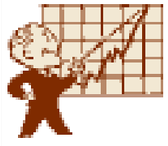
Points of distinctions	Hire purchase	Instalment purchase
	from the buyer.	balance amount but has no right to repossess the goods.
6. Return of goods	The buyer can return the goods at any time before the payment of final installment	The buyer can return the goods unless there is any defect in the goods.
7. Effect of default in payment	The seller gains if there is default in payment by the the hire purchaser	The seller does not gain in case of default in payment by the buyer
8. Legal action	If the buyer is in default of payment of installment, the seller has the right to repossess the goods and hence no legal action against the buyer is necessary	If the buyer is in default of payment of instalment and delays in making settlement, the seller can take legal action against the buyer i.e. the seller can sue for price.



CHECK YOUR PROGRESS

Q1: What is meant by instalment purchase system.

.....

.....

.....

GBA S2 08-02

FINANCIAL ACCOUNTING

SEMESTER - 2

BACHELOR IN BUSINESS ADMINISTRATION

BLOCK - 2

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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- **Buyer's right:** The buyer has the legitimate right of selling the goods, mortgaging the goods etc. before he has made the full payment. The buyer has the right to sell, mortgage or otherwise deal with the goods because the ownership lies with him.

7.4 DIFFERENCES BETWEEN HIRE PURCHASE AND INSTALLMENT PURCHASE SYSTEMS

Points of distinctions	Hire purchase	Instalment purchase
1. Nature of contract	It is an agreement of hiring	It is an agreement to sell
2. Ownership	The buyer becomes the owner of the goods only after clearing the final installment	The buyer becomes the owner of the goods immediately after the agreement to sell is complete
3. Nature of payment	The payments made by the buyer are regarded as hire charges for the goods till the final instalment is paid.	The payments made by the buyer are regarded as part payment of the goods.
4. Right of dealing with the goods	The buyer is restricted to hire- out, sell, pledge etc. before paying the final installment	The buyer is free to use the goods as he likes i.e. sell, mortgage etc. before making the full payment
5. Rights of repossession	If the buyer fails to pay any instalment, the seller has to take back the goods	If the buyer fails to pay any instalment, the seller can only take steps to recover the

7.3 MEANING AND FEATURES OF INSTALLMENT PURCHASE SYSTEM

Installment Purchase System or Installment Payment System or Installment System is a system of sale under which the price of the goods is paid by the buyer in periodical installments which may be monthly, quarterly, half-yearly or yearly, along with interest on the outstanding balance for different period. In case of installment payment system, the ownership of the property in the goods passes to the buyer on signing the agreement and delivery of the goods, in spite of the fact that the seller has agreed to receive payment for the goods in installments. Under this system, in the event of default by the buyer in making payment of any installment, the seller cannot take back the goods; he can only take steps for the recovery of the unpaid installments.

Features of installment purchase system

Following are the special features of Installment Purchase System-

- **Ownership:** The ownership of the goods passes to the buyer as soon as the transaction is completed and delivery is affected.
- **Nature of sale:** Installment payment system is a type of credit sale where price of the goods is paid in periodical installments.
- **Interest:** Every installment is paid along with interest calculated on outstanding balance for different periods.
- **Repossession:** The seller under installment system does not have the right of repossession of goods, if the buyer defaults in payment of installments.
- **Return of goods:** The buyer can neither return the goods once they are purchased nor the seller can ask the buyer to return the goods, even if the buyer makes default in payment of installments. Of course, the seller can sue the buyer for the balance of payment along with interest thereon.

BLOCK INTRODUCTION:

This is the *Second Block* of the course '***Financial Accounting***'. After completing this block, which consists of six units, you will be able to get a fair idea on the different concepts on Installment Purchase System, Presentation of final accounts, depreciation, partnership financial statement analysis and ratio analysis.

This block comprises the following six units :

The seventh unit is Installment Purchase System.

The eighth unit highlights the concepts of presentation of final accounts.

The ninth unit highlights the concepts of Depreciation, Causes, Characteristics and Methods for Computing Depreciation, Methods of recording depreciation, Methods of proving depreciation.

The tenth unit help us in understanding the variuos aspects of Partnership like the meaning of Partnership,Accounting for Partnership firm, Admission of a new Partner,Retirement or Death of a Partner,Dissolution of firm,Insolvency of Partner/Partners.

The eleventh unit is about Fianancial Statement Analysis, balance sheet, Profit And Loss Account, Statement of Cash Flow, Sources and Uses of Cash, Change in Current Assets, Change in current Liabilities nad Funds flow Statement

The twelfth and the last unit hieghlights on the concept of Ratio anlysis,its types and limitations and about Time Series Analysis.

The structure of Block-2 is as follows :

UNIT 7 : Installment Purchase System
UNIT 8 : Presentation of Final Accounts
UNIT 9 : Depreciation
UNIT 10 : Partnership
UNIT 11 : Financial Statement Analysis
UNIT 12 : Ratio Analysis

BACHELOR IN BUSINESS ADMINISTRATION

FINANCIAL ACCOUNTING

DETAILED SYLLABUS

UNIT 7: Installment Purchase System

Meaning and features of Installment Purchase System, difference between the Hire Purchase and Installment Purchase System and accounting for installment Purchase System.

UNIT 8: Presentation of Final Accounts

Preparation of Final Accounts, Trading Account, Meaning of trading account and gross profit, Contents of Trading Account, Journal entries relating to preparation of Trading Account, Specimen form of Trading Account, Profit and Loss account, Preparation of profit and loss account, Balancing of profit and loss account, Distinction between Trading A/c and Profit and Loss A/c, Format of Profit and Loss Accounts, Provisions & Reserves, Provision for Bad Debts and Doubtful Debts, Usual Adjustment Entries, Closing entries for Preparation of Profit and Loss Account, Balance Sheet, Meaning, Steps for Preparation of Balance Sheet, Classification of Assets, Classification of Liabilities, Explanation of some items appearing in the Balance Sheet, Format of Balance Sheet.

UNIT 9: Depreciation

Concept of Depreciation, Depreciation Accounting, Depreciation as a source of fund, Causes of Depreciation, Characteristics of Depreciation, Choice of Methods for Computing Depreciation, Methods of recording depreciation, Methods of providing depreciation.

UNIT 10: Partnership

Meaning of Partnership, Accounting for Partnership firm, Admission of a new Partner, Retirement or Death of a Partner, Computation of retiring /deceased partner's share in the firm, Mode of payment of retiring / deceased partner's share, Dissolution of firm, Dissolution of Partnership and Dissolution of firms, Settlement of accounts, Accounting entries for dissolution, Insolvency of Partner/Partners.

UNIT 11: Financial Statement Analysis

Financial Statements, Balance Sheet, Components of Balance Sheet, Assets, Profit And Loss Account, Concept of Profit, Statement of Cash Flow, Sources and Uses of Cash, Change in Current Assets, Change in Current Liabilities, Funds flow Statement, Sources and Uses of Working Capital, Forms of funds flow statement, Uses Of the Statement Of Changes in Financial Position.

UNIT 12: Ratio Analysis

Ratio Analysis— Its meaning and types, Liquidity Ratios, Leverage Ratio, Activity Ratio/ Turnover Ratio, Profitability Ratio, Valuation Ratio,Limitations Of Ratio Analysis, Time Series Analysis.

UNIT 7: INSTALLMENT PURCHASE SYSTEM

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Meaning and Features of Installment Purchase System

7.4 Differences between Hire Purchase and Installment Purchase Systems

7.5 Accounting for Installment Purchase System

7.6 Let Us Sum up

7.7 Further Readings

7.8 Answers To Check Your Progress

7.9 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to :

- discuss the meaning of installment purchase system
- features, advantages and disadvantages of installment purchase system
- explain the accounting treatment for installment purchase system

7.2 INTRODUCTION

In the prvious unit 6, we had discussed the concpet of Hire Purchase System of accounting .In this unit you will get the basic idea on the concept on the Installment Purchase System of selling goods and its advantages as well as disadvantages. Moreover, the accounting entries for the systems will also be covered in this unit.

Like hire purchase system and installment payment system serve the same purpose i.e., enables the customers to purchase costly goods by making payment in easy installments though there are some differences between these two systems of sale.

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
2018 Dec. 31	Interest A/c Dr To Interest Suspense A/c (Being periodical interest transferred)		279	279
Dec. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation charged @ 10% on machine)		905	905
Dec. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being interest and depreciation Transferred)		1,042	137 905

LEDGER ACCOUNTS

MACHINERY ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017 Jan. 1	To Archana Machinery Company A/c		11,175	2017 Jan. 31	By Depreciaton A/c By Balance c/d		1,118 10,057
			11,175				11,175
2018 Jan.1	To Balance b/d		10,057	2018 Dec. 31	By Depreciaton A/c By Balance c/d		1,006 9,051
			10,057				10,057

7.5 ACCOUNTING FOR INSTALLMENT PURCHASE SYSTEM

Calculation of Interest

The allocation of element of cash price and interest included in each installment is of utmost importance for recording transactions under installment purchase system. The method to be followed for calculation of interest depends on the nature and extent of information supplied in the question. First step is to ascertain the total amount of interest payable as per the agreement.

Interest Suspense Account

Under installment purchase system, an 'Interest Suspense Account' is to be opened in the books of both the buyer and the seller with the total amount of interest. It consists of total interest payable by the buyer along with different installments during the period of contract. This is nothing but the total future liability of the buyer on account of interest to the vendor and total future income on account of interest to the vendor. Therefore, the buyer treats it as a deferred expense and spreads it over the different future periods on the basis of outstanding balance.

Accounting treatment of Interest Suspense Account:

Interest suspense account is treated in the books of account as under:

In the books of the buyer

The buyer, under installment purchase system, debits 'Interest Suspense Account' and credits Vendor's Account' on the day of agreement with the total amount of interest payable under the agreement. As and when the periodical installments become due, interest due on the date of each installment is transferred from 'Interest Suspense Account' to 'Interest Account' by debiting interest account and crediting interest suspense account. On the Balance Sheet date, the balance left in interest suspense account is shown in the liability side of the Balance Sheet as a deduction from Vendor's A/c and the amount of interest debited to interest account is transferred to the debit side of the Profit and Loss Account.

In the books of the vendor

The vendor, under installment purchase system, credits 'Interest Suspense Account' and debits Buyer's Account' on the day of agreement. As and when the periodical installments become due, interest due on the date of each installment is transferred from 'Interest Suspense Account' to 'Interest Account' by crediting 'interest account' and debiting 'interest suspense account'. On the Balance Sheet date, the balance left in interest suspense account is shown on the asset side of the Balance Sheet as a deduction from Buyer's A/c and, the amount of interest credited to interest account, is transferred to the credit side of the Profit and Loss Account.

Charging of depreciation

Under Installment purchase system, the buyer becomes the owner of the property in goods as soon as he receives the delivery of the goods. Therefore, as owner, he can charge depreciation on the asset owned and possessed by him. At the year end, depreciation on the asset is calculated at the rate and method stated in the question and the amount is treated as a loss and is debited to depreciation account and the asset account is credited, and ultimately, the amount of depreciation is debited to profit and loss account.

The depreciation is calculated on the cash price of the asset and not on the total amount paid irrespective of the method followed for recording the purchase of asset under installment purchase system.

Accounting entries

In every Installment purchase transaction; there are two parties – Buyer and Vendor (Seller). The accounting entries for recording of Installment purchase sale transactions are required to be passed in the books of both the Buyer and Vendor. These are explained below:

BOOKS OF ASSAM OIL COMPANY (BUYER)

JOURNAL

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
2017 Jan. 1	Machinery Account Dr. Interest Suspense Account Dr. To Archana Machinery Company Account (Being the machine purchased on instalment system)		11,175 825	 12,000
Jan.1	Archana Machinery Company Account Dr. To Bank Account (Being the down payment made)		3,000	3,000
Dec.31	Interest A/c Dr. To Imterest Suspense A/c (Being periodical interest transferred)		409	409
Dec.31	Archana Machinery Company Account Dr. To Bank (Being the first instalment paid)		3,000	3,000
Dec. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation @ 10% charged machinery)		1,118	1,118
Dec. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Deing interest and depreciation transferred)		1,527	 409 1,118

Solution : 1

Working:

Calculation of Interest and capital value

	Details Rs.	Interest Rs.	Capital Value Rs.
Cash price on 1.1.2017	11,175	-	
Less : Down Payment	3,000		
	8,175		
Add : Interest @ 5% p.a. for 1 year upto 31.12.2017	409		
	8,584		3,000
Less : 1st annual Instalment	3,000	409	
	5,584		2,591
Add : Interest @ 5% p.a. for 1 year upto 31.12.17	279		
	5,863		
Less : 2nd annual Instalment	3,000	279	
	2,863		
Add : Interest (balancing figure) upto 31.12.18	137		2,721
	3,000		
Less : 3rd annual Installment	3,000	137	2,863
	Nil	825	11,175

1. Calculation of Depreciation:

Cash price of the Machine on 1.1.17	11,175
Less : Depreciation for the year 2017 @ 10%	1,118
	10,057
Less : Depreciation for the year 2018 @ 10%	1,006
	9,051
Less : Depreciation for the year 2019 @ 10%	905
Value on 31.12.19	8,146

Books of the purchaser

The entries to be passed in the books of the purchaser under Installment System may be grouped as under:

(a) Entries on the date of agreement/taking delivery of the asset/on making down payment, if any.

(b) Entries on the due dates of periodical installments

(c) Entries on annual closing of account.

(a) **Entries on the date of agreement/taking delivery of the asset:** For the purpose of purchase of asset under Installment system, an agreement is usually entered into between the purchaser and vendor. As per the agreement, the asset is delivered to the purchaser who may or may not make any down payment. Therefore, on the date of agreement, the following entries will be passed:

(i) *On getting delivery of the asset on the date of agreement:*

Asset (by name of the asset) Dr.	[With the full cash price of the asset]
Interest Suspense Account Dr.	[With total interest of all installments]
To Vendor Account (By name)	[With the full cash price of the asset and total interest of all installments]

(ii) *For down payment made, if any, on the date of agreement:*

Vendor Account (By name) Dr.	[With the amount of down payment]
To Bank/Cash Account	

(Above entries will be passed only once for the purchase of each asset under Installment purchase system)

(b) **Entries on the due dates of periodical installments**: As per

the agreement, on periodical intervals, the interest on unpaid balance will become due and the periodical instilments (which may be monthly, quarterly, half-yearly or yearly) will have to be paid. Therefore, the following two entries will be passed on the due dates of periodical installments:

(i) For making the interest due:

Interest Account Dr.	[With the amount of periodical interest]
To Interest Suspense Account	

(ii) On making payment of the periodical installment:

Vendor (By name) Dr.	[With the amount of installment paid]
To Bank/Cash account	

This entry will be passed on the date of making the payment.

(Above entries will be repeated in subsequent years)

(c) ***Entries on annual closing of account:*** At the end of every financial year entries will have to be passed for charging depreciation on the asset and then entry will have to be passed for transfer of interest and depreciation to Profit & Loss Account. Therefore, the following entries will have to be passed on annual closing of account:

(i) *For charging depreciation on the asset:*

Depreciation Account Dr.	[With the amount of depreciation]
To Asset Account	

(ii) *For transfer of interest and depreciation to Profit & Loss Account:*

Profit and Loss Account Dr.	[With the amount of depreciation and interest]
To Interest Account	[With the total interest for the year]
To Depreciation Account	[With the amount of depreciation]

(Above entries will be repeated in subsequent years)

Consequent to the passing of above entries, the following accounts are opened in the books of the purchaser to record transactions under Installment system:

(i) Vendor Account (By name)

(ii) Asset Account (By name)

(iii) Interest Suspense Account

(iv) Interest Account

(v) Depreciation Account

(vi) Profit & Loss Account

(When the students are asked to prepare necessary accounts in the books of the purchaser, they are to prepare the above accounts)

Exercise 7.1

On 1st January 2017, Assam Oil Company purchased an Oil Machine on installment system from Archana Machinery Company. The cash price of the machine was Rs. 11,175 and payment was to be made as follows: Rs. 3,000 on signing the agreement and the balance in three equal installments of Rs. 3,000 each at the end of each year. 5% interest is to be charged by Archana Machinery Company per annum. Assam Oil Company has decided to write off 10% annually on diminishing balance of the cash price.

Give the journal entries and ledger account in the books of Assam Oil Company. Calculations are to be made to the nearest rupee.

IN THE BOOKS OF ARCHANA MACHINERY CO. (VENDOR)

JOURNAL

Date	Particulars	L.F	Amount	
			Debit Rs.	Credit Rs.
2019 Jan. 1	Assam oil Company A/c Dr. To Sales A/c Dr. To Interest suspense A/c (Being the sale of an oil machine on installment basis)		12,000	 11,175 825
,,	Bank Account Dr. To Assam oil Company A/c (Being the down payment made)		3,000	 3,000
,,	Bank Account Dr. To Assam oil Company A/c (Being the first annual instalment received)		3,000	 3,000
,,	Interest suspense Account Dr. To Interest A/c (Being the periodical interest transferred)		409	 409
,,	Sales A/c Dr. To Trading A/c (Being the transfer of balance of Sales a/c to Trading A/c)		11,175	 11,175
,,	Interest Account Dr. To Profit and Loss Account (Being interest transferred)		409	 409

2019 Jan. 1	To Balance b/d		9,051	2019 Dec. 31	By Depreciaton A/c By Balance c/d		905 8,146
			9,051				9,051
2020 Jan. 1	To Banalce		8,146				

ARCHANA MACHINERY ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017 Jan. 1 Dec.31	To Bank To Bank To Balance c/d		3,000 3,000 6,000	2017 Jan. 1	By Machinery A/c By Interest Suspense A/c		11,175 825
			12,000				12,000
2018 Dec.31	To Bank To Balance c/d		3,000 3,000	2018 Jan. 1	By Balance c/d		6,000
			6,000				6,000
2019 Dec.31	To Bank		3,000	2019 Jan. 1	By Balance b/d		3,000

INTEREST SUSPENSE ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017				2017			
Jan. 1	To Archana Machinery			Dec.31	By Interest A/c		409
	Company A/c		825		By Balance c/d		416
			825				825
2018				2018			
Jan. 1	To Balance b/d		416	Dec.31	By Interest A/c		279
					By Balance c/d		137
			416				416
2019				2019			
Jan. 1	To Balance b/d		137	Jan. 1	By Interest A/c		137
			137				137

INTEREST ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017				2017			
Jan. 1	To Interest Suspense A/c		409	Dec.31	By Profit & Loss A/c		409
2018				2018			
Dec.31	To Interest Suspense A/c		279	Dec.31	By Profit & Loss A/c		279
2019				2019			
Dec.31	To Interest Suspense A/c		137	Dec.31	By Profit & Loss A/c		137

Solution : 7.2

Working:

Calculation of Interest and capital value

	Details Rs.	Interest Rs.	Capital Value Rs.
Cash price on 1.1.2017	11,175	-	
Less : Down Payment	3,000		
	8,175		
Add : Interest @ 5% p.a. for 1 year upto 31.12.2018	409		
	8,584		3,000
Less : 1st annual Instalment	3,000	409	
	5,584		2,591
Add : Interest @ 5% p.a. for 1 year upto 31.12.2016	279		
	5,863		
Less : 2nd annual Instalment	3,000	279	
	2,863		
Add : Interest (balancing figure) upto 31.12.2019	137		2,721
	3,000		
Less : 3rd annual Installment	3,000	137	2,863
	Nil	825	11,175

1. Calculation of Depreciation:

Cash price of the Machine on 1.1.17	11,175
Less : Depreciation for the year 2015 @ 10%	1,118
	10,057
Less : Depreciation for the year 2018 @ 10%	1,006
	9,051
Less : Depreciation for the year 2019 @ 10%	905
Value on 31.12.19	8,146

(When you are asked to prepare necessary accounts in the books of the vendor you have to prepare the above accounts)

Exercise: 7.2



On 1st January 2017, Assam Oil Company purchased an oil machine on installment system. The cash price of the machine was Rs. 11,175 and payment was to be made as follows: Rs. 3,000 on signing the agreement and the balance in three equal installments of Rs. 3,000 each at the end of each year. 5% interest is to be charged by Archana Machinery Company per annum. Assam Oil Company has decided to write off 10% annually on diminishing balance of the cash price.

Give the journal entries and ledger account in the books of Archana Machinery Company. Calculations are to be made to the nearest rupee.

DEPRECIATION ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2017 Jan. 1	To Machinery A/c		1,118	2017 Dec.31	By Profit & Loss A/c		1,118
2018 Dec.31	To Machinery A/c		1,006	2018 Dec.31	By Profit & Loss A/c		1,006
2019 Dec.31	To Machinery A/c		905	2019 Dec.31	By Profit & Loss A/c		905

BOOKS OF THE VENDOR:

Transactions relating to sale under Installment system are recorded like ordinary credit sale of assets by the Vendor. Therefore, the vendor debits the purchaser's account and credits sales account with its full cash price on the date of delivery of the asset. Total amount of interest payable over the period over which the payment will be made is calculated and the same is credited to Interest Suspense Account along with the above entry. No entry for depreciation will be passed by the vendor. The entries to be passed in the books of the vendor may be grouped as under:

(a) Entries on the date of agreement/delivery of the asset/ on receiving the down payment.

(b) Entries on the due dates of periodical installments

(c) Entries on annual closing of account.

(a) ***Entries on the date of agreement/ delivery of the asset:*** For the purpose of sale of asset under installment system, an agreement is usually entered into between the purchaser and vendor. As per the agreement, the asset is delivered to the purchaser

who may or may not make any down payment. Therefore, on the date of agreement, the following entries will be passed:

(i) *On delivery of the asset to the Purchaser on the date of agreement:*

Purchaser Account (By name) Dr.	[With the full cash price of the asset]
To Sales account	[With the total cash price of the asset]
To Interest Suspense account	[With the total interest of all installments]

(ii) *For down payment received, if any, on the date of agreement:*

Bank/Cash Account Dr.	[With the amount of down payment received]
To Purchaser Account (By name)	

Note: ***Above entries will be passed only once for sale of each asset under Installment Payment System.***

(b) ***Entries on the due dates of periodical installments:*** As per the agreement, at periodical intervals, the interest on unpaid balance will become due and the periodical installments will be received by the vendor from the purchaser. Therefore, the following two entries will be passed on the due dates of periodical installments:

(i) *On receiving payment of periodical installments:*

Bank/Cash Account Dr.	[With the amount of installment received]
To Purchaser Account (By name)	

(ii) *On interest becoming due:*

Interest Suspense Account (By name) Dr.	
To Interest Account	[With the amount of periodical interest becoming due]

Note: Above entries will be repeated in subsequent years till the receipt of the last installment.

(c) ***Entries on annual closing of account:*** At the end of every financial year entries will have to be passed for transfer of Interest to Profit & Loss Account. The vendor will not pass any entry for depreciation. Therefore, the following entries will be passed on annual closing of account:

(i) *For closing the balance of Sales Account:*

Sales Account Dr.	[With the balance of Sales Account]
To Trading Account	

(ii) *For transfer of Interest to Profit and Loss Account:*

Interest Account Dr.	[With the total interest for the year]
To Profit and Loss Account	

(Above entries will be repeated in subsequent years)

Consequent to the passing of above entries, the following accounts are opened in the books of the vendor to record transactions under Installment system:

(i) Purchaser's Account (By name)

(ii) Interest Suspense Account

(iii) Interest Account

(iv) Profit & Loss Account

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- prepare final accounts
- learn trading account
- discuss the profit and Loss account
- learn about Balance Sheet

8.2 INTRODUCTION

In this unit we are going to discuss about Final accounts. Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger(dicussed in unit 3). It includes the accounts of all expenses, incomes, assets, liabilities, capital and drawings. Let us discuss in detail 'Final Accounts' in this unit. We will come to know how to prepare a trading account and balance sheet.

8.3 PREPARATION OF FINAL ACCOUNTS

Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger. The final accounts can be produced more often than once a year in order to give information to the owner(s) on how the business is progressing. However, it is customary to produce annual or final accounts for the benefit of the interested parties.

A trading firm prepares a Trading and Profit and Loss Account; a manufacturing business prepares a Manufacturing Account in addition to the Trading and Profit and Loss Account; a social club prepares and Income and Expenditure Account; and a professional man prepares only a Profit and Loss account; in addition to a Balance Sheet.

In case of sole proprietorship form of business, preparation of Final Accounts involves the preparation of accounts:

(a) Trading Account;

(b) Profit and Loss Account; and

(c) Balance Sheet.

2017 Dec. 31	Bank A/c Dr. To Assam oil Company A/c		3,000	3,000
,,	(Being the second annual installment received) Interest suspense Account Dr. To Interest A/c (Being the periodical interest transferred)		279	279
,,	Interest Account Dr. To Profit and Loss Account (Being interest transferred)		279	279
,,	Bank A/c Dr. To Assam oil Company A/c (Being the third annual installment received)		3,000	3,000
2018 Dec. 31	Interest suspense A/c Dr. To Interest A/c (Being the periodical interest transferred)		137	137
,,	Interest A/c Dr. To Profit and Loss A/c (Being interest transferred)		137	905

LEDGER ACCOUNTS

ASSAM OIL CO. ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2016				2016			
Jan. 1	To Sales A/C		11,175	Jan. 1	By Bank A/c		3,000
	To Interest suspense A/C		825	Dec.31	By Bank A/c		3,000
					By Balance c/d		6,000
			12,000				12,000
2017				2017			
Jan. 1	To Balance b/d		6,000	Dec. 31	By Bank A/c		3,000
					By Balance c/d		3,000
			6,000				6,000
2018				2018			
Jan. 1	To Balance b/d		3,000	Dec. 31	By Bank A/c		3,000

INTEREST SUSPENSE ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2016				2016			
Jan. 1	To Interest A/C		409	Jan. 1	By Assam Oil		
	To Balance c/d		416	Dec.31	Compaly A/c		825
			825				825
2017				2017			
Dec.31	To Interest A/C		279	Dec. 31	By Balance c/d		416
	To Balance c/d		137				
			416				416
2018				2018			
Dec.31	To Interest A/C		137	Dec. 31	By Balance b/d		137
			137				137

UNIT 8: PRESENTATION OF FINAL ACCOUNTS

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Preparation of Final Accounts

8.4 Trading Account

- 8.4.1 Meaning of trading account and gross profit
- 8.4.2 Contents of Trading Account
- 8.4.3 Journal entries relating to preparation of Trading Account.
- 8.4.4 Specimen form of Trading Account

8.5 Profit and Loss account

- 8.5.1 Preparation of profit and loss account
- 8.5.2 Balancing of profit and loss account
- 8.5.3 Distinction between Trading Account and Profit and Loss A/c
- 8.5.4 Format of Profit and Loss Accounts
- 8.5.5 Provisions & Reserves
- 8.5.6 Provision for Bad Debts and Doubtful Debts
- 8.5.7 Usual Adjustment Entries
- 8.5.8 Closing entries for Preparation of Profit and Loss Account.

8.6 Balance Sheet

- 8.6.1 Meaning of Balance Sheet
- 8.6.2 Steps for Preparation of Balance Sheet
- 8.6.3 Classification of Assets
- 8.6.4 Classification of Liabilities
- 8.6.5 Items appearing in the Balance Sheet
- 8.6.6 Format of Balance Sheet

8.7 Let us Sum Up

8.8 Further Reading

8.9 Answers to Check Your Progress

8.10 Model Questions

payment in five installments. It was decided to depreciate the machinery @ 10% per annum on reducing balance method. Ascertain the cash down price and show Interest Suspense Account and Machinery Account in the books of Rabi & Co. Ltd.

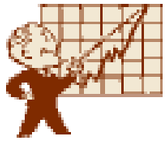
[**Hints**: Cash Price Rs. 21,648. Interest: 1st year Rs. 1,082; 2nd year Rs. 886; 3rd year Rs. 681; 4th year Rs. 465; 5th year Rs. 238.]

———————

INTEREST ACCOUNT

Dr. **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2016 Dec.31	To Profit & Loss A/c		409	2016 Dec. 31	By Interest Suspense A/C		409
			409				409
2017 Dec.31	To Profit & Loss A/c		279	2017 Dec. 31	By Interest Suspense A/C		279
			279				279
2018 Dec.31	To Profit & Loss A/c		137	2018 Dec. 31	By Interest Suspense A/C		137
			137				137



CHECK YOUR PROGRESS

Q2: Mention two features of instalment purchase system.

.....

.....

.....

.....

Q3: State two differences between hire- purchase and instalment purchase system.

.....

.....

.....

