

Centre for Distance & Online Education

UNIVERSITY OF JAMMU

JAMMU



**SELF LEARNING MATERIAL
FOR**

B.COM SEMESTER-I

(For examination to be held on 2025 onwards)

FINANCIAL ACCOUNTING

Subject: Financial Accounting
Course No. BCG-101

Lesson No. 1 to 20
Unit - I to IV

Course Co-ordinator

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<http://www.distanceeducationju.in>

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FINANCIAL ACCOUNTING

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Course No.: BC-101

Duration of Exam: 3 Hrs.

Title: Financial Accounting

Total Marks: 100

Theory Examination: 80

Internal Assessment: 20

OBJECTIVE: The course has been designed to give basic knowledge of accounting practices being adopted by Non- corporate entities.

UNIT-I : ACCOUNTING CONCEPTS AND ACCOUNTING STANDARDS

- ◆ Accounting standards issued by ICAI.
- ◆ International financial reporting system.
- ◆ Various systems of accounting viz., Cash system, mercantile system & hybrid system and
- ◆ Preparation of manufacturing A/c; Trading A/c; P&L A/c and B/S (With and without adjustments)

UNIT-II ROYALTY (EXCLUDING SUB LEASE)

Meaning of royalty, lessor, lessee, short working, surplus and right of recoupment; Preparation books of lessor and lessee-Journal and ledger.

UNIT-III HIRE PURCHASE SYSTEM

Meaning and difference between hire purchase and installment system

- ◆ Preparation of books of hire purchaser and hire seller excluding stock and debtor system; Default and repossession-Complete and partial,
- ◆ Preparation of books when cash prices is given, cash price not given, rate of interest given, rate of interest not given.

UNIT-IV INSOLVENCY

Insolvency cases of sole proprietary concerns under Presidency Town Insolvency Act 1909 and Provincial Act 1920; List of preferential creditors; Preparation of statement of affairs and deficiency account

SKILL DEVELOPMENT (SPECIMEN FOR CLASS ROOM TEACHING AND INTERNAL ASSESSMENT)

- ◆ Accounting standards vis-a vis Depreciation accounting.
- ◆ Treatment of goods delivered on 'Sale or return basis' in financial statements.
- ◆ Treatment of 'Unrealised profit or Stock reserve'
- ◆ Application of Annuity method for computing cash price.
- ◆ Draft a specimen of list-H under Insolvency Acts.

BOOKS RECOMMENDED

- | | | |
|-----|--|---|
| 1. | Jain, S.P & Narang, K.L. : | Financial Accounting, Kalyani Publishers, New Delhi. |
| 2. | Shukla, M.C, Grewal, T.S. & Gupta, S.C | Advance Accounts Vol- I & II, S. Chand Pub., New Delhi |
| 3. | Maheshwari, S.N. & Maheshwari S. | Advance Accounts Vol- I & II, Vikas Pub. New Delhi |
| 4. | Kishore, R.M. | Financial Accounting, Taxman Pub., New Delhi |
| 5. | Pillai, R.S.N, Bagavathi & Uma, S. | Fundamentals of Adv. Accounting Vol I & II, S. Chand Pub. New Delhi |
| 6. | Gangwar, Sharad & Gangwar K. | Financial Accounting, Himalaya Publishing House, New Delhi |
| 7. | Rajasekaran | Financial Accounting, Pearson Pub., New Delhi |
| 8. | Singhal & Roy : | A Text Book of Financial Accounting, Vayu Education of India, New Delhi |
| 9. | Banerjee : | Financial Accounting- Concepts, Analysis, Methods and Uses, PHI Learning Pub. New Delhi |
| 10. | Bhatia and Arora : | Financial Accounting, Alpha Pub., New Delhi |
| 11. | Pratiyogita Darpan Publication | Commerce Edition |
| 12. | Arihant Publication | Commerce Edition |

NOTE FOR PAPER SETTER

Equal weightage shall be given to all the units of the syllabus. The external paper shall be of the two sections viz, A& B.

Section-A: This section will contain four short answer questions selecting one from each unit. Each question carries 5 marks. A candidate is required to attempt all the four questions. Total weightage to this section shall be 20 marks.

Section-B: This section will contain eight long answer questions of 15 marks each. Two questions with internal choice will be set from each unit. A candidate has to attempt any four questions selecting one from each unit. Total weightage to this section shall be 60 Marks.

MODEL QUESTION PAPER

FINANCIAL ACCOUNTING

Section A

Attempt all the questions. Each question carries 5 marks.

1. Define accounting standards and explain its significance.
2. What is hire purchase system and give two points of distinction between H.P.S. & Installment purchase system.
3. Explain the following terms in reference to royalty accounts.
 - (i) Minimum rent
 - (ii) Short working
 - (iii) Right of recoupment.
4. Explain difference between balance sheet & statement of affairs.

Section B

Attempt any four questions, selecting one from each unit. Each question carries 15 marks.

1. What is capital expenditure & explain the difference between:
 - (a) Capital expenditure & revenue expenditure
 - (b) Capital receipts & revenue receipts.

OR

Following is the Trail balance of M/s Kasturi Agencies as on 31st March, 2010. Prepare Trading and Profit & Loss Account for the year ended 31st March, 2010 and a Balance sheet on that date:

	Dr.	Cr.
	Rs.	Rs.
Capital		1,00,000
Drawings	18,000	
Buildings	15,000	
Furniture & fittings	7,500	
Motor Van	25,000	
Loan from Hari @ 12% interest (1-4-2009)		15,000
Interest paid on above	900	

Sales		1,00,000
Purchases	75,000	
Opening stock	25,000	
Establishment expenses	15,000	
Wages	2,000	
Insurance	1,000	
Commission received		4,500
Sundry debtors	28,100	
Bank balance	20,000	
Sundry creditors		10,000
Interest		3,000
	2,32,500	2,32,500

Adjustments:

(a) The value of closing stock on 31st March, 2010 was Rs. 32,000. (b) Outstanding Wages Rs. 500. (c) Prepaid insurance Rs. 300. (d) Commission received in advance Rs. 1,300. (e) Allow interest on capital @ 10%. (f) Depreciate: building 2.5% Furniture & fitting 10%, Motor van 10%. (g) Charge interest on drawing Rs. 500. (h) Accrued interest Rs. 500.

2. X purchased a machine for manufacturing steel utensils on Hire- Purchase system from Y. Payment was to be made as Rs. 18,000 at contract and three annual instalments of Rs. 18,000 each, interest charged at 20% p.a. which was included in the annual payments of Rs. 18,000. Depreciation charged by X was 10% p.a. on straight line method.

Calculate cash price and prepare Machinery Account and Y's Account in the books of X.

or

Delhi Co. purchased from Mumbai Co. three machines costing Rs. 40,000 each on the Hire- Purchase System. Payment was to be made Rs. 30,000 down and the remainder in three equal instalments together with interest at 5%. Delhi Co. writes off depreciation @ 20% on the diminishing balance. It paid the instalment due at the end of the first year but could not pay the next.

Give the necessary ledger accounts in the books of both the parties for two years if the hire vendor took possession of all the three machines. The hire vendor spent Rs. 5,800 on getting the machines thoroughly overhauled and sold them for Rs. 70,000.

3. A owned certain patent rights. He granted a licence to B to use such patent rights on royalty basis. Following are the relevant particulars:

Year	I	II	III	IV	V
Minimum rent (Rs.)	1,750	2,000	2,250	2,500	2,500
Royalty Earned (Rs.)	1,500	1,800	1,900	2,750	2,600

The deficiency of any year is to be set off against the excess payable within the next two years. Give journal entries in the books of B.

OR

Give the journal entries in the books of lessee & lessor when the royalty is more than the M.R. & S.Ws of previous year are to be recouped (using imaginary figure)

4. A merchant became insolvent on 1-1-2010 on which date his total asset were Rs. 75,000 and liabilities Rs. 65,000 and he estimated a deficiency of Rs. 20,000 before taking the following items into consideration which were not passed through his account books:

- (1) Interest on his capital of Rs. 25,000 @6% for one year.
- (2) A contingent liability for Rs. 3,000 on bills discounted by 10 him for Rs. 8,000.
- (3) Amount due was wages Rs. 300; as salaries Rs. 600; as rent Rs. 500; as rates and taxes Rs. 1,000.
- (4) A loan of Rs. 5,000 taken from a friend for the marriage of his daughter, and Rs. 2,000 from his wife.
- (5) Prepare a statement of affairs and a deficiency account.

OR

Calculate the amount of preferential and unsecured creditors from the following figures pertaining to an insolvent debtor according to Presidency Towns Insolvency Act and Provincial Insolvency Act.

Sales tax	25,000
Wages of 2 servants for 4 months	800
Income tax	15,000
Wages of 5 labourers for 3 months	3,000
Municipal tax	5,000
Salary of the manager	5,000
4 Month's rent due to landlord	20,000
Salary of 2 clerks for 4 months	2,400

ACCOUNTING AND BOOK KEEPING

STRUCTURE

- 1.0 Learning Objectives and Outcomes
- 1.1 Accounting meaning
- 1.2 Attributes of accounting
- 1.3 Difference between book keeping and accounting
- 1.4 Accounting a Science or Art
- 1.5 Objectives of auditing
- 1.6 Function of auditing
- 1.7 Advantage of auditing
- 1.8 Limitations of auditing
- 1.9 Rules of Accounting Equation
- 1.10 Let Us Sum Up
- 1.11 Glossary
- 1.12 Self Assessment Questions
- 1.13 Lesson End Exercise
- 1.14 Suggested Readings

1.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

- To distinguish between bookkeeping and accounting practices.
- To identify the essential features and characteristics of accounting.

- To understand the purpose and goals of auditing in financial environments.
- To understand and apply the fundamental accounting equation.

Learning Outcomes

- Identify and explain the key objectives of auditing, including verifying accuracy and ensuring compliance.
- Explain how bookkeeping serves as a foundation for accounting.
- Describe the key users of accounting information.

1.1 ACCOUNTING MEANING:

Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the act of making significant summarises

analysis and interpretation of these transactions and events and communicating the results to persons who must make decisions or form judgments.

Accounting is the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.

Definition of Accounting:

“Accounting is the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information” – **American Accounting Association.**

“Accounting is a service activity. Its function is to provide quantitative information primarily financial in nature, about economic activities that is useful in making economic decision in making reasoned choices among alternatives course of action”. – **Accounting Principles Board**

“Accounting is defined the identifying, measuring, recording and communicating of financial information” – **H. Bierman and AR Drebin**

1.2 ATTRIBUTES OF ACCOUNTING

- 1. Identifying the transactions and events:** Accounting identifies transactions and events of a separate entity. A transactions is a particular type of external

event which can be expressed in terms of money and bring changes in the financial position of a business unit.

2. **It is the art of recording business transactions:** All financial transactions should be recorded in the journal or in the books of original entry known as subsidiary books as and when they take place so that a complete record of financial transactions is available.
3. **Art of classifying business transactions:** All entries in the journal or subsidiary books should be classified by posting them to the appropriate ledger accounts to find out at a glance the total effect of all such transactions in a particular account.
4. **All transactions of a business recorded in monetary terms:** If there are certain events which cannot be measured in terms of money, they will not be recorded in financial accounting .
5. **Art of summarising financial transactions:** After recording and classifying financial transactions next stage is to prepare the trial balance and final accounts with a view to ascertaining the profit or loss made during a trading period and the financial position of the business on a particular date.

1.3 DIFFERENCE BETWEEN BOOK KEEPING AND ACCOUNTING

Book keeping	Accounting
The object of book keeping is to prepare original books of accounts , trail balance and final accounts and to maintain systematic records of financial results.	The object of accounting is to record, classify, summarise, analyse and interpret the business transactions and to ascertain operating results and financial position and to communicate to various users.
It has limited scope and is concerned with recording, classifying and summarising of business transactions.	It has a wider scope and covers book-keeping plus analysis and interpretation.

The job of book – keeper is often routine and clerical in nature.	The job of an accountant is analytical in nature.
The book- keeper is not required to have higher level of knowledge than that of an accountant.	The accountant must have higher level of knowledge than that of bookkeeper
It is performed by junior staff.	Accounting work is performed by senior staff.

1.4 ACCOUNTING A SCIENCE OR ART

Accounting is both a science and arts. Science may be defined as a systematised body of knowledge based on certain principles which have universal application. It establishes relationship of cause and effect about any occurrence or happening, scientific knowledge is based on observation, experiments and testing of facts.

Art on the contrary part is the application of knowledge comprising of some accepted theories, principles, rules, concepts and conventions. It help us to achieve our goals and tells the manner in which objective is attained in best possible way.

It has not been possible to develop principles which have universal applicability. Accounting is based on certain concepts and conventions and is subject to some limitations. It is influenced by bias and personal judgment of the accountant.

1.5 OBJECTIVES OF ACCOUNTING

- 1. To ascertain whether the business operations have been profitable or not:** Accounting helps to know whether a business has earned profit or loss during the accounting period. It will give us an idea of efficiency of the business. To determine profit or loss of the accounting period, a trading are profit and loss account is prepared by matching revenue and expired costs.
- 2. To ascertain the financial position:** Balance sheet is prepared to give an idea of the financial position the businessman a particular date. A properly drawn balance sheet gives information relating to the nature and value of assets, the nature and extent of liabilities and whether the enterprise is solvent or not.

- 3. To generate and communicate information to the users:** Accounting records generate and communicate persons in planning, control, evaluation of performance and decision making.

A. CHECK YOUR PROGRESS

FILL UPS

1. Accounting helps to know whether a business has earned _____ during the accounting period.

Ans: profit or loss

2. It gives an idea about the _____ of the business.

Ans: efficiency

3. To determine profit or loss, a _____ account is prepared.

Ans: trading and profit and loss

4. Profit and loss is determined by matching _____.

Ans: revenue and expired costs.

1.6 FUNCTIONS OF ACCOUNTING

1. It keeps systematic record of business transactions post them to the ledger and ultimately to prepare the final accounts.
2. It protects the property of business so that not put on wrong use.
3. It supply the required relevant information about the financial activities of the business to various parties i.e. owners, creditors, investors, government, public etc.
4. It helps in filing income tax return, return for sale tax purposes, etc.
5. It assists the management in planning, evaluation of performance, control and decision making by providing requires information.

1.7 ADVANTAGES OF ACCOUNTING

1. It provides records which will furnish information as and when desired and thus it replaces human memory.
2. It acts as an evidence in court of law to settle a dispute.
3. It helps to ascertain the proper purchase price in case the businessman is interested to sell his business.

4. It facilitates raising loans from lenders by providing them the required financial information.
5. It provides the facility of comparative study of the various aspects of the business such as profits, sales, expenses, etc.

B. CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. Which of the following is a major advantage of accounting?

- A. It increases the number of business transactions
- B. It helps replace human memory by maintaining records
- C. It restricts business growth
- D. It reduces business profits

Answer: B. It helps replace human memory by maintaining records

2. Accounting records can be used as evidence in:

- A. Sales department
- B. Court of law
- C. Advertising agency
- D. Market research

Answer: B. Court of law

3. In case a businessman wants to sell his business, accounting helps to:

- A. Hide business liabilities
- B. Increase the number of buyers
- C. Ascertain proper purchase price
- D. Reduce tax liability

Answer: C. Ascertain proper purchase price

4. How does accounting help in raising loans?

- A. By reducing company's equity
- B. By hiding financial details
- C. By providing required financial information to lenders
- D. By increasing tax benefits

Answer: C. By providing required financial information to lenders

5. Which of the following is made easier due to accounting?

- A. Estimating future weather
- B. Comparative study of business aspects like profits and expenses
- C. Political campaigning
- D. Customer feedback

Answer: B. Comparative study of business aspects like profits and expenses

1.8 LIMITATIONS OF ACCOUNTING

1. It records only monetary transactions.
2. It may not be realistic as accounting statements are prepared by following basic concepts and conventions.
3. It is influenced by personal judgment of the accountant. Accountant may select any method of depreciation, valuation of stock, treatment of deferred revenue expenditure.
4. Profit may be shown in excess by manipulation of accounts by suppressing such costs as depreciation, advertisement and research and development.
5. The Balance Sheet cannot exhibit the true and fair view of state of affairs in the business.

1.9 RULES OF ACCOUNTING EQUATION

1. **Regarding assets:** Increases in assets and debits and decreases in assets are credits.
2. **Regarding Liabilities:** Increases in liabilities are credits and decreases in liabilities are debits.
3. **Capital:** Increases in Capital are credits and decreases in capital are debits.
4. **Expenses:** Increases in expenses are debits and decreases in expenses are credits.
5. **Income:** Increases in income are credits and decreases in income and debits.

1.10 LET US SUM UP

Accounting is the art of recording, classifying and summarising in a significant manner in terms of money transactions. It is helpful in the preparation of financial statements.

1.11 GLOSSARY

- **Assets:** Resources owned by a business that have economic value and can provide future benefits. Example: Cash, machinery, buildings.
- **Liabilities:** Obligations or debts that a business owes to others, usually payable in money, goods, or services. Example: Loans, accounts payable
- **Balance Sheet:** A financial statement that shows the financial position of a business at a specific date, listing its assets, liabilities, and capital. Formula: $\text{Assets} = \text{Liabilities} + \text{Capital}$.
- **Capital:** The owner's claims on the assets of the business after all liabilities have been deducted. Also called owner's equity. Example: Initial investment made by the owner
- **Attributes:** The key characteristics or features that define accounting information, such as relevance, reliability, comparability, and consistency. Example: Financial data should be accurate and useful for decision-making.

1.12 SELF ASSESSMENT QUESTIONS

1. Define Accounting.

2. What are the functions of accounting?

3. Distinguish between Accounting and Book Keeping.

1.13 LESSON END EXERCISE

1. What are the attributes of Accounting?
2. Give limitations of Accounting.

1.14 SUGGESTED READINGS

- Jain, S. P., & Narang, K. L. (Latest ed.). *Advanced Accountancy*. New Delhi: Kalyani Publishers.
- Arihant Experts. (Latest ed.). *Financial Accounting for Competitive Exams*. Meerut: Arihant Publications.
- Editorial Board. (Monthly/Annual Issues). *Pratiyogita Darpan: Commerce & Finance Sections*. Agra: Pratiyogita Darpan Publications.
- Rajasekaran, V., & Lalitha, R. (Latest ed.). *Financial Accounting*. Chennai: Pearson Education.
- Singhal, A., & Roy, M. (Latest ed.). *Fundamentals of Financial Accounting*. Mumbai: Himalaya Publishing House.
- Banerjee, B. (Latest ed.). *Financial Accounting: A Managerial Emphasis*. New Delhi: PHI Learning.

B.com. I Sem**UNIT - I****Course No. 101****Lesson No. 2**

ACCOUNTING PRINCIPLES**STRUCTURE**

- 2.0 Learning Objectives and Outcomes
- 2.1 Accounting principles and policies
- 2.2 Sources of Indian GAAP
- 2.3 Meaning of accounting principles
- 2.4 Characteristics of accounting principles
- 2.5 Accounting concepts
- 2.6 Accounting conventions
- 2.7 Let Us Sum Up
- 2.8 Glossary
- 2.9 Self Assessment Questions
- 2.10 Lesson End Exercise
- 2.11 Suggested Readings

2.0 LEARNING OBJECTIVES AND OUTCOMES**Learning Objectives**

After completing this unit, learners will be able to:

- Understand the basic accounting principles and policies followed in financial reporting.

- Identify the main sources of Indian GAAP (Generally Accepted Accounting Principles)
- Explain the meaning and significance of accounting principles in maintaining consistency and comparability.
- Recognize the key characteristics that make accounting principles effective and universally accepted.

Learning Outcomes

By the end of this unit, learners will be able to:

- Define and differentiate between accounting principles, concepts, and conventions.
- Describe the role and importance of Indian GAAP in financial reporting.
- Apply basic accounting principles and policies to practical accounting problems.
- Interpret financial statements based on accepted accounting norms.

2.1 ACCOUNTING PRINCIPLES AND POLICIES

Accounting is the language of business. To make the language convey the same meaning to all people, accountants all over the world have developed certain rules, procedures and conventions which represent a consensus view by the profession of good accounting practices and procedures and are generally referred to as generally accepted accounting principles (GAAP). The phrase generally accepted accounting principles (GAAP) is a technical accounting term that encompasses the conventions, rules and procedures necessary to define accepted at a particular time. It includes not only broad guidelines of general applications but also detailed practices and procedures. These conventions, rules and procedures provide a standard by which to measure financial presentation.

Thus, GAAPs are common set of accounting principles, standards and procedures that companies use while preparing their financial statement . GAAPs are a combination of authoritative standards (set by policy boards) and simply the commonly

accepted ways of recording and reporting accounting information. GAAPs recognize the importance of reporting transaction and events in accordance with their substance. They originate from a combination of tradition, experience and official decree and require authoritative support and some means of enforcement.

GAAPs are imposed on companies so that investors have a maximum level of consistency in the financial statements they use when analyzing companies for investment purposes. Companies are expected to follow GAAPs rules when reporting their financial data via financial statements.

GAAPs are only a set of standards. There is plenty of room within GAAPs for accountants to distort figures. So, even when a company uses GAAPs, still need to scrutinize its financial statements. Accounting statements are prepared in conformity with these principles in order to place more reliance on them. The need for the common accounting principles becomes more apparent when we contemplate the chaotic conditions that would prevail if every accountant could follow his own principles about the measurement of revenue and expenses.

2.2 SOURCES OF INDIAN GAAPS

The principal sources of Indian GAAPs are:

- (1) Company law
- (2) Accounting standards and related documents of the ICAI.
- (3) SEBI requirements.
- (4) Established conventions.

A. CHECK YOUR PROGRESS
MULTIPLE CHOICE QUESTIONS

1. What is the main objective of GAAP?

- A. To increase tax revenue
- B. To allow flexibility in financial reporting
- C. To ensure consistency and comparability of financial statements
- D. To reduce auditing efforts

Answer: C

2. GAAP is a combination of:

- A. Legal laws and government rules
- B. Authoritative standards and commonly accepted practices
- C. Market trends and investor demands
- D. Business policies and internal guidelines

Answer: B

3. Why are financial statements required to be prepared as per GAAP?

- A. To follow traditional business norms
- B. To confuse competitors
- C. To ensure reliability and standardization in reporting
- D. To reduce the workload of accountants

Answer: C

4. Which of the following is NOT true about GAAP?

- A. It includes broad guidelines and detailed procedures
- B. It is developed only by the government
- C. It provides a standard for financial presentation
- D. It helps investors analyze companies consistently

Answer: B

5. GAAP emphasizes that transactions should be reported in accordance with:

- A. Legal language
- B. Cash flow
- C. Their substance over form
- D. Management's expectations

Answer: C

2.3 MEANING OF ACCOUNTING PRINCIPLES

The term 'principles' refers to fundamental belief or a general truth which once established does not change. It is incorrect to apply the term with respect to accounting which is merely an art involving adaption for the attainment of some useful

results by its applications. Application implies changing nature and hence is contradictory to the meaning of fundamental truth implied by the term principle. To others, the term principles means rule of action or conduct and hence can be aptly applied to rules in accounting. AICPA defined the term principles as a guide to action, a settled ground or basis of conduct or practice. Accounting principles may be defined as those rules of conduct or procedure which are adopted by the accountants universally while recording the accounting transactions. If accounting has to serve its purpose of communicating the results of a business to the outside world, it should be based on certain uniform and scientifically laid down principles. Some accountants prefer to use the term standards instead of using the word principle but accounting principles and accounting standards is not one and the same thing. Accounting principles are guidelines to established standards for sound accounting practices and procedures in reporting the financial status and periodic performance of a business. Accounting standards are written policy documents issued by the government or professional institutes or other regulatory body covering various aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statements.

2.4 CHARACTERISTICS OF ACCOUNTING PRINCIPLES

Following are the main characteristics of accounting principles

1. Accounting principles are manmade so they do not have the authoritativeness as universal principles like the principles of physics, chemistry and other natural sciences. They represent the best possible guidelines based reasons and observations and have been developed by accountants to enhance the usefulness of accounting data in an ever changing society accounting is a social science and is the natural result of economic phenomena.
2. The science of accounting is not in a finished form. It is in the process of evolution; consequently, accounting principles are fast developing. These are influenced by business practices and customs, government agencies and other business groups.
3. The general acceptance of an accounting principle usually depends on how well it meets there criteria: relevance, objectivity and feasibility. A principle is relevant to the extent that it results in information that is useful to those who want to know something about a certain business. A principle is objective to

the extent that the accounting information is not influenced by the personal bias of those who furnish the information. The accounting information given in the financial statements should be free from the personal bias of the persons who have taken part in the preparation of such statement. A principle is feasible to the extent that it can be applied without undue complexity or cost.

Accounting principles can be classified into two categories:

(1) Accounting concepts and (2) accounting conventions.

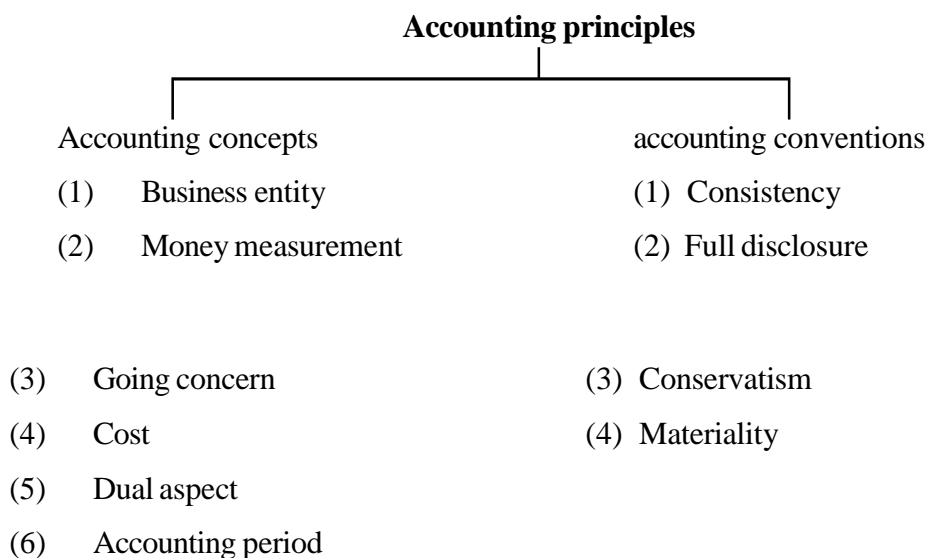
2.5 ACCOUNTING CONCEPTS

Accounting concepts may be considered as postulates i.e., basic assumptions or conditions upon which the science of accounting is based. There is no authoritative list of these concepts but most of the concepts have fairly general support.

2.6 ACCOUNTING CONVENTIONS

The term conventions denote circumstances or traditions which guide the accountant while preparing the accounting statements.

Concepts and conventions are often used interchangeably. The basic difference between them is that concepts are concerned with maintenance of accounts whereas conventions are applicable while preparing financial statements i.e., profit and loss account and balance sheet.



- (7) Matching
- (8) Realization
- (9) Objective evidence
- (10) Accrual

ACCOUNTING CONCEPTS

(1) Business entity concept

This concept implies that a business unit is separate and distinct from the persons who supply capital to it. Irrespective of the form of organization, a business unit has got its own individuality as distinguished from the persons who own or control it. The accounting equation (i.e., $\text{assets} = \text{liabilities} + \text{capital}$) is an expression of the entity concept because it shows that the business itself owns the assets and in turn owes to the various claimants.

Business is kept separate from the proprietor so that transaction of the business may also be recorded with him. In case this concept is not followed affairs of the business will be mixed up with the private affairs of the proprietor and the true picture of the business will not be available. Thus, in the books of sole trader, a firm or a limited company, only business transaction of the sole proprietor, the partners of the firm and the shareholders of the company but their transaction with the business. (i.e., capital provides to the business, goods and amount withdraw from the business for the personal use of the sole trader and the partner of the firm, income tax or life insurance premium paid from the business on the taxable income or life of the proprietor etc.) are recorded so that true financial position and profitability of the may be disclosed. For example, if the proprietor of the business invests Rs. 25,000 into the business, it will be deemed that he has given that much of money to the business as a loan which will be shown as a liability in the books of firm. On receipt of the amount, cash account will be debited and the proprietors' capital account will be credited. Similarly, on withdrawal of the amount from the business for personal use of the proprietor, the proprietor's capital or drawings account will be debited and cash account will be credited.

(2) Money measurement concept

Money is the only practical units of measurement that can be employed of achieve homogeneity of financial data, so accounting records only those transactions which can be expressed in terms of money though quantitative records are also kept.

The advantage of expressing business transaction in term of money is that money serves a common denominator by means of which heterogeneous facts about a business can be expressed in terms of numbers (i.e, money) which are capable of additions and subtractions. It can better, be illustrated by taking the following examples. A business unit has the following assets on December 31, 2013.

Cash in hand and at bank Rs 25,000; sundry debtors Rs 48,500; bills receivables Rs. 6,500; motor cars Rs. 1,11,500; stock Rs. 5,000 tons; furniture 100 chairs and 20 tables; machines & building space 5,000sq. meters; land 10 acres.

The items give in different units measurement cannot be added together to get an idea of the total value of the assets owned by the business. To get an idea of the total value of the assets, all items should be expressed in terms of money as given below:

Cash in hand and at Bank Rs 25,000; Sundry debtors Rs 48,500; Bills receivables Rs. 6,500; Motor cars Rs 1,15,000; Stock Rs 4,00,000; Furniture Rs 5,000; machines Rs 2,50,000; Building Rs 4,40,000; Land Rs 1,00,000; Total Rs. 13,90,000.

The money measurement concept restricts the scope of accounting as it does not record the fact that there is a strike in the factory or the sales manager is not on speaking terms with the production manager. Accounting, therefore, does not give a complete account of the happening a business unit. Money provides a common denominator for measuring butt does not take care of inflation which takes place with the passage of time. Money is expressed in terms of value at the time a financial transaction is recorder in the books. Subsequent changes and the purchasing power of money due to inflation do not affect this amount in the example given above cash in hand and at bank is expressed at the value of 31st march 2014 but the amount of cars, furniture , machines, land and building are in terms of rupees of five years back when they were acquired. The value of rupees of five year back was much more than value 31st march, 2014 because the purchasing power of the rupee has decreased due to inflation. Thus, money measurement concept of accounting and reporting the activities of an enterprise has two major limitations:

- (1) It restricts the scope of accounting because it is not capable of recording transactions which cannot be expressed in terms of money.
- (2) It does not take care of the effects of inflation because it assumes a stability of

the money measurement unit.

Generally, business entity concept and money measurement concept are called fundamental accounting concepts.

(3) Going concern concept

It is assumed that a business unit has a reasonable expectation of continuing business at a profit for an indefinite period of time. A business unit is deemed to be a going concern and not a gone concern. It will continue to operate in the future. Transaction is recorded in the books keeping in view the going concern aspect of the business unit. It is because of this concept that suppliers supply goods and services and other business firms enter into business transactions with the business unit. Suppliers will not supply goods and services and other persons will not have business dealing with the business entity if they have the feeling the concern will be liquidated. This assumption provides much of the justification for recording fixed assets at original cost (i.e., acquisition cost) and depreciating them in a systematic manner without reference to their current realizable value. It is useless to show fixed assets in the balance sheet at their estimated realizable for use in the business values if there is no immediate expectation of selling them. Fixed assets are acquired for use in the business for earning revenues and are not meant for resale, so they are shown at their book values and not at their current realizable values. But when the concern is not a going concern and is to be liquidated, current realizable values of fixed assets become relevant.

Similarly, the going concern concept supports the treatment of prepaid expenses as assets even though they may be virtually unsalable. Prepaid expenses are made assets on the assumption that the business entity will continue in future and the benefit of prepaid expenses will be utilized in future. A less direct effect of the going concern concept is that it lays emphasis on the determination of net income rather than on the valuation of assets. The earning capacity of the business entity is more significant than the market value of its individual assets in judging the overall worth of a business because of this emphasis on the earnings, the accountants directs his attention to the to the proper allocation of incomes and expenses to the current period and does not bother about the market value of fixed assets which will not be sold.

Following are the cases where going concern concept is not valid:

1. When an enterprise was set up for a particular purpose which has been achieved

or to be achieved shortly.

2. When a company is declared sick by BIFR.
3. When an enterprise has been in the grip of severe financial crisis and is expected to wind it shortly.
4. When a receiver or liquidator has been appointed in case of a company which is to be liquidated.

(4) Cost concept

A fundamental concept of accounting, closely related to the going concern concept, is that an asset is recorded in the books at the price paid to acquire it and that this cost is the basis for all subsequent accounting for the asset. This concept does not mean that the asset will always be shown at cost but it means that cost becomes basis for all future accounting for the asset. Asset is recorded at cost at the time of its purchase but is systematically reduced in its value by charging depreciation.

The cost concept has the advantages of bringing objectivity in the accounts. Information given in the financial statement is not influenced by the personal bias or judgment of those who furnish such statements. In the absence of cost concept, assets will be shown at their market values which will depend of the subjective views of persons who furnish financial statements. However, on account of high degree of inflation in the economy in the recent past, the preparation of financial statements on the basis of cost concept has become irrelevant for judging the financial position and ascertaining the profitability of the business entity to overcome the drawback of cost concept, inflation accounting is advocated which makes a provision for recording all items regularly in the financial statement at their current values. But keeping in view the practical difficulties and absence of legal provision for inflation accounting historical cost accounting based on cost concepts still serves as a fair and adequate basis for reporting business performance.

According to this concept, it is possible to remove the cost of fixed assets from the accounts altogether by writing off their cost as depreciation against income even though assets are still in good condition and are being used in the business. As a result of this drawback, secret reserves are created and the auditor may overlook the verification of assets showing zero book value because their accounts will no longer appear in the books.

The cost concept raises another problem. There are some assets which earn income but are not shown in the books of account on account of this concept because no cost has been incurred to acquire such assets. According to *Glautier and Underdown*, “Often the major asset of a highly successful firm is the Knowledge and the skill created as a result of team work and good organization. This asset will not appear in the accounts, since the firm has nothing for it, except in terms of salaries which have been written off against yearly profits. Allied to this problem is the failure in making any mention in the balance sheet of the value of the human assets of the firm”.

(5) Dual aspect concept

This is the basic concept of accounting. According to this concept, every financial transaction involves a two- fold aspect, (a) yielding of a benefit and (b) the giving of that benefit. For example, if a business has acquired an asset, it must have given up some other asset such as cash or the obligation to pay for it in future. Thus, a giver necessarily implies a receiver and a receiver necessarily implies a giver. There must be a double entry to have a complete record of each business transaction, an entry being made in the receiver account and an entry of the same amount in the giving account. The receiving account is termed as debtor and the given account is called creditor. Thus, every debit must have a corresponding credit and vice versa and upon this dual aspect has been raised the whole superstructure of double entry system of accounting. The accounting equation (i.e., assets = equities or liabilities + capital) is based on dual aspect concept. The term assets denotes the resources owned by the business while the term equities denotes the claims of various claimants including the proprietors of the business against the assets. For example, if the business purchases machinery and furniture worth Rs 25,000 and Rs 5,000 respectively out of Rs 40,000 provided by A (the proprietor) of the business, the situation will be as follows:

Assets = equities

Machinery Rs 25,000 + furniture Rs 5,000 + cash Rs 10,000 = capital Rs 40,000

Subsequently, if the business purchases stock worth Rs 8,000 on credit, the position will be as follows:

Machinery Rs 25,000 + furniture Rs 5,000 + cash Rs 10,000 + stock Rs 8,000 = creditor Rs 8,000 + capital Rs 40,000

Thus accounting equation demonstrates the fact that for every debit there is an equivalent credit.

(6) Accounting Period Concept

Truly speaking, the measurement of income or loss of a business entity is relatively simple on a Whole –life basis. A complete and accurate picture of the degree of success achieved by a business unit cannot be obtained until it is liquidated, converts its assets into cash and pays off its debts. On liquidation, it is possible to determine with finality its net income. But the owner, the investors and overall the government, all are impatient and do not want to wait, until the dissolution of the concern, to know what has been the results of the business activities. All these persons are interested in regular reports and accounts at proper intervals to know how things are going? This means that the final accounts must be prepared on a periodic basis rather than waiting till the business is terminated.

Under the going concern concept, it is assumed that a business entity has reasonable expectation of continuing business for an indefinite period of time. This assumption provides much of the justification that the business will not be terminated, so it is reasonable to divide the life of the business into accounting periods so as to be able to know the profit or loss of each such period and the financial position at the end of such a period. Normally, accounting period adopted is one year as it helps to take any corrective action, to pay income tax, to absorb the seasonal fluctuations and for reporting to the outsiders, a period of more than one year reduces the utility of accounting data.

The principle of segregating capital expenditure from revenue expenditure is based on the accounting period concept. The revenue expenditure for a particular period is transferred to the profit and loss account of the period whereas capital expenditure is carried forward to the extent its benefit will be utilized in future accounting periods. Thus, the accounting period concept plays a very important role in determining the income of a particular accounting period. It is also helpful in ascertaining the true and fair financial position of a business entity on a particular date at a particular point of time.

(7) Matching concept

This concept is based on the accounting period concept. The most important objective of running a business is to ascertain profit periodically. The determination of profit of a particular accounting period is essentially a process of matching the revenue recognized during the period and the cost to be allocated to the period to obtain the revenue. It is, thus, a problem of matching revenue and expired costs, the residual amount being the net profit or net loss for the period. Revenue is considered to be earned on the date at which it is realized i.e. on the date when the goods are delivered or services

rendered to the customer even though payment may be received at some future date. Revenue may also be considered to be earned at the time the cash is collected, regardless when the sale is made or service is rendered as is the practice with physicians, attorney and other enterprises in which professional services are revenue. It has little theoretical justification but has the practical advantages of simplicity of operation avoidance of the problem of estimating losses on account of bad debts. It is also advantages from income tax point of view because income tax is paid only on cash income.

Like revenue, all costs incurred during the period are not taken, but only costs related to the accounting period are taken. The purchase price of fixed assets is not taken but only depreciation on fixed assets related to the accounting period is taken. Expenses paid in advance are excluded from the total costs and expenses outstanding are added to the total costs to arrive at the costs attached to the period.

8) Realisation method :

Accounting to this concept revenue is considered as being earned on the date at which it is realised.

9) Objective Concept :

It connotes reliability, trustworthiness and verifiability which mean there is some evidence reported. Entries in accounting records and data reported in financial statement must be based on objectively determine evidence.

10. Accrual Concept

The essence of the accrual concept is that revenue is recognised when it is realised, that is when sale is complete or services are given and it is immaterial whether cash is received or not therefore, outstanding expenses and incomes are taken into consideration while preparing final accounts of a business entity.

B. CHECK YOUR PROGRESS

TRUE OR FALSE

1. Revenues and expenses are recorded when they are earned or incurred, not when cash is received or paid.

Ans: True

2. Revenue is recognized only when it is realized.

Ans: True

3. All expenses incurred are recorded, regardless of whether they relate to the current period.

Ans: False

4. Capital expenditure and revenue expenditure are treated the same under this concept.

Ans: False

5. Every transaction affects two accounts.

Ans: True

6. Going concern concept assumes the business will continue indefinitely.

Ans: True

7. Accounting records only those transactions that can be expressed in monetary terms.

Ans: True

2.6 CONVENTIONS

1. **Convention of consistency:** It means that every enterprise should follow same accounting methods and procedures of recording and reporting business transactions. The development of international and national accounting standards is due to the convention of consistency.
2. **Convention of full disclosure:** All accounting statements should be honestly prepared and to that end full disclosure of all significant information should be

made. All information which is of material interest to proprietors, creditors and investors should be disclosed in accounting statement.

3. **Convention of prudence:** Conservation means taking the gloomy view of a situation. It is a policy of caution or playing safe and had its origin as a safeguard against possible losses in a world of uncertainty. It compels the businessman to wear a risk proof jacket. The working rule is to anticipate no profits but provide for all possible losses.
4. **Convention of materiality:** An accounting concept according to which all relatively important and relevant items i.e., items, the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

2.7 LET US SUM UP

GAAP are set of standards and these standards are prepared in conformity with these principles in order to place more reliance on them. These principles are manmade so they do not have the authentativeness as universal principles like the principles of Physics, Chemistry and other natural sciences.

2.8 GLOSSARY

- **Dual Concept:** It states that every accounting transaction has two effects – one debit and one credit – ensuring the accounting equation ($\text{Assets} = \text{Liabilities} + \text{Capital}$) remains balanced.
- **Conservatism:** An accounting convention that advises anticipating future losses but not future gains. It ensures that assets and income are not overstated, and liabilities and expenses are not understated.
- **Prudence:** It is closely related to conservatism, it requires caution when making accounting judgments.
- **Materiality:** This principle states that all significant (material) items must be properly reported in financial statements.

2.9 SELF ASSESSMENT QUESTIONS

1. What is GAAP ?

2. Give Accounting Concepts.

3. What is convention of full disclosure?

2.10 LESSON END EXERCISE

1. What is money measurement concept?
2. What is convention of prudence?
3. Explain in brief accounting period concept.

2.11 SUGESTED READINGS

- 3 Jain, S. P., & Narang, K. L. (Latest ed.). *Advanced Accountancy*. New Delhi: Kalyani Publishers.
- 4 Arihant Experts. (Latest ed.). *Financial Accounting for Competitive Exams*. Meerut: Arihant Publications.
- 5 Editorial Board. (Monthly/Annual Issues). *Pratiyogita Darpan: Commerce & Finance Sections*. Agra: Pratiyogita Darpan Publications.
- 6 Rajasekaran, V., & Lalitha, R. (Latest ed.). *Financial Accounting*. Chennai: Pearson Education.
- 7 Singhal, A., & Roy, M. (Latest ed.). *Fundamentals of Financial Accounting*. Mumbai: Himalaya Publishing House.

B.com. I Sem	UNIT - I
Course No. 101	Lesson No. 3
ACCOUNTING STANDARD BOARD	

STRUCTURE

- 3.0 Learning Objectives and Outcomes
- 3.1 Accounting standard and IFRS
- 3.2 Formation of accounting standard board
- 3.3 Objectives of accounting standard board
- 3.4 Functions of accounting standard board
- 3.5 Scope of Accounting Standard Board
- 3.6 Accounting Standard in detail
- 3.7 Meaning of IFRS
- 3.8 Let Us Sum Up
- 3.9 Glossary
- 3.10 Self Assessment Questions
- 3.11 Lesson End Exercise
- 3.12 Suggested Readings

3.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

- Understand the purpose and significance of Accounting Standards and IFRS in financial reporting.
- Understand the key functions and responsibilities of the ASB in the standard-setting process.
- Grasp the concept, purpose, and global significance of International Financial Reporting Standards.
- Explain the ASB's role in formulating, reviewing, and updating Accounting Standards.

Learning Outcomes

- Analyze the impact of adopting IFRS on financial reporting practices.
- Delve into specific Accounting Standards to understand their application and implications.
- Discuss how the ASB provides guidance and interpretations to ensure consistent application of standards.

3.1 ACCOUNTING STANDARDS AND IFRS

Accounting is the language of business. To make the language convey the same meaning to all people, accountants all over the world have developed certain rules, procedures and convention which represent a consensus view by the profession of good accounting practices and procedures and are generally referred to as generally accepted accounting principles (GAAP). Accounting statement is prepared in conformity with these principles in order to place more reliance on them. The need for the common accounting principles becomes more apparent when we contemplate the chaotic conditions that would prevail if every accountant could follow his own principles about the measurement of revenue and expenses.

To maintain uniformity in accounting principles throughout the world, international accounting standards committee (IASC) came into being on 29th June, 1973 when 16 accounting bodies from nine nations (i.e., U.S.A, Canada, U.K, Australia, France, Germany, Japan, Mexico and Netherlands) signed the agreement and constitution for its formation. The committee's headquarters are at London. A revised agreement and constitution was signed in October, 1997.

The objectives of the committee (i.e., IASC) as set out in paragraph 1 of the 1977 agreement are to formulate and publish in the public interest, standards to be observed in presentation of audited financial statements and to promote their world-wide acceptance and observance. The development of international accounting standards will facilitate international accounting understanding and a smooth flow of international investments.

By the same agreement, the members agree to support the objectives as set out in by undertaking the following obligations:

- (a) To support the standards promulgated by the committee;
- (b) To use their best endeavors;

- (1) To ensure that published financial statements comply with these standards and that there is disclosure of the extent to which they do not and to persuade government, the authorities controlling securities markets and the industrial and business community that published statements should comply with these standards;
 - (2) To ensure (a) that the auditors satisfy themselves that the financial statements comply with these standards that the facts of non-compliance is disclosed in the financial statements, (b) that in the event of non-compliance disclosure reference in the audit report;
 - (3) To ensure that, as soon as practicable appropriate action is taken in respect of auditors whose audit reports do not meet the requirements of (2) above:
- (c) To seek to secure similar general acceptance and observance of these standards internationally.

The committee (i.e., IASC) makes a choice of the subjects on which uniformity or standardisation is required. it prepare the draft of a standard practice to be adopted in respect of the presentation of the financial information in regard to the subject selected, circulates the draft among the member bodies to elicit their views and then finalises the draft (which becomes international accounting standards on the subject selected) after taking into consideration the views, of all bodies. The final draft approved known as standard is published for adoption by the members of the international federation of accountants (i.e., IFAC) in their respective countries from the date notified in the international accounting standards.

International accounting standards do not have any statutory authority, so they do not acquire a compulsiveness associated with legislation. They do not impose any legal obligation on companies preparing financial statements for presentation to shareholders to adopt the same. They acquire a persuasive value of persuading professionals i.e. chartered accountants to see that these standards are adhered to in the preparation of financial statements.

The accounting standards already published in many countries keep in view local regulations and customs and as a result sometimes differ in form and contents. IASC takes note of accounting standards already issued and in the light of such knowledge produces an international accounting standard for worldwide acceptance

because one of the objective of the formation of IASC was to bring uniformity as far as possible in the diverse accounting standards and accounting policies at present in use in different countries.

Accounting information should be reliable in use so that users of accounting information may be able to rely on some basic assumptions about the quality of accounting information produced by accountants. But in practice the accounting profession has failed to give reliable information to investors about the true state of affairs of a number of celebrated investors about the true state of affairs of a number of celebrated companies. Consequently, the need for international accounting standards has become imperative. To quote *Glautier, Underdown and Clark*, “Although, accountants have been able to formulate their own conventions about what is ‘true and fair’, their interpretation of truth and fairness has not seemed convincing to the public. In the wake of public concern and the fear that governments might intervene to impose a measure of state control in the affairs of the profession, the pressure for standardisation has become overwhelming”.

In all disciplines, theories are developed in historical continuity. Same is the case with accounting. Accounting is not in a finished form; it is the process of evolution. Its environment has undergone vast changes in the last five decades and an accelerating rate of changes is expected in the future. One thought leads to another thought. Where we are today depends to a great extent on where we were yesterday. In the light of this, it is expected that the international accounting standards issued by IASC will undergo revision and a greater degree of sophistication may be brought in accounting standards. It is all the more necessary with the development of multinational and international business enterprises which has given impetus to international cooperation in the setting up of international accounting standards to maintain uniformity in accounting principles to be observed in the preparation of financial statements throughout the world to make them sophisticated and reliable.

International accounting standards are being used as national standards in some developing countries such as Pakistan, Malaysia, Malawi, Singapore and Zimbabwe. These standards are also forming the basis of research for national standards in some countries as India, Yugoslavia, Egypt, Nigeria and Kenya.

IASC is permitting alternatives in many areas of reporting practice, but the board of the IASC believes that the time is right to reduce the alternatives. As a step in this direction, the board set up a special steering committee in March, 1987 to find

ways of reducing or eliminating alternatives. If all countries follow the policy, as being followed in U.K and some other countries that departures from the international standards be disclosed in the financial statements, international accounting standards will be harmonised throughout the world and the real purpose of developing IAS will be achieved.

Approval of the international accounting standards, now referred to as international financial reporting standard i.e.; IFRS is the responsibility of the IASB (i.e, international accounting standard board). Out of the international accounting standards issued so far, some have been superseded while some have been revised.

International accounting standards committee now known as IASB has laid down certain standards regarding the following accounting matters a list of which is given as under:-

- | | |
|--------|---|
| IAS 1 | Presentation of financial statements |
| IAS 2 | Inventories |
| IAS 3 | No longer effective (Replaced by IAS – 27 &28) |
| IAS 4 | Withdrawn (Replaced by IAS – 16 , 22 & 38) |
| IAS 5 | No longer effective (Replaced by IAS15) |
| IAS 7 | Cash flow statements |
| IAS 8 | Profit and loss for the period, fundamental errors and changes in accounting policies |
| IAS 9 | Research and development costs is superseded by IAS 38, effective from 1-7-99 |
| IAS 10 | Events after the balance sheet date |
| | |
| IAS 11 | Construction contracts (Revised) |
| IAS 12 | Income taxes |
| IAS 13 | No longer effective (Replaced by IAS – 1) |

IAS 14	Segment reporting
IAS 15	Information reflecting the effect of changing prices
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employment benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates (Revised)
IAS 22	Business combinations
IAS23	Borrowing costs
IAS24	Related party disclosures
IAS25	Accounting for investment
IAS26	Accounting and reporting by retirement benefit plans
IAS27	Consolidated financial statements and accounting for investments in subsidiaries
IAS28	Accounting for investments in associates
IAS29	Financial reporting in hyper inflationary economies
IAS30	Disclosures' in financial statements of bank and similar financial institution
IAS31	Financial reporting of interest in joint ventures
IAS32	Financial instruments: disclosure and presentation
IAS33	Earning per sharing
IAS34	Interim financial reporting
IAS35	Discontinuing operations (1-1-99)
IAS36	Impairment of assets
IAS37	Provisions, contingent liabilities & contingent assets

IAS38	Intangible assets
IAS39	Financial instruments: Recognition and measurement.
IAS40	Investment property
IAS41	Agriculture
IFRS1	First time adoption of international reporting standards
IFRS2	Shared based payment
IFRS3	Business combinations
IFRS4	Insurance contracts
IFRS5	Non-current assets held for sale and discontinued operations
IFRS6	Exploration for and evaluation of mineral resources
IFRS7	Financial instruments: disclosures
IFRS8	Operating segments

INDIAN AND INTERNATIONAL ACCOUNTING STANDARDS

The institute of Chartered Accountants of India being the premier accounting body in India has tried to improve its accounting and auditing standards continuously in the country in the last four decades. In 1964, the Institute issued its Statements of Auditing Practices to explain to explain the generally accepted auditing practices. Many Statements have since been issued by the institute from time to time to lay emphasis on important accounting matters however the most important step in developing accounting standards in the country has been setting up of an Accounting Standards Boards in 1977. Important function of this Board is to formulate accounting standards sot that such standards will be established by the Council of the Institute of chartered Accountings. It has been made by the Institute that while formulating the accounting standards, the accounting Standards (ASB) will keep in view customs, usages, applicable laws and the business environments in India and the Institute of Cost and Works Accountants of India and International Accounting Standards issued by the International Accounting Standards Committee. It is Gratifying to note that the Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India are both members of International Accounting Standards Committee. This development will go a long way in the uniform

adoption of International Accounting Standards in the Country. The standards formulated by Accounting Standards board are initially Recommendatory in nature, but many organisations in the corporate sector have adopted these standards voluntarily.

In the formulation and finalisation of accounting standards, the Accounting Standards Board seeks the views and guidance of industrial concerns, governments and other interested parties. In this connection, the Board organised a workshop in September, 1983 to seek the guidance of various interested bodies and groups like the Chambers of Commerce and Industry, Central Board of Direct Taxes, Comptroller and Auditor General of India and Others on the Uniform adoption of standards in the country. It was decided that the initially accounting standards should be made applicable to the public section companies, private sectors companies listed on a stock exchange and large borrowers of funds from financial institutions and banks. It was also decided that there should be a recommendatory period of three years for an accounting standards to be issued in future so that the users may have sufficient time for the assimilation and implementation of standards.

The establishment of the Accounting Standards board (ASB) itself marked a commendable effort by the Institute of the Chartered Accountants in its endeavor to formulate and harmonise accounting practices and has played a significant role in improving corporate practices, but it has not come up to the expectations of several users of financial statements. To quote **Arijit Mukherji**; the first set of accounting standards represents a commendable efforts in this direction But inconsistencies remain and the recommendations have often been guided by extraneous considerations. An Effort must be made to simplify and revise accounting standards to take accounts closer to the real world and make them easier for laymen to understand. Standardisation is not a panacea for all accounting problems. In formulating more accurate, consistent and relevant accounting standards, the ASB must be bold enough to challenge the establishment and announce the independence of the profession.”

A. CHECK YOUR PROGRESS
MULTIPLE CHOICE QUESTIONS

1. The ICAI first issued Statements of Auditing Practices in:

- A. 1960
- B. 1964
- C. 1977
- D. 1983

Answer: 1964

2. In which year was the Accounting Standards Board (ASB) set up by ICAI?

- A. 1973
- B. 1975
- C. 1977
- D. 1979

Answer: 1977

3. Which factors does the ASB keep in view while formulating standards?

- A. Only international standards
- B. Only Indian customs and laws
- C. Both A and B plus professional bodies
- D. None of the above

Answer: Both A and B plus professional bodies

4. Which Indian professional organisation is also a member of the International Accounting Standards Committee?

- A. Institute of Company Secretaries of India
- B. ICAI
- C. ICWAI
- D. Institute of Bankers

Answer: C. ICWAI

5. Initially, ASB's standards are:

- A. Mandatory by law
- B. Voluntary till corporate adoption
- C. Recommendatory in nature
- D. Only for government bodies

Answer: C. Recommendatory in nature

6. The ASB's 1983 workshop participants included all EXCEPT:

- A. CAG
- B. CBDT
- C. Chambers of Commerce & Industry
- D. State Governments

Answer: D. State Governments

APPLICABILITY OF ACCOUNTING STANDARDS FORMULATED BY

ASB w.e.f 1-4-2008

	Accounting Standard	Applicability to Level- I Enterprise	Applicability to Level- II Enterprise	Applicability to Level- III Enterprise
No.	Name			
AS 1	Disclosure of Accounting Policies	Yes	Yes	Yes
AS 2	Valuation of Inventories	Yes	Yes	Yes
AS 4	Cash Flow Statement	Yes	N.A	N.A
AS 5	Contingencies & Events occurring After the balance Sheet Date	Yes	Yes	Yes
AS 5	Net profit or loss for the period prior period items and changes in accounting policies	Yes	Yes	Yes

AS6	Depreciation accounting	Yes	Yes	Yes
AS7	Construction accounting	Yes	Yes	Yes
AS 8	Accounting for research and development	Yes	Yes	Yes
AS 9	Revenue recognition	Yes	Yes	Yes

AS 10	Accounting for fixed assets	Yes	Yes	Yes
AS 11	The effects of changes in foreign exchange rates	Yes	Yes	Yes
AS 12	Accounting for government grants	Yes	Yes	Yes
AS 13	Accounting for investments	Yes	Yes	Yes
AS 14	Accounting for amalgamation	Yes	Yes	Yes
AS 15	Employee benefits (revised 2005)	Yes	Yes	Yes
AS 16	Borrowing costs	Yes	Yes	Yes
AS 17	Segment reporting	yes	N.A	N.A
AS 18	Related party disclosures	Yes	yes	Yes
AS 19	Leases	yes	Yes Except para 22 (c),22 (e), 22 (f), 25(a), 25(b), 25(e), 37 (a), 37(f), 37(g), 46(b), 46(d), 46(e)	Yes Except para 22 (c), 22 (e), 22 (f), 25(a), 25(b), 25(e), 37 (a), 37(f), 37(g), 46(b), 46(d), 46(e)
AS 20	Earnings per share		Yes Except disclosure of diluted EPS	Yes Except disclosure of diluted EPS

AS 21	Consolidated financial statements *	Yes	Yes	Yes
AS 22	Accounting for taxes on income	Yes	Yes	Yes
AS 23	Accounting for investments in consolidated financial statements*	Yes	Yes	Yes

AS 24	Discounting operations	yes	N.A	N.A
AS 25	Interim financial reporting	yes	N.A	N.A
AS 26	Intangible assets	Yes	Yes	Yes
AS 27	Financial reporting of interests in joint ventures *	Yes	Yes	Yes
AS 28	Impairment of assets	Yes	Yes	Yes
AS 29	Provisions, contingent liabilities and contingent assets	Yes	Yes Except para 66,67	Yes Except para 66,67
AS 30	Financial instruments : recognition and measurement	Yes (w.e.f 1-4-11)	Yes (w.e.f 1-4-11)	Yes (w.e.f 1-4-11)
AS 31	Financial instruments : presentation	Yes (w.e.f 1-4-11)	Yes (w.e.f 1-4-11)	Yes (w.e.f 1-4-11)
AS 32	Financial instruments - disclosures	Yes (w.e.f 1-4-11)	Yes (w.e.f 1-4-11)	Yes (w.e.f 1-4-11)

Note : More accounting standards are under finalisation and some accounting standards are under revision.

Categorisation of enterprises for ascertaining applicability of accounting standards

Level –I Enterprises		Level –II Enterprises		Level –III Enterprises
<input type="checkbox"/>	Enterprises whose equity or debt securities are listed whether in India or outside India		-	
<input type="checkbox"/>	Enterprises which are in the process of listing their equity or debt securities as evidenced by BOD resolution in this regard		-	
<input type="checkbox"/>	Banks including co-operative banks		-	
<input type="checkbox"/>	Financial institutions		-	

<input type="checkbox"/>	Enterprises carrying on insurance business		-	Enterprises which are not covered under level –I and Level –II are considered as level III enterprises
<input type="checkbox"/>	All commercial, industrial and business reporting enterprises, whose turnover excluding other income for the immediately preceding accounting period exceeds Rs 50 crores (based on audited results)	<input type="checkbox"/>	All commercial , industrial and business reporting enterprises, whose turnover excluding other income for the immediately preceding accounting period exceeds Rs 40 crores but does not exceed Rs 50 crores(based on audited results)	
<input type="checkbox"/>	All commercial, industrial and business reporting enterprises having borrowing including public deposits exceeds Rs 10 crores (at any time during the accounting period)	<input checked="" type="checkbox"/>	All commercial, industrial and business reporting enterprises having borrowing including public deposits exceeds Rs 1 crore but does not exceed Rs 10 crores (at any time during the accounting period)	
<input checked="" type="checkbox"/>	Holding and subsidiary enterprises of above. (relationship at any point during the accounting period)	<input checked="" type="checkbox"/>	Holding and subsidiary enterprises of above. (relationship at any point during the accounting period)	

Special points

Enterprises not disclosing certain information pursuant to relaxations/ exemptions to level –II or level -III	Enterprises should disclose the fact in notes to accounts
Enterprises covered under level – I, subsequently ceases to be covered under level -I	Such enterprises continue to be considered as level- I enterprises for compliance of accounting standards unless cessation is for 2 consecutive years
Similar rule for level-II and level –III enterprises will continue to be considered at same level if subsequently not covered/ moved to lower level. Will be considered at higher level if subsequently moves to higher level.	

Enterprises not covered under level –I, Subsequently covered	Compliance as level–I enterprises becomes mandatory from current period. However, previous year figures need not be disclosed.
Similarly rule for level –II and level- III Enterprises.	
Position of Revised AS: 7	AS: 7 (Revised 2002) is applicable for all contracts entered on or after 1-4- 2003.
Position of AS: 8 Withdrawn	AS:8 withdrawn from the date AS: 26 Becomes mandatory for the concerned enterprise. Since AS: 26 has become mandatory for certain enterprises w.e.f 1-4- 2003 and to all enterprises w.e.f 1-4- 2004, accordingly AS: 8 Stands withdrawn from 1-4-2004 for all enterprises.
Position of Revised AS: 11	AS: 11 (Revised 2003) is applicable w.e.f 1-4- 2004.
*Position of Revised AS: 21, 23 & 27	Applicable only if CFS is prepared by an enterprise whether for compliance of statue, compliance of regulator, voluntarily (Presently the compulsion is only as per SEBI under listing agreement)

3.2 FORMATION OF THE ACCOUNTING STANDARDS BOARD

The institute of chartered accountants of India (ICAI), recognising the need to harmonise the diverse accounting policies and practice in use in India, constituted the accounting standards board (ASB) On 21st April, 1977.

The composition of the ASB is fairly broad based and ensures participation of all interest groups in the standard setting process. Apart from the elected members of the council of the ICAI nominated on the ASB, the following are represented on the ASB.

1. Nominee of the central government representing the department of company affairs on the council of the ICAI.
2. Nominee of the central government representing the offices of the comptroller

and auditor general of India on the council of the ICAI.

3. Nominee of the central government representing the central board of direct taxes in the council of the ICAI.
4. Representative of the institute of cost and works accountants of India.
5. Representative of the Institute of company secretaries of India.
6. Representative of industry associations (1 from associated chambers of commerce and industry (ASSOCHAM), 1 From confederation of India industry (CII) and 1 from federation of Indian chambers of commerce and industry (FICCI).
7. Representative of RBI.
8. Representative of SEBI
9. Representative of controller general of accounts.
10. Representative of central board of excise and customs.
11. Representative of academic institutions (1 from universities and 1 from Indian institutes of management)
12. Representatives of financial institutions.
13. Eminent professional's co-opted by the ICAI (They may be in practice or in industry, government, education, etc.)
14. Chairman of the research committee and the chairman of the expert advisory committee of the ICAI, if they are not otherwise members of the accounting standards board.
15. Representatives of any other body, as considered appropriate by the ICAI.

B. CHECK YOUR PROGRESS

FILL UPS

1. The Accounting Standards Board (ASB) was constituted by the ICAI on _____.

Ans: 21st April, 1977

2. One of the members of ASB is a nominee from the Central Government representing the _____.

Ans: Department of Company Affairs.

3. Another representative from the Central Government on the ASB comes from the office of the _____ of India.

Ans: Comptroller and Auditor General (CAG)

4. The ASB also includes a nominee of the _____.

Ans: Central Board of Direct Taxes (CBDT)

5. A representative from the _____ is included in ASB.

Ans: ICWAI

3.3 OBJECTIVES & FUNCTIONS OF THE ACCOUNTING STANDARDS BOARD

Following are the objectives of the accounting standards board.

1. To conceive and suggest areas in which accounting standards need to be developed.
2. To formulate accounting standards with a view to assisting the council of the ICAI in evolving and establishing accounting standards in india.
3. To examine how far the relevant international accounting standard/international financial reporting standard.
4. To review, at regular intervals, the accounting standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.
5. To provide, from time to time, interpretations and guidance accounting standards.
6. To carry out such other functions relating to accounting standards.

3.4 FUNCTIONS OF ASB

Important function of the ASB is to formulate accounting standards so that such standards may be established by the ICAI in India. While formulating the accounting standards, the ASB will take into consideration the applicable laws, customs, usages and business environment prevailing in India.

The ICAI, being a full-fledged member of the international federation of accountants (IFAC), is expected, inter alia, to actively promote the international accounting standards board (IASB). Will give due consideration to international accounting standards (IAS) issued by the international accounting standards committee (Predecessor body to IASB) or international financial reporting standards (IFRS) issued by the IASB, the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

The accounting standards are issued under the authority of the council of the ICAI. The ASB has also been entrusted with the responsibility of propagating the accounting standards and of persuading the concerned parties to adopt them in the preparation and presentation of financial statements. The ASB will provide interpretations and guidance on issues arising from accounting standards. The ASB will also review the accounting standards at periodical intervals and, if necessary, revise the same.

General purpose financial statements

1. For discharging its functions, the ASB will keep in view the purposes and limitations of financial statements and the attest function of the auditors. The ASB will enumerate and describe the basic concept to which accounting principles should be oriented and state the accounting principles to which the practices and procedures should conform.
2. The ASB will clarify the terms commonly used in financial statements and suggest improvements in the terminology wherever necessary. The ASB will examine the various current alternative practices in vogue and endeavor to eliminate or reduce alternatives within the bounds of rationality.

Accounting standards are designed to apply to the general purpose financial statements and other financial reporting, which are subject to the attest function of the members of the ICAI. Accounting standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, irrespective of whether it is profit oriented or it is established for charitable or religious purposes. Accounting standards will not, however, apply to enterprises only carrying on the activities which are not of commercial, industrial or business nature, e.g. an activity of collecting donations and giving them to flood affected people.

3.5 SCOPE OF ACCOUNTING STANDARDS

1. Efforts will be made to issue Accounting Standards which are in conformity with the provision of the applicable laws, customs, usages and business environment in India. However, if a particular Accounting standard is found to be not in conformity with law, the provisions of the said law will prevail and the financial statements shall be prepared in conformity with such law.
2. Accounting standards are intended to apply only to items which are material. Any limitations with regard to the applicability of a specific accounting standard will be clear by the ICAI from time to time. The date from which a particular standard will come into effect, as well as the class of enterprises to which it will apply will also be specified by the ICAI.
3. The institute will use its best endeavors to persuade the Government, appropriate authorities, industrial and business community to adopt the accounting standards in order to achieve uniformity in preparation and presentation of financial statements.
4. The ASB may consider any issue requiring interpretation on any accounting standard. Interpretations are the same as that of accounting standard to which it relates.

3.6 ACCOUNTING STANDARDS

1. **AS-1 Disclosure of Accounting Policies:** It refers to the specific accounting Principles and Materials adopted by an enterprise in applying these principle in preparation and presentation of financial statements. Objective of this standard is to ensure disclosure of significant accounting principles and policies and changes made there in preparation of financial statements for meaningful use.
2. **AS-2 Valuation of Inventory (Revised):** It is revised on 1-4-1999. The standard applies to inventories comprising finished goods, work in progress and raw materials. The standard provides the inventories should be valued at cost or net realised value whichever is lower.
3. **AS-3 Cash from Statements:** This standard requires certain entries to report

cash generation and utilisation under appropriate classification and relevant disclosures.

