Unit-1

INTRODUCTION TO ACCOUNTING STANDARDS

Unit Structure:

1.0 OBJECTIVES

After studying the unit students will be able to:

- Understand the meaning of Accounting Standard.
- Know the scope of Accounting Standard.
- Understand the composition, objectives and functions of Accounting Standard Board.
- Explain the procedure for issuing Accounting Standards.
- Know the list of Accounting Standards issued by ICAI

1.1 INTRODUCTION

Financial statements are prepared to summarize the end-result of all the business activities by an enterprise during an accounting period in monetary terms. These business activities vary from one enterprise to the other. It is very difficult to compare the financial statements of different reporting enterprises because of different methods and principles adopted by these business enterprises in preparing their financial statements. Accounting standards are evolved to make these methods and principles uniform and financial statements comparable to the possible extent. Following are the different group of persons interested in the financial statements:-

1. Bankers
2. Shareholders
3. Investors
4. Creditors
5. Customers
6. Employees
7. Competitors
8. Income tax/Sales tax/Excise authorities

1.2 MEANING OF ACCOUNTING STANDARDS

1.2.1 MEANING

'Accounting Standards are written, policy documents issued by expert accounting body or by Government or other regulatory authorities covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transaction in the financial statement.' The main purpose of formulating accounting standard is to standardize the diverse accounting policies with a view to eliminate to the extent possible the incomparability of information provided in financial statements and add reliability to such financial statements. Accounting standards ensure the consistency and the comparability of the financial statements reported by the different enterprises creating a general sense of confidence that users have in the fairness and reliability of the statements they rely.

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. Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise are considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those which are not commercial, industrial or business in nature.

1.2.2 OBJECTIVES:

1. To standardise the diverse accounting policies.

2. To standardise the accounting practices.

3. To enhance the reliability of financial statements.

4. To eliminate non-comparability of financial statements

1.2.3 ADVANTAGES:

1. It provides the accountancy profession with useful working rules.
2. It assists in improving quality of work performed by accountant.
3. It strengthens the accountant's resistance against the pressure from directors to use accounting policy which may be suspect in that situation in which they perform their work.
4. It ensures the various users of financial statements to get complete crystal information on more consistent basis from period to period.
5. It helps the users to compare the financial statements of two or more organizations engaged in same type of business operation.

1.2.4 DISADVANTAGES:

1. Users are likely to think that said statements prepared using accounting standard are foolproof.
2. They have been derived from social pressures which may reduce freedom.
3. The working rules may be rigid or bureaucratic to some users of financial statement.
4. The more standards there are, the more costly the financial statements are to produce.

1.3 FORMATION OF THE ACCOUNTING STANDARDS BOARD

The Institute of Chartered Accountants of India (ICAI), recognizing the need to harmonize the diverse accounting policies and practices in use in India, constituted the Accounting Standards Board (ASB) on 21st April, 1977.

1.3.1 COMPOSITION OF THE ACCOUNTING STANDARDS BOARD (ASB)

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 Office 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 on 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. Representatives of Industry Associations (1 from Associated Chambers of Commerce and Industry (ASSOCHAM), 1 from Confederation of Indian Industry (CII) and 1 from Federation of Indian Chambers of Commerce and Industry (FICCI)
7. Representative of Reserve Bank of India
8. Representative of Securities and Exchange Board of India
9. Representative of Controller General of Accounts
10. Representative of Central Board of Excise and Customs
11. Representatives of Academic Institutions (1 from Universities and 1 from Indian Institutes of Management)
12. Representative of Financial Institutions
13. Eminent professionals 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. Representative(s) of any other body, as considered appropriate by the ICAI

1.3.2 OBJECTIVES OF THE ACCOUNTING STANDARDS BOARD

The following are the objectives of the Accounting Standards Board:

i. To conceive of and suggest areas in which Accounting Standards need to be developed.

ii. To formulate Accounting Standards with a view to assist the Council of the ICAI in evolving and establishing Accounting Standards in India.

iii. To examine how far the relevant International Accounting Standard/International Financial Reporting Standard can be adapted while formulating the Accounting Standard and to adapt the same.

iv. To review, at regular intervals, the Accounting Standards from the point of view of acceptance or changed conditions, and, if necessary, revise the same.

v. To provide, from time to time, interpretations and guidance on Accounting Standards.

vi. To send comments on various consultative papers such as exposure drafts, discussion papers etc., issued by International Accounting Standards Board and various other International bodies such as Asian-Oceania Standard-Setters Group (AOSSG).

vii. To carry out such other functions relating to Accounting Standards.

1.3.3 FUNCTIONS OF THE ACCOUNTING STANDARDS BOARD

The main 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's (IASB) pronouncements in the country with a view to facilitate global harmonization of accounting standards. Accordingly, while formulating the Accounting Standards, the ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standards Committee (predecessor body to IASB) or International Financial Reporting Standards (IFRSs) issued by the IASB, as the case may be, and try to integrate them, to the extent possible, in the light of the conditions and practices prevailing in India.

1.4 PROCEDURE FOR ISSUING AN ACCOUNTING STANDARD

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. The following procedure is adopted for formulating Accounting Standards:

1. The ASB determines the broad areas in which Accounting Standards need to be formulated and the priority in regard to the selection thereof.

2. In the preparation of Accounting Standards, the ASB will be assisted by Study Groups constituted to consider specific subjects. In the formation of Study Groups, provision will be made for wide participation by the members of the Institute and others.

3. The draft of the proposed standard will normally include the following:
    a) Objective of the Standard,
    b) Scope of the Standard,
    c) Definitions of the terms used in the Standard,
    d) Recognition and measurement principles, wherever applicable,
    e) Presentation and disclosure requirements.

4. The ASB will consider the preliminary draft prepared by the Study Group and if any revision of the draft is required on the basis of deliberations, the ASB will make the same or refer the same to the Study Group.

5. The ASB will circulate the draft of the Accounting Standard to the Council members of the ICAI and the specified bodies for their comments.

6. The ASB will hold a meeting with the representatives of specified bodies to ascertain their views on the draft of the proposed Accounting Standard. On the basis of comments received and discussion with the representatives of specified bodies, the ASB will finalize the Exposure Draft of the proposed Accounting Standard.

7. The Exposure Draft of the proposed Standard will be issued for comments by the members of the Institute and the public. The Exposure Draft will specifically be sent to specified bodies (as listed above), stock exchanges, and other interest groups, as appropriate.

8. After taking into consideration the comments received, the draft of the proposed Standard will be finalized by the ASB and submitted to the Council of the ICAI.

The Council of the ICAI will consider the final draft of the proposed Standard and if found necessary, modify the same in consultation with the ASB. The Accounting Standard on the relevant subject will then be issued by the ICAI.

1.5 COMPLIANCE WITH THE ACCOUNTING STANDARDS

Accounting Standards are mandatory from the respective dates mentioned in the standards. Hence, it is the duty of the management to see that all the Accounting Standards are complied with while preparing financial statement, in the case of any deviation, necessary disclosure should be made in the audit report so as to make the readers aware of the deviations.

The mandatory status of an Accounting Standard implies that while discharging their attest functions, it will be the duty of the members of the Institute

(a) To examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and

(b) To ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures there from.

1.6 LIST OF THE ACCOUNTING STANDARDS AS ISSUED BY ICAI

The council of the Institute of the Chartered Accountants of India has so far issued 32 Accounting Standards, However AS- 8 on Accounting for Research and Development (stands withdrawn after introduction of AS-26), thus effectively there are 31 Accounting standards.

Accounting Standard No.	**Title of Accounting Standard**
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventories
AS-3	Cash Flow Statements
AS-4	Contingencies and Events (Occurring after the Balance Sheet Date)
AS-5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS-6	Depreciation Accounting
AS-7	Construction Contracts
AS-8	Accounting for Research and Development (standard withdrawn after introduction of AS-26)
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets
AS-11	The Effect of Changes in Foreign Exchange Rates
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Employee Benefits
AS-16	Borrowing Cost
AS-17	Segment Reporting
AS-18	Related Party Disclosures
AS-19	Leases
AS-20	Earnings per Share
AS-21	Consolidated Financial Statements
AS-22	Accounting for Taxes on Income
AS-23	Accounting for Investment in Associates in Consolidated Financial Statements
AS-24	Discontinuing Operations
AS-25	Interim Financial Reporting

AS-26	Intangible Assets
AS-27	Financial Reporting of Interests in Joint Venture
AS-28	Impairment of Assets
AS-29	Provisions, Contingent Liabilities and Contingent Assets
AS-30	Financial Instruments: Recognition and Measurement
AS 31	Financial Instruments: Presentation
AS 32	Financial Instruments: Disclosures

1.7 LIST OF IAS / IFRS AND CORRESPONDING IND AS NITIFIED BY MCA

IAS No.	**Title**	**Corresponding Converged IND AS**
IAS-1	Presentation of Financial Statements	IND AS 1
IAS-2	Inventories	IND AS 2
IAS- 7	Cash Flow Statements	IND AS 7
IAS-8	Accounting policies, change in accounting estimates and errors	IND AS 8
IAS-10	Events after the Balance Sheet date	IND AS 10
IAS-12	Income Taxes	IND AS 12
IAS-16	Property, Plants and Equipment	IND AS 16
IAS- 17	Leases	IND AS 17
IAS-19	Employees Benefits	IND AS 19
IAS-20	Accounting for Government Grants and Disclosure of Government Assistance	IND AS 20
IAS-21	The Effect of Changes in Foreign Exchange Rates	IND AS 21
IAS-23	Borrowing Costs	IND AS 23

IAS-24	Related Party Disclosures	IND AS 24
IAS-26	Accounting and Reporting by Retirement Benefit Plan	
IAS-27	Consolidated and Separate Financial Statements	IND AS 27
IAS-28	Investments in Associates and Joint Ventures	IND AS 28
IAS-29	Financial Reporting in Hyper Inflationary Economies	IND AS 29
IAS-32	Financial Instruments :- Presentation	IND AS 32
IAS-33	Earnings per Share	IND AS 33
IAS-34	Interim Financial Reporting	IND AS 34
IAS-36	Impairment Assets	IND AS 36
IAS-37	Provisions, Contingent Liabilities and Contingent Assets	IND AS 37
IAS-38	Intangible Assets	IND AS 38
IAS-40	Investment Property	IND AS 40
IAS-41	Agriculture	IND AS 41

1.8 LIST OF IFRS ISSUED BY IASB

IFRS:-
The term 'IFRS' includes standards and interpretations approved by IASB and the International Accounting Standards and interpretations issued by the International Financial Reporting Interpretations Committee.

International Accounting Standards Board (IASB) has issued the following International Financial Reporting Standards (IFRS):-

IAS No.	Title	Corresponding Converged IND AS
IFRS-1	First Time Adoption of IFRS	IND AS 101
IFRS-2	Share based payments	IND AS 102
IFRS-3	Business Combination	IND AS 103
IFRS-4	Insurance Contracts	IND AS 104

IFRS-5	Non-currents Assents held for sale and discontinued operations	IND AS 105
IFRS-6	Exploration for and evaluation of mineral resources	IND AS 106
IFRS-7	Financial instruments: disclosure	IND AS 107
IFRS-8	Operating segment	IND AS 108
IFRS-9	Financial instruments	IND AS 109
IFRS-10	Consolidated Financial Statements	IND AS 110
IFRS-11	Joint Arrangement	IND AS 111
IFRS-12	Disclosure of Interest in Other Entities	IND AS 112
IFRS-13	Fair Value Measurement	IND AS 113
IFRS-14	Regulatory Deferral Accounts	IND AS 114
IFRS-15	Revenue from contracts with customers	IND AS 115
IFRS-16	Leases	-

1.9 QUESTIONS

1. What do you understand by Accounting standard?
2. What is the need and purpose of accounting standards?
3. Briefly explain the importance of accounting standards?
4. What is the duty of the auditor in case of non-compliance of mandatory accounting standard?
5. Briefly explain the procedure for issuing an accounting standard?
6. Select Correct Alternative:

i. Accounting standards are important
   1. For making correct financial statements
   2. For correct valuation of inventories
   3. For correct treatment of depreciation and lease and investment
   4. All of the above

ii. Accounting standards are statements prescribed by
1. Law
2. Bodies of shareholders
3. Professional accounting bodies
4. All of the above

iii. The Policy of 'anticipate no profit and provide for all possible losses' arises due to convention of
1. Consistency
2. Disclosure
3. Conservatism
4. All of Above

iv.Accounting has certain norms to be observed by the accountants in recording of transactions and preparation of financial statements. These norms reduce the vagueness and chances of misunderstanding by harmonizing the varied accounting practices. These norms are
1. Accounting regulations.
2. Accounting guidance notes.
3. Accounting standards.
4. Accounting framework.

v. Following is the example of external users:
1. Government.
2. Owners.
3. Management.
4. Employees.

vi. Following is the example of internal users:
1. Government.
2. Investors.
3. Creditors.
4. Employees.

vii. The information provided in the annual financial statements of an enterprise pertain to
1. Business Industry.
2. Economy.
3. Individual business entity.
4. None of the above.

Answers: i-4, ii-3, iii- 3, iv-3, v-1, vi-4, vii-3

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Unit-2

AS-1 DISCLOSURE OF ACCOUNTING POLICIES

Unit Structure:

2.0 Objectives
2.1 Introduction
2.2 Meaning and Nature of Accounting Policies
2.3 Areas of different Accounting Policies
2.4 Notes to Accounts
2.5 Disclosure of Accounting Policies
2.6 Disclosure of Change in Accounting Policies
2.7 Illustrations
2.8 Practical Applications
2.9 Questions

2.0 OBJECTIVES

After studying the unit students will be able to:

- Understand the meaning and nature of accounting policies.
- Explain the areas of different accounting policies.
- Know the disclosure of accounting policies.
- Know the disclosure of change in accounting policies.
- Give some examples of significant accounting policies.
- Solve the practical problems related to accounting policies.

2.1 INTRODUCTION

Accounting Standard (AS) 1 issued by the Accounting Standards Board, the Institute of Chartered Accountants of India on 'Disclosure of Accounting Policies' deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements. It may be noted that this Accounting Standard is now mandatory for use by companies listed on a recognized stock exchange and other large commercial, industrial and business enterprises in the public and private sectors. Accounting Standards are intended to apply only to items which are material.

2.2 MEANING AND NATURE OF ACCOUNTING POLICIES

'Accounting policies are the specific accounting principles and methods of applying those principles adopted by the enterprise in the preparation and presentation of the financial statements.' E.g. to depreciate fixed asset of the company over a period of time is accounting policy and which method should follow to depreciate the asset (SLM or WDV) is method of accounting.

There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable.

IMPORTANCE OF ACCOUNTING STANDARD (AS) 1

The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

PURPOSE OF ACCOUNTING STANDARD (AS) 1

The disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements would facilitate better understanding of financial statements and a more meaningful comparison between financial statements of different enterprises.

FUNDAMENTAL ACCOUNTING ASSUMPTIONS

The Financial Statements are prepared with the following three Fundamental Accounting Assumptions. Unless otherwise specified, it is assumed that the Financial Statements are prepared according to following assumptions:

1. Going Concern,
2. Consistency,
3. Accrual.

They are explained as follows:

1. Going Concern:

The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

2. Consistency:

It is assumed that accounting policies are consistent from one period to another.

3. Accrual:

Revenues and costs are accrued, that is, recognized as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate.

It is mandatory to disclosure if the above mentioned assumptions are not followed.

2.3 AREAS OF DIFFERENT ACCOUNTING POLICIES

The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

- Methods of depreciation, depletion and amortization
- Treatment of expenditure during construction
- Conversion or translation of foreign currency items
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities.

CONSIDERATIONS IN THE SELECTION OF ACCOUNTING POLICIES

The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and of the profit or loss for the period ended on that date.

For this purpose, the major considerations governing the selection and application of accounting policies are:—

1. Prudence
2. Substance over Form
3. Materiality

They are explained as follows:

1. **Prudence**: In view of the uncertainty attached to future events, profits are not anticipated but recognized only when realized though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. Example of Prudence is to select an accounting policy where inventory valuation is at lower of cost or net realizable value.

2. **Substance over Form:** The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form. Best example of this assumption can be state is hire purchase. If company is purchasing any asset on hire purchase system then purchaser is not legal owner at the time of purchase. In hire purchase ownership is transferred on the payment of the last installment but actually the asset is in the possession of purchaser and he is using in his business operation, so substantially he is better owner than legal. It should be recorded in the books of purchaser.

3. **Materiality:** Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements. That means if profit & loss accounts contains an irregular transaction which is not routine and probably effects shareholders or investors, the same should be disclosed separately. Example- Any expense having amount more than Rs.5000 or 1% of turnover whichever is higher should be disclosed separately rather to club with miscellaneous expenses.

2.4 NOTES TO ACCOUNTS

Notes to accounts are the explanation given by the management about the items in the financial statements i.e. Profit and Loss Account and Balance Sheet. The management of the institute has to give more explanation and information as regards the items given in the Profit and Loss Account and Balance Sheet and any other item in the way of notes to accounts. E.g. Disclosure of details of contingent liability by notes to accounts. Notes to accounts are part and parcel of the financial statement.

2.5 DISCLOSURE OF ACCOUNTING POLICIES

To ensure proper understanding of financial statements, it is necessary that:-

1. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

2. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.

3. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

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

2.6 DISCLOSURE OF CHANGE IN ACCOUNTING POLICIES

A change in the accounting policies should be made in the following conditions:

1. Adoption of different accounting policies is required by statue or for compliance with an Accounting Standard.

2. It is considered that change would result in more appropriate presentation of financial statements.

In case if there is a change in accounting policies, the following information must be disclosed:

1. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed.

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

2.7 ILLUSTRATIONS

Significant accounting policies can be found in financial statements of public companies. Some examples of significant accounting policies are as follows:

1. Inventories

This significant accounting policy comes from 2017-18 annual financial statements of Zimmer Holdings, Inc.

Inventories are stated at the lower of cost or market, with cost determined on a first-in first-out basis.

2. Property and Equipment

This significant accounting policy comes from 2017-18 annual financial statements of Google, Inc.

We account for property and equipment at cost less accumulated depreciation and amortization. We compute depreciation using the straight-line method over the estimated useful lives of the assets, generally two to five years. We depreciate buildings over periods up to 25 years. Depreciation for equipment commences once it is placed in service and depreciation for buildings and leasehold improvements commences once they are ready for our intended use. Land is not depreciated

3. Cash and Cash Equivalents

This significant accounting policy comes from 2017-18 annual financial statements of Hill-Rom, Inc.

We consider investments in marketable securities and other highly liquid instruments with a maturity of three months or less at date of purchase to be cash equivalents. Investments which have no stated maturity are also considered cash equivalents.

2.8 PRACTICAL APPLICATIONS

1. A Company has switched over to weighted average formula for ascertaining the cost of inventory, from the earlier practice of using FIFO. The closing inventory by using FIFO is Rs. 4 lakh and that by weighted average formula is Rs.3.85 lakh. Explain the Accounting Treatment/Disclosures as necessary

Ans: The fact that change in accounting policy pull down profit and value of inventory by Rs.15,000 is to be disclosed.

2. Shreya's Ltd. prepared Profit and Loss Account and the Balance Sheet for the year 2017-18.The accounting policies about Profit and

Loss Account have been disclosed below Profit and Loss Account and accounting policies about Balance Sheet have been disclosed before Balance Sheet. Comment

Ans: As per AS-1, the accounting policies adopted for preparation of final accounts should form part of the final accounts. These policies should be disclosed at one place only forming part of the accounts. It should not be disclosed separately.

3. PG Ltd. prepared Profit & Loss Account and Balance Sheet on cash basis. Comment.

Ans: As per AS-1, accrual basis is the fundamental accounting assumption. The company follows cash basis. The fundamental accounting assumption is not followed; it should be disclosed in the form of a note to the accounts.

4. Akshata Ltd. prepared final accounts for the year 2017-18. During the year accident took place in the factory, the worker who got injured lodged a claim of Rs.3,00,000 against the company .The claim is under dispute, the accountant did not mention this in the accounts, Comment.

Ans. Claim for compensation under dispute is a contingent liability. As per AS-1, it should be disclosed as a foot-note to the final accounts. The company must make a disclosure about the contingent claim.

5. Draft the Accounting policies to be disclosed in the financial statements for the following items:
i. Revenue Recognition-Sale of goods

Ans. Sales are recognized when good are invoiced and dispatched to customers and are recorded inclusive of excise duty, net trade discount and sales tax.

ii. Revenue Recognition-Sale of Equipment

Ans. Sale of Equipment is recognized when (1) it has a firm contract, (2) the product has been shipped to and accepted by the customer or the service has been provided, and (3) amounts are reasonably assured of collection. Most equipment sales require installation of the product. As such, revenue is recognized at the time of delivery and installation at the customer location. Equipment revenues are based on established prices by product type and model and are net of discounts.

iii. Revenue Recognition-Sales Return

Ans. A sales return is accepted only when the equipment is defective and does not meet product performance specifications.

iv. Inventories

Ans. Inventories, other than scrap, are valued at cost, on weighted average basis. Scrap is valued at realizable value.

v. Depreciation – Machinery Spares

Ans. Machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular are capitalized and depreciated over the residual useful life of the related plant and machinery.

vi. Depreciation- Fixed Assets

Ans. Fixed assets (Other than leasehold land, technical knowhow and temporary structure) are depreciated on straight-line method (SLM) at the rate and in the manner prescribed in schedule XIV to the Companies Act, 1956 by writing off 95% of the cost of the assets over the specified period of the assets.

6. Explain requirement in the following cases with reference to DISCLOSURE OF ACCOUNTING POLICIES (AS-1)

1. Where proper disclosures regarding changes in accounting policies have not been made by a company, in the method of providing depreciation on plant and machinery from straight line method to written-down value method and due to the change the net profit for the year, the net block as well as the reserves and surplus lowered by Rs.50,00,000.

Ans. The company has not disclosed in its accounts the fact of change, from this year, in the method of providing depreciation on plant and machinery from straight line method to written-down value method, as also the effect of this change. As a result of this change, the net profit for the year, the net block as well as the reserves and surplus are lower by Rs.50,00,000 each as compared to the position which would have prevailed had this change not been made.

2. Where a company has not disclosed all significant accounting policies like treatment of research and development costs and has also not disclosed the accounting policies at one place.

Ans. The company had disclosed those accounting policies the disclosure of which is required by the Companies Act, 1956. Other significant accounting policies, viz., those relating to treatment of research and development costs have not been disclosed nor have all the policies been disclosed at one place, which is contrary to Accounting Standard (AS) 1, `Disclosure of Accounting Policies' issued by the Institute of Chartered Accountants of India.

2.9 QUESTIONS

1. What is an accounting policy?
2. List out different Accounting policies?
3. Mention the areas in which different policies may be adopted by different organizations?
4. Write a short note on selection of accounting policies?
5. What are basic accounting assumptions?
6. What are the disclosure requirements of AS-1 issued by ICAI?
7. What do you understand by “notes to accounts”?

8. Select Correct Alternative:

i. Accounting policy is
1. accounting postulate
2. accounting convention
3. accounting standard
4. specific accounting principle or method chosen by management out of permissible alternatives

ii. Example of accounting policy is
1. Method of depreciation chosen by management
2. Separate entity concept
3. Balance sheet
4. Standard audit

iii. RPC Ltd. follows the written down value method of depreciating machinery year after year due to
1. Comparability.
2. Convenience.
3. Consistency.
4. All of the above.

iv. A change in accounting policy is justified
1. To comply with accounting standard.
2. To ensure more appropriate presentation of the financial statement of the enterprise.
3. To comply with law.
4. All of the above.

v. Fundamental accounting assumptions are

1. Materiality.
2. Business entity.
3. Going concern.
4. Dual aspect

vi. M/s ABC Brothers, which was registered in the year 2000, has been following Straight Line Method (SLM) of depreciation. In the current year it changed its method from Straight Line to Written down Value (WDV) Method, since such change would result in the additional depreciation of Rs. 200 lakhs as a result of which the firm would qualify to be declared as a sick industrial unit. The auditor raised objection to this change in the method of depreciation.

The objection of the auditor is justified because

1. Change in the method of depreciation should be done only with the consent of the auditor.

2. Depreciation method can be changed only from WDV to SLM and not vice versa.

3. Change in the method of deprecation should be done only if it is required by some statute and change would result in appropriate presentation of financial statement.

4. Method of depreciation cannot be changed under any circumstances.

vii. State the case where the going concern concept is applied?

1. When an enterprise was set up for a particular purpose, which has been achieved, or to be achieved shortly.

2. When a receiver or liquidator has been appointed in case of a company which is to be liquidated.

3. Fixed assets are acquired for use in the business for earning revenues and are not meant for resale.

4. When an enterprise is declared sick.

viii. Principle requires that the same accounting method should be used from one accounting period to the next.

1. Conservatism.
2. Consistency.
3. Business entity.
4. Money measurement.

ix. The cost of a small calculator is accounted as an expense and not shown as an asset in a financial statement of a business entity due to __________

1. Materiality concept.
2. Matching concept.
3. Periodicity concept.
4. Conservatism concept.

x. It is generally assumed that the business will not liquidate in the near foreseeable future because of

1. Periodicity.
2. Materiality.
3. Matching.
4. Going concern.

xi. The accounting concept requiring the practice of crediting closing stock to the trading account

1. Going concern
2. Cost
3. Matching
4. All of Above

xii. Accounting Principles are generally based on

1. Practicability
2. Subjectivity
3. Convenience in recording
4. All of Above

xiii. "Substance of any transaction should be considered while recording them and not only the legal form" is the statement which holds true for

1. Substance over form.
2. Disclosure of accounting policies.
3. Both (a) and (b).
4. None of the three.

xiv. Change in the method of depreciation is change in ________.

1. Accounting estimate.
2. Accounting policy.
3. Measurement discipline.
4. None of the above.

Answers: i-4, ii-1, iii-3, iv-4, v-3, vi-3, vii-3, viii-2, ix-1, x-4, xi-1, xii-1, xiii-3, xiv-2

8. State whether the following statements are true or false:

1. The 'materiality concept' refers to the state of ignoring small items and values from accounts.

2. Accounting principles are rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.

3. The ‘conservatism concept’ leads to the inclusion of all unrealized profits.

4. Accounting concepts are broad assumptions.

5. India is a member of IASC (International Accounting Standards Committee).

6. The Institute of Chartered Accountants of India (ICAI), the apex body of accounting and auditing, constituted an Accounting Standards Board (ASB) on April 21, 1977, to pronounce standards on various items of the financial statements.

Answers: True: 1, 2, 4, 5, 6
False: 3.

❖❖❖❖

Unit-3

AS-2 VALUATION OF INVENTORIES

Unit Structure:

3.0 OBJECTIVES

After studying the unit students will be able to:

- Understand objective and scope of AS-2.
- Make the measurement of inventories at various cases.
- Solve the examples related to allocation of Fixed Overheads
- Calculate the cost of inventories.
- Solve the problems on calculation of the cost of inventories.

3.1 INTRODUCTION

Accounting Standard (AS) 2 'Valuation of Inventories', issued by the Council of the Institute of Chartered Accountants of India supersedes Accounting Standard (AS) 2, 'Valuation of Inventories', issued in June, 1981. The revised standard comes into effect in respect of accounting periods commencing on or after 1.4.1999 and is mandatory in nature. **Inventories** consist of Finished Goods which are held for sale in the ordinary course of business, Raw Material & Work in Progress.

DEFINITION

1. INVENTORY

Inventories are assets:

- Held for sale in the ordinary course of business,
- In the process of production for such sale or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are accounted for in accordance with Accounting Standard (AS) 10,Accounting for Fixed Assets.

2. NET REALISABLE VALUE

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

3.2 OBJECTIVE AND SCOPE OF AS-2

3.2.1 OBJECTIVE

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognized. This Statement deals with the determination of such value, including the ascertainment of cost of inventories and any write-down thereof to net realizable value.

3.2.2 SCOPE

This Statement should be applied in accounting for inventories other than:

a. work in progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7, Accounting for Construction Contracts 3);

b. work in progress arising in the ordinary course of business of service providers;

c. shares, debentures and other financial instruments held as stock-in-trade; and

d. producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realizable value in accordance with well established practices in those industries.

The inventories referred to in paragraph (d) are measured at net realizable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Statement.

3.3 MEASUREMENT OF INVENTORIES

Inventories should be valued at the lower of cost and net realizable value.

3.3.1 Cost of Inventories

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

3.3.2 Costs of Purchase

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

3.3.3 Costs of Conversion

The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

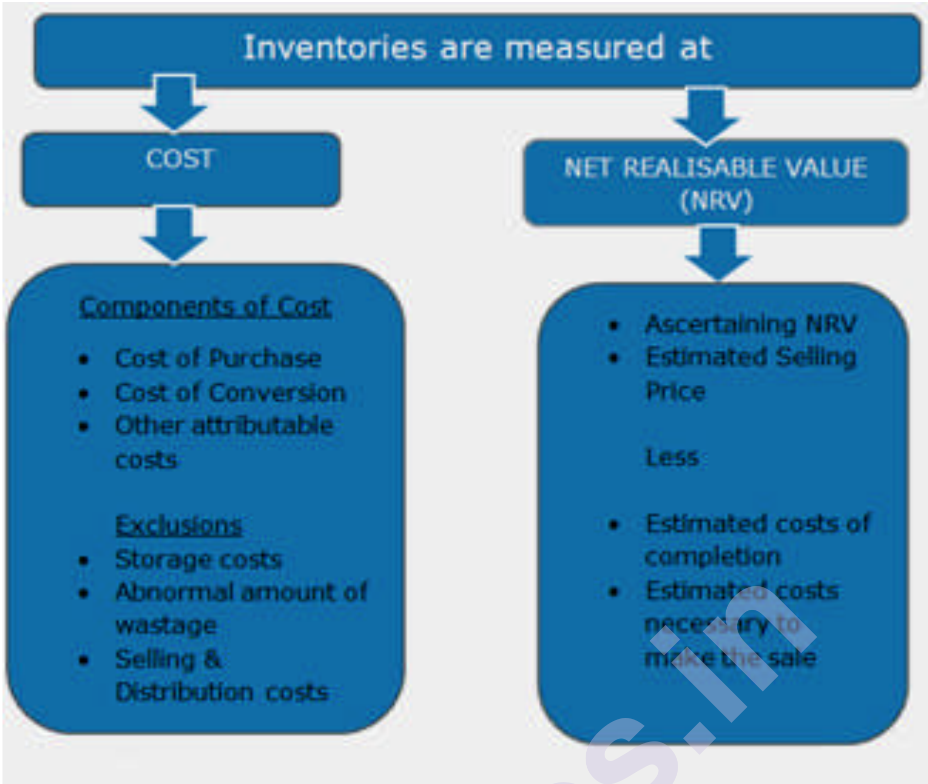


Fig 3.1: Measurement of Inventory

3.3.4 Allocation of fixed Overheads

The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is **based on the normal capacity of the production facilities.** Normal capacity is the production expected to be achieved on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. **The amount of fixed production overheads allocated to each unit of production is not increased as a consequence of low production or idle plant.**

Unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of **abnormally high production**, the amount of fixed production overheads allocated to each unit of production is **decreased so that inventories are not measured above cos**t. Variable production overheads are assigned to each unit of production on the basis of the **actual use** of the production facilities.

1.3.5 Examples - Allocation of Fixed Overheads

Example 1.

Total Production	100 Units
Normal Capacity	50 Units
Goods Sold	80 Units
Closing Stock	20 Units
Direct Cost	10 per unit
Fixed Overhead	Rs.80
Variable Overhead	Rs.120

Ans: Valuation of Stock = Direct Cost + Fixed Cost + Variable Cost
=10 + 0.8 + 1.2
= **Rs.12**

Fixed Cost= (80/100) = **Rs.0.8**

Variable cost= (120/100) = **Rs.1.2**

Note: In case of Actual Production is abnormally high then, Fixed Overhead is allocated to Finished Goods on actual Production basis.

3.3.6 Joint Products

A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products as well as scrap or waste materials, by their nature, are immaterial. When this is the case, they are often measured at net realizable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

3.3.7 Other Costs

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

3.3.8 Exclusions from the Cost of Inventories

In determining the cost of inventories in accordance with paragraph 6, it is appropriate to exclude certain costs and recognize them as expenses in the period in which they are incurred. Examples of such costs are:

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

(b)Storage costs, unless those costs are necessary in the production process prior to a further production stage;

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

(d) Selling and distribution costs.

3.3.9 Cost Formulae

1. Specific Identification Method for–

i) Goods not ordinarily interchangeable;
ii) Goods/services produced and segregated for specific projects.

Specific identification of cost means that specific costs are attributed to identify items of inventory. This is an appropriate treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. However, when there are large number of items of inventory which are ordinarily interchangeable, specific identification of costs is inappropriate since, in such circumstances, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting a particular method of ascertaining the items that remain in inventories.

2. FIFO, Weighted Average Method in other cases.

The cost of inventories, in other cases should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

A variety of cost formulae is used to determine the cost of inventories other than those for which specific identification of individual costs is appropriate. The formula used in determining the cost of an item of inventory needs to be selected with a view to providing the fairest possible approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

3.3.10 Techniques for the Measurement of Cost

Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions.

The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

3.4 NET REALISABLE VALUE

3.4.1 MEANING

It means the estimated selling price in ordinary course of business, less estimated cost of completion and estimated cost necessary to make the sale. Estimation of NRV also takes into account the purpose for which the inventory is held.

3.4.2 When cost of inventories may not be recoverable?

i. If inventories are damaged,
ii. If they have become wholly or partially obsolete,
iii. If their selling prices have declined.
iv. If the estimated costs of completion or the estimated costs necessary to make the sale have increased.

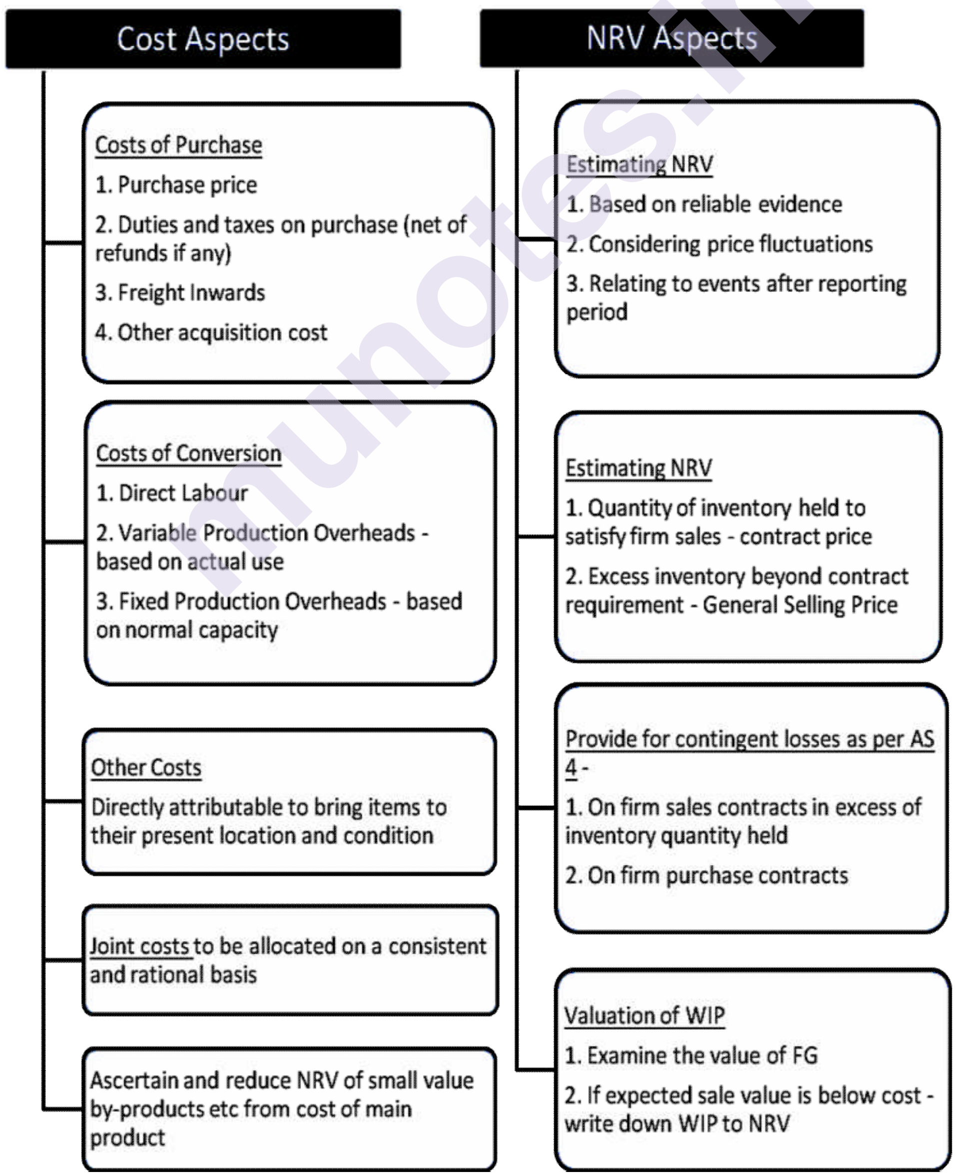
The practice of writing down inventories below cost to net realizable value is consistent with the view that assets should not be carried in excess of amounts expected to be realized from their sale or use. An assessment is made of net realizable value as at each balance sheet date.

3.4.3 Net Realizable Value for Raw Material - Para 24 of AS 2

1) If finished goods in which Raw Material is used, is sold at or above cost, then net realizable value of Raw Material is considered more than its cost.

2) If finished goods in which Raw Material used is sold below cost, then net realizable value of Raw Material is equal to replacement price of Raw Material.

3.4.4 Analysis of Inventory valuation under cost and NRV Aspects



Example 2:
Suppose, there are 1,00,000 units in stock, of which 60,000 are to be delivered for Rs.40 each as per contract with one of the customer. Cost of stock is Rs.45 per unit & NRV is estimated of Rs.50 per unit. What will be the value of stock?

Ans. In this case, 60,000 units will be valued at Rs.40 & balance stock of 40,000 units will be valued at Rs.45 per unit.

Example 3:

Items	X	Y	Z	Total
Cost	20	16	8	44
NRV	14	16	12	42

How will you value the stock under provisions of AS-2?

Ans:

Items	X	Y	Z	Total
Cost	20	16	8	44
NRV	14	16	12	42
Value (under AS 2)	14	16	8	38

3.5 DISCLOSURES

The financial statements should disclose:
i. Accounting policies relating to inventories
ii. Cost formula used
Iii.Carrying amount of inventories with appropriate classifications

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are raw materials and components, work in progress, finished goods, stores and spares, and loose tools.

3.6 DISCLOSURE PRACTICE ON VALUATION OF INVENTORIES (AS-2)

Illustration:
This significant accounting policy comes from 2006 annual financial statements of Bharat Forge America Inc.

Inventories are stated at the lower of cost or market, with the cost determined on the First-In, First-Out (FIFO) method.

Explain requirement in the following cases with reference to

VALUATION OF INVENTORIES (AS-2)

1. The company is valuing its stocks at `cost' instead of `lower of cost or net realizable value". Further, in valuing the closing stock at cost, the company has included interest and other borrowings in `cost'.

Ans. That the company is valuing its stocks at 'cost' instead of `lower of cost and net realizable value'. Further, in valuing the closing stock at cost, the company has included interest and other borrowings in 'cost'. This is not in accordance with principles of valuation of inventory as laid down in Revised Accounting Standard AS-2 on Valuation of Inventories , issued by the Institute of Chartered Accountants of India, which recommends, inter alia, that the inventories should be valued at `lower of cost and net realizable value' and that the interest and other borrowing should not normally be included in the cost.

2. The Company in respect of its Chemical Division followed the practice of valuing its inventories on FIFO basis. This year it changed the basis of valuation from FIFO to LIFO basis. If this change had not been made, the profit of the Company would have been higher by Rs.20 lakhs and inventories would have been higher by Rs.20 lakhs.

Ans. The Company in respect of its Chemical Division followed the practice of valuing its inventories on FIFO basis. This year it changed the basis of valuation from FIFO to LIFO basis. Had this change not been made, the profit of the Company would have been higher by Rs.20 lakhs and inventories would have been higher by Rs.20 lakhs. This is not accordance with principles of valuation of inventory as laid down in Revised Accounting Standard AS-2 on `Valuation of Inventories', issued by the Institute of Chartered Accountants of India, which recommends, inter alia, that the inventories should be value at FIFO and at LIFO.

3. As per the past practice, the excise duty paid on finished goods inventory amounting to Rs.3 crores has been treated as prepayment till the goods are sold and estimated excise duty of Rs.2 crores on finished goods lying in the factory premises but not cleared from excise bonded warehouse as on March 31, 2011 has not been included in inventory valuation.

Ans. As per the past practice, the excise duty paid on finished goods inventory amounting to Rs.3 crores has been treated as prepayment till the goods are sold and estimated excise duty of Rs.2 crores on finished goods lying in the factory premises but not cleared from excise bonded warehouse as on March 31, 2011 has not been provided and hence, not included in inventory valuation. This treatment, however, has no effect on the profits for the year.

3.7 GUIDANCE NOTE ON MODVAT/CENVAT ISSUED BY THE ICAI AND VALUATION OF INVENTORY

ICAI issued a "Guidance Note on Accounting Treatment for MODVAT / CENVAT", with the substitution of the MODVAT Credit Scheme with CENVAT w.e.f. 1-4-2000. The revised Guidance Note has provided clarification on the above anomaly, with examples on both the inclusive method (Sec.145A) and exclusive method (AS-2), where it is clear that the above anomaly is only in respect of the disclosure, with no effect on the total profit/loss of the enterprise.

Therefore, for purposes of tax filings and tax audit forms, the inclusive method should be used as per section 145A of the Income-tax Act, whereas for purposes of general purpose financial statements, the exclusive method under AS-2 should be followed.

Inclusive Method (Gross Value Approach)

- Raw material is accounted for at gross value inclusive of specified duty.
- CENVAT credit available on final products can be accounted for through a separate account CENVAT Credit Availed Account.
- Inputs may be consumed partly. CENVAT Credit available should be segregated into two parts:
  - CENVAT Credit on inputs consumed in respect of final products;
  - CENVAT credit on inputs lying in the stock.

CENVAT credit available on inputs consumed for final products is adjusted with the cost of raw material consumed.

CENVAT credit available on inputs lying in the godown should be adjusted against the value of closing stock of raw material.

Exclusive Method (opening separate CENVAT Credit Account)

- Specified duty (i.e., duty paid against which CENVAT credit is available) paid on inputs is debited to a separate account, namely CENVAT Credit Receivable (Input) Account.

- As and when CENVAT credit is actually utilized against payment of excise duty on final products, CENVAT Credit Receivable (Input) Account is credited.
- Inputs consumed and inventory is valued excluding specified duty.

Balance standing in the CENVAT Credit Receivable (Input) Account is shown on the asset side of the Balance Sheet under Advances.

3.8 COST OF INVENTORIES

A] Cost of Purchase:			
I] Purchase Price	xx		
ii] Duties & Taxes	xx		
iii] Freight Inward	xx		
iv] Other Expenditure directly attributable to acquisition	xx	xx	
Less: i] Duties and Taxes recoverable from tax authorities	xx		
ii] Trade discount	xx		
iii] Rebate	xx		
iv] Duty Drawback	xx		
v] Other similar items	xx	xx	xxx
B] Cost of Conversion:			
Direct Materials	xx		
Direct Labour	xx		
Direct Expenses	xx		
Systematic allocation of:			
Variable Production Overheads	xx		
Fixed Production Overheads	xx		xxx
C] Other Costs:			
Cost incurred for bringing the inventories to their present			xxx
location and condition			xxx

3.9 PRACTICAL APPLICATIONS

Illustration 1: (Duties and taxes not recoverable)

Ambalal furnishes you following details

Ascertain the cost of purchase of inventory

i] Purchase of Raw materials	Rs. 10 lakhs
ii] Duties and Taxes paid on the acquisition and are not recoverable	Rs. 2 lakhs
iii] Carriage inward	Rs. 1 lakhs
iv]Others paid for acquisition of inventory	Rs. 1 lakhs

Solution:

Cost of Purchase	**Rs. in lakhs**
Cost of Purchase of Raw Materials	10
Duties & Taxes not recoverable	02
Carriage inward	01
Other Expenses	01
Total	**14**

Illustration 2

Big Bagha Associates furnishes you following details from which you are required to ascertain cost of purchase of inventories.

i]	Cost of Purchase of Inventory	Rs. 20 lakhs
ii]	Duties & Taxes paid and are recoverable from Tax Authorities	Rs. 5 lakhs
iii]	Trade Discount	Rs. 2 lakhs
iv]	Duties & Taxes paid and not recoverable	Rs. 2 lakhs
v]	Freight Inwards	Rs. 1 lakhs
vi]	Other Expenses directly attributable to Acquisition of Inventory	Rs. 2 lakhs

Solution : Big Bagha Associates

Calculation of Cost of Purchase		**Rs. in lakhs**
Cost of Purchase		20
Duties & Taxes paid and not recoverable		02
Freight Inward		01
Other Expenses		02
		25
Less : Duties & Taxes recoverable from		
Tax Authorities	05	
Trade Discount	02	07
Total		**18**

Illustration 3

Chrome Ltd. manufactures different types of Dichromates. From the following information find the value of inventory per kg of Sodium Dichromate

Material cost	Rs. 150 per kg
Direct Labour Cost	Rs. 50 per kg
Direct Variable Production Overheads	Rs. 20 per kg

Fixed production overheads for the year on normal capacity of 1,00,000 kgs is Rs.15 lakhs.

Finished goods on stock at the end of the year 3,000 kgs.

Solution: **Chrome Ltd.**

Cost per kg of Sodium Dichromate

As per AS-2 cost of conversion includes a systematic allocation of fixed and variable production overheads, which are incurred for converting materials into finished goods. The allocation of fixed production overheads is based on normal capacity.

Statement of Cost (Per Kg)	**Rs.**
Material Cost	150
Direct Labour	50
Direct Variable Production Overheads	20
Fixed Production Overheads $\left(\dfrac{15,00,000}{1,00,000}\right)$	15
	235

Value of Stock = 3,000 kgs @ Rs. 235
= **Rs. 7,05,000**

Illustration 4

Ind Ltd. manufacture computers, during the year ended 31st March, 2008 the company manufactured 550 computers, it has the policy of valuing finished stock of goods at a standard cost of Rs.1.8 lakhs per computer. The details of the cost are as under;

	(Rs. in Lakhs)
Raw material consumed	400
Direct Labour	250
Variable production overheads	150
Fixed production overheads (Including interest of Rs. 100)	290

Compute the value of cost per computer for the purpose of closing stock.

Solution: As per AS-2 (Revised) (refer point 3.6), on valuation of Inventories, finished stock of goods should be valued on the basis of absorption costing. While absorbing fixed production overheads the normal production capacity is considered. In this case, finished stock has been valued at a standard cost of Rs.1.8 lakhs per computer which incidentally synchronizes with the value computed on the basis of absorption costing as under:

		(Rs. in lakhs)
Materials		400
Direct Labour		250
Fixed production overheads		150
Fixed production overheads	290	
Less : Interest	100	190
Total Cost		**990**

Number of computers produced 550
(Assumed to be normal production)
Cost per computer 990/550 = **Rs. 1.80 lakhs**

Policy of the company to value closing stock is not as per AS-2. As per para 18 of AS-2, (refer point 3.9-1) the techniques of standard cost method may be used for convenience if the result approximates to the actual cost and standard cost is regularly reviewed if necessary. In the instant case, the cost of inventory can be conveniently calculated as per absorption costing. Therefore, there is no reason that standard costing method should be adopted.