7.6 LET US SUM UP

In this unit we have discussed the following

- Installment purchase system under which the buyer acquires the ownership of the goods immediately and can pay the price of the goods in periodical installments.
- Differences between hire- purchase and installment purchase systems regarding nature of contract, ownership, right of repossession etc.
- Accounting treatment for installment purchase system, calculation of interest and depreciation etc.



7.7 FURTHER READING

1. Ashis Bhattacharya,(2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari,(2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.



7.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q1: Installment Purchase System is a system of sale under which the price of the goods is paid by the buyer in periodical installments which may be monthly, quarterly, half-yearly or yearly, along with interest on the outstanding balance for different period.

Ans to Q.2:
i) Ownership of the goods passes to the buyer as soon as the sale is complete
ii) The seller does not have the right of repossession of goods if the buyer fails to pay installment.

Ans to Q.3:
i) In hire- purchase, the buyer becomes the owner of the goods after payment of last installment.
In installment purchase system, the buyer becomes the owner of the goods as soon as the agreement to sell is complete.
ii) In hire- purchase system, the payments made by the hire purchaser are regarded as hire charges.
In installment purchase system, the payments made by the buyer are regarded as part payment of the goods.



7.9 MODEL QUESTIONS

Q1. What is installment purchase system? Discuss the features of installment purchase system.

Q2. Discuss the differences between hire- purchase and installment purchase systems.

Q3. Rabi & Co. Ltd. purchased on installment basis a machinery on 1st January, 2003. The term was that on 31st December each year, a payment of Rs. 5,000 has to be made to the vendor M/s. Archana Machinery which includes interest @ 5 % p.a. on the balance of cash down price due for five years completing the

will be treated as selling expenses and debited to Profit and Loss Account.

B. Items shown on the Credit side of the Trading Account:

(1) Sales: Sales account appearing in the Trial Balance, shows the total sales made during the accounting period. This includes both cash and credit sales. Sales account shows credit balance. It is treated as revenue and as such it is shown on the credit side of the Trading account. In respect of sales, the following points must be noted :

1) Only the sale of goods is treated as sales for the purpose of preparation of Trading Account.
2) If sales include sale of fixed asset, it should be deducted from sales.
3) If any goods have been sold on approval and included in sales, it should be deducted from sales, if the approval period has not expired. Such sales should be recorded separately.

(2) Sales Return: When goods are returned by the buyers, for some reasons, “Returns Inwards Account” or “Sales Return Account” is debited in the books of account and the buyer’s account is credited. ‘Sales Return Account’ appears on the debit side of the Trial Balance. There are two ways of showing sales returns in the Trading Account. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns is to put it in the debit side of the Trading Account. But normally it is shown by way of deduction from sales in order to show the figure of net sales.

(3) Closing Stock (Closing Inventory): The goods remain unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the Closing Stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods. Accounting treatment of closing stock will be as under :

The starting point for preparing final accounts is the trial balance. All the figures recorded on the trial balance are used in the final accounts. The trading account and the profit and loss account are both ‘accounts’ in terms of double-entry book-keeping. This means that amounts recorded in these accounts must also be recorded elsewhere in the book-keeping system. By contrast, the balance sheet is not an account, but is simply a statement of account balances remaining after the trading and profit and loss accounts have been prepared.

The following points are to be noted while preparing final accounts:

(i) In examination problems, if the question is not given in the form of a trial balance, a Trial Balance should be prepared before preparing the final accounts because the balance sheet will not agree if the trial balance does not agree, if there is a difference in the Trial Balance, the difference should be placed to ‘Suspense A/c’ and shown in the Balance Sheet in order to get the balance sheet agreed.

(ii) All items which appear in the Trial Balance should be shown only once for the same amount whereas items which appear outside the Trial Balance, known as adjustments, have to be shown at two places.

(iii) Items which appear on the debit side of the trial balance is shown on the debit side of the Trading Account or on the debit side of the Profit and Loss Account or on the assets side of the Balance Sheet depending on the nature of account.

However, item such as Returns Inward which appears on the debit side of the trial balance is shown on the credit side of the Trading Account as deduction from sales.

(iv) Items which appear on the credit side of the trial balance is shown on the credit side of the Trading Account or on the credit side of the Profit and Loss Account or on the liabilities side of the Balance Sheet depending on the nature of account.

However, Returns Outward account although shows credit balance and appears on the credit side of the trial balance is shown on the debit side of Trading Account as a deduction from Purchases.

Drawings account, although appears on the debit side of the trial

balance, is shown as a deduction from Capital on the Liabilities side of the Balance sheet.

(v) The direct expenses are shown on the debit side of the Trading Account and indirect expenses are shown on the debit side of the Profit and Loss Account and other incomes are shown on the credit side of the Profit and Loss Account.

(vi) Remaining accounts will be the accounts of Assets, Liabilities, Capital and Drawings which will be shown in the Balance Sheet.

(vii) Additional information or adjustments given by way of notes are the matters which have not been recorded in the books of account. These are to be considered by adjusting the items of expenses, losses, assets, drawings, incomes, liabilities or capital as applicable while preparing the Final Accounts. Adjustments requires both the Trading and Profit and Loss Account and the Balance Sheet depending on the nature of the adjustment. Sometimes an adjustment may have effects on both sides of the balance sheet only. For example, credit purchase of asset omitted to be recorded on the books.

(viii) No column for L.F. is required to be given in Final Accounts.

(ix) The total of both sides of the Balance Sheet will always be equal. (Ref. Theory and Practice of Accountancy: B.B. Dam etel).

8.4 TRADING ACCOUNT

8.4.1 Meaning of Trading Account and Gross Profit

Meaning of Trading Account:

Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods. Ascertainment of overall result of trading is the ascertainment of gross profit earned or gross loss incurred as a result of the trading activities by a business during a particular accounting period.

If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the

purchase of goods is charged to trading account and when it is paid on the sale of good it is charged to profit and loss account. In the absence of specific instructions, these are debited to trading account.

(f) **Excise Duty:** Excise Duty is the amount of duty or charges paid to the government on goods manufactured and is, therefore, debited to the trading account.

(g) **Octroi:** Octroi is the amount ***levied*** by the municipal authority when the goods enter the city and hence debited to trading account because they are connected with purchases.

Levied: Impose and collect

(h) **Royalty:** Royalty is the amount paid to the owner of a mine or patent for using his right or patent. Where the payment of royalty is based on production, it is usually charged to trading account because it increases the cost of production. However, if it is specifically started in the problem that the Royalty is payable on the basis of sales, it will be charged to Profit and Loss account.

(i) **Packing Charges/Packing Expenses:** Packing material is used for packing of materials at different stages.

(a) If packing charges are incurred to make goods saleable or to bring it in a saleable condition, these are direct expenses. They are as such debited to the Trading Account.

(b) If the packing expenses are connected with sales or they have been incurred after the goods have been sold, they are treated as selling expenses and are debited to the Profit and Loss Account.

For example, a manufacturer of biscuits sell biscuits packed in poly packs. In order to make the biscuits available in saleable condition, this primary packing is necessary. Therefore, they are treated as direct expenses. Now, a person purchases three packets of such biscuits and the seller packs these three packets for handing over the purchaser, the expenses incurred on such secondary packing is indirect and

production of goods and as such are debited to the trading account. While preparing Trading Account, it should be noted that :

a) If the item 'Wages and Salaries' is given in the problem, it will be shown in the trading account. On the contrary, if 'Salaries and Wages' are given it will be shown in the profit & loss account.

b) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence such expenses or wages will not be shown in the trading account.

(b) Carriage or Carriage Inward or Freight: Carriage or Carriage Inward or Freight is the expenses which are paid for bringing the goods to the shop or to the factory and hence should be debited to trading account. However, if any carriage or freight is paid for carrying charge of an asset, the amount should be added to the asset account and should not be debited to trading account.

(c) Manufacturing Expenses: Manufacturing Expenses such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc. are the expenses which are incurred in the manufacture of goods and hence these are shown on the debit side of the Trading account (where manufacturing account is not prepared).

(d) Dock Charges: Dock Charges are the charges levied on ships and their cargo while entering or leaving docks. If dock charges are paid on import of goods they are shown on the debit side of trading account. If dock charges are paid on export of goods they are shown on the debit side of the Profit and Loss account. In the absence of specific instructions, these are debited to trading account.

(e) Import Duty or Custom Duty: Custom Duty is paid on import as well as on export of goods. Custom duty when paid on the

difference is termed as **gross profit**. On the contrary, if the purchases and direct expenses exceed the sales, the difference is called **gross loss**.

All expenses which relate to either purchase of raw material or manufacturing of goods, called 'Direct Expenses', which are recorded in the Trading Account. Thus, trading account is a part of Income Statement.

Meaning of Gross Profit

Gross profit generated from carrying on the basic activity of a business. The basic activity of a business comprises of buying and selling of goods. The excess of revenue generated over cost of manufacture or purchase of goods is known as **gross profit**. In other words, gross profit is the excess of Net Sales over the cost of goods sold. This is explained as under:

Gross Profit	=	Net Sales – Cost of goods sold.
Net Sales	=	Sales – Sales Returns or Returns Inward.
Cost of Goods sold	=	Opening Stock (Inventory) + Net Purchases – Closing Stock
Net Purchases	=	Purchases – Purchase Returns or Returns Outward

Or

Cost of goods sold	=	Opening Stock (Inventory) + Purchases + Expenses incurred in connection with purchases and manufacture (Direct expenses) – Closing Stock.

Exercise: 8.1

From the following information, calculate: **(i)** Cost of Goods sold; and **(ii)** Gross profit:

	Rs
Opening Inventory	12,000
Cash Purchases	16,000
Credit Purchases	28,000

Purchase Return	3,000
Cash Sales	39,000
Credit Sales	72,000
Sales Return	4,000
Wages	8,000
Salaries	9,000
Rent	3,000
Other Direct Expenses	14,000
Closing Inventory	5,000

Solution:

(i) **Cost of Goods sold** = Opening Inventory + Net purchases + Expenses incurred in connection with purchases (Direct Expenses) - Closing Inventory.

= Rs. [12,000 + (16,000 + 28,000 – 3,000) + (8,000 + 14,000) – 5,000]

= Rs. 70,000

(ii) **Gross Profit** = Net Sales – Cost of goods sold.

= Rs. [(39,000 + 72,000) – 4,000] – 70,000

= Rs. (1,07,000 – 70,000)

= Rs. 37,000

8.4.2 Contents of Trading Account

Trading Account is an account like any other account. It has two sides – Debit and Credit. All expenses which relate to either purchase or manufacturing of goods are written on the debit side of the Trading Account.

A. Items shown on the Debit side of the Trading Account:

(1) **Opening Stock (Opening Inventory):** The stock of goods remains unsold at the end of the last year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. This item is shown as the first item on the debit side of the Trading account. It should be kept in mind that there will

be no opening stock in case of newly started business. Opening Stock will include the Stock of Raw Materials, Semi-finished goods and finished goods. This item appears on the debit side of the trial balance. Stock of goods is also termed as inventory and, therefore, opening stock is termed as opening inventory.

(2) **Purchases:** Purchases includes goods which have been bought for resale. The amount of Purchases appearing in the trial balance includes cash purchases as well as credit purchases. Purchases account shown debit balance and hence it appears on the debit side of the Trial balance. While preparing the final account, it is shown on the debit side of the Trading account.

(3) **Purchases Returns:** When goods are returned by the business, for some reasons, “Returns Outwards Account” or “Purchase Returns Account” is credited in the books of account and supplier’s account is debited. “Purchases Returns Account” shows credit balance and appears on the credit side of the Trial balance. There are two ways of showing purchase returns in the Trading Account. It may be shown by way of deduction from Purchases on the debit side of the Trading Account or it may be shown on the Credit side of the Trading Account. However, normally it is shown by way of deduction from Purchases in order to show the figure of net purchase in the Trading Account.

(4) **Direct Expenses:** In case of a trading concern, all expenses incurred in purchasing the goods, bringing them to the godown and into saleable condition are treated as direct expenses and charged to trading account. For example, carriage inward, freight, wages etc. In case of manufacturing concern, cost of converting the raw materials into finished products form part of direct expenses. Direct expenses to be debited to trading account include the following.

(a) **Wages:** Wages are paid to workers who are engaged in the

8.5.1 Preparation of Profit and Loss Account

A Profit and Loss Account starts with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account will now be debited to Profit & Loss Account. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on the credit side of this account.

These expenses are incidental to carrying on business; these are called 'Indirect Expenses'. and are broadly grouped under three categories of expenses; viz.

a) Administrative Expenses which include Salaries to Staff, Office Rent, Printing and Stationery etc.

b) Financial Expenses which include Interest on Loan, etc.

c) Selling and Distribution Expenses which include Carriage Outward, Advertisement, etc.

If the credit total is heavier, the difference is called Net Profit and if the debit total is heavier, the difference is called Net Loss.

Transfer of Net Profit or Net Loss:

Net Profit indicates an increase in proprietor's equity or capital by the amount of profit while Net Loss indicates a decrease in owner's equity or capital by the amount. So Net Profit or Net Loss is to be transferred to the Proprietor's Capital Account by passing a journal entry as given below:

(a) For Transfer of Net Profit:

Profit and Loss account Dr.

To Capital Account.

(b) For Transfer of Net Loss :

Capital Account Dr.

To Profit and Loss Account.

A. Items shown on the Debit side of Profit & Loss Account:

(1) Gross Loss: If trading account discloses Gross Loss, it is

(a) Where the amount of closing stock is stated outside the Trial Balance

Normally, the Closing Stock is given outside the Trial Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry:

Closing Stock A/c Dr.

To Trading A/c

(Being the incorporation of Closing Stock in the books of account.)

Closing stock account will be posted to the credit side of the trading account and on the other hand, debit aspect of the closing stock account will be shown on the Asset side of the Balance Sheet, in order to complete the double entry.

(b) Where the amount of Closing Stock is stated inside the Trial Balance:

Sometimes, the Closing Stock may be given inside (on the debit side) the Trial Balance. This means that the entry for incorporating the closing stock in the books has already been passed. It implies that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear only on the Assets side of the Balance Sheet.

Again, the Closing Stock may be given both on the debit side and credit side of the Trial Balance. In such a case, the debit balance will be shown on the asset side of the balance sheet and the balance appearing on the credit will be shown on the credit side of the Trading account.

c) Valuation and recording of closing stock:

Closing stock should be valued either at cost or

market price whichever is lower and should be recorded accordingly. While preparing final account, if the figure of both cost price and market price of the closing stock is given, the closing stock will be shown both in the Trading account and the balance sheet either **at the cost price or market price whichever is lower.** (Ref. Theory and Practice of Accountancy: B.B. Dam etel).

For example, the cost price of stock held by a trader on 31-3-2004 is Rs.12, 000 and will be recorded in the books of account accordingly.

8.4.3 Journal Entries relating to preparation of Trading Account

The preparation of the Trading Account requires that the balances of all such accounts which are due to appear in the Trading Account are transferred to it. The entries required for such transfer are termed as closing entries. These will be as follows:

(1) **For transfer of opening stock:**

Trading A/c Dr.

To Opening Stock A/c

(2) **For transfer of purchases:**

Trading A/c Dr.

To Purchases A/c

(3) **For transfer of purchases returns:** The balance of purchases return account is transferred to purchases account or Trading account.

Purchases Return A/c Dr.

To Purchases A/c or Trading A/c

(4) **For transfer of direct expenses:**

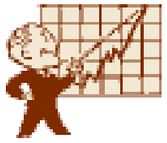
Trading A/c Dr.

To Direct Expenses (Individually) A/c

(5) **For transfer of Sales**

Sales A/c Dr.

To Trading A/c



CHECK YOUR PROGRESS

Q 1: Fill in the Blanks:

a) Final accounts are prepared after the preparation of .....

b) Every adjustments has ..... effects in Final Accounts.

c) All ..... expenses are recorded in trading account.

Q 2: State True or False:

a) Every adjustment in final account has three effects. True/ False

b) Carriage outward is debited to trading account. True/ False

c) Closing Stock is always valued at Market Price. True/ False

d) Gross Profit =Net Sales – Cost of Goods Sold. True/ False

Q 3: What do you mean by Opening stock.

.....

.....

8.5 PROFIT AND LOSS ACCOUNT

Meaning of Profit and Loss Account:

After preparing a Trading Account and ascertaining Gross Profit or Gross Loss, we are to prepare Profit and Loss Account in order to ascertain Net Profit or Net Loss. Profit and Loss Account is the statement wherein the various items of profit and revenue earned on one hand and the losses, and expenses incurred on the other hand are collected and set off and the resulting balance represents the Net Profit or Net Loss of the period under review. It means, the expenses for earning the income are set off against that income to ascertain Net Profit or Net Loss.

If the gains exceed the losses; the excess is the Net Profit. If the losses exceed the gains, the excess is the Net Loss. American Accountants call this Account a “Loss and Gain Account” which is more appropriate in relation to its formation.

Solution: **In the books of Ram and Shyam**

Trading Account

For the year ended 31st March, 2015

Particulars		Amount (Rs.)	Particulars		Amount (Rs.)
To Opening Stock		10,000	By Sales	1,20,000	
To Purchases	80,000		Less : Returns		
Less : Purchase			inward	3,000	1,17,000
Returns	2,000		By Closing Stock		15,000
	78,000				
Less : Goods taken					
by Ram					
transferred to					
his Drawings A/c	1,000	77,000			
To Octroi Duty		500			
To Freight		2,000			
To Excise Duty		1,000			
To Coal, gas and water		1,500			
To Productive					
wages	15,000				
Add : Outstanding	500	15,500			
To Profit & Loss A/c					
(Gross Profit c/c)		24,500			
		1,32,000			1,32,000

Note: Trade expenses ordinarily indicate General Expenses and it is indirect in nature and, therefore, taken to Profit & Loss A/c. In case the Trial balance contains both Trade Expenses and General Expenses, Trade Expenses will be treated as direct and will be taken to the Trading A/c and General Expenses will be taken to the Profit & Loss A/c.

(6) **For transfer of Sales Returns or Returns Inward :**

Trading A/c / Sales A/c Dr.

To Returns Inward A/c

(7) **For transfer of Closing Stock :**

Closing Stock A/c Dr.

To Trading A/c

(8) **Entry for closing the Trading account:**

(a) If the credit side of the Trading Account exceeds the debit side: After passing the above entries, if the total of amounts of the credit side of the Trading Account exceeds the total of amounts of debit side, the difference is termed as Gross Profit. The Gross Profit will be transferred to the credit of a newly opened account called Profit and Loss account. The following entry is passed for the same:

Trading A/c Dr.

To Profit and Loss A/c

(Being the transfer of Gross Profit to the Profit and Loss A/c)

(b) If the debit side of the Trading Account exceeds the credit side: If the total of amounts of debit side of the Trading Account exceeds the total amounts of the credit side, the difference will be termed as Gross Loss. It will be transferred to the debit of Profit and Loss Account by means of the following entry:

Profit and Loss A/c Dr.

To Trading A/c

(Being the transfer of Gross Loss to the Profit and Loss A/c)

8.4.4 Specimen Form of Trading Account

In the books of ……..

Trading Account

For the year ended on ……

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Opening Stock		By Sales	
To Purchases		Less : Sales Returns Or	
Less : Purchase Returns Or		Returns inward	
Returns outward		By Closing Stock	
To Wages		By Profit and Loss A/c	
To Wages & Salaries		(Gross loss transferred)	
To Direct Expenses		(Balancing figure)	
To Carriage, or			
Carriage on Purchase			
To Duty on Purchase			
To Gas, Fuel and Power			
To Freight/ Cartage			
To Manufacturing Expenses,			
Or Productive Expenses			
To Factory Expenses, such as :			
Factory Lighting			
Factory Rent etc.			
To Octroi			
To Dock charges			
To Clearing charges			
To Import Duty or			
Custom Duty			
To Excise Duty			
To Insurance Premium			
(factory)			
To Royalty on production			
To Profit and Loss A/c			
(Gross Profit transferred)			
[Balancing Figure]			



Exercise 8.2

Following is the extract of the Trial Balance of Ram and Shyam firm as on 31.3.2015.

Particulars	**Debit**	**Credit**
	Rs.	Rs.
Stock on 1.4.15		10,000
Carriage on Sales		2,000
Purchases		80,000
Discount		2,000
Sales		1,20,000
Purchase returns		2,000
Octroi Duty		5000
Returns inward		3,000
Productive wages		15,000
Freight		2,000
Excise Duty		1,000
Coal, gas and water		1,500
Salaries		5,000
Trade Expenses		1,000

Additional information:

(i) Stock on 31.3.2015 Rs.15,000

(ii) Outstanding wages 500

(iii) Goods taken by Ram for Personal Use 1,000

Prepared the Trading Account of the firm for the year ended 31.3.2015

provision for discount on debtors and provision for taxation etc. A definite sum is charged every year out of profit and loss account to meet the known contingency. Provisions account should be compulsorily posted at the debit side of profit and loss account, whether the firm earns profit or suffers loss.

The provision against any asset is generally shown as deduction from concerned asset in the balance sheet. For example; Provision for doubtful debts and provision for discount on debtors. They are shown as deduction from debtors on the assets side of the Balance Sheet. Sometimes, the provision may also be shown at the liabilities side of the balance sheet. For example; provision for taxation.

Provision for doubtful debts generally has old balance. The old provision is deducted from the total of bad debts and new provision at the debit side of profit and loss account. In case old provision exceeds the total of bad debts and new provision, the treatment should preferably be made at the credit side of profit and loss account, where the total of bad debts and new provision should be deducted from old provision.

8.5.6 Provision for Bad debts and Doubtful debts

It is a common feature for every business to sell goods on credit. The people to whom goods have been sold on credit are known as 'Debtor' and the total of all the debtors is termed as 'Sundry Debtors'. Sundry Debtors are also termed as 'Book Debts'. The total debtors of a firm may be classified into: Good debts, Bad debts and Doubtful debts.

(i) **Good Debts:** Good debts are those debts which will be recovered in full. In other words, that portion of sundry debtors which will be recovered in full is termed as 'Good Debtors'.

(ii) **Bad Debts:** Sometimes due to the financial difficulty, death or insolvency or dishonesty of a Debtor, full amount due from them may not be recovered from such person/persons. When

shown as the first item on the debit side of the Profit and Loss Account.

(2) **Indirect Expenses:** Each and every business house is required to incur some other expenses other than the direct expenses in course of their day to day business activities. Such expenses include expense of revenue nature other than the direct expenses such as Office and Administrative expenses, Selling and Distribution expenses, financial charges etc. These expenses are termed as indirect expenses because they are not directly related to purchase of goods and bringing them into saleable condition. Indirect expenses debited to profit and loss account are state below :

(a) **Office and Administrative Expenses:** Expenses such as salary of office employees, office rent, lighting, postage, printing, stationery, audit fee, legal charges etc. are treated as Office and Administrative Expenses.

(b) **Selling and Distribution Expenses :** Expenses such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc. are treated as Selling and Distribution Expenses.

(c) **Financial Charges:** Expenses such as interest on loan, interest on capital, interest on overdraft etc. are treated as financial charges.

(d) **Miscellaneous Expenses:** Expenses such as interest on loan, interest on capital, repair charges, depreciation, charity etc. are treated as Miscellaneous Expenses.

(e) **Other Losses:** Such as loss by fire, loss due to accident etc.

(f) **Provisions:** Such as Provision for doubtful Debts, provision for Discount on Debtors etc.

B. Items shown on the Credit side of Profit & Loss Account:

(1) **Gross Profit:** If the Trading Account discloses Gross Profit,

Gross Profit is shown as the first item on the credit side of Profit and Loss Account.

(2) Other Incomes and Gains: All items of incomes and gains such as income from investments, rent received, discount received, commission earned, and interest received, bad debts recovered etc. are shown on the credit side of the Profit & Loss Account.

8.5.2 Balancing of Profit and Loss Account

The balance of the Profit & Loss Account, after posting all nominal accounts to the respective side, is termed as Net Profit or Net Loss. If the credit side of the profit and loss account is more than the total of the debit side, the difference is termed as net profit. On the other hand, if the total of the debit side exceeds the total of the credit side, the difference is termed as net loss. The Net Profit/ Net Loss is transferred to the capital account. Net profit is added to the capital whereas net loss is deducted from the capital in the balance sheet.

8.5.3 Distinction between Trading Account and Profit and Loss Account

Sl. No.	Basis of Distinction	Trading Account	Profit & Loss Account
1.	Items included	Sales and all the items relating to ascertainment of cost of sales are shown in this account.	All the items of indirect expenditure such as salary, rent, bad debts, discount etc. are shown in this account.
2.	Result	The balance of this Account is named as gross profit/ gross loss.	The balance of this Account is named as net profit/ net loss.
3.	Transfer of balance	The balance of this Account is transferred to Profit and Loss Account.	The balance of this Account is transferred to Capital account.

provision for taxation, provision for repairs, provision for damages likely to arise from a pending suit and such others.

d) For proper allocation of expenses: Provision is also required to be made for proper allocation of expenses. For example; total amount to be spent on repairs and renewals during the life of an asset is estimated and spread over on an average basis because the amount of expenses in earlier years would be comparatively lower than that of the later years. Therefore, in order to allocate the expenses on repairs on an equitable basis it is necessary to create provision for repairs. Actual expenses of repairs incurred each year will then be debited to this account. Hence, it will put equal burden each on the Profit and Loss account of each year in respect of expenses of repairs.

Nature of balances of Provision and Reserves Accounts:

Any reserve or Provision account usually show credit balance. But there is only one exception i.e. Reserve for Discount on Creditors Account which shows debit balance.

Disclosure in the Balance Sheet:

The amount of provision created is required to be shown in the balance sheet as under:

(i) If the provision is created for liabilities and charges, the amount of provision should be shown on the liability side of the Balance sheet. For example, Provision for Income Tax, Provision for Repairs and Renewals.

(ii) If the provision is created for a definite object such as to meet expected contingency, e.g., doubtful debts, discount on debtors, the provision is shown as deduction from Sundry Debtors on the assets side of the balance sheet.

Accounting Treatment of Provisions:

Provisions are charged against profit. Provisions are created by debiting profit and loss account for specific and known contingency or expected loss, e.g., provision for doubtful debts,

Characteristics / Features of Provisions:

a) Provision is made to meet a known liability.

b) Although the liability is known, the amount of such liability cannot be determined with reasonably accuracy. For example, it is almost certain that some of the amount receivable from debtors will become bad but it is not possible to predict the exact amount of such bad debts.

c) Provision is a charge against profits and as such the creation of provision reduces the profits or increases the loss of the year in which it is created. The loss when actually occurs is adjusted against such provision and thus the profit of the year in which such loss occurs is not affected.

d) Provision is created even if there is loss.

Need for creating Provisions:

a) To ascertain the true net profit of the business: For the purpose of ascertaining the true profit of a business, it is necessary that all expenses pertaining to that year, whether paid or not, must be debited to Profit and Loss account. Hence, provision should be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for doubtful debts, because the amount of such bad debts cannot be estimated correctly.

b) To ascertain the true financial position of the business: In order to see that the Balance Sheet discloses the true and fair view of the financial position of the business, it is necessary that provision is made for all the anticipated losses and expenses.

c) To provide for known losses in future : Provisions are made to provide funds for meeting those which are likely to occur in the near future such as provision for bad debt,

4.	Utility	Trading Account shows the trend of business activities.	This Account shows the net result of the business. By
5.	Sequence of preparation	By comparing the Trading Account of consecutive periods steps can be taken to increase profitability. It is prepared before the preparation of Profit and Loss Account.	comparing net results of consecutive periods, steps can be taken for an all round development of the business. It is prepared after the preparation of Trading Account.

8.5.4 Format of Profit and Loss Account

Profit and Loss Account

(for the year ending .....)