4. AS-4 Contingencies and event occurring after the Balance Sheet date:

Both favourable as well as unfavourable that occurs between the Balance sheet and the date on which the financial statements are approved contingent gains if any, not to be recognised in the financial statements. Contingent loss, on the other hand should be disclosed if above conditions are not met, unless the possibility of loss is remote. Proposed or declared dividend for the period should be adjusted.

5. AS-5 Net Profit/Cost for the Period, Prior Period items and changes in Accounting Policies:

All items of income and expenses which are recognised in a period should be included in determination of profit or loss for the period unless an accounting standard requires or permit otherwise. Separate disclosure of prior period item should be made so that its impact on current year's profit is known.

6. AS-6 deals with depreciation accounting and applies to all depreciable assets, except the following items to which special consideration apply:

- i. Forests, plantations and similar regenerative natural resources.
- ii. Wasting assets
- iii. Expenditure on research and development
- iv. Goodwill
- v. Livestock

Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed is necessary for appreciating the view presented in the financial statements of the enterprise.

The amount of depreciation to be charged in an accounting period is usually based on the following three factors:

- i. Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued.
- ii. Expected useful life of the asset.
- iii. Estimated residual value of the depreciable asset.

Cost of a depreciable asset is the total cost spent in connection with its

acquisition, installation and commissioning as well as incurred for improvement of the depreciable asset.

Estimated useful life of a depreciable asset is the period over which it is expected to be used by the enterprise. Generally useful life of a depreciable asset is shorter than its physical life is:

- i. Predetermined by legal or contractual limits;
- ii. Directly governed by extraction or consumption;
- iii. Depend on the extent of use and physical deterioration on account of wear and tear;
- iv. Reduced by obsolescence.

7. Accounting Standard 7 (Revised)—Construction Contracts

This revised standard comes into effect in respect of all contracts emerged into during the accounting period commencing on or after 1-4-2003 and is mandatory in nature from that date

AS-7 deals with accounting for construction contracts in the financial statements of contractors. This accounting standard does not apply to contractees and would not be applicable for the construction projects undertaken by the enterprise as a commercial venture in the nature of production activities. Important problem relating to accounting for construction contracts is the allocation of revenues and related costs to accounting periods over the duration of the contract

In accounting for construction contracts in financial statements, either the percentage of completion method or the completed contract method may be used. When a contractor uses a particular method of accounting for a contract, then the same method should be followed for all other contracts which meet similar criteria. However, the revised standard has eliminated the option of completed contract method for recognising the revenue and advocates only percentage of completion method.

As per this standard, profit in case of fixed price contracts normally should not be recognised unless the work on a contract has progressed to a reasonable extent. While recognising the profit under percentage of completion method, an appropriate allowance or future unforeseeable factors should be made on either a specific or a percentage basis.

The costs included in the amount at which construction contract work should comprise those costs that relate directly to a specific contract and those that are attributable to the contract activity in general and can be allocated to specific contracts.

A foreseeable loss on the entire contract should be provided for in the financial statements irrespective of the amount of work done and the method of accounting followed.

An enterprise should disclose (a) the amount of contract revenue recognised as revenue in the period; (b) the methods used to determine the contract revenue recognised in that period; and (c) the Methods used to determine the stage of completion of contract in progress.

An enterprise should also disclose contracts in progress at the reporting date: (a) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date; (b) the amount of advances received; and (c) the amount of retentions.

8. Accounting Standard 9—Revenue Recognition

AS-9 deals with bases for recognition of revenue in the statement of profit and loss of an enterprise. The standard is concerned with the recognition of revenue arising in the course of ordinary activities of the enterprise from the sale of goods, the rendering of the services and the use by others of enterprise resources yielding interest, royalties and dividends. This standard does not deal with the following aspects of revenue recognition to which special considerations apply:

- (i) Revenue arising from construction contracts.
- (ii) Revenue arising from hire-purchase and lease agreements.
- (iii) Revenue arising from government grants and other similar subsidies.
- (iv) Revenue of insurance companies arising from insurance contracts.

As per AS 10, the following information should be disclosed in the financial statements:

- (i) gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other

movements;

- (ii) expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- (iii) revalued amount substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated -at revalued amount.

9. Accounting Standard 11—Accounting for the Effects of Changes in Foreign Exchange Rates

AS-11 is applied by an enterprise in accounting for transactions in foreign currencies and in translating the financial statements of foreign branches for inclusion in the financial statements of the enterprise. This statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts. As per this standard, a transaction in a foreign currency should be recorded in the reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency prevailing at the date of the transaction. This exchange rate is known as spot rate. For practical reasons, a rate that approximates the actual rate is often used, for example, an average rate for all transactions during the week or month in which the transactions occur. At each balance sheet date, the assets and liabilities should be converted into rupees at the closing exchange rate.

Exchange differences arising on foreign currency transactions should be recognised as income or as expense in the period in which they arise.

10. Accounting Standard 12—Accounting for Government Grants

AS12 deals with accounting for government grants such as subsidies, cash incentives, duty drawbacks etc. and has come into force with effect from April, 1992. This standard does not deal with government assistance (such as tax holiday in backward area) other than in the form of government grants. Government participation in the ownership of the enterprise is also not covered in this standard. According to AS-12, government grants should not be recognised until there is reasonable assurance that the enterprise will comply with the conditions attached to them and the grants will be received. Mere receipt of a grant is not necessarily conclusive evidence that condition

attaching to the grant has been or will be fulfilled.

Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement; Such grants should either be shown separately under 'other income' or deducted in reporting the related expense. If government grants become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period, then such grants are recognized in the income statement of the period in which they become receivable, as extraordinary items, if appropriate. If government grants take the form of non-monetary assets, such as land or other resources given at concessional rates, then such assets as per this standard should be recorded at their acquisition cost. Non-monetary assets given free of cost should be recorded at nominal value. Government grants that become refundable because of non-fulfillment of the conditions attached to those grants should be accounted for as an extraordinary item. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant.

11. Accounting Standard 13—Accounting for Investments

AS-13 deals with accounting for investments in the financial statements of enterprises and related disclosure requirements. AS-13 defines investments as below:

"Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Assets held as stock-in-trade are non-investments.

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

According to AS-13, an enterprise should disclose current investments and

long term investments distinctly in its financial statements. The cost of an investment should include acquisition charges such as brokerage, fees and duties. An enterprise holding investment properties should treat them as long term investments. Current investments should be carried in the financial statements at the lower of cost and fair value determined on an individual investment basis or by category of investment, but not on overall basis. Long term investments should be carried in the financial statements at cost. On sale of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement.

12. Accounting Standard 14—Accounting for Amalgamations

AS-14 deals with accounting for amalgamations. According to this standard, an amalgamation may be either an amalgamation in the nature of merger or an amalgamation in the nature of purchase. An amalgamation is considered to be an amalgamation in the nature of merger when all the following conditions are satisfied:

- i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held immediately before the amalgamation, by the transferee company or subsidiaries or their nominees) become equity shareholders of the transferor company by virtue of the amalgamation.
- iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferor company wholly by the issue of equity shares in the transferee company except that cash may be paid in respect of any fractional shares.
- iv) The business of the transferor company is intended to be carried on, after amalgamation, by the transferee company.
- v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in financial statements of the transferor company except to ensure uniformity of accounting policies.

An amalgamation should be considered to be an amalgamation in the nature of purchase when any one or more of the conditions specified in case of amalgamation in nature of merger is not satisfied.

Pooling of interests method is applied in case of amalgamation in the nature of merger and purchase method is applied in case of amalgamation in the nature of purchase.

13. Accounting Standard 15—Employee Benefits (Revised 2005)

AS-15 deals with accounting for retirement benefits and is mandatory in nature. This standard requires an enterprise to recognise a liability when an employee has provided service in exchange for employee benefits to be paid in future and an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits. According to this standard, retirement benefits usually include provident fund, pension, and gratuity, leave encashment benefit on retirement, post retirement health and welfare schemes and other retirement benefits, and termination benefits.

In respect of retirement benefits in the form of provident fund and other defined contribution schemes, the contribution payable by the employer for the year should be charged to the profit and loss account for the year. As per this standard, an enterprise should recognise the expected cost of profit sharing and bonus payments. Post-employment benefit plans are classified as defined benefit plans.

Financial statements should disclose the method by which costs of employee benefits for the period have been determined. In case the costs related to gratuity and other defined benefit schemes are based on actuarial valuation, the financial statements should disclose whether on actuarial valuation was made at the end of the period or at an earlier date.

14. Accounting Standard 16—Borrowing Costs

This standard comes into force in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature. The objective of this standard is to prescribe the accounting treatment for borrowing costs. This standard covers the borrowing costs for borrowing of fund for the qualifying assets i.e., assets that necessarily take a substantial period of time to get

ready for their intended use or sale. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment.

Borrowing costs that are directly attributable to the acquisition, construction and production of a qualifying asset should be capitalised as part of the cost of that asset. If the extent that funds are borrowed generally and used for the purpose of obtaining qualifying asset, the amount of borrowing costs eligible for capitalisation should be ascertained by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period other the borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale area complete. The financial statements should disclose:

- (a) the accounting policy adopted for borrowing costs ; and
- (b) the amount of borrowing costs capitalised during the period.

15. Accounting Standard 17—Segment Reporting

This standard comes into effect with effect from 1-4-2001 and is mandatory in nature. The objective of this standard is to establish principles for reporting financial information about the different types of products and services an enterprise produces and the different geographical areas in which it operates. Provision of segment reporting helps users of financial statements in better understanding the performance of the enterprise in better assessing the risks

and returns of the enterprise and in making more informed judgments about the enterprise as a whole.

Business and geographical segments of an enterprise for external reporting should be those organisational units for which information is reported to the board of directors and to the chief executive officer for the purpose of assessing the unit's performance and for making decisions about future allocations of resources.

Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. An enterprise should disclose the following for each reportable segment:

- (a) segment revenue;
- (b) segment result;
- (c) total carrying amount of segment assets and liabilities;
- d) total cost incurred during the period to acquire segment tangible and intangible fixed assets ; and
- (e) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period and other significant non-cash expenses.

16. Accounting Standard 18-Related Party Disclosures

AS-18 comes into effect in respect of accounting periods commencing on or after 2000-2001 and is mandatory in nature. The objective of this standard is to establish requirements for disclosure of related party relationships and transactions between a reporting enterprise and its related parties. Related parties include holding companies, subsidiaries and fellow subsidiaries, associates and joint ventures, key management personnel and relatives of such personnel and individuals having substantial voting power of the reporting enterprise. Related party disclosure requirements as laid down in conflict standard do not apply in circumstances where providing such disclosure would conflict with the reporting enterprise's duties of confidentiality as specifically required in us of a statute or by any regulator or similar competent authority. Disclosure is also required in consolidated financial statements in respect of

intra-group transactions in the financial statements of state-controlled enterprises as regards related party with other state-controlled enterprises and transactions with such

Name of the related party and the nature of the related party relationship where control exists should be disclosed irrespective of whether or not there have been transactions between the related parties.

According to this standard, if there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

- a) Name of the transacting related party.
- b) A description of the relationship between the parties.
- c) A description of the nature of transaction.
- d) Volume of the transactions.
- e) Any other elements of the related party transactions necessary for an understanding of the financial statements.
- f) Amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date.
- g) Amounts written off or written back in the period in respect of debts due from to related parties.

17. Accounting Standard 19—Leases

AS-19 for leases comes into effect in respect of all assets leased during accounting periods commencing on or after 1-4-2001 and is mandatory in nature. The objective of this standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures in relation to finance leases and operating leases. A finance lease is release that transfers substantially all the risks and rewards incident to ownership of an asst. A lease other than a finance lease is an operating lease. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability According to this standard, the finance charg  should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on

the remaining balance of the liability for each period.

The lessor should present an asset given under operating lease in its balance sheet under, fixed assets. Lease income from operating leases should be recognised in the statement of profit and loss on straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. The depreciation of the leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets and the depreciation charge should be calculated on the basis set out in AS-6, Depreciation Accounting.

As per AS-19, if a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the lease asset. If a sale and leaseback transaction results in an operating lease at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately and if the sale price is above fair value, any excess over fair value should be deferred and amortised over the period for which the asset is expected to be used. In case of operating leases, if the fair value at the time of a sale of leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

18. Accounting Standard 20—Earnings per Share

AS-20 comes into effect in respect of accounting period commencing on or after 1-4-2001 and is mandatory in nature. It is applicable to enterprises whose equity shares or potential equity shares are listed in a recognised stock exchange in India. In consolidated financial statements, the information required by this standard should be presented on the basis of consolidated information. The objective of this standard is to prescribe principles for the determination and presentation of earnings per share. According to this standard, an enterprise should present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share). Basic earnings per share should be calculated by dividing the net profit or loss for the period pertaining to equity

shareholders by the weighted number of equity shares outstanding during the period. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends on cumulative and non-cumulative preference shares for the period and any attributable tax thereto for the period. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods. For the purpose of calculating diluted earnings per share, the net profit or loss attributable to equity shareholders and the weighted number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares. Diluted earnings per share are calculated when there are potential equity shares in capital structure of the enterprises. Potential equity shares are those financial instruments or other contracts which entitle to their holders the right to acquire equity shares like convertible debentures, equity shares, bonus shares, etc.

19. Accounting Standard 21—Consolidated Financial Statements

AS-21 'Consolidated Financial Statements' comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature. The objective of this standard is to lay down principles and procedures for preparation and presentation of consolidated financial statements. A parent (also known as holding enterprise) which presents consolidated financial statements is required to prepare and present these statements in accordance with this standard in addition to its separate financial statements. A holding enterprise which presents consolidated financial statements should consolidate all subsidiaries, domestic as well as foreign other than those subsidiaries whose control is intended to be temporary or those subsidiaries which operate under long-term restrictions which significantly impair their ability to transfer funds to the parent. In consolidated financial statements, such subsidiaries which are excluded should be accounted for investments in accordance with Accounting Standard 13, Accounting for Investments. The reasons for not consolidating a subsidiary should be disclosed in the consolidated financial statements.

For preparing consolidated financial statements, the financial statements of the parent and its subsidiaries should be combined on a line by line basis by adding together like items of assets, liabilities, income and expenses.

20. Accounting Standard 22—Accounting for Taxes on Income

The objective of this standard is to prescribe accounting treatment for taxes on income. This standard comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature. According to this standard, accounting income (loss) is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax saving. Expense or saving related to taxes on income in respect of an accounting period should be determined and such an amount should be disclosed in the financial statements. According to this standard, tax expense for the period, comprising current tax and deferred tax should be included in the determination of the net profit or loss for the period. Deferred tax should be recognised for all the timing differences, subject to the consideration of prudence in respect of deferred tax assets. Current tax is the amount of income tax determined to be applicable tax rates. Difference between the tax expense (which is calculated on accrual basis i.e. tax as per accounting books) and current tax liability to be paid for a particular period as per Income Tax Act. Therefore, timing differences are the differences between taxable income and accounting income for a period that originate in one period as deferred tax asset or deferred tax liabilities capable of reversal in one or more subsequent periods.

Deferred tax assets and liabilities should be determined using the tax rates and tax laws that have been enacted by the balance sheet date and these assets and liabilities should not be discounted to their present value.

An enterprise should set off assets and liabilities representing current tax if the enterprise has a legally enforceable right to set off the recognised amounts and (b) intends to settle the asset and liability on a net basis.

As per AS-22, deferred tax assets and liabilities should be distinguished from assets and liabilities representing current tax for the period.

3.7 MEANING OF IFRS

Introduction

IFRS is not a monster which is going to gobble up the existing Financial Reporting System practiced by the corporates in India. Rather, it is a much refined system of Financial Reporting which is going to benefit all the stakeholders in the years to come, together with improved Corporate Governance and increased free flow of capital across the globe.

Likewise, implementation of convergence with IFRS is not at all a complex exercise - giving tension, stress to the CEOs and CFOs. On the contrary it is an excellent opportunity of learning an advanced system of Financial Reporting for everyone engaged in the Accounting, Financing and Auditing- functions at every level in every business organisation.

At the same time; IFRS is not an entirely new Financial Reporting System for us in India. Generally speaking, the current Indian GAAP covers 75-80% of IFRS already. Therefore, one only needs to learn this remaining 20-25% portion of the IFRS to facilitate IFRS compliance by his/her organisation and continue Financial Reporting under IFRS thereafter.

What is IFRS?

The term IFRS has both, a narrow and a broad meaning. Narrowly, IFRS refers to the new numbered series of pronouncements that the IASB is issuing, as distinct from the IAS series issued by its predecessor IASC.

- More broadly, IFRS refers to the entire body of IASB pronouncements, including Standards and Interpretation approved by the IASB, JASC, and SIC.
- IFRS is principle based Standards, drafted lucidly and easy to understand and apply. However, the application of IFRS requires an increased use of fair values for measurement of assets and liabilities.

Objective Behind IFRSs

To develop a single set of high quality, understandable and enforceable global accounting standards that will form the stable platform for international accounting.

The correct adoption of IFRSs will bring more transparency and a higher degree of comparability, both of which promise many benefits for the organisation as

well as economies.

A brief explanation of 8 International Financial Reporting Standards is given below:

IFRS-1—First Time Adoption of International Financial Reporting Standards

When an organisation that reports under an accounting framework other than the International Financial Reporting Standards such as Indian Accounting Standard decides to adopt IFRS, it has to comply with certain requirements prescribed by IFRS conversion to IFRS. IASB makes it incumbent upon all new entrants to IFRS compulsorily pass the International Financial Reporting Standard 1 (IFRS-1) test conversion of their accounting framework to IFRS. This standard is gaining important day by day as more and more countries of the world are adopting IFRS as their nation accounting standards.

The objective of this IFRS is to make sure that an entity's first IFRS financial statements and its interim financial reports for part of the period covered by those financial statements contain high quality information that (a) is transparent for use and comparable over all periods presented; (b) provides a suitable starting point for accounting in accordance with International Financial Reporting Standards; and (c) can be generated at a cost that does not exceed the benefits to users.

An entity shall prepare and present an opening IFRS statement of financial position at the date of transition to IFRSs. This is the starting point in accordance with IFRSs.

An entity shall use the same accounting policies in its opening IFRS statement financial position and throughout all periods presented in its first IFRS financial statements. In general, those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period.

In general, IFRS requires an entity to do the following in the opening IFRS statement of financial position that it prepares as a starting point for its accounting under IFRSs.

- (a) recognise all assets and liabilities whose recognition is required by IFRS;
- (b) not recognise items as assets or liabilities if IFRSs do not permit such recognition;

- (c) reclassify items that it recognised in accordance with previous GAAP as one type, of asset, liability or component of equity in accordance with IFRSs; and
- (d) apply IFRSs in measuring all recognised assets and liabilities.

An entity makes estimates in accordance with IFRSs for the opening statement to financial position and all other periods covered by the financial statements. An entity shall explain how the transition from previous GAAP to IFRSs affected its reported financial position, financial performance and cash flows.

IFRS-2—Share-based Payment

Entities often grant shares or share option to employees, directors and other parties as remuneration packages or in exchange for goods and services acquired. The objective of IFRS-2 is to specify the financial reporting of share-based payment transactions and to show the effects of such transactions (including associated expenses) on profit or loss and financial position.

IFRS-2 identifies three types of share based transactions as follows:

1. Equity-settled share-based payment transactions.
2. Cash-settled share-based payment transactions.
3. Share-based payment transactions with cash alternative.

This standard also applies to transfers of equity instruments of the entity's parent or equity instruments of another entity in the same group as the entity, to parties that have supplied goods or services to the entity.

Equity settled share-based payment transactions are those in which the entity receives goods or services as consideration for equity instruments of the entity. This requires an entity to measure the goods or services received and the, or responding increase in equity at the fair value of goods or services received, unless that fair value cannot be estimated reliably. If the fair value of the goods or services cannot be estimated reliably by the entity, then the entity is required to measure the value of the goods or services received and the corresponding increase in equity indirectly by reference to the fair value of the equity instruments granted.

Cash-settled share-based payment transactions are those in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price or value of the entity's shares or other equity instruments of the entity. For such type of transactions the entity shall measure the goods or services acquired and the liability incurred at the fair value of

the liability. Until the liability is settled, the entity is required to measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in fair value recognised in, profit or loss for the period.

Share based payment transactions with cash alternative are those transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash or by issuing equity instruments. For share-based payment transactions in which the terms of the arrangement provide either the - entity or the supplier of goods or services with a choice whether the entity settles the transaction in cash or by issuing equity instruments, the entity is required to account for that transaction, or component of that transaction as a cash settled share-based-payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash, or as an equity-settled share-based - payment transaction if, and to the extent that, no such liability has been incurred

As per this standard, an entity shall disclose information that - enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period and the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position. The entity is also required to disclose how the fair value- of the goods or services acquired, or the fair value of the equity instruments granted, during the period was determined.

IFRS-3—Business Combination

The objective of -IFRS-3 is to specify the -financial reporting- to be provided by an entity when it undertakes a business combination. IFRS-3 establishes principles and requirements for how an acquirer recognises and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non controlling interest in the acquire It also establishes principles and requirements for recognising and measuring the goodwill acquired in the business combination or a gain from a bargain purchase and for determining what information to disclose to enable users of the financial statements to -evaluate the nature and financial effects of the business combination.

As per this IFRS, a business combination in be accounted for by applying the acquisition method, unless it is a, combination involving entities or businesses under common control. One of the parties to a business combination is identified as the acquirer,

being the entity that obtains control of the other business, (the acquire). It may, be noted that formations of a joint venture or the acquisition of an asset or a group of assets that does not constitute a business are not business combinations. .

Core principle of IFRS-3 is that an acquirer of a business recognises the assets acquired and liabilities assumed at their acquisition date fair values and discloses information that enables users to evaluate the nature and financial effects of the acquisition. -

As per IFRS-3, the acquirer shall measure the cost of a business combination as the aggregate of the fair values, at the date of exchange, of assets given, liabilities assumed, and equity instruments issued by the acquirer, in exchange for control of the business of the acquire plus any costs directly attributable to the business combination. The acquirer shall at the acquisition date recognise goodwill acquired in a business combination as an asset and initially measure that goodwill at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities.

When a business combination provides for an adjustment to the cost of the combination contingent on future events, the acquirer should include the amount of that adjustment in the cost of combination at the acquisition date if the adjustment can be measured reliably. After a business combination, the acquirer should disclose any adjustments recognised in the current reporting period that relate to business combinations that occurred in the current or previous reporting periods.

IMRS-4—Insurance Contracts

The objective of IFRS-4 is to specify the financial reporting for insurance contracts by any entity that issues such contracts until the Board completes the second phase of its project on insurance contracts. In particular, this IFRS requires limited improvements to accounting by insurers for insurance contracts and disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

IFRS-4 applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRSS. It does not apply to other assets and liabilities of

an insurer, such as financial assets and financial liabilities. This IFRS does not cover accounting by policyholders.

As per this IFRS, an insurer is required to assess at each reporting date whether its recognised insurance liabilities are adequate using current estimates of future cash flow under its insurance contracts. If the assessment shows that the carrying amount of its insurance liabilities is inadequate in the light of the estimated future cash flows, the entire deficiency should be recognised in profit and loss statement.

IFRS-4 permits an insurer to change its accounting policies for insurance contracts if and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant. This IFRS requires an insurer to disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts. An insurer should also disclose information that enables users of the financial statements to understand the amount, timing and uncertainty of future cash flows arising from insurance contracts.

IFRS-5—Non-Current Assets Held for Sale and Discontinued Operations

The objective of IFRS 5 is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations. In particular, this IFRS requires.

Held for Sale—assets that meet the criteria to be classified as held for sale to be measured at the lower of carrying amount and fair value less; costs to sell, and depreciation on such assets to cease,

Disposal Group—an asset classified as held for sale and the assets and liabilities included within a disposal group classified as held for sale to be presented separately in the statement of financial position, and

Discontinued Operation—the results of discontinued operations to be presented separately in the statement of comprehensive income

As per IFRS-5, an entity shall classify a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sale of such asset or disposal group and its sale must be highly probable. For the sale to be highly probable, the appropriate level of

management must be committed to a plan to sell the asset or disposal group, and an active programme to indicate a buyer and complete the plan must have been initiated. An entity shall not classify as held for sale a non-current asset (or disposal group) that is to be abandoned. This is because its carrying amount will be recovered principally through continued use. Further, an entity shall present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposal of non-current assets or disposal groups

IFRS-6—Exploration for and Evaluation of Mineral Resources

The objective of IFRS 6 is to specify the financial reporting for the exploration and Valuation of mineral resources As per this IFRS, exploration and mineral expenditures are expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability extracting a mineral resource are demonstrable Exploration for and evaluation of mineral resources has been defined as the search for mineral resources including minerals oil, natural gas and similar non-regenerative resources after the entity has legal rights to explore in a specific area as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource.

As per this IFRS, exploration and evaluation assets shall be measured at cost exploration and evaluation assets are exploration and evaluation expenditures recognised as assets in accordance with the entity s accounting policy. An entity adopting IFRS-6 may continue to use the accounting policies applied immediately before adopting the IFRS.

Exploration and evaluation assets shall be assessed for impairment when facts and circumstances suggest that the carrying amount of an exploration and evaluation asset may exceed its recoverable amount In such a case, the entity shall measure, present and disclose any resulting impairment loss.

As per this IFRS, an entity shall determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units the purpose of assessing such assets for impairment. Each cash-generating unit or group of units to which an exploration and evaluation asset is allocated shall not be larger than an operating segment determined in accordance with IFRS-8, Operating Segments. Further, an entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and

evaluation of mineral resources.

IFRS-7—Financial Instruments: Disclosures

IFRS-7 deals with the disclosure requirements in relation to all risks arising from financial instruments and applies to an entity that holds financial instruments. The objective of the IFRs is to require entities to provide disclosures in their financial statements that enable users to understand the significance of financial instruments for the entity's financial position and performance and the nature and extent of risk arising from the financial instruments to which the entity is exposed during the period at the reporting dates.

This IFRS prescribes specific disclosure of certain policies relating to financial instruments such as criteria for designating financial assets and financial liabilities at fair value through profit or loss and accounting policy for financial assets that are subject to re-negotiation terms. Disclosure for fair value determination should be made, whether the fair value is based on quoted prices or valuation techniques.

Risk information disclosure requirement is of relevance where user of the financial statements uses these for predicting future financial position and performance. There are three types of instruments of risks (i.e. credit risk, liquidity risk and market risk) which arise from financial Credit risk is that risk that one party to a financial instrument will incur a financial loss for the other party by failing to discharge an obligation. Liquidity risk arises when the entity will encounter difficulty in meeting obligation associated with financial liabilities. It may not have required cash or cash equivalent to meet its financial obligation resulting in default. Market risk arises when the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. For each type of risk, the entity should disclose the exposure to the risk and how they arise and the entity's objective, policies and processes for managing the risks and methods used to measure the risk. Any changes to these disclosures from the previous accounting period should also be reported.

Note: There is no difference between IFRS-7 and AS-32. Please refer to AS-32.

IFRS-8—Operating Segments

IFRS-8 requires publicly held entities to report certain information about the following:

- their products and services
- the geographic areas in which they operate

- their major customers.

This IFRS specifies how an entity should report about its operating segments in annual financial statements and also requires an entity to report selected information about its operating segments in interim financial reports. It also sets out requirements for related disclosures about products and services, geographical areas and major customers.

C. CHECK YOUR PROGRESS

Case Study: Adoption of IFRS by Infosys Ltd.

Background:

Infosys Ltd., one of India's leading IT companies, adopted IFRS voluntarily for its financial reporting to attract global investors and ensure transparency.

Problem:

As Infosys expanded globally, its financial statements prepared under Indian GAAP were not easily comparable with those of companies listed on international stock exchanges. This limited investor confidence and hindered foreign investment.

IFRS Implementation:

In 2010, Infosys started reporting its financials under IFRS voluntarily, alongside Indian GAAP. The company had to address several challenges:

- **Employee stock options** had to be fair-valued under IFRS.
- **Revenue recognition** principles were stricter and more detailed.
- **Property, plant, and equipment (PPE)** had to be measured differently.
- Transition required training for finance staff and system changes.

Impact:

- Improved comparability of financial statements globally.
- Increased confidence among foreign investors and stakeholders.
- Higher compliance costs initially, but better long-term reporting benefits.

Conclusion:

Infosys' early adoption of IFRS showcased its commitment to global best practices. It benefited the company by enhancing global transparency, credibility, and access to foreign capital markets.

3.8 LET US SUM UP

Accounting standard is prepared with the uniformity and accounting principles become more apparent with the help of these standards.

3.9 GLOSSARY

- **GAAP (Generally Accepted Accounting Principles):**
A set of accounting rules, standards, and procedures used for preparing financial statements to ensure accuracy, consistency, and comparability.
- **IFRS (International Financial Reporting Standards):**
A set of global accounting rules developed by the International Accounting Standards Board (IASB) to ensure transparency, consistency, and comparability of financial statements across different countries.
- **Accounting Standards:**
Written policy documents issued by recognized accounting bodies that provide guidelines for financial reporting.
- **ASB (Accounting Standards Board):**
A board set up by the Institute of Chartered Accountants of India (ICAI) in 1977 to formulate and recommend accounting standards in India, aiming to harmonize diverse accounting practices.

3.10 SELF ASSESSMENT QUESTIONS

1. What is IFRS?

2. What is ASB?

3. Give scope of ASB.

3.11 LESSON END EXERCISE

Give objectives of Accounting Standard Board.

1. Give the formation of ASB.
2. What is Cash Flow Statement?

3.12 SUGGESTED READINGS

- Jain, S. P., & Narang, K. L. (Latest ed.). *Advanced Accountancy*. New Delhi: Kalyani Publishers.
- Arihant Experts. (Latest ed.). *Financial Accounting for Competitive Exams*. Meerut: Arihant Publications.
- Editorial Board. (Monthly/Annual Issues). *Pratiyogita Darpan: Commerce & Finance Sections*. Agra: Pratiyogita Darpan Publications.
- Rajasekaran, V., & Lalitha, R. (Latest ed.). *Financial Accounting*. Chennai: Pearson Education.
- Singhal, A., & Roy, M. (Latest ed.). *Fundamentals of Financial Accounting*. Mumbai: Himalaya Publishing House.
- Banerjee, B. (Latest ed.). *Financial Accounting: A Managerial Emphasis*. New Delhi: PHI Learning.

B.com. I Sem**UNIT- I****Course No. 101****Lesson No. 4**

FINANCIAL STATEMENTS

STRUCTURE

- 4.0 Learning Objectives and Outcomes
- 4.1 Introduction of financial statements
- 4.2 Definition of financial statements
- 4.3 Nature of financial statements
- 4.4 Attributes of financial statements
- 4.5 Objectives of financial statements
- 4.6 Limitations of financial statements
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- 4.9 Glossary
- 4.10 Self-Assessment Questions
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4.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After studying this unit, learners will be able to

- Understand the purpose and components of financial statements.
- Recognize the role of financial statements in business decision-making.
- Identify the primary types: Balance Sheet, Income Statement (P&L), and Cash Flow Statement.

- Recognize the impact of limitations on financial analysis and decision-making.

Learning Outcomes

By the end of this unit, students will be able to:

- Clearly define and describe the components and purpose of financial statements.
- Interpret and analyze the nature and attributes of financial reports.
- Evaluate the usefulness and identify the limitations of financial statements in real-world scenarios.
- Develop a critical perspective on how financial data is presented and understood.

4.1 INTRODUCTION OF FINANCIAL STATEMENTS

Accounting is a service activity. One of its functions is communication of information at a specific interval, usually at the year ended by the financial statements. In accounting, financial statements are the means of conveying to management, owners and to interested outsiders a concise picture of profitability and financial position of the business. The preparation of financial statements is not the first step in the accounting process but they are the end products of the accounting process which give concise accounting information of the accounting period after the accounting period is over. All financial transactions are recorded first in subsidiary books and subsequently they are posted to relevant ledger accounts. The balances of ledger accounts at the end of the year are ultimately presented through financial statements. These statements are called final accounts because they are prepared after the accounting period is over and they give final picture of the financial transactions of an accounting period. It helps in measuring the correct profit and knowing the financial position of the business entity.

4.2 DEFINITIONS OF FINANCIAL STATEMENTS

According to John N. Myer, “The financial statements provide a summary of the accounts of a business enterprise, the balance sheet reflecting the assets and liabilities and the income statement showing the results of operations during a certain period”. This definition emphasis the importance of balance sheet and profit and loss account, but ignores the importance of other financial statements like cash flow statement and statement of retained earnings.

Smith and Ashburne define financial statements as “ the end product of financial accounting is a set of financial statements, that purports to reveal the financial position of the enterprise, the results of its recent activities , and an analysis of what has been done with earnings”. From this definition, it is clear that financial statements are the outcome of preparing financial accounts and these statements reveal financial position and profitability of the concern and the utilisation of retained earnings.

4.3 NATURE OF FINANCIAL STATEMENTS

Financial statements are prepared for the purpose of presenting a periodical review or report by the management and deal with the state of investment in business and results achieved during the period under review. They reflect a combination of recorded facts, accounting conventions and personal judgments.

From this, it is clear that financial statements are affected by three things i.e recorded facts, accounting conventions and personal judgments. Only those facts which are recorded in the business books will be reflected in the financial statements. For example, fixed assets are recorded in the books at cost price and shown in the balance sheets at cost price irrespective of their market or realisable price. Again, financial statements are prepared by following certain principles which are in use from a long time. For example, the conservatism principle indicates that all anticipated losses are to be provided whereas anticipated profits are not to be taken in to account while preparing financial statements. Such convention will not reflect the true position of the business as the actual position of the business will definitely be better as compared to the position depicted from the financial statements. Personal judgment of the accountant again will reflect the preparation of financing statements. For example, the choice of the method of depreciation will also affect the preparation of the financial statements.

Following points reflect truly the nature of financial statements of business entities:

1. These are reports or summarised reviews about the performance, achievements and weakness of the business.
2. These are prepared at the end of the accounting period so that various parties may take decisions of their future actions in respect of the relationship with

the business.

3. The reliability of financial statements depends on the reliability of accounting data. These statements cannot be said to be true and fair representatives of the strength or profitability of the concern if there are numerous frauds and defalcations in the accounts.
4. The figures in the financial statements are a combination of recorded facts. There may be certain developments and factors which may be very important for the business are not taken into account as these are not recorded in the routine of accounting. Moreover, fixed assets are recorded at historical value without taking into consideration the changes in their values due to price level fluctuations.
5. These statements are prepared as per accounting concepts and conventions.
6. These statements are influenced by the personal judgments of the accountant though he is expected to be more objective in his approach. These judgments may relate to valuation of inventory, depreciation of fixed assets and while making distinction between capital and revenue.

A. CHECK YOUR PROGRESS

TRUE OR FALSE

1. Financial statements are prepared annually/quarterly to help stakeholders (investors, creditors, etc.) make decisions.

Ans: True

2. Standards provide guidelines and limits to reduce bias; such judgment is not entirely discretionary.

Ans: False

3. Statements are based on historical cost and do not always reflect current values or non-recorded events.

Ans: True

4. The reliability of financial statements depends on the reliability of accounting data.

Ans: True

5. Some accounting frameworks (like IFRS) allow for fair value accounting or revaluation of certain assets to reflect updated values.

Ans: False

4.4 ATTRIBUTES OF FINANCIAL STATEMENTS

1. **Relevance:** Financial statements prepared should be relevant for the purpose they are supposed to serve. As far as possible, relevant and material information should be disclosed properly but confusing and irrelevant disclosures should be avoided.
2. **Accuracy and freedom from bias:** It should be prepared accurately so that these may convey a full and correct idea about the progress, position and prospects of an enterprise. Inaccurate financial statements prepared, besides involving legal consequences, may defeat the objectives for which they are meant. Those persons, who prepare and present financial statements, must keep themselves free from personal bias.
3. **Comparability:** Comparison is the foundation of financial analysis as it increases the utility of financial statements. Comparison of present statements, with previous statements, helps in assessing the performance and knowing the trends in progress and position of the business enterprise. Inter or intra firm comparison reveals the strength and weaknesses of the enterprise vis-à-vis other departments, firms and industry.
4. **Analytical presentation:** Financial statements should be prepared in analytical and classified form so that a better and meaningful analysis can be made. It also helps in tracing and understanding in causes of the results as shown in these statements in revealing inefficient performances and wasteful activities and in speedier analysis of these documents.
5. **Promptness:** Financial statements should be prepared after the end of the accounting period without any delay as undue delay may present difficulty in tracing the causes of the results as disclosed by these statements. Such delays

and the delayed action there on, may do more harm than good to the enterprise.

6. **Generally accepted principles:** Financial statements must be prepared in accordance with the generally accepted accounting principles to have wider acceptability and understandability by the clients. This will also increase the reliability of these statements and adds confidence to the users.
7. **Consistency:** Financial statements must be prepared on consistent basis following the same rules, procedures and principles in successive periods, unless the situation demands otherwise. Consistency also affects the comparability of these statements.
8. **Authenticity:** Financial statements prepared must be authenticated by an independent and capable person called auditor in order to make them more reliable and acceptable by the users. Unaudited statements are unreliable and give room to doubt.
9. **Compliance with law:** Financial statements must meet the requirements of law, if any, in the matter of form, contents and disclosures, procedures and methods. Non-compliance with legal provisions impairs the confidence of the public investors besides invoking penalties. In India, these statements are required to be prepared according to provisions of section 211 of the companies act, 1956.

4.5 OBJECTIVES OF FINANCIAL STATEMENTS

1. To provide the reliable information about economic resources and obligations of a business enterprise.
2. To provide reliable information about the net resources of an enterprise that results from its activities.
3. To provide financial information that assists in estimating the earning potentials of a business.
4. To provide other needed information about changes in economic resources or obligations.
5. To disclose to the extent possible, other information related to the financial statements that is relevant to the needs of the users of these statements.

Importance or users of the financial statements

1. **Owners:** The owners provide funds for the operations of a business and they want to know whether their funds are being properly utilised or not. The financial statements prepared from the time to time satisfy their curiosity.
2. **Creditors:** Creditors want to know the financial position of a concern before giving loans or granting credit. The financial statements help them in judging such position.
3. **Investors:** Prospective investors, who want to invest money in a firm, would like to make an analysis of the financial statements of that firm to know how safe the proposed investments will be .
4. **Employees:** Employees are interested in the financial statements of a concern they serve, particularly, when payment of bonus depends upon the size of the profits earned. They would like to know that the bonus being paid to them is correct, so they become interested in the preparation of correct profit and loss account.
5. **Government:** Central and state governments are interested in the financial statements because they reflect the earnings for a particular period for purposes of taxation. Moreover, these financial statements are used for compiling statistics concerning business which, in turn, help in compiling national accounts.
6. **Research scholars:** The financial statements, being a mirror of the financial position of a firm, are of immense value to the research scholar who wants to make a study into financial operations of a particular firm.
7. **Consumers:** Consumers are interested in the establishment of good accounting control so that cost of production may be reduced with the resultant reduction of the prices of goods they buy.
8. **Managers:** Management is the art of getting things done through others. This requires that the subordinates are doing work properly. Financial statements are an aid in this respect because they serve the manager in appraising the performance of the subordinates. Actual results achieved by the employees can be measured against the budgeted performance they were expected to achieve and remedial action can be taken if the performance is not up

to the mark.

B. CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. Who uses financial statements to assess whether their funds are being used properly in a business?

- a) Creditors
- b) Investors
- c*) Owners
- d) Government

Answer: c) Owners

2. Before granting a loan or credit, which stakeholder checks the financial position of a business?

- a) Employees
- b) Creditors
- c) Customers
- d) Researchers

Answer: b) Creditors

3. Who analyzes financial statements to determine the safety of a proposed investment?

- a) Government
- b) Suppliers
- c) Prospective investors
- d) Consumers

Answer: c) Prospective investors

4. Why are employees interested in the profit and loss account of a firm?

- a) To assess tax liability
- b) To claim share in profits
- c) To verify correctness of bonus payments
- d) To manage production cost

Answer: c) To verify correctness of bonus payments

5. How do government authorities use financial statements?

- a) For marketing research

- b) For bonus calculation
- c) For taxation and national statistics
- d) For improving inventory

Answer: c) For taxation and national statistics

6. What is the main concern of consumers regarding financial statements?

- a) Accurate tax reporting
- b) Performance appraisal
- c) Cost control leading to price reduction
- d) Bonus distribution

Answer: c) Cost control leading to price reduction

4.6 LIMITATIONS OF FINANCIAL STATEMENTS

- 1. Interim and not final reports:** It do not depict the exact the position and are essentially interim reports. The exact position can be only known if the business is closed.
- 2. Lack of precision and definiteness:** It may not be realistic because these are prepared by following certain basic concepts and conventions. For example, going concern concept gives us an idea that business will continue and assets are to be recorded at cost but the book value at which the asset is shown may not be actually realisable. Similarly, by following the principles of conservatism the financial statements will not reflect the true position of the business.
- 3. Lack of objective judgment:** It is influenced by the personal judgment of the accountant. He may select any method for depreciation, valuation of stock, amortisation of fixed assets and treatment of deferred revenue expenditure. Such judgment if based on integrity and competency of the accountant will definitely affect the preparation of the financial statements.
- 4. Records only monetary facts:** It discloses only monetary facts i.e., Those transactions are recorded in the books of accounts which can be measured in monetary terms. Those transactions which cannot be measured in monetary terms such as conflict between production manager and marketing manager may be very important for a business concern but not recorded in the business books.
- 5. Historical in nature:** These statements are drawn after the actual happening

of the events. They attempt to present a view of the past performance and have nothing to do with the accounting for the future. Modern management is forward looking but these statements do not directly help them in making future estimates and taking decisions for the future.

6. **Artificial view:** These statements do not give a real and correct report about the worth of the assets and their loss of value as these are shown on historical cost basis. Thus, these statements provide artificial view as market or replacement value and the effect of the changes in the price level are completely ignored.
7. **Scope of manipulation:** These statements are sometimes prepared according to the needs of the situation or the whims of the management. A highly efficient concern may conceal its real profitability by disclosing loss or minimum profit whereas an inefficient concern may declare dividend by wrongly showing profit in the p/l a/c. For this under or over valuation of inventory, over or under charge of depreciation, excessive or inadequate provision for anticipated losses and other such manipulations may be resorted to. Window dressing may also be resorted to in order to show better financial position of a concern than its real position.
8. **Inadequate information:** There are many parties who are interested in the information given in the financial statements but their objectives and requirements differ. The financial statements as prepared under the provisions of the companies act, 1956, fail to meet the need of all. These are mainly prepared to safeguard the interest of shareholders.

C. CHECK YOUR PROGRESS

Scenario Based Questions

Scenario: Ravi is planning to invest in XYZ Ltd. after reviewing its financial statements. The balance sheet shows stable profits for the past 3 years. However, Ravi later finds out that the company is involved in a major legal case, which could result in huge penalties, but this was not disclosed in the

financial statements. On the basis of above scenario answer the following questions.

Questions:

1. What limitation of financial statements is evident in this case?
2. How might this hidden information affect Ravi's investment decision?
3. What additional sources of information should Ravi have considered before investing?

4.7 ACCOUNTING SYSTEM

a) Accrual Basis of Accounting

Accrual Basis of Accounting is a method of recording transactions by which revenue; costs, assets and liabilities are

reflected in the accounts for the period in which they accrue. This basis includes consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting.

b) Cash Basis of Accounting

Cash Basis of Accounting is a method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts for the period in which actual receipts or actual payments are made.

Distinction between Accrual Basis of Accounting and Cash Basis of Accounting

Basis of Distinction	Accrual Basis of Accounting	Cash Basis of Accounting
1. Prepaid/Outstanding Expenses/ accrued/un accrued Income in Balance Sheet.	Under this, there may be prepaid/ outstanding expenses and accrued/un accrued incomes in the Balance Sheet.	Under this, there is no prepaid/outstanding expenses or accrued/un accrued incomes.
2. Higher/lower Income in case of prepaid expenses and accrued income	Income Statement will show a relatively higher income	Income Statement will show lower income.
3. Higher/lower income in case of outstanding expenses and un accrued income	Income Statement will show a relatively lower income.	Income Statement will show higher income.
4. Availability of options to an accountant to manipulate the accounts by way of choosing the most suitable method out of several alternative methods of accounting e.g. FIFO/LIFO/SLM/WDV	Under this, an accountant has options.	Under this an accountant has no option to make a choice as such.

c) Hybrid or Mixed Basis

Under the hybrid system of accounting, incomes are recognised as in Cash Basis Accounting i.e. when they are received in cash and expenses are recognised on accrual basis i.e. during the accounting period in which they arise irrespective of when they are paid.

4.8 LET US SUM UP

Financial statements are formal records that summarize an entity's financial activities. They provide information about its performance, position, and

cash flows, helping stakeholders make well-informed economic decisions. These statements are defined as structured reports — such as the Balance Sheet, Income Statement, and Cash Flow Statement — that reflect an entity's financial results over a period. They have a historical and quantitative nature, presenting data based on past transactions.

Financial statements possess key attributes like relevance, reliability, comparability, and understandability, making them valuable tools for assessing an organization's financial health. Their primary objectives are to aid in decision making, evaluate the stewardship of management, and assess the entity's profitability, liquidity, and solvency.

However, financial statements also have certain limitations. They rely on estimates, focus on historical cost, and often exclude qualitative factors, making it important for readers to interpret them with care and context.

4.9 GLOSSARY

- **Balance Sheet:** Shows the financial position of a business (assets, liabilities, and equity) at a specific point in time.
- **Historical:** Financial statements record past events and are based on actual transactions that have already occurred.
- **Relevance:** The quality that ensures financial information is meaningful and helpful for making decisions.
- **Comparability:** Enables users to compare financial information across periods or with other businesses.
- **Stewardship:** Financial statements help assess how well management has used the resources entrusted to them.
- **Estimates:** Figures like depreciation or bad debts are estimated, making financial statements subject to potential error or bias.

4.10 SELF-ASSESSMENT QUESTIONS

Q1. What is the main purpose of preparing financial statements?

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Q2. Name any two stakeholders who use financial statements for decision making.

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Q3. How do financial statements help in assessing the financial health of a business?

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4.11 LESSON END EXERCISE

1. What are the two main financial statements a business prepares?
2. Why are financial statements important for a business?

4.12 SUGGESTED READINGS

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan
- Banerjee

- Bhatia and Arora
- Pratiyogita Darpan Publication

B.com. I Sem	UNIT - I
Course No. 101	Lesson No. 5
P&L ACCOUNT	

STRUCTURE

- 5.0 Learning Objectives and Outcomes
- 5.1 Final Accounts of Sole Traders
- 5.2 Preparation of manufacturing Account
- 5.3 Preparation of trading Account
- 5.4 Preparation of P&L Account
- 5.5 Preparation of Balance Sheet
 - 5.5.1 Difference between Trail Balance and Balance Sheet
 - 5.5.2 Difference between Trail Balance and P&L Account
- 5.6 Solved Problems
- 5.7 Let Us Sum Up
- 5.8 Glossary
- 5.9 Self-Assessment Questions
- 5.10 Lesson End Exercise
- 5.11 Suggested Readings

5.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

This chapter will help the students to:

- Understand the structure and purpose of Final Accounts.
- Learn to prepare Manufacturing, Trading, Profit & Loss Account, and Balance Sheet.
- Identify direct and indirect expenses and compute profits.

Learning Outcomes:

After completing this lesson, students will be able to:

- Prepare Final Accounts accurately.
- Differentiate between direct and indirect expenses.
- Evaluate a business's profitability and financial position.

5.1 Final accounts of Sole Traders

Financial statements in different organisations may differ. Financial statements in case of sole traders may consist of trading or manufacturing and trading account, profit and loss account and balance sheet but in case of partnership firms these statements are trading and profit and loss account, profit and loss appropriation account and balance sheet.

Financial statements of companies refer to the three statements which are prepared by a business concern at the end of the year. These are (a) income statement or statement of profit and loss which is prepared by a business concern in order to know the profit earned and loss sustained during a specified period. (b) position statement or balance sheet which is prepared by a business concern on a particular date in order to know its financial position . (c) cash flow statement . It gives

various items of inflow and outflow of cash from operating, investment and financing activities. To these statements are added notes to the financial statements giving

information of share capital, reserves and surplus in the balance sheet shows the utilisation of profits of the company i.e., dividend declared, amount transferred to general reserve or any other reserve are shown in this account.

Income statement

This statement in trading concerns is prepared under the heading trading and profit and loss account or in manufacturing concerns as manufacturing, trading and profit and loss account.

5.2 PREPARATION OF MANUFACTURING ACCOUNT

Some businesses may manufacture their own products instead of trading in finished goods. A manufacturing business is the most complete form of a business because it buys raw materials, converts them into finished items and then sells these items to its customers. Businesses that make their own products must prepare a manufacturing account as part of their internal financial statements. A manufacturing account shows the cost of running and maintaining the factory. It is prepared to calculate the cost of goods produced during the year and it is also known as the production account. Cost of production includes direct cost and indirect cost.

Direct costs are expenditure which can be economically identified with a specific cost unit. It has a direct relationship with number of output (units produced). For example:

- Direct materials.
- Direct labour/ direct wages/ factory direct wages/ factory direct labour/

manufacturing wages.

- Direct expenses (example: royalties)

The total of the direct cost is termed as prime cost.

Indirect costs are factory expenses that are not directly related with the final product. It is commonly termed as factory overheads and is incurred in running the operation of the factory. Indirect cost does not vary with the level of output. Whatever be the level of production, indirect cost remains the same.

Example of factory overheads:

- Factory rent and rates
- Factory machinery's depreciation
- Factory insurance
- Factory supervisor's salary
- Indirect materials
- Indirect labour
- Indirect wages
- Factory light and heat
- Depreciation of Factory NCA

Items not included in the manufacturing account but treated as an expense in the income statement:

- Office rent and rates
- Office insurance
- Sales staff wages
- Carriage outwards

- Discount allowed
- Depreciation of office non-current assets
- Administrative, selling and distribution cost
- Finance cost
- General expenses, sundry expenses, advertising cost
- Bad debts and provision for doubtful debts

Inventories in Manufacturing Businesses

Type of inventory Raw Materials	Opening inventory Manufacturing	Closing inventory Manufacturing Statement of financial position
Work in progress	Manufacturing Account	Manufacturing Account Statement of financial position
Finished goods	Income statement	Income statement Statement of financial position

Note: Closing inventories must be recorded at cost and not at transfer value in the statement of financial position

Factory profit

Manufacturing businesses usually transfer finished goods from the manufacturing account to the income statement at market value (wholesale price) to evaluate how efficiently the factory is operating. The market value or transfer value is obtained by adding a percentage of profit to the cost of production. This profit is known as factory profit/ manufacturing profit. Factory profit (loss) is the difference between the market price (the price the business

has to pay if the goods produced were to be purchased in the wholesale market from other suppliers) and the cost of producing these goods. Factory profit may be calculated as follows:

Factory profit

$$= \text{mark up} \times \text{cost of production}$$

$$= \text{margin} \times \text{cost of production at transfer value (TV)}$$

$$= \text{cost of production at transfer value} - \text{cost of production}$$

Factory profit must be added with cost of production in the manufacturing account and recorded as an income in the income statement.

Provision for unrealized profit (PFUP)

Many businesses transfer finished goods at market value. Therefore, closing inventory of finished goods will be valued at market price and will include an element of factory profit. In that case it is necessary to provide for the element of manufacturing (unrealised) profit which is included in their valuation since it is against the prudence concept and realisation concept. Therefore, the factory profit must be adjusted for any unrealised profit and inventories of finished goods must be disclosed at cost (not at transfer value). For this purpose a provision for unrealised profit is set up and maintained. Provision for unrealised profit may be calculated as follows:

If inventory of finished goods is at cost:

$$\text{PFUP} = [\text{Manufacturing profit} / \text{Cost of production}] \times \text{closing inventory of finished goods at cost}$$

$$= \text{mark up} \times \text{closing inventory of finished goods at cost}$$

If inventory of finished goods is at transfer value:

$$\text{PFUP} = [\text{Manufacturing profit} / \text{Cost of Production at TV}] \times \text{Closing inventory of FG at TV}$$

= margin × closing inventory of finished goods (FG) at transfer value
(TV)

Note:

- Provision for unrealised profit at start is calculated using opening inventory of finished goods and at end using closing inventory of finished goods.
- Provision for unrealised profit must be deducted from inventory of finished goods at transfer value (TV) in the statement of financial position.

Particulars	Units	Amount	Particulars	Units	Amount
		✓			✓
To Raw Material Consumed:			By By-products at net realizable value		
Opening inventory					
Add: Purchases	...		By Closing Work-in- Process		
Less: Closing inventory		By Trading A/c		
To Direct Wages	Cost of production		
To Direct expenses:				
Prime cost				
To Factory overheads:					
Royalty				
Hire charges				
To Indirect expenses:				
Repairs & Maintenance				
Depreciation			
Factory cost				
To Opening Work-in-process				

A. CHECK YOUR PROGRESS

Short Answer Type Questions

1. What is a Manufacturing Account?

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2. State the purpose of preparing a Manufacturing Account.

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.....

3. Name any three components of a Manufacturing Account.

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5.3 PREPARATION OF TRADING ACCOUNT

This account is prepared to know the trading results or gross margin on trading of the business, i.e., how much gross profit the business has earned from buying and selling during a particular period. The difference between the sales and cost of goods sold is gross profit. For the purpose of calculating cost of goods sold, we take into consideration opening stock, net purchases, direct expenses on purchasing or manufacturing the goods and closing stock. The balance of this account represents gross profit or loss and is transferred to the p/l account . Thus, trading account shows the results of buying and selling of goods and in preparing this account indirect expenses are ignored. Only the transactions in goods and expenses related to purchase of goods and manufacturing of goods are included in this account.

In the form of equation

Gross profit = sales – cost of goods sold.

Or = sales – [opening stock + net purchases + direct expenses – closing stock]

Or = sales – opening stock – net purchases – direct expenses + closing stock

Or opening stock + net purchases + direct expenses + gross profit = sales + closing stock.

The left-hand side of this equation depicts the debit side and right-hand side credit of trading account.

Proforma of a trading account

TRADING ACCOUNT

For the year ended 31st March, 2014

Particulars	Amount	Particulars	amount
To Opening stock	+	By sales	+
To purchases			
Less: return outwardp/urchase return	+	Less: return	+
To direct expenses		inward/ sales	+
To Carriage inward	+	return	
To Wages	+	By closing	+
To Wages and salaries	+	stock	
To Manufacturing or production	+	By gross loss	+
expenses	+	c/d (Bal. Fig.)	
To Coal, water and gas	+		
To Motive power	+		
To Factory lighting	+		
To Octroi	+		
To Import duty	+		
To Custom duty	+		
To Excise duty	+		
To Consumable stores	+		
To Foreman/ works manager salary	+		
To Factory rent, rates and taxes	+		
To Royalty on manufactured goods	+		
To Gross profit c/d (Bal. Fig.)	+		
	++++		++++

Detailed study of the items posted to the debit side of trading account

- 1. Opening stock:** This is the amount of goods in hand at the beginning of the period for which the trading account is prepared. The figure is available from the trail balance. There will be no opening stock in case of a new business. Opening stock consists of raw materials, work in progress and finished goods.
- 2. Purchases:** It includes both cash and credit purchases of goods which are for resale purposes. Purchases returns and discount on purchases, if any, should be deducted from purchases in the inner column and only net purchases are shown in the outer column. The worth noting points in this respect are:-
- i) Goods purchased but in transit will not affect the trading account. It is better to debit the goods in transit account and credit the supplier's account for such goods. Goods in transit, account appears as an asset and supplier's account as a liability in the balance sheet.
 - ii) Goods purchased for personal use of the proprietor should be first recorded as ordinary purchases debiting purchases account and crediting the supplier's account. Then, it should be recorded as goods withdrawn by the proprietor for personal use and entry for that will be debit drawings account and credit purchases account.
 - iii) Sometimes invoices of goods purchased are received in advance before the actual receipt of such goods. For such goods neither the purchases account will be debited nor the goods will be included in the closing stock.
 - iv) Purchases made under future transactions i.e., the goods will be delivered in future, and goods received on consignment or on behalf of third party, should not be included in purchases.
 - v) Purchases of any asset such as furniture, machinery, etc. should be kept separate.
 - vi) Adjusted purchases: Some concerns, for comparison purposes, prefer to adjust the opening and closing stock through purchases account. entries for this will be as under:-

- a) For adjustment of opening stock

Purchases A/c	Dr
To Opening stock	

Closing stock a/c	Dr
To Purchases a/c	

vii) Goods distributed as samples will be deducted from purchases and will be debited to advertisement account which ultimately will be shown on the debit side of the p/l a/c.

Charity a/c Dr
To Purchases a/c

3. Direct expenses: These include all expenses which have been incurred before the goods becomes ready for sale and are shown on the debit side of trading account. Examples are given below:

ii) Duty drawbacks and motivatable excise duty: AS per accounting standard - 2 duty drawbacks should be deducted from the cost of purchases. Modvatable excise duty is refundable to a manufacturer and is deducted from the cost of purchases whereas gross excise duty on finished goods is debited to the trading account.

iii) **Wages and salaries:** If wages have been incurred on manufacturing goods or making them more saleable, they become an item of direct expenses and are debited to trading a/c but other wages indirect should

be debited to the p/l a/c . If nothing is mentioned whether the wages are direct or indirect , they should be treated as direct and are shown on the debit side of trading a/c. Wages must include all wages outstanding but wages spent on constructing a building or manufacturing any other asset should be excluded while calculating the amount of wages.

- iv) **Carriage, cartage or freight:** These expenses when paid on the purchases of goods are taken to the debit side of the trading account. such expenses, if incurred on purchasing an asset should be capitalised by debiting the asset account and should not be taken to trading account. outstanding carriage, cartage or freight should be added to these expenses and appears as a liability in the balance sheet.
- v) **Import duty and dock charges:** In case goods are imported from abroad, custom duty, dock charges ,etc. have to be paid. As these relate to the goods purchased, they are shown on the debit side of the trading account.
- vi) **Octroi:** when goods are brought within the municipal limits, octroi duty has to be paid. This is debited to trading account.
- vii) **Motive power, coal, gas and fuel:** These are direct expenses and are shown on the debit side of trading a/c.
- viii) **Manufacturing expenses:** All expenses incurred in manufacturing the goods in the factory such as factory rent, factory insurance, depreciation on factory machinery, factory lighting,etc. are debited to trading a/c.
- ix) **Consumable stores:** These are incurred to keep the machine in right condition and include engine oil, soft soap, cotton waste,oil, grease and waste consumed in a factory.

Expenses of consumable stores will be calculated as under:-

Opening balance of stores	+
Add: purchases of stores during the year	+

	+++
Less: closing balance of stores	+
Stores consumed during the year	+++

The amount of such stores consumed during the year will be shown on the debit side of trading account.

- x) **Royalties:** These are the payments to a patents, author or landlord for the right to use his patent, copyright or land. If royalty is paid on the basis of production. It is debited to trading account and if it is paid on the basis of sales, it is debited to profit and loss account.
- xi) **Packing charges:** These may be of three types of packing as given below:
 - a) Ordinary or primary packaging which is necessary for the handling of the product as tooth paste tube or bottle in case of ink. The cost of such packaging is a direct expense and should be debited to the trading account.
 - b) If the packaging is required to transport the goods from one place to another as boxes or containers, etc. then such packaging charges should be treated as distribution expenses and being indirect expenses should be debited to the p/l a/c.
 - c) If the packaging is fancy to attract the customers as in case of cosmetic goods then it should be treated as selling expenses and should be debited to p/l a/c.

Detailed study of the items posted to the credit side of the trading account.

1. **Sales:** Sales should be both cash and credit sales of goods which were purchased for resale purposes. Some customers might return the goods sold to them called sales return which are deducted from the sales in the inner column and net amount is shown in the outer column. While ascertaining the amount of sales, the following points need attention

- i) If a fixed asset such as furniture, machinery, etc., is sold, it should not

be included in sales. However, if the amount realised from the sale of

Sales a/c	Dr
To Asset a/c	

- Sales a/c Dr
To Consignee's or hire purchaser's or customer's a/c

2. **Sales tax:** This type of tax charged from customers on sales of goods is not a part of sales revenue but this amount is to be deposited with the sales tax authorities of the government. Therefore, if sales inclusive of sales tax charged are given the amount of sales tax charged and payable to the government should be deducted from sales figure to get the correct amount of sales revenue.
3. **Closing stock:** It is the amount of unsold goods in hand at the end of the trading period. Generally, the closing stock is given outside the trial balance, but when purchases are adjusted through opening and closing stock, in that case closing stock will have a debit balance in the trial balance. If given outside the trial balance, it will be credited to the trading account but if it is given in the trial balance, then it appears as asset in the balance sheet. Closing stock may be of raw materials, work in progress, and finished goods. In order to ascertain the value of closing stock, a list of all goods in stock after physical checking is prepared. Stock includes only those goods which are normally bought and sold by the trader. Goods unsold at branches and with agent should

also be included in closing stock but stock of stationery and postage stamps will not be included in the closing stock. Closing stock is valued at cost or

realisable price whichever is less. It is, hence, valued on conservative basis i.e., expected profit should be ignored but possible losses should be duly provided for.

Closing entries

All the accounts relating to expenses and revenues must be closed at the end of the year. For closing such accounts they are transferred either to trading account or profit and loss account. The journal entries required for transferring these accounts to trading account or profit and loss account are known as closing entries. Closing entries are passed at the end of each accounting period for the purpose of transferring the various revenue items to trading and profit and loss account and thus, close the nominal accounts.

The process of framing closing entries is very simple. A debit balance in an account is credited and either trading account or profit and loss account is debited. Similarly, a credit balance in an account is debited and trading account or profit and loss account is credited. Closing entries in a journal may be divided into two categories, i.e., Simple and compound entries. A simple closing entry is one in which only two accounts are affected, one account to be debited and another account to be credited with an equal amount. In a compound entry, there may be several accounts to be debited and only one to be credited, or one account to be debited and several accounts to be credited or several accounts to be debited and several accounts to be credited.

Closing entries for trading account

The journal entries necessary to transfer opening stock, purchases, sales and returns to the trading account are called closing entries, as they are recorded to close these accounts. These are as follows:

For transfer of opening stock, net purchases and direct expenses to trading account,

Trading a/c	Dr
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To Stock a/c – (opening)

To Purchases a/c – (net)

To Direct expenses a/c

- 4. Fixation of selling price:** In case of a new product, the selling prices can be easily fixed by adding in the cost of goods manufactured the desired percentage of gross profit.

B. CHECK YOUR PROGRESS

Multiple Choice Questions

1. What is the primary purpose of a Trading Account?

- a) To calculate net profit
- b) To determine gross profit or loss
- c) To record fixed assets
- d) To list liabilities

2. Which of the following appears on the debit side of a Trading Account?

- a) Sales
- b) Purchases
- c) Capital
- d) Bank loan

3. Which item is NOT shown in the Trading Account?

- a) Cost of Goods Sold
- b) Sales Returns
- c) Rent Expenses
- d) Closing Stock

4. Gross Profit is calculated as:

- a) Sales – Expenses
- b) Sales - Cost of Goods Sold
- c) Cost of Goods Sold – Expenses
- d) Sales + Expenses

Which of the following affects the Gross Profit?

- a) Salary Expense
- b) Advertisement Expense
- c) Cost of Goods Sold
- d) Bank Charges

Answers:

- 1. (b) To determine gross profit or loss
- 2. (b) Purchases
- 3. (c) Rent Expenses
- 4. (b) Sales - Cost of Goods Sold
- 5. (c) Cost of Goods Sold

5.4 PREPARATION OF PROFIT AND LOSS ACCOUNT

This account is prepared to calculate the net profit of the business. There are certain items of incomes and expenses of the business which must be taken into consideration for calculating net profit of the business. These are of indirect nature i.e., concerning the whole business and relating to various activities which are done by the business for the purpose of making the goods available to the consumers. Indirect expenses may be selling and distribution expenses,

management expenses, financial expenses, extraordinary losses and expenses to maintain the assets into working order. Profit and loss account is prepared from nominal accounts and its balance is transferred to capital account as the whole profit or loss will be that of the owner and it will increase or decrease his capital.

The specimen proforma of this account is given as under:

To gross loss b/d	+	By gross profit b/d	+
To selling and distribution expenses		By Interest received	+
Advertisement	+	By Discount received	+
Traveller salaries	+	By Commission received	+
Bad debts	+	By Rent from tenants	+
Godown rent	+	By Income from investments	+
Export expenses	+	By Apprenticeship premium	+
Carriage outwards	+	By Interest on debentures	+
Bank charges	+	By Income from any other source	+
Agent's commission	+	By Miscellaneous revenue receipts	+
Unkeep of motor lorries	+	By Net loss (Bal. Fig.)	+

To management expenses			
Rent, rates and taxes	+		
Heating and lighting	+		
Office salaries	+		
Printing & stationery	+		
Postage & telegrams	+		
Telephone charges	+		
Legal charges	+		
Audit fees	+		
Insurance	+		

General expenses	+		
To Depreciation and maintenance		+	
Depreciation	+		
Repairs & maintenance	+		
To financial expenses		+	
Discount allowed	+		
Interest on capital	+		
Interest on loans	+		
Discount on bills discounted	+		
To Extraordinary expenses		+	
Loss by fire not covered by insurance	+		
Cash deflacations	+	+	
To Net profit (Bal. Fig.)		+	

Indirect expenses to be shown on the debit side of p/l a/c can also be divided into two categories i.,e., operating and non- operating expenses.