Illustration 5

Dolphin Simulators Ltd. manufactures simulators.

Raw material was purchased at Rs. 100 per kg. Price of raw material is on the decline. The finished goods in which the raw material is incorporated are expected to be sold at below cost. 10,000 kgs of raw material is in stock at the year-end. Replacement cost is Rs. 80 per kg. How will you value the inventory?

Solution :

Dolphin Simulators Ltd.

As per para 24 of AS-2, on valuation of inventories, material and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the material may be the best available measure of their net realisable value.

Hence, in this case, the stock of 10,000 kgs. of raw material will be valued at Rs.80 per kg. The finished goods, if on stock, should be valued at cost or net realisable value, whichever is lower.

Illustration 6

Lurcko Pvt. Ltd. manufactures computers. During the year ended 31st March, 2017, the company manufactured 1000 computers. The break up of cost is as under:

Raw Material	Rs. 450 lakhs
Direct Labour	Rs. 300 lakhs
Variable Production Overheads	Rs. 200 lakhs
Fixed Production Overheads	
(Includes interest of Rs.100 lakhs)	Rs. 300 lakhs

Compute the cost per computer for the purpose of closing stock.

Solution:

As per AS-2 Inventory should be valued as per absorption costing. The cost is calculated as under :

Calculation of Cost of Purchase

		Rs. in lakhs
Raw Material		450
Direct Labour		300
Variable Production Overheads		200
Fixed Production Overheads	300	
Less Interest	100	200
		1150

Cost per computer = **1,150 Lakhs /1,000** = **Rs. 1.15 lakhs**

Note: Interest is excluded from cost of inventory.

Illustration –7

Gurecha Pvt. Ltd. furnishes you following information from which you are required to value inventory of Finished Goods.

Material cost	Rs. 200 per kg.
Direct Labour cost	Rs. 40 per kg.
Direct variable production overhead	Rs. 20 per kg.

Fixed production charges for the year on normal capacity of one lakh kgs. is Rs. 20 lakhs. 2000 kgs. of finished goods are on stock at the year-end.

Solution: Gurecha Pvt. Ltd.

In accordance with paras 8 & 9 of AS-2, (refer point 3.6) the cost of conversion include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. The allocation of fixed production overheads for the purpose of their inclusion in the cost of conversion is based on the normal capacity of the production facilities.

Thus, cost per kg. of finished goods can be computed as follows:

	Rs	**Rs.**
Material cost		200
Direct Labour cost	40	
Direct variable production overhead	20	
Fixed production overhead (Rs. 20,00,000/100000)	20	80
		280

Thus, the value of 2000 kgs. of finished goods on stock at the year-end will be **Rs.5,60,000** = (2000 kgs. X Rs. 280)

Illustration 8

Hirel Techno points Associates is a company situated at MIDC, Pune. The company deals in three products A, B and C, which are neither similar nor interchangeable. At the time of closing of its accounts for the year 2016-17; the historical cost and net realisable values of the items of closing stock are given below:

Items :	**Historical Cost (Rs. in lakhs)**	**Net Realisable Value (Rs. in lakhs)**
A	25	20
B	20	20
C	10	15
	55	55

What will be the value of stock?

Solution: HIREL TECHNOPOINTS, PUNE

Historical Cost or Net Realisable Value whichever is less is the value of stock. This should be done item by item as given below:

		Rs. in lakhs
A.	Net Realisable Value	20
B.	Historical Cost	20
C.	Historical Cost	10
	Value of Closing Stock	**50**

Illustration 9

The company deals in three products, A, B and C, which are neither similar nor interchangeable. The Historical Cost and Net Realizable Value of the items of closing stock for the year 2016-17 are determined as follows:

Items	Historical Cost	Net Realizable Value
	(Rs. in lakhs)	(Rs. in lakhs)
A	40	28
B	32	32
C	16	24

What will be the value of Closing Stock?

Ans: As per Para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by item basis in the given case.

Items	Historical Cost	Net Realizable Value	Valuation of closing stock
	(Rs. in lakhs)	(Rs. in lakhs)	(Rs. in lakhs)
A	40	28	28
B	32	32	32
C	16	24	16
Total	**88**	**84**	**76**

Hence, closing stock will be valued at Rs. 76 lakhs.

Illustration 10

X Co. Limited purchased goods at the cost of Rs.40 lakhs in October, 2011. Till March, 2012, 75% of the stocks were sold. The company wants to disclose closing stock at Rs.10 lakhs. The expected sale value is Rs.11 lakhs and a commission at 10% on sale is payable to the agent. Advice, what is the correct closing stock to be disclosed as at 31.3.2012.

Ans: As per Para 5 of AS 2 "Valuation of Inventories", the inventories are to be valued at lower of cost and net realizable value. In this case, the cost of inventory is Rs.10 lakhs. The net realizable value is 11, 00,000 @ 90% = Rs.9, 90,000. So, the stock should be valued at Rs.9, 90,000.

Illustration 11

The Company X Ltd. has to pay for delay in cotton clearing charges. The company up to 31.3.2017 has included such charges in the valuation of closing stock. This being in the nature of interest, X Ltd. decided to exclude such charges from closing stock for the year 2006-07. This would result in decrease in profit by Rs.5 lakhs. Comment.

Ans: As per Para 12 of AS 2 (revised), interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are therefore, usually not included in the cost of inventories. However, X Ltd. was in practice to charge the cost for delay in cotton clearing in the closing stock. As X Ltd. decided to change this valuation procedure of closing stock, this treatment will be considered as a change in accounting policy and such fact to be disclosed as per AS 1. Therefore, any change in amount mentioned in financial statement, which will affect the financial position of the company should be disclosed properly as per AS 1, AS 2 and also a note should be given in the annual accounts that, had the company followed earlier system of valuation of closing stock, the profit before tax would have been higher by Rs. 5 lakhs.

Illustration 12

Normal capacity = 20,000 units
Production = 18,000 units
Sales = 16,000 units
Closing Stock = 2,000 units
Fixed Overheads = Rs. 60,000
Calculate cost of fixed overheads to closing stock

Ans: Fixed Overheads = Rs.60,000 / 20,000 = Rs. 3 per unit
Fixed Overheads will be bifurcated into three parts:
Cost of Sales: 16,000*3 = 48,000
Closing Stock: 2,000 *3 = Rs. **6,000**

Under normal capacity: 2,000 *3 = Rs. 6,000
(to be charged to P/L A/c)

Illustration 13

Normal capacity = 20,000 units
Production = 25,000 units
Sales = 23,000 units
Closing Stock = 2,000 units
Fixed Overheads = Rs 60,000
Calculate Cost of fixed overheads to closing stock

Ans: Fixed Overheads = Rs 60,000/20,000 = Rs.3 per unit
But, Due to production above normal capacity = Rs.60,000 / 25,000 = Rs. 2.40 per unit
Cost of Sales: 23,000 * 2.4 = **Rs. 55,200**
Closing Stock: 2,000 * 2.4 = **Rs. 4,800**

Illustration 14
Ascertain the cost of Inventory by using the data given below:

i. Purchase Price	Rs.20 lakhs
ii. Duties and Taxes paid on acquisition and are not recoverable	Rs.2 lakhs
iii. Freight inward	Rs.2 lakhs
iv .Others paid for acquisition of inventory	Rs.1 lakhs

Ans. Cost of Purchase:

Cost of Inventory	**Rs. in lakhs**
Purchase Price	20
Duties and Taxes paid on acquisition and are not recoverable	02
Freight inward	02
Others paid for acquisition of inventory	01
Total	**25**

Illustration 15
Zenith Ltd. manufactures computers. During the year ended 31st March 2017, the Company manufactured 5,000 computers and incurred following cost:

i. Raw Material	Rs.400 lakhs
ii. Direct Labour	Rs.400 lakhs
iii.Variable Production overheads	Rs.150 lakhs
iv. Fixed Production overheads (including interest 50 lakhs)	Rs.250 lakhs

Compute cost per computer for the purpose of closing stock.

Ans.

Cost of Purchase	**Rs. in lakhs**
Raw Material	400
Direct Labour	400
Variable Production overheads	150
Fixed Production overheads	200
Total	**1,150**

Note: Interest excluded from cost of Inventory

Cost per Computer (1,150 lakhs / 5,000)	**Rs. 23,000**

3.10 EXERCISE

3.10.1 PRACTICAL PROBLEMS

1. How do you ascertain the cost of purchase of inventory by using the following data

i]	Purchase Price	Rs. 5,00,000
ii]	Duties and Taxes paid on the Acquisition of Inventory and are not recoverable	Rs. 2,00,000
iii]	Freight Inward	Rs. 1,00,000
iv]	Other Expenses for Acquisition of Materials	Rs. 2,00,000

[Ans. Rs. 10,00,000]

2. Ganesh Pvt. Ltd. produces product x 2007.
The production cost per unit

Raw Materials	Rs. 15
Labour	Rs. 6
Direct Expenses	Rs. 5
Normal capacity	10,000 units p.a.
Actual production	7,000 units
Fixed Factory overheads	Rs. 30,000 p.a.
Closing Stock	2500 units

Calculate the value of closing stock

Normal Capacity	10000units
Actual Production	7000 units
Total Fixed overheads	30000
Fixed overhead per unit	3Rs

Ans. Value of closing stock= 2500 units@29 =72500

3. Company deals in three products X, Y and Z, which are neither similar nor interchangeable. At the time of closing its account for the year 2001-2002. The historical cost and net realisable values of the items of closing stock are determined as below :

Items	**Historical Cost (Rs. in lakhs)**	**Net realisable value (Rs. in lakhs)**
X	20	14
Y	16	16
Z	8	12
	44	42

What will be the value of closing stock?

[Ans. : Rs. 38]

4. Company is collecting Gumkriya from the plant of forest for collecting Gumkriya. Company paid Rs.5 crores to forest department as license fee for financial year 2001-2002. During the year it collected 1 crore kg. of Gumkriya from the forest and sold 60 thousand kg. for Rs.12 crores. Other direct expenses and overheads were Rs.7 crores for the financial year 2001-2002. The company valued the closing stock of 40,000 kg. at Rs. 4.80 crores following the AS-2. Whether the valuation is correct.

[Ans. : AS-2 does not apply to forest product]

5. X Ltd. is selling refrigerator; purchase price of the Refrigerator is Rs.15,000 as per the terms of sales. The refrigerator is to be delivered and installed at customer's house free of cost. X Ltd. has hired Y & Co. for the purpose and being paid Rs.1,000 – per Refrigerator for delivery and installation. At year ended on 31-3-2002, 10 refrigerator were in stock. The market price of the refrigerator is Rs.15,750. Calculate the value of closing stock as per AS-2.

[Ans. : Rs. 1,47,500]

6. Apple Consultancy Ltd. is the management consultant giving the consultancy in the field of re-structuring, amalgamation and valuation. The company has got consultancy contract worth Rs.20 lakhs from Y Ltd. for giving their report of restructuring of the organization. X Consultancies Ltd. commences the work on 1-3-2008 and expect that work will take four months to be completed. X Consultancy Ltd. has deployed four senior consultants for the assignment whose salary is Rs. 20,000 per month. For the year ended 31-3-2008. The company values the work-in-progress of Rs.80,000 in its financial statement applying the formula of valuation of cost or nets realisable value whichever is less as per AS-2.

Is the valuation of W.I.P. of Rs. 80,000 is correct. If not why?

[Ans. : AS-2 does not apply to service contract]

7. Z Ltd. produced 10,000 units of product A during 2007-2008 per unit cost is as follows :

Raw Material	Rs. 100
Direct wages	Rs. 50
Direct Expenses	Rs. 2
	Rs. 152

Production overhead is Rs. 20,000 of which 40% is fixed. The company sold 800 units and 2,000 units were in stock as on 31st March 2008. Normal capacity is 50,000 units.

Calculate the value of closing stock.

[Ans.: Rs. 309600]

8. Historical Cost and Net Realibsable Value of five inventory items are given below :

Items :	Historical Cost Rs.	Net Realisable Value Rs.
A	20,000	30,000
B	12,000	10,000
C	12,000	18,000
D	32,000	26,000
E	28,000	26,000
	1,04,000	1,10,000

Determine the value of inventory.

[Ans. Rs. 94,000]

9. Cost of Production of Product x 100 is given below :

Direct Material per unit	Rs. 150
Direct Wages per unit	Rs. 100
Overheads per unit	Rs. 50
	Rs. 300

As on the balance sheet date, replacement cost of material is Rs. 120 per unit. There were 2,000 units of material on 31st March, 2008

Calculate the value of stock of material under the following conditions:

i] If finished product is sold at Rs.320 per unit, what will be the value of stock of material.

ii] If finished product is sold at the rate of Rs.280 per unit, what will be the value of closing stock of materials.

[Ans. (i) Rs. 3,00,000. (ii) Rs. 2,40,000]

10. Indulkar Ltd. produced 1,00,000 units during the year 2006-07. The cost per unit is as follows:

Direct Materials	Rs. 100
Direct Labour	Rs. 50
Direct Expenses	Rs. 10

Production overheads are Rs. 2,00,000 of which 60% is variable. The company sold 80,000 units and 20,000 units were in stock as on 31st March, 2007. Normal capacity is 50,000 units. Calculate the value of Closing Stock.

[Ans. Variable Production Overheads Rs. 1,20,000

Fixed Production Overheads Rs. 80,000

Variable Production Overheads per unit $= \dfrac{\text{Rs. } 1{,}20{,}000}{\text{Rs. } 1{,}00{,}000} = 1.20$

Fixed Production Overheads Per unit $= \dfrac{\text{Rs. } 80{,}000}{\text{Rs. } 50{,}000} = 1.60$

Cost per unit Rs. 162.80

Value of Stock = 20,000 x 162.80

= Rs. 32,56,000]

3.10.2 THEORY QUESTIONS

1] What are the objectives of AS-2?

2] Under what circumstances AS-2 is applicable?

3] Define the term 'Inventories'?

4] Write a detailed note on 'Measurement of Inventories'?

5] State and explain important aspects of 'Inventory Valuation'.

6] Write short notes on
   - i] Treatment of other cost
   - ii] Inclusion of excise duty in valuation of finished goods
   - iii] Exclusion from cost of inventories
   - iv] Disclosure of inventory valuation policy in financial statement.
   - v] Cost formula
   - vi] Net realisable value

7] Explain the following
   - a] Cost of purchase
   - b] Cost of conversion
   - c] Standard method
   - d] Retail method
   - e] Specific cost method
   - f] Net Realisable value

8] Compare the following
   - i] Standard cost and retail method
   - ii] Historical cost and Realisable value

9] Briefly explain Main Product, Joint Product and By Product.

3.10.3 OBJECTIVE TYPE QUESTIONS

1. Select Correct Alternative:

1. Under inflationary conditions, ________ method will show highest value of closing stock?

a. FIFO
b. LIFO
c. Weighted Average
d. None of the above

2. The inventory valuation method that identifies the invoice cost of each item in ending inventory to determine the cost assigned to that inventory is the:

a. Weighted-average inventory method.
b. Retail inventory method.
c. Specific identification method.
d. First-in, First-out method.

3. A company had the purchases shown below during the current year. On December 31, there were 26 units remaining in ending inventory. These 26 units consisted of 2 from January, 4 from February, 6 from May, 4 from September and 10 from November. Using the specific identification method, what is the cost of the ending inventory?

January	10 units @ 120
February	20 units @ 130
May	15 units @ 140
September	12 units @ 150
November	10 units @ 160

a. 3,500
b. 3,800
c. 3,960
d. 3,280

4. The original cost of an inventory item is above the replacement cost. The inventory item's replacement cost is above the net realizable value. Under the lower of cost or market method, the inventory item should be valued at:

a. Original cost.
b. Replacement cost.
c. Net realizable value.
d. Net realizable value less normal profit margin.

5. A manufacturer has the following per-unit costs and values for its sole product:

Cost Rs.10.00
Current replacement cost Rs.5.50
Net realizable value Rs. 6.00
Net realizable value less normal profit margin Rs. 5.20

In accordance with AS 2, what is the per unit carrying value of inventory in the manufacturer's statement of financial position?

a. 5.20
b. 5.50
c. 6.00
d. 10.00

6. AS-2 is related to :

a. Valuation of inventories
b. Accounting for Construction Contracts
c. Cash Flow Statements
d. Depreciation accounting

7. Assuming constant inventory quantities, which of the following inventory-costing methods will produce a lower inventory turnover ratio in an inflationary economy?

a. FIFO (first in, first out).
b. LIFO (last in, first out).
c. Moving average.
d. Weighted average.

8. In specific identification method of inventory valuation the method applicable will be

a. FIFO
b. LIFO
c. Average cost
d. None of the above

9. Sales for the year ended 31st March, 2005 amounted to Rs.10,00,000. Sales included goods sold to Mr. A for Rs. 50,000 at a profit of 20% on cost. Such goods are still lying in the godown at the buyer's risk. Therefore, such goods should be treated as part of

a. Sales.
b. Closing stock.
c. Goods in transit
d. Sales return

10. Approximate actual cost method of inventory valuation is --

a. Actual cost
b. Standard cost
c. Weighted average cost
d. FIFO

11. A company normally sells its product for Rs.20 per unit, which includes a profit margin of 25%. However, the selling price has fallen to Rs.15 per unit. This company's current inventory consists of 200 units purchased at Rs.16 per unit. Replacement cost has now fallen to Rs.13 per unit. Calculate the value of this company's inventory at the lower of cost or market.

a. 2,600
b. 2,550
c. 2,700
d. 3,000

12. A businessman purchased goods for Rs.25,00,000 and sold 70% of such goods during the accounting year ended 31st March, 2005. The market value of the remaining goods was Rs.5,00,000. He valued the closing stock at Rs.5,00,000 and not at Rs.7, 50,000 due to

a. Money measurement.
b. Conservatism.
c. Cost.
d. Periodicity.

13. At the end of the accounting year, material A costing Rs.10,000 was having net realizable value of Rs.9,500 only, while material B costing Rs.12,000 was having a net realizable value of Rs.13,000 in the market and material C costing Rs.15,000 was having net realizable value of Rs.14,000 only. The total amount of closing stock will be

a. Rs.37, 000.
b. Rs. 35,500.
c. Rs. 36,500.
d. Rs. 38,000.

14. The following data has been provided by Omega Ltd.:

Item No.	Units	Cost per unit	Realization value per unit
1	2	10	11
2	10	5	4
3	2	2	2

The value of inventory on item by item basis will be

a. Rs. 40.
b. Rs.64.
c. Rs.66.
d. Rs.60.

15. "Inventories should be out of godown in the sequence in which they arrive" is based on

a. HIFO.
b. LIFO.
c. FIFO.
d. Weighted average.

Answers: 1- a, 2-c, 3-b, 4-c, 5-c, 6-a, 7- a, 8-d, 9- a, 10-c, 11-a, 12- b,13- b,14-b, 15-c.

❖❖❖❖

Unit-4

AS-9 REVENUE RECOGNITION

Unit Structure:

4.0 OBJECTIVES

After studying the unit the students will be able to:

- Understand the purpose and scope of AS-9.
- Know the non applicability of AS-9
- Explain the effects of uncertainties on revenue recognition.
- Understand the circumstances in which revenue recognition has been postponed.
- Recognize revenue practically.

4.1 INTRODUCTION

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services and from the use by others of enterprise resources yielding interest, royalties and dividends. This Statement AS-9, Revenue Recognition issued in 1985 deals with the bases for recognition of revenue in the statement of profit and loss of an enterprise. The statement is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

1. The sale of goods,
2. The rendering of services, and
3. The use by others of enterprise resources yielding interest, royalties and dividends.

Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition. This standard is mandatory for all enterprises.

4.2 PURPOSE

The Purpose of AS-9 is recognizing revenue arising in the course of the ordinary activities of the enterprise.

SCOPE of AS-9

It includes the following activities:

- **Sale of goods.**
- **Rendering of services.**
- **Use by others of enterprise resources yielding interest, royalties and dividends.**

4.3 NON APPLICABLITY of AS-9

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

1. Revenue arising from construction contracts.
2. Revenue arising from hire-purchase, lease agreements.
3. Revenue arising from government grants and other similar subsidies.
4. Revenue of insurance companies arising from insurance contracts.
5. Profit or loss on sale of fixed assets
6. Realized or unrealized gains resulting from changes in foreign exchange rates

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

1. Realized gains resulting from the disposal of and unrealized gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;

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

3. Realized or unrealized gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

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

5. Unrealized gains resulting from the restatement of the carrying amount of an obligation.

4.4 REVENUE RECOGNITION

1. Sale of goods

A key criterion for determining when to recognize revenue from a transaction involving the sale of goods is that the **seller has transferred the property in the goods to the buyer for a consideration.** The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. **Revenue in such situations is recognized at the time of transfer of significant risks and rewards of ownership to the buyer.** Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

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

Thus, sale of goods is recognized when

1. **The property in goods in transferred for a price.**
2. **All significant risks and rewards have been transferred and no effective control is retained.**
3. **No significant uncertainty exists regarding the amount of consideration.**
4. **It is reasonable to expect ultimate collection of consideration.**

2. Rendering of Services

Revenue from service transactions is usually recognized **as the service is performed,** either by the proportionate completion method or by the completed service contract method.

i) **Proportionate Completion Method** — Performance consists of the execution of more than one act. Revenue is recognized proportionately by reference to the performance of each act. The revenue recognized under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognized on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

ii) **Completed service Contract Method** — Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. **The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognized when the sole or final act takes place and the service becomes chargeable.**

Revenue recognition in rendering of services

Completed service method recognises revenue only

- When service complete or substantially complete.
- In such cases there are more than one act involved and revenue is recognised on' execution of all those acts.

Proportionate completed method

- Recognises revenue proportionate with the degree of completion of services.
- There is more than one act involved and revenue is recognised on execution of certain acts.

Thus, Service is recognized when

- **Service is recognised either on completed service or proportionate completion method.**
- **No significant uncertainty exists regarding amount of consideration.**
- **It is reasonable to expect ultimate collection of consideration.**

EXAMPLES

1] On sale, buyer takes title and accepts billing but delivery is delayed at buyer's request.

Ans. Revenue should be recognised notwithstanding that physical delivery has not been completed.

2] Sale on approval.

Ans. Revenue should not be recognised until the goods have been formally accepted or time for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

3] Sales with the condition of 'money back if not completely satisfied.

Ans. It may be appropriate to recognize the sale but to make suitable provision for returns based on previous experience.

4] Consignment sales.

Ans. Revenue should not be recognised until the goods are sold to a third party.

5] Instalment sales.

Ans. Revenue of sale price excluding interest should be recognised on the date of sale.

6] Special order and shipments.

Ans. Revenue from such sales should be recognized when the goods are identified and ready for delivery.

7] Where seller concurrently agrees to repurchase the same goods at a later date.

Ans. The sale should not be recognised, as this is a financial arrangement.

8] Subscriptions received for publications.

Ans. Revenue received or billed should be deferred and recognised either on a straight-line basis over time or where the items delivered vary in value from period to period, revenue should be based on the sales value of the item delivered.

9] Sale of show tickets.

Ans. Revenue should be recognised when the event takes place.

10] Guaranteed sales of agricultural crops.

Ans. When sale is assured under forward contract or government guarantee, the crops can be recognised at net realizable value although it does not satisfy the criteria of revenue recognition.

Rendering of Services

1] Installation Fees

Ans. In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2] Advertisement commission received

Ans. It is recognised when the advertisement appears before public.

3] Insurance agency commission received

Ans. It is recognised on the effective commencement or renewal dates of the related policies.

4] Tuition fees received

Ans. It should be recognised over the period of instruction.

5] Admission fees

Ans. Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

6] Entrance and membership fees

Ans. Revenue recognition from these sources will depend on the nature of the services being provided. **Entrance fee received is generally capitalised.** If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. Publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

3. Use of enterprise resources by others:

The use of such enterprise resources by others gives rise to:

(i) **Interest**—charges for the use of cash resources or amounts due to the enterprise;

(ii) **Royalties**—charges for the use of such assets as know-how, patents, trademarks and copyrights;

(iii) **Dividends**—rewards from the holding of investments in shares.

Revenue recognition in use of enterprise resources by others

1.Interest: Revenue is recognized on the time basis determined by the amount outstanding and the rate applicable.

2.Royalty: Revenue is recognized in accordance with the terms of the relevant agreement.

3.Dividends: Revenue is recognized only when a right to receive payment is established.

When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

4.5 EFFECT OF UNCERTAINTIES ON REVENUE RECOGNITION

1. Recognition of revenue requires that revenue **is measurable** and that at the time of sale or the rendering of the service **it would not be unreasonable to expect ultimate collection.**

2. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., and revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be **appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognized at the time of sale or rendering of service** even though payments are made by installments.

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

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

5. When recognition of revenue **is postponed due to the effect of uncertainties**, it is **considered as revenue of the period in which it is properly recognized.**

4.6 DISCLOSURE REQUIREMENTS

In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), When recognition of revenue is postponed due to the effect of uncertainties, an enterprise should disclose the circumstances in which revenue recognition has been postponed.

Question:-Explain requirement in the following cases with reference to REVENUE RECOGNITION (AS-9)

Accounts of certain items of income are recorded on cash basis, As a result, the net profit for the year and current assets are understated by Rs.20,000 each.

Ans. Accounts of certain items of income recorded on cash basis which is not in line with the Accounting Standard 9 regarding "Revenue Recognition" issued by the Institute of Chartered Accountants of India. As a result, the net profit for the year and current assets are understated by Rs.20,000 each as compared to the position which would have prevailed if the company has accounted for interest income on accrual basis." should be disclosed.

4.7 PRACTICAL APPLICATIONS

1) Arjun Ltd. sold farm equipments through its dealers. One of the conditions at the time of sale is payment of consideration in 14 days and in the event of delay interest is chargeable @ 15% per annum. The Company has not realized interest from the dealers in the past. However, for the year ended 31.3.2018, it wants to recognize interest due on the balances due from dealers. The amount is ascertained at Rs.9 lakhs. Decide whether income by way of interest from dealers is eligible for recognition as per AS 9.

Ans. As per AS 9 "Revenue Recognition", where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, the revenue recognition is postponed to the extent of uncertainty expected. In such cases, the revenue is recognized only when it is reasonably certain that the ultimate collection will be made.

In this case, the company never realized interest for the delayed payments made by the dealers. Hence, it has to recognize the interest only if the ultimate collection is certain. The interest income hence is not to be recognized.

2) Y Ltd. used certain resources of X Ltd. In return X Ltd. receives Rs.10 lakhs and Rs.15 lakhs as interest and royalties respectively, from Y Ltd. during the year 2017 –2018. State on what basis X Ltd. should recognize their revenue, as per AS 9.

Ans. As per AS 9 on 'Revenue Recognition', interest of Rs.10 lakhs received in the year 2017-2018 should be recognized on the time basis, whereas royalty of Rs.15 lakhs received in the same year should be recognized on accrual basis as per the terms of relevant agreement.

3) The Board of Directors of X Ltd. decided on 31.3.2017 to increase sale price of certain items of goods sold retrospectively from 1st January, 2017. As a result of this decision the company has to receive Rs.5 lakhs from its customers in respect of sales made from 1.1.2017 to 31.3.2017. But the Company's Accountant was reluctant to make-up his mind. You are asked to offer your suggestion.

Ans. As per Para 10 of AS 9 'Revenue Recognition', the additional revenue on account of increase in sales price with retrospective effect, as decided by Board of Directors of X Ltd., of Rs.5 lakhs to be recognized as income for financial year 2016-17, only if the company is able to assess the ultimate collection with reasonable certainty. If at the time of rising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

4) X Limited has recognized Rs.10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs.50 lakhs held by it as at the end of the financial year 31st March, 2017. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2017. The dividend was proposed on 10th April, 2017 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.

Ans. Paragraph 8.4 and 13 of Accounting Standard 9 on Revenue Recognition states that dividends from investments in shares are not recognized in the statement of profit and loss until a right to receive payment is established. In the given case, the dividend is proposed on 10^{th} April, 2017, while it is declared on 15^{th} June, 2003. Hence, the right to receive payment is established on 15th June, 2017. As per the above mentioned paragraphs, income from dividend on units of mutual funds should be recognized by X Ltd. in the financial year ended 31^{st} March, 2018.

5) The stages of Production and sale of the producer are as follows (all in rupees):

Stage	Activity	Cost to date(Rs.)	Net Realizable Value(Rs.)
A	Raw Materials	45,000	43,000
B	WIP 1	47,000	48,000
C	WIP 2	50,000	54,500
D	Finished Product	55,000	1,10,000
E	For Sale	55,000	1,10,000
F	Sale Agreed	55,000	1,10,000
G	Delivered	56,950	1,10,000
H	Paid For	56,950	1,10,000

State and explain the stage at which you think revenue will be recognized?

Ans. According to As-9, sales will be recognized only when

1. The sale value is fixed and determinable.
2. Property of the goods is transferred to the customer.

Both these conditions are satisfied at stage F, when sales are agreed at a price and goods allocated for delivery purpose.

4.8 EXERCISE

4.8.1 PRACTICAL PROBLEMS

1. AST Co. Ltd. uses certain resources of BST Co. Ltd. In return BST Co. Ltd. received Rs. 8 lakhs and Rs. 12 lakhs as interest and royalties from AST Co. Ltd. during the year 2017-18.You are required to state on whether and what basis this revenues can be recognized by BST Co. Ltd.?

2. X Limited has recognized Rs.10 lakhs on accrual basis income from dividend on securities of the face value of Rs.50 lakhs held by it as at the end of the financial year 31st March, 2017. The dividends on mutual funds were declared at the rate of 20% on 25th May, 2017. The dividend was proposed on 10th April, 2017 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.

3. The Board of Directors of X Ltd. decided on 31.3.2017 to increase sale price of certain items of goods sold retrospectively from 1st January, 2017. As a result of this decision the company has to receive Rs.5 lakhs from its customers in respect of sales made from 1.1.2017 to 31.3.2017. The decision was communicated to customers and was approved. Can X Ltd. recognize revenue pertaining to increase in sale -price?

4. Goods worth Rs.6 lakhs are supplied to Ram & Co on 15th March 2017 on sale on approval basis. Comment in light of AS-9 whether revenue should be recognized?

4.8.2 THEORY QUESTION

1. When can revenue be recognized in the case of transaction of sale of goods?

Ans. As per AS 9 Revenue Recognition, revenue from sales transactions should be recognized when the following requirements as to performance are satisfied, provided that at the time of performance, it is not unreasonable to expect ultimate collection:

(i) The seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

(ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods.

2. What are the two general criteria that must be satisfied before a company can recognize revenue?

3. Explain why, in most cases, a seller recognizes revenue when it delivers its product rather than when it produces the product.

4. Distinguish between the percentage-of-completion and completed contract methods of accounting for long-term contracts with respect to income recognition. Under what circumstances should a company use the completed contract method?

5. When does a consignor recognize revenue for a consignment sale?

4.8.3 OBJECTIVE TYPE QUESTIONS

1. Select Correct Alternative:

i. In AS-9 Revenue recognition applies to
1. Sale of goods only
2. Sale of services only
3. Use of enterprises resources by other only
4. All the above

ii. In AS-9 Revenue recognition requires that revenue from divided be recognized
1. On date of proposal
2. On date of declaration
3. On date of dispatch of divided warrant
4. On accrual basis

iii. Revenue from sale of products, is generally, realized in the period in which
1. Cash is collected.
2. Sale is made.
3. Products are manufactured.
4. None of the above.

iv. AS-9 deals with Revenue recognition except:
1. Revenue arising from construction contracts.
2. Revenue arising from hire-purchase, lease agreements.
3. Both (1) & (2)
4. None of these

v. Revenue is the gross inflow of cash through
1. sale of goods,
2. rendering of services,
3. Yielding interest, royalties and dividends.
4. All of the above

.vi. As per AS 9 items not included in the definition of "revenue" are:

1. Unrealized holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
2. Realized gains resulting from the discharge of an obligation at less than its carrying amount;
3. Unrealized gains resulting from the restatement of the carrying amount of an obligation.
4. All of the above

Answers: i-4, ii-2, iii-2, iv-3, v-4, vi-4

2. Match the following:

1. AS 1	(i) Revenue Recognition
2. AS 9	(ii)Disclosure of Accounting policies.
3. AS 10	(iii) Non- Refundable Taxes
4. AS 2	(iv) Accounting for Fixed Assets.
5. Cost of Purchase include	(v) Inventory Valuation
6. Completed contract method	(vi) Refundable Taxes
7. Percentage of completion method	(vii)Defers recognition until project is complete
8. Consignment sales	(viii)Recognition proportion to work completed.
	(ix)Risks and rewards of ownership retained by seller

Answers: 1-ii, 2-i, 3-iv, 4-v, 5-iii, 6-vii, 7-viii, 8-ix

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Unit-5

INVENTORY VALUATION - I

UNIT STRUCTURE

5.0 OBJECTIVES

After studying the unit students will be able to:

- Understand the meaning of inventory and importance of inventory valuation.
- Explain the methods of stock valuation.
- Know the advantages and disadvantages of FIFO method and Average cost method.
- Understand the reconciliation of physical stock and stock as per stock register.
- Solve the problems of stock valuation.

5.1 INTRODUCTION

The stock that kept to meet further requirements of production and sales is called "Inventory". The basic reason for holding stock is to keep up the production activities undisturbed. It is neither physically possible nor economically justifiable to wait for the stocks to arrive at the time when they are actually required. Therefore, keeping of inventory is a must for the efficient working of an industrial unit. The principal types of inventories are**:**

(i) Raw materials and suppliers,
(ii) Work-in progress and
(iii) Finished goods.

Raw materials represent goods kept by a manufacturing firm prior to being utilized in the production process generally include tools, stores and spares which are consumed in the production of goods and service.

Work-in progress represent the semi finished goods and include those materials that have been commuted to production process but have not yet been converted into finished goods.

Finished goods are completed goods awaiting sale. In a manufacturing concern or in case of trading concern, it will comprise only finished goods or stock in trade owned by it for sale to customers in the normal course of business.

5.2 IMPORTANCE OF INVENTORY / STOCK VALUATION

The balance sheet of a concern must show true and fair view of the financial position of the concern. For this purpose assets including inventory should be properly valued to exhibit a true and fair view.

If stock is valued at a value which is less than the actual value and as a result, the profits will reduce. Shareholders would get less dividend. On the other hand, if inventory is valued at a value which is more that the actual value, the profits would be inflated and the shareholders would receive more dividend, a part of which would thus be paid out of capital. Payment of dividend out of capital would exhaust the capital and the company would be insolvent. Moreover, under / over valuation of inventory will not only affect the operating results and financial position of the current period but will also affect those of the next period.

The following are some of the important reason for too much emphasis on inventory or stock valuation:

1. Sufficient stock for production / sale process :

For all manufacturing and trading concerns, inventory represents a major current asset investment. Adequate inventory is essential for the Production / Sales process of an enterprises as insufficient inventory hampers production and fails to generate sufficient sales. This shows the necessity for proper valuation of inventory.

2. Proper determination of profit :

The proper determination of profit depends upon the proper valuation. If the ending inventory is valued at a lower figure, profit is under stated and if it is overvalued, profit is overstated. This shows that proper method of valuation of inventory should be followed.

3. True financial position :

Over valuation of inventory amounts to window dressing which gives wrong idea about the liquid position of the company. The proper valuation of inventories which constitute a significant portion of current assets is essential so that short term creditors may not be misled about the liquid position of the company. Balance sheet can exhibit a true and fair view of the financial position of a company if there is a proper valuation of inventory which constitutes a major portion of current assets.

5.3 METHODS OF STOCK VALUATION

Methods of taking inventories / stock

Method of Inventory

(1) Periodic inventory method. (2) Perpetual inventory Method

1. Periodic Inventory Method:

Under this method of taking inventories, value of stock is determined by physical counting of the stock on the accounting date of preparation of the final accounts. It is possible that stock taking may take a week or so in large enterprises and purchases and sales may have to be suspended for that period to get correct figure of closing inventory. This method of ascertaining the value of stock at the end of the year is also known as annual stock taking. Thus this method is based on physical stock taking, it provides data once in a year. It is simple and economical method of stocktaking. It can be adopted in small concerns. It does not provide basis for control.

2. Perpetual Inventory Method:

Perpetual Inventory Method is defined as a system under which records are maintained by the controlling department, which reflects the physical movements of stock and their current balance. Under this method, stock registers are maintained to make a record of the physical movements of stock and their current balance. Stores ledger is maintained to keep a record of the receipt and issue of the materials and also reflects the balance in store. Similarly, work-in-progress ledger is maintained to give the value of work-in-progress on hand and a finished goods ledger is maintained to know the value of finished goods on hand. Thus, this system provides a running record of inventories on hand at any time. To ensure the accuracy of perpetual inventory records , physical verification of the inventory is made by a program of continuous stock taking.

It is possible that the balance of stock by the perpetual inventory may differ from the actual balance of stock as ascertained by physical verification. Any difference noted between actual stocks as disclosed by the physical verification and the stocks shown by stock records should be investigated and rectification will be made. If the physical verification reveals that actual balance of stock is more than the balance shown by the stores ledger or work-in-progress ledger or finished goods ledger, debit note is prepared and stock records are adjusted accordingly so that balance may reconcile with actual balance. A **Stock Adjustment Account** is prepared and debited with the shortage of stock and credited with surplus.

Continuous stock taking is an essential feature of the perpetual inventory system. But the two terms, perpetual inventory and continuous stock taking should not be taken as one**; perpetual** means the system of stock records and continuous stock taking whereas **continuous stock taking** means only the physical verification of stock records with actual stocks.

In continuous stock taking, physical verification is spread throughout the year. Every day 10 to 15 items are taken at rotation and checked in order to maintain surprise element in short verification and each item is checked for a number of times during the year. On the other hand, surprise element is missing in case of periodical checking because checking is usually done at the end of the year. In short, this method is based on records. It requires a lot of recording and is thus expensive. It can be adopted only in big concerns. It provides data on running basis and thus facilitates the preparation of financial statements at shorter intervals. It also provides basis for control by investigation of the discrepancies arising from the comparison of physical stock with their book values.

Difference between Periodic Inventory and Perpetual Inventory.

The following are the main differences between the two methods of taking inventory.

Periodic Inventory	Perpetual Inventory
1. It is based on physical stock taking	1. It is based on records.
2. It provides data periodically i.e. once in year.	2. It provides the data on running basis and thus facilitates the preparation of financial statements at shorter intervals.
3. It does not provide basis for control.	3. It provides basis for control by investigating the discrepancies arising from the comparison of physical stock with book values.

4. It is simple and economical method of taking inventory and can be adopted in small concern.	4. It is expensive as it requires a lot of recording because of an elaborate method of taking inventory. It can be adopted by big concerns only.

5.4 VALUATION OF STOCK AT LOWER OF COST OR MARKET PRICE

Stock is valued at cost or market price whichever is lower. Stock is valued at lower of cost or market price to ensure that anticipated profits must not be accounted for until they have been realized and that full provision should be made for anticipated losses. This principle of valuation is on the important accounting **convention of conservatism**. Conservatism means taking the gloomy view of a situation. It is policy of caution or playing safe and had its origin as a safeguard against possible losses in a world of uncertainty. According to this principle of valuation based on convention of conservatism, if market price of the stock is higher than the cost of the stock, the higher amount is ignored in the accounts because profit is not booked by valuing inventory at market value which is higher than cost value. It is possible that dividends to shareholders may be distributed out of unrealized profit. It will not be sound policy and in the future, if the expected market price is not realized and there is a loss, unrealized profit distributed will amount to distribution of dividend out of capital. On the contrary, if the stock is valued at market price which is lower than the cost. In this way, anticipated loss is taken into consideration and even if a loss occurs in the future, the business will not be affected adversely because loss has already been provided by valuing the asset at a lower value and if there is no loss as expected, it is quite good for the business.

Cost in relation to stock is outlay of cash or its equivalent in the acquisition or manufacturing of the inventory concerned. In other words, cost of stock is the sum of the applicable expenditure and charges directly or indirectly incurred in brining inventory to its existing condition and location.

Market value in relation to stock is the realizable value of the stock in the market i. e. the price at which it can be replaced, the valuation of stock affects the profit of the year. Therefore, the method of valuation of stock should not be changed from year to year to enable comparison of profits of different years.

Methods for Valuation of Stock:
The following are the various methods of the valuation of inventory:

5.5 FIRST IN FIRST OUT (FIFO)

5.5.1 Meaning

Under this method, the earliest lot of materials or goods purchased or goods manufactured are exhausted first and closing stock is out of the latest consignments received or goods manufactured and is valued at the cost of such goods. In other words, cost of goods sold is calculated keeping in view the earliest lots exhausted on the presumption that units are sold in which they were acquired. In short, under this method, it is assumed that goods or materials which are purchased first are issued first. Stock consist of latest purchase. Hence items lying in the stock should be valued at latest purchase price.

5.5.2 Advantages

(1) This method is simple to understand and easy to operate.

(2) It is logical method because it takes into consideration the normal procedure of utilizing first those items of inventory which are received or manufactured first.

(3) This method is very useful when prices are falling because cost of goods so sold will be high on account of using earliest lots which are costly.

(4) Closing stock is valued nearer the market price as it would consist of recent purchase of units.

(5) This method is useful when transactions are not too many and prices are fairly steady.

(6) This method is useful when inventory is subject to deterioration and obsolescence.

5.5.3 Disadvantages

(1) This method increases the possible clerical errors if the price fluctuates, considerably at every time as issue of material is sold, the store ledger clerk will have to go through his and ascertain the price to be changed.

(2) If the prices fluctuate, comparison between different jobs executed by the concern becomes difficult because one job started a few minutes later than another of the same nature may have consumed the supply of lower priced or higher priced stock.

5.6 AVERAGE COST

The principal on which the average cost method is based is that all items on the store are so mixed up that consumption of material or sale of finished goods are carried out at the average cost of the various items on hand. Average may be of two types:

(a) Simple Average Method (not in syllabus)
(b) Weighted Average Method

Stock taking is done which consist of following items :-

1,000 units purchased	@ Rs. 10 per unit
2,000 units purchased	@ Rs. 11 per unit
3,000 units purchased	@ Rs. 12 per unit

Weighted Average Method : This price is obtained by dividing the total cost of items in stock by the total quantity of items in hand.

Per unit weighted average cost is calculated as follows :-

$$\text{Rs. } 11.33 = \frac{(1.000 \times 10) + (2{,}000 \times 11) + (3{,}000 \times 12)}{(1{,}000 + 2{,}000 + 3{,}000)}$$

The above rate is used to value the cost of sale of goods or cost of consumption of goods.

Weighted average method is quite superior to other methods and it is better to follow this method. This method can be used with advantage in those cases where price and quantity vary widely. The average rate does not change with issue but would vary with a fresh supply of materials received when a new average will have to be calculated. In a period of fluctuating price, this method will even out the fluctuations. This method is goods as the weighted average rate lies in between the extreme rates as shown by FIFO and LIFO method. However, the difficulty is that fresh calculations are needed at every purchase of materials or goods.

Practical Problems

Problem No: 01

A firm has just completed six months operations from 1st January, 2000, to 30th June, 2017. It is about to value its stock at cost price. It has dealt with only one type of goods. From the particulars given below, your are required to value closing stock at the half year ending 30th June, 2017 under following method of stock valuation –

(i) FIFO Method and
(ii) Weighted Average Method

	Purchase			Sales		
Date	**Units**	**Rate**	**Amount Rs.**	**Units**	**Rate**	**Amount Rs.**
15-1-17	200	20	8,000	-	-	-
16-2-17	-	-	-	300	25	7500
17-3-17	600	22	13,200	-	-	-
18-4-17	-	-	-	400	-	12,00
19-5-17	800	25	20,000	-	-	-
10-6-17	-	-	-	400	32	12,800
30-6-17	-	-	-	200	38	7,600

The firm had opening stock of 200 units at Rs.19 per unit.

Solution :

We have to prepare 'Store Ledger' showing of goods and the closing stock as on 30th June, 2017.

STORE LEDGER
FIFO METHOD

	Receipt (Purchase)			Issue (Sales)			Balance		
Date	Qty.			Qty.			Qty.		
	Unit	Rate (Rs.)	Amount (Rs.)	Unit	Rate (Rs.)	Amount (Rs.)	Unit	Rate (Rs.)	Amount (Rs.)
Op.St.									
1-1-17	-	-	-	-	-	-	200	19	3,800
15-1-17	200	20	4,000	-	-	-	200	19	3,800
	-	-	-	-	-	-	200	20	4,000
16-1-17	-	-	-	200	19	3,800			
	-	-	-	100	20	2,000	100	20	2,000
17-3-17	600	22	13,200	-	-	-	100	20	2,000
	-	-	-	-	-	-	600	22	13,200
19-4-17	-	-	-	100	20	2,000	300	22	13,200
	-	-	-	300	22	6,600			
19-5-17	800	25	20,000	-	-	-	300	22	6,600
	-	-	-	-	-	-	800	25	20,000
10-6-17	-	-	-	300	22	6,600	700	25	17,500
	-	-	-	100	25	2,500			
30-6-17	-	-	-	200	25	5,000	500	25	$\boxed{12,500}$
						$\boxed{28,500}$			

Cost of Goods sold

Value of Closing stock

Date	Receipt (Purchase)			Issue (Sales)			Balance		
	Qty.			Qty.			Qty.		
	Unit	Rate (Rs.)	Amount (Rs.)	Unit	Rate (Rs.)	Amount (Rs.)	Unit	Rate (Rs.)	Amount (Rs.)
1-1-17	-	-	-	-	-	-	200	19.00	3,800
15-1-17	200	20.00	4,000	-	-	-	400	19.50	7,800
16-1-17	-	-	-	300	19.50	5,850	100	19.50	1,950
17-3-17	600	22.00	13,200	-	-	-	700	21.64	15,150
19-4-17	-	-	-	400	21.64	8,657	300	21.64	6,493
19-5-17	800	25.00	20,000	-	-	-	1100	24.08	26,493
10-6-17	-	-	-	400	24.08	9,634	700	24.08	16,859
30-6-17	-	-	-	200	24.08	4,817	500	24.08	**12,042**
						28,954			

Cost of Goods sold

Value of Closing stock

Notes :

(i) The rate changes every time goods are purchased. The average rate is found out by dividing the total amount with the total units on hand.

(ii) The rate remains unaffected with the issue or sale of goods.

5.7 RECONCILIATION AT PHYSICAL STOCK AND STOCK AS PER STOCK REGISTER.

Problems of stock taking for the purpose of final accounts:

At the end of the last day of the accounting year, stocks in hand are verified and valued for the purpose of recording in the final accounts. But in case of big organisations, it may not be possible to verify the stock exactly on the last date of the accounting period owing to certain difficulties. In such a case, stock is taken under either few days earlier or later, according to the situation or convenience and assuring least disturbance in the normal flow of work. Therefore, stock taken under circumstances shall always be subject to some adjustments where stock taking is completed few days before the closing date should be adjusted with the value of stock taking so as to arrive at the value of stock on the ending date of accounting year, Similarly, if stock taking takes place on the date after the closing date, the whole of the transactions of goods from the closing date (*i.e. stock taking date) are to be adjusted with the value of stock on the date of stock taking so as to arrive at the value of stock on the closing date of accounting year.

(A) When stock taking takes place on any date after the year end dates

If the stock is taken on a later date, the following adjustments are required to arrive at the stock as on the closing date.

Statement showing value of stock as to the end of the accounting year.