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Trading A/c (Gross Loss Transferred)		By Trading A/c (Gross Profit transferred)	
Office & Administrative Expenses :		By Rent (Cr.)	
To Salaries		By Rent of premises sub-let	
To Salaries & Wages		By Discount received	
To Rent, Rates & Taxes		Or Discount (Cr.)	
To Printing & Stationery		By Commission Received	
To Postage & Telegram		By Interest on Investments	
To Lighting		By Dividend on Shares	
To Insurance Premium (office)		By Sundry Receipts	
To Telephone Charges		By Bad debts Recovered	
To Legal Charges		By Profit on sale of assets	
To Audit Fees		By Income from other Sources	
To Traveling Expenses		By Apprenticeship Premium	
To Establishment Expenses.		By Sale of Scraps	
To Trade Expenses [see note (ii)]		By Royalty Received	
To General Expenses.		By Subsidy from Govt.	
To Royal on sales.		By Interest on Drawings	
To Establishment		By Capital A/c	
To Commission of Office Manager		[Net Loss Transferred to]	

Selling and Distribution Expenses :			
To Carriage Outwards, or Carriage on Sales			
To Advertisement			
To Commission			
To Discount			
To Rebate			
To Brokerage			
To Bad debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses.			
To Wages (Unproductive)			
To Commission to Sales Manager			
Financial Charges :			
To Interest on Loan			
To Bank Charges			
To interest on Overdraft.			
Sundry Expenses :			
To Sales Tax			
To Repairs			
To Depreciation on fixed assets			
To Entertainment Expenses			
To Contingencies			
To Conveyance Expenses			
To Donation and Charity			
To Loss on Sale of Assets			
Provisions :			
To Provision for Doubtful Debts			
To Provision for Discount on Debtors			
To Capital A/c(Net Profit Transferred)			

8.5.5 Provisions & Reserves

Meaning and Characteristics of Provisions:

In course of carrying out business activities, each and every entity is required to prepare itself for meeting all eventualities both expected and unexpected. In order to ensure that the profit has not been distributed out of capital, it is important that necessary provisions are made and reserves are created out of profit at the time of preparation of final accounts. The terms 'Provisions' and 'Reserves' are different forms each other.

The term 'Provision' means the setting aside of an estimated amount to meet known liability or loss the amount of which may not be exactly ascertained. It is a charge against profit to meet certain known liabilities or contingencies. Charge against profit means that the amount should be provided for even if there is no profit. For the purpose of making provision, the amount of provision to be made is debited to the Profit and Loss account in order to ascertain the correct profit.

According to Companies Act, 1956, the term 'Provision' refers to any one of the following amounts:

1 The amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets; or

2 The amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

Examples of provisions:

(i) Provision for Income Tax;
(ii) Provision of Sales Tax;
(iii) Provision for liability for disputed claim.
(iv) Provision for depreciation;
(v) Provision for Repairs and Renewals;
(vi) Provision for doubtful debts;
(vii) Provision for discount on debtors;

(2) For transfer of accounts of various items of incomes and gains :

Interest received A/c Dr.
Commission Received A/c Dr.
Rent Received A/c Dr.
To Profit and Loss A/c

(Being the transfer of nominal accounts showing credit balances to the credit of Profit and Loss A/c)

(3) For the transfer of credit balance of Profit & Loss A/c, known as net profit:

Profit and Loss A/c Dr.
To Capital A/c

(Being the transfer of net profit to Capital A/c)

(4) For the transfer of debit balance of Profit & Loss A/c, known as net loss:

Capital A/c Dr.
To Profit and Loss A/c

(Being the transfer of net loss to Capital A/c)

Exercise : 8.5

From the following particulars, pass necessary journal entries and prepare a Profit & Loss Account of Mr. K. Baruah for the year ending 31st March, 2016.

Particulars	Rs.	Particulars	Rs.
Gross Profit	3,12,000	Discount allowed	3,000
Trade Expenses	2,000	Lighting	780
Carriage on Sales	10,000	Commission Received	840
Office Salaries	15,800	Bad-debts	1,200
Postage and Telegram	720	Discount (Cr.)	600
Office Rent	7,500	Interest on Loan	2,200
Legal Charges	400	Wages (Unproductive)	1,400
Audit fee	1,600	Export Duty	2,300

the business firm finds that a particular amount due from a particular debtor cannot be recovered either in full or in part, the unrecoverable portion is termed as 'Bad Debts'.

When the business entity feels that a particular amount cannot be recovered from a particular debtor, it is meaningless to carry forward the balance in the account of such debtor in the ledger every year. The balance standing to the debit of that account is cancelled. The process of cancellations of balance in the account of a debtor is called 'writing off' bad debts. This is done by recording the following journal entry:

Bad debts A/d Dr.
To Debtors A/c (Individually)

(Being bad debts written off)

In examination problems where the name of the debtor is not given, the entry for 'writing off' bad debts will be as under:

Bad debts A/c Dr.
To Sundry Debtors A/c

(Being bad debts written off)

Need for creating Provision for Doubtful Debts:

As credit sales are made in a particular year during which debtors are created, the profit on such sales is included in the Trading and Profit and Loss Account of that year as revenues are ascertained on the basis of accrual assumption. Doubtful Debts is a business loss arising from credit sales; so it is logical that such a loss is charged against the revenue earned through credit sales of that year according to the matching principle. Moreover, on the basis of the modifying principle of conservatism and according to the principle of revenue recognition, expected loss must be taken into account during that year while ascertaining net profit.

Hence, it is not only fair but also logical that doubtful debts being a business loss in connection with credit sales must be provided for out of the revenue earned during the period so that the

Profit and Loss Account of the following year is not burdened with the loss of earlier years.

Provision for Doubtful Debts – How Created:

Since doubtful debts can only be estimated, a provision is created on estimated basis. This is calculated at a certain percentage on the amount of Debtors at the end of the year. The percentage is fixed on the basis of past experience in connection with the reliability of debtors. The provision so created is called 'Provision for Doubtful Debts' or 'Provision for Bad Debts' or 'Provision for Bad and Doubtful Debts'. All these three terms are used interchangeably. Sometimes the term 'Reserve' is used in place of the 'Provision'. It is not proper to use the term Reserve in place of 'Provision' for Doubtful Debts created for the first time in a particular year is carried forward to the next year. In the next year, this provision is terms as 'Old Provision' or 'Existing Provision' and the provision to be created in that year is termed as 'New Provision'. Following journal entry is passed for creating 'Provision for Doubtful Debts':

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry debtros)

Exercise : 8.3

On 31-12-2014, the Sundry debtors of a firm amounted to Rs.60, 800. Out of debtors Rs. 800 is irrecoverable and the same is to be written off as bad debt.

Pass journal entries relating to bad debts and show how the accounts will be reflected in the Profit and Loss Account and the Balance Sheet.

XIII. Goods used as stationery in office.	Printing and Stationery A/c(a) Dr. To Purchases A/c(b)	(a) Debit side of the Profit and Loss A/c and (b) a deduction from Purchases in Trading A/c.	
XIV. Loss of stock by fire etc. insured and claim admitted.	Insurance Claim A/c(a) Dr. To Trading A/c(b)	(b) Credit side of Trading A/c	(a) Assets side as Insurance Claim
XV. Loss of stock partially insured and admitted by insurance Co.	Insurance Claim A/c(a) Dr. Loss by Fire A/c(b) Dr. (to be transferred to P/L. A/c) To Trading A/c (c)	(b) Debit side of the Profit and Loss A/c and (c) credit side of the Trading A/c	(a) Insurance claim on the Asset side.
XVI. Loss of stock by fire uninsured	Loss by Fire A/c(a) Dr. To Trading A/c(b)	(a) Debit side of the Profit and Loss A/c and (b) Credit side of Trading A/c	

8.5.8 Closing entries for Preparation of Profit & Loss Account

The preparation of the Profit & Loss Account requires that the balances of such accounts which are due to appear in the Profit & Loss Account are transferred to it. The entries required for such transfer are termed as closing entries. These are as follows:

(1) For transfer of account of various items of expenses and losses:

Profit and Loss A/c Dr.

To Salaries A/c

To Rent, Rates and Taxes A/c

To Printing and Stationery A/c

To Postage and Telegram A/c

To General Expenses etc

(Being the transfer of nominal accounts showing debit balances to the debit of Profit and Loss A/c)

USUAL ADJUSTMENT ENTRIES

Adjustment items	Adjustment Entries	Effect to be shown in	
		Profit & Loss Account	Balance Sheet
I. To provide for outstanding expenses	Expense Account (concerned) (a) Dr. To Outstanding Expenses A/c (b)	(a) Debit Side, as an addition to the concerned A/c	(b) Liabilities side
II. To adjust prepaid expenses :	Prepaid Expense A/c (a) Dr. To Expense Account (concerned)(b)	(a) Debit side, as a deduction from the concerned Expense A/c	(b) Assets side.
III. To adjustincome earned but not received	Outstanding Income A/c (a) Dr. To Income A/c (concerned) (b)	(b)Credit side, as an addition to the concerned Income A/c	(a) Assets side
IV. To adjustIncome received in advance	Income A/c (concerned) (a) Dr. To Income Received in Advance A/c(b)	(a) Credit side, as a deduction from Income A/c concerned	(b) Liabilities side
V. To write off bad debt	Bad Debt. A/c(a) Dr. To Debtors A/c(b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VI. To provide for doubtful debt	Profit and Loss A/c(a) Dr. To Reserve for Doubtful Debt A/c(b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VII. To provide for discount on Debtors	Profit and Loss Account(a) Dr. To Reserve for Discount on Debtors A/c(b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VIII. To provide for discount on Creditors	Reserve for Discount on Creditors A/c(a) Dr. To Profit and Loss A/c (b)	(b) Credit side	(a) Liabilities side, as a deduction from Sundry Creditors
IX. To provide for depreciation on a permanent asset	Depreciation A/c(a) Dr. To (concerned) Asset A/c(b)	(a) Debit side	(b) Assets side, as a deduction from the concerned assets.
X. To adjust interest on proprietor's capital	Interest on Capital A/c(a) Dr. To Capital A/c(b)	(a) Debit side	(b) Liabilities side, as a addition to Capital.
XI. To adjust interest on drawings	Capital A/c(a) Dr. To Interest on Drawing A/c(b)	(b) Credit side	(a) Liabilities side, as deduction from Capital
XII. For goodsused as free samples	Free Samples A/c(a) Dr. Or Advertisement A/c(a) To Purchase A/c(b) Dr.	(a) Debit side, and (b) a deduction from Purchase A/c in the Trading Account.	

Journal

Date	Particulars	L F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2014 Dec.31	Bad Debts A/c Dr. To Sundry Debtors (Being the amount of bad debts written off)		800	800
Dec.31	Profit and Loss Account Dr. To Bad Debt Account (Being the transfer of bad debts to Profit and Loss A/c)		800	800

Note: Since the bad debts are to be written off, the entry for writing off bad debts is required to be passed.

Profit and Loss Account for the year ended 31-12-2014

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Bad Debts	800		

Balance Sheet as at 31-12-2014

Dr. **Cr.**

Liabilities (Rs.)	Amount (Rs.)	Assets	Amount
		Sundry Debtors 60,800 Less: Bad Debts 800	60,000

Creation and Accounting Treatment of Provision for Doubtful Debts:

Where an entity decides to make provision for doubtful debt, a new account called 'Provision for Doubtful Debts Account'/ 'Provision for Bad Debt Account'/ 'Provision for Bad and Doubtful Debts Account' is required to be opened in the ledger. The balance of this account will be carried forward to the next year. While preparing final accounts the amount of provision for doubtful debts will be shown on the debit side of the Profit and

Loss Account and the same will be shown as deduction from Sundry Debtors in the Balance Sheet.

The following journal entry is required to be passed for creating 'Provision for Doubtful Debts' :

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry Debtors)

Note : It should be kept in mind that the creation of Provision for Doubtful Debts does not reduce the balance of sundry debtors. The Provision for Doubtful Debts is shown as deduction from sundry debtors in the assets side of the balance sheet for the purpose of showing the amount of sundry debtors at its estimated realizable value.



Exercise :8.4

Following is the extract of Trial Balance as on 31st December, 2016.

Trial Balance

Sundry debtors	40,000

Create Provision for Doubtful Debts @5% on Debtors. You are required to pass Journal entry for creating provision for Doubtful Debts. Show the Provision for Doubtful Debts Account as it will appear in the Ledger. Also show how the Provision for Doubtful Debts will appear in the Profit and Loss Account and the Balance Sheet. The accounting year ends on 31st December each year.

Solution : **Journal**

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2016				
Dec.31	Profit and Loss Account Dr.			2,000
	To Provision for Doubtful Debts A/c			2,000
	(Being the creation of Provision for Doubtful Debts % 5% on Sundry Debtors)			

Dr. **Provision for Doubtful Debts Account** **Cr.**

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2016				2016			
Dec. 31	To Balance c/d		2,000	Dec. 31	By Profit and Loss A/c		2,000
				2017			
				Jan.1	By balance b/d		2,000

Profit and Loss Account

For the year ended 31st December, 2016

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.
To Provision for Doubtful Debts A/c	2000		

Balance Sheet as on 31st December, 2016

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Sundry Debtors 40,000	
		Less: Provision	
		For doubtful debts 2,000	38,000

8.5.7 Usual Adjustment Entries

Journal entries are necessary to adjust the revenue and expenses accounts at the end of each accounting year. They are given below in a tabular form with their effect in the Profit and Loss Account and the Balance Sheet.

(i) Accounts payable or bills payable and trade creditors,

(ii) Liabilities for outstanding expenses,

(iii) Bank overdraft,

i) **Deferred Liabilities:** Deferred liabilities are those liabilities which are repayable in course of less than one year but more than one month.

ii) **Liquid or Quick Liabilities:** Debts which are repayable in course of a month are called liquid or quick liabilities viz. outstanding expenses like salaries, rent, etc.

iii) **Contingent Liabilities:** Contingent liabilities are those liabilities which are at present not liabilities but which may or may not arise in future on the happening of a certain event viz. liability on bills discounted, liability under a damage suit, etc.

8.6.5 Items appearing in the Balance Sheet

Capital: It is shown in the Balance Sheet on the liabilities side as the excess of assets over liabilities. It denotes a debt of the business to the proprietor.

Reserve: It is a portion of profit, not yet paid to the proprietor. It is kept aside to strengthen the financial position of the business and is shown on the Liabilities Side of the Balance Sheet.

Loan: If money is borrowed by the business from somebody for the purpose of the business, it is credited to Loan Account. It is a liability of the business and is shown on the liabilities side of the Balance Sheet. If any interest on loan is outstanding, such outstanding interest is also shown in the liabilities side of the Balance Sheet as a separate item named 'Outstanding Interest'.

Conversely, if any loan is granted to any person by the business, 'Loan Account' is debited as an asset. It is to be shown on the assets side of the Balance Sheet. Any interest accrued but

Donation	1,100	Miscellaneous Receipts	500
Sundry Expenses	360	Advertisement	4,100
Selling Expenses	5,320	Travelling Expenses	2,500

Solution: **In the books of Mr. K. Baruah**

Journal Entries

Date	Particulars		L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2016	Profit and Loss Account	Dr.		62,280	
Mar.31	To Trade expenses Account				2,000
	To Carriage on sales Account				10,000
	To Office Salaries Account				15,800
	To Postage & Telegram Account				720
	To Office Rent Account				7,500
	To Legal charges Account				400
	To Audit Fee Account				1,600
	To Donation Account				1,100
	To Sundry expenses Account				360
	To Selling expenses Account				5,320
	To Discount allowed Account				3,000
	To Lighting Account				780
	To Bad Debts Account				1,200
	To Interest on Loan Account				2,200
	To Wages (Unproductive) Account				1,400
	To Export duty Account				2,300
	To Advertisement Account				4,100
	To Travelling expenses Account				2,500
	(Being the transfer of nominal accounts showing debit balances to the Profit & Loss A/c)				
	Commission Received Account	Dr.		840	
	Discount Received Account	Dr.		600	
	Miscellaneous Receipts Account	Dr.		500	

	To Profit & Loss Account (Being the transfer of nominal accounts showing credit balances to the Profit & Loss A/c)			1,940
	Profit and Loss Account Dr. To Capital Account (Being the transfer of net profits to the Capital account)		2,51,660	2,51,660

In the books of Mr. K. Baruah

Profit and Loss Account

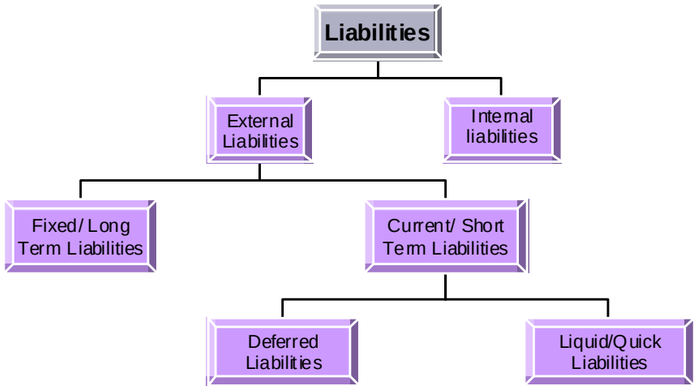
For the year ending on 31st March, 2016

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Trade expenses	2,000	By Trading Account	3,12,000
To Carriage on sales	10,000	(Gross Profit transferred)	
To Office Salaries	15,800	By commission received	840
To Postage & telegram	720	By Discount	600
To Office Rent	7,500	By Miscellaneous	500
To legal charges	400	Receipts	
To Audit Fee	1,600		
To Donation	1,100		
To Sundry expenses	5,320		
To Selling expenses	3,000		
To Discount allowed	780		
To Lighting	1,200		
To Bad Debts	2,200		
To interest on Loan	1,400		
To Wages (Unproductive)	2,300		
To Export duty	4,100		
To Advertisement	2,500		
To Travelling expenses	2,51,660		
To Capital Account			
(Net Profit transferred)	3,13,940		3,13,940

satisfied by the disbursement or utilization of corporate resources". All liabilities are shown in the liabilities side or left hand side of the Balance Sheet.

Classification of Liabilities



1. **Internal Liabilities:** Internal Liabilities denote proprietor's equity, which consists of capital, reserve and net profit. In case of a net loss, it is deducted from capital.
2. **External Liabilities:** External liabilities are the claims of outsiders against the assets of the business. They are loans taken, creditors, bills payable, bank overdraft, etc. External liabilities are classified into long-term liabilities and short-term liabilities.
   a. **Long-Term Liabilities or Fixed Liabilities:** Long term liabilities are repayable after a long period of time and not repayable in one year. They do not require current assets for repayment Viz. Loan on mortgage, debentures, long term loan from banks or other financial institutions.
   b. **Current Liabilities:** Current liabilities are those liabilities which are usually payable within a year. Generally they are paid out of current assets or by creation of current liabilities. The following are the current liabilities in a business.

Current Assets: They are those assets which are made or acquired and merely held for a short period of time with a view to reselling them at a profit in the ordinary course of business such as stock. They also include such other assets as are constantly circulating and arise out of the business dealings. They are temporarily held for subsequent conversion into money. As for example, debtors, bill, cash at bank etc.

Contingent Assets: Contingent Assets are such assets which are not at present under the possession of the business but which may or may not be acquired on the happening of a certain event on future. Examples are, claim against damage suit under a contract. They are not recorded in the books of accounts but are shown in the Balance Sheet, on the Assets side as notes in the inner column.

Investments: Investments may be short-term investment or long-term investments. When the investments are made for a short period representing temporary surplus of funds, they are treated as current assets as they will be soon converted into cash but investment of long term period which are held for a definite purpose or which represent permanently unutilized funds are called fixed assets.

Sundry Debtors and Creditors: Sundry debtors and creditors indicates the total of balances of debtors and creditors at the end of the year. They do not represent any particular ledger account. At the end of each financial period, all the outstanding balances of the debtors and creditors are taken out from the Ledger and two separate lists are prepared with those balances. The total of the list of balances of customers' accounts is called Sundry Debtors; while the total of the list of balances of creditors is called Sundry Creditors.

8.6.4 Classification of Liabilities

The term liability denotes claims against the assets of the business by the outsiders and the proprietor. According to the American Accounting Association, Liabilities are "claims of Creditors against the enterprise arising out of past activities that are to be

8.6 BALANCE SHEET

8.6.1 Meaning of Balance Sheet

At the end of the accounting year, a trader naturally desires to know two things viz.

(a) The results of his trading operation for the period and;

(b) His true financial position at the end of the period.

In order to ascertain the financial results, he prepares Trading and Profit and Loss Account. The Trading Account shows gross profit while the Profit and Loss Account shows the net profit. After ascertaining net profit, the businessman desires to know his financial position and the correctness of his net profit disclosed by the Profit and Loss Account. As assets and liabilities continuously change during the operation of the business, he is also interested in knowing the composition of various assets and liabilities and the amount of capital standing at the end of the period. In order to obtain this information at the end of a trading period, a businessman sets out various assets and liabilities as on that date in the form of a statement which is known as Balance Sheet.

Definition of Balance Sheet:

According to CARTER 'A Balance Sheet is a statement drawn up at the end of each trading or financial period, setting forth the various assets and liabilities of the concern as at this date.

However, it is also described as a classified summary of debit and credit balances existing in the ledger after the Profit and Loss Account has been constructed. This is a better definition because it often contains items which are not either assets or liabilities. It is prepared with a view to measure the exact financial position on a certain fixed date. So it is also called a 'Position Statement'.

8.6.2 Steps for Preparation of balance Sheet

Following steps should be followed for preparation of a balance sheet:

(i) All accounts of Assets (i.e. the accounts remaining in the trial balance after the preparation of Trading and Profit and Loss Account) appearing on the debit side of the trial balance will be shown on the 'Assets side of the balance sheet' i.e. the right hand side of the balance sheet, **except drawings account which will be shown on the liabilities side as a deduction from Capital account.**

(ii) All the accounts of Liabilities (i.e. the accounts remaining in the trial balance after the preparation of Trading and Profit and Loss Account) appearing on the credit side of the trial balance will be shown on the 'Liabilities side of the balance sheet' i.e. the left hand side of the balance sheet.

(iii) Net Profit/ Net Loss as shown by the Profit and Loss Account will be added / deducted from capital on the liabilities side of the balance sheet.

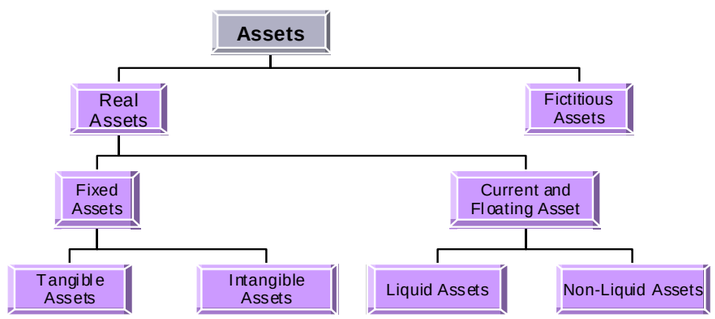
(iv) Drawings account which appears on the debit side of the trial balance will be shown on the liabilities side as a deduction from Capital account.

(v) The assets and liabilities should be shown under proper groups.

(vi) The assets and liabilities should be shown in certain order.

8.6.3 Classification of Assets

Assets may be classified as follows:



Assets: Kohler defines asset as "any cost benefiting a future period". Thus anything which gives a benefit in future may be termed as an asset. Assets, therefore, are various properties or possessions under the ownership of a concern, with the help of which the activities of the concern are carried on, e.g. land, buildings, plant and machinery, furniture, cash, etc. All assets are shown on the Assets Side of the Balance Sheet.

Real Assets: Real assets are those assets which have some market value. They include assets of permanent as well as of floating nature. Examples are – buildings, plant, stock, cash, etc.

Fixed Assets: "Fixed Assets are those assets of a business which are of a permanent nature and are held for the purpose of earning revenue and not with a view to resale". W. Pickles. Examples are – buildings, plant, machinery, furniture, etc. They depreciate- due to wear and tear.

Tangible Fixed Assets: The fixed assets which have physical existence and which can be seen and touched are known as Tangible Fixed Assets viz. – buildings, land, furniture, etc.

Intangible Fixed Assets: The fixed assets which have no physical existence and which cannot be seen and touched are known as Intangible Fixed Assets viz. – goodwill, patent right, trade marks etc. However, they are not fictitious assets as they are represented by value.

Wasting assets: Wasting assets are those fixed assets whose value gradually reduces on account of use and finally exhausts completely viz. – mines, forest, leasehold properly etc.

Fictitious Assets: Fictitious assets are merely some debit balances not written-off. They are items of expenditure or losses of an unusual character and are not recoupable. They are not represented by any tangible possession or property and hence they have no market value. Examples are – removal of (Business from one place to other) expenses, preliminary expenses, loss or issue of shares and debentures, etc. Fictitious are also called Paper Assets or Nominal Assets.

(a) Stock on 31st December Rs.6, 000

(b) Wages Outstanding Rs.500

(c) Salaries Outstanding Rs.425

(d) Prepaid Insurance Rs.50

11. From the following information of Kalita Printers prepare a Trading Account for the year ended 31st March, 1998.

	Rs.
Fuel	100
Purchases (Adjusted)	9,800
Sales	15,000
Trade Expenses	500
Postage and Telegrams	100
Commission (received)	300
Discount (allowed)	200
Rent paid	1,500
Returns Inward	200
Carriage Outwards	300
General Expenses	300
Closing Stock	8,000

12. From the following information of M/s. Baruah Enterprise prepare a trading Account for the year ended 31st March, 2005

Particulars	**Amount**	**Particulars**	**Amount**
	(Rs.)		**(Rs.)**
Opening Inventory	5,000	Salaries to Clerk	500
Purchases less returns	8,000	Wages of Office	
Sales less returns	10,000	and Shop Assistant	2,000
Wages	2,000	Rent of Office and Shop	100
Freight on Purchases	800	Sundry Expenses	3,000
Marine insurance		Motive Power	50
on purchases	100	Office lighting and heating	50
Duty on goods imported	300	Carriage inward	100
Closing Inventory	4,000		

13. From the following information of Bulbul Enterprises prepare a Profit

not received is also shown on the assets side as a separate item named 'Accrued Interest'.

Bank Overdraft: When the business withdraws money from the bank in excess of its deposits with or without a previous arrangement with that bank, the excess amount so withdrawn is known as 'Bank Overdraft'.

Bills Payable: It denotes the amount of bills issued to creditors but not yet due for payment. It is a liability of the business and will be shown on the liabilities side of the Balance Sheet.

Liabilities for Outstanding Expenses: It signifies the liability of the business for expenses incurred during this year and will be shown on the 'Liabilities Side' of the Balance Sheet.

Investments: When the business has excess money compared to the needs of the business, it invests such fund outside the business in shares, debentures and government bonds. These are 'grouped under the heading' Investments. They are assets and will be shown in the Balance Sheet on the 'Assets Side' as a separate item named as 'Accrued Income from Investment'.

Bill Receivable: It is the total of the bills received from debtors but not yet due for payment. It is an asset and will be shown on the assets side of the Balance Sheet.

Working Capital: It denotes the excess of current assets over current liabilities. Current assets consist of stock debtors, bills receivable, short term investments, cash at bank, cash in hand and prepaid expenses, while current liabilities consist of creditors, bills payable, bank overdraft and liabilities for outstanding expenses. It is that part of the Capital, which is left after the purchase of, fixed assets and any long term investment.

Prepaid Expenses: It denotes payment for services not yet received. So it is an asset and will be shown on the 'assets side' of the Balance Sheet.

Valuation of Assets:

i) **Fixed Assets :** Fixed assets are used in the business for the purpose of earning revenue. So they must be valued on the

basis of their usefulness to the business which is a going concern. Market value or replacement value need not be considered while valuing fixed assets.

ii) **Current or Floating Assets:** Current Assets or Floating Assets are held for the purpose of conversion into cash within a short period. So they are to be valued at the figures at which they are likely to be realized in near future.

In short, fixed assets mush be valued at cost less depreciation while current assets must be valued a cost price or not realizable market price whichever is lower except book debt which should be valued always at realizable value.

8.6.6 Format of Balance Sheet

Forms of Balance Sheet (Under Permanency Order)

Balance sheet of Mr. X as on …….. 20 …….

Liabilities	**Rs.**	**Assets**	**Rs.**
Proprietors' Equity :		**Fixed Assets :**	
Capital		Goodwill	
Reserve/ Reserve Fund		Freehold Land and Building	
Long term Liabilities :		Leasehold Land & Building	
Long term Loans		Buildings	
Current liabilities:		Plant and machinery	
Short term Loans		Furniture and Fittings	
Income Received in Advance		Loose Tools	
Outstanding Expenses		Vehicles	
Sundry Creditors		Patents and patterns	
Bills Payable		Trade Marks	
Bank Overdraft		**Long Term Loans & Advances Current Asset :**	
		Closing Stocks :	
		Raw Materials	
		Work-in-Progress	
		Finished goods	

Q 5: Distinguish between Trading Account and Profit and loss account.

Q 6: Explain how to prepare a Profit and loss account.

Q 7: What do you mean by Balance Sheet .Explain the steps for preparing Balance Sheet?

Q 8: What the different types of Assets. Explain and classify them.

Q 9: Write Short notes on the following:

a) Gross Profit

b) Opening Stock

c) Provisions and Reserves

d) Provisions for bad and doubtful debts

e) Bills payable and Bills receivable

f) Prepaid Expenses

Q 10: From the following Trial Balance of M/s Ram and Sons; prepared a Trading and Profit and Loss Account for the year ended 31st December….20… and a Balance Sheet as on that date.