Operating expenses: It referes to those expenses which are incurred in a concern to run the business efficiently and smoothly. Expenses incurred on administration, selling and distribution come under this category.

Non- operating expenses: It refers to those expenses which are not required to be incurred for efficient and smooth operation of the business but still shown on the debit side of the p/l a/c. These include loss on the slae of fixed assets, writing off tangible assets and intangible assets, financial expenses,etc.

Modern trend is to present trading and p/l a/c or income statement in the form of a statement rather than in the form of an account as shown below:

Sales	+
Less: cost of goods sold	+

Raw materials consumed	+
Consumables	+
Direct labour	+
Other direct expenses	+
Gross profit	+++
Less: operating expenses	+
Administration expenses	+
Selling expenses	+
Depreciation	+
Operating profit	+++
Add: non- operating incomes	+
Less: non operating expenses	+
Net profit before interest and tax	+

Less interest paid	+
Net profit before tax	+
Income tax @ 50 %	+
Net profit after tax	+++

Nature of profit and loss account

1. It is a periodic account prepared after a certain period usually a year for ascertaining profit or loss of that period , therefore, it is called a periodic account. unlike, other accounts,it is not operated throughout the accounting period.
2. It is an interim report. It is assumed that a business unit has a reasonable expectation of continuing business at a profit for an indefinite period of time unless otherwise stated. Truly speaking, ascertainment of profit or loss of a business entity is relatively simple on a whole life basis when a business liquidates

and converts its assets into cash and pays off its debts. But the owners, the investors and overall the government all are impatient and do not want to wait, until the liquidation of the business entity to know what has been the result of the business activities. All these persons are interested in regular reports and accounts can be stated as an interim reports for an unambiguous final report can be available only on the liquidation of a business entity.

3. It is an absorbent account. At the end of an accounting period all nominal accounts are absorbed in the p/l a/c for ascertaining profit or loss.
4. It is an allocation statement. Receipts and payments should be allocated between present and future periods for ascertaining profit or loss of a specific period. Profit or losses, incomes and expenses of a particular accounting period are allocated to the profit and loss account of that period and receipts and payments related to the future period are shown in the balance sheet. That is why profit and loss account is called a statement of allocated income and expenditure.

Important points in the p/l a/c

1. **Salaries:** These include salaries paid to the office, godown and warehouse staff and should be shown in p/l a/c being indirect expenses. Salaries to partners must be debited separately. If salaries are paid after deduction of income tax or provident fund, then, these should be added back to the salaries in order to have gross figure of salaries to be shown in the p/l a/c. Gross salaries payable should be debited. Employer's contribution to the provident fund of the employees should be charged as an expense to the p/l a/c. Both employer's and employees contribution to the provident fund will also be shown as a liability in the balance sheet under the heading employees provident fund.

If salaries are paid in kind by providing certain facilities to the employees such as house free of rent, meals or cloth or washing facility free of charge, e.g., in hospitals, hotels, farms, etc. then, the value of such facilities should be regarded as salaries.

Sometimes, in certain problems and wages are not separately given but both are put together either as salaries and wages or as wages and salaries.

In such a case, a difficulty always arises as to whether the same should be charged to the trading account or to the p/l a/c. In such a case, one should follow any of the following two alternative treatments and append a foot note stating the assumption taken.

- a) From the point of view of materiality, it may be presumed that when the account is styled as wages and salaries, the greater or the material portion of the expenses included there in comprises of wages than of salaries. Hence, salaries being immaterial no separate account has been maintained for salaries. On the assumption, wages and salaries may be charged to the trading account.

Again, when the account is styled as salaries and wages, it may be presumed from the point of view of materiality that greater portion of the expenses comprised therein consists of salaries than of wages. Hence, wages being immaterial, separate account for wages has not

been kept. On this assumption, salaries and wages account may be debited to the p/l a/c.

- b) Another view growing amongst the accountants is that wages implies only productive wages and is a direct expense, while salaries imply an unproductive or indirect expense. When salaries and wages are put together it becomes an unproductive or indirect expense. So , it does not matter whether it is salaries and wages or wages and salaries ,it should always be treated as indirect expense and shown only in the p/ l a/c on the ground that any productive expense when combined with an unproductive expense becomes only an indirect expense.

- 2. **Rent, rates and taxes :** This include offices and warehouse rent, municipal rates and taxes . Factory rent, rates and taxes should be debited to trading account and other to profit and loss account. if any rent is received on sub- letting of the building , the same should be shown separately on the credit side of the p/l a/c . If rent is paid after deduction of some taxes, then these should be added back to know the correct amount of rent payable.
- 3. **Commission:** Commission received for doing the work for others firms

may be credited to profit and loss as a gain and commission payable to the agents employed to sell the firm's goods is debited as an expenses.

4. **Depreciation:** It is an expense due to wear and tear, lapse of time and exhaustion of assets used in business. This is loss sustained by fixed assets and should be charged to the p/l a/c.
5. **Abnormal losses:** Some abnormal losses like loss on sale of fixed assets cash defalcation, stock destroyed by fire not covered by insurance ,etc may arise during the accounting period. Such losses are taken as extra ordinary expenses and debited to the p/l a/c.

C. CHECK YOUR PROGRESS

True And False

1. The Profit and Loss Account shows the net profit or net loss of a business for an accounting period.
2. Expenses related to selling and administration are charged in the Profit and Loss Account.
3. The Profit and Loss Account starts with Gross Profit brought down from the Trading Account.
4. The Profit and Loss Account includes Capital and Drawings.
5. Profit and Loss Account is prepared after the Trading Account.
6. Net Profit is transferred to the Balance Sheet.

Answers:

- | | | |
|----------|---------|---------|
| 1. True | 2. True | 3. True |
| 4. False | 5. True | 6. True |

5.5 PREPARATION OF BALANCE SHEET

A business organisation conveys financial information to the users-through financial statements and reports. A financial statement is nothing but collection of data according to logical and consistent accounting procedures. Accounting involves:

- 1) The recording of transactions in books of original entry also called the transactions.
- 2) The classification of these transactions in ledger.
- 3) The summarization of these records.

The preparation of financial statements takes place in phase of accounting process. According to accounting view the Balance Sheet is or summary of the balances of various accounts after a formal closing of the books for a period. The balance of each account indicates the position of that account and, therefore, the Balance Sheet may be regarded as a master account or summary of the position of different accounts.

A Balance Sheet shows on one side the various sources from which money used in the business came. These sources consist of the owner's capital, loans taken from various parties and the amounts due to other parties for goods purchased, expenses incurred, and the profit made in the business but not withdrawn. On the other side Balance Sheet shows in what way the money was used in the business. It consists of things by it, such as permanent assets, stock, cash and also amounts yet to be received from other parties. A Balance is a photograph of the business at any point of time.

In specific term, the Balance Sheet:

- i) indicates the financial position of a business as on a date or at a point of time, shows the different sources from which money or money's worth was obtained for the business from its inception, and shows the various forms in which money or money's worth has been employed in the business from its inception.

In short, you should keep in mind the following important aspects of Balance Sheet:

- i) A Balance Sheet is always prepared from the point of view of the firm, company or business, and not from that of its owners, creditors, directors or employees.
- ii) The financial position of the business is shown in the amount of various assets like

land, buildings, machinery, stock in trade, cash or any other thing of value.

iii) The financial relationship of the business is shown to its owners in the amount of capital, reserves and undistributed profits, to its creditors in the amount of loans due to them, and to its debtors in the amount due from them.

iv) A Balance Sheet always relates to a particular point of time or date and not a period.

v) A Balance Sheet is always expressed in terms of money or money value.

vi) Since, the amount obtained by the firm from various sources is shown on one side and the amount used for various purposes is shown on the other, the total money value on both sides of the Balance Sheet must be the same.

A Balance Sheet is a financial statement that shows the financial position of a firm on a specific date, usually on the close of the accounting period. The Balance Sheet contains information about the resources and obligations of a business enterprise. In accounting language, it shows the assets, liabilities and equity for the firm as on specific day.

The Indian Companies Act 1956, requires that Balance Sheet should give a true and fair view of the state of affairs of the company. In addition to this, contents and presentation of periodic final accounts of business are governed by accounting concepts. The concepts which are central to the preparation of financial accounts and statements are:

Going concern, Entity Concept, Consistency, Prudence, Accruals, and Dual Aspect.

Going concern concept assumes that the business entity shall continue to exist and operate unless there is an intention to the contrary. This has an important implication for the evaluation of assets and liabilities. Assets are normally carried in the books at their cost less depreciation, and not at their liquidation value. This reflects better value of assets. Likewise, liabilities also

reflect what the business owns, not the liquidation value.

Consistency concept requires that the accounting treatment of items, in different periods, should be followed consistently.

Prudence (or conservatism) basis of accounts preparation requires, that: .

- 1) Profits will not be recognised until they are
- 2) Losses will be recognised as soon as they are apparent even though they have not been realised.

The rationale of this convention lies in considering the uncertainty of events.

Accruals (or matching) mean that income and the costs of earning that income should be matched, when calculating the income of a period. Costs and incomes are to be recognised as incurred or earned - not when money is paid or received.

Entity Concept: In accounting, a business enterprise is considered to be a separate entity than the owners. Therefore, transactions are recorded from the view point of enterprise. Accordingly, when statements are prepared then the personal assets or liabilities of the owners are not considered.

As per Dual Aspect concept, assets equal . Assets indicate what business 'owns' while liabilities refers to what business 'owes'. The term liabilities includes capital and other liabilities of the firm.

Proforma of Balance Sheet

Balance Sheet of XYZ Business as at 31st March 2024

Liabilities	Amount	Assets	Amount
Capital Add: Net Profit (or) Less: Net Loss Liabilities: Bank Loan		Fixed Assets Land & Buildings Plant & Machinery Furniture & Fittings	

Creditors Outstanding Expenses		Current Assets Stock Debtors Bank Balance	
	----- -		-----
	<u>Total Liabilities</u>		<u>Total Assets</u>

Format of Balance Sheet

Particulars	Amount	Amount
I. EQUITY AND LIABILITIES		
1. Shareholders' Fund		
• Capital		
• Reserves and Surplus		
2. Non-Current Liabilities		
• Long-term Borrowings		
• Long-term Provisions		
3. Current Liabilities		
• Trade Creditors		
• Short-term Borrowings		
• Other Current Liabilities		

• Short-term Provisions		
Total Equity and Liabilities		
II. ASSETS		
1. Non-Current Assets		
• Fixed Assets		
• Long-term Investments		
• Other Non-Current Assets		
2. Current Assets		
• Inventories		
• Trade Receivables		
• Cash and Bank Balances		
• Other Current Assets		
Total Assets		

5.5.1 DISTINCTION BETWEEN TRIAL BALANCE AND BALANCE SHEET

Points of distinction	Trial balance	Balance sheet
Statement	It is a statement of debit and credit balances taken from the ledger.	It is a statement of assets and liabilities
Purpose of preparation	It is prepared to test the arithmetical accuracy of books of account.	It is prepared to ascertain the financial position of the organisation on a particular date.
Type of balances shown	Balances of all types of accounts, i.e., personal,	Balances of real and personal accounts only are shown.

When prepared	real and nominal accounts are shown. It is usually prepared at the end of each month, three months, six months, or year before preparation of trading and p/l a/c.	It is usually prepared at the end of the year after the preparation of trading and p/l a/c.
Closing stock	Closing stock does not appear in the trail balance.	Closing stock is shown on the assets side of the balance sheet.
Use	It is prepared for internal use.	It is prepared for external use. i.e., for outside parties such as creditors, shareholders, government authorities, etc.

5.5.2 Distinction Between Trading And P/L A/C

Trading a/c	Profit & Loss Account
It is prepared to calculate gross profit or gross loss.	It is prepared to arrive at net profit or net loss.
In this account, cost of goods sold, sales and direct expenses are recorded.	In this a/c, indirect expenses such as administrative, selling & distribution expenses are charged against gross profit and other revenues.
Gross profit or loss is transferred to profit and loss a/c.	Net profit or loss is transferred to capital account which will be shown in the balance sheet.

5.6 SOLVED PROBLEMS

Problem 1 : following figures are available relating to the business of shri Ram for the

year 2014.

Opening stock Rs 45,000, purchases Rs 181,000; direct expenses Rs 12,000; indirect expenses Rs 48,000; closing stock Rs 38,000; sales Rs 418,000

Calculate gross profit & cost of goods sold .

Solution 1 : Cost of goods sold = opening stock + purchases + direct expenses – closing stock

$$= 45,000 + 181,000 + 12,000 - 38,000 = \text{Rs } 200,000.$$

Gross profit = sales – cost of goods sold

$$= 418,000 - 200,000 = \text{Rs } 218,000.$$

Problem 2: prepare a trading account of Rajesh kumar for the year ending 31st march, 2014 from the following particulars:

Stock of goods on 1-1-13	250,000	return to suppliers	25,000
Stock of goods on 31-3-14	475,000	returns by customers	20,000
Purchases- cash	370,000	goods withdrawn by rajesh	

Purchases – credit	825,000	kumar for personal use	21,000
Sales – cash	510,000	goods distributed as free samples	4,000
Sales – credit	11,50,000	duty and clearing charges	55,000
Cost of goods rent on consignment	10,000		

Solution 2:

TRADINGACCOUNT OF RAJESH KUMAR

For the year ended 31st March, 2014

Particulars	Amount	Particulars	Amount
To opening stock	250,000	By sales - cash	510,000
To purchases - cash	370,000	Credit	<u>11,50,000</u>
- credit	<u>825,000</u>		16,60,000
	11,95,000	Less: returns inward	<u>20,000</u>
Less: returns	25,000	By closing stock	475,000
Goods for personal use	21,000		

Goods used for samples	4,000		
Consignment	<u>10,000</u>	11,35,000	
	<u>60,000</u>	55,000	
To duty & clearing charges		675,000	
To gross profit c/d			
		21,15,000	21,15,000

Problem 3: Prepare a trading account for the year ending 30th June, 2014 of Mr. Arun Sharma from the following balances:

Stock on 1 st July, 13	480,000	indirect expenses incurred:	
Cash purchases	360,000	office salaries	50,000
Credit purchases	840,000	office lighting	5,000
Cash sales	760,000	printing & stationery	4,000
Credit sales	14,20,000	goods destroyed by fire	10,000
Freight	27,500	subsidies on purchase of goods	30,000
Carriage	2,500	excise duty on finished goods	35,000
Octroi duty	12,000	duty drawbacks	15,000
Import duty & dock charges	130,000	(movtable excise duty)	
Clearing charges	40,000	stock on 30th June, 14 at cost	310,000
Manufacturing expenses	120,000	(market value Rs 300,000)	

Solution 3:

TRADING ACCOUNT OF MR. ARUN SHARMA

For the year ending 30th June, 14

Particulars	Amount	Particulars	Amount
To opening stock	480,000	By sales - cash	760,000
To purchases - cash	360,000	Credit	<u>14,20,000</u>
- credit	<u>840,000</u>		
	12,00,000	By closing stock	300,000
Less: subsidies on purchase		By stock destroyed by fire	10,000
Of goods	30,000		

Duty drawbacks	<u>15,000</u>		
	<u>45,000</u>	11,55,000	
To freight		27,500	
To carriage		2,500	
To octroi duty		12,000	
To import duty & dock charges		130,000	
To clearing charges		40,000	
To manufacturing expenses		120,000	
To excise duty on finished goods		35,000	
To gross profit c/d		488,000	
		<u>24,90,000</u>	<u>24,90,000</u>

Problem 4: from the following balan ces extracted at the close of the year ended 31st March,14, prepare p/l a/c of M/s ashok & sons as at that date:

Gross profit	101,000	discount (Dr.)	500
Carriage outward	2,500	apprentice premium (Cr.)	1,500
Salaries	5,500	printing & stationery	250
Rent	4,100	rates & taxes	350
Fire insurance premium	900	travelling expenses	200
Bad debts	2,100	sundry trade expenses	300
Income tax paid	3,500	rent received on sub letting	1,000
Life insurance premium	3,000		

Solution 4:

PROFIT AND LOSS ACCOUNT OF M/S ASHOK & SONS

For the year ended 31st March, 2014

Particulars	amount	Particulars	amount
To carriage outward	2,500	By gross profit b/d	101,000
To salaries	5,500	By apprentice premium	1,500
To rent	4,100	By rent received on sub letting	1,000

To fire insurance premium	900		
To bad debts	2,100		
To discount	500		
To printing & stationery	250		
To rates & taxes	350		
To travelling expenses	200		
To sundry trade expenses	300		
To net profit	86,800		
	103,500		103,500

Income tax and life insurance premium being personal expenses of the proprietor have not been debited to the p/l a/c. These are to be taken as drawings and will be deducted from capital account.

Problem 5 : Following are the balances in the ledger of Mr. Suresh for the year ended 31st ended, 14.

Discount Dr.	2,500	carriage outwards	12,400
Carriage inwards	10,200	advertisement	12,000
Rent, taxes & rates	13,300	miscellaneous expenses	3,300
Printing & stationery	2,600	interest paid	10,792
Purchase of raw materials	349,800	Fuel & Coal	11,200
Sales	560,000	Factory power	25,600
Opening stock of raw materials	124,400	Insurance fire	1,760
Opening stock – finished goods	63,800	Staff salaries	13,800
Factory wages	59,700	Electricity	2,500
Sale of scrap	600	Bad debts	6,080
Depreciation on p & m	11,690	Depreciation on furniture	2,860

Prepare manufacturing trading and p/l a/c for the year ended 31st March, 14 . the stock as

at 31-3-14 was raw materials Rs 46,900 and finished goods Rs 152,300.

Solution 5:

MANUFACTURING TRADING AND PROFIT & LOSS A/C

For the year ended 31st March, 14

To raw materials used:		By sale of scrap	600
Opening stock 124,400		By cost of goods manufactured	545,090
Add: purchases 349,800			
474,200			
Less: closing stock <u>46,900</u>	427,300		
To carriage inwards	10,200		
To factory wages	59,700		
To fuel and coal	11,200		
To factory power	25,600		
To depreciation on plant & machinery	<u>11,690</u>		
	<u>545,690</u>		<u>545,690</u>
To opening stock of finished goods	63,800	By sales	560,000
To cost of goods manufactured	545,090	By closing stock of finished goods	<u>152,300</u>
To gross profit c/d	<u>103,410</u>		<u>712,300</u>
	<u>712,300</u>	By gross profit	103,410
To carriage outwards	12,400		
To advertisement	12,000		
To discount	2,500		
To rent, rates & taxes	13,300		
To printing & stationery	2,600		
To bad debt	6,080		
To misc. Expenses	3,300		
To interest	10,792		
To insurance	1,760		
To staff salaries	13,800		
To electricity	2,500		
To depreciation on furniture	2,860		
To net profit	19,518		
	<u>103,410</u>		<u>103,410</u>

Problem 6: Following balances are extracted from the books of kautilya and co. On 31st march, 2014. You are required to make the necessary closing entries and to prepare the trading and p/l a/c and a balance sheet as on that date.

Purchases	19,500	Trade expenses	100
Wages	1,400	Office expenses	500
Insurance	550	Cash in hand	250
Sundry debtors	15,000	Cash at bank	2,375
Carriage inward	400	Rent and taxes	550
Commission Dr.	400	Carriage outward	725
Interest on capital	350	Sales	25,000
Stationery	225	Bills payable	1,500
Returns inward	650	Creditors	9,825
Capital	8,950		

Closing stock was valued at Rs 12,500.

Solution 6 : Closing entries

(Pl. see table on next page)

Date	particulars	LF	Dr. Amount	Cr. Amount
2014 31st March	Trading a/c Dr To stock a/c To purchases a/c To wages a/c To carriage inward a/c (being balances transferred)		21,550	500 19,250 1,400 400
“	Sales a/c Dr. To trading a/c (being balances transferred)		24,350	24,350

“	Stock a/c Dr. To trading a/c (being value of closing stock)	12,500	12,500
“	Trading a/c Dr. To P/L a/c (being gross profit transferred)	15,300	15,300
“	P/L a/c Dr. To insurance a/c To commission a/c To interest on capital a/c To stationery a/c To trade expenses a/c To rent & taxes a/c To carriage outward a/c (being balances transferred)	2,900	550 400 350 225 100 550 725
“	Commission a/c Dr. To p/l a/c (being balance transferred)	200	200
“	P/l a/c Dr. To capital a/c (being net profit transferred)	12,600	12,600

TRADING & PROFIT & LOSS A/C

For the year ended 31st March, 2014

To opening stock	500	By sales	25,000	
To purchases	19,500	Less: return	650	24,350
Less: returns	<u>250</u>	By closing stock		12,500
	19,250			
To wages	1,400			
To carriage inward	400			
To gros profit c/d	<u>15,300</u>			
	<u>36,850</u>			<u>36,850</u>
To insurance	550	By gross profit b/d		15,300

To commission	400	By commission	200
To interest on capital	350		
To stationery	225		
To trade expenses	100		
To rent and taxes	550		
To carriage outward	725		
To net profit	12,600		
	<u>15,500</u>		<u>15,500</u>

BALANCE SHEET
As on March 31, 2014

Creditors	9,825	Cash in hand	250
Bills payable	1,500	Cash at bank	2,375
Capital		Bills receivable	2,250
April 1, 13	8,950	Stock	12,500
Add: net profit	12,600	Sundry debtors	15,000
	21,550	Office fixtures	<u>500</u>
	<u>32,875</u>		<u>32,875</u>

Problem 7 : Following trading and P/L a/c has been prepared by a junior accountant of a firm. Criticise it and redraft it correctly.

TRADING AND P/L A/C

For the year ended March 31, 2014

To opening stock of raw materials	7,352	By closing stock of raw materials	9,368
To purchases	63,681		
To sundry creditors	25,375	By sales	170,852
To carriage inwards	2,654	By sundry debtors	40,659
To carriage outwards	394	By gross loss c/d	8,182
To salaries	24,370		
To wages	51,963		
To rent, rates and taxes	3,981		
To repairs to factory	35,368		

To insurance	13,923		
	<u>229,061</u>		<u>229,061</u>
To gross loss b/d	8,182		
To interest on loan	6,180	By bank overdraft	17,681
To dividend from investments	9,375	By interest on bank overdraft	123
To furniture purchases	17,681	By net loss transferred to	39,691
To telephone charges	985	balance sheet.	
To electric charges	2,756		
To depreciation on plant & machinery	663		
To general expenses	11,673		
	<u>57,495</u>		<u>57,495</u>

Solution 7 :

Trading and p/l a/c prepared by junior accountant shows more personal accounts like sundry creditors, sundry debtors and bank overdraft. It is correct to take these items in the trading and p/l a/c as these items are taken in the balance sheet. In trading and p/l a/c relating to expenses, losses and incomes are taken. Further, some indirect expenses like carriage outwards, salaries , rent,rates and taxes and insurance which should have been debited to the p/l a/c have been wrongly debited to trading account.

Amount spent on furniture purchases being capital expenditure should have been shown as an asset in the balance sheet but it has been incorrectly debited to the profit and loss account by the junior accountant.

Another glaring mistake in the preparation of the p/l a/c is that dividend from investments is income whereas it has been taken as an expense. Similarly, interest on overdraft is an expense whereas it has been taken as an income by showing it on the credit side of the p/l a/c.

Correct trading and p/l a/c will be as follows:

TRADING & P/LA/C

For the year ended March 31st, 2014

To opening stock	7,352	By sales	170,852
To purchases	63,681	By closing stock	9,368

To wages	51,963		
To carriage inwards	2,654		
To repairs to factory	35,368		
To gross profit c/d	<u>19,202</u>		
	<u>180,220</u>		<u>180,220</u>
To salaries	24,370	By gross profit b/d	19,202
To rent, rates and taxes	3,981	By dividend from investments	9,375
To insurance	13,923	By net loss c/d	36,471
To carriage outwards	394		
To interest on loans	6,180		
To interest on bank overdraft	123		
To telephone charges	985		
To electric charges	2,756		
To depreciation	663.		
To general expenses	<u>11,673</u>		
	<u>65,048</u>		<u>65,048</u>

ADJUSTMENTS

While preparing trading and p/l a/c one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken in to consideration. This means that if an expense has been incurred but not paid during that period, a liability for the unpaid amount should be created before the accounts can be said to show the true profit or loss. All expenses and incomes should properly be adjusted through entries. These entries which are passed at the end of the accounting period are called adjusting entries. Some important adjustments which are to be made at the end of the accounting year are discussed in the following pages one by one.

Closing stock

Unsold goods lying in the stock at the end of the accounting period are called closing stock. Every concern prepares a list of items of stock which remains unsold and puts value against it. Stock is to be valued at cost or net realisable value whichever is less. For the total value of closing stock, say Rs 50,000 , the following adjustment entry will be passed at the end of the year.

Stock A/c	Dr.	50,000
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The two accounts accounts affected are:-

To trading a/c	50,000	By balance c/d	50,000
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		By stock A/c	50,000
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- i) Stock being debit balance will be shown on the assets side of the balance sheet.
- i) It will be shown on the credit side of the trading a/c.

closing stock (debit balance) will be given in the trial balance. Adjusted purchases will be taken on the debit side of the trading a/c and closing stock will be shown on the assets side of the balance sheet. It should be noted carefully that closing stock in this case will not be shown on the credit side of the trading a/c as closing stock has already been adjusted through purchases account. at the beginning of the next accounting year, closing stock will become opening stock and will be brought into account by passing reverse entry as under:

Those expenses which have been incurred and are due for payment i.e., not paid as yet are called outstanding expenses. For example, Rs 1,000 p.m is paid as salary to an employee but during the year 2013, only Rs 10,000 are paid as salary. Two month's salary i.e., Rs 2,000 which is due but not paid is outstanding salary. In order to bring this fact in to books of account , the following adjusting entry will be passed at the end of the year.

Salaries outstanding a/c	Dr	2,000
To outstanding salaries a/c		2,000

The effect of this entry on two accounts will be:

Salaries A/c

To cash

To Cash	10,000	By P/LA/c	12,000
To outstanding salaries a/c	2,000		
	12,000		12,000

Outstanding salaries A/c

To balance C/d	2,000	By salaries A/c	2,000
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The two fold effect of the above accounts will be :

- Outstanding expenses will be shown on the debit side of trading and P/LA/c by way of addition to the expenses and
- Outstanding expenses will be shown on the liabilities side of the balance sheet.

If no adjustment were made for the outstanding salary then, the net profit would be overstated by Rs 2,000 and liabilities understated by Rs 2,000

In the beginning of the next year, a reverse entry will be passed to cancel the effect of the adjustment entry. Reverse entry will close outstanding salaries account and adjust the next year's salary account.

Prepaid or unexpired expenses

Those expenses which have been paid in advance i.e. whose benefit will be available in future are called prepaid or unexpired expenses. For example, if a fire insurance policy is taken for a year paying Rs 1,000 as insurance premium on 1st July, 2013, when accounts are closed, will be that Rs 500 i.e., premium from 1st July, 2013 to 31st December, 2013 will be an expense but Rs 500 i.e, premium from 1st January, 2014 to 30th June, 2014 will be prepaid or unexpired expense. In order to bring this into account on 31st December, 2013, the following adjusting entry will be passed:

Prepaid insurance premium A/c	Dr.	500
To insurance premium A/c		500

Two accounts affected will be:

Prepaid insurance premium A/c

To ins. Pre. A/c	500	By balance C/d	500
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Insurance premium A/c

To bank A/c	1,000	By prepaid ins. Pre. A/c	500
		By P/L A/c	500
	1,000		1,000

The two fold effect of prepaid expenses will be:

- i) Prepaid expenses will be shown in p/l a/c by way of deduction from the expenses and
- ii) Prepaid expenses being debit balance will be shown on the assets side of the balance sheet.

In the beginning of the next year, a reverse entry will be passed to nullify the effect of adjusting entry.

Accrued income

That income which has been earned but not received during the accounting year is called accrued income. For example, if the business has invested Rs 10,000 in 5 % gilt edged securities on 1st January, 2013 but during the year 350 has been received as interest on securities. Then Rs 150 interest on securities earned and due for payment on 31st December, 2013 but not received, will be accrued interest for the year 2010 . In order to bring accrued interest into books of account, the following adjusting entry will be passed:

Accrued interest A/c

To interest A/c	150	By balance C/d	150
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Interest A/c

To P/L A/c	500	By bank A/c	350
		By accr. int.A/c	150

	500		500
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The two fold effect of accrued income will be:

- i) It will be shown on the credit side of the p/l a/c by way of addition to income, and
- ii) Accrued income being debit balance, will be shown on the assets side of the balance sheet.

Next year, in the beginning, a reverse entry will be passed in order to eliminate the effect of adjusting entry and to bring the same to the correct position.

Income received in advance

Income received but not earned during the accounting year is called as income received in advance. For Example. If building has been given to a tenant on Rs 24,000 p.a. but during the year Rs 30,000 has been received, then, Rs 6,000 will be rent received in advance. In order to bring this into books of account, the following adjusting entry will be made at the end of the accounting year.

Rent A/c

To balance C/d	600	By rent A/c	600
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Rent received in advance A/c

To rent received in advance a/c	600	By bank A/c	3,000
To p/l a/c	2400		
	3,000		3,000

The two fold effect of this adjustment will be:

- i) It is shown on the credit side of p/l a/c by way of deduction from the income and
- ii) Income received in advance being credit balance, is shown on the liabilities side of the balance sheet.

Problem 8: Pass necessary adjusting entry in shri Ram Bhrose's journal on 31st March,

2014.

- a) The stock on 31st March, 2104 of raw materials was of the value of Rs 400,000 and that of finished goods of Rs 350,000
- b) Rs 30,000 for wages and Rs 10,000 for printing were outstanding.
- c) Rs 12,000 for insurance personal and Rs 20,000 for income tax were paid in advance.

- d) Write off depreciation on machinery Rs 80,000 and on building Rs 30,000
- e) Rs 25,000 were received in advance for commission.
- f) Rs 1,000 is interest accrued on investment.

Before making the above adjustments his net profits for the year ended 31st March, 2014 was Rs 215,000 , what will be net profit for the year after making the adjustments.

Solution 8: Shri Ram Bhrose's journal

Date	particulars	LF	Debit	Credit
a)	Stock of raw materials a/c Dr Stock of finished goods a/c Dr To trading a/c (being closing stock as on march 31 , 2014)		400,000 350,000	750,000
b)	Wages a/c Dr. Printing charges a/c Dr. To expenses o/s a/c (being wages and printing charges outstanding)		30,000 10,000	40,000
c)	Drawings a/c Dr. To insurance a/c To income tax a/c (being private expenses paid in advance)		32,000	12,000 20,000
d)	Depreciation a/c Dr. To machinery a/c To building a/c (being depreciation written off)		110,000	80,000 30,000
e)	Commission received a/c Dr.			

f)	To commission received in advance (being commission received in advance)		25,000	25,000
	Accrued interest a/c Dr. To interest a/c (being accrued interest brought into the books)		1,000	1,000

Net profit after making the value adjustments will be Rs 791,000 (i.e., Rs 215,000 + Rs 750,000+ 1,000 – 40,000 – 110,000 – 25,000)

Depreciation

Depreciation is the reduction in the value of fixed assets due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the profit of that year in order to show correct profit or loss and to show the asset at its correct value in the balance sheet. Generally, depreciation is charged at some percentage on the value of an asset. Suppose machinery for Rs 10,000 is purchased on 1st January, 2014, 20 % p.a. is the rate of depreciation. Then, Rs 2,000 will be depreciation for the year 2014 and will be brought in to account by passing the following adjusting entry:

Depreciation A/c	Dr.	2,000
To machinery A/c		2,000

Two accounts affected will be :

Depreciation A/c

To machinery A/c	2,000	By P/L A/c	2,000
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Machinery A/c

To bank A/c	10,000	By dep. A/c	2,000
		By balance C/d	8,000
	10,000		10,000

The two fold effect of depreciation will be :

- Depreciation is shown on the debit side of the p/l a/c

- ii) It is shown on the assets side by way of deduction from the value of concerned asset.

Bad debts

Bad debts cannot be recovered or become irrecoverable are called bad debts.

It is a loss for the business. For example, if sundry debtors on 31st march, 2014 are Rs 55,200, bad debts on that date are Rs 200. In order to bring this into account, an adjusting entry will be passed:

Bad debts a/c	Dr. 200
To sundry debtors a/c	200

Two affected accounts will be:

Bad debts A/c

To sundry debtors A/c	200	By P/L A/c	200
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Sundry debtors A/c

To bal B/d	55,200	By bad debts A/c	200
		By balance C/d	55,000
	55,200		55,200

Problem 9: Following are the balances of Shri Gupta as on 30th June, 2014.

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Debit balances:

Cash in hand	540
Cash at bank	2,630
Purchases	40,675
Returns inward	680
Wages	8,480
Fuel and power	4,730
Carriage on sales	3,200
Carriage on purchases	2,040
Stock as on 1st July, 2013	5,760
Buildings	22,000
Freehold land	10,000

Credit balances:

Sales	98,780
Returns outwards	500
Capital	62,000
Sundry creditors	6,300
Rent	9,000

Machinery	20,000	
Investments	10,000	
Patents	7,500	
Salaries	15,000	
General expenses	3,000	
Insurance	600	
Drawings	5,245	
Sundry debtors	14,500	

Taking into account the following adjustments prepare the trading and P/LA/c and balance sheet as on 30th June, 2014.

- Stock on hand on 30th June, 2014 is Rs 6,800
- Machinery is to be depreciated @ 10 % and patents @ 20 %
- Salaries for the month of June, 2014 amounting to Rs 1,500 were unpaid.

- d) Insurance includes a premium of Rs 170 on a policy expiring on 31st December, 2014
- e) Bad debts are 725
- f) Rent received in advance Rs 1,000
- g) Interest on investment of Rs 2,000 is accrued.

Solution 9:

**Trading and P/L A/c of Shri gupta For the year ended
30th June ,2014**

To opening stock	5,760	By sales	98,780	
To purchases 40,675		Less: returns	<u>680</u>	98,100
Less: returns <u>500</u>	40,175	By closing stock		6,800
To wages	8,480			
To carriage on purchases	2,040			
To factory fuel and power	4,730			
To gross profit c/d	<u>43,715</u>			
	<u>104,900</u>			<u>104,900</u>
To carriage on sales	3,200	By gross profit b/d		43,175
To salaries 15,000		By rent	9,000	
Add: o/s 1,500	16,500	Less: rent received		
To general expenses	3,000	in advance	<u>1,000</u>	8,000
To insurance 600		By accrued interest		2,000
Less: prepaid 85	515			
To depreciation on :				
-machinery 2,000				
-patents 1,500	3,500			
To bad debts	725			
To net profits c/d	<u>26,275</u>			
	<u>53,175</u>			<u>53,175</u>

**Balance Sheet of Shri Gupta
As on 30th June, 2014**

Sundry creditors	6,300	Cash	540
O/s salaries	1,500	Bank	2,630

rent received in advance	1,000	Sundry debtors	14,500	
capital	62,000	Less: bad debts	<u>725</u>	13,775
less: drawings	<u>5,245</u>	Closing stock		6,800
	56,755	Prepaid insurance		85
Add: net profit	<u>26,275</u>	Buildings		22,000
	83,030	Freehold land		10,000
		Machinery less dep. (22,000 – 2,000)		18,000
		Patents less w/o (7,500 -1,500)		6,000
		Accrued interest		<u>2,000</u>
	<u>91,800</u>			<u>91,800</u>

INTEREST ON CAPITAL

Sometimes in order to see whether the business is really earning profit or not, interest on capital at a certain rate is provided. For example, if A has invested Rs 50,000 as capital and 10 % interest is to be provided, then Rs 5,000 as interest on capital is to be brought into the books by passing the following adjusting entry:

Interest on capital a/c	Dr	5,000	
To A 's capital a/c			5,000

Interest on capital A/c

To capital A/c	5,000	By P/LA/c	5,000
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A's Capital A/c

To bal B/d	55,000	By bal B/d	50,000
		By int. On capital A/c	5,000
	55,000		55,000

The two fold effect of this adjusting entry will be :

- Interest on capital will be shown on the debit side of the P/L A/c
- It will be shown on the liabilities side of balance sheet by way of addition to the capital.

Interest on drawings

If interest on capital is allowed, it is but natural that interest on drawings should be charged from the proprietor, as drawings reduce capital. Suppose during an accounting year, drawings are Rs 10,000 and interest on drawings is Rs 500. In order to bring this into account, the following entry will be passed.

Drawings A/c	Dr.	500
To interest on drawings		500

Two affected accounts will be:

Interest on drawings A/c

To P/L A/c	500	By drawings A/c	500
------------	-----	-----------------	-----

Drawings A/c

To cash A/c	10,000	By capital A/c	10,500
To int. On drawings	500		
	10,500		10,500

The two fold effect of interest on drawings will be:

- a) Interest on drawings will be shown on the credit side of p/l a/c, and
- b) It is shown on the liabilities side of balance sheet by way of addition to the drawings which are ultimately deducted from the capital.

Provision for doubtful debts

Sometimes, a merchant finds on the last day of accounting year that certain debts are doubtful, i.e. the amount to be received may or may not be received. It is one of the golden principles of accountancy that anticipated losses must be provided. So, provision

for doubtful debts is generally made on the basis of some percentage say 5 % which is fixed on the basis of past experience. Suppose sundry debtors on 31-12-2013 are Rs 55,200 further bad debts are Rs 200. Provision of 5% is to be made on debtors. In order to bring the provision for doubtful debts of Rs 2,750 i.e. 5 % on Rs 55,000, the following entry will be made:

P/LA/c	Dr.	2,750
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To provision for doubtful debts A/c 2,750

Two affected accounts will be:

- i) It will be shown on the debit side of the p/l a/c or by way of addition to bad debts.
Old provision for doubtful debts at the beginning of the year will be deducted.
- i) Provision for doubtful debts is shown on the assets side of the balance sheet by way of deduction from sundry debtors after deduction of further bad debts, if any.

Problem 10: From the following trail balance extracted from the books of Shri Vishnu Charan Singh, prepare a trading and P/L A/c for the year ended 30th Septemeber, 2013 and a balance sheet as on that date:

<i>Debit balances:</i>		<i>Credit balances</i>	
Drawings	6,480	Capital A/c	120,000
Land and buildings	25,000	Bad debts provision as on 1-10-12	2,470
Plant & machinery	14,270	Sales	91,230
Furniture	1,250	Discount A/c	120
Carriage inwards	4,370	Purchases returns	8,460
Wages	21,470	Sundry creditors	12,170
Sales return	1,760	Apprentice premium	500
Sundry debtors	37,800		
Stock as on 1 oct, 12	26,420		
Fire insurance	490		

Cash at bank	13,000		
Cash	850		
Bank charges	140		
Coal, gas and water	720		
Rates and taxes	840		
Purchases	42,160		

Bills receivable	1,270		
Trade expenses	1,990		
Investments	30,000		

Charge depreciation on land & building A/c at 2.5 % , on plant and machinery A/c @ 10 % , and on furniture @ 10 % . Make a provision of 5 % on sundry debtors for doubtful debts. Carry forward the unexpired amounts for fire insurance Rs 125, rates and taxes Rs 240 and apprentice premium Rs 400. Charge 5 % Interest on capital and interest on drawings is Rs 300. The value of stock as on 30th September, 2013 was 29,390. outstanding wages are Rs 530. Interest on investment Rs 3,000 is accrued.

Solution 10.

Trading & Profit and Loss Account of Shri Vishnu Charan Singh

For the year ended 30th September, 2013

To opening stock	26,420	By sales	91,230	
To purchases	42,160	Less: returns	<u>1,760</u>	89,470
Less: returns	<u>8,460</u>	By closing stock		29,390
To carriage inwards	4,370			
To wages	21,470			
Add: o/s	<u>530</u>			
To coal , gas and water	720			
To gross profit c/d	<u>31,650</u>			
	<u>118,860</u>			<u>118,860</u>
To salaries	4,670	By gross profit b/d		31,650
To bank charges	140	By discount		120
To rates and taxes	840	By apprentice premium	500	
Less: prepaid	<u>240</u>	Less: received in advance	<u>400</u>	100
To trade expenses	1,990	By bad debts provision	2,470	
To fire insurance	490	Less : new provision	<u>1,890</u>	580
Less : prepaid	<u>125</u>	By interest on drawings		300
	365			

To depreciation on L& B	625	By accrued interest on	3,000
To depreciation on plant & machinery	1,427	investments	
To depreciation on furniture	125		
To interest on capital	4,500		
To net profit	<u>21,308</u>		
	<u>35,750</u>		<u>35,750</u>

Balance Sheet

Capital		Cash	850
120,000		bank	13,000
Add : profit	21,308	bills receivable	1,270
Int. On cap.	<u>4,500</u>	debtors	37,800
	145,808	less: provision	<u>1,890</u>
Less: drawings	6,480	stock	29,390
Int. On drawings	<u>300</u>	accrued interest	3,000
	6,780	prepaid insurance	125
Sundry creditors	400	prepaid rates and taxes	240
Apprentice premium received	530	land and buildings	25,000
Outstanding wages		less: depreciation	<u>625</u>
		plant less depreciation (14,127 – 1427)	12,843
		furniture less dep. (1,250- 125)	1,125
		investments	30,000
	<u>152,128</u>		<u>152,128</u>

Provision for discount on debtors

If sales are made by the merchant on the condition that if the amount of sales is paid within a certain period, he will allow a certain percentage of discount . For example, if goods worth Rs 10,000 are sold to X on 1st Decemeber, 2013 with the terms of 2.5 % discount. If payment is made within 40 days on 31st December, 2013 when accounts are to be closed , the position is that X may pay the amount of Rs 10,000 upto 10th January, 2014 and earn a discount of Rs 250. For such discount is made generally on the basis of past experience and certain percentage say 2.5 % on

debtors is determined to calculate such provision. In order to incorporate such provision for discount on debtors, an entry is made:

P/LA/c	Dr.	250	
To provision for discount on debtors a/c			250

Note: Such provision is made on debtors after deduction of further bad debts and provision for doubtful debts as discount is allowable to debtors who intend to make payments.

P/LA/c

To provision for discount on debtors	250		
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Provision for discount on debtors A/c

To balance C/d	250	By P/L A/c	250
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The two fold effect of this entry will be:

- i) Such provision will be shown on the debit side of p/l a/c
- ii) It will be shown by way of deduction from sundry debtors after deduction or further bad debts and provision for doubtful debts on the assets side of the balance sheet.

Reserve for discount on creditors

As the firm has to provide for discount on debtors, similarly, the firm may have chance to receive discount on the last date of the accounting year, if the payment is made within the scheduled period. Such discount on creditors is anticipated profit and therefore reserve for discount on creditors will be made instead of provision for discount on creditors. Such reserve will be calculated on the amount of creditors. Suppose on 31st December, 2013, the creditors, are Rs 10,000 and 2.5 % reserve is to be made for discount on creditors. In order to bring this into account, the following entry will be passed:

Reserve for discount on creditors A/c	Dr.	250	
To P/L A/c			250

Two affected accounts will be :

P/L A/c

		By reserve for discount on creditors a/c	250
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Reserve for discount on creditors

To P/LA/c 250 By bal C/d 250

The two fold effect of this reserve will be :

- i) It is shown on the credit side of the p/l a/c
- ii) Reserve for discount on creditors is shown on the liabilities side of the balance sheet by way of deduction from sundry creditors.

Problem 11: On 1ST January, 2012, the provision for bad debts showed a credit balance of Rs 3,600. During the year, the bad debts amounted to Rs 2,800. The debtors on 31st December, 2012 amounted to Rs 96,000 and a provision of 5 % for doubtful debts was maintained.

In 2013, the bad debts amounted to Rs 1,200 and the debtors at the end of the year amounted to Rs 40,000 on which a provision of 5 % for bad debts was to be maintained.

Make journal entries and prepare the provision for doubtful debts a/c. Also show how these items are to appear in the p/l a/c and balance sheet of respective years.

Solution 11:

Journal Entries

2012 Dec. 31	Bad debts a/c	Dr.	2,800	
	To sundry debtors			2,800
	(being the amount of bad debts written off)			
“	Provision for doubtful debts a/c	Dr.	2,800	
	To bad debts a/c			2,800
	(being the transfer of bad debts to the former a/c)			
“			4,000	

2013 Dec.31 “ “	P/L A/c To provision for doubtful debts a/c	Dr.		4,000
	Bad debts a/c To sundry debtors a/c (being the amount of bad debts written off)	Dr.	1,200	1,200
	Provision for doubtful debts a/c To bad debts a/c (being the transfer of bad debts to the former a/c)	Dr.	1,200	1,200
	Provision for doubtful debts a/c To P/L A/c (being the entry to reduce the provision)	Dr	1,600	1,600

Provision for doubtful debts A/c

To bad debts A/c	2,800	By balance B/d	3,600
To balance C/d	<u>4,800</u>	By P/L A/c	<u>4,000</u>
	<u>7,600</u>		<u>7,600</u>
To bad debts A/c	1,200	By balance b/d	4,800
To P/L A/c	1,600		
To balance C/d	<u>2,000</u>		
	<u>4,800</u>		<u>4,800</u>

Profit and Loss A/c

To bad debts	2,800	BY OLD provision for D/D	4,800
Add: new provision	<u>4,800</u>	Less: bad debts	1,200
	7,600	New provision	<u>2,000</u>
For D/D	<u>3,600</u>		
	4,000		1,600

Balance Sheet Assets side

Sundry debtors	96,000	
Less: provision of doubtful debts	<u>4,800</u>	91,200

Sundry debtors	40,000	
Less: provision for doubtful debts	<u>2,000</u>	38,000

5.6 UNSOLVED PROBLEMS

1. Prepare Trading A/c.

Opening stock Rs. 40,000, purchases Rs. 100,000, carriage Rs. 2,000, sales Rs. 330,000, manufacturing wages Rs. 4,000, consumable stores Rs. 2000, closing stock Rs. 40,000.

2. Prepare profit and loss account.

Purchases Rs. 35,000, sales Rs. 75,000, purchase return Rs. 4,000, sales return Rs. 500, freight in Rs. 200, freight out Rs. 400, Advertisement Rs. 300, discount allounces Rs. 400, discount receiver Rs. 100, opening stock Rs. 10,000, wages & salaries Rs. 2,000, closing stock Rs. 30,000.

3. Prepare balance Sheet

Particulars	Dr.	Cr.
Opening Stock	10,000	-
Purchases & Sales	40,000	100,000
Debitors & Creditors	20,000	30,000
B/R & B/P	2,000	1,000
Capital	-	40,000
Cash at Bank	50,000	-
Salaries	2,000	-
Discount allowed	6,000	-
Wages	3,000	-
Discount rerreived	-	1,000

Furniture	10,000	-
Building	29,000	-
	<hr/>	<hr/>
	1,72,000	1,72,000

- Adjustment :
- (a) Closing stock Rs. 40,000
 - (b) Outstanding wages Rs. 200
 - (c) Prepaid salaries Rs. 300
 - (d) Depreciate furniture by 10 %
 - (e) Provision for bad debt Rs. 300

5.6 LET US SUM UP

Final Accounts comprise three important components that together reflect the financial position and performance of a business. The Trading Account is prepared first to determine the gross profit or loss by comparing sales revenue with the cost of goods sold, including direct expenses like raw materials, wages, and carriage. The Profit and Loss Account then takes this gross profit or loss as its starting point and incorporates all indirect incomes and expenses, such as salaries, rent, and interest, to compute the net profit or net loss for the period. Lastly, the Balance Sheet provides a snapshot of the financial position of the business at a specific date, listing all assets, liabilities, and the owner's capital, thereby indicating the overall worth of the business. Together, these three statements form the Final Accounts, offering a complete picture of an enterprise's trading results, operational efficiency, and financial health.

5.6 GLOSSARY

- **Trading Account:** Shows the gross profit or loss earned from buying and selling goods during an accounting period.
- **Profit and Loss Account:** Displays the net profit or loss after charging all expenses and incomes related to the business, excluding trading expenses.
- **Balance Sheet:** A statement that shows the financial position of a business by listing its assets, liabilities, and owner's equity on a specific date.
- **Gross Profit:** The difference between sales and cost of goods sold, measuring how efficiently a business makes money from its core trading activities.
- **Net Profit:** The remaining profit after deducting all expenses (including operating expenses, interest, and taxes) from the gross profit.
- **Capital:** The owner's investment in the business, including any additional profits earned and retained in the business.

5.7 SELF ASSESSMENT QUESTIONS

1. Give importance of financial statements.

2. Give limitation of financial statements.

-
3. Is these statements helpful for organisation in future or not. If so, in what context.
-
-
-

5.6 LESSON END EXERCISE

1. Draw complete format of trading and profit and loss A/c and Balance Sheet.
2. Give the treatment of Bad Debt and Bad Debit Recovered by the way of Journal entires.
3. Give nature of P/LA/c.

5.6 SUGGESTED READINGS

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan
- Arihant Publication
- Gangwar, Sharad & Gangwar K.
- Rajasekaran

UNIT - II

Lesson No. 6

Course No. 101

ROYALTY

STRUCTURE

6.0 Learning Objectives and Outcomes

1.1 Introduction

1.2 Meaning of Royalty

1.3 Definitions of Royalty

1.4 Terms used in Royalty Agreements

1.5 Let Us Sum Up

1.6 Glossary

1.7 Self-Assessment Questions

1.8 Lesson End Questions

1.9 References

6.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After studying this topic, students will be able to:

- Understand the concept and nature of royalties in accounting.
- Identify the different types of royalties (e.g., mining royalties, publishing royalties).
- Learn key terms such as lessor, lessee, royalty, minimum rent, short workings, and recoupment.

Learning Outcomes

After studying this topic, students will be able to:

- Define and explain the significance of royalties and associated terms.
- Differentiate between Lessor and Lessee roles in a royalty agreement.

6.1 INTRODUCTION

There are some special rights over something which are possessed by some persons. For example, a landlord possess an exclusive right over some property say mine or quarry in his land. Apatentee who has invented something new has an exclusive right over his patent rights. An author has an exclusive copy right over the work or his writing in the form of a book . These rights either can be used by these persons themselves or can be given to some other persons on lease basis for some consideration. If the second option is adopted, there comes into existence a royalty agreement. A royalty agreement is an agreement between two parties. i.e, the person who gives out his rights and the person who takes out the special rights on lease for a consideration. The person who gives out some special rights over something to another person for a consideration is called lessor or landlord or patentee or author. The person who takes out some special rights from its owner on lease for a consideration is called lessee or tenet or patentor or publisher.

Royalty is a form of **payment or compensation** made by one party (the **lessee**) to another party (the **lessor**) for the **right to use, explore, or commercially exploit** an asset or resource that the lessor **owns**. These payments are typically made in accordance with an agreement or contract that specifies the terms, rates, and conditions of usage.

The concept of royalties is common across various industries. In **mining and petroleum**, royalties are paid to the landowner or the state for extracting minerals, oil, or gas. In **publishing**, an author earns royalties from the publisher for every book sold. Similarly, in **music, films, and software**, creators and inventors receive royalties when others use, reproduce, or distribute their works.

The amount of royalty is generally calculated based on **a unit of output** (such as per ton of mineral), **a percentage of sales**, or any other agreed metric. The agreement may also include certain provisions like **minimum rent** (a guaranteed payment regardless of actual production), **shortworkings** (a shortfall when actual royalties are less than the minimum rent), and **recoupment** (the recovery of shortworkings in future periods).

In accounting, royalties are treated as an expense for the party using the resource and as income for the party granting the right. Understanding the nature of royalties, their accounting treatment, and the associated terms is vital for accurate financial reporting and sound business negotiations.

6.2 MEANING OF ROYALTY

Royalty is a payment made by one party (the user or lessee) to another party (the owner or lessor) for the right to use, utilize, or exploit an asset or resource belonging to the owner. The payment is generally based on an agreement or contract that specifies its terms and conditions, including how it will be calculated, when it will be paid, and what rights and obligations both parties have.

Royalty payments arise when one person or entity grants another person or entity permission to use their property, asset, or intellectual right. These payments can be made for a variety of rights and resources, such as:

- **Natural resources** like minerals, oil, gas, or coal (e.g., a mining company extracting coal from a landowner's site).
- **Literary works** (e.g., an author receiving a percentage of book sales).
- **Artistic works** (e.g., a music composer being paid every time a song is streamed or sold).

- **Industrial or technical rights** (e.g., a manufacturer using a patented technology).
- **Franchise or trademark rights** (e.g., a franchisee making regular payments for using the brand name of a franchisor).

The amount of the royalty is typically calculated based on an agreed measure, such as:

- A fixed **rate per unit** (for example, per ton of mineral extracted),
- A fixed **percentage of sales revenue**, or
- A percentage of net profits earned from the use of the asset.

Royalty payments are advantageous because they allow the owner of an asset (lessor) to monetize their property while allowing the user (lessee) access to utilize the resource for their commercial benefit. The agreement usually includes certain terms and conditions such as:

- **Minimum Rent:** The least amount the lessee must pay regardless of the quantity extracted or sold.
- **Shortworkings:** The difference between the actual royalty due and the minimum rent when the actual quantity used is low.
- **Recoupment:** The right granted to the lessee to recover the shortworkings in future periods when the actual royalties exceed the minimum rent.

In summary, royalty is a fair and structured compensation mechanism that balances the interests of both the owner and the user of an asset. It forms an integral part of accounting in industries like mining, publishing, music, films, and technology, ensuring that the owner of the resource receives a reward for its use, while providing the user an opportunity to utilize the resource for economic gain.

A. CHECK YOUR PROGRESS

Fill in the Blanks

- 1) Royalty is a _____ paid by one party to another for using an asset or resource.

- 2) The person who grants the right to use an asset is called the _____.
- 3) The person who uses the resource or right is called the _____.
- 4) Royalties are generally calculated based on the _____ of goods sold or produced.
- 5) In mining, the _____ receives a royalty for extracting mineral resources.
- 6) In publishing, an _____ receives a royalty for every book sold.
- 7) The agreement for the payment of royalties is called a _____ agreement.
- 8) A _____ rent guarantees a fixed minimum payment regardless of actual usage.

Answers:

- | | | | |
|--------------|-----------|------------|-------------|
| 1. Payment | 2. Lessor | 3. Lessee | 4. Quantity |
| 5. Landowner | 6. Author | 7. Royalty | 8. Minimum |

6.3 DEFINITIONS OF ROYALTY

J.R. Batliboi — *“The term royalty expresses an amount payable by one person in return of some special right or privilege conceded to him by another person, such as the right to publish a book, or to manufacture and sell a patented article or to work a mine.”*

William Pickles — *“Royalty is the remuneration payable to a person in respect of the use of an asset, whether hired or purchased from such person, calculated by reference to and varying with quantities produced or sold as a result of such asset.”*

Institute of Chartered Accountants of India (ICAI) — *“Royalty is the consideration paid periodically by the lessee to the lessor for the right to utilize a resource, calculated based on quantity extracted, sold, or used, or a fixed percentage of sales or revenue*

earned from the resource.”

Accounting Definition: *“Royalty is an expense charged for the right to use a specific resource or right, calculated based on quantity sold, produced, or used, as per the agreement between the parties.”*

Investopedia — *“A royalty is a payment made to a property owner, such as intellectual property, for the ongoing use of that property. A royalty agreement... lays out the terms for how and when these payments are made. Royalties can be applied to both tangible and intangible assets... often calculated as a percentage of sales or revenue generated from the use of the property.”*

General Business Usage — *“Royalty is a periodic payment made by the user (lessee) to the owner (lessor) for the right to utilize or exploit an asset, resource, or intellectual property belonging to the owner.”*

B. CHECK YOUR PROGRESS

Short Answer Type Questions

Q1. Define Royalty as per Institute of Chartered Accountants of India.

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.....
.....

Q2. *“The term royalty expresses an amount payable by one person in return of some special right or privilege conceded to him by another person”* Who propounded this definition?

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.....
.....

6.4 TERMS USED IN ROYALTY

There are some special terms which generally are used in royalty agreements.

The meaning of such terms must be clear to the reader. The special terms are:-

1. **Landlord:** The persons who gives out his some special rights over something say mining rights or patent rights or copy rights, on lease to another person for a consideration is called the landlord, or lessor, or patentee or an author.
2. **Lessee:** The person who takes out the special rights from its owner on lease for a consideration is called tenet or lessee or patentor or publisher.
3. **Royalty:** It is a periodical payment based on output or sale for the use of a certain asset or right like mine, copyright or patent to its owner. Thus, royalty is paid by the lessee of a mine to the owner of the mine, by the manufacturer to the patentee or by the publisher to the author of the book. Royalty is also paid by concerns dealing in raising of earthy, clay stone, or by concerns engaged in collection of forest products as lac, honey, etc. to the landlord or to the government from whom lease has been taken to continue their activities.
4. **Minimum rent or dead rent:** Royalty agreements are usually associated with a clause that the lessor or landlord must receive a minimum amount whatever be the production or sales in a particular period. Such minimum amount is known as minimum rent or dead rent or fixed rent. The fixation of such rent is in the interest of the landlord because it guarantees him the receipt of the minimum amount in case of low output or sales. Further, it gives incentive to the lessee to increase the production or sales. Since, the guarantee is for the payment of a minimum amount, it has the effect of paying actual royalty based on output or sales or minimum rent, whichever ever is higher. In the absence of minimum rent, the lessee may acquire rights from different landlords to obviate competition and deliberately may under utilise such rights. For example, M/s Kalyani publishers printed a book on accountancy at a minimum rent of

Rs 200,000 p.a. royalty being payable @ 75 rupees per copy sold and the number of copies sold in the first year is Rs 2,000 and in the second year is Rs

4,000 . In this case, kalyani publishers will have to pay Rs 200,000 to the authors as a minimum rent in the first year even though the royalty works out to be Rs 150,000 for 2,000 Copies @ Rs 75 per copy sold. In the second year Rs 300,000 as royalty for 4,000 copies @ Rs 75 per copy sold will be paid to the authors even though the minimum rent is Rs 200,000.

5. **Shortworkings:** The excess of minimum rent over royalty calculated on the basis of output or sales is termed as shortworkings. In the example cited above, there is a shortworking of Rs 50,000 i.e, Rs 200,000 minimum rent – Rs 150,000 actual royalty for 2,000 copies @ 75 per copy in the first year. There is no shortworking in the second year because actual royalty of Rs 300,000 is more than the minimum rent of Rs 200,000 . Normally shortworkings are during gestation period or due to the abnormal working conditions during the early periods of lease as the activity level is low .
6. **Ground or surface rent:** It is fixed yearly or half yearly rent payable by the lessee to the landlord in addition to the minimum rent.
7. **Right of recouping shortworkings:** Usually, in the first few years of the royalty agreement, the work does not gather the required momentum because of the time taken in the preparation for starting the production or pushing up the sales , so shortworkings, arising in the first few years may not due to inefficiency of the lessee. Keeping this in view, royalty agreements may contain a clause that shortworkings i.e., excess amount paid in earlier years are recoverable by the lessee in subsequent years when royalties are in excess of the minimum rent. The right of getting back the excess payment made by the lessee in earlier years is called the right of recoupment of shortworkings. The right of recoupment of shortworkings can be restricted i.e. fixed or unrestricted i.,e floating.

When the lessee gets the right of recoupment of shortworkings for a certain period say four or five years commencing from the date of the royalty agreement, the right is said to be restricted or fixed. Any shortworking arising

beyond this period cannot be reimbursed. But when the lessor allows the lessee to recoup any shortworkings within two or three subsequent or following years, then the right is said to be unrestricted or floating because this can be

availed of in any year when shortworkings arises.

Shortworkings should be carried forward and shown in the assets side of the balance sheet so long as they are recoverable and shortworkings which could not be recouped during the allowed period of recoupment should be closed by transferring to P/L account. If there is no shortworkings recoupment provision, then the same should be transferred to the p/l account in the very year of the shortworkings.

8. Recoupment of shortworkings : It means the recovery of shortworkings of the previous years out of surplus royalty of subsequent years. Following conditions can be there for recoupment of shortworkings.

- a) Shortworkings are recouped when there is a surplus i.e excess of royalty over minimum rent.
- b) Recoupment of shortworkings is to be done within the agreed period as given in the agreement.
- c) If shortworkings could not be recouped within the agreed period, it will be transferred to P/L account in the year in which the right of recoupment is lost. By this process, shortworkings account gets closed and will not appear as an asset in the balance sheet.

9. Surplus: It indicates the excess of actual amount of royalty over minimum rent. **Surplus = Actual Royalty – Minimum Rent.**

C. CHECK YOUR PROGRESS

Match the Coloumn

Column A

Column B

1. Royalty	A. Owner of the resource or right
2. Lessor	B. Party that uses the resource
3. Lessee	C. Payment for using an asset or right
4. Minimum Rent	D. Fixed amount payable regardless of usage
5. Shortworkings	E. Deficit when actual royalty is less than minimum rent
6. Recoupment	F. Recovery of shortworkings in future periods
Answers:	
1–C	2–A
3–B	4–D
5–E	6–F

6.5 LET US SUM UP

Royalty is an agreement between a **lessor** (the owner of an asset or resource) and a **lessee** (the user of that resource), wherein the lessor grants certain special rights to the lessee for the use or exploitation of the property over a specified period of time. The lessor is the legal owner of the resource — such as land, mineral rights, a patent, or an intellectual property — and allows the lessee to utilize it for productive or commercial activity. In return, the lessee agrees to pay a periodic sum, known as **royalty**, based on the quantity used, sold, or extracted, or as a fixed percentage of revenue earned from its use. This agreement clearly defines the roles and responsibilities of both parties and ensures a fair and transparent sharing of benefits arising from the use of the resource.

6.6 GLOSSARY

- **Royalty:** A payment made by the lessee to the lessor for the right to use an asset, resource, or property, typically calculated based on quantity used or sales revenue.
- **Lessor:** The owner of the resource or property who grants the right of its use to another party (the lessee) in return for royalty payments.
- **Lessee:** The person or entity that uses or exploits the resource or property of the lessor and pays royalties as per the agreement.
- **Minimum Rent:** The fixed minimum amount of royalty that the lessee must pay to the lessor regardless of the quantity used or sales made.
- **Shortworkings:** The shortfall when actual royalties earned in a period are less than the minimum rent agreed upon in the contract.
- **Recoupment:** The right granted to the lessee to recover shortworkings in future periods when actual royalties exceed the minimum rent.

6.7 SELF ASSESSMENT QUESTIONS

1. Who is tenet.

2. What is surplus.

3. What do you mean by minimum rent.

6.8 LESSON END EXERCISE

- 1) What is Royalty and Royalty agreement. Explain with the help of suitable example.
- 2) What is shortworkings. How it can be recouped.
- 3) Give two methods of recomponent of shortworking.

6.9 SUGGESTED READINGS

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan
- Shukla, M.C, Grewal, T.S. & Gupta, S.C
- Maheshwari, S.N. & Maheshwari S.
- Kishore, R.M.

TYPES OF ROYALTY**STRUCTURE**

7.0 Learning Objectives and Outcomes

7.1 Introduction

7.2 Difference between rent and royalty

7.3 Types of royalty

7.4 Let Us Sum Up

7.5 Glossary

7.6 Self-Assessment Questions

7.7 Lesson End Exercise

7.8 Suggested Readings

7.0 LEARNING OBJECTIVES AND OUTCOMES**Learning Objectives**

After studying this topic, students will be able to:

- Understand the fundamental differences between Rent and Royalty.
- Recognize their characteristics and accounting treatments.
- Identify and describe the various types of royalties used in practice.

Learning Outcomes

After studying this topic, students will be able to:

- Distinguish clearly between Rent and Royalty.
- Apply the correct accounting treatments for Rent and Royalty.

- List, describe, and give examples of the different types of royalties (mineral, copyright, patent, franchise, trademark).

7.1 DIFFERENCE BETWEEN RENT AND ROYALTY

Points of difference	Rent	Royalty
1. Nature of assets	It is the consideration payable for the use of only tangible assets as buildings, machinery, etc.	It is the consideration payable for the use of special rights for both tangible and intangible assets.
2. Basis of payment	It is the mostly payable on the basis of time as weekly, monthly or yearly.	It is paid on the basis of production or sale.
3. Period	The amount of rent is generally fixed with regard to time.	The amount of royalty is variable and is calculated in accordance with the production or sales
4. Provision	There is no provision of minimum rent.	It generally contains a clause in the agreement to pay minimum rent.
5. Parties	The tenant and landlord are two parties to the rent	The parties to the royalty are lessor and lessee.

A. CHECK YOUR PROGRESS

Choose the Correct Option

1. Which of the following best describes Rent?

- Payment for extracting natural resources
- Payment for using property or land
- Payment for using a patent or copyright
- Payment for a franchise agreement

2. Royalty is primarily a payment for:

- The use of physical land or buildings
- The use of intellectual property or mineral resources

- c) The salary of an employee
- d) The cost of raw materials

3. Which statement is true about Rent?

- a) It is charged for using a patent or trademark
- b) It applies only to intellectual properties
- c) It is paid for using physical property or land
- d) It is always calculated as a percentage of sales

4. Royalty is typically calculated based on:

- a) Area of the land used
- b) Quantity of production or sales
- c) Time period of use only
- d) Fixed cost regardless of usage

5. Which of the following is a key difference between Rent and Royalty?

- a) Rent applies only to intangible properties
- b) Royalty applies only to tangible properties
- c) Rent applies to the use of tangible assets; Royalty applies to the use of intangible or mineral rights
- d) Both apply to physical land only

Answers

- 1. b) Payment for using property or land
- 2. b) The use of intellectual property or mineral resources
- 3. c) It is paid for using physical property or land
- 4. b) Quantity of production or sales
- 5. c) Rent applies to the use of tangible assets, Royalty applies to the use of intangible or mineral rights

7.2 TYPES OF ROYALTIES:

There are three types of Royalties :

- i) **Mining Royalty:** Mining royalty is the periodical payment generally based on output, made by lessee of a mine or quarry to the lessor or the landlord.
- ii) **Patent Royalty:** Patent royalty is the periodical payment based on output made by the lessee of a patent or patent right to be lessor or the patentee.
- iii) **Copyright Royalty:** Copyright royalty is the periodical payment based on sales, made by the lessee of a copyright.

