material)

(a) Profits has increasing trend.
(b) Profits has decreasing trend.
(c) Either 'a' or 'b'.
(d) None of the above

Sol. (c)

5. In the absence of any provision in the partnership agreement, profits and losses are shared (ICAI Study Material)

(a) In the ratio of capitals.
(b) Equally.
(c) In the ratio of loans given by them to the partnership firm.
(d) None of the above

Sol. (b)

6. The profits and losses for the last 4 years are 2018-19 Losses ₹ 10,000; 2019-20 Losses ₹ 2,500; 2020-21 Profits ₹ 98,000 & 2021-22 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%.

The remuneration of partners is estimated to be ₹ 1,000 per month not charged in the above losses/profits. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years. (ICAI Study Material)

- (a) ₹ 9,000.
- (b) ₹ 8,750.
- (c) ₹ 8,250
- (d) None of the above

Sol. (b)

7. A, B and C are partners sharing profits and losses in the ratio 3:2:1. They decide to change their profit-sharing ratio to 2:2:1. To give effect to this new profit-sharing ratio they decide to value the goodwill at ₹ 30,000. Pass the necessary journal entry if Goodwill not appearing in the old balance sheet and should not appear in the new balance sheet. (ICAI Study Material)

- (a) B's Capital Account Dr. ₹ 2,000
C's Capital Account Dr. ₹ 1,000
To A's Capital Account ₹ 3,000
- (b) Goodwill Account Dr. ₹ 30,000
To A's Capital Account ₹ 15,000
To B's Capital Account ₹ 10,000
To C's Capital Account ₹ 5,000
- (c) A's Capital Account Dr. ₹ 12,000
B's Capital Account Dr. ₹ 12,000
C's Capital Account Dr. ₹ 6,000
To Goodwill Account ₹ 30,000
- (d) None of the above

Sol. (a)

THEORY QUESTIONS

1. Write short note on methods for valuation of goodwill.

(ICAI Study Material)

Sol.

There are three methods for valuation of goodwill

- (i) Average profit method – Simple and Weighted
- (ii) Super profit method – No. of Year Purchase, Annuity basis, Capitalization of Super Profit

(iii) Capitalization method

2. Explain Accounting treatment of goodwill in case of change in profit sharing ratio. Distinguish between Super profit basis and Capitalization Basis. (ICAI Study Material)

Sol. When there is a modification in the profit-sharing ratio, it is essential to assess the value of goodwill. Ideally, this valuation should be reflected and adjusted in the capital accounts of the partners, taking into account the ratio by which profits are sacrificed.

Super Profit Basis: When utilizing the average profit approach, the valuation of goodwill involves the multiplication of the average profit by a specified number of years. The formula for calculating super profit is $\text{Super Profit} = \text{Actual Profit} - \text{Normal Profit}$, where the Actual Profit is the average profit, and Normal Profit is equivalent to the Normal Rate of Return (NRR).

Capitalization Basis: In this method, the overall value of the business is ascertained by applying the normal rate of return. If the resulting value, derived from applying the normal rate of return, exceeds the capital employed in the business, the disparity represents the goodwill.



ADMISSION OF A NEW PARTNER

UNIT – 3: ADMISSION OF A NEW PARTNER

3.1 INTRODUCTION

Partners are admitted to the partnership firm with the aim of enhancing its overall performance. This admission may occur to increase the partnership's capital or to improve the firm's management.

3.2 REVALUATION ACCOUNT OR PROFIT AND LOSS ADJUSTMENT ACCOUNT

Upon the admission of a new partner to the partnership, there is a reassessment of assets and liabilities. To facilitate this process, a Revaluation Account (alternatively known as a Profit and Loss Adjustment Account) is initiated.

Within this account, reductions in asset values and increases in liabilities are debited, while increases in asset values and decreases in liabilities are credited.

The variance between the two sides of the Revaluation Account signifies either a profit or a loss. This financial outcome is subsequently transferred to the Capital Accounts of the existing partners in accordance with the established profit-sharing ratio. The necessary entries to execute this process are as follows:

1.	Revaluation A/c Dr. To Assets A/c (individually which show a decrease)	with the reduction in the value of the assets
	To the Liabilities A/c (Individually which have to be increased)	with the increase in the liabilities.
2.	Assets A/c (Individually) Dr. Liabilities A/c	with the increase in the value of the of assets.
	Dr. To Revaluation A/c	with the reduction in the amount liabilities.
3.	Revaluation A/c Dr.	with the profit in the old profit-sharing ratio

	To Capital A/cs of the old partners or Capital A/cs of the old partners	
	Dr. To Revaluation A/c	with the loss in old profit-sharing ratio.

The adjustments made through the aforementioned entries lead to alterations in the capital account balances of the existing partners. Consequently, it becomes necessary to align the assets and liabilities with their accurate values. These adjusted values will then be reflected in the Balance Sheet at revised figures.

When the revised values are not to be Recorded in the books

On occasion, all partners, including the new partner, may collectively decide to maintain the assets and liabilities at their original values, even if they agree to reassess them. To document this agreement, a Memorandum Revaluation Account is established and divided into two segments.

- (a) In the first segment, entries for the revaluation of assets and liabilities are recorded in the standard manner, as previously explained. No entries for the revaluation are made in the corresponding ledger accounts. The resulting profit or loss from this revaluation is then transferred to the capital accounts of the existing partners, adhering to the established profit and loss sharing ratio.
- (b) To maintain the double-entry system, the entries made in the first part of the Memorandum Revaluation Account are reversed in the second part, ensuring that the values of assets and liabilities remain unaltered. The balance of the second part is then transferred to the capital accounts of all partners, including the new partner, in their updated profit and loss sharing ratio. Consequently, if there is a profit in the first part, an equivalent loss is recorded in the second part. It is essential to note that the outcome of the first part is distributed among old partners based on the original profit-sharing ratio, while the outcome of the second part is distributed among all partners, including the new one, in the new profit-sharing ratio.

Alternatively, partners may mutually agree to exclude the reassessed figures from the Balance Sheet, opting to display assets and liabilities at their original values. In this scenario, a Memorandum Revaluation Account is initiated, and any increase in asset value and/or decrease in liabilities is credited to the Memorandum Revaluation Account. The corresponding journal entry would be:

Likewise, any reduction in the value of assets and/or elevation in liabilities is recorded as a debit to the Memorandum Revaluation Account. The corresponding journal entry is as follows:

Assets A/c Dr.	(with increase in the amount of individual assets)
Liabilities A/c Dr.	(With decrease in the amount of individual liabilities)
To Memorandum Revaluation A/c	

Likewise, any reduction in the value of assets and/or elevation in liabilities is recorded as a debit to the Memorandum Revaluation Account. The corresponding journal entry is as follows:

Memorandum Revaluation A/c Dr.

To Assets A/c (with increase in the amount of individual assets)

To Liabilities A/c (with decrease in the amount of individual liabilities)

If the total credits on the Memorandum Revaluation Account exceed the debits, indicating a profit, the said profit needs to be allocated to the Capital Accounts of the existing partners in accordance with the original profit-sharing ratio. The corresponding journal entry is as follows:

Memorandum Revaluation A/c Dr.

To Old Partners' Capital A/c

Following the outlined process, reverse entries are executed for adjustments related to both increases in asset values and/or decreases in liabilities, as well as decreases in asset values and/or increases in liabilities. This reversal is specifically carried out in the latter section of the Memorandum Revaluation Account. The profit from the revaluation is subsequently allocated to the Capital Accounts of all partners in accordance with the updated profit-sharing ratio:

Memorandum Revolution A/c Dr.

To All Partners' Capital A/c (New profit and loss sharing ratio)

The loss incurred through the revaluation is required to be distributed among the Capital Accounts

of all partners in accordance with the updated profit-sharing ratio. The corresponding journal entry is as follows:

All Partners' Capital A/c Dr . (New profit and loss sharing ratio) To

Memorandum Revaluation A/c

It's important to highlight that if the initial section of the Memorandum Revaluation Account indicates a profit, the subsequent section must reflect a loss. Conversely, if the first section shows a loss, the latter section should demonstrate a profit.

When crafting a Memorandum Revaluation Account, the intrinsic book values of assets and liabilities remain unaltered. Essentially, the resulting profit or loss from the revaluation is reconciled through adjustments in the Partners' Capital Accounts. This approach allows the incoming partner's capital investment to be aligned with the current fair value of the partnership, despite the fact that the recorded values of assets and liabilities in the existing partnership remain static in the accounting books.

Alternatively, if partners opt to present assets and liabilities in the balance sheet using original figures without initiating a Revaluation Account, any alterations (whether an increase or decrease) in the values of assets and liabilities can be directly accommodated through adjustments in the Partners' Capital Accounts.

i.e. Gaining Partner Capital A/c Dr

ADMISSION OF A NEW PARTNER

To Sacrificing Partner Capital A/c

3.3 RESERVES IN THE BALANCE SHEET

Upon the admission of a new partner, it is recommended to transfer any reserves or similar items listed in the Balance Sheet to the Capital Accounts of the existing partners, following the established profit-sharing ratio.

The necessary journal entry would be:

Dr: Reserves or Profit and Loss A/c

Cr: Old Partners' Capital A/c (In the old profit sharing ratio)

3.4 COMPUTATION OF NEW PROFIT SHARING RATIO

In the absence of any agreement indicating otherwise, the assumption is made that, upon the admission of a new partner, the existing partners will maintain their previous profit-sharing ratio among themselves.

Computation of New profit sharing ratio- Cases

Case I : If the allocation of the new partner's share is specified, but the question does not address the sacrifice made by the existing partners, the assumption is made that the existing partners will distribute the remaining share among themselves in accordance with their established profit-sharing ratio.

Question: A and B are partners sharing profits in the ratio 3:2. They admit C for $\frac{1}{3}$ share in future profits. Calculate the new ratio. (ICAI Study Material)

Sol. Share in Firm = 1 C's Share = $\frac{1}{3}$

Remaining Profit = $1 - \frac{1}{3} = \frac{2}{3}$

This remaining share of $\frac{2}{3}$ will be divided between A and B in the ratio of 3:2

So A's share will be = $\frac{2}{3} \times \frac{3}{5} = \frac{6}{15}$

B's share will be = $\frac{2}{3} \times \frac{2}{5} = \frac{4}{15}$

C's share will be = $\frac{1}{3} \times \frac{5}{5} = \frac{5}{15}$

New ratio will be = $\frac{6}{15} : \frac{4}{15} : \frac{5}{15} = 6:4:5$

Case II: In a scenario where a new partner acquires a share from existing partners in a specified ratio, the calculation of the new ratio for the existing partners involves deducting the proportion allotted to the new partner from the shares of the old partners.

Question: A and B are partners sharing in the ratio 3:2. They admit C as a new partner for $\frac{1}{3}$ rd share in future profits which he gets $\frac{1}{9}$ from A and $\frac{2}{9}$ from B. Calculate the new ratio. (ICAI Study Material)

Sol. A's old share = $\frac{3}{5}$; A sacrifice in favour of C is = $\frac{1}{9}$ So A's new share will be
= $\frac{3}{5} - \frac{1}{9} = \frac{22}{45}$

B's old share = $\frac{2}{5}$; B sacrifice in favour of C = $\frac{2}{9}$ So B's new share will be
= $\frac{2}{5} - \frac{2}{9} = \frac{8}{45}$

C's new share will be = $\frac{3}{9} \times \frac{5}{15} = \frac{15}{45}$ New ratio = 22: 8: 15

Case III: When the existing partners relinquish a specific fraction of their share in favor of a new partner, the process unfolds as follows:

1. Identify the portion of the share surrendered by the existing partners.
2. Determine the new share of the existing partners by subtracting the surrendered share from their original share.
3. Compute the share of the new partner by summing up the surrendered shares of the existing partners.
4. Calculate the new ratio based on the adjusted shares

Question A and B are partners sharing in the ratio 3:2. They admit C as the new partner. A surrenders $\frac{1}{3}$ rd of his share and B surrenders $\frac{2}{3}$ rd of his share in favour of C. calculate the new ratio. (ICAI Study Material)

Sol. A's old share = $\frac{3}{5}$; A surrender in favour of C = $\frac{3}{5} \times \frac{1}{3} = \frac{3}{15}$ A's new share will be= $\frac{3}{5} - \frac{3}{15} = \frac{6}{15}$

B's old share will be= $\frac{2}{5}$; B surrender in favour of C = $\frac{2}{5} \times \frac{2}{3} = \frac{4}{15}$

B's new share will be= $\frac{2}{5} - \frac{4}{15} = \frac{2}{15}$

C's share will be= $\frac{3}{15} + \frac{4}{15} = \frac{7}{15}$

New ratio = 6:2:7

Case IV: In the scenario where the new partner acquires their entire share from a specific existing partner, the calculation of the sacrificing partner's share involves subtracting their sacrifice from their original share.

Question: A and B are partners sharing in the ratio 3:2. They admit C for $\frac{1}{5}$ th share in profits which he acquires entirely from A. Calculate the new ratio. (ICAI Study Material)

Sol. A's old share = $\frac{3}{5}$; Sacrifice in favour of C = $\frac{1}{5}$ A's new share will be= $\frac{3}{5} - \frac{1}{5} = \frac{2}{5}$

B's share = $\frac{2}{5}$ C's share = $\frac{1}{5}$

New ratio will be= 2:2:1

Case V: When the new partner obtains their share from the existing partners in a specified ratio, the determination of each partner's sacrifice involves subtracting the individual sacrifices from their original shares.

Question: A and B are partners sharing profits in the ratio 3:2. C is admitted for $\frac{1}{5}$ th share which he acquires from A and B in the ratio of 2:1. Calculate the new ratio.

(ICAI Study Material)

Sol. A's old share = $\frac{3}{5}$, A's sacrifice = $\frac{1}{5} \times \frac{2}{3} = \frac{2}{15}$ A's new share will be= $\frac{3}{5} - \frac{2}{15} = \frac{7}{15}$

B's old share = $\frac{2}{5}$, B's sacrifice = $\frac{1}{5} \times \frac{1}{3} = \frac{1}{15}$ B's new share will be= $\frac{2}{5} - \frac{1}{15} = \frac{5}{15}$

C's share = $\frac{1}{5} \times \frac{3}{3} = \frac{3}{15}$

New ratio will be= 7:5:3

Sacrificing Partner: The partners whose portions have diminished due to a modification are referred to as partners making sacrifices.

Sacrificing Ratio: The ratio in which the existing partners reduce their share in support of the new partner is termed the sacrificing ratio. This ratio is computed by determining the variance between the original profit shares and the revised profit shares.

$\text{Sacrificing ratio} = (\text{Old Profit sharing ratio} - \text{New Profit sharing ratio})$

Gaining Partners: Partners who experience an increase in their shares due to a change are identified as gaining partners.

Gaining Ratio: The ratio in which partners have mutually decided to increase their shares in profits from another partner or partners is termed the gaining ratio. This ratio is determined by subtracting the original profit shares from the revised profit shares.

Question: X and Y are partners in a firm sharing profits and losses in the ratio 5:3. They admit Z into partnership. The new ratio 3:2:1. Calculate the Sacrificing Ratio.

(ICAI Study Material)

Sol. X's sacrifice = X's old share - X's new ratio = $\frac{5}{8} - \frac{3}{6} = \frac{6}{48}$ Y's sacrifice = Y's old share - Y's new ratio = $\frac{3}{8} - \frac{2}{6} = \frac{2}{48}$ Thus, sacrificing ratio = 6:2 or 3:1

Question: A, B and C are sharing profits and losses in the ratio of 5:3:2. Calculate the new profit sharing ratio and the sacrificing ratio in each of the following alternative cases:

Case (a) If C acquires $\frac{1}{10}$ th share from B

Case (b) If C acquired $\frac{1}{10}$ th share equally from A and B

Case (c) If C's share is increased by $\frac{1}{10}$ th share by acquiring from A.

Case (d) If C's share is increased to $\frac{3}{10}$ th by acquiring from B.

Case (e) if A, B and C decide to share future profits and losses in the ratio of 5:2:3.

Case (f) if A, B and C decide to share future profits and losses in the ratio of 2:3:5.

Case (g) if A, B and C decide to share future profits and losses in the ratio of 2:1:2.

Case (h) if A, B and C decide to share future profits and losses equally.

Case(i) If A, B and C decide that the future profit sharing ratio between B and C shall be the same as existing between A and B

(ICAI Study Material)

Sol.

Case (a)	A	B	C
Their existing shares	$\frac{5}{10}$	$\frac{3}{10}$	$\frac{2}{10}$
Share acquired by C from B	-	$-\frac{1}{10}$	$+\frac{1}{10}$
Their new shares	$\frac{5}{10}$	$\frac{2}{10}$	$\frac{3}{10}$

New Profit sharing ratio of A, B and C = 5 : 2 : 3 Share sacrificed by B = $\frac{1}{10}$

Case (b)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from A and B	-1/20	-1/20	+1/10
Their new shares	9/10	5/20	3/10

New Profit sharing ratio of A, B and C = 9 : 5 : 6

Sacrificing ratio of A and B = 1 : 1

Case (c)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-1/10	-	+1/10
Their new shares	4/10	3/10	3/10

New Profit sharing ratio of A, B and C = 4 : 3 : 3

Share sacrificed by A = 1/10

Share acquired by C = New Share - Old share = 3/10 - 2/10 = 1/10

Case (d)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-	-1/10	+1/10
Their new shares	5/10	2/10	3/10

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = 1/10

Case (e)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	5/10	2/10	3/10
	-	1/10	-1/10

C gains by 1/10th share and B sacrifice 1/10th Share

Case (f)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/10	3/10	5/10
	3/10	-	-3/10

C gains by 3/10th share and A sacrifice 3/10th Share

Case (g)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/5	1/5	2/5
	1/10	1/10	-2/10

C gains by 2/10th share and A sacrifices 1/10th Share & B sacrifices 1/10th share.

B gains by 1/30th share, C gains by 4/30th share and A sacrifices by 5/30th Share
Case (i)

Ratio of A and B = 5 : 3

Ratio of B and C should be 5 : 3

Since B's share in relation to A is 3/5 or 60% of A's share, C's share should also be 60% of B's share

Thus C's share (60% of 3) = 1.8

New ratio of A, B and C = 5 : 3 : 1.8 or 25 : 15 : 9

C sacrifices by 8/490 and A gains by 5/490 and B gains by 3/490

3.5 HIDDEN GOODWILL

In cases where the specific value of the firm's goodwill is not provided but the question wants us to give effect of goodwill as it's one the necessary adjustment in reconstitution, one must calculate the goodwill value using the following method.

Particulars	
Incoming partner's capital x Reciprocal of share of incoming partner	XXXXXX
Less: Total capital of old partners + Net Accumulated Profits and Reserves (if any) + capital brought in by incoming partner Value of Goodwill	XXXXX
	XXX

True or False

1. A newly admitted partner does not have same rights as old partners.

(ICAI Study Material)

Sol. False, Every partner maintains equal rights at all times, unless specified otherwise in the partnership deed or mutually agreed upon by the partners.

2. When a new partner is admitted, old partners have to forego certain share in profits of the firm, this is called as sacrifice ratio.

(ICAI Study Material)

Sol. True,; When a new partner joins, the existing partners must relinquish a portion of their share, known as the sacrificing ratio.

3. Revaluation account is also called as Profit and Loss Adjustment Account.

(ICAI Study Material)

Sol. True,; Revaluation is alternatively referred to as the profit and loss adjustment account.

4. Any appreciation in the value of an asset is credited to Revaluation account.

(ICAI Study Material)

Sol. True: An increase in assets is considered income, and therefore, it is credited to the revaluation account.

5. All the partners may decide not to change the values of assets and liabilities in the books

of accounts.

(ICAI Study Material)

Sol. True,: Achieving this can be facilitated by initiating a Memorandum Revaluation Account.

6. New partner is entitled to have share in reserves appearing in the balance sheet prior to his admission.

(ICAI Study Material)

Sol. False,: The newly admitted partner does not possess any entitlement to a share in the firm's reserves before admission. Instead, these reserves are distributed among the existing partners based on their original profit-sharing ratio.

7. If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners equally.

(ICAI Study Material)

Sol. False,: When the revaluation account displays a credit balance, it signifies a profit. Consequently, this profit is credited to all partners based on their individual profit-sharing ratios, not equally.

8. New partner brings necessary amount as his capital.

(ICAI Study Material)

Sol. True,: Each new partner is required to contribute a certain capital amount to the firm.

9. New partner is entitled to share in revaluation profit.

(ICAI Study Material)

Sol. False,: The newly added partner does not have a claim to the profit resulting from revaluation; it is allocated to the existing partners based on their original profit-sharing ratio.

10. The cash contribution of goodwill by a new partner, upon joining a partnership firm, is absorbed by the existing partners in accordance with their adjusted profit-sharing ratios.

Sol. False: The cash brought in by a new partner for goodwill is absorbed by the existing partners in accordance with their sacrificing ratio

11. Upon the entry of a new partner into a partnership firm, the profit or loss on the revaluation account is allocated to all partners based on their updated profit-sharing ratios.

(Nov. 2020, 2 Marks)

Sol. False: The transfer of Profit & Loss on the Revaluation account is exclusively directed to the old partners, adhering to their original profit-sharing ratios.

MULTIPLE CHOICE QUESTIONS

1. A and B are partners sharing profits and losses in the ratio 5:3. They admitted C and agreed to give him $\frac{3}{10}$ th of the profit. What is the new ratio after C's admission?

(a) 35:42:17.

(b) 35:21:24.

(ICAI Study Material)

(c) 49:22:29.

(d) None of the above

Sol (b)

2. A and B are partners sharing profits in the ratio 5:3, they admitted C giving him $\frac{3}{10}$ th share of profit. If C acquires $\frac{1}{5}$ from A and $\frac{1}{10}$ from B, new profit sharing ratio will be:

(ICAI Study Material)

(a) 5:6:3.

(b) 2:4:6.

(c) 17:11:12

(d) None of the above

Sol. (c)

3. C was admitted in a firm with $\frac{1}{4}$ th share of the profits of the firm. C contributes ₹ 15,000 as his capital, A and B are other partners with the profit sharing ratio as 3:2. Find the required capital of A and B, if capital should be in profit sharing ratio taking C's as base capital: (ICAI Study Material)
- (a) ₹ 27,000 and ₹ 16,000 for A and B respectively.
(b) ₹ 27,000 and ₹ 18,000 for A and B respectively.
(c) ₹ 32,000 and ₹ 21,000 for A and B respectively.
(d) None of the above

Sol (b)

4. A, B and C are partners sharing profits and losses in the ratio 6:3:3, they agreed to take D into partnership for $\frac{1}{8}$ th share of profits. Find the new profit sharing ratio. (ICAI Study Material)
- (a) 12:27:36:42. (b) 14:7:7:4.
(c) 1:2:3:4. (d) None of the above

Sol. (b)

5. A and B are partners sharing profits and losses in the ratio of 3:2 (A's Capital is ₹ 30,000 and B's Capital is ₹ 15,000). They admitted C and agreed to give $\frac{1}{5}$ th share of profits to him. How much C should bring in towards his capital? (ICAI Study Material)
- (a) ₹ 9,000.
(b) ₹ 12,000.
(c) ₹ 11,250.
(a) None Of the above
6. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who brings in ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. In what ratio will this amount will be shared among the old partners A & B. (ICAI Study Material)
- (a) ₹ 8,000: ₹ 2,000.
(b) ₹ 5,000: ₹ 5,000.
(c) Old partners will not get any share in the goodwill brought in by C.
(d) None of the above

Sol. (a)

7. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C brought cash for his share of Capital and agreed to compensate to A and B outside the firm. How this will be treated in the books of the firm. (ICAI Study Material)
- (a) Cash brought in by C will only be credited to his capital account.
(b) Goodwill will be raised to full value in old ratio.

- (c) Goodwill will be raised to full value in new ratio.
- (d) None of the above

Sol (a)

8. X and Y are partners sharing profits in the ratio of 3: 1. They admit Z as a partner who pays ₹4,000 as Goodwill the new profit sharing ratio being 2:1: 1 among X, Y and Z respectively. The amount of goodwill will be credited to:
- (a) X and Y as ₹3,000 and ₹1,000 respectively. (ICAI Study Material)
 - (b) X only
 - (c) Y only.
 - (d) None of the above

Sol (b)

9. P and Q are partners sharing Profits in the ratio of 2:1. R is admitted to the partnership with effect from 1st April on the term that he will bring ₹20,000 as his capital for 1/4th share and pays ₹9,000 for goodwill, half of which is to be withdrawn by P and Q. If profit on revaluation is ₹6,000 and opening capital of P is ₹40,000 and of Q is ₹30,000, find the closing balance of each capital. (ICAI Study Material)
- (a) ₹47,000: ₹33,500: ₹20,000
 - (b) ₹50,000: ₹35,000: ₹20,000.
 - (c) ₹40,000: ₹30,000: ₹20,000
 - (d) None of the above

Sol (a)

10. Adam, Brain and Chris were equal partners of a firm with goodwill ₹1,20,000 shown in the balance sheet and they agreed to take Daniel as an equal partner on the term that he should bring ₹1,60,000 as his capital and goodwill, his share of goodwill was evaluated at ₹60,000 and the goodwill account is to be written off before admission. What will be the treatment for goodwill? (ICAI Study Material)
- (a) Write off the goodwill of ₹1,20,000 in old ratio.
 - (b) Cash brought in by Daniel for goodwill will be distributed among old partners in sacrificing ratio.
 - (c) Both (a) & (b)
 - (d) None of the above

Sol. (c)

THEORY QUESTIONS

1. Write short note on Revaluation account. (ICAI Study Material)

Sol. Upon the admission of a new partner into the partnership, there is a revaluation of assets and a reassessment of liabilities. To facilitate this, a Revaluation Account (or Profit and Loss Adjustment Account) is established. Any decrease in the value of assets and an increase in liabilities are debited to this account, while an increase in the value of assets and a decrease in liabilities are credited. The disparity between the two sides of the account indicates either a profit or a loss, which is subsequently

transferred to the Capital Accounts of the existing partners based on their original profit-sharing ratio.

2. What is the difference between revaluation account and memorandum revaluation account? (ICAI Study Material)

Sol. Distinguishing between Revaluation Account and Memorandum Revaluation Account:

- (i) Revaluation account serves to determine the profit or loss resulting from the revaluation of assets and liabilities, which are reflected in the new balance sheet at their updated or revalued values. Conversely, the Memorandum Revaluation Account is crafted to document the impact of revaluation on assets and liabilities, which are, however, recorded at their original values in the new balance sheet.
- (ii) Unlike Revaluation Account, which remains undivided, the Memorandum Revaluation Account is divided into two parts: the first part designated for the old partners and the second part for all partners, including the newly added partner.



5.1 INTRODUCTION

The existence of a partnership firm remains unaffected by the death of a partner, constituting a Reconstitution of Partnership. The remaining partners are responsible for the ongoing operation of the business.

5.2 The entitlement of a departing partner in specific scenarios to share in subsequent profits.

In accordance with the stipulations outlined in Section 37 of the Indian Partnership Act, if a member of a firm has either passed away or ceased to be a partner, and the surviving or continuing partners continue the firm's business using its assets without a final settlement of accounts with the departing partner or their estate, then, unless there is a specific contract indicating otherwise, the outgoing partner or their legal representative has the option to choose either a share of the profits generated since their departure, attributable to the use of their share of the firm's assets, or interest at a rate of six percent per annum on the amount of their share in the firm's assets.

This implies that the outgoing partner (legal representative) has the flexibility to choose between receiving interest at a rate of 6% per annum or a share of the profits earned on the unsettled amounts until their dues are settled by the firm, in the absence of a contrary contract. It's important to note that the outgoing partner is not obligated to make this election until the precise amount of the profit payable to them is determined.

For example, X, Y and Z are in a partnership business—sharing profits and losses equally. Z died on 31st October, 2021. The capitals of the partners, after all necessary adjustments stood at 100,000, 150,000 and ₹ 2,40,000 respectively. X and Y continued to carry on the business further without settling the accounts of Z. Final payment to Z is made on February 1, 2022. The profit made during the period of three months amounts to 56,000.

Under Section 37 of the Partnership Act, Z can exercise any of the following two alternatives.

(i) Share in subsequent profits of firm: Profit made—₹ 56,000

$$2,40,000 \times \frac{56,000}{2,40,000 + 1,50,000 + 1,00,000} = 56,000 \times \frac{2,40,000}{4,90,000}$$

$$4,90,000 = ₹ 27,428$$

(ii) Interest at 6% p.a.

$$2,40,000 \times \frac{6}{100} \times \frac{3}{12} = ₹ 3,600$$

Since, (i) option is beneficial for C, he will necessarily go for his proportionate share in profits.

5.3 AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

In the event of a partner's death, the sum owed to them is disbursed to their legal representatives, who are entitled to the following:

- (a) The balance in the deceased partner's capital account,
- (b) Interest on capital, if stipulated in the partnership agreement, up to the date of death,
- (c) Proportional share of the firm's goodwill,
- (d) Portion of undistributed profits or reserves,
- (e) Share of the profits resulting from the revaluation of assets and liabilities,
- (f) Share of profits up till the date of death,
- (g) Stake in the Joint Life Policy or Separate Life Policy.

Legal representatives are liable for:

- (i) Drawings
- (ii) Interest on the drawings
- (iii) Share of loss on the revaluation of assets and liabilities;
- (iv) Portion of losses incurred up to the date of their demise.

Calculation of profit upto the date of death of a partner.

The computation of this profit is conducted using the P&L Suspense account. Once the amount owed to the deceased partner is determined, it ought to be credited to the Executor's Account. In instances where a partner passes away within a fiscal year, the representatives of the deceased partner are eligible for their share of profits earned up to the date of death. The determination of this profit can be achieved through any of the methods given below:

- (i) Time Basis
 - (ii) Turnover or Sales Basis
- (i) Time Basis**

In this scenario, the assumption is made that profit has been generated consistently over the entire year. For instance:

Considering a total profit of 4,50,000 in the previous year and a partner's demise three months after the close of that year, the profit for the three months is 62,500 (calculated as $2,50,000 \times 3/12$). If the deceased partner held a $2/10$ share of the profit, their portion of the profit until the date of death amounts to 12,500 (derived from $62,500 \times 2/10$).

(ii) Turnover or Sales Basis

In this method, we have to take into consideration the profit and the total sales of the last year. Thereafter the profit up to the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Example-

Arjun, Taniya, and Nidhi form a partnership with a profit-sharing ratio of 3:2:1. Unfortunately, Nidhi passes away on May 31, 2023. The sales for the fiscal year 2022-2023 totaled 8,00,000, with a corresponding profit on sales of 120,000. The accounting period concludes on March 31 each year. Sales from April 1, 2023, to May 31, 2023, amount to ₹ 2,00,000. The deceased partner's portion of the profit until the date of death will be determined as follows:

Profit from 1st April 2023 to 31st May 2023 on the basis of sales:

If sales are ₹ 8,00,000, profit is ₹ 120,000

If the sales are ₹ 2,00,000 profit is: $120,000 / 8,00,000 \times 2,00,000 = ₹ 30,000$ Neha's share = $30,000 \times 1/6 = ₹ 5,000$

This approach involves factoring in both the profit and total sales from the preceding year. Subsequently, the profit until the date of death is approximated based on the sales data from the last year. The assumption underlying this method is a uniform earning of profit at a consistent rate. The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor. The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment

SPECIAL TRANSACTIONS IN CASE OF DEATH: JOINT LIFE POLICY (Refer Class notes for better understanding)

In the context of a partnership, it is common for partners to collectively obtain a Joint Life Policy (JLP) in the names of all partners. In the event of a partner's demise, the surviving partners have a rightful claim to a share in the Joint Life Policy.

Method 1: If Joint Life Policy does not appear in the Balance Sheet, - In the event of a partner's demise, the firm stands to benefit. For instance, consider the partnership of Aman, Bhuvan, and Chetan, who share profits and losses in the ratio of 5:3:2. They collectively hold a Joint Life Policy with a coverage of 2,00,000. If Aman were to pass away, the firm would receive a payout of 2,00,000 from the insurance company.

journal

		₹	₹
(i) Bank A/c	Dr.	2,00,000	
To Joint Life Policy A/c			2,00,000
(Being the Policy value received from the insurance company on Aman's demise)			
(ii) Joint Life Policy A/c	Dr.	2,00,000	
To Aman's Capital A/c			100,000
To Bhuvan's Capital A/c			60,000
To Chetan's Capital A/c			40,000
(JLP written off and credited in the old Profit Sharing Ratio)			

Method 2: In the scenario where the Joint Life Policy is reflected in the Balance Sheet at its surrender value, the firm stands to benefit upon the death of a partner. For illustration, consider the partnership of Aman, Bhuvan, and Chetan, with a profit and loss-sharing ratio of 5:3:2. They have a Joint Life Policy valued at 2,00,000, but it is recorded in the Balance Sheet at the surrender value of 20,000. If Aman were to pass away, the firm would receive ₹ 2,00,000 from the insurance company. The corresponding journal entries would be as follows:

		₹	₹
(i) Bank A/c	Dr.	2,00,000	
To Joint Life Policy A/c			2,00,000
(Policy amount received from the insurance company on Aman's demise)			
(ii) Joint Life Policy A/c	Dr.	180,000	
To Aman's Capital A/c			90,000
To Bhuvan's Capital A/c			54,000
To Chetan's Capital A/c			36,000
(JLP written off and credited in the old partners in old Profit Sharing Ratio)			

Method 3:

If the Joint Life Policy is listed in the Balance Sheet at its surrender value, in conjunction with the Joint Life Policy Reserve, the firm stands to benefit upon the death of a partner, and the reserve will be distributed among the partners. For instance, consider the partnership of Aman, Bhuvan, and Chetan, with a profit and loss-sharing ratio of 5:3:2. They possess a Joint Life Policy valued at 2,00,000, recorded in the Balance Sheet at the surrender value of 20,000, accompanied by the Joint Life Policy reserve. In the event of Aman's demise, the firm would receive ₹ 2,00,000 from the insurance company.

Journal

To Bhuvan's Capital A/c		3,000
To Chetan's Capital A/c		2,000
(JLP reserve written off and credited to the old partners in Profit Sharing Ratio)		

5.5 SPECIAL TRANSACTIONS IN CASE OF DEATH: SEPARATE LIFE POLICY (Refer Class notes for better understanding)

Rather than taking a single joint life policy covering all partners, individual policies on the lives of each partner may be obtained. The premiums paid for these policies are expensed in the profit and loss account. In the event of a partner's demise, the insurance company would disburse only the amount for which the deceased partner was insured. While the policies of surviving partners remain in force, the surrender value of these policies is considered in determining the amount payable to the legal representatives of the deceased partner. In essence, the legal representatives are entitled to receive a share in the surrender value proportionate to the profit-sharing ratio of the deceased partner.

Bank A/c Dr. (Assured amount)
 To Separate Life Policy of the Deceased partner A/c

(Policy amount received on the demise of a partner)

Separate Life Policy of Deceased Partner A/c Dr. (Assured amount)

Separate Life Policy of Remaining Partners A/c Dr (Surrender amount)

To Deceased executor's A/c (Total amount distributed in profit sharing ratio)

To Remaining partners A/c (Total value distributed in the profit sharing ratio)

Comprising the aggregate of the assured value from the life policy of the deceased partner and the surrender value of life policy(s) held by the other partners, distributed in accordance with the

Profit sharing ratio.

5.6 SPECIAL TRANSACTIONS IN CASE OF DEATH:

PAYMENT OF DECEASED PARTNER'S SHARE

The fundamental difference between the retirement and death of a partner lies in determining the amount payable to the executor of the deceased partner. While the revaluation of goodwill follows a similar process as in the case of retirement, an additional entitlement for the executor of the deceased partner includes a share of the profit up to the date of death.

TEST YOUR KNOWLEDGE

True and False

1. Business of partnership comes to an end on death of a partner. (ICAI Study Material)

Sol. False: The remaining partners proceed with the ongoing business operations..

2. Legal heir of a deceased partner automatically becomes a partner in the firm.

(ICAI Study Material)

Sol. False: Legal heirs of deceased partners are entitled to dues of the deceased partner.

3. A revaluation account is opened in the books of accounts on death of a partner.

(ICAI Study Material)

Sol. True: To find out the actual values of the assets and liabilities, revaluation account is prepared.

4. Any reserve appearing in the balance sheet on the date of death of a partner is transferred to all partners capital account in their profit sharing ratio. (ICAI Study Material)

Sol. True: reserves belong to the partners in the same manner the capital contributed by them. Hence it is distributed to them through the capital account.

5. Legal heirs of a deceased partner are entitled to his capital account balance only.

(ICAI Study Material)

Sol. False: Legal heirs of a deceased partner are entitled to all the dues of deceased partner.

6. It is not necessary to adjust goodwill on death of a partner. (ICAI Study Material)

Sol. False: It is very much necessary to adjust goodwill on death of a partner.

7. On death of a partner continuing partners can agree to change their capital contribution and profit sharing ratio. (ICAI Study Material)

Sol. True: Yes, it can be continued in the earlier share or in new share—in either case it leads to computing a new profit sharing ratio.

8. On death of a partner, the firm gets surrender value of the joint life policy.

(ICAI Study Material)

Sol. False: On death of a partner the firm gets full value of sum assured of the joint life policy.

9. Only legal heirs of deceased partner are entitled to amount received from joint life policy.

(ICAI Study Material)

Sol. False: All the partners are entitled to amount received from joint life policy.

10. Obtaining a joint life policy for a partnership firm aims to safeguard the lives of the firm's current partners.

Sol. False: Securing a joint life policy serves the purpose of facilitating payments to the legal representatives of a deceased partner or to a retiring partner

MULTIPLE CHOICE QUESTIONS

1. In the absence of proper agreement, representative of the deceased partner is entitled to the Dead partner's share in (ICAI Study Material)

- (a) Profits till date, goodwill, joint life policy, share in revalued assets and liabilities.
- (b) Capital, goodwill, joint life policy, interest on capital, share in revalued assets and liabilities.
- (c) Capital, profits till date, goodwill, joint life policy, share in revalued assets and liabilities.
- (d) None of the above.

Sol. (c) Capital, profits till date, goodwill, joint life policy, share in revalued assets and liabilities.

2. A, B and C are the partners sharing profits and losses in the ratio 2:1:1. Firm has a joint life policy of ₹1,20,000 and in the balance sheet it is appearing at the surrender value i.e. ₹20,000. On the death of A, how this JLP will be shared among the partners.