Trail Balance of M/s ram and Sons

Particulars	**Dr.Rs.**	**Cr.Rs.**	**Particulars**	**Dr.Rs.**	
Cr.Rs.					
Purchases	21,750		Traveling Expense	400	
Discount Allowed	1,300		Commission	425	
Wages	6,975		Carnage Inward	275	
Salaries	2,000		Trade Expenses	705	
Sales		35,000	Interest	100	
Outstanding Trade		475	Insurance	150	
expenses			Furniture	200	
Buildings	5,000		Capital		
13,000					
Debtors	4,250		Cash	7,045	
Creditors		2,100			
	50,575	50,575		50,575	

50,575

Adjustments:

4. R. L. Gupta and M. Radhaswamy, (2017), "*Advance Accountancy*", Sultan Chand & Sons, New Delhi.

5. S.C. Jain & K.L. Narang,(2006), "*Accounting Theory and Management Accounting*", Kalayani Publishers.

8.9 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q.1.: a) Trail Balance b) Two c) Direct

Ans. to Q.2.: a) False b) False c) False d) True

Ans. to Q.3.: The stock of goods which remained unsold at the end of the last year is termed as the opening stock of the current year.

Ans. to Q.4.: a) True b) False c) True d) True

Ans. to Q.5.: Examples of provisions:

a) Provision for Income Tax;

b) Provision of Sales Tax;

c) Provision for liability for disputed claim.

d) Provision for depreciation;

e) Provision for Repairs and Renewals;

f) Provision for doubtful debts;

g) Provision for discount on debtors;

8.10 MODEL QUESTIONS

Q 1: What do you mean by final Account? Explain.

Q 2: Write a note on trading account and also write the items that are shown in the debit side of the trading account. Explain and illustrate with a specimen form of trading account.

Q 3: Explain Profit and loss account with a specimen form.

Q 4: How Profit and loss account is balanced.

		Stationery (Stock)	
		Goods on Consignment	
		Prepaid Expenses	
		Accrued Incomes	
		Sundry Debtors	
		Bills Receivable	
		Investment (Short-Terms)	
		Cash at Bank	
		Cash in hand	

Exercise : 8.6

From the following information draft a Balance Sheet of M/s Goswami Traders as on 31st December 20…..

Trial Balance as on 31st December, 20…

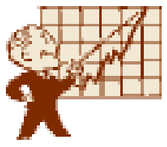
	Rs.		Rs.
Land and Buildings	40,000	Bills Payable	15,350
Investments	15,000	Loan from Bank	10,000
Good will	20,000	Loan on Mortgage	20,000
Sundry Debtors	22,750	Sundry Creditors	25,500
Prepaid Expenses	1,000	Outstanding expenses	1,500
Cash in Hand	1,400	Reserve Fund	10,000
Cash at Bank	10,700	Capital	1,05,000
Drawings	9,000	Net Profit	47,000
Bills Receivable	6,500		
Plant and Machinery	20,000		
Closing Stock	50,000		
Furniture	18,000		
Freehold Landx	20,000		
	2,34,350		2,34,350

Solution: Ref. Under Liquidity Order:

Balance Sheet of M/s Goswami Traders

as on the 31st December. 20…..

Liabilities	Rs.	Assets	Rs.
Current Liabilities :		**Current Assets :**	
Bills Payable	15,350	Cash in hand	1,400
Sundry Creditors	25,500	Cash at Bank	10,700
Outstanding expenses	1,500	Investment	15,000
Long term liabilities :		Bills Receivable	6,500
Loan from Bank	10,000	Sundry Debtors	22,750
Loan on Mortgage	20,000	Prepaid Expenses	1,000
Capital and Reserve :		Closing Stock	50,000
Reserve Fund	10,000	**Fixed Assets :**	
Capital on 1,1.20… 1,05,000		Furniture	18,000
Add. Net Profit 47,000			
1,52,000		Plant and Machinery	20,000
Less Drawings 9,000	1,43,000	Land and Buildings	40,000
		Freehold Land	20,000
		Goodwill	20,000
	2,25,350		2,25,350



CHECK YOUR PROGRESS

Q 4. State True or False:

a) Capital is shown in the Balance Sheet on the liabilities side as the excess of assets over liabilities. True/False

b) Balance sheet is an account. True/False

c) Bill Receivable is the total of the bills received from debtors but not yet due for payment. True/False

d) Provisions are made to meet a known liability. True/false

Q 5: Write some examples of Provisions

.....



8.7 LET US SUM UP

- Final accounts are prepared after the preparation of trial balance.
- For most businesses, the final accounts, which are produced at the end of each financial year, comprise:
  - Trading account
  - Profit and loss account
  - Balance sheet
- Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods.
- The Profit & Loss Account (P&L) is a report of the company's profit on the sale of their goods or the provision of their service over a trading period, normally one year.
- A balance sheet is a statement of the total assets and liabilities of an organization at a particular date - usually the last date of an accounting period.
- In order to measure the result of the business operations with reasonable accuracy, it is required to match revenues of an accounting period with cost in earning the same revenue. If the revenue does not match with cost, the same is accounted for by passing adjusting entries.



8.8 FURTHER READING

1. Ashis Bhattacharya,(2006), *"Financial Accounting"*, Prentice hall of India Pvt. Ltd, New Delhi.
2. S. N. Maheshwari,(2014), "*Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam,"*Theory and Practice of Financial Accounting*", Capital Publishing Company, Guwahati

To Asset Account

(iii) In case of profit on sale

Asset Account……Dr.

To Profit and Loss Account

(iv) In case of loss on sale:

Profit and Loss Account……..Dr.

To Asset Account

II. When a Provision for Depreciation Account is not maintained:

Under this method, depreciation is directly charged to the Asset Account by debiting the Depreciation Account and crediting the Asset Account. When the accounting period is over, the Depreciation Account is closed by transferring it to the Profit and Loss Account. In the Balance Sheet, the asset appears at its written down value which is obtained after deducting depreciation (charged up to-date) from the book value.

The journal entries in this method are:

(a) For providing depreciation

Depreciation Account ……..Dr.

(Annual amount of depreciation)

To Asset Account

(b) For transfer of the amount of annual depreciation to the Profit and Loss Account

Profit and Loss Account ……Dr.

To Depreciation Account

(c) On sale of the asset

(i) On realization of sale proceeds

Cash Account……...Dr.

To Asset Account

(ii) In case of profit on sale

Asset Account……Dr.

To Profit and Loss Account

(iii) In case of loss on sale

& Loss Account for the year ended 31st December, 2004.

Particulars	Rs.	Particulars	Rs.
Gross Profit	21,000	Capital	18,000
Salaries	4,000	Discount received	100
Rent and taxes	500	Repairs	150
Trade expenses	100	Interest paid	50
Discount (Dr.)	200	Bank charges	20
Selling commission paid	2,120	Reserve	4,000
Rebate	100	Bad debts	150
Contingencies	50	Commission (Cr.)	210
Conveyance	200	Machinery	3,500
Petty Cash in hand	80	Sundry receipts	10
Bad debt recovered	120	Goodwill	8,000

*** ***** ***

UNIT 9: DEPRECIATION

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Concept of Depreciation

- 9.3.1 Depreciation Accounting
- 9.3.2 Depreciation as a source of fund
- 9.3.3 Causes of Depreciation
- 9.3.4 Characteristics of Depreciation

9.4 Choice of Methods for Computing Depreciation

- 9.4.1 Methods of recording depreciation
- 9.4.2 Methods of providing depreciation

9.5 Let Us Sum Up

9.6 Further Reading

9.7 Answers to check your progress

9.8 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- define the concept of depreciation
- explain the causes of depreciation
- outline the characteristics of depreciation
- explain various methods of charging depreciation

9.2 INTRODUCTION

In the earlier unit, we discussed about presentation of final accounts. In this unit we will discuss about depreciation, its various concepts, causes, characteristics, and the methods of charging depreciation.

The concept of depreciation occupies an important place in the determination of income and in the measurement of the service potential of assets.

Here, depreciation is not directly charged to the Asset Account. Under this method, the annual amount of depreciation is to be debited to the 'Depreciation Account' and credited to the 'Provision for Depreciation Account' or 'Accumulated Depreciation Account'. At the end of the accounting period, the Depreciation Account is closed by transferring it to the Profit and Loss Account. In the Balance Sheet, the value of the asset is always shown at its cost price and the accumulated depreciation is shown as a deduction from the Asset Account or may be shown as a provision account on the Liabilities side. Hence, at any point the original cost of asset and the accumulated depreciation that is charged up to a particular date may be ascertained from the Balance Sheet.

After the expiry of useful life of the asset, the two accounts are closed by debiting the Provision for Depreciation Account and crediting the Asset Account. The sale proceeds of the asset are credited to the Asset account and the balance if any, in the Asset Account is transferred to the Profit and Loss Account.

The necessary journal entries under this method are as follows:

(a) For providing depreciation

Depreciation Account …….. Dr.

(Annual amount of depreciation)

To Provision for Depreciation Account

(b) For transfer of the depreciation amount to the Profit and Loss Account

Profit and Loss Account ……Dr.

To Depreciation Account

(c) On sale of the asset

(i) For transfer of Provision of Depreciation:

Provision for Depreciation Account……Dr.

To Asset Account

(ii) On sale of asset(realization of cash)

Cash Account ..... Dr.

Q 3: State True/False

a) Depreciation is a source of fund. True/False

b) Circumstances like accident etc. may also lead to a decline in asset value. True/False

c) Depreciation is charged on continuous basis. True/False

d) The decline in value is of a permanent nature and cannot be recouped later. True/False

9.4 CHOICE OF METHODS FOR COMPUTING DEPRECIATION

Three important factors need to be underlined while measuring the depreciation charge for each fixed asset. They are:

a. **Cost of asset**: It is the basis for all subsequent accounting for that asset. It comprises the acquisition cost and all expenses in carrying and installing the asset to put it in a workable condition.

b. **Scrap value:** It is the estimated value of a fixed asset at the end of its economic life. This value needs to be considered while determining the depreciable value of an asset for the purpose of estimating the annual amount of depreciation of the asset.

Depreciable value= cost – scrap value.

c. **Useful life of asset:** It refers to the number of accounting periods for which the asset will be useful to the business or will fetch revenue to the business. The estimated useful life of an asset may be expressed in terms of years, units of output, operating periods etc. It is usually based on the intensity of use, physical exhaustion, obsolescence etc.

9.4.1 Methods of Recording Depreciation

There are two ways of recording depreciation in the books of accounts:

I. When a provision for Depreciation Account is maintained.

II. When a provision for Depreciation Account is not maintained.

I. When a Provision for Depreciation Account is maintained:

Depreciation is a term used in accounting and finance with reference to the fact that assets with finite lives lose value over time. A company needs to report depreciation accurately in its financial statements in order to achieve two main objectives. First, to match its expenses with the income generated by means of those expenses, second, to ensure that the asset values in the balance sheet are not over stated. An asset acquired in Year 1 is unlikely to be worth the same amount in Year 5.

After completion of this unit you will be able to compute depreciation for any partnership firm.

9.3 CONCEPT OF DEPRECIATION

Defining Depreciation:

According to W. Pickles, 'Depreciation is the gradual and permanent decrease in the value of an asset from any cause.'

The Indian Accounting Standard-6 states: Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes the amortization of assets whose useful life is predetermined.

9.3.1 Depreciation Accounting

When an asset declines in value through obsolescence or deterioration and depreciation has to be accounted for, it is essential to determine how this decline in asset utility is to be measured in monetary terms. It is not necessary that the unexpired value of the asset at the end of a particular accounting period be the same as was expected when the asset was acquired. This has led accountants to assess the asset value based on cost and not upon present values.

The concept of depreciation is more of an accounting

amortization of its original cost. Depreciation Accounting is a system of accounting which attempts to distribute the cost of an asset less salvage value(if any) over the useful life of the asset in a systematic and useful manner. Its main objective is to absorb the cost of using the asset to different accounting periods in a way that the profit and loss account may give a true figure of the profit and loss made by the business.

9.3.2 Depreciation as a source of fund

Depreciation simply writes off the cost of an asset already incurred, as an expense. The accounting entry for depreciation is an internal transaction, and is in no way a source of fund. Further, since providing for depreciation does not involve any cash payment, depreciation is regarded as a non-cash expense.

However depreciation may affect funds in ways such as:

- Depreciation is periodically charged to revenue, thereby affecting periodic income of the firm. This in turn may affect the managerial decisions on different issues like pricing, dividend or profit retention etc.
- Depreciation charges affect taxable income and therefore, the amount of income taxes payable by the firm.

9.3.3 Causes of Depreciation

(a) **Wear and tear:** An asset value may decline due to its continued use and eventually the asset may get reduced to an unusable state. E.g.: Plant and Machinery.

(b) **Exhaustion:** Certain assets may get exhausted because of limited nature of its source. For instance, continuous extraction of minerals may exhaust the asset.

(c) **Obsolescence:** Certain assets may become outdated and therefore, obsolete due to technological improvements. Even if they may still be in a working condition, they may need to be replaced with newer or more up-to-date inventions.

(d) **Efflux of time:** Assets like copyright, leases also depreciate in value because such assets have a time limit attached to their existence.

(e) **Special causes:** Circumstances like accident etc. may also lead to a decline in asset value.

9.3.4 Characteristics of Depreciation

Following are the characteristics of Depreciation:

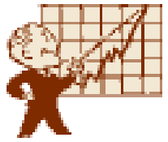
a. Depreciation is a charge pertaining to fixed assets only, against the revenue of the current year. Current assets are not depreciated, rather these are valued.

b. Depreciation is charged on continuous basis. Once the depreciation is charged, it must be charged on regular basis in the succeeding period also.

c. It is a decline in the book value of the asset and has no relation with the market value of the asset.

d. The decline in value is of a permanent nature and cannot be recouped later.

e. Depreciation is normally an estimated figure and not an actual figure unless it is in relation to assets like trademark, lease etc.



CHECK YOUR PROGRESS

Q 1: What do you mean by depreciation?

.....

.....

.....

Q 2: Write down the causes of depreciation

.....

.....

.....

(5) Insurance Policy Method:

This method is similar to the Sinking Fund Method but here the annual amount of depreciation is not invested in securities and is instead used for taking an insurance policy for the required amount. The amount of insurance premium is paid as annual depreciation on the asset and is debited to the Profit and Loss account and is credited to the Depreciation Fund Account. This policy is called Depreciation Insurance Policy.

At the end of the specified period, the agreed amount under the Depreciation Insurance Policy will be received and a new asset will be purchased with that amount. Any gain under the insurance policy is transferred to the Depreciation Fund Account and the balance of the Depreciation Fund Account is transferred to the Asset Account. Further, after sale of any scrap value of the old asset, if there remains any balance in the Asset Account, the same is to be transferred to the Profit and Loss Account.

(6) Revaluation Method:

This method is applied in case of miscellaneous assets like loose tools, live stock, stationery etc. At the end of each financial year, the assets are revalued and the difference between the book value and the revalued amount is debited to the Depreciation Account and is credited to the Asset Account. If any profit arises out of revaluation of the assets, it should be credited to Revaluation Reserve Account which is placed on the liability side of the Balance-Sheet.

(7) Depletion Method:

Also known as Productive Output Method, this method is applied to wasting assets like mines, quarries etc. from which a certain quantity of output is expected to be extracted. Depreciation is calculated per unit of products produced or per ton of materials raised. The amount of depreciation to be charged to the Profit and Loss Account is calculated by multiplying the units of output obtained/extracted with the rate of depreciation per unit of output.

Profit and Loss Account……..Dr.

To Asset Account

9.4.2 Methods of providing Depreciation

There are different methods for providing depreciation. In deciding on the best depreciation method, the choice would depend on the pattern of probable benefits that may be obtained in each period from its use.

(1) Straight Line Method or Fixed Installment Method or Fixed Percentage on Original Cost
(2) Deminishing Balance Method
(3) Annuity Method
(4) Depreciation Fund Method
(5) Insurance Policy Method
(6) Revaluation Method
(7) Depletion Method
(8) Machine Hour Rate Method
(9) Sum of Digits Method

All of these methods are discussed below:

(1) Straight Line Method: Fixed Installment Method / Fixed percentage on Original Cost.

This is one of the simplest methods of charging depreciation. Here, a fixed percentage of the original value of the asset is written off every year so as to reduce the book value of the asset to zero or its residual value as the case may be, at the end of its estimated life. The amount of depreciation is calculated by dividing the cost of the asset minus the estimated salvage value by its estimated useful life.

$$\text{Depreciation} = \frac{\text{Original Cost - Salvage Value}}{\text{Estimated Life of the Asset}}$$

Exercise: 9.1

An asset is purchased for Rs.10, 000 and it has a salvage value of Rs.2, 000 at the end of its useful life of 10 years. So the annual amount of depreciation will be:

$$\text{Depreciation} = \frac{10{,}000 - 2{,}000}{10} = \text{Rs. } 800$$

Advantages:

(a) It is easy to understand and simple to calculate.

(b) Book value of asset reduces to zero at the end of its economic life.

(c) The amount of depreciation charged to the Profit and Loss Account is uniform throughout the life of the asset.

(d) This method is quite appropriate for assets whose utility expires within a fixed period of time. Examples are: leases, patents, copyrights etc.

Disadvantages:

(a) The annual amount of depreciation is the same each year irrespective of the fact that the utility of the asset declines with time while the repairs and maintenance charges increase with the passage of time. The total cost of depreciation and repairs will be more in the later periods than in the earlier periods.

(b) This method does not consider the effective utilization of the asset. The depreciation charge remains the same from year to year irrespective of the use of the asset.

(c) In case of addition to the existing asset, the amount of depreciation to be charged is to be recalculated with respect to the newly purchased asset.

(2) Deminishing Balance Method:

Under this method, depreciation is charged as a fixed rate on the book value of the asset each year. Since the book value of the asset diminishes every year after charging depreciation, the amount of depreciation to be charged in each year decreases every

(e) For investing (amount of depreciation plus interest earned)

Depreciation Fund Investment Account…….Dr.

To Bank Account

(III) Last Year

(a) For interest on investment

Bank Account……..Dr.

To Interest on Depreciation Fund Investment Account

(b) Interest on Depreciation Fund Investment Account……Dr.

To Depreciation Fund Account

(c) For providing depreciation

Depreciation Account……..Dr.

To Depreciation Fund Account

(d) For transferring depreciation to Profit and Loss Account

Profit and Loss Account……..Dr.

To Depreciation Account

(e) For sale of investment

Bank Account……Dr.

To Depreciation Fund Investment Account

(f) For profit/loss on sale of investment

For profit:

Depreciation Fund Investment Account…….Dr.

To Depreciation Fund Account

For Loss:

Depreciation Fund Account……..Dr.

To Depreciation Fund Investment Account

(g) For sale proceeds of old asset,if any

Bank Account……Dr.

To Asset Account

(h) For closing Depreciation Fund Account

Depreciation Fund Account……Dr.

To Asset Account

(i) For closing Asset Account

If there is any balance in the Asset Account, it is transferred to the Profit and Loss Account

The asset is shown in the balance-sheet every year, at its original value. Depreciation Fund is shown on the liabilities side while the Depreciation fund investment is shown on the assets side of the balance-sheet

Since the funds necessary for purchase of the new asset becomes available from outside the business, the working capital thereby remains intact. How much amount is to be invested every year so that a given sum is available at the end of the given period can be ascertained from the Sinking Fund Table.

Journal Entries:

(I) At the end of the first year

(a) For setting aside the required amount

Depreciation Account……..……..Dr.

To Depreciation Fund Account

(b) For investing the amount

Depreciation Fund Investment Account..……Dr.

To Bank Account

(c) For transferring depreciation to Profit and Loss Account

Profit and Loss Account……...Dr.

To Depreciation Account

(II) Subsequent years

(a) For interest on investment

Bank Account……...Dr.

To Interest on Depreciation Fund Investment Account

(b) Interest on Depreciation Fund Investment Account……Dr.

To Depreciation Fund Account

(c) For providing depreciation

Depreciation Account……..……..Dr.

To Depreciation Fund Account

(d) For transferring depreciation to Profit and Loss Account

Profit and Loss Account……...Dr.

To Depreciation Account

year even if the percentage at which depreciation is charged remains fixed.



Exercise: 9. 2

Cost of asset is Rs.1,00,000/- and the rate of depreciation is 10% annually.

Depreciation in 1st year = 10% of Rs.1,00,000/- =Rs.10,000/-

Depreciation in 2nd year = 10% of book value at the end of 1st year

= 10% of Rs.(1,00,000 – 10,000)= Rs.9,000/-

This calculation will continue in this manner till the expiry of the useful life of the asset.

Advantages:

(a) This method allows a fair charge against the revenues of each year because while depreciation goes on diminishing each year, the cost of repairs for the asset goes on increasing each year.

(b) It is simple to understand and calculate.

(c) In case of frequent purchase (additions and extensions)of assets, no recalculation is needed.

(d) It is recognized by the Income- Tax authorities in India.

(e) The problem of obsolescence is considered under this method as it allows a significant portion of the cost to be written off in early life.

Disadvantages:

(a) It is not easy to determine the appropriate rate of depreciation.

(b) This method does not allow the value of the asset to be brought down to zero.

Distinction between Straight Line Method and Diminishing Balance Method:

Points of distinction	Straight Line Method	Diminishing Balance Method
(1) Amount of depreciation	The amount of depreciation charged remains the same each year.	The amount of depreciation is more during the earlier years of the life of the asset than in the later years.
(2) Basis of calculation	Depreciation is calculated on the original cost less scrap value, if any, each accounting year.	Depreciation is calculated on the book value of the asset each accounting period.
(3) Depreciation in first year	In the first year, depreciation is charged on the cost of the asset less scrap value, if any.	In the first year, depreciation is charged on the cost of the asset.
(4) Terminal value	On expiry of useful life, the book value of the asset is reduced to zero.	The book value of the asset can never be reduced to zero at the end of its economic life.
(5) Effect on Profit & Loss account	While the depreciation amount remains the same each year, the cost of repairs goes on increasing year after year. This reduces the profits of the business gradually.	As the depreciation amount diminishes from year to year while the cost of repairs goes on increasing, the business profits do not get substantially reduced in the latter part of the life of the asset.
(6) Determi-ning depreciation rate	The rate of depreciation can be easily fixed once the useful life of the asset is ascertained.	It is relatively difficult to fix the rate of depreciation even if the useful life of the asset is known.

(3) Annuity Method:

When an amount is invested in acquiring an asset, the business has to forego some amount of interest that could have been earned if the money was instead employed in the purchase of an income-generating asset, like securities.

The annuity method considers this interest lost on the acquisition of the asset. The cost of the asset and the interest thereon are written down annually by equal installments until the book value of the asset is reduced either to zero or the residual value at the expiry of its useful life. The amount of depreciation which includes the loss of the asset and the loss of interest is determined with the help of an Annuity Table. Interest calculated at a fixed rate on the capital outlay involved, is debited to the Asset Account and credited to the Interest Account. This method is appropriate for assets whose lives extend to a definite period, e.g., a lease.

Journal Entries:

(a) Asset Account ……Dr.

To Interest Account

(b) Depreciation Account……..Dr.

To Asset Account

(4) Depreciation Fund Method:

Under this method, also known as Sinking Fund Method, a fund is created for the replacement of an existing asset at the end of its useful life besides bringing the annual loss of depreciation into account. The annual amount of depreciation is debited to the Depreciation Account and credited to the Depreciation/Sinking Fund Account. The Depreciation Account is ultimately transferred to the Profit and Loss Account.

An amount equivalent to depreciation charged is invested outside the business in readily saleable securities. Interest earned on this investment is credited to Depreciation Fund Account and the same is also reinvested .The securities accumulate and on expiry of the life of the asset, the securities are sold and a new asset is purchased with the sale proceeds. Further, any profit or loss on sale of the investment is transferred to the Depreciation Fund Account.

Ans. to Q.3.: a) False b) True c) True d) True

Ans. to Q.4.: a) When a provision for Depreciation Account is maintained

b) When a provision for Depreciation Account is not maintained.

Ans. to Q.5.: a) Fixed Rate b) Income -Tax c) Sinking Cost method



9.8 MODEL QUESTIONS

Q 1: What is depreciation? State its causes and characteristics.

Q 2: What are the different methods for calculating depreciation? State the advantages of the written down value method.

Q 3: Is depreciation a source of funds? Explain.

Q 4: State the differences between straight line method and the written down value method.

Q 5: A plant was purchased on 1.1.2015 for Rs.50,000. On 1.7.2015, another plant was purchased for Rs.20,000. Depreciation is charged @ 10% on written down value method. Prepare Machinery A/c and Depreciation A/c for 2015 and 2016 respectively. Books are closed on December 31 every year.

[Depreciation in 2015:Rs.6,000 and in 2016: Rs.6,400]

Q 6: On 1st of January, 2014, a plant was bought for Rs.16,000, with an estimated value of 5 years and scrap value of Rs.1,000.Straight line method of depreciation is followed. Prepare the Plant A/c for the first 3 years, assuming accounts are closed on 31st of December.

(Balance in Plant A/c: Rs.7,000)

Q 7: On 1st of April, 2016, Cherry Ltd bought a machine for Rs.2,00,000. Depreciation @ 10% p.a. is provided under straight line method. Life of the machine is estimated at 10 years and scrap value is Rs.20,000. Prepare Machinery Account upto 31st of March, 2019, assuming books are closed on March 31 every year.

[Depreciation: Rs.18,000 every year, Balance in Machinery Account on March 31,2019:Rs.1,46,000.

Q 8: M/s Kajal bought on 1st of January 2015 a plant for Rs.28,000 and spent Rs.2,000 on its installation. On 1st of April 2016, another plant



Exercise : 9.3

If a mine has 2,00,000 tonnes of coal and has been acquired for Rs.1,00,000, the rate of depreciation is Rs.1,00,000/2,00,000 tonne =Rs.0.50/ tonne. If in a particular year, 50,000 tonnes of coal is extracted, depreciation will be (0.50 X 50,000) i.e., Rs.25,000.

(8) Machine Hour Method:

This method is useful in case of machines. It first requires estimation of the life of the machine in terms of hours. Thereafter, the cost of the machine is divided by this total effective life(in hours)to arrive at an hourly rate of depreciation. Depreciation to be written off in a year will be ascertained by multiplying the hourly rate of depreciation by the number of hours the machine actually runs in that year.

$$\text{Depreciation per hour} = \frac{\text{Original Cost - Scrap Value}}{\text{Effective Working Hours}}$$

(9) Sum of Digits Method:

This method is a variant of the Diminishing Balance Method or Reducing Balance Method. Under this method, depreciation is written off each year by the formula:

$$\frac{\text{No. of years of the remaining life of the asset (including current year)}}{\text{Total of all the digits representing life of the asset (in years}} \textbf{ X } \text{(Cost–Scrap value)}$$



Exercise : 9.4

If the cost of a machine is Rs.20,000 and scrap value is Rs.1,000, with an estimated life of 10 years, the amount of depreciation in different years will be:

1st year 19,000 X 10/55 = Rs.3,455 [Here, 10+9+….+3+2+1=55]

2nd year 19,000 X 9/55 = Rs.3,109

.....

.....

10th year 19,000 X 1/55 = Rs.345

This method is appropriate for assets that provide more service benefits in the earlier years as compared to the later years. E.g. copying machines, computers etc..



Exercise :9.5

On 1.1.2015, Riyaz purchased a machinery costing Rs.80,000, installation charges being Rs.3,000.The accounting year ends on 31st of December each year. Depreciation is to be written off @10% under straight line method. Give necessary journal entries and prepare Machinery Account and Depreciation Account for 2 years.

Solution:

In the books of Riyaz

Journal Entries

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount(Rs.)
2015 Jan. 1	Machinery A/c……Dr. To Cash A/c (Being machinery purchased for Rs.80,000 and installation charges incurred Rs.3,000)		83,000	83,000
Dec 31	Depreciation A/c……...Dr. To Machinery A/c (Being annual depreciation @ 10% on straight line method on cost of machine)		8,300	8,300
Dec 31	Profit and Loss A/c……..Dr. To Depreciation A/c (Being transfer of annual depreciation charge to P/L A/c)		8,300	8,300
2016 Dec 31	Depreciation A/c……..Dr. To Machinery A/c (Being annual depreciation @ 10% on straight line method on original cost of machine)		8,300	8,300
Dec 31	Profit and Loss A/c……..Dr. To Depreciation A/c (Being transfer of balance in Depreciation A/c to P/L A/c)		8,300	8,300



9.5 LET US SUM UP

In this Unit, we discussed the following points :-

- Depreciation means a permanent, continuing and gradual decrease in the value of an asset.
- It generally takes place due to reasons like wear and tear of the asset, obsolescence, passage of time, depletion etc.
- Charging depreciation is necessary so as to state the assets in the balance-sheet at their proper values, to report correct profits and losses and to ensure that sufficient funds are available at the time of replacement of the asset.
- There are different methods for providing depreciation of which, the most popular are straight line method and the diminishing value method.