The basis on which royalty is calculated in various cases are given below:

- a) Author of a book – No. Or sale value of books sold.
- b) Owner of a mine – quantity of coal produced.
- c) Scientist holding a patent – output.
- d) An owner of an oil well – quantity of oil extracted.

The lessee making the payment of royalty treats it as ordinary business expenditure and debits royalty account. Thus, royalty account is a nominal account and is closed at the end of every accounting year by transferring it to P/L account. Strictly, royalty based on output is a part of the cost of production and as such should be transferred to trading or manufacturing or production account. Royalty based on sales is a selling expenditure and as such should be transferred to P/L account.

It may be remembered that a lump sum payment for the outright purchase of a patent, mine or book is not treated as royalty but is a capital expenditure and recorded as a fixed asset.

B. Check Your Progress

Case study

The Scenario: Lakshmi Publishers is a well-known publishing house in India. The company operates in different areas and uses various forms of intellectual property and natural resources:

The company has entered into an agreement with a popular author to publish and sell her books across the country. The agreement states that Lakshmi Publishers must pay the author 10% of the sales revenue of each book sold.

Lakshmi Publishers has a franchise agreement with a foreign brand for selling stationery products under that brand name. Under this agreement, Lakshmi must pay a fixed percentage of its revenue every year.

The company has also secured rights from a mining corporation to extract mineral resources from a piece of land. According to the agreement, Lakshmi must pay a certain amount for every metric ton of mineral extracted.

Questions:

- a) Identify the type of royalty in each situation.
- b) What is the basis of payment for each?
- c) What is the key difference between the three examples?

7.3 LET US SUM UP

Rent and royalty are both payments for the use of an asset, but they have distinct characteristics and applications. Rent is a fixed, periodic payment made for the use of a tangible property like land, buildings, or equipment. In contrast, royalty is a payment made for the use of intangible assets or natural resources, such as copyrights, patents, or mineral rights. There are various types of royalties, including mineral royalties (for extracting resources like coal or oil), copyright royalties (for using an author's or artist's work), patent royalties (for utilizing patented inventions), franchise royalties (for using a brand or business model), and trademark royalties (for using a registered symbol or brand). While rent applies to physical properties, royalty is generally calculated based on usage, production, or sales, making it a more variable form of compensation.

7.4 GLOSSARY

- **Royalty:** A payment made for the use of a resource, such as land, mineral rights, or intellectual property.
- **Mineral Royalty:** Payment for extracting natural resources like coal, oil, or gas from land.
- **Copyright Royalty:** Payment made for the right to use or reproduce an author's or artist's work.
- **Patent Royalty:** Payment for utilizing a patented invention or

7.5 SELF ASSESSMENT QUESTIONS

1. Distinguish between Rent and Royalty

2. What is minning royalty ?

3. Is provision of minimum rent applicable to rent. If not, why.

7.6 LESSON END EXERICSE

1. What do you mean by copyright royalty ?
2. Who are two parties in case of rent and royalty ?
3. What is patent royalty ?

7.7 SUGGESTED READINGS

1. S. P. Jain, K. L. Narang
2. Arihant Publications
3. Pratijogitya Darpan
4. Maheshwari, S.N. & Maheshwari S.
5. Kishore, R.M.
6. Pillai, R.S.N, Bagavathi & Uma, S.

ACCOUNTING TREATMENT OF ROYALTY

STRUCTURE

- 8.0 Learning Objectives and outcomes
- 8.1 Income tax provision in royalty
- 8.2 Accounting treatment in the books of lessee.
- 8.3 Accounting treatment of stoppage of work due to strike/ lockout/ accident
- 8.4 Creation of provision against shortworkings
- 8.5 Let Us Sum Up
- 8.6 Glossary
- 8.7 Self-Assessment Question
- 8.8 Lesson End Exercise
- 8.9 Suggested Reading

8.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After studying this topic, students will be able to:

- To understand the income tax provisions related to royalties.
- To learn the accounting treatments for royalties in the lessee's books.
- To understand the accounting treatment of stoppages due to strikes, lockouts, or accidents.
- To gain knowledge of the creation of provisions against shortworkings.

Learning Outcomes

After studying this topic, students will be able to:

- explain income tax provisions for royalties.
- record royalty transactions accurately in the lessee's books.
- account for stoppages caused by strikes, lockouts, or accidents.
- calculate and create provisions for shortworkings appropriately.

8.1 INCOME TAX PROVISION IN ROYALTY

Royalty is a payment made by one party (the licensee or lessee) to another (the licensor or lessor) for the ongoing use of an asset, typically intellectual property such as patents, trademarks, copyrights, or technical know-how. The Income Tax Act, 1961, governs the tax treatment of such royalty payments in India, both for residents and non-residents.

1. Meaning of Royalty:

Under Section 9(1)(vi) of the Income Tax Act, "royalty" includes consideration for:

- Transfer of rights in respect of a patent, invention, model, design, secret formula or process;
- Use of any copyright, literary, artistic, or scientific work;
- Use of trademarks or logos;
- Use or right to use industrial, commercial, or scientific equipment;
- Providing technical know-how or assistance related to these.

The consideration can be lump-sum or periodic, and even indirect payments qualify as royalty.

2. Taxability of Royalty Income:

(A) In the hands of the recipient:

- For residents, royalty income is taxable under the head "Income from Other

Sources” or “Profits and Gains of Business or Profession”, depending on the nature of the recipient’s activities.

(B) For non-residents, royalty income is deemed to accrue or arise in India if it is paid by:

- The Government of India;
- A resident, for use in India;
- A non-resident, if the royalty is used for a business or profession carried out in India.

In both cases, the amount is chargeable to tax in India, unless exempted under a Double Taxation Avoidance Agreement (DTAA).

3. Tax Deduction at Source (TDS):

Royalty payments are subject to TDS under different sections:

- Section 194J: Applicable to residents, where TDS at 10% is deducted on royalty payments exceeding ₹30,000 in a financial year.
- Section 195: For non-residents, tax is deducted at the rate prescribed in the Income Tax Act or DTAA (whichever is lower). Generally, the rate is 10% (plus applicable surcharge and cess), subject to treaty benefits.

The payer must deduct TDS before making payment and deposit it with the Government within the prescribed time.

4. DTAA and Relief:

If India has signed a Double Taxation Avoidance Agreement (DTAA) with the country of the recipient, the provisions of the treaty may override the domestic law. DTAA often provides a reduced rate of tax on royalty income (usually 10%-15%) and may define royalty differently.

The recipient can claim relief under Section 90 or 91 by providing a valid Tax Residency Certificate (TRC) from their home country.

5. Grossing Up of Royalty:

If the Indian payer agrees to bear the tax liability of the foreign recipient (i.e., tax is borne by the payer), then the royalty amount must be grossed up as per Section 195A. This means the actual income of the recipient will be treated as inclusive of the tax, and tax will be calculated accordingly.

6. Assessment and Compliance:

- Royalty recipients (both domestic and foreign) must include royalty income in their income tax returns.
- Foreign companies may also need to file returns if the income is taxable in India.
- The payer must comply with TDS return filing (Form 26Q/27Q) and issue TDS certificates (Form 16A) to the payee.

The taxation of royalty under the Indian Income Tax Act is clearly laid out, with the intent of taxing income arising or accruing in India, especially where Indian resources or markets are used. Both residents and non-residents earning royalty from Indian sources are covered under various provisions. However, the ultimate tax liability often depends on the DTAA provisions, nature of payment, and usage of royalty rights. Proper documentation, compliance with TDS requirements, and understanding of treaty benefits are essential for correct taxation and avoidance of penalties.

A. CHECK YOUR PROGRESS

Fill in the Blanks:

1. Royalty income is taxable under the head _____ or Profits and Gains of Business or Profession depending on the nature of the assessee.
2. Under Section _____ of the Income Tax Act, TDS is deducted at 10% on royalty payments made to residents.
3. For non-residents, TDS on royalty payments is deducted under Section _____.

4. If the Indian payer agrees to bear the tax liability of the non-resident recipient, the royalty amount is required to be _____.
 5. To claim benefits under a Double Taxation Avoidance Agreement (DTAA), a non-resident must furnish a valid _____.
- Answers:**
1. Income from other sources
 2. Section 194J
 3. Section 195
 4. Grossed up
 5. Tax Residency Certificate (TRC)

5. Tax Residency Certificate (TRC)

- ## 5. Tax Residency Certificate (TRC)

8.2 ACCOUNTING TREATMENT IN THE BOOKS OF LESSEE

When there are no royalties in a year

- | | | |
|----|----------------------------|-----|
| a) | Minimum rent is not opened | |
| | Shortworking A/c | Dr. |
| | To Landlord's A/c | |
| b) | If minimum rent is opened | |
| 1. | Minimum rent A/c | Dr |
| | To Landlord's A/c | |
| 2. | Shortworkings A/c | Dr |
| | To Minimum rent | |

Entries for the payment to landlord and for transfer of royalties to P/L account will be the same as discussed afterwards .

When royalties are less than the minimum rent and shortworkings are recoverable in subsequent years

If minimum rent account is not opened

a)	Royalties a/c	Dr. (With the actual amount of royalties earned)
	Shortworkings a/c	Dr. (With the difference between the minimum rent and the royalties earned)

b) Landlord A/c Dr.

To Bank

c) P/LA/c Dr.

To Royalties A/c (with the actual amount of royalties transferred)

The debit balances of the shortworkings account will be carried forward and shown as an asset in the balance sheet till it is recoupable.

If the minimum rent account is opened in the books.

a) Minimum rent A/c Dr.

To Landlord A/c

(Being minimum rent payable to the landlord)

b)	Royalties A/c	Dr.
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Shortworkings A/c

To Minimum rent A/c

(Being actual amount of royalties earned and excess amount payable to the landlord debited to shortworking a/c)

c) Landlord A/c Dr

To Bank A/c

(Being the amount of minimum rent paid)

d) P/LA/c Dr.

To Royalties A/c

(Being actual amount of royalties transferred)

The only difference in two methods is that entry (a) in the first method requires two entries (a) and (b) in the second method, other entries being same.

When royalties are equal to minimum rent in a year

**As there will be no shortworkings, no minimum rent account is opened.
So the entry for the amount payable to the landlord will be**

Royalties A/c Dr.

To Landlord A/c

Other entries will be the same as in case above

**When royalties exceed the minimum rent and shortworking are
recouped:**

a) Royalties A/c Dr.

To Landlord A/c

(Being the amount of royalties earned by the landlord)

b) Landlord A/c Dr.

To Shortworkings A/c

To Bank A/c

(Being the amount paid to landlord after recovery of shortworking)

c) P/L A/c Dr.

To Royalties A/c

(Being actual royalties earned transferred to P/LA/c)

Entries (a) and (b) can also be shown as follows:

a) Royalties A/c Dr.

To Shortworking A/c

To Landlord A/c

b) Landlord A/c Dr.

To Bank A/c

B. CHECK YOUR PROGRESS

True and False

1. Royalty paid is always treated as capital expenditure.
2. Shortworkings arise when actual royalty exceeds minimum rent.
3. Lessor's account is credited when royalty becomes payable.
4. If actual royalty is more than minimum rent, there is no shortworking.
5. Shortworkings can be carried forward indefinitely.

Answers:

1. False
2. False
3. True
4. True
5. False

8.3 STOPPAGE OF WORK DUE TO STRIKE / LOCK OUT/ ACCIDENT ETC.

Generally minimum rent is fixed taking into consideration the minimum expected output under normal conditions. Whenever, there is stoppage of work due to abnormal reasons due to strike, lockout, accident, etc. or for other reason, the minimum rent is required to be adjusted as provided for in the agreement. Such agreement may have the following arrangements:

- i) **Non- application of the condition of minimum rent:** In such a case, the clause of minimum rent is not applied. Actual royalties will discharge all rental obligations. There will not be any shortworking or surplus.
- ii) **Reduction in the amount of minimum rent:** If there is any clause in the agreement, regarding reduction in the amount of minimum rent, it can take the following form
 - a) The minimum rent is reduced proportionately to the length of the stoppage of work during the relevant year.

- b) The minimum rent can be reduced by a fixed percentage or by a fixed amount in the year of stoppage.

C. CHECK YOUR PROGRESS

Case Study

Background: M/s Galaxy Tiles Ltd. entered into an agreement with M/s Marble Mines & Co. to extract and manufacture tiles using raw stone from a quarry. The terms of the royalty agreement were as follows:

Royalty payable: ₹25 per metric ton of raw stone extracted.

Minimum Rent: ₹2,00,000 per annum.

Provision for recoupment of shortworkings within the next 2 years.

No clause in the agreement regarding exemption during strike or accident.

Incident: In the year 2024–25, the factory faced a major 4-month strike, resulting in very limited production of only 4,000 metric tons of raw stone.

Actual royalty = $4,000 \times ₹25 = ₹1,00,000$

Minimum rent = ₹2,00,000

Shortworkings = $₹2,00,000 - ₹1,00,000 = ₹1,00,000$

Despite low production, the company had to pay the full minimum rent, as the agreement did not provide relief for strike periods.

Accounting Treatment in the Books of Lessee (M/s Galaxy Tiles Ltd.):

At the time of recording royalty and shortworkings:

Royalty A/c Dr. ₹1,00,000

Shortworkings A/c Dr. ₹1,00,000

To M/s Marble Mines & Co. A/c ₹2,00,000

- At the time of payment:

M/s Marble Mines & Co. A/c Dr. ₹2,00,000

To Bank A/c ₹2,00,000

Questions Based on the Case Study:

1. What was the amount of shortworkings for the year 2024–25, and what caused it?
2. Was M/s Galaxy Tiles Ltd. exempted from paying minimum rent during the strike? Why or why not?
3. How long can M/s Galaxy Tiles Ltd. carry forward the shortworkings for recoupment according to the agreement?

8.4 CREATION OF PROVISION AGAINST SHORT-WORKINGS

- i) Sometimes, it may not be possible to recoup the shortworkings out of future Payments of royalty due to some factors (physical or economical) even though the period to recover the same still has not lapsed. In such cases, provision against shortworkings should be created in the year in which shortworkings arise by passing the following entry.

P/LA/c	Dr
To Provision against shortworkings a/c	
(Being provision against shortworkings created)	

- ii) When shortworkings against which provision has been made are actually recovered the balance in the provision against shortworkings account should be reduced by transfer to the P/LA/c by passing the following entry.

Provision against shortworkings a/c	Dr
To P/LA/c	
(Being recoupment of shortworkings)	

- iii) In case it is clear that shortworkings is no longer recoupable, the following entry is to be passed.

(Being provision against shortworkings eliminated on account of irrecoverable shortworkings)

iv) After shortworkings are recouped, the excess provision against shortworkings is credited to P/LA/c as a prior period adjustment because P/L was debited when provision against shortworkings was created. Entry for excess provision is :

To P/LA/c

(Being transfer of excess provision after shortworkings are recouped)

The above method of creation of provision against shortworkings is adopted when the amount of shortworkings is substantial and chances of recovery of shortworkings are uncertain.

8.5 LET US SUM UP

In Royalty, sometimes the work is not gained momentum due to strike, lockout period, accident, etc. In that particular period, the lessor provided a concession to lessee in case of minimum rent. So that lessee perform his work sincerely. In the context of royalty agreements, there may be situations where the lessee is unable to carry out operations effectively due to unforeseen circumstances such as a workers' strike, lockout by management, natural calamities, fire, machinery breakdown, or other accidents. During such periods of involuntary stoppage of work, the lessee may not be able to meet the expected level of production or sales. As a result, the actual royalty payable based on output may fall significantly below the agreed minimum rent. Recognizing the financial hardship this may cause, and to maintain a healthy and long-term business relationship, the lessor may choose to provide a concession or waiver to the lessee regarding the minimum rent obligation for the affected period. This concession is often granted as a gesture of goodwill and to encourage the lessee to resume work with sincerity and dedication once normalcy is restored.

8.6 GLOSSARY

Strike / Lockout / Accident: Events that lead to temporary stoppage of work. If covered in the agreement, these may lead to concession in minimum rent.

Income Tax on Royalty: The taxation applied to royalty income under the Income Tax Act. For residents, global royalty is taxed; for non-residents, Indian-source royalty is taxable.

TDS (Tax Deducted at Source): A tax deducted by the payer (lessee) on royalty payments to the lessor, under sections like 194J (residents) and 195 (non-residents).

Grossing Up: A situation where the lessee agrees to bear the tax burden of the lessor, requiring the royalty amount to be increased before TDS is calculated.

8.7 SELF ASSESSMENT QUESTIONS

1. What is lockout period.

2. Give journal entries in the books of lessee.

3. Give treatment of income tax provision in royalty.

8.8. LESSON END EXERCISES

1. When condition of minimum rent is not applied.
2. What do you mean by stoppage of work by strike period.
3. When reduction of minimum rent is done.

8.9 Suggested Readings

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan
- Shukla, M.C, Grewal, T.S. & Gupta, S.C
- Maheshwari, S.N. & Maheshwari S.
- Kishore, R.M.

UNIT - II

Lesson No. 9

Course No. 101

TREATMENT OF NAZRANA

STRUCTURE

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9.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives:

After studying this topic, students will be able to:

- To understand how the lessor records royalty income and capital receipts like nazrana.
- To learn the treatment of minimum rent, shortworkings, and one-time payments.
- To distinguish between recurring royalty and non-recurring nazrana.
- To identify correct journal entries in lessor's books for both cases.

Learning Outcomes:

By the end of this topic, students will be capable of:

- Students will accurately record royalty and nazrana in the books of lessor.
- They will prepare entries for minimum rent, shortworkings, and lump-sum receipts.
- Understand the capital and revenue nature of various payments.
- Apply correct treatment in final accounts and balance sheet.

9.1 ACCOUNTING ENTRIES IN THE BOOKS OF LESSOR OR LANDLORD

In the books of the lessor or landlord receiving the royalties, the treatment will be the reverse of what we have done so far. Following entries will be recorded:

- i) When the royalties received are less than the minimum rent and shortworkings are recoverable out of future years, the following entries are made:

Lessee's A/c	Dr (with minimum rent)
To Royalties receivable A/c	(with actual royalties)
To Shortworkings	
Or Royalty suspense A/c	(with the difference)
Bank A/c	Dr [with the amount received]
To Lessee's A/c	
Royalty receivable a/c	Dr [with the amount of royalties earned transferred]
To P/LA/c	

- ii) The credit balance of shortworkings suspense account will be carried forward and shown as a liability in the balance sheet till it is recoupable.

When the royalties earned exceed the minimum rent and shortworkings are recovered, the entries are as follows:

Lessee's A/C	Dr (with the amount of royalties earned)
To Royalties receivable A/c	
Shortworkings suspense A/c	Dr [with the amount of shortworkings recovered]
To Lessee's A/c	
Bank a/c	Dr [with the amount due received]
To Lessee's A/c	

Royalty receivable A/c

Dr [with the amount of royalties
earned]

To P/LA/c

- iii) If any balance of shortworkings suspense account is no longer recoverable it should be transferred to P/LA/c as follows:

Shortworkings suspense A/c

Dr

To P/LA/c

A. Check Your Progress

Short Answer type Questions

Q1. What is the accounting treatment for royalty income in the books of the lessor?

Answer:

Q2. How are shortworkings recorded when allowed to the lessee?

Answer:

Q3. Which account is credited when minimum rent is received by the lessor?

Answer:

9.2 ACCOUNTING TREATMENT IN PAYMENT OF NAZRANA OR LEASE PREMIUM IN ADDITION TO ROYALTY

In some cases, the lessee may agree to pay lumpsum amount to the lessor in addition to royalty. This extra payment in addition to royalty is known as nazrana or lease premium or goodwill. Under such a situation, a nazrana A/c is opened in the books of the lessee and lessor. In the books of the lessee, the whole amount of nazrana is debited to nazrana A/c. This account being a capital expenditure for the lessee, can be written off every year during the period of lease by debiting P/LA/c and crediting nazrana A/c. In the books of lessor, the amount received as nazrana is credited to nazrana a/c and equal amount is credited to P/LA/c each year during the life of lease. The balance in nazrana account is shown as an asset (in lessee's books) and as liability (in the books of the lessor).

9.3 COPYRIGHT ROYALTIES

Copyright means the sole right granted by law to an author to publish and sell his book in the market. The author generally gives this right to a firm of publishers, who will undertake to do the production and sales of the book for a consideration. This consideration may be a lumpsum payment or a fixed percentage as agreed between the author and the publishers on the number of books sold multiplied by the printed price of the books sold. The number of copies sold can be calculated in the following manner:

	No.
Opening stock of books	xxx
Add: no. Of books printed	xxx
Books available	xxx
Less: specimen books	xxx
Waste books	xxx
Closing stock of books	xxx
No. Of books sold during the year	xxx

Generally, copyright agreements do not contain any clause for the payment of minimum

amount of royalty. Hence, the problem of shortworkings,recoupment of shortworkings or writing off shortworkings to P/LA/c does not arise in such cases.

B. CHECK YOUR PROGRESS

Multiple Choice

1. Nazrana is also known as:

- A) Penalty B) Shortworking C) Salami D) Interest

2. Nazrana is treated as _____ in the books of lessor.

- A) Revenue Income B) Expense C) Capital Receipt D) Liability

3. Royalty is paid:

- A) Once at the start B) Monthly C) Annually or periodically D) Not at all

4. In publishing agreements, royalty is paid to:

- A) Author B) Publisher C) Printer D) Buyer

5. Copyright royalty is calculated on the basis of:

- A) Raw material used B) Books sold C) Pages printed D) Sales returns

6. If royalty is less than minimum guarantee, the difference is called:

- A) Rent B) Advance C) Shortworkings D) Bonus

7. Royalty receivable by author is shown in his books as:

- A) Asset B) Expense C) Revenue D) Liability

8. In the books of publisher, royalty payable is treated as:

- A) Income B) Expense C) Capital D) Asset

Answers:

- 1 – C 2 – C 3 – C 4 – A
5 – B 6 – C 7 – C 8 – B

9.4 ACCOUNTING TREATMENT DAMAGE PAYABLE BY THE LESSOR OR AUTHOR TO THE LESSEE OR PUBLISHER

In case of lease of copyrights, the royalty agreement may contain a clause that the author should revise the book and give the revised manuscript to the publishers for publication within a stipulated time failing which the author should pay some compensation of damage to the publisher . If there is such a clause in the agreement and there is default on the part of the author he becomes liable to pay damage or compensation to the publishers. Following journal entries will be passed:

In the books of publisher

Author's A/c	Dr
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To Damage receivable A/c

Damages receivable by the publisher from the author are not actually received in cash. These are generally set off against the royalty payable to the author. The entry for the payment of the net amount to the author will be passed. Damages receivables account will be closed by transferring its balance to the credit side of P/LA/c.

In the books of author

Such damages payable by the author to the publishers is a loss to him. The journal entry will be

Damages	payable	A/c
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Dr

To Publisher A/c

Damages payable by the author to the publisher are not actually paid in cash. These are generally set off against the royalty receivable from the publisher. The entry for the net receipt of the amount of royalty will be passed in the books of the author. Damages payable a/c will be closed by transfer to the debit side of P/LA/c.

B. CHECK YOUR PROGRESS

Multiple Choice

1. Damages paid by the lessor to the lessee are treated as an income in the lessee's books.
2. If an author fails to deliver the manuscript on time, the publisher may claim damages.
3. Damages received by the lessee are recorded as capital receipts.
4. The author records damages payable as an expense in their books.
5. Damages payable can be adjusted against royalty in the same accounting period.
6. All damage claims are added to royalty accounts in the books of the lessor.

Answers:

1. True 2. True 3. False 4. True 5. True 6. False

9.5 LET US SUM UP

In royalty agreements, both the lessor (owner) and the lessee (user) must maintain accurate accounts of royalty payments, minimum rent, and shortworkings. The lessor records royalty as income, while the lessee records it as an expense. If actual royalty falls below the minimum rent, the difference is treated as shortworkings, which may be recouped in future periods if the agreement allows.

Nazrana (also called salami or lease premium) is a non-recurring lump-sum payment made by the lessee to the lessor at the start of the lease, treated as a capital receipt in the lessor's books.

In copyright royalty agreements, typically between an author (lessor) and a publisher (lessee), royalty is paid based on the number of copies sold or printed, and may include a minimum guarantee clause. The accounting treatment involves proper recording of royalty payable, shortworkings, and any advances.

In case of a stoppage of work due to strike, lockout, or accident, if the

agreement does not allow relief, the lessee is still liable to pay minimum rent. However, if concessions are permitted, royalty may be reduced or waived for that period.

Lastly, if damages are payable by the lessor or author to the lessee or publisher (due to breach of contract or delay), such amounts are treated as expenses in the payer's books and income or reduction in expense in the recipient's books. These adjustments ensure fair treatment of both parties in the financial records.

9.6 GLOSSARY

- **Nazrana (Lease Premium / Salami):** A one-time, lump-sum payment made by the lessee to the lessor at the beginning of a lease. It is treated as a capital receipt in the books of the lessor.
- **Copyright Royalty:** A payment made by a publisher (lessee) to an author (lessor) for the right to publish and sell a literary work. It is generally based on the number of copies printed or sold.
- **Damages Payable:** Compensation paid by the lessor or author to the lessee or publisher due to breach of agreement, delay, or non-performance. It is treated as an expense in the payer's books and income or deduction in cost for the receiver.

9.7 SELF-ASSESSMENT QUESTIONS

Q1. What is the accounting treatment of royalty in the books of the lessor?

Q2. Define nazrana. How is it treated differently from regular royalty payments?

Q3. How are damages payable by the lessor or author to the lessee or publisher recorded in accounts?

9.8 LESSON END EXERCISE

1. Distinguish between royalty and nazrana. Explain their accounting treatment in the books of the lessor.
2. What are shortworkings? How are they recorded and recouped in royalty agreements?
3. Explain the accounting treatment of damages payable by the lessor or author to the lessee or publisher.

9.9 SUGGESTED READINGS

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan
- Arihant Publication
- Gangwar, Sharad & Gangwar K.
- Rajasekaran

ACCOUNTING TREATMENTS**STRUCTURE**

- 10.0 Learning Objectives and Outcomes
- 10.1 Introduction
- 10.2 Solved practical problems
- 10.3 Unsolved practical problems
- 10.4 Let Us Sum Up
- 10.5 Glossary
- 10.6 Self-Assessment Questions
- 10.7 Lesson End Exercise
- 10.8 Suggested Readings

10.0 LEARNING OBJECTIVES AND OUTCOMES**Learning Objectives**

By the end of this chapter, the learner will be able to:

- Solve practical problems related to royalty, shortworkings, and recoupment.
- Apply the learned concepts in unsolved practical problems for Better conceptual clarity.

Learning Outcomes

After completing this chapter, the learner will be able to:

- Define and explain the term “royalty” and its associated terms.
- Journalize and post entries related to royalty transactions in the books of both lessor and lessee.

- Accurately solve numerical problems based on royalty with or without minimum rent.
- Identify and apply the correct method to deal with shortworkings and recoupment.
- Demonstrate improved problem-solving skills through both solved and unsolved exercises.

10.1 INTRODUCTION

In this chapter, we will discuss the accounting treatment of royalty transactions. The focus will be on understanding the entries in the books of both the lessor and the lessee. You will learn how to record transactions related to royalty agreements, minimum rent, shortworkings, and their recoupment.

The chapter includes solved practical problems to illustrate the application of accounting principles in royalty-related situations. These examples will help in building a clear understanding of the format and method used in actual accounting records.

Additionally, the chapter provides a set of unsolved problems for practice, encouraging the development of analytical and problem-solving skills. By working through these exercises, learners will gain confidence in handling real-world royalty accounting cases.

This chapter is especially useful for students preparing for exams, as well as for those seeking practical knowledge in the field of business accounting.

10.3 SOLVED PROBLEMS

Problem 1 : Bengal coal limited leased a colliery on 1st January, 2010 at a minimum rent of Rs 15,000 merging into a royalty of Re 1 per ton with a stipulation to recoup shortworkings over the first three years of the lease. The output for the first four years of the lease was 8,000; 13,000; 21,000 and 18,000 tons respectively. Draft the necessary journal entries in the books of the company giving effect to the above.

Solution:

Analytical table

Year	Output (in tons)	Royalties @ Re 1 p.t	Short workings	surplus	Recoup -ment	Short Workings Not recouped	Paid to landlord
2010	8,000	8,000	7,000	-	-	-	15,000
2011	13,000	13,000	2,000	-	-	-	15,000
2012	21,000	21,000	-	6,000	6,000	3,000	15,000
2013	18,000	18,000	-	3,000	-	-	18,000

Journal entries in the books of Bengal coal ltd.

2010	Royalties a/c	Dr	8,000	
Dec. 31	Shortworkings a/c	Dr	7,000	
	To landlord a/c			15,000
	(Being royalties due to landlord)			
Dec. 31	Landlord a/c	Dr	15,000	
	To bank a/c			15,000
	(Being the minimum rent paid)			
“	Production a/c	Dr	8,000	
	To royalties a/c			8,000
	(Being transfer of actual royalties to production a/c)			
2011	Royalties a/c	Dr	13,000	
Dec. 31			2,000	

	Shortworkings a/c	Dr			15,000
	To landlord a/c				
	(Being royalties due to landlord)				

2012 Dec. 31	Landlord a/c	Dr	13,000	
	To bank a/c			13,000
	(Being the minimum rent paid)			
	Production a/c	Dr	21,000	
	To royalties a/c			21,000
	(Being transfer of actual royalties to production a/c)			
	Royalties a/c	Dr	21,000	
	To landlord a/c			21,000
	(Being royalties due to landlord)			
2013 Dec. 31	Landlord a/c	Dr	21,000	
	To bank a/c			21,000
	(Being the minimum rent paid)			
	Production a/c	Dr	3,000	
	To royalties a/c			3,000
	(Being transfer of actual royalties to production a/c)			
	Production a/c	Dr	18,000	
	To shortworkings a/c			18,000
	(Being transfer of irrecoverable shortworkings)			
2013 Dec. 31	Royalties a/c	Dr	18,000	
	To landlord a/c			18,000
	(Being royalties due to landlord)			
	Landlord a/c	Dr	18,000	
	To bank a/c			18,000
	(Being the minimum rent paid)			

“	Production a/c	Dr	18,000	
	To royalties a/c (Being transfer of actual royalties to production a/c)			18,000

A. Check Your Progress

Case Study

Background: Bengal Coal Ltd. took a colliery on lease from 1st January 2010. The agreement fixed a minimum rent of ₹15,000 per year, with a royalty of ₹1 per ton of coal raised. The company was allowed to recoup shortworkings within the first three years of the lease. The output of coal for the first four years was as follows:

- 2010: 8,000 tons
- 2011: 13,000 tons
- 2012: 21,000 tons
- 2013: 18,000 tons

Instructions:

Based on the above information, answer the following questions:

1. Calculate the royalty payable for each year.
2. Identify the shortworkings (if any) for each of the first three years.
3. State whether the shortworkings can be recouped and in which year.
4. Mention any journal entry that would be recorded in 2010 related to royalty.

Where the minimum rent is reduced by fixed percentage during strike

Problem 2 : The bangle mine company obtained a mine on lease for a period of 30 years beginning from 1st January, 2011 on the following terms:

1. To pay minimum rent of Rs 24,000 per year.
2. Each year's excess of minimum rent over the actual royalties i.e. shortworkings can be recovered during the subsequent two years.
3. Due to accident or strike minimum rent is to be reduced by 25 % for that year.
4. Royalty was to be calculated at 50 paise per tonne.
5. Production during four years from 2011 to 2014 was as follows:

Year	2011	2012	2013	2014
Production	28,000	36,000	60,000	44,000

(strike for 3 months)

Open minimum rent a/c, royalties a/c, landlord's a/c and shortworkings a/c in the books of the bangle mine company

Solution:

Analytical table

Year	Output (in tons)	Royalties @ Re 1 p.t	Minimum rent	Short workings	Surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2011	28,000	14,000	24,000	10,000	-	-	-	24,000
2012	36,000	18,000	24,000	6,000	-	-	-	24,000
2013	60,000	30,000	24,000	-	6,000	6,000	4,000	24,000
2014	44,000	22,000	18,000	-	4,000	4,000	2,000	18,000

Minimum Rent A/c

2011	To landlord's a/c	24,000	2011	By royalties a/c	14,000
				By shortworkings A/c	<u>10,000</u>
		<u>24,000</u>			<u>24,000</u>
2012	To landlord's a/c	24,000	2012	By royalties a/c	<u>18,000</u>

		<u>24,000</u>	By shortworkings A/c	<u>6,000</u>
				<u>24,000</u>

Royalties A/c

2011	To minimum rent A/c	<u>14,000</u>	2011	By production A/c	<u>14,000</u>
2012	To minimum rent A/c	<u>18,000</u>	2012	By production A/c	<u>18,000</u>
2013	To shortworking A/c	6,000	2013	By production A/c	30,000
	To landlord's A/c	<u>24,000</u>			
		<u>30,000</u>			<u>30,000</u>
2014	To shortworking A/c	4,000	2014	By production A/c	22,000
	To landlord's A/c	<u>18,000</u>			
		<u>22,000</u>			<u>22,000</u>

Landlord's A/c

2011	To bank a/c	<u>24,000</u>	2011	By minimum rent a/c	<u>24,000</u>
2012	To bank a/c	<u>24,000</u>	2012	By minimum rent a/c	<u>24,000</u>
2013	To short working a/c	6,000	2013	By Royalty a/c	30,000
2013	To bank a/c	24,000			
		<u>30,000</u>			<u>30,000</u>
2014	To short working a/c	4,000	2014	By Royalty a/c	22,000
2014	To Bank a/c	<u>18,000</u>			
		<u>22,000</u>			<u>22,000</u>

Shortworkings A/c

2011	To minimum rent A/c	<u>10,000</u>	2011	By balance C/d	<u>10,000</u>
2012	To balance b/d	10,000	2012	By balance C/d	16,000
	To minimum rent A/c	6,000			
		<u>16,000</u>			<u>16,000</u>
2013	To balance b/d	16,000	2013	By royalties A/c	6,000
			"	By p/l A/c	4,000

		<u>16,000</u>	“	By balance c/d	<u>6,000</u>
					16,000
2014	To balance b/d	6,000	2014	By royalties A/c	4,000
		<u>6,000</u>	“	By p/l A/c	<u>2,000</u>
					6,000

B. CHECK YOUR PROGRESS

Case Study

Scenario: Maharashtra Mining Ltd. leased a mine from 1st January 2015 at an annual minimum rent of ₹24,000, and royalty of ₹2 per ton of output. The lease agreement included a clause stating that if a strike occurs, the minimum rent will be reduced by 60% for that year.

The output and situation for the first three years are as follows:

- 2015: Output = 6,000 tons (No strike)
- 2016: Output = 8,000 tons (Strike occurred for 6 months)
- 2017: Output = 12,000 tons (No strike)

Shortworkings are recoupable within the next 2 years.

Answer the following questions based on the case above:

1. What is the royalty payable for each year?
2. What is the minimum rent applicable in 2016 after applying the strike clause?
3. Identify the shortworkings (if any) for 2015 and 2016.

4. Can the shortworkings of 2015 be recouped in 2016 or 2017? Explain.
5. Write the journal entry for royalty and shortworkings adjustment for 2016.

When there is strike and recoupment of shortworkings in next year only.

Problem 3 : X ltd. took a mine on lease from Y at a given rate of royalty with a minimum rent of Rs 10,000 a year. Each year's excess of minimum rent over royalties is recoverable out of the next year only. In the event of a strike and the minimum rent not being reached, it was provided that the actual royalties earned for the year would be the full royalty obligation for the year.

The results of the working were as follows:

Year	First	Second	Third	Fourth	Actual
Royalties	nil	8,000	8,000	9,000	

Give journal entries and draw up shortworking A/c, minimumrent A/c, and royalties A/c for all the years in the books of X ltd.

Solution:

Analytical table

Year	Output (in tons)	Royalties @ Rs 1 p.t	Minimum rent	Short workings	Surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
1	-	-	10,000	10,000	-	-	-	10,000
2	8,000	8,000	10,000	2,000	-	-	10,000	10,000
3	8,000	8,000	-	-	-	-	2,000	8,000
4	9,000	9,000	10,000	1,000	-	-	-	10,000

Journal entries in the books of X ltd.

2010	Royalties A/c	Dr		10,000	
Dec 31	To Y's A/c				10,000

2011 Dec 31	“	(being royalties due to landlord)		
		Shortworkings A/c Dr	10,000	
		To minimum rent A/c (being royalties nil total amount of minimum rent treates as shortworking)		10,000
	“	Y’s A/c Dr	10,000	
		To bank A/c (being the minimum rent paid)		10,000
		Minimum rent A/c Dr	10,000	
		To Y’s A/c (being minimum rent payable to Y)		10,000
	“	Royalties A/c Dr	8,000	
		Shortworkings A/c Dr	2,000	
		To Minimum rent A/c (being royalties due to landlord)		10,000
	“	Y’s A/c Dr	10,000	
		To bank A/c (being the minimum rent paid)		10,000

2012		P/LA/c Dr	18,000	
		To royalties A/c		8,000
		To shortworking A/c (being transfer of actualroyalties to productionA/c)		10,000
	“	Royalties A/c Dr	8,000	
		To Y’s A/c (being royalties due to landlord)		8,000
	“	Y’s A/c Dr	8,000	
		To shortworkings A/c		8,000
		To bank A/c (being the minimum rent paid)		
	“	P/L A/c Dr	10,000	
		To royalties A/c		2,000

2013 Dec. 31 “ “ “ “	To shortworking A/c (being transfer of actual royalties to production A/c)		8,000
	Minimum rent A/c Dr	10,000	
	To Y's A/c (being rent payable to Y)		10,000
	Royalties A/c Dr	9,000	
	Shortworking A/c Dr	1,000	
	To landlord A/c (being royalties due to landlord)		10,000
	Y'S A/c Dr	10,000	
“	To bank A/c (being the minimum rent paid)		10,000
	P/L A/c Dr	9,000	
	To royalties A/c (being transfer of actual royalties to production A/c)		9,000

LEDGER A/C'S

Shortworking A/c

Year			Year		
1	To minimum rent A/c	<u>10,000</u>	1	By balance c/d	<u>10,000</u>
2	To balance B/d	10,000	2	By P/L A/c	10,000
	To minimum rent A/c	<u>2,000</u>		By balance c/d	<u>2,000</u>
		<u>12,000</u>			<u>12,000</u>
3	To balance B/d	<u>2,000</u>	3	By P/L A/c	<u>2,000</u>
4	To minimum rent A/c	<u>1,000</u>	4	By balance c/d	<u>1,000</u>

Minimum Rent A/c

Year			Year		
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1	To Y's A/c	<u>10,000</u>	1	By shortworkings A/c	<u>10,000</u>
2	To Y's A/c	10,000	2	By royalties A/c	8,000
			"	By shortworkings A/c	<u>2,000</u>
		<u>10,000</u>			<u>10,000</u>
4	To Y's A/c	10,000	4	By royalties A/c	9,000
				By shortworkings A/c	<u>1,000</u>
		<u>10,000</u>			<u>10,000</u>

Royalties A/c

Year			Year		
2	To minimum rent A/c	<u>8,000</u>	2	By P/L A/c	<u>8,000</u>
3	To Y's A/c	<u>8,000</u>	3	By P/L A/c	<u>8,000</u>
4	To minimum rent A/c	<u>9,000</u>	4	By P/L A/c	<u>9,000</u>

Where right of recoupement by 50 % if not required in succeeding year

Problem 4: Sunil took lease of an oil well from Ajay oil ltd. on 1-1-2011. The minimum rent was Rs 200, 000 and royalty was Rs 20 per ton of crude oil raised. The shortworkings were recoverable in the succeeding two years of such shortworkings, but on the condition that if during the next year of any shortworkings, the lessee is unable to recover the same either fully or partly, he will lose the right to recover 50 % of such uncovered amount of short workings. The output during the first 4 years respectively was 5,500; 8,000; 11,250; 12,500 tons. Prepare minimum rent A/c, royalty A/c, shortworkings A/c and Ajay Oil Ltd. A/c's in the books of Sunil

Solution:

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	Surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2011	5,500	110,000	200,000	90,000	-	-	-	200,000

2012	8,000	160,000	200,000	40,000	-	-	45,000	200,000
2013	11,250	225,000	200,000	-	25,000	25,000	40,000	200,000
2014	12,500	250,000	200,000	-	50,000	20,000	-	230,000

In the books of Sunil
Minimum rent A/c

2011	To Ajay oil ltd. A/c	200,000	2011	By royalties A/c	110,000
				By shortworkings A/c	<u>90,000</u>
		<u>200,000</u>			<u>200,000</u>
2012	To Ajay oil ltd. A/c	200,000	2012	By royalties A/c	160,000
				By shortworkings A/c	<u>40,000</u>
		<u>200,000</u>			<u>200,000</u>

Royalties A/c

2011	To minimum rent A/c	<u>110,000</u>	2011	By P/L A/c	<u>110,000</u>
2012	To minimum rent A/c	<u>160,000</u>	2012	By P/L A/c	<u>160,000</u>
2013	To Ajay oil ltd. A/c	<u>225,000</u>	2013	By P/L A/c	<u>225,000</u>
2014	To Ajay oil ltd. A/c	<u>250,000</u>	2014	By P/L A/c	<u>250,000</u>

Shortworking A/c

2011	To minimum rent A/c	<u>90,000</u>	2011	By balance c/d	<u>90,000</u>
2012	To balance b/d	90,000	2012	By P/L A/c	45,000
“	To minimum rent A/c	<u>40,000</u>	“	By balance c/d	<u>85,000</u>
		<u>130,000</u>			<u>130,000</u>
2013	To balance b/d	85,000	2013	By Ajay Oil Ltd. A/c	25,000
				By P/L A/c	40,000
				By balance C/d	<u>20,000</u>
		<u>85,000</u>			<u>85,000</u>
2014	To balance b/d	<u>20,000</u>	2014	By Ajay Oil Ltd. A/c	<u>20,000</u>

Ajay Oil Ltd A/c

2011	To bank A/c	<u>200,000</u>	2011	By minimum rent A/c	<u>200,000</u>
2012	To bank A/c	<u>200,000</u>	2012	By minimum rent A/c	<u>200,000</u>
2013	To short workings A/c	25,000	2013	By royalties A/c	225,000
	To bank A/c	<u>200,000</u>			<u>225,000</u>
		<u>225,000</u>			<u>225,000</u>
2014	To short workings A/c	20,000	2014	By royalties A/c	250,000
“	To bank A/c	<u>230,000</u>			<u>250,000</u>
		<u>250,000</u>			<u>250,000</u>

Where production units are to be calculated for royalty amount and minimum rent reduced pro rata

Problem 5: On 1st July, 2009 , A obtained from B a lease of some coal bearing land, terms buying a royalty of Rs 2 per ton raised subject to a minimum rent of Rs 9,000 p . a. With a right to recoupe the shortworkings over the first four years upto 2012 of the lease. From the following details, prepare royaltieis A/c, shortworkings A/c, and B’s account in the books of A .

Year	2009	2010	2011	2012	2013	2014
Sales						
(in tons)	1,500	2,300	5,000	6,000	3,600	4,500
Closing						
Stock						
(in tons)	500	400	700	800	600	500

There is strike for 2 months in 2013 and lock out for 2 months in 2014

Inthe event of strike the minimum rent would be taken pro rata on the basis of actual period of working but in the event of lock out, the lessee would enjoy a concession in respect of minimum rent for 40 % of the period of lock out.

Solution:

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2009	2,000	4,000	9,000	5,000	-	-	-	9,000
2010	2,200	4,400	9,000	4,600	-	-	-	9,000
2011	5,300	10,600	9,000	-	1,600	1,600	-	9,000
2012	6,100	12,200	9,000	-	3,200	3,200	4,800	9,000
2013	3,400	6,800	7,500	700	-	-	700	7,500
2014	4,400	8,800	8,400	-	400	-	-	8,800

Production = closing stock + sales – opening stock

$$= \frac{9,000}{12} \times 11.2 = 8,400$$

12 months – 40 / 100 x 2 months = 11.2 months.

Royalties A/c

2009	To landlord A/c	<u>4,000</u>	2009	By p/l A/c	<u>4,000</u>
2010	To landlord A/c	<u>4,400</u>	2010	By p/l A/c	<u>4,400</u>
2011	To landlord A/c	<u>10,600</u>	2011	By p/l A/c	<u>10,600</u>
2012	To landlord A/c	<u>12,200</u>	2012	By p/l A/c	<u>12,200</u>
2013	To landlord A/c	<u>6,800</u>	2013	By p/l A/c	<u>6,800</u>
2014	To landlord A/c	<u>8,800</u>	2014	By p/l A/c	<u>8,800</u>

Landlord A/c

2009	To bank A/c	9,000	2009	By royalties A/c	4,000
		<u>9,000</u>	“	By shortworkings A/c	<u>5,000</u>
		9,000			<u>9,000</u>
2010	To bank A/c	<u>9,000</u>	2010	By royalties A/c	<u>4,400</u>
		<u>9,000</u>	“	By shortworkings A/c	4,600
		9,000			<u>9,000</u>
2011	To shortworking A/c	1,600	2011	By royalties A/c	10,600

“	To bank A/c	<u>9,000</u>			<u>10,600</u>
2012	To shortworking A/c	<u>3,200</u>	2012	By royalties A/c	<u>12,200</u>
“	To bank A/c	<u>9,000</u>			<u>12,200</u>
2013	To bank A/c	<u>7,500</u>	2013	By royalties A/c	<u>6,800</u>
		<u>7,500</u>	“	By shortworkings A/c	<u>700</u>
2014	To bank A/c	<u>8,800</u>	2014	By royalties A/c	<u>8,800</u>
		<u>8,800</u>			<u>8,800</u>

Shortworkings A/c

2009	To landlord's A/c	<u>5,000</u>	2009	By balance c/d	<u>5,000</u>
2010	To balance b/d	<u>5,000</u>	2010	By balance c/d	<u>9,600</u>
“	To landlord's A/c	<u>4,600</u>			<u>9,600</u>
		<u>9,600</u>			<u>9,600</u>
2011	To balance b/d	<u>9,600</u>	2011	By landlord's A/c	<u>1,600</u>
		<u>9,600</u>	“	By balance c/d	<u>8,000</u>
2012	To balance b/d	<u>8,000</u>	2012	By landlord's A/c	<u>3,200</u>
		<u>8,000</u>	“	By p/l A/c	<u>4,800</u>
2013	To landlord's A/c	<u>700</u>	2013	By p/l A/c	<u>700</u>

When there is special condition for recoupment of shortworkings

Problem 6 : Mohan took a mine on lease for 20 years . rate of royalty is Re 1 P.t . Minimum rent is Rs 8,000 per year. Next year shortworkings of that year will not be recouped in which yield will be less than 4,000 tons and the year in which royalty will be more than minimum rent, only 50 % of excess will be used for recoupment of shortworkings.

Prepare the necessary accounts in the book of mohan when the yield for the first four years respectively is Rs 3,500 tons, 7,000 tons , 7,500 tons and 9,000 tons.

Solution:

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
1	3,500	3,500	8,000	4,500	-	-	-	8,000
2	7,000	7,000	8,000	1,000	-	-	4500	8,000
3	7,500	7,500	8,000	500	-	-	1,000	8,000
4	9,000	9,000	8,000	-	1,000	500	-	8,500

In the books of Mohan

Royalties A/c

1	To landlord A/c	<u>3,500</u>	1	By P/L A/c	<u>3,500</u>
2	To landlord A/c	<u>7,000</u>	2	By P/L A/c	<u>7,000</u>
3	To landlord A/c	<u>7,500</u>	3	By P/L A/c	<u>7,500</u>
4	To landlord A/c	<u>9,000</u>	4	By P/L A/c	<u>9,000</u>

Shortworkings A/c

1	To landlord's A/c	<u>4,500</u>	1	By balance c/d	<u>4,500</u>
2	To balance B/d	4,500	2	By P/L A/c	4,500
“	To landlord's A/c	<u>1,000</u>	“	By balance C/d	<u>1,000</u>
		<u>5,500</u>			<u>5,500</u>
3	To balance B/d	1,000	3	By landlord's A/c	1,000
“	To landlord's A/c	500	“	By balance C/d	<u>500</u>
		<u>1,500</u>			<u>1,500</u>
4	To balance B/d	<u>500</u>	4	By landlord's A/c	<u>500</u>

Landlord's A/c

1	To bank A/c	8,000	1	By royalties A/c	3,500
		<u>8,000</u>	“	By shortworking A/c	4,500
		<u>8,000</u>			<u>8,000</u>
2	To bank A/c	8,000	2	By royalties A/c	7,000
		<u>8,000</u>	“	By shortworking A/c	1,000
		<u>8,000</u>			<u>8,000</u>
3	To bank A/c	8,000	3	By royalties A/c	7,500
		<u>8,000</u>	“	By shortworking A/c	500
		<u>8,000</u>			<u>8,000</u>
4	To shortworkings A/c	500	4	By royalties A/c	9,000
“	To bank A/c	8,500			<u>9,000</u>
		<u>9,000</u>			<u>9,000</u>

Profit and Loss A/c

1	To royalties A/c	<u>3,500</u>			
2	To royalties A/c	7,000			
“	To shorworkings A/c	4,500			
		<u>11,500</u>			
3	To royalties A/c	7,500			
“	To shorworkings A/c	1,000			
		<u>8,500</u>			
4	To royalties A/c	<u>9,000</u>			

When figures of shortworkings , surplus and amount paid to landlord are given.

Problem 7 : The bharat mining company holds a lease of a coal mine for a period of 20 years , commencing from 1st april, 2007. The lease provided for a payment on

15th April, 2008 and annually thereafter a royalty of Rs 2 per ton on coal produced in

the previous year subject to a minimum rent of Rs 8,000 per year. shortworkings can be recouped out of royalty in excess of the minimum rent for the next two years only. In the year of strike the minimum rent was to be regarded as having been reduced proportionately having regard to the length of stoppage. The first year in respect of which minimum rent was payable expired on 31st March,2008. The excess paid for the first year was Rs 3,750, of the second year Rs 3,000. In the third year, the surplus was Rs 3,200 and of the fourth year Rs 4,000. In the fifth year, actual royalties amounted to Rs 14,000 and in the sixth year Rs 7,500 only. During the sixth year there was a stoppage due to strike lasting three months.

Write up the necessary accounts in the books of bharat mining company

Analytical table

Year	Royalties	Mini- mum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2008	4,250	8,000	3,750	-	-	-	8,000
2009	5,000	8,000	3,000	-	-	-	8,000
2010	11,200	8,000	-	3,200	3200	550	8,000
2011	12,000	8,000	-	4,000	3,000	-	9,000
2012	14,000	8,000	-	6,000	-	-	14,000
2013	7,500	6,000	-	1,500	-	-	7,500

Royalties A/c

2008	To landlord A/c	<u>4,250</u>	2008	By production A/c	<u>4,250</u>
2009	To landlord A/c	<u>5,000</u>	2009	By production A/c	<u>5,000</u>
2010	To landlord A/c	<u>11,200</u>	2010	By production A/c	<u>11,200</u>
2011	To landlord A/c	<u>12,000</u>	2011	By production A/c	<u>12,000</u>
2012	To landlord A/c	<u>14,000</u>	2012	By production A/c	<u>14,000</u>
2013	To landlord A/c	<u>7,500</u>	2013	By production A/c	<u>7,500</u>

Shortworkings A/c

Mar.31 ,08	To landlord's A/c	<u>3,750</u>	Mar 31 ,08	By balance c/d	<u>3,750</u>
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B/d

B/d

Apr 1 , 08	To balance b/d	3,750	Mar 31 ,09	By balance c/d	6,750
Mar 31 ,09	To landlord's A/c	<u>3,000</u>			
		<u>6,750</u>			<u>6,750</u>
Apr 1 , 09	To balance b/d	6,750	Mar 31,10	By landlord's A/c	3,200
			"	By production A/c	550
			"	By balance c/d	3,000
		<u>6,750</u>			<u>6,750</u>
Apr 1 , 10	To balance b/d	<u>3,000</u>	Mar 31, 11	By landlord's A/c	<u>3,000</u>

Landlord A/c

Mar 31 ,08	To balance c/d	8,000	Mar. 31, 08	By royalties A/c	4,250
		<u>8,000</u>	"	By shortworking A/c	3,750
Apr 15,09	To bank A/c	8,000	Apr.1, 08	By balance b/d	8,000
Mar 31,09	To balance c/d	8,000	Mar. 31, 09	By royalties A/c	5,000
		<u>16,000</u>	"	By shortworking A/c	3,000
Apr 15,10	To bank A/c	8,000	Apr.1 , 09	By balance b/d	8,000
Mar 31, 10	To shortworking A/c To	3,200	Mar. 31 , 10	By royalties A/c	11,200
"	balance c/d	<u>8,000</u>			<u>19,200</u>
		<u>19,200</u>	Apr.1 , 10	By balance b/d	8,000
Apr 15,11	To bank A/c	8,000	Mar. 31 , 11	By royalties A/c	12,000
Mar 31, 11	To shortworkings A/c To	3,000			<u>20,000</u>
"	balance c/d	<u>9,000</u>	Apr.1 , 11	By balance b/d	9,000
		<u>20,000</u>	Mar. 31 , 12	By royalties A/c	14,000
Apr 15,12	To bank A/c	9,000			<u>23,000</u>
Mar 31, 12	To balance c/d	<u>14,000</u>	Apr.1 , 12	By balance b/d	14,000
		<u>23,000</u>	Mar. 31 , 13	By royalties A/c	7,500
Apr 15,13	To bank A/c	14,000			<u>21,500</u>
Mar 31, 13	To balance c/d	<u>7,500</u>	Apr.1 , 14	By balance b/d	7,500
		<u>21,500</u>			
Apr 15,14	To bank A/c	7,500			

Where production units are to be calculated for calculation of royalty and recoupment of shortworking is made only in the next year

Problem 8 : On 1st January, 2009, bright ltd. patentees of a new type of a gas burner, issued a licence to popular ltd. for the manufacture and sale of burners for 5 years on the following terms and conditions:

- Popular ltd. to pay a royalty of Rs 100 for every burner manufactured
- Minimum rent is Rs 50,000 per year.
- If , for any year, the shortworkings against royalties payable in excess of the

minimum rent in the next year.

d) Payments should be made on 31st December.

e) Sales and closing stock of burners of popular ltd. for five years were as under:

Year	2009	2010	2011	2012	2013
Sales (units)	200	400	600	550	230
Closing stock (in units)	50	100	70	150	20

From the above particulars prepare royalties payable A/c, shortworkings A/c, bright ltd. A/c in the books of popular ltd. assuming the accounts are closed on 31st December, each year . also prepare the analytical table.

Solution:

Calculation of production units = sales + closing stock – opening stock

$$2009 = 200 + 50 - \text{nil} = 250$$

$$2010 = 400 + 100 - 50 = 450$$

$$2011 = 600 + 70 - 100 = 570$$

$$2012 = 550 + 150 - 70 = 630$$

$$2013 = 230 + 20 - 150 = 100$$

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2009	250	25,000	50,000	25,000	-	-	-	50,000
2010	450	45,000	50,000	5,000	-	-	25,000	50,000
2011	570	57,000	50,000	-	7,000	5000	-	52,000
2012	630	63,000	50,000	-	13,000	-	-	63,000
2013	100	10,000	50,000	40,000	-	-	40,000	50,000

In the books of M/s Popular Ltd.

Royalties A/c

Dec.31,09	To bright ltd.	<u>25,000</u>	Dec.31,09	By P/L A/c	<u>25,000</u>
Dec.31,10	To bright ltd.	<u>45,000</u>	Dec.31 ,10	By P/L A/c	<u>45,000</u>

Dec.31,11	To bright ltd.	52,000	Dec.31,11	By P/L A/c	57,000
	To shortworkings A/c	<u>5,000</u>			<u> </u>
		<u>57,000</u>			<u>57,000</u>
Dec.31,12	To bright ltd.	<u>63,000</u>	Dec.31,12	By P/L A/c	<u>63,000</u>
Dec.31,13	To bright ltd.	<u>10,000</u>	Dec.31,13	By P/L A/c	<u>10,000</u>

M/s Bright Ltd. A/c

Dec.31,09	To bank A/c	50,000	Dec.31,09	By royalties A/c	25,000
			“	By shortworkings A/c	<u>25,000</u>
		<u>50,000</u>			<u>50,000</u>
Dec.31,10	To bank A/c	50,000	Dec.31, 10	By royalties A/c	45,000
			“	By shortworkings A/c	5,000
		<u>50,000</u>			<u>50,000</u>
Dec.31,11	To bank A/c	<u>52,000</u>	Dec.31,11	By royalties A/c	<u>52,000</u>
Dec.31,12	To bank A/c	<u>63,000</u>	Dec.31,12	By royalties A/c	<u>63,000</u>
Dec.31,13	To bank A/c	50,000	Dec.31,13	By royalties A/c	10,000
			“	By shortworkings A/c	<u>40,000</u>
		<u>50,000</u>			<u>50,000</u>

Shortworkings A/c

Dec. 31,09	To bright ltd. A/c	<u>25,000</u>	Dec.31,09	By balance c/d	<u>25,000</u>
Jan 1 ,10	To balance B/d	25,000	Dec.31 ,10	By p/l A/c	25,000
Dec. 31,10	To bright ltd. A/c	<u>5,000</u>		By balance c/d	<u>5,000</u>
		<u>30,000</u>			<u>30,000</u>
Jan 1 ,11	To balance B/d	<u>5,000</u>	Dec.31,11	By royalties A/c	<u>5,000</u>
Dec.31 ,13	To bright ltd. A/c	<u>40,000</u>	Dec.31,13	By P/L A/c	<u>40,000</u>

Note: The licence to manufacture gas burners was granted for 5 years only. Hence, shortworking for 2013 not being recoverable written off.

Where depreciation is charged on cost of development

Problem 9 : Mining corporation ltd. obtained a lease of coal mine for 99 years from Mr. Landlord on the following terms from 1st January, 2011.

- a) Mining corp. Ltd will develop the land and will bear the cost of development.
- b) Royalties will be Rs 2 per ton of coal raised during the period.
- c) Minimum rent will be Rs 10,000 for the first year with an annual increase of Rs 1,000 till it reaches Rs 15,000.
- d) Shortworkings, if any, are recoverable within first three years only. Mining corp. Ltd. developed the land at the cost of Rs 2 crores and estimated coal deposit of Rs 20 lakhs of tonnes. It was decided to depreciate this expenditure on depletion method of depreciation .
- e) The coal raised by mining corp. Is as under

Year	production in tonnes
2011	1,000
2012	2,000
2013	10,000
2014	15,000

Show the necessary royalty accounts in the books of mining corp. Ltd.

Solution:

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	surplus	Recou-pment	Short Workings Not recouped	Paid to landlord
2011	1,000	2,000	10,000	8,000	-	-	-	10,000
2012	2,000	4,000	11,000	7,000	-	-	-	11,000
2013	10,000	20,000	12,000	-	8,000	8,000	7,000	12,000
2014	15,000	30,000	13,000	-	17,000	-	-	30,000

In the books of Mining Corp. Ltd.

Royalties A/c

2011	To landlord A/c	<u>2,000</u>	2011	By production A/c	<u>2,000</u>
2012	To landlord A/c	<u>4,000</u>	2012	By production A/c	<u>4,000</u>
2013	To shortworking A/c	8,000	2013	By production A/c	20,000
	To landlord A/c	<u>12,000</u>			

		<u>20,000</u>			<u>20,000</u>
2014	To landlord A/c	<u>30,000</u>	2014	By production A/c	<u>30,000</u>

Shortworkings A/c

2011	To landlord A/c	<u>8,000</u>	2011	By balance c/d	<u>8,000</u>
2012	To balance c/d	8,000	2012	By balance c/d	15,000
	To landlord A/c	7,000			
		<u>15,000</u>			<u>15,000</u>
2013	To balance B/d	15,000	2013	By royalties A/c	8,000
			“	By p/l A/c	7,000
		<u>15,000</u>			<u>15,000</u>

Landlord A/c

2011	To bank A/c	10,000	2011	By royalties A/c	2,000
			“	By shortworkings A/c	<u>8,000</u>
		<u>10,000</u>			<u>10,000</u>
2012	To bank A/c	11,000	2012	By royalties A/c	4,000
			“	By shortworkings A/c	<u>7,000</u>
		<u>11,000</u>			<u>11,000</u>
2013	To bank A/c	<u>12,000</u>	2013	By royalties A/c	<u>12,000</u>
2014	To bank A/c	<u>30,000</u>	2014	By royalties A/c	<u>30,000</u>

Depreciation per tonne = $\frac{\text{cost of the development of the land}}{\text{Quantity of estimated coal deposit}} = \frac{2 \text{ crores}}{20 \text{ lakh tonnes}}$
= Rs 10

When there is strike and the minimum rent is reduced proportionately

Problem 10 : X coal ltd. has taken on lease coalfields from Y, on the following terms:

- Lease is for 99 years.
- Lease rent is to be 50 paise p.a. for every tonne of coal raised.

- iii) Minimum royalty p.a. is to be Rs 30,000 the lessee has a right to recoup any shortworking within a period of three years for which the excess payment was made.
- iv) In case of the working of the mines was affected by any strike or riot and there were no raisings, then the minimum rent payable would abate proportionately.
- v) Following were the raisings for the different years:

Years	production (in tonnes)
2009	20,000
2010	35,000
2011	30,000 (there was a strike for 3 months during which no coal raised)
2012	70,000
2013	80,000
2014	100,000

You are required to show royalties, shortworkings and landlord's A/c in the books of X coal ltd.

Solution:

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2009	20,000	10,000	30,000	20,000	-	-	-	30,000
2010	35,000	17,500	30,000	12,500	-	-	-	30,000
2011	30,000	15,000	30,000	7,500	-	-	-	22,500
2012	70,000	35,000	30,000	-	5,000	5,000	15,000	30,000
2013	80,000	40,000	30,000	-	10,000	10,000	2,500	30,000
2014	100,000	50,000	30,000	-	20,000	7,500	-	42,500

In the books of X Coal Ltd.

Royalties A/c

2009	To Y's A/c	<u>10,000</u>	2009	By production A/c	<u>10,000</u>
2010	To Y's A/c	<u>17,500</u>	2010	By production A/c	<u>17,500</u>
2011	To Y's A/c	<u>15,000</u>	2011	By production A/c	<u>15,000</u>
2012	To Y's A/c	30,000	2012	By production A/c	35,000
“	To shortworkings A/c	<u>5,000</u>			
		<u>35,000</u>			<u>35,000</u>
2013	To Y's A/c	30,000	2013	By production A/c	40,000
“	To shortworkings A/c	10,000			
		<u>40,000</u>			<u>40,000</u>
2014	To Y's A/c	42,500	2014	By production A/c	50,000
	To shortworkings A/c	7,500			
		<u>50,000</u>			<u>50,000</u>

Shortworkings A/c

2009	To Y's a/c	<u>20,000</u>	2009	By balance c/d	<u>20,000</u>
2010	To balance B/d	20,000	2010	By balance c/d	32,500
	To Y's A/c	<u>12,500</u>			
		<u>32,500</u>			<u>32,500</u>
2011	To balance B/d	32,500	2011	By balance c/d	40,000
	To Y's a/c	<u>7,500</u>			
		<u>40,000</u>			<u>40,000</u>
2012	To balance B/d	40,000	2012	By royalties A/c	5,000
			“	By p/l A/c	15,000
			“	By balance c/d	<u>20,000</u>
		<u>40,000</u>			<u>40,000</u>
2013	To balance B/d	20,000	2013	By royalties A/c	10,000
			“	By p/l A/c	2,500

		<u>20,000</u>	“	By balance c/d	<u>7,500</u>
		<u>7,500</u>			<u>20,000</u>
2014	To balance B/d	<u>7,500</u>	2014	By royalties A/c	<u>7,500</u>

Y's A/c

2009	To bank A/c	30,000	2009	By royalties A/c	10,000
		<u>30,000</u>		By shortworkings A/c	20,000
		<u>30,000</u>			<u>30,000</u>
2010	To bank A/c	30,000	2010	By royalties A/c	17,500
		<u>30,000</u>		By shortworkings A/c	12,500
		<u>30,000</u>			<u>30,000</u>
2011	To bank A/c	22,500	2011	By royalties A/c	15,000
		<u>22,500</u>		By shortworkings A/c	7,500
		<u>22,500</u>			<u>22,500</u>
2012	To bank A/c	30,000	2012	By royalties A/c	30,000
2013	To bank A/c	30,000	2013	By royalties A/c	30,000
2014	To bank A/c	42,500	2014	By royalties A/c	42,500

Journal entries in the books of lessor

Problem 11 : Bihar coal ltd. leased a colliery from Himalaya coal ltd. on 1st January ,2009 at a minimum rent of Rs 30,000 merging into a royalty of Rs 1.50 per ton with power to recoup shortworkings during the first three years of the lease. The output of the colliery for the five years of the lease was Rs 9,000, 15,000, 27,000, 17,000 and 28000 tons respectively.