		Rs.
	The value of stock on the later date ….	X
Add :	Sales at cost between two dates i.e. date of closing and Date of stock taking (Actual goods between)	X
Add :	Purchase returns during the said period	X
Less :	Purchase between two dates i.e. date of closing and date of stock taking (Actual – goods received between the Two dates)	X
Less :	Sales return (At cost price) between the above two dates	X
Add :	Any under costing in stock sheet	X
Less :	Any over costing in stock sheet	X
Less:	Any goods held on consignment basis (as Agent)	X
Less :	Any goods included in stock but title of such has been transferred to the buyer	X
Less :	Goods purchased between the two dates but already received before the closing date (such represents purchases of next accounting year) (normally it happens when goods are received first & invoice is received later on)	X
Add :	Goods sold between the two dates but already delivered before Closing date (Such goods represents sales of next accounting Year) (Normally it happens when goods are delivered to Customer first & invoice is prepared on later date)	X

Add :	Any goods sent to consignee between the two dates (Whether They sold by consignee or not)	X
Value of physical stock as on the date of closing		X
Add :	Any goods purchased before closing date hence included in Purchase of the last accounting year but not received until the Date of stock-taking	X
Add:	Any goods sent to customer before closing date on approval basis but lying with them as an approved as on the date closing (Such goods must be taken at cost price) Value of stock-in-trade as on the date of closing for inclusion In final accounts.	X

B) If stock are taken on an earlier date

If stock is taken on a date before the closing date of accounting year, the necessary adjustments should be made in respect of transactions of goods taken place between the date of stock-taking and closing date so as to obtain the correct value of stock as on the closing date.

Statement showing value of stock as on the ending date of accounting year.

		Rs.
The value of stock on the later date		X
Add :	Purchase between the two dates i.e. from the date of stock taking to the date of closing (Goods actually received up to the date of closing	X
Add:	Sales returns (at cost price) between the two dates	X
Less:	Sales (at cots) between the two dates (goods actually delivered)	X
Less:	Purchase returns between the two dates	X
Less:	Goods sent on approved basis (at cost price) between the two dates	X
Less:	Goods sent to consignee (at cost price) (whether sold or not) between the two dates	X

Less:	Goods received from consignor and held on their behalf	X
Add:	Any under costing in stock sheet	X
Less:	Any over costing in stock sheet	X
Value of physical stock on the date of closing		X
Add:	Goods purchased before the closing date but not received upto the end of the accounting year (Goods-in-transit)	X
Add:	Cost of goods sent on approval basis but not approved before the closing date still lying with the customers as on the date of the closing.	X
Add:	Unsold goods in the hands of the consignee as on the date of closing. Value of stock-in-trade as on the date of closing for inclusion in final accounts	X

5.8 EXERCISE

1. Select the correct alternative:

1. If Cost of goods sold is Rs.80,700, Opening stock Rs.5,800 and Closing stock Rs.6,000. Then the amount of purchase will be
   (a)Rs.80,500
   (b)Rs.74,900
   (c)Rs.74,700
   (d)Rs.80,900.

2. If sales are Rs. 2,000 and the rate of gross profit on cost of goods sold is 25%, then the Cost of goods sold will be
   (a)Rs. 2,000.
   (b)Rs. 1,500.
   (c)Rs. 1,600.
   (d)None of the above.

3. The total cost of goods available for sale with a company during the current year is Rs.12,00,000 and the total sales during the period are Rs.13,00,000. If the gross profit margin of the company is 331/3% on cost, the closing inventory during the current year is
   (a)Rs.4,00,000
   (b)Rs.3,00,000
   (c)Rs.2,25,000
   (d)Rs.2,60,000.

4. C Ltd. recorded the following information as on March 31, 2005:

	Rs.
Stock as on April 01, 2016	80,000
Purchases	1, 60,000
Sales	2, 00,000

It is noticed that goods worth Rs.30, 000 were destroyed due to fire. Against this, the Insurance company accepted a claim of Rs.20,000.The Company sells goods at cost plus 33 %**.** The value of closing inventory, after taking into account the above transactions is,

(a)Rs.10,000
(b)Rs.30,000
(c)Rs.1,00,000
(d)Rs.60,000

5. Consider the following for Alpha Co. for the year 2017-18:
Cost of goods available for sale Rs.1, 00,000
Total sales Rs. 80,000
Opening stock of goods Rs. 20,000
Gross profit margin 25%
Closing stock of goods for the year 2017-18 was

(a)Rs.80,000
(b)Rs.60,000
(c)Rs.40,000
(d)Rs.36, 000.

6. Cost of physical stock on 15.4.16 was Rs.3,00,000. Sales amounting Rs.1,00,000 and purchases worth Rs.50,000 were held between 31.3.16 and 15.4.16. Goods are sold at a profit of 20% on sales. Value of inventory as on 31.3.16 is

(a)Rs.3,50,000.
(b)Rs.2,70,000.
(c)Rs.3,30,000.
(d)Rs.3,00,000.

7. Record of purchase of T.V. sets.

Date	Quantity	Price per unit
	Units	Rs.
March 4	900	5
March 10	400	5.50

Record of issues

March 5 600 Units
March 12 400 Units

The value of T.V. sets on 15 March, as per FIFO will be

(a)Rs.1,500
(b)Rs.1,650
(c)Rs.1,575.
(d)None of the three.

8. Goods costing Rs.4,80,000 were sent on consignment basis. Goods are invoiced at 125% of the cost price. The invoice price and the loading will be:
   (a)Rs.6,00,000 and Rs.1,00,000.
   (b)Rs.5,00,000 and Rs.1,00,000.
   (c)Rs.6,00,000 and Rs.1,20,000.
   (d)Rs.5,00,000 and Rs.1,20,000.

9. A firm dealing in cloth has 15000 meters of cloth on April 1, 2015 valued at Rs.1,50,000 according to FIFO. The firm purchased 20,000 meters @ Rs.12 per meter during the year ending 31st March, 2016 and sold 30,000 meters @ Rs.25 per meter during the same period. As per FIFO, the closing stock will be valued at:
   (a)Rs.60,000
   (b)Rs.1,25,000
   (c)Rs.50,000
   (d)None of the above.

10. A minimum quantity of stock always held as precaution against out of stock situation is called _________
    (a)Zero stock.
    (b)Risk stock.
    (c)Base stock.
    (d)None of the above.

11. A trader has credited certain items of sales on approval aggregating Rs.60,000 to Sales Account. Of these, goods of the value of Rs.16,000 have been returned and taken into stock at cost Rs.8,000 though the record of return was omitted in the accounts. In respect of another parcel of Rs.12,000 (cost being Rs.6,000) the period of approval did not expire on the closing date. Cost of goods lying with customers should be
    (a)Rs. 12,000.
    (b)Rs. 54,000.
    (c)Rs. 6,000.
    (d)None of the above.

12. If cost of physical stock on 31.3.2018 is Rs.2,80,000 and out of which stock of Rs.1,20,000 is held as consignee. Goods costing Rs. 25,000 were damaged beyond repair and were expected to realize at Rs.5,000 only. The value of own stock on 31.3.2018 will be
    (a)Rs.2,60,000
    (b)Rs.1,60,000
    (c)Rs.1,35,000
    (d)Rs.1,40,000

13. Bank overdraft as per trial balance is Rs.1,60,000. Bank has allowed the customer to overdraw 80% of the hypothecated value of the stock. Hypothecation of stock has been done by the bank at 80% of the original closing stock value. The amount of closing stock is
    (a)Rs. 2,00,000.
    (b)Rs. 2,50,000.
    (c)Rs. 1,02,400.
    (d)Rs. 1,28,000.

14. Mr. Prakash sells goods at 20% above cost. His sales were Rs.10,20,000 during the year. However, he sold damaged goods for Rs.20,000 costing Rs.30,000. This sale is included in Rs.10, 20,000. The amount of gross profit is:
    (a)Rs. 1,90,000
    (b)Rs.2,50,000
    (c)Rs.2,40,000
    (d)Rs.2, 00,000.

15. Opening stock of raw material of a manufacturing concern is Rs.10,000, Purchase during the year is Rs.2,00,000, Wages Rs.50,000, Carriage Rs.5,000, Factory overheads Rs.1,25,000 and closing stock of raw material is Rs. 15,000. The amount to be transferred is
    (a)Rs. 3,75,000 to cost of goods manufactured account.
    (b)Rs.3,75,000 to cost of goods sold account.
    (c)Rs. 3,75,000 to cost of sales account.
    (d)Rs. 3,75,000 to cost to company account.

16. Goods costing Rs. 600 is supplied to Ram at the invoice of 10% above cost and a trade discount for 5%. The amount of sales will be
    (a)Rs. 627.
    (b)Rs. 660.
    (c)Rs. 570.
    (d)Rs. 620.

17. Goods purchased Rs.1,00,000. Sales Rs. 90,000. Margin 20% on sales. Closing stock is
    (a)Rs. 10,000.
    (b)Rs. 25,000.
    (c)Rs. 28,000.
    (d)None of the above.

Answers: 1- d, 2- c, 3-c, 4-d, 5-b, 6-c, 7-b, 8-c, 9-b, 10-c, 11-c, 12-d, 13-b, 14-a, 15-a, 16-a, 17-c

❖❖❖❖

Unit-6

INVENTORY VALUATION II

ILLUSTRATION & EXERCISE

Unit Structure :

6.0 OBJECTIVES

After studying the unit, students will be able to solve the practical problems on inventory valuation.

6.1 SOLVED PROBLEMS

Illustration No. 1

From the following particulars prepare Stores Ledger for the month of March 2018
(a) FIFO to "ABC",
(b) Weighted average to "XYZ".

	ABC	XYZ
Stocks (Kgs) on1-3-2018	2,000 @ Rs. 28	4,000 @ Rs. 13
Purchases (Kgs)		
[i] On 11-3-2018	1,800 @ Rs. 27	2,500 @ Rs. 14
[ii] On 21-3-2018	1,700 @ Rs. 25	2,000 @ Rs. 18
Sales (Kgs)		
[i] On 6-3-2018	1,300	2,500
[ii] On 15-3-2018	1,400	2,000
[iii] On 18-3-2018	700	1,300
[iv] On 29-3-2018	1,100	1,700

(IDE, Nov. 1999, adapted)

Solution :

(A) FIFO to "ABC"

STOCK LEDGER OF ABC

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
01-3-2008	Opening	-	-	-	-	-	2,000	28.00	56,000
06-3-2008	-	-	-	1,300	28.00	36,400	700	28.00	19,600
11-3-2008	1,800	27.00	48,600	-	-	-	700 1,800	28.00 27.00	19,600 48,600
15-3-2008	-	-	-	700 700	28.00 27.00	19,600 18,900	1,100	27.00	29,700
18-3-2008	-	-	-	700	27.00	18,900	400	27.00	10,800
21-3-2008	1,700	25.00	42,500	-	-	-	400 1,700	27.00 25.00	10,800 42,500
29-3-2008	-	-	-	400 700	27.00 25.00	10,800 17,500	1,000	25.00	25,000

Therefore, the value of stock of ABC as on 31-3-2004 :

1,000 units @ Rs. 25.00 = Rs. 25,000

(B) Weighted Average (Under Perpetual System of Inventory)

STOCK LEDGER OF XYZ

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Wt. Avg. Rate	Value
01-3-2008	Opening	-	-	-	-	-	4,000	13.00	52,000
06-3-2008	-	-	-	2,500	13.00	32,500	1,500	13.00	19,500
11-3-2008	2,500	14	35,000	-	-	-	4,000	13.63	54,500
15-3-2008	-	-	-	2,000	13.63	27,250	2,000	13.63	27,250
18-3-2008	-	-	-	1,300	13.63	17,712	700	13.63	9,538
21-3-2008	2,000	18	36,000	-	-	-	2,700	16.87	45,538
29-3-2008	-	-	-	1,700	16.87	28,672	1,000		16,866

Working Notes :

1] Issued of XYZ on March 15 is valued at Rs. 13.63 which is the weighted average rate, arrived at as follows :

$$\frac{19,500+35,000}{1,500+2,500}=\frac{54,500}{4,000}=13.625 r/o 13.63$$

2] Issue of XYZ on March 29 is valued at Rs. 16.87 per kg. which is the weighted average rate arrived at as follows :

$$\frac{9,538+36,000}{700+2,000}=\frac{45,538}{2,700}=16.865 r/o 16.87$$

Therefore, the value of stock as on 31-3-2008 : 1,000 units @ Rs. 16.87 = Rs. 16,867

Illustration : 2

From the following information relating A to Z item, value closing stock on 31-12-2008 applying – (a) FIFO, (b) Weighted Average

Stocks (Kgs) on 1-12-2008 5,000 units @ Rs. 14

Purchases (Kgs)

[i] On 18-12-2008 4,200 units @ Rs. 13

[ii] On 23-12-2008 3,800 units @ Rs. 9

Sales (Kgs)

[i] On 7-12-2008 1,200 units

[ii] On 16-12-2008 2,600 units

[iii] On 19-12-208 1,800 units

[iv] On 30-12-2008 3,400 units

(IDE, April 1999, adapted)

Solution :

(A) FIFO

STOCK LEDGER

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
01-12-2008	Opening	-	-	-	-	-	5,000	14.00	70,000
07-12-2008	-	-	-	1,200	14.00	16,800	3,800	14.00	53,200
16-12-2008	-	-	-	2,600	14.00	36,400	1,200	14.00	16,800
18-12-2008	4,200	13.00	54,600	-	-	-	1,200 4,200	14.00 13.00	16,800 54,600
19-12-2008	-	-	-	1,200 600	14.00 13.00	16,800 7,800	3,600	13.00	46,800
23-12-2008	3,800	9.00	34,200	-	-	-	3,600 3,800	13.00 9.00	46,800 34,200
30-12-2008	-	-	-	3,400	13.00	44,200	200 3,800	13.00 9.00	2,600 34,200

Therefore, the value of stock as on 31-12-2008 : 4,000 units @ Rs. 36,800

B] Weighted Average (Perpetual Inventory system)

STOCK LEDGER

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Wt. Avg. Rate	Value
01-12-2008	Opening	-	-	-	-	-	5,000	14.00	70,000
07-12-2008	-	-	-	1,200	14.00	16,800	3,800	14.00	53,200
16-12-2008	-	-	-	2,600	14.00	36,400	1,200	14.00	16,800
18-12-2008	4,200	13.00	54,600	-	-	-	5,400	13.22	71,400
19-12-2008	-	-	-	1,800	13.22	23,800	3,600	13.22	47,600
23-12-2008	3,800	9.00	34,200	-	-	-	7,400	11.05	81,800
30-12-2008	-	-	-	3,400	11.05	37,584	4,000		44,216

Working Notes :

[1] Issue on December 19 is valued at Rs. 13.22 which is the weighted average rate, arrived at as follows :

$$\frac{16,800+54,600}{1,200+4,200}=\frac{71,400}{5,400}=13.222\,\text{r/o}\,13.22$$

[2] Issue on December 30 is valued at Rs. 11.05 per kg. which is the weighted average rate arrived at as follows :

$$\frac{47,604+34,200}{3,600+3,800}=\frac{81,804}{7,400}=11.054\,\text{r/o}\,11.05$$

Therefore, the value of stock as on 31-12-2003 : 4,000 units @ Rs.11.05 = Rs. 44,216

Illustration : 3

The following particulars have been extracted in respect of Material X. Prepare a Stores Ledger Account showing the receipts and issues, pricing the materials issued on the basis of

(a) Weighted Average and

(b) First In First Out.

[i]	01-10-2017	Opening Stock	200 units at Rs. 3.50 per unit
[ii]	03-10-2017	Purchased	300 units at Rs. 4.00 per unit
[iii]	13-10-2017	Purchased	900 units at Rs. 4.30 per unit
[iv]	23-10-2017	Purchased	600 units at Rs. 3.80 per unit

Issues :

[i]	05-10-2017	Issued	400 units
[ii]	15-10-2017	Issued	600 units
[iii]	25-10-2017	Issued	600 units

Solution:

(A) FIFO

STOCK LEDGER OF 'X'

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
01-10-2017	Opening	-	-	-	-	-	200	3.50	700
03-10-2017	300	4.00	1,200	-	-	-	200 300	3.50 4.00	700 1,200
05-10-2017	-	-	-	200 200	3.50 4.00	700 800	100	4.00	400
13-10-2017	900	4.30	3,870	-	-	-	100 900	4.00 4.30	400 3,870
15-10-2017	-	-	-	100 500	4.00 4.30	400 2,150	400	4.30	1,720
23-10-2017	600	3.80	2,280	-	-	-	400 600	4.30 3.80	1,720 2,280
25-10-2017	-	-	-	400 200	4.30 3.80	1,720 760	400	3.80	1,520

Therefore, the value of stock as on 31-10-2017 : 400 units @ Rs. 3.80 = **Rs. 1,520**

(B) Weighted Average (Perpetual Inventory System)

STOCK LEDGER OF 'X'

Date	**Receipts**			**Issues**			**Balance**		
	Units	**Price**	**Amt.**	**Units**	**Wt. Avg. Rate**	**Amt.**	**Units**	**Wt. Avg. Rate**	**Value**
01-10-2017	Opening	-	-	-	-	-	200	3.50	700
03-10-2017	300	4.00	1,200	-	-	-	500	3.80	1,900
05-10-2017	-	-	-	400	3.80	1,520	100	3.80	380
13-10-2017	900	4.30	3,870	-	-	-	1,000	4.25	4,250
15-10-2017	-	-	-	600	4.25	2,550	400	4.25	1,700
23-10-2017	600	3.80	2,280	-	-	-	1,000	3.98	3,980
25-10-2017	-	-	-	600	3.98	2,388	400	3.98	1,592

Working Notes:

[1] Issue on October 5 is valued at Rs. 3.80 which is the weighted average rate, arrived at as follows **:**

$$\frac{700+1,200}{200+300}=\frac{1,900}{500}=3.80$$

[2] Issue on October 15 is valued at Rs. 4.25 which is the weighted average rate, arrived at as follows :

$$\frac{380+3,870}{100+900}=\frac{4,250}{1,000}=4.25$$

[3] Issue on October 25 is valued at Rs. 3.98 which is the weighted average rate, arrived at as follows :

$$\frac{1,700+2,280}{400+600}=\frac{3,980}{1,000}=3.98$$

Illustration 4

From the following particulars, prepare stock record by FIFO and Weighted Average Method.

Date	Transaction	Units	Rate Rs.
04-1-2018	Purchase	40	30
17-1-2018	Purchase	60	28
20-1-2018	Sale	50	35
22-1-2018	Purchase	80	29
25-1-2018	Sale	80	33
28-1-2018	Sale	20	34
30-1-2018	Purchase	100	26
31-1-2018	Sale	90	35

Stock on hand on 1st January 2018 was 50 units @ Rs.25 each.

Solution :

(A) FIFO

STOCK LEDGER X'

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
01-1-2018	Opening	-	-	-	-	-	50	25.00	1,250
04-1-2018	40	30.00	1,200	-	-	-	50 40	25.00 30.00	1,250 1,200
17-1-2018	60	28.00	1,680	-	-	-	50 40 60	25.00 30.00 28.00	1,250 1,200 1,680
20-1-2018	-	-	-	50	25.00	1,250	40 60	30.00 28.00	1,200 1,680
22-1-2018	80	29.00	2,320	-	-	-	40 60 80	30.00 28.00 29.00	1,200 1,680 2,320
25-1-2018	-	-	-	40 40	30.00 28.00	1,200 1,120	20 80	28.00 29.00	560 2,320
28-1-2018	-	-	-	20	28.00	560	80	29.00	2,320
30-1-2018	100	26.00	2,600	-	-	-	80 100	29.00 26.00	2,320 2,600
31-1-2018	-	-	-	80 10	29.00 26.00	2,320 260	90	26.00	2,340

Therefore, the value of stock as on 31-01-2008 : 90 units @ Rs. 26 = **Rs. 2,340.**

[B] Weighted Average (Perpetual Inventory System)

STOCK LEDGER

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Wt. Avg. Rate	Value
01-1-2018	Opening	-	-	-	-	-	50	25.00	1,250
04-1-2018	40	30.00	1,200	-	-	-	90	27.22	2,450
17-1-2018	60	28.00	1,680	-	-	-	150	27.53	4,130
20-1-2018	-	-	-	50	27.53	1,377	100	27.53	2,753
22-1-2018	80	29.00	2,320	-	-	-	180	28.18	5,073
25-1-2018	-	-	-	80	28.18	2,254	100	28.18	2,819
28-1-2018	-	-	-	20	28.18	564	80	28.18	2,255
30-1-2018	100	26.00	2,600	-	-	-	180	26.97	4,855
31-1-2018	-	-	-	90	26.97	2,427	90	26.97	2,428

Working Notes :

[1] Issue on January 20 is valued at Rs. 27.53 which is the weighted average rate, arrived at as follows :

$$\frac{1{,}250+1{,}200+1{,}680}{50+40+60}=\frac{4{,}130}{150}=27.533 \text{ r/o } 27.53$$

[2] Issue on January 25 is valued at Rs. 28.18 per kg. which is the weighted average rate arrived at as follows:

$$\frac{2{,}753+2{,}320}{100+80}=\frac{5{,}073}{180}=28.183 \text{ r/o } 28.19$$

[3] Issue on January 31 is valued at Rs. 26.97 per kg. which is the weighted average rate arrived at as follows:

$$\frac{2{,}255+2{,}600}{80+100}=\frac{4{,}855}{180}=26.971 \text{ r/o } 26.97$$

Therefore, the value of stock as on 31-1-2004 : 90 units @ Rs. 26.97 = **Rs. 2,428.**

[4] Note: The Stock Book entries for both purchases / receipts and sales / issued are always made at cost. The selling price, even if given, is to be ignored.

Illustration: 5

Sumit Ltd. has purchased and issued the materials in the following order:

Month	Date	Particulars	Units	Cost Per Unit Rs.
August, 2017	01	Purchases	300	3
	04	Purchases	600	4
	06	Issues	500	-
	10	Purchases	700	4
	15	Issues	800	-
	20	Purchases	300	5
	23	Issues	100	-

Ascertain the quantity of closing stock as on 31st August, 2017 and what will be the value under the following methods.

[i] First in first out method.

[ii] Weighted Average method.

(IDE, Nov. 2000, adapted)

Solution :

(A) FIFO

STOCK LEDGER

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Price	Amt.	Units	Price	value
1-8-2017	Opening	-	-	-	-	-	Nil	Nil	Nil
1-8-2017	300	3.00	900	-	-	-	300	3.00	900
4-8-2017	600	4.00	2,400	-	-	-	300 600	3.00 4.00	900 2,400
6-8-2017	-	-	-	300 200	3.00 4.00	900 800	400	4.00	1,600
10-8-2017	700	4.00	2,800	-	-	-	400 700	4.00 4.00	1,600 2,800
15-8-2017	-	-	-	400 400	4.00 4.00	1,600 1,600	300	4.00	1,200
20-8-2017	300	5.00	1,500	-	-	-	300 300	4.00 5.00	1,200 1,500
23-8-2017	-	-	-	100	4.00	400	200 300	4.00 5.00	800 1,500

Therefore, the value of stock as on 31-8-2003 : **Rs. 2,300**

[B] Weighted Average (Perpetual Inventory System)

STOCK LEDGER

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Wt. Avg. Rate	Value
01-8-2017	Opening	-	-	-	-	-	Nil	Nil	Nil
01-8-2017	300	3.00	900	-	-	-	300	3.00	900
04-8-2017	600	4.00	2,400	-	-	-	900	3.67	3,300
06-8-2017	-	-	-	500	3.67	1,834	400	3.67	1,466
10-8-2017	700	4.00	2,800	-	-	-	1,100	3.88	4,266
15-8-2017	-	-	-	800	3.88	3,103	300	3.88	1,163
20-8-2017	300	5.00	1,500	-	-	-	600	4.44	2,663
23-8-2017	-	-	-	100	4.44	444	500	4.44	2,219

Working Notes :

[1] Issue on August 6 is valued at Rs. 3.67 which is the weighted average rate, arrived at as follows :

$$\frac{900+2,400}{300+600}=\frac{3,300}{900}=3.666\,r/o\,3.67$$

[2] Issue on August 15 is valued at Rs. 3.88 per kg. which is the weighted average rate arrived at as follows :

$$\frac{1,465+2,800}{400+700}=\frac{4,265}{1,100}=3.877\,r/o\,3.88$$

[3] Issue on August 23 is valued at Rs. 4.44 per kg. which is the weighted average rate arrived at as follows:

$$\frac{1,161+1,500}{300+300}=\frac{2,661}{600}=4.435\,r/o\,4.44$$

Therefore, the value of stock as on 31-8-2002 : 500 units @ Rs. 4.44 = **Rs. 2,219.**

Illustration :6

Following are the purchases and sales of wheat in the months of March, 2018. Prepare a statement showing valuation of stock on the basis of Weighted Average method.

Date	Purchases	Rate	Sales
2018	(Kg.)	(Rs.)	(Kg.)
March 1	600	4	-
4	-	-	300
5	300	3.80	-
10	-	-	200
18	200	4.20	-
23	-	-	400
29	400	4.40	-
31	-	-	300

Out of purchases on March 5, 50 Kgs were returned to the supplier on March 8.Out of Sales on March 23, a customer returned 20 Kgs. on March 26.

B] Weighted Average (Perpetual Inventory System)

STOCK LEDGER

Date	Receipts			Issues			Balance		
	Units	Price	Amt.	Units	Wt. Avg. Rate	Amt.	Units	Wt. Avg. Rate	Value
01-3-2018	600	4.00	2,400	-	-	-	600	4.00	2,400
04-3-2018	-	-	-	300	4.00	1,200	300	4.00	1,200
05-3-2018	300	3.80	1,140	-	-	-	600	3.90	2,340
05-3-2018	-	-	-	50	3.90	195	550	3.90	2,145
10-3-2018	-	-	-	200	3.90	780	350	3.90	1,365
18-3-2018	200	4.20	840	-	-	-	550	4.01	2,205
23-3-2018	-	-	-	400	4.01	1,604	150	4.01	601
26-3-2018	20	4.01	80	-	-	-	170	4.01	681
29-3-2018	400	4.40	1,760	-	-	-	570	4.28	2,441
31-3-2018	-	-	-	300	4.28	1,285	270	4.28	1,156

Working Notes :

[1] Issue on March 5 & March 10 is valued at Rs. 3.90 which is the weighted average rate, arrived at as follows :

$$\frac{1{,}200+1{,}140}{300+300}=\frac{2{,}340}{600}=3.90$$

[2] Purchase returns of 50 kg. are out of the total stock of 600 kg. which was valued at Rs. 3.90 per kg.

[3] Issue on March 23 is valued at Rs. 4.01 per kg. which is the weighted average rate arrived at as follows :

$$\frac{1{,}365+840}{350+200}=\frac{2{,}205}{550}=4.01$$

[4] Sales on March 23 are out of stock valued at Rs. 4.01 per kg. Hence returns of 20 kg. are also taken at a rate of Rs. 4.01 per kg.

[5] Weighted Average Rate on March 31 is arrived at as follows :

$$\frac{681+1{,}760}{170+400}=\frac{2{,}441}{570}=4.28$$

Therefore, the value of stock as on 31-3-2008 : 270 units @ Rs. 4.28 = Rs. 1,156

Illustration : 7

A company deals in 3 products viz. A, B and C. The details for purchases and sales for January 2018 are as under.

Product	A		B		C	
	Units	Rs.	Units	Rs.	Units	Rs.
Selling Price per Unit		100		200		250
Opening Stock	100	60	100	100	50	120
Purchases :						
Jan 9	300	65	200	110	50	135
Jan 20	100	64	50	120	100	140
Jan 29	50	68	50	125	20	130
Closing Stock	140		70		60	

You are required to prepare a trading and profit and loss account for the month assuming the selling and distribution expenses to be Rs. 63,000. Use FIFO method for stock valuation.

Solution

Stock Ledger (FIFO Method)

Product – A

Date	Purchases	Sales	Closing Stock	
	Qty. Rs.	Qty.	Qty. × Rs. =	Amount
01-1-2018	-	-	100 × 60 =	6,000
09-1-2018	300 × 65	-	100 × 60 =	6,000
			300 × 65 =	19,500
				25,500
20-1-2018	100 × 64	-	100 × 60 =	6,000
			300 × 65 =	19,500
			100 × 64 =	6,400
				31,900
29-1-2018	50 × 68	-	100 × 60 =	6,000
			300 × 65 =	19,500
			100 × 64 =	6,400
			50 × 68 =	3,400
				35,300
Total Sales		100 ×60	90 × 64 =	5,760
During		300 ×65	50 × 68 =	3,400
January		10 × 64		**9,160**
		410		

Product – B

Date	Purchases	Sales	Closing Stock	
	Qty. Rs.	Qty.	Qty. × Rs. =	Amount
01-1-2018	-	-	100 × 100=	10,000
09-1-2018	200 × 110	-	100 × 100=	10,000
			200 × 110=	22,000
				32,000
20-1-2018	50 × 120		100 × 100=	10,000
			200 × 110=	22,000
			50 × 120 =	6,000
				38,000
29-1-2018	50 × 125		100 × 100=	10,000
			200 × 110=	22,000
			50 × 120 =	6,000
			50 × 125 =	6,250
				44,250
Total Sales		100× 100	20 × 120 =	2,400
During		200 × 110	50 × 125 =	6,250
January		30 × 120		**8,650**
		330		

Product C

Date	Purchases	Sales	Closing Stock	
	Qty. Rs.	Qty.	Qty. × Rs. =	Amount
01-1-2018	-	-	50 × 120 =	6,000
02-1-2018	50 × 135		50 × 120 =	6,000
			50 × 135 =	6,750
				12,750
20-1-2018	100 × 140	-	50 × 120 =	6,000
			50 × 135 =	6,750
			100 × 140=	14,000
				26,750
29-1-2018	20 × 130	-	50 × 120 =	6,000
			50 × 135 =	6,750
			100 × 140=	14,000
			20 × 130 =	2,600
				29,350
Total Sales		50 × 120	40 × 140 =	5,600
During		50 × 135	20 × 130 =	2,600
January		60 × 140		**8,200**
		160		

Note : 1

Number of units sold during January :

Product	**A**	**B**	**C**
Opening Stock	100	100	50
Add : Total Purchase	450	300	170
	550	400	220
Less : Closing Stock	140	70	60
Units Sold	410	330	160

Dr. Trading Account Cr.

Particulars	Rs.	Particulars	Rs.
To Opening Stock		By sales	
A 100 × 60 =6,000		A 410 × 100 = 41,000	
B 100 × 100 = 10,000		B 330 × 200 = 66,000	
C 50 × 120 = 6,000	22,000	C 160 × 250 = 40,000	1,47,000
To Purchases		By Closing Stock	
A 29,300		A 9,160	
B 34,250		B 8,650	
C 23,350	86,900	C 8,200	26,010
To Gross Profit c/d	64,110		
	1,73,010		1,73,010

Dr. Profit & Loss Account Cr.

Particulars	Rs.	Particulars	Rs.
To Selling & Distribution Expenses	63,000	By Gross Profit b/d	64,110
To Net Profit	1,110		
	64,110		64,110

6.2 EXERCISES

Problem 1

From the following particulars, value the closing stock separately under : (A) FIFO; (B) Weighted Average

1st April, 2018	Opening Stock	800 @ Rs. 4
4th April, 2018	Sales	200
8th April, 2018	Purchase	1,000 @ Rs. 5
10th April, 2018	Sales	500
12th April, 2018	Sales	200
15th April, 2018	Purchase	700 @ Rs.5.50
18th April, 2018	Sales	500
20th April, 2018	Purchase	1,200 @ Rs.6.00
28th April, 2018	Sales	1000

The market value of 30th April, 2018 is Rs. 5.75.

Problem 2

The following is an extract of the record of receipt and issue of certain chemicals in a chemical factory during the month of March, 2018.

Date	Particulars	Units	Rate
2018 March 1	Opening balance	**500 Tonnes**	@ Rs.200
" 3	Issue	70 Tonnes	
" 4	Issue	100 Tonnes	
" 5	Issue	80 Tonnes	
" 13	Received	200 Tonnes	@ Rs.190
" 14	Returned from Department	150 Tonnes	
" 16	Issue	180 Tonnes	
" 20	Received	240 Tonnes	@ Rs.-192
" 24	Issue	300 Tonnes	
" 25	Received	320 Tonnes	@ Rs.194
" 26	Issue	115 Tonnes	
" 27	Received	350 Tonnes	@ Rs.195
" 30	Issue	400 Tonnes	

Issues are to be priced on the principle of 'First-in-First-out' Principle. The stock verifier has found shortage of 10 tonnes on the 22nd June, 1999 and left a note accordingly.

Prepare a Store Ledger Control Account for the material showing the above transactions.

Problem 3

Find the value of closing stock on FIFO method

Receipts : Purchase of Pipes		
04.06.2017	20 Pipes	@ Rs. 15.00 each
17.06. 2017	30 Pipes	@ Rs. 14.00 each
02.07. 2017	40 Pipes	@ Rs. 14.50 each
30.07. 2017	30 Pipes	@ Rs. 13.00 each
Sold :		
20-6-2017	25 Pipes	
05-7-2017	40 Pipes	
31.07. 2017	45 Pipes	

On 28.07.2017, 2 pipes sold on 20.6.2017 were received back, out of which one pipe was found damaged on 28.7.2017 and had to be discarded.

❖❖❖❖

Unit-7

CAPITAL, REVENUE EXPENDITURE AND RECEIPTS

Unit Structure :

7.0 OBJECTIVES

After studying the unit students will be able to:

- Understand the meaning and characteristics of capital expenditure and revenue expenditure.
- Distinguish between capital expenditure and revenue expenditure.
- Understand the meaning and characteristics of capital receipts and revenue receipts.
- Distinguish between capital receipts and revenue receipts.
- Understand the meaning and characteristics of deferred revenue expenditure
- Know the disclosure of various items in final accounts.

- Recognise with reason the given item is of capital nature or revenue nature or deferred revenue nature.

7.1 INTRODUCTION

Final Accounts prepared at the end of the year consists of Income Statement and Balance Sheet. These are prepared from trial balance. Debit balance shown in trial balance represents either revenue expenses or capital expenditure, credit balances are either revenue income or capital receipts. All revenue expenses & gains / incomes are transferred to Income Statement. Capital expenditure represents assets shown on assets side of the Balance Sheet. Credit balance represents either gains or capital receipts, various gains shown in Income Statement and capital receipts shown on liabilities side of the Balance Sheet. Therefore, it is very essential to know, WHICH and WHY, how to distinguishing which are capitals or revenue? While recording transaction in various books of accounts, it is necessary to classify them into revenue or capital. This classification is relevant for adherence to the requirements as per A.S. 9 & the accounting concept of matching costs with revenue.

7.2 CHARACTERISTICS / TESTS FOR CAPITAL OR REVENUE

For deciding whether it is CAPITAL OR REVENUE following features should be tested.

1. Business Activity / Nature :

In case such activities are recurring nature i.e. purchases or sales of goods or rendering serves, it is revenue. Expenditure pertains to investing / financing activity, it is capital expenditure.

2. Long / Short Term Benefits :

Benefits of expenditure is for short term, normally it is Revenue e.g. wages paid, rent paid, while if benefits for long term, it is capital, e.g. purchase of Plant, Furniture, etc.

3. Recoverable :

Amount spent is recoverable in short term, it is revenue, if it is recoverable in long term, it is capital e.g. sale of goods is revenue, sale of assets is capital receipts.

4. Recurring - Non-recurring :

Any recurring receipts / payments are recurring in nature, then it is revenue, if such receipts are non-recurring, it may be capital expenditure e.g. issue of shares is capital receipts and interest received is revenue income.

5. Effect on Funds and Profits :

Revenue receipts and revenue payments affects profits whereas capital receipts increases funds, capital payments or expenditure increases assets.

6. Treatment in Final Accounts :

Revenue receipts or payments are shown in Income Statement, capital expenditure or receipts are shown in the Balance Sheet.

7. Materially of amount :

Huge or small amount doesn't indicate whether it is capital or revenue.

8. Treatment by other party :

Treatment by other party to transaction is not relevant. E.g. furniture sold by furniture manufactures is revenue receipts for him, it is capital expenditure for buyer as it is assets purchased, thus, there are no clear cut tests / rules, whether it is capital or revenue, it can be decided upon nature of transactions / nature of business / ultimately nature of receipts or payments.

7.3 EXPENDITURE

7.3.1 Meaning:

As per guidance notes issued by I.C.A.I. in relation to Financial Statements, "**Expenditure** means incurring a liability or disbursement of cash or transfer of property for the purpose of obtaining goods, services or assets" Expenditure does not only involve outflow of resources, but also giving rise to liability or transfer of property. Such expenses may be Capital or Revenue expenditure, depends up benefits that firm gets i.e. short term or long term. An expenditure whether it is Capital or Revenue is dependent on various factors, such as:

7.3.2 Benefit of expenditure:

In case benefit of it is available for short period i.e. less than 12 months, it is revenue expenditure. Expenditure is for longer period i.e. more than one year, it is capital expenditure.

7.3.3 Recurring or non-recurring:

Revenue expenditure is reoccurring, is payable again and again, i.e. rent, wages, salaries etc. It is considered as period cost. However, capital expenditure is not payable as per period, it is incurred only when Fixed Assets are purchased.

7.3.4 Decreases Cost of production / increased earning capacity

Expenses on increasing earning capacity are treated as capital expenditure whereas expenses incurred for keeping assets in working condition are revenue expenditure.

7.4 CAPITAL EXPENDITURE

7.4.1 Meaning:

Capital Expenditure means an expenditure carring probable future benefit [Guidance Notes - I.C.A.I.] Eric. Kohler has defined Capital expenditure as "expenditure intended to benefit future periods, an addition to fixed assets. The term is generally restricted to expenditure that add to Fixed Assets units or those have effects of increasing earning capacity, efficiency, life span or economy of an existing assets."

In short, Capital Expenditure means:

i) Expenditure incurred for acquisition of Fixed Assets.
ii) Expenditure incurred in connection to acquisition of Fixed Assets.
iii) Expenditure which results in increases earning capacity of business.
iv) Expenditure which decreases cost of operation.

Balance in capital expenditure being an asset is carried forward to subsequent period; still it is fully depreciated or disposed off. Depreciation is charged annually either on book value or cost of Fixed Assets.

7.4.2 Characteristics / Tests:

If expenditure has any of the following features, then it is treated as Capital Expenditure.

1. Long Term Benefits :

The benefits of capital expenditure can be enjoyed for long periods and future period of time e.g. purchased of Plant & Machinery.

Any expenditure incurred in connection with acquisition of fixed assets, e.g. Custom duty paid on machinery imported, installation cost of machinery.

2. Investing Activity :

Such expenditure pertains to investing activity. Capital expenditure helps to set up and develop a business. It creates and increases earning capacity of the business. It gives birth to a new source of income. It leads to acquisition of new asset. Examples are Fixed Assets like Machinery, Furniture & Fixtures, Computer, etc.

3. Recoverable :

Money spent on capital expenditure can be recovered though income generated by the Assets itself or even by selling the assets at the end of its economic life or at the time of replacement of assets.

4. Non-recurring :

Capital expenditure is non-recurring in nature, i.e. it need not be incurred again and again. If a firm takes Building on rent, it is payable every month, but if it purchased Building, it does not purchase another building for many years.

5. Effect on Funds and Profits :

Capital expenditure decreases funds in current year as money goes out of business. But it may increase profits in future from income derived by using such assets. Investment purchased is capital expenditure, income earned from investment is Revenue Receipt.

6. Increases in performance of existing Assets :

Normally amount spent is large, but not necessarily, e.g. Calculator purchased, it is shown in the Balance Sheet as assets at book value [cost less depreciation].

7.4.3 Examples of Capital Expenditure:

Purchase of any Fixed Asset for use in the business, as per AS-10, cost of fixed asset includes :

a. Cost of purchase of Fixed Assets.
b. Custom duty, taxes, cusses on cost.
c. Freight paid for transportation to factory site.
d. Professional charges paid in connection with acquisition of Fixed Assets, Installation of assets e.g. Legal charges paid for preparing documents, project report, conducting feasibility study, market surveys, negotiations for Collaboration etc.
e. Office and administrative expenditure connected with project.
f. Interest on loan taken for purchase of Fixed Assets till it is put to use.
g. Any expenditure incurred during construction period.
h. Cost of an addition or extension to an existing asset.
i. Cost of development of Wasting Assets.
j. Cost of acquisition of an Intangible Assets.

7.5 REVENUE EXPENDITURE

7.5.1 Meaning:

1. **REVENUE EXPENDITURE**

Revenue expenditure means expenditure incurred for carrying out the day to day business activities and from which no future benefits expected. **[Guidance Notes - ICAI].**

Eric Kohler has defined revenue expenditure as "Expenditure charged against operations, a term used to contrast with capital expenditure".

Any expenditure which is not capital expenditure is Revenue Expenditure. The items of expenditure having immediate or short-term benefices less than 12 months are treated as Revenue Expenditure.

2. **COST**

Cost means amount of expenditure incurred on a specific article, product or activity [Guidance notes ICAI]. Thus, cost may be the cost of an asset or cost of goods or cost of services.

3. **Expenses**

Expenses means:

a) A cost relating to the operation during the accounting period.
b) A cost relating to the income earned during the accounting period.
c) A cost whose benefits do not extend beyond the accounting period.
d) An expired cost i.e. that portion of expenditure from which no further benefits are expected. [Guidance Notes ICAI].
e) Expenditure incurred to maintain assets in working condition.
f) Expenditure of revenue nature incurred after the plant starts commercial production. [AS-10].
g) Research and development cost written off.

In short, Revenue expenses means operating costs, matching costs, period cost, product cost and expired costs incurred during the accounting year.

7.5.2 Characteristics / Test:

If expenditure have any of the following characteristics or tests, it should be treated as Revenue Expenditure:

1. Business Activity :

The expenditure that pertain to business activity is recorded as revenue expenditure, as it helps to run a business and earn income. Examples are purchase of goods, fees paid etc.

2. Maintain Assets :

Expenditure that helps to maintains fixed assets in working condition is treated as revenue expenditure. e.g. repairs, maintenance.

3. Not Recoverable :

Money spent on revenue expenditure is not irretrievably gone. It can be recovered hence expired costs and revenue losses are treated as revenue expenditure.

4. Recurring :

Revenue expenditure is recurring in nature. A same type of expenditure is incurred again and again. e.g. salaries paid, rent, traveling expenses, audit fees.

5. Reduces Funds and Profits :

Revenue expenditure reduces both funds and profits of the current year. As money goes out, the funds available with the concern are reduced. And as the money goes out irretrievably (i.e. never to comes back), it reduces the profits of the concern.

7.5.3 Disclosure in final accounts:

Revenue expenditure pertains to current year is shown as expenditure in the Profit & Loss A/C. However, part of the expenses, if pertains to next year, is shown in the Balance Sheet as prepaid expenditure, on the assets side. Revenue expenditure incurred but not paid is taken in Profit & Loss A/C and it is shown in the Balance Sheet as liabilities.

7.5.4 Examples:

1. Cost relating to business activities during the accounting year is treated as revenue expenditure i.e.

- Cost of production [purchases of goods, wages paid. manufacturer expenses etc.]
- Cost of administration [salaries, rent, printing & stationery, audit fees etc.]
- Selling & Distribution cost [commission, traveling expenses, advertisement, etc.]
- Cost of raising finance [interest on loans, debentures interest, and cash discount, etc.]

2. Cost relating to income earned during the same accounting period are treated as revenue expenditure e.g. carriage, freight, buying expenses, interest on loans.

- Costs whose benefits do not extend beyond the accounting year are treated as revenue expenditure i.e. white washing factory, loose tools and packing materials.

- Expired Costs: Expenditure from which no future benefits expected is treated as revenue expenditures e.g. Depreciation on Fixed Assets, when any asset is sold at loss, book value represents loss on sale of assets, it is treated as expired cost & written off as expired cost, debited to Profit and Loss A/C.

- Revenue Loss: is treated as revenue expenditure e.g. goods destroyed by fire, bad debts and unsalable goods written off. Revenue losses arises in respect of business activities [trading or / and manufacturing] or in respect to current assets such as stock, cash lost, debtors etc.

- Revenue expenditure incurred after the plant has begun commercial production is treated as expenses. AS - 10.

- Expenditure on repairs which maintains the standard of performance of an existing fixed assets and machinery spares consumed are treated as revenue expenditure . A.S.-10.

- According to A.S.8, any Research & Development costs incurred but it is not certain whether it will give rise to any benefit in future can be treated as revenue expenditure.

7.6 DISTINCTIONS BETWEEN CAPITAL EXPENDITURE AND REVENUE EXPENDITURE

No.	Capital Expenditure	Revenue Expenditure
1.	Its benefit extends for more than one accounting year .	It benefits only for current accounting year [12 months]
2.	It is incurred for acquisition of fixed assets .	It is incurred for earning revenue.
3.	It may be incurred to improve the existing fixed assets held by the concern.	It maintained fixed assets in working condition.
4.	It increases revenue earning capacity.	It does not change revenue earning capacity.

5.	It benefits more than one accounting year.	It benefits only in the same accounting year.
6.	It decreases funds, but benefits for longer period.	It decreases funds as well as profits of business.
7.	It may decreases cost of production.	It decreases profits of current year.
8.	It is shown on assets side of Balance Sheet.	It is shown as expense in Revenue A/C.
9.	Examples = goodwill, plant & machinery, land, building, furniture & fixtures, railway sidings etc.	Examples = purchases of goods, wages, salaries, legal fees, rents. Insurance, carriage, interest, selling expenses, commission. etc.

CHECK YOUR PROGRESS

1. **Fill in the blanks**

   a. Revenue expenditure is shown on ------------- side of Profit & Loss A/C.

   b. -------------- expenditure is incurred for acquisition of Fixed Assets.

   c. -------------- expenditure benefits only in same accounting year.

   d. Purchase of goods is the example of ------------------ expenditure.

   e. Goodwill is the---------------------------expenditure.

   f. Cost relating to income earned during the --------- accounting period are treated as revenue expenditure.

   g. Expenditure from which no future benefits expected is treated as --------------expenditures.

   h. Goods destroyed by fire is a ------------------------- expenditure.

   i. Expenditure pertains to investing / financing activity is -------- expenditure.

   j. Custom duty, taxes, cusses on cost is a ----------- expenditure.

   k. Expenditure which results in increase in earning capacity of business is ---------------------- expenditure

   l. Expenditure which decreases cost of operation is -------------- expenditure.

2. Enlist the tests for treating the expenditure as Revenue.
3. Define the following terms:
   a. Revenue expenditure
   b. Capital expenditure
   c. Cost
   d. Expenditure

7.7 DEFERRED REVENUE EXPENDITURE

7.7.1 Meaning:

Deferred Revenue Expenditure is that of revenue expenditure which is carried forward on the presumption that it will benefit over subsequent periods.

Guidance note issued by ICAI "Deferred Revenue Expenditure is that part of expenditure for which payment has been made or a liability incurred but which is carried forward on presumption that it will benefit over a subsequent period or periods".

They are of a Quasi Capital Expenditure. Any heavy revenue expenditure which is incurred in one year but it is likely to benefit more than one accounting year, are considered as deferred revenue expenditure. To defer means to postpone. Deferred Revenue Expenditure has mixed nature and has same features of both revenue and capital expenditure.

7.7.2 Medium term Benefits:

The Deferred Revenue Expenditure has medium term benefits, may be 3 to 4 years, therefore, cost of expenditure is divided in say 3 to 4, or 5 years, the part of Deferred Revenue Expenditure benefit for current year debited to Profit & Loss A/C, remaining balance carried to subsequent years till It is fully written off. e.g. Discount allowed Rs.1,00,000 on issue of Debentures, Debenture, likely to be redeemed after 10 years. The benefits of issue of Debentures are for 10 years. Every year 1,00,000/10 = Rs.10,000 shall be written off, balance in Discount on issue of Debentures carried forward. After ten year, there will be no balance in that account.