- (a) ₹50,000: ₹25,000: ₹25,000 (b) ₹60,000: ₹30,000: ₹30,000
- (c) ₹40,000: ₹35,000: ₹25,000 (d) None of the above

Sol. (a) ₹50,000: ₹25,000: ₹25,000 18 Partnership Accounts

3. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2020. It was decided to value the goodwill on the basis of three year's purchase of last five years average profits. If the profits are ₹29,600; ₹28,700; ₹28,900; ₹24,000 and ₹26,800. What will be D's share of goodwill? (ICAI Study Material)

- (a) ₹20,700 (b) ₹27,600
- (c) ₹82,800 (d) None of the above

Sol. (a) ₹20,700

4. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2020 and profits for the accounting year 2019-2020 were ₹24,000. How much share in profits for the period 1st April 2020 to 30th June 2020 will be credited to D's Account. (ICAI Study Material)

- (a) ₹6,000 (b) ₹1,500
- (c) ₹2,000 (d) None of the above

Sol. (b) ₹1,500

5. Revaluation account is prepared at the time of (ICAI Study Material)

- (a) Admission and retirement of a partner
- (b) Death of a partner
- (c) All of the above
- (d) None of the above

Sol. (c) All of the above

6. If three partners A, B & C are sharing profits as 5:3:2, then on the death of a partner A, how much B & C will pay to A's executor on account of goodwill. Goodwill is to be calculated on the basis of 2 years purchase of last 3 years average profits. Profits for last three years are: ₹3,29,000; ₹3,46,000 and ₹4,05,000. (ICAI Study Material)

(a) ₹2,16,000 & ₹1,42,000

(b) ₹2,44,000 & ₹2,16,000

(c) ₹2,16,000 & ₹1,44,000

(d) None of the above

Sol. (c) ₹2,16,000 & ₹1,44,000

THEORY QUESTIONS

1. Explain distinction between retirement and death of a partner as relating to finalisation of amount payable. (ICAI Study Material)

Sol. The primary difference between the retirement and death of a partner lies in the determination of the amount payable to the Executor of the deceased partner. While the revaluation of goodwill follows a similar process as in the case of retirement, an additional entitlement for the executor of the deceased partner includes a share of the profit up to the date of death.

2. What amount is payable to legal representatives of dead partner? (ICAI Study Material)

Sol. In the event of a partner's demise, the amount due is disbursed to their legal representatives, who are entitled to the following:

(a) The balance in the deceased partner's capital account;

(b) Interest on capital, if specified in the partnership deed up to the date of death;

(c) Proportional share of the firm's goodwill;

(d) Portion of undistributed profits or reserves;

(e) Share of profit resulting from the revaluation of assets and liabilities;

(f) Share of profits up to the date of death;

(g) Stake in the Joint Life Policy.

Retirement of A Partner

INTRODUCTION

A partner might withdraw from the partnership due to reasons such as old age or illness. Typically, the dissolution of the partnership is not inevitable when a partner retires; instead, the remaining partners can continue operating the business. Similar to the process of admitting a new partner, adjustments are made during the retirement of a partner. Upon a partner's retirement, the remaining partners experience a shift in the profit-sharing ratio, resulting in gains. Consequently, the continuing partners organize the necessary funds to settle the retiring partner's claims. This involves revaluing assets and liabilities, increasing the goodwill value, and considering the surrender value of any joint life policy. Revaluation profits and reserves are then transferred to the capital or current accounts of the partners. Finally, the ultimate amount owed to the retiring partner is determined and settled.

CALCULATION OF GAINING RATIO

Upon the retirement of a partner, the remaining partners experience a shift in their profit-sharing ratio. For instance, if partners X, Y, and Z originally shared profits and losses in the ratio of 5:3:2 and Y decides to retire, X and Z must mutually determine the new ratio for future profit sharing. If, for example, they agree on a new ratio of 3:2, then X gains $\frac{1}{10}$ th $[(\frac{3}{5}) - (\frac{5}{10})]$ and Z gains $\frac{2}{10}$ $[(\frac{2}{5}) - (\frac{2}{10})]$. Consequently, the gaining ratio between X and Z becomes 1:2. Alternatively, if X and Z choose to continue at the ratio of 5:2, it indicates a division of the gained share based on the previous profit-sharing ratio.

To illustrate, consider partners A, J, and S in a partnership with an initial profit-sharing ratio of 3:2:1. If A decides to retire and J and S opt to continue at the ratio of 3:2, J gains $\frac{8}{30}$ th of the partnership share ($\frac{3}{5}$ less $\frac{2}{6}$), while S gains $\frac{7}{30}$ th ($\frac{2}{5}$ less $\frac{1}{6}$). This results in a gaining ratio between J and S of 8:7. Alternatively, if J and S decide to continue at the ratio of 2:1, J would gain $\frac{2}{6}$ th of the partnership share $[(\frac{2}{3}) - (\frac{2}{6})]$, and S would gain $\frac{1}{6}$ th $[(\frac{1}{3}) - (\frac{1}{6})]$. In this case, the gaining ratio of J and S would remain at 2:1, consistent with their existing profit-sharing ratio.

In summary, when a partner retires or passes away, the remaining partners absorb the departing partner's share in the profit, leading to an increase in their overall share—a clear gain or benefit.

The determination of the gaining ratio or benefit ratio involves the following steps:

- If the new ratio is specified, the gaining ratio is computed by subtracting their new share of profits from the old share.
- In cases where the new profit-sharing ratio is not provided, and the remaining partners continue to share future profits in the same ratio as before, the gaining ratio corresponds to the old profit-sharing ratio.

Ratio between Remaining Partners

	New Ratio	Gaining or Benefit Ratio
1. When the new ratio is given	As given in the question	New Ratio less Old ratio
2. When the new Ratio is not provided	The old ratios between the partners	The old ratios between the partner
3. When gaining/benefit ratio is provided	Old ratio + Gaining ratio	As given in question

Calculation of New Profit Sharing Ratio

Case 1: In instances where information regarding the new profit-sharing ratio of the remaining partners is not provided, the determination of the new ratio involves excluding the share of the retiring partner.

Example : Alok, Bhaskar and Chetan are partners sharing in the ratio 3:2:1. Calculate new ratio if:

- If Alok retires.
- If Bhaskar retires.
- If Chetan retires.

(ICAI Study Material)

Sol:-

Old Profit ratio = 3:2:1

- If Alok retires then new profit ratio= 2:1
- If Bhaskar retires then new profit ratio= 3:1
- If Chetan retires then new profit ratio= 3:2

Case 2: If the question explicitly provides information about the gains of the continuing partners, the process involves calculating the new shares of the continuing partners by combining their individual gains with their original shares.

New share = Old share + Gain

Example : Aarav, Banta and Chunmun are partners sharing in the ratio 3:2:1. Aarav retires and his share is taken over by the remaining partners as follow

Banta takes $\frac{2}{6}$ th from Aarav. Chunmun takes $\frac{1}{6}$ th from Aarav.

Calculate new ratio.

Sol:-

(ICAI Study Material)

Banta's New Share = Banta's old share + Banta's gain = $\frac{2}{6} + \frac{2}{6} = \frac{4}{6}$ Chunmun's

New Share = Chunmun's old share + Chunmun's gain = $\frac{1}{6} + \frac{1}{6} = \frac{2}{6}$ So the new share will be = $\frac{4}{6} : \frac{2}{6} = 2:1$

Case 3: When the ratio in which the remaining partners acquire the share of the outgoing partner is given:

Example : Deepu, Tasha and Honey are partners sharing profits in the ratio 3:2:1. Tasha retires and his share was acquired by deepu and honey in the ratio 2:1. Calculate new ratio.

(ICAI Study Material)

Sol.- Share acquired by Deepu is= $\frac{2}{6} \times \frac{2}{3} = \frac{4}{18}$ Share acquired by Honey is= $\frac{2}{6} \times \frac{1}{3} = \frac{2}{18}$

Deepu's new Share will be = Deepu 's old share + Deepu's gain = $\frac{3}{6} + \frac{4}{18} = \frac{13}{18}$
Honey's new Share will be = Honey's old share + Honey's gain = $\frac{1}{6} + \frac{2}{18} = \frac{5}{18}$ New Ratio = 13:5

Calculation of Gaining Ratio

Case 1: Partners X, Y, and Z are engaged in a partnership with an initial profit-sharing ratio of $\frac{1}{2}$, $\frac{3}{10}$, and $\frac{1}{5}$, respectively. Following Y's retirement, A and C choose to alter their future profit and loss sharing to a ratio of 3:2.

Their new shares	(a)	X $\frac{3}{5}$	Z $\frac{2}{5}$
Their old shares	(b)	$\frac{1}{2}$	$\frac{1}{5}$
Difference being gain	(a - b)	$\frac{1}{10}$	$\frac{2}{10}$
Gaining ratio of X and Z	= $\frac{1}{10} : \frac{2}{10} = 1 : 2$		

Case 2: Partners S, P, Q, and R are in a business venture, initially distributing profits and losses in the ratio of $\frac{1}{3}$, $\frac{1}{6}$, $\frac{1}{3}$, and $\frac{1}{6}$, respectively. Following Q's retirement, S, P, and R opt for an equal sharing arrangement for future profits and losses.

		S	P	R
Their new shares	(a)	$\frac{1}{3}$	$\frac{1}{3}$	$\frac{1}{3}$
Their old shares	(b)	$\frac{1}{3}$	$\frac{1}{6}$	$\frac{1}{6}$
Difference being gain	(a - b)	-	$\frac{1}{6}$	$\frac{1}{6}$
Gaining ratio of A and C	= $\frac{1}{6} : \frac{1}{6} = 1 : 1$			

Case 3: X , Y and Z are partners sharing profits and losses in the ratio of 25:15:9. Y retires and it is decided that profit sharing ratio between X & Z will be the same as existing between Y and Z.

Ratio of Y and Z = 15 : 9 = 5 : 3

Therefore new ratio of X and Z should be 5 : 3

		X	Z
Their new shares	(a)	5/8	3/8
Their old shares	(b)	25/49	9/49
Difference being gain	(a-b)	45/392	75/392

Gaining ratio of A and C = 45 : 75 = 3 : 5

Case 4: X, Y and Z are partners sharing profits and losses in the ratio of 4/9, 1/3 and 2/9. Y retires and surrenders 1/9th of his share in favour of X and remaining in favour of Z.

X Z

Their existing shares (a) 4/9 2/9

Share surrendered by Y (b) $1/9 \times 1/3 = 1/27$ $8/9 \times 1/3 = 8/27$ New share of remaining partner (a + b) 13/27

14/27 New ratio of X and Z = 13 : 14

Gaining ratio = 1/27 : 8/27 = 1 : 8

Case 5: X, Y & Z are partners sharing profits and losses in the ratio of 1/2, 3/10 and 1/5 respectively. Y retires and his share is taken by X and Z in the ratio of 2:1. Then immediately P is admitted for 1/4th share of profit, half of which was gifted by X and remaining share was taken by P equally from X and Z.

		X	Z
Their existing shares	(a)	1/2	1/5
Share acquired by remaining partners	(b)	$2/3 \times 3/10 = 2/10$	$1/3 \times 3/10 = 1/10$
New shares of remaining partners	(c = a + b)	7/10	3/10
Share gifted by X	(d)	$1/2 \times 1/4 = 1/8$	-
Share acquired by P (other than gift)	(e)	$1/2 \times 1/8 = 1/16$	$1/2 \times 1/8 = 1/16$
New Shares	(c - d - e)	41/80	19/80

New ratio of X, Z and P = 41/80 : 19/80 : 20/80 = 41 : 19 : 20

REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

Upon the retirement of a partner, it becomes necessary to reassess the values of assets and liabilities, similar to the process undertaken when admitting a new partner. If there is a revaluation profit, this amount should be distributed among the existing partners, including the retiring partner, according to the prevailing profit-sharing ratio. Conversely, in the case of a revaluation loss, it is also allocated to all partners, including the retiring partner, based on the existing profit-sharing ratio. To determine the profit or loss on the revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is initiated. This account is automatically closed by transferring the profit or loss balance to

the Partners' Capital Accounts.

In scenarios where it is decided that the revalued figures of assets and liabilities will not be reflected in the balance sheet of the continuing partners, a journal entry is made to record the amount payable or chargeable to the retiring partner. The continuing partners then divide this amount according to the gain ratio. Initially, the journal entry for the distribution of profit or loss on revaluation, which will also be presented in the balance sheet, is as follows

Revaluation A/c Dr.
To Partners' Capital A/cs (For profit on revaluation)
Or Partners' Capital A/c's Dr.
To Revaluation A/c
(For loss on revaluation)

RESERVE

Upon the retirement of a partner, any undistributed profit or reserve listed on the Balance Sheet is to be credited to the Partners' Capital Accounts based on the old profit-sharing ratio. Alternatively, if the remaining partners maintain the same profit-sharing ratio, only the retiring partner's share may be transferred to their Capital Account.

Example: A, B and C were in partnership sharing profits and losses at the ratio 5:3: 2. A retired and B and C agreed to share profits and losses at the ratio of 3:2. Reserve balance was ₹ 10,000. Pass journal entry.-

(ICAI Study Material)

Sol:- In this case either of the following journal entries can be passed:

		₹	₹
(1)	Reserve A/c Dr.	10,000	
	To A's Capital A/c To B's Capital A/c To C's Capital A/c		5,000
	(Transfer of reserve to Partners' Capital A/cs in 5 : 3 : 2 on A's retirement)		3,000
			2,000
(2)	Reserve A/c Dr.	5,000	
	To A's Capital A/c		5,000
	(Transfer of A's share of Reserve to the Capital Account on his retirement)		

Please be aware that option (2) carries identical consequences, as B and C sustained their previous ratio of 3:2 following A's retirement.

FINAL PAYMENT TO A RETIRING PARTNER

The following adjustments are initiated in the Capital A/cs:

□ Transfer of reserve,

Retirement of A Partner

- ❑ Transfer of goodwill,
- ❑ Transfer of profit/loss on revaluation.

Upon reconciling the mentioned adjustments, the Capital Account balance credited to the retiring partner signifies the amount owed to them. The remaining partners have the option to settle the entire claim at the time of retirement. The corresponding journal entry would be as follows:

Retiring Partner's Capital A/c Dr.

To Bank A/c

At times, a retiring partner may opt to maintain a portion of their claim within the partnership as a loan. The corresponding journal entry is outlined below:

Retiring partner's Capital A/c Dr.

To Retiring Partner's Loan A/c To Bank A/c

Typically, payments are executed in accordance with the terms specified in the partnership agreement, which may encompass the following options:

- (a) Repayment in installments over a designated period, with interest paid on the outstanding balance, treated as a loan from the departing partner.
- (b) Treating the amount owed as a firm loan, with the firm reciprocating by either paying interest at a predetermined rate or sharing the firm's profits.
- (c) Providing an annuity to a retired partner for their lifetime or for a mutually agreed-upon number of years, potentially extending to the life of a dependent.

PAYING A PARTNER'S LOAN IN INSTALMENT

Precisely, settling a partner's loan is essentially a financial arrangement. Nevertheless, there are instances where it is specified that the loan is to be repaid in a predetermined number of equal installments with the remaining balance accruing interest. In such situations, the recommended approach involves dividing the loan into equal segments, calculating the interest for the given period, and structuring the payment to encompass both the installment for the loan and the accrued interest.

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policy. Notably, this method varies from the one discussed earlier (2) only with regard to the reserve account.

Upon the death of a partner, the Joint Life Policy Reserve Account is transferred to the Joint Life Policy Account, and the remaining balance is then transferred to the Partners' Capital Accounts.

SEPARATE LIFE POLICY

Rather than obtaining a joint life policy in the names of all partners, each partner may individually acquire life policies, with the firm covering the premiums. Upon retirement, the departing partner is entitled to a share of the total sum assured from the life policies held by all partners, proportionate to their contribution.

Example: Sona, Gabbu and Amit are partners Profit sharing ratio is 3:1:1

	SONA	GABBU	AMIT
Policy	1,00,000	2,00,000	3,00,000
Surrender Value	10,000	20,000	30,000

Q. Write down claimable amount if Amit retires.

(ICAI Study Material)

Sol:- If Amit retires, then, Amit will get ₹ $60,000 \times 1/5 = 12,000$

True and False

Q. Business of a partnership has to be closed if any one of the partners retires.

(ICAI Study Material)

Sol. False, The partnership business persists without closure in the event of the retirement of one partner, as the remaining partners continue the operation of the business.

Q. At the time of retirement of a partner no special treatment is required for any reserves appearing in the Balance Sheet.

(ICAI Study Material)

Sol:- False, Upon a partner's retirement, all reserves presented in the balance sheet are distributed among the partners according to their original profit-sharing ratio.

Q. After retirement of a partner, profit sharing ratio of continuing partners remains the same.

(ICAI Study Material)

Sol:- False, Following the retirement of a partner, the profit-sharing ratio among the remaining partners undergoes a change.

Q. If any partner wants to retire from the business, he must retire on 1st day of the accounting year.

(ICAI Study Material)

Sol:- False, A partner has the flexibility to retire on any day based on their own decision.

Q. Retiring partner has to forego his share of goodwill in the firm.

Sol:– False, The partner who is retiring has the right to their portion of the goodwill in the firm.

Q. If a partner retires in between the accounting year then he is not entitled to any profit from the date of beginning of the year till his date of retirement.

(ICAI Study Material)

Sol:– False, If a partner decides to retire during the accounting year, they are unequivocally eligible for the profit share from the commencement of the year until their retirement date.

Q. If the firm has taken any joint life policy then it is to be surrendered at the time of retirement of a partner.

(ICAI Study Material)

Sol:– True, The partnership is entitled to receive the surrender value of the Joint Life Policy held for the partners upon their retirement.

Q. Any joint life policy reserve appearing in the Balance Sheet is credited to all the partners in their old profit sharing ratio.

(ICAI Study Material)

Sol:– True, Under the surrender policy approach, the Joint Life Policy (JLP) reserve is allocated among the partners via their respective capital accounts based on the profit-sharing ratio.

Q. No revaluation account is necessary on retirement of a partner.

(ICAI Study Material)

Sol:– False, The creation of a Revaluation Account becomes imperative when a partner retires.

Q. Profit on revaluation is credited to continuing partners, retiring partner is not entitled to any profit on revaluation.

(ICAI Study Material)

Sol:– False, The profit resulting from revaluation is allocated to all partners in accordance with their respective profit-sharing ratios.

Q. Upon a partner's retirement, the remaining partners experience a positive adjustment in their profit-sharing ratio.

Sol. True: In the event of a partner's retirement, the distribution of their share of profit or loss among the remaining partners will be based on their agreed-upon profit-sharing ratio, unless stated otherwise

12. Upon a partner's retirement, the remaining partners experience a positive adjustment

in their profit-sharing ratio.

Sol. True: In the event of a partner's retirement, the distribution of their share of profit or loss among the remaining partners will be based on their agreed-upon profit-sharing ratio, unless stated otherwise

Multiple Choice Questions

Q. C, D and E are partners sharing profits and losses in the proportion of $\frac{1}{2}$, $\frac{1}{3}$ and $\frac{1}{6}$. D retired and the new profit sharing ratio between C and E is 3:2 and the Reserve of ₹ 12,000 is divided among the partners in the ratio:

- (a) ₹ 2,000: ₹ 4,000: ₹ 6,000.
- (b) ₹ 5,000: ₹ 5,000: ₹ 2,000.
- (c) ₹ 6,000: ₹ 4,000: ₹ 2,000.
- (d) None of the above

(ICAI Study Material)

Sol (c)

Q. A, B and C takes a Joint Life Policy, after five years B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement, A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy premium is fully charged to revenue as and when paid?

- ₹ 50,000 credited to all the partners in old ratio.
- ₹ 2,50,000 credited to all the partners in old ratio.
- ₹ 2,00,000 credited to all the partners in old ratio.
- None of the above

(ICAI Study Material)

Sol (a)

Q. A, B and C take a Joint Life Policy, after five years, B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy is maintained at the surrender value?

- (a) ₹ 50,000 credited to all the partners in old ratio.
- (b) ₹ 2,50,000 credited to all the partners in old ratio.
- (c) No treatment is required.
- (d) None of the above

(ICAI Study Material)

Sol (c)

Q. A, B and C are partners sharing profits in the ratio 2:2:1. On retirement of B, goodwill was valued as ₹ 30,000. Find the contribution of A and C to compensate B.

- (a) ₹ 20,000 and ₹ 10,000.
- (b) ₹ 8,000 and ₹ 4,000.

(c) They will not contribute anything.

(d) None of the above

(ICAI Study Material)

Sol (b)

Q. A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1 respectively with the capital balance of ₹ 50,000 for A and B, for C ₹ 25,000. B declared to retire from the firm and balance in reserve on the date was ₹ 15,000. If goodwill of the firm was valued as ₹ 30,000 and profit on revaluation was ₹ 7,050 then what amount will be transferred to the loan account of B.

(a) ₹ 70,820.

(b) ₹ 50,820.

(c) ₹ 25,820.

(d) None of the above

(ICAI Study Material)

Sol (a)

Q. A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires on a decided date and Goodwill of the firm is to be valued at ₹ 60,000. Find the amount payable to retiring partner on account of goodwill.

(a) ₹ 30,000.

(b) ₹ 20,000.

(c) ₹ 10,000.

(d) None of the above

(ICAI Study Material)

Sol (c)

Q. A, B and C were partners sharing profits and losses in the ratio of 3:2:1. A retired and Goodwill of the firm is to be valued at ₹ 24,000. What will be the treatment for goodwill?

(a) Credited to Revaluation Account at ₹ 24,000.

(b) Adjusted through partners' capital accounts in gaining/sacrificing ratio.

(c) Only A's capital account credited with ₹ 12,000.

(d) None of the above

(ICAI Study Material)

Sol (b)

Q. Balances of A, B and C sharing profits and losses in proportionate to their capitals, stood as A - ₹ 2,00,000; B - ₹ 3,00,000 and C - ₹ 2,00,000. A desired to retire from the firm, B and C share the future profits equally, Goodwill of the entire firm be valued at ₹ 1,40,000 and no Goodwill account being raised.

(a) Credit Partner's Capital Account with old profit sharing ratio for ₹ 1,40,000.

(b) Credit Partner's Capital Account with new profit sharing ratio for ₹ 1,40,000.

(c) Credit A's Account with ₹ 40,000 and debit B's Capital Account with ₹ 10,000 and C's Capital Account with ₹ 30,000.

(d) None of the above

(ICAI Study Material)

Sol (c)

Theoretical questions

Q. Write short notes on Final payment of a retiring partner.

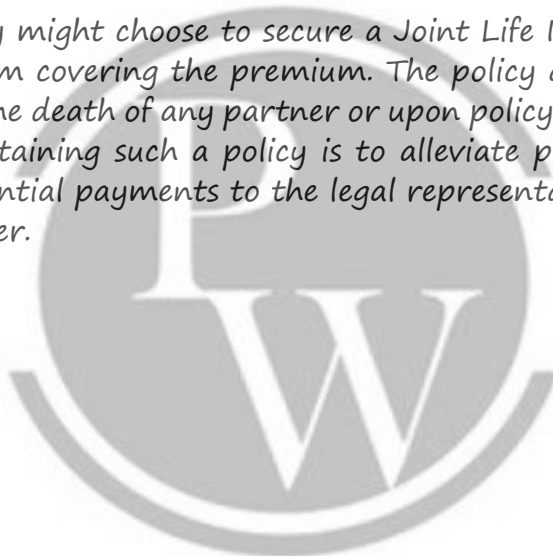
(ICAI Study Material)

Sol.– The Capital Account requires the following adjustments: (i) Transfer of reserves, (ii) Transfer of goodwill, and (iii) Transfer of profit/loss on revaluation. Once these adjustments are made, the Capital Account balance credited to the retiring partner signifies the amount owed to them. The remaining partners have the option to settle the entire claim at the time of retirement.

Q. What is joint life policy? What is the objective of taking such a policy?

(ICAI Study Material)

Sol.– A partnership entity might choose to secure a Joint Life Insurance Policy covering all partners, with the firm covering the premium. The policy amount becomes payable to the firm either upon the death of any partner or upon policy maturity, whichever occurs earlier. The aim of obtaining such a policy is to alleviate potential financial challenges associated with substantial payments to the legal representatives of a deceased partner or to a retiring partner.



UNIT - 6: DISSOLUTION OF PARTNERSHIP FIRMS AND LLP

6.1 INTRODUCTION

Besides the realignment of partners' profit-sharing rights through adjustments in the profit-sharing ratio due to events such as the introduction of a new partner or the retirement/death of a partner, an equally significant facet of partnership accounting pertains to the closure of books in case of dissolution. Within this unit, we will explore the situations that lead to the dissolution of a partnership firm and delve into the accounting procedures essential for closing its books. Additionally, we will address specific challenges associated with partner insolvency and the resolution of the partnership's obligations.

6.2 SITUATIONS RESULTING IN DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:

- (i) The end of the specific period for which partnership was established.
- (ii) Completion of the undertaking for which it was entered.
- (iii) Demise of a partner
- (iv) When a partner becomes insolvent

Nevertheless, the partners, or the remaining partners in the event of death or insolvency, have the option to persist in the business. In this scenario, a new partnership may be formed while the firm endures. The firm is considered dissolved only when the business concludes. A firm undergoes dissolution in the following circumstances:

The court possesses the authority to declare the dissolution of a firm under the following conditions:

- (a) In the event of a partner being declared mentally unsound;
- (b) If a partner experiences permanent incapacity;
- (c) When a partner engages in misconduct affecting the business;
- (d) If a partner consistently ignores the terms of the partnership agreement;
- (e) When a partner transfers their interest or share to a third party;
- (f) If the business is unsustainable except at a loss; and
- (g) When it is deemed fair and equitable to do so.

6.3 CONSEQUENCES OF DISSOLUTION

Upon the dissolution of a partnership, the initial step involves the realization of the firm's assets, encompassing goodwill. Subsequently, the realized amount is initially allocated to settle obligations to external entities and loans from partners. Following this, the partners' contributed capital is repaid, and any surplus is distributed among the partners based on their profit-sharing ratio.

Conversely, if, after settling the firm's liabilities and repaying loans from partners, the remaining assets are inadequate to fully reimburse the capital contributed by each partner, the shortfall is borne by the partners in accordance with their profit-sharing ratio.

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As per the provisions of Section 48 of the Partnership Act, the resolution of the mutual rights of partners in the event of partnership dissolution, unless otherwise agreed upon, is determined through the following steps:

- (a) Losses, including capital deficiencies, are initially settled from profits, then from capital, and, if required, individually by the partners in proportion to their entitlement to share profits.
- (b) The assets of the firm, including any contributions by partners to address capital shortfalls, must be allocated in the following sequence:
 - (i) Settling the firm's debts to third parties.
 - (ii) Distributing, in a proportional manner, amounts owed to each partner for advances, distinct from capital.
 - (iii) Settling the amounts owed to each partner on account of capital.
 - (iv) Distributing any remaining residue among the partners based on their entitlement to share profits.

Distinction between Dissolution of Partnership and Dissolution of Partnership Firm

Dissolution of Partnership	Dissolution of Partnership Firm
The dissolution of a partnership denotes the termination of the association among the partners of the firm..	The dissolution of the firm signifies the complete cessation of its existence, encompassing the relationships among all the partners.
The profit-sharing ratio may undergo alterations, or there might be instances of a partner's admission, death, or retirement.	During the dissolution of the partnership firm, the process takes place.
Upon the dissolution of the partnership, the business operations persist, but the partnership undergoes a reconstitution.	In the event of the firm's dissolution, the business comes to a halt.

Dissolution of Partnership	Dissolution of Partnership Firm
There is no involvement or interference by the court.	The court possesses inherent authority to intervene, and it can issue an order leading to the dissolution of a firm.
The economic relationships among partners may either stay unchanged or undergo alterations.Top of Form	The economic relationship among partners concludes.Top of Form
Assets and liabilities undergo revaluation, leading to the preparation of a new balance sheet.	Assets are sold and converted into cash, while liabilities are settled and paid in full. Top of Form
Revaluation account is maintained.	Realization account is maintained.
Assets and liabilities undergo a revaluation following the winding up of the current partnership.	Assets and liabilities are resolved during the winding up of a firm.
The closure of the books of accounts does not take place.	Closure of books of accounts takes place.

6.3.1 Dissolution before the expiry of a fixed term

A partner who, upon admission, offers a premium to the existing partners under the condition that the firm will not be dissolved before a specified term elapses, is eligible for a reasonable refund of the premium, or a proportionate amount, if the firm dissolves before the designated term concludes.

No claim will be there if:-

- (a) The dissolution of the firm results from the demise of a partner;
- (b) the dissolution primarily stems from the misconduct of the partner seeking a refund;
- (c) the dissolution occurs in accordance with an agreement that lacks provisions for the reimbursement of the premium or any portion thereof.

The repayment amount shall be determined reasonably, taking into consideration the terms of the admission agreement and the duration of the agreed-upon period, including the elapsed period. Any due amounts will be shared among the remaining partners based on their profit-sharing ratio.

6.4 CLOSURE OF BOOKS ON DISSOLUTION

In order to finalize the accounting records of a Partnership Firm, it is necessary to transfer all assets and liabilities to the Realization Account. Provided below is an example of the Realization Account.

Realization A/c

Particulars	₹	Particulars	₹
To Sundry Assets		By Sundry Liabilities	
(Excluding Cash/Bank balance, Dr Balance of P&L A/c, Partners' Current A/c, Capital A/c, and Loan A/c)		(Not including Cr Balance of P&L A/c, Partners' Current A/c, Capital A/c, and Loan A/c)	
To Bank/Cash (expenses amount paid for realization)		By Provision on Assets	
To Cash/Bank A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from selling recorded assets and unrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities amount paid by partners)		By Partners' Capital A/cs (Amount of Assets taken over by partners)	
To Partners' Capital A/cs		By Partners' Capital A/cs	
(Profit on realization divided in profit sharing ratio)		(Loss on realization divided in profit sharing ratio)	

6.4.1 Treatment of Goodwill at the time of dissolution of Firm

- If Goodwill is present in the Balance Sheet, it is recognized as acquired Goodwill, treated akin to any other asset, and subsequently transferred to the realization account.
- If Goodwill is absent from the balance sheet, no entry is necessary.
- In cases where Goodwill is realized or acquired by a partner, either the Cash Account is debited or the Partner's Capital Account is debited, with a corresponding credit to the Realization Account.

We will understand how to close the books of accounts through illustration the required journal entries to be made for closing the books of a firm with the example given below:

Balance Sheet of Falguni and Kanika as on 31/12/21

Liabilities		₹	Assets		₹
Sundry Creditors		40,000	Plant and Machinery		80,000
Falguni's Loan		20,000	Patents		12,000
General Reserve		20,000	Stock		50,000
Capitals:			Sundry Debtors	38,000	

Liabilities		₹	Assets		₹
Falguni	60,000		Less: Prov. for doubtful debts	(2,000)	36,000
Kanika	50,000	110,000	Cash		12,000
		190,000			190,000

Falguni and Kanika share profits in the ratio of 3:2. On 1st January, 2022 the firm was dissolved. Falguni took over the patents at a value of 10,000. The other assets realized as under:

Particulars	₹
Plant and Machinery	90,000
Stock	44,000
Sundry Debtors	37,000
Total	171,000

The outstanding creditors were settled with a 5% discount, and the total expense was 7,000. The procedure to conclude the accounting records is outlined below:

1. Initiate a Realization Account and transfer all assets, excluding cash on hand or in a bank, at their respective book values. Debit the Realization Account, and credit the distinct assets, thereby concluding them. It is essential to note that Sundry Debtors and Provisions for Bad Debts are distinct accounts, and the total amount of debtors should be moved. In the given illustration, the entry would be as follows:

Particulars		₹	₹
Realization A/c	Dr.	180,000	
To Plant and Machinery A/c			80,000
To Patents A/c			12,000
To Stock A/c			50,000
To Sundry Debtors			38,000
(Being transfer of various assets to the dr side of Realization A/c)			

2. Move the external liabilities, as well as provisions and reserves related to assets (such as Provision for Doubtful Debts), to the credit side of the Realization account. Debit the accounts of liabilities and provisions, thereby concluding them. The entry should be made at book figures. The corresponding entry would be:

Particulars		₹	₹
Sundry Creditors A/c	Dr.	40,000	

Particulars		₹	₹
Provision for Doubtful Debts A/c	Dr.	2,000	
To Realization A/c			42,000
(Transfer of liabilities to outsiders and provision against debtors to Realization Account)			

Note: Do not include accounts reflecting accumulated losses or profits in the transfer to the Realization Account.

3. Credit the Realization Account with the realized amount from asset sales, disregarding the book figures. It's important to note that the Cash (or Bank) Account will be debited.

Particulars		₹	₹
Cash A/c Dr.		171,000	
To Realization A/c			171,000
(Being amount realized from sale of assets)			

When a partner assumes control of an asset, debit his Capital Account, and credit the Realization Account with the mutually agreed-upon value, Thus:

Particulars		₹	₹
Falguni's Capital Account Dr.		10,000	
To Realization Account (Patents taken over by Falguni at 10,000)			10,000

Dissolution or asset realization expenses are recorded by debiting the Realization Account and crediting the Cash Account.

Particulars		₹	₹
Realization A/c Dr.		7,000	
To Cash A/c(Payment of Expenses)			7,000

- (i) Debit the Realization Account with the actual payment made to creditors, and credit the Cash Account:

Particulars		₹	₹
Realization A/c Dr.		38,000	
To Cash A/c			38,000
(Payment to Sundry Creditors 40,000 - 5%)			

- (ii) If a partner takes over a liability, credit his Capital Account, and debit the Realization Account with the agreed-upon amount..

At this stage, the Realization Account indicates either a profit or a loss. If the debit side surpasses the credit side, it signifies a loss; conversely, if the credit side is greater, it indicates a profit. The profit or loss is then allocated to the Capital Accounts of partners based on the

established profit-sharing ratio. In the case of a profit, the Realization Account is debited, and the Capital Accounts are credited. Conversely, for a loss, the entry is the reverse. In the provided example, the Realization Account reveals a loss of 2,000 (refer to the account below)..

Particulars		₹	₹
Falguni's Capital A/c	Dr.	1200	
Kanika's Capital A/c	Dr.	800	
To Realization A/c			2,000
(Being transfer of loss to the Capital A/c in the ratio of 3:2)			

Any loans from partners should be settled at this stage. The entry involves debiting the Loan Account and crediting the Cash Account. Thus:

Particulars		₹	₹
Falguni's Loan Account	Dr.	20,000	
To Cash Account (Being Repayment of Falguni's Loan)			20,000

Any reserve of accumulated profit or loss recorded in the books (as indicated by the Balance Sheet) should be shifted to the Capital Account in accordance with the profit-sharing ratio. Thus:

Particulars		₹	₹
General Reserve A/c	Dr.	20,000	
To Falguni's Capital A/c			12,000
To Kanika's Capital A/c			8,000
(General Reserve A/c transferred to Capital A/c in the ratio of 3:2)			

At this point, the Capital Accounts of partners will indicate the amount due to them or from them. If a partner owes money to the firm, they will make the payment, resulting in a debit to the Cash Account and a credit to their Capital Account, which is then closed. Conversely, if a partner is owed money, it will be paid to them, resulting in a debit to their Capital Account and a credit to the Cash Account. This process closes both the Capital Accounts and the Cash Account. The entry in the given example is illustrated in the Capital Accounts below.

Particulars		₹	₹
Falguni's Capital A/c	Dr.	60,800	
Kanika's Capital A/c	Dr.	57,200	
To Cash A/c			118,000
(Being amount paid to partners on Capital A/c)			

Ledgers

Plant and Machinery A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	80,000	Jan. 1	By Realization A/c	80,000

Patents A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	12,000	Jan. 1	By Realization A/c	12,000

Stock A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	50,000	Jan. 1	By Realization A/c	50,000

Sundry Debtors A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	38,000	Jan. 1	By Realization A/c	38,000

Provision for Doubtful Debts A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c	2,000	Jan. 1	By Balance b/d	2,000

Sundry Creditors A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c	40,000	Jan. 1	By Balance b/d	40,000

Falguni's Loan A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Cash A/c	20,000	Jan. 1	By Balance b/d	20,000

General Reserve A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Capital Accounts Falguni Kanika	12,000 8,000	Jan. 1	By Balance b/d	20,000
		20,000			20,000

Realization A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Sundry Assets Plant and Machinery Patents Stock	80,000 12,000 50,000	Jan. 1	By Sundry Creditors By Provision for Doubtful Debts By Cash Account - assets realized	40,000 2,000 1,71,000
	Sundry Debtors	38,000		By Falguni's Capital Account - patents taken over	10,000
	To Cash Account - Exp. To Cash Account - Creditors paid	7,000		By Loss to: Falguni Kanika	1200
		38,000			800
					2,000
		2,25,000			2,25,000

Cash A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	12,000	Jan. 1	By Realization A/c - Expenses	7,000
	To Realization b/d	171,000	Jan. 1	By Realization A/c - Creditors	38,000
			Jan. 1	By Falguni's Loan Account	20,000
			Jan. 1	By Falguni's Capital A/c	60,800
			Jan. 1	By Kanika's Capital A/c	57,200
		183,000			183,000

Falguni's Capital A/c

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c - Patents	10,000	Jan. 1	By Balance b/d	60,000
	To Realization A/c - Loss	1200	Jan. 1	By General Reserve	12,000
	To Cash Account	60,800			
		72,000			72,000

Kanika's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-loss	800	Jan. 1	By Balance b/d	50,000
	To Cash Account	57,200		By General Reserve	8,000
		58,000			58,000

Note:

- (1) If a partner acquires any assets at a value agreed upon by the partners, debit the Partner's Capital Account and credit Realization Account with the agreed-upon price of the asset.
- (2) Settle the liabilities, crediting cash and debiting the liability accounts. The difference between the book figure and the amount paid is then transferred to the Realization Account.
- (3) Liabilities to external parties may also be transferred to the Realization Account. In this scenario, the amount paid in cash for these liabilities should be debited to the Realization Account, with the Cash Account being credited. If a liability is assumed by a partner, the Realization Account should be debited, and the Partners' Capital Accounts credited at the agreed-upon amount.
- (4) The remaining balance in the Realization Account signifies either a profit or loss on realization. Distribute this balance among the partners in the proportion they shared profits and losses. For a loss, credit the Realization Account and debit the various partners' Capital Accounts, and vice versa for a profit.
- (5) Settle the partners' loans or advances that are distinct from their contributed capital, offsetting any debit balance in the concerned partner's capital account.
- (6) The closing balance of the cash account will precisely match the balance of the capital account, assuming they are in credit. Credit the cash and debit the partners' capital accounts with the payable amount to close their accounts.

6.5 CONSEQUENCES OF INSOLVENCY OF A PARTNER

If a partner's capital account is in debit, following the adjustment of their share of loss or profit, the firm may not have adequate cash or assets to settle amounts owed to other partners until the debit balance is repaid by the partner in question. However, if the partner is insolvent, the outstanding amount may not be recoverable. In such instances, the shortfall may be shouldered by the solvent partners based on their profit-sharing ratio or following the principle established in the well-known case of *Garner vs. Murray*. In the latter scenario, the deficiency would be borne by the solvent partners proportionate to their capitals, not in alignment with the proportion in which they share profits and losses.

If a partner goes insolvent then the following are the consequences:

1. The Partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.	2. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.	3. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication,	4. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

In the event of a partner becoming insolvent, the resulting outcomes are as follows:

- (a) The partner declared insolvent ceases to be a partner on the date of the adjudication order.
- (b) The firm undergoes dissolution upon the date of the adjudication order unless there exists a contract specifying otherwise.
- (c) The estate of the insolvent partner is not accountable for any actions of the firm occurring after the date of the adjudication order.
- (d) The firm is not responsible for any actions of the insolvent partner following the date of the adjudication order.

LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is incapable of settling their debt to the firm, leading to insolvency, the loss share is borne by other solvent partners, as established in the English case of *Garner vs. Murray*. Following this decision, solvent partners are obligated to absorb the loss attributed to the insolvency of a partner. It's essential to specify that while the regular loss on the realization of assets is distributed among all partners (including the insolvent partner) in the profit-sharing ratio, a loss resulting from a partner's insolvency is to be shouldered by the solvent partners in the capital ratio.

The determination of the capital ratio in this context is elucidated below. The provisions of the Indian Partnership Act align with the *Garner vs. Murray* rule. However, if the partnership deed outlines a specific method for handling partner insolvency, the stipulations within the deed should be applied.

Capital Ratio on Insolvency

- Partners have the flexibility to opt for either fixed or fluctuating capitals within the firm.
- When maintaining fixed capitals, adjustments related to profit shares, interest on capitals, drawings, interest on drawings, salary, etc., are managed through Current Accounts, which may have debit or credit balances. Insolvency loss is distributed in proportion to fixed capitals.
- If capitals are not fixed and all transactions, including drawings, profits, interest, etc., are recorded through Capital Accounts, the Balance Sheet should not display Current Accounts of the partners. The capital ratio is determined after adjusting

reserves, accumulated profits up to the dissolution date, drawings up to the dissolution date, interest on capitals and drawings up to the dissolution date, but before adjusting the profit or loss on the Realization Account.

- ❑ In cases where a partner has a debit balance in their Capital Account and is not insolvent, they are not obligated to bear the loss due to the insolvency of another partner.

Insolvency of all Partners

- ❑ When the firm's liabilities cannot be fully settled from both the firm's assets and the personal assets of the partners, all partners of the firm are considered insolvent. In such a scenario, it is advisable not to transfer the creditors' amount to the Realization Account. Instead, the balance of the creditors' accounts is shifted to the Deficiency Account.
- ❑ Creditors may receive payments based on the available amount, including the contributions made by the partners.
- ❑ The remaining unsettled portion of the creditor account is then moved to the Capital Accounts of the partners in accordance with the profit-sharing ratio. Subsequently, the Capital Accounts are closed. In this process, it is prudent to start by closing the Partners' Capital Account with the most unfavorable position, and the last account will be automatically closed.

PIECEMEAL PAYMENTS

Typically, assets sold during the dissolution of a partnership are realized gradually in small installments over time. In such situations, there is a decision to either distribute whatever is collected or to wait until the entire amount is gathered. Generally, the former approach is chosen. To guarantee that the cash distribution among partners aligns with their stake in the partnership, one of the two methods outlined below may be employed to determine the order in which payments should be made.

1. Maximum Loss Method

Every installment received is treated as the ultimate payment, rendering outstanding assets and claims as worthless. Partners' accounts are adjusted accordingly each time a distribution is made, following either the Garner vs. Murray Rule or the profit-sharing ratio rule.

2. Highest Relative Capital Method

In this approach, known as the proportionate capital method, the partner with the higher relative capital—meaning a capital larger in proportion to their profit-sharing ratio—is prioritized for payment. To establish the excess capital of each partner, their capitals are initially divided by figures proportionate to their profit-sharing ratio. The smallest quotient indicates the basic capital. After identifying the partner with the smallest basic capital, the hypothetical capitals of other partners, proportionate to the profit-sharing ratio of the basic capital, are computed. These are essentially their hypothetical capitals. The excess capital of each partner is then determined by subtracting the amount of their hypothetical capital from their actual capital. This process is repeated, if necessary, between partners with excess capital. After ascertaining the amount by which each partner's capital exceeds the basic

capital, payment is initiated by settling the partner with the largest excess capital first, followed by those with the next highest excess capital until all partners' capitals are aligned with their profit-sharing ratio.

WINDING UP OF A LIMITED LIABILITY PARTNERSHIP (LLP)

The closure of a Limited Liability Partnership (LLP) can occur through voluntary proceedings or through the intervention of the Tribunal, leading to the dissolution of the LLP.

Winding up of an LLP by the Tribunal may be instigated if:

- ❑ The LLP expresses the intent to wind up.
- ❑ The LLP has fewer than two partners for an extended period exceeding six months.
- ❑ The LLP is incapable of settling its debts.
- ❑ The LLP has not acted in the interest of the sovereignty and integrity of India.
- ❑ The LLP has neglected to furnish statements of accounts, solvency, or annual returns for more than five consecutive financial years to the Registrar.
- ❑ The Tribunal deems it just and equitable to wind up the LLP.

Additionally, the Central Government has the authority to establish rules governing the provisions related to the winding up and dissolution of an LLP.

True and False

1. Books of accounts are closed in dissolution of partnership. (ICAI Study Material)

Sol. False, The closure of books of accounts does not occur in the dissolution of a partnership but is implemented in the case of the dissolution of a partnership firm.

2. On the dissolution of a partnership, firstly, the assets of the firm are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders.

(ICAI Study Material)

Sol. True, Upon the dissolution of a partnership, the initial step involves realizing the assets of the firm. Subsequently, the amount obtained is prioritized for settling liabilities to outsiders and loans from partners. Following this, the repayment of the capital contributed by partners takes place.

3. In event of the dissolution of the firm, the business ceases to end. In event of dissolution of the partnership, the partnership is reconstituted and the business discontinues.

(ICAI Study Material)

Sol. True, In the event of the firm's dissolution, the business comes to an end. On the other hand, in the event of the dissolution of the partnership, the business continues its usual operations, but the partnership undergoes a reconstitution.

4. Expenses of dissolution on realization of assets are credited to the Realization Account.

(ICAI Study Material)

Sol. False, The costs associated with the dissolution and realization of assets are charged to the Realization Account.

5. Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm. (ICAI Study Material)

Sol. True, A Revaluation Account is formulated during the dissolution of a partnership, while a Realization Account is prepared specifically during the dissolution of a partnership firm.

MULTIPLE CHOICE QUESTIONS

1. Partnership could be dissolved because of

- (a) Death of a partner.*
- (b) Insolvency of a partner.*
- (c) Either (a) or (b).*
- (d) None of the above*

(ICAI Study Material)

Sol. (c)

2. On the dissolution of partnership, profit or loss on realization of assets and liabilities should be divided among partners

- (a) In the ratio of their capitals.*
- (b) In the same ratio in which they share profits.*
- (c) Equally.*
- (d) None of the above*

(ICAI Study Material)

Sol. (b)

3. An unrecorded asset realized at the time of dissolution is credited to

- (a) Realization account.*
- (b) Revaluation account.*
- (c) Capital accounts.*
- (d) None of the above*

(ICAI Study Material)

Sol. (a)

4. A liability taken over by a partner at the time of dissolution is credited to

- (a) Profit and loss account.*
- (b) Partners' capital accounts.*
- (c) Realization account.*
- (d) None of the above*

(ICAI Study Material)

Sol. (b)

5. Realization account is a

- (a) Nominal account.
- (b) Real account.
- (c) Personal account.
- (d) None of the above

(ICAI Study Material)

Sol. (a)

6. Which of the following method/methods is adopted to ensure that distribution of cash among partners is in proportion to their interest in partnership?

- (a) Maximum loss method.
- (b) Highest relative capital method.
- (c) Either (a) or (b).
- (d) None of the above

(ICAI Study Material)

Sol. (c)

THEORETICAL QUESTIONS

1. State the circumstances when Garner V/S Murray rule not applicable.

(ICAI Study Material)

Sol. Exceptions to the Application of Garner vs. Murray Rule:

- (i) In cases where a solvent partner maintains a debit balance in the capital account, only solvent partners bear the loss of the capital deficiency of the insolvent partner in their capital ratio. If, by chance, a solvent partner has a debit balance in their capital account, they are exempt from the obligation to bear the loss resulting from the insolvency of another partner.
- (ii) When a firm consists of only two partners.
- (iii) In situations where there is a predefined agreement among the partners to distribute the deficiency in the capital account of the insolvent partner.
- (iv) In instances where all partners of the firm are insolvent.

2. W paid a premium to other partners of the firm at the time of his admission to the firm, with a condition that they will not be dissolved before the expiry of five years. The firm is dissolved after three years. W claims refund of premium.

- (i) List the criteria for the calculation of the amount of refund.
- (ii) Also list any two conditions when no claim in this respect will arise.

(ICAI Study Material)

Sol. In the event of the firm dissolving before the term expiration, particularly when W, a partner who paid a premium upon admission, is entitled to a repayment or refund, the criteria for determining the refund amount include:

- (i) The terms agreed upon during admission,
- (ii) The specified duration for which the firm committed not to dissolve,
- (iii) The duration for which the firm has already been in existence.

No claim for a refund will arise if:

- (i) The firm dissolves due to the death of a partner,*
- (ii) The dissolution is primarily a result of misconduct by W,*
- (iii) The dissolution occurs through an agreement that lacks a provision for the refund of the premium.*



Theoretical Framework of A/c's

Unit-1: Meaning and Scope of Accounting

INTRODUCTION

Every person engages in various economic activities. For instance, a salaried individual receives income, which they allocate toward necessities like food, clothing, shelter, children's education, and more. Similarly, sports club, business, a local governing body or government entities at the central or state level, all partake in some form of economic activity.

It's important to note that not all economic activities are solely motivated for gain/profit; many of them have the potential to yield broader social benefits, serving the public at large. Ex: Rolex sell premium watch but most of the gain from Rolex Watch sales goes for charitable purpose.

Economic activities are executed through a series of "transactions and events."

"Transaction signifies performance of an action, while Event refers to Results of one or more transactions"

Example -

(ICAI Study Module)

An individual invests ₹2,00,000 for running a stationery business.

On 1st January, he purchases goods for ₹1,15,000 and sells for ₹1,47,000 during the month of January.

He pays shop rent for the month Rs.5,000 and finds that still he has goods worth ₹.15,000 in hand.

Here, the individual performs an economic activity. He carries on a few transactions (i.e. sale, purchase, rent payment) and encounters with some events (i.e Profit and Cl. Stock).

Is it not logical that he will want to know the result of his activity?

We see that the individual, who runs the stationery business, earns a surplus of ₹42,000.

		₹
Goods sold		1,47,000
Goods in hand (Cl. Stock)		15,000
		1,62,000
Less : Goods purchased	1,15,000	
Shop rent paid	5,000	(1,20,000)
Profit/Surplus		42,000

Earning a surplus of ₹42,000 constitutes an event (i.e. Result of Transactions), as does the management of inventory.

Meanwhile, the purchase and sale of goods, investment of funds, and rent payments are considered transactions.

Every Person (Natural or Artificial) maintains records of their financial transactions and events to ensure they have sufficient information for effective decision-making.

Accounting helps in documenting transactions and events and providing information for decision-making. Accounting's core objective is to cater to the information requirements of decision-makers, thereby Accounting is given designation as the "language of business."

MEANING OF ACCOUNTING

"Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof."

Accounting –

- Identifying Financial Events & Transactions
- Recording these transactions – Journal Entry or Subsidiary Book
- Classification of Records – Ledger Posting & TB
- Summarizing – Trading and Profit & Loss, BS
- Analysing – Presenting data in organized form
- Interpreting & Communicating Results – To user for their decision making

Procedural aspects of Accounting

Based on the definitions mentioned above, the accounting process can be fundamentally segmented into two key components:

- Generating financial information, and
 - Employing (use) the financial information to user's.
- (i) Producing Financial Information

1. **Recording** – This defines the fundamental role of accounting. All financial transactions are documented in the accounting books. This recording takes place “Journal,” which can be further subdivided into various subsidiary journals (books)
2. **Classifying** – Once these transactions have been recorded in the Journal, they are systematically categorized under their respective account heads in the Ledger aimed at grouping transactions or entries, this organized data is contained in “Ledger”.
3. **Summarising** – This phase involves arranging and delivering the categorized data in a format that serves the needs of both internal and external users of financial statements. This progression ultimately culminates in the creation of financial statements (Trading and P&L A/c with BS and Notes to A/c)
4. **Analysing** – The figures unless not organized in a simplified manner may not be of use. This process aims to establish connections between items within the Profit and Loss Account and Balance Sheet, forming the foundation for interpretation.
5. **Interpreting** – This represents the ultimate role of accounting. It involves analysis of accounting data. In essence, financial statements should not only narrate past occurrences but also delve into the reasons behind them and provide insights into what may occur under specific circumstances.
6. **Communicating** – This process pertains to delivering condensed, analyzed, and explained data to users, equipping them to make informed decisions.

(ii) Employing the Financial Information

It is now widely recognized that, in addition to the owner and the management of the business, users of financial accounts encompass investors, employees, lenders, suppliers, customers, government bodies, various agencies, and the general public. Accounting serves as the means to systematically present this information to these users.

EVOLUTION OF ACCOUNTING AS A SOCIAL SCIENCE

History & Development of Accounting

In India, accounting practices can be traced back to the time of Kautilya, a minister in Chandragupta's kingdom, who authored the Arthashastra, which detailed the principles of maintaining accounting records.

The foundation of modern double-entry bookkeeping can be attributed to Luca Pacioli, a Franciscan friar and merchant-class figure. His book “Summa de Arithmetica, Geometria, Proportion at Proportionality” published in Venice in 1494 is considered the first text on double-entry bookkeeping. Pacioli introduced terms like “Debit” (Dr.) and “Credit” (Cr.) in his book, originating from Italian and Latin roots.

OBJECTIVES OF ACCOUNTING

The objectives of accounting encompass the following aspects:

1. **Methodical Recording of Transactions:** The primary objective methodically document the financial elements of business transactions, commonly known as bookkeeping. These recorded transactions are subsequently organized and logically summarized to generate financial statements and facilitate their analysis and interpretation.

2. **Determination of Outcomes from Recorded Transactions:** Accountants create profit and loss accounts to assess the outcomes of business operations during a specific time frame. If a business is not proving lucrative profits or into losses, the management can investigate the reasons for this and take corrective measures.
3. **Evaluation of the Financial Status of the Business:** Business owners are not only interested in understanding the profitability or loss of their business for a specific period but also want to ascertain their obligations (liabilities) to external parties and the assets they possess on a given date.
4. **Furnishing Information for Informed Decision-Making:** Accounting, often referred to as the 'language of business,' conveys the financial performance of an enterprise. Accounting seeks to cater to the information requirements of decision-makers and assists them in making well-informed choices.
5. **Assessing Solvency:** Through the compilation of the balance sheet, the management not only discloses the enterprise's assets and liabilities but also provides insight into the company's ability to meet its short-term (liquidity) and long-term (solvency) obligations as they come due. This aids in evaluating the financial stability of the company.

FUNCTIONS OF ACCOUNTING

The primary functions of accounting encompass the following:

- (a) **Measurement:** Accounting serves as a tool to measure the historical performance of a business entity and portray its present financial standing.
- (b) **Forecasting:** Accounting plays a pivotal role in predicting the future performance and financial status of the enterprise by analyzing historical data and discerning trends.
- (c) **Facilitating Decision-Making:** Accounting offers pertinent information to the users of financial records, enabling them to make well-informed decisions.
- (d) **Comparing & Evaluating:** Accounting appraises the performance achieved in relation to set objectives and divulges details about accounting methods and potential obligations, which are vital for predicting, comparing, and evaluating financial outcomes.
- (e) **Enhancing Control:** Accounting also identifies weaknesses in the operational system and provides feedback on the effectiveness of measures taken to rectify these weaknesses.
- (f) **Compliance with Government Regulations and Taxation:** Accounting supplies essential information to the government for the purpose of overseeing the entity and collecting tax revenues.

BOOK-KEEPING

Book-keeping is the practice of systematically recording financial data related to business activities in an organized and meaningful manner. When we refer to "financial statements," we are talking about the Profit and Loss Account, Balance Sheet, and cash flow statements, which may include Schedules and Notes that are integral parts of these accounts.

Book-keeping also involves the essential task of appropriately categorizing transactions and events. A bookkeeper might be responsible for maintaining all the records of a business, or they may focus on a specific segment, such as tracking customer accounts in a department.

store. Accounting, in its broader sense, relies heavily on a well-organized and efficient book-keeping system.

It's important to recognize that book-keeping and the creation of financial statements also have legal implications. The maintenance of books of accounts and the preparation of financial statements for a company are governed by the Companies Act, while banks and insurance companies have specific Acts that regulate their accounting practices. In contrast, for sole proprietorships and partnerships, there are no specific legal requirements regarding the maintenance of books of accounts and the preparation of financial statements.

Objectives of Book-keeping

1. **Thorough Transaction Recording:** This pertains to the comprehensive recording of every transaction in a methodical and coherent fashion, illustrating its financial impact on the business.
2. **Determining the Financial Impact on the Business:** This involves assessing the cumulative impact of all transactions conducted throughout the accounting period on the overall financial status of the business.

DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

Many individuals erroneously consider bookkeeping and accounting as interchangeable, yet they are, in fact, distinct from each other. Accounting is a broader spectrum. It necessitates a deeper comprehension of the data derived from bookkeeping. Bookkeeping constitutes the initial recording stage, whereas accounting is centered on the subsequent summarization phase within an accounting system.

S. No.	Book-keeping	Accounting
1.	It is a procedure dedicated to the recording of transactions..	It is a process focused on the summarization of recorded transactions.
2.	Financial statements are not included in this procedure.	This process involves the creation of financial statements relying on the records provided by book-keeping.
3.	These records are insufficient for making managerial decisions.	Management makes decisions relying on these records.
4.	Bookkeeping does not have any sub-disciplines.	It encompasses includesspecialized areas, including financial accounting, management accounting, and more.
5.	Bookkeeping records alone cannot be used to determine the financial position of the business.	The financial position of the business is determined based on the information presented in accounting reports.

SUB-FIELDS OF ACCOUNTING

The various subfields of accounting include:

- (i) **Financial Accounting:** The creation and interpretation of financial statements, with the aim of communicating this information to stakeholders. It primarily aids in determining

the net outcome for a specific accounting period and the financial position as of a given date.

- (ii) **Management Accounting:** Management accounting focuses on **internal reporting** to the managers within a business unit, various approaches to organizing information and producing reports, tailored to the needs of managers in carrying out their functions To fulfill their roles in stewardship, planning, control, and decision-making, **An integral component of management accounting is cost accounting**, which deals with cost determination and control. Management Accounting is covered in more depth at advanced levels in the Chartered Accountancy Course.
- (iii) **Cost Accounting:** The **process of accounting for costs**, which begins with the recording of income and expenditures or the bases on which they are calculated, and concludes with the preparation of periodic statements and reports for determining and controlling costs.
- (iv) **Social Responsibility Accounting:** The call for social responsibility accounting arises from a growing awareness of the adverse effects of economic activities on society. As mentioned earlier, social responsibility accounting is concerned with **accounting for the social costs incurred by the enterprise and the social benefits generated**.
- (v) **Human Resource Accounting:** An attempt, Human resource accounting is an endeavor to identify, quantify, and report on investments made in the human resources of an organization that are not presently considered in conventional accounting practices.

USERS OF ACCOUNTING INFORMATION

Users of financial information fall into two main categories:

- (a) internal users and
- (b) external users.

Here are various categories of users of accounting information:

- (i) **Investors:** These individuals supply capital to the business and require **information to assess whether to buy, hold, or sell their investments**. They are also keen to understand the business's capacity to endure, thrive, and distribute dividends.
- (ii) **Employees:** Growth of employees is intimately connected to the advancement of the organization. Therefore, they are interested in the enterprise's stability, sustainability, growth, and its ability to provide compensation, retirement benefits, and employment opportunities.
- (iii) **Lenders:** Lenders need to ascertain whether their loans, including principal and interest, will be repaid on schedule.
- (iv) **Suppliers and Creditors:** These parties are concerned with the enterprise's capability to meet its financial obligations, which assists them in formulating credit policies, determining interest rates, and making other related decisions.
- (v) **Customers:** The stability and profitability of the enterprise matter to customers, especially when their operations depend on the enterprise's products or services.

- (vi) **Government and Regulatory Bodies:** Government entities and their agencies regulate business operations for the public good. They allocate resources among competing enterprises, enforce pricing controls, impose excise duties and taxes, making them continuously interested in the activities of business enterprises.
- (vii) **The General Public:** The broader public is interested in the operations of the enterprise because it can significantly contribute to the local economy in various ways, such as by employing people and patronizing local suppliers.
- (viii) **Management:** The entire management team also relies on accounting information for various managerial decisions. Based on the accounts, management assesses the effects of their decisions on the organization's operations, which aids in making further managerial choices.

RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

In many instances, there is an intersection between accounting and these disciplines. Accountants need to possess a working knowledge of these related fields to comprehend areas of overlap and, where applicable, apply insights from these disciplines to their work or seek expert guidance.

- (a) **Accounting and Economics:** Economics is concerned with allocation of limited resources to satisfy human needs. It examines the efficient utilization of scarce resources. Accounting, on the other hand, is a system that offers data to enable informed judgments and decisions. While some non-accounting data are also pertinent for decision-making, accounting and economics intersect in numerous ways.
Accounting provides the database upon which economic decision models have been built at a macro level. However, the development of transaction and event recording systems, harmonization through uniform rules, and data communication is essentially an area where accounting operates independently of economics.
- (b) **Accounting and Statistics:** Accounting information is extremely precise, to the last unit of currency.. Accounting takes a short-term view of events, usually limited to one year, while statistical analysis often requires a longer perspective. Numerous financial ratios and calculations in accounting are based on statistical formulas, and statistics play a crucial role in developing and interpreting accounting data. Therefore, a solid grasp of statistical methods enhances the utility of accounting data.
- (c) **Accounting and Mathematics:** Double-entry bookkeeping can be expressed algebraically, using the fundamental accounting equation ($\text{Asset} = \text{Liability} + \text{Capital}$). A fundamental understanding of arithmetic and algebra is essential for accounting computations and measurements, including calculations of interest and annuities, depreciation calculations, determining hire-purchase installments, and estimating amounts for loan repayment, asset replacement, and lease rentals.
Today, graphs and charts are extensively employed to convey accounting information, requiring knowledge of geometry and trigonometry for a more comprehensive grasp of accounting communication systems.
- (d) **Accounting and Law:** Economic entities function within a legal framework, with all transactions subject to contract law, sales of goods regulations, negotiable instruments

statutes, and more. Often, specific legal requirements dictate the accounting system for instance:

The Companies Act prescribes the format of financial statements for corporations.

Banks, insurance companies, and electric supply companies may also need to produce financial statements in accordance with relevant legislation.

Importantly, legal requirements concerning accounting systems are informed by developments in accounting knowledge, accounting influences the law while being influenced by it.

- (e) **Accounting and Management:** Management constitutes a broad field, encompassing various functions and drawing on a multitude of disciplines, including those mentioned earlier. Accountants play an integral role in management, providing a significant portion of accounting information for decision-making. While management depends on other data sources as well, accounting data serve as fundamental source documents. Within the management team, an accountant is uniquely positioned to understand and utilize this data effectively. Accountants actively participate in management and therefore are well-acquainted with the data needs

LIMITATIONS OF ACCOUNTING

It is a common assumption that an income statement provides a completely accurate view of an enterprise's income or loss, and that a balance sheet presents a perfectly true and fair representation of the enterprise's financial standing.

However, it is important to recognize that accounting, as a language, has its inherent limitations. The assumptions and conventions on which accounting is founded become the inherent limitations of accounting.

Financial statements are never entirely free from subjectivity since they largely depend on the personal judgment of the accountant in terms of adopting accounting policies. Here are some examples:

1. Some factors that are essential in assessing the value of an enterprise do not find their place in the accounts because they cannot be quantified in monetary terms (**Ex: Skill of Personnel, Loyalty of Skilled Personnel**)
2. The balance sheet reflects the state of the business on the day it is prepared, not on future dates. However, users of financial statements are often more interested in understanding the business's position in the near and distant future rather than its past.
3. Accounting often disregards changes in certain monetary factors, such as **inflation**, which can significantly affect the value of assets and liabilities.
4. There are instances where accounting principles may conflict with each other, leading to ambiguity in certain financial statements. (**i.e Materiality & Full Disclosure**)
5. Accounting involves several estimates that rely on the personal judgment of the accountant. For example, determining the provision for doubtful debts, selecting depreciation methods, classifying certain expenditures as revenue or capital, and choosing inventory valuation methods all involve a significant degree of judgment.

6. Financial statements typically consider only those assets that can be expressed in monetary terms. Human resources, despite being a critical asset for an enterprise, are not represented on the balance sheet, and there is no universally accepted method for valuing human resources in monetary terms.
7. Different accounting policies for treating the same item can lead to variations in financial statements, increasing the potential for manipulation. (Ex: SLM , WDV Method for Depn., LIFO,FIFO etc for inventory valuation)

ROLE OF ACCOUNTANT IN THE SOCIETY

There are only a few professions in the world that hold a special place of honor in the eyes of the public, and it's undeniable that the accounting profession is one of them. Accountants, armed with the science of accountancy and guided by their artistic acumen, have the remarkable ability to transform the lifeless, mute figures of financial data into a dynamic blueprint that assists businesses in shaping their future.

With their education, training, analytical minds, and experience, accountants are exceptionally well-equipped to offer a diverse range of services tailored to the constantly evolving needs of society.

Areas of Service

The practice of accountancy has extended beyond its traditional scope of preparing financial statements, interpreting these statements, and conducting audits. Accountants now play an active role in matters related to company laws, corporate legislation, taxation laws (both direct and indirect), and general management issues. Here are some of the key services that accountants provide to society:

1. **Maintenance of Books of Accounts:** Accountants are skilled in maintaining systematic records of financial transactions to determine the financial results of activities over a specific period and to assess the financial position of an organization on a particular date. This meticulous record-keeping assists management in planning, decision-making, and controlling functions.
2. **Statutory Audit:** Accountants, often chartered accountants, are appointed as auditors for limited companies. They are legally required to report annually on whether the balance sheet presents a true and fair view of the company's financial status and if the profit and loss account accurately reflects the financial performance for the year. Auditing is not confined to companies; other organizations may also have their accounts audited due to legal requirements or for the benefit of proprietors.
3. **Internal Audit:** Internal auditors scrutinize accounting transactions and systems to ensure proper maintenance of accounts, the presence of adequate safeguards against revenue leakage or asset misappropriation, and adherence to management's plans. Internal auditing is now considered a service to enhance operational efficiency.
4. **Taxation:** Accountants can handle taxation matters for businesses or individuals and represent them before tax authorities to resolve tax liabilities. They also offer assistance in tax planning to minimize tax burdens.
5. **Management Accounting and Consultancy Services:** Management accountants provide advisory services to internal management. They collect, analyze, interpret, and present

accounting information for planning, control, and decision-making. Their expertise covers areas such as management information systems, cost control, investment evaluation, working capital management, and corporate planning.

6. **Financial Advice:** Accountants with knowledge in finances, taxation, and family matters can offer guidance on personal financial affairs. They can assist with investments, insurance decisions, business expansion, financial investigations, pension schemes, and more.
7. **Other Services:** Accountants are involved in various additional activities such as secretarial work, share registration, company formation, receiverships, liquidations, arbitrations, cost accounting, and information services. They ensure timely and clear information flow within organizations and across different periods to benefit management and investors.

Chartered Accountant in Industry

An accountant, despite being a vital member of the top-tier planning team, doesn't primarily function as an industry planner. Instead, they collaborate with various functional departments and convert the organization's objectives into financial expectations. Consequently, they must conduct an in-depth analysis of the business and the individuals within functional departments, which may include engineers or sales professionals. A certified accountant is well-equipped to assume significant responsibilities in key business functions related to accounting, cost analysis, budget management, financial estimation, and treasury operations.

Chartered Accountant in Public Sector Enterprises

In both developed and developing countries, public sector enterprises have become a prominent component of the national economy. Consequently, the practices of financial and budgetary control, as well as accounting, auditing, and reporting, have garnered considerable attention and significance for the entire nation, extending beyond the confines of a limited number of shareholders. The accounting methods employed by these public corporations or companies differ from those used in conventional government accounting. Accountants bear the responsibility of preparing the financial accounts and reports for these public entities in a manner that provides the general public with insights into the rationale behind the entries in various records and financial statements. This transparency helps the public evaluate the legitimacy of these entries.

Chartered Accountant in Framing Fiscal Policies

Accountants have a constructive role to fulfill in shaping sound fiscal policies and promoting the growth of trade, commerce, and industry. It is imperative for them to continually evolve and acquire new skills to meet the demands of emerging service areas, in alignment with their dedication to the concept of public welfare. The success of a business enterprise, both from a commercial and societal perspective, hinges on the synergy between accounting and business expertise. Both accountants working within companies and those in private practice bear a social responsibility to enhance transparency by providing more comprehensive information about corporate performance. This transparency is essential for gaining a comprehensive understanding of the economic landscape.

Chartered Accountant and Economic Growth

In today's context, accountants should perceive their responsibilities in a broader sense, adapting to the evolving needs of the situation and not confining themselves solely to strict legal compliance. Their primary objective should be to prevent any individual from benefiting at the expense of the nation. Accountants must take on a proactive role and strive to promote

efficiency within individual businesses while supporting the key principles that underpin a welfare state.

TEST YOUR KNOWLEDGE

TRUE AND FALSE

1. There is no difference between book keeping and accounting, both are same.

(ICAI Study Material)

Sol. False, Book-keeping and accounting represent distinct entities within the realm of financial management. Accounting, being a comprehensive discipline, necessitates a profound comprehension of the records derived from bookkeeping, coupled with the proficiency to analyze and interpret the information gleaned from these records. Bookkeeping primarily involves the recording phase, whereas accounting is more concerned with the summarizing phase within an accounting system.

2. Management Accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.

(ICAI Study Material)

Sol. False, Financial accounting encompasses the creation and analysis of financial statements, as well as the communication of these statements to the users of accounts.

3. Financial accounting is concerned with internal reporting to the managers of a business unit.

(ICAI Study Material)

Sol. False, Management accounting focuses on providing internal reports to the managers of a business unit.

4. Customers of business should not be considered as users of accounts prepared by business. They are not interested to know performance of the business

(ICAI Study Material)

Sol. False, Customers are also interested in the stability and profitability of the enterprise since their operations are to some extent reliant on a consistent supply of goods.

5. Summarising is the basic function of accounting. All business transactions of a financial characters evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account.

(ICAI Study Material)

Sol. False, Documentation serves as the fundamental role in accounting, while summarization involves arranging and presenting classified data in a manner beneficial to both internal and external users of financial statements.

6. Balance sheet shows the position of the business on the day of its preparation and not on the future date

(ICAI Study Material)

Sol. True, The Balance Sheet is a representation of the financial status of an enterprise as of a specific date.

7. Objectives of book-keeping are complete recording of transactions & ascertainment of financial effect on the business.

(ICAI Study Material)

Sol. True, Book-keeping involves the thorough recording and the cumulative impact of transactions conducted throughout the accounting period.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is not a subfield of accounting?

(ICAI Study Material)

- (a) Management accounting.
- (b) Cost accounting.
- (c) Book-keeping
- (d) None of the above

Sol. (c) Book Keeping

2. Purposes of an accounting system include all the following except

- (a) Interpret and record the effects of business transaction.
- (b) Classify the effects of transactions to facilitate the preparation of reports.
- (c) Dictate the specific types of business enterprise transactions that the enterprises may engage in.
- (d) None of the above

(ICAI Study Material)

Sol. (c) Dictate the specific types of business enterprise transactions that the enterprises may engage in.

3. Book-keeping is mainly concerned with

(ICAI Study Material)

- (a) Recording of financial data.
- (b) Designing the systems in recording, classifying and summarising the recorded data.
- (c) Interpreting the data for internal and external users.
- (d) None of the above

Sol. (a) Recording of financial data.

4. Financial statements are part of

(ICAI Study Material)

- (a) Accounting.
- (b) Book-keeping.
- (c) Management Accounting.
- (d) None of the above

Sol. (a) Accounting

5. Financial position of the business is ascertained on the basis of

(ICAI Study Material)

- (a) Records prepared under book-keeping process.
- (b) Trial balance.
- (c) Balance Sheet.
- (d) None of the above

Sol. (c) Balance Sheet

6. Users of accounting information include

(ICAI Study Material)

- (a) Creditors/Supplier
- (b) Lenders/Customers
- (c) Both (a) and (b)
- (d) None of the above

Sol. (c) Both (a) and (b)

7. Financial statements do not consider

(ICAI Study Material)

- (a) Assets expressed in monetary terms.
- (b) Liabilities expressed in monetary terms.

- (c) Assets and liabilities expressed in non-monetary terms
- (d) None of the above

Sol. (c) Assets and liabilities expressed in non-monetary terms

8. On January 1, Sohan paid rent of ₹5,000. This can be classified as

- (a) An event. (b) A transaction. (ICAI Study Material)
- (c) A transaction as well as an event. (d) None of the above

Sol. (b) A transaction

9. On March 31, 2022 after sale of goods worth ₹2,000, he is left with the closing inventory of ₹10,000. This is (ICAI Study Material)

- (a) An event. (b) A transaction.
- (c) A transaction as well as an event. (d) None of the above

Sol. (a) Event

10. Which of the following is not a business transaction? (ICAI Study Material)

- (a) Bought a machine of ₹10,000 for business
- (b) Paid towards salaries of employees ₹5,000
- (c) Paid son's fees from her personal bank account ₹8,000
- (d) None of the above

Sol. (c) Paid son's fees from her personal bank account ₹8,000

11. Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented? (ICAI Study Material)

- (a) Understandability (b) Relevance
- (c) Comparability (d) None of the above

Sol. (a) Understandability

THEORETICAL QUESTIONS

1. Define accounting. What are the sub-fields of accounting? (ICAI Study Material)

Sol. Accounting is the practice of systematically recording, categorizing, and summarizing transactions and events in a meaningful monetary context. These transactions and events, to some extent, have a financial nature, and the results are then interpreted.

Accounting encompasses diverse subfields, including Financial Accounting, Management Accounting, Cost Accounting, Social Responsibility Accounting, and Human Resource Accounting.

2. Who are the users of accounting information? (ICAI Study Material)

Sol. Investors, Employees, Lenders, Suppliers, Creditors, Customers, Government and its agencies, the general public, and Management.

3. Discuss the limitations which must be kept in mind while evaluating the Financial Statements. (ICAI Study Material)

Sol. Some factors that are essential in assessing the value of an enterprise do not find their place in the accounts because they cannot be quantified in monetary terms (**Ex: Skill of Personnel, Loyalty of Skilled Personnel**)

The balance sheet reflects the state of the business on the day it is prepared, not on future dates. However, users of financial statements are often more interested in understanding the business's position in the near and distant future rather than its past.

Accounting often disregards changes in certain monetary factors, such as **inflation**, which can significantly affect the value of assets and liabilities.

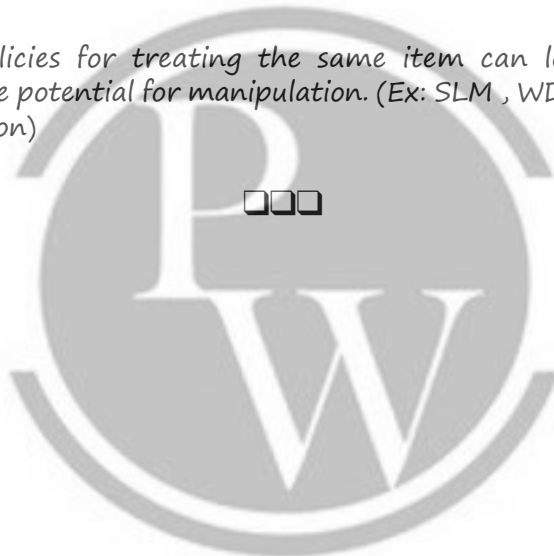
There are instances where accounting principles may conflict with each other, leading to ambiguity in certain financial statements. (**i.e Materiality & Full Disclosure**)

Accounting involves several estimates that rely on the personal judgment of the accountant.

For example, determining the provision for doubtful debts, selecting depreciation methods, classifying certain expenditures as revenue or capital, and choosing inventory valuation methods all involve a significant degree of judgment.

Financial statements typically consider only those assets that can be expressed in monetary terms. Human resources, despite being a critical asset for an enterprise, are not represented on the balance sheet, and there is no universally accepted method for valuing human resources in monetary terms.

Different accounting policies for treating the same item can lead to variations in financial statements, increasing the potential for manipulation. (**Ex: SLM , WDV Method for Depn., LIFO, FIFO etc for inventory valuation**)



Unit-2: Capital and Revenue Expenditure and Receipts

Understand the linkage of such distinction with the preparation of final accounts.



INTRODUCTION

Accounting aims to determine and present the business results for a specific accounting period. To achieve this, transactions are analyzed to determine if they are of capital or revenue nature.

Revenue expenses are related to the operations of the business within the accounting period or to the revenue earned during that period. They are associated with physical activities of the entity, such as production and sales, which generate revenue. Expenses are recognized in the Profit & Loss Account based on the matching principle, ensuring that they are appropriately matched against revenue.

On the other hand, capital expenditures generate enduring benefits and contribute to revenue generation over multiple accounting periods. They are placed on the asset side of the balance sheet as they provide benefits beyond a single accounting period.

Eventually, both capital and revenue expenditures are transferred to the profit and loss account. Revenue expenditures are transferred in the year they are incurred, while capital expenditures are transferred in the year when their benefits are utilized.

The distinction between capital and revenue expenditures is crucial but can be challenging at times, as the boundary between them may be unclear in certain cases. Nonetheless, the timing and matching of expenses against revenue play a significant role in their recognition and classification.

CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

The distinction between capital and revenue expenditures is based on several considerations:

- (a) **Nature of business:** Depending on the nature of the business, certain expenses may be treated as revenue expenditures or capital expenditures. For example, the purchase of

furniture may be considered revenue expenditure for a furniture trader but capital expenditure for other trades.

- (b) **Recurring nature of expenditure:** Expenses that occur frequently within an accounting year are generally (i.e. most of the time but not always) classified as revenue expenditures, while non-recurring expenses are more likely to be capital in nature.
- (c) **Purpose of expenses:** Expenses for regular maintenance and repairs are typically considered revenue in nature, while expenditures aimed at enhancing the asset's productive capacity are regarded as capital expenditures.
- (d) **Effect on revenue generation:** Expenses that directly contribute to generating income in the current period are considered revenue expenditures, whereas expenditures with long-term revenue-generating benefits are classified as capital expenditures.
- (e) **Materiality of the amount:** The relative proportion of the amount involved is also taken into account when distinguishing between revenue and capital expenditures.

These considerations guide the classification of expenses and determine whether they are recognized as revenue or capital, impacting their treatment in the Profit and Loss Account or inclusion in the book value of fixed assets. However, it should be noted that determining the appropriate classification can sometimes be complex.

CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

Capital expenditure refers to investments made by a business in assets that contribute to its revenue-earning capacity over multiple accounting periods. On the other hand, revenue expenses are incurred to generate revenue within a specific accounting period.

Revenue expenses are either directly linked to revenue, such as the cost of goods sold, or associated with the duration of accounting periods, like salaries and rent. In contrast, capital expenditure involves acquiring tangible or intangible fixed assets that provide long-lasting benefits beyond a single accounting period. The benefits derived from capital expenditure extend over multiple accounting periods, while the benefits from revenue expenses expire within the same accounting period.

