



# ADVANCED FINANCIAL ACCOUNTING

Course Code : **B21CM03DC**

**Bachelor of Commerce**  
**Discipline Core Course**



## SELF LEARNING MATERIAL

**SREENARAYANAGURU OPEN UNIVERSITY**

The State University for Education, Training and Research in Blended Format, Kerala

# **SREENARAYANAGURU OPEN UNIVERSITY**

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Access and Quality define Equity.

**Advanced Financial Accounting**  
Course Code: B21CM03DC  
Semester - II

**Discipline Core Course**  
**Bachelor of Commerce**  
**Self Learning Material**  
(With Model Question Paper Sets)



SREENARAYANAGURU  
OPEN UNIVERSITY

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The State University for Education, Training and Research in Blended Format, Kerala

**Advanced Financial Accounting**  
**Course Code: B21CM03DC**  
**Semester - II**  
**Bachelor of Commerce**



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# MESSAGE FROM VICE CHANCELLOR

Dear learner,

I extend my heartfelt greetings and profound enthusiasm as I warmly welcome you to Sreenarayanaguru Open University. Established in September 2020 as a state-led endeavour to promote higher education through open and distance learning modes, our institution was shaped by the guiding principle that access and quality are the cornerstones of equity. We have firmly resolved to uphold the highest standards of education, setting the benchmark and charting the course.

The courses offered by the Sreenarayanaguru Open University aim to strike a quality balance, ensuring students are equipped for both personal growth and professional excellence. The University embraces the widely acclaimed “blended format,” a practical framework that harmoniously integrates Self-Learning Materials, Classroom Counseling, and Virtual modes, fostering a dynamic and enriching experience for both learners and instructors.

The university aims to offer you an engaging and thought-provoking educational journey. The Bachelor of Commerce is one of the highly popular programmes due to the current need for skilled professionals in the field. This demand guided our approach as we developed the programme's curriculum. The programme offers a comprehensive grasp of theoretical concepts alongside clear explanations of practical applications. We are careful to maintain a balance in the management components to preserve the integrity of the discipline. The Self Learning Material has been thoughtfully crafted to include illustrative examples. The Self-Learning Material has been meticulously crafted, incorporating relevant examples to facilitate better comprehension.

Rest assured, the university's student support services will be at your disposal throughout your academic journey, readily available to address any concerns or grievances you may encounter. We encourage you to reach out to us freely regarding any matter about your academic programme. It is our sincere wish that you achieve the utmost success.



Warm regards.  
Dr. Jagathy Raj V. P.

01-05-2024

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BLOCK

# INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

# Unit 1

## Introduction to IFRS

### Learning Outcomes

After completing this unit, the learners will be able to:

- ◊ gain insights on the concept of IFRS
- ◊ learn why convergence with IFRS is essential
- ◊ be aware of the benefits of adopting IFRS

### Prerequisites

Consider two multinational companies, Company A and Company B, operating in different countries. Company A follows the accounting standards prescribed by its home country, while Company B adheres to IFRS. Company A's adherence to its home country's standards and Company B's use of IFRS lead to significant differences in reporting financial assets and revenue recognition. Consequently, investors face difficulty in accurately assessing the financial health and performance of these companies and struggle to make informed investment decisions.

Convergence to IFRS is essential to address these challenges by providing a standardised framework for financial reporting. By adopting IFRS, both companies would report financial information consistently, enhancing transparency and comparability across international borders. This convergence would enable investors to more effectively analyse and compare the financial performance of companies operating in different countries, facilitating better resource allocation and diversification of investment portfolios. Ultimately, convergence to IFRS fosters a more transparent and efficient global marketplace, benefiting investors and stakeholders alike. This unit explains the concept of IFRS and the need for convergence to IFRS to overcome the challenges posed by disparate accounting standards and ensures access to investors in the global marketplace.