9.6 FURTHER READING

1) K R Das & K M Sinha : *"Financial Accounting"*; Lawyers Book Stall

2) Maheshwari, S.N. and S. K. Maheshwari (2003), *"An Introduction to Accountancy"*, Eighth Edition, Vikas Publishing House.

3) Gupta, R.L. and V.K. Gupta (2003), *"Financial Accounting: Fundamental"*, Sultan Chand.



9.7 ANSWERS TO CHECK YOUR PROGRESS

Ans. to Q.1.: Depreciation is a term used in accounting and finance with reference to the fact that assets with finite lives lose value over time.

Ans. to Q.2.: a) Wear and Tear b) Exhaustion c) Obsolescence d) Efflux of Time e) Special Causes

2017 Jan 1	To Balance b/d		32,300	2017 Jul 1	By Cash A/c (Sale)		12,000
				Jul 1	By Depreciation A/c (½of 32,300X15%X 6mths)		1,211
				Jul 1	By Profit and Loss A/c (loss on sale)		2,939
				Dec31	By Depreciation A/c (½ of 32,300 X 15%X 1 yr)		2,423
				Dec 31	By Balance c/d		13,727
			32,300				32,300
2018 Jan 1	To Balance b/d		13,727				

Calculation of loss on sale of Plant:

Book Value on 1.1.2017 = (32,300X ½) = 16,150

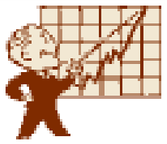
Less: Depreciation for 6 months = (16,150 x 15 x ½ yr)= 1,211

100

Book Value on 1.7.2017 14,939

Less: Sale Value 12,000

Loss on sale = 2,939



CHECK YOUR PROGRESS

Q 4: What are the various methods of recording depreciation?

.....

.....

.....

Q 5: Fill in the blanks:-

a) Under written down value method, depreciation is charged as a ..... on the book value of the asset each year.

b) Written down value method is recognized by the ..... authorities in India.

c) Depreciation Fund method is also known as .....

.....

Dr **LEDGER** Cr

Machinery A/c

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2015 Jan 1	To Cash A/c		83,000	2015 Dec 31	By Depreciation A/c		8,300
				Dec 31	By Balance c/d		74,700
			83,000				83,000
2016 Jan 1	To Balance b/d		74,700	2016 Dec 31	By Depreciation A/c		8,300
				Dec 31	By Balance c/d		66,400
			74,700				74,700
2017 Jan 1	**To** Balance b/d		66,400				

Dr Cr

Depreciation A/c

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2015 Dec 31	To Machinery A/c		8,300	2015 Dec 31	By Profit and Loss A/c(transferred)		8,300
			8,300				8,300
2016 Dec 31	To Machinery A/c		8,300	2016 Dec 31	By Profit and Loss A/c(transferred)		8,300
			8,300				8,300



Exercise : 9.6

On 1.1.2017, the Machinery Account in the books of Trinity Ltd. stands at Rs. 50,000. A portion of the machinery (whose book value on 1.1.2017 was Rs.4, 000) is sold for Rs.2, 500 on 1.4.2017. On 1.9.2017, the firm purchased a new machine at Rs.15,000. The firm charges depreciation at 10% on diminishing balance method and closes the books on 31st December every year.

Show journal entries in the books of the firm for the year ended 31.12.2017.

Solution: **In the books of Trinity Ltd.**

Journal

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount(Rs.)
2017 Apr 1	Depreciation A/c……Dr. To Machinery A/c (Being depreciation charged on machinery sold , for 3 months @ 10%)		100	100
Apr 1	Cash A/c……...Dr. To Machinery A/c (Being sale proceeds of a part of machinery)		2,500	2,500
Apr 1	Profit and Loss A/c……Dr. To Machinery A/c (Being transfer of loss on sale of machinery to P/L A/c)		1,400	1,400
Sept 1	Machinery A/c ……...Dr. To Cash A/c (Being purchase of machinery)		15,000	15,000
Dec 31	Depreciation A/c……. ……Dr. To Machinery A/c (Being depreciation charged on machinery @10% for 12 months on Rs.46,000 and for 4months on Rs.15,000)		5,100	5,100
Dec 31	Profit and Loss A/c……Dr. To Depreciation A/c (Being total depreciation transferred to Profit and Loss Account)		5,200	5,200

Workings:

(1) Depreciation:

(a) Depreciation on Rs.4, 000 for 3 months @ 10% = Rs.100

$$\left(\frac{4,000}{12}\times\frac{3}{100}\times 10\right)$$

(b) Depreciation on Rs.46, 000 for 12 months @ 10% = Rs.4,600

$$\left(\frac{46,000}{100}\times 10\right)$$

(c) Depreciation on Rs.15, 000 for 4 months @ 10% = Rs.500

$$\left(\frac{15,000}{12}\times\frac{4}{100}\times 10\right)$$

Total Depreciation= Rs.5,200

(2) Loss on sale of Machinery:

Book Value (as on 1.1.2017)	= Rs.4,000
Less: Depreciation for 3 months	= Rs.100
Book Value (as on 1.4.2017)	= Rs.3,900
Less: Selling Price (on 1.4.2017)	= Rs.2,500
Loss on sale	Rs.1,400

Exercise : 9.7

On 1st July 2015, Gauri bought a plant worth Rs.40, 000.Depreciation was provided at 10% p.a. on straight line method on 31st of December each year. With effect from 1.1. 2016, she started to charge depreciation based on diminishing balance method @15% p.a. On 1.7.2017, he sold half of the plant for Rs.12,000. Prepare the Plant Account for four years up to 31.12.2017.

Solution: **LEDGER**

Dr. **Plant A/c** **Cr.**

Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2015 Jul 1	To Cash A/c (purchase)		40,000	2015 Dec 31	By Depreciation A/c (40,000X 10%X ½yr)		2,000
				Dec 31	By Balance c/d		38,000
			40,000				40,000
2015 Jan 1	To Balance b/d		38,000	2016 Dec 31	By Depreciation A/c (38,000X 15%X 1yr)		5,700
				Dec 31	By Balance c/d		32,300
			38,000				38,000

c) The relation among the partners is governed by mutual agreement known as the ……

Q 3: State True/False

a) Capitals of the partners may be fixed or fluctuating depending on the provisions in the partnership deed. True/ False

b) Partners are generally entitled to interest on capital unless the Partnership agreement specifically provides for the same. True/False

c) Interest on drawings is allowed only when it is specifically provided for in the Partnership Deed. True/False

10.5 ADMISSION OF A NEW PARTNER

With the admission of a new partner, the partnership firm is reconstituted, and a new partnership agreement is entered for the purpose of carrying on the business. A newly admitted partner acquires two rights:

a) **Right to share in the assets of the business:** For acquiring this right, normally the new partner brings in an agreed amount as capital either in cash or kind.

b) **Right to share in the profits of the business:** When a new partner is admitted into a business, the share of profits of existing partners gets reduced to the extent they surrender it to the newly admitted partner. Therefore, for this right in the profits of the business, this new partner is required to pay some amount called premium, to the old partners.

Certain adjustments with respect to the following items are necessary in the books of accounts:

i) Profit-sharing ratio

ii) Goodwill

iii) Revaluation of assets and liabilities

iv) Accumulated profits, reserves and surplus

v) Partners' Capital

We discuss these adjustments below:

worth Rs.20,000 was purchased. On 1st July, 2017, machinery bought on 1st of January 2015 was sold off for Rs.20,000. Depreciation was originally provided on the straight line method @ 10% p.a.; however, from 2017 onwards, it was decided to charge depreciation @15% on the diminishing balance method.

Prepare Plant Account for the years 2015-2017, assuming books are closed on 31st of December each year.

[Depreciation in Yr1:Rs.3,000, Yr 2:Rs.(3,000+1,500)=Rs.4,500, Yr 3: Rs.1,800 (for sold machinery)+Rs.2,775 (for balance machinery)=Rs.4,575

Balance of Plant Account: Rs.15,725, Loss on sale = Rs.2,200]

*** ***** ***

UNIT 10: PARTNERSHIP

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Meaning of Partnership

10.4 Accounting for Partnership firm

10.5 Admission of a new Partner

10.6 Retirement or Death of a Partner

- 10.6.1 Computation of retiring /deceased partner's share in the firm
- 10.6.2 Mode of payment of retiring / deceased partner's share

10.7 Dissolution of firm

- 10.7.1 Dissolution of Partnership and Dissolution of firm
- 10.7.2 Settlement of accounts
- 10.7.3 Accounting entries for dissolution

10.8 Insolvency of Partner/Partners

10.9 Let Us Sum up

10.10 Further Reading

10.11 Answers to check your progress

10.12 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- learn the concept of partnership
- discuss admission of a new partner
- discuss retirement/death of a partner
- learn dissolution of the partnership firm
- learn the ensolvancy of partners.

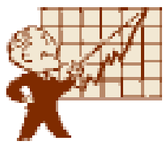
10.2 INTRODUCTION

In this unit we will discuss about the basic accounting practices of partnership firm, specifically with respect to: admission of a partner, retirement/death of a partner, dissolution of the partnership firm.

may also include any reserve created by the business but will not include any drawings made by the partners. A specimen of this account is given below (assuming there are two partners A and B;A is entitled to salary and B is entitled to commission):

Profit and Loss Appropriation Account for the year ended …….

Particulars	Rs.	Particulars	Rs.
To Interest on Capital		By Profit and Loss A/c	
A	--------	(Net Profit transferred)	------
B	--------		
		By Interest on Drawings	
To Interest on Partners' Loan		A	------
A	--------	B	------
B	--------		
To Salary to Partners			
A	--------		
To Commission to Partners			
B	--------		
To Reserve A/c	--------		
To others(if any)	--------		
To Share of profit (balancing fig.)			
A	--------		
B	--------		
	---------		------



CHECK YOUR PROGRESS

Q 1: What do you mean by partnership?

.....

.....

Q 2: Fill in the Blanks

a) The persons who have entered into partnership with one another are individually known as ..... and collectively as .....

b) There should be …… persons to form a partnership.

To Partner's Capital/Current A/c

h) **Loan by a partner :** When a partner provides a loan to the firm, it should be credited to a separate Loan Account which is quite distinct from the partner's capital account. In the absence of any agreement, partners are entitled to get 6% interest p.a. on loan. The journal entry required for such interest on loan will be:

Interest on Loan from Partner A/c……Dr.

To Partner's Capital/Current Account

It is to be noted that sometimes, a partner may receive a loan from the partnership for repayment in future. Loans payable to partners are shown as liabilities in the Balance Sheet while loans receivable from partners appear as assets in the Balance Sheet.

i) **Division of Profits/Losses:** Generally, the Partnership Deed specifies the profit sharing ratio of the partners. If the agreement does not say anything on this aspect, the profit should be shared equally, irrespective of capital contribution.

There might be instances where the partners may share profits in a particular ratio and the losses may be shared in a different ratio. After determining the share of profit due to each partner, the following journal entry needs to be passed:

Profit and Loss Appropriation A/c……..Dr.

To Partner's Capital/Current A/c

j) **Profit and Loss Appropriation Account:** This account is an essential part of the partnership accounts since it indicates how the net profit of the business is being apportioned among the partners. This account includes all necessary adjustments as stated in the Partnership Deed such as interest on capital, interest on partners' loan, salaries/ commission to partners, interest on drawings and share of profit. These transactions are distinct from the general trading transactions since they are appropriations of profit and not charges against profit, i.e., these items would get distributed as profits if they were not distributed in the form of salaries, interest etc. Therefore, these transactions do not appear in the Profit and Loss Account and instead appear in the Profit and Loss Appropriation Account. This account

A partnership is a type of business entity in which partners (owners) share with each other the profits or losses of the business undertaking in which all have invested. A partnership is a nominate contract between individuals who, in a spirit of cooperation, agree to carry on an enterprise; contribute to it by combining property, knowledge or activities; and share its profit. Partners may have a partnership agreement or declaration of partnership and in some jurisdictions such agreements may be registered and available for public inspection. In many countries, a partnership is also considered to be a legal entity, although different legal systems reach different conclusions on this point. A partnership can be formed by two or more people.

Let's discuss about partnership in detail in this unit.

10.3 MEANING OF PARTNERSHIP

In India, the Partnership Act 1932, which governs partnership businesses, defines partnership in Section 4 of the Act as: the relation between persons who have agreed to share the profits of a business carried on by all or by any of them acting for all.

The persons who have entered into partnership with one another are individually known as partners and collectively as a firm. There should be two or more persons to form a partnership. But the number of persons must not exceed 20 and in case of banking business, it must not exceed 10.

From the accounting view, it is important to note that the relation among the partners is governed by mutual agreement, preferably in writing, known as the Partnership Deed. The mutual rights and liabilities of the partners are normally contained in the partnership agreement and in the absence of such an agreement; the provisions contained in the Indian Partnership Act will apply.

It is important to remember that in the absence of special agreement between the partners, the following rules are applicable:

i) Profits and losses are to be shared equally.

ii) No partner is entitled to any salary

iii) No partner is to be allowed any interest on capital

iv) No interest is to be charged on drawings

v) Interest at the rate of 6 per cent is to be allowed on a partner's loan to the firm

vi) The Partnership books are to be kept at the principal place of business and all partners are entitled to have access to the same and take copies.

10.4 ACCOUNTING FOR PARTNERSHIP FIRM

Some important points to be noted in accounting for partnership are:

a) **Capital:** Generally each partner contributes to the share capital of the firm and the individual amount of such capital is determined by an agreement. It is not necessary that the capital contribution has to be in equal proportion or in the profit sharing ratio. A separate capital account has to be opened for each partner and the amount contributed by him will be credited to this account. Capitals of the partners may be fixed or fluctuating depending on the provisions in the partnership deed for the same.

b) **Fixed Capital Accounts:** Under this method, each partner has two accounts: a capital account and a current account. A partner's capital account shows the partner's original contribution to the business as capital. The balance in this account is changed only when there is a change in the constitution of the firm or such special circumstances. The other account, i.e., the partner's current account is opened to record transactions between the partners and the firm, e.g., salary, interest on capital, drawings, share of profit/loss etc.. This current account will then be closed by balancing and will be shown as quite distinct from the capital accounts on the Balance Sheet.

c) **Fluctuating Capital Accounts:** Under this method, all entries with respect to partners' drawings, interest, salaries, and share of profit / loss are passed through the Capital account of the partners. At the end of the accounting period, the capital account is closed; the balance will represent the partners' capitals at the beginning of each new period.

In such a case, the capital accounts of the partners keep on fluctuating.

d) **Interest on Capital:** Partners are generally not entitled to interest on capital unless the Partnership agreement specifically provides for the same. The logic behind providing for this interest is to compensate for any return the partners may have earned by investing this amount elsewhere with little or no risk. Further, interest allowed on capital serves to balance any disadvantage that may arise when the ratio of capital distribution is different from the profit sharing ratio.

The journal entry for giving effect to interest on capital is:

Interest on Capital A/c……..Dr.

To Partner's Capital/ Current A/c

e) **Partners' Drawings:** Any withdrawal of money by the partners in anticipation of profits or for personal needs is known as 'Drawings'. When drawings are made, the following journal entry is passed:

Drawings A/c……Dr.

To Cash (or Bank) A/c

At the end of the accounting period, the Drawings Account will be closed by transferring its total to the Capital account by crediting the Drawings Account and debiting the Capital Account.

f) **Interest on Drawings:** Interest on drawings is allowed only when it is specifically provided for in the Partnership Deed. Such interest is generally allowed at a fixed rate per cent from the date of drawings till the last day of the accounting period. The journal entry in this case is:

Partner's Capital Account/Current A/c ..... Dr.

To Interest on Drawings A/c

g) **Partners' Salaries, Commission etc.:** No partner is entitled to any salary unless specifically provided for in the Partnership agreement**.** When all partners do not give equal attention to the business of the firm, it is natural that the partners who devote more time to the business of the firm than others are given some kind of remuneration before the profit is divided. Such remuneration or salary is brought into account by passing a journal entry thus:

Partner's Salary A/c ..... Dr.

incoming partner brings in his share of goodwill in part or does not bring at all: Goodwill is written up to its full value by crediting the difference between the full value and the existing value, to the capital accounts of the old partners in the old profit sharing ratio and debiting the goodwill account. If any premium is brought in by the new partner toward goodwill, the same will be credited to the new partner's capital account.

- When Goodwill already exists in the books at full value and the incoming partner is not required to bring in any goodwill premium: Under this situation, if the new partner does bring in any cash as premium for goodwill, the same will be credited to his capital account. The logic behind this is that old partners' capital accounts have already been benefited by way of full value of the goodwill and they are not entitled to further benefit in respect of goodwill.
- When Goodwill appears in the books of account at a value higher than the existing value: The amount exceeding the present value of goodwill should be written back by debiting the old partners' accounts in the old profit sharing ratio and crediting the goodwill account accordingly. If the new partner brings in any premium for goodwill, the same will be credited to his capital account.

(iii) Revaluation of assets and liabilities:

On admission of a new partner, it is desirable that all assets and liabilities appearing in the existing Balance-Sheet are revalued and are shown at true value**.** The new partner should not be given any benefit of appreciation in the value of assets and also should not be burdened for undisclosed liabilities or losses. For passing necessary entries with respect to appreciation, depreciation etc., a Revaluation Account(Profit and Loss Adjustment Account) should be opened. The Revaluation Account being a nominal account, represents either net profit or net loss, which is transferred to old partners' accounts in their old profit sharing ratio. Necessary journal entries are:

(a) For any increase in the value of an asset:

Asset A/c... ……..Dr.

i) Change in the profit sharing ratio:

The calculation of profit-sharing ratio will depend on the new partnership agreement made at the time of reconstitution of the partnership firm. There can be different situations involving adjustments in the profit-sharing ratio.

Situation I: If the share of the new partner is given and nothing is mentioned about changes in the shares of old partners, it is presumed that the old partners will share the rest of the profit/loss in the old profit sharing ratio between them.



Exercise : 10.1

A and B are partners, sharing profits and losses in the ratio of 3:2. C is admitted as a new partner for ¼th share in future profits. After admission, the new profit sharing ratio will be as under:

Suppose total share = 1

Share of C = 1/4 of 1 or ¼

Remaining share = 1- ¼ = 3/4

This remaining share will be shared by A and B in their previous profit sharing ratio i.e., 3:2

So, new share of A = 3/5 of 3/4 = 9/20

And of B = 2/5 of 3/4 =6/20

Therefore, new profit sharing ratio among A,B and C=9/20: 6/20:1/4

= 9/20: 6/20:5/20 = 9: 6: 5

Situation II : When the newly admitted partner purchases his share from the existing partners in a definite proportion, the old partners' share will be calculated by deducting the proportion they have given up in favour of the new partner.



Exercise : 10.2

Suppose A and B share profits in the ratio of 7:5. C is admitted and he purchases one-sixth share of profit, 1/24th from A and 1/8th from B.

Here, C's share = 1/24 + 1/8 = 4/24 =1/6

Here, A's new share will be (7/12 – 1/24) or 13/24

and B's new share will be (5/12 – 1/8)= 7/24

So, A: B: C = 13:7:4

Situation III: In case an existing partner surrenders a fraction of his share, it is required to first calculate the surrendered portion. This surrendered share is to be deducted from the share of the existing partner in order to arrive at his new share. The share of the newly admitted partner will be the summation of all the shares surrendered by the old partners.



Exercise : 10.3

A and B are partners with a profit sharing ratio of 3:2. C is admitted as a partner, whereby A surrenders 1/4th of his share and B 1/2 of his share in favour of C. The new profit sharing ratio will be calculated thus:

Share surrendered by A = 1/4 of 3/5 =3/20

∴ A's new share= 3/5 – 3/20 = 9/20

Similarly, B's new share = 2/5 – (1/2 of 2/5) = 2/5 – 2/10 = 1/5

Now, C's share = share surrendered by A + share surrendered by B

= 3/20 + 1/5 = 7/20

So, new profit sharing ratio = 9/20 : 1/5 :7/20 =9: 4:7

Sacrificing Ratio: When a new partner is admitted, the old partners suffer a loss. This sacrifice ratio is calculated thus:

Sacrifice = Old share – New share

When the individual sacrifices of the old partners are put in the form of a ratio, we get the sacrifice ratio.



Exercise : 10.4

The old profit sharing ratio of A and B was 2:1 and after admission of C the ratio among A, B and C is 2:1:1.

A's sacrifice will be (2/3 – 2/4) or 2 /12 and that of B will be (1/3 – 1/4) or 1/12.

So, sacrifice ratio of A and B is 2/12:1/12 or 2:1.

In case the incoming partner brings in only a portion of the premium, a possible alternative is to credit the premium brought to the capital account of the new partner and to further raise goodwill in the books of account at full value against the capital accounts of the existing partners in their old profit sharing ratio.

3. Memorandum Revaluation Method: Since the value of goodwill undergoes constant change, and partners may not wish that an account should remain in the books, goodwill is raised in the books first and then it is written off. Journal Entries to be passed are:

(a) Goodwill A/c……Dr. (Full value)

To Old Partners' Capital A/cs (in Old ratio)

(Being goodwill raised in the books at its full value)

(b) All Partners' Capital A/cs……Dr. (In New ratio)

To Goodwill A/c

(Being goodwill written off from the books)

II. When Goodwill exists in the books of accounts:

There is no uniform practice for the treatment of goodwill under this situation. Generally the facts of the case will determine the same. The different situations that may arise are:

- Where goodwill appears in the balance-sheet at part value and the incoming partner brings in premium for goodwill: Here, the existing goodwill can be written off against the capital accounts of old partners in their old profit sharing ratio and the premium brought in by the new partner will be credited to the capital accounts of the old partners in the sacrificing ratio.

Further, if the partners desire to show the original value of the goodwill (or any agreed value of goodwill) in the books of account, it can be raised through the following entry:

Goodwill A/c……Dr.(Original or agreed value)

To All Partners' Capital A/c

(New profit- sharing ratio)

(Being goodwill raised in the books of account)

- Where goodwill account appears in the books at part value and the

Solution: **In the books of ……..**

Dr.	**Journal entries**	**Cr.**

Note: When the profit share of the new partner is given and there is no change in the profit sharing ratio of the old partners in between themselves, the profit sharing ratio and the sacrificing ratio remain the same which in this case is 3:2.

In case the goodwill money is withdrawn by the old partners, an additional entry would be required thus:

Date	Particulars	L.F.	Amount(Rs.)	Amount(Rs.)
?	A's capital A/c……Dr. B's capital A/c……Dr To Bank A/c (Being the shares of goodwill of A and B withdrawn by them)		4,800 3,200	8,000

2. Revaluation Method: When the newly admitted partner is unable to bring in his share of goodwill in cash, a goodwill account is raised in the books of the firm at its full value and the capital accounts of the existing partners are credited with this value of the goodwill in their old profit sharing ratio. Goodwill thereafter appears in the Balance-Sheet as an asset.

Journal entry to be passed is:

Goodwill A/c…… Dr.
To Existing Partners' A/cs
(in the old profit sharing ratio)

ii) Adjustment with regard to the Goodwill :

Goodwill is the value of the reputation of a firm in respect of profits expected in future over and above the normal rate of profits. It is the aggregate of all those intangible attributes of a business which contribute to its superior earning capacity over the normal return on investment. It becomes necessary to value goodwill when there is a change in the profit sharing ratio,in case of admission of a new partner, death/retirement of a partner, sale/dissolution of a firm etc. Some of the usual methods used or valuation of goodwill are:

(a) Average Annual Profit Method: At first, average profit is calculated based on the past few years' profits, and necessary adjustments are made for any expected change in future profits. The average profit figure is then multiplied by a number (3 or 4, i.e., three or four years), as agreed. The product will be the value of the goodwill. It should be noted that average profit may be based on simple average or weighted average.

Exercise 10.5

The profits of the last 3 years are Rs.20,000, Rs.16,000 and Rs.21,000. So, average profit for 3 years = (20,000+16,000+21,000)/3 =Rs.19,000. If goodwill is 2 years purchase of 3 years' average profits, then the value of the goodwill will be Rs.19,000 X 2= Rs.38,000.

Date	Particulars	L.F.	Amount(Rs.)	Amount(Rs.)
?	Bank A/c……Dr. To C's capital A/c To Goodwill A/c (Being cash brought in as capital and premium for goodwill)		38,000	30,000 8,000
?	Goodwill A/c……Dr. To A's capital A/c To B's capital A/c (Being premium brought by C divided in sacrificing ratio i.e. 3:2)		8,000	4,800 3,200

(b) Purchase of Super Profits Method: Super profit is the excess of actual profit over the normal profit of an enterprise. Actual profit is generally taken as the actual average profit of the past few years while normal profit means the interest on capital employed at the prevailing rate of interest and reasonable remuneration to the owners/ partners. Super profit thus, is the excess of average actual profit over normal profit(Interest on Capital + Remuneration to owners). Super profit multiplied by a given number gives us the value of goodwill.

Exercise : 10.6

The capital employed in a firm is Rs.1,00,000. The normal rate of return may be considered to be 15% p.a. Profits for the last three years are: Rs.30,000, Rs.35,000 and Rs.40,000.Goodwill is to be valued at 3 years' purchase of super profit.

Here, Average Profit = (30,000+ 35,000+40,000)/3= Rs.35,000

Normal Profit = 15% of Rs.1,00,000 = Rs.15,000

So, Super Profit= Rs.35,000 – Rs.15,000 = Rs.20,000

Value of Goodwill = Super Profit X 3 = Rs.60,000

(c) Turn over Basis: Under this method, average annual turnover of a few previous years is multiplied by some agreed number to arrive at the value of goodwill. This method is appropriate for valuing goodwill of professional firms such as medical practitioners, lawyers etc. in which case, the gross annual recurring fees are the base for calculation of goodwill.

Exercise : 10.7

If the average annual fees of a medical practitioner is Rs.40,000 and 3 years' purchase of such average annual fees is taken as the value of goodwill, then goodwill value will be Rs.40,000 X 3= Rs.1,20,000

(d) Capitalisation Method: This method involves finding out the value of the business (by considering it as an equivalent of investment) and thereafter, deducting the value of the net tangible assets there from to find the value of goodwill. The value of the business is found by using the formula given below:

$$\frac{\text{Average Annual Profit - Remuneration of owners}}{\text{Reasonable rate of return on Capital}} \times 100$$

Value of Goodwill = Value of the Business- Net Tangible Assets of the firm

Exercise : 10.8

Net Tangible assets = Rs.1,20,000, Average Profits of last few years is Rs.45,000. Partner remuneration is Rs.15,000 and reasonable rate of return is 15%.

Here, value of Business is Rs. (45,000- Rs.15,000)/15 X 100 =Rs.2,00,000

Now, Goodwill = Rs.(2,00,000 – 1,20,000) = Rs. 80,000

Treatment of Goodwill on admission of a partner may be discussed under two situations:

I. When Goodwill does not exist in the books of accounts, and

II. When Goodwill exists in the books of accounts

I. When Goodwill does not exist in the books of accounts:

Under such a situation, one may follow different methods such as:

1. Premium Method
2. Revaluation Method
3. Memorandum Revaluation Method

1. Premium Method: This method requires the new partner to bring cash for his capital and his share of goodwill. There are different ways in which a newly admitted partner can bring in his share of goodwill, which is also called premium such as:

-If the premium is paid privately to the old partners outside the business; such kind of transaction will not be recorded in the books of account.

-If the premium paid to the firm is retained in the business.

-If the premium paid to the firm is withdrawn by the old partners.

Exercise : 10.9

A and B are partners sharing profits and losses in the ratio of 3:2. P is admitted into the firm for 1/6th share in future profits. His share of capital and goodwill are Rs.30,000 and Rs.8,000 respectively. The goodwill money paid by C is retained by the business. Pass necessary journal entries.

A retires from business adjustments made were:

(i) Goodwill of the firm is valued at Rs.3, 600.

(ii) Necessary revaluation of assets and liabilities are as follows: Stock: Rs.1,800; Land and Building: Rs.3,390; Sundry Debtors:Rs.1,575; Machinery: Rs.3,750; Sundry Creditors:Rs.2,100.

(iii) B and C are required to bring in additional capital to the extent of Rs.3,000 and Rs.750 respectively.

(iv) A was to be paid Rs.2,430 in cash and the balance of his Capital Account to be transferred to his Loan Account.

Prepare Revaluation Account, Partners' Capital A/cs, Cash A/c and the Balance Sheet of the firm after A's retirement.