CAPITAL RECEIPTS AND REVENUE RECEIPTS

Receipts obtained during regular business activities, such as the sale of goods or services and interest income, are classified as revenue receipts. Conversely, receipts that are not related to revenue, such as proceeds from the sale of fixed assets or investments, loans, and owner's contributions, are considered capital receipts. Both revenue and capital receipts are recognized on an accrual basis once the right to receive them is established.

“It is important to note that revenue receipts are not synonymous with actual cash receipts. Revenue receipts are recorded as credits in the Profit and Loss Account.”

It is to be noted that capital receipts are not transferred to Profit and Loss Account.

For example, when an asset is sold for ₹67,000 (cost ₹60,000), the capital receipts ₹67,000 is not directly transferred to P/L A/c, only the profit element is transferred.

Sale Value	₹67,000
Purchase Price	(₹60,000)
Profit/Loss	<u>₹7,000</u>

TEST YOUR KNOWLEDGE

True and False

1. Expenditure incurred on a second hand equipment purchased to make it in workable condition was marked as Revenue expenditure.
Sol. False, expenses incurred to put an asset in workable condition is a capital expenditure.
2. Money allocated to decrease operational costs is classified as revenue expenditure.
Sol. False, It can be reasonably assumed that funds invested in reducing revenue expenses would likely yield long-term advantages for the organization. If the expenditure takes the form of technical expertise, it becomes part of intangible fixed assets, while if it involves the replacement of existing tangible fixed assets, it becomes part of tangible fixed assets. Therefore, such expenditures are considered capital expenditures.
3. Fees paid to lawyer for acquiring a building is a Capital Expenditure.
Sol. True, The payment of legal fees for acquiring a Building is considered an integral component of the Building's overall cost. These fees are incurred with the purpose of obtaining the ownership rights to the building, making it a capital expenditure.
4. The expenditure made on lawyer's fees to defend a lawsuit regarding the ownership of the property is classified as a capital expenditure. It is incurred to protect the ownership rights and integrity of a significant asset belonging to the firm.
Sol. False, Legal expenses incurred to defend a lawsuit asserting ownership of the firm's factory site are classified as maintenance expenditure. Such expenses do not result in any additional long-term benefits or increase the asset's capacity. Therefore, they are considered revenue expenditures associated with the maintenance of the asset.
5. The expenditure incurred for replacing a worn-out part of a machine is considered a capital expenditure.
Sol. False, It is an expenditure related to the maintenance of the asset so it will be classified as revenue expenditure.
6. Expenditure related to painting an old building which is just purchased is a revenue expenses.
Sol. False, The expenses associated with painting an old building for the first time are considered capital expenditure. This is because the painting contributes to improving the building's overall condition and making it usable. As a result, these expenses are treated as part of the building's cost and classified as capital expenditure. Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.
7. The lease premium will be categorized as Revenue expenditure.

Sol. False: Lease premium is a capital expenditure.

8. The funds obtained through the issue of debentures are considered a capital receipt.

Sol. True: Funds acquired through the issuance of shares or debentures by a company are categorized as capital receipts.

9. Capital expenditure is incurred to restore the efficiency of an asset.

Sol. False: Capital expenditure is incurred to enhance/improve the effectiveness of an asset.

10. A revenue loss should not be confused with a revenue expenditure.

Sol. True: Revenue expenditure is expended with the aim of deriving benefits within the current year, while revenue loss typically arises as part of regular business activities without providing any benefit.

11. Expenditure that enhances the worth of fixed assets is referred to as capital expenditure.

Sol. True: Expenditure related to the acquisition of fixed assets or that results in an increase in the value of fixed assets is categorized as capital expenditure.

12. Preliminary expenses are categorized as deferred revenue expenditure.

Sol. True: Preliminary expenses are considered deferred revenue expenditure, primarily because they can be amortized over a period of 4 to 5 years. However, it's important to note that in accordance with AS 26, preliminary expenses incurred during the incorporation of a company should be expensed in the year of their incurrence.

13. Wages disbursed to workers for the installation of machinery will be categorized as a revenue expenditure.

Sol. False: Expenditure associated with the installation of machinery is an instance of capital expenditure.

14. Expenditures of significant magnitude that are of a revenue nature, but their benefits are spread over multiple years, can be categorized as capital expenditures.

Sol. False: Expenditure of this type will be referred to as deferred revenue expenditure.

15. Capital receipts are presented either as an Increase in liabilities or as a decrease in the valuation of assets.

Sol. True: In the balance sheet, capital receipts are depicted as either a rise in liabilities or a decrease in the value of assets.

16. Funds spent to reduce working expenses are considered as capital expenditure.

Sol. True: Expenditures that result in a reduction of operating/working expenses are classified as capital expenditure.

17. In all situations, interest payments made during the acquisition of an asset are regarded as capital expenditure.

Sol. False: If such expenses are incurred during the production or construction phase, they are categorized as capital expenditure. However, once the asset is put into operation, the expenses are treated as revenue.

18. Expenditure incurred on experiments that did not yield successful results is considered

a capital loss.

Sol. False: This can be categorized as a deferred revenue expenditure so that it helps to distribute the financial impact of the loss over several years.

19. A building with an initial book value of ₹45,000 was demolished, and subsequently, a new building with a book value of ₹17,00,000 was constructed. In this scenario, ₹45,000 represents a revenue loss, while ₹17,00,000 stands as a capital receipt.

Sol. False: ₹45,000 is a revenue loss but ₹17,00,000 is a capital expenditure,

20. Expenses incurred for repairing a second-hand machine, which was recently acquired and necessary for its initial use, will be classified as capital expenditure.

Sol. True: Expenditures related to overhauling and repairing a second-hand machine to make it operational and derive future benefits are classified as capital expenditure.

21. An amount of ₹10 lakhs was invested in building a cafeteria for the well-being of employees, with a grant of ₹6 lakhs received from the government. In this instance, ₹4 lakhs will be regarded as capital expenditure, while ₹6 lakhs will be recognized as a capital receipt.

Sol. False: The sum of ₹10,00,000 will be considered as capital expenditure, despite it being received as a grant, because it was utilized for the construction of the mess hall.

22. Expenditures associated with the issuance of capital should be categorized as capital expenditure, whereas legal expenses incurred in connection with capital issuance should be regarded as revenue expenditure.

Sol. False: Legal costs arising from capital issuance will be classified as capital expenditure

23. Expenses in connection with obtaining a license for running the Cinema Hall is Revenue Expenditure. [May 2018, 2 Marks]

Sol. False: The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is to be capitalized. Such expenses are not revenue and amortized over a period of time.

24. Costs associated with enhancing the fuel efficiency of a car's engine are categorized as revenue expenditure. [Nov. 2018, 2 Marks]

Sol. False: Incurring expenses for the engine overhaul of a motor car to achieve improved fuel efficiency is considered a capital expenditure, as it contributes to a reduction in ongoing operating costs.

25. Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the Cinema House was ready, is capital expenditure. [May 2019, 2 Marks]

Sol. True: Amount spent for the construction or acquisition of a capital asset (here, Cinema house), in whatever form, will be treated as Capital Expenditure.

26. M/s. Roshan & Bros runs a cafe. They renovated some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 23 to 27. The total expenditure incurred was ₹50,000 and was treated as a revenue expenditure [Nov. 2019, 2 Marks]

Sol. False: This expenditure should be treated as Capital expenditure since it will increase profitability of the business.

27. Insurance claim received on account of plant and machinery completely damaged by fire is a capital receipt. [Nov. 2020, 2 Marks]

Sol. True: It is a Capital receipt because it is received against a Capital expenditure.

28. Subsidy received from the government for working capital by a manufacturing concern is a revenue receipt. [Jan. 2021, 2 Marks]

Sol. True: Subsidy received from Government for working capital by a manufacturing concern is treated as revenue receipt because it is received for working expenses of manufacturing concern.

29. Any amount spent to minimize the working expenses is revenue expenditure.

[Dec. 2021, 2 Marks]

Sol. False: Expenditure which result in increase in capacity or in reduction of day to day expenses are treated as capital expenditure.

30. Expenses incurred on the repairs for the first time on purchase of an old building are capital expenditure. [Dec. 2021, 2 Marks]

Sol. True: All amounts spent upto the point an asset is ready for use should be treated as capital expenditure, whether it is new or old asset.

31. Any amount spent for replacement of worn out part of a machine is capital expenditure.

[June 2022, 2 Marks]

Sol. False: Any amount spent for replacement of worn part of a machine is treated as revenue expenditure

32. The nature of the business does not play a significant role in distinguishing between capital and revenue expenditure.

Sol. False, the nature of the business is a crucial factor in determining whether an expenditure should be classified as capital or revenue. For instance, while the purchase of computer by a computer trader is considered revenue expenditure, it is classified as capital expenditure for other businesses and recorded as an asset on the balance sheet.

33. Expenditure incurred for increasing the mileage of a car owned by the company is Revenue in nature.

Sol. False, As this will increase the mileage of the car which will help business in long run, thus this will be classified as Capital expenditure.

34. Expenditure on constructing temporary huts, which were constructed to facilitate construction of a new factory is termed as capital expenditure.

Sol. True, This expenditure will be capitalized and included in the Cost of factory

MULTIPLE CHOICE QUESTIONS

1. Entry fee of ₹5000 received by ABC Club is

(a) Capital receipt	(b) Revenue expenditure
(c) Revenue receipt	(d) None of the above

Sol. (a) Capital receipt

2. Subsidy received from the government of ₹90,000 working capital by a factory

(a) Capital receipt	(b) Capital expenditures
(c) Revenue receipt	(d) Revenue expenditure

Sol. (c) Revenue receipt

3. Interest on debentures received is a

(a) Capital receipt	(b) Capital expenditures
(c) Revenue receipt	(d) Revenue expenditure

Sol. (c) Revenue receipt

4. Amount received from bank as a loan is

(a) Capital expenditures	(b) Revenue expenditures
(c) Capital receipt	(d) Revenue receipt

Sol. (c) Capital receipt



Unit-3: Accounting Concepts Principles and Conventions

INTRODUCTION

Imagine a situation where a proprietor approaches five accountants with their books of account to prepare financial statements and calculate profits.

However, the accountants provide vastly different profit calculations, because they were not following standardized rules which ultimately led to demand for Standard Rules in the accounting profession.

To address this issue, a generally accepted set of rules called **Generally Accepted Accounting Principles (GAAPs)** has been developed which helped and ensured better preparation and presentation of financial statements.

Accounting serves as the language of business, with financial statements conveying financial information to stakeholders for decision-making. It is crucial that financial statements across different organizations are prepared uniformly and maintain consistency over time which helps in Inter Firm and Intra Firm comparison.

ACCOUNTING CONCEPTS

Accounting concepts are fundamental assumptions that guide the preparation of financial statements for a business entity. They represent universal ideas and notions that are universally applied. Accounting methods and interpretations of financial transactions are influenced by these concepts. Unlike principles in physical science, accounting concepts are the product of a broad consensus. These concepts serve as the foundation upon which accounting principles are developed.

ACCOUNTING PRINCIPLES

Accounting principles are a set of doctrines that encompass the theory and procedures of accounting. They serve as an explanation of existing practices and provide guidance for selecting conventions or procedures when there are options available. These principles need to fulfill several conditions: they should be grounded in realistic assumptions, be simple and easily comprehensible, consistently applied, capable of reflecting future predictions, and provide informative value for users.

ACCOUNTING CONVENTIONS

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice.. Accounting conventions need not have universal application.

The terms 'accounting concepts', 'accounting principles' and 'accounting conventions' have been used interchangeably to mean those basic points of agreement on which financial

accounting theory and practice are founded.

CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

- (a) **Entity concept:** This concept states that a business enterprise is considered a separate entity distinct from its owner. This practice originated with the advent of double-entry bookkeeping and helps maintain a clear separation between the business's affairs and the owner's personal affairs. The entity concept applies to all types of organizations, including sole proprietorships, partnerships, and corporations.
- (b) **Money measurement concept:** This concept dictates that transactions that can be quantified in monetary terms should be recorded. Even if certain transactions have a significant impact on the business, they are not recorded if they cannot be expressed in monetary terms.

For instance, while employees are valuable assets to an organization, their value cannot be measured in monetary terms, and thus they are not included in the organization's books of account. The measurement unit for money is typically the currency of the ruling country.

Example: If total sales are Rs 20 lakhs + 1 lakh Dollars, to ensure uniformity and facilitate easier accounting treatment. Take Dollar 1 = Rs 81.

Total Sales = Rs 20 lakhs plus 81 lakhs = Rs 101 lakhs.

- (c) **Periodicity concept:** The concept of the accounting period, also known as the definite accounting period concept, assumes that a business entity has an indefinite lifespan as per going concern concept. However, because of going concern, assumption challenges while measuring the entity's performance over a specific period in the regular course of business.

Example: If Business runs for 70 years, one cannot measure financial position after completing 70 years.

The periodicity concept helps in practical and manageable time frame for measuring performance and assessing the financial position of a business entity.

Typically, a one-year period, such as from April 1st to March 31st of the following year, is chosen, although it could be shorter or longer. This concept suggests that accounts should be prepared at regular intervals rather than waiting until the end of the entity's life.

This concept enables the accounting system to function effectively and gives meaning to the term "accrual." Without a defined period, there would be no concept of accrued expenses or revenue or matching principle can be complied.

- (d) **Accrual concept:** The accrual concept in accounting recognizes the effects of transactions and events when they occur, rather than when cash is received or paid. This basis, known as the mercantile basis, Financial statements prepared on an accrual basis provide information not only about past cash flows but also about future cash obligations and expected cash inflows.

According to the Accrual Concept, the formula Revenue (-) Expenses = Profit is used.

This concept forms the foundation upon which modern accounting is built. In contrast, the cash basis considers profit as the difference between cash received and cash paid in the ordinary course of business. The timing of revenue and expense recognition can differ from the actual cash receipt or payment.

Under the cash basis:

When cash is received before revenue is recognized, a liability is created for cash received in advance.

When cash is received after revenue is recognized, an asset called Trade Receivables is created.

When cash is paid before an expense is recognized, an asset called Trade Advance is created.

When cash is paid after an expense is recognized, a liability called payables or Trade Payables or outstanding liabilities is created.

- (e) **Matching concept:** In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earning that revenue should also be recognized.

This concept is based on accrual concept, This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.

In other words, the periodicity concept has also been followed while applying the matching concept.

- (f) **Going Concern concept:** The preparation of financial statements is typically based on the assumption that a business entity will continue its operations as a going concern in the foreseeable future. This assumption implies that the enterprise has no intention or necessity to significantly reduce its operations or liquidate.

The valuation of assets in a business entity relies on this going concern assumption. Historically, accountants have predominantly used the historical cost as the basis for valuing assets in most cases.

- (g) **Cost concept:** By this concept, the value of an asset is determined based on its original acquisition cost. While there are alternative measurement bases available, accountants typically favor this concept to ensure objectivity in financial reporting.

The cost concept may have some negative points also:

- (a) If there is inflation then the prices go up, thus acquisition cost becomes irrelevant.
- (b) The use of historical cost-based accounting can lead to a loss of comparability between different financial statements.
- (h) The cost concept in accounting fails to recognize certain assets, such as human assets, that do not have acquisition costs. This limitation overlooks the significance of these assets, which are crucial for any organization.
- (i) **Realisation concept:** The concept closely aligns with the cost concept, stating that any change in the value of an asset should only be recorded when the business realizes it.

Example: An asset is recorded at its historical cost of Rs 4,00,000 and even if its

current cost is Rs 10,00,000 such change shouldn't affect the balance sheet unless there is surety that such change will materialize (i.e. Sold)

Accountants generally adopt a conservative approach by recognizing probable losses but not probable gains.

Example: Mr. A purchased a land on 1.1.2001 by paying Rs 5,000. Its current market price is Rs 4,05,000 on 31.12.2022. Should the accountant show the land at Rs 5,000 by following historical cost concept and ignoring Rs 4,00,000 value increment because it is not realised? If he follows this then the financial position would be:

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	5,000	Land	5,000
	5000		5000

Should it be shown in the following manner?

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital Unrealised Gain	5,000	Land	4,05,000
	4,00,000		
	4,05,000		4,05,000

In modern practice, the revaluation of assets is widely accepted for recognizing permanent changes in value. Accountants adjust for such value changes by creating a revaluation (capital) reserve. Therefore, the valuation criteria for assets are determined by the concepts of going concern, cost, and realization.

(i) Dual aspect concept: The concept of double-entry book-keeping is based on this idea that every transaction or event has two aspects.

These aspects include:

- Increasing one asset and decreasing another asset.
- Increasing an asset and simultaneously increasing a liability.
- Decreasing one asset and increasing another asset.
- Decreasing one asset and decreasing a liability.

Alternatively:

- Increasing one liability and decreasing another liability.
- Increasing a liability and increasing an asset.
- Decreasing liability and increasing another liability.
- Decreasing liability and decreasing an asset.

Example:

Liabilities	₹	Assets	₹
Capital	2,50,000	Machinery	2,00,000

Bank Loan	85,000	Cash	1,60,000
Other Loan	25,000		
	3,60,000		3,60,000

Transactions:

(a) A new machine is purchased paying Rs 20,000 in cash.

Effect of the Transaction:

(a) Increase in machine value and decrease in cash balance by Rs 20,000.

BALANCE SHEET

Liabilities	₹	Assets	₹
Capital	2,50,000	Machinery	2,20,000
Bank Loan	85,000	Cash	1,40,000
Other Loan	25,000		
	3,60,000		3,60,000

So every transaction has two aspects where basic accounting equation applies which is:

Equity (E) + Liabilities (L) = Assets (A)

or

Equity (E) = Assets (A) – Liabilities (L)

Or, Equity + Long Term Liabilities + Current Liabilities = Fixed Assets + Current Assets

Or, Equity + Long Term Liabilities = Fixed Assets + (Current Assets – Current Liabilities)

Or, Equity = Fixed Assets + Working Capital – Long Term Liabilities

Question

1. Develop the accounting equation from the following information:

Particulars	₹	March 31, 2022	₹
Capital			2,00,000
10% Bank Loan			3,00,000
Trade Payables			50,000
Fixed Assets			1,10,000
Trade Receivables			95,000
Inventory			?
Cash & Bank			10,000

Required

Find the inventory as on 31/3/2022.

Sol. Equity + Capital = Assets

Equity = Capital Rs 2,00,000

Liabilities = 10% Bank Loan + Trade Payables

$$\text{Rs } 3,00,000 + \text{Rs } 50,000 = \text{Rs } 3,50,000$$

$$\text{Assets} = \text{Fixed Assets} + \text{Trade Receivables} + \text{Inventory} + \text{Cash \& Bank}$$

$$\text{Rs } 1,10,000 + \text{Rs } 95,000 + \text{Inventory} + \text{Rs } 10,000 = \text{Rs } 2,15,000 + \text{Inventory}$$

$$\text{Equity} + \text{Liabilities} = \text{Assets}$$

$$\text{Rs } 2,00,000 + \text{Rs } 35,000 = 2,15,000 + \text{Inventory}$$

$$\text{Inventory} = 55,000 - 21,500 = 33,500$$

For the year ended March 31, 2020:

$$\text{Assets} = \text{Rs } 1,10,000 + \text{Rs } 80,000 + \text{Rs } 80,000 + \text{Rs } 6,000 = \text{Rs } 2,76,000$$

$$\text{Liabilities} = \text{Rs } 1,00,000 + \text{Rs } 70,000 = \text{Rs } 1,70,000$$

$$\begin{aligned} \text{Equity} &= \text{Assets} - \text{Liabilities} = \text{Rs } 2,76,000 - \text{Rs } 1,70,000 = \text{Rs } 1,06,000 \\ \text{Profits} &= \text{New Equity} - \text{Old Equity} = \text{Rs } 1,06,000 - \text{Rs } 1,00,000 = \text{Rs } 6,000 \end{aligned}$$

(j) **Conservatism:** The conservatism concept in accounting emphasizes that accountants should not anticipate future income but should provide for potential losses. The principle of valuing current assets at the lower of cost or market price originates from this concept. Financial statements should possess three qualitative characteristics: prudence, neutrality, and trustworthy representation of alternative values.

(k) **Consistency:** Accounting policies are applied consistently over time to ensure comparability of financial statements. Changes in accounting policies are made only in exceptional circumstances. Consistency is particularly important when there are acceptable alternative methods of accounting, such as depreciation methods or inventory valuation methods. However, consistency does not prevent the introduction of improved accounting methods.

(l) **Materiality:** The materiality principle allows for the omission of insignificant items in financial statements if their effect is considered immaterial. Materiality is subjective and based on the judgment of the accountant. Significant items with an economic impact on the business should be disclosed, while insignificant items that do not affect users' decision-making can be omitted.

Materiality depends on factors such as the amount, size of the business, nature of information, and decision-maker's level.

The omission of information should not hinder decision-making for various users.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three key accounting assumptions:

- (a) Going concern
- (b) Consistency, and
- (c) Accrual.

If there is no mentioning of these assumptions in the financial statements, it is assumed that they have been followed in their preparation. However, if any of these assumptions are not followed, it should be explicitly disclosed in Financial Statement.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

Qualitative characteristics are essential attributes that enhance the usefulness of financial

statement information for users.

1. **Understandability:** Financial statements should possess the quality of understandability, meaning that the information presented should be easily understandable to users for their decision making.

However, it is assumed that users have a reasonable understanding of business, economics, and accounting principles and approach the information with reasonable diligence. Even if certain complex matters are challenging to grasp, they should not be excluded from financial statements if they are relevant to users' economic decision-making needs.

2. **Relevance:** Relevance is a crucial characteristic of financial information as it directly impacts the decision-making needs of users. Information is considered relevant when it influences users' economic decisions by helping them evaluate past, present, or future events and confirming or correcting their previous assessments. .

Financial information plays a crucial role in predicting future financial position, performance, and other matters of direct interest to users, such as dividend payments, wage payments, share prices, and the enterprise's ability to meet its commitments.

3. **Reliability:** For information to be useful, it must also be reliable. Reliability means that the information is free from significant errors and bias, and users can trust it to accurately represent what it claims or reasonably should represent. While information may be relevant, it can still be unreliable, leading to potential misinterpretation.

For instance, if the validity and amount of a claim for damages in a legal action against the enterprise are uncertain (i.e. contingent liability), it may not be appropriate to recognize the claim amount in the balance sheet. However, disclosing the amount and details of the claim can still be relevant.

4. **Comparability:** To facilitate meaningful comparisons, users of financial statements need to be able to compare an enterprise's financial statements over time and with those of other enterprises. Consistency in measurement and presentation of financial effects is essential within an enterprise, across time periods, and among different enterprises. To achieve comparability, it is crucial to disclose the accounting policies used, any changes in those policies, and their effects. Compliance with Accounting Standards aids in attaining comparability.

However, comparability should not be mistaken for uniformity, and it should not hinder the adoption of improved accounting standards.

Users also desire to compare an enterprise's financial position, performance, and cash flows over time. Therefore, it is important for financial statements to include corresponding information from preceding periods.

5. **Materiality:** Materiality is a crucial aspect of information in financial statements. It refers to the significance of information in influencing the economic decisions made by users based on the financial information. If the misstatement or error in information could impact user decisions, it is considered material.

Materiality is determined based on the size and nature of the item or error, taking into account the specific circumstances of its misstatement. Rather than being a primary

qualitative characteristic, materiality sets a threshold or cut-off point that information must meet to be considered useful.

6. **Faithful Representation:** Reliability of information in financial statements is essential, and it should faithfully represent what transactions and events intends to portray or reasonably be expected to portray.

For instance, a balance sheet should accurately reflect the assets, liabilities, and equity of the enterprise based on the recognition criteria at the reporting date.

However, financial information has its own inherent limitations and is susceptible to some level of risk, which may prevent it from being a completely faithful representation.

7. **Substance over Form:** For information to accurately represent the intended transactions and events, it is important to account information and present them based on their substance and economic reality rather than solely relying on their legal form.

Example: In cases where the rights and beneficial interest in a property are transferred, even if the documentation and legal formalities are pending, the recording of the acquisition or disposal would accurately reflect the substance of the transaction that took place.

8. **Neutrality:** To ensure reliability, the information in financial statements should be neutral, meaning it should be unbiased. Financial statements are considered biased if the selection or presentation of information intentionally influences decision-making or judgments to achieve a predetermined result or outcome.

9. **Prudence:** In preparing financial statements, uncertainties surrounding events and circumstances are acknowledged, such as the collectability of receivables or the useful life of assets. These uncertainties are disclosed, and caution is exercised through prudence to avoid overstating assets or income and understating liabilities or expenses. Prudence involves being cautious in making estimates under conditions of uncertainty. However, prudence should not be used to create hidden reserves, excessively high provisions, or intentionally misrepresent financial information, as it would compromise the neutrality and reliability of the financial statements.

10. **Full, fair and adequate disclosure:** Financial statements should provide reliable and relevant information to both internal and external users, enabling them to make informed decisions. Full disclosure is necessary to accurately assess the financial position of the enterprise, meaning that no relevant information should be omitted.

Fair disclosure requires that all transactions are accounted for in a manner that presents a true and fair view of the enterprise's results. Adequate disclosure entails providing detailed information that influences user decisions.

Example: The Companies Act specifies the format of balance sheets and profit and loss accounts, and major accounting policies and other information are disclosed through footnotes and annexures. The practice of including notes in financial statements stems from this principle.

11. **Completeness:** For financial statements to be reliable, they must be complete within the boundaries of materiality and cost. Omissions can make the information false or

misleading, reducing its reliability and relevance. It is crucial to account for and present transactions and events in line with their substance and economic reality, rather than their legal form. Neutrality, or freedom from bias, is also essential for reliable financial statements. However, preparers of financial statements must deal with uncertainties related to events like collectability of receivables and useful life of assets. Such uncertainties should be disclosed, and prudence should be exercised to avoid overstatement of assets and income, as well as understatement of losses and liabilities.

TEST YOUR KNOWLEDGE

TRUE AND FALSE

1. Accrual accounting recognizes revenue and costs when money is received or paid, rather than when revenue is earned or costs are incurred.
Sol. False, The accrual concept in accounting states that revenue should be recorded when sales are made or services are rendered, regardless of whether cash is received at that time. Similarly, expenses should be recorded in the accounting period in which they contribute to earning revenue, regardless of whether cash has been paid for them.
2. The matching of revenues with expenses follows the Going Concern assumption.
Sol. False, The Matching concept guides the matching of revenues with expenses. It suggests that in calculating the net profit from business operations, all costs related to the revenue of the period should be offset against that revenue. To ensure proper matching, revenues are recognized first, followed by the recognition of costs incurred in generating that revenue.
3. The going concern concept necessitates the consistent use of accounting methods across consecutive accounting periods.
Sol. False, The consistency concept dictates the use of consistent accounting methods across successive accounting periods. In accordance with the going concern concept, it is assumed that the business will persist in operation for an extended period in the future.
4. The Business Entity Concept best illustrates the notion that a business is distinct and separate from its owner
Sol. True, The Business Entity Concept dictates that a business is regarded as an independent entity, separate from its owners, creditors, managers, and other parties involved. This means that the owner of a business is always seen as distinct from the business itself. It requires maintaining a separate set of books for the business entity and recording transactions from the perspective of the firm, not the proprietor.
5. A machinery is purchased for cash, this transaction will result in total asset unchanged
Sol. True, When machinery is purchased, it results in an increase in the asset called Machinery and a decrease in the asset called Cash. As a result, the total assets of the business remain the same.
6. The entire lifespan of the company is divided into specific time periods to measure profits based on the assumption of the business's continuity (Going Concern Assumption).
Sol. True, The Accounting Period Concept divides the entire lifespan of a company into time intervals to measure its profits. This concept ensures that financial statements provide regular updates on the business's performance. Typically, a twelve-month period is used for this purpose. The amended income tax law mandates that businesses adopt a financial year starting on April 1st and ending on March 31st of the following calendar year as their accounting period.
7. An example of the Convention of Conservatism is setting aside a provision to account

for fluctuations in the price of investments.

Sol. The Convention of Conservatism dictates that anticipated losses should be documented in the financial records, while anticipated or unrealized gains should be disregarded. In essence, Conservatism is a cautious approach that emphasizes prudence. It involves creating provisions for all identified liabilities and losses, even if the exact amount cannot be determined with certainty.

8. In accounting, both significant and insignificant items or facts are recorded.

Sol. False, As per the Materiality Convention, it is not necessary to disclose items that have a negligible impact or are irrelevant to the user. This convention serves as an exception to the Full Disclosure Convention. In order to avoid unnecessary complexity, insignificant items may be omitted or combined with others. Therefore, accounting focuses on recording only material items or facts.

9. The Matching concept, ensures that the personal affairs of the owner do not affect the business affairs.

Sol. The Business entity concept ensures that business affairs remain separate from the personal affairs of the owner. Financial statements should be objective, free from personal bias or influence. In line with the Matching concept, costs related to revenue should be deducted from that revenue to determine the net profit from business operations. This requires recognizing revenue first and then matching it with the corresponding costs.

10. The principle of materiality deviates from the Convention of Full Disclosure.

Sol. The principle of materiality allows for the omission of items that have a negligible impact or are irrelevant to the user, providing an exception to the Convention of Full Disclosure. Such insignificant items may be excluded or consolidated with other items to prevent unnecessary complexity in financial statements.

11. The notion of prudence involves identifying potential gains rather than acknowledging potential losses.

Sol. False: Prudence is a principle that aims to identify expected losses rather than gains.

12. According to AS-1, Fundamental Accounting Assumptions encompass the principles of the Going Concern, Full Disclosure, and Accrual Concept.

Sol. False: In accordance with AS 1, Fundamental Accounting Assumptions consist of the Going Concern concept, Consistency principle, and Accrual concept.

13. The full disclosure principle mandates that financial statements should provide complete and trustworthy information.

Sol. True: To adhere to AS-1, Disclosure of Accounting Policies, the financial statement should divulge all reliable and relevant information.

14. The Accrual concept involves accounting on a non-cash basis.

Sol. False: The Accrual concept signifies accounting on an accrual basis rather than a cash basis.

15. According to the Conservatism principle, accountants should make provisions for all potential losses but refrain from anticipating income.

Sol. True: In line with the Concept of Conservatism, accountants are advised to make provisions for all conceivable losses but not to anticipate income.

16. In compliance with the going concern assumption, the economic life of a business is divided into discrete time intervals for accounting purposes.

Sol. True: The economic life of an enterprise is artificially segmented into periodic intervals as per the accounting period concept. The going concern assumption posits that an enterprise will continue its operations indefinitely.

17. Assessing inventory at its cost or net realizable value is based on the principle of prudence. (Nov 2019, 2 Marks)
- Sol. True: In the principle of lower of cost or net realizable value, any loss resulting from a decline in the inventory's selling price below its cost is promptly recognized. This is because it is expected that the enterprise will incur losses whenever it makes a sale at such reduced prices.
18. A company plans to cease its operations by December 2020 and intends to sell all its plants within a three-month period. As of December 31, 2020, the Balance Sheet should still reflect the plants at their historical costs since the disposal of these assets will occur after the Balance Sheet date. (Nov 2020, 2 Marks)
- Sol. False: According to the going concern concept, a business typically presents its fixed assets at their historical cost. However, in the event of business discontinuance, they should be represented at their anticipated realizable value.
19. The financial statements are crafted without assuming that the enterprise will continue its operations as a going concern for the foreseeable future. (Dec 2022, 2 Marks)
- Sol. False: The financial statements are constructed with the assumption that the enterprise is a going concern and will persist in its operations for the foreseeable future.
20. The provision for discounts on creditors is frequently not established, in line with the principle of conservatism. (Dec 2022, 2 Marks)
- Sol. True: In accordance with the principle of conservatism, provisions are set aside for anticipated future losses. Discount on creditors, being an income, does not necessitate the establishment of a provision.

MULTIPLE CHOICE QUESTIONS

1. Which principle necessitates the consistent utilization of accounting methods across consecutive accounting periods?
- (a) Dual Aspect (b) Going concern
(c) Accrual Concept (d) Consistency
- Sol. (d) The principle of consistency emphasizes that accounting principles and methods should maintain uniformity and continuity from one fiscal year to the next.
2. As per Going Concern concept, business will continue for:
- (a) A long period of time (b) For next 5 years
(c) A short period of time (d) For next 100 years
- Sol. (a) As per going concern concept, it is assumed that the business will continue for long period of time.
3. Assets are purchase in business for:
- (a) Generating revenue (b) Resale
(c) Both (a) and (b) (d) None of the above
- Sol. (a) Assets encompass valuable items owned, leased, or utilized by a business for its operations, such as Plant and Machinery, Buildings, and more. These assets are typically acquired and held by the business with the intention of generating revenue or facilitating income generation.
4. ABC Enterprises follows the written down value method of depreciating machinery year after year due to:

- (a) Consistency
- (b) Matching principle
- (c) Comparability
- (d) All of the above

Sol. (a) The principle of consistency emphasizes that accounting principles and methods should maintain consistency over consecutive years. They should not be altered from year to year, allowing management to effectively compare financial statements across different periods and draw meaningful insights about the performance of the enterprise.

5. The practice of excluding decimals and presenting rounded figures in financial statements is based on:

- (a) Going concern concept
- (b) Materiality
- (c) Comparability
- (d) None of the above

Sol. (d) The Convention of Materiality states that insignificant or irrelevant items do not need to be disclosed to users. This convention serves as an exception to the Convention of Full Disclosure. In order to prevent accounting statements from becoming excessively burdensome figures are rounded off.

THEORETICAL QUESTIONS

1. Write a short note on Periodicity Concept

Sol. The continuity of a business over a long period makes it necessary to assess its true financial performance. However, waiting until the business is completely wound up to determine profit would be impractical for stakeholders who need timely information for decision-making. To address this, the financial results are measured at regular intervals, typically a twelve-month period. According to tax regulations, businesses are required to adopt a financial year starting from April 1st and ending on March 31st of the following year as their accounting period. This allows users of financial statements to have timely and relevant insights into the business's performance.

2. Why is the complete cost of an asset not considered as an expense in the year it is acquired?

Sol. Due to the Going Concern Concept, it is presumed that the business will persist for an extended duration. Therefore, the cost of an asset is allocated over its useful lifespan, and only the depreciation for the current year is recognized as an expense.

3. Under what circumstances is a change in accounting policy considered justified?

Sol. Changes in accounting policies may be implemented for several reasons, including:

- (a) Compliance with legal requirements.
- (b) Adherence to accounting standards.
- (c) Improvement in the transparency and presentation of the business's profits and financial position.

Furthermore, it is essential to provide clear disclosure through footnotes, outlining the nature, impact, and rationale behind the policy change. This ensures that users of financial statements are informed about the modification and its implications.

4. Differentiate between the Money Measurement Concept and the Matching Concept.

Sol. Money Measurement Concept:

The Money Measurement Concept dictates that transactions recorded in the books of accounts must be measurable in monetary terms.

Transactions that cannot be quantified in monetary units are excluded from the accounting

records.

For instance, the monetary value of purchased machinery is recorded, while intangible attributes like a manager's analytical skills, which lack monetary measurement, are not accounted for.

MATCHING CONCEPT

The Matching Concept emphasizes the correlation between expenses and revenues within a specific accounting period.

It requires that expenses associated with generating revenue should be recognized in the same accounting period.

In other words, if revenue is recognized in a particular period, the related expenses incurred to earn that revenue should also be recognized within the same period, without any additional expenses.

Adjustments for prepaid and outstanding expenses, as well as unearned or accrued incomes, are made during the preparation of financial statements to ensure proper matching of revenues and expenses.



Unit-4: Accounting Policies

MEANING OF ACCOUNTING POLICIES

Accounting policies encompass the principles and methods employed by a business to prepare and present its financial statements. These policies are derived from accounting concepts, principles, and conventions. As enterprises operate in diverse and complex environments, there is no universally applicable list of accounting policies. Instead, each enterprise must adopt policies that suit its specific circumstances, requiring thoughtful judgment from management. The Institute of Chartered Accountants of India (ICAI) has collaborated with the government, regulatory bodies, and forward-thinking managements to streamline acceptable accounting policies. Guidance Notes and Accounting Standards have been instrumental in this endeavor, leading to notable progress in reducing the variety of acceptable policies.

Comprehensive list that serve as illustration of areas wherein different accounting policies are frequently encountered can be given as follows:

- (1) Valuation of Inventories;
- (2) Valuation of Investments.
- (3) Adoption of depreciation method

Consider a scenario where an enterprise possesses investments in the form of shares of a company by the conclusion of an accounting period. In order to determine the value of these shares, the enterprise may choose to employ methods such as FIFO or the average method. The chosen method for valuation is referred to as an accounting policy, which can vary across different enterprises. Similarly, various methods exist for calculating depreciation on fixed assets, such as straight line or written down, resulting in different depreciation amounts for each business entity.

SELECTION OF ACCOUNTING POLICIES

The choice of accounting policy is a critical decision that significantly impacts both the performance evaluation and financial position of a business entity. **Selecting an inappropriate accounting policy can result in either understatement or overstatement of performance and financial position.** Hence, it is crucial to carefully choose an accounting policy, taking into account its impact on the financial performance from the perspective of various users of financial statements.

It is widely recognized that no comprehensive and universally applicable list of accounting policies can be prescribed.

However, three key characteristics should be considered when selecting and applying accounting policies:

- (a) prudence,
- (b) substance over form, and
- (c) materiality.

Accounting policies that provide a true and fair representation and actual state of affairs shall be adopted.

Here is one of the example of situations where the selection of accounting policies is required:

Inventory is generally valued at Cost or NRV whichever is lower, but By-product is valued at NRV

It is essential to disclose the chosen treatment, but disclosure alone cannot rectify an incorrect or unsuitable treatment.

CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be considered under the following circumstances:

- (a) When it is required by law or to comply with an Accounting Standard.
- (b) When it would lead to a more appropriate presentation of the financial statements.

It's important to note that a change in accounting policy can have a significant impact on the financial statements. To provide meaningful information to users of the financial statements, it is necessary to quantify the impact of such changes on items like assets, liabilities, and profit/loss to ensure a more accurate reflection of the financial position and performance of the company.

For example, XYZ Ltd recently revised its accounting policy regarding the valuation of inventories from FIFO to weighted average. This change should be quantified and disclosed

TEST YOUR KNOWLEDGE

True and False

1. There is no universal list of accounting policies that is applicable to all enterprises in all circumstances.

Sol. True, It is not possible to have a single list of accounting policies that applies to all enterprises in all circumstances. The choice of accounting policies varies among industries and depends on specific circumstances and requirements.

2. The selection of accounting policy has a significant impact on the financial performance and financial position of the business.

Sol. True, accounting policy plays a crucial role in determining the value of items presented in financial statements, thus influencing the financial performance and financial position of the business.

3. A change in accounting policies should be made based on the business's objective to present results in a manner aligned with their preferences and requirements

Sol. False, A change in accounting policies should be considered under the following circumstances:

- (a) When it is mandated by statutory requirements or to ensure compliance with Accounting Standards.
- (b) When the change would lead to a more suitable and accurate presentation of the financial statements.