7.7.3 Nature of Expenses :

Deferred Revenue Expenditure should be Revenue Expenditure by nature in the first instance, for example, advertisement. But its matching with revenue may be deferred considering the benefit to be accrued in future.

7.7.4 Revenue Expenses, Deferred Revenue Expenditure & Prepaid Expenditure:

A thin line of difference exists between revenue expenses, deferred revenue expenditure and prepaid expenses. Revenue Expenditure is short time expenses, benefits of all these are excused in the same accounting year. In some cases, part of Revenue Expenses is treated as Deferred Revenue Expenditure and is carried forward on the presumption that it will benefit over subsequent period or periods. e.g. heavy advertisement for new product launch in the market, such expenses may be assumed, it is going to benefit for 3 to 5 years, hence it can be treated as Deferred Revenue Expenditure. The benefits available from prepaid expenses can be precisely [not presumption] estimated but that is not so in case of Deferred Revenue Expenditure. e.g. Insurance premium paid for the year ended 30th June 2018 Rs. 24,000/- Accounting year ended 31st March 2018. In this case three months premium pertains to subsequent period, = 24000/12*3 = Rs. 6000. Amount is ascertained and carried forwards according as prepaid insurance Rs. 6000/-.

7.8 CAPITAL RECEIPTS

7.8.1 Meaning:

Receipts means an amount received by a concern either during its business activity [supply of goods or services] or during its financing [obtaining money as capital or loan or sale of assets]. Receipt arising out of business activity is known as revenue receipts, wherever receipts arising out of financing activity are known as capital receipts or liability.

Capital receipts means an amount received by a concern in the course of financing activity [obtaining money as capital or loan or sale of Assets]. A concern need money to carry on its business activities and investing activities. The money is obtained either from the owner or loans or sales of assets or sales of investment. Capital receipts are non-recurring in nature.

- Capital means the amount invested in the concern by its owners, it to be refunded only when the concern finally stops its business and is closed down.
- Liability means amounts received as loan basis from outsiders e.g. from Bank, financial institution.
- Capital receipts are recognized on accrual basis as soon as the rights of receipts are established. Capital receipts are not credited to Profit & Loss A/C, it is shown as the liability or it may reduce from Fixed Asset. However, it may be credited to Profit & Loss A/C to the profit realized on sale of asset.

7.8.2 Characteristics / Tests:

If receipts have any of the following features, then it should be treated as Capital Receipts:

- **Financing Activity**:
  Receipts which arises from financingl activities are concerned as Capital Receipts. It provides funds to acquire new fixed assets. e.g. capital introduced, loan taken from sale of assets, etc.

- **Non-recurring**:
  Capital receipts are always non-recurring in nature. Such amounts are not received again and again. These are long term commitments.

- **Returnable**:
  Money received as loan is returnable, as per various terms agreed upon. Capital introduced is paid back to owner when business is closed down.

- **Effect on fund and profits**:
  Capital receipts increases fund available to business in the year of receipts, as money comes in the business. But it may decreases profits in future as one has to pay interest on loan. However, in long term, it will increase profits of the firm. e.g. Say you are borrowing @ 12%; return on investment to firm say 18% and then extra 6% increases return to owner, without additional capital. This is possible only when returns are higher from the business.

7.8.3 Disclosure in Final Accounts:

Capital receipts are shown in Balance Sheet on liability side. Capital receipts from sale of fixed assets are deducted from concerned fixed assets.

7.8.4 Example:

a) Additional capital introduced by the owner Rs. 1,50,000.
b) Loan of Rs. 5,00,000 taken from H.D.F.C. Bank.
c) Investment costing Rs. 75,000 sold.
d) Grants from government received Rs.1,75,000 for construction of building.

7.9 REVENUE RECEIPTS

7.9.1 Meaning:

- Revenue receipts are those items of income, which are received or accrued in ordinary course of business. Revenue receipts means receipts from customers for sale of goods or rendering services or for use of funds or use of assets. **[Guidance Notes - I.C.A.I.]** Revenue receipts are recurring in nature; this gives rise to Gross Income regularly so long as the business continues.

- Income means revenue earned during the particular accounting year.

7.9.2 Characteristics / Tests:

If receipts have any of the following features, then it should be treated as Revenue Receipts:

a) Business Activity:

Receipts in course of business activities are recorded as Revenue Receipts e.g. Sale of goods, interest received, dividend received, discount earned, etc.

b) Recurring:

Revenue Receipts are recurring in nature. Same types of receipts are received again and again on regular basis, periodically received in gap of two or three months, like interest on loan given.

c) Not Returnable:

Revenue Receipts are not returnable / refundable. It needs not be paid back as concern has supplied goods or rendered services to customers. Amounts received for sale of goods or rendering reverses, in normal case, money is not to be refunded to customers back. Legal ownership is with seller and need not to be paid back.

d) Increase in funds and profits:

Revenue receipts increases both funds and profits of the current year. As money received in the from of income, it increases profits and it is not to be refunded. It increases funds available at disposals with the concern.

7.9.3 Disclosure in final accounts:

Revenue receipts pertaining to current year are credited to Profit & Loss A/C. Revenue receipts relating to future period shown in the Balance Sheet as received in advance, on liability side. [as income received in advance]. However income is different than receipts. Income excludes revenues relating to the further period, received in advance & includes income earned in current year but not received [income receivable] and income received in earlier years for current year.

7.9.4 Examples:

Sales of goods:

Goods means the commodities in which the concern deals. Sales of goods whether manufactured or purchased are revenue income.

Revenue is said to be arise from sale of goods when sale is complete and the buyer has no legal right to return the goods or ask for refund. If at the time of receipts, sale is not complete or buyer has right to ask for refund, [sale on approval, goods sent on consignment] then it is treated as advance and the receipt is based on advance and not as revenue. Only when the sale is complete, such advance is to be treated as revenue.

Rendering of Services:

Services means 'AID TO TRADE', such as marketing, financing, administration, distribution, transport etc. Receipts are taken as revenue when services are provided.

- **Interest :**
  Interest is taken as income on loan given by the concern. Amount received when such loan itself is returned, then it is capital receipt.

- **Dividend** :
  Receipt is treated as dividend when it is in the form of a reward from investment in shares. Amount is received on sales of such shares themselves are treated as capital receipts.

- **Royalty :**
  Receipt is treated as royalty when it is received for used of assets such as know-how, patents, trademarks and copyrights. Amount received on outright sales of such patents etc. are capital receipts.

- **Insurance claim :**
  Compensation received from insurance company for loss of current assets e.g. loss of goods, loss of cash due to theft etc., are treated as revenue receipts.

7.9.5 GOVERNMENT GRANTS

Grants received from Government are of two types. Grants received for capital expenditure is capital receipt e.g. for road construction, for Equipments to be purchased. However, grant received to re-imbrue or compensate for specified revenue expenditure or revenue losses are revenue receipts. [e.g. salary grant, rent, power grant] are treated as Revenue Receipts [A.S. - 15 on Government Grants]. In brief, any receipt is recurring &

benefits are likely to be lost for not more than 12 months, are Revenue Receipts.

7.10 DISTINCTIONS BETWEEN CAPITAL RECEIPTS AND REVENUE RECEIPTS

No.	Capital Receipts	Revenue Receipts
1.	It is non-recurring in nature.	It is recurring in nature.
2.	It arises from financial / investing activity.	It arises from business activity.
3.	Capital receipts which are liabilities are to be repaid as per terms.	They are not repaid in normal course of business.
4.	They are not gains to the concern.	They are gains to the concern.
5.	They appear in Balance Sheet.	They appear in Income Statement.
6.	Capital receipts are recognized on accrual basis but not matched with capital expenditure.	Revenue receipts are matched with Revenue expenditure at the end of accounting year.
7.	Examples of capital receipts are capital brought in by owner, loan taken, sale of fixed assets and sale of investment.	Examples of revenue receipts are sale of goods, rent received, interest received, discount earned, income from investment etc.
8.	Capital receipts may be capital profit, it increases funds available.	In increases profits as well as funds of business concern.

CHECK YOUR PROGRESS

1. Fill in the blanks

- **a.** Commission received is --------------receipt.
- **b.** Rent received by sub-letting premises is -------------receipt.
- **c.** Sale proceeds on sale of old car is -------------receipt.
- **d.** Sale of furniture by furniture dealer is -------------receipt.
- **e.** --------------- means assets held for short period.
- **f.** Capital of owner of business is shown on -------------- side of balance sheet.
- **g.** ------------- assets does not have physical identity.
- **h.** Grants received from Government for capital expenditure is a-------------------------receipt.

- **i.** Grant received for road construction is a ------------receipt.
- **j.** Grant received for re-imbrues or compensate for specified revenue expenditure or revenue losses are-------------- receipts.
- **k.** Sales of goods whether manufactured or purchased are ------ income.
- **l.** Revenue receipts pertaining to current year are ------------ to Profit & Loss a/c.
- **m.** Revenue receipts relating to ---------- period shown in the balance sheet as received in advance, on-------- side.
- **n.** Deferred revenue expenditure should be ----------expenditure by nature in the first instance.
- **o.** Discount on issue of debenture is a ----------------expenditure.

2. Define the following terms:

a. Revenue receipts

b. Capital receipts

c. Deferred revenue expenditure

3. What is the difference between income and receipt.

7.11 DEFERRED REVENUE INCOME

7.11.1 Meaning:

Deferred Revenue Income means income received in advance before it is earned, which is carried forward to subsequent period to which it relates [Guidance note - ICAI] such income is received in advance. Such items of income is shown as 'Income received in advance' on the liability side of Balance Sheet.

7.11.2 Examples:

Club annual membership fees received in advance from some members is to be treated as income received in advance, to be carried forward to the period it belongs.

Educational institution fees may be collected for entire course, say three years, two years fees received is income received in advance.

Grants received from Government for acquiring depreciable assets are treated as deferred income. Proportionate amount of grant basined on useful life of asset [i.e. total grant divided by the useful life of assets] is taken as income every year and credited to Profit & Loss A/C. [A.S. - 15 on Government Grants - I.C.A.I.]

7.12 REVENUE PROFIT AND CAPITAL PROFIT

Business activities give rise to revenue profit whereas investing and financing activities give rise to capital profit. Revenue profit / operating profit mean the net profit arising from the normal operations / operating activities of the concern. Net operating profit means excess of gross operating income over total operating expenditure during the particular period. Capital profit arises when assets or investment sold at higher price than cost. Shares are issued by the company at higher price than face value / nominal value, extra amount received is credited to Securities Premium A/C and not to Profit and Loss A/C. In case of sale of Fixed Assets, difference between sale proceeds and cost is capital profit, difference between cost and book value is revenue profit. e.g. Plant costing Rs. 7,50,000/- book value on date of sale Rs. 4,50,000/- [due to depreciation], sold for 9,00,000/-

Capital profit = 9,00,000 - 7,50,000= Rs. 1,50,000 [sale proceeds - cost]
Revenue profit = 7,50,000 - 4,50,000 = Rs. 3,00,000 [cost - book value]

7.13 REVENUE LOSS AND CAPITAL LOSS

Revenue due to business activity is revenue loss, e.g. loss on sale of goods, bad debts, goods lost by theft. Such revenue losses are expired cost and debited to Profit & Loss A/C. On the other hand, losses due to investing and financing activity is capital loss. Capital loss due to investing activity is debited to Profit and Loss A/C as expired cost with no future benefits whereas losses due to capital, financing i.e. discount on issue of shares is carried forward as 'fictitious assets' shown in the Balance Sheet under the heading "Miscellaneous Expenditure".

7.14 EFFECT OF WRONG TREATMENT ON PROFIT

We believe that to erris human, to ignore its effect will cost on someone, who may blame accountant.

Any error in classification of payments / receipts will affect final accounts. Every receipts and payments are classified into either Revenue or Capital. Revenue expenditure & incomes are transferred to Profit & Loss A/C to ascertain net profit or loss for the period. Capital expenditure and capital receipts are shown in the balance sheet. Balance shown in the balance sheet are carried forward to subsequent period. Thus, any error in classification will effect on accuracy of entire final accounts. Effect of such error can be as under:-

1. Revenue Expenditure is shown as Capital Expenditure:

Revenue expenditure wrongly capitalized will increase profits of this year and assets are overvalued, depreciation part in subsequent year shall decrease profits of all subsequent years e.g. Repairs to Machinery Rs. 60.000 wrongly debited to Machinery A/C. Since it is wrongly capitalized, expenditure not debited to Profit & Loss A/C profit shall be shown at higher amount and also at higher amount, in subsequent year, due to higher depreciation, it will reduce profits.

2. Capital Expenditure is shown as Revenue Expenditure :

As capital expenditure is debited to Profit & Loss A/C, Profit & Loss A/C will show lower profit and Balance Sheet shows lower assets. It will affect profits / loss in subsequent years also, as depreciation shall not be charged, as entire amount is already debited to Profit & Loss A/C e.g. Furniture purchased for Rs.51,000, wrongly recorded in purchase day book. In this case, gross profit as well as net profit reduced by Rs. 51,000/- .Furniture is not added to furniture in Balance Sheet. So, Balance Sheet shows fixed assets lower by Rs.51,000 if this type of error results in to Window Dressing.

3. Capital Receipts are shown as Revenue Receipts:

The Profit & Loss A/C shows higher profits and the Balance Sheet shows lower liabilities or higher assets. e.g. Sale of old assets for Rs. 25,000 recorded in Sales Day Book. In this case, as sales are shown at higher amount, Gross Profit, Net Profit shall be higher, since it is not deducted from assets, they are shown at higher amount by Rs. 25,000. Profit or loss on sale of assets are also not accounted. Deposit received from customers' Rs. 27,000, wrongly credited to interest A/C, profit shown by Profit & Loss A/C will be higher and liabilities are shown lower by Rs. 27,000.

4. Revenue Receipts are shown as Capital Receipts:

The Profit & Loss A/C shows lower profit and the Balance Sheet shows higher liabilities, or lower assets e.g. Commission received Rs. 71,000, from Z & Co. credited to Z & Co., income is shown less and Z & Co. as liability.

Sale of goods wrongly credited to Furniture A/C, sales is shown lower results in lower income and Furniture is reduced by the same amount, assets are shown at lower amount.

7.15 ILLUSTRATION

Illustration 1:

State with reason whether following are capital or revenue expenditure:

i) Rs.12,000, paid for removable of stock to new site.

ii) Purchase of NOKIA mobile phone Rs.5,000 for office work.

iii) Expenses incurred in connection with obtaining a licence for starting the factory for Rs.27,000.

iv) Legal fees to acquire property Rs.10,000.

v) The amount spent for replacement of work out part of machine Rs.50,000.

vi) Money spent to reduce working expenses Rs.25,000.

vii) Ring & Pistons of an engine were changed at cost of Rs.10,000 to get fuel efficiency.

Solution :

i) Rs.12,000, paid for removable of stock to new site is **revenue expenditure**. This is neither bring enduring benefit nor enhance the value of the asset.

ii) Purchase of NOKIA mobile phone Rs.5,000 is **capital expenditure**; as it is incurred for acquisition of fixed assets.

iii) Money paid Rs. 27,000 for obtaining license to start a factory is a **capital expenditure**. This is an item of expenditure incurred to acquire the right to carry on business.

iv) Legal fees to acquire property Rs.10,000 are part of cost of that property. It is incurred to possess the ownership rights of the property and hence it is a **capital expenditure**.

v) The amount spent for replacement of work out part of machine Rs.50,000 is **revenue expenditure** since it is part of its maintenance cost. If was incurred to keep machine in working condition.

vi) Money spent on reducing working expenses Rs.25,000 is **capital expenditure**, as it generates long term benefit to the entity. It is part of intangible fixed assets. if is incurred for any specific assets then it is also capital expenditure. It should be capitalized.

vii) Rs.10,000 spent in changing rings and pistons of an engine to get fuel efficiency is **capital expenditure**. This is an expenditure on improvement of fixed assets. It results in increasing profit earning capacity of the business by cost reduction.

Illustration 2 :

State whether the following expenditure is a capital, revenue or deferred revenue expenditure. Give reasons :

1. Legal expenses incurred in connection with issue of capital.
2. Cost of replacement of a defective part of the machinery.
3. Expenditure incurred in preparing a project report.
4. Expenditure for training employees for better running of machinery.
5. Expenditure incurred for repairing cinema screen.

Solution:

1. **Deferred revenue expenditure**: Legal expenses incurred in connection with issue of capital are not treated as revenue expenditure because the funds from issue of shares will benefit the concern for many years, it is not treated as capital expenditure because it does not create any real asset. Hence, it is treated as deferred revenue expenditure and written off over certain number of years.

2. **Revenue expenditure**: As replacement of a defective part will help to maintain the machinery in working condition.

3. **Capital expenditure**: If the project is implemented; as according to Accounting Standard 10, all expenditure till a project commences is capitalized. However, if the project is given up or not implemented and the amount is small, it will be written off as revenue expenditure (as expired costs which will bring no benefit in future); if the project is not implemented and the amount is heavy, it will be treated as deferred revenue expenditure.

4. **Revenue expenditure**: As expenditure for training employees for better running of machinery is cost of administration related to normal business activities incurred in order to earn income during the year.

5. **Revenue expenditure**: As expenditure incurred for repairing cinema screen is a cost incurred to maintain an existing asset in working condition.

Illustration 3:

State, with reasons, whether you would consider the following as capital expenditure or revenue expenditure :

1. Amount spent on uniform of workers.
2. White-washing of the factory building.

3. Cost of stores consumed in manufacturing machinery for installation in own factory.
4. Wages paid for construction of the building extension.
5. Import duty on raw material purchased.

(June 1980, adapted)

Solution :

1. **Revenue expenditure**: As amount spent on uniform of workers is an administration cost related to normal business activities.
2. **Revenue expenditure**: As white-washing of the factory of building is a cost of maintaining an asset in working condition.
3. **Capital expenditure**: As cost of stores consumed in manufacturing machinery for installation in own factory is a direct cost incurred for manufacturing an asset which is to be capitalized as per Accounting Standard 10.
4. **Capital expenditure**: As wages paid for construction of an extension to an existing asset is a direct cost incurred for acquiring an asset which is to be capitalized as per Accounting Standard 10.
5. **Revenue expenditure**: As import duty on raw material purchased is a direct product cost related to normal business activities incurred in order to earn income during the year.

Illustration 4:

State with reasons, whether you would consider the following as capital expenditure or revenue expenditure.

1. Raw material costing $ 2,000/- was imported when 1 dollar was worth Rs. 40; when payment was actually made the foreign exchange was purchased at the rate of 1 dollar equal to Rs. 42.
2. Premium paid in connection with acquisition of leasehold premises.
3. Renovation of factory canteen.
4. Fees paid for renewal of licence for factory.

(April 1984 adapted)

Solution :

1. **Revenue Expenditure:** As due to change in exchange rate, raw material cost, which is a direct product cost, has gone up. Cost of raw materials = 2000 × 40 = ₹80,000. it is purchased of goods. However, extra amount paid 2000 × (42 - 40) = 4,000

shall be treated as loss due to exchange fluctuation is also revenue expenditure, should be debited to profit & loss a/c.

2. **Capital expenditure**: As premium paid in connection with acquisition of leasehold premises is a direct cost incurred in connection with the acquisition of an asset to be added to the cost of the asset [Accounting Standard 10].

3. **Revenue expenditure**: As renovation of factory canteen helps to maintain the asset in working condition.

4. **Revenue expenditure**: As fees for renewal of factory licence is a recurring expenditure incurred in the course of normal business activities.

Illustration 5:

Electric Engineers Private Limited removed their factory to a more suitable premises in Navi Mumbai. State with reasons the accounting treatment for the following items:

1. A sum of Rs.99,500 was spent for dismantling, removing and re-installing plant, machinery and fixtures.
2. The removal of stock from the old factory to the new at a cost of Rs.1,000.
3. Plant and Machinery which stood in the books at ₹1,50,000 included a machine at a book value of Rs. 1,50,000 included a machine at a book value of Rs. 3,400. This being obsolete, was sold off at Rs. 900 and was replaced by a new machine which cost Rs. 4,800.
4. The freight and cartage on the new machine amounted to ₹300 and erection charges Rs.550.
5. The furniture appeared in the books at Rs.15,000. Of these, some portion of the book value at Rs.3,000 was discarded and sold at Rs.1,200. New furniture of the book value of ₹2,400 was acquired.
6. A sum of Rs.2,200 was spent on painting the new factory

(**Oct. 1981, adapted)**

Solution:

1. **Deferred revenue expenditure**: Cost of dismantling, removing and re-installing plant etc. is not treated as revenue expenditure because it is not a normal operating cost. If it is not treated as capital expenditure because it does not create any real asset.

Hence it is treated as deferred revenue expenditure and written off over certain number of years.

2. **Revenue expenditure**: As removal of stock from the old factory to the new is a normal operating cost related to a current asset (stocks) and not capital asset.
3. When a machine costing Rs.3,400 is sold for Rs.900 received on sale of machinery is treated as **capital receipt**; and the book value of the machine becomes Rs.2,500. As the machine has been sold at its book value represents an 'expired cost' with no future benefits i.e. loss on sale of asset which is to be written off by debit to the Profit and Loss Account. Cost of new machine (Rs.4,800) will be treated as **Capital expenditure**.
4. **Capital expenditure**: As freight and cartage on the new machine as well as the erection cost is a direct cost of bringing an asset to a condition where it can be put to use, which is capitalized as per Accounting Standard 10.
5. Loss on sale of old furniture (Rs.3,000 - Rs. 1,200) is written off as expired cost by debit to the Profit and Loss Account; cost of new furniture (Rs.2,400) will be treated as **Capital expenditure.**
6. **Capital expenditure**: painting the new factory is a direct cost till an asset is first put to use, which is capitalized as per Accounting Standard 10.

Illustration 6:

State with reasons whether the following are Capital or Revenue Expenditure:

1. Freight and cartage on new machine Rs.150, and erection charges Rs.200.
2. Fixtures of the book value of Rs.1,500 was sold off at Rs.600 and fixtures of the value of Rs.10,000 was acquired, cartage on purchase Rs.50.
3. A sum of Rs.100 was spent on painting the factory.
4. Rs.5,150 spent on repairs before using a second-hand car purchased recently to put it in useable condition.

(FY, March 1995, adapted)

Solution :

1. **Capital expenditure**: Freight and cartage on new machine and erection charges are capitalized as all costs till an asset is installed are added to its cost as per Accounting Standard 10.
2. When fixtures are sold at Rs.600.Amount received on sale are treated as **Capital receipt** and credited to Fixtures A/C; the book value of the fixtures indicating Loss on sale of old fixtures

(1,500-600) is treated as an expense (expired cost) and written off by debit to the Profit and Loss Account cost of new fixtures (Rs.10,000) and cartage (Rs.50) will be treated as **Capital expenditure**.

3. **Revenue expenditure**: As painting the factory helps to maintain the asset in good working condition.

4. **Capital expenditure**: Repairs before using a second-hand car purchased recently to put it in useable condition are capitalized as per Accounting Standard 10 which states that all direct costs of bringing the asset to its working condition for its intended use form part of the cost of the asset.

Illustration 7:

State with reasons whether the following items relating to a sugar mill company are capital or revenue:

1. A motor truck costing Rs.15,000 and standing in the books at Rs.7,250 was sold for Rs.12,000.
2. Rs.20,000 received from the issue of further shares, the expenses of the issue being Rs. 2,500.
3. Rs.75,000 being cost of land purchased for agricultural farm and ₹450 paid for land revenue.
4. Rs.1,50,000 paid for excise duty on sugar manufactures.
5. Rs.50,000 invested in a government loan, interest received Rs.4,500
6. Rs.60,000 spent on construction of railway siding.

(FY, March 1996; adapted).

Solution :

1. **Capital receipt**: As Rs.12,000 is received from sale of a capital asset. The profit on sale of asset (Rs.12,000 - Rs. 7,250) will be credited to the profit and loss account as an extraordinary item of income on sale of motor truck.

2. **Capital receipt**: (Rs.20,000) : As amount has been received from issue of shares in the course of financing activity of the company. Rs.2,500 spent as expenses on issue of shares will be treated as deferred revenue expenditure. It is not treated as revenue expenditure because it is not a normal operating cost. It is a nonrecurring expenditure. It is not treated as capital expenditure because it does not create any real asset. Hence it is treated as deferred revenue real asset. Hence, it is treated as deferred revenue expenditure and written off over certain number of years.

3. Rs.75,000 will be treated as **capital expenditure** as agricultural land is a capital asset; Rs.450 paid for land revenue is **revenue expenditure** in the course of normal operations of business.
4. **Revenue expenditure**: Excise duty on sugar manufactured is the cost incurred during the course of normal business operations incurred in order to earn income. It is recurring expenses payable on manufacture of excisable goods.
5. **Capital expenditure**: Purchase of government loan is an investment which will be returned on due date. Interest received Rs.4,500, being income revenue income to be credit to Profit & Loss A/C.
6. **Capital expenditure**: As cost of construction of railway siding is for acquisition of a capital asset.

Illustration 8 :

State which of the following items are capital, revenue and deferred revenues. Explain with reasons.

1. Expenditure incurred on overhauling machinery.
2. Taxes paid.
3. Wages paid to the workers for election of a new machinery.
4. Cost of goodwill.
5. Heavy expenditure incurred on advertisements.
6. Cost of construction of a building.
7. Machinery costing Rs.10,000 sold for Rs.12,000
8. Purchased machinery for Rs.15,000.

(FY, October 1996; adapted)

Solution :

1. **Revenue expenditure**: As expenditure incurred on overhauling machinery helps to maintain the machinery in working condition.
2. **Revenue expenditure**: If taxes are on goods purchased e.g. sales tax (Income tax is treated as drawings), goods manufactured, then excise duty has to pay.
3. **Capital expenditure**: Wages paid to workers for erection of a new machinery are capitalized as all costs till an asset is installed are added to its cost as per Accounting Standard 10.
4. **Capital expenditure**: As cost of goodwill is an acquisition of capital (intangible) asset.
5. **Deferred revenue expenditure**: If the heavy expenditure incurred on advertisements is going to benefit for a number of years.

6. **Capital expenditure**: As cost of construction of a building helps to create a capital asset.
7. **Capital receipt**: As the amount of Rs.10,000 is received on sale of fixed asset. Profit on sale (Rs.2,000) is credited to the Profit & Loss A/c as an extra-ordinary item of income.
8. **Capital expenditure**: As it is an acquisition of a fixed asset.

Illustration 9:

State whether the following expenditure is a capital, revenue or deferred revenue expenditure. Give reasons:

1. Legal expenses incurred in connection with issue of Equity Shares of the company.
2. Cost of replacement of a defective part of the machinery.
3. Expenditure incurred in preparing a project report.
4. Expenditure for training employees for better running of machinery.
5. Purchase of machinery for sale.
6. Daily wages paid to office peon.

(FY, April, 1996, adapted)

Solution:

1. **Deferred revenue expenditure**: Legal expenses incurred in connection with issue of equity shares are not treated as revenue expenditure because the funds received from issue of shares will benefit the concern for many years. It is not treated as capital expenditure because it does not create any real asset. Hence, it is treated as Deferred Revenue Expenditure and written off over certain number of years.
2. **Revenue expenditure**: As replacement of a defective part will help to maintain the machinery in working condition.
3. **Capital expenditure**: If the project is implemented; as according to Accounting Standard 10, all expenditure till a project commences is capitalized. However, if the project is given up or not implemented and the amount is small, it will be written off as revenue expenditure (as expired costs which will bring no benefit in future); if the project is not implemented and the amount is heavy, it will be treated as Deferred Revenue Expenditure.
4. **Revenue expenditure**: As expenditure for training employees for better running of machinery is cost of administration related to normal business activities incurred in order to earn income during the year.

5. **Revenue expenditure**: As expenditure incurred for purchase of machinery for sale is a direct product cost related to normal business activities incurred in order to earn income during the year.
6. **Revenue expenditure**: As daily wages paid to office peon is cost of administration related to normal business activities incurred in order to earn income during the year.

Illustration 10:

State whether the following expenditure is a capital, revenue or deferred revenue expenditure. Give reasons:

1. Payment for purchase of goods.
2. Payment for purchase of stationery.
3. Payment for purchase of a car.
4. Payment for heavy inaugural expenses.
5. Partial refund of capital to a partner.
6. Payment of a loan taken earlier.
7. Payment of salaries.
8. Wages for erection or machinery.

(FY, October, 1996 adapted)

Solution :

1. **Revenue expenditure**: As expenditure incurred for purchase of goods is a direct product cost related to normal business activities incurred in order to earn income during the year.
2. **Revenue expenditure**: As purchase of stationary is cost of administration related to normal business activities incurred in order to earn income during the year.
3. **Capital expenditure**: As purchase of a car helps to create a capital asset.
4. **Deferred revenue expenditure**: Heavy inaugural expenses are not treated as revenue expenditure because these will benefit the concern for many years. These are not treated as capital expenditure because these expenses do not create any real asset. Hence these are treated as deferred revenue expenditure and written off over certain number of years.
5. **Capital expenditure**: As partial refund of capital to a partner reduces the liabilities of the concern.
6. **Capital expenditure**: As payment of a loan taken earlier reduces the liabilities of the concern.

7. **Revenue expenditure**: As salaries is cost of administration related to normal business activities incurred in order to earn income during the year.
8. **Capital expenditure**: As wages for erection of machinery is a direct cost incurred for acquiring an asset which is to be capitalized as per Accounting Standard 10.

Illustration 11. :

State, with reasons, whether you would consider the following as capital expenditure or revenue expenditure:

1. Stock of Rs.25,000 was destroyed by fire of which Rs.15,000 was received from the Insurance Company.
2. The concern spent Rs.1,00,000 on heavy advertisement campaign to introduce a new product in the market.
3. Cost of dismantling a plant from a particular locality and reinstalling the same in another locality.
4. Cost of transporting newly purchased furniture.
5. Amount spent by factory in overhauling its plant which has enhanced the life of the plant by five years.
6. Travelling expenses for a trip abroad for purchase of capital goods.
7. Amount spent on replacement of defective part of an old plant.
8. Cost of Goodwill purchased.

(FY, May 1998, adapted)

Solution :

1. **Revenue loss / expenditure**: Of net amount of Rs.10,000 as loss of stock by fire is related to loss of current assets (stocks) and not capital assets. Insurance claim received is revenue receipts.
2. **Deferred revenue expenditure**: Expenses on heavy advertisement campaign to introduce a new product in the market are not treated as revenue expenditure because these will benefit the concern for many years. These are not treated as capital expenditure because these expenses do not create any real asset. Hence these are treated as deferred revenue expenditure and written off over certain number of years.
3. **Deferred revenue expenditure**: Cost of dismantling a plant from a particular locality and reinstalling the same in another locality is not treated as revenue expenditure because it will benefit the concern for many years. It is no treated as capital

expenditure because it does not create any real asset. Hence, it is treated as deferred revenue expenditure and written off over certain number of years.

4. **Capital expenditure**: As cost of transporting newly purchased furniture is a direct cost incurred for acquiring an asset which is to be capitalized as per Accounting Standard 10.

5. **Capital expenditure**: Amount spent by factory in overhauling its plant which has enhanced the life of the plant by five years is an expenditure which helps to improve the standard of performance (working life) of an existing asset and is to be capitalized as per Accounting Standard 10.

6. **Capital expenditure**: As traveling expenses for a trip abroad for purchase of capital goods is a direct cost incurred for acquiring an asset which is to be capitalized as per Accounting Standard 10.

7. **Revenue expenditure**: As amount spent on replacement of defective part of an old plant will help to maintain the plant in working condition.

8. **Capital expenditure**: As cost of Goodwill purchased is a direct cost incurred for acquiring an asset which is to be capitalized as per Accounting Standard 10.

Illustration 12:

State, with reasons, whether you would consider the following as capital expenditure or revenue expenditure:

1. Professional fees paid in connection with acquisition of leasehold premises.
2. Cost of registration and documentation of a newly formed company.
3. Compensation paid to a retrenched employee for loss of employment.
4. Expenditure incurred on purchase of cloth for uniform of employees.
5. Payment of import duty on purchase of raw materials.

(FY, November 1998, adapted)

Solution:

1. **Capital expenditure**: As professional fees paid in connection with acquisition of leasehold premises is a direct cost incurred in connection with the acquisition of an asset to be added to the cost of that asset [Accounting Standard 10].

2. **Deferred revenue expenditure**: Cost of registration and documentation of a newly formed company is not treated as revenue expenditure because it will benefit the concern for many years. It is not treated as capital expenditure because it does not create any real asset. Hence it is treated as deferred revenue expenditure and written off over certain numbers of years. This type of expenses may be group known as preliminary expenses.
3. **Revenue expenditure**: As compensation paid to a retrenched employee for loss of employment is an administrative expenditure incurred in the course of normal business activities. However, if the amount is heavy, it may be treated as Deferred Revenue Expenditure, as it is a non-recurring expenditure, not in the normal course of business which benefits the business for many years by way of reduction in salary**.**
4. **Revenue expenditure**: As purchase of cloth for uniform of employees is an administrative expenditure incurred in the course of normal business activities.
5. **Revenue expenditure**: As payment of import duty on purchase of raw materials is a direct product cost incurred in the course of normal business activities in order to earn income. It should be added to cost of material purchased.

Illustration 13 :

Saraswati Sisters removed their factory to their New Mumbai premises. They carried out the following transactions:-

1. Cost of dismantling, transporting and re-installing the plant Rs.50,500.
2. An old plant having depreciated value of Rs.60,000 was sold for Rs.55,000.
3. A new machine was purchased for Rs.2,00,000 and installed at the cost of Rs.35,000.

   Apportion these into capital and revenue.

(IDE March 2000, adapted)

Solution :

1. **Deferred revenue expenditure**: Cost of dismantling, transporting and re-installing plant etc. is not treated as revenue expenditure because it is not a normal operating cost. It is not treated as capital expenditure because it does not create any real asset. Hence it is treated as deferred revenue expenditure and written off over certain number of years.

2. **Capital receipt**: As the machine has been sold, its book value represents an 'expired cost' with no future benefits i.e. loss on sale of asset which is to be written off. Rs.55,000 is treated as capital receipt.

3. **Capital expenditure**: Cost of new machine (Rs.2,00,000) will be treated as capital expenditure. Installation cost (Rs.35,000) is a direct cost of bringing an asset to a condition where it can be put to use which is capitalized as per Accounting Standard 10. Therefore, cost of machinery shall be Rs.2,35,000.

7.16 EXERCISES

1. Write short notes on

a) Capital Expenditure
b) Deferred Revenue Expenditure
c) Capital Profit
d) Revenue Expenditure
e) Revenue Profit.

2. Distinguish between

a) Capital expenditure & revenue expenditure.
b) Revenue expenditure & deferred revenue expenses.
c) Revenue receipts & income.
d) Revenue profits & capital profit.
e) Revenue receipt & capital receipt.

3. Practical problems

Exercise 1 : S. Jaggi sells and services typewriters. State which of the following are capital expenditure and which are revenue expenditure, giving reasons for your answer.

a. Purchase of a typewriter for office use.
b. Purchase of typewriters for re-sale.
c. Traveling expenses to service typewriters.
d. Purchase of spare parts to service typewriters.
e. Wages of mechanic
f. Wages of office staff.
g. Telephone charges.
h. Purchase of tools for servicing work.

[**Ans. Capital - (a), (h); Revenue - other]**

Exercise 2: Indicate - briefly giving your reasons in each case - which of the following represent capital receipts, capital expenditure, revenue income, revenue expenditure.

a. Interest on bank overdraft.

b. Purchase of typewriter for re-sale by the Office Supplies Co.

c. Purchase of typewriter for office use by the Sonali Social Club.

d. Sale of a delivery van by Office Supplies Co.

e. Receipt of commission by a firm of brokers.

[Ans. CR - (d); CE - (c); RI - (e); RE - (a), (b)]

Exercise 3: State which of the following are Capital Expenditure and which are Revenue Expenditure, giving reasons in each case.

i) Payment by cheque for carriage on purchases.

ii) Purchase of packing material for distribution of goods from the Calcutta Paper Mill Ltd.

iii) Purchase of duplicator for use in own office from Gulab & Co.

iv) The firm acquired a private car from B. Raha, one of the partners of the firm.

[Ans. RE - (i) & (ii); CE - (iii) & (iv)]

Exercise 4: During the year 2017 A. Ashar had the following transactions :-

1. Purchased a new motor van Rs.17,500 from B.G. Traders Ltd. on credit.
2. Paid cheque Rs.740 to Office Furnishing Ltd. being Rs.650 for a new office desk and Rs.90 for repair of an existing desk.
3. Paid Rs.1,420 by cheque for repairs and improvements to premises. Rs.1,000 of this amount is to be capitalized.
4. Purchased additional premises for Rs.30,000 which was paid by cheque.

State the total amount of capital expenditure involved in the above transactions.

[Ans. Capital expenditure - Rs. 49,150]

Exercise 5: State with reasons whether the following are Capital or Revenue expenditure:

1. Expenses incurred in connection with obtaining a licence for starting the factory were Rs. 8,000.
2. Rs.1,500 paid for removal of stock to a new site.
3. Rings and Pistons of an engine were changed at a cost of Rs. 4,000 to get fuel efficiency.

4. Rs. 2,500 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff. The suit was not successful.
5. Rs. 8,000 were spent on advertising the introduction of a new product in the market, the benefit of which will be effective during four years.
6. A factory shed was constructed at a cost of Rs.1,20,000. A sum of Rs.7,000 had been incurred in the construction of temporary huts for storing building material.

[Ans. : CE - (i), (iii), (vi), RE - (ii), (iv); DRE - (v)]

4. Objectives type Questions:
Multiple Choice Questions:

1) Amount received from insurance company on account of machinery damaged completely by fire.
   a) Capital Receipts b) Revenue Receipt
   c) Revenue Expenditure d) Capital Expenditure

2) Subsidy of Rs.20,000 received from Government by a manufacturing concern.
   a) Capital Receipt b) Capital Expenditure
   c) Deferred Revenue income d) Revenue Receipts

3) Grant Rs.5,00,000 received from Government for construction of Building.
   a) Revenue income b) Capital Income
   c) Capital Receipts d) Non of the above

4) Amount received from I.F.C.I. as a medium term loan for working capital.
   a) Deferred Revenue income b) Capital Receipt
   c) Revenue Receipts d) Capital Profit

5) Painting of office premises Rs.---1,00,000 once in five year.
   a) Revenue Expenditure b) Revenue loss
   c) Deferred Revenue Expenditure d) Capital Expenditure

Ans. : 1 - a, 2 - d, 3 - c, 4 - b, 5 - c

Multiple Choice Questions:

Pick up the correct answer from the following choices:

1) Amount received from S.B.I. as a term loan.
   a) Revenue Receipt b) Capital Receipt
   b) Capital Loss d) Non of above

2) Dividend on shares received
   a) Deferred Revenue Income   b) Revenue expenses
   c) Revenue Income   d) Capital Gain

3) Insurance claim received for loss of stock by fire.
   a) Revenue Loss   b) Capital Loss
   c) Revenue Receipt   d) Capital Receipt

4) Subsidy of Rs.10,000 received from Government for purchase of computer.
   a) Capital Receipt   b) Revenue Receipt
   c) Capital Loss   d) Liability payable

5) Audit fees paid to Chartered Accountant.
   a) Revenue Expenditure   b) Capital Expenditure
   c) Capital Loss   d) Revenue Receipts

6) Legal fees paid to lawyer to defend civil suit.
   a) Capital Expenditure   b) Revenue expenditure
   c) Deferred Revenue expenditure   d) Non of the above

7) Travelling expenses of the director on trips abroad for purchase of machinery.
   a) Revenue expenditure   b) Capital Expenditure
   c) Revenue Loss   d) All of the above

Ans. : 1 - b, 2 - c, 3 - c, 4 - a, 5 - a, 6 - b, 7 - b

Multiple Choice Questions:
Pick up the correct answer from the following choices :

1) A bad debts recovered during the year.
   a) Capital receipt   b) Revenue Receipt
   b) Revenue loss   d) Capital expenditure

2) Sale of old plant & machinery at loss.
   a) Capital loss   b) Capital gain
   c) Capital Receipt   d) Revenue receipt

3) Heavy advertisement expenditure to launch a new product.
   a) Revenue Expenditure   b) Capital expenditure
   c) Deferred Revenue Expenditure   d) Revenue loss

4) Annual white-washing expenses.
   a) Capital Expenditure   b) Revenue Expenditure
   c) Revenue loss   d) Deferred Revenue expenditure

5) Goods withdrawn by proprietor for own use.
   a) Capital Gain b) Capital loss
   c) Capital Receipt d) Non of the above

6) Stationery purchased for office use.
   a) Revenue expenditure b) Capital expenditure
   c) Revenue loss d) Capital loss

7) Amount spend on the overhauling of old machinery purchased.
   a) Capital expenditure b) Revenue expenditure
   c) Deferred revenue expenditure d) Capital loss

8) Placed an order for purchase of plant.
   a) Capital expenditure b) Revenue expenditure
   c) Revenue loss d) None of the above

Ans. : 1 - b, 2 - c, 3 - c, 4 - b, 5 - d, 6 - a, 7 - a, 8 - d

Match the following columns :

Column A	**Column B**
1) Capital work-in-progress	a) Deferred revenue expenditure
2) Raw material purchased	b) Capital Receipt
3) Heavy advertisement	c) Investment
4) Sale of old furniture	d) Revenue expenditure
5) Purchase of shares	e) Drawing
	f) Capital expenditure
	g) Deferred revenue income

Ans. : 1 - g, 2 - d, 3 - a, 4 - b, 5- c

Match the following columns :

Column A	**Column B**
a) Capital receipt	i) Profit for current year
b) Revenue expenditure decrease	ii) Sundry debtors
c) Current assets	iii) Current liability
d) Bills payable	iv) Revenue expenditure
e) An Expenditure from which no future benefit is expected	v) Non-recurring nature
f) Capital introduced by the proprietor	vi) Capital receipt
	vii) Fixed Assets
	viii) Fictitious assets

Ans. : a - v, b- i, c- ii, d- iii, e- iv, f - vi

State with reasons whether the following statements are True or False.

i) Legal fees paid to acquire a property is capital expenditure.

ii) Expenses incurred on the repairs & white washing for the first time on purchase of an old building are revenue expenditure.

iii) Amount spent for replacement of worn out part of machine is revenue expenditure

iv) Expenditure means payment made by business to obtain some benefit.

v) Capital expenditure is recurring in nature.

vi) Intangible asset is an asset which has a physical identify.

vii) Revenue expenditure reduces profit & funds for the year.

Ans. : True : i, ii, iv, vii

False : iii, v, vi

State with reasons whether the following statements are True or False.

a) Carriage paid for purchases of machinery is capital expenditure.

b) Repairs to furniture Rs.500 is capital expenditure.

c) A petrol car engine was replaced by a diesel engine is revenue expenditure.

d) Purchase of 10% Govt. loan is capital expenditure.

e) Custom duty paid on import of raw materials is revenue expenditure.

f) A sum of Rs.45,000 was spent on painting of office building once in five years is revenue expenditure.

Ans. : True : a, d, e,

False : b, c, f.

❖❖❖❖

Unit-8

FINAL ACCOUNTS OF MANUFACTURING CONCERN [PROPRIETARY FIRM]

UNIT STRUCTURE

8.0 OBJECTIVES

After studying the unit, students will be able to:

- Understand the meaning, purpose, form and items of Manufacturing A/C.
- Understand the form and items of Trading A/C and Profit & Loss A/C.
- Know the meaning and form of Balance sheet.
- Draw the specimen forms of final accounts.
- Understand the meaning, types and closing entries for adjustments.

8.1 INTRODUCTION

All business transactions are recorded in books of accounts. The primary function of accounting is to accumulate accounting data in a manual that the amount of profit or loss suffered during the period can be determined along with status of the business in financial terms. Final Accounts are prospered for this purpose. Final Accounts are also known as Financial Statements. Preparation of Final Accounts is last phase of the accounting process.

The accounting process starts from recording all business transactions in set of books. At the end of accounting year, a statement is proposed listing all balances namely Debit & Credit. This statement is called Trial Balance. The total of debit and credit balances must tally with each other.

This chapter deals with preparation of Final Accounts of manufacturing concern carried on by sole proprietor. Sole proprietor concern means business is camped and headed by one person only.

Final Accounts of Manufacturers include Manufacturing A/C, Trading A/C, Profit & Loss A/C and Balance Sheet. Normally Final Accounts are prepared for a period of 12 months, called as Accounting Year, Calendar Year (ending on 31st December) or Financial Year / Govt Year (ending on 31st March) or it many any other year ended (Diwali).

The purpose of preparing Manufacturing A/C is to ascertain cost of goods produced during the period. Manufacturing A/C is part of Final Account, it addition to Trading A/C and Profit & Loss A/C. Costs of finished goods produced are then transferred to Trading Account. Trading and Profit & Loss A/C is prepared to find out gross profit and net profit/loss of the year. These accounts measure the result of business operations. It is essential to match revenues of an accounting period with costs assignable in earning the said revenues. This process is known as “The Matching Concept” which leads to the preparation of Final Accounts. Balance Sheet is prepared to show the financial position of the business at the end of accounting year.

Once all the adjustment entries are passed, the Trial Balance contains a ready list of the closing balances of all ledger accounts. The Trial Balance can now be directly used for preparing the Final Accounts i.e. the Profit & Loss Account and the Balance Sheet. In case of a Manufacturer, the Profit & Loss Account is divided into: (a) Manufacturing Account, (b) Trading Account and (c) Profit & Loss Account. In case of a trader, the Profit & Loss Account is divided into: (a) Trading Account, and (b) Profit & Loss Account. Each account in the Trial Balance must be shown in either the Profit & Loss Account or the Balance Sheet.

8.2 MANUFACTURING ACCOUNT

8.2.1 Meaning:

A manufacturer sells finished goods manufactured by himself in his factory; while a trader sells goods purchased by him from the manufacturer. The manufacturer purchases raw materials and converts them into finished goods by means of machinery and labour in the factory. So, it is necessary for a manufacturer to spend on wages to workers, on the manufacturing process, on the factory etc. The manufacturer, therefore, prepares a "Manufacturing Account" to find out his cost of finished goods manufactured. Manufacturing A/C means an account showing the summary of the cost of the manufacturing activity during the accounting year.

8.2.2 Purposes

The manufacturing account serves the following purposes.

i) It shows total cost of finished goods manufactured.
ii) It also shows cost of raw material consumed.
iii) It also provide details of appropriate i.e. direct and indirect manufacturing cost.
iv) Comparison of cost of finished goods as per Manufacturing Account and as per cost records kept by Costing Department.
v) Finished goods manufactured may be transferred to Trading at market price. In such care production profit can be ascertained.

8.2.3 FORM

Manufacturing Account is a ledger account. Its title is written as Manufacturing Account for the year ended ….. It is divided into two equal sides Debit and Credit, (see Worksheet 6.5 for specimen Manufacturing Account.)

8.2.4 ITEMS

A Manufacturing Account contains the following items:

1. **Opening Stock of WIP:**
   The opening stock of Work-in-process (WIP) is shown as the first item on the debit side of the Manufacturing Account. Work-in-process means raw materials not yet fully converted into finished goods, also known as partly finished goods. The value of Work-in-Process is made up of the cost of raw material and the manufacturing expenses incurred for processing.