Pass the journal entries for five years for the above transactions in the books of Himalaya coal ltd.

Solution:

Analytical table

Year	Output (in tons)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2009	9,000	13,500	30,000	16,500	-	-	-	30,000
2010	15,000	22,500	30,000	7,500	-	-	-	30,000
2011	27,000	40,500	30,000	-	10,500	10,000	13,500	30,000
2012	17,000	25,500	30,000	4,500	-	-	4,500	30,000
2013	28,000	42,000	30,000	-	12,000	-	-	42,000

In the books of Himalaya Coal Ltd.

Journal entries

2009	Bihar coal ltd	Dr		30,000	
Dec. 31	To royalties receivable A/c				13,500
	To shortworkings suspense A/c				16,500
	(being the minimum rent due from Bihar Co.)				
“	Bank A/c	Dr		30,000	
	To Bihar Co. Ltd A/c				30,000
	(being the amount of royalties received)				
“	Royalties A/c	Dr		13,500	
	To P/LA/c				13,500
	(being amount of royalties receivable transferred to P/LA/c)				
2010	Bihar Coal Ltd.	Dr		30,000	
Dec. 31	To royalties receivable A/c				22,500
	To shortworkings suspense A/c				7,500
	(being the minimum rent due from Bihar Co.)				
“	Bank A/c	Dr		30,000	
	To Bihar Co. Ltd A/c				30,000

“	(being the amount of royalties received)			
	Royalties A/c Dr	22,500		
	To P/LA/c		22,500	
	(being amount of royalties receivable transferred to P/LA/c)			
2011	Bihar Coal Ltd. Dr	40,500		
Dec. 31	To royalties receivable A/c		40,500	
	(being the minimum rent due from Bihar Co.)			

“	Shortworking suspense A/c Dr	10,500		
	To Bihar Coal Ltd. A/c		10,500	
	(being shortworkings suspense recouped by Bihar Coal Ltd. in excess of minimum rent)			
“	Bank A/c Dr	30,000		
	To Bihar Co. Ltd A/c		30,000	
	(being the amount of royalties received)			
“	Royalties receivable A/c Dr	40,500		
	Shortworking suspense A/c Dr	13,500		
	To P/LA/c		54,000	
	(being transfer of royalties receivable and irrecoverable balance in shortworkings suspense A/c to P/L A/c)			
2012	Bihar Coal Ltd. Dr	30,000		
Dec. 31	To royalties receivable A/c		25,500	
	To shortworkings suspense A/c		4,500	
	(being the minimum rent due from bihar co.)			

“	Bank A/c Dr	30,000	
	To bihar Co. Ltd A/c (being the amount of royalties received)		30,000
“	Royalties receivable A/c Dr	25,500	
	Shortworking suspense A/c Dr	4,500	
	To P/LA/c (being transfer of royalties receivable and irrecoverable balance in shortworkings suspense A/c to P/LA/c)		30,000

2013	Bihar Coal Ltd. A/c Dr	42,000	
Dec. 31	To Bihar Co. Ltd A/c (being the amount of royalties received)		42,000
“	Bank A/c Dr	42,000	
	To bihar co. Ltd A/c (being the amount of royalties received)		42,000
“	Royalties receivable A/c Dr	42,000	
	To P/LA/c (being transfer of royalties receivable to P/LA/c)		42,000

When royalty is to be paid on production and sales together and accounts are to be prepared in the books of lessor.

Problem 12: Srikant had patented a new type of pocket transistor . on 1-1-2011 , he granted parker a licence for 20 years to manufacture and sell the transistor on the following terms:

- Parker to pay a royalty of Rs 5 for each transistor manufactured and a further royalty of Rs 3 for each transistor sold with a minimum rent of Rs 8,000 p.a
- If , in any year , the royalties calculated on the transistors manufactured and sold be less than the minimum rent ,parker to have the right to recoup

shortworking out of the royalties in excess of the minimum rent during the two years immediately following subject to a maximum amount of Rs 2,000 p .a

- c) The number of transistors manufactured and sold for the first four years were as follows:

Year	manufactured	sold
2011	800	500
2012	1,000	700
2013	2,500	1,500
2014	500	2,000

All the payments were made by parker on the due date. Prepare parker's A/c; royalties receivable A/c; shortworkings suspense A/c for the first four years as they would appear in the books of srikant.

Analytical table

Year	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2011	5,500	8,000	2500	-	-	-	8,000
2012	7,100	8,000	900	-	-	-	8,000
2013	17,000	8,000	-	9,000	2,000	500	15,000
2014	8,500	8,000	-	500	500	400	8,000

Parker's A/c

2011	To royalty receivable A/c	5,500	2011	By bank A/c	8,000
	To shortworkings suspense A/c	<u>2,500</u>			
		<u>8,000</u>			<u>8,000</u>
2012	To royalty receivable A/c	7,100	2012	By bank A/c	8,000
	To shortworkings suspense A/c	<u>900</u>			
		<u>8,000</u>			<u>8,000</u>
2013	To royalty receivable A/c	17,000	2013	By shortworkings suspense A/c	2,000
		<u>17,000</u>		By bank A/c	<u>15,000</u>
					<u>17,000</u>

2014	To royalty receivable A/c	<u>8,500</u>	2014	By shortworkings suspense A/c	<u>500</u>
		<u>8,500</u>		By bank A/c	<u>8,000</u>
					<u>8,500</u>

Royalty receivable A/c

2011	To P/L A/c	<u>5,500</u>	2011	By parker's A/c	<u>5,500</u>
2012	To P/L A/c	<u>7,100</u>	2012	By parker's A/c	<u>7,100</u>
2013	To P/L A/c	<u>17,000</u>	2013	By parker's A/c	<u>17,000</u>
2014	To P/L A/c	<u>8,500</u>	2014	By parker's A/c	<u>8,500</u>

Shortworkings suspense A/c

2011	To balance c/d	<u>2,500</u>	2011	By parker's A/c	<u>2,500</u>
2012	To balance c/d	<u>3,400</u>	2012	By balance B/d	<u>2,500</u>
		<u>3,400</u>		By parker's A/c	<u>900</u>
2013	To parker's A/c	<u>2,000</u>	2013	By balance B/d	<u>3,400</u>
	To p/l A/c	<u>500</u>			
	To balance c/d	<u>900</u>			<u>3,400</u>
		<u>3,400</u>			<u>900</u>
2014	To parker's A/c	<u>500</u>	2014	By balance B/d	<u>900</u>
	To p/l A/c	<u>400</u>			<u>900</u>
		<u>900</u>			<u>900</u>

Problem 13 : On January 1, 2010, a Brick Co. Acquired a lease of 15 years from Mr. X on lease for getting earth. Terms of lease are:-

- Annual rate of royalty is Re 1 per 100 cubic feet of earth taken out.
- Minimum rent is Rs 12,000 p.a
- On 1st January, 2010, company gave Rs 150,000 to X for nazrana.
- Short workings can be recouped during first 4 years only.
- Annual royalty is paid on 31st December, each year.

Brick making company extracted earth in the following manner.

Years	2010	2011	2012	2013
Earth in cubic feet	10,00,000	15,00,000	900,000	14,00,000

Open nazrana A/c, Royalty A/c and shortworking A/c in the books of brick co.

Solution:

Analytical table

Year	Earth (in cu. Feet)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
Nazrana A/c								
2010	10,00,000	10,000	12,000	2,000				12,000
2011	15,00,000	15,000	12,000	150,000	31-12-10	By P/L A/c -	-	10,000
2012	900,000	9,000	12,000	3,000	“	By balance c/d	120,000	13,000
2013	14,00,000	14,000	12,000	2,000	“	By balance c/d	1,000	12,000
				<u>150,000</u>				<u>150,000</u>
1-1-11		To balance B/d	140,000	31-12-11		By P/L A/c		10,000
				“		By balance c/d		130,000
			<u>140,000</u>					<u>140,000</u>
1-1-12		To balance B/d	130,000	31-12-12		By P/L A/c		10,000
				“		By balance c/d		120,000
			<u>130,000</u>					<u>130,000</u>
1-1-13		To balance B/d	120,000	31-12-13		By P/L A/c		10,000
				“		By balance c/d		110,000
			<u>120,000</u>					<u>120,000</u>

Royalty A/c

2010	To landlord A/c	<u>10,000</u>	2010	By production A/c	<u>10,000</u>
2011	To landlord A/c	<u>15,000</u>	2011	By production A/c	<u>15,000</u>
2012	To landlord A/c	<u>9,000</u>	2012	By production A/c	<u>9,000</u>
2013	To landlord A/c	<u>14,000</u>	2013	By production A/c	<u>14,000</u>

Shortworkings A/c

2010	To landlord A/c	<u>2,000</u>	2010	By balance c/d	<u>2,000</u>
2011	To landlord A/c	<u>2,000</u>	2011	By landlord A/c	<u>2,000</u>
2012	To landlord A/c	<u>3,000</u>	2012	By balance c/d	<u>3,000</u>
2013	To balance B/d	<u>3,000</u>	2013	By landlord A/c	<u>2,000</u>

				By p/l A/c	<u>1,000</u>
		<u>3,000</u>			<u>3,000</u>

Problem 14: Ram took a mine on lease for 20 years . Rate of royalty is Rs 10 per ton. Minimum rent is Rs 80,000 p.a. Shortworkings of that year will not be recouped in which yield will be less than Rs 4,000 tons and the year in which surplus will be more than minimum rent only 50 % of excess will be used for recoupement of shortworking. Prepare the necessary accounts in the books of lessee when the yield for 4 years respectively is 3,500 tons; 7,000 tons; 7,500 tons and 9,000 tons.

Solution:

Analytical table

Year	Output (tons)	Royalties	Minimum rent	Short workings	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
1	3,500	35,000	80,000	45,000	-	-	45,000	80,000
2	7,000	70,000	80,000	10,000	-	-	-	80,000
3	7,500	75,000	80,000	5,000	-	-	-	80,000
4	9,000	90,000	80,000	-	10,000	5,000	-	85,000

Royalty A/c

1	To landlord A/c	<u>35,000</u>	1	By production A/c	<u>35,000</u>
2	To landlord A/c	<u>70,000</u>	2	By production A/c	<u>70,000</u>
3	To landlord A/c	<u>75,000</u>	3	By production A/c	<u>75,000</u>
4	To landlord A/c	<u>90,000</u>	4	By production A/c	<u>90,000</u>

Shortworkings A/c

1	To landlord A/c	<u>45,000</u>	1	By p/l A/c	<u>45,000</u>
2	To landlord A/c	<u>10,000</u>	2	By balance c/d	<u>10,000</u>
3	To balance B/d	<u>10,000</u>	3	By balance c/d	<u>15,000</u>
	To landlord A/c	<u>5,000</u>			<u>15,000</u>
		<u>15,000</u>			<u>15,000</u>
4	To balance B/d	<u>15,000</u>	4	By landlord A/c	<u>5,000</u>

		<u>15,000</u>	By balance c/d	10,000
				<u>15,000</u>

Landlord A/c

1	To bank A/c	80,000	1	By royalty A/c	35,000
			"	By shortworkings A/c	<u>45,000</u>
		<u>80,000</u>			<u>80,000</u>
2	To bank A/c	80,000	2	By royalty A/c	70,000
			"	By shortworkings A/c	<u>10,000</u>
		<u>80,000</u>			<u>80,000</u>
3	To bank A/c	80,000	3	By royalty A/c	75,000
			"	By shortworkings A/c	5,000
		<u>80,000</u>			<u>80,000</u>
4	To shortworkings A/c	5,000	4	By royalty A/c	90,000
"	To bank A/c	85,000			
		<u>90,000</u>			<u>90,000</u>

Where annual minimum rent charges vary with passage of time

Problem 15 : A colliery was obtained on lease on 1st Oct, 2010, 4,000 acres of land subject to a royalty of Rs 5 per ton on all coal despatched . It was also agreed that the minimum rent of Rs 9 per acre p.a. will be charged up to the commencement of despatches and thereafter a minimum of Rs 12 per acre p.a will be charged. Despatches began from 1st August, 2011, as follows:

Year	2011	2012	2013
Despatches (tons)	5,000	12,000	8,000

Prepare royalties A/c, landlord's A/c; and shortworkings A/c in the books of lessee assuming that shortworkings can be recouped only upto 2012.

He closed his books every year on 31st December.

Solution:**Analytical table**

Year	despatches (tons)	Royalties	Mini- mum rent	Short working s	surplus	Recou- pment	Short Workings Not recouped	Paid to landlord
2010	-	-	9,000	9,000	-	-	-	9,000
2011	5,000	25,000	41,000	16,000	25,000	-	-	41,000
2012	12,000	60,000	48,000	-	12,000	12,000	13,000	48,000
2013	8,000	40,000	48,000	8,000	10,000	-	8,000	48,000

Calculations of minimum rent

Minimum rent for 3 months from 1st Oct, 2010 to 31st Dec, 2010

$$= 4,000 \times 9 \times 3 / 12 = \text{Rs } 9,000$$

Minimum rent for 7 months from 1st Jan, 2011 to 31st July, 2011

$$= 4,000 \times 9 \times 7 / 12 = \text{Rs } 21,000$$

Minimum rent for 5 months from 1st Aug, 2011 to 31st Dec, 2011

$$= 4,000 \times 12 \times 35 / 12 = \text{Rs } 20,000$$

Total minimum rent for 2011 = Rs 21,000 + Rs 20,000 = Rs 41,000

Royalty A/c

31-12-11	To landlord A/c	<u>25,000</u>	31-12-11	By P/L A/c A/c	<u>25,000</u>
31-12-12	To landlord A/c	<u>60,000</u>	31-12-12	By P/L A/c A/c	<u>60,000</u>
31-12-13	To landlord A/c	40,000	31-12-13	By P/L A/c A/c	40,000

Landlord's A/c

31-12-10	To bank A/c	<u>9,000</u>	31-12-10	By shortworkings A/c	<u>9,000</u>
31-12-11	To bank A/c	41,000	31-12-11	By royalty A/c	25,000
			“	By shortworkings A/c	<u>16,000</u>

31-12-12	To shortworkings A/c	<u>41,000</u>	31-12-12	By royalties A/c	<u>41,000</u>
“	To bank A/c	12,000			60,000
		<u>48,000</u>			
		<u>60,000</u>			<u>60,000</u>
31-12-13	To bank A/c	48,000	31-12-13	By royalty A/c	40,000
			“	By shortworkings A/c	<u>8,000</u>
		<u>48,000</u>			<u>48,000</u>

Shortworkings A/c

31-12-10	To landlord's A/c	<u>9,000</u>	31-12-10	By balance c/d	<u>9,000</u>
1-1-11	To balance B/d	9,000	31-12-11	By balance c/d	25,000
31-12-11	To landlord's A/c	16,000			
		<u>25,000</u>			<u>25,000</u>
1-1-12	To balance B/d	25,000	31-1-12	By landlord's A/c	12,000
			“	By P/L A/c	13,000
		<u>25,000</u>			<u>25,000</u>
31-12-13	To landlord's A/c	<u>8,000</u>	31-12-13	By P/L A/c	<u>8,000</u>

Problem 16 : Prof. Narang wrote a book on advanced accountancy and gave the right of its publication and sale to M/s Kalyani Publishers in the month of April, 201 at a royalty of 15 % of Printed sale price of books sold. Each year royalty is paid to the author on 15th Septemeber of next year. Accounts of M/s Kalyani Publishers are closed on 31st March, each year. From the following particulars prepare necessary accounts in the books of M/s Kalyani Publishers:

Year	Books printed	Wastage	Specimen copies	Closing balance	Printed price
2010-11	6,000	200	200	600	120
2011-12	10,000	400	400	800	140
2012-13	12,000	600	400	1,000	160
2013-14	14,000	200	600	200	200

Solution:

Year	No . of books sold = opening stock + books printed - specimen - wastage – closing stock	Printed price	Total sales	Royalty	Paid to Landlord
2010-11	6,000 + 200 – 200 – 600 = 5,000	120	600,000	90,000	90,000
2011-12	600 + 10,000 – 400 – 400 – 800 = 9,000	140	12,60,000	189,000	1,89,000
2012-13	800 + 12,000 – 400 – 600 – 1,000 = 10,800	160	17,28,000	259,200	2,59,200
2013-14	1,000 + 14,000 – 600 – 200 – 200 = 14,000	200	28,00,000	420,000	4,20,000

In the books of M/s Kalyani Publishers
Royalties A/c

31-12-11	To prof. Narang A/c	<u>90,000</u>	31-12-11	By P/L A/c	<u>90,000</u>
31-12-12	To prof. Narang A/c	<u>189,000</u>	31-12-12	By P/L A/c	<u>189,000</u>
31-12-13	To prof. Narang A/c	<u>259,200</u>	31-12-13	By P/L A/c	<u>259,200</u>
31-12-14	To prof. Narang A/c	<u>420,000</u>	31-12-14	By P/L A/c	<u>420,000</u>

Prof. Narang's A/c

31-3-11	To balance c/d	<u>90,000</u>	31-3-11	By royalties A/c	<u>90,000</u>
15-9-12	To bank A/c	90,000	1-4-11	By balance B/d	90,000
3-3-12	To balance c/d	189,000	31-3-12	By royalties A/c	189,000
		<u>279,000</u>			<u>279,000</u>
15-9-12	To bank A/c	189,000	1-4-12	By balance B/d	189,000
31-3-13	To balance c/d	<u>259,200</u>	31-3-13	By royalties A/c	<u>259,200</u>
		<u>448,200</u>			<u>448,200</u>
15-9-12	To bank A/c	259,200	1-4-13	By balance B/d	259,200
31-3-14	To balance c/d	<u>420,000</u>	31-3-14	By royalties A/c	<u>420,000</u>
		<u>679,200</u>			<u>679,200</u>
15-9-14	To bank A/c	420,000	1-4-14	By balance B/d	420,000

C. CHECK YOUR PROGRESS

Choose the Correct Option

1. A lease agreement provides for a royalty of ₹2 per ton and a minimum rent of ₹10,000. If the output is 3,000 tons, the royalty payable will be:

- A) ₹10,000 B) ₹6,000 C) ₹7,000 D) ₹5,000

2. If royalty for the year is ₹12,000 and minimum rent is ₹15,000, then shortworkings will be:

- A) ₹3,000 B) ₹27,000 C) ₹12,000 D) Nil

3. Shortworkings can be recouped if the royalty in the subsequent year is:

- | | |
|---------------------------|---------------------------|
| A) Equal to minimum rent | B) Less than minimum rent |
| C) More than minimum rent | D) Zero |

4. When shortworkings are recouped, the journal entry will include:

- A) Debit Royalty A/c, Credit Bank A/c
- B) Debit Royalty A/c, Credit Shortworkings A/c
- C) Debit Shortworkings A/c, Credit Royalty A/c
- D) Debit Landlord A/c, Credit Bank A/c

5. In case of strike, if minimum rent is reduced by 50% and the original minimum rent was ₹20,000, the revised minimum rent during the strike year will be:

- A) ₹10,000 B) ₹20,000 C) ₹15,000 D) ₹25,000

Answers:

1-B 2-A 3-C 4-B 5-A

Problem 17 : Professor kundan lal wrote a book and gave kalyani publishers the publishing rights on the following terms with effect from 1-1-2010.

- i) Royalties @ 10 % on published price of the copies sold.
- ii) Minimum payment of Rs 60,000 in the first year any excess of minimum rent paid over thereafter.
- iii) Right to deduct in following two years any excess of minimum rent paid over actual royalties in any year.
- iv) Revision of book by the author on request and to pay Rs 6,000 per month to kalyani publishers for every month of delay after six months of request made by the publisher.
- v) In the event of delay the condition of minimum amount payable was not to be applied. On 1-1-2013 request for revision was made and the revised manuscript was supplied by the author on 1-11-2013.
- vi) Prepare ledger accounts in the books of the publisher based on the following information

Year	2010	2011	2012	2013	2014
Copies sold in number	1,500	4,900	5,000	4,000	5,000
Printed price per copy in rupees	200	200	250	250	250

Solution:
Analytical table

Year	sales	Royalties	Minimum rent	Short workin gs	surplus	Reco- upment	Short Workings Not recouped	Paid to landlord
2010	300,000	30,000	60,000	30,000	-	-	30,000	60,000
2011	980,000	98,000	100,000	2,000	-	-	32,000	100,000
2012	12,50,000	125,000	100,000	-	25,000	25,000	2,000	100,000
2013	10,00,000	100,000	-	-	-	-	-	76,000
2014	12,50,000	125,000	100,000	-	25,000		-	125,000

Notes:

In the year 2013 as per agreement - Condition of minimum rent is not applicable. Royalty payable works out to be Rs 100,000.

But because of delay of four months in the submission of manuscript by the author, the publisher shall deduct Rs 24,000 .hence, the net royalty payable is Rs 76,000.

Royalties A/c

2010	To Kundan Lal A/c	<u>30,000</u>	2010	By P/L A/c	<u>30,000</u>
2011	To kundal lal A/c	<u>98,000</u>	2011	By P/L A/c	<u>98,000</u>
2012	To kundal lal A/c	<u>125,000</u>	2012	By P/L A/c	<u>125,000</u>
2013	To kundal lal A/c	<u>100,000</u>	2013	By P/L A/c	<u>100,000</u>
2014	To kundal lal A/c	<u>125,000</u>	2014	By P/L A/c	<u>125,000</u>

Shortworkings A/c

2010	To kundal lal A/c	<u>30,000</u>	2010	By balance C/d	<u>30,000</u>
2011	To balance B/d	30,000	2011	By balance C/d	32,000
	To kundal lal A/c	2,000			
		<u>32,000</u>			<u>32,000</u>
2012	To balance B/d	32,000	2012	By Kundan Lal A/c	25,000
				By p/l A/c	5,000
				By balance c/d	<u>2,000</u>
		<u>32,000</u>			<u>32,000</u>
2013	To balance B/d	<u>2,000</u>	2013	By p/l A/c	<u>2,000</u>

Damage receivable A/c

2013	To p/l A/c	<u>240,000</u>	2013	By Kundan Lal A/c	<u>24,000</u>
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Kundan Lal A/c

2010	To bank A/c	60,000	2010	By royalties A/c	30,000
				By shortworkings A/c	<u>30,000</u>
		<u>60,000</u>			<u>60,000</u>
2011	To bank A/c	100,000	2011	By royalties A/c	98,000
				By shortworkings A/c	<u>2,000</u>
		<u>100,000</u>			<u>100,000</u>
2012	To bank A/c	100,000	2012	By royalties A/c	125,000
	To shortworking A/c	25,000			
		<u>125,000</u>			<u>125,000</u>
2013	To bank A/c	76,000	2013	By royalties A/c	100,000
	To damage receivable A/c	<u>24,000</u>			
		<u>100,000</u>			<u>100,000</u>
2014	To bank A/c	<u>125,000</u>	2014	By royalties A/c	<u>125,000</u>

10.3 UNSOLVED PRACTICAL QUESTIONS

1. X owned certain patent rights. He granted a licence to Y to use such rights on royalty basis. Following are the relevant particulars.

	Minimum rent	royalty
2011	3,750	2,500
2012	5,000	4,000
2013	6,250	4,500

The deficiency of any one year is to be set off against excess payable with in next two years. Give journal entries in the books of Y.

2. A company leased a colliery on 1st January , 2011 at a minimum rent of Rs 20,000 merging into a royalty of Rs 1.50 per ton with power to recoup shortworkings over the first three years of the lease. The output of the colliery for the first four years were 9,000 tons, 12,000 tons, 16,000 tons and 20,000 tons respectively.

Pass the necessary journal entries for each of the four years in the books of the company.

3. Gokul Mines Co. Took a lease from a landlord for a period of 10 years from 1st January, 2009, on a royalty of Rs 5 per ton with a right to recoupment of shortworkings during the first four years of the lease. Dead rent is Rs 20,000 p.s

2009 – 2000 tons; 2010 – 3,000 tons ; 2011 – 4,000 tons; 2012 – 4,500 tons; 2013 – 5,000 tons. Prepare dead rent and shortworkings A/c in the books of the gokul mines co.

4. A company leased a colliery from the swantara coal ltd. on 1st January, 2010 at a minimum rent of Rs 40,000 merging into royalty of Rs 1 per ton with power to recoup shortworkings over the the first three years of the lease. The output of the colliery for the first four years was 18,000 tons; 32,000 tons; 48,000 tons and 38,000 tons respectively.

Pass the necessary journal entries in the books of both the parties.

5. On 1st January, 2009 singrarenii colliery company ltd. took on lease a piece of land agreeing at a dead rent of Rs 2,000 in the first year , Rs 4,000 in the second year and thereafter Rs 6,000 per annum merging into a royalty of Re 1 per ton with power to recoup shortworkings over the first four years only.

the figures of annual output for five years upto 31-12-2013 were 1,000; 3,000 ; 6,000 ; 8,000 and 9,000 tons respectively. Show the ledger accounts in the books of both the parties.

6. A owned certain patent rights. He granted a licence to B to use such patent rights on royalty basis. Following are the relevant particulars:

Year	1	2	3	4	5
Minimumrent	3000	2000	4000	5000	3000
Royalty	1000	2000	3000	6000	4000

There is no right to recamp short working

10.4 Let US SUM UP

In royalty accounting, a lessee pays a certain amount to the lessor for the right to use resources such as land, minerals, copyrights, or patents. Apart from the royalty amount

based on actual output or sales, an extra payment—often referred to as nazrana, lease premium, or goodwill—is sometimes made by the lessee to the lessor at the beginning of the lease. This amount is generally paid in advance and is not recurring.

In the books of the lessor, the full amount received as nazrana is initially credited to the Nazrana Account. Then, an equal proportion of the amount is transferred to the Profit and Loss Account every year throughout the life of the lease. This ensures that the benefit of the lump sum received is spread over the years of usage or exploitation of the rights granted under the lease.

Royalty may include clauses for minimum rent, shortworkings, and recoupment. When the actual royalty amount is less than the agreed minimum rent, the difference is treated as shortworkings, which may be recouped in future years when royalty exceeds minimum rent, as per agreement.

Strike or lockout periods may lead to a reduction in minimum rent, depending on the lease terms. Proper journal entries must be passed in the books of both lessor and lessee, reflecting royalties payable, shortworkings, and their adjustments.

Thus, the royalty system ensures that the lessor receives a fair return, while the lessee has flexibility to manage low-output years through the mechanism of shortworkings and recoupment.

10.3 GLOSSARY

- **Royalty** **Payable:**
The amount calculated based on actual production or sales (e.g., ₹2 per ton \times 5,000 tons = ₹10,000). It is recorded as an expense in the books of the lessee.
- **Minimum Rent Payable:**
The guaranteed amount the lessee must pay annually, even if royalty based on output is less. Used to calculate **shortworkings**.

- **Shortworkings (Practical Use):**
When royalty is ₹8,000 and minimum rent is ₹15,000, the shortworkings amount to ₹7,000 (₹15,000 – ₹8,000).
- **Recoupable Shortworkings:**
If a lease allows recovery of shortworkings over 3 years, and in the 2nd year royalty exceeds minimum rent by ₹5,000, the lessee can use this excess to recoup part of the earlier shortworkings.

10.3 SELF ASSESSMENT QUESTIONS

1. What is nazrana.

2. Give journal entries in the books of lesser.

3. What is the accounting treatment of nazrana.

10.3 LESSON END QUESTIONS

1. What is copyright royalties.
2. What is the concept of damage in case of books written by author. Give accounting treatment of this damage.
3. What is Royalty suspense A/c.

10.3 Suggested Readings

1. S. P. Jain, K. L. Narang

2. Arihant Publications
3. Pratijogitya Darpan
4. Banerjee
5. Bhatia and Arora
6. Arihant Publication

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UNIT - III

Course No. 101

Lesson No. 11

HIRE PURCHASE SYSTEM

STRUCTURE

- 11.0 Learning Objectives and Outcomes
- 11.1 Introduction and meaning of hire purchase system
- 11.2 Features of hire purchase system
- 11.3 Glossary
- 11.4 Let Us Sum Up
- 11.5 Self Assessment Questions
- 11.6 Lesson End Exercise
- 11.7 Suggested Readings

11.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

- Identify and examine the essential features of a hire purchase agreement.
- Understand the legal and financial implications of the hire purchase system for buyers and sellers.
- Recognize the rights and obligations of both the hirer and the seller.

Learning Outcomes

- Learners will be able to list and explain the main features of the hire purchase system (e.g., ownership transfer, down payment, instalments, and default consequences).
- Learners will be able to analyze real-life examples or case studies involving hire purchase.
- Learners will gain clarity on the legal position of ownership and possession under a hire purchase contract.

11.1 INTRODUCTION & MEANING OF HIRE PURCHASE SYSTEM

There are different ways by which the goods can be sold i.e, possession as well as ownership of goods will be passed from the seller to the purchaser. Goods can be sold for cash i.e., where ownership and possession is immediately passed from the seller to the purchaser and purchaser also makes the payment in cash at the time of taking the delivery of goods. Goods can be sold on credit also where ownership and possession of goods passes immediately from the seller to the buyer but the payment is deferred, ie. made after sometimes. Another way of selling goods is either on hire purchase system or instalment purchase system.

Under hire purchase system, the buyer acquires the possession of the goods

immediately and agrees to pay the total hire purchase price in instalments, each instalment is treated as a hire charge until the payment of the last instalment. When ownership of goods passes from the seller to the buyer. In case the buyer makes any default in the payment of any instalment, the seller will have a right to repossess these goods from the buyer and forfeit the amount already received treating it as a hire charge. But if the buyer is paying all the instalment on the due dates, the seller has no right to repossess these goods from the buyer. Thus, this system is advantageous both to the buyer and the seller. The buyer gets the facility of paying the total amount in instalments under the system and the seller is able to sell more goods under this system receiving the price in instalments with the added security to repossess the goods in case the buyer makes any default in the payment of any instalment.

A. CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. Which system allows the seller to repossess goods upon buyer's default?

- A. Cash sale
- B. Credit sale
- C. Hire purchase
- D. Instalment purchase

Answer: C. Hire purchase

2. What happens if a buyer defaults on a hire purchase installment?

- A. Ownership transfers to the buyer
- B. Seller can repossess the goods
- C. Buyer retains the goods without penalty

D. Agreement is automatically renewed

Answer: B. Seller can repossess the goods

3. Under a credit sale, which of the following is true?

A. Ownership transfers after full payment

B. Possession remains with the seller

C. Payment is made after a certain period

D. Goods are delivered after payment

Answer: C. Payment is made after a certain period

4. Under which system does the seller retain ownership until all payments are made?

A. Cash sale

B. Credit sale

C. Hire purchase

D. Instalment purchase

Answer: C. Hire purchase

11.2 FEATURES OF HIRE PURCHASE SYSTEM

- 1. Agreement:** There is an agreement between the seller and the purchaser.
- 2. Possession:** The possession of goods immediately passes from the seller to the buyer on signing the agreement.
- 3. Instalments:** The buyer will make payment in instalments over a period of time.
- 4. Ownership:** The ownership of the goods will remain with the seller and passes to the buyer on the payment of last instalment.
- 5. Constituents of hire purchase:** Each instalment is treated as hire charge till

the last instalment in paid.

6. **Option to returning goods:** The buyer has an option to return the goods to the seller and can terminate the agreement if he does not want to pay the rest of the instalments.
7. **Repossession:** If there is any default in payment of any instalment, the seller has a right to repossess the goods sold on hire purchase and forfeit the amount already received either as down payment or in instalments.

We know from our common experience that if the goods are purchased for cash, the price will be less than if the goods are purchased under hire purchase system. This is because of the fact that hire purchase price includes some

element of interest i.e, financing charges. Besides, the cash price ie. H.P Price = cash price + interest. It is essential to split the total hire purchase price into two parts. i.e,

- 1) Payment towards cash price to be treated as capital expenditure for the purchase of an asset,
- 2) Interest to be charged to profit and loss account treating it as a revenue expense.

B.CHECK YOUR PROGRESS

FILL IN THE BLANKS

1. The hire purchase price includes an element of _____(i.e., financing charges).

Ans: **Interest**

2. Formula for Hire Purchase Price = _____ + Interest

Ans: **Cash Price**

3. Cash price is treated as _____ for purchasing the asset.

Ans: **Capital expenditure**

4. Interest is charged to the Profit & Loss account as a _____

Ans: **Revenue expense**

11.3 PARTIES TO A HIRE PURCHASE SYSTEM

There are typically three main parties involved in a hire purchase transaction:

1. Hire Vendor (Seller / Financier):

The party who owns the goods and agrees to sell them under a hire purchase agreement and retains the ownership of the goods until the final instalment is paid. He may be the original seller or a finance company (in case of indirect hire purchase).

2. Hirer (Buyer / Customer):

The person or entity that takes possession of the goods and agrees to pay in instalments and gets possession immediately, but ownership transfers only after full payment. He has the right to use the asset and the option to return it before completing all payments

3. Dealer (Optional / Intermediary):

In some cases, a dealer sells the goods and facilitates the hire purchase agreement

through a finance company. It acts as a link between the hirer and the finance company. Usually present in indirect hire purchase arrangements, such as car or appliance financing

11.4 LET US SUM UP

Hire purchase agreement is an agreement between two parties (Hire vendor and Hire purchaser) where possession of the goods are immediately transferred but the ownership is transferred to the hire purchaser at the end or payment of last instalment together with interest. The buyer will make payments in instalments over a period of time.

11.5 GLOSSARY

- **Possession:** It means the physical control or custody of goods.
- **Cash Price:** The amount that would be paid if the goods were purchased outright for cash, without using the hire purchase system.
- **Repossession:** The act of taking back goods by the seller if the buyer (hirer) fails to pay instalments as agreed.

11.6 SELF ASSESSMENT QUESTIONS

Q1. What do you mean by hire purchase agreement?

Q2. What is repossession?

Q3. What are two types of parties in the agreement of hire purchase system?

11.7 LESSON END EXERCISES

1. What do you mean by Possession?
2. What are the options to return the goods in case of hire purchase system?
3. What is Hire Vendor?

11.8 SUGGESTED READINGS

1. S. P. Jain, K. L. Narang
2. Arihant Publications
3. Pratijogitya Darpan
4. Shukla, M.C, Grewal, T.S. & Gupta, S.C
5. Maheshwari, S.N. & Maheshwari S.
6. Kishore, R.M.

LEGAL PROVISIONS RELATED TO HIRE PURCHASE SYSTEM

STRUCTURE

- 12.0 Learning Objectives and Outcomes
- 12.1 Legal provisions relating to hire purchase transactions
- 12.2 Termination of hire purchase agreement and rights of hirer
- 12.3 Rights to hire purchaser upon repossession by the owner
- 12.4 Let Us Sum Up
- 12.5 Glossary
- 12.6 Self Assessment Questions
- 12.7 Lesson End Exercise
- 12.8 Suggested Readings

12.0 Learning Objectives and Outcomes

Learning Objectives

- Understand the statutory framework governing hire purchase agreements.
- Identify essential legal definitions (hirer, owner, goods, cash price, etc.).

- Examine the formation, content requirements, and validity of hire purchase contracts.

Learning Outcomes

Upon completion, learners will be able to:

- Articulate hirer's rights to reimbursement or rebate when goods are repossessed.
- Describe procedural and legal constraints on the owner's repossession actions—e.g., percentage of payments made, court orders, and notice periods.
- Demonstrate understanding of remedies available to the hirer if the owner wrongfully repossesses goods.

12.1 LEGAL PROVISION RELATING TO HIRE PURCHASE TRANSACTIONS

To regulate the hire purchase business, and to protect more particularly the interest of the hire purchaser, the government enacted the hire purchase act, 1972. This act was to have come into force with effect from 1 Sept., 1973 but by a subsequent notification on 30th august, 1973, the government rescinded the earlier notification and as a result the act became inoperative. Despite this rescission the provisions of the act are worth noting.

Hire purchase price [sec .2 (d)]

Hire purchase price means the total sum payable by the hirer under a hire purchase agreement in order to complete the purchase of or acquisition of property in the goods to which the agreement relates and includes any sum so payable by the hirer under the hire purchase agreement whether by way of deposit or otherwise.

Net hire purchase price [sec. 8 (1) (e)]

Net hire purchase price means the total amount of hire purchase price of goods sold under hire purchase. Following amounts, if included in hire purchase price, shall be deducted to determine the net hire purchase price,

- i) Delivery expenses, if any
- ii) Registration or kinds of fees in respect of goods sold ;and
- iii) Cost of insurance, if any.

Net hire purchase charges [8 (1) (d)]

Net hire purchase charges in respect of the goods sold on hire purchase means the difference between the net hire purchase price and the net cash price of the goods.

Net cash price [8 (1) (c)]

Net cash price means the total cash price of goods sold on hire purchases less any deposit. The term deposit refers to initial payment whether actually paid or credited to be paid because of delivery of goods.

Cash price [4 (1) (b)]

Cash price means the cash price of goods at which the hire purchaser can purchase the goods for cash or the seller is prepared to accept the cash price of goods sold if the full payment is made in a lump sum immediately on sale.

Down payment: Down payment means the amount which is paid at the time of taking delivery of the goods or on signing the agreement under the hire purchase or instalment purchase system.

Cash price instalment [sec. 7 (1) (a)]:

Cash price instalment means an amount which bears to the net price the same

proportion as the amount of the hire purchase instalment bears to the total amount of hire purchase price. The formula for determining the cash price instalment can be stated as under:

$$\frac{\text{Hire purchase instalment}}{\text{Hire purchase price}} \times \text{net cash price}$$

Hirer:

It means the person who obtains delivery of possession of goods from the owner under the hire purchase agreement.

Hire:

It means the sum payable periodically by the hirer under the agreement.

Instalment:

It means the amount which is inclusive of interest together with the part of principal amount paid periodically as per agreement.

Hire purchase agreement:

Hire purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to buy the goods as per terms of the agreement and includes the following stipulations:

- i) Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments.
- ii) The property in the goods is to be transferred to the hirer on payment of the last instalments.; and
- iii) Such a person has a right to terminate the agreement at any time before the property is so transferred.

Goods repossessed:

Under hire purchase system, the hire purchaser has the option to return the goods to hire vendor any time and stop making payment of the future instalments. In

case, the hire purchaser has committed a default in payment of any instalment, the vendor has also the right to take possession of the goods. The goods taken back by the hire vendor are known as goods repossessed.

Hire purchaser:

It is the party who has agreed to buy some goods on hire purchase basis.

Forms and contents of the hire purchase agreement [sec. 3 and sec. 4]

The hire purchase agreement must be in writing and signed by the parties. A surety if any, must sign the agreement, the contents of the hire purchase agreement must include the following:

- i) The hire purchase price of the goods to which it relates.
- ii) The cash price of the goods.
- iii) The date of commencement of the agreement.
- iv) The number of instalments by which the hire purchase price is to be paid, the amount of each of those instalments and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable.
- v) The goods to which the agreement relates in a manner sufficient to identify them.
- vi) Where any part of the hire purchase price is to be paid otherwise than by cash or by cheque, the hire purchase agreement shall contain a description of that part of the hire purchase price, and
- vii) Where any of the above requirement has not been complied with, the hirer may institute a suit for getting the hire purchase agreement rescinded, and the court may, if it is satisfied that the failure to comply with any such

requirements has prejudiced the hirer, rescind the agreement on such terms as it thinks fit in the circumstances of the case.

A.CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. Hire purchase price (Sec. 2(d)) is defined as:

- A. The deposit paid on delivery
- B. The total sum payable by the hirer, including the deposit, to complete the purchase of goods
- C. The total amount of rent paid during the hire period
- D. The outstanding balance after the last instalment

Answer: B. The total sum payable by the hirer, including the deposit, to complete the purchase of goods

2. Instalment under a hire-purchase agreement is:

- A. Only the principal portion of payment
- B. An amount including both interest and part principal paid periodically
- C. A financing charge only
- D. The deposit amount

Answer: B. An amount including both interest and part principal paid periodically

3. Hire means:

- A. The deposit paid upfront
- B. The sum payable periodically by the hirer under the agreement
- C. The interest on principal

D. A nominal purchase price at end of agreement

Answer: B. The sum payable periodically by the hirer under the agreement

4. Down payment refers to:

A. The last instalment

B. Amount paid at time of delivery or signing of agreement

C. Net cash price

D. Total interest payable

Answer: B. Amount paid at time of delivery or signing of agreement

5. Cash price (Sec. 4(1)(b)) means:

A. The hire purchase price minus interest

B. The lump-sum price payable immediately in cash

C. The deposit at the start of agreement

D. The total sum of all instalments

Answer: B. The lump-sum price payable immediately in cash

Limitation of hire purchase charge [sec. 7]

With a view to avoiding exorbitant hire charges levied by the owner of the goods, this section states that the maximum statutory charge should not exceed 30 % of this instalments, or the amount calculated according to the following formula; whichever is lower.

$$SC = \frac{CI \times R \times T}{100}$$

100

Where as

SC= The statutory charges.

CI = The amount of cash price instalment expressed in rupees or fraction.

Thereof.

R = The rate 10 % or such higher rate as may be determined by the central government in consultation with the RBI.

T = The time, expressed in years and fraction thereof , that elapses between the date of agreement and the date on which the hire purchase instalment corresponding to the cash price instalment payable under the agreement.

Rights of the hirer to purchase with rebate [sec. 9]

The hirer may at any time by giving at least 14 days notice to the owner, complete the purchase of the goods. In such a case, he will have to pay to the owner, the hire purchase price or the balance thereof as reduced by the rebate calculated in the following manner.

$$\text{Rebate} = \frac{2}{3} \frac{\text{hire purchase charges} \times \text{No. of instalments not yet due}}{\text{Total no. of instalments}}$$

12.2 TERMINATION OF HIRE PURCHASE AGREEMENT AND RIGHTS OF HIRER

The hire purchaser may, at any time, terminate the hire purchase agreement after giving the owner at least 14 days notice in writing. He has to redeliver the goods to the owner and pay any instalment of hire which might have become due before the termination. With a view to safeguarding the interest of the hirer, the act has made the following provisions:

- i) Where the sum total of the amount due in respect of the hire purchase price immediately before the termination, exceeds one – half of the hire purchase

price, the hirer shall not be liable to pay the sum stated in the agreement.

- ii) Where the sum total of the amount paid and the amount due in respect of

the hire purchase price immediately preceding the termination of the agreement does not exceed one – half of the hire purchase price, the hirer shall be liable to pay the difference between the said sum total and the said one- half or the sum stated and the agreement whichever is lower.

B.CHECK YOUR PROGRESS

FILL UPS

1. The hire purchaser can terminate the agreement by giving _____ days' notice.

Ans: 14

2. On termination, the hirer must _____ the goods to the owner.

Ans: redeliver

3. The hirer must pay all _____ due before termination.

Ans: instalments

4. If the amount due exceeds _____ of the hire purchase price, no further payment is needed.

Ans: one-half

5. If the total amount paid and due is less than one-half, hirer pays the _____.

Ans: difference

6. The owner must give _____ before repossession.

Ans: notice

7. The hirer has the right to _____ goods by paying dues.

Ans: redeem

12.3 RIGHTS OF THE HIRE PURCHASER UPON REPOSSESSION BY THE OWNER

In case the owner repossesses the goods owing to failure of the hire purchaser to pay any instalment on the due date, he will have to refund to the hire purchaser, any excess of amount paid by the hire purchaser plus the value of the goods on the date of repossession over the hire purchase price of such goods.

When the owner repossesses goods under a hire purchase agreement due to default in payment or other breaches by the hirer, the hire purchaser still retains certain legal rights and protections. These rights are designed to ensure fairness and to prevent arbitrary or unjust treatment. The main rights of the hire purchaser upon repossession include:

1. Right to Notice:

The hire purchaser must be given proper notice before repossession, in accordance with the terms of the agreement or applicable laws (e.g., a 14-day notice period).

2. Right to Receive a Statement of Accounts:

After repossession, the owner must provide a clear statement detailing the amount received, the balance due, and the value of the repossessed goods.

3. Right to Compensation for Excess Payment:

If the hire purchaser has paid more than the depreciated value of the goods, they may be entitled to a refund or compensation for the excess payment.

4. **Right to Prevent Repossession:**

The hire purchaser may avoid repossession by paying off the due instalments or the entire outstanding amount, as per the terms of the agreement, before the goods are physically taken back.

5. **Right Against Wrongful Repossession:**

If the repossession is carried out without following due process or in violation of contractual/legal provisions, the hire purchaser can take legal action against the owner.

6. **Right to Redeem Goods:**

In some cases, the hire purchaser may have the right to reclaim the goods by paying the outstanding dues, even after repossession, within a reasonable time.

7. **Right to Seek Relief under Consumer Protection Laws:**

If the hire purchaser is a consumer, they may seek relief under consumer protection laws in case of unfair practices or harassment during repossession.

8. **Right to Fair Valuation:**

The goods repossessed must be fairly valued, and if sold, the proceeds must be adjusted against the hire purchaser's liability.

9. **Right to Reasonable Treatment of Repossessed Goods:**

The owner must ensure that the repossessed goods are not damaged or undervalued due to negligence, as this affects the hire purchaser's liability.

10. **Right to Terminate Agreement Voluntarily:**

The hire purchaser has the right to voluntarily terminate the agreement and return the goods, provided any outstanding dues are cleared as per terms.

12.4 LETS SUM UP

Hire purchase price means total sum payable by the hirer in order to complete

the purchase of property. Cash price means the original price of the product or property which becomes base for selling the property on hire purchase system.

12.5 GLOSSARY

- **Net Hire Purchase:** Net Hire Purchase price is the total amount payable for the goods excluding any interest or finance charges.
- **Rebate:** Rebate is a deduction or discount allowed for early payment or settlement before the due date.
- **Goods Repossessed:** Goods repossessed refer to items taken back by the owner when the hirer defaults on payment.

12.6 SELF ASSESSMENT QUESTIONS

1. What is down payment?

2. Give provisions for termination of hire purchase agreement.

3. Who is hire purchaser?

12.7 LESSON END EXERCISE

1. What do you mean by Cash Price and Net Cash Price?
2. Give limitations of hire purchase charge.
3. What is hire purchase agreement?

12.8 SUGGESTED READINGS

1. S. P. Jain, K. L. Narang
2. Arihant Publications
3. Pratijogitya Darpan
4. Rajasekaran
5. Singhal & Roy
6. Banerjee

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UNIT - III

Course No. 101

Lesson No. 13

ACCOUNTING TREATMENT OF HIRE PURCHASE SYSTEM

STRUCTURE

- 13.0 Learning Objectives and Outcomes
- 13.1 Rights of owner to termination
- 13.2 Terms used in hire purchase
- 13.3 Accounting treatment in buyer's books
- 13.4 Accounting treatment in vendor's books
- 13.5 When the vendor charges insurance premium from the hire purchaser
- 13.6 Transfer of assets by the hire purchaser
- 13.7 Provision against free maintenance
- 13.8 Goods of comparatively small value
- 13.9 Stock and debtors method
- 13.10 Let Us Sum Up
- 13.11 Glossary
- 13.12 Self Assessment Questions
- 13.13 Lesson End Exercise
- 13.14 Suggested Readings

13.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

After studying this chapter, learners will be able to:

- Understand the legal rights of the owner in case of termination of the hire purchase agreement.
- Identify and explain the key terms used in hire purchase transactions.

- Record appropriate accounting entries in the books of the buyer (hirer).
- Apply the correct accounting treatment in the books of the vendor (seller).

Learning Outcomes

By the end of this chapter, students will be able to:

- Explain the conditions under which the owner can terminate a hire purchase agreement.
- Define and use terms like cash price, hire charges, net hire purchase, and repossession.
- Journalize and post entries related to hire purchase in the buyer's ledger.
- Prepare accounts in the vendor's books including sales and interest recognition.

13.1 RIGHTS OF OWNER TO TERMINATION [SEC. 19]

Where the hire purchase agreement has been terminated, the owner is entitled to retain the hire which has already been paid and to recover any arrears of hire which

has become due. He will further be entitled to repossess the goods. These rights will, however, be subject to the provisions of sec. 17 and 20 of this act.

Permission of the court required to repossess the goods in certain cases [sec. 20]

In the following cases, the owner can repossess the goods from the hirer only with the permission of the appropriate court.

- I) When the hire price is less than Rs 15,000 and one half of the price has been paid.

- II) In any other case when three fourth of the hire purchase price has been paid.

But the right of repossession will lapse in case of motor vehicles, if the hire purchase price is less than Rs 5,000 and $\frac{1}{2}$ of the amount has been paid or $\frac{3}{4}$ of the hire purchase price has been paid in other cases. The central government has the power of raising the limit to $\frac{9}{10}$ where hire purchase price is Rs 15,000 or more.

13.2 TERMS USED IN HIRE PURCHASE

Following are the main terms which are frequently used in hire purchase transactions and their understanding is necessary.

1. **Hire purchaser or hirer:** He is the buyer of goods.
2. **Hire vendor:** He is the seller of the goods.
3. **Cash price:** It is the price on which purchaser can buy the goods for cash. It is the value of goods to be recorded in the books of account.
4. **Hire purchase price:** It is the total amount which the hire purchaser is required to pay to the hire vendor. Hire purchase price is the aggregate of cash price and interest on outstanding amount.
5. **Down payment:** It is the price which is paid by the hire purchaser to the vendor at the time of agreement and taking the possession of the goods.
6. **Goods repossessed:** It means goods taken back by the hire vendor from the hire purchaser in case he makes any default in the payment of any instalment.
7. **Interest:** It is the cost of borrowed funds to buy the asset. It is the excess of hire purchase price over cash price.
8. **Instalments:** These are convenient amounts in which hire purchase price is spilt.

- 9. Stock with customers or H.P stock:** It is the value of goods with the hire purchasers for which instalments will become due in the subsequent accounting periods.
- 10. Instalments due or H.P debtors:** These are instalments which are due in the accounting period but not paid by the hire purchaser.

A.CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. Who is the hire purchaser in a hire purchase agreement?

- a) The seller of goods
- b) The financier
- c) The buyer of goods
- d) The guarantor

Ans: c) The buyer of goods

2. Who is known as the hire vendor?

- a) The guarantor
- b) The buyer
- c) The financier
- d) The seller of goods

Ans: d) The seller of goods

3. What does 'cash price' refer to?

- a) Total hire purchase price
- b) Down payment only
- c) Price paid in instalments
- d) Price of goods if paid fully in cash

Ans: d) Price of goods if paid fully in cash

4.What does the hire purchase price include?

- a) Only cash price
- b) Interest only
- c) Cash price + Interest on outstanding amount
- d) Down payment only

Ans: c) Cash price + Interest on outstanding amount

5.What is the amount paid at the time of agreement and possession called?

- a) Instalment
- b) Cash price
- c) Down payment
- d) Interest

Ans: c) Down payment

6.What are goods repossessed?

- a) Goods returned voluntarily
- b) Goods taken back by vendor on completion
- c) Goods taken back due to payment default
- d) New goods supplied on request

Ans: c) Goods taken back due to payment default

7.What are instalments?

- a) Penalty payments
- b) Final settlement amounts
- c) Down payments
- d) Convenient parts of hire purchase price

Ans: d) Convenient parts of hire purchase price

Accounting records

There are two parties in the hire purchases agreement, i.e., buyer and seller. The method of recording hire purchase transactions in the account books depends upon the nature of goods, i.e., whether they are of considerable value or of comparatively small value.

13.3 ACCOUNTING TREATMENT IN THE BOOKS OF BUYER

Goods of considerable value

In buyer's books, there are three methods of recording the hire purchase transactions

1. Treating the goods not becoming the property of the hirer (cash price or assets accrual method)

Under this method, the asset is deemed to be acquired gradually on the basis of cash price paid and will not become the property of the buyer until all the instalments are paid. Following entries are made in the books of buyer:

- i) When an asset is purchased on hire purchase
No entry
- ii) For cash down payment on delivery of the asset

Assets account	Dr
To Bank account	

- iii) When the first instalment becomes due

Asset account	Dr (payment towards cash price)
---------------	---------------------------------

Interest account	Dr (for interest)
------------------	-------------------

To Hire vendor account	(amount of instalment)
------------------------	------------------------

iv) When the first instalment is paid

Hire vendor account Dr

 To Bank account

v) When depreciation is charged

Depreciation account Dr

 To Asset account

Alternatively, a firm may maintain provision for depreciation account instead of charging to hire price asset account. In such a case the journal entry is

Profit and Loss account Dr

 To Provision for depreciation for assets

In hire purchase and asset on hire purchase is shown at its historical cost.

vi) When interest and depreciation accounts are closed by transfer to profit and loss account

Profit and loss account Dr

 To Interest account

 To Depreciation account

Note: Entries (iii) to (vi) will be repeated in subsequent years.

Asset will be shown in the balance sheet at purchase cost minus the depreciation

2. Credit purchase with interest method (i.e treating the goods as outright property

Some accountants are of the opinion that goods purchased on hire purchase

i) When an asset is purchase on hire purchase system

Assets account Dr (with cash price)
To Hire vendor account

Hire vendor account Dr
To Cash/ Bank account

Interest account	Dr
To Hire vendor account	

Hire vendor account	Dr
To Bank account	

Depreciation account Dr
To Asset account

Profit and loss account Dr
To Interest account

To Depreciation account

Note: Entries (iii), (iv), (v) & (vi) will be repeated in subsequent years.

3. Interest suspense method

Under this method asset is debited with cash price and difference between

hire purchase price and cash price is also debited to interest suspense account corresponding total credit is given to the vendor. Interest included in each instalment is credited to interest suspense account by giving debit to interest account. Following entries are passed in the books of buyer:

- I) When an asset is purchased on hire purchase system
- | | |
|---|--|
| Assets account | Dr (with cash price) |
| Interest suspense account | Dr (Difference between H.P price and cash price) |
| To Hire vendor account (with total hire purchase price) | |
- II) For cash down payment on delivery
- | | |
|----------------------|-----|
| Hire vendor account | Dr. |
| To Cash/bank account | |
- III) For interest due at the end of the year
- | | |
|------------------------------|----|
| Interest account | Dr |
| To Interest suspense account | |
- IV) For the payment of the first instalment
- | | |
|---------------------|----|
| Hire vendor account | Dr |
| To Bank account | |
- vii) For depreciation charge
- | | |
|----------------------|----|
| Depreciation account | Dr |
| To Asset account | |

viii) For transfer of interest and depreciation to profit and loss account

Profit and loss account Dr

 To Interest account

 To Depreciation account

Under this method, asset will be shown in the balance sheet at cash price less

depreciation charged and net balance due to vendor (i.e., balance due to vendor less suspense account balance).

Note: Second method has been adopted while solving illustrations.

B.CHECK YOUR PROGRESS

TRUE OR FALSE

1. Under the cash price or assets accrual method, the asset is deemed to be acquired gradually as payments are made.

Ans: True

2. In the cash price method, the buyer records the full value of the asset on the date of agreement.

Ans: False

3. Under interest suspense method, the total credit is given to the bank account at the time of purchase.

Ans: False

4. Depreciation is charged to the asset account under all three methods.

Ans: True

5. In the credit purchase with interest method, the asset is treated as property of the buyer as soon as it is received.

Ans: True

13.4 ACCOUNTING TREATMENT IN THE BOOKS OF VENDOR

First method

Under this method, the following entries are passed in the books of vendor:

- i) When goods are sold on hire purchase
Hire purchaser's account Dr
To Hire sales account
(Being hire sales account is ultimately closed by transfer to trading account)
- ii) For cash received on delivery
Cash/bank a/c Dr.
To Hire purchaser's account
- iii) For interest due on instalment at the end of the year
Hire Purchaser's a/c Dr.
To Interest a/c
- iv) For receipt of the amount of instalment
Cash/bank a/c Dr.
To Hire purchaser's a/c
- v) For transferring the balance of interest to P/LA/c
Interest a/c Dr.
To P/L a/c

Second Method

Under this method , the difference between the hire purchase price and the cash price is credited to the interest suspense account and hire sale account is also credited with cash price corresponding debit being given to the hire purchaser's account.

as and when the interest becomes due on each instalment, it is credited to interest account corresponding debit given to interest suspense account. Following entries passed in the books of vendor.

- i) When goods are sold on hire purchase
Hire purchaser's a/c Dr.
To Hire sales a/c
To Interest suspense a/c
- ii) For cash received on delivery
Cash/bank a/c Dr
To Hire purchaser's A/c
- iii) For interest due on instalment at the end of the year
Interest suspense A/c Dr
To Interest A/c
- iv) For receipt of the amount of instalment
Cash/bank A/c Dr
To Hire purchaser's A/c
- v) For transfer of interest to P/LA/c
Interest A/c Dr.
To P/LA/c

13.5 WHEN THE VENDOR CHARGES INSURANCE

PREMIUM FROM THE HIRE PURCHASER

The vendor remains the owner of the property or goods till the last instalments are paid by the hire purchaser. In order to avoid any risk to the property, the vendor gets the insurance policy and the premium paid is charged to the hire purchaser. The hire purchaser will pass the journal entry for insurance premium as it is passed for interest at the end of the year. The insurance premium account is closed by transfer to the profit and loss account at the end of the year and is paid to the vendor along with the instalment.

Following journal entries are passed:

In the books of purchaser

- I when the amount of insurance premium is due

Insurance premium a/c	Dr
To Vendor a/c	

- II When insurance premium is paid

Vendor a/c	Dr
To Bank a/c	

In the books of vendor

- I when the insurance premium is paid

Hire purchaser a/c	Dr
To Bank a/c	

- II When the amount of insurance premium is received

Bank a/c	Dr
To hire purchaser a/c	

13.6 TRANSFER OF ASSET BY THE HIRE PURCHASER

Sometimes the hire purchaser, with the consent of the vendor, transfers the asset to some other person after paying some instalments during the period of hire purchase agreement. In such a case, the hire purchaser receives some amount in lieu of the instalments paid by him and gives the responsibility of payment of future instalments due on such asset to the person to whom the asset is transferred. Following entries will be passed in the books of transferee.

Asset a/c	Dr
To Transferor's a/c	[for the amount paid to the hire purchaser]
To Vendor's a/c	[for cash price of remaining instalments]

Transferee will calculate depreciation on the total amount debited to the asset account and will pass all entries as might have been passed in the books of the transferor.

Default and repossession

When the buyer makes default in the payment of any instalment, the vendor has a right to repossess the goods sold on hire purchase and forfeit whatever amount he has already received treating it as a hire charge. There are two possibilities in repossession of goods i.e, (i) when the vendor takes back the complete repossession of the asset and (ii) when the vendor takes repossession of only a part of the total asset sold to the hire purchaser.

When the vendor takes back the complete repossession of asset

Entries for interest and depreciation will be passed in the books of buyer and vendor except the entry for payment up to the date of default.

Buyer will close the account of the vendor by transferring the balance to assets

account by debiting the vendor's account and crediting the asset account. any balance left in the asset account will represent loss on default and will be closed by transfer to the profit and loss account.

Vendor will pass the entry for interest except the entry for payment upto the date of payment. The vendor will close the account of the hire purchaser by transferring the balance to goods repossessed account. This account will further be debited with expenses incurred in repairing or overhauling goods and credited with sales price. The balance will represent profit and loss on repossessed goods and will be closed by transfer to profit and loss account.

Journal entries in the books of hire purchaser

1. Entry for interest due in the year of default

Interest A/c	Dr.
To Vendor's A/c	

2. For transferring credit balance including interest in vendor's A/c to asset A/c in case of possession of entire goods.

Vendor's A/c	Dr.
To Assets A/c	

3. For providing depreciation for current year in current period

Depreciation A/c	Dr.
To Asset A/c	

4. The balance in asset A/c being loss on default is closed by transferring to P/LA/c

Profit and loss A/c	Dr.
To Asset A/c	

Journal entries in the books of vendor

1. Entry for interest due in the year of default

Hire purchaser A/c Dr.
To Interest A/c

2. On repossession of goods

Goods repossessed A/c Dr.
To Hire purchaser A/c

3. For expenses incurred on goods repossessed to make them fit for sale

Goods repossessed A/c Dr.
To Cash/bank A/c

4. For cash received from sale of repossessed goods

Cash/bank A/c Dr.
To Goods repossessed A/c

5. Any balance left in goods repossessed a/c is profit or loss on repossession
and is transferred to P/LA/c

If profit

Goods repossessed A/c Dr.
To P/LA/c

If loss

P/LA/c Dr

to goods repossessed A/c

**When the vendor takes repossession of only a part of the total asset sold to the
hire purchaser**

In this case, entries for interest will be passed in the book of purchaser and vendor except the entry for payment upto the date of default. Depreciation entry will be passed only in the books of purchaser.

Both the hire purchaser and vendor will not close vendor's account and hire purchaser's account in their respective books but an entry will be passed with the agreed value of that asset which has been taken back by the vendor. The vendor will generally agree to take back a part of asset only at enhanced rate of depreciation.

The hire purchaser will calculate the value of the asset left with him by the vendor by providing normal rate of depreciation and will keep this amount as balance carried down in the asset account. The asset account balance will show profit or loss on default and will be transferred to the profit and loss account.

C.CHECK YOUR PROGRESS

FILL UPS

1. Sometimes the hire purchaser, with the _____ of the vendor, transfers the asset _____ to _____ another _____ person.

Ans: consent

2. The hire purchaser receives some amount in lieu of the _____ paid by him.

Ans: instalments

3. The transferee takes the responsibility of payment of _____ instalments.

Ans: future

4. The vendor debits this account with repair expenses and credits it with _____ proceeds.

Ans: sale

For transfer of maintenance charges to maintenance suspense A/c

Hire sales A/c Dr

To Maintenance suspense A/c

For interest due on assets sold

Hire purchaser A/c Dr

To Interest A/c

For receipt of instalment

Bank a/c Dr

To Hire purchaser A/c

For payment of actual cost of maintenance

Maintenance suspense A/c Dr

To Cash a/c

For transfer of excess of actual cost of maintenance to P/LA/c

P/LA/c Dr

To Maintenance suspense a/c

For Transfer of excess of maintenance suspense to P/LA/c

Maintenance suspense A/c Dr

To P/LA/c

For transfer of interest to P/LA/c

Interest a/c Dr

To P/LA/c

NOTE: Interest will be calculated on cost price including the amount of repairs.

13.8 GOODS OF COMPARATIVELY SMALL VALUE

When numerous goods of small value are being sold by a firm under hire purchase system on different dates, then it becomes inconvenient and impracticable to maintain separate account for each customer and to calculate interest in respect of sale of each type of goods. Following method can be adopted under these circumstances:

- a) A subsidiary book under the name of hire purchase register may be maintained in record name of the article, cost price, selling price, number of instalments, down payment, and many small columns for recording the receipt of instalments as and when received. The specimen ruling of this register is as under:

Hire purchase register

Date of contract	Name of customer	Name of article	Cost price	Selling price	Number of instalments	Down payment	Date of payments							
							1st	2nd	3rd	4th	5th	6th	7th	8th

- b) From the register, the following information will be collected at the end of the financial year:
 - i) Cost price of the goods sold on hire purchase to various customers.
 - ii) Total cash received from customers.
 - iii) Total instalments due but not paid by customers. This may be due to the delay on the part of the customers.
 - iv) Cost price of the goods lying in the hands of customers on which instalments have not become due. The total amount of unpaid and not due instalments gives the cost price of the goods in the hands of customers and is known as stock out on hire at cost price. The value

of such items can be ascertained in the following ways provided the gross profit margin is uniform:

1. $\frac{\text{Amount of unpaid instalments} \times \text{cost}}{\text{Amount of hire purchase price}}$ or
2. Unpaid instalments – gross profit margin or
3. $\frac{\text{No. of unpaid instalments} \times \text{cost}}{\text{No. of instalments including down payment}}$

Notes: In case (iii) the amount of down payment must be the same as that of instalment.

The cost price of unpaid and not due instalments (or stock at the end) will be calculated and will be shown on the credit side of trading account.

Accounting procedure for preparing hire purchase trading account

After obtaining the necessary information from the hire purchase register, a hire purchase trading account can be prepared.

Following entries will be prepared in the books of the vendor.

1. When goods sold on hire purchase

Hire purchase trading A/c	Dr	
To Goods sold on hire purchase A/c		H.P. Price

2. On receipt of instalments

Cash A/c	Dr	
To Hire purchase trading A/c		

3. For instalments due at the end of the year but not received

Instalments due or H.P Debtors A/c	Dr.	
To Hire purchase trading A/c		

Note: For opening balance of instalment due, a reverse entry will be passed.

4. For goods repossessed due to non– payment of instalments

Repossessed goods A/c	Dr.
To Hire purchase trading A/c	with the estimated value of goods received

5. For goods lying with customers in respect of which instalments are not due:

Hire purchase stock A/c	Dr.
To Hire purchase trading A/c	

Note: for opening stock of such goods reverse entry will be passed.

6. To remove the loading in hire purchase sales

Goods sold on hire purchase A/c	Dr.
To Hire purchase trading A/c	for loading only

7. To remove the loading in closing stock

Hire purchase trading A/c	Dr.
To Stock reserve A/c	for loading only

Note: for removing the loading in opening stock , reverse entry will be passed.

8. Hire purchase trading account is now complete and will show profit or loss which will be closed by transfer to profit and loss account.

If profit

Hire purchase trading A/c	Dr
To P/LA/c	

If loss

P/LA/c	Dr.
To H.P. Trading a/c	

Instalment due, hire purchase stock and stock reserve account will be closed by transfer to the hire purchase trading account.