4. The selection between LIFO or FIFO for inventory valuation represents the adoption of

an accounting policy in determining the value of inventory.

Sol. True, An enterprise has the option to adopt either the FIFO or weighted average method for inventory valuation, and the chosen method is referred to as an accounting policy.

MULTIPLE CHOICE QUESTIONS

1. The accounting policy of ABC Ltd for inventories follows the principle of valuing inventories at the lower of cost or net realizable value.? Which accounting principle is followed here.

- (a) Materiality.
- (b) Substance over form.
- (c) Prudence.
- (d) None of the above

Sol. (b) Substance over form.

2. Different accounting policies can be adopted in various areas, including but not limited to:

- (a) Providing depreciation.
- (b) Valuation of investments.
- (c) Valuation of inventories.
- (d) All of the above

Sol. (d) All of the above

3. Accounting policies means accounting

- (a) Principles.
- (b) Both (a) and (b).
- (c) Methods of applying those principles.
- (d) None of the above

Sol. (c) Methods of applying those principles.

THEORETICAL QUESTIONS

1. Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered

Sol. Accounting Policies encompass the particular accounting principles and the corresponding application methods chosen by an enterprise for the formulation and disclosure of its financial statements.

2. A modification in accounting policy can potentially result in significant impacts on the financial statement items. Explain

Sol. A change in accounting policy can significantly impact the financial statements, especially when it involves modifications to key elements like the cost formula for inventory valuation, such as a shift from weighted average to FIFO. It is essential to quantify the effects of such changes in order to ensure that the financial statements provide meaningful information to the users of the accounts



Unit-5: Accounting Standards

Accounting Standards address various aspects related to transactions and events

Recognition

Measurement

Presentation

Disclosure

The development of Accounting Standards

The process of identifying specific areas for consideration

The formation of a study group for the purpose

Creating a draft and circulating it

Seeking input from various bodies regarding the draft

Completion of the exposure draft (E.D) in its final form

Feedback received on the exposure draft (E.D)

Applying changes to the draft

Accounting Standard Issued

INTRODUCTION OF ACCOUNTING STANDARDS

Accounting serves as the “language of business”, conveying the financial outcomes of an organization to stakeholders through financial statements. Without proper regulation of the financial accounting process, there is a risk of presenting misleading and distorted financial statements that do not reflect the true state of the business. Standardizing accounting principles and policies is crucial to ensure transparency, consistency, comparability, adequacy,

and reliability in financial reporting.

Accounting standards are policy documents issued by expert accounting bodies, governments, or regulatory bodies. These accounting standards cover aspects regarding recognition, measurement, presentation, and disclosure of accounting transactions and events in financial statements. The primary objective of standard-setting bodies is to facilitate the timely and informative dissemination of financial information to investors and other stakeholders interested in the company's economic performance.

The accounting standards address various aspects, including:

- (i) determining how events and transactions are recognized in financial statements,*
- (ii) establishing guidelines for measuring these transactions and events,*
- (iii) presenting them in a clear and comprehensible manner within the financial statements, ensuring meaningfulness to readers,*
- (iv) specifying the necessary disclosure requirements. These disclosures enable the general public, stakeholders, and potential investors to gain insights into the purpose and content of the financial statements. This information empowers them to make informed and prudent business decisions.*

OBJECTIVES OF ACCOUNTING STANDARDS

The primary objective of accounting standards is to promote consistency and uniformity in accounting policies and practices across different business entities. This harmonization aims to achieve the following:

- (i) Enhance the comparability of financial statements by eliminating variations in accounting practices, leading to increased reliability.*
- (ii) Establish a set of standardized accounting policies, valuation principles, and disclosure requirements.*

Accounting standards help minimize the range of accounting options available during the preparation of financial statements, ensuring that the statements are comparable among different enterprises while maintaining rationality.

BENEFITS AND LIMITATIONS OF ACCOUNTING STANDARDS

Accounting standards aims to ensure a true and fair view by providing guidelines for accounting principles, valuation techniques, and the application of these principles in the preparation and presentation of financial statements. By establishing accounting standards, accountants benefit in the following ways:

- (i) Reduction or Elimination of confusing variations in accounting treatments used for financial statements, promoting consistency and comparability.*
- (ii) Additional disclosure beyond what is legally mandated (Ex: Contingent Liability) ensuring important information is adequately communicated.*
- (iii) Standards enable comparison of financial statements among companies in different regions or within the same country. However, variations in institutions, traditions,*

and legal systems across countries can result in different accounting standards.

Nevertheless, accounting standards have certain limitations:

- (i) **Difficulty in selecting between alternative treatments:** Some accounting problems may have multiple plausible solutions, making it challenging to choose the most appropriate treatment.
- (ii) **Limited scope:** Accounting standards cannot supersede statutory requirements. They must be developed within the framework of existing laws and regulations.

PROCESS OF FORMULATION OF ACCOUNTING STANDARDS IN INDIA

The Institute of Chartered Accountants of India (ICAI), established the Accounting Standards Board (ASB) in 1977 to take a leading role in setting accounting standards. The ICAI has implemented measures to ensure a consultative and transparent standard-setting process. When formulating Indian Accounting Standards (ASs), the ASB considers International Financial Reporting Standards (IFRSs) and aims to integrate them within the legal, customary, and business environment of India. The ASB comprises representatives from various industries, regulators, academicians, government departments, etc. While the ASB is constituted by the ICAI Council, it operates independently in formulating accounting standards, and the Council cannot modify draft accounting standards without consulting the ASB.

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

Identification of areas by the ASB for developing accounting standards.

Formation of study groups by the ASB to address specific projects and prepare initial drafts of proposed accounting standards.

“The draft typically includes the objective, scope, definitions, recognition and measurement principles (if applicable), and presentation and disclosure requirements.”

Review of the preliminary draft by the ASB, incorporating any revisions based on discussions.

Circulation of the revised draft accounting standard to the ICAI Council members and specified external bodies for their input, such as the Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc.

Meetings with representatives of the specified external bodies to gather their views on the proposed accounting standard draft.

Finalization of the exposure draft of the proposed accounting standard and its issuance for public comments.

Consideration of the received comments on the exposure draft, and finalization of the accounting standard draft by the ASB for submission to the ICAI Council for review, approval, and issuance.

The ICAI Council examines the final draft of the proposed standard, and if necessary, modifications are made in consultation with the ASB.

The ICAI issues the accounting standard related to the subject matter for non-corporate entities, while for corporate entities, the accounting standards are issued by the Central Government of India.

LIST OF ACCOUNTING STANDARDS IN INDIA

The Accounting Standards issued by the Accounting Standards Board provide a set of guidelines that business entities must adhere to in order to ensure that their financial statements are prepared in accordance with widely accepted accounting principles.

List of Accounting Standards is as follows:

AS 1	Disclosure of Accounting Policies
AS 2 (Revised)	Valuation of Inventories
AS 3 (Revised)	Cash Flow Statements
AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
AS 5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 7 (Revised)	Accounting for Construction Contracts
AS 9	Revenue Recognition
AS 10	Property, Plant and Equipment
AS 11 (Revised)	The Effects of Changes in Foreign Exchange Rates
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 15 (Revised)	Employee Benefits
AS 16	Borrowing Costs
AS 17	Segment Reporting
AS 18	Related Party Disclosures
AS 19	Leases
AS 20	Earnings Per Share
AS 21	Consolidated Financial Statements
AS 22	Accounting for Taxes on Income
AS 23	Accounting for Investments in Associates in Consolidated Financial Statements
AS 24	Discontinuing Operations
AS 25	Interim Financial Reporting
AS 26	Intangible Assets

AS 27	Financial Reporting of Interests in Joint Ventures
AS 28	Impairment of Assets
AS 29	Provisions, Contingent Liabilities & Contingent Assets

TEST YOUR KNOWLEDGE

True and False

- Accounting standards are official documents that outline the policies and guidelines established by expert accounting bodies, government authorities, or regulatory bodies. These standards focus on the recognition, measurement, presentation, and disclosure of accounting transactions and events within financial statements. Accounting standards can override the statute.
- Sol. True,** Accounting standards encompass guidelines pertaining to the acknowledgment, quantification, representation, and disclosure of accounting transactions and events within financial statements. These documents provide comprehensive directions on how to handle various aspects of accounting to ensure accuracy and transparency in financial reporting.
- One of the advantages of accounting standards is that they help address the challenges associated with choosing between different accounting treatments.
- Sol. False,** Accounting standards are always bound by the laws and regulations in place and cannot supersede them. The standards must be developed and formulated in compliance with the existing statutes and regulatory framework.
- Full name of ASB stands for Accounting standard board.
- Sol. True,** Full name of ASB is stands for Accounting standard board
- Accounting Standards for non-corporate entities in India are formulated and issued by the Central Government.
- Sol. False:** Accounting Standards for non-corporate entities in India are formulated and issued by the Central Government.
- Accounting standards can override the status. (ICAI Study Material)
- Sol. False:** Accounting standards cannot supersede statutory regulations. These standards must be developed within the boundaries defined by existing statutes.

MULTIPLE CHOICE QUESTIONS

- The issuance of Accounting Standards for Non-Corporate entities in India is entrusted to the responsibility of
 - Central Govt.
 - State Govt.
 - Institute of Chartered Accountants of India.
 - Reserve Bank of India.

Sol. (c) Institute of Chartered Accountants of India

2. It is essential to standardize the accounting principles and policies in order to ensure

- (a) Transparency.
- (b) Consistency
- (c) Comparability.
- (d) All the three.

Sol. (d) All the three

3. Accounting Standards

(ICAI Study Material)

- (a) Harmonise accounting policies.
- (b) Eliminate the non-comparability of financial statements.
- (c) Both (a) and (b).
- (d) None of the above

Sol. (c) Both (a) and (b)

THEORETICAL QUESTIONS

1. Provide a brief explanation of the objective of "Accounting Standards."

Sol. Accounting Standards are a set of carefully chosen accounting policies or guidelines that provide principles and methods for financial reporting. The primary goal of Accounting Standards is to ensure that financial statements are prepared in accordance with widely accepted accounting principles. By suggesting rules and criteria for accounting measurements, Accounting Standards aim to harmonize the various accounting policies and practices currently employed in India.

2. Write down the benefits of establishing Accounting Standards.

Sol. Setting accounting standards offers several key benefits. It ensures uniformity, comparability, and improved quality in financial statement preparation and presentation. Additional advantages include reduced variations in accounting practices, disclosures exceeding legal requirements, and enhanced comparability of financial statements.



Unit-6: Accounting Terminology Glossary

ACCOUNTING TERMINOLOGY GLOSSARY

Note: This content is given in New Module Annexure but we had given as chapter. Kindly make sure You read at least Terminologies in which Bold Formatting is Done

Acceptance

The drawee's authorized endorsement on a bill of exchange, confirming the order of the drawer. This phrase is also used to characterize a bill of exchange that has received formal acceptance.

Accounting policies

Accounting policies encompass the distinct accounting principles and the methods used by a business when preparing and displaying financial statements.

Accrual

Recognition of revenues and expenses occurs when they are earned or incurred, regardless of when money is received or paid. This encompasses recognising transactions involving assets and liabilities as they occur, independent of the timing of cash receipts or payments.

Accrual/Mercantile Basis of Accounting

The accrual basis of accounting is a method of recording transactions that reflects revenues, costs, assets, and liabilities in the accounts during the period when they are earned or incurred. It includes aspects such as deferrals, allocations, depreciation, and amortization. This accounting approach is also known as the mercantile basis of accounting.

Accrued Asset

A developing, non-enforcing entitlement against another party that grows over time or as services are provided. It can stem from the provision of services (including the use of funds) that, at the accounting date, have been partially delivered and are not yet ready for invoicing.

Accrued Expense

An expenditure that has been accrued during an accounting period, yet no legally binding obligation for payment has matured against the company within that same period. This can result from the acquisition of services (including the utilization of funds) that have only been partially provided by the accounting date and are not yet subject to billing.

Accrued Liability

An emerging claim held by another party, which is not yet legally enforceable, but grows with time or as services are received. This claim can arise from the acquisition of services (including the use of funds) for which, at the accounting date, only a portion has been fulfilled.

Accrued Revenue

Income that has been generated during an accounting period, but for which the enterprise does not yet have a legally enforceable claim within that same period. This can occur from

providing services (including utilizing funds) where, as of the accounting date, only a portion of the work has been completed, and billing has not yet occurred.

Accumulated Depletion

The cumulative amount of periodic depletion expenses incurred on depleting assets up to the current point in time.

Accumulated Depreciation

The aggregate amount of periodic depreciation expenses recorded on depreciable assets up to the present time.

Advance

A payment made in advance for a contract, goods, or services, before their completion, acquisition, or receipt.

Amortised Value

The remaining amortizable value, subtracting any portion that has already been accounted for through amortization.

Annual Report

The yearly disclosure by a company's management to its shareholders and other stakeholders about its financial status and operational performance. This encompasses mandatory information, such as the company's balance sheet, income statement, notes on accounts, the auditor's report, and the Board of Directors' report, as required by law. Additionally, it can encompass optional information like a value-added statement, graphical representations, charts, and more.

Appropriation Account

An account, at times presented as a distinct section within the income statement, that illustrates how profits are allocated to dividends, reserves, and other purposes.

Assets

Physical items or abstract assets possessed by a business that are expected to yield future advantages.

Authorised Share Capital

The quantity and nominal value of each share class that a company is authorized to issue based on its corporate charter. This is occasionally termed as the nominal share capital.

Average Cost

The cost of an item at a specific moment, calculated by taking an average of the costs of all similar items over a defined period. If this calculation involves using weightings, it is referred to as weighted average cost.

Bad Debts

Obligations/Debts owed to a business that are deemed to be uncollectible.

Balance Sheet

A snapshot of a company's financial status as of a specific date, displaying its assets, liabilities, capital, reserves, and other account balances at their recorded book values.

Bill of Exchange

A written document with an absolute directive, signed by the creator, instructing a specific individual to pay a precise sum of money to a particular person, to their order, or to the holder of the document.

Bonus Shares

Shares issued through the conversion of a corporate enterprise's reserves or surplus.

Book Value

The value at which an item is recorded in the company's financial records or statements. This value is not tied to any specific method used for its determination, such as cost, replacement value, etc.

Borrowing costs

Borrowing costs include interest and other expenses accrued by a company in relation to the acquisition of borrowed funds.

Bond/Debenture

An official document that serves as formal recognition of a debt by a company, typically issued under its official seal, and typically outlining terms related to interest payments, principal repayment, and, when applicable, collateral. This document can be transferred according to the prescribed procedure.

Call

A request, as per the terms of the issuance, for payment of a portion or the entire outstanding balance on shares or debentures after initial allotment.

Called-up Share Capital

The portion of the authorized share capital that shareholders have been obligated to contribute.

Capital

Typically pertains to the money or money worth injected into a business by its owner, such as the fully paid-up share capital in a corporate company. It also alludes to the owners' stake in the assets of the enterprise.

Capital Assets

Assets, encompassing investments that are not intended for sale, conversion, or consumption as part of the regular business operations.

Capital Commitment

Anticipated obligations for capital expenses for which contractual agreements have been established.

Capital Employed (SHF + NCL)

The financial resources allocated by a company in its net fixed assets, investments, and working capital (CA-CL). It's worth noting that capital employed in a specific operation may not encompass investments made outside of that particular operation.

Capital Profit/Capital Loss

The surplus generated from the sale, transfer, or exchange of an entire capital asset or a portion thereof, exceeding its original cost. When the outcome of this calculation is negative, it is termed as a capital loss.

Capital Reserve

A corporate company's reserve that cannot be utilized for dividend distribution.

Capital Work-in-progress

Spending on capital assets that are currently under construction or in completion stage.

Cash

Cash includes both physical currency held on hand and funds deposited in demand accounts with banks.

Cash equivalents

Cash equivalents are investments with short maturities and with high liquidity i.e. easily convertible into known cash amounts, and carrying minimal risk of value fluctuations.

Cash Basis of Accounting

The approach for recording transactions where revenues, costs, assets, and liabilities are registered in the accounts during the period when real cash receipts or disbursements occur.

Cash Discount

A discount provided by a supplier, applied to the invoiced price as a reward for either immediate payment or payment within a specified timeframe.

Cash Profit

The net profit, adjusted for non-cash expenses such as depreciation and amortization. When this calculation results in a negative figure (if any), it is referred to as a cash deficit.

Carrying amount

The carrying amount is the value at which an asset is recorded on the balance sheet (after Depn.), i.e. taking into account any accumulated amortization and accumulated impairment losses associated with it.

Charge

A claim on an asset used as collateral to guarantee a debt or other responsibilities. This claim can be either a fixed or floating charge.

Cheque

A promissory note issued to a designated bank, with the condition that it is payable upon request and without any other specified payment terms.

Collateral Security

An additional form of security provided alongside the primary security for the same liability or obligation.

Costs of disposal

Disposal costs are the *additional expenses directly linked to the process of selling an asset, excluding finance charges and income tax liabilities.*

Contingency

A contingency represents a circumstance or scenario where the final result, whether it leads to a gain or loss, will only become clear upon the happening or non-happening of one or more uncertain future events.

Contingent Asset

An asset whose presence, ownership, or worth can only be ascertained upon the realization or non-realization of one or more uncertain future events.

Contingent Liability

An obligation tied to a current condition or circumstance that might come into effect in the future, contingent upon the happening or non-happening of one or more uncertain future events.

Contra Account

One or more accounts that partially or completely offset another account or accounts.

Cost

The sum of expenses accrued for or linked to a particular item, product, or undertaking.

Cost of Purchase

The total cost of acquisition, which comprises the purchase price along with duties, taxes, inward freight, and other directly related expenses, while subtracting trade discounts, rebates, duty drawbacks, and subsidies related to the purchase.

Cost of Goods Sold

The *expenses associated with the sale of goods* over the course of an accounting period. In manufacturing operations, this encompasses (i) the cost of materials, and (ii) labor and factory overheads, with the exclusion of selling and administrative expenses.

Conversion Cost

The *expenses associated with transforming raw materials or components into finished or partially finished products.* This generally comprises costs directly tied to units of production, such as direct labor, direct expenses, subcontracted work, and relevant production overheads based on either the direct cost or absorption costing method. Production overheads exclude costs related to general administration, finance, selling, and distribution.

Convertible Debenture

A debenture that grants the holder the **option to convert it, either entirely or partially, into shares as outlined in the terms of its issuance.**

Cumulative Dividend

A dividend due on cumulative preference shares that, when left unpaid, accrues as a demand against the profits of a corporate enterprise before any distribution is made to other shareholders.

Cumulative Preference Shares

A category of preference shares with the right to receive cumulative dividends. By default, preference shares are considered cumulative, unless explicitly designated as non-cumulative.

Current Assets

Funds and other resources anticipated to be transformed into cash or utilized in the creation of goods or the provision of services as part of regular business operations.

Current Liability

Obligations, which encompass loans, deposits, and bank overdrafts, that are slated for settlement within a relatively brief timeframe, typically not exceeding twelve months.

DEFERRAL

Delaying the acknowledgment of revenue or expense until a later period based on Accounting Policy, Principles or Assumptions that corresponds to its relevance, following the receipt, payment, or incurring of a liability. Typical instances of deferrals encompass prepayments for items like rent and taxes, as well as unearned subscriptions received in advance by companies in the newspaper and magazine industry.

Deficiency

The condition where an enterprise's **liabilities surpass its assets** at a specific date. This is reflected as a debit balance in the profit and loss statement.

Deficit

A debit balance in the profit and loss statement.

Depletion

A measure of the **reduction in value of a wasting asset (i.e natural resources)**, indicated by periodic write-offs of cost or an equivalent value.

Depreciation

Depreciation signifies the decrease in value of a depreciable asset due to use, the passage of time, or obsolescence due to technological and market changes. Depreciation is allocated to spread a fair share of the depreciable amount over each accounting period throughout the anticipated useful life of the asset. This also includes amortization of assets with predetermined lifespans.

Depreciable amount

The depreciable amount of a depreciable asset is its historical cost or any other value substituted for historical cost in the financial statements, minus the estimated residual value.

DEPRECIABLE ASSETS

Depreciable assets are assets that meet the following criteria:

- (i) They are intended to be utilized over multiple accounting periods.
- (ii) They have a limited expected lifespan.
- (iii) They are owned by an enterprise for purposes such as producing or delivering goods and services, renting to others, or administrative use, rather than for sale as a standard part of business operations.

Depreciation Method: Any approach for calculating depreciation over an accounting period.

Depreciation Rate: A percentage applied to the historical cost or its substituted value of a depreciable asset (or in the case of the diminishing balance method, the historical cost or its substituted value minus accumulated depreciation).

Diminishing Balance Method: A method where the periodic depreciation charge for an asset is computed by applying a fixed percentage to its historical cost or substituted value, reduced by accumulated depreciation (net book value). This is also known as the written down value method.

Discount: A reduction from a list price, quoted price, or invoiced price. It can also refer to the price for receiving payment on a bill before its maturity.

Dividend: A distribution of profits or reserves available for this purpose to shareholders.

Entity Concept: The perspective regarding the relationship between the accounting entity and its owners, treating the entity as a distinct entity separate from its owners.

Equity Share: A share that is not a preference share, sometimes referred to as ordinary share.

Exchange Difference: The difference resulting from reporting the same quantity of units of a foreign currency in the reporting currency at different exchange rates.

Expenditure: Incurring a liability, disbursement of cash, or transferring property to obtain assets, goods, or services.

Expense: A cost associated with the operations of an accounting period, revenue earned during the period, or benefits not extending beyond that period.

Expired Cost: That portion of an expenditure from which no further benefit is expected, also known as an expense.

Extraordinary Items: Income or expenses arising from events or transactions distinct from the regular activities of the enterprise and not expected to occur frequently.

Fair Value: The amount for which an asset could be exchanged or a liability settled between informed, willing parties in an arm's length transaction.

Fair Market Value: The price agreed upon in an open and unrestricted market between informed, willing parties dealing at arm's length.

First Charge: A charge with priority over others.

First In, First Out (FIFO): Computing the cost of items sold or consumed as if they were used in the order of their acquisition.

Fixed Asset: An asset intended for use in producing or providing goods or services, not held for sale in the normal course of business.

Fixed Cost: A production cost that remains relatively constant within a defined time period regardless of production volume.

Fixed Deposit: A deposit for a specified period and at a specified interest rate.

Fixed or Specific Charge: A charge attached to a specific asset identified when the charge is created, with the asset's identity remaining unchanged during the charge's existence.

Floating Charge: A general charge on some or all enterprise assets not attached to specific assets, provided as security against a debt.

Financial Instrument: A financial instrument refers to any agreement that results in a financial asset for one enterprise and a financial liability or equity shares for another enterprise.

Foreign Currency: Foreign currency is a currency other than the reporting currency of an enterprise.

Forfeited Share: A share for which ownership is forfeited by a member due to non-payment of call money, failure to meet obligations between members, or expulsion as provided in the articles of association.

Free Reserve: A reserve that can be used without any restrictions.

Functional Classification: A method of categorizing expenses, revenues, assets, and liabilities based on their associated function or activity, rather than their inherent nature.

Fund: An account, often similar to a reserve or provision, represented by specifically designated assets.

Fundamental Accounting Assumptions: Basic assumptions that form the foundation for preparing and presenting financial statements. These include the assumptions of going concern, consistency, and accrual. They are typically implicit, but disclosure is necessary if they are not followed.

Gain: A financial benefit, profit, or advantage resulting from a single transaction or a series of transactions.

General Reserve: A revenue reserve not earmarked for a specific purpose.

Going Concern Assumption: An accounting assumption where an enterprise is assumed to continue its operations in the foreseeable future without the intent or necessity of liquidation or substantial reduction in its activities.

Goodwill: An intangible asset arising from an enterprise's business connections, trade name,

or reputation.

Gross Margin or Gross Profit: The surplus of revenue generated from selling goods and providing services over their cost before accounting for administration, selling, distribution, and financing expenses. A negative result is referred to as a gross loss.

Government: Government refers to governmental bodies at local, national, or international levels.

Government Grants: Government grants are financial or in-kind assistance provided by the government to an enterprise, either for past compliance or to meet specific conditions in the future. These do not include government assistance that cannot be reasonably valued or transactions that are indistinguishable from the enterprise's normal commercial transactions.

Gross Book Value: The gross book value of a fixed asset is its historical cost or any other value substituted for historical cost in the accounting books or financial statements. When this amount is displayed net of accumulated depreciation, it is called the net book value.

Income and Expenditure Statement: A financial statement typically prepared by non-profit organizations, like clubs and associations, to display their revenues and expenses for an accounting period, along with the surplus of revenues over expenses (or vice versa) for that period. It is akin to a profit and loss statement and is also referred to as a revenue and expense statement

INTANGIBLE ASSET

Intangible assets, such as goodwill, patents, and copyrights, do not possess a tangible physical form.

Inventories are assets that fall into one of the following categories:

- (a) Held for sale as part of the regular business operations.
- (b) In the process of being produced for eventual sale.
- (c) Existing as materials or supplies meant for consumption in the production process or in the provision of services.

Investment: Expenditure on assets held with the aim of generating interest, income, profit, or other benefits.

Investments: Assets held for purposes other than regular operational use, rendering services, or as fixed or current assets (e.g., securities, shares, debentures, immovable properties).

Issued Share Capital: The part of the authorized share capital that has been offered for subscription, including any bonus shares allotted by the corporate enterprise.

Joint Venture: A contractual arrangement in which **two or more parties jointly control an economic activity.**

Last In, First Out (LIFO): A method for calculating the cost of items sold or consumed during a period, based on the assumption that the most recently acquired items are sold or consumed first.

Liability: The financial obligation of an enterprise, excluding owner's equity.

Lien: The right of one person to satisfy a claim against another by holding or retaining

possession of that person's assets/property.

Long: term Liability – A liability that is not due for payment within a relatively short period, typically not exceeding twelve months.

Lease: An agreement in which the lessor conveys to the lessee the right to use an asset in exchange for payments over an agreed period. (i.e. **Sort of Rent Agreement**)

Materiality: An accounting principle stating that significant and relevant items, capable of influencing the decisions of financial statement users, must be disclosed.

Mortgage: The transfer of interest in specific immovable property as security for a loan or existing/future debt or performance of an obligation.

Net Assets/Shareholders' Funds/Net Worth: The surplus of an enterprise's assets (excluding fictitious assets) over its liabilities, also known as net worth or shareholders' funds.

Net Fixed Assets: Fixed assets minus accumulated depreciation up to the current date.

Net Profit/Net Loss: The surplus of revenue over expenses during a specific accounting period. A negative result is referred to as a net loss. Net profit may be shown before or after tax.

Net Realizable Value: The estimated selling price in the ordinary course of business, less the estimated costs of completion and sale.

Obsolescence: A reduction in the value of an asset due to factors such as technological changes, improvements in production methods, shifts in market demand, or legal restrictions.

Operating Profit: The net profit derived from the regular operations of an enterprise, excluding extraneous transactions and purely financial expenses.

Paid-up Share Capital: The portion of the subscribed share capital for which consideration, either in cash or other forms, has been received. This includes bonus shares allotted by the corporate enterprise.

Preference Share Capital: The share capital with preferential rights regarding fixed dividends and capital repayment. Preference shares may also carry full or partial participating rights in surplus profits or capital.

Preliminary Expenses: Expenses related to the formation of an enterprise, such as legal, accounting, and share issue expenses.

Prepaid Expense: Payment for an expense in one accounting period, with the benefit expected to accrue in subsequent periods.

Prime Cost: The total cost of direct materials, direct wages, and other direct production expenses.

Prior Period Item: Income or expenses arising in the current period due to errors or omissions in the financial statements of one or more prior periods.

Profit/Loss: A general term for the surplus of revenue over related costs. A negative result is referred to as a loss.

Profit and Loss Account: A financial statement that presents an enterprise's revenues and expenses for an accounting period, showing the surplus of revenues over expenses (or vice versa). It is also known as a profit and loss account.

Promissory Note: A written instrument, other than a banknote or currency note, containing an unconditional promise, signed by the maker, to pay a specified sum of money to a certain

person or bearer of the instrument.

Provision: An amount set aside for depreciation, diminution in asset value, or for known liabilities whose exact amount cannot be determined with certainty.

Provision for Doubtful Debts: A reserve created to cover debts considered doubtful of recovery.

Prudence: An accounting concept emphasizing caution and care, recognizing profits only when realized, and making provisions for known liabilities and losses, even when their exact amounts cannot be determined with certainty.

Redeemable Preference Share: A preference share that can be repaid after a fixed or determinable period or at any time per management's decision, under conditions stipulated in the instrument of incorporation or the terms of issue.

Redemption: The repayment of preference shares or debentures as specified in the terms and conditions.

Reserve: A portion of earnings, receipts, or other surpluses, both capital and revenue, set aside by management for general or specific purposes, excluding provisions for depreciation, diminution in asset value, or known liabilities. Reserves are typically categorized as capital reserves or revenue reserves.

Revaluation Reserve: A reserve created when assets or net assets of an enterprise are revalued, representing the surplus of the estimated replacement cost or estimated market values over their book values.

Residual Value: The amount an enterprise expects to obtain for an asset at the end of its useful life, after deducting estimated disposal costs.

Revenue/Income: Revenue encompasses cash inflow, receivables, or other considerations arising from an enterprise's ordinary activities, such as selling goods, rendering services, and earning interest, royalties, and dividends. Revenue is measured by charges to customers or clients for goods and services and by charges and rewards from resource usage. In an agency relationship, revenue is the commission, not the gross cash inflow.

Revenue Reserve: Any reserve, excluding capital reserves

Right Share: An allocation of shares when a corporate enterprise issues new capital, given to shareholders based on the number of shares they already hold. This allocation is proportional to their existing shareholding. (In certain cases, shares allotted to specific categories of debenture holders as part of their rights are also referred to as right shares).

Sales Turnover/Gross Turnover/Gross Sales: The total amount for which an enterprise makes sales or provides services. To distinguish between sales before and after deducting returns and trade discounts, the terms gross turnover and net turnover (or gross sales and net sales) are sometimes used.

Secured Loan: A loan secured either wholly or partially against an asset.

Share Capital: The total amount of money paid or credited as paid on the shares and/or stocks of a corporate enterprise.

Share Discount: The surplus of the face value of shares over their issue price.

Shareholders' Equity: The shareholders' interest in the net assets of a corporate enterprise. In the event of liquidation, it represents the remaining assets after settling prior claims.

Share Issue Expenses: Costs incurred in relation to the issuance and allocation of shares. These costs encompass legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and expenses related to the issuance of prospectuses and share allotments.

Share Warrants: Financial instruments that grant the holder the right to acquire equity shares.

Securities Premium: The excess of the issue price of shares over their face value.

Sinking Fund: A fund established for repaying a liability or replacing an asset.

Straight Line Method: A depreciation calculation method that involves dividing the depreciable amount of an asset by the estimated number of years of its useful life to determine the periodic depreciation charge.

Subscribed Share Capital: The portion of the issued share capital that has been subscribed and allotted, including any bonus shares allocated by the corporate enterprise.

Substance over Form: An accounting principle asserting that the substance, rather than just the legal form, of transactions and events governs their accounting treatment and presentation in financial statements.

Sundry Creditors/Trade Creditors/Trade Payables: Amounts owed by an enterprise for goods purchased, services received, or contractual obligations. Also referred to as trade creditors, account payables, or trade payables.

Sundry Debtors/Trade Debtors/Trade Receivables: Individuals or entities from whom amounts are due for goods sold, services rendered, or contractual obligations. Also known as debtors, trade debtors, account receivables, or trade receivables.

Surplus: The credit balance in the profit and loss statement remaining after making provisions for proposed appropriations, such as dividends or reserves.

Trade Discount: A reduction provided by a supplier from the list price of goods or services due to business considerations other than prompt payment.

Unexpired Cost: The portion of an expenditure for which the benefit has not yet been fully realized.

Unissued Share Capital: The segment of authorized share capital for which shares have not been offered for subscription.

Unpaid Dividend: Dividends declared by a corporate enterprise but not yet paid, or the corresponding warrant or check not dispatched within the prescribed timeframe.

Useful Life: The duration over which a depreciable asset is expected to be used by the enterprise or the number of production or similar units anticipated from the asset's use by the enterprise.



Unit-7: Accounting as a Measurement Discipline

- Valuation Principles, Accounting Estimates

MEANING OF MEASUREMENT

Measurement is a crucial component of accounting, where transactions and events are primarily quantified in monetary terms.

Any measurement discipline involves three elements:

- (a) identifying the transaction and events to be measured,
- (b) selecting the appropriate standard or scale, (i.e Money) and
- (c) evaluating the dimensions of the measurement standards or scale. (i.e 1Kg = 1000gm, was; is and will be)

Note: "In ICAI Module we can find word *Object* and here instead of *object* we have used *Transaction* because *Object* means description of transaction"

TRANSACTION OR EVENTS TO BE MEASURED

Earlier, we defined Accounting as the process of identifying, measuring, and communicating economic information to facilitate informed judgments and decisions by the users of the information.

Consequently, accounting fundamentally involves the measurement of 'information.'

Decision-makers require information from the past, present, and future. Typically, for external users, the communicated information pertains to the past.

In accounting, there is no standardized set of events and transactions necessary for decision-making.

For instance,

In the cash system of accounting, various cash receipts and expenses constitute essential transactions and events. Clearly, decision-makers require historical data on cash receipts and expenses, along with projections.

When extending a credit or giving loan to a business, information about the repayment ability can be judged using past information, the current state of affairs, and future projections.

It's important to note that while past and present transactions and events can be measured with some degree of accuracy, future events and transactions are predicted, not measured. Prediction is a crucial element of accounting information, as decision-makers must make informed choices about an unseen future, for which they need proper financial & non-financial information.

STANDARD OR SCALE OF MEASUREMENT

In accounting, money serves as the measurement scale (refer to the money measurement concept), but contemporary practices involve the communication of both quantitative and

monetary information.

The monetary scale of measurement does not have a universal denomination; it is dependent on the currency prevailing in a specific country.

For instance, in India, the measurement scale is the Rupee, in the U.K. it is Pound-Sterling (£), in Germany it is Deutschmark (DM), in the United States it is the Dollar (\$)

Money as a unit of measurement lacks consistent applicability Due to fluctuations in exchange rates over time.

Example: A businessman from India borrows \$1,000 from a U.S.A., he would record the transaction in his books using the currency exchange rate., if the exchange rate at the time of the loan agreement was US \$1 = ₹50, then the loan amount would be ₹50,000. Subsequently, if the exchange rate changes to \$1 = ₹55, the loan amount would be recalculated as ₹55,000.

DIMENSION OF MEASUREMENT SCALE

An ideal measurement scale should exhibit stability over time.

For instance, purchasing 1 kg of potatoes today should yield the same quantity as buying 1 kg of potatoes a day or week or month or year later. In essence, a measurement scale should maintain stability in dimension.

However, money as a scale of measurement lacks this stability due to continuous fluctuations in input and output prices that lead to changes in the purchasing power of the same quantity of money over time. Consequently, the identical amount of money may not possess the capacity to purchase the same quantity of identical goods at different points in time.

Due to this, information measured in monetary terms for one year may not be directly comparable with that of another year. Consider the production and sales data of a company in two different years as an example:

Year 1		Year 2	
Qty.	₹	Qty.	₹
10,000 pcs	10,00,000	9,000 pcs	10,80,000

Upon examining the financial numbers, one might initially perceive an 8% growth in sales. However, the reality is a 10% decrease in both production and sales. The apparent growth indicated by monetary figures is solely attributable to changes in prices. To illustrate this further, let's consider the production costs for the aforementioned two years.

Year 1		Year 2	
Qty.	₹	Qty.	₹
10,000 pcs	8,00,000	9,000 pcs	9,00,000

Consider Gross Profit as the difference between Sales and Cost of Production. In the first year, the profit amounted to ₹2,00,000, whereas in the second year, it was ₹1,80,000, indicating a 10% decrease in gross profit.

Therefore, the unit of measurement, money, lacks stability in dimension. Accounting

predominantly measures information in monetary terms, which is an unstable scale with limited universal applicability and lacks consistency in dimension for comparisons over time. Consequently, accounting is not considered an exact measurement discipline.

ACCOUNTING AS A MEASUREMENT DISCIPLINE

Determining the measurement basis is a critical step in assessing transactions or events, setting the stage for the record-keeping function in bookkeeping. Accounting is designed to generate information essential for users' judgments and decisions, involving processes like recording, classifying, and summarizing data.

These processes help to quantify

- (a) the performance of a business entity, indicating profit or loss and
- (b) revealing its financial position.

Despite its integral role in accounting, measurement operates under a set of governing theorems that elucidate the functioning of the accounting system. Three fundamental accounting assumptions—going concern, consistency, and accrual—are commonly accepted in the accounting profession.

While money is the unit of measurement in accounting, various policies are employed during the processes of recording, classifying, summarizing, and presenting information. Accounting encompasses not only measurement but also the recording, classifying, summarizing, and communication of information, extending beyond the strict confines of the measurement discipline. Consequently, categorizing accounting solely as a measurement discipline may oversimplify its multifaceted nature.

It is acknowledged, however, that in accounting, money serves as the unit of measurement, with the understanding that all transactions and events must be recorded in monetary terms. While quantitative information is occasionally necessary, it is considered supplementary to monetary information.

VALUATION PRINCIPLES

The four generally accepted measurement basis or valuation principles are:

- (i) Historical Cost; (i.e. Cost of Acquisition)
- (ii) Current Cost; (i.e. Asset valued at Present Replacement cost & Liabilities accounted at amount needed to immediately settle the obligation)
- (iii) Realizable Value; (i.e. Asset valued at price which it can fetch today if sold & liabilities accounted at amount intended to be paid to fulfill obligation)
- (iv) Present Value. (i.e. Asset recorded at PV of future cash inflow it can generate & liabilities accounted at PV of future cash outflow)

Let us discuss these principles in detail.

- (i) **Historical Cost:** It means acquisition price. For example, the business paid ₹14,00,000 to purchase the machine and spent ₹2,00,000 on its installation, its acquisition price including installation charges are ₹16,00,000. The historical cost of machine would be ₹16,00,000.

In accordance with this basis, assets are documented at the cash or cash equivalent amount disbursed during the acquisition. Liabilities are noted at the proceeds received in exchange for the obligation. Under certain circumstances, a liability is recorded at the expected cash or cash equivalent amount to be paid in the normal course of business to fulfill it.

For instance, when a businessman obtains a ₹10,00,000 loan from a bank at a 10% annual interest rate, it is recorded at the proceeds received in exchange for the obligation. In this scenario, the obligation encompasses both loan repayment and interest payment at the agreed rate of 10%. The received proceeds amount to ₹10,00,000, constituting the historical cost of the transaction.

Consider another situation involving the settlement of income tax liability. Although individuals are obligated to pay income tax on earnings surpassing a specified minimum limit, the income tax liability is not settled immediately upon earning the income. The income tax authority typically settles it at a later time, termed the assessment year. Following the historical cost basis, this liability is recorded at the anticipated amount to be paid to discharge the obligation.