## Keywords

International Accounting standards, Convergence, Need, Benefits

## Discussion

### 1.1.1 Concept of IFRS

International Financial Reporting Standards (IFRS) refers to a group of accounting standards which provides guidelines to report transactions in the book of accounts. IFRS are issued by International Accounting Standards Board (IASB) in 2001 by replacing the International Accounting Standards, with the aim of ensuring transparency, comparability, and consistency in the preparation of financial statements. The adoption of IFRS helps the users of financial statement to make an international comparison among public companies.

The world is now a single market where businesses can buy and sell products and services across different countries. This has complicated the process of comparing financial statements of businesses that operate in many nations for investors and caused uncertainty among preparers on which accounting standards to adhere to. There is a push for the adoption of a single set of accounting standards worldwide to address these issues. This action is thought to be crucial for guaranteeing financial reporting's ease of use, comparability, and transparency. A rising number of people are realising how crucial it is to implement comparable global accounting standards as India becomes a major hub for trade and investment. India would receive more foreign funding and technology if IFRS were adopted. Additionally, it would present India as a desirable location for international businesses seeking to conduct business. Adoption of IFRS in India would also improve the comparability of financial statements across domestic and foreign enterprises, as IFRS is widely used and globally acknowledged by multinational corporations.

### 1.1.2 Need for Convergence

In India, IFRS convergence is required for the following reasons:

- i. IFRS convergence guarantees a broad comprehension of best accounting procedures. By converging with IFRS, Indian companies and professionals will be exposed to globally accepted standards, thereby enhancing their understanding and application of sound accounting principles.
- ii. It harmonises financial reporting and accounting globally. Globally harmonising financial reporting and accounting suggests that by aligning with IFRS, India aims to standardise its reporting practices with those of other countries, facilitating comparability and consistency in financial reporting on a global scale.

- iii. Convergence with IFRS can enhance transparency, comparability, and reliability of financial statements, benefiting investors, creditors, and other stakeholders. Ensuring that financial statements are transparent, comparable, and reliable emphasises the importance of providing high-quality financial information to users.
- iv. Convergence encourages foreign investment and industrial expansion. It is therefore needed to improve the attractiveness of India's financial markets to international investors by providing familiarity and confidence in the financial reporting standards used.
- v. Convergence with IFRS can simplify cross-border transactions and investment decisions by eliminating the need to interpret different accounting standards, thereby enhancing the accessibility and usability of financial information for users. Thus convergence to IFRS is essential to remove informational obstacles for financial statement users.

### 1.1.3 Features of IFRS

The main features of International Financial Reporting Standards are as follows:

- i. Principle-based- International Financial Reporting Standards are based on clearly stated principles. Therefore, they are known as principle-based accounting standards. They are not rule-based accounting standards. IFRS provides general guidance for financial reporting, rather than setting rules for industry specific reporting.
- ii. Substance over form- International Financial Reporting Standards emphasize that transactions should be recorded on the basis of their economic reality and not on the basis of their legal form. For example, if an asset is purchased on hire-purchase, it is shown as an asset in the books of the hire purchaser even though he will become the owner after paying all the instalments.
- iii. Fair values- International Financial Reporting Standards are based primarily on accounting at fair values.
- iv. Functional currency- Under International Financial statements, assets, liabilities, revenues and expenses are reporting in the functional currency instead of local currency.
- v. Reassessment of useful life and depreciation- Under International Financial Reporting Standards, the useful life and depreciation of property, plant and equipment is to be reassessed annually.

### 1.1.4 Benefits with Convergence

The following are the benefits of convergence with IFRS:

- i. Convergence with IFRS facilitate international commerce and attract foreign investment by providing a common financial reporting framework that is widely accepted and understood across borders.
- ii. Convergence with IFRS can lead to improvements in the quality and comparability of financial reporting by adopting globally recognised accounting

standards. This can enhance transparency and trust in financial statements, benefiting stakeholders such as investors, creditors, and regulators.