Solution: **In the books of ……..**

Dr. **Revaluation A/c** **Cr.**

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
2005				2005			
Jan 1	To Stock A/c		450	Jan 1	By Land and		390
Jan 1	To Sundry			Jan 1	Building A/c		
	Debtors A/c		75	Jan 1	By Sundry		150
Jan 1	To Machinery		225		Creditors A/c		
	A/c				By Partners'		
					Capital A/cs:		210
					A(4/7) - Rs.120 B(2/7) - Rs.60 C (1/7)- Rs.30		
	Total		750		Total		750

To Revaluation A/c

(b) For any decrease in the value of an asset:

Revaluation A/c……Dr.

To Asset A/c

(c) For any increase in the value of a liability:

Revaluation A/c……..Dr.

To Liability A/c

(d) For any decrease in the value of a liability:

Liability A/c ……..Dr.

To Revaluation A/c

(e) For profit on revaluation:

Revaluation A/c…….Dr.

To Old Partners' Capital A/cs(in the old profit sharing ratio)

(f) For loss on revaluation

Old Partners' Capital A/cs……..Dr.

(in the old profit sharing ratio)

To Revaluation A/c

(iv) Accumulated profits, reserves and surplus:

At the time of admission of a new partner, any undistributed profit or loss or general reserve appearing in the existing balance-sheet should be transferred to the capital accounts of the old partners in the old profit sharing ratio. These entries are necessary even when there are no instructions to do so since these profits and losses belong to the old partners only. Necessary journal entries are:

(a) For transfer of profits/reserves:

Profit and Loss A/c (or General Reserve A/c)……..Dr.

To Old Partners' A/cs(Old ratio)

(b) For transfer of accumulated losses:

Old Partners' A/cs…….Dr.(Old ratio)

To Profit and Loss A/c

(v) Adjustment in respect of Partners' Capitals:

At times, after a partner is admitted, all the partners may decide to make their capitals proportionate to the profit-sharing ratio or any other

ratio agreed upon. This may be done on the basis of new partner's capital. On the other hand, a newcomer may also bring in his share of capital on the basis of the old partners' capitals after adjustment.

The following example shows the capital requirement of the new partner.



Exercise : 10.10

X and Y are partners with a profit sharing ratio of 2:1. Their adjusted capitals are Rs.10,000 and Rs.5,000 respectively. Z is admitted as a new partner for 1/4th share of future profits by bringing in proportionate capital.

Here, Z's capital will be determined thus:

Z's share= 1/4

Remaining share of X and Y = 1- 1/4 = 3/4

Total adjusted existing capital(for 3/4th share of profits) of X and Y = 10,000 + 5,000= Rs.15,000

So, total capital = 15,000 X 4/3 = Rs.20,000

Therefore, Z's share of capital = 20,000 X 1/4 = Rs.5,000



Exercise : 10.11

A and B are partners sharing profits and losses in the ratio of 3:1. On January 1, their Balance sheet stood as follows:

Liabilities	Amount(Rs.)	Assets	Amount(Rs.)
Capitals:A 50,000		Machinery	40,000
B 30,000	80,000	Stock	30,000
Sundry creditors	2,000	Sundry debtors	10,000
		Bank balance	8,000
Trade loan	8,000	Cash at hand	2,000
	90,000		90,000

C is admitted into the partnership with 1/4th share in the future profits. He pays Rs.20,000 as premium for goodwill and agrees to pay one-half of the combined capital of existing partners after depreciating machinery and stock

profit is to be transferred to the capital accounts of all partners in the old profit sharing ratio. Alternatively, only the retiring/deceased partner's share may be credited to his capital account and debited to the reserve account.

10.6.1 Computation of Retiring/Deceased Partner's share in the firm

Necessary items to be considered for this are:

i) Opening Balance of Capital and Current Account of outgoing partner
ii) Share of undistributed reserves/profits
iii) Share of profit/loss on revaluation
iv) Share of profit/loss till date of retirement/death
v) Share of Firm's goodwill
vi) Salary and/or interest due to the retiring/deceased partner up to the date of retirement/death
vii) Drawings and interest thereon, of the retiring/deceased partner

10.6.2 Mode of Payment of Retiring/Deceased Partner's share

The total amount due to the retiring /deceased partner may be paid by way of a lump sum or in instalments or by way of an annuity.



Exercise : 10.12

A, B and C carry on a partnership business and has a profit sharing ratio of 4:2:1**.** Their Balance-Sheet as on January 1, 2015 is given below:

Liabilities	Amount(Rs.)	Assets	Amount(Rs.)
Capitals:		Goodwill	1,500
A 4,000		Land and Building	3,000
B 3,500		Machinery	3,975
C 2,500	10,000	Vehicle	600
General Reserve	1,050	Sundry Debtors	1,650
Bills Payable	125	Stock	2,250
Sundry creditors	2,250	Cash at hand	450
	13,425		13,425

(ii) Continuing Partners' Capital A/cs……Dr.
[Gaining ratio]
To Goodwill A/c

(Being the goodwill written off in the gaining ratio of remaining partners)

Gaining Ratio = New Profit Sharing Ratio - Old Profit Sharing Ratio

An Alternative entry for situation (3) would be thus:

Continuing Partners' Capital A/cs……Dr.[Gaining ratio]
To Capital A/c of retiring or deceased partner [Share of retiring partner]

(Being the goodwill of retiring partner adjusted)

b. Goodwill Account exists in the last Balance-Sheet

(1) Where goodwill appears in the balance-sheet at part value: The difference between the full value and the existing value will be recorded in the books through the following journal entry:
Goodwill A/c……Dr.(Difference between full value and existing value)
To All Partners' Capital A/cs (Old profit- sharing ratio)
(Being goodwill raised in the books of account)

(2) When Goodwill already exists in the books at full value: No adjustment for goodwill is required.

(3) When Goodwill appears in the books of account at a value higher than its actual value: The difference between the book value and the real value is written back by debiting all the partners' capital accounts in their old profit sharing ratio and crediting the goodwill account. The journal entry necessary is:
All Partners' Capital A/cs……Dr.(Old profit sharing ratio)
To Goodwill A/c (Excess of book value over real value)

(ii) Adjustment with regard to revaluation of assets and liabilities

Unless the Partnership Deed specifies otherwise, revaluation of assets and liabilities is necessary on the retirement/death of a partner. Just as in admission, a Revaluation account is prepared to ascertain the profit or loss on revaluation. The profit/loss on revaluation is transferred to All Partners' Capital Accounts in the old profit sharing ratio.

(iii) Adjustment with regard to reserves etc.

On the retirement/death of a partner, any reserve or undistributed

at 20% and 10% respectively and creating a reserve of 10% of sundry debtors.

Pass necessary journal entries and prepare opening balance-sheet of the firm.

Solution: **In the books of ……..**

Dr. **Journal Entries** **Cr.**

Date	Particulars	L.F.	Amount(Rs.)	Amount(Rs.)
Jan 1	Revaluation A/c……Dr. To Machinery A/c To Stock A/c To Provision for doubtful debts A/c (Being revaluation of assets on C's admission)		12,000	 8,000 3,000 1,000
Jan 1	A's capital A/c……Dr. B's capital A/c……Dr. To Revaluation A/c (Being loss on revaluation transferred to old partners' capital accounts in old profit sharing ratio i.e. 3:1)		9,000 3,000	 12,000
Jan 1	Bank A/c……..Dr. To C's Capital A/c To Goodwill A/c (Being cash brought in by C as capital and premium for goodwill.)		64,000	 44,000 20,000
Jan 1	Goodwill A/c……..Dr. To A's capital A/c To B's capital A/c (Being goodwill divided between A and B in sacrificing ratio of 3:1)		20,000	 15,000 5,000

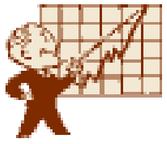
Liabilities		Amount(Rs.)	Assets	Amount(Rs.)
Capital A/cs:			Machinery	32,000
A-	Rs.56,000		Stock	27,000
B-	Rs.32,000		Sundry debtors	9,000
C-	Rs.44,000	1,32,000	Bank balance	72,000
Sundry Creditors		2,000	Cash at hand	2,000
Trade loan		8,000		
		1,42,000		1,42,000

Workings: Calculation of C's capital:

	A's capital	B's capital
Opening balance	50,000	30,000
Less: Loss on revaluation	9,000	3,000
	41,000	27,000
Add: Goodwill	15,000	5,000
	56,000	32,000

Combined capital of A and B = Rs.(56,000 + 32,000) = Rs.88,000

So, C's combined capital = 1/2 of combined capital of A and B = Rs.44,000



CHECK YOUR PROGRESS

Q 4: What are the two rights that a nearly admitted partner requires?

.....

.....

.....

Q 5: What do you mean by premium method?

.....

.....

.....

10.6 RETIREMENT/ DEATH OF A PARTNER

A partnership is legally dissolved in any of the following situations viz.: retirement, death or expulsion, and the remaining partners may agree

to form a new partnership immediately after such dissolution. The primary accounting issue here is the proper determination of the retiring/deceased partner's capital account. Necessary adjustments are with respect to:

(i) Goodwill

(ii) Revaluation of assets and liabilities

(iii) Undistributed profits / Reserves etc.

(i) Adjustment in regard to Goodwill:

Valuation of goodwill on retirement / death of a partner is made in the same manner as in case of admission of a partner. Adjustment entries in respect of goodwill will depend on whether:

a. Goodwill Account does not exist in the last Balance-Sheet

b. Goodwill Account exists in the last Balance-Sheet

a. Goodwill Account does not exist in the last Balance-Sheet

(1) Goodwill is raised in the books of accounts at full value thus:

Goodwill A/c……..Dr.[Full value]

To All Partners' Capital A/cs [Old ratio]

(Being goodwill raised in the books on retirement)

(2) Goodwill is raised in the books of the firm at full value but is written off immediately thus:

(i) Goodwill A/c……..Dr. [Full value]

To All Partners' Capital A/cs [Old ratio]

(Being goodwill raised in the books on retirement/death)

(ii) Continuing Partners' Capital A/cs [New ratio]…….Dr.

To Goodwill A/c

(Being goodwill written off from the books)

(3) Goodwill Account is raised only to the extent of retiring or deceased partner's share thus:

(i) Goodwill A/c ……..Dr. [Share of retiring partner]

To Capital A/c of retiring or deceased partner

(Being retiring/deceased partner's share of goodwill raised in the books)

In this case Goodwill Account will appear in the Balance Sheet as an asset. However, it is advisable to write it off. Therefore, the journal entry would be:

Dr. **Partners' Capital A/cs** **Cr.**

Date	Particulars	J F	A	B	C	Date	Particulars	J F	A	B	C
2015 Mar 31	To RealisationA/c		7,200	4,800	-------	2015 Mar 31	By Balance b/d		28,000	30,000	4,000
Mar 31	To RealisationA/c		13,650	9,100	4,550	Mar 31	By Bank A/c (Amount brought in by C)		-------	-------	550
Mar 31	To Bank A/c (Final payment)		7,150	16,100	-------						
			28,000	30,000	4,550				28,000	30,000	4,550

Note: Bank overdraft means negative balance in Bank account and therefore, it should not be transferred to Realisation Account.

Workings: Realisation amount **:** Rs.42,000(machinery) + Rs.8,000(stock) + Rs.10,800 (debtors) = Rs.60,800

10.8 INSOLVENCY OF PARTNER/PARTNERS

If a partner becomes insolvent and fails to pay his debit balance of capital account either wholly or in part, the unrecoverable portion is a loss to be borne by the solvent partners.Prior to the decision in Garner vs. Murray, the loss arising from the insolvency was deemed to be an ordinary business loss and was to be shared in the profit-sharing ratio.

The decision in **Garner vs. Murray** lays down thus:

i) Solvent partners will bring cash equivalent to their share of loss on realisation and not the insolvent partners' share.

ii) The deficiency of capital of the insolvent partner gets distributed among the solvent partners in the ratio of their last agreed capitals.

Therefore, what happens is that the insolvency of a partner is not to be shared by the solvent partners in the ratio in which they share profits and losses but in the ratio of capitals just before dissolution. However, a solvent partner having debit balance in Capital Account will not share any loss due to insolvency of a partner.

Dr. **Partners' Capital A/cs** **Cr.**

Date	Particulars	J. F	A	B	C	Date	Particulars	J. F	A	B	C
2005 Jan 1	To Revaluation A/c(loss)		120	60	30	2005 Jan 1	By Balance b/d		4,000	3,500	2,500
						Jan 1	By Reserve A/c		600	300	150
Jan 1	To Cash A/c		2,430	------	------	Jan 1	By Goodwill A/c		1,200	600	300
Jan 1	To A's Loan A/c		3,250	------	------						
Jan 1	To Balance c/d		------	7,340	3,670		By Cash A/c		-------	3,000	750
			5,800	7,400	3,700				5,800	7,400	3,700

Dr. **Cash A/cs** **Cr.**

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
2005 Jan 1	To Balance b/d		450	2005 Jan 1	By A's Capital A/c		2,430
Jan 1	To B's Capital A/c		3,000	Jan 1	By Balance c/d		1,770
Jan 1	To C's Capital A/c		750				
			4,200				4,200

Balance-Sheet
(After A's retirement) as on January 1, 2015

Liabilities		Amount(Rs.)	Assets	Amount(Rs.)
Capitals:			Goodwill	3,600
B	7,340		Land and Building	3,390
C	3,670	11,010	Machinery	3,750
A's Loan A/c		3,250	Vehicle	600
Bills Payable		125	Sundry Debtors	1,575
Sundry creditors		2,100	Stock	1,800
			Cash at hand	1,770
		16,485		16,485

Note: The amount of goodwill that is further raised is credited to all partners' capital accounts in the ratio of 4:2:1.

10.7 DISSOLUTION OF FIRM

10.7.1 Dissolution of Partnership and Dissolution of Firm:

A partnership comes to an end in the following situations:

- The expiry of the term for which it was formed
- The completion of the venture for which the partnership was formed.
- The death of a partner
- The retirement of a partner
- The insolvency of a partner

However, the remaining partners (in case of retirement or death or insolvency) may continue to do the business. In such a situation, the partnership will be new but the firm continues. Thus, the dissolution of the partnership means a reconstitution of the firm due to the retirement /death or insolvency of a partner and the remaining partners provide for the continuance of the firm by means of an agreement.

On the other hand, a firm is said to be dissolved when the partnership business also comes to an end. On dissolution of a firm, the firm's assets are realised and the liabilities are discharged since the firm is to be closed or discontinued.

Dissolution of firm takes place when:

- All partners agree that the firm should be dissolved
- All partners except one become insolvent
- The business becomes illegal
- The Court orders dissolution
- A partner gives notice of dissolution, in case of partnership at will.

10.7.2 Settlement of Accounts

The assets of the firm have to be applied in the following order:

1. In paying debts due to third parties/outsiders

Mar 31	A's capital A/c……..Dr. B's capital A/c……..Dr. To Realisation A/c (Being assets taken over by partners)		7,200 4,800	 12,000
Mar 31	A's capital A/c……..Dr. B's capital A/c……..Dr. C's capital A/c……..Dr. To Realisation A/c (Being loss on realisation transferred to partners' capital accounts in profit sharing ratio)		13,650 9,100 4,550	 27,300
Mar 31	Bank A/c……..Dr. To C's capital A/c (Being required amount brought in by C to make up for deficiency in capital account)		550	 550
Mar 31	A's capital A/c……..Dr. B's capital A/c……..Dr. To Bank A/c (Being final payment to partners on dissolution)		7,150 16,100	 23,250

Dr. Bank A/c Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
2015				2005			
Mar 31	To Realisation A/c		60,800	Mar 31	By Balance b/d		23,000
				Mar 31	By Realisation A/c		15,000
Mar 31	To C's Capital A/c		550	Mar 31	By Realisation A/c		100
				Mar 31	By Partners' Capital A/cs(Final Payment):		
					A- 7,150		
					B- 16,100		23,250
			61,350				61,350

at 10% less book value. Goodwill realised no value.

Balance 50% of stock was taken over by A at Rs.7,200 while furniture was taken over by B at Rs.4,800.Realisation expenses were Rs.100.

Show Journal entries, and prepare Bank A/c and Partners' Capital A/cs.

Solution: In the books of ……..

Dr. Journal Cr.

Date	Particulars	L.F	Amount(Rs.)	Amount(Rs.)
2005	Realisation A/c……Dr.		1,00,000	
Mar	To Goodwill A/c			12,000
31	To Machinery A/c			50,000
	To Furniture A/c			6,000
	To Stock A/c			20,000
	To Trade Debtors A/c			12,000
	(Being transfer of various assets to Realisation Account at book values on firm's dissolution)			
Mar 31	Trade Creditors A/c……Dr.		15,000	
	To Realisation A/c			15,000
	(Being transfer of trade creditors to Realisation Account at book value on firm's dissolution)			
Mar 31	Bank A/c……..……Dr.		60,800	
	To Realisation A/c			60,800
	(Being realisation of various assets)			
Mar 31	Realisation A/c……..Dr.		15,000	
	To Bank A/c			15,000
	(Being payment to trade creditors made)			
Mar 31	Realisation A/c……..Dr.		100	
	To Bank A/c			100
	(Being realisation expenses paid)			

2. In paying rateable advances or loans made by partners (apart from their capital contribution) to the firm
3. In paying the partners the amounts due to them as their capital contribution

In case any surplus remains, it needs to be distributed among the partners in the profit sharing ratio.

Losses of the partnership firm that may arise on dissolution need to be made up in the following order from:

1. Out of Accumulated profits
2. Then out of capitals of the partners
3. If the loss still does not get covered, then out of contributions from the private estates of the partners in the profit sharing ratio. However, the separate estate for each partner is to be utilised first for paying his private debts.

10.7.3 Accounting Entries for Dissolution

The steps necessary to close the books of accounts are:

(i) For this purpose, a Realisation Account is opened and all assets except Cash/Bank account are transferred to this account at book values. Realisation Account is debited and the various asset accounts are credited and closed. However, accounts related to depreciable assets and sundry debtors etc. are to appear at their gross figures in the Realisation Account. And valuation accounts such as provision for doubtful debts or provision for depreciation which have credit balances are to be transferred to the credit side of the Realisation Account.

Realisation A/c…… Dr.
To Machinery A/c
To Sundry Debtors A/c
To Stock A/c

(ii) All liabilities to outsiders and provisions and reserves against assets (e.g. provision for doubtful debts) are transferred to the credit side of the Realisation Account. However,

accumulated losses or profits are not to be transferred.

Sundry Creditors A/c…….. Dr.

Bills Payable A/c…… Dr.

Provision for Bad Debts A/c…… Dr.

To Realisation A/c

(iii) The amount received on the sale of assets are credited to Realisation Account and debited to Cash or Bank Account.

Cash A/c…… Dr.

To Realisation A/c

(iv) If a partner takes over an asset, his Capital Account should be debited and the Realisation Account be credited with the value agreed upon.

Partner's Capital A/c…… Dr.

To Asset A/c

(v) All expenses of dissolution or realisation of assets are to be debited to the Realisation Account and credited to the Cash/ Bank Account.

Realisation Account……..Dr.

To Cash A/c

(vi) After realisation of assets, the outside liabilities are to be paid off first.

Realisation Account……..Dr.

To Cash A/c

(vii) If a partner takes over a liability, his Capital Account is to be credited and the Realisation Account be debited with the value agreed upon.

Realisation Account……..Dr.

To Partner's Capital A/c

(viii) After all necessary entries, the Realisation Account is to be closed and the balance is to be transferred to the Partners' Capital Accounts in their profit-sharing ratio.:

For Profit:

Realisation Account……..Dr.

To Partners' Capitals A/c

For Loss:

Partners' Capitals A/c……Dr.

To Realisation Account

(ix) Partners' Loans ,if any, are to be paid now.

Partners' Loan A/c……..Dr.

To Cash A/c

(x) Any accumulated profits /losses are to be transferred to the Capital Accounts of the partners in the profit sharing ratio.

(xi) At this point, the Capital Accounts will indicate how much amount is due to or due from the partners. If one of the Partner's Capital Account shows a debit balance, the respective partner is to bring in the required amount to the business to make up the deficiency. Thereafter, the final payment is to be made to partners having credit balances in their capital accounts.

After the claims of the partners are settled, there will be no balance in the Cash/Bank Account.



Exercise : 10.13

A,B and C are partners sharing profits and losses in the ratio of 3:2:1.Their Balance-Sheet as on 31.3.2015 was as follows:

Liabilities		Amount(Rs.)	Assets	Amount(Rs.)
Capitals :			Goodwill	12,000
A	28,000		Machinery	50,000
B	30,000		Furniture	6,000
C	4,000	62,000	Stock	20,000
Bank Overdraft		23,000	Trade Debtors	12,000
Trade Creditors		15,000		
		1,00,000		1,00,000

They decide to dissolve the partnership. Realisation proceeds were as follows:

Machinery: Rs.42,000; 50% of stock at Rs.8,000; Debtors were collected

UNIT 11: FINANCIAL STATEMENT ANALYSIS

UNIT STRUCTURE

11.1 Learning Objectives

11.2 Introduction

11.3 Financial Statements

11.4 Balance Sheet

- 11.4.1 Components of Balance Sheet
- 11.4.2 Assets

11.5 Profit And Loss Account

- 11.5.1 Concept of Profit

11.6 Statement of Cash Flow

- 11.6.1 Sources and Uses of Cash
- 11.6.2 Change in Current Assets
- 11.6.3 Change in Current Liabilities

11.7 Funds flow Statement

- 11.7.1 Sources and Uses of Working Capital
- 11.7.2 Forms of funds flow statement

11.8 Uses Of the Statement Of Changes in Financial Position

11.9 Let Us Sum Up

11.10 Further Reading

11.11 Answer To Check Your Progress

11.12 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will be able to;

- analyse financial statements
- discuss the concept of balance Sheet
- discuss components of balance sheet
- explain profit and loss account
- explain the concept of profit
- outline statement of cash flow
- outline Statement of Fund flow

There might be a situation where all the partners are insolvent and the firm's assets are not sufficient to pay its liabilities. In this case, the available cash with the firm(cash in hand and the final dividend received from the partners' estates) is first used to pay the realisation expenses and thereafter, the balance amount, if any, is paid to creditors proportionally. In order to close the books of the firm, the Realisation Account is opened in the normal manner; however the liabilities are not transferred to the Realisation Account. All liabilities are directly paid to the extent possible. Any amount that remains unpaid is transferred to the Deficiency Account. Further, the Partners' capital accounts are also closed by transfer to the Deficiency Account.



Exercise : 10.14

X, Y and Z are partners sharing profit and loss in the ratio of 3:2:1 respectively. The Balance-Sheet as on the date of dissolution is given below:

Liabilities	Amount(Rs.)	Assets	Amount(Rs.)
Capitals :		Capital Account:	1,300
A	12,000	C	5,500
B	8,400	Furniture	16,000
A's Loan Account	3,000	Stock	32,000
Trade Creditors	45,000	Trade Debtors	13,600
	68,400	Cash in hand	68,400

Realisation proceeds are as follows: Stock- Rs. 12,900; Furniture: Rs.2,300; and Debtors: Rs.27,500. Creditors were paid less a discount of Rs, 1,400. Prepare

(i) Realisation A/c (ii)Cash A/c and (iii)Partners' Capital A/cs

A and B are solvent but C is insolvent and he is unable to contribute anything. Realisation expenses are Rs.800. [Apply Garner vs. Murray rule]

Solution: In the books of…

Dr. Realisation A/c Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To Stock A/c		16,000		By Trade Creditors A/c		45,000
	To Furniture A/c		5,500		By Cash A/c:		
	To Trade Debtors A/c		32,000		Stock- 12,900 Furniture - 2,300 TradeDebtors- 27,500		42,700
	To Cash A/c(payment to creditors)		43,600		By Partners' Capital A/cs:		
	To Cash A/c (realisation expenses)		800		X - 5,100 Y- 3,400 Z- 1,700		10,200
			97,900				97,900

Dr. A' Loan A/c Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To Cash A/c		3,000		By balance b/d		3,000
			3,000				3,000

Dr. Cash A/c Cr.

Date	Particulars	J.F	Amount (Rs.)	Date	Particulars	J.F	Amount (Rs.)
	To balance b/d		13,600		By Realisation A/c		43,600
	To Realisation A/c		42,700		By Realisation A/c		800
	ToPartners' Capital A/c:				By A's Loan A/c		3,000
	A - 5,100				By Partners' Capital A/cs(Final Payment):		
	B - 3,400		8,500		A- 10,235 B- 7,165		17,400
			64,800				64,800

[Revaluation profit :Rs.300, B's Loan A/c: Rs6,520 and Balance-Sheet: Rs.27,300]

Q 13: Given below is the Balance-Sheet of A,B and C sharing profits in the ratio of 2:2:1.

Liabilities	Amount (Rs.)	Assets	Amount(Rs.)
Capitals :		Sundry assets	85,000
A 70,000		Cash	25,000
B 30,000	1,00,000	C's Capital A/c	5,000
Sundry Creditors	15,000		
	1,15,000		1,15,000

The firm was dissolved and sundry assets realised Rs. 82,000. Sundry creditors were paid Rs.13,500 in full settlement of their debt. Realisation expenses were Rs.200. C was declared insolvent and his estate contributed only 50 paise in a rupee. Prepare Realisation A/c, Cash A/c and Partners' Capital A/cs. [Apply Garner vs. Murray rule]

[Realisation Loss: Rs.1,700; Deficiency of C Rs.2,670 borne by A and B in their capital ratio i.e.,7:3]

*** ***** ***

(a) D is admitted into the partnership for 1/4th share of profits. He brings in Rs.20,000 as capital and Rs.9,000 for goodwill.

(b) That half the goodwill shall be withdrawn by the old partners.

(c) Stock and furniture are to be depreciated by 10%.

(d) A provision of 5% on debtors is to be created as provision for doubtful debts.

(e) Value of building to be raised to Rs.25,000.

Prepare Revaluation A/c, Partners' Capital A/cs and Balance-Sheet as on 1.1.2016 after D's admission.

[Profit on revaluation: Rs.4,200; Capital balances: A Rs.19,900, B Rs.15,300, C Rs.9,000 and D Rs.20,000; Balance-Sheet : Rs.67,400]

Q 12: A, B and C are partners sharing profits in the ratio 2:2:1.On 1.1.2015, their balance-sheet stood as follows:

Liabilities		Amount(Rs.)	Assets		Amount(Rs.)
Capitals :			Furniture		2,000
A	5,000		Stock		10,000
B	4,000		Sundry Debtors	15,000	
C	2,000	11,000	Less Prov. for		
Profit and Loss A/c		4,000	doubtful debts	1,000	14,000
Sundry Creditors		13,500	Cash		2,500
		28,500			28,500

B retires as on this date under the conditions:

(a) Goodwill is to be valued at 2 years' purchase of 3 years' average profits which are Rs.3,000, Rs.4,500 and Rs.3,000. No Goodwill Account is to be raised in the books of accounts.

(b) Provision for doubtful debts is to be raised to 10% ;Furniture to be revalued at Rs.1,800; Stock to be appreciated by 15% and outstanding expenses of Rs.500 to be brought into account.

(c) New profit sharing ratio between A and C is 3:2.

(d) Rs.2,000 is to be paid immediately to B and the balance due to him be transferred to his Loan A/c.

Show necessary journal entries and prepare Balance-Sheet after B's retirement.

Dr. **Realisation A/c** **Cr.**

Date	Particulars	J.F	A	B	C	Date	Particulars	J.F	A	B	C
	To balance b/d		–	–	1300		by balance b/d		12,000	8,400	–
	To realisation		5100	3400	1700		by cash a/c				
	a/c (loss)						(cash brought in)		5100	3,400	–
	To partners		1765	1235	–		By partners				
	capital a/c						capital a/c				
	C						A		–	–	1765
	(Final Payment)		10235	7165			B		–	–	1235
			17100	11800	3000				17100	11800	3000



10.9 LET US SUM UP

- Partnership is the relation that exists between or among persons who have agreed to share the profit of a business carried on by all or by any of them acting for all. In India, Partnership is governed by the Indian Partnership Act, 1932
- The terms and conditions regarding the conduct of the partnership business are contained in an agreement among the partners; it is called the Partnership Deed.
- After the formation of the partnership firm, there may be several changes in the constitution of the firm due to admission of a new partner, retirement or death of a partner.
- Dissolution of a partnership firm takes place when the partnership business is discontinued due to reasons such as mutual agreement among partners for such dissolution, by the operation of law, by order of Court , by notice of partnership at will etc.