Companies commonly adopt the historical cost method, especially for long-term assets such as machinery, furniture, licenses, etc.

- (ii) **Current Cost:** Consider Mr. X's purchase of a machine on January 1, 2011, for ₹14,00,000. According to the historical cost base, he records it at ₹14,00,000, representing the acquisition price. Fast forward to January 1, 2022, and Mr. X determines that it would cost ₹50,00,000 to acquire a similar machine. Additionally, Mr. X secured a loan from a bank on January 1, 2011, amounting to ₹10,00,000 at an 18% annual interest rate, repayable at the end of the 15th year along with interest. As of January 1, 2022, the bank imposes a 1% prepayment penalty on the loan amount if settled within 15 days from that day. According to the historical cost, the liability is recorded at ₹10,00,000, reflecting the proceeds received in exchange for the obligation, and the asset is recorded at ₹14,00,000.

Alternatively, the current cost serves as an alternative measurement basis. Under this approach, assets are valued at the amount of cash or cash equivalent that would be required to purchase the same or an equivalent asset at present. Liabilities are valued at the undiscounted amount of cash or cash equivalents needed to settle the obligation immediately.

Therefore, based on the current cost basis, the machine's value is ₹50,00,000, and the value of the bank loan is ₹10,10,000.

- (iii) **Realisable Value:** Consider if Mr. X were to discover that he could fetch ₹40,00,000 by selling the machine he purchased on January 1, 2011, for which he paid ₹14,00,000 and which would currently cost ₹50,00,000 if acquired. Additionally, let's assume that Mr. X realizes he does not have the funds to settle the current bank loan of ₹10,00,000.

In line with the realisable value concept, assets are valued at the cash or cash equivalents that could currently be obtained by selling them in an orderly disposal, recognizing that a haphazard disposal might yield a lesser amount. Liabilities are recorded at their

settlement values, indicating the undiscounted amount of cash or cash equivalents intended to be paid to fulfill the liabilities in the normal course of business.

Therefore, according to the realizable value concept, the machine should be recorded at ₹40,00,000, representing its realizable value in an orderly sale, while the bank loan should be recorded at ₹10,00,000, reflecting its settlement value in the normal course of business. The realizable value concept is commonly applied in the case of inventories, where they are measured at the lower of cost and net realizable value.

- (iv) **Present Value:** Let's consider the scenario as of January 1, 2022, as our point of reference. Suppose the machine purchased by Mr. X is expected to remain operational for another 10 years, generating an annual cash inflow of ₹2,00,000. Additionally, Mr. X's bank loan of ₹10,00,000 is scheduled for repayment by December 31, 2028, with an annual interest of ₹1,80,000.

According to the present value concept, an asset is recorded at the present discounted value of the anticipated future net cash inflows it is expected to generate in the regular course of business. Similarly, liabilities are recorded at the present discounted value of anticipated future net cash outflows required to settle the liabilities in the normal course of business. This present value concept is commonly employed in accounting for investments and loans.

The terms 'discount,' 'cash inflow,' and 'cash outflow' necessitate a bit of clarification. ₹1,000 in hand on January 1, 2022, is not equivalent to ₹1,000 in hand on December 31, 2022, considering the one-year time gap. If Mr. X had ₹1,000 on January 1, 2022, he could utilize it at that time. However, if he received it only on December 31, 2022, he would have to forego its use for a year. The value of this sacrifice is termed the 'time value of money.' A rational individual would only agree to receive money on December 31, 2022, if adequately compensated for this sacrifice. Therefore, ₹1,000 on January 1, 2022, is not equivalent to ₹1,000 on December 31, 2022. To equalize the value of money receivable in the future with money from the present, it needs to be devalued. This devaluation process is referred to as the discounting of future money.

Top of Form

Compound interest rule: $A = P (1 + i)^n$

n A = Amount

P = Principal

i = interest/100 n = Time

This formula establishes a link between the current amount of money, principal, and the future sum of money. When A, i, and n are provided, calculating P requires a minor adjustment to the equation.

$$P = \frac{A}{(1 + i)^n}$$

Through the utilization of this equation, individuals can determine the present value when provided with the values of A, i, and n.

Suppose $i = 20\%$, now what is the present value of ₹2,00,000 to be received as on 31.12.2022 (Let 1.1.2022 as reference).

$$P = \frac{2,00,000}{(1+0.20)^1} = ₹1,63,333$$

Similarly,

Time of Receipt	Money Value ₹	Present Value ₹
31.12.2023	2,00,000	138888
31.12.2024	2,00,000	115740
31.12.2025	2,00,000	96450
31.12.2026	2,00,000	80376
31.12.2027	2,00,000	66980
31.12.2028	2,00,000	55816
31.12.2029	2,00,000	46514
31.12.2030	2,00,000	38762
31.12.2031	2,00,000	32300

Total of all these present values is ₹838492. Since the machine purchased by Mr. X will produce cash equivalent to ₹838492 in terms of present value, it is to be valued at present value measurement basis.

Here, Mr. X will receive ₹2,00,000 at different points of time—these are cash inflows. In the other example, he has to pay interest and principal of bank loan—these are cash outflows.

Perhaps you also know the annuity rule:

Present value of an Annuity or Re. A for n periods is

A = Annuity

i = interest

t = time 1, 2, 3,...n.

$$\frac{A}{i} \left[1 - \frac{1}{(1+i)^n} \right]$$

Applying this rule one can derive the present value of ₹2,00,000 for 10 years @ 20% p.a.

$$\frac{2,00,000}{0.20} \left[1 - \frac{1}{(1+0.20)^{10}} \right] = ₹8,38,492$$

Similarly, the present value of bank loan is

$$\frac{1,80,000}{0.20} \left[1 - \frac{1}{(1+0.20)^5} \right] + \frac{10,00,000}{(1+0.20)^5}$$

$$= ₹538310 + ₹401878 = ₹940188$$

Thus, we get the four measurements as on 1.1.2022:

	Historical cost ₹	Current cost ₹	Realisable value ₹	Present value ₹
Asset: Machine	14,00,000	50,00,000	40,00,000	838492
Liability: Bank Loan	10,00,000	10,10,000	10,00,000	940188

The accounting system explored in the upcoming chapters is commonly referred to as historical cost accounting. However, it's important to note that this doesn't imply an exclusive adherence to the historical cost basis of accounting. In advanced stages of the CA course, we will discover that the accounting system incorporates various measurement bases. Although, in the traditional system, a predominant portion of transactions and events is measured using the historical cost.

MEASUREMENT AND VALUATION

Value pertains to the benefits derived from transaction, abilities, or ideas. From an economic standpoint, value signifies the utility (i.e., satisfaction) of an economic resource to the individual contemplating or enjoying its use. In accounting, when referring to the value of an object, abilities, or ideas, a monetary equivalent is employed.

In other words, value is quantified in monetary terms. For example, if an individual purchases a car for ₹5,00,000, its value lies in the satisfaction the individual anticipates from using the car in the future. Economists often employ an ordinal scale to denote the level of satisfaction, while accountants exclusively utilize cardinal scales. When the value of the car is expressed as ₹5,00,000, it represents a specific type of value known as acquisition cost or historical cost. Therefore, value is denoted through measurement, and in accounting, this measurement is consistently expressed in terms of money.

ACCOUNTING ESTIMATES

In the preceding section of this module, we covered the methodology for quantifying a transaction that has already transpired, involving either a monetary payment or the application of valuation principles for measurement. However, certain items have yet to occur and thus cannot be measured using existing valuation principles. Nonetheless, it is essential to document these items in the accounting records—take, for instance, the provision for doubtful debts. In such cases, the need for a value arises, and reasonable estimates are crafted based on the current scenario and past experiences.

The valuation of certain assets and liabilities hinges on estimates of unpredictable future events. Due to the inherent uncertainties in business activities, many items in financial statements cannot be precisely measured but only estimated. Consequently, management formulates various estimates and assumptions for assets, liabilities, incomes, and expenses when preparing financial statements. Such estimates are integral to computations involving depreciation, amortization, impairment losses, accruals, provisions, and employee benefit obligations. Additionally, estimates may be requisite for determining bad debts, the useful life and residual value of plant and machinery, and inventory obsolescence. The estimation process involves judgments founded on the most recent information available.

Estimates may necessitate revision if changes occur regarding the circumstances upon which

the estimate was based, or due to new information, increased experience, or subsequent developments. A change in accounting estimate denotes the difference between certain parameters estimated earlier and those re-estimated during the current period or the actual results achieved during the current period.

Examples of scenarios requiring accounting estimates include:

1. A company incurs a development expenditure of ₹20,00,000 on a patent. The company must estimate for how many years the patent will benefit the company, a determination based on the latest information and logical judgment.
2. A company engaged in long-term construction contracts employs the percentage-of-completion method for recognizing revenue at the end of the accounting year. Provisions for unforeseen contingencies during the remaining contract execution are necessary under this method. Since estimating these contingencies is essential, there may be excess or insufficient provisioning, which needs adjustment when recognized.
3. A company needs to create a provision for taxes, a process based on estimation due to potential interpretational differences that tax authorities may accept or reject, leading to distinct tax liabilities.
4. Company XY Ltd purchases a machine for ₹20 lakhs in 2021, with an initial expectation that the machine will provide benefits for the next 10 years. After three years of use, technological advancements make the machine obsolete, and it is now projected to offer benefits for only an additional three years. This represents a change in the estimate of the machine's useful life.

TEST YOUR KNOWLEDGE

TRUE AND FALSE

1. There are four generally accepted measurement bases. (ICAI Study Material)

(i) Historical Cost;	(ii) Current Cost;
(iii) Realizable Value;	(iv) Future Value.

Sol. False: There are four generally accepted measurement basis.

(i) Historical Cost;	(ii) Current Cost;
(iii) Realizable Value;	(iv) Present Value

2. Historical Cost means price paid at time acquisition. (ICAI Study Material)

Sol. True: Historical cost means "acquisition price".

3. As per future value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.

(ICAI Study Material)

Sol. False: Under the concept of realizable value, assets are recorded at the sum equivalent to the cash or cash equivalents currently attainable through the orderly disposal of these assets.

4. At Present value, liabilities are carried at the value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Sol. False: Under this principle, obligations are reflected at the present discounted value of the anticipated future net cash outflows essential for settling these liabilities in the regular conduct of business.

5. XYZ purchased machinery amounting Rs.5,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for Rs.10,00,000. Historical cost of machine is Rs.10,00,000

Sol. False: Historical cost is ₹5,00,000

6. XYZ purchased machinery amounting ₹5,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹10,00,000. Current cost of machine is ₹10,00,000

Sol. True: Since similar machine is purchased at 10,00,000, the current cost of machine is ₹10,00,000

7. Change in accounting estimate has to be given retrospective effect. (ICAI Study Material)

Sol. False: Retrospective effect is not required for a change in accounting estimate.

MULTIPLE CHOICE QUESTIONS

1. (i) Measurement discipline deals with

(ICAI Study Material)

- (a) Identification of transaction and events. (b) Selection of scale.
(c) Both (a) and (b) (d) None of the above

Sol. (c) Both (a) and (b)

- (ii) All of the following are valuation principles except

(ICAI Study Material)

- (a) Historical cost. (b) Present value.
(c) Future value. (d) None of the above

Sol. (c) Future Value

- (iii) Book value of machinery on 31st March, 2022 ₹10,00,000 Market value as on 31st March, 2022 if sold ₹1,00,000

As on 31st March, 2022, if the company values the machinery at ₹11,00,000, which of the following valuation principles is being followed? (ICAI Study Material)

- (a) Historical Cost. (b) Present Value.
(c) Realisable Value. (d) None of the above

Sol. (c) Realisable value

2. Mohan purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000 but the realizable value of the machinery (purchased on 1.4.2001) was estimated at ₹15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹12,00,000.

(i) The current cost of the machinery is

(ICAI Study Material)

(a) ₹10,00,000

(b) ₹20,00,000

(c) ₹15,00,000

(d) None of the above

Sol. (b) 20,00,000

(ii) The present value of machinery is

(ICAI Study Material)

(a) ₹10,00,000

(b) ₹20,00,000

(c) ₹12,00,000

(d) None of the above

Sol. (c) 12,00,000

(iii) The historical cost of machinery is

(ICAI Study Material)

(a) ₹10,00,000

(b) ₹20,00,000

(c) ₹15,00,000

(d) None of the above

Sol. (a) 10,00,000

(iv) The realizable value of machinery is

(ICAI Study Material)

(a) ₹10,00,000

(b) ₹20,00,000

(c) ₹15,00,000

(d) None of the above

Sol. (a) 10,00,000

THEORETICAL QUESTIONS

1. Define Measurement in brief. Explain the significant elements of measurement.

(ICAI Study Material)

Sol. Evaluation is a crucial element in accounting, where transactions and events are primarily quantified in monetary terms. The three key components of measurement include: (1) Identifying the transaction and events to be measured; (2) Choosing the appropriate standard or scale; (3) Assessing the dimension of the measurement standard or scale.



Unit-8: Contingent Assets and Liabilities

CONTINGENT ASSETS

A contingent asset – a potential asset (i.e. economic gains) that arises from past events, and its existence depends on uncertain future events beyond the enterprise's complete control. Typically, these assets arise from unforeseen circumstances that create the possibility of economic gains for the business.

Example: A claim being pursued through legal proceedings, the outcome of which remains uncertain.

In accordance with conservatism / prudence principles and prevailing accounting standards, it is not advisable for an enterprise to recognize a contingent asset.

These assets are characterized by their uncertainty and often arise from legal claims whose realization is unpredictable. Recognizing contingent assets might lead to reporting income that may never materialize.

Nevertheless, when the likelihood of income realization becomes almost certain, the contingent asset transforms into a recognized asset.

There is no obligation to disclose a contingent asset in the financial statements. Typically, contingent assets are disclosed in reports approved by the relevant authority (e.g., Board of Directors for a company) when the probability of economic benefits becoming realized is high. Continual assessment of contingent assets is necessary, and when it becomes nearly certain that economic benefits will materialize, both the asset and related income are then recorded in the financial statements for the period when this change occurs.

CONTINGENT LIABILITIES

The concept of a 'Contingent liability' is defined as:

- (a) It refers to a potential obligation that originates from past events. The confirmation of this obligation's existence arises on the occurrence or non-occurrence of one or more uncertain future events, events that are not entirely under the enterprise's control.
- (b) It can also pertain to an existing obligation arising from past events but goes unrecognized due to either of the following reasons:
 - (i) There is a lack of probability that an outflow of resources, embodying economic benefits, will be necessary to settle the obligation.
 - (ii) An accurate and dependable estimate of the obligation's amount cannot be determined.

For example: Mr. X sells a machine to Mr. Y, and any damages incurred by Mr. Y while using the machine must be compensated by Mr. X. A few days after the sale, Mr. X receives a notice from Mr. Y, claiming damages of Rs.20 lac.

The notice states that a worker had an accident while using the machine and requires compensation. The receipt of this notice does not immediately establish Mr. X's liability to

pay the amount. It necessitates a thorough investigation to determine whether the damage resulted from a defect in the machine or negligence during operation. The receipt of the notice, however, triggers an event that mandates the recognition of a contingent liability, as it represents a potential obligation contingent on future confirmation.

Let's consider another scenario: Mr. AB sells cars to customers, and during a test drive, one of the cars catches fire due to a faulty part. The customer initiates a court case seeking a claim of Rs.50 lac due to this incident. While Mr. AB acknowledges a present obligation, it remains uncertain whether he will be held responsible for the damages. The final outcome will only become clear during the court proceedings.

A contingent liability can be either a potential obligation arising from past events, dependent on the occurrence or non-occurrence of uncertain future events (part (a) of the definition), or it can be a present obligation originating from past events (part (b) of the definition).

In accordance with accounting principles, an enterprise should not recognize a contingent liability on the balance sheet. However, it must disclose it in the notes to the financial accounts, unless the possibility of an outflow of resources with economic benefits is considered remote. These contingent liabilities are continuously assessed to determine if the likelihood of an outflow of resources with economic benefits has become probable.

If it does become probable that an outflow of future economic benefits will be necessary for an item previously treated as a contingent liability, a provision is recognized in the financial statements for the period in which the change in probability occurs, except in exceedingly rare cases where a reliable estimate cannot be made.

DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is primarily a matter of managerial judgment.

A liability is characterized as a current financial obligation of an enterprise arising from past events, where the settlement of this obligation leads to an outflow of resources carrying economic benefits.

Conversely, in the case of a contingent liability, there are two possible scenarios, either the outflow of resources to fulfill the obligation is not likely to occur, or the amount anticipated for settling the liability cannot be reliably measured.

Examples: Claims against the enterprise that haven't been officially recognized as debts, guarantees issued on behalf of third parties, obligations associated with discounted bills, and legal responsibilities that are under dispute, among others.

In addition to the current obligations acknowledged as liabilities in the balance sheet, enterprises are obligated to divulge contingent liabilities in their financial statements, typically through explanatory notes.

DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

The term "Provision" is defined as the setting aside of funds to account for depreciation, asset renewal, or a reduction in asset value, or for known liabilities where the precise amount

cannot be reliably determined.

Understanding the difference between provisions and contingent liabilities is crucial. The differentiation between these two concepts can be elucidated as follows:

	Provision	Contingent liability
(1)	A provision represents a current obligation of undetermined value , which can be reasonably quantified through a significant level of estimation..	A contingent liability is a potential obligation that may or may not materialize, contingent upon the occurrence or non-occurrence of uncertain future events.
(2)	A provision fulfills the requirements for recognition .	A contingent liability does not satisfy the same criteria.
(3)	A provision is acknowledged when (a) the enterprise holds a current obligation resulting from prior events with a likely outflow of resources carrying economic benefits, and (b) a dependable estimate can be generated for the obligation's amount.	A contingent liability encompasses existing obligations that do not conform to the recognition criteria due to either the improbability of necessitating the outflow of economic benefits for their settlement or the inability to establish a reliable estimate of their amount.
(4)	When the management assesses that the likelihood of an obligation resulting in an outflow of economic benefits is high, it records a provision in the balance sheet.	If the management determines that it is less probable for any economic benefit to be disbursed by the firm to fulfill the obligation, it discloses the obligation as a contingent liability.

To illustrate the difference between provisions and contingent liabilities, let's consider an example. Suppose the Central Excise Officer imposes a penalty on Alpha Ltd. for a violation of a provision in the Central Excise Act. In response, the company decides to file an appeal. If the company's management assesses that it's highly likely the company will ultimately be required to pay the penalty, it will record a provision on the balance sheet to account for this liability. Conversely, if the management anticipates that the appellate authority's judgment will likely favor the company, making it less probable for the penalty to be paid, the company will disclose the obligation as a contingent liability, rather than recognizing it as a provision.

TEST YOUR KNOWLEDGE

True and False

1. A contingent liability need not be disclosed in the financial statements.

(ICAI Study Material)

Sol. False, A contingent liability must be disclosed unless there is a remote possibility of an outflow of a resource with economic benefits.

2. A Provision fails to meet the recognition criteria.

(ICAI Study Material)

Sol. False, A contingent liability does not satisfy the recognition criteria.

3. A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent liability (ICAI Study Material)

Sol. False, A claim that an enterprise is pursuing through legal means, with an uncertain outcome, is considered a contingent asset.

4. When it is probable that the firm will need to pay off the obligation, this gives rise to Contingent liability (ICAI Study Material)

Sol. False: The establishment of a provision occurs when there is a likelihood that the firm will be required to settle the obligation.

5. Present financial obligation of an enterprise, which arises from past event is termed as contingent liability. (ICAI Study Material)

Sol. False: The assertion that a present financial obligation of a business, stemming from past events, is referred to as a liability is not accurate.

6. A current obligation of an indeterminate amount, which can be reasonably estimated with a substantial degree of accuracy, is referred to as a contingent liability.

Sol. False: A current obligation of an undetermined amount that can be reasonably quantified through a substantial level of estimation is referred to as a provision.

7. Contingent liabilities are acknowledged in the financial statements.

Sol. False: Contingent liabilities are not reflected in the financial statements.

8. A contingent asset is disclosed in the financial statements when there is a likelihood of inflow of an economic benefit.

Sol. False: When there is a likelihood of economic benefits flowing in, a contingent asset is disclosed in the report of the appropriate governing body, such as the Board of Directors for a company or the equivalent authority for other types of enterprises.

9. A contingent asset typically originates from unforeseen or unanticipated events that create the potential for an outflow of economic benefits to the business entity.

Sol. False: Contingent asset usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity.

MULTIPLE CHOICE QUESTIONS

1. Contingent asset usually arises from unplanned or unexpected events that give rise to (ICAI Study Material)

- (a) The possibility of an inflow of economic benefits to the business entity.
- (b) The possibility of an outflow of economic benefits to the business entity.
- (c) Either (a) or (b).
- (d) None of the above

Sol. (a) The possibility of an inflow of economic benefits to the business entity.

2. If an inflow of economic benefits is probable then a contingent asset is disclosed

- (a) In the financial statements.
- (b) In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).
- (c) In the cash flow statement.
- (d) None of the above

Sol. (b) In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).

3. In the case of , either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

(ICAI Study Material)

- (a) Liability
- (b) Provision
- (c) Contingent liabilities
- (d) None of the above

Sol. (c) Contingent liabilities

4. Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as. _____

(ICAI Study Material)

- (a) Provision.
- (b) Liability.
- (c) Contingent liability.
- (d) None of the above

Sol. (a) Provision

5. In the financial statements, contingent liability is _____

(ICAI Study Material)

- (a) Recognised.
- (b) Not recognised.
- (c) Adjusted.
- (d) None of the above

Sol. (b) Not recognised

THEORETICAL QUESTIONS

Differentiate between:

- (i) Provision and Contingent Liability.
- (ii) Liability and Contingent Liability.

(ICAI Study Material)

Sol.

1. A provision represents a current liability of an indeterminate amount, which can be reasonably measured through a significant degree of estimation. In contrast, a contingent liability is a potential obligation that may or may not materialize, contingent upon the happening or non-occurrence of one or more uncertain future events.
2. A liability is characterized as the existing financial commitment of an enterprise, stemming from past events. Conversely, with contingent liability, either the likelihood of resource outflow to fulfill the obligation is uncertain, or the anticipated amount to settle the liability cannot be reliably measured.



INTRODUCTION

Errors are common in the process of recording transactions and can occur due to various unintentional mistakes. These errors may arise during the collection of financial data used for preparing financial statements or during the recording stage. They can result from mathematical errors, incorrect application of accounting policies, misinterpretation of facts, or oversight. To ensure the accuracy of the journal and ledger accounts, a trial balance is prepared. If the trial balance does not balance, it indicates the presence of errors that need to be rectified. While some errors impact the trial balance, others may affect the determination of profit or loss, as well as the assets and liabilities of the business, without directly affecting the trial balance itself.

Example of Errors

After preparing ledger accounts and obtaining a trial balance, discrepancies between the debit and credit totals indicate the presence of errors. In order to understand the types of errors that can occur and how to rectify them, we will examine the following illustrative cases. By carefully analyzing these cases, we can gain insights into the nature of errors and their appropriate solutions.

Examples of Errors in Financial Transactions

- (a) **Wrong Entry:** Let's begin by examining the initial stage of the accounting process, where errors can occur in recording the values of transactions and events in subsidiary books, the Journal Proper, and the Cash Book.

Example 1: Credit sales of 12,320 are entered in the Sales Day Book as ₹12,230. Credit purchases of ₹7000 gross less 2% trade discount are wrongly recorded in Purchase Day Book at ₹6,000.

- (b) **Wrong casting (totalling) of subsidiary books:** Periodically, the values recorded in subsidiary books are added up and transferred to the respective ledger accounts. During this process, there is a possibility of encountering totalling errors. These errors can arise due to incorrect entries or they can occur independently as separate errors.

Example 2: For the month of February, 2021 total of credit purchases are ₹2015500, this is wrongly totaled as ₹220500 and posted to sales account as ₹220500.

- (c) **In case of a cash book,** wrong calculation of the balance c/d may arise due to wrong casting.
- (d) **Wrong posting from subsidiary books:** In this scenario, there is a possibility of incorrect posting in the ledger account. The wrong amount may be entered, or the amount may

be posted on the wrong side or to an incorrect account. For example, Sales to X may be posted to Y's account.

- (e) **Wrong casting of ledger balances:** Similarly, just like the Cash Book, errors can occur in casting the balances of ledger accounts. Incorrect postings can result in an incorrect balance, but that is different from a casting error in the balances. When there is an independent error in casting, it is referred to as a wrong casting of ledger balances.

Example 3: Following is the list of credit purchase transactions for M/s. Kumar Bros.:
2021

June. 7 Purchases from M/s. Shakti & Co. – gross ₹50,000 less 2% trade discount.

June. 8 Purchases from M/s. Nikunj & Co. – gross ₹35,000 less 2% trade discount.

June. 11 Purchases from M/s. Shakti & Co. – gross ₹30,000 less 2% trade discount

Now let's prepare M/s. Shakti & Co.'s Account:

Dr. M/s Saurabh & Co. Account			Cr.		
Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2021			2021		
Jan. 1	To Balance c/d	85400	Jan. 1	By Purchases A/c	49000
			Jan. 6	By Purchases A/c	29400
		85400			85,400*

* An error has been made while calculating the credit side, leading to an incorrect balance in the account.

STAGES OF ERRORS

Mistakes can happen during various stages of the accounting process, including:

During the process of recording transactions in the journal

Various types of errors can occur at this stage:

- (i) Errors of principle,
- (ii) Errors of omission,
- (iii) Errors of commission.

During the process of posting the entries in ledger

- (i) Errors of omission:
 - (a) Partial omission,
 - (b) Complete omission.
- (ii) Errors of commission:
 - (a) Posting to wrong account,
 - (b) Posting on the wrong side,
 - (c) Posting the wrong amount.

During the process of balancing the ledger accounts

- (a) Wrong Totaling of accounts,
- (b) Wrong Balancing of accounts.

During the process of preparing the Trial Balance

- (a) Errors of omission,
- (b) Errors of commission:
 - 1. Taking wrong account,
 - 2. Taking wrong amount,
 - 3. Taking to the wrong side.

Based on the mentioned criteria, we can categorize errors into four general classifications.:

- 1. Errors of Principle,
- 2. Errors of Omission,
- 3. Errors of Commission,
- 4. Compensating Errors.

TYPES OF ERRORS

Basically errors are of two types:

- (a) **Errors of principle:** When a transaction is recorded in violation of accounting principles, such as incorrectly treating the purchase of an asset as an expense, it is considered an error of principle. In this situation, although the amounts are placed on the correct side, they are allocated to the wrong account. As a result, there is no impact on the trial balance, and it will still reconcile. For instance, if the purchase of a machine is debited to the building expenses account, the trial balance will remain unaffected.
- (b) **Clerical errors:** These errors occur due to mistakes made during the regular accounting process. They can be categorized into three types:
 - i) **Errors of Omission:** These errors occur when a transaction is either completely or partially omitted from the books of account. For example, not recording a credit purchase of furniture or failing to post an entry in the ledger.
 - ii) **Errors of Commission:** These errors occur when an amount is posted in the wrong account, recorded on the wrong side, incorrect totals are calculated, or an incorrect balance is struck. These errors involve incorrect actions taken during the accounting process.
 - iii) **Compensating Errors:** Compensating errors refer to errors where their effects offset each other, resulting in the trial balance still agreeing. For instance, if an amount of 1000 received from customer X is not credited to their account, but the sales book shows an excess credit of 1000, the omission of credit to x's account is compensated by the increased credit in the Sales Account.

It's important to identify and rectify these errors to ensure accurate financial reporting.

From a different perspective, errors can be categorized into two groups:

Rectification of Errors

(a) Errors affecting the trial balance:

These errors result in the trial balance not agreeing. They include:

- (i) Incorrect totaling of subsidiary books.
- (ii) Incorrect balancing of an account.
- (iii) Posting an amount on the wrong side.
- (iv) Posting the wrong amount.
- (v) Omitting to post an amount from a subsidiary book.
- (vi) Omitting to post the totals of subsidiary books.
- (vii) Failing to include cash book balances in the trial balance.
- (viii) Failing to include the balance of an account in the trial balance.
- (ix) Writing a balance in the wrong column of the trial balance.
- (x) Incorrectly totaling the trial balance.

(b) Errors not impacting the trial balance:

These errors include:

- (i) Completely omitting an entry from the subsidiary book.
- (ii) Recording an entry with an incorrect amount in the subsidiary book.
- (iii) Posting an amount in the wrong account but on the correct side. For example, debiting an amount intended for account A to account B. In this case, the trial balance will still agree.

It is crucial to identify and rectify these errors to ensure accurate financial records and a balanced trial balance.

STEPS TO LOCATE ERRORS

It is essential to identify and rectify errors even if there is only a minor discrepancy in the trial balance. Such a small difference could be indicative of multiple errors that need to be identified and addressed. To locate errors, the following steps can be helpful:

- (i) Recalculate the totals of both columns in the trial balance. If only one amount is written instead of multiple accounts, recheck and recalculate the list of such accounts. For example, verify the Trade Receivables list to ensure the Trade Receivables balance is derived correctly.
- (ii) Verify that cash and bank balances are correctly included in the trial balance.
- (iii) Determine the exact difference in the trial balance and carefully review the ledger. It's possible that a balance equal to the difference has been omitted from the trial balance. Also, consider halving the difference, as a balance equal to half the difference might have been recorded in the wrong column.
- (iv) Rebalance the ledger accounts.
- (v) Review the casting of subsidiary books, especially when the difference is in amounts such as 1 or 10 or 1000.

- (vi) In case of a significant difference, compare the balances in various accounts with the corresponding accounts from the previous period. If the figures differ significantly, investigate potential errors. For example, if the Sales Account balance for the current year is 35,52,000, whereas it was 34,35,000 last year, there might be an error in the Sales Account.
- (vii) Double-check postings of amounts equal to the difference or half the difference. It's possible that an amount was omitted or posted on the wrong side.
- (viii) If there is still a difference in the trial balance, a thorough verification is necessary. Check all entries, including the opening entry. It may be beneficial to start with the nominal accounts.

RECTIFICATION OF ERRORS

Errors should never be corrected by overwriting. If immediately after making an entry it is clear that an error has been committed, it may be corrected by neatly crossing out the wrong entry and making the correct entry. If however the errors are located after some time, the correction should be made by making another suitable entry, called rectification entry. In fact the rectification of an error depends on at which stage it is detected. An error can be detected at any one of the following stages:

- (a) Before preparation of Trial Balance.
- (b) After Trial Balance but before the final accounts are drawn.
- (c) After final accounts, i.e., in the next accounting period. (We use P&L Adjustment A/c)

Before preparation of Trial Balance

There are certain errors that affect one side of an account or multiple accounts in a way that a complete rectification entry cannot be made. In such cases, the errors can be rectified by making a rectification statement on the appropriate side(s) of the respective account(s). It is important to note that these errors may involve a single account or multiple accounts. Let's look at the following examples:

- (i) The sales book for January is undercast by 500. resulting in the Sales Account being credited short by 500. Since the customers' accounts are posted with individual sales amounts and are correct, only the Sales Account needs correction. This can be done by making a credit entry of 500 on the credit side: "By undercasting of Sales Book for January 500".
- (ii) While posting in the discount column on the dr side of the cash book a discount of ₹ 50 allowed to Suresh has not been posted. cash book is correct, It can be assumed that the total of the discount column has been mistakenly debited to the discount account. The error of not crediting Ramesh by 50 can be rectified by crediting Suresh by 50.

Hence, based on the provided examples, we can conclude that the general rule stating that errors impacting two accounts can be rectified through a journal entry is not universally applicable.

Up until now, we have explored how to rectify errors that impacted either a single account or multiple accounts, without requiring complete journal entries for correction. Now, let's

delve into the correction of errors that affect multiple accounts in a way that necessitates complete journal entries for rectification. Please refer to the following example:

The purchase of furniture for ₹10,000 has been wrongly entered in the purchase book. Although, The account of the vendor (Shyam & co) has been credited by 10,000 which is correct, But the debiting the purchase account is wrong. Furniture Account should be debited. To rectify this, the debit in the purchases Account has to be transferred to the Furniture account So, now the rectifying entry will be to Credit Purchases Account and debit the Furniture account. As seen below:

Wrong Entry:		₹	₹
Purchases Account	Dr.	10,000	
To Shyam & Co.			10,000
Correct Entry:			
Furniture Account	Dr.	10,000	
To Shyam & Co.			10,000
Rectifying Entry:			
Furniture Account	Dr.	10,000	
To Purchases Account			10,000

After Trial Balance but before Final Accounts

The approach for rectifying errors discussed thus far is suitable when errors are identified before the end of the accounting period. By making the necessary corrections, the trial balance will become balanced. However, in some cases, the trial balance may be artificially balanced by creating a suspense account and including the difference in the trial balance. If the credit column exceeds the debit column, the suspense account will be debited, and vice versa.

It is important to note that this artificial balancing of the trial balance is not a true reconciliation. Efforts should be made to locate and rectify the errors instead of relying on the suspense account.

The rule for rectifying errors detected at this stage is straightforward. Errors that couldn't be rectified through complete journal entries in the earlier stage (before the trial balance) can now be rectified by including journal entry(s) with the assistance of the suspense account. These errors are the ones that led to the creation of the suspense account in the trial balance. Other types of errors that affect multiple accounts and can be rectified through complete journal entries will follow the same process as in the earlier stage (before the trial balance).

In summary, every error detected at this stage can only be rectified by a complete journal entry. Errors that previously couldn't be rectified through journal entries will now be addressed using journal entry(s), with the suspense account accounting for the difference or the unknown side. Errors that could be rectified through entries at the earlier stage will be rectified in a similar manner.

Suppose, the sales book for May, 2020 is cast ₹500 short; as a result, the trial balance will not agree. The credit column in the trial balance will have a shortfall of 500, leading to a

credit entry of 500 in the Suspense Account. To rectify this error, the Sales Account will be credited to adjust the credit to the correct amount. With only one remaining error, it is necessary to close the Suspense Account by debiting it.

The entry will be:

Suspense Account	Dr.	₹500	
To Sales Account			₹500
(Rectification of error of undercasting the sales Book for May 2020)			

Correction in the next Accounting Period

The process of rectifying errors that have been discussed so far assumes that it was done before closing the books for the relevant year. However, there are instances where rectification occurs in the subsequent year, with the balance in the Suspense Account either carried forward or transferred to the Capital Account. Suppose, the Purchase Book was undercast by ₹500 in December, 2021 and a Suspense Account was created with the difference in the trial balance. If the error is then rectified in the next year and the entry is passed is to debit the Purchase Account and credit the Suspense Account, it will result in a situation where the Purchases Account for the year 2022 will be ₹500 more than the amount which relates to the year 2021 resulting in less profits than the actual profits for the year 2022. Thus, rectifying errors in this manner will inaccurately represent the Profit and Loss Account.

To prevent such inaccuracies, it is recommended to rectify all amounts related to nominal accounts, such as expenses and incomes, through a dedicated account known as the "Prior Period Items" or "Profit and Loss Adjustment Account." The balance in this account should then be transferred to the Profit and Loss Account. However, it is important to note that these Prior Period Items should be accounted for after calculating the net profit of the current year. Prior Period Items refer to significant income or expenses that arise in the current period due to errors or omissions in the preparation of financial statements from one or more periods. These items should be clearly disclosed in the current statement of profit and loss, providing details of their nature and amount, in a manner that allows for a clear understanding of their impact on the current profit or loss.

TEST YOUR KNOWLEDGE

True and False

1. When there is a complete omission error, the trial balance will not balance equally.

Sol. False: In the event of a complete omission error, the trial balance will balance equally.

2. When errors are identified after the preparation of the trial balance, a suspense account is created.

Sol. True, In order to reconcile the discrepancy in the balances of the trial balance, a suspense account is created.

3. When an expense is incorrectly categorized as the purchase of an asset, it is referred to as an error of principle.

Sol. True, When the account being debited is fundamentally incorrect, it is referred to as an error of principle.

4. The trial balance agrees when compensating errors are present.

Sol. True: Compensating errors occur when two different mistakes result in the same amount being credited and later debited, canceling each other out. As a result, when the trial balance is prepared, these errors do not affect its balance.

5. An error of principle occurs when an amount is mistakenly recorded on the wrong side of the account.

Sol. False, An error of commission refers to the situation where an amount is mistakenly recorded on the wrong side of the account.

6. When purchasing furniture, the expenses incurred for repairs should be recorded by debiting the Repairs Account.

Sol. False, When acquiring furniture, the amount allocated for repairs should be debited to the Furniture Account, considering it as a capital expenditure.

7. To rectify the errors identified in the current accounting period, an account named "Profit & Loss adjustment account" is opened.

Sol. False, To correct the errors identified in the following (next) accounting period, the "Profit & Loss adjustment account" is created.

8. Correcting errors in subsequent accounting periods invariably impacts the profit or loss of that specific period.

Sol. False, Rectifying errors in subsequent accounting periods pertaining to Personal & Real Accounts will have no impact on the profit of that particular period.

9. Errors of principle occur when there is an incorrect allocation of expenditure or receipt between capital and revenue.

Sol. True, An error of principle arises when a transaction is recorded in a fundamentally incorrect manner.

10. Incorrect totaling of subsidiary books does not have any impact on the trial balance.

Sol. False, The trial balance is affected by the incorrect totaling of subsidiary books because it leads to inaccurate postings in the accounts and subsequently impacts the trial balance itself.

11. When an amount is erroneously posted in an incorrect account or written on the incorrect side of an account, it is referred to as an error of commission.

Sol. True, Error of commission encompasses various mistakes such as incorrect posting, improper balancing, inaccurate carry forward, erroneous totaling, and similar errors.

12. An instance of commission error can be illustrated by either undercasting or overcasting a subsidiary book.

Sol. True, Error of commission refers to an error that occurs due to incorrect posting, incorrect balancing, incorrect carry forward, incorrect totaling, and similar factors.

13. If the general expenses account has been charged for the acquisition of a computer, it results in a compensating error.

Sol. False, This error reflects error of principle as the capital nature (computer) item is treated as revenue nature.

14. Error of principle can have an impact on the trial balance.

Sol. False, The trial balance remains unaffected by errors of principle when both debit and credit aspects of a transaction are recorded accurately

15. The method for correcting errors is based on the point at which the errors are identified.

Sol. True, Errors can be identified at different stages, and the process of rectification depends on the stage of error detection. These stages include:

(a) Before preparing the Trial Balance.

(b) After the Trial Balance but before final accounts are prepared.

(c) After final accounts have been prepared, in the subsequent accounting period.

16. In case of complete omission, trial balance doesn't tally.

Sol. False, An error of omission arises when a transaction is unintentionally left unrecorded in the books of original entry.

In the scenario of a complete error of omission, the trial balance still balances because the transaction is entirely omitted from the records.

Detecting a complete omission error can be challenging since there are no corresponding debits or credits recorded. As a result, the overall balance appears to be correct.

17. When errors are identified after preparation of trial balance, suspense account is created.

Sol. True, If errors are detected after the trial balance has been prepared, a suspense account is established to adjust for the difference in the trial balance caused by errors that cannot be rectified with complete journal entries.