- iii. Standardising reporting requirements promotes consistency and simplifies financial analysis. Convergence with IFRS can eliminate differential reporting practices, where companies follow different accounting standards based on factors such as size or industry.
- iv. Convergence with IFRS drives professional development within the accounting field by promoting the adoption of best practices and fostering a common understanding of accounting principles. This can lead to improvements in accounting education, training, and professional standards.
- v. Convergence with IFRS improves access to international financial capital markets for companies by aligning their financial reporting standards with global norms. This can enhance the visibility of companies in international markets, reduce capital costs, and broaden opportunities for financing and investment.

It is anticipated that the convergence with IFRS will strengthen international trade, which will help the economy. It fosters a more effective capital market, boosts capital formation, draws in more foreign investment, and thereby promotes economic expansion.

## Recap

- ◊ IFRS- International Financial Reporting Standards
- ◊ IASB- International Accounting Standards Board
- ◊ IFRS- guidelines to report transactions
- ◊ Aim of IFRS- transparency, comparability, and consistency in the preparation of financial statements
- ◊ Convergence- harmonise financial reporting and accounting globally
- ◊ Convergence- encourage foreign investment and industrial expansion
- ◊ Convergence- leads to economic growth
- ◊ Convergence- improve access to international financial capital markets

## Objective Questions

1. State the fulform of IFRS.
2. What do standardising reporting requirements promote?
3. Which body issued IFRS?
4. What is the main aim of IFRS?
5. In which year IFRS was issued by IASB?
6. Who benefits from enhanced transparency, comparability, and reliability?
7. Which accounting standards did IFRS replace?
8. What is the fulform of IASB?

## Answers

1. International Financial Reporting Standards
2. Consistency
3. International Accounting Standards Board
4. Bring transparency, comparability, and consistency in the preparation of financial statements
5. 2001
6. Investors, creditors, other stakeholders
7. International Accounting Standards
8. International Accounting Standards Board

## Self-Assessment Questions

1. Why is the implementation of comparable global accounting standards considered crucial for India?
2. What is IFRS? Explain its concept.
3. How does convergence with IFRS facilitate international commerce and attract foreign investment?
4. What are the reasons for convergence with IFRS?
5. State the benefits of convergence with IFRS.

6. How do IFRS contribute to transparency, comparability, and consistency in financial reporting?
7. Explain the role of convergence with IFRS in boosting capital formation.
8. In what ways would the adoption of IFRS enhance India's attractiveness for international businesses?

## Assignments

1. Evaluate the impact of globalization on the comparability of financial statements for investors.
2. Analyse the challenges faced by preparers in adhering to different accounting standards across multiple countries.
3. Evaluate the challenges and opportunities associated with the convergence of Indian accounting standards with IFRS.
4. Investigate and examine how IFRS convergence contributes to boosting capital formation and attracting foreign investment.

## Suggested Readings

1. Jain, V. K., & Singh, H. (2020). Relevance of IFRS in India. *International Journal of Management (IJM)*. IAEME Publication.
2. Saxena, N., & Mittal, S. (2017). Perception of Indian Accountants towards IFRS Adoption: A Study. *Indian Journal of Accounting and Finance*.
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5. Sharma, S., & Verma, R. (2020). IFRS Convergence and Its Impact on Indian Financial Reporting: A Study of Listed Companies. *Indian Journal of Accounting*.
6. Lopez, M., & Fernandez, R. (2016). IFRS Compliance and Financial Reporting Quality: A Study of Listed Companies in European Union. *European Accounting Review*.

# Unit 2

## Adoption of IFRS

### Learning Outcomes

After completing this unit, the learners will be able to:

- ◊ differentiate IndAS and IFRS
- ◊ gain insights on US GAAP and Indian GAAP
- ◊ learn the concept of first time adoption of IFRS

### Prerequisites

The adoption of IFRS represents a significant milestone for companies seeking to enhance the transparency, comparability, and credibility of their financial reporting. Through first-time adoption, companies shift towards global financial integration, offering a standardised approach to accounting that overcomes the barriers of geographical boundaries and fosters trust among stakeholders.