2. **Raw Materials:**

Next, the consumption of raw materials (also called Rs.direct materials') is shown as follows:

Opening stock of raw materials.
Add : Purchase of raw materials
Add : Direct Purchase Expenses
(Carriage inwards, freight inwards, octroi, customs duties)
Less : Purchase returns of raw materials
Less : Closing stock of raw materials
= Consumption of raw materials

Direct purchase expenses means all expenses incurred in connection with purchase of raw materials e.g. transportation, loading and unloading, coolie charges, insurance etc. Goods may be purchased locally or imported from other countries. Local purchases involve expenses of Carriage inward, Freight inward, Coolie charges and cartage etc. Imported goods involves imports expenses of dock dues, customs duties, insurance etc. These expenses increase the cost of purchased raw materials.

a) **Carriage Inward:** Carriage expenses means expenses for transporting goods. These are also known as freight, cartage, coolie and cartage etc. The expenses for transporting the goods purchased from the supplier to manufacturer's premises, known as Carriage inward. Freight inward etc. are debited to the Manufacturing Account. The expenses on transporting the goods sold from manufacturer's premises to the customer, known as Carriage outward, Freight outward, are debited to the Profit & Loss A/C. The expenses on transporting new machinery etc. purchased are debited to the Machinery A/C. i.e. that expenses are capitalized.

b) **Octroi Duty:** Octroi duties mean the taxes paid to a Municipality on goods brought within the municipal area from outside. Octroi on purchase of goods is debited to the Manufacturing Account. Octroi on machinery purchased is debited to the Machinery A/C.

c) **Dock Dues, Custom Duties:** Dock dues mean the expenses of unloading the goods in a port. Custom duties means the taxes paid to the Government; on goods imported from other countries, also known as import duties. Freight, insurance, dock dues and customs duties on imports of Raw Materials are debited to the Manufacturing Account. However, if goods are sold to other countries (exported), expenses on such exports (freight, dock dues for loading the goods on ship, export duties etc.) should be debited to the Profit & Loss Account, since they are selling expenses. Dock dues and custom duties on machinery imported are debited to the Machinery A/C.

(3) Wages: These include the wages paid to workers directly engaged in production, also known as direct or productive wages or direct labour costs. (A combined item of Wages and Salaries appearing in the trial balance is shown in the Manufacturing Account, while a combined item of Salaries and Wages is shown in the Profit & Loss Account).

(4) Manufacturing Expenses: These include the expenses directly connected to manufacture such as royalty, hire charges of special machinery, design expenses etc. While royalty for using know-how connected with manufacturing process is taken to

Manufacturing Account, royalty for use of trade mark is a selling expense shown in the Profit and Loss Account.

(5) Factory Expenses : These include all expenses incurred at the factory such as (a) stores, oil, grease (b) salary to supervisors (c) power and fuel (d) repairs and maintenance of factory building and machinery (e) depreciation of factory assets such as factory building and machinery (f) rent, rates and taxes, insurance, lighting of factory building and so on.

(6) Closing Stock of WIP: The value of closing stock of work-in-process is shown on the credit side of the Manufacturing Account.

[Note: Alternatively, instead of showing opening WIP on debit and closing WIP on credit, the difference between the opening and closing stocks of WIP is calculated first. If opening stock is more than closing stock, the difference (opening stock of WIP – closing stock of WIP) is shown on the debit side of the Manufacturing A/C; if closing stock is more than opening stock (closing stock of WIP – opening stock of WIP), the difference is shown on the credit side of the Manufacturing A/C]."

(7) Sale of Scrap: Sale of scrap is shown on the credit side of the Manufacturing Account.

(8) Cost of Production: The cost of production of goods is found out by balancing the Manufacturing Account. The Manufacturing Account is balanced like a ledger account. We take the totals of both the debit and credit sides of the Manufacturing A/C. In a Manufacturing A/C, the debit side will always be bigger than the credit side. This indicates the Net Cost of Production of the concern. Thus, Gross cost of production Less WIP (Closing) and Sales of scrap = Net cost of production. We write the amount of cost of production on the credit side of the Manufacturing A/C and carry it down to the debit side of the Trading Account. The cost of production (also known as cost of manufacture or cost of goods produced is transferred to the Trading Account in order to find out the Gross Profit or Gross Loss on sale of finished goods.

8.2.5 CLOSING ENTRIES:

The following worksheet shows entries to be passed to transfer the closing balances of the Goods Accounts and other Manufacturing Expenses Accounts, to the Manufacturing Account:

WORKSHEET 1: CLOSING ENTRIES (MANUFACTURING A/C)

No.	Entries		Amount Dr.	Cr.
(1)	Transfer Debit Balances :			
	Manufacturing Account	Dr.	X	
	To Opening Stock of WIP A/c			X
	To Raw Material Purchases A/c			X
	To Direct Purchase Expenses A/c			X
	To Wages A/c			X
	To Manufacturing Expenses A/c			X
	To Factory Expenses A/c			X
(2)	Closing Stock of WIP :			
	Closing Stock of WIP A/c	Dr.	X	
	To Manufacturing Account			X
(3)	Sales of Scrap :			
	Sales of Scrap A/c	Dr.	X	
	To Manufacturing Account			X
(4)	Transfer Cost of Production to Trading A/c.			
	Trading Account	Dr.	X	
	To Manufacturing Account			X

8.2.6 TRANSFER AT PRICE HIGHER-THAN-COST:

1) **Transfer at Sales Price or Cost + Fixed %:** We have already seen how manufacturing account is prepared when the manufactured items are transferred at cost to the Trading account. However, the items produced by the manufacturing section may be transferred to the Trading A/C at a price higher than the cost i.e. (i) at cost plus a mark-up (e.g. cost + 25%); or (ii) at selling price.

2) **Entries for Transfer:** If the goods are transferred at a higher-than-cost price, the transfer to the Trading A/C will be credited to the Manufacturing Account at the transfer value (i.e. loaded price or selling price) and not at cost of manufacturing. The excess of transfer price over the cost of manufacturing will indicate the manufacturing profit. If, cost of manufacturing is more than the transfer price it shows as manufacturing loss.

3) **Closing Stock of Finished Good at Transfer Value:** If some of the manufactured goods remain unsold and form part of the closing stock of finished goods at the year-end, such closing stock will be valued at the transfer price in Trading A/C.

If the transfers to the Trading Account were made at cost price, the closing stocks would also be valued at cost and no further adjustment is needed.

If all the goods transferred at higher-than-cost have been sold, it means that the anticipated profits have been actually earned and no further adjustment need be made.

However, if any of the finished goods transferred to the Trading Account at loaded price or selling price are in stock, the value of the stock needs to be adjusted. Thus, if the cost is Rs.100 and the goods are transferred at Rs.120, the profit element (Rs.20) is included in the closing stock. Otherwise, it will amount to taking credit for anticipated or unrealised profit which is against the accounting principle of "conservatism." Unrealised profit included should be considered as Stock Reserve.

4) **Stock Reserve:** The unrealised profit in closing stock is eliminated by creating a stock reserve in respect of the stock of manufactured goods. The amount of stock reserve is calculated by the following formula:

Stock reserve =

$$\text{Transfer Value of Stock} \times \frac{\text{Profit Included in Transfer Price}}{\text{Transfer Price}}$$

5) **Entry for Stock Reserve:** The creation of the reserve is made by the concern in the General Profit and Loss Account as follows:

Profit of Loss A/c. Dr.
    To Stock Reserve A/c.

(Being the reserve created for unrealised profit included in closing stock)

6) **Balance Sheet:** The relevant part of the Balance Sheet will appear as follows:

Balance Sheet as at….

Assets	Rs.
Current Assets :	
Closing Stock (Transfer Value) xx x y	
Less : Stock Reserve (xx)	XX
	XX

7) **Next Year:** In the beginning of the next year, the above entry is reversed as follows:
Stock Reserve A/c. Dr.
To Profit & Loss A/c.

8.3 TRADING ACCOUNT OF A MANUFACTURER

8.3.1 ITEMS

1) **Opening Stock of Finished Goods:** The opening stock of Finished Goods (FG) is shown as the first item on the debit side of the Trading Account.

2) **Cost of Finished Goods manufactured:** Next, the Cost of goods manufactured transferred from the Manufacturing Account is shown on debit side of the Trading Account.

3) **Sales of Finished Goods:** The net sales of finished goods (sales less returns) are shown on the credit side of the Trading Account.

4) **Other Out Going of Finished Goods :** Sometimes, the Trial Balance or it may be given by way of adjustment may contain Other Goods Accounts such as Goods Lost by Fire A/c, Goods Withdrawn by Proprietor, Goods Distributed as Free Samples, etc. These accounts record the cost of finished goods lost, withdrawn or distributed. Since goods go out, these accounts are shown on credit side. These balances are transferred on the credit of the Trading Account.

5) **Closing Stock of Finished Goods:** The closing stock of Finished Goods is shown as the next last item on the credit side of the Trading Account.

6) **Gross Profit or Gross Loss:** The final result is found out by balancing the Trading Account. The Trading Account is balanced like a ledger account. We take the totals of both the debit and credit sides of the Trading A/c. If the credit side is higher, it indicates that the value of sales is more than the cost of goods manufactured & sold. This is called the Gross Profit

earned by the business. Thus, **Income From Goods Sold Less Cost of Goods Sold = Gross Profit.** We write the amount of Gross Profit on the debit side and carry it down on credit side of the Profit and Loss Account. If the debit side is higher, it indicates that the cost of manufacture is more than the value of sales. This is called Gross Loss. **Gross Loss = Cost of Goods Sold Less Sales**. We write the amount of Gross Loss on the credit side of the Trading A/c and carry it down to the debit side of the Profit and Loss Account. The Gross Profit or Gross Loss is transferred to the Profit and Loss Account in order to find out the Net Profit or Net Loss after deducting other indirect expenses. Thus, **Gross Profit Less Expenses = Net Profit**. **In case expenses are more than Gross Profit, then it amounts to Net Loss.**

8.3.2 Closing Entries:

The following worksheet shows entries to be passed to transfer the closing balances of the Sales Accounts and other Accounts, to the Trading Account:

WORKSHEET 2: CLOSING ENTRIES (TRADING A/C)

A/o.	Entries	Amount	
(1)	Transfer Debit Balances :	Dr.	Cr.
	Trading Account Dr.	X	
	To Opening Stock of Finished Goods A/c		X
	To Returns Inwards A/c		X
(2)	Transfer Credit Balances :		
	Sales of Finished Goods A/c. Dr.	X	
	Finished Goods Lost/Taken/Distributed A/c	X	
	(at cost) Dr.	X	
	To Trading A/c		X
(3)	Closing Stock of Finished Goods		
	Closing Stock of Finished Goods A/c Dr.	X	
	To Trading Account		X
(4)	Transfer Gross Profit or Gross Loss to Profit & Loss A/c:		
	(i) Gross Profit :		
	Trading Account Dr.	X	
	To Profit & Loss A/c		X
	(ii) Gross Loss :		
	Profit & Loss A/c Dr.	X	
	To Trading Account		X

8.4 PROFIT & LOSS ACCOUNT

8.4.1 Meaning

Closing balances of all nominal accounts, relating to the remaining income and expenses are transferred to Profit & Loss A/c. Debit side of the Profit & Loss A/c shows expenses like Administrative Expenses, Selling Expenses, Financial Expenses, Depreciation and other Unusual Expenses and Losses. Credit side of the Profit & Loss A/c shows Other Business Incomes and Gains. The balance of the Profit & Loss A/c shows the result of business operations during the year. The net profit or net loss shown by the Profit & Loss A/c is transferred to the Capital Account of the proprietor.

8.4.2 FORM

Profit & Loss Account is a ledger account. Its title, is written as "Profit & Loss Account for year ended….. " It is divided into two equal sides: Debit and Credit as per the specimen shown in Worksheet 7.

8.4.3 ITEMS

The following items normally appear in a Profit & Loss Account.

(1) **Gross Profit or Gross Loss b/d :** The Gross profit b/d from the Trading Account is the first item on the credit side of the Profit & Loss Account. If there is Gross loss, it is the first item shown on the debit side of the Profit & Loss Account.

(2) **Administrative Expenses:** Administrative expenses are the expenses incurred to plan, organize, administer and control the business. Examples are (a) Salaries to office staff, (b) Rent, rates, insurance, lighting of office, (c) Printing, telephones, telex, postage, (d) Depreciation and repairs of office equipments, building, furniture, vehicles, (e) Legal charges, Audit charges, Bank charges etc.

(3) **Selling and Distribution Expenses:** Selling expenses are the expenses incurred to create and increase demand for goods. Distribution expenses are the expenses incurred from the time goods sold leave the trader's premises till the goods reach the customer. Examples are (a)Packing materials (b) Salaries of Sales and Distribution staff (c) Traveling, Conveyance (d) Commission or discount on sales (Advertisement or showroom expenses (f) Warehouse or sales office rent, rates, insurance, lighting etc. (g) Freight outward, carriage outwards, expenses on exports (h) Depreciation and repairs or delivery van, vehicles etc.

(4) Finance & Interest Expenses: Finance expenses are the expenses incurred to obtain loans, bank charges and cash discount to debtors etc. The other item shown under this head is interest paid on loans.

(5) Losses: Losses include amounts lost by the business by way of Goods lost by fire, Goods distributed as free samples, Bad debts, Loss on sale of fixed assets etc. These are debited to the Profit & Loss Account.

(6) Other Income : Other income includes amounts received by way of interest on loans given, dividends received on amounts invested in shares, rent received from premises given on rent, discount received, commission received, Profit on sale of fixed assets and so on. All these amounts/incomes are credited to the Profit & Loss Account.

(7) Gains: Gains includes amounts received by the business by way of recovery of bad debts, subsidies or grants received etc. These are credited to the Profit & Loss Account.

(8) Appropriations: Appropriations mean amounts transferred out of net profits for payment of income-tax or creating a reserve (e.g. reserve for contingencies). These appear on the debit side of the Profit & Loss A/c. Income Tax is considered as personal expenses. Therefore, it should be treated as Drawings.

9) Net Profit or Net Loss: The net profit or the net loss is found out by balancing the Profit & Loss Account. The Profit & Loss Account is balanced like a ledger account. We take the totals of both the debit and credit sides of the Profit & Loss Account. If the credit side is higher, it indicates that the Total Income is more than the Total Expenses. This is called the Net Profit earned by the business. Thus**, Income Less Expenses = Net Profit.** In the next step, the amounts of income tax or transfer to Reserves etc. (known as Rs. appropriations' out of profits) are debited to the Profit and Loss Account. Appropriations can be made only after ascertaining the amount of net profits (as the amount of income-tax depends upon the amount of net profits). Then, write the amount of Net Profit on the debit side and transfer it to the credit of the Capital Account.

If the debit side is higher, it indicates that the Expenses are more than Income. This is called Net Loss. Thus, **Expenses Less Income = Net Loss**. In case of net losses, there can be no appropriations (e.g. no income-tax is payable if there is a net loss). We write the amount of Net Loss on the credit side of the Profit & Loss Account A/c and transfer it to the debit of the Capital Account. The Net Profit or Net Loss belongs to the owner and hence is transferred to the Capital Account. The net profit is a reward to the owner for his money invested in the business, for his efforts in running the business and for the risks taken by him.

8.4.4 Closing Entries:

The following work-sheet shows entries to be passed to transfer the closing balances of the Nominal Accounts to the Profit & Loss Account:

WORKSHEET 4: CLOSING ENTRIES (P & L A/C)

No.	Entries		Amount	
(1)	Transfer Debit Balances :		Dr.	Cr.
	Profit & Loss Account	Dr.	X	
	To Various Expense Accounts			X
	To Various Losses Accounts			X
(2)	Transfer Credit Balances :			
	Various Income Accounts	Dr.	X	
	Various Gains Accounts	Dr.	X	
	To Profit & Loss Account			X
(3)	Appropriations :			
	Profit & Loss Account	Dr.	X	
	To Income-tax (Drawings)			X
	To Reserve (e.g. Contingency Reserve) A/c			X
(4)	Transfer Net Profit or Net Loss to Capital A/c			
	(i) Net Profit:			
	Profit & Loss Account	Dr.	X	
	To Capital A/c			X
	(ii) Net Loss :			
	Capital A/c		X	
	To profit & Loss A/c			X

CHECK YOUR PROGRESS

1. Define the following terms
   a. Appropriations
   b. Finance expenses
   c. Selling and distribution expenses
   d. Administration expenses

e. Manufacturing A/c
f. Direct Expenses
g. Stock reserve.

2. Fill in the blanks:
a. If the debit side of the Profit and Loss A/c is higher, it indicates ----------------.
b. Gross loss is shown on the ----------------side of the P &L A/c.
c. --------- side of the Profit & Loss A/c shows Expenses.
d. The Income From Goods Sold Less Cost of Goods Sold = ---------------------.
e. Manufacturing Account is prepared to find out cost of ---------.
f. Opening and closing balances of finished goods are shown on the ----------------------- A/c.

3. Enlist the items to be shown on the debit side of the Manufacturing A/c.

4. Give the formula for calculating the consumption of raw materials.

8.5 BALANCE SHEET

8.5.1 Meaning

From the Trial Balance, all Nominal (manufacturing Expenses) Accounts are transferred to the manufacturing and Trading Account and all the Nominal Accounts of Income and Expenses are transferred to the Profit & Loss Account. At this stage, only the Real Accounts pertaining to Assets and the Personal Accounts of debtors, creditors and liabilities remain in the Trial Balance. All these remaining accounts are shown in a statement known as the Balance Sheet. Balance Sheet is a statement containing the list of all Real and Personal Accounts as on a particular day, normally the year end. The Real Accounts and Personal Accounts are classified in the Balance Sheet into Assets and Liabilities. Debtors are included under Assets and Creditors and Capital Account are shown under liabilities. Hence, Balance Sheet also means a statement of assets and liabilities of the business as on the last day of the accounting year. **Balance Sheet, thus, shows the financial position of the business i.e. what it owns and what it owes.**

Balance Sheet is not an account; it is a statement. As its name suggests, it is a Sheet of Balances, remaining after the Manufacturing, Trading and Profit & Loss Account is prepared. While preparing a Balance Sheet, no closing entries are passed, as the balances are not transferred from the Trial Balance, but only listed in the Balance Sheet. Various Assets & External Liabilities may be transferred to Capital Account by passing following entries.

Date	Particulars	L. F.	Dr. Rs.	Cr. Rs.
31.3 1]	Capital A/c Dr.		X	
	To Fixed Assets A/c			X
	To Current Assets			X
	[Being various assets transferred to capital A/c]			
2]	Loans A/c Dr.		X	
	Sundry creditors A/c Dr.		X	
	Bills Payable A/c Dr.		X	
	Other Sunday Liabilities A/c Dr.		X	
	To Capital A/c			X

After passing above entries at the end of the year, all accounts are closed.

In next year above entries are revised, to open books of Accounts.

The balances appearing in the Balance Sheet are carried forward as the opening balances of these accounts in the ledger of the next year. A Balance Sheet need not be balanced; its totals must always tallied. The Total Assets must always be equal to the Total Liabilities.

8.5.2 Form:

The title is written as Balance Sheet as on… Balance Sheet is not an Account, hence the words DR. and CR. are not required. Balance Sheet is vertically divided into two side: Left Hand Side and Right Hand Side. Left hand side of the Balance Sheet shows Liabilities like Capital, Reserves, Loans, Creditors for goods, outstanding expenses etc. Right hand side of the Balance Sheet shows Assets e.g. Fixed Assets (Gross Cost Less Depreciation), Investments, Current Assets like pre-paid expenses, advances, debtors, stock, cash bank etc. (See Worksheet 8.)

8.5.3 Order:

The Various items of assets and liabilities are listed in the order of permanence of the items. On the Assets side, the permanent or the long term items i.e. the Fixed Assets are shown first, followed by short term assets i.e. the current assets. On the Liabilities side, the long term liabilities i.e. Capital and Loans are shown first, followed by short term liabilities i.e. current liabilities. In case, the items are shown in order of liquidity, the assets and liabilities are shown in the reverse order, i.e. short term items are shown first, followed by long term items.

8.5.4 Items:

(1) Fixed Assets: Fixed Assets are items like Goodwill, Land, machinery, building and trucks etc, which benefit the business for a long term. Fixed assets are not normally sold: Fixed Assets may be tangible or intangible. Tangible Assets are items like machinery, building etc. which physically exist (tangible means that which can be touched). Intangible Assets are invisible items like Goodwill, Patent, and Trade Marks etc. which do not physically exist, but do benefit the business over a long period of time. Goodwill means the reputation of a concern which attracts more and more customers to it., enables to earn more super profit on Capital employed. Patent means a legal right of an inventor or of a new product to exclusively use or sell such product. Trade Mark is a registered name or symbol of a product which can be used only by the owner of the trade mark.

(2) Investments: Investments includes items like Shares, Debentures and Savings certificates etc. which earn interest or dividends.

(3) Fictitious Assets: Fictitious Assets include items like Deferred Revenue Expenses, Preliminary Expenses etc. Deferred Revenue Expenses is defined as the expenses which are carried forward as their benefit is also available in subsequent years. To defer means to carry forward. For example, if advertising expenses of Rs.1,00,000 incurred in 2012 are expected to benefit the business for 5 years, the entire amount of Rs.1,00,000 is not debited to the Profit & Loss Account in 2012. Only $1/5^{th}$ amount (Rs.20,000) is debited to the Profit & Loss Account every year for 5 years from 2012 to 2016. The amount not yet written off at the year end will be shown as Deferred Advertising Expenses on the Asset side in the Balance Sheet.

(4) Current Assets: Current Assets are items like cash, debtors, stock etc. which remain in the business only for a short time [less than 12 months]. Current assets are constantly changed into cash. Thus, goods are sold and cash is received, debtors pay their dues and cash is received and so on. Current Assets also includes Pre-paid Expenses and Income Receivable.

(5) Capital: Capital means the amount due to the owner of the business. Capital is shown on liabilities side of the Balance Sheet as follows:

Capital A/c b/d (opening balance)
Add: Net Profits for the year
Less: Net Loss for the Year
Less: Drawings
= Closing Balance of Capital

(6) Reserves: Reserve means part of profits "reserved" for future use. It is an amount set aside out of profits to meet any unknown sudden liability in future. Out of Net Profits, some amount is transferred first to the Reserve, only if it is asked the only part of profit to be transferred to reserve and only the balance is transferred to the Capital Account.

(7) Loans: Loans include Bank Loans and the amounts borrowed from others on which interest is paid.

(8) Current Liabilities: Current Liabilities are short term liabilities. These include creditors for goods, outstanding expenses, various provisions for expenses, income received in advance, Bank over draft. Current liabilities are payable within 12 months.

CHECK YOUR PROGRESS

1. **Fill in the blanks:**
   a. A Balance Sheet need not be balanced; its totals must always -------------------.
   b. Balance Sheet is not an Account, it is a -----------------------.
   c. Left hand side of the Balance Sheet shows ----------------.
   d. Right hand side of the Balance Sheet shows --------------.
   e. Goodwill and patents are --------------------assets.
   f. Deferred Revenue Expenses is a ---------------------asset.
   g. Balance Sheet is a statement containing the list of all --------- and ----------- Accounts.
   h. Current assets are constantly changed into -----------------.
   i. Current liabilities are payable within ----------months.
   j. The items which earn interest or dividends are termed as ---.

2. Enlist the items shown on the assets side of the Balance Sheet.
3. Define the following terms:
   a. Balance Sheet
   b. Current Assets
   c. Tangible Assets
   d. Intangible Assets
   e. Capital
   f. Current Liabilities

8.6 SPECIMEN FORMS:

8.6.1 Specimen Form of Manufacturing Account

Dr. Manufacturing Account for the year ended… Cr.

Particulars	Rs.	Rs.	Particulars	Rs.
To Work-in-process (Opening)		xxx	By Work-in-process (Closing)	xxxx
To Raw materials consumed:			By Sales of scrap	xxxx
Opening Stock	xxx		By Trading Account	xxxx
Add : Purchase	xxx		(Cost of production tfd Bal.)	
Add : Purchase expenses				
- Carriage Inward	xxx			
- Octroi duty	xxx			
- Dock dues	xxx			
- Custom duties	xxx			
Less : Purchase Returns	(xxx)			
Less : Closing stock of materials	(xxx)	xxxx		
To Direct Wages		xxxx		
To Direct manufacturing expenses				
To Royalty related to manufacture	xxx			
To Hire of special machinery	xxx			
To Design Expenses	xxx	xxxx		
To Direct factory expenses				
To Stores, oil, grease	xxx			
To Salary to supervisors	xxx			
To Power and fuel	xxx			
To Repairs of factory assets	xxx			
To Deprecation on factory assets	xxx			
To Rent, lighting of factory building	xxx	xxxx		
Total		xxxx	Total	xxxx

8.6.2 Trading Account for the year ended …..

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Opening stock (FG)	xxxx	By Sales xxxx	
To Manufacturing		Less:Return inwards xxxx	xxxx
Account (cost of	xxxx	By Goods lost or destroyed	xxxx
Production tfd.)		By Goods taken by proprietor	xxxx
To Purchase of FG		By Goods given as free sample	xxxx
To Gross profit c/d	xxxx	By Closing stock (FG)	xxxx
		By Gross loss c/d	xxxx
Total	xxxx	Total	xxxx

8.6.3 WORKSHEET 7: PROFIT & LOSS ACCOUNT

Profit & Loss Account for the year ended……

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Gross Loss	xxxx	By Gross Profit b/d	xxxx
b/d		Other Income or Gains	
To Administrative Expenses	xxxx	By Commission received	xxxx
To Rent, insurance & repairs	xxxx	By Discount received	xxxx
To Office salaries	xxxx	By Provision for discount	xxxx
To Postage, telephones,	xxxx	From creditors	
Telex etc.	xxxx	By Interest on loans	xxxx
To Printing & stationery	xxxx	Given to outsiders	xxxx
To Fees (legal/audit etc.)		By Income (dividend) on	xxxx
To Sundry/general	xxxx	Investments	
Expenses	xxxx	By Profit on sale of fixed	
To Selling & Distribution	xxxx	Assets	
Expenses	xxxx	By Net loss tfd. to capital	
To Salesmen's salaries,	xxxx		
Commission, etc,	xxxx		
To Traveling	xxxx		

To Carriage outwards,			
Freight, duties	xxxx		
To Warehousing charges			
To Packing expenses	xxxx		
To Royalties on sale	xxxx		
To advertising & sales	xxxx		
Promotion expenses			
To Goods given as free			
Samples			
To Financial Expenses & Interest	xxxx		
	xxxxx		
To Interest & bank charges	xxxx		
To Bad debts & provision for Bad debts	xxxx		
To Discount given			
To provision for discount on Debtors	xxxx		
Depreciation	xxxx		
To Depreciation on :			
- Building	xxxx		
- Motor vehicles/delivery vans			
- Office equipments			
To Unusual Expenses or Losses			
To Goods lost or destroyed			
(Cost less insurance claim)			
To Loss on sale of fixed			
Assets			
To Appropriations			
To Reserves			
To Net profit tdf. to			
Capital …..	xx		
Total	xxxx	Total	xxxx

8.6.4 WORKSHEET 8: BALANCE SHEET :

There may be either Net Profit or Net Loss.

Balance Sheet as at ……….

Liabilities	Rs.	Assets	Rs.
Capital A count :		Fixed Assets	
Balance b/d (opening) x		Goodwill	xxxx
		Land	xxxx
Add : Fresh capital x		Plants & machinery xx	
Brought in			
Add : Net profit for the x		Less : Depreciation x	
Years			xxxx
Less : Drawing xx		Premises/Building x	
			xxxx
Less : Loss during the		- Less Depreciation x	
Year xx	xxxx		
Reserves		Vehicles	
General Reserve	xx		
Loans		-Less : Depreciation xx	
Loans from bank xx			xxxx
Bank overdraft xx	xxxx	Furniture & fittings xx	
Current Liabilities			
Sundry creditors xx		- Less Depreciation xx	xxx
Less : Provision for xx		Investments	xxxx
Discount		Investment in	xxxx
Bills payable xx		Shares/bonds	xxxx
Outstanding expense xx		Current Assets	xxxx
Income received in		Closing Stock	xxxx
Advance xx	xxx	Debtors xx	xxxx
		- Less; Prov, for bad x	xxxx
		Debts x	
		- Recoverable x	
		- Less : Prov, for	
		Discounts xx	
		- Relisable	xx

		Loans and advance	xx
		Given	xx
		Bills receivable	xx
		Prepaid expenses	xx
		Cash at bank	xx
		Cash in hand	
		Fictitious assets	
		Deferred expenses	
		Not written off xx	
		Capital account debit	
		Balance xx	xxx
Total	xxxx	Total	xxxx

8.7 ADJUSTMENTS:

8.7.1 Meaning:

The trial Balance prepared indicates summery of all actual transactions recorded in the Book of Accounts. The trial balance ignores items not yet recorded in the books of accounts. e.g. closing stock, outstanding expenses, prepaid expenses, Depreciation, bad about etc. unless & until these items are not give true and fair view of business operations and financial position. These items must be recorded in books of accounts. The book balances need to be adjusted from all items which pertains for the period but not recorded in books. Adjustments mean recording such items relating the current year but not appearing in the Trial Balance.

8.7.2 Accounting:

Adjustment entries are passed in the journal proper at the end of the year. Entries are passed by following rules of debit & credit, then they are posted into the ledger. It should be noted that each adjustment has two effects in the final Accounts.

Adjustments may be given below the Trial Balance, or may be given in the Trial Balance, called implied adjustment,

Adjustment	Journal Entries	Manufacturing Trading Profit & Loss A/c.	Balance Sheet
1) Closing Stock (Goods Purchased but remain unsold). . a. Raw Material.	i. Stock of Raw Material A/c Dr To Raw Material Consumed.	Debit from Raw material Purchases, or debit side of Manufacturing A/c.	Show as "Stock of Raw Material on Asset Side"
b. Work in Progress	ii. Stock of work in progress A/c Dr To Trading A/c	Credit side of mfg A/c Show on credit side of Trading A/c.	Show as "Stock of W.I.P on Asset Side. Show as "Stock of Finished Goods" on Asset Side.
c. Finished Goods.	iii. Stock of Finished Goods A/c Dr. To Trading A/c.	-	All stock may be as under Stock of Raw Material Stock W.I.P. Stock of Finished Goods
2) Prepaid Expenses	Prepaid Expenses A/c. Dr To Expenses. A/c.	Deduct from the conserved Expense on debit side.	Show as "Prepaid Expenses" on asset side.
3) Outstanding expense related to current year but not record / paid.	Expense A/c Dr To outstanding expenses A/c	Add to concerned exp. on debit side.	Show on "outstanding exp." on liabilities side.
4) Income Receivable	Income Receivable A/c Dr To Income A/c.	Add to Concerned income on credit side.	Show "income Receivable" on asset side.
5) Income Received in advance income Received but not accrued. i.e. relates to subsequent year.	Income A/c Dr. To Income Received in allowance A/c.	Deduct from concerned income on credit side.	Show as |income received in advance" as on liabilities side
6) Depreciation	Depreciation A/c Dr. To Fixed Asset A/c	Depreciation on factory Assets debit to mfg. a/c Depreciation on other asset debit to profit & A/c.	Deduct Depreciation from Concerned Asset on asset side. OR Add to provision for depreciation A/c

7) Goods destroyed Lost & Stolen. a) Uninsured goods. Good lost	Loss by Fire/Theft A/c. Dr. To trading A/c. or To purchases A/c.	a)" Loss by fire" debit A/c profit & loss A/c. b) Credit Cost of goods lost to trading A/c.	-
8) Unrecorded Sales.	Sundry debtors A/c Dr To Sales A.c.	Add to sales on Credit side of trading a/c.	Add to Sunday debtors on assets side.
9) Unrecorded Sales (return) Good Returned by Customer but Credit not, is not Prepared. Recorded.	Sales Return A/c Dr. To Sundry Debtor.	Deduct from Sales Credit side of Trading A/c.	Deduct from Sunday Debtor on Asset Side.
10) Unrecorded Purchases: Goods Purchase but not recorded in Purchase day book.	Purchase A/c Dr To Supplier A/c.	Add to Purchase on debit side of mfg. A/c Or Trading A/c.	Add to Sunday Creditors on the Liabilities Side.
11) Unrecorded Purchase return. Goods retuned to suppliers but debit note not prepaid preceded.	Supplier A/c Dr. To Purchase Return A/c	Deduct from Purchase on debit side of mfg. A/c Or Trading A/c..	Deduct from Sunday Creditors on the liabilities side.
12) Goods distributed as free sample.	Free samples A/c Dr To Trading A/c.	Deceit to P & L A/c as Advertisement A/c Credit to Trading A/c as goods distributed as free samples.	-
13] Good withdrew by owner for personal use	Drawings A/c Dr. To Trading A/c.	Credit to Trading A/c as personal use goods withdrawn for own use.	Deduct from capital on Liabilities Side
14] Interest on Loan outstanding	Interest A/c Dr. To Loon A/c	Added to interest on debit side Profit & Loss A/C.	Add to Loon, as interest outstanding on Liabilities Side.

15) Good Sold on approve not yet approved. Goods sold on Sales or Return basis Customer save right to return goods	a)For consolation of Sales a) at sales Price Sales A/c Dr To Customer b) For stock with Customer at cost. Stock on approval A/c Dr To Trading A/c.	a) Deduct from Sales on Trading A/c Credit Side. b) Credit to Trading A/c on stock with customer i.e. add to closing stock.	a) Deduct from Sunday Debtor on asset side. b) Add to Closing Stock on asset side.
16)Baddebts /Further bad debit to be written off	Bad debts A/c Dr To Sunday Debtors.	Add Bad depts. on debit side of Profit & Loss A/c. [as new bad debts]	Deduct from Sunday debtors an Assets Side.
17) Provision for Bad Debts/ doubtful debts: Provision made for future out of present credit sales.	Profit & Loss Ac Dr. To R.D.D. A/c	Profit & loss A/c Debit Side To new BDD x (Adj) + Bad debts x (Trial Bal) + New Bad debts $\frac{x}{x}$ (adj) -Old R.D.D $\frac{x}{x}$ (T.Bal)	Asset Side Sundry Debtors x – Further / New Bod debts)x) x – New R.d.d. X = x (x) final Balance after all other adjustment tilting to Sunday Debtors.
18) Reserves for Discount on Debtors: Provision made for Discount on Debtors:	Discount A/c Dr To R.F.D.C. A/c	When old R.D.D is more than required should be credited to profit & loss A/c. Add to discount on the debit side of the Profit & Loss A/c.	Deduct from Sunday debtors on Asset side, after adjustment as R.D.D.
19) Reserve for discount on Creditors:	Reserve for discount on Creditors A/c Dr To Discount A/c.	Add it discount on Credit side of the Profit & Loss A/c.	Deduct from sundry Creditors on Liabilities Side.

8.7.3 HIDDEN ADJUSTMENT/TEMPLED ADJUSTMENT.

Sometimes information about adjustments is given in the trial balance. These adjustments should be considered while preparing final accounts.

For example, Trial balance shows the following information.

Trial Balance as on 31st December 2012.

No.	Particulars	Rs.	Rs.
1	Rent (11 months)	22,000	
2	Insurance (For the Year 31.3.13)	12,000	
3	10% Govt Bonds (30-06-12)	1,00,000	
4	Interest on Govt Bonds	-	2,500.
5	12% Investment (Face value Rs. 1,00,000)	1.12.000	
6	Interest on investment	-	9,000.
7	18% Bank Loan (01.10.12)		2,00,000
8	Advertisement (3 years)	30,000.	
9	Building Rent (3/4 Factory)	60,000	

Solution: Explanation:

1) Rent Paid for 11 months Rs. 22,000. It implies that Rent for one month is outstanding.

= 22,000 / 11 = Rs. 2,000.

Add to Rent on Debit side of P & L A/c, Show in the Balance Sheet Liabilities

2) Insurance Premium Paid for the year ended 31/03/13. Trial Balance as on 31/12/12.

Therefore, 3 months insurance is paid in advanced $\therefore$Prepaid Insurance = 12,000 x 3/12 = Rs. 3,000/-.
Less from insurance on P & L A/c. Debit Side and write on Asset side of Balance Sheet.

3 and 4: 10% Govt Bonds Purchased on 30-06-12; Interest on Bonds for SDC months = 1,00,000 x 10% x $\frac{6}{12}$ = Rs. 5,000/-. Out of Rs.5,000, Rs.2,500 are only received. Balance interest Rs.2,500/- still not received. It is outstanding. Income on date of Balance Sheet. Add to interest on credit side of P & L. A/c. and show on asset side of Balance sheet as Interest Account bat not received.

5 and 6: 12% Investment face value of Rs.1,00,000 Purchase for Rs.1,12,000. Interest on this investment received Rs.9,000 only. Interest should be always calculated on face value.

Interest for the year = 1,00,000 x 12%

= Rs.12,000/-.

Out of this, Rs.9,000/- only received. Balance Rs.3,000 still receivable. Add to credit side of P & L A/c to income and show on assets side of Balance sheet as Interest Receivable.

7. 18% Bank Loan taken on 1st Oct. 12.

Therefore, 3 months interest due to be provided

Outstanding Interest = 2,00,000 x 18% x 3/12

= Rs. 9,000/-.

Add to interest on Debit side of P & L A/c and add to Bank Loan on Liabilities Side of Balance Sheet.

8. Advertisement Rs.30,000 paid for 3 years.

Two years advertisement 3,00,000 x $\frac{2}{3}$ = Rs. 20,000 is prepaid.

Prepaid Advertisement Rs.20,000, deduction from Advertisement on debit side of P & L A/c show on Assets Side of Balance Sheet, as a Prepaid Insurance.

9. Building Rent Rs.60,000.

$\frac{3}{4}$ Offices. Therefore, 60,000 x $\frac{3}{4}$ = Rs.45,000 should be debited to the Manufacturing A/c. balance (i.e. $\frac{1}{4}$) Rs.15,000 to be debited to Profit & Loss A/c.

Journal Entries

No	Particulars	J.H.	Rs.	Rs.
1	Rent A/c. Dr.		2000	
	To Outstanding Rent A/c			2000
2	Prepaid Insurance A/c Dr.		3000	
	To insurance A/c			3000
3-4	Interest Receivable A/c Dr.		2500	
	To interest. A/c			2500
5-6	Interest Receivable A/c Dr.		3000	
	To Interest A/c.			3000
7	Interest A/c. Dr.		9000	
	To 18% Bank Loan. A/c			9000
8	Prepaid Advertisement A/c Dr.		20,000	
	To Advertisement A/c			20,000
9	Manufacturing A/c Dr.		45,000	
	Profit & Loss A/c Dr.		15,000	
	To Building Rent A/c.			60,000.

8.8 EXERCISES

1. Write Short note on
   a. Manufacturing A/c
   b. Work in Progress.
   c. Transfer of Goods at price higher than cost.
   d. Stock Reserve
   e. Trading A/c
   f. Current Assets
2. Explain goods sold on sales or return basis.
3. Why Manufacturing A/c is prepared.
4. Explain how to calculate Raw Material consumed.

5. Objective Type Questions:

a. Multiple Choice Question

1. Debit Balance of Manufacturing A/c show:
   a) Gross Profit b) Gross Loss,
   c) Net Loss d) None of above.

2. Carriage inward shown in Trial Balance debited to:
   a) Manufacturing A/c b) Profit & Loss A/c
   c) Capital A/c d) Selling & Distribution exp.

3. Raw Material Consumed is transferred to:
   a) Trading A/c b) Purchase A/c
   c) Manufacturing A/c d) Balance Sheet.

4. Sale of scrap is credited to:
   a) Manufacturing A/c. b) Cash/Bank A/c
   c) Raw Material Consumer d) Trading A/c.

5. Credit Balance in Trading A/c shows.
   a) Net Loss b) Cost of Goods sold
   c) Gross Profit d) Gross Loss.

6. Carriage on machinery purchased debited to:
   a) Manufacturing A/c b) Trading A/c
   c) Plant & Machinery A/c d) Trading A/c

7. Prepaid Insurance shown in the Trial Balance is shown in :
   a) Profit & Loss A/c
   b) Liability side of Balance Sheet
   c) Asset Side of Balance Sheet
   d) Deducted insurance on Dr. side of Profit & Loss A/c.

8. Consumption of Raw Materials shown to:
   a) Credit Side of Trading A/c
   b) Credit side of Profit a Loss A/c
   c) Debit Side of Manufacturing A/c
   d) Purchases A/c

9. Stock of Raw Material given in Trial Balance is shown on:
   a) Debit Side of Manufacturing A/c
   b) Credit side of manufacturing A/c
   c) Asset gives of the balance sheet

10. Opening work-in-progress appearing in the trial balance is shown on:
    a) Debit Side of manufacturing A/c
    b) Trading A/c.
    c) Credit side of manufacturing A/c
    d) Asses side of Balance sheet
    e) Non-of the above.

11. Depreciation of Factory Building is shown under.
    a) Trading A/c b) Profit & Loss A/c.
    c) Manufacturing A/c d) All of the above.

12. Trade Mark is:
    a) Current Assets b) Fixed Asses
    c) Intangible Asset d) Movable properties

13. Opening Stock of Raw Materials is :
    a) Added to purchase of finished Goods.
    b) Deducted from Raw Material Consumed.
    c) Added to purchase of Raw Materials.
    d) None of the above.

14. Reserve for Discount on creditors shows :
    a) Credit Balance b) Debit Balance
    c) Nil Balance d) Non of above

15. Manufacturing A/c balance always shows.
    a) Gross Profit b) Net Profit
    c) Cost of production d) Cost of sales.

16. Goodwill is:
    a) Current Assets b) Fictitious Assets
    c) Fixed Assets d) Terrible Assets

17. Trade Discount shall be shown:
    a) Debit Side of Mfg. A/c b) Deducted from purchases
    c) Debit side of p & L A/c. d) None of the above

Ans. 1-d, 2-a, 3-c, 4-a, 5-c, 6-c, 7-c, 8-c, 9-a, 10-a, 11-c, 12-c, 13-c, 14-a, 15-c, 16-b, 17-d.

b. Fill in The Blanks.

1) Debit balance of Manufacturing A/c indicates _______.

2) Plant & machinery is a --------------- asset.

3) Income received in advance is shown on _______ side of Balance Sheet.

4) Income Tax Paid is transferred to ________ A/c.

5) Goods distributed as free samples is credited to _____ A/c.

6) Goods withdrawn by proprietor is credited to ______ A./c.

7) Commission paid is credited to ______ A/c.

8) _______ shows the finical position of business.

9) Manufacturing A/c is prepared only by ______.

10) Debit balance of Profit & Loss A/c shows ________.

11) Net Profit is transferred to ________ A/c.

12) Prepaid Insurance is credited to ______ A/c.

13) Depreciation on office equipments is credited to _______ A/c.

14) Bad debt written off is credited to _____ A/c.

15) _______ note is prepared for sales return of goods.

16) Gross Profit, 25% on cost is equal to _____ % on sales.

17) Bank Overdraft is shown on ______ side of Balance Sheet.

18) Stock of Stationery is shown on ______ side of Balance Sheet.

19) Carriage paid on furniture purchased is debited to _______ A/c.

20) Debit balance of Manufacturing A/c is transferred to ____ A/c.

21) Carriage outward paid is credited to _______ A/c.

22) Opening stock of work in progress is debited to _______ A/c.

23) Recovery of bad debts is credited _______ A/c.

24) Octroi paid on plant purchased is debited to ________ A/c.

Ans.

1) Cost of production,	**2)Fixed,**	**3) Liabilities,**
4) Drawings,	**5) Trading A/c,**	**6) Trading A/c**
7) Cash A/c Bank A/c,	**8) Balance Sheet**	**9) Manufacturer**
10) Net Loss	**11) Capital A/c**	**12) Insurance A/c,**
13) Office Equipment	**14) Sundry debtors**	**15) Credit Note**
16)20%	**17) Liabilities**	**18) Assets**
19) Furniture	**20) Trading**	**21) Cash / Bank A/c,**
22) Manufacturing	**23) P & L**	**24) Plant**

c. Match the following Columns:

1)

COLUMN A	COLUMN B
a) Purchase of Raw Material	i) Credit Balance
b) Bank Overdraft	ii) Assets side of Balance Sheet.
c) Outstanding Wages	iii) Manufacturing A/c
d) Prepaid Insurance	iv) Capital A/c
e) Goodwill	v) Liabilities side
	vi) Intangible Assts

Ans. a) - iii, b)- i c)v d)- ii e)- vi

2)

COLUMN C	COLUMN D
i) Income due but not received	a) Bills Payable
ii) Current Liabilities	b) Manufacturing A/c
iii) Tallied Balance sheet	c) Carriage paid on Good sold
iv) Carriage Inward	d) Capital A/c
v) Drawings	e) Profit Loss A/c
	f) Asset side of Balance Sheet
	j) Arithmetical accountancy

Ans. i) f, ii) – a, iii) – j, iv) b, v) –d

3)

COLUMN E	COLUMN F
i) Raw Material consumed	a) Profit & Loss A/c Credit Side
ii) Profit on Sale of Assets	b) Added to income.
iii) Accrued Income	c) Tangible Assets
iv) Furniture	d) Manufacturing A/c
v) Outstanding Expenses in Trial Balance	e) Profit & Loss A/c Debit Side
	f) Liabilities Side
	g) Fixed Asset

Ans. i) – d, ii) – a, iii) – b, iv) – g, v) – f

d. State Whether the following statements are True or False :-

1) Trial Balance shows financial position of the concern.
2) Goodwill written off is credited to Trading A/c
3) Credit balance of Profit & Loss A/c is net profit
4) Interest on capital is credited to Drawing A/c
5) The Drawing A/c always shows debit balance.
6) Income received in advance is asset.
7)Provision for Depreciation is also known as Accumulated Depreciation.
8) Interest on Drawings is debited to Profit and Loss A/c.
9) Stock is always valued at cost.
10) Prepaid expenses in Trial balance is shown on Assets side of the Balance Sheet.
11) Withdrawal of cash by the proprietor is credited to Cash A/c.
12) Trading A/c shows Net Profit or Net Loss.
13) All income and expenses are shown in the Balance Sheet.
14) Balance Sheet is always prepared for the year ended.
15) Carriage Outwards is credited to Trading A/c.
16) Capital A/c of proprietor is always shown on Asset Side of Balance Sheet.
17) Manufacturing A/c is prepared to find out Gross Profit.
18) Interest on investment is calculated on Face Value of the investment.

Ans. False: 1,2, 4, 6, 7, 9, 12, 13, 14, 15, 16, 17
True: 3, 5, 8, 10, 11, 18

❖❖❖❖

Unit-9

FINAL ACCOUNTS II

UNIT STRUCTURE

9.0 Objectives
9.1 Solved Problems
9.2 Exercise

9.0 OBJECTIVES

After studying the unit students will be able to solve the practical problems on final accounts.

9.1 SOLVED PROBLEMS

Illustration 1: (Mfg. & Tr. A/c)

From the following particulars, prepare a Manufacturing Account and a Trading Account for the year ended 31-3-2018.

Particulars	Rs.	Particulars	Rs.
Raw Materials (1-4-2012)	12,000	Carriage Inwards	1,000
Work –in-Progress (1-4-2012)	8,000	Returns Outward	2,000
Finished Goods (1-4-2012	9,000	Royalty on Production	1,000
Purchase of Raw Materials	80,000	Purchase of Finished goods	8,000
Direct Wages	10,000	Carriage Outwards	500
Indirect Wages	8,000	Fuel and Power	2,500
Sales	1,74,000	Repairs and Maintenance	1,500
Returns Inward	5,000	Raw Materials (31-3-2013)	6,000
Depreciation on Factory Assets	4,000	Work-in-Progress (31-3-2013)	2,500
Purchase of Finished Goods	37,000	Finished Goods (31-3-2013)	5,000

Adjustments:

(i) Outstanding Direct Wages amounted to Rs. 3,000; (ii) Prepaid Fuel and Power amounted to Rs.500.