13.9 STOCK AND DEBTORS METHOD

This is an alternative method of calculating profit or loss of those traders who sell a number of goods of comparatively small value daily on the hire purchase system. Instead of preparing one H.P trading account to calculate the profit, hire purchase stock account, H.P debtors a/c, shop stock a/c and H.P adjustment a/c are prepared. Following entries are passed relating to hire purchase transactions:

When goods are purchased for shop stock

Shop stock a/c	Dr	(cost price)
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To Purchases a/c

When goods are sold on hire purchase

Hire purchases stock a/c	Dr	(at sales price)
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To Goods sold on H.P A/C

For total instalments which become due

Hire purchase debtors A/c	Dr	(H.P price)
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To Hire purchase stock A/c

When cash is received from debtors

Cash a/c	Dr
----------	----

To Hire purchase debtors a/c

When goods are repossessed on default and loss is transferred to hire purchase adjustment A/c

Goods repossessed A/c	Dr	(for realisable value)
-----------------------	----	------------------------

H.P adjustment a/c	Dr	(loss)
--------------------	----	--------

To H.P debtors A/c		(instalment due and not received in cash)
To H.P Stock A/c		(for instalments not yet due)
To H.P adjustment a/c		(profit on repossession)
For transfer of goods sold on H.P		
Goods sold on H.P A/c	Dr	
To H.P adjustment A/c		(loading)
To Trading A/c		(cost price)
For reserve on closing stock		
Hire purchase adjustment A/c	Dr	(for loading)
To Stock reserve A/c		

For reserve on opening stock

Stock reserve A/c	Dr	(for loading)
To H.P adjustment A/c		
For profit or loss on hire purchase		
If profit		
H.P adjustment A/c	Dr	
To P/LA/c		
If loss		
P/LA/c	Dr	
To H.P adjustment A/c		

13.10 LET US SUM UP

In hire purchase agreement, the assets or property can be transferred to some

other person with the consent of hire vendor. Hire purchaser after paying certain instalments can move its burden of paying instalments to some another person with the consent of hire vendor.

If buyer makes a default in the payment of any instalment, hire vendor has full right to repossess that particular property or assets.

13.11 GLOSSARY

- **Termination:** The process by which a hire purchase agreement is legally ended, either by the hire purchaser (by giving due notice and returning the goods) or by the vendor (in case of default by the hirer).
- **H P Stock: (Hire Purchase Stock):**
It refers to the value of goods that are with the hire purchaser, for which instalments are yet to become due in future accounting periods. These goods are still technically owned by the vendor.
- **Interest:** The cost paid by the hire purchaser for using the goods without full ownership. It is the difference between the hire purchase price and the cash price of the goods.

13.12 SELF ASSESSMENT QUESTIONS

1. What is complete repossession?

2. What is the provision against free maintenance?

3. What is interest suspense method?

13.13 LESSON END EXERCISE

1. What do you mean by partial repossession?
2. What do you mean by hire purchase register?
3. Give in detail credit purchase interest method.

13.14 SUGGESTED READINGS

1. S. P. Jain, K. L. Narang
2. Arihant Publications
3. Pratijogitya Darpan
4. Gangwar, Sharad & Gangwar K.
5. Rajasekaran

Singhal & Roy

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UNIT - III

Course No. 101

Lesson No. 14

INSTALMENT PURCHASE SYSTEM

STRUCTURE

- 14.0 Learning Objectives and Outcomes
- 14.1 Meaning of instalment purchase system
- 14.2 Features of instalment purchase system
- 14.3 Distinguish between hire purchase system and instalment purchase system
- 14.4 Let Us Sum Up
- 14.5 Glossary
- 14.6 Self Assessment Questions
- 14.7 Lesson End Exercise
- 14.8 Suggested Readings

14.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this unit, learners will be able to:

- Explain the meaning and concept of the instalment purchase system.
- Identify and describe the key features of the instalment purchase system.
- Understand the legal and accounting implications of instalment purchase agreements.

Learning Outcomes

After completing this unit, learners will be able to:

- Apply knowledge to identify appropriate scenarios for the use of instalment purchase agreements.
- Demonstrate conceptual clarity while solving practical problems or preparing accounts under the instalment purchase method.
- List and explain the distinct features that characterize the instalment purchase system.

14.1 INSTALMENT PURCHASE SYSTEM

Under instalment purchase system, the possession as well as ownership passes from the seller to the buyer immediately on entering the agreement but the buyer agrees to pay the total price in instalments. If the buyer makes any default in the payment of any instalment, the seller has no right to repossess the goods. The seller can file a suit in the court of law for recovery of the price.

14.2 FEATURES OF INSTALMENT PURCHASE SYSTEM

1. There is an agreement between the seller and the buyer
2. The buyer is required to pay the total price in instalment.
3. The buyer gets the possession and ownership of goods immediately on signing the agreement.
4. If there is any default in the payment of any instalment, the seller has no right to repossess the goods. He can go to the court and sue the purchaser for unpaid balances.
5. As the purchaser is the owner of goods, he can dispose of the goods in any manner he likes.

A.CHECK YOUR PROGRESS

TRUE OR FALSE

1. The buyer is required to pay the total price in instalments.

Ans: True

2. The buyer gets both possession and ownership of goods immediately upon signing the agreement.

Ans: True

3. In case of default, the seller can repossess the goods, but can sue the buyer for the unpaid balance.

Ans: False

4. As the purchaser is the owner of goods, he can dispose of the goods in any manner he likes.

Ans: True

5. On default, the seller can take back the goods and cannot sue for the unpaid balance.

Ans: False

14.3 DIFFERENCE BETWEEN HIRE PURCHASE SYSTEM AND INSTALMENT PURCHASE SYSTEM

Basis of difference	Hire purchase system	Instalment purchase system
Nature of contract	It is an agreement of hiring.	It is an agreement of sale.

Ownership	The ownership remains with the seller until the payment of last instalment.	The ownership passes from the seller to the buyer immediately on entering the agreement.
Return of goods	Goods can be returned if the buyer does not want to pay rest of the instalments.	The goods cannot be returned by the buyer to the seller unless there is some default on the part of the seller.
Rights of disposal	The buyer cannot sell, destroy, transfer, damage or pledge the goods	The buyer can do all these things.
Rights of seller	The seller can repossess the goods if the buyer makes default in the payment of any instalment	The seller can sue in the court of law for price if the buyer makes default in the payment of any instalment.

Right of forfeiture of instalments received under hire purchase system	In case of default in the payment of instalments, hire vendor has a right to forfeit the instalments already received treating it as hire charge.	The seller cannot forfeit the instalments already received he can sue only for the unpaid balance.
Risk under H.P system	Loss occurring to goods has to be borne by the hire vendor as the risk lies with the ownership.	Any loss will have to be borne by the buyer.

Responsibility of normal repairs	The responsibility of normal repairs lies with the hire vendor being owner of goods.	The seller is not at all agreement for the normal repairs as the purchaser is the owner of goods from the very beginning.
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B. CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1: What is the nature of contract in a hire purchase system?

- A) It is an agreement of sale
- B) It is an agreement of loan
- C) It is an agreement of hiring
- D) It is an agreement of exchange

Ans: It is an agreement of hiring

2: Under instalment purchase system, when does ownership transfer to the buyer?

- A) After the payment of last instalment
- B) On signing the agreement
- C) On delivery of goods
- D) After one year

Ans: On signing the agreement

3. Which of the following is true about return of goods under hire purchase?

- A) Goods can be returned only after full payment
- B) Goods can be returned if buyer defaults
- C) Goods cannot be returned under any condition
- D) Goods can be returned if buyer does not want to pay further instalments

Ans: Goods can be returned if buyer does not want to pay further instalments

4. What rights does the buyer have under instalment purchase system regarding the goods?

- A) Buyer cannot transfer or pledge the goods
- B) Buyer can sell, destroy, transfer, damage or pledge the goods
- C) Buyer can return the goods anytime
- D) Buyer is not allowed to keep the goods

Ans: Buyer can sell, destroy, transfer, damage or pledge the goods

5. What remedy is available to the seller under hire purchase if buyer defaults in instalment payment?

- A) Repossess the goods
- B) File a complaint in consumer court
- C) Demand a loan
- D) Charge interest

Ans: Repossess the goods

14.4 LET US SUM UP

In instalment purchase system, the ownership as well as possession of the goods is immediately transferred from seller to buyer. The buyer of the goods has to pay all the instalments in time. The buyer has full right to sell, destroy, damage, transfer and pledge the goods to anyone.

14.5 GLOSSARY

- **Instalment Purchase System:** A system of purchase where the buyer agrees to pay the purchase price in several installments over a period of time.
- **Transfer Possession:** The act of handing over the physical control or custody of goods from one person to another.

14.6 SELF ASSESSMENT QUESTIONS

1. What is instalment purchase system?

-
2. Give the features of instalment purchase system.
-
-
-
-

3. Distinguish between hire purchase and instalment purchase system.
-
-
-

14.7 LESSON END EXERCISE

1. Give the treatment of right of disposal under instalment system.
2. What are the journal entries in the system of instalment purchase system?
3. Is there any risk intend in case of instalment purchase system.

14.8 SUGGESTED READINGS

1. S. P. Jain, K. L. Narang
2. Arihant Publications
3. Pratijogitya Darpan
4. Shukla, M.C, Grewal, T.S. Gupta, S.C
5. Maheshwari, S.N. & Maheshwari S.
6. Kishore, R.M.

B.Com.-I

UNIT – III

Course No. 101

LessonNo.15

**ACCOUNTING TREATMENT IN
INSTALMENT SYSTEM**

STRUCTURE

15.0 Learning Objectives and Outcomes

15.1Accounting treatment in instalment system

15.2Solved problems

15.3 Unsolved problems

15.3Let Us Sum Up

15.4Glossary

15.5 Self Assessment Questions

15.6 Lesson End Exercise

15.7 Suggested Readings

15.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of the lesson, learners should be able to:

- Understand the basic concept and features of the Instalment Purchase System.
- Learn how to record journal entries in the books of both buyer and seller under the instalment system.
- Calculate interest and cash price from the instalment amount.

Learning Outcomes

- Accurately pass journal entries for purchase of assets under instalment terms in the books of the buyer and seller.
- Compute the interest component in each instalment and apportion it correctly.
- Demonstrate competence in preparing final accounts reflecting instalment-related adjustments.
- Apply theoretical knowledge to practical problems and case studies involving instalment purchases.

15.1 ACCOUNTING TREATMENT IN INSTALMENT SYSTEM

Buyer's books

Following entries are passed in the books of buyer under instalment system, when an asset is purchased on instalment purchase system

Asset A/c Dr (with cash price)

Interest suspense A/c Dr (difference between total price and cash price)

 To Vendor's A/c (with total instalment purchase price)

 For cash down payment on delivery

Vendor's A/c Dr

 To Cash/bank A/c

 For interest due at the end of the year

Interest A/c Dr

 To Interest suspense A/c

 For the payment of the first instalment

Vendor's A/c Dr

 To Bank A/c

 For depreciation charge

Depreciation A/c Dr

 To Asset A/c

 For transfer of interest and depreciation to P/LA/c

P/LA/c Dr

 To Interest A/c

 To Depreciation A/c

Notes: entries (iii) to (iv) will be repeated in subsequent years.

In vendor's books

Following entries are to be passed in the books of the vendor.

When goods are sold on instalment purchase system

Purchaser's A/c Dr (with total price)

 To Sale A/c (with cash price)

To interest suspense A/c (with difference between total price and cash price)

For cash received on delivery

Cash/bank A/c Dr

 To Purchaser's A/c

For interest due on instalment at the end of the year

Interest suspense A/c Dr

 To Interest A/c

For receipt of the amount of instalment

Cash/bank A/c Dr

 To Purchaser's A/c

For transfer of interest to P/LA/c

Interest A/c Dr

 To P/LA/c

Note: entries from (iii) to (v) will be repeated in subsequent years.

A.CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

Q1. In the buyer's books, the Asset Account is debited with:

- A) Total instalment price
- B) Cash down payment only
- C) Cash price of the asset
- D) Interest portion of instalments

Ans: Cash price of the asset

Q2. In the buyer's books, which account is credited when the asset is initially purchased?

- A) Bank Account
- B) Vendor's Account
- C) Interest Account
- D) Sales Account

Ans: Vendor's Account

Q3. In the instalment system, the difference between total instalment price and cash price is recorded as:

- A) Profit
- B) Discount
- C) Interest Suspense Account
- D) Outstanding Liability

Ans: Interest Suspense Account

Q4. In the buyer's books, what is the journal entry for interest due at the end of the year?

- A) Interest Suspense A/c Dr. To Interest A/c
- B) Interest A/c Dr. To Interest Suspense A/c
- C) Interest A/c Dr. To Vendor A/c
- D) Interest A/c Dr. To Bank A/c

Ans: Interest A/c Dr. To Interest Suspense A/c

Q5. In the buyer's books, which account is debited when depreciation is charged?

- A) Vendor's Account
- B) Asset Account
- C) Depreciation Account
- D) Interest Account

Ans: Depreciation Account

15.8 SOLVED PROBLEMS

Problem 1: From the following information given below, calculate the amount of rebate and amount payable as purchase consideration if the hirer desires to purchase after the payment of three instalments. Rebate is to be $\frac{2}{3}$ of proportionate hire purchase charges relating to the instalments not yet due.

Hire purchase price	Rs 120,000
Cash price	Rs 100,000
No. of instalments	8

Solution:

$$\text{Amount of each instalment} = \text{Rs } \frac{120,000}{8} = \text{Rs } 15,000$$

$$\text{Hire purchase charge} = \text{Rs } 120,000 - \text{Rs } 100,000 = \text{Rs } 20,000$$

$$\text{Balance of hire purchase price} = 5 \text{ instalments of Rs } 15,000 \text{ each} = \text{Rs } 75,000$$

$$\begin{aligned} \text{Amount of rebate} &= \frac{2}{3} \left[\frac{\text{Hire purchase charges} \times \text{No. of instalments not yet due}}{\text{Total no. of instalments.}} \right] \\ &= \frac{2}{3} \left[\frac{\text{Rs } 20,000 \times 5}{8} \right] \\ &= \frac{2}{3} \times 12,500 \\ &= \text{Rs } 8,333.33 \end{aligned}$$

$$= \text{Rs } 8,333$$

Amount payable as purchase consideration = Rs 75,000 – Rs 8,333 = Rs 66,667.

Problem 2: Following are the particulars relating to the hire purchase.

Purchaser – Ram & Co., Seller - Shyam & Co.

Date of Purchase – Jan 1, 2011; Asset purchased – Machine; Cash price - Rs 12,894

Payments – Rs 2,000 on signing of the agreement and the balance in the three equal instalments of Rs 4,000 due on 31st December each year.

Rate of interest – 5 % p.a., depreciation – 20 % on the WDV each year.

Pass the journal entries and prepare necessary ledger accounts

Solution:

Particulars	Cash price (in Rs.)	Interest (in %)	Instalments	
			Payments towards instalments	Interest
Cash price	12,894	5 %		
Less: Paid on 1-1-2011	2,000		2,000	-
	<u>10,894</u>			545
Less: Paid on 31-12-2011	3,455			
	<u>7,439</u>			
Less: Paid on 31-12-2012	<u>3,628</u>			
	3,811		3,628	372
	<u>3,811</u>			
		Total	<u>3,811</u>	<u>189</u>
			12,894	1,106

Calculation of depreciation

Cash price on 1-1-2011	12,894
Less: Depreciation @ 20 % for 2011	2,579

Balance on 1-1-2012	10,315
Less : Depreciation @ 20 % for 2012	2,063
Balance on 1-1-2013	8,252
Depreciation @ 20 % for 2013	1,650
Balance on 1-1-2014	6,602
First method	

In the books of Ram & Co.

Journal entries

Date	particulars	2011		2012		2013	
		Dr	Cr	Dr	Cr	Dr	Cr
Jan 1	Machinery account Dr	2,000		-	-	-	-
	To cash account		2,000				
Dec 31	Machinery account Dr	3,455		3,628		3,811	
	Interest account Dr	545	4,000	372	4,000	189	4,000
	To interest account						
Dec 31	Depreciation account Dr	2,579		2,063		1,659	
	To machinery account		2,579		2,063		1,659
Dec 31	Profit and loss account Dr	3,124		2,435		1,839	
	To interest account		545		372		189
	To depreciation account		2,579		2,063		1,659
	(Being interest and depreciation						

Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
2011			2011		
Jan 1	To cash A/c	2,000	Jan 1	By depreciation	2,579

Dec 31	To cash A/c	3,455	Dec 31	By balance c/d	2,876
		<u>5,455</u>			<u>5,455</u>
2012			2012		
Jan 1	To balance b/d	2,876	Jan 1	By depreciation A/c	2,063
Dec 31	To cash A/c	3,628	Dec 31	By balance c/d	4,441
		<u>6,504</u>			<u>6,504</u>
2013			2013		
Jan 1	To balance b/d	4,441	Jan 1	By depreciation A/c	1,650
Dec 31	To cash A/c	<u>3,811</u>	Dec 31	By balance c/d	<u>6,602</u>
		8,252			8,252

Interest account

31-12-2011	To cash A/c	<u>545</u>	31-12-2011	By P/L A/c	<u>545</u>
31-12-2012	To cash A/c	<u>—</u>	31-12-2012	By P/L A/c	<u>—</u>
		<u>372</u>			<u>372</u>
31-12-2013	To cash A/c	<u>189</u>	31-12-2013	By P/L A/c	<u>189</u>

Depreciation account

31-12-2011	To machinery A/c	<u>2,579</u>	31-12-2011	By P/L A/c	<u>2,579</u>
31-12-2012	To machinery A/c	<u>2,063</u>	31-12-2012	By P/L A/c	<u>2,063</u>
31-12-2013	To machinery A/c	<u>1,650</u>	31-12-2013	By P/L A/c	<u>1,650</u>

Balance Sheet As on 31st December, 2012

	Assets	
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	Machinery on hire purchase at cost	6,504	
	Less: depreciation	<u>2,063</u>	
			4,441

Second Method

Journal entries

Date	Particulars	2011		2012		2013	
		Dr	Cr	Dr	Cr	Dr	Cr
Jan 1	Machinery account Dr	12,894		-			
	To Shyam & Co. account		12,894	-			
	(Being purchase of machine on hire purchase)						
Dec 31	Shyam & Co. account Dr	2,000					
	To cash account		2,000				
	(Being cash down payment made)						
Dec31	Interest A/c Dr	545		372		189	
	To Shyam & co.		545		372		189
Dec 31	Shyam & Co. account Dr	4,000		4,000		4,000	
	To cash account		4,000		4,000		4,000
	(Being cash down payment made)						
	Depreciation account Dr	2,579		2,063		1,650	
	To machinery account		2,579		2,063		1,650
	(Being depreciation charged)						
	Profit and loss account Dr	3,124		2,435		1,839	
	To interest account		545		372		189
	To depreciation account		2,579		2,063		1,650
	(Being interest and depreciation transferred to profit and loss account)						

When all the particulars are given and instalments are inclusive of interest

Problem 3: Sumit Dunga, the owner of a printing press , prepares final accounts annually to 31st December. On 31st December, 2010 he purchased a printing machine on hire purchase system from Sreeram enterprise. The cash price of the machine was Rs 400,000.

Dunga made a down payment of Rs 100,000 on the date of purchase. He paid three instalments of Rs 120,634 each on 31st December, 2011, 31st December 2012 and 31st December 2013. The vendor charged interest at 10 % p.a. on the outstanding balance on 1st January each year. Machine account was maintained at cost and a separate depreciation provision account was created to record accumulated depreciation. Dunga charged depreciation at 25 % on a reducing balance basis.

Required:

15.8.1 Prepare the following accounts in the books of Dunga for the period of the contract:

Machinery on hire purchase account, Sreeram Enterprise Account, hire purchase interest payable account, provision for depreciation on machinery account

15.8.2 Show how the above matters would be reflected in the balance sheet of Dunga on 31st December, 2011

Sreeram enterprise prepares the final accounts to 31st December, on which date it charges Dunga with the interest due.

Solution:

Machinery on hire purchase account

2010			2010		
Dec. 31	To Sreeram Enterprise	<u>400,000</u>	Dec. 31	By balance c/d	<u>400,000</u>
2011		_____	2011		_____
Jan 1	To balance b/d	<u>400,000</u>	Jan 1	By balance c/d	<u>400,000</u>
2012		_____	2012		_____
Jan 1	To balance b/d	<u>400,000</u>	Jan 1	By balance c/d	<u>400,000</u>
2013		_____	2013		_____
Jan 1	To balance b/d	<u>400,000</u>	Jan 1	By balance c/d	<u>400,000</u>
2014		_____			_____

Jan 1	To balance b/d	<u>400,000</u>			
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Shreeram Enterprise Account

2010			2010		
Dec. 31	To Bank A/c	100,000	Dec. 31	By machinery on H.P A/c	400,000
Dec. 31	To balance c/d	<u>300,000</u>			
		<u>400,000</u>			<u>400,000</u>
2011			2011		
Dec 31	To Bank A/c	120,634	Jan 1	By balance b/d	300,000
"	To balance c/d	<u>209,366</u>	Dec.31	By H.P interest A/c	<u>30,000</u>
		<u>400,000</u>			<u>400,000</u>
2012			2012		
Dec. 31	To Bank A/c	120,634	Jan 1	By balance b/d	209,366
"	To balance b/d	<u>109,668</u>	Dec.31	By H.P interest A/c	20,936
		<u>400,000</u>			<u>400,000</u>
2013			2013		
Jan 1	To Bank A/c	<u>120,634</u>	Jan 1	By balance b/d	109,668
		<u>120,634</u>		By H.P Interest A/c	10,966
					<u>120,634</u>

Hire purchase interest payable account

2011			2011		
Dec. 31	To Sreeram enterprise A/c	<u>30,000</u>	Dec. 31	By profit and loss A/c	<u>30,000</u>

2012			2012		
Dec. 31	To Sreeram enterprise A/c	<u>20,936</u>	Dec. 31	By profit and loss A/c	<u>20,936</u>
2013			2013		
Dec. 31	To Sreeram enterprise A/c	<u>10,966</u>	Dec. 31	By profit and loss A/c	<u>10,966</u>

Provision for depreciation on machinery account

2011			2011		
Dec. 31	To balance c/d	<u>100,000</u>	Dec. 31	By profit and loss A/c (400,000 x 25 %)	<u>100,000</u>
2012			2012		
Dec 31	To balance c/d	<u>175,000</u>	Jan 1	By balance b/d	100,000
			Dec.31	By profit and loss A/c (300,000 x 25 %)	75,000
		<u>175,000</u>			<u>175,000</u>
2013			2012		
Dec. 31	To balance b/d	231,250	Jan 1	By balance b/d	175,000
			Dec.31	By profit and loss A/c (225,000 x 25 %)	6,250
		<u>231,250</u>			<u>231,250</u>
			2013		

			Jan 1	By balance b/d	<u>231,250</u>
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Balance sheet of Sumit Dunga

As on 31st December, 2011

		Machinery on H.P at cost	400,000	
		Less: provision for depreciation	<u>100,000</u>	
			300,000	
		Less: payable to Sreeram Ent.	<u>209,366</u>	
				90,634

Case 2 : When there are different amounts of instalments but inclusive of interest

Problem 4: X purchased a machine on hire purchase system. The total cash price of the machine is Rs 31,960 payable Rs 8,000 down and three instalments of Rs 12,000 ; Rs 10,000 and Rs 4,000 payable at the end of the first , second and third year respectively. Interest is charged @ 5% and depreciation @ 10 % on straight line method. Prepare ledger accounts in the books of X.

Solution:

Ledger accounts in the books of X

Machinery account

Year I			
To hire vendor A/c	<u>31,960</u>	By depreciation A/c	<u>31,960</u>
Year II			

To balance b/d	28,764	By depreciation A/c	3,196
		By balance c/d	<u>25,568</u>
	<u>28,764</u>		<u>28,764</u>
Year III			
To balance b/d	25,568	By depreciation A/c	3,196
		By balance c/d	<u>22,372</u>
	<u>25,568</u>		<u>25,568</u>

Hire Vendor A/c

Year I			
To Bank A/c	8,000	By machinery A/c	31,960
To Bank A/c	12,000	By interest A/c (23,960 x 5 %)	<u>1,198</u>
To Balance c/d	<u>13,158</u>		<u>33,158</u>
	<u>33,158</u>		
Year II			
To Bank A/c	10,000	By balance b/d	13,158
To Balance c/d	<u>3,816</u>	By interest A/c	<u>658</u>
	<u>13,816</u>		<u>13,816</u>
Year III			
To Bank A/c	4,000	By balance b/d	3,816
	<u>4,000</u>	By interest A/c	<u>184</u>
			<u>4,000</u>

Interest A/c

Year I			
To Hire vendor A/c	<u>1,198</u>	By profit and loss A/c	<u>1,198</u>

Year II			
To hire vendor A/c	<u>658</u>	By profit and loss A/c	<u>658</u>
Year III			
To hire vendor A/c	<u>184</u>	By profit and loss A/c	<u>184</u>

Depreciation Account

Year I			
To machinery A/c	<u>3,196</u>	By profit and loss A/c	<u>3,196</u>
Year II			
To machinery A/c	<u>3,196</u>	By profit and loss A/c	<u>3,196</u>
Year III			
To machinery A/c	<u>3,196</u>	By profit and loss A/c	<u>3,196</u>

Case 3 : When instalments are exclusive of interest

Problem 5: On 1st January, 2011 Sharada purchased a machine from Kusum on hire purchase system . The particulars are as follows:

Cash price Rs 10,000; Rs 4,000 to be paid on signing the contract and balance in three instalments of Rs 2,000 plus interest. Interest charged on outstanding balance at 5 % . Depreciation at 10 % p.a. on written down value method.

Prepare kusum's A/c in the books of purchaser.

Solution:

Kusum's account

Machinery account

2011			2011		
Jan 1	To Bank A/c	4,000	Jan 1	By machinery A/c	10,000
Dec.31	To Bank A/c	2,300	Dec.31	By interest A/c (6,000 x 5%)	<u>300</u>
"	To Balance c/d	<u>4,000</u>	"		
		<u>10,300</u>			<u>10,300</u>
2012			2012		
Dec.31	To Bank A/c	2,200	Jan 1	By balance b/d	4,000
"	To Balance c/d	<u>2,000</u>	Dec.31	By interest A/c	<u>200</u>
		4,200			4,200
2013		<u>2,100</u>	2013		<u>2,000</u>
Dec. 31	To Bank A/c	<u>2,100</u>	Jan 1	By balance b/d	2,000
			Dec. 31	By interest A/c	<u>100</u>
					<u>2,100</u>

Case 4: calculation of interest when rate is not given

If case price and each instalment amount together with down payment is given but rate of interest is not given, then total interest will be calculated by deducting cash price from the total hire purchase price. Total interest should be divided in the ratio of amount outstanding for each year.

Problem 6: On 1st January, 2009 messers XYZ & Co. Took delivery from ABC Co. Ltd of a machine on hire purchase system, Rs 1,500 being paid on delivery and the balance in five instalments of Rs 3,000 each payable annually on 31st December. The cash price of the machine was Rs 15,000. Calculate the amount of interest for each year.

Solution:

2009 amount outstanding for interest after down payment Rs 15,000; 2010 amount

outstanding for interest after 1st instalments Rs 12,000; 2011 amount outstanding for interest after 2nd instalments Rs 9,000 ; 2012 amount outstanding for interest after 3rd instalments Rs 6,000; 2013 amount outstanding for interest after 4th instalments Rs 3,000.

Total interest for all the five years is Rs 1,500 (i.e Rs 16,500 hire purchase price – Rs 15,000 cash price) which should be divided in the ratio of 5:4 :3:2:1 for all these years.

Hence , the interest comes to

2009	Rs 1,500 x $\frac{5}{15}$	= 500
2010	Rs 1,500 x $\frac{4}{15}$	= 400
2011	Rs 1,500 x $\frac{3}{15}$	= 300
2012	Rs 1,500 x $\frac{2}{15}$	= 200
2013	Rs 1,500 x $\frac{1}{15}$	= 100

Case 5: Calculation of interest by product method

When cash price, hire purchase price and the amounts of various instalments are given but rate of interest is not given, the following procedure is adopted:

Hire purchase price – cash price = total interest.

Hire purchase price - first instalment = first balance.

First balance – second payment = second balance.

Second balance – Third payment = Third balance

These balances are multiplied by the period for which the amounts remain outstanding in order to calculate the product. The total interest is apportioned in the ratio of individual product to the total product. Interest in each period will be deducted from the payment made for each period in order to calculate the amount of cash price portion included in the instalment. This will be more clear from the following illustration.

Calculation of interest by product method

Problem 7: X purchased from Y a machine on hire purchase system on 1st January, 2013. It hire purchase price was Rs 95,000 and cash price was Rs 86,800. Rs 5,000 was paid on delivery, Rs 10,000 was paid after 4 months, Rs 15,000 was paid after 6 months, Rs 30,000 was paid after 9 months and Rs 35,000 was paid after 12 months. The date of payment of each instalment is counted from the date of purchase of machinery.

Calculate interest in each instalment and cash price portion included in each instalment.

Solution:

Total interest = H.P Price – cash price = Rs 95,000 – Rs 86,800 = Rs 8,200.

Instal- ment No.	Period	Amount (In Rs)	Product (in Rs)	Interest $\frac{8200}{820,000} = \frac{1}{100}$	Amount of cash price portion
1	4 months	90,000	90,000 x 4 = 360,000	3,600	10,000 – 3,600 = 6,400
2	6 months - 4 months = 2 months	90,000 – 10,000 = 80,000	80,000 x 2 = 160,000	1,600	15,000 – 1,600 = 13,400
3	9 months – 6 months	80,000 – 15,000 =	65,000 x 3 = 195,000		30,000 – 1,950 = 28,050

4	= 3 months	65,000		1,950	
	12 months – 9	65,000-	35,000 x 4 =		35,000 – 1,050 = 33,950
	months = 3 months	30,000 =	105,000	1,050	
		35,000			
			<u>820,000</u>	<u>8,200</u>	<u>81,800</u>

Case 6: Calculation of cash price , when it is not given

Sometimes in the question the cash price is not given. The asset account cannot be debited with more than the cash price of the asset, so it becomes essential to find out the cash price first before solving such type of questions. The procedure to calculate cash price is to take up the final instalment first and to deduct the interest from it. Interest can be calculated for one year by multiplying the sum due at the end of the year by the formula – rate of interest / 100 + rate of interest. Suppose x owes y Rs 100, interest being 10 % p.a. At the end of one year x will have to pay Rs 110 out of which Rs 10 is for interest. Hence, 10/110 of the sum due at the end of the year will be interest. If this interest is deducted from the sum due at the end of the year, the residual will be the sum due at the beginning of the year. This will also be the amount due

at the end of the last but one year after paying the annual instalment. The total of these two will give the sum due at the end of the last but one year. That year's interest will be calculated by multiplying the sum due by 10/110 and so on the process continues for other previous years also. If the instalments are half yearly and rate of interest is given p.a, then it should be reduced to half for the purpose of calculating interest out of the total amount.

Problem 8: Determine cash price in the following cases:

- a) On 1st January, ram purchased a machine on hire purchase price under a hire

purchase agreement which provided for an initial payment of Rs 1,500 and the balance in four equal half – yearly instalments of Rs 2,000 each, the first instalments falling due on 30th June. Assume a rate of interest @ 6 % p.a.

- b) Ram purchases a machine on hire purchase system. He pays Rs 10,000 down and Rs 8,000, Rs 7,000 and Rs 6,000 at the end of 2nd year, 4th year and 6th year respectively. Interest is charged by the vendor @ 10 % p.a. at 2 yearly rest on the unpaid balance.
- c) Shyam purchased a machine on hire purchase system. He pays Rs 20,000 down and Rs 16,300, Rs14,200 and RS 12,100 in three instalments respectively at the interval of two years. Rate of interest is 10 % p.a. at yearly rest.

Solution:

- a) The cash price in each case is determined as under:

No. Of instalment (1)	Closing balance (2)	Amount of instalment (3)	Total (4)	Interest 3/103 of (4) (5)	Opening balance (6)
4	Nil	2,000	2,000	58	1,942
3	1,942	2,000	3,942	115	3,827
2	3,827	2,000	5,827	170	5,657
1	5,657	2,000	7,657	223	7,434

- b) Cash price = down payment plus Rs 7,434 = Rs 1,500 plus Rs 7,434 = Rs 8,934

No. Of instalment	Closing balance	Amount of instalment	Total	Interest 20/120	Opening balance
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3 – end of 6 th year	Nil	6,000	6,000	1,000	5,000
2-end of 4 th year	5,000	7,000	12,000	2,000	10,000
1-end of 2 nd year	10,000	8,000	18,000	3,000	15,000

c) Cash price = down payment + Rs 15,000 = Rs 10,000 + Rs 15,000 = Rs 25,000

No. Of instalment	Closing balance	Amount of instalment	Total	Interest 21/121	Opening balance
3-6 th year	Nil	12,100	12,100	2,100	10,000
2-4 th year	10,000	14,200	24,200	4,200	20,000
1-2 nd year	20,000	16,300	36,300	6,300	30,000

Cash price = down payment + Rs 30,000

= Rs 20,000 + Rs 30,000 = Rs 50,000

Notes:

Fraction of interest on total cash paid = $\frac{\text{half yearly interest}}{100 + \text{half yearly interest}} = \frac{3}{103}$

Fraction of interest on total cash paid = $\frac{\text{interest for two years}}{100 + \text{interest for two years}}$

$$= 100 \times \frac{10}{100 + 20} \times 2 = \frac{20}{120} = \frac{1}{6}$$

Compound interest at yearly rest on Rs 100 @ 10 % for two years = Rs 21

$$\left[\text{Rs } 100 \times \frac{110}{100} \times \frac{110}{100} = \text{Rs } 121 \right] \text{ Compound amount}$$

$$\begin{aligned} \text{Interest} &= \text{compound amount} - \text{Principal} = \text{Rs } 121 - \text{Rs } 100 = \text{Rs } 21 \\ \text{Fraction of interest on total cash paid} &= \frac{\text{interest}}{100 + \text{interest}} = \frac{21}{100 + 21} = \frac{21}{121} \end{aligned}$$

Case 7: calculation of cash price when reference to annuity table, rate of interest and instalments are given.

Sometimes in the question, a reference to annuity table where in present value of the annuity for a number of years at a certain rate of interest is given, the cash price is calculated by multiplying the amount of instalment and adding in the product the down payment. This will be clearer from the following illustrations:

Problem 9: Determine cash price in each of the following cases:

- Mr. Ram purchases a machine on hire purchase system paying Rs 20,000 annually for ten years. The rate of interest charged by the vendor is 5 % p.a. Given the present value of an annuity of Rs 1 for 10 years at 5 % is 7.7217
- Mr. Sharma purchased a plant on hire purchase system paying Rs 15,000 down and Rs 15,000 at the end of three successive years. The rate of interest charged by the vendor is 5 % p.a. Given the present value of an annuity of Rs 1 p.a @ 5% interest for three years is Rs 2.7232
- Mr. Verma purchased a machine on hire purchase system paying Rs 7,767 down and Rs 10,000 each at the end of 1st, 2nd and 3rd year. The rate of interest is 5% p.a. Given the present value of annuity of Rs 1 at 5 % for one, two and three years respectively as 0.9524, 0.9070 & 0.8639.

Solution :

- Cash price = Reference to annuity value x Rs 20,000 = 7.7217 x Rs 20,000

$$= \text{Rs } 154,434$$

b) Cash price = reference to annuity value x instalment + down payment

$$= \text{Rs } 2.7232 \times 15,000 + 40,848 = \text{Rs } 55,848$$

c) Cash price = (1st instalment x 0.9524) + (2nd instalment x 0.9070) + (3RD instalment x 0.8639) + down payment

$$\begin{aligned} &= (\text{Rs } 10,000 \times 0.9524) + (\text{Rs } 10,000 \times 0.9070) + (\text{Rs } 10,000 \times 0.8639) \\ &+ 7,767 \\ &= 35,000. \end{aligned}$$

Case 8 : Calculation of interest when rate and cash price are not given

When cash price and rate of interest is not given and it is desired to calculate the amount of interest included in each instalment, then the question will be solved by forming equation for each instalment and solving them. This will be clear from the following illustration:

Problem 10: M/s India motors ltd. sells scooters on the hire purchase system. The terms of payment for the sale of a scooter are Rs 1,000 on delivery, Rs 1,040 at the end of the first year, Rs 960 at the end of the second year and Rs 880 at the end of the third year, inclusive of finance or interest. Calculate amount of interest included in each instalment.

Solution:

Suppose the cash price is 'P' and interest is 'i'

$$\text{Then , first instalment} = P + 3i = \text{Rs } 1,040 \quad \text{_____} \quad (\text{i})$$

$$\text{Second instalment} = P + 2i = \text{Rs } 960 \quad \text{_____} \quad (\text{ii})$$

$$\text{Third instalment} = P + i = \text{Rs } 880 \quad \text{_____} \quad (\text{iii})$$

Adding (ii) and (iii) = $2P + 3I = \text{Rs } 1,640$ ————— (iv)

Deducting (i) from (iv) i.e., $P = \text{Rs } 800$

Cash price paid each time is Rs 800

Interest in each instalment is as follows:

No. of instalment	Instalment paid	Cash price paid	Interest paid
1	1,040	800	240
2	960	800	160
3	880	800	80

Note:

Assume

- (i) The difference in various instalments (leaving down payment) is due to the difference of interest i.e; all payments towards cash price are equal.
- (ii) Rate of interest is uniform all through.

Purchase through financial institutions

When an asset is purchased on hire purchase, purchaser sometimes gets if finance through some financial institution. In such a case, the instalments are paid to financial institution instead of vendor and right on the property will be that of financial institution. Such method is applied in case of more valuable assets as motor, truck, tractor, etc. Which are purchased with the help of some financial institution. In such a case an account of financial institution (instead of vendor) will be opened in the books of purchaser but other accounts will be the same.

Problem 11: On 1st January, 2011 X Ltd. acquired a tractor of the cash price of Rs

176,000. The purchase of the tractor was financed by Delhi finance corporation to whom X Ltd. paid Rs 56,000 on 1st January, 2011 and 3 instalments (exclusive of interest) of Rs 40,000 at the end of each year are to be paid. The rate of interest was 15 % p.a.

X Ltd. writes off depreciation at 20 % p.a. on diminishing balance method. Tractor met with an accident on 1st April, 2013 and X Ltd. received from the insurance company Rs 84,000 as claim. The debt of Delhi Finance Corporation was discharged on that date.

Solution:

In the books of X Ltd.

Tractor account

1-1-11	To Delhi Finance corp.	176,000	31-12-11	By depreciation A/c	35,200
			“	By balance c/d	140,800
		<u>176,000</u>			<u>176,000</u>
1-1-12	To balance b/d	140,800	31-12-12	By depreciation A/c	28,160
			“	By balance c/d	112,640
		<u>140,800</u>			<u>140,800</u>
1-1-13	To balance b/d	112,640	1-4-13	By depreciation A/c	5,632
			“	By bank A/c	84,000
			31-12-13	(insurance claim)	23,000
				By profit and loss A/c	

	<u>112,640</u>		<u>112,640</u>
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Delhi Finance Corporation Account

1-1-11	To bank A/c	56,000	1-1-11	By tractor A/c	176,000
31-12-11	To bank A/c		31-12-11	By interest A/c	
“	(Rs 40,000 + Rs 18,000)	58,000	“	(15 % of Rs 120,000)	18,000
	To balance c/d	<u>80,000</u>			
		<u>194,000</u>			<u>194,000</u>
31-12-12	To bank A/c		1-1-12	By balance b/d	80,000
“	(Rs 40,000 + Rs 12,000)	52,000	31-12-12	By interest A/c	
	To balance c/d	<u>40,000</u>	“	(15 % of Rs 80,000)	<u>12,000</u>
		<u>92,000</u>			<u>92,000</u>
1-4-13	To bank A/c	41,500	1-1-13	By balance b/d	40,000
	(final payment)		1-4-13	By interest A/c	1,500
		<u>41,500</u>		(Rs 40,000 x 15 % x 3/12)	
					<u>41,500</u>

Problem 12: Delhi engineering works purchase a machinery on hire purchase system. The cash price of the machinery is Rs 64,000, the deposit is Rs 6,400 and four annual instalments of Rs 14,400 are to be paid, commencing a year after delivery. In addition, interest is to be paid at 7 % on yearly balance and the purchaser is to pay the seller an insurance premium of 25 paise per hundred rupees p.a. on the outstanding balances.

Show vendor's A/c and insurance premium A/c in the books of the purchaser for the agreement period.

Solution:

In the books of Delhi Engineering Works

Vendor's account

Year			Year		
1 st	To bank A/c	6,400	1 st	By machinery A/c	176,000
	To bank A/c			By interest A/c	
	(Rs 14,400+ Rs 4,032 + Rs 144)			(7 % of Rs 57,600)	4,032
	To balance c/d	18,576		By insurance premium A/c	
		43,200		(Rs 57,600 x 25 % x 1 / 100)	144
2 nd	To bank A/c	<u>68,176</u>	2 nd	By balance b/d	<u>68,176</u>
	(Rs 14,400+ Rs 3,024 + Rs 108)	17,532		By interest A/c	43,200
	To balance c/d	<u>28,800</u>		(7 % of Rs 43,200)	
				By insurance premium A/c	3,024
		<u>46,332</u>		(Rs 43,200 x 25 % x 1 / 100)	<u>108</u>
					<u>46,332</u>
3 rd	To bank A/c		3 rd	By balance b/d	
	(Rs 14,400 + Rs 2,016 + Rs 72)	16,488		By interest A/c	2,016
	To balance c/d	<u>14,400</u>		(7 % of Rs 28,800)	<u>72</u>
		<u>30,888</u>		By insurance premium A/c	<u>30,888</u>
				(Rs 28,800 x 25 % x 1 / 100)	
4 th	To bank A/c		4 th	By balance b/d	14,400
	(Rs 14,400 + Rs 1,008 + Rs 36)	15,444		By interest A/c	1,008
				(7 % of Rs 14,400)	36
				By insurance premium A/c	
				(Rs 14,400 x 25 % x 1 / 100)	
		<u>15,444</u>			<u>15,444</u>

Insurance premium A/c

Year			Year		
1 st	To vendor's A/c	<u>144</u>	1 st	By P/L A/c	<u>144</u>

2 nd	To vendor's A/c	<u>108</u>	2 nd	By P/L A/c	<u>108</u>
3 rd	To vendor's A/c	<u>72</u>	3 rd	By P/L A/c	<u>72</u>
4 th	To vendor's A/c	<u>36</u>	4 th	By P/L A/c	<u>36</u>

Problem 13: ALtd. entered into a hire purchase agreement with B ltd. for the purchase of 100 wagons over a period of three years from January 1 , 2013 by half- yearly instalments of Rs 7,385 payable on June 30 and December 31, each year , the cash price being Rs 400 per wagon and the rate of interest 6 % p.a. with half – yearly rest.

On January 1, 2014 after paying two instalments Altd., transfered their rights in the agreement to C ltd. for a consideration of Rs 10,000 . C ltd paid this sum to A ltd. On 1st January, and the next instalments to B ltd. on due dates.

Show in the form of journal entries how the transactions should appear in the books of C ltd. upto 30th June, 2014 when its financial year ended writing off depreciation @ 10 % p.a. Calculations may be done the nearest rupee.

Solution:

Journal entries

2014					
Jan. 1	Wagons A/c	Dr		37,444	
	To A ltd. A/c				10,000
	To B ltd. A/c				27,444
	(being 100 wagons taken over on hire purchase system as per agreement)				
June 30	Interest A/c	Dr			
	To B ltd. A/c			823	823
	(being interest on Rs 27,444 @ 6 % for 6 months)				
June 30	B ltd. A/c	Dr.			
	To bank A/c			7,385	7,385
	(Being payment of instalment)				
June 30	Depreciation A/c	Dr			
	To wagons A/c			1,872	1,872
	(being depreciation @ 10 % p.a. on Rs 37,444 for 6 months)				

June 30	Profit and loss A/c Dr.		
	To interest A/c		823
	To depreciation A/c	2,695	
	(interest and depreciation amount transferred to P/L A/c)		1,872

Working notes:

Calculation of amount due to B ltd.

B ltd A/c

2013			2013		
June 30	To bank A/c	7,385	Jan. 1	By wagons A/c	40,000
Dec. 31	To bank A/c	7,385	June 30	By interest A/c	
Dec. 31	To balance c/d	27,444		$\frac{6}{100} \times 40,000 \times \frac{1}{2}$	1,200
			Dec. 31	By interest A/c	
				$\frac{5}{100} \times 33,815 \times \frac{1}{2}$	1,014
		<u>42,214</u>			<u>42,214</u>

The amount of Rs 27,444 is due to B ltd. from A ltd. will now have to be paid by C ltd. to B ltd.

Calculation of interest

$$\frac{6}{100} \times 27,444 \times \frac{6}{2} = 823 \text{ approx}$$

Problem 14: X purchased a car from Y costing Rs 150,000 on hire purchase system. Payment was to be made Rs 30,000 down and remainder in 3 equal annual instalments together with interest at 5 % p.a. X provides depreciation at 20 % p.a. on diminishing

balance basis. X paid the first instalment at the end of first year but could not pay the next.

Y took possession of the car and spends Rs 5,800 on the car and sold it for Rs 80,000.

Show necessary ledger accounts in the books of both the parties.

Solution :

In the books of X

Car account

To Y's A/c	150,000	By depreciation A/c	30,000
		By balance c/d	<u>120,000</u>
	<u>150,000</u>		<u>150,000</u>
To balance b/d	120,000	By depreciation A/c	24,000
		By Y's A/c	84,000
		By P/L A/c (loss on default)	12,000
	<u>120,000</u>		<u>120,000</u>

Y's account

To bank A/c	30,000	By car A/c	150,000
To bank A/c (Rs 40,000 + Rs 6,000)	46,000	By interest A/c	6,000
To balance c/d	<u>80,000</u>		
	<u>156,000</u>		<u>156,000</u>
To car A/c	<u>84,000</u>	By balance b/d	80,000
		By interest A/c	4,000
	<u>84,000</u>		<u>84,000</u>

In the books of Y

X's A/c

To hire sales A/c	150,000	By bank A/c	30,000
To interest A/c	6,000	By bank A/c	46,000
		By balance c/d	<u>80,000</u>
	<u>156,000</u>		<u>156,000</u>
To balance b/d	80,000	By goods repossessed A/c	84,000
To interest A/c	4,000		
	<u>84,000</u>		<u>84,000</u>

Goods repossessed A/c

To X's A/c	84,000	By bank A/c (sales)	80,000
To bank A/c	5,800	By P/L A/c (loss on repossession)	9,800
	<u>89,800</u>		<u>89,800</u>

Moonshine ltd. of Mumbai purchased from sunshine ltd. of surat 3 machines costing Rs 5,000 each on the hire purchase basis. Payment was to be made Rs 3,000 down and the remainder in three equal instalments together with interest at 9 %. Moonshine ltd. write off depreciation @ 20 % on the diminishing balance. It paid the instalment due at the end of the first year but could not pay the next. Sunshine ltd. agreed to leave one machine with the purchaser, adjusting the value of the other 2 machines against the amount due. The machines were valued on the basis of 30 % depreciation annually (diminishing balance method). Sunshine ltd. spent Rs 500 on repairs and sold these for 6,000 . show the necessary accounts in the books of moonshine ltd. and sunshine ltd. for 2 years.

In the books of moon shine ltd.

Machinery A/c

Year I		Year I	
To sunshine ltd.	15,000	By Depreciation A/c	3,00
		By balance c/d	12,000
	<u>15,000</u>		<u>15,000</u>
Year II		Year II	
To balance b/d	12,000	BY Depreciation A/c	2,400
		By sunshine ltd.	4,900
		By P/L A/c (loss on default)	1,500
		By balance c/d	3,200
	<u>12,000</u>		<u>12,000</u>

Sunshine ltd. A/c

Year I		Year II	
To bank A/c	3,000	BY Machinery A/c	15,000
To bank A/c (Rs 4,000 + Rs 1,080)	5,080	By interest A/c	1,080
To balance c/d	<u>8,000</u>		
	<u>16,080</u>		<u>16,080</u>
Year II		Year II	
To machinery A/c	4,900	BY Balance b/d	8,000
To balance c/d	3,820	By interest A/c	720
	<u>8,720</u>		<u>8,720</u>

In the books of Sunshine Ltd.

Year I		Year I	
To hire sale	15,000	By bank A/c	3,000
To interest A/c	1,080	By bank A/c	5,080
		By balance c/d	8,000
	<u>16,080</u>		<u>16,080</u>
Year II		Year II	
To balance b/d	8,000	BY Goods repossessed A/c	4,900
To interest A/c	720	By balance c/d	3,820
	<u>8,720</u>		<u>8,720</u>

Goods repossessed A/c

Year II		Year II	
To moonshine Ltd.	4,900	By bank A/c	6,000
To bank A/c	500		
To P/L A/c (profit on repossession)	600		
	<u>6,000</u>		<u>6,000</u>

Value of 2 machines repossessed

Cost (5,000 x 2)	<u>10,000</u>
Less: depreciation 30 % for the 1 st year	<u>3,000</u>
	<u>7,000</u>
Less: depreciation 30 % for the 2 nd year	<u>2,100</u>
	<u>4,900</u>
Value of one machine left with the purchaser Cost	5,000

Less: depreciation 20 % for the 1 st year	<u>1,000</u>
	<u>4,000</u>
Less: depreciation 20 % for the 2 nd year	<u>800</u>
	<u>3,200</u>

Problem 15: D ltd. sold three machines costing Rs 10,000 each to p on hire purchase system on hire purchase system on 1-1-2102. P paid Rs 6,000 on the above date to receive delivery of these machines and agreed to pay five half-yearly instalments of Rs 6,000 each.

P could not pay the third instalment in time where upon D ltd. repossessed one machine and P retained the other two machines. The value of the returned machine was agreed to be cash price less 40 %. The purchaser charges depreciation @ 10 % p.a. on reducing balance method.

D ltd. sold the repossessed machine for Rs 4,500 on 31st December, 2013 after incurring repairs of Rs 200.

You are required to show:

- i) D ltd. A/c and machinery A/c in the books of hire purchaser and
- i) P's A/c and goods repossessed A/c in the books of D ltd.

Solution:

Cash price = Rs 10,000 x 3 = Rs 30,000.

Hire purchase price = Rs 6,000 down + (6,000 X 5) = Rs 36,000

Interest = Rs 36,000 – Rs 30,000 = Rs 6,000.

Calculation of interest on each instalment

Half yearly instalments	Outstanding amount (in Rs)	ratio	Interest (in Rs)
1	30,000	5	$6,000 \times 5 / 15 = 2,000$
2	24,000	4	$6,000 \times 4 / 15 = 1,600$
3	18,000	3	$6,000 \times 3 / 15 = 1,200$
4	12,000	2	$6,000 \times 2 / 15 = 800$
5	6,000	<u>1</u>	$6,000 \times 1 / 15 = \underline{400}$
		15	6,000

In the books of P

Machinery A/c

2012			2012		
Jan 1	To D ltd.	30,000	Dec. 31	By depreciation A/c	3,000
			“	By balance c/d	<u>27,000</u>
		<u>30,000</u>			<u>30,000</u>
2013			2013		
Jan 1	To balance b/d	27,000	Jun 30	By D ltd. (goods repossessed)	6,000
				By depreciation A/c (6 months)	1,350
				By P/L A/c (loss on default)	2,550
				By balance c/d	17,100
		<u>27,000</u>			<u>27,000</u>
2013					
July 1	To balance b/d	17,100			

D ltd A/c

2012			2012		
Jan 1	To bank A/c	6,000	Jan 1	By machinery A/c	30,000
June 30	To bank A/c	6,000	June 30	By interest A/c	2,000
Dec. 31	To bank A/c	6,000	Dec. 31	By interest A/c	1,600
“	To balance c/d	<u>15,600</u>			
		<u>33,600</u>			<u>33,600</u>
2013			2013		
June 30	To machinery A/c	6,000	Jan 1	By balance b/d	15,600
“	To balance c/d	<u>10,800</u>	June 30	By interest A/c	<u>1,200</u>
		<u>16,800</u>			<u>16,800</u>
			2013		
			July 1	By balance b/d	10,800

In the books of D ltd.

P's A/c

2012			2012		
Jan 1	To hire sales A/c	30,000	Jan 1	By bank A/c	6,000
June 30	To interest A/c	2,000	June 30	By bank A/c	6,000
Dec. 31	To interest A/c	1,600	Dec. 31	By bank A/c	6,000
			“	By balance c/d	<u>15,600</u>
		<u>33,600</u>			<u>33,600</u>
2013			2013		
Jan 1	To balance b/d	15,600	June 30	By machinery A/c	6,000
June 30	To interest A/c	<u>1,200</u>	“	By balance c/d	<u>10,800</u>

2013		<u>16,800</u>			<u>16,800</u>
July 1	To balance b/d	10,800			

Goods repossessed A/c

2013			2013		
June	To P's A/c	6,000	Dec. 31	By cash A/c (sales)	4,500
30	To cash A/c (repairs)	<u>200</u>	"	By profit and loss A/c (loss)	<u>1,700</u>
		<u>6,200</u>			<u>6,200</u>

Notes:

Value of one returned machine

Cash price	10,000
Less: 40 %	4,000
Value	14,000

Balance value of two machines

Cash price of 2 machines	20,000
Less: depreciation @ 10 %	2,000
Value	18,000
Less : depreciation @ 10 % for 6 months	900
Value	17,100

Problem 16 : Roman & Co. Purchased five machines from ramos machinery ltd. on 1st January , 2010 on hire purchase system. The cash price of each machine is Rs 120,000. The mode of payment was as follows:

15 % of the cash price down and 25 % of cash price at the end of each year for 4 years. Roman Co. Writes off 15 % depreciation annually on diminishing balance method . The payment due on 31st December, 2011 could not be made. Ramos ltd. agreed to leave three machines with the buyer on the condition that the value of the other two machines would be adjusted against the amount due, the machines being valued at cost less 25 % depreciation on diminishing balance method.

Show the necessary account s in the books of roman Co.

Solution:

In the books of Roman Co.

Machinery A/c

2010 Jan 1	To Ramos Co. ltd.	600,000	2010 Dec. 31	By depreciation A/c	90,000
		<u>600,000</u>	“	By balance c/d	<u>510,000</u>
					600,000
2011 Jan 1	To balance b/d	510,000	2013 Dec. 31	By Ramos ltd. (goods repossessed)	135,000
			“	By depreciation A/c	76,500
		<u>510,000</u>	“	By P/LA/c (loss on default)	38,400
			“	By balance c/d	<u>260,100</u>
					510,000
2012 Jan 1	To balance b/d	260,100			

Ramos Co. ltd A/c

2010			2010		
Jan 1	To bank A/c	90,000	Jan 1	By machinery A/c	600,000
Dec. 31	To bank A/c	150,000	Dec. 31	By interest A/c	36,000
“	To balance c/d	<u>396,000</u>			
		<u>636,000</u>			<u>636,000</u>
2011			2011		
Dec. 31	To machinery A/c	135,000	Jan 1	By balance b/d	396,000
“	To balance c/d	288,000	Dec. 31	By interest A/c	27,000
		<u>423,000</u>			<u>423,000</u>
			2012		
			Jan 1	By balance b/d	288,000

Notes:

Year	Amount outstanding	Ratio	Interest
Dec. 2010	600,000	4	36,000 (90,000 x 4/10)
Dec. 2011	450,000	3	27,000 (90,000 x 3/10)
Dec. 2012	300,000	2	18,000 (90,000 x 2/10)
Dec. 2013	150,000	1	9,000 (90,000 x 1/10)

Value of 2 machines taken by romos machinery ltd.

Cost of 2 machines @ Rs 120,000	240,000
Less: depreciation @ 25 % for 2010	60,000
Value	180,000

Less: depreciation @ 25 % for 2011	45,000
Value	135,000

Value of 3 machines taken by romos machinery ltd.

Cost of 2 machines @ Rs 120,000	360,000
Less: depreciation @ 15 % for 2010	54,000
Value	306,000
Less: depreciation @ 15 % for 2011	45,900
Value	260,100

Problem 17: A ltd. sold 3 cars for a total cash price of Rs 600,000 on hire purchase basis to B on 1-1-2011. The terms of agreement provided for Rs 120,000 as down payment and the balance of cash price in three equal instalments together with interest at 12 % p.a. the instalments were payable on the following dates:

First instalment on 31-12-2011 ; Second instalment on 31-12-2012; third instalment on 31-12-2013.

B paid the two instalments in the time but could not pay the third instalments on due date. As a consequence the hire vendor repossessed the two cars and valued them at

60 % of the cash price paid. B charges depreciation at 15 % p.a. on diminishing balance method. Prepare necessary ledger accounts in the books of B.

Solution:

In the books of B

Cars A/c

2011			2011		
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Jan 1	To A ltd. A/c	600,000	Dec. 31	By depreciation A/c	90,000
		—	“	By balance c/d	<u>510,000</u>
		<u>600,000</u>			<u>600,000</u>
2012		—	2013		—
Jan 1	To balance b/d	510,000	Dec. 31	By depreciation A/c	76,500
		—	“	By balance c/d	<u>433,500</u>
		<u>510,000</u>			<u>510,000</u>
2013		—	2013		—
Jan 1	To balance b/d	433,500	Dec. 31	By A ltd. (goods repossessed)	176,000
		—	“	By depreciation A/c (6 months)	65,025
		—	“	By P/LA/c (loss on default)	69,650
		—	“	By balance c/d	122,825
		—			<u>433,500</u>
		<u>433,500</u>			

A ltd A/c

2011			2012		
Jan 1	To bank A/c	120,000	Jan 1	By Cars A/c	600,000
Dec. 31	To bank A/c	217,600	Dec. 31	By interest A/c	57,600
“	To balance c/d	<u>320,000</u>			
		<u>657,000</u>			<u>657,000</u>
2012			2013		
Dec.31	To bank A/c	198,400	Jan 1	By balance b/d	320,000
“	To balance c/d	<u>160,000</u>	Dec. 31	By interest A/c	<u>38,400</u>
		<u>358,400</u>			<u>358,400</u>
2013		—	2013		—
Dec.31	To cars A/c	176,000	Jan 1	By balance b/d	160,000

“	To balance c/d	<u>3,200</u>	Dec.31	By interest A/c	<u>19,200</u>
		<u>179,200</u>			<u>179,200</u>

Notes:

Book value of cars left and repossessed

	One left	Two repossessed
Cost	200,000	400,000
Less: Depreciation for 3 years @ 15% on DBM		
(Total depreciation = Rs 90,000 + Rs 76,500 + Rs 65,025 = Rs 231,525)	77,175 (1/3 of 231,525)	154,350 (2/3 of 231,525)
	<u>122,825</u>	<u>245,650</u>

Calculation of cash price paid for 2 cars

Cash price paid for 3 cars till the date of default = Rs 120,000 down + Rs 160,000 (1st instalment) + Rs 160,000 (2nd instalment) = Rs 440,000.

Cash price of 2 cars = 2/3 of Rs 440,000 = 293,333.

Agreed value for 2 cars = 60 % of Rs 293,333 = Rs 176,000

Loss on default = agreed value – book value = Rs 176,000 – Rs 245,650 = Rs 69,650.

Problem 18: Cash price of a machine is Rs 3,000 and hire purchase price is Rs 4,000.

This machine is sold on hire purchase system on 1st January, 2012 and payment is made in four six monthly instalments of Rs 1,000 each. It was agreed that the machine will be maintained free of charge for a period of two years. The actual expenses of maintenance were Rs 100 and Rs 250 for the first and second years respectively, though past experience showed that they are Rs 500 of which Rs 70 are for the first year. Pass the necessary journal entries in the books of the hire vendor and open the hire maintenance suspense account.

Solution:

2012	Hire purchaser A/c	Dr		3,000	
Jan 1	To hire sales A/c (being sales made)				3,000
June 30	Hire sales A/c	Dr			
	To maintenance suspense A/c (being transfer made)			500	500

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“	Hire purchaser A/c	Dr	400	400
	To interest A/c (being interest for half year due)			
Dec. 31	Bank A/c	Dr	1,000	1,000
	To hire purchaser A/c (being receipt of instalment)			
“	Hire purchaser A/c	Dr	100	
	To interest A/c (being interest for half year due)			
‘	Bank A/c	Dr	30	30
	To hire purchaser A/c (being receipt of second instalment)			
	Maintenance suspense A/c	Dr		
	To cash A/c			

2013 June 30	“	(being actual expenses made)	700	
		Profit and loss A/c Dr To maintenance suspense A/c (being excess of actual maintenance expenses over estimated)		700
	“		200	
		Interest A/c Dr To profit and loss A/c (being transfer of interest of profit and loss A/c)		200
	“		1,000	
2013 June 30		Hire purchaser A/c Dr To interest A/c (being interest for half year due)		1,000
		Bank A/c Dr To hire purchaser A/c (being receipt of instalment)	100	100
			1,000	
	“			1,000

Dec. 31	Hire purchaser A/c	Dr	100	
	To interest A/c			100
	(being interest for half year due)			
“	Bank A/c	Dr	1,000	
	To hire purchaser A/c			1,000
	(being receipt of third instalment)			
“	Maintenance suspense A/c	Dr	250	
	To cash A/c			250
	(being actual expenses made)			
“	Maintenance suspense A/c	Dr	180	
	To P/L A/c			180
	(being transfer balance of maintenance suspense A/c to profit and loss A/c)			
“	Interest A/c	Dr	300	
	To profit and loss A/c			300
	(being transfer of interest of profit and loss A/c)			

Maintenance suspense A/c

2012			2012		
Dec. 31	To cash A/c	100	Jan .1	By hire sales A/c	500

“	To balance c/d	<u>430</u>	Dec. 31	By P&L A/c (100-70)	<u>30</u>
2013		<u>530</u>	2013		<u>530</u>
Dec.13	To cash A/c	<u>250</u>	Jan 1	By balance b/d	<u>430</u>
“	To p& l A/c	<u>180</u>			
		<u>430</u>			<u>430</u>

Working notes:

Calculation of interest

Sales price Rs 4,000 - cash price Rs 3,000= Rs 1,000 interest

Instalment	Outstanding instalment	Ratio	Interest
I	4	4/10	1,000 X 4/10 = 400
II	3	3/10	1,000 X 3/10 = 300
III	2	2/10	1,000 X 2/10 = 200
IV	<u>1</u>	1/10	1,000 X 1/10 = 100
	10		

Problem 19 : Philips radio company sells radios for cash as well as on the hire purchase system. Cash price is Rs 800 and hire purchase price Rs 1,000, payable in 20 instalments of Rs 50 each. The price includes free maintenance for two years experience indicating that Rs 40 is the cost of maintenance in the first year and Rs 80 in the second year. During 2012, 200 sets were sold for cash and Rs 300 on hire purchase price basis. Actual maintenance expenses were Rs 7,000 in 2012 and Rs 33,600 in 2013. show maintenance

suspense account for the period . books are closed on 31st December every year.

Solution:

Total provisions for maintenance required:

1-1-2102@ Rs 20 per set for 500 radios

10,000

1-1-2013 to 30-6-2013 @ Rs 20 per set for 500 radios 10,000

1-7-2013 to 31-12-2013 @ Rs 40 per set for 500 radios 20,000 30,000

1-1-2014 to 30-6-2014 @ Rs 40 per set for 500 radios 20,000

60,000

Maintenance suspense A/c

2012			2012		
DEC.31	To cash A/c	7,000	July 1	By sales A/c	60,000
	To balance c/d	<u>53,000</u>			
		<u>60,000</u>			<u>60,000</u>
2013			2013		
DEC.31	To cash A/c	33,000	Jan.1	By balance b/d	53,000
	To balance c/d	<u>23,000</u>	Dec.31	By P/L A/c	<u>3,600</u>
		<u>56,600</u>		(33,000- 30,000)	<u>56,600</u>

Problem 20: From the following details set out the hire purchase trading account in the books of a trader who sells a number of articles of comparatively small value daily on the hire purchase system, showing the profit on this department of the business for the year

ended December 31, 2013. For the purposes of charging his hire purchase customers, he adds 60 % to the cost of the goods.

2013

Jan 1	Stock in customer's hands at selling price	1,620
Jan 1 to dec. 31		
	Sale of goods on hire purchase during the year at selling price	6,534
	Goods repossessed (instalment due Rs 1,000) valued at	250
	Cash received from hire purchase customers at selling price	2,100
Dec.31	Stock in customer's hand at selling price	4,674

Solution:

Hire purchase trading A/c

To H.P stock A/c	1,620	By cash A/c	2,100
To goods sold on H.P A/c	6,534	By instalments due A/c	380
To stock reserve A/c		By goods repossessed A/c	250
(60/160 x 4,674)	1,753	By H.P Stock A/c	4,674
To profit and loss A/c	555	By stock reserve A/c	
		(60/160 x 1,620)	608
		By goods sold on H.P A/c	
		(60/160 x 6,534)	2,450
	<u>10,462</u>		<u>10,462</u>

Note:

Calculation of instalment due on 31st December, 2013

Opening stock	1,620	
Add: goods sold on H.P		<u>6,534</u>
		8,154
Less: cash	2,100	
Repossessed stock	1,000	
H.P stock	<u>4,674</u>	<u>7,774</u>
Instalment due	<u>380</u>	

Amar and Co. has a hire purchase department and goods are sold on hire purchase at cost plus 60%. From the following information prepare hire purchase trading A/c to ascertain the profit or loss made in the H.P department.