First-time adoption of IFRS represents more than just a procedural shift. It symbolises a strategic move towards global financial integration. This transition not only enhances the consistency and reliability of financial reporting but also fosters trust among investors, creditors, regulators, and other stakeholders. Through first-time adoption, companies undergo a rigorous process of aligning accounting policies, classifications, and measurement criteria with IFRS standards. While this process may present challenges, such as the need for training, system upgrades, and comprehensive disclosures, the benefits of adopting IFRS are manifold. This unit deals with a comparison of IndAS and IFRS, US GAAP and Indian GAAP, and the first time adoption of IFRS.

## Keywords

IFRS, US GAAP, Indian GAAP, IndAS

## Discussion

### 1.2.1 Distinction between IndAS and IFRS

IndAS stands for Indian Accounting Standards. IndAS is known as the Indian version of IFRS. Ind AS is designed exclusively for Indian businesses and is implemented in the Indian corporate environment.

IFRS, which stands for International Financial Reporting Standards, is formulated by the International Accounting Standards Board (IASB) and is utilised in approximately 144 countries, making it one of the most widely accepted accounting standards globally.

Point of difference	IndAS	IFRS
Period of reporting	Companies are required to report financial statements annually	Companies are required to report financial statements quarterly
Date of filing	The filing date for companies following IndAS is determined based on when a company's first financial statement is filed with the Registrar of Companies. This filing date is typically five years after the initial filing, or as per the provisions of any other applicable law. This means that companies must submit their financial statements within five years from the initial filing or according to any other specified time frame mandated by law.	The filing date is three years after the company's first financial statement is filed with the Registrar of Companies, or as per the provisions of any other applicable law. This implies that companies adhering to IFRS must submit their financial statements within three years from the initial filing or according to any other specified time frame stipulated by law.

Scope	It is an internationally recognised accounting standard	It is also known as India specific version of IFRS
Language to be used	IndAS require companies to adhere to a specified language when preparing financial statements, disallowing the option for companies to choose their preferred language.	IFRS allow companies the freedom to select any language they prefer for preparing their Statement of Financial Position, Statement of Changes in Equity, Statement of Cash Flows, and accompanying Notes.
Formulated by	Institute of chartered Accountants of India (ICAI)	International Accounting Standards Board
Disclosure about compliance	Mandatory disclosure is not explicitly required for companies complying with Ind AS.	Companies complying with IFRS are required to disclose in the notes to their financial statements that the financial statements comply with IFRS.
Format of Balance sheet	Companies Ind AS are not mandated to adhere to such specific requirements regarding the classification of assets and liabilities as current and non-current. However, guidelines are provided for the presentation of the balance sheet in accordance with Ind AS.	Companies adhering to IFRS are required to follow specific guidelines for the presentation of their balance sheet. These guidelines include the classification of assets and liabilities into current and non-current categories.

### 1.2.2 Understanding of US GAAP and Indian GAAP

Generally Accepted Accounting Principles (GAAP or US GAAP) encompass a set of widely accepted accounting rules and standards utilised for financial reporting. These standards, endorsed by the U.S. Securities and Exchange Commission (SEC), outline definitions of key concepts and principles alongside industry-specific regulations. The primary objective of GAAP is to uphold transparency and uniformity in financial reporting practices across different organisations. India's transition to the Indian Accounting Standards, commonly referred to as Ind AS, poses a significant challenge due to the substantial differences between Ind AS and the existing Indian GAAP standards. Adaptation to Ind AS will require considerable effort and adjustment given its distinctiveness compared to the current accounting framework in India.