Manufacturing Account
For the year ended 31-3-2018

Dr **Cr**

Particulars	Rs.	Rs.	Particulars	Rs.
To Work-in-Progress (Opening		8,000	By Work-in-Progress (Closing)	2,500
To Raw Materials consumed :			By Trading A/c	1,20,000
Opening Stock	12,000		(Cost of Production transferred)	
Add : Purchase	80,000			
Add : Carriage Inward	1,000			
	93,000			
Less : Returns outward	2,000			
	91,000			
Less : Closing Stock	6,000	85,000		
To Direct Wages	10,000			
Add : Outstanding	3,000	13,000		
To Manufacturing Expenses :				
- Royalty on Production		1,000		
To factory Expenses :				
- Indirect Wages	8,000			
- Depreciation on Factory Assets	4,000			
- Fuel and Power 2,500				
Less : Prepaid 500	2,000			
- Repairs and maintenance	1,500	15,500		
		1,22,500		**1,22,500**

Trading Account
For the year ended 31-3-2018

Dr **Cr**

Particulars	Rs.	Particulars	Rs.	Rs.
To Opening stock (FG)	9,000	By Sales	1,74,000	
To Manufacturing A/c (Cost of Production tfd.)	1,20,000	Less : Returns Inward	5,000	1,69,000
To Purchase (FG)	37,000	By Closing Stock (FG)		5,000
To Gross Profit c/d (tfd. To P & L A/C)	8,000			
	1,74,000			**1,74,000**

Note: The concern is a manufacturer as well as a trader. Hence the Trading a/c shows purchase of finished goods (for re-sale) and closing stock of such goods held for re-sale.

Illustration 2: (Mfg. Tr., P & L A/c + Adjustments)

The following information is given to you from the books of a manufacturer in respect of the year ending 31st March, 2018.

Particulars	Rs.	Particulars	Rs.
Stock of Raw Material (1-4-2017)	25,000	Electricity & Telephone	6,000
Freight Inward	8,500	Selling Expenses	6,000
Freight Outward	6,000	Miscellaneous Expenses	14,000
Direct Wages	18,000	Stock of Finished Goods : (31-3-2018)	30,000
Indirect Wages	14,000	Provision for Doubtful Debts	8,500
Sales	4,80,000	Depreciation on Plant and Machinery	4,000
Stationery	1,500	Depreciation of Office	
Traveling Expenses	5,000	Furniture and Equipments	3,000
Salaries (H.O.)	26,000	Repairs to Plant and Machinery	4,650

Factory Expenses	26,000	Sale of Scrap	3,700
Interest on Loan paid	1,800	Purchase of Raw Materials	2,50,000
Returns-Inward	5,000	Coal Consumed	9,000
Returns-outward	3,500	Work-in-progress (1-4-2017)	7,000
Power and fuel	8,000	Bank Interest received	2,600

Adjustments necessary for the following:

(a) Finished goods worth Rs.5,000 were distributed as free samples.

(b) A loan was obtained on 1st October, 2017 for Rs. 50,000 carrying interest 10% p.a.

(c) Bad debts to be written off Rs..750 and provision for doubtful debts to be maintained Rs.7,000.

(d) Electricity and Telephone to be apportioned as Factory 3/5th and Office 2/5th.

(e) A fire occurred destroying finished goods worth Rs.15,000. Insurance Company admitted a claim of Rs.12,000 not yet received.

(f) Stock on 31-3-2018 stationery in hand Rs.150, Raw Materials Rs.22,000.Work-in-Progress Rs.4,000, Finished Goods Rs.40,000.

You are required to prepare the Manufacturing Account and Trading Account and Profit and Loss Account for the year ended on 31st March 2018. (ICWA adapted)

Solution:

Manufacturing Account
For the year ended 31-3-2018

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.
To Work-in Progress (Opening)		7,000	By Work-in Progress (Closing)	4,000
To Raw Materials Consumed :			By Sale of scrap	3,700
Opening Stock	25,000		By Trading A/c	3,44,550
Add : Purchases	2,50,000		(Cost of production tfd.)	
Add : Carriage Inwards	8,500			
	2,83,500			
Less : Returns outward (-)	3,500			
	2,80,000			
Less : Closing Stock	22,000	2,58,000		
To Wages		18,000		
To Factory Expenses :				
Wages indirect	14,000			
Factory expenses	26,000			
Power and fuel	8,000			
Coal consumed	9,000			
Electricity and telephone	3,600			
(3/5 x 6,000)				
Depreciation on Machinery	4,000			
Repairs to Plant	4,650	69,250		
		3,52,250		**3,52,250**

Trading and Profit & Loss Account
For the Year ended 31-3-2018

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening Stock (FG)		30,000	By Sales	4,18,000	
To Manufacturing A/c		3,44,550	Less : Returns	5,000	4,13,000
(Cost of production efd.)			By Goods distributed as		
To Gross Profit c/d		98,450	Free samples		5,000
			By Goods destroyed by fire		15,000
			By Closing Stock (FG)		40,000
		4,73,000			**4,73,000**
To Salaries		26,000	By Gross Profit b/d		98,450
To Electricity & Telephone		2,400	By Bank Interest received		2,600
(2/5x6,000)			By Provision for doubtful		750
To Stationery	1,500		Debts not required		
Less : Stock-in-hand	150	1,350	(8,500-750-7,000)		
To Interest on loan	1,800				
Add : Outstanding	700	2,500			
[(50,000 x 6/12 x 10% - 1,800]	700				
To Traveling expenses		5,000			
To Selling expenses		6,000			
To Fright outward		6,000			

To Miscellaneous expenses		14,000			
To Loss by fire	15,000				
Less : Claim admitted by					
Insurance Co.	12,000	3,000			
To Depreciation Office					
Furniture & Equipments		3,000			
To Advertisements		5,000			
(free samples)					
To Net profit tfd. To Capital A/c.		27,550			
		1,01,800			**1,01,800**

Illustration 3:

Vinayaka's Trial Balance as on 31st March 2012 is as follows:

Particulars	Dr. Rs.	Cr. Rs.	Particulars	Dr. Rs.	Cr. Rs.
Opening Stock			Printing and Stationery	5,200	
- Raw Materials	2,50,000		Bank Charges	2,500	
- Work-in-Progress	80,000		Traveling Expenses	10,000	
- Finished Goods	2,20,000		Discount	3,300	
Purchases	2,15,000		Sales Return	11,000	
Buildings	1,50,000		Advertisement	5,500	
Plant & Machinery	3,60,000		Sales		7,80,000
Furniture	40,000		Capital		8,50,000
Trade Mark	30,000		Sundry Creditors		52,000

Wages	83,000		Sundry Debtors	82,500	
Factory Taxes	4,000		Discount		2,500
Motive Power	9,000		Miscellaneous Expenses	5,500	
Factory Insurance	5,000		Bills Payable		34,000
Salary to Office Staff	11,000		Bill Receivable	16,000	
Office Rent	10,500		Corporation Bank	98,000	
Carriage Inward	2,500		Cash on hand	9,000	
				17,18,500	17,18,500

Adjustments:

(1) Closing Stock: Rs.

Raw Materials 85,000

Work-in-Progress 30,000

Finished Goods 2,05,000

(2) Factory taxes prepaid Rs.2,000

(3) Depreciation: Furniture 10%

Plant & Machinery 15%

Trade Mark 20%

Building 5%

Prepare Manufacturing, Trading and Profit & Loss Account for the financial year 2017-18 and Balance Sheet as on 31-3-2018.

(IDE, Mar. 2000, adapted)

Solution:

VINAYAK
Manufacturing & Trading Account
For the year ended 31-3-2018

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Work-in-process (Opng.)		80,000	By Work-in-process (Cl.)		30,000
To Raw materials consumed:			By Trading Account (Cost of production tfd.)		5,85,500
Opening Stock	2,50,000				
Add : Purchase	2,15,000				
- Carriage Inward	2,500 4,67,500				
Less : Closing stock	85,000	3,82,500			
To Direct Wages		83,000			
To Direct factory expenses					
- Factory Taxes	4,000				
Less : Prepaid taxes	2,000	2,000			
To Motive Power		9,000			
- Factory Insurance		5,000			
To Depreciation					
Plant & Machinery (15%)		54,000			
		6,15,500			**6,15,000**

To Opening stock (FG)		2,20,000	By Sales	7,80,000	
To Manufacturing Account			Less : Return Inwards	11,000	7,69,000
(Cost of production tfd.).		5,85,500	By Closing stock (FG)		2,05,000
To Gross profit c/d		1,68,500			
		9,74,000			**9,74,000**

Profit & Loss Account
For the year ended 31-3-2018

Dr **Cr**

Particulars	**Rs.**	**Rs.**	**Particulars**	**Rs.**
To Salaries to Office Staff		11,000	By Gross Profit B/d	1,68,500
To Office Rent		10,500	By Discount Received	2,500
To Printing & stationery		5,200		
To Bank charges		2,500		
To Traveling Expenses		10,000		
To Miscellaneous Expenses		5,500		
To Advertisement		5,500		
To Discount		3,300		
To Depreciation on				
- Tr. Mark (20%)	6,000			
- Building (5%)	7,500			
- Furniture (10%)	4,000	17,500		
To Net profit tfd. To capital		1,00,000		
		1,71,000		**1,71,000**

Balance Sheet As At 31-3-2018

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Account :			Fixed Assets :		
Balance b/d (opening)	8,50,000		Building	1,50,000	
Add:-Net profit for the years	1,00,000	9,50,000	Less: Depreciation @5%	-7,500	1,42,500
Current Liabilities :			Plant & machinery	3,60,000	
Sundry Creditors		52,000	Less : Depreciation @15%	54,000	3,06,000
Bills Payable		34,000	Furniture	40,000	
			Less : Depreciation @10%	4,000	36,000
			Trade Mark	30,000	
			Less : Depreciation @20%	6,000	24,000
			Current Assets :		
			Closing Stock :		
			- Raw Materials	85,000	
			- Work-in-Progress	30,000	
			- Finished Goods	2,05,000	3,20,000
			Debtors		82,500
			Bills receivable		16,000
			Prepaid taxes		2,000
			Corporation Bank		98,000
			Cash in hand		9,000
		10,36,000			**10,36,000**

Illustration 4:

Amar Chemicals has the following Ledger Balance as on 31st March 2018.

Particulars	Dr. Rs.	Cr. Rs.	Particulars	Dr. Rs.	Cr. Rs.
Goodwill	50,000		Net Sales		11,00,000
Factory Shed	20,000		Miscellaneous Income		4,000
Machinery	1,30,000		Bad Debts Reserve		5,000
Furniture	8,000		Purchase of Materials	8,60,000	
Investments	10,000		Freight on Materials	50,000	
Capital		1,95,000	Factory Power	15,000	
Bank Loan		3,00,000	Salaries and Wages		
Creditors		1,50,000	- Factory	1,50,000	
Debtors	1,35,000		- Office	65,000	
Stock on 1-4-2018			Repairs and Renewals	2,500	
- Materials	1,30,000		Rent and Taxes	16,500	
-Work-in-Progress	7,500		Insurance	3,900	
-Finished Goods	82,500		General Expenses	18,100	
				17,54,000	**17,54,000**

The following additional information is available:

(1) Closing Stock: Materials Rs.2,10,000; Work-in-Progress Rs.12,500 and Finished Goods Rs.2,07,500.

(2) Depreciation to be provided at 2.5% on Factory Shed, 10% on Machinery and 15% on Furniture.

(3) Repairs and rent and taxes are to be apportioned between Factory and Office in the ratio of 3: 2.

(4) Reserve for bad and doubtful debts are to be provided at 4% on debtors.

(5) Insurance Premium covers a period of one month in advance.

You are required to prepare Manufacturing, Trading, and Profit and Loss Account for the year ended 31st March 2018 and Balance Sheet as on that date.

(Mumbai, Nov. 1998, adapted)

Solution:

AMAR CHEMICALS
Manufacturing & Trading Account
For the year ended 31-03-2018

Dr **Cr**

Particulars	Rs.	Rs.	Particulars	Rs.
To Work-in-process(Opng.)		7,500	By Work-in-process (Cl.)	12,500
To Raw materials consumed :			By Trading Account (Cost of Production efd.)	10,14,900
Opening Stock	1,30,000			
Add : Purchase	8,60,000			
Add : Freight on Materials	50,000			
	10,40,000			
Less: Closing stock	2,10,000	8,30,000		
To Direct factory expenses				
- Factory Power	15,000			
- Salary & wages	1,50,000			
- Repairs etc. (3/5)	1,500			
- Rent & Taxes (3/5)	9,900			
- Depreciation on factory assets				
Factory shed	500			
- Machinery	13,000	1,89,900		
		10,27,400		**10,27,400**

To Opening stock (FG)		82,500	By Sales	11,00,000
To Manufacturing Account (cost of Production tfd.)		10,14,900	By Closing stock (FG)	2,07,500
To Gross profit c/d		2,10,100		
		13,07,500		**13,07,500**

Profit & Loss Account
For the year ended 31-03-2018

Dr **Cr**

Particulars	Rs.	Rs.	Particulars	Rs.
To Office Salary & Wages		65,000	By Gross profit b/d	2,10,100
To Repairs & Renewals (2/5)		1,000	By Miscellaneous Income	4,000
To Rent & Taxes (2/5)		6,600		
To Insurance	3,900			
Less : Prepaid (3,900 x 1/12)	325	3,575		
To General Expenses		18,100		
To Depreciation on Furniture		1,200		
To Reserve for Doubtful Debts	5,400			
Less : Old RDD	5,000	400		
To Net profit tfd. To capital		1,18,225		
		2,14,100		**2,14,100**

Balance Sheet
As At 31-03-18

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Account :			Fixed Assets :		
Balance b/d (opening)	1,95,000		Goodwill		50,000
Add : Net profit for the year	1,18,225	3,13,225	Machinery	1,30,000	
Loans :			Less : Depreciation @10%	13,000	1,17,000
Loans from bank		3,00,000	Factory Shed	20,000	
Current Liabilities :			Less : Depreciation @2.5%	500	19,500
Sundry creditors		1,50,000	Furniture	8,000	
			Less Depreciation @15%	1,200	6,800
			Investment		10,000
			Current Assets :		
			Closing Stock		
			- Raw material	2,10,000	
			- Work-in-process	12,500	
			- Finished goods	2,07,500	4,30,000
			Debtors	1,35,000	
			Less : Prov. for bad debts	5,400	1,29,600
			Prepaid insurance		325
		7,63,225			**7,63,225**

Illustration 5:

Following is the Trial Balance of Mrs. Rashmi as on 31-3-2018

Particulars	Dr. Rs.	Cr. Rs.	Particulars	Dr. Rs.	Cr. Rs.
Capital/Drawings	40,000	8,00,000	Printing and Stationery	41,400	
Opening Stock			Office Rent	64,600	
* Raw Materials	50,800		Bills Receivable	3,01,000	
* Work in progress	25,800		Bills Payable		1,00,000
* Finished goods	2,18,000		Sundry Debtors and Creditors	6,00,000	4,00,000
Purchase of Raw Materials	22,24,000		Plant and Machinery	16,00,000	
Wages	79,200		Motor Car	6,00,000	
Power and Fuel	48,500		Returns	24,000	30,000
* Factory Rent	25,000		Interest @ 14% on Investments		22,000
Carnage outward	34,700		Investments (1-4-2011)	2,00,000	
		48,74,000	Bad Debts	10,000	
Ins. Durance Premium	51,000		Provision for Bad and Cr.		
Discount	5,000	19,000	Doubtful debts		6,000
			Life Insurance Premium paid	8,000	
				62,51,000	**62,51,000**

a) Closing Stock

Closing Stock	Cost Price	Market Price
Raw Materials	90,000	1,00,000
Work in Progress	90,000	50,000
Finished Goods	4,00,000	3,60,000

b) Depreciate Plant & Machinery @ 15% p.a. and Motor Car @ 20% p.a.

c) General Insurance prepaid was Rs.9,000.

d) Provide for outstanding factory rent Rs.13,000.

e) Finished goods costing Rs.20,000 and Raw materials costing Rs.30,000 were destroyed by fire. Insurance Company admitted claim of Rs.15,000 for finished goods and Rs.20,000 for Raw Materials by the date of Balance Sheet.

f) Write off Rs. 20,000 as Bad debts.

g) Create provision for doubtful debts and provision for discount on debtors @ 5% and 2% respectively.

h) On 30-3-2018 goods costing Rs.40,000 were purchased on credit (included in closing stock) which remained unrecorded.

i) Purchase include Rs.80,000 in respect of Plant and Machinery purchased on 1-10-2011.

j) Proprietor had withdrawn goods at sale price of Rs.30,000 which included profit element of 20% on cost.

This amount was recorded through sales register and was wrongly debited to Mrs. Rama's (Debtor) Account. Being the Accountant of Mrs. Rashmi, you are required to prepare Manufacturing, Trading and Profit and Loss Account for year ended 31st March, 2018 and Balance Sheet as at the date.

(Oct. 1996)

Solution:

Dr. Mrs. RASHMI
Manufacturing Account
For the year ended 31-03-2018

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.
To Work-in-Progress (Opening)		25,800	By Work-in-Progress (Closing)	50,000
To Raw Materials consumed :			By Trading A/c (Cost of production transferred)	24,72,300
Opening Stock	50,800			
Add : Purchases	22,24,000			
Add : Unrecorded purchases	40,000			
Less : Purchases Returns	30,000			
Less : Machinery				
Purchased	80,000			
Less : Destroyed by fire	30,000			
Less : Closing Stock	90,000	20,84,800		
To Wages		79,200		
To Factory Expenses.				
Factory Rent	25,000			
Add : Outstanding	13,000			
	38,000			
Power and Fuel	48,500			
Depreciation : Plant & Machinery	2,46,000	3,32,500		
		25,22,300		**25,22,300**

Trading and Profit and Loss Account
For the year ended 31-3-2018

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening stock (FG)		2,18,000	By Sales	48,74,000	
To Manufacturing A/c		24,72,300	Less : Sales returns	24,000	
(Cost of Production tfd.)				48,50,000	
To Gross profit c/d		25,34,700	Less : Goods for personal use	30,000	48,20,000
			By Goods for personal use (cost)		25,000
			By Goods destroyed by fire		20,000
			By Closing stock (FG)		3,60,000
		52,25,000			**52,25,000**
To Carriage Outwards		34,700	By Gross Profit b/d		25,34,700
To Discount Allowed		5,000	By Discount Received		19,000
To Printing and Stationery		41,400	By Interest on Investments	22,000	
To Insurance	51,000		Add : Interest Receivable	6,000	28,000
Less : Prepaid	9,000	42,000			
To Office Rent		64,600			
To Bad Debts	10,000				
Add : Further Bad Debts	20,000				
Add : New R.D.D.	27,500				
Less : Old R.D.D.	6,000	51,500			
To Provision for discount on debtors		10,450			
To Depreciation on car (20% x 6,00,000)		1,20,000			
To Loss by Fire :					
- Raw Materials	10,000				
- Finished Goods	5,000	15,000			
To Net profit tfd. To capital		21,97,050			
		25,81,700			**25,81,700**

Balance Sheet
As at 31-03-2018

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capita / Account :			Fixed Assets :		
Balance b/d (opening)	8,00,000		Plant and Machinery	16,00,000	
Add : Net Profit	21,97,050		Add : New Machinery	80,000	
	29,97,050			16,80,000	
Less : Drawing [WN3]	73,000	29,24,050	Less : Depreciation [WN1]	2,46,000	14,34,000
Current Liabilities :			Motor Car	6,00,000	
Bills Payable		1,00,000	Less : Depreciation @ 20%	1,20,000	4,80,000
Sundry Creditors	4,00,000		Investments :		
Add : Unrecorded Purchase	40,000	4,40,000	Investment (1-4-2017)		2,00,000
Outstanding Rent		13,000	Current Assets :		
			Closing Stock :		
			- Raw Materials	90,000	
			- Work in Progress	50,000	
			- Finished Goods	3,60,000	5,00,000
			Debtors	6,00,000	
			Less : Goods for own use	30,000	
				5,70,000	
			Less : Further Bad Debts	20,000	
				5,50,000	

			Less : Prov. for doubtful debts		
			(5/100x5,50,000)	27,500	
				5,22,500	
			Less : Prov. for Discount on	10,450	5,12,050
			Debtors (2/100 x 5,22,500)		
			Insurance Claim :		
			- for Raw Materials	20,000	
			- for Finished Goods	15,000	35,000
			Bills Receivable		3,01,000
			Interest Receivable [WN2]		6,000
			Prepaid Insurance		9,000
		34,77,050			**34,77050**

Working Notes:

1. Depreciation of Plant and Machinery — Rs.

Depreciation on Rs. 16,00,000 for Full year @ 15%	2,40,000
Depreciation on Rs. 80,000 for 6 months (80,000 x 15/100 x 6/12)	6,000
	2,46,000

2. Interest Receivable on Investments — Rs.

Total Interest on Investments (2,00,000 x 14/100)	28,000
Less: Interest actually received	22,000
Balance Interest receivable	6,000

3. Total Drawings made — Rs.

Drawings as per Trial Balance	40,000
Add: Goods withdrawn for personal use	25,000
Add: Life Insurance paid as per Trial Balance	8,000
Total Drawings	73,000

Illustration 6:

The Trial Balance Mr. Lakhamichand is as below, Prepare final accounts for the year ended 31-12-2017.

Debit Balances	Rs.	Credit Balances	Rs.
Cash in hand	1,000	Capital Account	41,860
Machinery	30,000	Sales	1,38,780
Drawings	2,500	R.D.D.	560
Factory, Power and Fuel	450	Sundry Creditors	8,800
Office Salaries	6,225		
Carriage outwards	500		
Manufacturing wages	9,300		
Furniture and Fixture	3,400		
Opening Stock :			
- Finished goods	4,000		
- Work-in-progress	7,250		
- Raw Materials	2,800		
Carriage Inwards	1,000		
Rent (Factory ¾)	4,000		
Sundry Debtors	21,600		
Advertisement	775		
Printing & Stationery	1,200		
Factory Insurance	1,280		
Purchase of Raw Material	82,950		
Balance at Bank	8,530		
Discount Allowed	610		
Miscellaneous Expenses	630		
	1,90,000		**1,90,000**

Adjustments:

(1)Closing Stock: Finished Goods Rs.6,500, Raw Materials Rs.750 and Work-in-progress Rs.4,750.

(2) A Motor car purchased on 1-10-2017 for Rs.10,000 has been included in purchases.

(3) Depreciate Machinery at 15% p.a., Motor Car at 20% p.a., Furniture and Fixtures at 15% p.a.

(4) Provision for R.D.D. should be maintained at 10% of the debtors.

(5) Provision for unrealised Rent in respect of portion of the office sub-let at Rs.120 p.m. from 1-10-2017 has to be made.

(April 96, adapted)

Solution:

LAKHAMICHAND
Manufacturing Account
For the year ended 31-12-2017

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.
To Work-in-Progress (Opening)		7,250	By Work-in-Progress (Closing)	4,750
To Raw Materials consumed :			To Trading A/c (Cost of production transferred)	97,030
Opening Stock	2,800			
Add : Purchases	82,950			
Add : Carriage Inwards	1,000			
	86,750			
Less : Motor Car Purchase	10,000			
Less : Closing Stock	750	76,000		
To Manufacturing Wages		9,300		

To Factory Expenses :				
Rent [3/4 x 4,000]	3,000			
Insurance	1,280			
Power and Fuel	450			
Depreciation on Plant	4,500	9,230		
		1,01,780		**1,01,780**

Trading Account
For the year ended 31-12-2017

Dr. **Cr.**

Particulars	Rs.	Particulars	Rs.
To Opening stock (FG)	4,000	By Sales	1,38,780
To Manufacturing A/c (Cost of Production tfd.)	97,030	By Closing stock (FG)	6,500
To Gross profit c/d	44,250		
	1,45,280		**1,45,280**

Profit and Loss Account
For the year ended 31-12-2017

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.
To Office Salaries		6,225	By Gross Profit b/d	44,250
To Carriage Outwards		500	By Rent Accrued	360
To Office Rent (1/4 x 4,000)		1,000		
To Advertisement		775		
To Printing and Stationery		1,200		
To Discount Allowed		610		

To Miscellaneous Expenses		630		
To Prov. for Bad &				
Doubtful Debts				
New R.D.D.	2,160			
Less : Old R.D.D.	560	1,600		
To Depreciation :				
- on Motor Car	500			
(10,000x20/100x3/12)				
- on Furniture & Fixtures	510	1,010		
(3,400 x 15/100)				
To Net profit tfd. To capital		31,060		
	44,610			**44,610**

Balance Sheet
As at 31-12-2017

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital Account :			Fixed Assets :		
Balance b/d (opening)	41,860		Plant and Machinery	30,000	
Add : Net profit	31,060		Less : Depreciation @ 15%	4,500	25,500
	72,920		Motor Car	10,000	
Less : Drawings	2,500	70,420	Less : Depreciation @ 20% (for 3 months)	500	9,500
Current Liabilities :					
Sundry creditors		8,800	Furniture & Fixtures	3,400	
			Less : Depreciation @ 15%	510	2,890
			Current Assets :		
			Closing Stock :		

			- Raw Materials	750	
			- Work in Progress	4,750	
			- Finished Goods	6,500	12,000
			Debtors	21,600	
			Less : New R.D.D.	2,160	19,440
			Rent Accrued		360
			Balance at Bank		8,530
	//		Cash in Hand		1,000
		79,220			**79,220**

Illustration 7:

The following balances are extracted from the ledger accounts of Mr. Bharat as on 31st December, 2017.

Particulars	Dr. Rs.	Cr. Rs.	Particulars	Dr. Rs.	Cr. Rs.
Mr. Bharat's		1,40,000	Wages	30,000	
Capital			Salaries	22,000	
Plant and Machinery	45,000		Trade		
Opening Stock			Expenses	9,000	
Raw Materials	20,000		Rent	12,000	
Finished goods	5,000		Consignment (Mr. X) A/c.	33,000	
Purchases and Sales	3,74,000	4,60,000	Cash	5,000	
Debtors and Creditors	1,35,000	90,000			
				6,90,000	**6,90,000**

Adjustments:

(1) Opening stock of finished goods include stock of stationery of Rs.200.

(2) Closing stock of raw materials Rs. 10,000, closing stock of finished goods Rs.20,000 (including stock of stationery Rs. 100.)

(3) Trade expenses include payment of stationery of Rs.2,000.

(4) Closing creditors include creditors for stationery of Rs.500 for credit purchases.

(5) Mr. Bharat sent goods costing Rs.33,000 to Mr. X (consignee) who sold two third of the quantity for Rs.35,000. The consignee has incurred expenses of Rs.2,000 and is entitled for commission of 5% on sales.

(6) Sales include a sum of Rs.32,000 received on sale of all goods received on behalf of Mr. Y (consignor). Mr. Bharat is entitled to a commission of 10% on these sales for which no entries were passed. The expenses of Rs.1,000 for sale on behalf of Mr. Y are debited to trade expenses (the expenses should be incurred by Mr. Y)

(7) Provide 10% depreciation on plant and machinery.

Prepare manufacturing account, trading account and profit and loss account for the year ended 31st December, 2017 and the Balance Sheet on that date.

(March 95, adapted) 2012.

MR. BHARAT
Manufacturing Account
For the year ended 31-12-2017

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.
To Raw Materials consumed			By Trading A/c (Cost of production tfd.)	4,18,000
Opening Stock	20,000			
Add : Purchases	3,74,000			
	3,94,000			
Less : Purchases of Stationery	(500)			
Less : Closing Stock	(10,000)	3,83,500		
To Wages		30,000		
To Factory Expenses :				
To Depreciation on Machinery		4,500		
		4,18,000		**4,18,000**

Trading Account

For the year ended 31-12-2017

Dr. **Cr.**

Particulars	Rs.	Rs.	Particulars	Rs.	Rs.
To Opening stock (FG)	5,000		By Sales	4,60,000	
Less : Stock of Stationery	200	4,800	Less : Consignment Sales [Y]	32,000	
To Manufacturing A/c Cost of Production		4,18,000			
To Gross profit c/d		38,100	[35,000 – 33,000]	2,000	4,30,000
			By Closing stock		
			Finished Goods	20,000	
			Less : Closing stock of		
			Stationery	100	
				19,900	
			Add : Unsold Goods of Consignment [X]	11,000	30,900
		4,60,900			**4,60,900**

Profit and Loss Account

For the year ended 31-12-2017

Dr. **Cr,**

Particulars	Rs.	Rs.	Particulars	Rs.
To Office Salaries		22,000	By Gross Profit b/d	38,100
To Trade Expenses	9,000		By Commission from Consignor	3,200
Less : Payment for Stationery	(2,000)		By Net Loss tfd. To Capital	5,050
Less : Expense of Consignor Y	(1,000)	6,000		
To Stationery Consumed				
Opening stock	200			
Add : Stationery	2,000			
Add : Credit Purchase	500			
	2,700			
Less : Closing Stock	(100)	2,600		
To Rent		12,000		
To Commission to Consignee		1,750		
(5% x 35,000)				
To Expenses incurred by X		2,000		
		46,350		**46,350**

Balance Sheet
As on 31-12-2017

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Capital / Account :			Fixed Assets :		
Balance b/d (opening)	1,40,000		Plant and Machinery	45,000	
Add : Net profit	5,050	1,34,950	Less : Depreciation @ 10%	4,500	40,500
Current Liabilities					
Sundry creditors	90,000				
Less : Creditors for Stationary	500	89,500			
Creditors for stationary		500	Current Assets :		
Due to Y	32,000		Closing Stock :		
Less: Commission (10%)	3,200		- Raw Materials	10,000	
Less : Expenses of consignor Y included in trade	1,000	27,800	- Finished Goods 19,900 Add : Unsold goods (x) 11,000	30,900	
			- Stock of stationary	100	41,000
			Debtors		1,35,000
			Consignment A/c Mr. X	33,000	
			Add : sales of X	2,000	
				35,000	
			Less : Expenses	2,000	
			Less : Expenses	2,000	
			Less: Commission (5%)	1,750	31,250
			Cash in hand		5,000
		2,52,750			**2,52,750**

9.2 EXERCISE

Illustration 1

From the following details for the year ended 31st March 2018 prepare Manufacturing, Trading and Profit & Loss Account of M/s Razavi Traders:

Particulars	Rs.	Particulars	Rs.
Opening stock:		Electric and water charges	4,000
Raw Material	60,000	Wages	1,40,000
Work in progress	50,000	Salary of works manager	6,000
Finished goods	75,000	Office salaries	5,000
Purchase of raw materials	3,20,000	Advertisement	2,000
Sales	6,25,000	Deprecation	
Purchase returns	5,000	- on Plant	3,000
Sales returns	4,000	- on Factory Shed	1,000
Carriage inward	1,500	- on Office Furniture	6,00
Carriage outward	1,000	Closing Stock	
Duty and clearing charges	2,000	- Raw material	40,500
Factory rent	3,000	- Work in progress	60,000
Office rent	2,000	- Finished goods	55,000

Illustration 2

From the following Trial Balance and additional information of Miss. Shabana, prepare Manufacturing, Trading and Profit and Loss A/c for the year ended 31st March, 2018 and Balance Sheet as on that date.

Trial Balance
As on 31st March, 2018

Particulars	Dr. Rs.	Cr. Rs.
Bank Overdraft		49,000
Advertising	18,400	
Audit Fees	10,500	
Bad Debts	1,600	
Bills of Exchange	20,350	20,000
Goodwill	50,000	
Commission received		1,000
Discount received		2,000

Drawings	2,650	
Land and Building	40,000	
General Expenses	12,350	
Insurance	3,150	
Interest on Bank Overdraft	2,000	
Investment in Shares	56,000	
Plant and Machinery	1,00,000	
Capital		2,70,000
Purchases	2,10,320	
R.D.D.		1,000
Return Inwards	1,280	
Return Outwards		3,320
Debtors	81,750	
Wages	30,250	
Creditors		65,000
Opening Stock	40,000	
Sales		3,21,280
Salaries	52,000	
	7,32,600	**7,32,600**

The following further information is available:
(1)Closing Stock on 31st March, 2018 is Rs.87,000.

(2) Outstanding Wages Rs.2,500.
(3)Insurance is prepaid to the extent of Rs.650.
(4) Depreciate Plant and Machinery @10% p.a. and Land and Building@5% p.a.
(5) Write off Rs.1,750 for Bad debts. Provide 5% for Doubtful Debts on debtors.

(Ans.: G/P – Rs. 1,27,250, N/P Rs. – 14,150, Balance sheet total- 4,18,000.)

Illustration 3:

From the following particulars presented by Mazumdar Bros, prepare a Manufacturing Account for the year ended 31-03-2012.

Particulars	Rs.	Particulars	Rs.
Opening Stock :		Carriage Inward	1,000
- Raw Materials	3,000	Hire of Special Plant	2,000
- Work-in-Progress	4,000	Factory Rent	4,000
- Finished Goods	8,000	Repairs to Plant	2,000
Closing Stock :		Repairs to Factory	1,000
- Raw Materials	1,000	Supervisor's Salary	8,000
- Work-in-Progress	5,000	Factory Wages	1,000
- Finished Goods	4,000	Royalties on production	2,000
Purchase of Raw Materials	40,000	Works Manager's Salary	6,000
Wages of workers	20,000	Salary of Works Staff	3,000
Light, Gas etc. (Factory)	2,000		

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Unit-10

DEPARTMENTAL ACCOUNTS I

UNIT STRUCTURE

10.0 OBJECTIVES

After studying the unit students will be able to:

- Distinguish between Branch and Departmental Store.
- Know the purpose of Departmental Store.
- Understand the accounting procedure of Departmental Store.
- Explain the Basis of allocation of common expenditure and common income among different departments
- Understand the accounting procedure for Inter-Departmental Transfers of Goods.
- Calculate the value of closing stock and preparation of Stock Reserve A/c.
- Prepare Departmental Final Accounts.

10.1 INTRODUCTION

A large business concern may be divided into different segments; each segment is known as department. All departments operate under one roof. The division into various departments may be on basis of functions, processes or products or may be any combination of above as it may be suitable to the organisation. Management is usually interested in finding out the working results of each department to ascertain their relative efficiencies. Departmental Accounts are of great help to the management as information for taking various types of decisions. Management can compare result of one department with other departments.

Company may intra or inters departmental comparison, may be again that of same departments in the previous periods. This will help them to formulae sound policy of expansion/diversion/merger even if required, may be closing down a particular unprofitable departments.

10.2 BRANCH ACCOUNTS AND DEPARTMENTAL ACCOUNTS

A business may be expanded having number of branches as well as having number of departments under one roof. A large business may have various departmental stores at different places. e.g. Big Bazaar has departmental stores at various places, like in Mumbai, Pune, Navi Mumbai, Surat, and so on .

Distinguish between Branch & Departmental Store

No.	Branch	Departmental Store
1.	Located at different places, may be in different countries.	Departmental stores are always located under one roof.
2.	Normally branches are opened by manufacturer to avoid middleman’s chain.	Normally concerns purchase different types of goods directly from manufactures, sales to end users.
3.	Branches sale one type of goods manufactured by them.	Departmental Stores purchase goods from different manufactures & sales under one roof.
4.	Branches may be domestic [in same country] &/ or foreign branches.	Departments are located at one place, under one roof only.
5.	Since the branches located at different places, the problem of allocation of common expanses does not arises.	Common expenses are always allocated in some ratio.

6.	Accounting treatments depends upon types of branches, i.e. dependent branch or impendent branch.	The departments are located under one roof, all accounting records are maintained by head office.
7.	Reconciliation may be required for cash & goods in transit.	Question of such reconciliation doesn't arise, as all departments are at same place.
8.	In case of foreign branch, question of conversion of foreign currency in Head Office currency arises.	This problem does not arise in Departmental Accounting.

10.3 DEPARTMENTAL ACCOUNTING

10.3.1 Purpose:

In Departmental Accounting, if only a single Profit & Loss Account is prepared for the entire business, then profit / loss of each department cannot be ascertained. In Departmental Accounting, each department is treated as separate entity for the purpose of recording and reporting. In same premises, a separate Account Department records all transactions of all departments. Books of Accounts are so designed, so it is possible to prepare separate Trading A/c, Profit & Loss A/c for each department. The working of one department can be compared with another department. It facilities infra / inter comparison for same period with that of same department in the previous periods. This helps management to formulate sound policy for expansion, merger of departments, closing of loss making departments. Preparation of separate accounts serves the following purposes :

a) Gross Profit or Loss, Net Profit or Loss of each department can be ascertained.
b) Running cost of each department can be calculated.
c) Corrective timely measures for inefficient department can be taken.
d) It helps to fix branch manager's commission on basis on profit.
e) Departmental transfers can be recorded at transfer price / selling price.
f) Stock reserve, unrealized profit on goods transferred can be calculated.
g) Assist the management for controlling the business more efficiently, intelligently.

h) Wastage of material, money, human recourses can easily detect.
i) A separate stock records can be maintained department wise for controlling stock.
j) Department managers responsibly can be fixed and called for various reporting.
k) Department budget can be prepared.

10.3.2 Books of Accounts:

For preparation of Profit & Loss A/c of each department, it is necessary that separate sets of Books of Accounts should be maintained for each department. Instead of that Accounts Department maintains various Subsidiary Books in columnar form, it will also be necessary to devise a basis for allocation of common expenses among the departments. Normally, each department records its sales & maintains stock records. Daily cash collection in department is transferred to main cashier or deposited in Bank. Stocks are physically verified periodically.

10.3.3 Divisions of Subsidiary Books:

Subsidiary Registers are designed in such a way to record transactions of each department in same register; separate columns are made for each department in same subsidiary book, such as purchase Journal, Sales Journal, Return Inwards, Return Outwards, etc.

Specimen of Departmental ------- Journal
[Purchases, Purchases Returns, Sales, Sales Returns etc.]

Date	Serial No.	Name	L.F.	Total Rs	Depts. I	Dept. II	Dept. III	Dept. IV	Ref.
	Total Rs			xxxxx	x	x	x	x	

Direct Expenses / Sales etc. can be recovered in department, e.g. cash sales; cash is to be deposited with main cashier on same day.

10.4 BASIS OF ALLOCATION

Allocation of common expenditure among different departments:

Expenses incurred specially for each department are recorded separately and charged directly thereto, e.g. Salaries paid to staff working in the particular dept.

10.4.1 Common expenses:

The benefits of which is shared by all the departments and which are capable of precise allocation are distributed among the department concerned on equitable basis considered suitable in the circumstances of the case.

10.4.2 Common indirect expenses:

Common indirect expenses are the expenses which cannot be directly identified with particular departments, however departments are benefited. Such expenses which are not capable of accurate measurement are dealt with as shown in the chart.

The following table gives suitable basis for allocation of such expenses.

	Item of Expenses / Income	Basis of Allocation
1.	Rent and Rate	Floor space occupied by each department
2.	Lighting	On the basis of actual consumption, if actual is not available on the number of electric points or Power of Lamps used or area covered
3.	Advertisement	Sales
4.	Sales Commission	Sales
5.	Discount Allowed to Customers	Sales
6.	Bad debts	Actual of each department or on sales
7.	Electric Power for Machines	On the H.P. of equipments or number of machines in each department and the number of working hours.
8.	Works Manager's Salary	Time spent by him for each department
9.	Depreciation	Value of assets employed by each department
10.	Air-conditioning	Space occupied
11.	Insurance :	
	i) Stock	Value of stocks held in each of the departments

	ii) Buildings	Floor space occupied or capital value of the assets insured
12.	Staff Welfare	No. of employees in each of the department
13.	Printing and Stationery	Turnover of the departments
14.	Freight	
	a) Inward	Net purchases of each of the department
	b) Outward	Net sales of each of the department
15.	Repairs to Building	On the basis of space occupied by each department
16.	Heating	On the basis of points, lamps used or area
17.	Discount Earned	Sales ratio
18.	Commission Received	Sales ratio
19.	Discount Received	On the basis of purchases
20.	Delivery Van Expenses	On the basis of sales.
21.	Traveling Expenses	On the basis of sales.
22.	Administration Expenses	On the basis of time devoted
23.	Postage, Telephone, Printing and Stationery	Sales following the rule “What the traffic will bear”.
24.	Workmen’s Compensation	Wages incurred by each department.
25.	PF and ESI Contribution	Wages
26.	Canteen Subsidy, Medical Benefits	Number of workers
27.	Store Expenses, Expenses On Purchase, Direct Expenses On Purchases, Octroi Expenses	Material consumed or Net Purchases of each department
28.	All Production, Factory Expenses	Either on cost of material consumed or wages of each dept.
29.	Selling and Distribution Exp.	Sales ratio or k.g. or units sold by each dept.

10.4.3 Non Allocable Expenses / Uncommon Expenses / Gains

- The other common expenses which can't be identified or allocable on suitable basis.
- The financial or accounting expenses or losses / income e.g. interest/ loss on sale of investment.
- Examples - Interest on loans and advances, legal fees, loss on sale of any asset, income tax, audit fees, loss by fire.
- All these expenses should be debited to General Profit and Loss Account.
- Normal income may be as a whole, which can't be allocated to particular department. However, some income on basis of purchases (discount earned) or sales e.g. discount allowed, commission received etc.

CHECK YOUR PROGRESS

1. Define the terms:
   a. Department
   b. Branch
   c. Non Allocable Expenses
   d. Common Expenses
   e. Common Indirect Expenses

2. Give the examples of uncommon expenses.
3. Give suitable basis for allocation of the following expenses:
   a. Factory Expenses
   b. Canteen Subsidy
   c. Delivery Van Expenses
   d. Commission Received
   e. Discount Received
   f. Works Manager's Salary
   g. Air Conditioning
   h. Bad Debts

10.5 INTER DEPARTMENT TRANSFERS OF GOODS / SERVICES

Usually department supply goods / services to one another. These transactions should be separately recorded and changed to the department benefiting these by & credited to the department providing it. Total of such benefits should be disclosed in the Departmental Trading, Profit & Loss A/c, to distinguish them from other items of income or expenses.

The departmental transfer may be:

1) At cost
2) At cost plus profit (loading) (transfer value)
3) At selling price (transfer value = sale value)

10.5.1 Transfer at cost:

Usually goods are transferred at cost on the assumption that departmental stores as a whole one entity profit / loss earned or suffered only when goods are sold to outsides / external parties.

10.5.2 Transfer at cost plus profit:

Goods may be transferred at cost plus profit [transfer value / loaded price] so that both departments are in a position to ascertain profit / loss accurately.

10.5.3 Transfer at selling price:

In such case departmental transfers are recorded at usual selling price. Each department records such transfers as its goods are sold to outsiders. In such a case, each department is in position to account for profit or losses accurately, due to this, profit or loss of one department would not be affected due to efficiencies or inefficiency of another department.

10.5.4 Accounting for transfer of goods or services:

Receiving department should be debited at transfer price and department transferring goods / services should be credited at same value. [Transfer Price / Selling Price].

10.6 CLOSING STOCK AT TRANSFER VALUE

When one department transfers goods, at transfer price [may be at cost plus profit or selling price], is included profit charged by another department. In case, at the end of accounting year, part of goods remains unsold i.e. closing stock valued at cost to receiving department which includes profit charged by transferring department. Profits are always accounted only when realized. Therefore, value of stock needs to be adjusted by creating stock reserve.

10.7 STOCK RESERVE

The unrealized profit included in closing stock of receiving department is eliminated by creating stock reserve. Stock reserve is calculated as under:

Stock Reserve =

$$\text{Transferred value of closing stock} \times \frac{\text{Profit included in transfer price}}{\text{Transfer price}}$$

Entry for unrealized profit, is passed by concern in the General Profit & Loss A/c as under :

General Profit & Loss A/C Dr.
To Stock Reserve A/C

The amount of stock reserve is deducted from value of stock in the Balance Sheet.

In the beginning of the next year, entry passed for stock reserve is reversed.

Stock Reserve A/C Dr.
To General Profit & Loss A/C

E.g. Goods costing Rs.20,000 transferred by A department to Z department at Rs.24,000. Half of goods remained unsold at the end of the year.

For recording transfer:

i)	Department Z's Trading A/c		Dr. 24,000	
	To Department A's Trading A/c			24,000
ii)	Stock of Department Z			
	Stock A/c	Dr.	12,000	
	To Department Z's Trading A/c			12,000
iii)	General Profit & Loss A/c	Dr.	2,000	
	To Stock Reserve A/c			2,000

10.8 DEPARTMENTAL FINAL ACCOUNTS

The Departmental Final Accounts contain:

- Departmental Trading A/c
- Departmental Profit & Loss A/c
- General Profit & Loss A/c

Departmental Profit & Loss A/c is prepared in columnar form at the end of the year. The respective columns indicate the gross profit & net profit or net loss from each department as well as total.

The net profit or loss of the respective department will be carried to General Profit & Loss A/c where in expenses and incomes, which are not allocated to the various departments, are debited or credited. The balance of this account is transferred to Balance Sheet. However, the Balance Sheet is in usual form and not in the columnar form.