To put it simply, errors that were previously unresolvable due to the lack of suitable journal entries are now addressed by introducing one or more journal entries that account for the difference, utilizing the suspense account as a means of adjustment.

18. Rectifying errors in subsequent accounting period always affect the profit or loss of that period.

Sol. False: Rectifying errors in subsequent accounting related to Personal & Real Accounts will not affect the profit of that period.

19. Errors of principle involves an Incorrect allocation of expenditure or receipt between capital and revenue.

Sol. True, Recording the transaction in an incorrect fundamental manner is an error of principle.

20. Wrong casting of subsidiary books does not affect the trial balance.

Sol. False: Wrong casting of subsidiary books affects the trial balance because wrong total will be posted to its account and then to the trial balance.

21. If the amount is posted in the wrong account or It is written on the wrong side of an account, it is called an error of commission.

Sol. True, Error of commission is an error on account of wrong posting, wrong balancing, wrong carry forward, wrong totalling etc.

22. Under or over-casting of a subsidiary book is an example of error of commission.

Sol. True, Error of commission is an error on account of wrong posting, wrong balancing, wrong carry forward, wrong totalling etc.

23. Any type of error affects the agreement of trial balance.

Sol. False, Every error does not affect the agreement of trial balance because Errors of Principle, Compensating errors etc. do not affect the agreement of trial balance.

24. Purchase of office furniture has been debited to the general expenses account. It is a compensating error.

Sol. False, It is an error of principle because here an item of capital nature is treated as an item of revenue nature.

25. Errors of complete omission will be located, If trial balance is prepared.

Sol. False, Errors of Complete omission cannot be located because both debit and credit aspects of an entry are not recorded and hence it will not affect trial balance.

26. Errors of principle will affect trial balance.

Sol. False, Errors of principle will not affect trial balance because both the aspects (debit & credit) of a transaction are recorded, with correct figures.

27. Error of carry-forward of totals of purchase journal affects two accounts.

Sol. False, It will affect one account i.e. purchase account so it will affect the total of trial balance.

28. If the effect of errors committed cancel out, the errors will be called compensating errors and the trial balance will disagree. **[May 2018, 2 Marks]**

Sol. False, If the effect of errors committed cancel out, the errors will be called compensating errors and the trial balance will agree.

29. If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called an error of principle. **[May 2019, 2 Marks]**

Sol. False, Amount posted in the wrong account or on the wrong side of the account is an error of commission.

30. Purchase of office furniture & fixtures of ₹ 2,500 has been debited to General Expense Account. It is an error of omission. **[Nov. 2020, 2 Marks]**

Sol. False, It is an error of Principle.

31. If the errors are detected after preparing trial balance, then all the errors are rectified through suspense account. **[June 2022, 2 Marks]**

Sol. False, If the errors are detected after preparing trial balance, then all the errors are not rectified through suspense account. Generally double sided errors are rectified without using suspense account.

32. If the errors are detected after preparing trial balance, then all the errors are rectified through suspense account. **[Dec. 2022, 2 Marks]**

Sol. False, If the errors are detected after preparing trial balance, then all the errors are not rectified through suspense account. There may be errors of principle, which can be rectified without opening a suspense account

MULTIPLE CHOICE QUESTIONS

1. The error of recording goods purchased from Pankaj for 5,000 in the sales book will..... the gross profits: (ICAI Study Material)

- (a) Increase. (b) Decrease.
(c) Will have no effect on. (d) Result cannot be measured.

Sol. (a) Increase.

2. If a purchase return of ₹500 has been erroneously debited to the sales returns account, but has been accurately recorded in the suppliers' account, the following situation arises: (ICAI Study Material)

- (a) In the Trial balance, the Debit side will be 500 more than the credit side.
(b) In the Trial balance, the credit side will be 500 more than the debit side.
(c) In the Trial balance, the Debit side will be 1000 more than the credit side.
(d) None of the above

Sol. (c) In Trial balance, the Debit side will be 1000 more than the credit side.

3. If the amount is mistakenly recorded in an incorrect account or written on the wrong side of the account, it is referred to as (ICAI Study Material)

- (a) Error of omission. (b) Error of commission.
(c) Error of principle. (d) None of the above

Sol. (a) Error of commission

4. Goods valued ₹100 given as charity should be recorded as a credit to (ICAI Study Material)

- (a) Cash account. (b) Charity account.
(c) Purchase account. (d) None of the above

Sol. (c) Purchase Account

5. Sales of office furniture should be credited to (ICAI Study Material)

- (a) Sales Account. (b) Furniture Account.
(c) Depreciation account (d) Purchase Account.

Sol. (b) Furniture Account.

6. The purpose of preparing a trial balance is (ICAI Study Material)

- (a) To locate errors of commission. (b) To locate errors of principle.
(c) To locate clerical errors. (d) None of the above

Sol. (c) To locate clerical errors.

7. Goods purchased from X for ₹ 25,000 passed through sales book. This error will

- (a) Increase gross profit
- (b) Decrease gross profit
- (c) No effect on profit
- (d) None of the above

Sol. (a) Increase gross profit

8. When an amount is recorded in an incorrect account or placed on the incorrect side of the account, it is referred to as:

- (a) Error of commission
- (b) Error of omission
- (c) Error is principle
- (d) Compensating Error

Sol. (a) Error of commission

9. The payment of ₹ 100 for erecting a machine should be recorded as a debit to

- (a) Wages A/c
- (b) Machinery A/c
- (c) Repair A/c
- (d) None of the above

Sol. (b) Machinery A/c

10. Goods given as free samples should be credited to:

- (a) Purchases A/c
- (b) Charity A/c
- (c) Profit and Loss A/c
- (d) None of the above

Sol. (a) Purchases A/c

11. Goods taken over by Owner of the business should be credited to:

- (a) Purchases A/c
- (b) Drawings A/c
- (c) Profit and Loss A/c
- (d) None of the above

Sol. (a) Purchases A/c

12. Sale of office computer should be credited to:

- (a) Sales A/c
- (b) Bank A/c
- (c) Office Computer A/c
- (d) None of the above

Sol. (c) Office Computer A/c

13. Trial Balance is prepared for:

- (a) Finding clerical errors
- (b) Finding compensating errors
- (c) Finding errors of principle
- (d) All of the above

Sol. (a) Finding clerical errors

14. ₹ 500 received from Tarun whose account, was written off as a bad-debt should be credited to:

- (a) Tarun A/c
- (b) Bad debts recovered Account
- (c) Cash A/c
- (d) None of the above

Sol. (b) Bad debts recovered Account

THEORETICAL QUESTIONS

1. What is the distinction between errors of omission and errors of commission?

Sol.

- (i) **Errors of Omission:** Errors of omission occur when a transaction is completely or partially left out from the accounting records. This can happen when a credit purchase of furniture is not recorded or when an entry is not posted in the ledger.
- (ii) **Errors of Commission:** Errors of commission refer to situations where an amount is incorrectly posted in an account, written on the wrong side, or when there are mistakes in totals or balance calculations. These errors involve actions taken but done incorrectly, such as posting an amount in the wrong account or making errors in calculations.

2. What is “error of principle”, and how does it impact the Trial Balance?

Sol. Errors of principle: Errors of principle occur when a transaction is recorded in violation of accounting principles. For instance, if an asset purchase is mistakenly treated as an expense, it is considered an error of principle. Despite being recorded on the correct side, but in the wrong account, this type of error does not affect the trial balance. For example, if the purchase of a typewriter is erroneously debited to the office expenses account, the trial balance will still be in agreement.

The correction method discussed thus far is applicable when errors are identified before the end of the accounting period. After making the necessary corrections, the trial balance will be in balance. However, in some cases, errors are masked to make the trial balance artificially agree by using a suspense account. The difference in the trial balance is posted to the suspense account, debiting it if the credit column exceeds the debit column, or crediting it in the opposite case.

Every error detected requires a complete journal entry for correction. Errors that were not rectified earlier due to journal entry limitations are now addressed through one or more journal entries, with the suspense account accounting for the difference or unknown side. Errors that could have been corrected earlier will also be rectified using the same approach.

3. What are the various categories of errors and how do they impact the agreement of a trial balance?

Sol. Types of Errors and their Impact on the Agreement of Trial Balance:

Errors of Principle:

These errors occur when there is a deviation from accounting principles. They are double-sided errors and do not affect the agreement of the trial balance. Examples include treating revenue expenses as capital expenditures or recording the sale of a fixed asset as a regular sale.

Clerical Errors:

These errors result from mistakes in following accounting procedures. They may or may not affect the agreement of the trial balance. Clerical errors can be further classified as follows:

(a) Errors of Omission:

These errors involve completely omitting an entry from the subsidiary book. If an entry is fully omitted, the trial balance will agree. For example, failing to record a sale of ₹3,000 to A on 30.3.21.

(b) Errors of Commission:

These errors include writing the wrong amount in the subsidiary book or posting the wrong account in the ledger. The trial balance will still agree despite these errors. Examples include entering a purchase of ₹1,000 from A as ₹100 or debiting P's account by ₹4,000 instead of Q's account.

(c) Compensating Errors:

Compensating errors occur when two or more mistakes offset each other's effect on the trial balance, resulting in agreement. For instance, an excess debit of ₹4,000 to the Furniture account and an excess credit of ₹4,000 to the Sales account.

Note: Errors described in (b) (ii) to (vi) above will cause the trial balance to disagree.

4. What is a suspense a/c? write a short note.

Sol. When the trial balance doesn't balance, the difference is recorded in an account called Suspense account. The difference is:

debited (if the debit side of the trial balance is short) or credited (if the credit side of the trial balance is short) to the Suspense account.

Thus, by utilizing the Suspense account, the trial balance is artificially balanced.

For rectifying one-sided errors, the affected amount (either debit or credit) is adjusted in the account where the mistake occurred, while the opposite effect is recorded in the Suspense account.

Once all one-sided errors are rectified, the balance in the Suspense account becomes zero.

In the case of rectifying double-sided errors, the Suspense account remains unaffected.

5. How can we define an error of principle, and what impact does it have on the Trial Balance?

Sol. An error of principle occurs when a transaction is recorded in violation of established accounting principles, such as incorrectly categorizing the purchase of an asset as an expense. Despite the misclassification, the trial balance remains unaffected because the amounts are placed correctly, despite being in the wrong account.

For instance, if a computer purchase is erroneously debited to the office expenses account, the trial balance will still reconcile.



PRACTICAL QUESTIONS

1. Mr. Rohit was unable to agree the Trial Balance last year and wrote off the difference to the Profit and Loss A/c of that year. Next year, he appointed a Chartered Accountant who examined the old books and found the following mistakes:
- Purchase of a scooter was debited to conveyance A/c ₹30,000. Mr. Ratan charges 10% depreciation on scooter.
 - Purchase A/c was over cast by ₹1,00,000.
 - A credit purchase of goods from Mr. X for ₹20,000 was entered as sale.
 - Receipt of cash from Mr. Anand was posted to the A/c of Mr. Bhaskar ₹10,000.
 - Receipt of cash from Mr. Chandu was posted to the debit of his A/c, ₹5000.
 - ₹5,000 due by Mr. Ramesh was omitted to be taken to the Trial Balance.
 - Sale of goods to Mr. Ram for 20,000 was omitted to be recorded.
 - Amount of 23,950 of purchase was wrongly posted as 25,930.

Suggest the necessary rectification entries.

[July 2021, 10 Marks]

Sol.

Journal Entry in Books of Rohit

	Particulars	L/f	Dr.	Cr.
(i)	Motor Vehicles A/c To P & L Adjustment A/c (Purchase of scooter wrongly debited to conveyance A/c now rectified; capitalization of ₹2700, i.e., ₹30,000 less 10% depreciation)	Dr.	27,000	27,000
(ii)	Suspense A/c To P & L Adjustment A/c (Purchase A/c overcast in the previous year, error now rectified)	Dr.	1,00,000	1,00,000
(iii)	P & L Adjustment A/c To Mr. X A/c (Credit purchase from Mr. X ₹20,000 entered as sales last year, now rectified).	Dr.	40,000	40,000

	Particulars	L/f	Dr.	Cr.
(iv)	Mr. Bhaskar A/c To Mr. Anand A/c (Amount received from Mr. Anand wrongly posted to the A/c of Mr. Bhaskar; now rectified.)	Dr.	10,000	10,000
(v)	Suspense A/c To Mr. Chandu's A/c (₹5000 received from Mr. Chandu wrongly debited to his A/c; now rectified.)	Dr.	10,000	10,000
(vi)	Trade Receivable (Ramesh) A/c To Suspense A/c (₹5000 due by Mr. Ramesh not taken into trial balance; now rectified.)	Dr.	5,000	5,000
(vii)	Trade Receivable (Ram's) A/c To P & L Adjustment A/c (Sales to Mr. Ram omitted last year; now adjusted)	Dr.	20,000	20,000
(viii)	Suspense A/c To P & L Adjustment A/c (Excess posting to purchase A/c last year, ₹25,930 instead of ₹23,950, now adjusted.)	Dr.	1,980	1,980
IX	P & L Adjustment A/c To Rohit's Capital A/c (Balance of P & L Adjustment A/c transferred to Capital A/c)	Dr.	1,08,980	1,08,980
X	Rohit's Capital A/c To Suspense A/c (Balance of Suspense A/c transferred to Capital A/c)	Dr.	1,06,980	1,06,980

P & L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Mr. X's A/c	40,000	By Motor Vehicles A/c	27,000
To Mr. Rohit's Capital A/c (transferred)	1,08,980	By Suspense A/c	1,00,000
		By Mr. Ram A/c	20,000
		By Suspense A/c	1,980
Total	1,48,980	Total	1,48,980

Suspense A/c

Particulars	Amt	Particulars	Amt
To P & L Adjustment A/c	1,00,000	By Trade Receivable A/c	5,000
To Mr. Chandu's A/c	10,000	By Rohit's Capital A/c (Transferred)	1,06,980
To P & L Adjustment A/c	1,980		
Total	1,11,980	Total	1,11,980

2. The following is the list of errors found in the book of Keshav & Sons. Give the rectifying entries.

- (1) ₹7000 paid for Machinery purchased has been charged to Purchases A/c.
- (2) Electricity expenses incurred were debited to Building A/c for ₹1700.
- (3) Drawings by partner of ₹2000 were debited to General Expenses A/c.
- (4) ₹5000 paid for showroom rent debited to Landlord's A/c.

Sol.

Journal

	Particulars	L.F.	Dr. ₹	Cr. ₹
(1)	Machinery A/c Dr. To Purchases A/c (Rectifying the incorrect debit entry in the Purchases A/c for the purchase of machinery)		7000	7000
(2)	Electricity expenses A/c Dr. To Building A/c (Rectification of the erroneous debit entry in the Building A/c for electricity expenses incurred.)		1700	1700
(3)	Drawings A/c. Dr. To General Expenses A/c (Correction of wrong debit to Trade Expenses A/c for cash withdrawn by the proprietor for his personal use)		2000	2000
(4)	Showroom Rent A/c Dr. To Landlord's A/c (Rectifying the erroneous debit entry in the Landlord's A/c for the payment of rent.)		5000	5000

3. The trial balance of XYZ & Sons failed to agree and the difference 10285 was put into suspense pending investigation which disclosed that:

- (i) Purchase returns day book had been correctly entered and totalled at 3080, but had not been posted to the ledger.
- (ii) Discounts received 660 had been debited to discounts allowed.
- (iii) The Sales A/c had been under added by 5,000.
- (iv) A credit sale of ₹735 had been debited to a customer A/c at 870.
- (v) A furniture bought originally for 3500 four years ago and depreciated to 600 had been sold for 750 in the beginning of the year but no entries, other than in the bank A/c had been passed through the books.
- (vi) An accrual of 280 for telephone charges had been completely omitted.
- (vii) A bad debt of 780 had not been written off and provision for doubtful debts should have been maintained at 10% of Trade receivables which are shown in the trial balance at 11695 with a credit provision for bad debts at 1160.
- (viii) Tools bought for 600 had been wrongly debited to purchases.
- (ix) The proprietor had withdrawn, for personal use, goods worth 980. No entries had been made in the books.

You are required to give rectification entries without narration to correct the above errors before preparing annual A/cs

Sol.

S. No.	Particular		Dr. ₹	Cr. ₹
(i)	Suspense A/c To Purchase Returns A/c	Dr.	3080	3080
(ii)	Suspense A/c To Discount Allowed A/c To Discount Received A/c	Dr.	1320	610 610
(iii)	Suspense A/c To Sales A/c	Dr.	5,000	5,000
(iv)	Suspense A/c To Customer A/c	Dr.	135	135
(v)	Suspense A/c To Furniture A/c To Profit on Sale of furniture A/c	Dr.	750	600 150
(vi)	Telephone Charges A/c To Outstanding Expenses A/c	Dr.	280	280
(vii)	Bad Debts A/c To Trade Receivables A/c	Dr.	780	780

S. No.	Particular		Dr. ₹	Cr. ₹
(viii)	Provision for Doubtful Debts A/c To Profit and Loss A/c (Refer Working Note)	Dr.	82	82
(ix)	Loose Tools A/c To Purchases A/c	Dr.	600	600
(x)	Drawings A/c To Purchases A/c	Dr.	980	980

Working Note:

Net Amount of Trade Receivables after Bad Debts:

Trade Receivables as per Books = ₹11695

Less: Deduction as per entry iv) = ₹(135)

Less: Bad Debts = ₹(780)

Provision to be made on = ₹10780

Percent of provision required = 10%

Amount of Provision required = 10% ₹10780 = ₹1078

Provision already existing = ₹1160

Provision to be taken back = ₹1160 – ₹1078 = ₹82

4. In 2023 Riksha found accidentally that his books for 2022 contained some errors. The errors were:

- An invoice for ₹2,000 for goods purchased from Vasu was entered in Sales Returns Book.
- Good bought on credit from Samlal for ₹3000 were entered in the Sales Book as ₹2550.
- A Cash Discount of ₹100 allowed to Supta remained un-posted to his A/c.
- It was also found that a sale of ₹912 to Kabir was entered in the Sales Book as ₹1,290 from where he was debited by ₹1,230.
- A machine purchased on 1st January, 2020 for ₹20,000 (on which ₹4,000 depreciation had been written off for the two years 2020 and 2021) had been sold on 1st July, 2022 for ₹16000 but the sale was entered in the Sales Day Book.
- ₹450 paid for freight on machinery purchased on Nov. 1, 2022 was debited to Freight A/c as ₹650. Give journal entries to rectify the errors. Your entries must not affect current year's profit or loss. Have you any comments to offer?

Sol.

Journal Entry in Books of Riksha

	Particulars	L/f	Dr.	Cr.
i.	P & L Adjustment A/c Dr. To P & L Adjustment A/c <i>Alternatively No entry need to be passed</i>		2,000	2,000
ii.	P & L Adjustment A/c Dr. To Samlal A/c (Being purchase on credit from Samlal for ₹3000 entered in Sales Book as ₹2550, now rectified)		5,550	5,550
iii.	Suspense A/c Dr. To Supta (Being Discount of ₹100 to Supta omitted to record in his A/c, now rectified)		100	100
iv.	P&L Adj. A/c Dr. To Kabir A/c To Suspense A/c (Being sale of ₹912 entered as ₹1290 and debited to kabir by ₹1230, now rectified)		378	318 60
v	P & L Adjustment A/c Dr. To Machinery A/c (Being sale of machine having book value of Rs. 15000 (after deducting 6m depn. of Rs. 1000) was sold for 16000 at profit of Rs. 1000 was recorded as normal sales, now rectified)		15,000	15,000
vi.	Machinery A/c Dr. Suspense A/c Dr. To P & L Adjustment A/c (Being freight paid on machinery debited to Freight A/c as ₹650, now rectified)		450 200	650
Note: Balance of P&L adjustment A/c after all rectification, Dr. is transferred to capital A/c. Capital A/c To P & L Adjustment A/c			20,089	20,089

P&L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Samlal A/c	5,550	By Machinery A/c	450
To Kabir A/c	159	By Suspense A/c	200
To Suspense A/c	30	By Capital A/c (Bal. Fig)	20089
To Machinery A/c	15000		
	20739		20739

Suspense A/c

Particulars	Amt	Particulars	Amt
To Supta A/c	100	By P&L Adj. A/c	30
To P&L Adj. A/c	200	By By Difference in TB (Bal. Figure)	270
	300		300

Comment:

- Balance in suspense A/c indicates that in last year's Trial balance, Credit side was short by ₹270.

5. Mr. Sahil, an Accountant finds the difference in the Trial Balance amounting to ₹1,000 and puts it in the Suspense A/c. Later on he detects the following errors.

1. Purchased goods from Ankit ₹20,000 but entered into Sales Book.
2. Received one bill for ₹30,000 from Aku but recorded in Bills Payable Book.
3. An item of ₹8,500 relating to prepaid rent A/c was omitted to be brought forward.
4. An item of ₹7,000 in respect of purchase returns, had been wrongly entered in the purchase book, party A/c was correctly posted.
5. ₹30,000 paid to Jat against our accept our acceptance were debited to Jatish A/c.
6. Bills received from Sanvi for repairs done to Machine ₹7,500 and Machine supplied for ₹50,000 were entered in the Purchase Book as ₹51,000. Sanvi A/c was credited with ₹58,500.

Give rectifying journal entries with full narration and prepare Suspense A/c.

Sol.

Journal Entry in Books of Mr. Sahil

	Particulars		L/f	Dr.	Cr.
1.	Purchase A/c	Dr.		20000	
	Sales A/c	Dr.		20000	
	To Ankit A/c				40000
	(being Purchased from Ankit entered into Sales Book., now rectified)				

	Particulars		L/f	Dr.	Cr.
2.	B/R A/c B/P A/c To Arun A/c (being bill recd. from Aku but recorded in Bills Payable Book, now rectified)	Dr. Dr.		30000 30000	60000
3.	Prepaid rent A/c To Suspense A/c (being prepaid renr of omitted to be brought forward, now rectified)	Dr.		8500	8500
4.	Suspense A/c To Purchase Return To Purchase A/c (being purchase returns wrongly entered in the purchase book, party A/c was correctly posted ,now rectified)	Dr.		14000	7000 7000
5.	B.P. A/c To Jatin A/c (being ₹30,000 paid to Jat against our acceptance were debited to Jatish A/c,now rectified)	Dr.		30000	30000
6.	Repairs A/c Machine A/c Sanvi A/c To Purchase A/c To Suspense A/c (being repairs to Machine and New Machine purchase in the Purchase Book and credited to sanvi with ₹58,500,now rectified)	Dr. Dr. Dr.		7500 50000 1000	51000 7500

Suspense A/c

Particulars	Amt	Particulars	Amt
To Diff. in T.B. (Bal. figure)	1,000	By Prepaid rent A/c	8,500
To Purchases Return A/c	7,000	By Sundry A/c	6,500
To Purchase A/c	7,000		
	15,000		15,000

6. Rectify the following errors which were detected before preparing the Trial Balance:

- (i) Purchase book has been undercast by ₹5,000.
- (ii) Purchase from X ₹7500 has been omitted to be posted to his A/c.
- (iii) Purchase from Y ₹20,000 has been wrongly posted to his A/c as ₹30,000
- (iv) Purchase from Z ₹40,000 has been posted to the wrong side of his A/c.

Sol.

- (i) The error occurred during the totaling of the Purchase Book and not during the initial entry in the book. As the amounts recorded in the Purchase Book are accurate, the individual creditors' A/cs will also be correct. However, the mistake affects only the Purchase A/c, where a short posting of ₹5,000 has been made on the debit side. To rectify this, the following notation will be written on the debit side of the Purchase A/c:

"To undercasting of Purchase Book ₹5,000."

For example:

Purchase A/c

Date	Particulars	Amount	Date	Particulars	Amount
	To undercasting of Purchase Book	5,000			

- (ii) The error occurred during the posting process in the ledger. As the entry in the Purchase Book is accurate, the total of the Purchase Book and the posting to the Purchase A/c will be correct. However, the mistake affects only X's A/c, where ₹7,500 has not been posted to the credit side. To rectify this, the following notation will be written on the credit side of P's A/c:

"By omission in posting ₹7500"

For example:

X's A/c

Date	Particulars	Amount	Date	Particulars	Amount
				By omission in posting	7500

- (iii) An error occurred during the ledger posting process. As the entry in the Purchase Book is accurate, the total of the Purchase Book and the posting to the Purchase A/c will also be correct. However, the mistake only impacts Y's A/c, where an excessive amount of ₹10,000 has been posted on the credit side. To rectify this, the following notation will be written on the debit side of Y's A/c:

"To excess amount on the credit side ₹10,000"

For example:

Y's A/c

Date	Particulars	Amount	Date	Particulars	Amount
	To excess amount on the credit side	5,000			

- (iv) An error occurred during the ledger posting process. Both the Purchase Book and the Purchase A/c will be accurate. However, the mistake only affects Z's A/c, where ₹20,000 has been incorrectly debited instead of being credited. To rectify this, the correction will be made by doubling the amount of the entry. Therefore, ₹40,000 will be written on the credit side of Z's A/c :

"By Error in posting to the wrong side..... ₹80,000."

For example:

Z's A/c

Date	Particulars	Amount	Date	Particulars	Amount
				By Error in posting to the wrong side	80,000

7. Lal Path Lab were unable to agree the Trial Balance as on 31st March, 2020 and have raised a Suspense A/c for the difference. Next year the following errors were discovered:
- Repairs made during, the year were wrongly debited to the building A/c - ₹12,500.
 - The addition of the 'Freight' column in the purchase journal was short by ₹1,500.
 - Goods to the value of ₹1,050 returned by a customer, Rani & Co., had been posted to the debit of Rani & Co. and also to sales returns.
 - Sundry items of furniture sold for ₹30,000 had been entered in the sales book, the total of which had been posted to sales A/c.
 - A bill of exchange (received from Raja & Co.) for ₹20,000 had been returned by the bank as dishonoured and had been credited to the bank and debited to bills receivable A/c.

You are required to pass journal entries to rectify the above mistakes.

[Nov. 2020, 5 Marks]

Sol.

Journal Entry in Books of Lal Path Lab

	Particulars	L/f	Dr.	Cr.
(i)	P & L Adjustment A/c To Building A/c (Being repairs debited to building A/c, now rectified)	Dr.	12,500	12,500
(ii)	P & L Adjustment A/c To Suspense A/c (Being under casting of 1,500 in freight column, rectified)	Dr.	1,500	1,500
(iii)	Suspense A/c To Rani & Co. A/c (Being Rani's A/c debited instead of crediting, now rectified)	Dr.	2,100	2,100
(iv)	P & L Adjustment A/c To Furniture A/c (Being sale of furniture credited to sales A/c, now rectified)	Dr.	30,000	30,000
(v)	Raj & Co. A/c To Bills receivables A/c (Being dishonour of bill wrongly debited to Bills receivable A/c, now rectified)	Dr.	20,000	20,000
	Capital A/c To P & L Adjustment A/c (Being Balance of P & L Adjustment A/c transferred to Capital A/c)	Dr.	44,000	44,000

P & L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Building A/c	12,500	By Capital A/c (Bal. fig.)	44,000
To Suspense A/c	1,500	(Loss on adjustment)	
To Furniture A/c	30,000		
Total	44,000	Total	44,000

8. To rectify errors identified during the preparation of the Trial Balance, please provide the specific errors or details of the transactions, be passing the necessary journal entries:

- (i) Wages paid for construction of office building debited to wages A/c ₹20,000.
- (ii) A credit sale of goods ₹1,200 to Ramesh has been wrongly passed through the Purchase Book.
- (iii) An amount of ₹2,000 due from Mahesh Chand which had been written off as a bad debt in the previous year was unexpectedly recovered and has been posted to the personal A/c of Mahesh Chand.
- (iv) goods (Cost being ₹5,000 and Sales price being ₹6,000) distributed as free sample among prospective customers were not recorded anywhere.
- (v) Goods worth ₹1,500 returned by Green have not been recorded anywhere.

Sol.

Journal Entry in Books of _____

	Particulars	L/f	Dr.	Cr.
1	Building A/c To Wages A/c (Being wages paid for construction of building wrongly debited to wages A/c, now rectified)	Dr.	20,000	20,000
2.	Ramesh A/c To Purchases A/c To Sales A/c (Being goods sold to Ramesh wrongly recorded in purchase book, now rectified)	Dr.	2,400	1,200 1,200
3.	Mahesh Chand A/c To Bad Debts Recovered A/c (Being bad debts recovered from Mahesh Chand wrongly credited to his A/c, now rectified)	Dr.	2,000	2,000

	Particulars	L/f	Dr.	Cr.
4.	Advertisement A/c To Purchases A/c (Being goods distributed as samples not recorded earlier, now recorded)	Dr.	5,000	5,000
5.	Return Inward A/c To Green's ac/ (Being goods returned by Green not recorded earlier, now recorded)	Dr.	1,500	1,500

9. The trial balance of a M/s Raju is out. The following errors were found subsequently, to have been committed. Pass journal entries to correct them, and ascertain the difference in the Trial Balance.

- An amount of ₹200 was received from Dinesh on 31st December, 2022, but had been entered in the Cash Book on 1st January, 2023.
- The Returns Inwards Books for November has been cast ₹200 short.
- The purchase of an office chair costing ₹600 had been passed through the Purchase Day Book.
- ₹3000 paid for wages to workers for making show cases. had been charged to wages A/c.
- A purchase of ₹971 had been posted to the 'debit of the creditor's A/c as ₹917. The creditor is Q. Quest & Co.
- A cheque for ₹400 received from P.C Jain has been dishonoured on maturity and was passed to the debit of Allowances A/c.
- Goods amounting to ₹200 had been returned by a customer and were taken into stock but no entry in respect thereof was made in the books.
- ₹4,000 paid for the purchase of a car for Miss Diya (a partner) had been charged to Miscellaneous Expenses A/c.
- A sale of ₹400 to Pawan & Co. was credited to their A/c.
- A sale of ₹2,000 had been passed through the Purchase Day Book. The customer's A/c has, however, been correctly debited.
- While carrying forward the total of the sales hook from one page to the next, the amount was written as ₹49,415 instead of ₹47,142.

Sol.

Journal Entry in Books of M/s Raju

	Particulars	L/f	Dr.	Cr.
(a)	Bank A/c To Dinesh A/c (Being amount received from Dinesh on 31st December, 2022, entered in the Cash Book on 1st January, 2023, now rectified)	Dr. Dr.	200	200

	Particulars	L/f	Dr.	Cr.
(b)	Sales return To Suspense A/c (Being The Returns Inwards Books cast ₹200 short, now rectified)	Dr.	200	200
(c)	Furniture A/c To Purchase A/c (Being furniture purchase passed through the Purchase Book., now rectified)	Dr.	600	600
(d)	Furniture A/c To Wages A/c (Being wages for making show cases charged to wages A/c, now rectified)	Dr.	3000	3000
(e)	Suspense A/c To Q. Quest A/c (Being purchase of ₹971 debited to Q. Quest & Co debit 917, now rectified)	Dr.	1888	1888
(f)	P.C. Jain A/c To Allowance A/c (Being cheque dishonoured was debited of Allowances A/c, now rectified)	Dr.	400	400
(g)	Sales return To Customer A/c (Being Entry in respect goods returned omitted, now rectified)	Dr.	200	200
(h)	Drawing A/c To Misc. A/c (Being amount paid for purchase of car for Miss Diya (a partner) had been charged to Miscellaneous Expenses A/c, now rectified)	Dr.	4000	4000
(i)	Pawan & Co A/c To Suspense A/c (Being sale to Pawan & Co. credited to their A/c, now rectified)	Dr.	800	800
(j)	Suspense A/c To Sales A/c To Purchase A/c (Being sale passed through the Purchase Day Book. The customer's A/c has, however, been correctly debited, now rectified)	Dr.	4000	2000 2000

	Particulars	L/f	Dr.	Cr.
(k)	Sales A/c To Suspense A/c (Being sales amount was wrongly carried forward, now rectified)	Dr.	2273	2273

Suspense A/c

Particulars	Amt	Particulars	Amt
To Q. Quest A/c	1,888	By Sales return A/c	200
To Sundry A/c	4,000	By Pawan & Co. A/c	800
		By Sales A/c	2,273
		By Difference. in T.B. (Bal. figure)	2,615
	5,888		5,888

10. The following mistakes were located in the books of a firm after its books were closed and a Suspense A/c was opened in order to get the Trial Balance agreed:

- (i) Sales Day Book was overcast by ₹1,000.
- (ii) A sale of ₹5,000 to X was wrongly debited to the A/c of Y.
- (iii) General expenses of ₹180 were posted in the General Ledger as ₹810.
- (iv) A Bill Receivable for ₹1,550 was passed through Bills Payable Book. The Bill was given by P.
- (v) Legal expenses ₹1,190 Paid to Mrs. Neetu was debited to her personal A/c.
- (vi) Cash received from Ram was debited to Shyam ₹1,500.
- (vii) While carrying forward the total of one page of the Purchases Book to the next, the amount of ₹1,235 was written as ₹1,325.

Find out the nature and amount of the Suspense A/c and pass entries (including narration) for the rectification of the above errors in the subsequent year's books.

[Nov. 2018, 10 Marks]

Sol.

Journal Entries in the books of _____

	Particulars	L/f	Dr.	Cr.
(i)	P&L Adjustment A/c To Suspense A/c (Being sales day book over cast by ₹1,000, now rectified)	Dr.	1,000	1,000
(ii)	X's A/c To Y's A/c (Being sale of ₹5,000 to X wrongly debited to Y, now rectified)	Dr.	5,000	5,000

	Particulars	L/f	Dr.	Cr.
(iii)	Suspense A/c To P&L Adjustment A/c (Being amount of general expenses wrongly posted now rectified)	Dr.	630	630
(iv)	Bills Receivable A/c Bills Payable A/c To Suspense Ac (Being B/R wrongly recorded in B/P Book, now rectified)	Dr. Dr.	1,550 1,550	3,100
(v)	P&L Adjustment A/c To Neetu's A/c (Being Legal Exp. wrongly posted to Neetu's A/c, now rectified)	Dr.	1,190	1,190
(vi)	Suspense A/c To Ram's A/c To Shyam's A/c (Being amount of purchase book wrongly carried forward, now rectified)	Dr.	3,000	1,500 1,500
(vii)	Suspense A/c To P&L Adjustment A/c (Being amount of purchase book wrongly carried forward, now rectified)	Dr.	90	90
	Capital A/c To Profit and Loss Adjustment A/c (Being balance in P&L Adjustment to Capital A/c)	Dr.	1,470	1,470

Suspense A/c

Particulars	Amt	Particulars	Amt
To P&L Adjustment A/c	630	By Difference in Trial Balance (Balancing fig.)	2,720
To Ram's A/c	1,500		
To Shyam's A/c	1,500	By P&L Adjustment A/c	1,000
To P&L Adjustment A/c	90		
	3,720		3,720

P&L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Suspense A/c	1,000	By Suspense A/c	630
To Neet's A/c	1,190	By Suspense A/c	90
		By Capital A/c (Bal. Trf)	1,470
	2,190		2,190

11. Miss Riya, Accountant while preparing his trial balance finds that the debit exceeds by ₹14,500 Being required to prepare the final A/c for the year 2023, he places the difference to a Suspense A/c In the next year i.e. 2024 the following mistakes were discovered:

- A sale of ₹8,000 has been passed through the Purchase Day-book. The entry in customer's A/c has been correctly recorded.
- Goods worth ₹5000 taken away by the proprietor for his use has been debited to Repairs A/c.
- A Bill receivable for ₹2600 received from Krish has been dishonoured on maturity but no entry passed.
- Salary ₹1300 paid to a clerk has been debited to his Personal A/c.
- A Purchase of ₹1500 from Raghu has been debited to his A/c. Purchases A/c has been correctly debited.
- A sum of ₹4500 written off as depreciation on furniture has not been . debited to Depreciation A/c.

Draft the Journal entries for rectifying the above mistakes and prepare Suspense A/c.

Sol.

Journal Entry in Books of Miss Riya

	Particulars	L/f	Dr.	Cr.
(a)	Suspense A/c Dr. To P & L Adjustment A/c (Being sale passed through the Purchase Day-book. The entry in customer's A/c has been correctly recorded., now rectified)		16000	16000
(b)	Drawings A/c Dr. To P & L Adjustment A/c (Being Goods taken by proprietor for his personal use debited to Repairs A/c, now rectified)		5000	5000
(c)	Krish A/c Dr. To B/R A/c (Being Bill receivable Krish has been dishonoured on maturity but no entry passed, now rectified)		2600	2600

	Particulars	L/f	Dr.	Cr.
(d)	P & L Adjustment A/c To Clerk A/c (Being Salary paid to a clerk debited to Personal A/c., now rectified)	Dr.	1300	1300
(e)	Suspense A/c To Raghu A/c (Being Purchase from Raghu has debited to his A/c. However, Purchases A/c has been correctly debited, now rectified)	Dr.	3000	3000
(f)	P & L Adjustment A/c To Suspense A/c (Being sum of ₹4500 written off as depreciation on furniture has not been debited to Depreciation A/c, now rectified)	Dr.	4500	4500
	Balance P & L Adjustment A/c indicating that last years profit was shown less, transferred to capital A/c. P & L Adjustment A/c To Capital A/c	Dr.	15200	15200

Suspense A/c

Particulars	Amt	Particulars	Amt
To P&L A/c	16000	By Difference in TB (Bal. Figure)	14500
To Raghu A/c	3000	By P&L Adj. A/c	4500
	19000		9500

P&L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Clerk A/c	1300	By suspense A/c	16000
To Suspense A/c	4500	By Drawings A/c	5000
To Capital A/c (cr. transferred)	15200		
	21000		21000

12. Give journal entries (narrations not required) to rectify the following:

- The purchase of furniture on credit from Nigam for ₹3,000 was erroneously posted to Shubham's A/c as ₹300.
- The sales return of ₹5,000 to Jyothy, despite being accurately recorded in the stock book, was inadvertently omitted from the financial A/cs.
- The sale of investments, amounting to ₹75,000 with a profit of ₹15,000, was incorrectly recorded in the Sales A/c.

- (iv) An amount of ₹10,000 withdrawn by the proprietor (Darshan) for his personal use has been debited to Trade Expenses A/c. [May 2018, 4 Marks]

Sol.

Journal Entry in Books of _____

	Particulars	L/f	Dr.	Cr.
(i)	Shubham A/c Dr. Furniture A/c Dr. To Nigam A/c (Being purchase of furniture on credit from Nigam for ₹3,000 was erroneously posted to Subham's A/c as ₹300, now rectified)		300 2,700	3,000
(ii)	Sales Returns A/c Dr. To Jyothy A/c (Being sales return to Jyothy, omitted, now rectified)		5,000	5,000
(iii)	Sales A/c Dr. To P&L A/c (Gain on sale of investment) To Investment A/c (Being sale of investments, recorded in the Sales A/c, now rectified)		75,000	15,000 60,000
(iv)	Drawings A/c Dr. To Trade Expenses A/c (Being ₹10,000 withdrawn by the proprietor debited to Trade Expenses A/c., now rectified)		10,000	10,000

13. Tapeshe drew a Trial Balance of his operations for the year ended 31.03.2023. There was a difference in the Trial Balance which he closed with a Suspense A/c. On a scrutiny by CA Rishabh, auditor, the following errors were found:

- (1) Purchases day book for the month of April, was undercast by ₹2000
- (2) Sales day book of December, was overcast by ₹20,000
- (3) A table purchased for ₹9,100 was entered in the Furniture A/c as ₹910.
- (4) A bill for ₹20,000 drawn by Tapeshe was not entered in the Bills Receivable Book.
- (5) A machine purchased for ₹20,000 was entered in the purchased day book.