10.10 FURTHER READING

1. K R Das & K M Sinha : *"Financial Accounting"*; Lawyers Book Stall
2. Maheshwari, S.N. and S. K. Maheshwari (2003), *"An Introduction to Accountancy"*, Eighth Edition, Vikas Publishing House.
3. Gupta, R.L. and V.K. Gupta (2003), *"Financial Accounting: Fundamental"*, Sultan Chand



10.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: A partnership is a nominate contract between individuals who, in a spirit of cooperation, agree to carry on an enterprise; contribute to it by combining property, knowledge or activities; and share its profit.

Ans to Q No 2: a) Partner , Firm b) Two or more c) partnership deed

Ans to Q No 3: a) True b) False c) True

Ans to Q No 4: Right to share in the assets of the business and Right to share in the profits of the business

Ans to Q No 5: Premium method requires the new partner to bring cash for his capital and his share of goodwill.



10.12 MODEL QUESTIONS

Q 1: What are fixed and fluctuating capitals?

Q 2: What are the different methods for valuation of goodwill? What are the different circumstances that require valuation of goodwill?

Q 3: Why is Revaluation Account prepared? How does it differ from Realisation Account?

Q 4: What are the matters considered in determining the amount payable to an outgoing partner?

Q 5: What is the Garner vs. Murray Rule?

Q 6: Explain the difference between dissolution of partnership and dissolution of firm.

Q 7: Aliya and Bina are partners sharing profits and losses in the ratio of 3:2. C joins business with 1/7th share in the profits .Calculate the new profit sharing ratio and the sacrifice ratio.[Sacrifice ratio X:Y=3:2]

Q 8: X and Y are partners sharing profits and losses in the ratio 4:2. Z is admitted as a new partner. The new profit sharing ratio becomes 3:1:2. Z brings in Rs.10,000 as capital and Rs.2,000 as premium for goodwill. Pass necessary journal entries.[Sacrifice ratio X:Y=1:1]

Q 9: Shashi and Riya are partners in the ratio of 3:2. Goodwill appears in the books at Rs.16,000. Chumki is admitted with 1/4th share of profits and brings in Rs.40,000 as capital but is unable to bring in his share of goodwill of Rs.20,000.Show journal entries when:

(i) Goodwill is raised to its full value.

(ii) Goodwill is first raised to its full value but is then written off

Q 10: Sara and Holy are partners in the ratio of 5:3. Romi is admitted as a partner, with Rs.40,000 as his capital and necessary amount as his share of goodwill. Goodwill is valued at Rs.60,000 for the firm. His share in the profits is 1/5 which he takes 1/10 from Sara and 1/10 from Holy. Show necessary journal entries on Romi's admission. What will be the new profit-sharing ratio.[New profit sharing ratio: 21:11:8]

Q 11: A, B and C are partners sharing profits on an equal basis. Their balance-sheet as on December 31, 2016 is given below:

Liabilities		Amount(Rs.)	Assets	Amount(Rs.)
Capitals :			Building	19,500
A	17,000		Furniture	5,000
B	12,400		Stock	2,600
C	6,100	35,000	Sundry Creditors	10,800
Bills payable		2,000	Cash	800
Sundry Creditors		1,200		
		38,700		38,700

surpluses less any non-operating loss. It is a measure of profit before considering interest expenses and tax burden.

d. Profit before Taxes (PBT) is the difference between profit before interest and taxes and interest changes, that is PBT = PBIT-Interest.

e. Profit after Taxes (PAT) or Net Profit (NP) is the difference between profit before tax and taxes, that is NP=PBT-Tax.

11.6 STATEMENT OF CASH FLOW

A firm generates cash and spends cash and as such cash flow analysis is very useful for a firm. It is mainly needed for short-term planning. A cash flow helps to make projections of cash inflows and outflows for the near future to determine the availability of cash during a particular time period. A cash flow statement summarises the changes in cash position between dates of two balance sheets. To understand how a firm obtains cash and how it spends cash during a given period, one needs to look at the changes in each of the items of the balance sheet over that period. It indicates the sources and uses of cash. Moreover, this statement analyses changes in non-current assets as well as current assets (other than cash) to determine the flow of cash.

11.6.1 Sources and Uses of cash

The following are the sources of cash-

a. the profitable operations of the firm,

b. decrease in assets (expect cash),

c. increase in liabilities (including debentures or bonds), and

d. Sale proceeds from an ordinary or preference share issue.

The uses of cash are-

a) the loss from operations,

a) increase in assets (except cash),

a) decrease in liabilities (including redemption of debentures or bonds),

11.2 INTRODUCTION

In this unit, we are going to discuss about different financial statements, like- balance sheet, profit and loss account (which we discussed in unit 8), cash flow and fund flow.

Here we will discuss about the concept of financial statement. Financial statements provide information about a firm and its performance over a period of time. Balance sheet, which shows the financial condition of a business at a given point of time.

Another important financial statement is Profit and loss account, which represents the summary of revenues, expenses and net income (or net loss) of a firm.

A cash flow helps us to make projections of cash inflows and outflows for the near future to determine the availability of cash during a particular time period.

You will find this unit very interesting because, after going through this unit you will able to analyse the financial position of different companies.

11.3 FINANCIAL STATEMENTS

Financial statements are the sources of information for financial decisions. These statements provide information on how a firm has been performing over the years and are useful for financial forecasting and planning. Financial analysis involves analysis of a firm's financial statements and its flow of funds. It is used by various interested parties like creditors, investors, and managers to determine the firm's financial position relative to that of others. Financial analysis is also the starting point for making plans before using any sophisticated forecasting and planning procedures. The commonly used financial statements are the followings- Balance Sheet, Profit and Loss Account, Statement of Cash Flows and Statement of Fund Flow.

11.4 BALANCE SHEET

Balance sheet is the most significant financial statement. The balance sheet shows the financial condition of a business at a given point of time. In terms of accounting, balance sheet communicates information about assets, liabilities and owner's equity for a firm as on a specific date. As per the Companies Act, the balance sheet of a firm may be presented in either the account form or the report form. The structure of both forms are given below:

Balance sheet of Assam Tea Ltd. As on March 31,20…..

Table1: Account Form

Liabilities	Rs. In million	Assets	Rs. in million
Share capital	150	Fixed assets	330
Resources & surplus	112	Investment	15
Secured loans	143	Current assets, loans & advances	234
Unsecured loans	69	Miscellaneous expenditures and loans	0
Current liabilities and provisions	105		
Total	**579**	**Total**	**579**

Table2: Report Form

I. Sources of funds	Rs. In million	
1. Shareholders funds		262
a). share capital	150	
b). reserves & surplus	112	
2. Loans funds		212
a). secured loans	143	
b). unsecured loans	69	
TOTAL		474

II. Application of funds

1. Fixed Assets	330
2. Investments	15
3. Current Assets, Loans & Advances	234
Less: Current Liabilities and Provisions	105
Net Current Assets	129

Table: 11.4 Profit and Loss Account of ABC Ltd. for the year ending on March 2015.

Particulars	Rs. in million	
A. Net Sale		701
B. Cost of goods sold		
Stocks	421	
Wages & salaries	68	
Other manufacturing expenses	63	
C. Operating expenses		60
Depreciation	30	
General administration	12	
Selling	18	
D. Operating profit/Profit before interest & Tax (A-B-C)		89
E Interest		21
F Profit before tax (D-E)		68
G Provision for tax (@50%)		34
Profit after tax (F-G)		34

11.5.1 Concept of Profit

There are several useful concepts of profit which are discussed below :

a. Gross Profit (GP) is the difference between Net Sales and Cost of goods Sold (CGS). Net sales can be defined as Sale less Sales return less sales tax/VAT/excise duty, whereas cost of goods sold is the manufacturing costs of the goods that have been sold.

b. Operating Profit (OP) is the difference between gross profit and operating expenses (OE) consisting of general and administrative and selling expenses and depreciation(DEP), that is OP = GP – OE – DEP

c. Profit before Interest or Taxes: Profit before Interest or Taxes (PBIT), referred to as Earnings before Interest and Taxes (EBIT), is the operating profit of the firm plus any non-operating

after deduction of the uncommitted reserves, if any exist.

11.5 PROFIT AND LOSS ACCOUNT

Profit and loss account represents the summary of revenues, expenses and net income (or net loss) of a firm. The earning capability and potential of a firm are reflected by its profit and loss account. The Companies Act specifies that the profit and loss accounts must show information as required by Schedule of companies IV Act, 1956. This account may be presented in lither account form or in report form. The report form statement may be a single-step statement or a multi-step statement. In a single step statement, all revenue items are recorded first then the expenses items are shown and finally the net profit is given. But a multi-step profit and loss account provides disaggregated information. Table 11.3 represents a single step Profit and Loss account and Table 11.4 represents a multi-step Profit and Loss account.

Table: 11.3 Profit and Loss Account of ABC Ltd. for the year ending on March 2015.

Particulars	Rs. In million
Income:	
(i) Sales	701
Expenditure:	
(ii) Material & other expenditure	582
(iii) Interest	21
(iv) Depreciation	30
(v) Profit before tax[(i)-(ii)-(iii)-(iv)]	68
(vi) Provision for tax	34
(vii) Profit after tax [(v) – (vi)]	34

4. Miscellaneous expenditures and losses	-
TOTAL	474

11.4.1 Components of Balance Sheet

Liabilities:

Liabilities defined broadly, means what the firm owes others. Liabilities represent debts payable in the future by the firm to its lenders and creditors. Liabilities are of two types (i) current liabilities and (ii) long-term liabilities. Current liabilities are debts payable within an accounting period whereas long term liabilities are the obligations or debts payable in a period of time greater than the accounting period. The components of long term and current liabilities are described below:

(i) **Equity Capital**: Equity capital represents ownership capital, as equity shareholders collectively own the firm. Their liability is limited to their capital contribution. Though the paid-up share capital is shown against the share capital, but the balance sheet also provides information on authorised capital, issued capital, subscribed capital. The amount of capital that a firm can potentially issue, as per its memorandum, represents the authorised capital. The amount offered by the firm to the investors is called the issued capital and the part of issued capital which has been subscribed to by the investors is called the subscribed capital.

(ii) **Reserves and Surplus**: This comprises of retained earnings as well as non-earnings items like share premium and capital subsidy.

There are two kinds of resources, namely - Capital Reserves and Revenue Reserves. Capital Reserves includes items such as share premium account, revaluation reserve, and capital redemption reserve. A capital reserve cannot be distributed as dividend to shareholders. Revenue reserves represent accumulated retained earnings from the profits of business.

They are held in accounts like investment allowance reserve, dividend reserve, taxation reserve and general reserve. The reserves and surplus along with paid up capital represent owners' equity which is also called shareholders' funds or net worth.

(iii) Secured Loans: These loans are secured by a charge on the assets of the firm. The charge may be created in the form of pledge or hypothecation of movable assets such as inventories and debtors or in the form of mortgage of immovable assets such as land, buildings and plant and machinery.

(iv) Unsecured Loans: These loans are not secured by a charge on the assets of the firm. The most common forms of unsecured loans are public deposits, commercial paper, unsecured loans from promoters, commercial banks and financial institutions.

(v) Current Liabilities and Provisions: These include items such as bills payable, sundry, creditors, advance payments and invest accrued but not due on loans. Provisions include items such as provision for taxes, provision for dividend, and provision for provident fund, gratuity etc.

11.4.2 Assets

Assets are resources, which are expected to provide a firm with future economic benefits. Assets represent (a) stored purchasing power (e.g. cash), (b) money claims (e.g. receivables, stock) and (c) tangible and intangible items which generate earnings. Under the Companies Act, assets can be classified as

(i) Fixed Assets,

(ii) Investments,

(iii) Current Assets, Loans and Advances and

(iv) Miscellaneous expenditure and loans.

(i) Fixed Assets*:* These are assets that are expected to produce benefits for more than one year. Fixed assets are divided into

two categories-tangible and intangible. Tangible fixed assets include items such as loans, buildings, plant, machinery and other assets, which can be used more than one year. These assets are reported in the balance sheet at their net book value, which is the gross value less accumulated depreciation whereas intangible fixed assets include items like – patents, copyrights, trademarks and goodwill. Intangible fixed assets are reported at their net book value, which is simply the gross value less accumulated amortisation.

(ii) Investments*:* Investments represent financial securities owned by the firm. These can be divided into two categories-long term and current investments. Long-term investments comprise of financial securities like equity shares, preference shares and debentures of other companies. Current investment represents short-term holdings of units or shares of mutual fund schemes. These investments are made primarily to generate income from short-term cash surpluses of the firm.

(iii) Current Assets, Loans and Advances: These are called as liquid assets as these assets are either held in the form of cash or are expected to be converted in cash within the accounting period of the business. Current assets include cash, tradable (marketable) securities, debtors (account receivables) and stock of raw materials, work-in-process and finished goods. Further, loans and advances comprise of items such as advances and loans to subsidiaries, advances recoverable in cash and deposits with governmental authorities.

(iv) Miscellaneous Expenditure and Loans*:* Miscellaneous expenditure comprises of items such as preliminary expenses, discount allowed on the issue of securities, interest paid out of capital during construction and development expenditure to the extent not written off or adjusted. Whereas "losses" are the debit balance of profit and loss account carried forward

Table: 11.8 Kamrup Ltd. Funds flow statement

Sources and Uses of Working Capital		
Sources		Rs.
▪ Funds from operations		1,20,000
▪ Sale of machine		30,000
▪ Issuance of debentures		1,00,000
▪ Issuance of equity shares		1,00,000
Funds provided		**3,50,000**
▪ **Uses**		
▪ Purchase of long-term investments	80,000	
▪ Payment of long-term loans	90,000	
▪ Payment of cash dividend	60,000	
Fund applied		**2,30,000**
Increase in Working Capital		**120000**

11.8 USES OF THE STATEMENT OF CHANGES IN FINANCIAL POSITION

The balance sheet and the profit and loss statement do not explain the changes in assets, liabilities and equity capital.The statement of changes in financial position is prepared to show these changes.These changes are shown by the cash flow and fund flow statements. This statement of changes in financial position gives clear picture of the causes of changes in the firm's working capital or cash flow position. The statement shows the non-current assets acquired by the firm, and the way these have been financed from internal and external sources. Further, a projected statement of changes in financial position is an important planning tool as it helps management to plan the repayment of long-term debt and interest, acquisition of fixed assets and payment of dividends to equity shareholders. Realising the importance of cash and fund flow statement, the stock exchange requires listed companies in India to include these statements in their annual reports.

a) redemption of redeemable preference shares, and

a) cash dividends

The easiest and direct method of preparing a statement of changes in cash position is to only record inflows and outflows of cash, and find out the net change during a given period. If the net change in the cash position has to be found out from the income or profit and loss statement and comparative balance sheets, adjustments for the non-cash items are also to be made. Like cash from operations can be found out by adding depreciation to net profit as depreciation is a non-cash expense. Gain on sale of a non-current asset should be deducted while loss should be added to net profit.

11.6.2 Change in Current Assets

Increase in current assets (that is, end of the year balance exceeding the beginning balance) reduces cash flow from operations while decreases in current assets (that is, beginning balance exceeding end of the year balance) increase cash flow.

Let us take the following situations:

a) Increase in debtors implies cash collections from customers are less than sales figure (shown in the profit and loss statement), while decrease in debtors indicates that cash collections are greater than sales figure.

b) Increase or decrease in inventory is adjusted to the cost of goods sold. Increase in inventory implies that cash outflow is greater than the cost of goods sold figure (shown in the profit and loss statement), while decrease in inventory means that cash outflow is less than the cost of goods sold figure.

c) Increase in prepaid expenses implies that cash outflow is greater than the amount of actual expenses (shown in the profit and loss statement), while decrease in prepaid expenses means that cash outflow is less than the amount of actual expenses.

11.6.3 Change in Current Liabilities

Increase in current liabilities increase cash flow operation while decrease in current liabilities reduces it.

Let us take the following situations:

a. Increase in creditors implies that cash payments to creditors are less than the purchase figure (as shown in the profit and loss statement), while decrease in creditors indicates that cash payments to creditors are greater than purchases figure

b. Increase in 'income in advance' implies greater cash inflow than shown in the profit and loss statement as income, while decrease in 'income in advance' means less cash flow than shown as income.

This is illustrated with the help of the following example:

Table:11.5 Balance Sheet of CCI, Assam as on March 31, 2007

Liabilities	2007	2006	Assets	2007	2006
Share Capital	150	150	Fixed assets	330	322
Reserves and surplus	112	106	Investments	15	15
Secured loans	143	131	Current assets, loans and advances	234	156
Unsecured loans	69	25			
Current liabilities	105	81	Miscellaneous expenditure and losses	-	5000
Total		**245000**			
Current Liabilities	**579**	**493**	**TOTAL**	**579**	**493**
▪ Bills payable		20000	8000	12000	
▪ Creditors		45000	47000		2000
▪ Other current liabilities		25000	5000	20000	
Total		**90000**	**60000**	**32000**	**2000**
Working capital		155000	275000	127000	7000
Increase in working capital					120000
Total				**127000**	**127000**

Table:11.6 Change in Balance Sheet Items

Rs. in million				
	2007	**2006**	**Increase**	**Decrease**
Owner's equity and liabilities				
Share Capital	150	150	–	–
Preference Capital	–	–	–	–
Reserves & surplus	112	106	6	–
Secured Loans				
Term loans	70	58	12	–
Cash credit	73	73	–	–

Table 11.7: **Kamrup Ltd. Statement of Changes in working capital for the year ended December 31, 2016**

(a) Sources and Uses of Working Capital	
Sources	Rs.
▪ Funds from operations	1,20,000
▪ Sale of machine	30,000
▪ Issuance of debentures	1,00,000
▪ Issuance of equity shares	1,00,000
Funds provided	**3,50,000**
Uses	
▪ Purchase of long-term investments	80,000
▪ Payment of long-term loans	90,000
▪ Payment of cash dividend	60,000
▪ Increases in working capital	1,20,000
Fund applied	**3,50,000**

(b) Schedule of Changes in Working Capital

	31Dec. 2016	31 Dec. 2017	Increase	Decrease Rs.
Current Assets				
▪ Cash	80000	125000	45000	
▪ Debtors	50000	45000		5000
▪ Inventory	115000	165000	50000	
Total	**245000**	**335000**	**95000**	**5000**
Current Liabilities				
▪ Bills payable	20000	8000	12000	
▪ Creditors	45000	47000		2000
▪ Other current liabilities	25000	5000	20000	
Total	**90000**	**60000**	**32000**	**2000**
Working capital	155000	275000	127000	7000
Increase in working capital				120000
Total			**127000**	**127000**

(iv) Short-term financing such as bank borrowings.

Uses of working capital

The uses of working capital are as follows:

(i) Adjusted net loss operations,

(ii) Purchase of non-current assets:

a. Purchase of long-term investments like shares, bonds/ debentures etc.

b. Purchase of tangible fixed assets, like land, building, plant, machinery, equipment etc.

c. Purchase of intangible fixed assets, like goodwill, patents, copyrights etc.

(iii) Repayment of long-term debt (debentures or bonds) and short-term debt (bank borrowing),

(iv) Redemption of redeemable preference shares

(v) Payment of cash dividend.

11.7.2 Forms of Funds Flow Statement

The statement of changes in working capital or funds flow is the summary of the sources and uses of working capital. This statement is presented in two parts in Table 11.7. The first part explains the cause of the change in the amount of working capital from the end of one period to another. It gives a list of sources which provide working capital and uses to which working capital is applied. The second part of the statement contains an analysis of the changes in the working capital items. This part of the statement shows items of current assets and current liabilities at the beginning and at the end of the accounting period and the effect of their changes between two periods on the working capital.

Bank credit	25	25	–	–
Inter corporate deposit	44	–	44	–
Current liabilities & provisions				
Trade credit	75	60	15	–
Advance (taken)	20	13	7	–
Provisions	10	8	2	–
Total	**579**	**493**		
Assets				
Fixed assets (net)	330	322	8	–
Investments	15	15	–	–
Current Assets				
Cash & bank	10	6	4	–
Debtors	114	68	46	–
Inventories	105	72	33	–
Advances	5	10	–	5
Miscellaneous Expenditure & losses	0	0	–	–
Total	**579**	**493**		

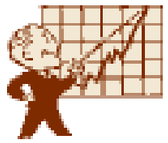
Using the above sources and uses of cash, we get

Sources	Rs. In million
Increase in reserves & surplus	6
Increase in term loans	12
Increase in inter-corporate deposits	44
Increase in trade credit	15
Increase in advances (taken)	7
Increase in provisions	2
Decrease in advances (given)	5
(Total Sources)	91

Uses	Rs. In million
Increase in fixed assets (net)	8
Increase in debtors	46
Increase in inventories	33
Total Uses	**87**

Net addition to cash is Sources-Uses =Rs. 4 million.

The above tables explain how a firm obtains cash and how it spends cash during the given time period from 2006 to 2007.The point to note is that the net addition to cash has to match the changes in cash and bank balance of the two time periods.



CHECK YOUR PROGRESS

Q 1: What do you mean by financial statements?

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.....

Q 2: What do you mean by Profit and Loss Account?

.....

.....

Q 3: What are the sources and uses of cash?

.....

.....

11.7 FUNDS FLOW STATEMENT

The statement of changes in financial position, prepared to determine only the sources and uses of working capital between dates of two balance sheets, is known as the funds flow statement. Working capital is defined as the difference between current assets and current liabilities. As mentioned earlier, working capital determines the liquidity position of the firm. As a historical analysis, the statement of changes in working capital reveals to management the way in which working capital has been obtained used. With this insight, management can prepare the estimates of the working capital flows. A statement reporting the changes in working capital is useful in addition to the financial statement.

a. Funds from operations:

The major source of working capital is the firm's net profit operations. The ultimate success of a firm depends upon its ability to earn profits. However, the profit and loss accounts contain certain items that do not affect working capital. Therefore, in determining the amount of working capital from operations, the figure of net profit, as shown in the profit and

loss account, should be adjusted. The expense items that do not involve working capital should be adjusted to net profit. For example:

i. To obtain net profit depreciation is deducted. As depreciation does not reduce working capital, it should be added back to net profit.

ii. The gain on sale of plant is deducted from net profit because the total amount received will be shown as a separate source of working capital. If the amount of gain is not deducted from net profit, it would amount to double counting.

b. Adjusted Net Loss:

The loss from operations consumes the firm's working capital. Loss arises when expenses, that involve application of working capital, exceed the revenues received. To get net profit, the expense and revenue items involving no working capital should be adjusted to net loss. The non-cash expenses items like depreciation when added to net loss (shown with negative sign) will reduce its magnitude of loss. The gain or loss on the sale of non-current assets should also be adjusted to net loss.

11.7.1 Sources and Uses of Working Capital

Sources of Working capital:

The typical sources of working capital are summarised below:

(i) Funds from operations (adjusted net income)

(ii) Sale of non-current assets:

- **b.** Sale of long-term investments (shares, bonds/debentures etc)
- **c.** Sale of tangible fixed assets like land, building, plant, or equipments.
- **d.** Sale of intangible fixed goodwill, patents, or copyrights.

(iii) Long-term financing:

- **a.** Long-term borrowings (institutional loans, debentures, bonds etc.)
- **b.** Issuance of equity and preference shares

comprise of (i) Loans, secured or unsecured and (ii) Current liabilities and provisions.

The current ratio indicates the availability of current assets in rupees for every one rupee of current liability. A ratio of greater than one means that the firm has more current assets than current obligations or claims. As a conventional rule, a current ratio of 2:1 is considered satisfactory. A current ratio of 2.0, means that the company can cover its current liabilities even if its current assets reduce by 50 %.

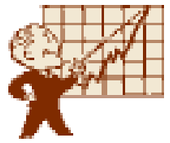
(b) Quick ratio*:* In interpreting current ratio, the components of current assets are not taken into consideration. For example- inventory may be slow moving and a portion of loans and advances may not be recovered quickly. These two components will add up the current assets and make it huge. Correspondingly, the current ratio may be high but it may not represent the true capacity of the company to meet its short-term obligations.

In order to remove this inherent problem in the current ratio, the quick or acid-test ratio has been formulated. The quick or acid-test ratio establishes relationship between quick or liquid assets and current liabilities. An asset is liquid if it can be converted into cash immediately without a loss of value. The components of liquid assets are cash, debtors and bills receivables and marketable securities. As mentioned earlier, to compute quick ratio, inventories are to be deducted from current assets.

The quick ratio is found out by dividing quick assets by current liabilities.

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventories}}{\text{Current Liabilities}}$$

Normally, a quick ratio of 1:1 is considered to represent a satisfactory current financial condition. However, a quick ratio of



CHECK YOUR PROGRESS

Q 4: Classify each of the following transactions as a source of cash or a use of cash.

a) A plant was sold for Rs 550,000

b) A profit of Rs 75,000 was reported

c) Long –term debentures were redeemed

d) Cash dividends of Rs 420,000 were paid

e) A loss for the year was reported.



11.9 LET US SUM UP

- Financial statements are the sources of information for financial decisions.
- The balance sheet shows the financial position of a firm at a given point of time.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

- The profit and loss account reflects the performance of a firm over a period of time.
- The cash flow and fund flow statements show the change in financial position during a given time period.
- The cash flow statement is prepared to analyse changes in the firm's cash position.
- The funds flow statement provides an analysis of changes in the firm's working capital position.
- Funds flow and cash flow statements are important managerial tools for financial analysis.
- They help the firm to know its liquidity position, capital expenditures incurred, dividend paid and the need for external financing.



11.10 FURTHER READING

1. Ashis Bhattacharya (2010); *"Financial Accounting"*; Prentice hall of India Pvt. Ltd, New Delhi
2. S. N. Maheshwari (fourth edition); *"Financial Accounting"*, Vikash Publishing House Pvt. Ltd., New Delhi.
3. B. B Dam and H C Gautam(); *"Theory and Practice of Financial Accounting"*; Capital Publishing Company, Guwahati



11.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q.1.: Financial statements are the sources of information for financial decisions.

Ans to Q.2.: Profit and loss account represents the summary of revenues, expenses and net income (or net loss) of a firm.

Ans to Q.3.: The following are the sources of cash-

a. the profitable operations of the firm,
b. decrease in assets (expect cash),
c. increase in liabilities (including debentures or bonds), and
d. Sale proceeds from an ordinary or preference share issue.

The uses of cash are-

a. the loss from operations,
b. increase in assets (except cash),
c. decrease in liabilities (including redemption of debentures or bonds),
d. redemption of redeemable preference shares, and
e. cash dividends

Ans to Q.4.: (i) source of cash, (ii) source of cash,(iii) use of cash, (iv) use of cash, (v) use of cash]

d. Projected ratios i.e. ratios developed using the projected financial statements of the same firm.

12.4 TYPES OF RATIO

Normally, ratios are grouped into five categories. These ratios serve the different purpose for different parties; like the trade creditors are interested in the liquidity ratios as these represent the company's liquidity position, whereas investors are interested to know the company's long term solvency, earnings growth and future profitability and these are represented by the leverage and profitability ratios. The four types of ratios are given below:

a. Liquidity ratios
b. Leverage ratios
c. Turnover ratios
d. Profitability ratios
e. Valuation ratios.

Let us the discuss these types of ratios in the following section.

12.4.1 Liquidity ratios

Liquidity refers to the ability of a firm to meet its obligations in the short run, usually one year. Liquidity is essential to conducting business activity, particularly during shut down or strike or recession. If liquidity is insufficient to cushion such losses, serious financial difficulty may arise. A company should ensure that it does not suffer from lack of liquidity at any time, and also that it does not have excess liquidity as it will affect profitability. If the company fails to meet its short term obligations due to lack of sufficient liquidity, then it will result in poor credit worthiness and loss of creditors' confidence. The important liquidity ratios are (a) Current Ratio, (b) Quick or acid-test ratio (c) Cash ratio, (d) Net Working Capital ratio.

(a) Current ratio: It is calculated by dividing current assets by current liabilities. Current assets include cash, current investments, debtors, inventories (Stocks), loans, advances and pre-paid expenses. Current liabilities represent liabilities that are expected to mature in the next twelve months and

Ratios involve establishing a financial relationship between components of financial statement. We will explain about different types of ratios in this unit.

Financial ratios over different time periods need to be calculated for comparison, because of this we require time series analysis which gives an indication of the direction of change and reflects whether the company's financial performance has improved, deteriorated or remained constant over time. After going through this unit you will be able to analyse financial conditions of different companies.

12.3 RATIO ANALYSIS – ITS MEANING AND TYPES

Sometimes information or figures given in the balance sheet and profit and loss account are not enough for proper interpretation regarding the financial performance of the firm. These information or figures need to be worked out to establish proper relationship between the items of balance sheet and the profit and loss account. Ratio analysis is a powerful tool of financial analysis. A ratio is defined as "the indicated quotient of two mathematical expressions" and as "the relationship between two or more things".