10.9 PROFORMA OF DEPARTMENTAL ACCOUNTS

Departmental Trading A/c

For the year ended

Particulars	Basis	Dept. A	Dept. B	Total	Particulars	Basis	Dept. A	Dept. B	Total
To Opening Stock	A	xxx	xxx	xxxx	By Sales	A	xxx	xxx	xxxx
To Purchase	A	xxx	xxx	xxxx	Less : Returns		xxx	xxx	xxxx
Less: Purchase Returns		xxx	xxx	xxxx	By Transferred to Dept. A	A	xxx	xxx	xxxx
To Received from Dept. B	A	xxx	xxx	xxxx	By Cost of Goods Lost	A	xxx	xxx	xxxx
To Purchase Expenses	A	xxx	xxx	xxxx	By Cost of Goods Damaged	A	xxx	xxx	xxxx
To Direct Wages	A	xxx	xxx	xxxx	By Closing Stocks	A	xxx	xxx	xxxx
To Lighting, Power		xxx	xxx	xxxx					
To Repairs Workshop Cost		xxx	xxx	xxxx					
To Stores Dept. Cost		xxx	xxx	xxxx					
To Other Factory Expenses		xxx	xxx	xxxx					
To Gross Profits c/d		xxx	xxx	xxxx	By Gross loss c/d		xxx	xxx	xxxx
Total	Rs	xxx	xxx	xxxx	Total	Rs	xxx	xxx	xxxx

Profit & Loss A/c

For the year ended

Particulars	Basis	Dept. A	Dept. B	Total	Particulars	Basis	Dept. A	Dept. B	Total
To Gross Loss b/d		xxx	xxx	xxxx	By Gross Profit b/d		xxx	xxx	xxxx
To Salesman's Salaries Commission		xxx	xxx	xxxx	By Discount Received		xxx	xxx	xxxx
To Traveling Expenses		xxx	xxx	xxxx					
To Carriage Outwards		xxx	xxx	xxxx					
To Ware Housing Charges		xxx	xxx	xxxx					
To Packing Expenses		xxx	xxx	xxxx					
To Advertising		xxx	xxx	xxxx					
To Other Selling Expenses		xxx	xxx	xxxx					
To Other Distribution Expenses		xxx	xxx	xxxx					
To Bad Debts / Discount		xxx	xxx	xxxx					
To Rent, Taxes Repairs		xxx	xxx	xxxx					
To Staff Welfare		xxx	xxx	xxxx					
To Canteen Expenses		xxx	xxx	xxxx					
To Contribution to PF, ESIS		xxx	xxx	xxxx					
To Insurance		xxx	xxx	xxxx					

- Assets		xxx	xxx	xxxx					
- Stocks		xxx	xxx	xxxx					
- Workmen		xxx	xxx	xxxx					
To Officer Salaries		xxx	xxx	xxxx					
To Postage Telephones		xxx	xxx	xxxx					
To Printing and Stationary		xxx	xxx	xxxx					
To Other Admin / Office Expenses		xxx	xxx	xxxx					
To Depreciation on Assets		xxx	xxx	xxxx					
To Net Profit Ltd.		xxx	xxx	xxxx	By Net Loss Ltd.		xxx	xxx	xxxx
To Gen. Profit & Loss A/C		xxx	xxx	xxxx	By Gen. Profit & Loss A/C		xxx	xxx	xxxx
Total	Rs	xxx	xxx	xxxx	Total		xxx	xxx	xxxx

General Profit and Loss Account

For the year ended

Particulars	Amounts Rs.	Particulars	Amounts Rs.
To Net Loss from Depts.		By Net Profits tfd. From Deptts.	
- Department A	Xxxx	- Department A	Xxxx
- Department B	Xxxx	- Department B	Xxxx
To Stock Reserve (Opening Stock)	Xxxx	By Interest on Loans Given	Xxxx
- Department A	Xxxx	By Dividends on Shares Received	Xxxx
- Department B	Xxxx	By Profits on Sale of Assets	Xxxx

To General Admin. Expenses	Xxxx	By Stock Reserve (on Closing Stock)	
To Audit / Legal Fees	Xxxx	- Department A	Xxxx \\1h00
To Interest and Bank Charges Paid	Xxxx	- Department B	Xxxx
To Depreciation (General Assets)	Xxxx		
To Loss on Goods Destroyed / Damaged	Xxxx		
To Loss on Sale of Fixed Assets	Xxxx		
To Income Tax	Xxxx		
To Transfer to Reserves	Xxxx		
To Net Profit tfd. to Capital	Xxxx	But Net Loss tfd. to Capital	xxxx
Total	xxxx	Total	xxxx

Balance Sheet

As on

Liabilities		Amounts Rs.	Assets	Amounts Rs.
Capital :	x		Buildings	x
Add : Net Profit	x		Furniture	x
	x		Closing Stock	x
Less: Drawings	x	x	Less Profit on Inter Departmental Goods	
Loans		x		x
Sundry Creditors		x	Sundry Debtors	x
Bills Payable		x	Bill Receivable	x
Outstanding Expenses		x	Bank Balance	x
			Cash on hand	x
Total		xxx	Total	xxx

10.10 EXERCISE

A) Theory Questions

1. What is meant by Departmental Accounts?
2. What are the advantages of Departmental Accounts?
3. What difficulties are faced in the preparation of Departmental Profit & Loss Account?
4. What are the different methods of allocating expenses among the departments?

B) Objective Questions

a. Test your understanding by selecting the most appropriate alternative:

1. Repairs and maintenance charges relating to Plant & Machinery are apportioned over different departments according to :
   a) The number of machines in each department.
   b) Book value of machines.
   c) Area occupied by each machine.

2. Lighting charges are apportioned over the departments on the basis of :
   a) Number of light points.
   b) Cost of machines.
   c) Sales.

3. Items of expenses not connected with any department are :
   a) Charged to departments on the basis of total sales.
   b) Charged to the General Profit & Loss Account.
   c) Charged to departments on the basis of fixed assets employed.

4. Cost of electric power should be apportioned over different departments according to :
   a) H.P. of motors
   b) No. of light points.
   c) Cost of machines.

5. Supervision charges should be apportioned over the different departments on the basis of :
   a) Time devoted for supervision.
   b) Area occupied by each department.
   c) Sales of each department.

6. Which of the following is divided in the ratio of number of employees?
   a) Rent b) Repairs
   c) Wages d) Carriage

7. Following entry is passed in journal means :
   Stock Reverse A/c Dr.
   To General Profit & Loss A/c.
   a) Unrealized profit on closing stock
   b) Loss on sale of goods by department.
   c) Unrealized profit on opening stock.
   d) Profit on sale of goods.

8. Which of the following allocated in the sales ratio :
   a) Discount allowed b) Advertisement
   c) Commission d) All the above

9. Credit balance in Departmental Trading A/c means
   a) Gross Loss b) Gross Profit
   c) Net Profit d) Non of the above

10. Which of the following not debited to Department Trading A/c.
   a) Loss due to fire b) Purchases
   c) Carriage d) Opening Stock

11. Which of the following not debited to department Trading, Profit & Loss A/c.
   a) Abnormal gain b) Abnormal loss
   c) Income tax d) All of the above

12. Canteen subsidy is allocated on the basis of each department.
   a) Sales b) Purchases
   c) No. of workers d) Value of assets in canteen

13. Air - conditioning is allocated on the basis of each department.
   a) Purchases b) Sales
   c) Area occupied d) No. of employees

14. Postage is allocated on the basis of each department.
   a) Purchases b) No. of employees
   c) Value of stock d) Sales

15. Which of the following debited to General Profit and Loss A/c.
    a) Wages b) Closing stock reserve
    c) Opening stock reserve d) Net loss

16. Debit balance in General Profit & Loss A/c means :
    a) Net loss b) Net profit
    c) Departments profit transferred d) All of the above

Answer: 1-b, 2-a, 3-b, 4-a, 5-a, 6 - C, 7 - C, 8 - d, 9 - b, 10 - a, 11 - d, 12 - c, 13 - c, 14 - d, 15 - b, 16-a.

b) State whether True or False

1) Carriage outwards debited to Departmental Trading A/c.
2) Distribution expenses are allocated to Department on the basis of sales of each department.
3) Audit fees is credited to General Profit & Loss A/c.
4) Management expenses debited to al& Loss A/c.
5) Insurance of stock is allocated in the ratio of value of stock in each department.
6) Net loss appears on the debit side of Departmental Profit & Loss A/c.
7) Bad debts recovery is debited to General Profit And Loss A/c.
8) Return inwards deducted from purchases of each department.
9) Rent of building is allocated on the basis of sales of each department.
10) All expenses are allocated on the basis of sales of each department.
11) Goods transferred by department must be recorded at cost.
12) Stock reserve is reduced from stock in the Balance Sheet.
13) Departmental gross profit is credited to Departmental Profit & Loss A/c.
14) Depreciation is to be apportioned on the basis of value of assets in each department.
15) If purchases & sales are double in Department A as compared to Department B, gross profit is also double in Department A as compared to Department B.
16) Cost of insurance of stock is allocated in the ratio of employees employed in each department.
17) Each department is treated as separate entity for the purpose of preparing Trading, Profit & Loss A/c.

18) Loss due to fire in department is debited to general profit & loss a/c.

19) Legal expenses incurred by a department is debited to General Profit & Loss A/c.

Answer:

False: 1, 3, 6, 7, 8, 9, 10, 11, 15, 16
True: 2, 4, 5, 12, 13, 14, 15, 17, 18, 19

c) Fill in the blanks:

1) Income Tax paid is debited to --------------- A/c.

2) Closing stock reserve is credited to --------------- A/c.

3) Power is allocated on the basis of ------------ of each department.

4) Depreciation is allocated on the basis of ------------ of each department.

5) Legal charges should be debited to -------------- A/c.

6) Goods transferred by A Department to B Department credited to -------------- Department Trading A/c.

7) Depreciation on delivery van should be allocated on basis of -------- of each department.

8) Goods transferred by Z department to K Ltd. should be credited to -------------- Department Trading A/c.

9) Stock Reserve is not required if goods are transferred at ------.

10) Income from investment should be credited to --------------- a/c.

11) Contribution to P.F. is allocated on the basis of ---------- of each department.

12) Profit of a department is credited to ------------- A/c.

13) For transferring opening stock reserve ------------- A/c is credited.

Answer:

1) Drawing, 2) Stock Reserve, 3) No. of electric points, 4) value of assets, 5) General Profit & Loss A/c, 6) A dept., 7) Sales, 8) Z dept., 9) cost, 10) General Profit & Loss A/c, 11) Wages or Salaries, 12) General Profit & Loss, 13) Stock Reserve.

d) Match the following:

I)

Column A			Column B
	Common Expenses		Basis of Allocation
A)	Rent	1)	No. of employees in each department
B)	Cost of stores	2)	Value of plant in each department
C)	Depreciation on plant	3)	Floor area of each department
D)	Labour welfare	4)	Purchase of each department
		5)	Material consumed by each department

Answer: I)A - 3, B - 5, C - 2, D - 1

II)

Column A			Column B
1)	Stock Reserve	a)	General Profit & Loss A/c
2)	Loss due to fire	b)	Debit to A Dept. Trading A/c
3)	Transfer of goods from A Dept. to K Dept.	c)	Debited to Dept. Trading A/c
4)	Selling expenses	d)	Sales of each department
		e)	Deduct from stock in Balance Sheet
		f)	Debit to K Dept. Trading A/c

Answer: II) **1 - e, 2 - a, 3 - e, 4 - d**

III)

Column A			Column B
A)	Insurance of machinery	1)	Wages
B)	Power	2)	On the basis of credit sales
C)	E.S.I. contribution	3)	General Profit & Loss A/c
D)	Discount received	4)	W.D.V. of machinery
E)	Audit fees	5)	H.P. of machinery
		6)	On the basis of credit purchases

Answer: A – 4, B – 5, C – 1, D – 6, E - 3

IV)

Column A			Column B
	Common Expenses		Basis of Allocation
i)	Repairs to Building	1)	Space occupied by each Department
ii)	Bad debts	2)	Purchases of each Department
iii)	Carriage inwards	3)	Sales of each Department
iv)	Medical benefits	4)	Stock of each Department
		5)	Sales Return of each department
		6)	Purchases of each dept.
		7)	No. of workers

Answer: I - 1, ii - 3, iii - 2, iv - 7

V)

Column A			Column B
	Common Expenses		Basis of Allocation
1)	Manager salaries	a)	On basis of sales of each dept.
2)	Building Insurance	b)	Actual of each dept.
3)	Traveling expenses	c)	On the basis of time devoted
4)	Discount received	d)	Floor space occupied
		e)	On basis of purchases of each dept.

Answer: 1 - c, 2 - d, 3 - a, 4 - e

VI)

Column A			Column B
	Common Expenses		Basis of Allocation
1)	Depreciation of Delivery Van	a)	On the basis of points in each dept.
2)	Lighting	b)	On the basis of purchases of each dept.
3)	Works manager's salaries	c)	On the basis of sales of each dept.
4)	Purchase manager's salary	d)	Value of stock purchased by each dept.
		e)	Time spent by him for each dept.

Answers: 1 -c, 2 - a, 3 - e, 4- b

❖❖❖❖

Unit-11

DEPARTMENTAL ACCOUNTS II

UNIT STRUCTURE

11.0 OBJECTIVES

After studying the unit students will be able to prepare the Departmental final accounts

11.1 SOLVED PROBLEMS

Illustration 1

Mr. Ramkrushna is the proprietor of Venus; a shop selling books and toys for the purpose of his accounts. He wishes the business to be divided into two departments: Department R: Books, Department V: Toys.

The following balances have been extracted from his books as at 31st March 2018.

Name of the Account	Amount (Rs)
Sales : Department R	3,00,000
: Department V	2,00,000
Stock : Department R	5,000
: Department V	4,000
Purchases : Department R	2,36,000
: Department V	1,64,000
Salesmen : Department R	20,000
: Department V	15,000
Book delivery wages	3,000
General office salaries	15,000

Rates	2,600
Fire insurance - building	1,000
Heating & lighting	2,400
Repairs to premises	500
Telephone	500
Cleaning	600
Audit Fees	2,400
General office expenses	1,200
Discount Allowed	5,000
Discount Received	2,000
Stock (closing) Department R	6,000
Department V	3,000

The floor area occupied Department R one fifth Department V four - fifth. Prepare Trading and Profit and Loss Account for the year ended 31st March 2018 apportioning the overhead expenses, where necessary to show the Departmental Profit or Loss. Show clearly the basis on which the expenses are apportioned.

Solutions : 1

Venus Trading
Trading and Profit and Loss Account
For the year ended 31st March 2018

Particulars	Dept. R (Rs)	Dept. V (Rs)	Particulars	Dept. R (Rs)	Dept. V (Rs)
To Opening stock	5,000	4,000	By Sales	3,00,000	2,00,000
To Purchases	2,36,000	1,64,000	By Closing Stock	6,000	3,000
To Gross Profit c/d.	65,000	35,000			
	3,06,000	**2,03,000**		**3,06,000**	**2,03,000**
To Salaries	10,000	15,000	By Gross profit b/d	65,000	35,000
To Delivery Wages	3,000	--	By Dis. Received	1,180	820
To Gen Office Salaries	9,000	6,000			
To Rates	520	2,080			
To Fire Insurance	200	800			

To Lighting & Heating	480	1,920			
To Repairs to Premises	100	400			
To Telephone	300	200			
To Cleaning	120	480			
To Audit Fees	1,440	960			
To General Office Exp.	720	480			
To Dis. Allow	3,000	2,000			
To Net profit	37,300	5,500			
	66,180	**35,820**		**66,180**	**35,820**

Working Notes:

1) Sales ratio: 3: 2
2) Purchase ratio: 59: 41
3) Floor space ratio: 1: 4

Illustration No. 2

From the following particulars of Kirti Enginer's prepare a departmental Trading and Profit and loss account for their two departments viz. Cars Department and Dolls Department for the year ended 31st March 2018:

Particulars	Cars	Dolls
Opening stock	50,000	1,50,000
Wages	30,000	60,000
Sales	9,00,000	1,80,000
Closing stock	1,20,000	60,000

Other Information :

Raw materials consumed (Cars)	3,60,000
Stores consumed	90,000
Advertising	15,000
Packing expenses (Dolls)	6,000
Office expenses	48,000
Depreciation on factory equipment	32,000
Building	16,000

Additional Information :

a) Dolls making does not require any equipment

b) Only 1/8 of the total area of building is occupied by dolls Department.

c) Office expenses are to be allocated in ratio of 5:1.

d) Value of materials used by Dolls department is Rs. 20,000 out raw materials consumed.

Kirti Engineers
Trading and Profit and Loss Account
For the year ended 31st March 2018

Particulars	Cars (Rs.)	Dolls (Rs.)	Particulars	Cars (Rs.)	Dolls (Rs.)
To Opening Stock	1,50,000	50,000	By Sales	9,00,000	1,80,000
To Raw Material	3,40,000	20,000	By Closing Stock	1,20,000	60,000
To Stores	85,000	5,000			
To Wages	60,000	30,000			
To Gross Profit c/d	3,85,000	1,35,000			
	10,20,000	**2,40,000**		**10,20,000**	**2,40,000**
To Packing Exp.	--	6,000	By Gross Profit b/d	3,85,000	1,35,000
To Advertisement	12,500	2,500			
To Office Exp.	40,000	8,000			
To Dep. On Factory Equipment	32,000	--			
Building	14,000	2,000			
To Net Profit	2,86,500	1,16,500			
	3,85,000	**1,35,000**		**3,85,000**	**1,35,000**

Notes :

1) Stores are allocated in proportion of raw materials consumed it. 17:1.

2) Sales Ration 5:1.

Illustration 3: (Transfer of goods at cost)

The following figures are extracted from the books of M/s Krishna. For the year ended 31st December 2017.

Particulars	Department		
	P	Q	R
	Rs	Rs	Rs
Purchases	4,40,000	5,20,000	1,10,000
Sales	6,10,000	9,25,000	3,20,000
Return Inward	10,000	25,000	20,000
Return Outward	40,000	20,000	10,000
Wages	8,000	5,000	7,000
Stock on 01.01.2017	45,000	35,000	40,000
Stock on 31.12.2017	65,000	20,000	10,000

Other Information's :

1. Goods transferred from P to Q Rs.10,000 and to R Rs.8,000.
2. Goods transferred from R to P Rs.5,000 and to Q Rs.6,000.
3. Goods transferred from Q to P Rs.6,500 and to R Rs.5,600.
4. Telephone charges Rs.15,800 to be apportioned in the ratio of 3:1:1 among departments P, Q and R respectively.
5. Rent Rs.24,000 to be divided as ¼, 2/4 and ¼ among Departments P, Q and R respectively.
6. Other Expenses
   Discount allowed Rs.18,000
   Bad debts Rs.15,000
   Income tax Rs.58,000
   Legal expenses Rs.24,000
   Insurance of goods Rs.8,600

You should allocate aforesaid expenses as you deem best indicating the basis of allocation. All working should form a part of your answer.

Prepare Departmental Trading and Profit and Loss account. In columnar form and General Profit and Loss accountant for the year ended 31st December, 2017.

M/s Krishna
Departmental Trading and Profit & Loss Account
For the year ended 31.12.2017

Particulars	Departments			Particulars	Departments		
	P (Rs.)	Q (Rs.)	R (Rs.)		P (Rs.)	Q (Rs.)	R (Rs.)
To Opening Stock	45,000	35,000	40,000	By Sales (Net)	6,00,000	9,00,000	3,00,000
To Purchases (Net)	4,00,000	5,00,000	1,00,000	By Closing stock	65,000	20,000	10,000
To Wages	8,000	5,000	7,000	By Transfer	18,000	--	--
To Transfer	--	10,000	8,000	By Transfer	--	--	11,000
To Transfer	5,000	6,000	--	By Transfer	--	12,100	--
To Transfer	6,500	--	5,600				
To Gross Profit c/d	2,18,500	3,76,100	1,60,400				
	6,83,000	**9,32,100**	**3,21,000**		**6,83,000**	**9,32,100**	**3,21,000**
To Telephone	9,480	3,160	3,160	By Gross Profit b/d	2,18,500	3,76,100	1,60,400
To Rent	6,000	12,000	6,000				
To Discount	6,000	9,000	3,000				
To Bad debts	5,000	7,500	2,500				
To Insurance	3,440	4,300	860				
To Net Profit	1,88,580	3,40,140	1,44,880				
	2,18,500	**3,76,100**	**1,60,400**		**2,18,500**	**3,76,100**	**1,60,400**

General P & L Account
For the year ended 31.12.2017

Particulars	Rs.	Particulars	Rs.
To Legal Expenses	24,000	By Net Profit b/d	
To Income Tax	58,000	P	1,88,580
To Net Profit c/d	5,91,600	Q	3,40,140
To B/S	--	R	1,44,880
	6,73,600		**6,73,600**

Notes :

1. Purchases and Sales are recorded at Net.
2. Telephone charges are apportioned in the ratio 3:1:1.

3. Discount allowed and Bad debts are apportioned in the ratio of Sales 2:3:1.
4. Insurance on goods is assumed to be on purchases & hence allocated in the ratio of purchases 4:5:1.

Alliteratively, it may be assumed to be on stock and allocated in the ratio of closing stock 65:20:10.

Illustration No. 4 (Inter department transfer at selling Price)

Following are the particulars of Dilip Kumar for the year ended 31st March 2018.

Particulars	Dept. A	Dept. B
	Rs.	Rs.
Opening Stock	20,000	14,000
Sales	1,44,000	1,88,000
Purchases	1,40,000	1,80,000
Transfer to other Department	16,000	12,000
Transfer to other Department	12,000	16,000

1. Closing stock of 'B' department is Rs.30,000. In which goods worth Rs.8,000 are such which were transferred by A department.
2. Closing Stock of A department is Rs.32,000 in which goods worth Rs.12,000 are such, which were transferred by B department.
3. Opening Stock of A department includes goods of Rs.1,600 which were transferred by B department. Gross Profit of B department in the last year was 10%.
4. Opening stock of B department includes goods of Rs.3,200 which was transferred by A department. Gross Profit of A department in the last year was 25%.

Prepare Department Trading and Profit & Loss Account and General Profit & Loss Account of Dilip Kumar from the above particulars.

Solution :

Dilip Kumar
Departmental Trading and Profit & Loss Account
For the year ended 31.03.2018

Particulars	Dept. P	Dept. Q	Particulars	Dept. P	Dept. Q
	Rs.	**Rs.**		**Rs.**	**Rs.**
To Opening Stock	20,000	14,000	By Sales	1,44,000	1,88,000
To Purchase	1,40,000	1,80,000	By Transfer	16,000	12,000
To Transfer	12,000	16,000	By Closing Stock	32,000	30,000
To Gross Profit b/d	20,000	20,000			
	1,92,000	**2,30,000**		**1,92,000**	**2,30,000**

General Profit & Loss Account
For the year ended 31.03.2018

Particulars	Rs.	Particulars	Rs.
To Stock Reserve		By Gross Profit b/d	
Department (A) W.N.1	1,040	Department A	20,000
Department (B) W.N.2	200	Department B	20,000
To Net Profit c/d	38,760		
	40,000		**40,000**

Working Note No. (1)

Total Sales of Dept. B = (1,88,000 + 12,000) = 2,00,000

Gross Profit Ratio of Dept. B = $\frac{20,000}{2,00,000} \times \frac{100}{1} = 10\%$

Stock Reserve of Department A is $\frac{12,000}{100} \times \frac{10}{1} = 1200$

Stock Reserve of Department A on opening stock is

Opening stock of Department A includes goods of Rs. 1,600

From Department B

Gross profit of last year is 10%

$\therefore$ Stock reserve on opening stock of department A = $\frac{16,00}{100} \times \frac{10}{1} = 160$

Net Stock Reserve = 1200 - 160 = 1040

Working Note No. (2)

Total Sales of department A (Rs. 1,44,000 + 16, 000 = 1,60,000

Gross profit Ratio of Dept A $\frac{20,000}{1,60,000} \times \frac{100}{1} = 12.50\%$

Stock Reserve of department A

On closing stock $\frac{8,000 \times 12.5}{100} = 1000$

On opening stock $\frac{3,200}{100} \times \frac{25}{1} = 800$

Net stock Reserve = 1,000 - 800 = 200

Illustration 5:

Ram Krishna Motors has three departments i.e. Jeep, Car and Servicing. The Department Jeep and Department Car sell spare parts and occupy a showroom. The servicing department uses a garage.

From the following particulars, prepare

a) Departmental Trading, Profit & Loss A/c

b) General Profit and Loss Account

Particulars	**Department**		
	Jeep Rs.	**Car Rs.**	**Servicing Rs.**
Opening Stock	70,000	25,000	--
Purchases	1,75,000	35,000	--
Sales	3,00,000	1,00,000	50,000
Wages	10,000	5,000	7,000
Closing Stock	**40,000**	8,000	**--**
Discount allowed	**2,000**	3,000	**--**

Other Expenses :	**Rs.**
Show room Expenses	11,000
Lighting Expenses	6,000
Transfer from Jeep to Servicing at cost	18,000
Transfer from Car to Servicing at cost	5,000
Directors fees	2,000
Bad debts	1,800
Income from Investment	1,500
Depreciation on Garage Equipment	4,000
Depreciation on showroom Furniture	2,000

Additional Information:

1. Show-room rent for one month is out-standing Rs. 1,000.
2. The departments using show room share the space and furniture equally.
3. 50% of light bill is to be charged to servicing department and the balance equally to other departments.
4. Allocate the above expenses as you deem best indicating the base of allocation.

Solution :

Ram Krishna Motors
Departmental Trading and Profit & Loss A/c
For the year ended

Particulars	Departments			Particulars	Departments		
	P (Rs.)	Q (Rs.)	R (Rs.)		P (Rs.)	Q (Rs.)	R (Rs.)
To opening stock	70,000	25,000	--	By Sales (Net)	3,00,000	1,00,000	50,000
To Purchases	1,75,000	35,000	--	By Transfer	18,000	5,000	--
To Wages	10,000	5,000	7,000	By Stock	40,000	8,000	---
To Transfer	--	--	23,000				
To Gross Profit c/d	1,03,000	48,000	20,000				
	3,58,000	**1,13,000**	**50,000**		**3,58,000**	**1,13,000**	**50,000**
To Showroom	5,500	5,500	--	By Gross Profit b/d	1,03,000	48,000	20,000
To lighting	1,500	1,500	3,000				
To Bad-debts	1,200	400	200				
To Deep on G.	--	--	4,000				
To Dep on Fur	1,000	1,000	--				
To o/s. Rent	500	500	--				
To Discount	2,000	3,000	--				
To Net Profit	91,300	36,100	12,800				
	1,03,000	**48,000**	**20,000**		**1,03,000**	**48,000**	**20,000**

General Profit & Loss Account

For the year ended

Particulars	Rs.	Particulars	Rs.
To Directors fees	2,000	By Income from Investment	1,500
		By Net Profit :	
To N.P. c/d to B/s	1,39,700	Jeep	91,300
		Car	36,100
		Servicing	12,800
	1,41,700		**1,41,700**

Illustration 6:

A firm has two departments X and Y. From the following figures prepare the Departmental Trading and Profit and Loss Account for the year ended 31st December 2017.

Particulars	Departments	
	X	Y
	Rs.	Rs.
Opening Stock	40,000	50,000
Purchase	1,50,000	1,00,000
Sales	2,50,000	1,50,000
Salaries	16,800	12,000
Particulars		**Rs.**
General Salaries		20,000
Carriage Inward		20,000
Carriage Outward		16,000
Advertising		12,000
Rent and Rates		18,000
Interest on Bank Loan		5,000
Lighting		2,400
Discount Received		3,000
Insurance		2,000

Area occupied by the two departments is in the ratio of 2:1. General salaries are to be allocated equally. Insurance premium is for a comprehensive policy, allocation being inconvenient. Closing Stocks were : X Rs. 36,000, Y Rs. 40,000.

(April 2003, adapted)

Solution :

Departmental Trading and Profit & Loss Account
For the year ended 31-12-2017

Particulars	**Dept. X**	**Dept. Y**	**Particulars**	**Dept. X**	**Dept. Y**
	Rs.	**Rs.**		**Rs.**	**Rs.**
To Opening Stock	40,000	50,000	By Sales	2,50,000	1,50,000
To Purchase	1,50,000	1,00,000	By Closing Stock	36,000	40,000
To Carriage Inward (3:2)	12,000	8,000			
To Gross Profit c/d	84,000	32,000			
	2,86,000	**1,90,000**		**2,86,000**	**1,90,000**
To Salaries	16,800	12,000	By Gross Profit b/d	84,000	32,000
To General Salaries (1:1)	10,000	10,000	By Discount Received (3:2)	1,800	1,200
To Carriage Outward (5:3)	10,000	6,000	By Net Loss c/d		6,100
To Advertising (5:3)	7,500	4,500			
To Rent & Rates (2:1)	12,000	6,000			
To Lighting (2:1)	1,600	800			
To Net Profit c/d	27,900	--			
	85,800	**39,300**		**85,800**	**39,300**

General Profit & Loss Account

Particulars	Rs.	Particulars	Rs.
To Net Loss b/d (Department Y)	6,100	By Net Profit b/d (Department X)	27,900
To Interest on Bank Loan	5,000		
To Insurance	2,000		
To Profit transferred to Capital A/c	14,800		
(Balance Figure)			
	27,900		**27,900**

Working Notes :

1) Purchase Ratio (PR) :

	Department X	Department Y
	1,50,000	1,00,000
	3	2

2) Sales Ratio (SR) :

	Department X	Department Y
	2,50,000	1,50,000
	5	3

Illustration 7

From the following information of Mr. Apte a proprietor having three departments X, Y and Z prepare Departmental Trading and Profit & Loss A/c for the year ended 31st December 2017 and Balance Sheet on that date.

Trial Balance as on 31st December 2017

Particulars	**Debit Rs.**	**Credit Rs.**
Mr. Apte's Capital		1,00,000
Stock :		
X	20,000	
Y	15,000	
Z	10,000	

Purchases :		
X	90,000	
Y	70,000	
Z	50,000	
Sales		
X		1,00,000
Y		75,000
Z		50,000
Salaries	25,000	
Rent & Rates	5,000	
Selling & Distribution Expenses	9,000	
Land & Building	25,000	
Furniture & Fixtures	10,000	
Cash in Hand	5,000	
Cash at Bank	10,000	
Sundry Debtors	25,000	
Sundry Creditors		44,000
	3,69,000	**3,69,000**

Other Information :

1. Stock in Trade as on 31st December, 2017 was X Rs. 35,000, Y Rs. 25,000 and Z Rs. 20,000.
2. Salaries are to be allocated in the ratio of 40%, 30%, 30% amongst all the departments.
3. The floor space occupied by each department is in the proportion of 40%, 30% and 30%.
4. Selling and distribution expenses are to be allocated on the basis of sales of each department.

(IDE - November 2010, April 2005, adapted)

Solution :

Departmental Trading and Profit & Loss Account
For the year ended 31-12-2017

Dr. **Cr.**

Particulars	Basis	Dept. X	Dept. Y	Dept. Z	Total
		Rs.	Rs.	Rs.	Rs.
To Opening Stock	Given	20,000	15,000	10,000	45,000
To Purchase	Given	90,000	70,000	50,000	2,10,000
To Gross Profit		25,000	15,000	10,000	50,000
		1,35,000	**1,00,000**	**70,000**	**3,05,000**
To Salaries	4:3:3	10,000	7,500	7,500	25,000
To Rent & Rates	4:3:3	2,000	1,500	1,500	5,000
To Selling & Distribution	Sales	4,000	3,000	2,000	9,000
To Net Profit c/d		9,000	3,000	-	12,000
		25,000	**15,000**	**11,000**	**51,000**

Departmental Trading and Profit & Loss Account
For the year ending 31-12-2017

Dr. **Cr.**

Particulars	Basic	Dept. X	Dept. Y	Dept. Z	Total
		Rs.	Rs.	Rs.	Rs.
By Sales	Given	1,00,000	75,000	50,000	2,25,000
By Closing Stock	Given	35,000	25,000	20,000	80,000
		1,35,000	**1,00,000**	**70,000**	**3,05,000**
By Gross Profit b/d		25,000	15,000	10,000	50,000
By Net Loss b/d				1,000	1,000
		25,000	**15,000**	**11,000**	**51,000**

Balance Sheet
As on 31-12-2017

Particulars	Basic	Dept. X	Assets	Rs.
Mr. Apte's Capital	1,00,000		Land & Building	25,000
Add : Net Profit	11,000	1,11,000	Furniture & Fixtures	10,000
Sundry Creditors		44,000	Sundry Debtors	25,000
			Closing Stock	80,000
			Cash at Bank	10,000
			Cash in Hand	5,000
		1,55,000		**1,55,000**

Illustration 8:

Tailors Ltd. have two departments, A and B. The latter department gets all its requirements from the A department at the usual selling price. On 31st December 2017 the following was the trial balance :

Particulars	Debit Rs.	Credit Rs.
Share Capital		1,00,000
Stock (A Department)	40,000	
Stock (B Department)	2,500	
Purchases : A	5,50,000	
Purchases : B	5,000	
Sales A		6,25,000
Sales B		75,000
Transfer of Goods to B Department	25,000	25,000
Director's Fees and Remuneration	15,000	
Wages and Salaries : A	10,000	
Wages and Salaries : B	20,000	
Rent and Rates (3/4 to A)	4,000	
Lighting ¾ to B)	1,000	
Depreciation : B	2,500	
Depreciation : A	500	
Office Expenses	1,500	
Furniture and Fittings	10,000	

Office Salaries	8,000	
Equipment	25,000	
Carriage Inwards (A)	33,000	
Investment	50,000	
Income from Investments		5,000
Cash at Bank	27,000	-
	8,30,000	**8,30,000**

Closing stock of A on hand was Rs. 48,000 and that in B amounted to Rs. 3,750. It is desired to ascertain profit or loss on strict accountancy principles.

Solution :

Trading and Profit & Loss A/c
For the year ended 31st December 2017

Particulars	Dept. X	Dept. Y	Particulars	Dept. X	Dept. Y
	Rs.	**Rs.**		**Rs.**	**Rs.**
To Opening Stock	40,000	2,500	By Sales	6,25,000	75,000
To Purchase	5,50,000	5,000	By Transfer of Goods to Dept. (B)	25,000	--
To Transfer of Goods From Dept. (A)	--	25,000	By Closing Stock	48,000	3,750
To Carriage Inwards	33,000	--			
To Wages & Salaries	10,000	20,000			
To Gross Profit c/d	65,000	26,250			
	6,98,000	**78,750**		**6,98,000**	**78,750**
To Rent & Rates (3:1)	3,000	1,000	By Gross Profit b/d	65,000	26,250
To Lighting (1:3)	250	750			
To Depreciation	500	2,500			
To Net Profit c/d	61,250	22,000			
	65,000	**26,250**		**65,000**	**26,250**

General Profit & Loss Account
For the year ended 31st December 2017

Particulars	Amt. Rs.	Particulars	Amt. Rs.
To Director's Fees & Remuneration	15,000	By Net Profit b/d	
		Department (A) 61,250	
To Office Salaries	8,000	Department (B) 22,000	83,250
To Office Expenses	1,500	By Income from Investment	5,000
To Stock Reserve A/c	375		
To Net Profit c/fd	63,375		
	88,250		**88,250**

Balance Sheet
As on 31st December 2017

Liabilities	Amt. Rs.	Assets	Amt. Rs.
Share Capital	1,00,000	Furniture & Fittings	10,000
Profit & Loss A/c	63,375	Equipment	25,000
		Investments	50,000
		Stock	
		Department (A) 48,000	
		Department (B) 3,750	
		51,750	
		Less : Stock Reserve 375	51,375
		Cash at Bank	27,000
	1,63,375		**1,63,375**

Working Note :

The gross profit of department (A) is Rs. 65,000 and its sales (including transfers) amount to Rs. 6,50,000.

$$\text{Gross Profit Rate} = \frac{65,000}{6,50,000} \times 100 = 10\%$$

Stock Reserve = 10% on 3,750 = 375

11.2 EXERCISE

Practical Exercises:

1. Trading, Profit & Loss A/c of the Modern Electronics Ltd. for the year ended 31st March 2018 is presented in the following form.

Trial Balance
As on 31st March 2018

Particulars	Amt.	Particulars	Amt.
	Rs.		**Rs.**
To Purchases :		By Sales	
T.Vs(A)	2,81,400	T.Vs(A)	2,71,200
Refrigerators (B)	1,81,200	Refrigerators (B)	2,00,000
Spare Parts (C)	1,00,000	Spare Parts and Receipts from servicing (C) Department	50,000
To Spare parts received by (C) Department from (A) Department	28,800	By Transfer from Department (A) to Department (C)	28,800
To Indirect Wages & Salaries	96,000		
To Rent	21,600	By Closing stock :	
To Office Expenses	22,000	T.Vs (A)	1,20,200
To Net Profit	69,000	Refrigerators (B)	40,600
	--	Spare Parts (C)	89,200
	8,00,000		**8,00,000**

Prepare Departmental Accounts for each of the three Departments A, B and C after taking into consideration the following information:

a) T.Vs and Refrigerators are sold at the showroom and repairing and servicing jobs are carried out at the workshop.

b) Salaries and wages comprise as follows :

Showroom ¾ and workshop ¼

It was decided to allocate showroom salaries and wages in the ratio of 1:2 between Departments A and B.

c) The workshop rent is Rs. 500 per month. The rent of the showroom is to be divided equally between Departments A and B as both the Departments occupy equal floor space.

d) Allocate office expenses on the basis of turnover of each department.

e) Inter-departmental transfers take place at cost to transferor department.

[Ans. Gross Profit - A : Rs. 1,38,800: B : Rs. 59,400, C : Rs. 10,400, Net Profit - A : Rs. 95,553, B : Rs. 4,842, C : Rs. 21,711]

2. Dadar Departmental Stores has three departments X, Y and Z. The following particulars regarding the three departments are given :-

Particulars	X	Y	Z
	Rs.	Rs.	Rs.
Opening Stock	30,000	30,000	60,000
Purchases	1,00,000	60,000	2,00,000
Sales	4,00,000	3,00,000	3,00,000
Closing Stock	20,000	40,000	40,000

The following expenses were also incurred:

Particulars	Amt.
	Rs.
Rent and Taxes	18,000
General Expenses	24,000
Discount Allowed	30,000
Sales Promotion Expenses	40,000
Salesman's Salary	10,000
Discount Received	15,000
Commission Received	10,000

a) Goods worth Rs. 8,000 were transferred from Department X to Department Y.

b) Allocate general expenses, rent and taxes equally among the three departments.

c) Commission received is to be divided in the ratio of 4:3:3 respectively.

Prepare Departmental Trading and Profit & Loss Account.

(**M.U. November 1998)**

3. The following Trail Balance for the year ended 31st March 2018 was extracted from the books of Shri Mukesh.

Trial Balance
As on 31st March 2018

Particulars	Debit	Credit
	Rs.	**Rs.**
Capital on 1.4.2017		50,000
Drawings Account	10,000	
Stock on 1.4.2017		
Radios	45,000	
Watches	21,000	
Sales :		
Radios		2,94,000
Watches		1,46,000
Purchases :		
Radios	2,25,000	
Watches	1,15,000	
Salaries	12,600	
Publicity Expenses	8,900	
Rent, Rates and Taxes	3,200	
Commission	10,600	
Sundry Expenses	5,000	
Furniture and Fixtures	12,400	
4% Govt. of India Loan	10,000	
Sundry Debtors	16,800	
Sundry Creditors		8,800
Interest		400
Reserve for Bad and Doubtful Debts		800
Cash Balance	4,500	
	5,00,000	**5,00,000**

Prepare the Departmental Trading and Profit & Loss Account for the year ended 31st March, 2018 after taking into account the following :

a) Stock as on 31st March, 2018 was : Radios : Rs. 30,000 Watches Rs. 24,000
b) An amount of Rs.1,200 out of sundry debtors has to be written off as bad debts and the provision for doubtful debts has to be increased thereafter to 10% of the debts outstanding.
c) The expenses outstanding as on 31st March, 2018 are Publicity Rs.1,300, Salaries Rs.1,200 and Commission Rs.1,700.
d) Provide 10% depreciation on furniture & fixtures.
e) Revenue items to be allocated in ratio 2:1 between Radio and Watches.

(Answer: Net Profit - Radio - 22,467 Watches – 18,233)

4. From the following particulars given by M/s Tins and Toys, prepare a Departmental Trading and Profit & Loss Account for their two departments, viz. Tins Dept. and Toys Dept. for the year ended 31st March, 2018.

Particulars	**Rs.**
Opening Stock Toys	5,000
Tins	15,000
Raw Material consumed (Tins)	36,000
Stores consumed	9,000
Wages : Tins	6,000
Toys	3,000
Advertisement	1,500
Packing Expenses (Toys)	600
Office Expenses	4,800
Depreciation : Factory Equipment	3,200
Building	1,600
Sales : Tins	90,000
Toys	18,000
Closing Stock : Toys	6,000
Tins	12,000

You are also given the following additional information :

a) Toys are made of end bits of sheets of raw material used by Tins Department. The value of such material used during the year by Toys Department Rs. 2,000.

b) Toy-making does not require any equipment.

c) Only one-eighth of the total area of building is occupied by Toys Department.

[Ans. Net Profit - Toys : Rs. 11,650, Tins : Rs. 28,650]

5. Following information is available from the books of Trupti Departmental Stores for the year.

Account heads	**Departments**			**Total**
	A	**B**	**C**	
	Rs.	**Rs.**	**Rs.**	**Rs.**
Purchases	1,00,000	1,50,000	4,00,000	6,50,000
Sales	3,05,000	6,10,000	9,15,000	18,30,000
Returns inwards	5,000	10,000	15,000	30,000
Returns outwards	10,000	5,000	15,000	30,000
Opening stock	25,000	35,000	50,000	1,10,000
Closing stock	40,000	25,000	20,000	85,000
Wages				90,000
Postage				1,500
Salaries				3,000
Office expenses				4,500
Rent				12,000
Discount allowed				9,000
Professional charges				12,000
Bad debts				6,500
Interest				31,500
Insurance				3,400

Additional Information :

1) Departmental transfers :

   i) Department A to B Rs. 5,000 and to C Rs. 10,000.

   ii) Department B to C Rs. 5,000 and to A Rs. 2,500.

   iii) Department C to A Rs. 3,500 and to B Rs. 4,500.

2) Allocation of expenses.

   i) Postage, salaries, office expenses and professional charges : Equally

   ii) Rent A - 1, B - 1, C - 2

   iii) Insurance A - 8, B - 5, C - 4

   iv) Wages and interest A - 2, B - 3, C - 4.

You are required to prepare Departmental Trading and Profit and Loss Account for the year.

[Ans. Gross profit A Rs. 2,14,000 B Rs. 4,13,000; C Rs. 4,38,000 Net profit A Rs. 1,92,817; B Rs. 3,86,333; C Rs. 4,02,450]

❖❖❖❖

Unit-12

HIRE PURCHASE - I

Unit Structure :

12.0 OBJECTIVES

After studying the unit students will be able to:

- Know the meaning of Hire purchase.
- Distinguish between Installment system and Hire purchase system.
- Calculate interest under different conditions.
- Calculate depreciation under Hire purchase system.
- Journalise the hire purchase transactions.
- Understand the accounting procedure.

12.1 INTRODUCTION

All big business houses and multinationals make sales on cash basis as well as on credit basis. When the goods are sold the purchaser may either make the full payment at one time (cash basis) or may defer the payment (credit basis). The credit sales are very important and essential for the growth of business. The sale proceeds under credit sales are not immediately collected but are collected in monthly, quarterly or yearly installments. When the price of an article is paid by installments, the total amount paid is higher than the actual cash price of the article. The excess price is the charge for interest and the risk involved. This arrangement of making the payment in installments is beneficial to both the seller and the buyer. There are two systems of deferred payments, namely, (i) Hire Purchase System, and (ii) Installment Payment System. Hire-purchase system is the most secured and effective tool of collecting the proceeds of a credit sale. Under this system, the goods are delivered to the purchaser at the time of agreement before the payment of installments but the title on the goods is transferred after the payment of all installments as per the hire-purchase agreement.

12.2 MEANING OF HIRE-PURCHASE TRANSACTION

12.2.1 Meaning

Hire-purchase is a credit purchase of an asset by the hire-purchaser from the hire- vendor. The asset is delivered in the possession of the purchaser at the time of commencement of the agreement. The price under hire-purchase system is paid in installments. The installments may be annual, six monthly, quarterly, etc. The installment includes the part of the outstanding cash price and the interest on the outstanding cash price from the date of the last installment paid to the due date of the installment. The hire-purchaser becomes the owner of the goods after the payment of all installments as per the agreement. The hire-purchaser has a right to use the goods as a bailer and terminate the agreement at any time in the capacity of a hirer.

12.2.2 Default in the payment of any installment:

Hire-purchase means a transaction where the goods are sold by hire-vendor to the purchaser under the hire-purchase agreement. If there is a default in the payment of any installment, the hire vendor will take away the goods from the possession of the purchaser without refunding him any amount. The payment of every installment is treated as the payment of hire charges by the purchaser to the hire vendor till the payment of the last installment. After the payment of the last installment, the amount of various installments paid is appropriated towards the payment of the price of the goods sold and the ownership or the goods is transferred to the purchaser. Hire vendor continues to be the owner of the goods till the payment of last installment.

12.2.3 Hire-Purchase Agreement

A hire purchase agreement is one under which the buyer takes delivery of goods, promising to pay the price in certain number of installments and until full payment is made, to treat the payment as hire charges for using the said goods. In fact, a hire purchase agreement stipulates that (i) the delivery of goods will be given by the owner of goods to the hire purchaser; (ii) payment will be made in installments, (iii) each installment will be treated as hire charge so that if default in respect of payment of even the last installment is made, the seller will be entitled to take away the goods without compensating, the hire purchaser in any form, and (iv) if all installments are paid and the other conditions are fulfilled, the ownership of the goods will pass to the buyer. Hire-purchase agreement means a contract between the hire vendor and the hire purchaser regarding the sale of goods under certain conditions.

Usually every hire-purchase agreement shall contain the following terms.

1. Date of hire-purchase: The date on which the hire-purchase agreement will commence.

2. Description of the goods: The description of the goods that will be delivered to the hire-purchaser at the commencement of the agreement.

3. Hire-Purchaser: A Person who gets the possession of the asset/goods from the owner under a hire-purchase agreement. He is the buyer (Hire-Purchaser) of the goods.

4. Hire-Vendor: A Person who sells goods under a hire-purchase agreement.

5. Cash price of the goods: Cash price means the price at which goods may be purchased against cash payment.

6. Hire-purchase price: Hire purchase price means the total amount which is payable by the hire-purchaser under the agreement.

7. Down payment: The down payment means the amount which is required to be paid by hire-purchaser to the hire vendor at the time of commencement of hire-purchase agreement.

8. Rate of interest: The rate of interest is the interest charged by the hire vendor on the outstanding amount of the cash price due to the hire-purchaser.

9. Installments: The number of installments to be paid by the hire-purchaser along with the amount of each installment and the date of payment of each installment. The installment paid by the purchaser is also called as “Hire”.

12.3 DIFFERENCE BETWEEN INSTALLMENT PAYMENT AND HIRE-PURCHASE SYSTEM

Installment payment transaction is a system of purchase and sale of goods in which title of goods is immediately transferred to the purchaser at the time of sale of goods and the sale price of the goods is paid in installments. The followings are the differences between Hire-purchase system and Installment payment system:

Hire-purchase system	Installment payment system
1.The transfer of ownership takes place after the payment of all installments.	1.The ownership is transferred immediately at the time of agreement.
2. Hire-purchase agreement is like a contract of hire though later on it may become a purchase after the payment of last installment.	2.The agreement is like a contract of credit purchase.
3.The vendor has a right to take back goods from the possession of the hire-purchaser.	3.The vendor has no right to take back the goods from the possession of the purchaser; he can simply sue for the balance due.
4.The provisions of the Hire-Purchase Act apply to the transaction.	4.The provisions of Sale of Goods Act apply to the transaction.

CHECK YOUR PROGRESS

1. Enlist the terms included in the Hire Purchase Agreement.
2. Define the terms:
   a. Hire Purchase
   b. Hire Purchaser
   c. Hire Vendor
   d. Installment
   e. Hire Purchase Agreement
   f. Down Payment

3. Fill in the blanks

a. A contract for sale of goods may be either a sale or an .... to sell.

b. Under a hire purchase agreement payments are made in ... ..,...........

c. Each installment payment is treated as..................

d. A hirer has the right to .... the agreement before payment of the last installment by paying the seller the agreed amount.

Answers: i) agreement, ii) installment,
iii) hire charges iv) terminate

4. State whether the following statements are True or False:

a. If the hirer fails to pay the last installment, the amounts paid earlier are considered as hire charges.

b. Under hire-purchase system the purchaser becomes the owner of the goods immediately after the down payment.

c. Under hire-purchase system the buyer does not charge the depreciation on the asset till he becomes the owner.

d. Interest is calculated on the hire purchase price at the given rate of interest.

Answers: True - (i). False - (ii), (iii), (iv).

12.4 CALCULATION OF INTEREST

Interest is to be calculated on the outstanding balance except down payment. The calculation of interest is made under three conditions:

1. **Rate of Interest given and Interest included in amount of installment:**
2. **Rate of Interest given and Interest is not included in installments:**
3. **Rate of interest not given:**

12.5 INTEREST INCLUDED IN AMOUNT OF INSTALLMENT

In case if hire-purchase price i.e. payment made in the form of down payment and all installments is more than the cash price, it is regarded that the interest is included in installments.

Following steps should be followed for calculating the amount of interest on each installment.

i) Calculate the outstanding cash price at the time of first installment by subtracting Down Payment from the Cash Price.

ii) Calculate interest on the outstanding cash price at the time of first installment by applying the given rate of interest, the mode of installment must be considered (whether the installment is annual, half-yearly or quarterly).

iii) Calculate the amount of cash price included in the first installment by subtracting the amount of interest as calculated in step (ii) from the amount of the first installment.

iv) Calculate the outstanding cash price at the time of second installment by Subtracting the amount of cash price of the first installment from the outstanding Cash price at the time of first installment i.e., (i) - (iii).

v) Calculate interest on the second installment by applying the rate of interest to the outstanding cash price at the time of second installment. It is explained in the following example.