Pass necessary Journal Entries to rectify the same and ascertain the difference in the Trial Balance that was shown under the Suspense A/c in respect of the above items.

Sol.

Journal Entry in Books of Tapesh

	Particulars	L/F	Dr.	Cr.
1	Purchase A/c To Suspense A/c (Being Purchases day book undercast, now rectified)	Dr.	2,000	2,000
2	Sales A/c To Suspense A/c (Being Sales day book overcast by ₹20,000, now rectified)	Dr.	20,000	20,000
3	Furniture A/c To Suspense A/c (Being table purchased for ₹9,100 entered as ₹910, now rectified)	Dr.	8,190	8,190
4	B/R A/c To Party A/c (Being, bill drawn not entered in the Bills Receivable Book, now rectified)	Dr.	20,000	20,000
5	Machine A/c To Purchase A/c (Being, machine purchased was entered in the purchased book, now rectified)	Dr.	20,000	20,000

Suspense A/c

Particulars	Amt	Particulars	Amt
To Difference in Trial balance (Bal. Figure)	30,190	By Sales A/c	20,000
		By Purchase A/c	2,000
		By Furniture A/c	8,190
	30,190		30,190

14. Give journal entries (with narrations) to rectify the following errors located in the books of M/s DRC after preparing the Trial Balance:

- An amount of ₹4,500 received on A/c of Interest was credited to Commission A/c.
- A sale of ₹2,760 was posted from Sales Book to the Debit of M/s Sobhag Traders at ₹2,670.
- ₹35,000 paid for purchase of Air conditioner for the personal use of proprietor debited to Machinery A/c.
- Goods returned by customer for ₹5,000. The same have been taken into stock but no entry passed in the books of A/c.

[May 2019, 4 marks]

Sol.

Journal Entry in Books of M/s DRC

	Particulars	L/f	Dr.	Cr.
1.	Commission A/c To Interest A/c (Being amount received on A/c of interest credited to commission A/c, now rectified)	Dr.	4,500	4,500
2.	M/s. Sobhag Traders A/c To Suspense A/c (Being sales understated in M/s Sobhag Traders' A/c, now rectified)	Dr.	90	90
3.	Drawings A/c To Machinery A/c (Being amount of drawings debited to Machinery A/c, now rectified)	Dr.	35,000	35,000
4.	Sales Return A/c To Customer A/c (Being entry for goods returned by customer not passed in the books of A/c, now recorded)	Dr.	5,000	5,000

15. Last year, Mr. Vivek encountered difficulties in reconciling the Trial Balance and decided to write off the discrepancy in the Profit and Loss A/c for that particular year. In the following year, he sought the assistance of a Chartered Accountant to review the previous books, and the Accountant identified the following errors:

- (1) Purchase of a motorcycle was debited to transport expenses A/c 5,000.
- (2) The total of the Purchase A/c was mistakenly overstated by 9,000.
- (3) There was an error in recording a credit purchase of goods from Mr. A for ₹3,000, which was mistakenly entered as a sale.
- (4) The cash of ₹2000 received from Mr. X was mistakenly posted to the A/c of Mr. Y.
- (5) Receipt of cash from Mr. Q was posted to the debit of his A/c ₹700.
- (6) ₹500 due by Mr. Q was omitted to be taken to the trial balance.
- (7) Sale of goods to Mr. R for ₹2,000 was omitted to be recorded.
- (8) Amount of ₹2,395 of purchase was wrongly posted as ₹2,593.

Mr. Roy used 10% depreciation on vehicles. Suggest the necessary rectification entries.

Sol.

Journal Entries in the books of Mr. Vivek

Date	Particulars		Dr. ₹	Cr. ₹
(1)	Motor Vehicles A/c To Profit and Loss Adjustment A/c (The erroneous debit entry made to the Transportation expense A/c for the purchase of a motorcycle has now been corrected). -capitalisation of 4500, i.e., ₹5,000 - 10% depreciation)	Dr.	4,500	4,500
(2)	Suspense A/c To P & L Adjustment A/c (In the previous year, there was an overcast error in the Purchase A/c, which has now been rectified.).	Dr.	9,000	9,000
(3)	P & L Adjustment A/c To A's A/c (error in recording a credit purchase of 3,000 from A, which was incorrectly entered as sales. This error has now been rectified.)	Dr.	6,000	6,000
(4)	Y's A/c To X's A/c (The amount received from X was incorrectly posted to Y's A/c. We have now rectified this error)	Dr.	2,000	2,000
(5)	Suspense A/c To Q's A/c (The amount of ₹700 received from Q was incorrectly debited to his A/c. We have now rectified this error)	Dr.	700	700
(6)	Trade receivables To Suspense A/c (₹500 due by Q not taken into trial balance; now rectified)	Dr.	500	500
(7)	R's A/c To P & L Adjustment A/c (Sales to R omitted last year; now adjusted)	Dr.	2,000	2,000
(8)	Suspense A/c To P & L Adjustment A/c (Excess posting to purchase A/c last year, ₹2,593, instead of ₹2,395, now adjusted)	Dr.	198	198

Date	Particulars		Dr. ₹	Cr. ₹
(9)	P & L Adjustment A/c To Roy's Capital A/c (Balance of P & L Adjustment A/c transferred to Capital A/c)	Dr.	10,898	10,898
(10)	Roy's Capital A/c To Suspense A/c (Balance of Suspense A/c transferred to the Capital A/c)	Dr.	10,698	10,698

Note : Entries No. (2) and (8) may even be omitted; but this is not advocated.

Profit and Loss Adjustment A/c
(Prior Period Items)

	₹		₹
To A	6,000	By Motor Vehicles A/c	4500
To Vivek's Capital (transfer)	7500	By Suspense A/c	9,000
	13500		13500

Suspense A/c

	₹		₹
To P & L Adjustment A/c	9000	By Vivek's Capital A/c (Transfer)	9700
To Q	700		
	9700		9700

16. Rectify the following discrepancies discovered in Mr. Subhash's records. The Trial Balance exhibited an excess credit of 345. Consequently, the difference has been recorded in a Suspense A/c.

- A sum of ₹500 received from Naman, was inadvertently omitted from being recorded in the Cash Book.
- The total of the Returns Inward Book for the month of May is 50 less than it should be due to an undercasting error.
- A furniture purchase amounting to ₹250 has been recorded in the Purchases Day Book.
- The purchase of 75 was erroneously recorded as 70 in the trade payables' A/c.
- The cheque received from K Sharma amounting to ₹100 was dishonoured and erroneously debited to the "Allowances A/c".
- The amount of 800 paid for the purchase of a motor cycle for Mr. Subhash was wrongly recorded under the "Miscellaneous Expenses A/c".

- (g) Goods with a value of 200 were returned by a customer and included in the inventory, but no entry was made in the books to A/c for this transaction.
- (h) Rectifying the error where a sale of 150 to Vishal & Co. was erroneously credited to their A/c instead of being correctly recorded in the sales book.

Sol. (a)

Journal Entries

	Particulars	L.F.	₹	₹
(a)	Cash A/c Dr. To Naman (entry passed for amount received)		500	500
(b)	Returns Inward A/c Dr. To Suspense A/c (Correcting the error in totalling the Returns Inward Book.)		50	50
(c)	Furniture A/c Dr. To Purchases A/c (Rectifying the mistake of recording the purchase of furniture in the Purchases Book and incorrectly debiting it to the Purchases A/c.)		250	250
(d)	Suspense A/c Dr. To Creditors A/c (The Trade Payables A/c was mistakenly credited 5 less, which has now been rectified.)		5	5
(e)	K Sharma Dr. To Allowances A/c (The cheque issued by K Sharma which was dishonoured, was incorrectly debited to the Allowances A/c, now rectified)		100	100
(f)	Drawings A/c Dr. To Miscellaneous Expenses (Rectifying entry for charging motorcycle amount to drawings instead of miscellaneous expenses)		800	800
(g)	Returns Inward A/c Dr. To Debtors (Personal) A/c (rectifying entry for recording return inwards)		200	200

	Particulars	L.F.	₹	₹
(h)	Vishal & Co. Dr. To Suspense A/c (Rectifying the error where the A/c of Vishal & Co. was mistakenly credited by 150 instead of being debited, the correction is made to debit the A/c of Vishal & Co. by 150.)		300	300

Suspense A/c

Dr.

Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
**	To Difference in Trial Balance		**	By Returns	
	To Trade Payables A/c	345		Inwards A/c By Singh & Co.	50
" "		5	" "		300
		350			350

17. Miss Rekha was unable to agree the Trial Balance last year and wrote off the difference to the profit and loss A/c of that year. On verifying the old books by a Chartered Accountant next year, the following mistakes were found: [May 2018, 10 Marks]

- Purchase A/c was undercast by ₹8,000.
- Sale of goods to Mr. Rahim for ₹2,500 was omitted to be recorded.
- Receipt of cash from Mr. Asok was posted to the A/c of Mr. Anbul ₹1,200.
- Amount of ₹4,167 of sales was wrongly posted as ₹4,617.
- Repairs to Machinery was debited to Machinery A/c ₹1,800.
- A credit purchase of goods from Mr. Paul for ₹3,000 entered as sale.

Sol.

Journal Entries in the books of Miss Daisy

	Particulars	L/f	Dr.	Cr.
(i)	P & L Adjustment A/c Dr. To Suspense* A/c (Purchase A/c under cast in the previous year; error now rectified)		8,000	8,000
(ii)	Rahim's A/c Dr. To P & L Adjustment A/c (Sales to Rahim omitted last year; now adjusted)		2,500	2,500

	Particulars	L/f	Dr.	Cr.
(iii)	Anbuls A/c To Ashok A/c (Amount received from Ahsok wrongly posted Anbul; now rectified)	Dr.	1,200	1,200
(iv)	P & L Adjustment A/c To Suspense A/c (Excess posting to sales A/c, now rectified)	Dr.	450	450
(v)	P & L Adjustment A/c To Machinery A/c (Repairs to machinery wrongly debited repairs A/c, now rectified)	Dr.	1,800	1,800
(vi)	P & L Adjustment A/c To Mr. Paul A/c (Credit purchase of goods from Mr. Paul entered as sale last year, now rectified)	Dr.	6,000	6,000
	Daisy's Capital A/c To Profit and Loss Adjustment A/c (Being balance in P&L Adjustment to Capital A/c)	Dr.	13,750	13,750
	Suspense A/c To Daisy's Capital A/c (Being balance of Suspense A./c transferred to Capital A/c)	Dr.	8,450	8,450

Profit and Loss Adjustment A/c

Particulars	Amt	Particulars	Amt
To Suspense A/c	8,000	By Rahim's A/c	2,500
To Suspense A/c	450	By Daisy's Capital A/c	13,750
To Machinery A/c	1,800	(Bal. Transfer)	
To Mr. Paul's	6,000		
	16,250		16,250

Suspense A/c

Particulars	Amt	Particulars	Amt
To Daisy's Capital A/c (Bal. trf)	8,450	By P&L Adj. A/c	8,000
		By P&L Adj. A/c	450
	8,450		8,450

18. The following mistakes were located in the books of M/s Aarti after its books were closed and a Suspense A/c was credited ₹200 in order to get the Trial Balance agreed.
- Sales Day Book was over cast by ₹200.
 - A sales of ₹100 to Q was wrongly debited to the A/c of R
 - General Expenses of ₹18 was posted in the General Ledger at ₹80.
 - A bill receivable for ₹255 was passed through Bills payable Day Book – This bill was given by Riya.
 - Legal expenses ₹219 paid to Mr. Ravi was debited to his personal A/c
 - Cash received from Chanda. was debited to F. Chanda ₹300.
 - While carrying forward the total of one page of the Purchases Book to the next the amount of ₹1355 was written as ₹1535.

Find out the nature and amount of the Suspense A/c and pass entries for the rectification of the above errors in the subsequent year's books.

Sol.

Journal Entry in Books of M/s Aarti

	Particulars	L/f	Dr.	Cr.
a.	P & L Adjustment A/c To Suspense A/c (Being Sales Day Book over cast , now rectified)	Dr.	200	200
b.	Q A/c To R A/c (Being sales to Q wrongly debited to R, now rectified)	Dr.	100	100
c.	Suspense A/c To P & L Adjustment A/c (Being General Expenses of ₹18 posted in the General Ledger at ₹80, now rectified)	Dr.	62	62
d.	B.R. A/c B.P. A/c To Riya A/c (Being bill receivable for ₹255 was passed through Bills payable Book, now rectified)	Dr. Dr.	255 255	510
e.	P & L Adjustment A/c To Mr. Ravi A/c (Being Legal expenses paid to Ravi was debited to his personal A/c , now rectified)	Dr.	219	219
f.	Suspense A/c To F. Chanda To Chanda (Being Cash received from Chanda. debited to F. Chanda, now rectified)	Dr.	600	300 300

	Particulars	L/f	Dr.	Cr.
g.	Suspense A/c To P & L Adjustment A/c (Being Purchases Book Total wrongly carried forward, now rectified)	Dr.	180	180
	Note: Balance of P&L adjustment A/c, after all rectification is transferred to capital A/c. Capital A/c To P & L Adjustment A/c		177	177

Suspense A/c

Particulars	Amt	Particulars	Amt
To Sundries	600	By Bal. b/d	352
To P&L Adj A/c	62	By P&L Adj. A/c	200
To P&L Adj A/c	180	By Difference in TB (Bal. Figure)	290
	842		842

P&L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Suspense A/c	200	By Suspense A/c	62
To Mr. Ravi A/c	219	By Suspense A/c	180
		By Capital A/c (Bal. transferred)	177
	419		419

Note: Debit balance ₹177 indicates that last year's profit was shown excess.

19. A merchant's trial balance as on June 30, 2021 did not agree. The difference was put to a Suspense A/c. During the next trading period, the following errors were discovered:

- The total of the Purchases Book of one page, 5427 was carried forward to the next page as ₹5472.
- A sale of ₹683 was entered in the Sales Book as ₹863 and posted to the credit of the customer.
- A return to a creditor, ₹255 was entered in the Returns Inward Book; however, the creditor's A/c was correctly posted.
- Cash received from Kamal, ₹3100 was posted to the debit of Gaurav.
- Goods worth ₹420 were dispatched to a customer before the close of the year but no invoice was made out.
- Goods worth ₹500 were sent on sale or return basis to a customer and entered in the Sales Book. At the close of the year, the customer still had the option to return the goods. The sale price was 25% above cost.

You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly.

Sol.

Journal Entries

S. No.	Particular	Dr. ₹	Cr. ₹
(i)	Suspense A/c Dr. To Profit and Loss Adjustment A/c (Being Purchases A/c over debited last year by ₹45, now rectified)	45	45
(ii)	Profit & Loss Adjustment A/c Dr. Customer's A/c Dr. To Suspense A/c (Being Correction of the entry - Sales A/c was over credited by ₹180 and Customer was credited by ₹863 instead of being debited by ₹683)	180 683	863
(iii)	Suspense A/c Dr. To P & L Adjustment A/c (Being Returns Inward A/c was debited by ₹255 instead of Returns Outwards A/c being credited by ₹255, now rectified)	510	510
(iv)	Suspense A/c Dr. To Kamal A/c To Gaurav A/c (Being cash received from Kamal, ₹620 was posted to the debit of Gaurav, now rectified)	620	310 310
(v)	Customer's A/c Dr. To P & L Adjustment A/c (Being goods worth ₹420 were dispatched to a customer before the close of the year but no invoice was made out, now rectified)	420	420
(vi)	P & L Adjustment A/c Dr. Inventory A/c Dr. To Customer's A/c	100 400	500
(vii)	P & L Adjustment A/c Dr. To Capital A/c (Being transfer of P & L Adjustment A/c balance to the Capital A/c)	695	695

P & L Adjustment A/c

Particulars	Amount	Particulars	Amount
To Suspense A/c	180	By Suspense A/c	45
To Customer's A/c	100	By Suspense A/c	510
To Capital A/c	695	By Customer's A/c	420
(Balancing Figure)			
—	975		975

20. Ramesh drew a Trial Balance for the year ended 31.03.2021. There was a difference in the Trial Balance which he reflects in a Suspense A/c. On a scrutiny by the Firm's Auditors, the following errors were found:

1. Purchases day book for the month of April, was undercast by ₹500.
2. Sales day book of October, was overcast by ₹5000.
3. A Computer purchased for ₹4050 was entered in the Computer A/c as ₹405.
4. A bill for ₹5,000 drawn by Ramesh was not entered in the Bills Receivable Book.
5. A machinery purchased for ₹5,000 was entered in the Purchase book.

Pass necessary Journal Entries to rectify the same and ascertain the difference in the Trial Balance that was shown under the Suspense A/c in respect of the above items.

Sol.

Date	Particulars	L.F	Debit	Credit
1.	Purchase A/c To Suspense A/c	Dr.	500	500
2.	Sales A/c To Suspense A/c	Dr.	5000	5000
3.	Computer A/c To Suspense A/c	Dr.	3645	3645
4.	B/R A/c To Party A/c	Dr.	5,000	5,000
5.	Machinery A/c To Purchase A/c	Dr.	5,000	5,000

Suspense A/c

To Difference in Trial Balance (Balancing figure)-	9145	By Purchase A/c	500
	9145	By Sales A/c	5000
		By Furniture A/c	3645
			9145

21. The books of A/c of Lazy & Co. for the year ending 31st March, 2023 were closed with a difference in books carried forward. The following errors were detected subsequently:
- Goods ₹251 returned to Rita Bros. were recorded in the Returns Inward Book as ₹351 and from there it was posted to the debit of Rita Bros A/c.
 - A credit sale of ₹860 was wrongly posted as ₹680 to the customer A/c in the Sales ledger.
 - Closing Stock was overstated by ₹10,000 being casting error in the schedule of inventory.
 - paid acceptance to Ram for ₹8,600 was posted to the debit of Sita as ₹6,800.
 - Goods purchased from D & Co/ ₹4,250 entered in the Sales Day Book for ₹4,520.
 - ₹3000 being the total of the discount column on the credit side of the Cash Book was not posted. Pass rectification entries in the next year.

Sol.

Journal Entry in Books of Lazy & Co.

	Particulars	L/f	Dr.	Cr.
(a)	Suspense A/c (602+100) Dr. To P&L Adjustment A/c (251 + 351) To Rita Brothers A/c (351 - 251) (Being error of commission, now rectified)		702	602 100
(b)	Customer A/c Dr. To Suspense A/c (Being short debit to customer A/c, now rectified)		180	180
(c)	P&L Adjustment A/c Dr. To Opening stock A/c (Being closing stock of last year overcast, now rectified)		10000	10000
(d)	Bills payable A/c Dr. To Sita A/c To Suspense A/c (Being debit to Sita instead of bills payable A/c now rectified)		8600	6800 1600
(e)	P&L Adjustment A/c (4250 + 4520) Dr. To D & Co. A/c (Being goods purchase entered in sales day book, now rectified)		8770	8770
(f)	Suspense A/c Dr. To P&L Adjustment A/c (Being omission of posting to Discount received A/c, rectified)		3000	3000
	Capital A/c Dr. To P&L Adjustment A/c		15168	15168

Suspense A/c

Particulars	Amt	Particulars	Amt
To P&L Adj. A/c	602	By Customer A/c	180
To Rita Brothers A/c	100	By Bill Payable A/c	1600
To P&L Adj. A/c	3000	By Difference in Trial Bal.(Bal. Fig)	1922
	3702		3702

P&L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Opening stock A/c	10000	By Suspense A/c	602
To D & Co. A/c	8770	By Suspense A/c	3000
		By Capital A/c (Bal. Fig)	15168
	18770		18770

22 Gaurav trial balance as on 31st March, 2020 did not agree. The difference was put to a Suspense A/c. During the next trading period, the following errors were discovered:

- (i) The total of the Purchases Book of one page, ₹5,615 was carried forward to the next page as ₹6,551.
- (ii) A sale of ₹281 was entered in the Sales Book as ₹821 - and posted to the credit of the customer.
- (iii) A return to creditor, ₹295 was entered in the Returns Inward Book; however, the creditor's A/c was correctly posted.
- (iv) Cash received from Senu, ₹895 was posted to debit of Sethu.
- (v) Goods worth ₹1,400 were dispatched to a customer before the close of the year but no invoice was made out.
- (vi) Goods worth ₹1600 were sent on sale or return basis to a customer and entered in the Sales Book at the close of the year, the customer still had the option to return the goods. The gross profit margin was 20% on Sale.
- (vii) ₹600 due from Mr. Q was omitted to be taken to the trial balance.
- (viii) Sale of goods to Mr. R for ₹3,000 was omitted to be recorded.

You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly. [Jan. 2021, 10 Marks]

Sol.

Journal Entry in Books of Gaurav

	Particulars	L/f	Dr.	Cr.
(i)	Suspense A/c Dr. To P & L Adjustment A/c (Being the total of the Purchases Book of one page, ₹6,551, now rectified)		936	936

	Particulars	L/f	Dr.	Cr.
(ii)	Trade receivables A/c Dr. P & L Adjustment A/c Dr. To Suspense A/c (Being a sale of ₹281 entered in the Sales Book as ₹821 and posted to the credit of the customer, now rectified)		1102 540	1642
(iii)	Suspense A/c Dr. To P & L Adjustment A/c (Being a return to creditor, ₹295 entered in the Returns Inward Book, now rectified)		590	590
(iv)	Suspense A/c Dr. To Senu A/c To Sethu A/c (Being cash received from Senu, ₹895 posted to debit of Sethu, now rectified)		1,790	895 895
(v)	Trade receivables A/c Dr. To P & L Adjustment A/c (Being Goods worth ₹1,400 were dispatched to a customer before the close of the year but no invoice was made out, now rectified)		1,400	1,400
(vi)	P & L Adjustment A/c (1600 × 20%) Dr. Closing Stock A/c (1600 × 80%) Dr. To Trade receivable A/c (Being goods worth ₹1,600 were sent on sale or return basis to a customer and no intimation has been received from him, at the close of year, now adjusted in books)		320 1,280	1,600
(vii)	Trade receivable (Q) A/c Dr. To Suspense A/c (Being ₹600 due from Q omitted to be taken to the trial balance, now rectified)		600	600
(viii)	Trade receivable (R) A/c Dr. To P & L Adjustment A/c (Being sale of goods to Mr. R for ₹3,000 omitted to be recorded, now rectified)		3,000	3,000
(ix)	P & L Adjustment A/c Dr. To Capital A/c (Being Profit on adjustment transferred to Capital A/c)		5,066	5,066

P & L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Suspense A/c	540	By Suspense A/c	936
To Trade receivable A/c	320	By Suspense A/c	590
To Capital A/c (Bal. fig.)	5,066	By Trade receivables A/c	1,400
		By Trade receivables	3,000
Total	16,250	Total	5,926

23. Pass necessary journal entries to rectify the following errors:

- (i) The withdrawal of ₹400 by the proprietor for personal use has been mistakenly debited to the trade expenses A/c.
- (ii) A purchase of goods from Mohan amounting to ₹600 has been wrongly entered through the sales-book.
- (iii) A credit sale of ₹200 to Raman has been wrongly passed through the purchases-book.
- (iv) ₹300 received from Joshi have been credited to Jain.
- (v) ₹600 paid on A/c of salary to the cashier Rohit stands debited to his personal A/c.
- (vi) A contractor's bill for extension of premises amounting to ₹5000 has been debited to building repairs A/c.
- (vii) On 30th June, goods of the value of ₹1000 were returned by Rohan and were taken into stock but the returns were entered in the books under date 1st July, i.e., after the expiration of the financial year on 30th June.
- (viii) The entry of a ₹400 bill for the sale of old office chair to Divya was incorrectly recorded in the sales daybook.
- (ix) The periodical total of the sales-book was cast short by ₹200.

Sol.

Journal Entry in Books of _____

	Particulars	L/f	Dr.	Cr.
(i)	Drawing A/c Dr. To Trade expense A/c (Being rectification of drawing wrongly debited to trade expense A/c)		400	400
(ii)	Sale A/c Dr. Purchase A/c Dr. To Mohan A/c (Being Purchase entered in sales book, consequently sales is credited & Mohan A/c debit instead of debiting purchase & crediting Mohan, now rectified)		600 600	1200

	Particulars	L/f	Dr.	Cr.
(iii)	Raman A/c Dr. To Purchase A/c To Sales A/c (Being sale wrongly entered in purchase book now rectified)		400	200 200
(iv)	Jain A/c Dr. To Joshi A/c (Being wrongl credit given to jain instead of Joshi, now rectified)		300	300
(v)	Salary A/c Dr. To Rohit A/c (Being salary wrongly debit to Rohit's personal A/c instead Now rectified)		600	600
(vi)	Building A/c Dr. To Repairs A/c (Being Capital expenditure wrongly debited to revenue exp. Now rectified)		5000	5000
(vii)	Sales Return A/c Dr. To Rohan A/c (Being sales return was not recorded in current year now entered, Entry already passed in the next year's books will have to be reversed).		1000	1000
(viii)	Sales A/c Dr. To Furniture A/c (Being sale of asset wrongly entered in sales book now rectified)		400	400
(ix)	Suspense A/c Dr. To Sales A/c (Being wrong credit to commission instead of Interest A/c now rectified)		180	180

24. Kavita closes his books on 31st December. In 2023, his books showed a difference which he transferred of his Capital A/c and prepared the Profit and Loss A/c and Balance Sheet after doing so he found that the under mentioned errors had been committed in 2023.

- A machine, book value ₹16400 was sold on credit to Tara for ₹15000. The amount was posted to the credit of Tari.
- A cheque for ₹4200 was received from Jaso and was correctly dealt with. It was, however, returned dishonoured and was then posted to the debit of Trade Expenses A/c.

- (iii) The closing stock sheets for 2023 were found to be totalled ₹20,000 in excess.
- (iv) The income tax paid on behalf of the proprietor, ₹3270 was debited to Income Tax A/c as ₹2370.
- (v) A metal cupboard was purchased for ₹2500, it was debited to General Expenses A/c as ₹5200. Give journal entries to carry out the corrections required. How much was the difference in the books on December 31, 2023?

Sol.

Journal Entry in Books of Kavita

	Particulars	L/f	Dr.	Cr.
(i)	Tara A/c Dr. Tari A/c Dr. To Suspense A/c (Being machine sold on credit to Tara posted to the credit of Tari, now rectified)		15000 15000	30000
(ii)	Jaso A/c Dr. To P & L Adjustment A/c (Being cheque of Jaso dishonoured and posted debit of Trade Expenses, now rectified)		4200	4200
(iii)	P & L Adjustment A/c Dr. To Op. Stock (Being closing stock for 2023 overcast, now rectified)		20000	20000
(iv)	Drawing A/c Dr. To Suspense A/c To P & L Adjustment A/c (Being proprietor income tax paid debited to Income Tax A/c, rectified)		3270	900 2370
(v)	Furniture Dr. Suspense A/c Dr. To P & L Adjustment A/c (Being purchase of asset debited to General Expenses A/c, now rectified)		2500 2700	5200
	Balance in Suspense A/c now credited to Capital A/c because diff. in Trial balance was last year debited to Capital A/c, instead of Suspense A/c Suspense A/c Dr. To Capital		28200	28200
	Balance in P&L adj. indicating that last year profit was shown excess now rectified by debiting to Capital A/c. Capital A/c Dr. To P&L Adj.		8230	8230

Suspense A/c

Particulars	Amt	Particulars	Amt
To P&L Adj. A/c	2700	By Tari A/c	15000
To Capital A/c (Bal. Fig)	28200	By Tara A/c	15000
		By Drawing A/c	900
	30900		30900

P&L Adjustment A/c

Particulars	Amt	Particulars	Amt
To Op. Stock A/c	20000	By Jaso A/c	4200
		By Drawings A/c	2370
		By Furniture A/c	2500
		By Suspense A/c	2700
		By Capital A/c (Bal. Fig.)	8230
	20000		20000

25. Before preparation of the Trial balance, the following errors were found in the books of Radhe & Sons. Give the necessary entries to correct them:

- (i) Minor Repairs made to the building amounting ₹1,850 were debited to the Building A/c.
- (ii) An amount of ₹3,000 due from Shayam Lal, which had been written off as bad debts in the previous year, recovered in the current year, and had been posted to the personal A/c of Shayam Lal.
- (iii) Furniture purchased for office use amounting to ₹20,000 has been entered in the purchase day book.
- (iv) Goods purchased from Ram Singh amounting to ₹8,000 have remained unrecorded so far.
- (v) College Fees of proprietor's son, ₹15,000 debited to the Audit fees A/c.
- (vi) Receipt of ₹4,500 from Meet Kumar credited to the Pinki Rani.
- (vii) Goods amounting to ₹6,200 had been returned by a customer and were taken in to inventory, but no entry was made in the books.
- (viii) ₹1500 paid for wages to workmen for making office furniture had been charged to wages A/c.
- (ix) Salary paid to clerk ₹12,000 has been debited to his personal A/c.
- (x) A purchase of goods from Raghav amounting to ₹20,000 has been wrongly entered through the sales book.

[Dec. 2022, 10 Marks]

Sol.

In the books of Radhe & Sons
Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	Repairs A/c Dr. To Building A/c (Being repairs made to building wrongly debited to building A/c, now corrected)		1,850	1,850
(ii)	Shyam Lal A/c Dr. To Bad debt Recovered A/c (Being bad debts recovered wrongly credited to Shyam Lal A/c, now corrected)		3,000	3,000
(iii)	Furniture A/c Dr. To Purchases A/c (Being furniture purchased wrongly recorded in purchases book, now corrected)		20,000	20,000
(iv)	Purchases A/c Dr. To Ram Singh A/c (Being goods purchased from Ram Singh not recorded earlier, now recorded)		8,000	8,000
(v)	Drawings A/c Dr. To Audit Fees A/c (Being college fees of proprietor's son wrongly debited to audit fees A/c, now corrected)		15,000	15,000
(vi)	Pinki Rani A/c Dr. To Meet Kumar A/c (Being amount received from Meet Kumar wrongly credited to Pinki Rani A/c, now corrected)		4,500	4,500
(vii)	Sales Return A/c Dr. To Customer A/c (Being sales return from a customer not recorded earlier, now recorded)		6,200	6,200
(viii)	Furniture A/c Dr. To Wages A/c (Being wages paid for furniture wrongly debited to wages A/c, now corrected)		1,500	1,500
(ix)	Salary A/c Dr. To Clerk Personal A/c (Being salary paid to clerk wrongly debited to his personal A/c, now corrected)		12,000	12,000

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
(x)	Purchases A/c Dr. Sales A/c Dr. To Raghav A/c (Being purchase of goods wrongly recorded in sales book, now corrected)		20,000 20,000	40,000

26. Pass Journal Entries to rectify the following errors:

- (I) Goods costing ₹500 have been purchased on credit from Mohan, but no entry has been made in the books, although the goods were taken into stock.
- (II) Goods amounting to ₹2000 have been sold on credit, but no entry has been made in the books.
- (III) No entry has been made for Purchases Return of ₹100.
- (IV) No entry has been made for Sales Return of ₹225.
- (V) Goods purchased from Kamlesh on Credit for ₹2500 was recorded in the purchase book as ₹250.
- (VI) Sales of ₹300 to Tarun were recorded as ₹30 in the Sales Book.
- (VII) Goods purchased on Credit from Rajan for ₹200 was recorded as ₹2000 in the purchase book.

Sol.

Date	Particulars	L.F	Debit ₹	Credit ₹
1.	Purchases A/c Dr. To Mohan (Goods purchased from Mohan , not entered in the books)		500	500
2.	Debtors A/c Dr. To Sales A/c (Goods sold on credit, not entered in the books)		2000	2000
3.	Creditors A/c Dr. To Purchase Return A/c (Purchase Return not recorded in the books)		100	100
4.	Sales Return A/c Dr. To Debtors A/c (Sales Return not recorded in the books)		225	225
5.	Purchases A/c Dr. To Kamlesh (Less amount recorded in the Purchase book)		2250	2250

Date	Particulars	L.F	Debit ₹	Credit ₹
6.	Tarun A/c To Sales A/c (Less amount recorded in the Sales book)	Dr.	270	270
7.	Rajan To Purchases A/c (Excess amount recorded in the Purchase book)	Dr.	1800	1800

27. Give rectifying entries for the following errors:

- (1) Purchase of stock from Shyam amounting to ₹800 has been wrongly entered in the Sales Book.
- (2) A Credit sale of ₹280 to Suresh has been wrongly entered in the Purchase Book.
- (3) Goods worth ₹500 were returned by Som and were taken stock on the same date but no entry was recorded in the books.
- (4) A sum of ₹900, which was previously written off as a Bad Debt in a prior year, has been unexpectedly recovered from Sachin. However, it was mistakenly posted to Sachin's personal A/c.
- (5) A cheque worth ₹5000 received from Mohit was not honored and was incorrectly posted as a debit to the Sales Returns A/c.

Sol.

Journal

	Particulars	L.F.	Dr. ₹	Cr. ₹
(1)	Purchases A/c Sales A/c To Shyam (Rectification of an incorrect entry in the sales book for the purchase of goods from Shyam)	Dr. Dr.	800 800	1600
(2)	Suresh A/c To Purchases A/c To Sales A/c (Rectification of an erroneous entry in the Purchases Book involving a credit sale of goods to Suresh.)	Dr.	560	280 280
(3)	Returns Inwards A/c To Som A/c (Entry for goods returned by Som and taken in stock omitted from the records)	Dr.	500	500

	Particulars	L.F.	Dr. ₹	Cr. ₹
(4)	Sachin A/c Dr. To Bad Debts Recovered A/c (Rectification of erroneous credit to Personal A/c for the recovery of previously written off bad debts.)		900	900
(5)	Mohit A/c Dr. To Sales Return A/c (Rectification of erroneous debit to Sales Returns A/c for the dishonour of a cheque received from Mohit.)		5000	5000

Hence, it can be concluded that errors identified prior to the creation of the trial balance can be rectified either by using rectification statements (not entries) or by rectification entries.

28. The Accountant of Daniel & Co. prepared the Trial Balance for the year ended 31st March, 2023. But there was a difference and the Accountant put the difference in Suspense A/c. Rectify the following errors found.

- (1) The total of the Returns outward book, ₹400 has not been posted in the ledger.
- (2) Purchase of ₹300 from Yamini has been entered in the sales book. However Yamini's A/c has been correctly entered.
- (3) A sale of ₹350 to Zara has been credited to his A/c as ₹150.
- (4) Old chair sold for ₹6,400 had been entered as ₹4,600 in sales A/c.
- (5) Goods taken by proprietor, ₹1,000 have not been entered in the books at all.

Sol.

Journal Entry in Books of Daniel & Co.

	Particulars	L/f	Dr.	Cr.
1.	Suspenses A/c Dr. To Purchase return. (Being total of the Returns outward book not posted in the ledger, now rectified)		400	400
2.	Sales A/c Dr. Purchase A/c Dr. To Suspense A/c (Being Purchase from Yamini has been entered in the sales book. However Yamini's has been correctly entered, now rectified)		300 300	600
3.	Zara A/c Dr. To Suspense A/c (Being A sale of ₹350 to Zara credited to his A/c as ₹150, now rectified)		500	500

	Particulars	L/f	Dr.	Cr.
4.	Suspense A/c Sales A/c To Old Furniture A/c (Being Old chair sold for ₹6,400 entered as ₹4,600 in sales A/c, now rectified)	Dr. Dr.	1800 4600	6400
5.	Drawing A/c To Purchase A/c (Being Goods taken by proprietor, ₹1,000 not recorded, now rectified)	Dr.	1000	1000

Suspense A/c

Particulars	Amt	Particulars	Amt
To Purchase Return A/c	400	By Sales A/c	300
To Furniture	1800	By Purchase A/c	300
		By Zara A/c	500
		By Difference in Trial Balance (Bal. Fig).	500
	2,200		2,200

29. Correct the following errors (i) without opening a Suspense A/c and (ii) with opening a Suspense A/c:

- (1) There is a shortfall of ₹2,100 in the total of the sales book.
- (2) The return of goods valued at ₹1,800 by Gaurav & Co. has not been documented in any record.
- (3) The purchase of goods amounting to ₹2,250 has been incorrectly debited to the A/c of the supplier, Sen Brothers.
- (4) Furniture purchased from Mary Associates, ₹15,000 has been entered in the purchase Daybook.
- (5) Discount received from Black and White ₹1,200 has not been entered in the books.
- (6) Discount allowed to Radhe Mohan & Co. ₹180 has not been entered in the Discount Column of the Cashbook. The A/c of Radhe Mohan & Co. has, however, been correctly posted.

[Nov. 2019, 10 Marks]

Sol. (i) Without opening a Suspense A/c

- (1) In the credit side of the Sales A/c:-

“By wrong totalling of the Sales Book ₹2100”

(2)

Date	Particulars	L.F.	Amount	Amount
	Sales Return A/c To Gaurav & Co.'s A/c (Being goods returned by Gaurav & Co. not recorded anywhere)	Dr.	1800	1800

(3) In the credit side of Supplier Sen Brother A/c:-
 "By error in posting ₹4500"

(4)

Date	Particulars	L.F.	Amount	Amount
	Furniture A/c To Purchases A/c (Being correction of Furniture purchased entered in the Purchase Day Book)	Dr.	15000	15000

(5)

Date	Particulars	L.F.	Amount	Amount
	Black and White A/c To Discount received A/c (Being rectification of the entry omitted)	Dr.	1200	1200

(6) In the debit side of Discount allowed A/c:-
 "To omission of entry in the Cash book ₹180"

(ii) With opening a Suspense A/c

Journal Entry in Books of _____

Particulars	L/f	Dr.	Cr.
Suspense A/c To Sales A/c (Being correction arising from under casting of sales day book)	Dr.	2100	2100
Sales return A/c To Gaurav & Co.'s A/c (Being the recording of unrecorded returns)	Dr.	1800	1800
Suspense A/c To Sen Brother's A/c (Being the correction of the error by which Sen Brothers was debited instead of being credited by ₹2250)	Dr.	4500	4500

	Particulars	L/f	Dr.	Cr.
	Furniture A/c Dr. To Purchases A/c (Being correction of recording purchase of furniture as ordinary purchases)		15000	15000
	Black and White Dr. To Discount received A/c (Being the recording of discount omitted to be recorded)		1200	1200
	Discount allowed A/c Dr. To Suspense A/c (Being correction of discount allowed not entered in the cash book)		180	180

Suspense A/c

Date	Particulars	L.F.	Amount	Date	Particulars	J.F.	Amount
	To Sales A/c		2100		By Discount allowed A/c		180
	To Sen Brothers' A/c		4500		By Difference in TB (Bal. Fig.)		6420
	Total		6600		Total		6600

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