Jan 1, 2013

Goods with H.P customers at H.P Price	16,000
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Jan 1 to Dec. 31, 2013

Cash received from customers	56,000
Goods received back from customers instalment due Rs	
2,000) valued at	300

Dec.31, 2013

Goods with H.P Customers at H.P Price	36,000
Instalment due	2,000

Solution:

Hire purchase Trading A/c

To H.P stock A/c	16,000	By cash A/c	56,000
To goods sold on H.P A/c	80,000	By instalments due A/c	2,000
To stock reserve A/c	13,500	By goods repossessed A/c	300
To profit and loss A/c	20,800	By H.P Stock A/c	36,000
		By stock reserve A/c	6,000
		By goods sold on H.P A/c	30,000
	<u>130,300</u>		<u>130,300</u>

H.P Stock A/c

To balance b/d	16,000	By H.P instalments due	60,000
To goods sold on H.P A/c	<u>80,000</u>	By balance c/d	<u>36,000</u>
	<u>96,000</u>		<u>96,000</u>

H.P instalments due A/c

To H.P stock A/c	60,000	By cash A/c	56,000
		By goods repossessed A/c	2,000
		By balance c/d	<u>2,000</u>
	<u>60,000</u>		<u>60,000</u>

Alternative method of computation of goods sold on hire purchase

Cash received from customers 56,000

Add: instalments due on goods repossessed	2,000	
Goods with customers at hire purchase price	36,000	
Instalments due on December 31, 2013		2,000
	96,000	
Less: Goods with customers on January 1, 2013		16,000
Goods sold on hire purchase during the year	80,000	

Sonam Corporation sells goods on hire purchase basis. The hire purchase price is cost plus 50 %. From the following particulars (all the figures are at invoice price) prepare hire purchase trading account for the year ended 31st march, 2014:

Instalments not yet due on 1-4-2013	300,000
Instalments due on 1-4-13	150,000
Goods sold on hire purchase during the year	900,000
Instalments collected from HP debtors	680,000
Stock with customers at hire purchase price	450,000
Goods repossessed during the year	0,000

On 31-3-2014 goods repossessed were valued at cost less 40 %

Solution :

Hire purchase trading account

For the year ended 31-3-2014

Hire purchase trading A/c

To opening balance		By bank A/c (instalment collected)	680,000
H.P stock A/c	300,000	By H.P Debtors	160,000
Hire purchase debtors	150,000	By goods repossessed A/c	24,000

To goods sold on H.P A/c	900,000	By H.P Stock A/c	450,000
To stock reserve A/c	150,000	By stock reserve A/c	100,000
To profit and loss A/c	214,000	By goods sold on H.P A/c	300,000
	<u>17,14,000</u>		<u>17,14,000</u>

Memorandum H.P Stock A/c

To balance b/d	300,000	By H.P debtors A/c	750,000
To goods sold on H.P A/c	<u>900,000</u>	By balance c/d	<u>450,000</u>
	<u>12,00,000</u>		<u>12,00,000</u>

Memorandum H.P debtors A/c

To balance b/d	150,000	By cash A/c	680,000
To H.P stock A/c	750,000	By goods repossessed A/c	60,000
		By balance c/d	<u>160,000</u>
	<u>900,000</u>		<u>900,000</u>

Value of goods repossessed = $60,000 \times 100/150 \times 60/100 = 24,000$

Problem 21: From the following information of M/s Chennai traders, you are required to prepare the hire purchase trading account to ascertain the profit made during the financial year 2013-14.

Chennai traders sell goods on hire purchase basis at cost plus 25 %. Following details are available all the figures are at invoice price.

Instalments not due on 31st March, 2013 450,000
 Instalments due and collected during the financial year 2013-14 12,00,000
 Instalments due but not collected during the financial year 2013-14 which

Hire purchase price of repossessed goods:		
Instalments collected	22,500	
Instalments due	15,000	
Instalments not due	30,000	
Cost of repossessed goods (67,000 x 100/ 125)		67,500

Valuation of repossessed goods (54,000 x 60 / 100)		54,000
Less: cost of instalments due + instalments not yet due		32,400
(Rs 15,000 + Rs 30,000) x 100/ 125		(36,000)
Loss on repossession		3,600

Goods taken from shop stock

Goods taken from shop stock	12,75,000
H.P purchase sales (12,00,000 + 75,000)	525,000
Add: stock with customers as on 31 st march 2014	<u>(450,000)</u>
(Rs 555,000 – Rs 30,000)	
Less: stock with customers as on 31 st March, 2013	<u>13,50,000</u>

Loading on goods taken from shop stock = Rs 13,50,000 x 25 /125 = Rs 270,000.

Problem 22: Harish sells goods on hire purchase at cost plus 50 %. From the following particulars relating to the hire purchase department for the year ending 31st December, 2013, prepare H.P debtors A/c, shop stock A/c, H.P stock A/c, H.P adjustment A/c, goods sold on H.P A/c and stock reserve A/c.

Jan 1	stock with hire purchase cutomers at selling price	4,500
	stock at shop at cost	9,000
	instalments due	
Jan 1	Cash received from customers	30,000
Dec. 31	Goods purchased during the year	30,000
	Goods repossessed (instalments due Rs 1,000)	
	valued at Rs 250	
	Hire expenses Rs 250	
Dec. 31	Instalments due customers paying	
	stock at shop at cost excluding repossessed goods	10,000

2,500

4,500

verify your result by preparing the H.P Trading A/c

Solution:

H.P stock A/c

To balance b/d	4,500	By H.P debtors A/c	33,000
To goods sold on H.P A/c		By balance C/d	15,000
Cost Rs 29,000			
Profit Rs 14,500	<u>43,500</u>		
	<u>48,000</u>		
			<u>48,000</u>

H.P debtors A/c

To balance b/d	2,500	By cash	30,000
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To hire purchase stock A/c (instalments due during the year)	33,000	By goods repossessed A/c	250
		By H.P adjustment A/c	750
		By balance c/d	<u>4,500</u>
	<u>35,500</u>		<u>35,500</u>

Shop stock A/c

To balance b/d	9,000	By cost of goods sold on H.P	29,000
To purchase A/c	30,000	By balance c/d	
		(excluding repossessed stock)	<u>10,000</u>
	<u>39,000</u>		<u>39,000</u>

H.P.adjustment A/c

To stock reserve A/c (15,000 x 50 /150)	5,000	By stock reserve A/c (4,500 x 50 / 150)	1,500
To H.P debtors A/c	750	By goods sold on H.P A/c	14,500
To hire expenses	250		
To P/L A/c(profit)	<u>10,000</u>		
	<u>16,000</u>		<u>16,000</u>

Goods sold on H.PA/c

To H.P adjustment A/c	14,500	By H.P stock A/c	43,500
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To trading A/c	29,000		
	<u>43,500</u>		<u>43,500</u>

Stock reserve A/c

To H.P adjustment A/c	<u>1,500</u>	By balance b/d	<u>1,500</u>
To balance c/d	<u>5,000</u>	By H.P adjustment A/c	<u>5,000</u>

Hire purchase trading A/c

To stock with customers	4,500	By cash A/c	30,000
To instalment due	300,000	By goods repossessed A/c	250
To goods sold on H.P A/c	43,500	By H.P Stock A/c	15,000
To stock reserve A/c	5,000	By stock reserve A/c	1,500
To hire expenses A/c	250	By goods sold on H.P A/c	14,500
To profit and loss A/c	10,000	By instalment due A/c	4,500
	<u>65,750</u>		<u>65,750</u>

Complete repossession and stock and debtors system

Problem 23: Varun sells goods on hire purchase system basis also. He fixes his purchase price by adding 50 % to the cost of goods to him. Following are the figures relating to his purchase business for the year 2013:

Balance of H.P stock account as on 1-1-2013	12,000
Balance of H.P debtors A/c as on 1-1-2013	300
Selling price of goods sold on H.P basis during the year	90,600
Cash received from customers during the year	92,400

Total amount of instalments that fell due 92,700

One customer to whom goods had been sold for Rs 1,200 paid only 3 instalments of Rs 100 each. On his failure to pay the monthly instalment of Rs 100 due on 4th December,

2013 the goods were repossessed on 27th December, 2013 after due legal notice.

Prepare ledger accounts on stock – debtors system for the year ended 31st December, 2013.

Verify your results by preparing H.P trading A/c

Solution:

H.P stock A/c

To balance b/d	12,000	By H.P debtors A/c	92,700
To goods sold on H.P A/c	90,600	By goods repossessed A/c	800
		By balance C/d	9,100
	<u>102,600</u>		<u>102,600</u>

H.P debtors A/c

To balance b/d	300	By bank A/c	92,400
To hire purchase stock A/c	92,700	By goods repossessed A/c	100
		By balance c/d	<u>500</u>
	<u>93,000</u>		<u>93,000</u>

H.P adjustment A/c

To stock reserve A/c	3,033	By stock reserve A/c	4,000
To goods repossessed A/c	300	By goods sold on H.P A/c	30,200
To P/L A/c(profit)	30,867		
	<u> </u>		<u> </u>
	<u>34,200</u>		<u>34,200</u>

Goods sold on H.PA/c

To H.P adjustment A/c	30,200	By H.P stock A/c	90,600
To trading A/c	60,400		
	<u>90,600</u>		<u>90,600</u>

Goods repossessed A/c

To H.P stock A/c	800	By H.P adjustment A/c	300
To H.P debtors A/c	<u>100</u>	By balance c/d	<u>600</u>
	<u>900</u>		<u>900</u>

Stock reserve A/c

To H.P adjustment A/c	<u>4,000</u>	By balance b/d	<u>4,000</u>
To balance c/d	<u>3,033</u>	By H.P adjustment A/c	<u>3,033</u>

Hire purchase trading A/c

To H.P Stock A/c	12,000	By cash A/c	92,400
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To H.P Debtors A/c	300	By goods repossessed A/c	600
To goods sold on H.P A/c	90,600	By H.P Stock A/c	9,100
To stock reserve A/c	3,033	By stock reserve A/c	4,000
To profit and loss A/c	30,67	By goods sold on H.P A/c	30,200
		By H.P Debtors A/c	500
	<u>136,800</u>		<u>136,800</u>

Problem 23: A trader has delivered goods to his customers on hire purchase system at hire purchase price amounting to Rs 23,000. He normally sells goods in the open market at retail price showing a gross profit of 30 % on that price. In order to sell goods at hire purchase price he adds 15 % to retail price to cover enhanced risk.

During the year, goods costing Rs 1,400 were returned by a hire purchaser, who had paid nothing. These goods are valued at cost on December 31. Instalments received during the year were Rs 9,200

You are required to prepare hire purchase trading account for the year ending December 31, 2013 so that profit to be taken into account is such proportion of the profits as instalments received bear to the total goods out on hire purchase.

Solution:

Suppose the retail price = Rs 100

Cost price = Rs 100 – Rs 30 = Rs 70.

H.P price = Rs 100 + Rs 15 = Rs 115

H.P Trading A/c

To goods sold on H.P	23,000	By cash – instalment received	9,200
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To stock reserve A/c (11,500 x 45 / 115)	4,500	By goods sold on H.P (23,000 X 45 / 115)	9,000
To P/L A/c	3,600	By goods repossessed A/c	1,400
		By H.P stock A/c	<u>11,500</u>
	<u>31,100</u>		<u>31,100</u>

Notes:

Calculation of stock in the hands of customers:

Total goods sent on H.P	23,000
Less: cash received as instalments	9,200
	13,800
Less: goods returned by customers on H.P price (1,400 x 115 / 70)	2,300
Total stock in the hands of customers	11,500

Instalments received = Rs 9,200

Profit margin in the instalment received = $9,200 \times 45 / 115 = \text{Rs } 3,600$

Problem 24 : Deeyen enterprises commenced business on 1st January, 2013. During the year the following sales were made under hire purchase arrangements:

Article	Cost	Sales price	Initial Amount	Monthly instalment	No. of instalments paid during the year
Radio	600	900	100	20 of Rs 40	8
Washing Machine	800	1,200	120	12 of Rs 90	2
Record Player	700	1,000	100	18 of Rs 50	4

After 4 instalments had been paid on record player it was returned on 28th December, 2013.

Prepare hire purchases trading A/c, goods repossessed A/c; memorandum hire purchases debtors A/c for the year ended 31st December, 2013.

Note: value of goods returned may be taken at cost equivalent.

Solution:

Deeyan enterprises

Hire purchases trading A/c

To purchases A/c	2,100	By cash received:	
To gross profit	330	Radio	420
		Washing machine	300
		Record player	300
			1,020
		By goods repossessed A/c	400
		By stock in hands of customers at cost	<u>920</u>
	<u>2,430</u>		<u>2,430</u>

Goods repossessed A/c

To hire purchase trading A/c	<u>490</u>	By balance c/d	<u>490</u>
	<u>490</u>		<u>490</u>

Memorandum H.P debtors A/c

To sales price of goods delivered (Rs 900 + Rs 1,200 + Rs 1,000)	3,100	By cash received	1,020
		By goods repossessed at H.P price	700
	<u>3,100</u>	By balance c/d	<u>1,380</u>
To balance c/d	<u>1,380</u>		<u>3,100</u>

Working notes:

Calculation of the value of stock at cost equivalent

Cost equivalent = $\frac{\text{instalment outstanding}}{\text{Hire purchase price}} \times \text{cost price}$

Hire purchase price

	Cost	H.P Sale	Initial payment	Instalment Paid	Instalment Outstanding	Cost equivalent
Radio	600	900	100	8 x 40 = 320	12x40 = 480	320
Washing machine	800	1,200	120	2 x 90 = 180	10x90 = 900	600
Record player	700	1,000	100	4 x 50 = 200	14x50 = 700	490
Total			320	700		

Problem 25: Omega corporation sells computers on hire purchase basis at cost plus 25%. Terms of sale are Rs 10,000 as down payment and 8 monthly instalment of Rs 5,000 for each computer. From the following particulars prepare hire purchase trading account for the year 2013.

As on 1st January , 2013 last instalment on 30 computers was outstanding as these were not due up to the end of the previous year.

During 2013 the firm sold 240 computers. As on 31st December, 2013 , the position of instalments outstanding were as under:

Instalments due but not collected:

2 instalments on 2 computers and last instalment on 6 computers

Instalments not yet due:

8 instalments on 50 computers, 6 instalments on 30 and last instalment on 20 computers.

Two computers on which 6 instalments were due and one instalment not yet due on 31-

12-13 had to be repossessed. Repossessed stock is valued at 50 % of cost. All other instalments have been received.

Solution:

In the books of Omega Corporation

H.P Trading A/c

To H.P stock A/c	150,000	By bank A/c	90,30,000
To goods sold on H.P A/c	120,00,000	By goods repossessed A/c	160,000
To stock reserve A/c	600,000	By H.P Stock A/c	30,00,000
To profit and loss A/c	18,00,000	By stock reserve A/c	30,000
		By goods sold on H.P A/c	24,00,000
		By goods repossessed A/c	40,000
	<u>145,50,000</u>		<u>145,50,000</u>

Working notes:

Cash collected

Cash down payment (240 x 10,000) 24,00,000

Add: instalments collected

Last instalment on 30 computers outstanding on 1-1—13 150,000

Instalments due and collected on 240 computers sold

Total instalments on 240 computers (8 x 240 x 500) 96,00,000

Less: instalments due but not collected

$$[(2 \times 2 + 1 \times 6 + 6 \times 2) \times 5,000] \quad 110,000$$

Instalments not due on 31-12-12

$$[(8 \times 50 + 6 \times 30 + 1 \times 20 + 1 \times 2) \times 5,000]$$

$$30,10,000 \quad 31,20,000 \quad 64,80,000 \quad 90,30,000$$

When goods are sold both for cash and H.P sales

Problem 26 : A company started business on 1st January, 2013. The business is to sell radio sets and refrigerators both for cash and on hire purchase basis. Information about the terms is given below:

	Radio sets	refrigerators
Sales price	600	2,800
Cost	400	2,000
Cash down for H.P	100	400
Monthly instalment	25	200
No. Of instalments	20	12

The company purchased goods costing Rs 96,000 and sales excluding hire purchase transactions amounted to Rs 63,900 . stock on 31st December, 2013 was valued at Rs7,210. Hire purchase transactions were as follows:

	No. Sold	instalments Collected	instalments due (customers paying)
Radio sets	40	520	30
Refrigerators	20	110	10

3 radio sets and 2 refrigerators on which only 8 instalments were collected were

repossessed and were valued at Rs 2,433; after paying reconditioning at a cost of Rs 400 these were sold for Rs3,633. This is not included in the figures of stock mentioned above.

Prepare H.P stock A/c, H.P debtors A/c, goods repossessed A/c, H.P adjustment A/c under stock and debtors system.

Solution:

Hire Purchase Trading A/c

To goods sold on H.P A/c	80,000	By cash A/c	50,800
To stock reserve A/c	7,069	By goods repossessed A/c	2,433
To profit and loss A/c	16,864	By H.P Stock A/c	23,950
		By instalment due A/c	2,750
		By goods sold on H.P A/c	24,000
	<u>103,933</u>		<u>103,933</u>

Profit and Loss A/c

To purchases	96,000		By sales A/c	63,900
Less: goods sold on H.P	56,000	40,000	By stock A/c	7,210
To profit		48,774	By profit on H.P	16,864
			By profit on goods repossessed	<u>800</u>
		<u>88,774</u>		<u>88,774</u>

H.P stock A/c

To goods sold on H.P A/c	80,000	By H.P debtors A/c	53,550
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		By goods repossessed A/c	2,500
		By balance c/d	<u>23,950</u>
	<u>80,000</u>		<u>80,000</u>

H.P debtors A/c

To H.P stock A/c	53,550	By cash collected	50,800
		By balance c/d	<u>2,750</u>
	<u>53,550</u>		<u>53,550</u>

Goods repossessed A/c

To H.P stock A/c	2,500	By H.P adjustment A/c	67
		By balance c/d	<u>2,433</u>
	<u>2,500</u>		<u>2,500</u>
To balance b/d	2,433	By cash (sales) A/c	3,633
To cash	400		
To P/L A/c (profit)	800		
	<u>3,633</u>		<u>3,633</u>

H.P adjustment A/c

To goods repossessed A/c	67	By goods sold on H.P A/c (loading)	24,000
To stock reserve A/c	7,069	By goods repossessed A/c (profit)	800
To P/L A/c	<u>17,664</u>		
	<u>24,800</u>		<u>24,800</u>

Working notes:

Amount of hire purchases cost and price are worked out as follows:

	Cost	H.P price
Radio sets	$40 \times 400 = 16,000$	$40 \times 600 = 24,000$
Refrigerators	$20 \times 2,000 = 40,000$	$20 \times 2,800 = 56,000$
	56,000	80,000
Cash collected	Radio sets	Refrigerators
Down payment	$100 \times 40 = 4,000$	$20 \times 400 = 8,000$
Instalments collected	$520 \times 25 = 13,000$	$110 \times 200 = 22,000$
Amount collected on goods repossessed	$3 \times 8 \times 25 = 600$	$2 \times 8 \times 200 = 3,200$
	17,600	33,200

Total cash collected = Rs 17,600 + Rs 33,200 = Rs 50,800

Instalments not yet due:

Radio sets

Total instalments on 37 radio sets (37×20)	740
Less: instalments collected and due	550
Instalments not yet due	190

Amount of instalments not yet due $90 \times 25 = 4,750$

Refrigerator

Total instalments on 18 radio sets (18×12)	216
Less: instalments collected and due	120
Instalments not yet due	96

Amount of instalments not yet due $96 \times 200 = 19,200$

Total amount of instalments not yet due = Rs 4,750 + Rs 19,200 = Rs 23,950

Stock reserve

	Radio sets	refrigerators
H.P price	600	2,800
Cost	400	2,000
Profit	200	800

$$\text{Radio sets - Reserve required} = \frac{200}{600} \times 4,750 = 1,583$$

$$\text{refrigerator - Reserve required} = \frac{800}{2,800} \times 19,200 = 5,486$$

$$\text{Total reserve required} = \text{Rs } 1,583 + \text{Rs } 486 = \text{Rs } 7,069$$

Instalments not due on repossessed goods

$$\text{Radio sets } (12 \times 25 \times 3) = \text{Rs } 900$$

$$\text{Refrigerator} = (4 \times 200 \times 2) = \text{Rs } 1,600$$

$$\text{Rs } 2,500$$

Hire purchase total amount receivable

Radio sets

$$\text{Cash down } (40 \times 100) \quad 4,000$$

$$\text{Instalments received and due} \quad 13,750$$

$$\text{Instalments received on repossessed goods} \quad 600$$

$$(3 \times 8 \times 25)$$

$$18,350$$

Refrigerators

Cash down (20 x 400)	8,000
Instalments received and due	24,000
Instalments received on repossessed goods (2 x 8 x 200)	3,200
	35,200
	53,550

Problem 27: On 1st January, 2011, om oil company purchased an oil machine on the instalment system. The cash price of the machine was Rs 11,175 and payment was to be made as follows:

Rs 3,000 was to be paid on the signing of the agreement and the balance in three instalments of Rs 3,000 each at the end of the year, 5 % interest is charged by the delhi

manufacturing company p.a. Om oil company has decided to write off 10 % annually on the diminishing balance of the cash price.

Give journal entries and ledger accounts in the books of purchaser and vendor both. Calculations are to be made to the nearest rupee.

Solution:

In the books of om oil co.

Journal entries

Date	Particulars	2011	2012	2013
Jan 1	Machinery A/c Dr	11,175	-	-
	Interest suspense A/c Dr	825		
	To Delhi manufacturing co. A/c (purchase of oil machine under		12,000	

Jan 1	Delhi Manufacturing Co. A/c Dr					
	To bank A/c					
	(being payment of cash to the vendor on-delivery)	3,000				
	Interest A/c Dr		3,000			
	To interest suspense A/c					137
	(being adjustments of interest falling due at this date to interest	409				
“	Delhi Manufacturing Co. A/c Dr			279	3,000	
	To bank A/c		409			
“	(being amount of instalment paid)			279		3,000
	Depreciation A/c Dr					905
	To machinery A/c					
..	(being depreciation charged @ 10 %)					905
	P/L A/c Dr	3,000				
	to interest A/c		3,000			
	to depreciation A/c			3,000	1,042	
	(being balance of interest and					137

Machinery A/c

2011			2011	By depreciation A/c	
Jan 1	To Delhi Manufacturing Co. A/c	11,175	Dec. 31	By balance c/d	1,118
					<u>10,057</u>
		<u>11,175</u>			<u>11,175</u>
2012			2012		
Jan 1	To balance b/d	10,057	Dec.31	By depreciation A/c	1,006
			“	By balance c/d	<u>9,051</u>
		<u>10,057</u>			<u>10,057</u>
2013			2013		

Jan 1	To balance b/d	9,051	Dec. 31	By depreciation A/c	905
			"	By balance c/d	<u>8,146</u>
		<u>9,051</u>			<u>9,051</u>

Interest suspense A/c

2011			2011		
Jan 1	To Delhi Manufacturing Co. A/c	825	Dec. 31	By interest A/c	409
			"	By balance c/d	<u>416</u>
		<u>825</u>			<u>825</u>
2012			2012		
Jan 1	To balance b/d	416	Dec.31	By interest A/c	279
			"	By balance c/d	<u>137</u>
		<u>416</u>			<u>416</u>
2013			2013		
Jan 1	To balance b/d	<u>137</u>	Dec. 31	By interest A/c	<u>137</u>

Delhi manufacturing co. A/c

2011			2011		
Jan 1	To bank A/c	3,000	Jan 1	By machinery A/c	11,175
Dec.31	To bank A/c	3,000	"	By interest suspense A/c	825
"	To balance c/d	<u>6,000</u>			<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>
2012			2012		
Dec. 31	To bank A/c	3,000	Jan 1	By balance b/d	6,000
"	To balance c/d	<u>3,000</u>			

Dec.31	To Om Oil Co. A/c					
	Interest suspense A/c Dr	409		279	137	
	To interest A/c		409		279	137
	(being amount of interest due)					
Dec.31	Bank A/c Dr	3,000		3,000	3,000	
	To Om Oil Co. A/c		3,000		3,000	3,000
	(being amount of instalment received)					
Dec.31	Interest A/c Dr	409		279	137	
	To P/L A/c A/c		409		279	137
	(being depreciation charged @ 10 %)					

Om Oil Company A/c

2011			2011		
Jan 1	To sales A/c	11,175	Jan 1	By bank A/c	3,000
“	To interest suspense A/c	825	Dec. 31	By bank A/c	3,000
			“	By balance c/d	<u>6,000</u>
		<u>12,000</u>			<u>12,000</u>
2012			2012		
Jan 1		6,000	Dec. 31	By bank A/c	—
	To balance b/d			By balance c/d	3,000
		<u>6,000</u>			
2013			2013		<u>3,000</u>
Jan 1		<u>3,000</u>	Dec. 31	By bank A/c	<u>6,000</u>
					—
	To balance b/d				—

					<u>3,000</u>
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Interest Suspense A/c

2011			2011		
Dec. 31	To interest A/c	409	Jan 1	By Om Oil Co. A/c	825
“	To balance c/d	<u>416</u>			
		<u>825</u>			<u>825</u>
2012			2012		
Dec.31	To interest A/c	279	Jan 1	By Om Oil Co. A/c	416
“	To balance c/d	<u>137</u>			
		<u>416</u>			<u>416</u>
2013			2013		
Dec 31	To interest A/c	<u>137</u>	Jan 1	By Om Oil Co. A/c	<u>137</u>

Interest A/c

31-12-11	To P/L A/c	<u>409</u>	31-12-11	By interest suspense A/c	<u>409</u>
31-12-12	To P/L A/c	<u>279</u>	31-12-12	By interest suspense A/c	<u>279</u>
31-12-13	To P/L A/c	<u>137</u>	31-12-13	By interest suspense A/c	<u>137</u>

15.9 UNSOLVED PROBLEMS

- On 1-1-2014, auto led, sold a scooter on hire purchase system to Achal Enterprise. Rs 4,000 was to be paid on signing of the agreement and the balance in three installments of Rs 4,000 each at the end of each year. The seller charged interest @ 5% p.a. calculate the amount of interest in each

instalment and also the amount of cash price

[cash price = Rs 14,893]

2. Mr. Gupta purchased machinery under hire purchase system from Mr. Pankaj. The cash price of the machinery Rs 15,500. The payment for the purchase is to be made as under: on signing of the agreement Rs 3,000; First year end Rs 5,000; Second year end Rs 5,000 and Third year end Rs 5,000. Make necessary ledger accounts in the books of the both the parties charging depreciation @ 10 % on diminishing balance method.
3. Kohli & Co. Purchased one machine On 1st January, 2012, on hire purchase price basis, Rs 10,000 being paid on the signing of the agreement and thereafter Rs 10,000 being paid annually for three years. Interest was charged @ 5% p.a. Depreciation was written off @ 20 % p.a. on the reducing instalment system. Given the present value of an annuity Re 1 p.a. @ 5 % Rs 2.7232.
4. On 1-4-2011, the Hazirika limited purchased one machine from M/s Bora brother on hire purchase system Rs 40,000 was paid on signing the agreement. Subsequently, three other installments of Rs 43,500; Rs 39,000 and Rs 34,500 were paid at the end of First, Second and Final year respectively to pay off the unpaid cash price of the machine along with area interest accruing from year to year.

Ascertain also the bora brothers account and show these transactions in the balance sheet as on 31st March, 2013 in the books of the hazirika limited.
5. On 1st January, 2012, X & Co. Entered into an agreement to purchase 200 sewing machines on hire purchase system from Y & Co. Price was to be paid in equal half yearly installments of Rs 400 per sewing machine and rate of interest was 6 % p.a. payable on half yearly balances.

On 1st January, 2013 after paying two installments X & Co. Transferred the Machines to Z & Co. After receiving Rs 20,000, Z & Co. Paid this amount to X & Co. Immediately and remaining installments to Y & Co. On due dates. Record the above transactions in the books of Z & Co. By way of journal entries for the financial year ended 30th June, 2013. Charge depreciation on sewing machines @ 10 % p.a.

6. Delhi Co. Purchased from Mumbai and co. Three machines costing Rs 40,000 each on the hire purchase system. Payment was to be made Rs 30,000 down and the remainder in three equal installments together with interest @ 5%. Delhi writes off depreciation @ 20 % on the diminishing balance method. He paid the installments due at the end of the first year but could not pay the next. Give necessary ledger accounts in the books of both the parties for two years if the hire vendor took possession of all the three machines. The hire vendor spent Rs 5,800 on getting the machines thoroughly overhauled and sold them for Rs 70,000.
7. A company purchased two machines of Rs 10,500 each on hire purchase system paying Rs 6,000 down and remainder in three equal installments of Rs 5,000 each together with interest @5% p.a. The company writes off depreciation at the rate of 10 % p.a. according to diminishing balance method. The company could not pay the second instalment. The vendor left one machine with the company adjusting the value of the other against amount due taking the machine at 20 % depreciation p.a. at diminishing balance method. Prepare the ledger accounts in the company books.
8. On 1st January, 2014 five machines were purchased by A on the hire purchase system. The cash price of each machine is Rs 55,000. The payment was to be made as follows: 10 % of cash price down. 25 % of cash price at the end of each of the subsequent four half years.

The payment due on 31st December , 2014 could not be made and hence machines were seized by the vendor but, after negotiation, A was allowed to keep the machines on the condition that the value of the other two machines

would be adjusted against the amount due, the machines being valued at cost less depreciation 25%. Accounting books are closed on 30th June each year and he charges 15% of the depreciation on machines on the original cost.

The vendor spent Rs 6,000 on getting the machines thoroughly overhauled and sold them for Rs 95,000. Show the necessary accounts in the books of both the parties.

15.4 LET US SUM UP

In the Instalment Purchase System, both ownership and possession of the goods are immediately transferred from the seller to the buyer at the time of agreement. The buyer agrees to pay the purchase price in fixed instalments over a period of time. Since ownership is transferred upfront, the buyer has full rights over the goods and can sell, transfer, pledge, or even dispose of the goods, subject to the terms of the agreement. However, the buyer is legally bound to pay all the instalments on time.

15.5 GLOSSARY

- **Pledge:** A pledge is a contractual arrangement in which personal property or goods are delivered by a borrower (the pledgor) to a lender (the pledgee) as security for a loan or debt.
- **Instalment:** An instalment is a partial payment of the total amount due, made at regular intervals (monthly, quarterly, etc.) as agreed between the buyer and seller.

15.6 SELF ASSESSMENT QUESTIONS

1. What is instalment purchase system?

2. Give features of instalment purchase system.

3. Pass necessary journal entries in the books of vendor.

15.7 LESSON END EXERCISE

1. Give the treatment of right of disposal under instalment system.

2. What are the journal entries in the system of instalment purchase system.

3. Is there any risk intend in case of instalment purchase system.

15.8 SUGGESTED READINGS

7. S. P. Jain, K. L. Narang

8. Arihant Publications

9. Pratijogitya Darpan

10. Shukla, M.C, Grewal, T.S. Gupta, S.C

11. Maheshwari, S.N. & Maheshwari S.

12. Kishore, R.M.

UNIT - IV**Lesson No. 16****Course No. 101**

INSOLVENCY ACCOUNTS**STRUCTURE**

16.0 Learning Objectives and Outcomes

16.1 Meaning of Insolvent

16.2 Details of insolvency in India

16.3 Details of When a person be declared insolvent

16.4 Meaning of Order of Discharge

16.5 Let Us Sum Up

16.6 Glossary

16.7 Self Assessment Questions

16.8 Lesson End Exercise

16.9 Suggested Readings

16.0 LEARNING OBJECTIVES AND OUTCOMES**Learning Objectives**

- To understand the concept and features of insolvent.
- To identify the conditions and explain the circumstances under which a person may be declared insolvent in India.
- To understand the concept of an order of discharge in insolvency proceedings.

Learning outcomes

- Demonstrate a clear understanding of the concept and features of insolvent.
- Identify and analyze the conditions and circumstances under which an individual may be declared insolvent under Indian law.
- Explain the significance and implications of an order of discharge in insolvency proceedings.

16.1 MEANING OF INSOLVENT

Solvent is one who is not able to pay his liabilities. But in legal sense, the term insolvent can be supplied to a person whose liabilities exceed his assets and against whom an order of adjudication has been passed by competent court.

In accounting terms, insolvency is the **financial condition** where the **net worth is negative**, and the person cannot meet financial obligations. For example: If a person has assets worth ₹2,00,000 but owes ₹5,00,000, they are insolvent by ₹3,00,000.

Under Indian law (e.g., **Provincial Insolvency Act, 1920**), once a person is declared insolvent:

- Their property is handed over to an Official Receiver or Assignee.
- The court supervises the realization and distribution of assets.
- An Order of Discharge may be granted, relieving the person from further liability (with some exceptions).

Features of an Insolvent:

Inability to Pay Debts:

The primary feature of an insolvent person or entity is the inability to pay debts as and when they become due.

Liabilities Exceed Assets:

The total liabilities are greater than the total assets, indicating a negative net worth.

Legal Declaration May Be Required:

A person is officially considered insolvent only when declared so by a court of law,

under insolvency laws.

Loss of Control Over Property:

Once declared insolvent, the ownership and control of the insolvent's property may pass to an official receiver or assignee.

Preparation of Statement of Affairs:

An insolvent person or firm must prepare a statement of affairs, listing all assets at realizable value and all liabilities.

Preparation of Deficiency Account:

A deficiency account is prepared to explain the causes of insolvency, showing how the deficit arose.

Possibility of Discharge:

The court may grant an order of discharge, which releases the insolvent from the legal obligation to repay the remaining debts (except a few excluded ones).

Impact on Creditworthiness:

Insolvency affects a person's reputation and future borrowing capacity, often leading to restrictions on future financial activities.

16.2 DETAILS OF INSOLVENCY IN INDIA

The proceedings taken by the court in case of insolvent person are known as insolvency proceeding. There are two acts dealing with insolvency affairs in India:

1. The presidency towns insolvency act, 1909 which applies to the persons residing in the presidency towns of Mumbai, Kolkata and Chennai.
2. The provincial insolvency act, 1920 which applies to the persons residing in the rest of India (except Mumbai, Kolkata and Chennai)

The insolvency acts mentioned above are applicable to individuals, partnership firms or hindu undivided families. In case of joint stock companies, the term liquidation (and not insolvency) is used and the companies act, 1956 is applicable. There is a significant difference between insolvency and liquidation. Insolvency takes place in

unable to pay its liabilities whereas a liquidation may take place even when a company has sufficient amount to pay its debts.

A.CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. When can a person be declared insolvent?

- A) When their assets are more than liabilities
- B) When they stop working
- C) When they are unable to pay their debts as they become due
- D) When they sell their property

Answer: C)

2. Which of the following is not a cause of insolvency?

- A) Heavy losses in business
- B) Excessive personal drawings
- C) Increase in capital
- D) Misappropriation of funds

Answer: C)

3. Which document explains the reasons for the shortfall between liabilities and assets of an insolvent?

- A) Trial Balance
- B) Profit and Loss Account
- C) Deficiency Account
- D) Balance Sheet

Answer: C)

4. Who has the authority to declare a person as insolvent under Indian law?

- A) Income Tax Department
- B) District or High Court
- C) Police Authority
- D) Ministry of Finance

Answer: B)

Which court has the authority to declare a person as insolvent under the Provincial Insolvency Act, 1920?

- A) Supreme Court
- B) High Court
- C) District Court
- D) Consumer Court

Answer: C)

16.3 DETAILS OF WHEN CAN A PERSON BE DECLARED INSOLVENT

Two conditions must be fulfilled before a person can be declared insolvent by a competent court. The first condition is that he must be a debtor and he must have inadequate assets for repayment in full of his liabilities. The second condition is that he must have committed an act of insolvency. An act of insolvency can be defined as some act of the debtor which shows that he is not in a position to make the full payment off his liabilities. An act of insolvency may take place in any of the following circumstances:

1. When the debtor makes a transfer of all or substantially all of his property to a third person for the benefits of his creditors.
2. When the debtor transfers his property or any part thereof with the intent to defeat or delay his creditors.
3. When the debtor transfers his property for fraudulent preference. Fraudulent preference takes place when the debtor prefers one creditor to another and pays the preferred creditor more than what he would have received had the assets been proportionately distributed among creditors of the debtor. Upon an order of adjudication the preferred creditor will have to return the money received by him.
4. When any of the property of the debtors is sold or attached for a period of

not less than 21 days in execution of the decree of any court. Under the provincial insolvency act, only a sale in execution is an act of insolvency.

5. When the debtors notifies any of his creditors that he has suspended, or that he is about to suspend, payment of his debts.
6. When the debtors petitions the court to be adjudged an insolvent.
7. When the debtor is imprisoned in execution of a court decree for payment of money.
8. If with intent to defraud or delay his creditors;
 - a) The debtor departs from or remains out of India.
 - b) The debtor departs from his dwelling house or usual place of business or

otherwise absents himself.

- c) The debtor secludes himself so as to deprive his creditors of the means of communicating with him.

Legally a person can be called insolvent only if an order of adjudication is passed against him by a competent court. Before the court can pass an order of adjudication, there must be a petition presented to it either by a creditor or creditors can be made only if (1) the debt, singly or jointly, of at least Rs 500 and (2) the debtors commits an act of insolvency within three months of the petition. After presentation of the petition, the court fixes a date for hearing and then it either rejects the petition or makes an order of adjudication.

Under the presidency towns insolvency act, the order of adjudication relates back to the first available act of insolvency and under the provincial insolvency act, its relates back to the date of the presentation for the petition. This doctrine is known as doctrine of relation back. So, the insolvency of a person commences, not from the date when the order of adjudication is passed, but from an earlier date.

The official who is appointed to conduct the insolvency proceedings after the order of adjudication is passed is known as official assignee in presidency towns and official receiver in other places. After the order of adjudication is passed, the

property of the insolvent vests in the official, assignee or receiver who proceeds to realise the assets and distribute the sale proceeds of the assets in the following order:

1. Fully secured creditors
2. Partly secured creditors to the extent they are secured.
3. Realisation expenses and remuneration of the official receiver or assignee.
4. Preferential creditors
5. Unsecured creditors.

B.CHECK YOUR PROGRESS

TRUE/ FALSE

1. A person can be declared insolvent only if a creditor files a petition in court.

False

2. A person is considered insolvent when they are unable to pay their debts as they become due.

True

3. Only individuals can be declared insolvent under Indian law.

False

4. The amount of debt must exceed ₹500 for an insolvency petition to be filed under the Provincial Insolvency Act.

True

5. A person automatically becomes insolvent if they fail to repay a single loan on time.

False

6. A person must have committed fraud to be declared insolvent.

False

16.4 MEANING OF ORDER OF DISCHARGE

After the order of adjudication, the insolvent debtor may apply to the court for an order of discharge, after hearing the insolvent debtor and examining the conduct of the insolvent by the official receiver or assignee, the court may issue an order of discharge which frees the insolvent from his previous debts except to government , debt incurred by fraud and liability of maintenance.

An **Order of Discharge** is a **legal declaration by a court** that releases an insolvent person (also called a debtor or bankrupt) from their **legal obligation to repay most of their debts**. It is typically issued **at the end of insolvency or bankruptcy proceedings**, after the court is satisfied that the debtor has complied with all necessary conditions.

Key Features of an Order of Discharge:

1. Legal Release from Debts:

The discharged person is **no longer legally bound to repay** the debts that existed before the insolvency declaration. It does **not apply to certain types of debts** such as fines, penalties, or maintenance payments (e.g., child support).

2. Issued by a Competent Court:

The **Insolvency Court** issues the order after examining whether the debtor has acted honestly and cooperated during the process.

3. **Timing:**

The order is usually granted **after the completion of insolvency proceedings**, such as liquidation of assets and settlement (as far as possible) of creditor claims.

4. **Effect on Creditors:**

Once discharged, creditors **cannot take legal action** to recover debts covered under the order.

5. **Restores Legal Status:**

The debtor's **legal capacity is partially or fully restored**, and they may regain the right to manage business or financial matters, depending on the laws of the jurisdiction.

Conditions for Granting a Discharge:

The court may grant the order **only if** the insolvent person:

- Has **disclosed all assets and liabilities honestly**.
- Has **not committed any fraud or misconduct** during the insolvency.
- Has **followed the insolvency process properly**, including asset surrender and cooperation with the official assignee or insolvency professional.

C.CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTIONS

1. What is an Order of Discharge in insolvency?

- A) A notice to creditors
- B) A court order releasing the insolvent from liability for unpaid debts
- C) An order to sell the debtor's assets
- D) A permission to declare insolvency

Answer: B)

2. Who issues the Order of Discharge in insolvency cases?

- A) Official Receiver
- B) Registrar of Companies

- C) Civil Court
- D) Insolvency Court

Answer: D)

3. An Order of Discharge:

- A) Makes the insolvent pay all remaining debts
- B) Dismisses the insolvency petition
- C) Legally frees the insolvent from most debts incurred before insolvency
- D) Transfers assets to the government

Answer: C)

4. Which of the following debts is not discharged by an order of discharge?

- A) Private loan from friends
- B) Trade creditors
- C) Government taxes and fines
- D) Credit card bills

Answer: C)

5. When is an Order of Discharge usually granted?

- A) Immediately after insolvency petition is filed
- B) After the debtor completes all required formalities and shows good conduct
- C) Before creditors are paid
- D) When the debtor's assets are fully recovered

Answer: B)

16.5 LET US SUM UP

An **insolvent** is a person or entity that is **unable to pay their debts** as and when they become due. Insolvency can arise due to poor financial management, business losses, excessive borrowing, or unexpected expenses. Insolvency Act is applied to individual person.

16.6 GLOSSARY

Insolvent

A **person or entity** who is **unable to pay their debts** as they become due.

Insolvency

The **financial state or condition** where a person or business cannot meet debt obligations due to insufficient assets or liquidity.

Order of Discharge

A **legal order issued by an insolvency court that releases an insolvent person** from liability to repay debts incurred before the declaration of insolvency (except certain debts like government dues).

Statement of Affairs

A financial statement prepared by the insolvent showing all **assets (at realizable value)** and **liabilities**, to determine the extent of insolvency and what can be paid to creditors.

Deficiency Account

A statement that **explains the shortfall** between an insolvent's assets and liabilities. It shows how the deficiency arose (e.g., losses, bad debts, drawings).

16.7 SELF ASSESSMENT QUESTIONS

1. Who is Insolvent ?

2. To whom this Insolvency Act applies.

3. What is order of discharge in Insolvency Act ?

16.8 LESSON END EXERCISE

1. What is presidency towns Insolvency Act, 1909
2. What is provisional Insolvency Act, 1920.
3. Who is debtor.
4. What do you understand by the term insolvent.

16.8 SUGGESTED READINGS

1. S. P. Jain, K. L. Narang
2. S.N. Maheshwari & S.K. Maheshwari
3. T.S. Grewal
4. M.C. Shukla, T.S. Grewal & S.C. Gupta
5. N.D. Kapoor

UNIT - IV

Lesson No. 17

Course No. 101

STATEMENT OF AFFAIRS

STRUCTURE

- 17.0 Learning Objectives and Outcomes
- 17.1 Meaning of Interest
- 17.2 Meaning of Voluntary Transfers
- 17.3 Meaning of Doctrine of Reputed Ownership
- 17.4 Detailed format of Statement of Affairs with all the lists.
- 17.5 Difference between balance sheet and statement of affairs
- 17.6 Let Us Sum Up
- 17.7 Glossary
- 17.8 Self Assessment Questions
- 17.9 Lesson End Exercise
- 17.10 Suggested Readings

17.0 **LEARNING OBJECTIVES AND OUTCOMES**

Learning Objectives

- To understand the concept of interest.
- To define and explain voluntary transfers.
- To interpret the doctrine of reputed ownership.
- To learn how to prepare a statement of affairs, including all required lists.
- To distinguish between a balance sheet and a statement of affairs.

Learning Outcomes

- Demonstrate a clear understanding of the **concept of interest**.
- Accurately **define and explain voluntary transfers** and their legal implications.

- Effectively **interpret the doctrine of reputed ownership.**
- **Prepare a comprehensive statement of affairs,** including all the required lists
- **Differentiate between a balance sheet and a statement of affairs**

17.1 MEANING OF INTEREST:

Creditors can claim interest on their debts up to the date of the order of adjudication. If the property of the debtor is sufficient to make the payment of creditors in full and a surplus exists, interest will be paid to the creditors for the period after the order of adjudication at the rate of 6 % p.a.

In financial accounting, **interest** refers to the **cost of borrowing money** or the **income earned on investments or savings**. It is usually expressed as a percentage of the principal amount and is paid over a specific period of time.

Types of Interest:

1. **Interest Expense** – Paid by a business on borrowed funds (e.g., loans, debentures).
2. **Interest Income** – Earned by a business on its investments or deposits.

Examples:

1. **Interest Expense:**

A company takes a loan of ₹1,00,000 at an interest rate of 10% per annum.

→ **Interest = ₹10,000 per year**

→ This ₹10,000 is recorded as **interest expense** in the Profit & Loss Account.

2. **Interest Income:**

A company deposits ₹50,000 in a fixed deposit account earning 8% interest.

→ **Interest = ₹4,000 per year**

→ This ₹4,000 is recorded as **interest income** in the Profit & Loss Account.

In accounting, interest is important for determining the true cost of finance and the return on investments.

17.2 MEANING OF VOLUNTARY TRANSFERS:

If a person transfers his property to another without consideration, it is called Voluntary transfer. Under the presidency towns insolvency act, all voluntary transfers of property made by the insolvent without consideration during two years preceding the order of adjudication shall be void and inoperative and in case of provincial insolvency act, such transfers are voidable and not void as against the receiver and may be annulled by the court. But voluntary transfers made by the insolvent will not be void in the following cases:

- a) When the transfer is made before and in consideration of marriage, and
- b) When the transfer is made in favour of a purchase or encumbrance in good faith and for valuable consideration.

Features of Voluntary Transfers

1. **Made Without Adequate Consideration:** The transfer is done without receiving fair value or full payment in return.
2. **Done Willingly by the Debtor:** It is not forced by any legal obligation or creditor — the debtor acts voluntarily.
3. **Usually to Close Relatives or Friends:** These transfers often involve gifting or undervalued sales to known persons.
4. **Can Be Declared Void by Court:** If made within a specific period before declaring insolvency, the court may reverse the transfer.

5. **Affects Creditors' Rights:** It reduces the available assets for settling debts, hence considered unfair to creditors.
6. **Subject to Legal Scrutiny:** All such transfers are reviewed carefully during insolvency proceedings.

17.3 MEANING OF DOCTRINE OF REPUTED OWNERSHIP

According to this doctrine, goods in the possession, order or disposing of a trading insolvent in his business with the consent of their true owner and under the circumstances the trader insolvent appears to be their true owner will be treated as assets of the insolvent for distribution to his creditors. According to this doctrine, **if an insolvent person is in possession of goods in such a way that it appears to the outside world (creditors) that he is the owner**, then those goods may be treated as part of the insolvent's property even if they were legally owned by someone else unless the true ownership is clearly disclosed. This is done to **protect creditors**, who may have relied on the apparent ownership while extending credit. For example: Mr. A owns a shop but borrows goods from Mr. B to display and sell in his shop. He does not disclose to customers or creditors that the goods belong to Mr. B. Creditors may assume the goods are Mr. A's property. Under the doctrine, those goods may be treated as **assets of Mr. A** during insolvency. The doctrine does not apply in the following cases:

1. Immovable properties.
2. Goods which were in the possession of the insolvent as repairer or carrier.
3. Goods in the possession of the insolvent as trustee or administrator.

Features of the Doctrine of Reputed Ownership:

1. **Possession with the Insolvent:** The property or goods must be physically held or possessed by the insolvent at the time of adjudication.

2. **Appearance of Ownership:** The possession must create a reasonable belief among outsiders (especially creditors) that the insolvent is the real owner.
3. **Consent of the Real Owner:** The true owner must have voluntarily allowed the insolvent to possess the goods without proper disclosure of ownership.
4. **No Public Notice or Disclosure:** The actual ownership is not made public through labeling, agreement, or documentation, leading to a false impression of ownership.
5. **Protects Creditors' Interests:** This doctrine is applied to prevent deception and to ensure that creditors are not misled by the debtor's apparent financial status.
6. **Applies in Insolvency Proceedings:** It is relevant only when the person is declared insolvent and affects the distribution of assets among creditors.
7. **Assets Treated as Part of Insolvent's Estate:** Goods under the doctrine may be considered part of the insolvent's property and can be sold to satisfy debts.

In a nut shell, the Doctrine of Reputed Ownership ensures that assets visibly in the hands of the insolvent are not unfairly shielded from creditors through undisclosed third-party claims. It reinforces transparency and fairness in insolvency proceedings.

B. CHECK YOUR PROGRESS

MULTIPLE CHOICE QUESTION

1. Which of the following best defines "interest" in financial accounting?
 - A. Tax paid on income
 - B. Cost of borrowing or income from lending money
 - C. Fine imposed for late payment
 - D. Discount on early payment

Answer: B

2. When is interest usually recorded as an expense in accounting?
 - A. When a sale is made
 - B. When inventory is purchased
 - C. When a loan is taken and interest is paid on it
 - D. When capital is increased

Answer: C

3. A voluntary transfer is a transfer made:

- A. Under court order
- B. By a creditor to the debtor
- C. Without adequate consideration and willingly
- D. With full payment in return

Answer: C

4. Which of the following is a valid example of a voluntary transfer?

- A. Sale of goods at market price
- B. Gift of property to a friend before insolvency
- C. Payment of employee salary
- D. Purchase of raw material

Answer: B

5. The Doctrine of Reputed Ownership applies when:

- A. The debtor owns all assets in their name
- B. The debtor has no possession of any goods
- C. Goods in debtor's possession appear to be owned by them, though legally not
- D. A court orders the sale of debtor's assets

Answer: C

6. What is the main objective of the Doctrine of Reputed Ownership?

- A. To transfer ownership of all goods to creditors
- B. To protect the debtor's relatives
- C. To safeguard creditors from misleading asset positions
- D. To increase the debtor's profit

Answer: C

17.4 DETAILED FORMAT OF STATEMENT OF AFFAIRS WITH ALL THE LISTS

Upon being adjudicated the insolvent has to submit a statement of affairs as on the date of order and a deficiency account

Form of the statement of affairs prescribed by rules made under the presidency towns insolvency act is given below. Under the provincial insolvency act, there is no provision for the submission of a statement of affairs to be submitted under the presidency towns insolvency act.

Statement of affairs

(as required by the Indian insolvency act)

IN THE COURT OF JUSTICE

In insolvency

To the insolvent , —— You are required to fill up carefully and accurately, this sheet and the several sheets, A,B,C,D,E,F,G and H , showing the s tate of affairs on the day on which the order of adjudication was made against you Viz.; the day of 20

Such sheets, when filled up will constitute your schedule and must be verified by oath or declaration.

Gross liabilities	Liabilities (as stated and estimated by the debtors)	Expected to rank	Assets (as stated and estimated bythe debtors)	Expected to produce
	Unsecured creditors as per list A Fully secured creditors as per list B Less: estimated value of securities Less: amount thereof carried to list C Balance thereof contra Partly secured creditors as per list C Less: estimated value of securities Preferential creditors as per list D (Creditors for rent, taxes, salaries and wages, etc.) payable in full as per contra		Property as per List E, viz Cash at bankers Cash in hand Cash deposited with solicitor for cost of petition Stock in trade Machinery Trade fixtures, fittings, utensils, etc. Furniture Life policies Other property Book debts as per list F, viz; Good Doubtful Bad	

			<p>Estimated to produce Bills of exchange or other similar securities on hand as per list G</p> <p>Estimated to produce Surplus from securities in the hands of creditors fully secured as per contra</p> <p>Deduct: Creditors for preferential rent, rates, taxes, wages, etc. (per contra)</p> <p>Deficiency as per list H</p>	
--	--	--	--	--

I/We make oath, solemnly affirm, and say, that the above statements and the several lists hereunto annexed marked A, B, C, D, E, F, G and H are to the best of my/ our knowledge and belief, a full and complete of my/our affairs on the date of the above mentioned order of adjudication made against me/us.

Affirmed

at, thisday of sworn before commissioner
(signature)

the statement of affairs like balance sheet is divided in the two parts , namely liabilities and assets. Liabilities of the insolvent debtor are classified into four lists as follows:

Unsecured creditors as per list A:

This list will include all creditors who have no security to fall back upon in case of non- payment of their dues, e.g., trade creditors, bills payable, bank overdraft, Mrs. Loan out of her stridhan, amount payable on account of bills discounted likely to be dishonoured, any other loan which is not secured and non- preferential amount for wages, salaries, rent, etc.

Loan from wife: a loan from wife is usually assumed to be given from her personal property i.e., stridhan. Such type of loan is treated like other loans taken and makes wife a creditor of the insolvent. If it is proved that loan has been given by wife out of the money given to her husband, then her position is not like other creditors and loan will not be included in the list of creditors. In such a case, loan is taken as the capital of the insolvent.

Interest: Interest is not allowed to a creditor after the date of insolvency. But if all claims have been paid in full, then interest at 6 % p.a. is allowed up to date of payment.

Fully secured creditors as per list B:

This list will include all those creditors who have sufficient of the insolvent debtor to meet their claims. Any surplus of securities in the hands of fully secured creditors after meeting their claims if not otherwise charged, will be shown on the assets side of the statement of affairs and will be available for distribution among the unsecured creditors.

Partly secured creditors as per list C:

These creditors are not fully secured and have insufficient securities to meet their claims. The unsatisfied amount of these creditors is written in the expected to rank column like unsecured creditors because they are to rank for dividend for the unsatisfied amount.

Preferential creditors for rent, rates, taxes, and wages as per list D:

Such creditors get preference over other unsecured creditors, so they are known as preferential creditors. By law the following are the preferential creditors:

- a) All debts due to government or any local authority, e.g., taxes.
- b) The salary of any clerk or wages of any servant or labourer in respect of the services rendered to the insolvent during four months preceding the date of the presentation of the insolvency petition, subject to the following limits:
 - i) Under the presidency towns insolvency act- Rs 300 for such clerk and Rs 100 for each such servant or labourer.
 - ii) Under the provincial insolvency act – Rs 20 for each such clerk , servant or labourer.
- c) One month's rent due to the landlord is preferential in the presidency towns insolvency act. Rent is not at all preferential in the provincial insolvency act.

Assets of the insolvent debtor shown in the statement of affairs have also been grouped into four lists as follows:

Property as per list E

All assets except book debts, bill of exchange in hand and assets kept as securities with the fully secured or partly secured creditors are included in this list.

Book debts as per list F:

The book debts are divided into three parts as follows: good, doubtful and bad.

Bill of exchange or other similar securities in hand as per list G

Deficiency account as per list H which shows the insolvent debtor is not able to pay to his creditors.

POINTS TO BE NOTED WHILE PREPARING THE STATEMENT OF AFFAIRS

1. While preparing the statement of affairs of an individual ,no distinction should

be observed between business assets and liabilities and private assets and liabilities. In other words, private assets and liabilities of the insolvent of the insolvent debtor are treated in the same way as assets and liabilities of the

business are treated. But a distinction is observed between assets and liabilities of the partnership firm and private assets and liabilities of the partners. Private assets of the partners are first utilised for making the payment of private liabilities, and if there is a surplus after meeting private liabilities, it can be utilised to pay the firm's liabilities and is included in property as per list E.

2. All the property of the insolvent debtor [excluding the tools of his trade, the necessary wearing apparel , bedding, cooking utensils (the total value of all these things exceeding Rs 300 will be included in case of the presidency towns insolvency act), properties held by him in trust for others and all stridhan is shown on the assets side of the statement of affairs. Assets mortgaged with fully or partly secured creditors are not shown on the assets side. Only surplus left in the hands of fully secured creditors after meeting their claims is shown on the assets side after list G unless the surplus is to be used for paying partly secured creditors.
3. The amount of fully secured creditors is not shown in the expected to rank column on the liabilities side because such creditors are not to rank for dividend.
4. The amount of fully secured creditors is shown in the inner column from which the estimated value of securities is deducted and the unsecured balance of such creditors is shown in expected to rank column on the liabilities side.
5. The amount of the preferential creditors is deducted from the assets side after taking the total of its lists E, F and G because such creditors are paid before the unsecured creditors.
6. Contingent liabilities expected to rank e.g., bills discounted to be dishonoured are included in unsecured creditors as per list A.

B. CHECK YOUR PROGRESS

FILL IN THE BLANKS

• A **Statement of Affairs** is prepared during _____ to show the financial position of the debtor.

Ans: insolvency

• The Statement of Affairs is supported by _____ **lists**, labeled from A to H.

Ans: eight

• **List A** contains details of **assets specifically pledged** or mortgaged to secured creditors.

Ans: pledged

• **List F** includes information about _____ **unsecured creditors**, such as trade creditors and bills payable.

Ans: unsecured

• The difference between total assets and total liabilities in the Statement of Affairs represents the _____ **or deficiency** to be shown to the Official Receiver.

Ans: surplus

17.5 DISTINGUISH BETWEEN STATEMENT OF AFFAIRS AND BALANCE SHEET

S.No.	Balance Sheet	Statement of Affairs
1	It shows assets at book value	It shows assets at book value as well as realisable value
2	It shows fictitious assets such as goodwill, prepaid expenses	It does not show such items.
3	No such classification is usually found in a balance sheet.	Creditors are classified as unsecured, fully secured creditors, partly secured creditors and preferential creditors.
4	It gives information about capital, profit or loss, drawings and interest on capital	It excludes all such items.
5	It is prepared usually at the end of each accounting period	It is prepared on the date on which order of adjudication is passed against the debtor
6	A balance sheet of an individual or a	It is prepared according to the rules

	partnership firm is not prepared according to any act	given in the insolvency acts.
7	It does not show such a figure	It shows the amount of deficiency which the solvent debtor is not able to pay to his creditors
8	It shows the assets and liabilities of a business as a going concern	It is prepared on the liquidation of the business of an insolvent and shows assets at realisable values and liabilities at their payable values.

C. CHECK YOUR PROGRESS

TRUE/FALSE

- A **Statement of Affairs** is prepared to show the financial position of a business under normal operating conditions.

False

- A **Balance Sheet** records actual values of assets and liabilities.

True

- A **Statement of Affairs** includes estimated realizable values of assets.

True

- Both **Balance Sheet** and **Statement of Affairs** are prepared using the double-entry accounting system.

False

- A **Balance Sheet** is a legal requirement under the Companies Act, while a **Statement of Affairs** is used in insolvency cases.

True

17.6 Let Us Sum Up

Interest in financial accounting refers to the cost of borrowing or the income from lending

money, and it plays a crucial role in determining financial obligations and returns. Voluntary Transfers are transfers of property made without fair value or adequate consideration, often just before insolvency. Such transfers may be declared void by the court if they appear to be made to defraud creditors. The Doctrine of Reputed Ownership holds that goods in the possession of the insolvent, which appear to be owned by them but are legally owned by someone else (without proper disclosure), may be treated as part of the insolvent's estate to protect creditors' interests. A Statement of Affairs is a detailed statement that shows the financial position of an insolvent person or business, listing assets, liabilities, and expected outcomes for creditors. It includes several supporting lists (A to H). Finally, we distinguished between a Balance Sheet (used in normal accounting to show financial position) and a Statement of Affairs (used during insolvency to show estimated realizable values and claims).

17.7 GLOSSARY

Interest: The cost of borrowing money or the income earned from lending funds, usually expressed as a percentage.

Voluntary Transfers: Transfers of property made by a debtor without receiving adequate consideration, often scrutinized during insolvency.

Doctrine of Reputed Ownership: A legal principle where goods in the debtor's possession, appearing as owned by them, may be treated as part of their assets in insolvency.

Statement of Affairs: A financial statement showing the estimated realizable value of assets and liabilities during insolvency, supported by detailed lists (A to H).

Balance Sheet: A Balance Sheet is a financial statement that shows the financial position of a business at a specific point in time. It presents the company's assets, liabilities, and capital (owner's equity)

17.8 SELF ASSESSMENT QUESTIONS

1. What is doctrine of reputed ownership

2. Give format statement of affairs

3. Who is unsecured creditors.

17.9 LESSON END EXERCISE

1. Who is partly secured creditor.
2. Define Voluntary Transfers.
3. What is Doctrine of Reputed Ownership?
4. What is a Statement of Affairs? Describe its format and explain the purpose of each list (A to H).
5. Give classification of book debts.
6. Distinguish between statement of affairs and Balance Sheet.

17.10 SUGGESTED READINGS

6. S. P. Jain, K. L. Narang
7. S.N. Maheshwari & S.K. Maheshwari
8. T.S. Grewal
9. M.C. Shukla, T.S. Grewal & S.C. Gupta
10. N.D. Kapoor

UNIT - IV**Lesson No. 18****Course No. 101**

INSOLVENCY ACCOUNTS**STRUCTURE**

- 18.0 Learning Objectives and Outcomes
- 18.1 Introduction
- 18.2 Difference between presidency town insolvency act and provincial insolvency act
- 18.3 Format of deficiency account as per list H
- 18.4 Insolvency of partnership firms
- 18.5 Let Us Sum Up
- 18.6 Glossary
- 18.7 Self-Assessment Questions
- 18.8 Lesson End Exercise
- 18.9 Suggested Readings

18.0 LEARNING OBJECTIVES AND OUTCOMES**Learning Inputs**

This Chapter will enable the students to:

- Study of two historical insolvency laws in India: Presidency Towns

Insolvency Act, 1909 and Provincial Insolvency Act, 1920.

- Understanding the preparation and purpose of a Deficiency Account
- Insights into Partnership Firm Insolvency, covering joint and personal estate treatment.

Learning Outcomes

By the end of these topics, learners will be able to:

- Differentiate between the presidency town and provincial insolvency acts in terms of jurisdiction, court authority, and procedures.
- Prepare a Deficiency Account as per List H, reflecting how debtor becomes insolvent.
- Explain the process and implications of insolvency in partnership firms, including how joint and separate estates are treated.

18.1 INTRODUCTION

Insolvency, in legal and financial terms, refers to a state where an individual or a business entity is unable to meet its financial obligations as and when they become due. This financial failure affects not only the debtor but also the rights of creditors, investors, and other stakeholders. In India, prior to the enactment of the Insolvency and Bankruptcy Code (IBC), 2016, insolvency laws were governed by two separate legislations: the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920. These laws, though now repealed, formed the backbone of the insolvency framework in India for over a century and were primarily concerned with personal and partnership insolvency (not corporate insolvency).

The Presidency Towns Insolvency Act, 1909 applied to the three presidency towns — Bombay (now Mumbai), Calcutta (now Kolkata), and Madras (now Chennai). It provided a more formal and complex legal process, with High Courts acting as the insolvency courts and appointing official assignees. On the other hand, the Provincial Insolvency Act, 1920 governed insolvency cases in the rest of British India through District Courts, with official receivers handling the administration of insolvent estates. Although both acts aimed at the equitable distribution of the debtor's property among creditors, their procedures, terminologies, and jurisdictions differed significantly.

An important part of the insolvency procedure under both acts was the preparation of a Deficiency Account, also known as List H. This account traced the financial deterioration of the debtor's estate leading up to insolvency. It explained how the debtor's assets became insufficient to meet the liabilities. It typically included items such as business losses, personal drawings, bad debts, household expenses, and loss on realization of assets. The objective of this account was to provide a transparent view of the debtor's past financial conduct and to justify the deficiency in the debtor's estate.

The complexity increases in the case of partnership firms. Under Indian insolvency law, a firm is not a separate legal entity from its partners. Therefore, when a partnership firm is declared insolvent, the process includes the insolvency of both the joint estate of the firm and the separate estates of individual partners. The law mandates that the firm's assets are first used to pay firm debts, and the partners' personal assets are used to pay

their individual liabilities. However, if there is a surplus or deficiency in either estate, it can be adjusted against the other, depending on legal priorities. Partners are considered jointly and severally liable for firm debts, meaning creditors can claim dues from both the firm and the personal assets of any partner.

18.2 DIFFERENCE BETWEEN PRESIDENCY TOWN INSOLVENCY ACT AND PROVINCIAL INSOLVENCY ACT

S.No.	Presidency towns insolvency act	Provincial insolvency act
1	This act was enacted in 1909	This act was enacted in 1920
2	This act applies to the persons residing in the towns of Mumbai, Kolkata and Chennai.	This act applies to the persons residing in the rest of India.
3	Under this act, maximum limit of preferential amount of a clerk is Rs 300 and of a servant or labourer Rs 100	Under this act the maximum limit of preferential amount per clerk per servant and per labourer is Rs 20
4	One month's rent due to the landlord is preferential under this act.	Rent is not at all preferential under this act.
5	Under this act domestic goods up to the value of Rs 300 are left with the insolvent.	Under this act, only those assets are left with the insolvent which have been exempted under the code of civil procedure, 1908

A. CHECK YOUR PROGRESS

Fill in the Blanks

- The Presidency Towns Insolvency Act was applicable only to _____, _____, and _____.
- The Provincial Insolvency Act, 1920, applied to the rest of _____.

6. Insolvency

Excess of assets over liabilities , i.e. capital			
Net profit arising from carrying on of business after deducting usual			

t trade expenses Income
or profit from other sources e.g.,

Excess of liabilities over assets

Net loss arising from carrying on of business after deduction from profits, usual trade expenses Bad debts as per list F

Income or profit from other sources e.g., interest on capital Excess of private assets over private liabilities profit on realisation of any asset Deficiency as per statement of affairs as per list H		Expenses incurred since..... other than usual trade expenses, viz, Household expenses (drawings) Other losses: Loss on realisation of assets Loss through dishonour of discount of bills Speculation loss Loss through betting Excess of private liabilities over private assets, etc.	
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From the above specimen, it is clear that on the debit side the capital and all other items (i.e; profits) that increase capital are shown and on credit side all losses and drawings are written. The differences between the two sides is deficiency as shown in the statement of affairs. The deficiency arises because losses and drawings outweigh capital and profits.