In financial analysis, a ratio is used as a benchmark for evaluating the financial position and performance of a firm. An accounting figure conveys meaning only when it is related to some other relevant information. For example, Rs.10 crore net profit may be considered impressive but it has to be related to the investment to find whether it is good or bad performance. Ratios help to summarize large quantities of financial data and to make qualitative judgment about the firm's financial performance.

As ratio is used as a benchmark, a single ratio in itself does not indicate favourable or unfavourable condition. It needs to be compared with some standard. Standard of comparison may consist of the followings:

a. Past ratio i.e. ratios calculated from the past financial statements of the same firm.

b. Competitors' ratios i.e. ratios of some selected firms, especially the most progressive and successful competitor at the same point of time.

c. Industry ratios, i.e. ratios of the industry to which the firm belongs and



11.12 MODEL QUESTIONS

Q 1: What do you mean by financial statements?

Q 2: Give a note on balance sheet and Profit and Loss account

Q 3: Describe the Scope of Profit

Q 4: Explain the concept of Cash Flow Statement

Q 5: Explain the concept of Funds Flow Statement

Q 6: From the following data of Assam Tea Ltd., prepare a statement of sources and uses of funds.

Assam Tea Ltd.

Balance sheet for the year ended on 31 March

Particulars	Amount (Rs)	Amount (Rs)
	2005	2006
Assets	126,000	114,000
Cash	42,400	20,000
Short-term investment		
Debtors	60,000	50,000
Inventory	38,000	28,000
Long-term investment	28,000	44,000
Machinery	200,000	140,000
Buildings	240,000	80,000
Land	14,000	14,000
Total	**748,400**	**490,000**
Liabilities		

Accumulated depreciation	110,000	60,000
Creditors	40,000	30,000
Bills payable	20,000	10,000
Secured loans	200,000	100,000
Share capital	220,000	160,000
Share premium	24,000	–
Reserves and surplus	134,000	130,000
Total	**748,000**	**490,000**

Assam Tea Ltd.

Income Statement for the year ended 31 March

Particulars	**Amount (Rs)**	**Amount(Rs)**
Sales		240,000
Cost of goods sold		134,800
Gross profit		105,200
Less :		
Operating expenses:		
Depreciation – Machinery	20,000	
Depreciation- Buildings	32,000	
Other expenses	40,000	92,000
Net profit from operations		13,200
Gain on sale of long-term investment		4,800
Total		18,000
Loss on sale of machinery		2,000
Net profit		16,000

*** ***** ***

UNIT 12: RATIO ANALYSIS

UNIT STRUCTURE

12.1 Learning Objectives
12.2 Introduction
12.3 Ratio Analysis— Its meaning and types
12.4 Types of Ratio
12.4.1 Liquidity Ratios
12.4.2 Leverage Ratio
12.4.3 Activity Ratio/ Turnover Ratio
12.4.4 Profitability Ratio
12.4.5 Valuation Ratio
12.5 Limitations Of Ratio Analysis
12.6 Time Series Analysis
12.7 Let Us Sum Up
12.8 Further Reading
12.9 Answer To Check Your Progress
12.10 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the nature of ratio analysis
- learn the different types of ratio analysis
- describe liquidity ratios, leverage ratios, turnover ratios and profitability ratios
- learn limitations of ratio analysis
- define time series analysis

12.2 INTRODUCTION

In this unit, we are going to discuss about ratio analysis and time series analysis. The basic objective of ratio analysis is to present to the potential user brief statements which describes the status of the company.

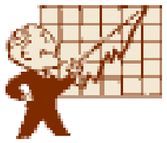
business, so that it is difficult to identify the industry group to which the company belongs. Comparing their ratios with those of other companies may be meaningless.

b. Operating and accounting practices differ from company to company, which can distort the ratios and make comparisons meaningless. For example, the use of different inventory valuation methods (LIFO versus FIFO) and different depreciation methods would affect inventory and asset turnover ratios.

c. Financial statements are based on historical costs and do not take inflation into account.

d. A ratio does not describe the quality of its components. For example, the current ratio may be high but inventory may consist of obsolete goods.

e. Ratios are static and do not consider future trends.



CHECK YOUR PROGRESS

Q 1: What do you mean by ratio analysis?

.....

.....

.....

Q 2: Fill in the blanks with appropriate words:

a) Liquidity ratio represents the company's ..... position.

b) Earnings growth and future profitability are represented by the ..... and ..... ratios.

Q 3: What are the different types of ratios?

.....

.....

12.6 TIME SERIES ANALYSIS

A single ratio by itself does not indicate favourable or unfavourable condition. Financial ratios over different time periods need to be calculated for comparison. This is known as time series analysis which gives an indication of the direction of change and reflects whether the company's

1:1 does not necessarily mean sound liquidity position. This ratio needs to be compared with debtors' turnover ratio and inventory turnover ratio for better interpretation of the liquidity position.

(c) Cash Ratio: It gives the amount of cash available in terms of liquidity. The ratio is calculated by dividing cash and marketable securities by current liabilities. This ratio measures the amount of cash and near cash items the company has in terms of its current liabilities.

$$\text{Cash Ratio} = \frac{\text{Cash} + \text{Marketable Securities}}{\text{Current Liabilities}}$$

(d) Net Working Capital Ratio: The difference between current assets and current liabilities excluding short term bank borrowing is called net working capital. Net working capital to total assets measures the company's potential reservoir of funds.

$$\text{Net Working Capital Ratio} = \frac{\text{Net Working Capital}}{\text{Total Assets}}$$

12.4.2 Leverage Ratio

A company has long-term creditors like debenture holders, financial institutions, who are interested to know the company's long-term financial strength. In general, everybody is concerned with long-term debts, because these commit the company to paying interest, and eventually the principal, over the long run. Moreover as creditors' claims must be satisfied before earnings can be distributed to shareholders, present and prospective shareholders pay close attention to the degree of indebtedness and ability to repay debts.

This long-term financial strength can be judged by using leverage ratios. There are mainly two types of leverage ratios: one measures the degree of indebtedness and the other measures the ability to service debts. The degree of indebtedness measures the amount of debt relative to other significant balance sheet amounts. This is commonly measured by the **Debt-Equity ratio** and **Debt ratio**.

The second type of debt measure, the ability to service debts, assesses a company's ability to make the contractual payments required on a scheduled basis over the life of a debt. The company's ability to pay certain fixed charges is measured using coverage ratios. The most common coverage ratio is the **Interest Coverage ratio**.

(a) Debt-Equity Ratio: This ratio can be calculated by dividing total debt by net worth.

$$\text{Debt - Equity Ratio} = \frac{\text{Total Debt (TD)}}{\text{Net Worth (NW)}}$$

Total debt includes short-term as well as long-term debt. Net worth includes equity capital and reserves and surplus. A simple variant of the debt-equity ratio is calculated by the following formula:

$$\text{Debt - Equity Ratio (D/E)} = \frac{\text{Long Total Debt}}{\text{Equity Capital}}$$

(b) Debt Ratio: This ratio is calculated by dividing total debt (TD) by capital employed (CE). Total debt includes short and long-term borrowings from financial institutions, debentures/bonds, bank borrowings, public deposits and any other interest-bearing loan. Capital employed includes Net fixed assets (NFA) and net current assets (NCA). Net current assets are current assets (CA) less current liabilities (CL) excluding interest-bearing short-term debt for working capital.

$$\text{Debt Ratio} = \frac{\text{Total Debt (TD)}}{\text{Capital employed (CE)}}$$

The debt-equity and debt ratio show how excellently debt financing has been used in the business. A high ratio for both the case means that claims of creditors are greater than those of owners. A high level of debt introduces inflexibility in the firm's operations due to the interferences from creditors. But a low debt-equity ratio implies a greater claim of owners than creditors. From the point of view of creditors, it represents a satisfactory situation since a high proportion of equity provides a larger margin of safety for them. Together with the level of indebtedness, the company's capacity to bear interest needs to be measured.

share capital, share premium and reserves and surplus less accumulated losses.

$$\text{Return on Equity} = \frac{\text{Profit after tax}}{\text{Net worth}}$$

Or

$$\text{Return on Equity} = \frac{\text{Profit after tax}}{\text{Equity capital}}$$

12.4.5 Valuation Ratio

A valuation ratio is a measure of how cheap or expensive a security (or business) is compared to some measure of profit or value. A valuation ratio is calculated by dividing a measure of price by a measure of value or vice-versa. The following are some of the types of valuation ratio :

(a) Earnings per Share:The earnings per share represent the number of rupees earned on behalf of each outstanding equity share. It is computed by dividing the profit after taxes by the total number of equity shares.

$$\text{EPS} = \frac{\text{Profit after tax}}{\text{Number of share outstanding}}$$

The EPS shows the profitability of the firm on a per-share basis and as a profitability index it is a valuable and widely used ratio.

(b) Price/Earnings (P/E) ratio: The P/E ratio measures the amount investors are wiling to pay for each rupee of the company's earnings. This ratio indicates the degree of confidence that investors have in the company's future performance. The higher the P/E ratio, the greater is the investors' confidence. It is calculated by dividing market price by EPS.

$$\text{P/E} = \frac{\text{Market Price}}{\text{EPS}}$$

12.5 LIMITATIONS OF RATIO ANALYSIS

Although ratio analysis is useful, it does have its limitations, some of which are listed below:

a. Many large companies are engaged in multiple lines of

and sales and indicates management's efficiency in manufacturing, administering and selling the products. This ratio is measured by dividing profit after tax by sales.

$$\text{Net Profit Margin} = \frac{\text{Profit after tax}}{\text{Sales}}$$

A company with a high net profit can survive in the face of falling selling prices, rising costs of production or declining demand for the product but it would not be possible for a low net profit margin company to withstand these adversities.

(c) Operating Expense Ratio:The operating expense ratio explains the changes in the profit margin ratio. This ratio is computed by dividing operating expenses i.e. cost of goods sold plus selling expenses and general and administrative expenses (excluding interest) by sales.

$$\text{Operating expense ratio} = \frac{\text{Operating expense}}{\text{Sales}}$$

A high operating expenses ratio is unfavourable to a company as it means high cost of goods sold or high general and selling expenses. A high operating ratio will leave a small amount of gross profit to pay interest, dividends etc. A company desires a low operating ratio as it is a yardstick of operating efficiency.

(d) Return on Investment:The Return on Investment also called as Return on Asset, measures the company's overall effectiveness in generating profits with its available assets. The higher the company's return on total investment, the better is the profitability. It is calculated by dividing profit after tax by total asset.

$$\text{Return on Investment} = \frac{\text{Profit after tax}}{\text{Total assets}}$$

(e) Return on Equity: The return on equity examines the profitability of owners' investment. This ratio measures the return earned on the owners' investment. Every company has the objective of getting high return on the shareholders equity or fund. This reflects the extent to which this objective has been accomplished. It is calculated by dividing profit after taxes by net worth or equity capital. Net worth consists of paid-up

(c) Interest Coverage Ratio: The interest coverage ratio, measures the company's ability to make contractual interest payments. The higher the value of this ratio, the better is the ability of the company to fulfil its interest obligations. It is calculated by dividing Profit before Interest and Taxes by Interest amount.

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest and Taxes}}{\text{Interest}}$$

12.4.3 Activity ratio/ Turnover ratio

Activity or turnover ratios measure the speed with which accounts are converted into sales or cash. These ratios are employed to evaluate the efficiency with which a company manages and utilises its assets. These ratios involve a relationship between sales and assets. The common Activity or Turnover ratios are discussed below:

(a) Inventory Turnover Ratio: This ratio shows how rapidly the inventory is turning into cash or receivables through sales. It measures the activity, or liquidity, of a firm's inventory. It is calculated by dividing the cost of goods sold by sales. If the cost of goods sold figure is not available to outside analyst then it is computed by taking sales figure instead of cost of goods sold.

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Inventory}}$$

Or

$$\text{Inventory turnover} = \frac{\text{Sales}}{\text{Inventory}}$$

Generally, a high inventory turnover is indicative of good inventory management i.e. products being manufactured are sold at a fast rate. A low inventory turnover implies excessive inventory levels than warranted by production and sales activities. This ratio needs to be compared with the current ratio to judge a company's liquidity position.

(b) Debtors (Accounts Receivable) Turnover: A company sells goods for cash and credit. When the company extends credits to its customers, debtors (accounts receivables) are created in the company's accounts. Debtors are convertible into cash over a short period, hence are included in current assets. This ratio has to be compared together with the other liquidity ratios to assess the liquidity position of the company. It is calculated by dividing credit sales by accounts receivables or debtors amount.

$$\text{Debtors turnover} = \frac{\text{Credit sales}}{\text{Debtors}}$$

This turnover ratio indicates the number of times receivables are turnover each year. The higher the value of this ratio, the more efficient is the management of credit.

(c) Total Asset Turnover Ratio: This ratio indicates the efficiency with which the company uses its assets to generate sales. Generally, the higher a company's total assets turnover, the more efficiently its assets have been used. It is calculated by dividing sales by total assets. This measure is probably of greater interest to management as it indicates whether the company's operations have been financially efficient.

$$\text{Total assets turnover} = \frac{\text{Sales}}{\text{Total assets}}$$

Some analyst exclude intangible assets like goodwill, patents etc, while computing total assets turnover. Similarly, fictitious assets, accumulated losses or deferred expenditures may also be excluded for calculating total asset turnover ratio.

(d) Fixed Asset Turnover Ratio: Sometimes, analyst wants to measure the efficiency only with respect to fixed assets. This ratio measures sales per rupee of investment in fixed assets. A high ratio indicates a high degree of efficiency in asset utilisation and a low ratio reflects inefficient use of assets. However, while interpreting this ratio, one has to examine the quality of the asset, as old and substantially depreciated fixed assets would tend to show a high turnover ratio.

$$\text{Fixed assets turnover} = \frac{\text{Sales}}{\text{Fixed assets}}$$

12.4.4 Profitability Ratio

Profitability ratios measure the capability of a company to survive and grow over a long period of time. As a group, these measures evaluate the company's earnings with respect to a given level of sales, a certain level of assets, the owners' investment, or share value. Management of the company, creditors, owners are all interested in the profitability of the company. Creditors are interested in getting back their interest and repayment of principal in time. Owners want to know the required rate of return on their investment. These can be evaluated by the profitability ratios. Usually two types of profitability ratios are calculated: (a) profitability in relation to sales and (b) profitability in relation to investment. The popular ratios of the first group are the **Gross profit margin**, **Net profit margin** and **Operating ratio**. The common ratios for the second group are **Return on Investment**, **Return on Equity**, **Earnings per share** and **Price-Earnings Ratio**.

(a) Gross Profit Margin: The gross profit margin measures the percentage of each sales remaining after the company has paid for its goods. Gross profit is defined as the difference between sales and cost of goods sold. It is calculated by dividing gross profit by sales.

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

This ratio indicates the average spread between the cost of goods sold and the sales revenue. The higher the gross profit margin, the better the profitability of the company. Whereas a low gross profit margin may reflect poor profitability, which may be due to higher, cost of goods sold or inefficient use of plant and machinery resulting in higher cost of production.

(b) Net Profit Margin: Net profit is obtained when operating expenses, interest and taxes are subtracted from the gross profit. This ratio establishes a relationship between net profit

Exercise : 12.3

The following is the Balance Sheet and Statement of Profit for the year ended March 31,2016 of North East Chemicals Ltd.

Balance Sheet as on March 31, 2016

Liabilities	(Rs)	Assets	(Rs)
Equity Share Capital	10,00,000	Plant and Equipment	6,40,000
(Rs 100 each)		Land & Building	80,000
Reserves & Surplus	3,68,000	Cash	1,60,000
Creditors	1,04,000	Debtors	3,20,000
Bills payable	2,20,000	Inventory	4,92,000
Total	16,92,000	Total	16,92,000

Statement of profit for the year ended March 31, 2016

Particulars	(Rs)
Net Sales	40,00,000
Less: Cost of goods sold	30,80,000
Gross Profit on Sales	9,20,000
Less: Operating expenses	6,80,000
Net Profit	2,40,000
Less taxes @ 50%	1,20,000
Net profit after taxes	1,20,000

Determine the following ratios for North East Chemicals: Current ratio, Quick ratio, Inventory Turnover ratio, Receivables Turnover ratio, Gross Profit ratio, Net Profit ratio, Operating ratio, Earnings per share, Return on Equity Capital and P/E ratio.

Solution:

$$\textbf{Current Ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$= \frac{\text{Cash} + \text{Debtors} + \text{Inventory}}{\text{Creditors} + \text{Bills payable}}$$

$$= \frac{\text{Rs}\,1,60,000 + 3,20,000 + 4,92,000}{\text{Rs}\,1,04,000 + \text{Rs}\,2,20,000}$$

$$= \frac{\text{Rs}\,9,72,000}{\text{Rs}\,3,24,000}$$

$$= 3 : 1$$

financial performance has improved, deteriorated or remained constant over time. Time series analysis is done by using two methods: (i) Horizontal analysis and (ii) Vertical analysis.

(i) **Horizontal analysis**: Horizontal analysis is used to evaluate the trend in the accounts over the years. Horizontal analysis examines the trends of the various accounts and it reveals the areas of wide divergence that require further attention. When an analysis covers a span of many years, comparative financial statements may become cumbersome. To avoid this, the results of horizontal analysis may be presented by showing trends relative to a base year. In this method, a year representative of the company's balance sheet and profitability statement is chosen as the base. Each account of the base year is assigned an index of 100.The index for each respective account in succeeding years is found by dividing the account's amount by the base year and multiplying by 100.

(ii) **Vertical analysis**: In vertical analysis, a significant item on a financial statement is used as a base value, and all other items on the financial statement are compared to it. In performing vertical analysis for the balance sheet, total asset is assigned 100 percent. Each asset account is expressed as a percentage of total assets. Total liabilities and equity capital is assigned 100 percent. Each liability and equity account is then expressed as a percentage of total liabilities and equity capital. In the income statement, net sale is given the value of 100 percent and all other accounts are evaluated in comparison to net sales. The resulting figures are then given in a common size statement.

Further, to determine the financial performance of a company, its ratios need to be compared with average ratios of the industry. These industry ratios provide benchmark for comparing a company's performance with that of the industry. This analysis is known as industry analysis .These industry ratios are calculated by averaging the important ratios of a few selected companies within the industry. Industry ratios are important standards as each industry has distinct characteristics.

Another way of comparison is to compare ratios of one company with selected companies in the same industry at the same point in time. This inter-company analysis indicates the relative financial position and performance of the company. In most cases, it is more useful to compare the company's ratios with ratios of a few selected companies belonging to the same industry for analysing the performance of the particular company in relation to the others.



Exercise : 12.1

Metford Ltd. provides the following comparative income statement:

Metford Ltd.

Comparative Income Statement, for the year ended March 31,2015 and 2016

Particulars	2016 Rs	2015 Rs
Sales	5,70,000	6,80,000
Cost of goods sold	2,00,000	1,70,000
Gross Profit	3,70,000	5,10,000
Operating expenses	10,000	2,10,000
Profit Before Interest And Tax	2,70,000	3,00,000

(a) Calculate the percentage change using horizontal analysis.

(b) Evaluate the results.

Solution: (a) Metford Ltd. Comparative Income Statement, for the years ended March 31, 2016 and 2015.

Particulars	2016 (Rs)	2015 (Rs)	% Increase or (Decrease)
Sales	5,70,000	6,80,000	(16.2)
Cost of goods sold	2,00,000	1,70,000	(17.6)
Goss Profit	3,70,000	5,10,000	(27.5)
Operating expenses	1,00,000	2,10,000	(52.4)
Profit Before Interest and Taxes	2,70,000	3,00,000	(10.0)

(b) Gross profit declined 27.5 percent due to the combined effects of lower sales and higher cost of goods. However, operating expenses were reduced.

This kept the decline in net income to only 10 percent.



Exercise : 12.2

The Elle Ltd. reported the following income statement data:

Particulars	2016 (Rs)	2015 (Rs)
Net sales	4,00,000	2,50,000
Cost of goods sold	2,80,000	1,60,000
Operating expenses	75,000	56,000

(a) Prepare a comparative statement for 2007 and 2006 using vertical analysis.

(b) Evaluate the results.

Solution: (a) The Elle Ltd. Common Size Analysis**,** for the years ended March 31, 2016 and 2015

Particulars	2016 Amount (Rs)	%	2015 Amount (Rs)	%
Net sales	4,00,000	100	2,50,000	100
Cost of goods sold	2,80,000	70	1,60,000	64
Gross Profit	1,20,000	30	90,000	36
Operating expense	75,000	18.8	56,000	22.4
Profit Before Interest Tax	45,000	11.2	34000	13.6

(b) Cost of goods sold (70%) may have increased in 2016 because of higher costs in buying raw materials. Operating expenses (18.8%) may have dropped due to better-cost control. However, the drop in expenses has not affect the rise in the cost of goods sold and so the company's profits have declined from 2015 to 2016.

Quick ratio $= \frac{\text{Liquid assets}}{\text{Current liabilities}}$

$= \frac{\text{Current assets - Inventory}}{\text{Current liabilities}}$

$= \frac{\text{Rs } 9,72,000 - 4,92,000}{\text{Rs } 3,24,000}$

$= \frac{\text{Rs } 4,80,000}{\text{Rs } 3,24,000}$

= 1.48:1

Inventory Turnover ratio $= \frac{\text{Cost of goods sold}}{\text{Inventory}}$

$= \frac{\text{Rs } 30,80,000}{\text{Rs } 4,92,000}$

= 6.3:1 times

Gross Profit ratio $= \frac{\text{Gross Profit}}{\text{Sales}} \times 100$

$= \frac{\text{Rs } 9,20,000}{\text{Rs } 40,00,000} \times 100$

= 23%

Net Profit ratio $= \frac{\text{Net Profit}}{\text{Sales}} \times 100$

$= \frac{\text{Rs } 1,20,000}{\text{Rs } 40,00,000} \times 100$

= 3%

Operating ratio $= \frac{\text{Cost of goods sold} + \text{Operating expenses}}{\text{Sales}} \times 100$

$= \frac{\text{Rs } 30,80,000 + \text{Rs } 6,80,000}{\text{Rs } 40,00,000} \times 100$

= 94%

Earnings per share (EPS) $= \frac{\text{Net Profit}}{\text{Number of equity shares}}$

(Number of equity shares $= \frac{\text{Equity Capital}}{\text{Par value}} = \frac{\text{Rs}\,10{,}00{,}000}{\text{Rs}\,100}$

= 10,000)

Earnings per share (EPS) $= \frac{\text{Rs}\,1{,}20{,}000}{10{,}000}$

= Rs 12

Rate of return on equity capital $= \frac{\text{Net Profit}}{\text{Equity capital}} \times 100$

Rate of return on equity capital $= \frac{\text{Rs}\,1{,}20{,}000}{\text{Rs}\ 13{,}68{,}000} \times 100$

= 8.8



Exercise : 12.4

From the ratio's and other data given below for the Asian Ltd, indicate your interpretation of the Company's financial condition.

Particulars	2016	2015	2014
Current Ratio	3.02	2.78	2.65
Acid-test	0.99	1.10	1.55
Working Capital turnover(times)	3.29	3.00	2.75
Receivable turnover (times)	7.20	8.41	9.83
Inventory Turnover (times)	5.41	6.01	6.11
EPS (Rs)	2.5	4.05	5.10
Op. exp. To sales (%)	25	23	18
Sales growth (%)	23	16	10
Net Profit Margin.(%)	2	5.09	7.03
Fixed Assets Turnover (%)	22.7	18.0	16.4
Return on Equity	7	8.5	11.07



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Wimco Ltd. Balance Sheet Statement, for the year ended March 31, 2006 and 2017

	2006 (Rs)	2007(Rs)
Sales	27,00,000	30,00,000
Cost of goods sold	17,20,000	19,02,500
Gross margin	9,80,000	10,97,500
Operating expenses	7,80,000	8,45,000
Profit before taxes	2,00,000	2,52,500
Taxes (40%)	80,000	1,01,000
Net Profit	1,20,000	1,51,500

Wimco Ltd. Statement of Profit and Loss, for the year ended March 31, 2006 and 2007

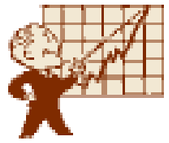
ASSETS

Current Assets	**2006 (Rs)**	**2007(Rs)**
Cash	12,500	16,400
Bills receivables	104,000	112,000
Debtors	68,500	81,600
Inventories	50,000	80,000
Fixed Assets		
Plant and Equipment	646,000	680,000
Total Assets	881,000	970,000
LIABILITIES		
Current Liabilities		
Accounts payable	72,000	69,000
Bills payable	60,500	76,000
Long term liabilities		
Equity capital		
(60,000 shares, Rs 10 par)	6,00,000	6,00,000
Reserves and surplus	1,48,500	2,25,000
Total liabilities	**8,81,000**	**9,70,000**

*** ***** ***

Solution:

- Declining profitability is evident from the following.
- Decrease in net profit margin from 7% in 2014 to 2 % in 2016, even though, sales growth has increased from 10% to 23%. The main reason may be raising Operating expense ratio. The return to owners is very poor as the return on equity stands at only 7 %.
- Current Ratio is comfortable, even though the quick ratio has declined. This is mainly attributed to the fall in inventory turnover. But the company is likely to encounter difficulty in payment of short-term obligations as the receivable turnover is also low.



CHECK YOUR PROGRESS

Q 4: Fill in the blanks:

a. The current ratio is equal to _____ divided by _____.

b. _____ is the ability of a company to meet its current liabilities out of current assets.

c. _____ is included in computing the current ratio but not the quick ratio.

d. Financial statement analysis should combine _____ and industry comparisons.

Q 5: A company's sales are Rs 450,000, cost of goods sold is Rs 240,000 and inventory is Rs 90,000. What is its inventory turnover? Also, calculate the company's gross margin?

Q 6: The only current assets possessed by a company are: cash Rs105,000 , inventories Rs 560,000 and debtors Rs 420,000. If the current ratio of the company is 2 : 1, determine its current liabilities.

Q 7: Determine the P/E ratio of the company that has a net profit of Rs 150,000 and 30,000 shares outstanding, selling at a market price of Rs10 per share. What rate of return do shareholders expect assuming par value of share at Rs 10?

Q 8: A company has the shareholders' equity of Rs 300,000. Total assets are 150 % of the shareholders' equity, while the assets turnover is 3. If the company has an inventory turnover of 5, determine the amount of inventory.



12.7 LET US SUM UP

- Ratio analysis is a widely used tool of financial analysis.
- It is defined as the systematic use of ratio to interpret the financial statements so that the strengths and weaknesses of a company, as well as its historical performance and current financial condition, can be determined.
- Ratios make the related information comparable as these are relative figures reflecting the relationship between related variables.
- Ratios can be compared by using trend analysis, inter- company comparison and comparison with standards or industry average.
- Ratios are broadly categorised into four groups: liquidity ratios, leverage ratios, turnover ratios and profitability ratios.
- Liquidity ratios measure the company's ability to meet current obligations, whereas the leverage ratios measure the proportion of outsiders' capital in financing the company's assets.
- Activity ratios reflect the company's efficiency in utilising its assets in generating sales, whereas the profitability ratios measure the overall performance of the company by determining the effectiveness of the company in generating profit.



12.8 FURTHER READING

1. Ashis Bhattacharya (2010); "*Financial Accounting*"; Prentice hall of India Pvt. Ltd, New Delhi
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12.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q.1.: In financial analysis, a ratio is used as a benchmark for evaluating the financial position and performance of a firm. Ratios help to summarize large quantities of financial data and to make qualitative judgment about the firm's financial performance.

Ans to Q.2.: (I) Liquidity, (ii) leverage and profitability ratios.

Ans to Q.3.: Liquidity ratios, Leverage ratios, Turnover ratios, Profitability ratios

Ans to Q.4.: (a) Current assets , Current liabilities (b) Liquidity (c) Inventory (d) Trend analysis ;

Ans to Q.5.: 2.66 times , 46%,

Ans to Q.6.: Rs 5,42,500,

Ans to Q.7.: 2, 50%,

Ans to Q.8.: Rs 270,000



12.10 MODEL QUESTIONS

Q 1: What do you mean by ratio analysis? Explain with example.

Q 2: What are different types of ratios? Explain them briefly.

Q 3: What do you mean by Time series?

Q 4: What are the two methods of time series analysis?

Q 5: Write the limitations of ratio analysis.

Q 6: The Balance sheet and Statement of Profit and Loss of Wimco Ltd. available for two years 2006 and 2007 . Examine its liquidity position and profitability for the years 2006 and 2007.