Example : On 1st January, 2009, Mr. A purchased from M/s B & Co. one 'Motor Car' under hire-purchase system, Rs.10,000 being paid on delivery and the balance in three annual installments of Rs.10,000 each payable on 31st December each year. The cash price of the motor car is Rs. 37,250 and vendors charge interest @ 5% per annum on yearly balances. Find out the amount of cash price and interest included in each installment.

Calculation of					
Date	**Calculation**	**Cash Price (Rs.)**	**Cash price paid (Rs.)**	**Interest (Rs.)**	**Installment (Rs.)**
1/1/2009	Cash Price	37250			
1/1/2009	Less Down Payment paid	10000	10000	0	10000
1/1/2009	Outstanding cash price	27250			
31/12/09	Add Interest@5%	1363			
31/12/09	Total Amount Due	28613			
31/12/09	Less Installment paid	10000	8637	1363	10000
31/12/09	Outstanding cash price	18613			
31/12/10	Add Interest@5%	931			
31/12/10	Total Amount Due	19544	9069	931	10000
31/12/10	Less Installment paid	10000			
31/12/10	Outstanding cash price	9544			
31/12/11	*Add Interest@5% (Bal fig)	456			
31/12/11	Total Amount Due	10000			
31/12/11	Installment paid	10000	9544	456	10000

CHECK YOUR PROGRESS

1. A Ltd. purchased a machine on hire purchase from Z Ltd, on January 1, 2009, paying Rs.8,000 immediately and agreeing to pay three annual installments of Rs.8,000 each on December 31, every year. The cash price of the machine is Rs.29,800 and the vendors charge interest @ 5% per annum. Calculate the amount of interest paid by the buyer to the seller every year.

Answers: Interest for 1st Year: 1090, 2nd Year: 745, 3rd Year: 365

12.6 WHEN INTEREST IS NOT INCLUDED IN INSTALLMENTS

When the total amount paid in the form of down payment and all installments is exactly equal to the cash price, it is regarded that the interest, is not included in installments. It means that interest is payable in addition to the agreed amount of installment. It is explained in the following example.

Example: On 1st January, 2009, Mr. A purchased from M/s B & Co. one 'Motor Car' under hire-purchase system, the cash price being Rs.37,250. Rs.10,000 being paid on delivery and the balance in three equal annual installments payable on 31st December every year. In addition to it, interest at 5% per annum was also payable to vendors on outstanding balances. Find out the amount of cash-price and interest included in each installment.

Calculation of Interest					
Date	**Calculation**	**Cash Price (Rs.)**	**Cash Price paid (Rs.)**	**Interest (Rs.)**	**Installment (Rs.)**
1/1/2009	Cash Price	37250			
1/1/2009	Less Down Payment paid	10000	10000	0	10000
1/1/2009	Outstanding cash price	27250			
31/12/09	Add Interest@5%	1363			
31/12/09	Total Amount Due	28613			
31/12/09	Less Installment paid	10446	9083	1363	10446
31/12/09	Outstanding cash price	18167			
31/12/10	Add Interest@5%	908			
31/12/10	Total Amount Due	19075	9083	908	9991
31/12/10	Less Installment paid	9991			
31/12/10	Outstanding cash price	9084			
31/12/11	*Add Interest@5%(Bal fig)	454			
31/12/11	Total Amount Due	9538			
31/12/11	Total Amount Paid	9538	9084	454	9538

CHECK YOUR PROGRESS

1. A Ltd purchased machinery on hire purchase basis from B ltd on the following terms: Cash price Rs.79,250, Cash Down Payment 25% and Balance to be discharged in 3 equal installments together with interest @10% p.a. to be paid at the end of each year. Compute the payment of interest and installment to be made each year

Answers: Interest for 1st Year: 5,944, 2nd Year: 3,962, 3rd Year: 1,981, Installment for 1st Year: 25,757, 2nd Year: 23,775, 3rd Year: 21,792

12.7 RATE OF INTEREST IS NOT GIVEN

When rate of interest is not given, there can be two situations.

1. When cash price and the amounts of installments are given and the amount of each installment is same.
2. When cash price and the amounts of installments are given and the amount of each installment is not same.

12.7.1 When Rate of Interest is not given and installments are of same amount:

When cash price and the amounts of installments are given and the amount of each installment is same.

Example: On 1st January, 2009, Mr. A purchased from M/s B & Co. one 'Motor Car' under hire-purchase system, Rs.10,000 being paid on delivery and the balance in three annual installments of Rs. 10,000 each payable on 31st December every year. The cash price of the motor car is Rs.37,250. Find out the amount of cash price and interest included in each installment.

*Add Interest@5% 477
Bal fig(Amount Due-Amount Paid) 456
Consider balancing figure while calculating last installment

The total interest of Rs 2,750 is to be apportioned among the 1st, 2nd and 3rd installment in the ratio of 3:2:1.(since there are three installments 3/6, 2/6, and 1/6 respectively)
(1)Share of 1st installment in the Interest= 2,750x3/6 = **Rs1,375**

(2)Share of 2nd installment in the Interest= 2,750x2/6 = **Rs.917**

(3)Share of 3rd installment in the interest= 2,750x1/6 = **Rs.458**

CHECK YOUR PROGRESS

1. A purchased a machine for down payment of Rs.20,000 and 3 annual installments of Rs.20,000 each. Cash price is Rs.74,500. Find out the amount of cash-price and interest included in each installment.

Answers: Interest for 1st Year: 2,750, 2nd Year: 1,833, 3rd Year: 917, Cash Price included for 1st Year: 17,250, 2nd Year: 18,167, 3rd Year: 19,083

12.7.2 When Rate of Interest not given and Installments given of different amounts

When cash price and amounts of installments are given but the amount of each installment is not equal:

Example: Cash price of a machine is Rs.1,25,000 on 1st January, 2009. Its hire- purchase price is Rs.1,50,000. This hire purchase price is paid in the following manner: Rs.30,000 on 1st January, 2009, Rs. 35,000 at the end of the first year, Rs.40,000 at the end of second year; Rs. 45,000 at the end of third year. Calculate interest and cash price included in each installment.

<u>**Step 1:** Calculation of Interest</u>

Hire Purchase Price	1,50,000
Less: Cash Price	1,25,000
Total Interest	**25,000**

<u>**Step 2:** Apportionment of Interest</u>

Total Interest of Rs.25,000 is to be apportioned among the three installments in the following manner:

At the end of Year	1	2	3	T
Outstanding Hire Purchase Price	120000	85000	45000	250000
*Interest	12000	8500	4500	25000

* Interest = Outstanding Hire Purchase Price before Installment* Total Interest /Total of Outstanding Hire Purchase Price for all installments

$$\text{Interest at the end of year 1} = \frac{120000 * 25000}{250000} = \text{Rs.}12000$$

$$\text{Interest at the end of year 2} = \frac{8500 * 25000}{250000} = \text{Rs.}8500$$

$$\text{Interest at the end of year 3} = \frac{45000 * 25000}{250000} = \text{Rs.}4500$$

CHECK YOUR PROGRESS

1. MTC purchased a taxi on hire purchase terms. The cash price was Rs.87,092.

Payments were to be made as under

On 1.1.2009	Rs.20,000 (down Payment)
On 31.12.2009	Rs.35,000
On 31.12.2010	Rs.25,000
On 31.12.2011	Rs.20,000

Calculate interest and cash price included in each installment.

Answers: Interest for 1st Year: 7122, 2nd Year: 4006, 3rd Year: 1780, Cash Price included for 1st Year: 27878, 2nd Year: 20994, 3rd Year: 18220

12.8 CALCULATION OF DEPRECIATION

Under Hire-Purchase system, the ownership is not transferred to the buyer. Hence, there is a dispute about charging of the depreciation on the asset. However, from practical point of view, depreciation on asset should be charged at a certain rate on the cash price of the asset acquired. The logic behind provision of depreciation on asset is

1. Asset is used by the buyer
2. Asset is to be shown at its real value
3. The Hire-purchaser is going to be owner after the payment of last installment

Depreciation should be provided as a matter of policy in the books of the buyer. Depreciation should be charged on asset every year on the cash price under straight line or reducing balance method.

12.9 ACCOUNTING METHODS

The method of accounting for hire-purchase transactions depends on the value of sales. Hire purchase accounting methods for goods of small sales value may be Debtors Method or Stock and Debtors Method. If the goods have substantial sales value then the accounting methods as per AS 10, which deals with the valuation of the Fixed Assets, Assets acquired on hire-purchase terms, are to be recorded at their cash- price. The interest has to be written off as an expense. The accounting entries can be passed by the buyer in any of the three methods

1. Asset Accrual Method (Actual Cash Price Method)
2. Interest Suspense Method
3. Full Cash Price Method

Assets taken on Hire purchase basis should be considered like ordinary purchase.

12.10 FULL CASH PRICE METHOD (CREDIT PURCHASE / SALE METHOD)

Under Full Cash Price Method, the Hire-Purchaser is considered as the owner of the asset, the asset is recorded at full cash price on the basis of the substance over form. The full cash price of the asset is debited to the Asset account and credited to the Hire-Vendor account. Interest account is debited and the Hire-Vendor account is credited with the interest on the outstanding balance. When the installment is paid, the Hire-Vendor A/c is debited and the Bank A/c is credited .At the time of the preparation of the final accounts, Interest is transferred to Profit & Loss Account and Asset is shown in the Balance Sheet at the cost less depreciation. The balance due to Hire- Vendor is shown in the Balance Sheet as a Liability.

- **BOOKS OF HIRE PURCHASER**

13.10.1 Journal Entries in the books of Hire-Purchaser:

1.	For buying assets (entering agreement) on hire purchase Asset A/c Dr. To Hire-Vendor A/c	Full Cash Price
2.	For paying the down payment to vendor: Vendor A/c Dr To Cash/ Bank A/c	Down Payment
3.	When Interest is Due on unpaid installments: Interest A/c Dr. To Hire Vendor A/c	Interest on outstanding balance
4.	For Installment Payment (Interest payment will be also included in it): Vendor A/c Dr To Cash/ Bank A/c	Amount of Installment
5.	For charging Depreciation: Depreciation A/c Dr. To Asset A/c	Calculated on Cash Price
6.	For transferring Interest and Depreciation to Profit and Loss Account: Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c	

(Repeat entry Nos. 3, 4, 5, and 6 in subsequent years)

However, a firm may maintain a Provision for Depreciation A/c instead of charging depreciation to asset on Hire-purchase A/c, in such case the journal entry is

Profit and Loss A/c Dr.
To Provision for Depreciation for Asset on Hire-Purchase A/c
(Being the asset on hire-purchase is shown on its historical cost).

12.10.2 Disclosure in Balance Sheet

Balance Sheet of Hire-Purchaser

Liabilities	Rs.	Ass	Rs.
Hire-Purchase		Fixed Assets:	xxxx
Balance in Hire-	xxxx	Asset(at cash Price)	xxxx
Less :Instalment	xxxx	Less Depreciation	xxxx
Instalment not yet	xxxx		

- **BOOKS OF HIRE VENDOR**

12.10.3 Journal Entries in the books of Vendor:

1.	For selling on hire purchase: Hire-Purchaser A/c Dr. To Hire Sales A/c	Full Cash Price
2.	For receiving the down payment: Cash/ Bank Dr To Hire-Purchaser A/c	Down Payment
3.	For Interest receivable Hire-Purchaser A/c Dr To Interest A/c	Interest on outstanding balance
4.	For Installment Received (Interest receipt will be also included in it): Cash/ Bank A/c Dr. To Hire-Purchaser A/c	Amount of Installment
5.	For transferring Interest to Profit and Loss Account: Interest A/c Dr. To Profit and Loss A/c	

(Repeat entry Nos. 3, 4, and 5, in subsequent years)

12.10.4 Disclosure in Balance Sheet

Balance Sheet of Hire-Vendor

Liabilities	Rs.	Asset	Rs.
		Hire-Purchase Debtors	
		Balance in Hire- Purchaser	xx

12.11 EXERCISE

1. Explain the meaning of Hire-Purchase System.

2. Write notes on:
   (a) Hire-Purchase Price (b) Cash Price (c) Initial Payment

3. **Objective Questions**

- **MULTIPLE CHOICE QUESTIONS**

1. Hire Purchase Price means the total amount payable by the hirer, made up of ---------
   (a) the cash price of the article and the interest
   (b) the cash price of the article less interest
   (c) the cash price of the article and the down payment
   (d) the installments and the interest

2. Each Hire Purchase installment amount is made up of ---------
   (a). part payment towards cash price only
   (b). part payment towards interest only
   (c). part payment towards cash price plus interest
   (d).none of the above

3. Under ---------method, entries are made as if asset is purchased for full price on credit on the date of Hire Purchase agreement itself.
   (a). Actual Cash Price
   (b). Full Cash Price
   (c). Asset Accrual
   (d).None of the above

4. The Hire Purchaser can record the asset under Full Cash Price Method at its ---------
   (a). Hire Purchase Price
   (b). Cash price
   (c).None of the above

5. Interest in the Hire Purchase transaction, is charged on the --------- cash price
   (a). Outstanding
   (b). Full cash price
   (c).None of the above

6. Under Hire –Purchase system buyer becomes the owner of goods ---------
   (a). immediately after the receipt of goods
   (b). immediately after the down payment

(c). immediately after the payment of the last installment
(d).None of the above

7. Under Hire –Purchase agreement the buyer agrees to pay --------
(a). Cash price only.
(b). Interest only
(c). Cash Price and Interest

8. The last installment paid under Hire –Purchase comprises ---------
(a). Cash price only.
(b). Interest only
(c). Cash Price and Interest

Answers:1.-(a), 2. -(c), 3.- (b). 4. - (b), 5.-(a), 6. -(c), 7. -(c), 8 -(c).

- **FILL IN THE BLANKS**

1.________________is the purchase price payable if full payment is made immediately.

2.________________means the total amount payable by the hirer, made up of the cash price of the article and interest.

3.__________________is the initial amount payable at the time of signing the agreement.

4. As soon as _________payment is made, the hirer gets possession of the article and can start using it immediately

5. Each Hire Purchase installment amount is made up of part payment towards___plus interest

6. Each Hire Purchase installment amount is made up of part payment towards cash price plus ______

7. Under the Hire –Purchase system, depreciation is provided on ______price

8. Under the Hire –Purchase system, depreciation is provided by the ___

9. If the Hire –Purchaser makes a down payment on signing the contract, it will not include any amount of _____

10. Depreciation is to be calculated on the full__________as the same is not affected by the extent of payment made.

Answers: 1. - Cash Price - 2. - Hire Purchase Price, 3. – Down Payment, 4. -Down, 5. - Cash Price 6. - Interest, 7. –Full Cash, 8. - Hire –Purchaser, 9. –Interest, 10. - Cash Price

- **STATE WHETHER TRUE OR FALSE**

1. Actual Cash Price Method is also known as Interest Suspense Method.

2. Full Cash Price Method is also known as Asset Accrual Method.
3. Asset Accrual Method is also known as Credit Purchase Method.

4. Actual Cash Price Method is also known as Credit Purchase Method.

5. The hire-purchaser has the right to terminate the agreement at any time before the property passes.

6. If the amount of each installment is equal, the total interest can be allocated to different installments by the fixed installment method.

7. Under the Hire –Purchase system, the buyer has the option to return the goods.

8. When assets are acquired under the hire purchase system, depreciation need not be provided as the vendor still continues to be the legal owner of the asset.

9. Hire Purchase Price is equal to Cash Price

10. Under the Hire –Purchase system, the interest is paid by the vendor to the hirer.

11. Cash Price is the purchase price payable if full payment is made immediately.
12. Hire Purchase Price is the initial amount payable at the time of signing the agreement.

Answers: TRUE: (5) (6) (7) (11)
FALSE: (1) (2) (3) (4) (8) (9) (10) (12)

❖❖❖❖

Unit-13

HIRE PURCHASE - II

Unit Structure :

13.0 OBJECTIVES

After studying the unit students will be able to the practical problems on Hire purchase system.

13.1 SOLVED PROBLEMS

Illustration 1.

Raj Textiles Ltd. purchased Motor Car on hire-purchase system. According to the terms, Rs. 30000 was payable on delivery on 1st January, 2005: and the balance by 4 annual installments of Rs.30000 each on 31st December. Krishna Motor Ltd who sold the Motor Car charged 5 % p.a. interest on the yearly balances. The cash value of the Car on delivery was 1,36,338. Depreciation @ 20% on diminishing balances was written off in each year. Show Journal Entries in the books of Raj Textiles Ltd

Journal Entries
In the books of Raj Textiles Ltd.

Date	Particulars	Debit(Rs.)	Credit(Rs.)
1/1/05	Motor Car A/c Dr. To Krishna Motor Ltd A/c (Being total cash price due to the hire-vendor for purchase of Motor Lorries)	136338	136338
1/01/05	Krishna Motor Ltd A/c Dr To Cash/ bank A/c (Being down payment paid)	30000	30000
31/12/05	Interest A/c Dr. To Krishna Motor Ltd A/c (Being Interest due on unpaid Cash Price)	5317	5317
31/12/05	Krishna Motor Ltd A/c Dr To Cash/ bank A/c	30000	12000
31/12/05	Depreciation A/c Dr. To Motor Car A/c (Being Depreciation charged)	27268	27268
31/12/05	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	32585	5317 27268
31/12/06	Interest A/c Dr. To Krishna Motor Ltd A/c (Being Interest due on unpaid Cash Price)	4083	4083
31/12/06	Krishna Motor Ltd A/c Dr To Cash/ bank A/c (Being Installment paid)	30000	30000
31/12/06	Depreciation A/c Dr. To Motor Car A/c (Being Depreciation charged)	21814	21814
31/12/06	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	25897	4083 21814
31/12/07	Interest A/c Dr. To Krishna Motor Ltd A/c (Being Interest due on unpaid Cash Price)	2787	2787

31/12/07	Krishna Motor Ltd A/c Dr To Cash/ bank A/c (Being Installment paid)	30000	30000
31/12/07	Depreciation A/c Dr. To Motor Car A/c	17451	17451
31/12/07	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	20238	2787 17451
31/12/08	Interest A/c Dr. To Krishna Motor Ltd A/c (Being Interest due on unpaid Cash Price)	1426	1426
31/12/08	Krishna Motor Ltd A/c Dr To Cash/ bank	30000	30000
31/12/08	Depreciation A/c Dr. To Motor Car A/c (Being Depreciation charged)	13961	13961
31/12/08	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	15387	1426 13961

Working Note: 1. Calculation of Interest

Date(1)	Opening Cash Price (Rs.) (2)	Cash Price paid(Rs.) (3)=(5-4)	Interest (Rs.) @5	Instalment (Rs.) (5)	Closing Cash Price (Rs.) (6)=(2)-(3)
1/1/2005	136338	30000	0	30000	106338
31/12/2005	106338	24683	5317	30000	81655
31/12/2006	81655	25917	4083	30000	55738
31/12/2007	55738	27213	2787	30000	28525
31/12/2008	28525	28574	1426	30000	0
	Total	136387	13613	150000	

Working Note: 2.

Calculation of Depreciation

Calculation of Depreciation		
Date	**Calculatio**	**(Rs.)**
1/1/2005	Cash Price	136338
31/12/05	less Depreciation	27268
31/12/05	Book-Value	109070
31/12/06	less Depreciation	21814
31/12/06	Book-Value	87256
31/12/07	less Depreciation	17451
31/12/07	Book-Value	69805
31/12/08	less Depreciation	13961
31/12/08	Book-Value	55844

Illustration 2.

Rama Company purchased Machinery from XY Trading Ltd. on 1st January, 2009 on hire-purchase system. The cash price of the Machinery was Rs.3,00,000 which was payable as under:

On 01-01-2009, Rs.1,00,000

On 31-12-2009, Rs.80,000

On 31-12-2010, RS.80,000

On 31-12-2011, RS.80,000

The purchasing company decided to write off depreciation @ 20% of the cost price each year. You are required to give the necessary journal entries in the books of both the parties for three years. Also show the calculation of interest, depreciation and the installment.

Journal Entries
In the books of Rama Company

Date	Particulars	Debit(Rs.)	Credit(Rs.)
1/1/09	Machinery A/c Dr. To XY Trading Ltd A/c (Being total cash price due to the hire-vendor for purchase of Truck)	300000	300000
1/1/09	XY Trading Ltd A/c Dr To Cash/ bank A/c (Being Down Payment paid)	100000	100000
31/12/09	Interest A/c Dr. To XY Trading Ltd A/c (Being Interest due on unpaid Cash Price)	20000	20000

31/12/09	XY Trading Ltd A/c Dr To Cash/ bank A/c (Being Installment paid)	80000	80000
31/12/09	Depreciation A/c Dr. To Machinery A/c (Being Depreciation charged)	60000	60000
31/12/09	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	80000	20000 60000
31/12/10	Interest A/c Dr. To XY Trading Ltd A/c (Being Interest due on unpaid Cash Price)	13333	13333
31/12/10	XY Trading Ltd A/c Dr To Cash/ bank A/c (Being Installment paid)	80000	80000
31/12/10	Depreciation A/c Dr. To Machinery A/c (Being Depreciation charged)	60000	60000
31/12/10	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	73333	13333 60000
31/12/11	Interest A/c Dr. To XY Trading Ltd A/c (Being Interest due on unpaid Cash Price)	6667	6667
31/12/11	XY Trading Ltd A/c Dr To Cash/ bank A/c (Being Installment paid)	80000	80000
31/12/11	Depreciation A/c Dr. To Machinery A/c (Being Depreciation charged)	60000	60000
31/12/11	Profit and Loss A/c Dr. To Interest A/c To Depreciation A/c (Being Interest and Depreciation transferred to profit and loss account)	66667	6667 60000

Journal Entries
In the books of XY Trading Ltd A/c

Date	Particulars	Debit(Rs.)	Credit(Rs.)
1/1/09	Rama Company A/c Dr. To Sales A/c (Being total cash price due from the hire- Purchaser for sale of Truck)	300000	300000
1/1/09	Cash/ bank A/c Dr To AB Transport Company A/c (Being Down Payment Received)	100000	100000
31/12/09	Rama Company A/c Dr. To Interest A/c	20000	20000
31/12/09	Cash/ bank A/c Dr To AB Transport Company A/c (Being Installment Received)	80000	80000
31/12/09	Interest A/c Dr. To Profit and Loss A/c (Being Interest transferred to profit and loss account)	20000	20000
31/12/10	Rama Company A/c Dr. To Interest A/c (Being Interest due on unpaid Cash Price)	13333	13333
31/12/10	Cash/ bank A/c Dr To AB Transport Company A/c (Being Installment Received)	80000	80000
31/12/10	Interest A/c Dr. To Profit and Loss A/c (Being Interest transferred to profit and loss account)	13333	13333
31/12/11	Rama Company A/c Dr. To Interest A/c (Being Interest due on unpaid Cash Price)	6667	6667
31/12/11	Cash/ bank A/c Dr To AB Transport Company A/c (Being Installment Received)	80000	80000
31/12/11	Interest A/c Dr. To Profit and Loss A/c (Being Interest transferred to profit and loss A/c)	6667	6667

Working Note: 1. Calculation of Interest

Step 1: Calculation of Total Interest:

Hire-purchase Price = 1,00,000 + (80,000 x 3) = Rs.3,40,000
Less: Cash Price - Rs.3,00,000
Total Interest = **Rs.40,000**

Step 2: Apportionment of Interest:

The total interest of Rs 40,000 is to be apportioned among the 1st, 2nd, and 3rd installment in the ratio of 3:2:1.(since there are three installments3/6,2/6, and 1/6 respectively)

(1)Share of Interest in the 1st installment = 40000x3/6 = **Rs.20,000**

(2)Share of Interest in the 2nd installment = 40000x2/6 = **Rs.13,333**

(3)Share of interest in the 3rd installment = 40000x1/6 = **Rs.6,667**

Working Note: 2. Calculation of Depreciation

Cost of Machinery = Rs. 300000

Less Depreciation (@ 20% of the cost price)= 60000(300000*20/100)

Illustration 3.

Ramsons purchased two printing machines from King Printers on Hire-purchase basis on 1st July ,2007 .The terms of the contract were as follows:-

i) The cash price of the each printing machine was Rs.75,000

ii) Rs.15,000 was paid on the signing of the contract on 1stJuly 2007

ii)The balance was paid in installments of Rs. 20,000 plus interest at 15% per annum

iv)The installments were paid on 31st December every year commencing from 31st December 2007. King Printers charged depreciation at 10% per annum under S.L.M. system. They closed their books on 31st December. Show in books of Ramsons necessary account.

In books of Ramsons
King Printers A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/07/2007	To Cash A/c	30000	01/07/2007	By Machine	150000
31/12/2007	To Cash A/c	49000	31/12/2007	By Interest A/c	9000
31/12/2007	To Balance	80000			
		159000			**159000**
31/12/2008	To Cash A/c	52000	01/01/2008	By Balance b/d	80000
31/12/2008	To Balance	40000	31/12/2008	By Interest A/c	12000
		92000			**92000**
31/12/2009	To Cash A/c	46000	01/01/2009	By Balance b/d	40000
			31/12/2009	By Interest A/c	6000
		46000			**46000**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/07	To King Printers A/c	9000	31/12/07	By Profit & Loss A/c	9000
		9000			9000
31/12/08	To King Printers A/c	12000	31/12/08	By Profit & Loss A/c	12000
		12000			12000
31/12/09	To King Printers A/c	6000	31/12/09	By Profit & Loss A/c	6000
		6000			6000

Machine A/c

Date	Particulars	RS.	Date	Particulars	RS.
1/7/2007	To King Printers A/c	150000	31/12/2007	By Depreciation A/c	7500
			31/12/2007	By Balance c/d	142500
		75000			150000
1/1/2008	To Balance b/d	142500	31/12/2008	By Depreciation A/c	15000
			31/12/2008	By Balance c/d	127500
		142500			142500
1/1/2009	To Balance b/d	127500	31/12/2009	By Depreciation A/c	15000
			31/12/2009	By Balance c/d	112500
		127500			127500

Depreciation A/c

Date	Particulars	RS.	Date	Particulars	RS
31/12/2007	To Machine A/c--1	7500	31/12/2007	By Profit &Loss A/c	7500
		7500			7500
31/12/2008	To Machine A/c--2	15000	31/12/2008	By Profit &Loss A/c	15000
		15000			15000
31/12/2009	To Machine A/c--3	15000	31/12/2009	By Profit &Loss A/c	15000
		15000			15000

Working Note: 1

Calculation of Depreciation

Date	Calculation	(Rs.)
1/7/2001	Cash Price	150000
31/12/01	less Depreciation for 6 months-----------1	7500
31/12/01	Book-Value	142500
31/12/02	less Depreciation-----------------------------2	15000
31/12/02	Book-Value	127500
31/12/02	less Depreciation-----------------------------3	15000
31/12/02	Book-Value	112500

Working Note: 2

Calculation of Interest

	Calculation	Cash Price (Rs.)	Cash Price paid (Rs.)	Interest (Rs.)	Instalment (Rs.)
1/7/2007	Cash Price	150000			
1/7/2007	Less Down Payment paid	30000	30000	0	30000
31/12/07	Outstanding cash price	120000			
31/12/07	Add Interest@ 15%	9000			
31/12/07	Total Amount Due	129000			
31/12/07	Less Instalment paid	49000	40000	9000	49000
31/12/07	Outstanding cash price	80000			
31/12/08	Add Interest@ 15%	12000			
31/12/08	Total Amount Due	92000	40000	12000	52000
31/12/08	Less Instalment paid	52000			
31/12/08	Outstanding cash price	40000			
31/12/09	Add Interest@ 15%	6000			
31/12/09	Total Amount Due	46000			
31/12/09	Total Amount Paid	46000	40000	6000	46000

Illustration 4.

On 1st January, 2003 Kavita Ltd. purchased Machinery on Hire-Purchase System from Jaya Traders for Rs. 26,000. They paid Rs. 2000 on signing the contract and four half –yearly installments of Rs. 6,000 plus interest at 20% per annum each on 30th June and 31st December every year thereafter. Depreciation was written off at rate of 10% per annum on the diminishing balance system.

i) Prepare Ledger accounts in the books of Kavita Ltd and Jaya Traders for the years 2003-2004; and

ii) Disclose the relevant items in Balance sheet of Kavita Ltd and Jaya Traders as on 31st December 2003

In books of Kavita Ltd. Industries Ltd
Jaya Traders A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2003	To Cash A/c	2000	01/01/2003	By Plant A/c	26000
30/06/2003	To Cash A/c	8400	30/06/2003	By Interest A/c	2400
31/12/2003	To Cash A/c	7800	31/12/2003	By Interest A/c	1800
31/12/2003	To Balance	12000			
		30200			**30200**
30/06/2004	To Cash A/c	7200	01/01/2004	By Balance	12000
31/12/2004	To Cash A/c	6600	30/06/2004	By Interest A/c	1200
			31/12/2004	By Interest A/c	600
		13800			**13800**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
30/06/2003	To Jaya Traders A/c	2400	31/12/2003	By Profit &Loss A/c	4200
31/12/2003	To Jaya Traders A/c	1800			
		4200			4200
30/06/2004	To Jaya Traders A/c	1200	31/12/2004	By Profit &Loss A/c	1800
31/12/2004	To Jaya Traders A/c	600			
		1800			1800

Machinery A/c

Date	Particulars	RS.	Date	Particulars	RS.
1/1/2002	To Jaya Traders A/c	26000	31/12/2002	By Depreciation A/c	2600
			31/12/2002	By Balance c/d	23400
		26000			26000
1/1/2003	To Balance b/d	23400	31/12/2003	By Depreciation A/c	2340
			31/12/2003	By Balance c/d	21060
		23400			23400

Depreciation A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/2003	To Machinery A/c	2600	31/12/2003	By Profit &Loss A/c	2600
31/12/2004	To Machinery A/c	2340	31/12/2004	By Profit &Loss A/c	2340

An Extract of Balance sheet of Kavita Ltd. as on 31st December 2003

Liabilities	Rs.	Asset	Rs.
Hire-Purchase Creditors		Fixed Assets:	
Balance in Jaya Traders	12000	Machinery (at cash Price)	26000
		Less Depreciation	2600
			23400

In books of Jaya Traders
Kavita Ltd. A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2003	To Sales A/c	26000	01/01/200	By cash A/c	2000
30/06/2003	To Interest A/c	2400	30/06/200	By cash A/c	8400
31/12/2003	To Interest A/c	1800	31/12/200	By cash A/c	7800
			31/12/200	By Balance	12000
		30200			**10400**
01/01/2004	To Balance b/d	12000	30/06/200	By cash A/c	7200
30/06/2004	To Interest A/c	1200	31/12/200	By cash A/c	6600
31/12/2004	To Interest A/c	600			
		13800			**13800**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/2003	To Profit &	4200	30/06/2003	By Kavita Ltd.	2400
			31/12/2003	By Kavita Ltd.	1800
		4200			**4200**
31/12/2004	To Profit &	1800	30/06/2004	By Kavita Ltd.	1200
			31/12/2004	By Kavita Ltd.	600
		1800			**1800**

An Extract of Balance sheet of Jaya Traders as on 31st December 2003

Liabilities	Rs.	Asset	Rs.
		Hire-Purchase Debtors	
		Kavita Ltd A/c	12000

Working Note: 1

Calculation of					
Date	**Calculation**	**Cash Price (Rs.)**	**Cash Price paid (Rs.)**	**Interest (Rs.)**	**Instalment (Rs.)**
01/01/2003	Cash Price	26000			
01/01/2003	Less Down Payment paid	2000	2000	0	2000
01/01/2003	Outstanding cash price	24000			
30/06/2002	Add Interest@ 20%*	2400			
30/06/2002	Total Amount Due	26400			
30/06/2002	Less Instalment paid	8400	6000	2400	8400
30/06/2002	Outstanding cash price	18000			
31/12/2003	Add Interest@20%*	1800			
31/12/2003	Total Amount Due	19800			
31/12/2003	Less Instalment paid	7800	6000	1800	7800
31/12/2003	Outstanding cash price	12000			
30/06/2004	Add Interest@20%*	1200			
30/06/2004	Total Amount Due	13200			
30/06/2004	Less Instalment paid	7200	6000	1200	7200
30/06/2004	Outstanding cash price	6000			
31/12/2004	Add Interest@20%*	600			
31/12/2004	Total Amount Due	6600			
31/12/2004	Less Instalment paid	6600	6000	600	6600

*Interest calculated for 6 months

Illustration 5.

Farhan Industries Ltd. acquired a plant at Cash Price of Rs. 75,000, delivered on 1st January 2002, on the following hire purchase terms:

1) An initial payment of Rs. 20,000 payable on delivery: and

2) Four half –yearly installments of Rs. 15,000 each commencing from 30th June, 2002.

In arriving at these terms the plant manufacturer computed interest at 7% per annum. Farhan Industries Ltd decided to write off depreciation @ 10% of the cost price each year. You are required to show the accounts in the books of Farhan Industries Ltd for the years ending on 31st December 2002 and 31st December 2003, necessary to record the above transactions

In books of Farhan Industries Ltd
Vendors A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2002	To Cash A/c	20000	01/01/2002	By Plant A/c	75000
30/06/2002	To Cash A/c	15000	30/06/2002	By Interest A/c	1925
31/12/2002	To Cash A/c	15000	31/12/2002	By Interest A/c	1467
31/12/2002	To Balance	28392			
		78392			**78392**

30/06/2003	To Cash A/c	15000	01/01/2003	By Balance	28392
31/12/2003	To Cash A/c	15000	30/06/2003	By Interest A/c	994
			31/12/2003	By Interest A/c	614
		30000			**30000**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
30/06/2002	To Vendors A/c	1925	31/12/2002	By Profit &Loss A/c	3392
31/12/2002	To Vendors A/c	1467			
		3392			3392
30/06/2003	To Vendors A/c	994	31/12/2003	By Profit &Loss A/c	1608
31/12/2003	To Vendors A/c	614			
		1608			1608

Plant A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2002	To Vendors A/c	75000	31/12/2002	By Depreciation A/c	7500
			31/12/2002	By Balance c/d	67500
		75000			75000
1/1/2003	To Balance b/d	67500	31/12/2003	By Depreciation A/c	7500
			31/12/2003	By Balance c/d	60000
		67500			67500

Depreciation A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/2002	To Plant A/c	7500	31/12/2002	By Profit &Loss A/c	7500
31/12/2003	To Plant A/c	7500	31/12/2003	By Profit &Loss A/c	7500

Working Note: 1. Calculation of Interest

Date (1)	Opening Cash Price (Rs.) (2)	Cash Price paid(Rs.) (3)=(5-4)	Interest (Rs.) @5% (4)	Instalment (Rs.) (5) Given	Closing Cash Price (Rs.) (6)=(2)-(3)
1/1/2002	75000	20000	0	20000	5500
31/6/2002	55000	13075	1925	15000	4192
31/12/2002	41925	13533	1467	15000	2839
31/06/2003	28392	14006	994	15000	1438
31/12/2003	14386	14386	614*	15000	0
	Total	75000	5000	80000	

*Balancing Figure

Illustration 6.

Bombay Trading Company purchased on 1st January, 2005 a machine on Installment purchase system. The cash price of the machine was Rs. 15,450 payment was to be made as under:

1. On 1st January, 2005 (on signing the contract) Rs. 3,000
2. On 31st December, 2005 Rs. 7,500
3. On 31st December, 2006 Rs. 4,500
4. On 31st December, 2007 Rs. 3,000

Bombay Trading Company charged depreciation at 10% p.a. under diminishing balance method; you are required to prepare necessary accounts in the books of Bombay Trading Company.

In books of Bombay Trading Company
Hire-Vendor A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2005	To Cash A/c	3000	01/01/2005	By Machine	15450
31/12/2005	To Cash A/c	7500	31/12/2005	By Interest A/c	1500
31/12/2005	To Balance	6450			
		16950			**16950**
31/12/2006	To Cash A/c	4500	01/01/2006	By Balance b/d	6450
31/12/2006	To Balance	2700	31/12/2006	By Interest A/c	750
		7200			**7200**
31/12/2007	To Cash A/c	23000	01/01/2007	By Balance b/d	2700
			31/12/2007	By Interest A/c	300
		3000			**3000**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/05	To Hire-Vendor A/c	1500	31/12/05	By Profit & Loss A/c	1500
		1500			1500
31/12/06	To Hire-Vendor A/c	750	31/12/06	By Profit & Loss A/c	750
		750			750
31/12/07	To Hire-Vendor A/c	300	31/12/07	By Profit & Loss A/c	300
		300			300

Machine A/c

Date	Particulars	RS.	Date	Particulars	RS.
1/1/2005	To Hire-Vendor A/c	15450	31/12/2005	By Depreciation A/c	1545
			31/12/2005	By Balance c/d	13905
		75000			75000
1/1/2006	To Balance b/d	13905	31/12/2006	By Depreciation A/c	1391
			31/12/2006	By Balance c/d	12514
		13905			13905
1/1/2007	To Balance b/d	12514	31/12/2007	By Depreciation A/c	1251
			31/12/2007	By Balance c/d	11263
		12514			12514

Depreciation A/c

Date	Particulars	RS.	Date	Particulars	RS
31/12/2005	To Machine A/c	1545	31/12/2005	By Profit &Loss A/c	1545
		1545			1545
31/12/2006	To Machine A/c	1391	31/12/2006	By Profit &Loss A/c	1391
		1391			1391
31/12/2007	To Machine A/c	1251	31/12/2007	By Profit &Loss A/c	1251
		1251			1251

Working Note: 1. Calculation of Interest

Step 1: Calculation of Total Interest:

Hire-purchase Price = Rs.18000
Less: Cash Price - Rs.15450
Total Interest = **Rs.2550**

Step 2: Apportionment of Interest

Total Interest of Rs.2550 is to be apportioned among the three installments in the following manner:

At the end of Year	2005	2006	2007	Total
Outstanding Hire Purchase Price	15000	7500	3000	25500
*Interest	1500	750	300	2550

$$\text{* Interest} = \frac{\text{Outstanding Hire Purchase Price before Installment* Total Interest}}{\text{Total of Outstanding Hire Purchase Price for all installments}}$$

Interest at the end of year 1 = $\frac{15000 * 2550}{25500} = 1500$

rest at the end of year 2 = $\frac{7500 * 2550}{25500} = 750$

Interest at the end of year 3 = $\frac{3000 * 2550}{25500} = 300$

Working Note: 2. Calculation of Depreciation

Date	Calculation	(Rs.)
1/1/2005	Cash Price	15450
31/12/05	less Depreciation	1545
31/12/05	Book-Value	13905
31/12/06	less Depreciation	1391
31/12/06	Book-Value	12515
31/12/07	less Depreciation	1251
31/12/07	Book-Value	11263

Illustration 7.

Doshi Roadways purchased two trucks from Tata Ltd. on hire-purchase system on 1st January, 2006. The cash price of each truck was Rs. 125,000. Payment was made as follows:

1.1.2006: RS 30,000 per truck.
31.12.2006: RS 45,000 per truck.
31.12.2007: RS 40,000 per truck.
31.12.2008: RS 35,000 per truck.
Depreciation at 20% per annum on original cost is charged.

You are required to: Calculate interest per year; and show the necessary accounts in the books of Doshi Roadways.

In books of Doshi Roadways
Tata Ltd A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2006	To Cash A/c	60000	01/01/2006	By Truck A/c	250000
31/12/2006	To Cash A/c	90000	31/12/2006	By Interest A/c	26087
31/12/2006	To Balance	126087			
		276087			**276087**
31/12/2007	To Cash A/c	80000	01/01/2007	By Balance	126087
31/12/2007	To Balance	62391	31/12/2007	By Interest A/c	16304
		142391			**142391**
31/12/2008	To Cash A/c	70000	01/01/2008	By Balance	62391
			31/12/2008	By Interest A/c	7609
		70000			**70000**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/06	To Tata Ltd. A/c	26087	31/12/06	By Profit & Loss A/c	26087
		26087			26087
31/12/07	To Tata Ltd. A/c	16304	31/12/07	By Profit & Loss A/c	16304
		16304			16304
31/12/08	To Tata Ltd. A/c	7609	31/12/08	By Profit & Loss A/c	7609
		7609			7609

Truck A/c

Date	Particulars	RS.	Date	Particulars	RS.
1/1/2006	To Tata Ltd. A/c	250000	31/12/2006	By Depreciation A/c	25000
			31/12/2006	By Balance c/d	225000
		250000			250000
1/1/2007	To Balance b/d	225000	31/12/2007	By Depreciation A/c	25000
			31/12/2007	By Balance c/d	200000
		225000			225000
1/1/2008	To Balance b/d	200000	31/12/2008	By Depreciation A/c	25000
			31/12/2008	By Balance c/d	175000
		200000			200000

Depreciation A/c

Date	Particulars	RS.	Date	Particulars	RS
31/12/2006	To Truck A/c	25000	31/12/2006	By Profit &Loss A/c	25000
31/12/2007	To Truck A/c	25000	31/12/2007	By Profit &Loss A/c	25000
31/12/2008	To Truck A/c	25000	31/12/2008	By Profit &Loss A/c	25000

Working Note: 1. Calculation of Interest

<u>Step 1: Calculation of Total Interest:</u>

Hire-purchase Price = Rs. 300000
Less: Cash Price - <u>Rs. 250000</u>
Total Interest = **<u>Rs. 50000</u>**

<u>Step 2: Apportionment of Interest</u>

Total Interest of Rs.2550 is to be apportioned among the three installments in the following manner:

At the end of Year	2005	2006	2007	Total
Outstanding Hire Purchase Price	240000	150000	70000	460000
*Interest	26087	16304	7609	50000

$$\text{* Interest} = \frac{\text{Outstanding Hire Purchase Price before Installment* Total Interest}}{\text{Total of Outstanding Hire Purchase Price for all installments}}$$

$$\text{Interest at the end of year 1} = \frac{240000 * 50000}{460000} = 26087$$

$$\text{Interest at the end of year 2} = \frac{150000 * 50000}{460000} = 16304$$

$$\text{Interest at the end of year 3} = \frac{70000 * 50000}{460000} = 7609$$

Working Note: 2. Calculation of Depreciation

Cost of Truck= Rs. 125000

Less Depreciation (@ 20% of the cost price) = **Rs.25000**
(125000*20/100)

Illustration 8.

Priya Trading purchased a machine on 1.1.2010 on hire purchase system from Rita Traders. The necessary details are given below:

Cash Price	Rs.60000
Amount paid on signing the agreement	Rs.20000
First Annual Installment	Rs.18000
Second Annual installment	Rs.16000
Last annual installment	Rs.13860
Rate of Interest	10% p.a.

Depreciation at 20% on cash price of machine by reducing installment method is charged. Calculate interest per year; and show the necessary accounts in the books of Rita Traders.

In books of Rita Traders
Priya Trading A/c

Date	Particulars	RS.	Date	Particulars	RS.
01/01/2010	To Sales A/c	60000	01/01/2010	By cash A/c	20000
31/12/2010	To Interest A/c	4000	31/12/2010	By cash A/c	18000
			31/12/2010	By Balance	26000
		64000			**64000**
01/01/2011	To Balance b/d	26000	31/12/2011	By cash A/c	16000
31/12/2011	To Interest A/c	2600	31/12/2011	By Balance	12600
		28600			**28600**
01/01/2012	To Balance	12600	31/12/2012	By cash A/c	13860
31/12/2012	To Interest A/c	1260			
		13860			**13860**

Interest A/c

Date	Particulars	RS.	Date	Particulars	RS.
31/12/2010	To Profit & Loss A/c	4000	31/12/2010	By Priya Trading A/c	4000
		4000			**4000**
31/12/2011	To Profit & Loss A/c	2600	31/12/2011	By Priya Trading A/c	2600
		2600			**2600**
31/12/2012	To Profit & Loss A/c	1260	31/12/2012	By Priya Trading A/c	1260
		1260			**1260**

Working Note: 1. Calculation of Interest

Date(1)	Opening Cash Price (Rs.)(2)	Cash Price paid (Rs.)	Interest (Rs.) @10%(4)	Installment (Rs.) (5) Given	Closing Cash Price (Rs.)
1/1/2010	60000	20000	0	20000	40000
31/12/2010	40000	14000	4000	18000	26000
31/12/2011	26000	13400	2600	16000	12600
31/12/2012	12600	12600	1260	13860	0

13.2 EXERCISE

1. Raja Transport Ltd. purchased a Motor car on 1st January, 2005, on hire-purchase basis from Meenakshi Motors Ltd. The cash –price of the Motor car was Rs.74,500. Under the agreement, a sum of Rs.20,000 was payable initially on 1st January, 2005: and the balance in three annual installments of Rs. 20,000 each falling due from 1st April, 2005. The financial year of the Raja Transport Ltd. end on the 31st March. The company charges interest at 5% p.a. and depreciation at 10% p.a on cash price of the Motor-car on diminishing balance method. Prepare Motor-car Account, Meenakshi's Motors Ltd Account and Interest Account in the books of Raja Transport Ltd.

Answers: Interest for 3 months till 1st April, 2005: Rs. 681, Interest for year ending 31st March, 2006: Rs. 1759, Interest for year ending 31st March, 2007: Rs. 847.

2. On 1.1.2002 Mr. Singh purchases machinery on Hire purchase system. The hire purchase agreement provided an initial down payment of Rs.1,500; the balance is to be paid in 4 equal half-yearly installments of Rs.2,000 each. Cash price is Rs.8,934. Rate of interest per annum is 6% and the rate of depreciation is 10% on original cost. Pass journal entries in the books of Mr. Singh from 1.1.2002 to 31.12.2003

Answers: Interest for half year ending 30/06/02: 223, Interest for half year ending 31/12/02: 170, Interest for half year ending 30/06/03: 115, Interest for half year ending 31/12/03: 58.

3. X Company Ltd. purchased a machine from Y Machines Ltd. on hire-purchase basis, the cash price being Rs.55,850 Rs.15,000 was paid on the signing of the contract and the balance in three annual installments of Rs.15,000 each on 31st March each year. Interest is charged at 5% per annum. Depreciation was written off at rate of 10% per annum on the diminishing balance system. Give journal entries in the books of X Company Ltd. whose accounting year ends on 31st March each year, under Full Cash Price Method.

Answers: Interest for 1st Year: 2043, 2nd Year: 1395, 3rd Year: 714.

4. M/s Asha Refrigeration Ltd. supplied Refrigerators to Ashok Hotel on the installment system, on 1st July, 2004. The cash price of Refrigerator was Rs. 22,350. Under Installment system, it was agreed to pay Rs.6,000 on that date and Rs.6,000 annually for three years. Depreciation was to be written off the asset 10% p.a. Show the relevant Ledger account in the books of both the parties for three years.

Answers: Interest for 1st Year: 825, 2nd Year: 550, 3rd Year: 275.

5. On 1st April, 2008 Modern Traders Ltd. took delivery of one Truck from GEM Motors Ltd. on Hire-Purchase Agreement, payable in three equal installments of Rs.60,000 each on 31st March, 2009, 2010, 2011. The cash value of the Truck on delivery was Rs.1,63,400. Vendor charges interest at 5% per annum on the yearly balances. The purchaser wrote off depreciation @ 25 per cent on the diminishing value method for each year. Pass the necessary Journal entries to record the above transactions in the books of both the parties.

Answers: Interest for 1st Year: 8170, 2nd Year: 5579, 3rd Year: 2852.

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