B. CHECK YOUR PROGRESS

Case Study

Background: Ms. Kavita owned a small bakery. She started her business with a capital of ₹2,00,000. Over the years, she faced losses due to rising ingredient costs and declining sales. She also withdrew ₹50,000 for household expenses. At the time of declaring insolvency, her business had suffered a total loss of ₹1,00,000, and she

had ₹30,000 in bad debts. Her assets could only realize ₹40,000, while she owed ₹2,40,000 to creditors.

♦ **Deficiency Account (List H):**

Particulars	Amount (₹)
Capital at start	2,00,000
Less: Business Loss	(1,00,000)
Less: Drawings	(50,000)
Less: Bad Debts	(30,000)
Total Deficiency	1,80,000

Questions:

1. What was the initial capital invested by Ms. Kavita?
2. How much did she withdraw for household expenses?
3. What was the total deficiency as shown in her deficiency account?

18.4 INSOLVENCY OF PARTNERSHIP FIRMS

While attempting the problems relating to insolvency of individuals the students must have noticed that no distinction was observed between business assets and liabilities and private assets and liabilities. Both were treated alike for the preparation of the statement of affairs. But this is not in the case of insolvency of partnership firms and a distinction is observed between the assets and liabilities of the partnership firm and private assets and liabilities of the partners. The assets of the firm are used first for paying liabilities of the firm and if a surplus remains after paying the firm's liabilities, a partner can use his share of the surplus for the payment of his private liabilities. In the same way, private assets of the individual partners are first utilised for the payment of their individual private liabilities and if there is a surplus in any partner's private

estate, it shall be treated as part of the partnership property and can be utilised for the payment of firm's liabilities.

Separate statement of affairs and deficiency accounts are prepared for the partnership firm and for each of the partners. Surplus from the private estates of the partners is transferred to the firm's statement of affairs and is shown in property as per list E. It is also shown in the deficiency account as income from other sources. But the private deficiency of a partner is not transferred to the firm's statement of affairs and deficiency account because firm's assets are used first for the payment of firm's liabilities.

Another point of importance in case of insolvency of partnership is that if a creditor of the partnership firm has taken some private property of the partner as security, then such a private asset will not be considered a security for ascertaining the nature of the creditor, whether fully secured or partly secured. The reason for doing so is that such creditor should try to get first whatever he can from the firm and for the remaining unpaid balance (not paid by the firm), he should sell the private property of the partner held by him. Suppose, there is a bank overdraft of Rs 50,000 against the firm secured by the mortgage of A's house worth Rs 30,000. The total creditors including bank overdraft who are to rank for dividend are Rs 450,000 and the total available from the realisation of assets is Rs 270,000. The bank will get from the firm $\text{Rs } 270,000 / 450,000 \times \text{Rs } 50,000 = \text{Rs } 30,000$ and for the remaining unpaid amount of Rs 20,000 (Rs 50,000 - Rs 30,000), the bank will sell the house of A and realise Rs 30,000. The bank will keep Rs 20,000 for the recovery of its unpaid amount by the firm and give the balance of house to the official assignee or receiver for the payment of A's private liabilities.

C. CHECK YOUR PROGRESS

True and False

1. A partnership firm is considered a separate legal entity from its partners during insolvency proceedings.
2. In partnership insolvency, joint estate is used first to pay the firm's debts.
3. Personal debts of a partner are paid using the joint estate of the firm.
4. If the joint estate is insufficient, the unpaid firm creditors can claim from the partners' separate estates.
5. A single insolvency petition can be filed for both the partnership firm and its partners.

Answers:

- | | | |
|----------|---------|----------|
| 1. False | 2. True | 3. False |
| 2. True | 4. True | |

18.5 LET US SUM UP

The Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 were two major legislations that governed insolvency in India before the introduction of the Insolvency and Bankruptcy Code (IBC), 2016. These two acts laid down the procedures for declaring a person or a partnership firm as insolvent. The Presidency Towns Act was applicable to the major cities of Bombay (Mumbai), Calcutta (Kolkata), and Madras (Chennai), and cases under this act were handled by the High Courts. On the other hand, the Provincial Insolvency Act applied to the rest of British India and was administered by the District Courts.

Both acts dealt with the insolvency of individuals as well as partnership firms, and they provided rules for the administration of assets, appointment of officers (Official Assignee or Official Receiver), and distribution of property among creditors. The concept of joint and separate estate in the case of partnership insolvency played an important role in determining how the liabilities were settled.

The Deficiency Account (List H) was used to explain how the financial loss occurred and how the debtor's liabilities came to exceed their assets. Overall, these acts provided a detailed legal framework for managing insolvency in a fair and systematic manner, ensuring that both the debtor's situation and the creditor's rights were balanced.

These older laws have now been repealed, and the IBC, 2016 provides a modern, unified approach to insolvency for individuals, firms, and companies alike.

18.6 GLOSSARY

- **Insolvent:** A person or firm whose liabilities exceed their assets and is unable to pay debts: Declared legally unable to meet financial obligations.
- **Official Assignee:** Officer appointed under the Presidency Towns Insolvency Act: Responsible for taking control of the insolvent's property and distributing it among creditors.
- **Official Receiver:** Officer appointed under the Provincial Insolvency Act: Similar to the Official Assignee but appointed in districts outside Presidency Towns.
- **Deficiency Account (List H):** A financial statement prepared during insolvency proceedings: Shows how the debtor's liabilities exceeded their assets and explains the reasons for the financial shortfall.
- **Joint Estate:** Assets that belong jointly to a partnership firm: Used to pay the firm's joint liabilities before addressing individual debts of partners.
- **Separate Estate:** Property owned individually by a partner in a firm: Used to satisfy the personal debts of that partner after the joint debts have been settled.
- **Adjudication:** Legal declaration of insolvency by the court: Marks the official beginning of the insolvency process.
- **Discharge:** Court order releasing the insolvent from legal responsibility for certain debts: Granted after satisfying conditions laid down in insolvency laws.
- **Proof of Debt:** Process by which creditors submit claims to the Official Assignee or

Receiver: Ensures that valid debts are recognized and paid out of available assets.

18.7 SELF ASSESSMENT QUESTION

1. Distinguish between presidency and provincial town Insolvency Acts.

2. Give format of deficiency A/c.

**

3. Give short note on Insolvency of Partnership firms.

18.8 LESSON END EXERCISE

1. What is speculation loss.
2. Give details of clerk salary and wages of labour under Insolvency Act.
3. What is the purpose of preparing Deficiency A/c.

18.9 Suggested Readings

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan

- Maheshwari, S.N. & Maheshwari S.
- 1. Kishore, R.M.
- 2. Pillai, R.S.N, Bagavathi & Uma, S.

UNIT - IV

Lesson No. 19

Course No. 101

ACCOUNTING TREATMENT OF INSOLVENCY ACCOUNTS

STRUCTURE

- 19.0 Learning Objectives and Outcomes
- 19.1 Practical Problems of Insolvency Accounts
- 19.2 Practice Theory Questions
- 19.3 Let Us Sum Up
- 19.4 Glossary
- 19.5 Self-Assessment Questions
- 19.6 Lesson End Exercise
- 19.7 Suggested Readings

19.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

This chapter will enable the students to:

- Prepare the Statement of Affairs and Deficiency Account for insolvent individuals or firms.
- Learn the treatment of various assets and liabilities in insolvency

cases.

- Understand the implications of insolvency on debtors and creditors.

Learning Outcomes

After studying this chapter, students will be able to:

- Accurately prepare insolvency accounts including Statement of Affairs and Deficiency Account.
- Analyze causes of business failure through the preparation of a Deficiency Account.

19.1 INTRODUCTION

In the course of business, sometimes a person or a firm is unable to pay their debts as they become due. This financial condition is termed as *insolvency*. Insolvency affects not just the insolvent individual or firm, but also the creditors and other stakeholders. To assess the financial position of an insolvent entity, special statements are prepared such as the Statement of Affairs and the Deficiency Account.

These statements help in understanding the value of assets realizable during insolvency and the extent of shortfall or deficiency suffered by the creditors. The rules and procedures for preparing insolvency accounts vary for individuals, firms, and companies, and are guided by specific laws like the Insolvency and Bankruptcy Code (IBC), 2016, and earlier laws such as the Presidency Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920.

This chapter focuses on the accounting treatment in case of insolvency of individuals and partnership firms, including preparation of essential statements, classification of creditors, and realization of assets.

19.2 PRACTICAL PROBLEMS

- Calculate the amount of preferential and unsecured creditors from the following figures pertaining to an insolvent debtor according to presidency towns insolvency act and provincial insolvency act.

Sales tax	Rs 25,000	Wages of 2 Servants for 4 months	Rs 800
Income tax	Rs 15,000	Wages of 5 labourers for 3 months	Rs 3,000
Municipal tax	Rs 5,000	Salary of the manager	Rs 5,000
4 months' rent due to landlord	Rs 20,000	Salary of 2 clerks for 4 months	Rs 2,400

Solution :-

Statement showing the calculation of preferential creditors and unsecured creditors

Amount due (in Rs)	Particulars	Under presidency insolvency act		Under provincial insolvency act	
		Preferential creditors	Unsecured creditors	Preferential creditors	Unsecured creditors
25,000	Sales tax	25,000	-	25,000	-
15,000	income tax	15,000	-	15,000	-
5,000	Municipal tax	5,000	-	5,000	-
20,000	4 months rent due to landlord	5,000	15,000	-	20,000
800	Wages of 2 servants for 4 months				
3,000	Wages of 5 labourers for 3 months	200	600	40	760
5,000	Salary of the manager				
2,400	Salary of 2 clerks for 4 months	500	2,500	100	2,900
		-	5,000	-	5,000
		600	1,800	40	2,360
76,200	Total	51,300	24,900	45,180	31,020

- From the following ascertain the creditors to be shown under list A and list D:

Creditors on open account	Rs 55,000	
B/R discounted (expected to rank Rs 3,000)		Rs 9,000
Bills payable	Rs 10,500	

Creditor having lien on stock		Rs 8,000
Bills of exchange	Rs 4,000	
Stock (estimated to produce)	Rs 6,000	
Income tax payable		Rs 550
Creditors for salaries and wages (preferential Rs 600)		Rs 2,200

Solution:

Unsecured creditors as per list A			
Creditors on open account		Rs 55,000	
B/P		Rs 10,500	
Creditors for salaries and wages over			
and above Preferential limits (Rs 2,200 – Rs 600)	Rs 1,600		
Liability on bills discounted		Rs 3,000	
Creditors for rent, taxes, wages, etc. payable in full as per list D		Rs. 70,100	
Creditors for salaries and wages		Rs 600	
Income tax payable		Rs 550	
		Rs 1,150	
2. Mr. Seth of Mumbai finds himself insolvent on 31 st December, 2013. His position was on follows:			
	Rs		Rs
Cash in hand	300	Bills Payable	28,000
Bills of exchange	4,800	Bank overdraft	12,000
Debtors : Good	8,000	Liability on bills discounted	10,000
Doubtful (estimated to realise 80%)	2,400	(estimated to rank Rs 6,000)	
Bad	1,000	Creditors secured by life policy (worth Rs 8,000)	13,000
Furniture (Estimated to		Household utensils	300

realise Rs 5,000)	7,000	Life policy not changed	6,000
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Machinery (estimated to produce Rs 41,000)	50,000
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Stock in trade (estimated to realise Rs 32,000)	Rs 40,000
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Household debts	Rs 1,000
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Rent due to landlord for 2 months	Rs 1,200
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Wages due to servant for 5 months	Rs 100
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Clerks salaries for 4 months is arrears	Rs 1,700
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Rates and taxes due	Rs 1,000
---------------------	----------

Mrs. Loan	Rs 11,000
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Trade creditors	Rs 45,000
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Mortgages (holding the security worth Rs 70,000)	Rs 50,000
--	-----------

Creditors holding a second charge on the assets held by fully secured creditors (to the extent of Rs 14,000)	Rs 18,000
--	-----------

Works manager's salary due for last 2 months	Rs 2,000
--	----------

Estimating the cost of winding up at Rs 1,200 tate the rate of dividend which could be expected to be paid to the creditors.

Solution :

The insolvent debtor resides in Mumbai , so presidency towns insolvency act will apply.

	Rs
Unsecured cresitors as per list A	
Trade creditors	45,000
Bills payable	28,000
Bank overdraft	12,000
Mrs. Loan	11,000
Liability on bills discounted expected to rank	6,000
Household debts	1,000
Rent due to landlord (one month's rent is preferential)	600
Wages due to the servant (4 months wages are preferential)	20
Clerks salary (in excess of preferential amount)	1,400
(only Rs 300 clerk's salary is preferential)	

Works manger salary	2,000
	107,020

Gross liability in respect of unsecured creditors is Rs 111,020 (Rs 107,020 + Rs 4,000); Rs 4,000 in respect of bills discounted not likely to be dishonoured have also been added.

Fully secured creditors as per list B

	Amount	Value of security
Mortgages	50,000	70,000

Partly secured creditors as per list C

	Amount	Value of security
Creditors holding a second charge on the assets		
Held by fully secured creditors to the extent of Rs 14,000	18,000	14,000
Creditors secured by life policy	13,000	8,000
	31,000	22,000

Preferential creditors as per list D

	Amount
Rent due to landlord (one month rent)	600
Wages (4 months wages)	80
Clerks salary	300
Rates and taxes	1,000
	1,980

Statement of affairs of Mr. Seth as at 31st December, 2013

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
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111,020	Unsecured creditors as per list A	107,020	Property as per list E		
	Fully secured creditors as per list B		Cash in hand	300	300
50,000	Rs 50,000		Stock in trade	40,000	32,000
	Less: estimated value		Machinery	50,000	41,000
	Of securities	Rs 70,000	Furniture	7,000	5,000
		Rs 20,000	Life policy	-	6,000
	Transferred to list C	Rs 14,000			
	Surplus as per contra	Rs 6,000	Book debts as per list F		
			Good	8,000	8,000
	Partly secured creditors as per list C		Doubtful	2,400	
31,000	Rs 31,000		Bad	1,000	
	Less: Estimated value		Estimated to produce		1920
	Of securities	Rs 22,000			
			9,000 Bills of exchange as per		
	Preferential creditors as per list D		list G	4,800	4,800
1,980	Rs 1980			113,500	99,020
	Deduction as per		Surplus from securities in		
	Contra	Rs 1980	the hands of fully		
			secured creditors as per		
			contra		6,000
					105,020
			Deduction of preferential		
			creditors as per contra		1980
					103,040
			Deficiency as per list H		12,980
<u>194,000</u>		<u>116,020</u>			<u>116,020</u>

Statement of estimated dividend payable to the creditors

Net assets as per statement of affairs	103,040
Less : cost of winding up	1,200
Amount available for unsecured creditors	101,840
Unsecured creditors	116,020

Estimated dividend per rupee payable to the creditors

$$= \text{Rs } 101,840 / \text{Rs } 116,020 = 88 \text{ paise}$$

Notes:

1. The insolvent debtor is an individual, so no distinction has been observed between business assets and liabilities and private assets and liabilities. Thus, household debts have been included in unsecured creditors as per list A and life policy has been included in property as per list E.
2. Household utensils have not been included in property list as per list E because under the presidency towns insolvency act, the insolvent debtor can retain his tools of trade, wearing apparel and cooking utensils up to the value of Rs 300

1. Dr. Jain of Mumbai had the following assets and liabilities:

Bank overdraft Rs 200,000 is secured against the mortgage of building, bills discounted are Rs 8,000 out of which Rs 2,000 are doubtful. Mr. Jain's private liabilities are Rs 10,000. Salary due to a clerk Rs 900; wages due to labourer Rs 400; landlord's two months rent Rs 200, manager's salary Rs 600. Mr. Jain is a trustee of a property valued at Rs 4,000. His household assets are valued at Rs 5,000 (Household assets worth Rs 200 have been exempted under civil procedure code in this case). Property of which he is a reputed owner Rs 3,000.

His wife's ornaments are of Rs 8,000 out of which, ornaments of Rs 3,000 are purchased from the drawings of her husband and the remaining from the amount received from her father.

Mr. Jain's business assets are – Furniture Rs 4,000 (Realisable Rs 3,000);

building Rs 60,000 (realisable value Rs 50,000); machinery Rs 75,000 (realisable Rs 72,000); stock Rs 8,000 (realisable Rs 6,000); business capital Rs 10,000; losses Rs 65,100. Prepare statement of affairs and deficiency account

72,600

Solution

Statement of affairs of Dr. Jain of Mumbai

As on

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
19,600	Unsecured creditors as per list A	13,600	Assets as per list E		
			Household asset	4,500	4,500
			Property of reputed ownership	3,000	3,000
-	Fully secured creditors as per list B		Wife's ornaments	3,000	3,000
			Furniture	4,000	3,000
200,000	Partly Secured creditors as per list C Rs 200,000		Machinery	75,000	72,000
	Less: Realisable amount from Building Rs <u>50,000</u>	150,000	Stock	8,000	6,000
					-
500	Preferential creditors as per list D Rs 500		Book debts as per list F		-
	Less: Deduction as per contra Rs <u>500</u>		Bills of exchange as per list G		-
			Total real assets	85,320	91,500
			Deduction of preferential creditors as per list D as per contra		<u>500</u>
					91,000
			Net real assets		<u>72,600</u>
			Deficiency as per list H		
<u>220,100</u>		<u>163,600</u>			<u>163,600</u>

Deficiency account

Capital	10,000	Business cases	65,100
Excess of private assets over private liabilities	500	Liability on bills discounted	2,000
Deficiency as per list H	72,600	Loss on sale of assets	
		Furniture	1,000
		Building	10,000
		Machinery	3,000

		Stock	2,000
	<u>83,100</u>		<u>83,100</u>

Calculation of preferential creditors

Salary of clerk	300
Wage of worker	100
Rent of one month	100
	500

Calculation of unsecured creditors

Liability on bills discounted	2,000
Private liabilities	10,000
Salary of clerk (900 -300)	600
Wage of worker (400 – 100)	300
Rent of one month	100
Manager's salary	600
	13,600

Private position account

Private liabilities	10,000	Private assets	
Excess of private assets over private liabilities	500	(5,000 – 200 – 300)	4,500
		Property of reputed ownership	3,000
		Wife's ornaments	3,000
	<u>10,500</u>		<u>10,500</u>

Note:

1. Household assets of Rs 300 are exempted under presidency towns insolvency act
2. Property of reputed ownership will be included in list E as ordinary assets and then it will be included in private position account.

A. CHECK YOUR PROGRESS

Answers the Following

How will you treat the following items while preparing statement of affairs and deficiency account?

- a) The insolvent has transferred a small private house of Rs 600,000 to his daughter in consideration of her marriage.
- b) Rs 40,000 loan from wife has been included in unsecured creditors of Rs 160,000. Wife has paid this loan out of her stridhan
- c) 18 months before the declaration of insolvency a private house of Rs 400,000 was transferred to his wife without consideration.
- d) The insolvent has private assets worth Rs 150,000 including stridhan of Rs 25,000 of his spouse and private liabilities worth Rs 50,000
- e) Bills received of Rs 20,000 were discounted out of which bills worth Rs 12,000 are not expected to be dishonoured.

Solution:

- a) Private house of Rs 600,000 transferred to the daughter in consideration of her marriage will neither be recorded in statement of affairs nor in deficiency account.
- b) Loan of Rs 40,000 taken from wife has rightly been included in unsecured creditors as she has given this loan to the insolvent out of stridhan. Whole of the amount of Rs 160,000 will be shown in list A as unsecured creditors in statement of affairs. Wife will be treated like other unsecured creditors who are to rank for dividend.
- c) Any asset transferred without valid consideration within two years before the date of declaration of insolvency can be taken back for payment to creditors. Hence, private house of Rs 400,000 will be taken back and recorded in list E as one item of the property.
- d) Stridhan of Rs 25,000 included in private assets will not be recorded in list E. Only Rs 125,000 (i.e Rs 150,000 – Rs 25,000) will be shown in property as per list E in statement of affairs. Private liabilities of Rs 50,000 will be recorded in list A as unsecured in statement of affairs. Excess of private assets over private liabilities Rs 75,000 (Rs 125,000 – Rs 50,000) will be shown as income from other sources in deficiency account.
- e) Bills discounted of Rs 20,000 will be shown in the column gross liabilities under

the category of unsecured creditors as per list A. The amount of Rs 8,000 of bills discounted and likely to be dishonoured will be included in unsecured creditors to be shown in expected to rank for dividend column and Rs 8,000 will also be shown as loss in deficiency account.

3. Shyam mohan filed a petition in bankruptcy on 30th June. His books showed the following balances:

	Rs	Rs
Cash in hand	10	
Fixtures and fittings (estimated to produce Rs 80)	250	
Stock in trade (estimated to produce Rs 1,200)		1,800
Sundry creditors:		
Trade creditors	2,000	
Bills payable		2,200
Sundry debtors:		
Good	1,000	
Doubtful (expected to realise 50 %)	2,000	
Bad	2,000	
Bank overdraft		1,200
Capital		1,660
	7,060	7,060

Liability on bills discounted Rs 500 expected to rank Rs 100. His household furniture was valued at Rs 250. he owned a house valued at Rs 750, having a mortgage on it of Rs 600 at 4 %. Interest paid up to the preceding 31st December.

Preferential creditors amounted to Rs 35 (included in sundry creditors) and Rs 15 for rates on the house.

Prepare a statement of affairs and deficiency account.

Solution:

Unsecured creditors as per list A

Trade creditors	1,965
Bills payable	2,200
Bank overdraft	1,200
Bills discounted expected to rank	100
	5,465

The gross liability of unsecured creditors is Rs 5,865; Rs 400 in respect of bills discounted not likely to be dishonoured have also been added.

Fully secured creditors as per list B

	Amount	value of security
Mortgage on house	600	750
Interest @ 4 % p.a on Rs 600 for 6 months	12	
	612	750

Preferential creditors as per list D

Included in trade creditors	35
Rates of the house	15
	50

Statement of affairs of Shiam Mohan

As at 30th June

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
5,865	Unsecured creditors as per list A	5,465	Assets as per list E		
			Cash in hand	10	10
612	Fully secured creditors as per list B Rs 612		Stock in trade	1,800	1,200
	Less: estimated value of securities Rs 750		Fixtures and fittings	250	80
	Surplus as per contra Rs 138		Household furniture		250
	Partly Secured creditors as per list C				
	Less: Realisable amount from Building		Book debts as per list F		

50	Preferential creditors as per list D	Rs 50	Good	1,000	1,000
	Less: Deduction as per contra	Rs <u>50</u>	Doubtful	2,000	1,000
			bad	2,000	-
			Bills of exchange as per list G	-	-
			Surplus from securities		138
			Total real assets	7,060	3,678
			Deduction of preferential creditors as per list D as per contra		<u>50</u>
			Net real assets		3,628
			Deficiency as per list H		<u>1,837</u>
<u>6,527</u>		<u>5,465</u>			<u>5,465</u>

Deficiency account

Capital	1,660	Loss on book debts as per list F	3,000
Excess of private assets over private liabilities	373	Other losses:	
Deficiency as per list H	1,837	Loss on realisation of fixtures and fittings	170
		Loss on realisation of stock	600
		Bills likely to be dishonoured	100
	<u>3,870</u>		<u>3,870</u>

8. Gupta of Guntur commenced business on 1-4-2007 with a capital of Rs 60,000. He drew on average Rs 6,000 a year. His profits for 3 years were Rs 20,000. He did not maintained proper account for the next two years. On 31-3-2014, he became bankrupt. From the following information prepare statement of affairs and deficiency account.

Sundry creditors	41,000	Bills discounted expected to rank	
Mortgage on property	38,000	Rs 4,000	
Creditors secured by life policy		Property estimated value Rs 40,000	80,000

(estimated to be Rs 8,000)	24,000	Machinery cost	50,000
Landlord's 2 months rent	400	Depreciation on it	22,000
Municipal taxes	360	Machinery estimated value Rs 4,000	
Second mortgage on property	24,000	Cash in hand	160
Book debts good	12,000	Furniture estimated value Rs 700	1,600
Doubtful (estimated 2,000)	4,000	Stock Estimated value Rs 11,100	16,000
Bad debts	1,000	Clerk's salary for 2 months	400
Mrs. Gutpa's loan	5,000		

Solution: It is stated that Mr. Guptas had not maintained proper accounts. Therefore, we have to prepare trail balance to ascertain whether the trader has earned profit or sustained loss during the 2 years period.

Trial balance

Particulars	Dr.	Cr.
Sundry creditors		41,000
Mortgage on property		38,000
Creditors secured by life policy		24,000
Landlord's 2 months rent		400
Municipal taxes		360
Second mortgage on property		24,000
Books debts (good + doubtful + bad = 12,000 + 4,000 + 1,000)	17,000	
Property	80,000	
Machinery (Rs 50,000 – Rs 22,000 depreciation)	28,000	
Cash in hand	160	
Furniture	1,600	
Stock	16,000	
Clerk's salary for 2 months		400
Capital		60,000
Profits for 3 years		20,000
Drawings (6,000 x 5 years)	30,000	

Loan from Mrs. Gupta		5,000
Difference in trial balance i.e. loss for 2 years (bal. Fig.)	40,400	
	<u>213,160</u>	<u>213,160</u>

Calculation of unsecured creditors as per list A

Sundry creditors	41,000	
Loan from Mrs. Gupta	5,000	
Bills discounted expected to rank	4,000	
2 months rent	400	
Salary in excess of preferential amount	380	(Rs 400 – Rs 20)
	50,780	

Partly secured creditors as per list C

	Amount	Value of security
Creditors secured by life policy	24,000	8,000
Second mortgage on property	24,000	2,000
	48,000	10,000

Preferential creditors as per list D

Municipal taxes	360
Salary to clerk	20
	380

Statement of affairs of Gupta

As on 31-3- 2014

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
50,780	Unsecured creditors as per list A	50,780	Assets as per list E		
			Cash in hand	160	160
	Fully secured creditors as per list		Stock in trade	16,000	11,100
38,000	B Rs 38,000		furniture	1,600	700

	Less: estimated value of securities Rs <u>40,000</u>		machinery	28,000	4,000
	Surplus as per contra Rs 2,000				
	Transferred to list C Rs 2,000		Book debts as per list F		
48,000	Partly Secured creditors as per list C Rs 48,000		Good	12,000	12,000
	Less: value of securities <u>Rs 10,000</u>		Doubtful	4,000	1,200
		38,000	bad	1,000	-
	Preferential creditors as per list D Rs 380		Bills of exchange as per list G	-	-
380	Less: Deduction as per contra Rs <u>380</u>		Surplus from securities		
			Total real assets	62,760	29,160
			Deduction of preferential creditors as per list D as per contra		<u>380</u>
			Net real assets		28,780
			Deficiency as per list H		<u>60,000</u>
<u>137,160</u>		<u>88,780</u>			<u>88,780</u>

Deficiency account

Capital	60,000	Net loss for two years	40,400
Profit for three years	20,000	Drawings	30,000
Life policy	8,000	Bad debts (Rs 4,000 – Rs 1,200) = 2,800 + 1,000	3,800
Deficiency as per list H	60,000	Loss on assets	
		Furniture (1,600- 700)	900
		Stock (16,000 – 11,100)	4,900
		Machinery (28,000–4,000)	24,000
		Property (80,000 – 40,000)	40,000
		Bills discounted	4,000
	<u>148,000</u>		<u>148,000</u>

9. Mr. X files a petition in insolvency as at December 31, 2013, on which date his

position was:

Liabilities	Amount	Assets	Amount
Trade creditors	30,000	Plant and machinery	
Bills payable	20,000	Realisable value Rs 55,000	80,000
Creditors with lien on stocks	25,000	Sundry trade debtors	
Creditors having a charge on plant and machinery	20,000	(bad Rs 15,500 and doubtful Rs 6,000 with 50 % realisable)	36,500
Payable for salaries and taxes	800	Patents Realisable value Rs nil	20,000
		Furniture realisable value Rs 500	1,000
		Stock realisable value Rs 17,500	28,500
		cash	1,500

The insolvent commenced business on 1st jan, 2009. After depreciation of plant and machinery at Rs 5,000 p.a. and allowing interest on capital at Rs 4,000 p.a. and a salary to proprietor at Rs 1,500 p.a. the trading resulted in profits of Rs 6,000 in 2009, Rs 5,000 in 2010, and losses of Rs 7,000 each in 2011 and 2012 and Rs 10,400 in 2013. The drawings during the period amounted to Rs 26,000.

Prepare statement of affairs and deficiency account.

Solution:

In the given question , the capital of X is not given. Hence, the trial balance is prepared to know the capital. The difference between credit side and debit side total of trail balance is assumed as capital. The trail balance is given below:-

Trail balance of Mr. X

As on Dec. 31st, 2013

Particulars	Dr.	Cr.
Plant and machinery	80,000	
Sundry trade debtors	36,500	
Patents	20,000	
Furniture	1,000	
Stock	28,500	
Cash	1,500	

Trade creditors		30,000
Bills payable		20,000
Creditors with lien on stocks		25,000
Creditors having a charge on plant and machinery		20,000
Payable for salaries and taxes		800
Interest on capital (4000 x 5)		20,000
Salary to proprietor (1500 x 5)		7,500
Profits for 2 years (6,000 + 5,000)		11,000
Loss for 3 years (7,000 + 7,000 + 10,400)	24,400	
Drawings	26,000	
Difference in trial balance		83,600
	<u>217,900</u>	<u>217,900</u>

As at 30th June

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
50,000	Unsecured creditors as per list A	50,000	Assets as per list E		
			Patents	20,000	
			Furniture	1,000	500
20,000	Fully secured creditors as per list B Rs 20,000		cash	1,500	1,500
	Less: estimated value of securities Rs 55,000		Book debts as per list F		
	Surplus as per contra Rs 35,000		Good	15,000	15,000
			Doubtful	6,000	3,000
25,000	Partly Secured creditors as per list C Rs 25,000		bad	15,500	-
	Less: value Rs 17,500	7,500	Bills of exchange as per list G	-	-
			Surplus from securities	35,000	35,000
	Preferential creditors as per list D Rs 800		Total real assets		55,000
800	Less: Deduction as per		Deduction of		

	contra	Rs <u>800</u>		preferential creditors as per list D as per contra	<u>800</u>
					54,200
				Net real assets	<u>3,300</u>
				Deficiency as per list H	
<u>95,800</u>			<u>57,500</u>		<u>57,500</u>

Deficiency account

Capital	83,600	Net loss for 3 years (7,000 + 7,000 + 10,400)	24,400
Interest on capital for 5 years (4,000 x 5)	20,000	Drawings	26,000
Salary to proprietor for 5 years (1,500 x 5)	7,500	Bad debts (15,500 + 3,000)	18,500
Net profit for 2 years (6,000 + 5,000)	11,000	Loss on Patents	20,000
Deficiency as per list H	3,300	P & M	25,000
		Furniture	500
		stock	11,000
	<u>125,400</u>		<u>125,400</u>

10. A filed his petition in bankruptcy on 30th June, 2014. Prepare his statement of affairs and deficiency account from the following information:

The stock in trade cost Rs 72,000 of which Rs 6,000 worth is in the hands of a creditor for Rs 10,000 who is entitled to exercise lien: book debts – good Rs 97,500; doubtful Rs 1,200 worth Rs 400, bad Rs 1,500; fixtures and fittings (after depreciation) Rs 2,300; cash in hand Rs 100.

Bills receivable Rs 11,000 (held by bankers) against overdraft of Rs 40,000 – balance of which his secured by a second mortgage on debtor's freehold property and by the guarantee of his brother. Customer's bill under discount Rs 15,000 of which Rs 2,000 is ascertained to be bad and Rs 1,000 is doubtful. Freehold property Rs 30,000 subject to a first mortgage of Rs 20,000. The unsecured creditors amount to Rs 298,000 in addition to the

claims for rates, taxes and wages amounting to Rs 2,400. The stock in trade and the book debts (outside the bills) are estimated to be realised at 75 % of their face value, and the freehold property which cost Rs 28,000 is valued at Rs 22,000. Subject to the modifications stated above, the assets are worth their book values.

You learn that the debtor had a surplus of assets of Rs 50,000 on 1st January,

2012 since when he has withdrawn Rs 30,000 p.a. in equal monthly instalments. His profit for the year ended 31st December, 2012 were Rs 21,000 and for 2013 Rs 4,200 since which time he has not made up his books.

Prepare statement of affairs and deficiency account.

Solution :

Profit and loss for the period of 6 months from January 1, 2014 to June 30, 2014 is not given in the question. Therefore, balance sheet as at June 30, 2014 is prepared to find it out.

Balance Sheet
As at June 30, 2014

Liabilities	Amount	Assets	Amount
Mortgage on stock	10,000	Stock	72,000
Bank overdraft	40,000	Book debt:	
First mortgage on freehold	20,000	Good Rs 97,500	
Unsecured creditors	298,000	Doubtful Rs 1,200	
Claims for rates, taxes and wages	2,400	Bad Rs <u>1,500</u>	100,200
Capital on 1-1-2012 Rs 50,000		Fixtures and fittings	2,300
Add: Profit Rs <u>25,200</u>		Cash in hand	100
(for 2012 + 2013)		Bills receivables	11,000
Rs 75,200		Freehold property (book value)	30,000
Less: drawings of 2.5 years		Loss for 2014 (bal. Fig.)	155,000
@ Rs 30,000 p.a. Rs <u>75,000</u>			
	200		

	<u>370,600</u>	<u>370,600</u>
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Unsecured creditors as per list A

Unsecured creditors Rs 298,000

Bills likely to be dishonoured Rs 3,000

Rs 301,000

Fully secured creditors as per list B

	Amount	Value of security
First mortgage on freehold property	20,000	22,000

Partly secured creditors as per list C

	Amount	Value of security
Creditors secured by stock	10,000	4,500 (75 % of Rs 6,000)
Bank overdraft	40,000	11,000 (bills receivable and 2,000 second mortgage on Freehold)
	50,000	17,500

Preferential creditors as per list D

Claims for rates, taxes and wages Rs 2,400

Statement of affairs of X

As on 31st Dec, 2014

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
313,000	Unsecured creditors as per list A	301,000	Assets as per list E		
			Cash in hand	100	100
	Fully secured creditors as per list		Stock in trad	66,000	49,500

20,000	B	Rs 20,000		Fixtures and fittings	2,300	2,300
	Less: estimated value of securities	Rs 22,000				
	Surplus as per contra	Rs 2,000		Book debts as per list F		
	Partly Secured creditors as per			Good (75 % produce)	97,500	73,125
50,000	list C	Rs 50,000		Doubtful	1,200	400
	Less: value	Rs 17,500		bad	1,500	-
			32,500	Bills of exchange as per list G	-	-
	Preferential creditors as per list D			Surplus from securities		-
	Rs 2,400			Total real assets	168,600	125,425
2,400	Less: Deduction as per contra					
	Rs <u>2,400</u>			Deduction of preferential creditors as per list D as per contra		<u>2,400</u>
				Net real assets		123,025
				Deficiency as per list H		210,475
<u>385,400</u>			<u>333,500</u>			<u>333,500</u>

NOTES:

1. Gross liability for unsecured creditors is Rs 313,000 , Rs 12,000 (Rs 15,000 - Rs 3,000) bills not expected to rank should also be added in gross liability
2. Good book debts are assumed to be worth 75 % of their face value
3. Personal guarantee of A's brother is immaterial for the purpose of preparing statement of affairs

Deficiency account

Capital	50,000	Net loss for 2014	155,000
Net profit for 2 years		Bad debts	26,675
		Household furniture	75,000
2012 Rs 21,000		Other losses:	
2013 Rs 4,200	25,200	Stock in trade Rs 18,000	
Deficiency as per list H	210,475	Freehold property Rs 8,000	26,000

		(Rs 30,000 – Rs 22,000)	
		Loss on bills dishonoured	3,000
	<u>285,675</u>		<u>285,675</u>

Note: Book value Rs 30,000 and not cost Rs 28,000 of freehold has been considered.

1. The assets of a merchant on 30th June, 2014 as shown by his books were Rs 45,000 and his liabilities Rs 31,000. He filed his insolvency petition and estimated his deficiency to be Rs 22,000. After making the above estimate, he found that the following items were not recorded in his books:
 - a) Interest on his capital @ 10 % from 1st January, 2014
 - b) Amount due as wages Rs 200; as salaries Rs 500, as rates and taxes Rs 300; as rent Rs 500
 - c) A contingent liability for Rs 3,000 on bills discounted by him for Rs 8,000
 - d) A loan of Rs 5,000 taken from a friend for the marriage of his daughter.

Prepare statement of affairs and a deficiency account.

Solution:

Statement of affairs of.....

As at 30th June, 2014

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
44,500	Unsecured creditors as per list A	39,500	Assets as per list E		
	Fully secured creditors as per list B		Book debts as per list F Good		
	Less: estimated value of securities		Doubtful	45,000	9,000
	Surplus as per contra		bad		
	Partly Secured creditors as per list C		Bills of exchange as per list G		
	Less: value		Surplus from securities		
			Total real assets		
				<u>45,000</u>	<u>9,000</u>

	Preferential creditors as per list D Rs			
	800		Deduction of preferential	
	Less: Deduction as per contra		creditors as per list D as per	
1,000	Rs <u>800</u>		contra	<u>1,000</u>
			Net real assets Deficiency	8,000
			as per list H	<u>31,500</u>
<u>45,500</u>		<u>39,500</u>		<u>39,500</u>

The amount of unsecured creditors has been calculated as follows:

Liabilities	31,000
Rent	500
Bills discounted likely to be dishonoured	3,000
Friend's loan	5,000
	39,500

The gross liability of unsecured creditors is Rs 44,000 ; Rs 5,000 in respect of bills discounted not likely to be dishonoured have also been added.

The amount of preferential creditors is :

Wages	200
Salaries	500
Rates and taxes	300
	1,000

While filing his petition, the merchant stated his deficiency as Rs 22,000 and liabilities as Rs 31,000. This shows that the assets must have realisable value of Rs 9,000 (Rs 31,000 – Rs 22,000) because only at this value he can estimate his deficiency of Rs 22,000

Interest on capital for 6 months has not been considered as the proprietor cannot get anything on becoming insolvent unless all the creditors are paid in full

1. Following is the balance sheet of Mr. Brown as at 31st March, 2014. He has filed

a petition in the court for being declared as insolvent:

Liabilities	Amount	Assets	Amount
Capital	18,000	Goodwill	5,000
Bank loan (secured) by first charge on building	80,000	Machinery	20,000
Loan from finance co. (secured by second charge on building)	30,000	Building	115,000
Sundry creditors	59,000	Investment in share	5,000
Sales tax payable	8,000	Furniture	7,000
Loan from wife	5,000	Stock	9,000
		Debtors:	
		Good 14,000	
		Doubtful 8,000	
		Bad <u>2,000</u>	24,000
		Cash and bank	15,000
	<u>200,000</u>		<u>200,000</u>

Mr. Brown estimated that except the following, all tangible assets are realisable:

- i) A machinery Rs 5,000 included in the balance sheet has no value.
- ii) Debtors (unrealisable) Rs 7,600
- iii) Non- moving stock Rs 3,000
- iv) Useless furniture Rs 4,000
- v) Investment has no value.

Further information:

- i) Building expected to realise Rs 120,000
- ii) Loan was given by his wife from her personal sources.
- iii) A bill discounted for Rs 10,000 is likely to be dishonoured
- iv) One creditor forgoes his claim for Rs 4,000
- v) Mr. Brown started his business on 1-04-2010. His household expenses upto 31-03-2014 are Rs48,000 .His private life insurance policy matured for Rs 30,000 on 31-03-2014.

He made profit of Rs 40,000 up to 31-3-2012

He incurred loss of Rs 50,000 from 1-4-2012 to 31-3-2014

Also, he suffered speculation loss of Rs 10,000 in the year ended 31-3-2014.

Based on the above information, prepare statement of affairs of Mr. Brown as on 31-3-2014 and deficiency account

Solution:

Statement of affairs

Gross liabilities	Liabilities As on 31st March 2014 as stated and estimated by the debtor)	As on 31st March 2014 as stated and estimated by the debtor)	Book value	Expected to produce
70,000	Unsecured creditors as per list A	70,000	Assets as per list E	
			Cash at bank	15,000
	Fully secured creditors as per list B		Stock	9,000
80,000	Rs 80,000		Machinery	20,000
	Less: estimated value of securities Rs <u>120,000</u>		Furniture	7,000
	Surplus as per contra Rs 40,000		Goodwill	5,000
	Less: Amount carried to list C Rs <u>30,000</u>		Investment in shares	5,000
30,000	balance thereof to contra Rs <u>10,000</u>		Book debts as per list F	
	Partly Secured creditors as per list C Rs 30,000		Good	14,000
30,000	Less: value Rs <u>30,000</u>		Doubtful bad	8,000
	Preferential creditors as per list D Rs 8,000		Bills of exchange as per list G	2,000
8,000	Less: Deduction as per contra Rs <u>8,000</u>		Surplus from securities	-
			Total real assets	10,000
				<u>85,000</u>
			Deduction of preferential creditors as per list D as per contra	<u>57,400</u>
			Net real assets	8,000
			Deficiency as per list H	57,400
<u>188,000</u>		<u>70,000</u>		<u>12,600</u>
				<u>70,000</u>

Deficiency account

Capital	56,000	Net loss arising from business	50,000
Deficiency as per list H	12,600	Drawings	48,000
Net profit arising from business	40,000	Bad debts	7,600
Profit on realisation of :		Loss on:	
Building	5,000	Furniture	4,000
Life policy matured	30,000	Machinery	5,000
Creditors forgone claims	4,000	Stock	3,000
		Goodwill	5,000
		Investments	5,000
		Loss on dishonour of bill	10,000
		Speculation loss	10,000
	<u>147,600</u>		<u>147,600</u>

13. Following are the particulars of the joint and separate estates of the firm and partners A and B.

Liabilities	Firm	A	B	Assets	Firm	A	B
Capitals				Debtors	12,000	-	-
A	16,000			Stock	40,000	-	-
B	12,000			Furniture	4,000	4,000	4,000
Creditors	60,000	4,000	16,000	Building	28,000	-	-
Preferential creditors	4,000			Investments	-	8,000	8,000
Mortgage on building	16,000			Plant	40,000	-	-
Bills payable	20,000			Capital A and B	-	16,000	12,000
Excess of assets over liabilities		24,000	8,000	cash	4,000	-	
	128,000	28,000	24,000		128,000	28,000	24,000

B/P was secured by second charge on building and B's personal guarantee

and B's investment as collateral security. Estimated realisable values are:

A's assets: furniture Rs 2,000; Investments Rs 6,000

B's assets: furniture Rs 2,000; investment Rs 4,000

Prepare statement of affairs and deficiency account

Solution:

The first point to note before preparing firm's statement of affairs.

Is there any surplus in any partner's private estate? There is no surplus in B's estate because B's private property is not sufficient even to pay B's private liabilities. But there is a surplus of Rs 4,000 in A's estate calculated as below:

Realisable value of A's private assets:

Furniture	Rs 2,000
Investments	Rs 6,000
	Rs 8,000
Less: private liabilities (A's Creditors)	4,000
Surplus in A's estate	4,000

Surplus of Rs 4,000 in A's estate can be utilised for paying creditors of the firm; so it will be shown as a property in the firm's statement of affairs

Statement of affairs A and B

As at

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
60,000	Unsecured creditors as per list A	60,000	Assets as per list E		
			Cash	4,000	4,000
			Stock	40,000	16,000
16,000	Fully secured creditors as per list B Rs 16,000		Plant	40,000	8,000
	Less: estimated value of securities Rs <u>22,000</u>		Furniture	4,000	2,000
	Carried to List C Rs 6,000		Surplus from A's estate	-	4,000
			Book debts as per list F		

20,000	Partly Secured creditors as per list C	Rs 20,000		Good	4,000	4,000
	Less: value	Rs 6,000	14,000	Doubtful bad	4,000	2,000
				Bills of exchange as per list G	4,000	-
	Preferential creditors as per list D	Rs 4,000		Surplus from securities	-	-
4,000	Less: Deduction as per contra	Rs <u>4,000</u>		Total real assets	100,000	40,000
				Deduction of preferential creditors as per list D as per contra		<u>4,000</u>
				Net real assets		36,000
				Deficiency as per list H		<u>38,000</u>
<u>100,000</u>			<u>74,000</u>			<u>74,000</u>

The amount of B/P is Rs 20,000. The holder of B/P realises Rs 6,000 by having a second charge on building and for the balance of the amount, holder will be considered as unsecured creditors of the firm. The holder of B/P realises Rs 6,811 as follows:

The partnership firm pays for Rs 74,000- Rs 36,000
Therefore, the firm pays for Rs 14,000 (i.e., Rs 20,000 – Rs 6,000) =

$$= \frac{36,000 \times 14,000}{74,000} = \text{Rs } 6,811$$

For the balance of the amount of B/P i.e., Rs 14,000 – Rs 6,811 = Rs 7,189, the holder of B/P has B's personal guarantee and investments, so this amount will be realised from B. Since the unsatisfied amount of B/P is Rs 7,189 and the realisable value of investments is Rs 4,000, the holder of B/P should be treated as partly secured creditor of B.

Deficiency account of A and B

Capital	28,000	Bad debts	6,000
Income or profit from other sources:	4,000	Loss on realisation of :	
Surplus from A's estate	38,000	Plant	22,000
			2,000

Deficiency as per list H		Furniture	24,000
		Stock	6,000
		building	
	<u>70,000</u>		<u>70,000</u>

Statement of affairs of A

4,000	Unsecured creditors as per list A	4,000	Property as per list E		
	Surplus carried to the firm of A and B as explained in list H		Furniture	4,000	2,000
		4,000	Investment	8,000	6,000
<u>4,000</u>		<u>8,000</u>		<u>12,000</u>	<u>8,000</u>

Surplus account of A

Capital	24,000	Loss on:	
		Investment	2,000
		Furniture	2,000
		Loss of capital in the firm	16,000
		Surplus as per statement of affairs	4,000
	<u>24,000</u>		<u>24,000</u>

Statement of affairs of B

16,000	Unsecured creditors as per list A	16,000	Property as per list E	4,000	2,000
7,189	Partly secured creditors as per list C Rs 7,189		Furniture		
	Less: estimated value Rs	3189	Deficiency as per list H		17,189
<u>23,189</u>	<u>4,000</u>	<u>19,189</u>		<u>4,000</u>	<u>19,189</u>

Deficiency account of B

Capital	8,000	Loss on realisation	
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Deficiency as per list H	17,189	Investment	4,000
		Furniture	2,000
		Loss on payment due to guarantee	7,189
		Loss on capital in the firm	12,000
	<u>25,189</u>		<u>25,189</u>

14. Ploughman and carter are equal partners. Insoveny petition is filed on 30-06-2014. The balance sheet as on 30-06-2014 is as follows (realisable indicated in brackets):

Mortgage loan on freehold	40,000	Freehold (120,000)	160,000
Bank overdraft secured by second mortgage of freehold	160,000	Plant & machinery (72,000)	120,000
Preferential creditors	6,000	Fixtures (4,000)	12,000
Unsecured creditors	200,000	Stock (40,000)	80,000
Capital – ploughman	88,000	Debtors (60,000)	100,000
		Cash	2,000
		Carter – capital overdrawn	20,000
	<u>494,000</u>		<u>494,000</u>

The overdraft is secured, in addition to second mortgage, by ploughman's personal guarantee against which his investments have been deposited. Ploughman's investments are estimated to realise Rs 64,000 and after meeting his guarantee his private estate was insolvent. Carter was insolvent and Rs 38,000 was available from his estate for firm's creditors.

Prepare statement of affairs, deficiency a/c and capital a/c in the ledger assuming realisation are as per estimates.

Solution:

Statement of affairs of ploughman and carter

As on 30th June, 2014

Gross liabilities	Liabilities (as stated and estimated by the debtor)	Expected to rank	Assets (as stated and estimated by the debtor)	Book value	Expected to produce
200,000	Unsecured creditors as per list A	200,000	Assets as per list E		
			Cash at bank	2,000	2,000
	Fully secured creditors as per list B		Stock	80,000	40,000
40,000	Rs 40,000		Machinery	120,000	72,000
	Less: estimated value of securities		Fixtures	12,000	4,000
	Rs <u>120,000</u>		Surplus from carter's estate		38,000
	Surplus as per contra Rs 80,000				
	Less: Amount carried to list C Rs <u>80,000</u>		Book debts as per list F		
	balance thereof to contra Rs <u>10,000</u>		Good	100,000	-
			Doubtful		60,000
			bad		-
	Partly Secured creditors as per list C Rs 160,000		Bills of exchange as per list G	-	-
160,000	Less: value Rs <u>80,000</u>		Surplus from securities		-
			Total real assets	314,000	216,000
	Preferential creditors as per list D Rs 6,000		Deduction of preferential creditors as per list D as per contra		<u>6,000</u>
6,000	Less: Deduction as per contra Rs <u>6,000</u>				-
			Net real assets		210,000
			Deficiency as per list H		70,000
					57,400
<u>406,000</u>		<u>280,000</u>			<u>280,000</u>

Rate of dividend per rupee of unsecured creditors is :

Available assets for unsecured creditors = Rs 210,000 = 75 Paise

Amount of unsecured creditors Rs 280,000

Deficiency account

Capital	68,000	Bad debts as per list F	40,000
Deficiency as per list H	70,000	Loss on realisation of other	
Surplus from carter's estate	38,000		40,000

		Stock	48,000
		Plant & machinery	8,000
		Fixtures	40,000
	<u>176,000</u>	freehold	<u>176,000</u>

Capital accounts

Particulars	Ploughman	Carter	Particulars	Ploughman	Carter
To Bal B/d		20,000	By bal b/d	88,000	
To realisation a/c	88,000	88,000	By cash – surplus		38,000
			By creditors		70,000
	88,000	108,000		88,000	108,000

Loss on realisation of assets

Freehold property	40,000
P & M	48,000
Fixtures	8,000
Debtors	40,000
Stock	40,000
	176,000

Loss on realisation transferred to :

Ploughman's capital a/c $(176,000 \times \frac{1}{2}) = \text{Rs } 88,000$

Carter's capital a/c $(176,000 \times \frac{1}{2}) = \text{Rs } 88,000$

B. CHECK YOUR PROGRESS

PRACTICAL QUESTIONS

Question 1: Statement of Affairs

Mr. Ramesh has been declared insolvent. The following details are available on the date of insolvency:

Assets:

- Furniture – ₹15,000 (Realizable value ₹10,000)

- Machinery – ₹40,000 (Realizable value ₹25,000)
- Debtors – ₹30,000 (Good: ₹20,000; Doubtful: ₹5,000; Bad: ₹5,000)
- Stock – ₹20,000 (Realizable value ₹15,000)
- Cash in hand – ₹2,000

Liabilities:

- Creditors – ₹60,000
- Bills Payable – ₹20,000
- Bank Loan (secured against machinery) – ₹10,000
- Preferential Creditors – ₹5,000

Required:

Prepare a Statement of Affairs showing estimated deficiency.

Question 2: Deficiency Account

From the following information, prepare a Deficiency Account of Mr. Sohan:

- Capital as on last Balance Sheet date – ₹50,000
- Drawings during the year – ₹10,000
- Loss during the year – ₹25,000
- Loss on realization of stock – ₹5,000
- Bad debts written off – ₹3,000
- Deficiency as per Statement of Affairs – ₹35,000

Required:

Prepare the Deficiency Account explaining the causes of deficiency.

Question 3: Insolvency of Partnership Firm

The firm of A and B has become insolvent. The balance sheet on the date of insolvency is:

Liabilities:

- Creditors – ₹40,000
- Bank Loan (secured against stock) – ₹10,000

- Capital A – ₹20,000; B – ₹10,000

Assets:

- Cash – ₹5,000
- Debtors – ₹30,000 (₹25,000 realizable)
- Stock – ₹15,000 (₹12,000 realizable)
- Furniture – ₹10,000 (₹6,000 realizable)

Required:

Prepare a Statement of Affairs and show estimated deficiency.

19.3 PRACTICE THEORY QUESTIONS

1. Define bills discounted, preferential creditors and unsecured creditors.
2. Prepare the format of statement of affairs and deficiency account.
3. What is doctrine of reputed ownership.
4. How you will deal with the voluntary transfer in case of insolvency accounts.
5. Give the classification of book debts as per list F
6. Give short note on treatment of rent due, wages due, salary of labourer & wages of clerk in presidency and provincial insolvency towns act.
7. What do you mean by stridhan.
8. Define fraudulent preference.

19.4 LET US SUM UP

In the world of business, not all ventures succeed. Sometimes, individuals or firms are unable to meet their financial obligations. This condition is known as **insolvency**. When insolvency occurs, it becomes necessary to understand the financial position of the insolvent party so that fair distribution can be made to creditors.

To do this, accountants prepare two main statements:

- The **Statement of Affairs**, which shows the estimated realizable value of assets against liabilities on the date of insolvency.
- The **Deficiency Account**, which explains how the financial loss (deficiency) occurred — such as through business losses, drawings, or depreciation in asset values.

Creditors in insolvency cases are classified as secured, unsecured, or preferential, and their rights differ based on this classification. While earlier laws like the Presidency Towns Insolvency Act, 1909, and the Provincial Insolvency Act, 1920 governed such matters, today, the Insolvency and Bankruptcy Code (IBC), 2016 provides a unified legal framework for resolving insolvency.

19.5 GLOSSARY

- **Secured Creditor:** A creditor who has the right over a specific asset as security for the loan or credit given.
- **Unsecured Creditor:** A creditor who has no specific asset as security and is repaid only after secured and preferential creditors.
- **Preferential Creditor:** A creditor who is given priority in repayment by law, like government tax or employee wages.
- **Realizable Value:** The actual amount that can be received by selling an asset during insolvency.
- **Capital Deficiency:** The shortfall between total liabilities and total realizable assets.
- **Insolvency Laws:** Legal rules that guide the process of declaring and handling insolvency, such as the IBC, 2016.

19.6 SELF- ASSESSMENT QUESTIONS

1. What is the purpose of preparing a Statement of Affairs in insolvency?

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.....
.....

2. How are secured creditors treated while preparing a Statement of Affairs?

.....
.....
.....

3. Mention any three causes that can lead to deficiency in the Deficiency Account.

.....
.....
.....

19.7 LESSON END EXERCISE

- 1.Explain the procedure of preparing a Statement of Affairs in insolvency.

Also, give its proforma.

- 2.What is a Deficiency Account? How is it prepared? Explain with suitable proforma.

19.8 SUGGESTED READINGS

- S. P. Jain, K. L. Narang
- Arihant Publications
- Pratijogitya Darpan

- Maheshwari, S.N. & Maheshwari S.
- Kishore, R.M.
- Pillai, R.S.N, Bagavathi & Uma, S.

UNIT - IV

Lesson No. 20

Course No. 101

INSOLVENCY ACCOUNTS

STRUCTURE

- 20.0 Learning Objectives and Outcomes
- 20.1 Introduction
- 20.2 Practical Unsolved Questions
- 20.3 Let Us Sum UP
- 20.4 Glossary
- 20.5 Summary
- 20.6 Self-Assessment Questions
- 20.7 Lesson End Questions
- 20.8 Suggested Readings

20.0 LEARNING OBJECTIVES AND OUTCOMES

Learning Objectives

By the end of this chapter or topic, students will be able to:

- Apply the rules of *Insolvency Acts* and *accounting principles* to solve practical questions involving insolvent accounts.
- Prepare *Statement of Affairs* and *Deficiency Account* with clarity in case of insolvency.
- Analyze the reasons and calculation of deficiency and allocation of available assets among creditors.

Learning Outcomes

After completing the topic and solving the unsolved problems, learners will be able to:

- Confidently handle practical questions based on real-world insolvency cases.

- Evaluate the financial position of an insolvent individual or firm through proper documentation.
- Develop a logical approach toward interpreting and solving unsolved problems on insolvent accounts.

20.1 INTRODUCTION

Insolvency accounting is an important area in financial studies that deals with situations where an individual or a firm is unable to pay their debts in full. It involves preparing special financial statements like the Statement of Affairs and the Deficiency Account to reflect the true financial position of the insolvent person or business.

The unsolved problems of insolvent accounts help students apply theoretical knowledge to practical cases. These problems include real-world situations where assets are insufficient to cover liabilities, requiring proper classification of creditors and fair distribution of available funds. They test a student's ability to interpret, calculate, and prepare necessary statements using correct accounting treatment.

By solving such practical problems, students gain confidence in handling complex insolvency scenarios, strengthen their understanding of insolvency laws, and develop problem-solving skills needed for professional exams and real business cases.

20.2 PRACTICAL UNSOLVED QUESTIONS

1. From the following information, prepare a statement of affairs of Mr. Singh who is declared insolvent on march 31 , 2014

Cash in hand 2,500 drawings 174,000 trade expenses 74,000

Debtors –Good 12,500 doubtful (expected to realise Rs 2,000) 6,000

*bad 10,000

Creditors- unsecured 250,000 shares in X ltd. 50,000 creditors- Partly secured
170,000

Bills receivable- good 42,500 creditors –Fully secured 237,000
preferential
claims 7,500

Other securities (30,000 Pledged with partly secured creditors and the balance with
fully secured creditors) 280,000.

2. A merchant became insolvent on 1-1-2014 on which date his total asset were
Rs 76,000 and liabilities Rs 65,000 and he estimated a deficiency of 20,000
before taking the following items into consideration which were not passed
through his account books:

- a) interest on his capital of Rs 25,000 @ 6 % for one year.
- b) a contingent liability for Rs 3,000 on bills discounted by him for Rs 8,000
- c) Amount due was wages Rs 300, as salaries Rs 600, as rent Rs 500, as
rates and taxes Rs 1,000
- d) a loan of Rs 5,000 taken from a friend for the marriage of his daughter
and Rs 2,000 from his wife.

Prepare a statement of affairs and a deficiency account.

3. A receiving order has been against shri angad on 15th December, 2014. The
particulars of his assets and liabilities on that date were:

Creditors on open accounts	14,487
Fully secured creditors (holding life policies values at Rs 12,315)	10,333
Creditors partly secured (security held is a second mortgage on an asset pledged to a fully secured creditor, the surplus available from the latter is estimated at 1020)	
1,582	
Rates and wages (preferential)	37

Cash in hand	4	
Life policy not charged, surrender value (estimated)		30
Stocks and shares (estimated)		154
Motor cycle (estimated)	249	
Debts Rs 76 of which 39 is good		52

The debtor has conveyed his furniture to his wife by deed of gift dated 18th October, 2014. The value of which is estimated at Rs 300.

The deficiency account starts from 30th June 2013, on which date the excess of liabilities of assets was Rs 3,936. The reasons cited for the failure of his business are unsuccessful trading, stock exchange speculation and excessive interest on money borrowed.

Prepare statement of affairs and deficiency account inserting in the latter such items of gain and loss as are usual, or suggested by the particulars given.]

A. CHECK YOUR PROGRESS

Case Based Questions

Case1: Mr. Ramesh is declared insolvent. His total assets are ₹40,000. His liabilities include:

- Secured creditors: ₹15,000 (secured against machinery worth ₹10,000)
- Unsecured creditors: ₹25,000
- Preferential creditors: ₹5,000

Questions:

1. The value of assets available for unsecured creditors = _____
2. The total deficiency = _____
3. The amount payable to preferential creditors = _____

Case 2: Mr. X is declared insolvent. His personal liabilities are ₹30,000, and his assets realized ₹18,000.

- Task:

Pass journal entries in the books of Mr. X for the following:

Transfer of assets to Realisation Account

Realisation of assets

Transfer of deficiency to Capital Account

4. The capital in the business of X on 31st December, 2012 was Rs 7,000. During the year ended 31st December 2013, he sustained a loss of Rs 7,800 and

his drawings out of the business were Rs 7,000. Owing to his unsatisfactory financial position, he was compelled to file his petition and a receiving order was made against him on 31st December, 2013; his assets consisted of:

- a) book debts of Rs 10,000 of which Rs 8,000 was considered good and the remaining estimated to produce Rs 1,000.
- b) stock (cost Rs 15,000) estimated to produce Rs 10,000.
- c) machinery (cost Rs 16,000) estimated to produce Rs 11,000.
- d) Freehold house valued at Rs 12,000, the deeds of which were lodged with the bank as security for an overdraft on business account of Rs 8,000.
- e) his life policy (surrenders value of Rs 2,000) given as part security for a private loan of Rs 3,000.
- f) His trade creditors amounted to Rs 40,400 and he owed Rs 400 to his clerk, being salaries for the two months ended 30th June, 2013.
- g) bills had been discounted amounting to Rs 3,000 in respect of which it was estimated that X would be liable for Rs 1,000.

Prepare his statement of affairs and deficiency account, estimating the cost of

winding up at Rs 800, state the amount of dividend which could be expected to be paid.

5. Shir Khushwant Singh position as on 31st December, 2013 was as follows:

Capital as on 1st Jan, 2011 10,000 Cash 200 Trading profit –first two years 6,000

Stock 10,000 (estimated to produce 5,000) unsecured creditors 5,000

Machinery Rs 8,000 (estimated to produce Rs 2,000) fully secured creditors 4,000

Shares Rs 3,000 (estimated to produce Rs 2,000) partly secured creditors Rs 6,000

Preferential creditors Rs 15,000 Furniture Rs 2,000 (estimated to produce Rs 500)

Book debts 10,300 (estimated to produce Rs 6,300) trading loss of last year 4,000

Speculation loss of all three years 5,000 drawings of all three years 5,000

Fully secured creditors and partly secured creditors took debts and shares respectively as security. Prepare statement of affairs and deficiency account.

B. CHECK YOUR PROGRESS

Solve the Following Problems:

Prepare a Statement of Affairs from the following details:

- Cash: ₹2,000
- Debtors (expected to realize ₹5,000): ₹8,000
- Furniture (expected to realize ₹1,000): ₹2,000
- Creditors: ₹10,000
- Preferential creditors: ₹1,000

Problem 2:

A firm is dissolved. Partner A is insolvent, and his capital account shows a debit balance of ₹3,000. Partner B decides to bear the loss.

Question:

Show how this loss is treated in the books of the firm (journal entry or adjustment).

20.3 LET US SUM UP

Imagine a trader, Mr. Arun, who is declared insolvent. His books show total liabilities of ₹80,000 and realizable assets of only ₹45,000. Here's what we learned from such practical cases:

- Insolvency arises when liabilities exceed realizable assets. In Arun's case, the deficiency is ₹35,000, which needs explanation through the Deficiency Account.
- We prepare a Statement of Affairs (similar to a balance sheet), but based on realizable values of assets and actual obligations to creditors—classifying them as secured, preferential, and unsecured.
- Secured creditors (like banks with a mortgage on Arun's building) are paid first from the sale of that asset.
 - If the asset sells for less than the loan amount, the balance becomes an unsecured debt.
- Preferential creditors, such as employees and government departments, get paid next, in full or proportionally, depending on available funds.
- Unsecured creditors share whatever remains, if anything. They usually face the highest risk of loss.
- If the insolvent person is a partner, any unpaid capital becomes the liability of the other partners depending on the partnership terms or legal precedent (like *Garner v. Murray*).

20.4 GLOSSARY

- **Bad Assets:** Assets which are unrecoverable or have no resale value, written off while preparing insolvency accounts.

- **Loss on Realisation:** The gap between book value and the actual value received upon sale of assets during insolvency.
- **Capital Deficiency:** The shortfall in a partner's capital account when liabilities exceed his or her capital contribution.
- **Legal Priority:** The order in which different classes of creditors must be paid as per insolvency law.
- **Final Settlement Sheet:** A document that outlines the closing figures of what each creditor receives after distributing all available assets.
- **Unexpired Expenses:** Prepaid or future expenses that are not recoverable and usually excluded in insolvency asset calculations.
- **Shadow Balance Sheet :** An informal balance sheet prepared using estimated or adjusted values at the time of insolvency.
- **Creditor Pool :** The collective group of all creditors eligible for payment from the insolvent's estate.

20.5 SELF ASSESSMENT QUESTIONS

1. Calculate amount of properties under list E from the following :

Furniture Rs. 10,000 (estimated to produce Rs. 4,000)

Book Debts : Good Rs. 16,000; Doubtful Rs. 12,000

(estimated to produce 40%), doubtful debts Rs. 3,000

Machinery Rs. 12,000 (estimated to produce Rs. 7,000)

Jewellery Rs. 5,000 (estimated to rank Rs. 7,000)

2. Do calculation of unsecured creditors as per list A

Bill Payable Rs. 3,000

Unsecured loan Rs. 4,000

Trade Creditors Rs. 3,000

20.6 LESSON END EXERCISE

1. Calculate amount of surplus under partly secured creditors.
Secured creditors Rs. 40,000 (property secured Rs. 38,000)
2. Calculate preferential creditors as per list D wages Rs. 400; Salaries Rs. 300, Rates & Rent Rs. 2,000, Income Tax due Rs. 3,000

20.7 SUGGESTED READINGS

3. S. P. Jain, K. L. Narang
4. Arihant Publications
5. Pratijogitya Darpan
6. Maheshwari, S.N. & Maheshwari S.
7. Kishore, R.M.
8. Pillai, R.S.N, Bagavathi & Uma, S.