Understanding the differences between Indian Generally Accepted Accounting

Principles (GAAP) and US GAAP is essential to gain insights on financial reporting practices in different jurisdictions. Indian GAAP adheres strictly to the principle of conservatism, emphasising caution in recognising revenues and gains to present a more conservative financial picture. This contrasts with US GAAP, which is less stringent on conservatism. In terms of reporting requirements, Indian GAAP mandates the preparation of cash flow statements for listed companies and certain enterprises with turnover exceeding a specified threshold, whereas US GAAP requires all companies to furnish cash flow statements for the current year and two preceding years. Another notable distinction lies in the treatment of subsidiary accounts, where Indian GAAP does not mandate consolidation unless an enterprise presents consolidated financial statements, while US GAAP requires consolidation to eliminate intercompany transactions and provide a clearer view of the business group's operations. Both frameworks allocate depreciation systematically over the useful life of assets, but Indian GAAP allows for higher rates if the asset's useful life is shorter under the Companies Act. Regarding intangible assets, both GAAPs capitalise them if recognition criteria are met; however, Indian GAAP imposes a maximum amortization period of 10 years, while US GAAP amortizes them over their useful life or reviews them for impairment if assigned an indefinite useful life. Property, Plant, and Equipment (PPE) valuation also diverge, with Indian GAAP permitting revaluations, whereas US GAAP adheres strictly to historical cost. Moreover, Indian GAAP values investments at the lower of cost and fair value, whereas US GAAP allows for the marking to market of long-term investments. Restatement policies differ as well, where Indian GAAP includes correction effects in the current year's income statement, while US GAAP mandates restatement of prior period balances for errors. Furthermore, Indian GAAP requires the capitalisation of exchange differences arising on repayment of liabilities incurred to acquire fixed assets, whereas US GAAP prohibits such capitalisation. Leave encashment provisions also vary, with Indian GAAP based on actuarial valuation and allowing amortization of voluntary retirement compensation, while US GAAP follows an actual basis and charges compensation upon acceptance. These distinctions underscore the complexity and importance of understanding international accounting standards for comprehensive financial reporting.

### 1.2.3 IFRS Standards

**IFRS 1 First-time Adoption of International Financial Reporting Standards:** This standard sets out the requirements for an entity that is preparing its financial statements for the first time using IFRS. It provides guidance on recognising and measuring assets, liabilities, equity, income, and expenses at the date of transition to IFRS.

**IFRS 2 Share-based Payment:** This standard sets out the accounting treatment for share-based payment transactions, including the recognition and measurement of equity-settled and cash-settled share-based payment transactions.

**IFRS 3 Business Combinations:** This standard sets out the accounting treatment for business combinations, including the recognition and measurement of the assets and liabilities acquired, the determination of the consideration transferred, and the recognition of goodwill or a gain on a bargain purchase.



**IFRS 5 Non-current Assets Held for Sale and Discontinued Operations:** This standard sets out the accounting treatment for non-current assets held for sale and discontinued operations, including the recognition and measurement of such assets and the presentation of the results of discontinued operations in the financial statements.

**IFRS 6 Exploration for and Evaluation of Mineral Resources:** This standard sets out the accounting treatment for exploration and evaluation activities in the mining and oil and gas industries, including the recognition and measurement of exploration and evaluation assets and the recognition of exploration and evaluation expenditure.

**IFRS 7 Financial Instruments: Disclosures:** This standard sets out the disclosure requirements for financial instruments, including information about the nature and extent of risks arising from financial instruments and the extent to which the entity manages those risks.

**IFRS 8 Operating Segments:** This standard sets out the requirements for the disclosure of information about an entity's operating segments, including the identification of operating segments, the measurement of segment profit or loss, and the disclosure of segment assets and liabilities.

**IFRS 9 Financial Instruments:** This standard sets out the requirements for the recognition and measurement of financial instruments, including the classification and measurement of financial assets and liabilities, the impairment of financial assets, and the hedge accounting of financial instruments.

**IFRS 10 Consolidated Financial Statements:** This standard sets out the principles for preparing and presenting consolidated financial statements for a group of entities under the control of a parent company. It replaces IAS 27 Consolidated and Separate Financial Statements.

**IFRS 11 Joint Arrangements:** This standard sets out the accounting treatment for joint arrangements, in which two or more parties have joint control. It specifies the criteria for determining whether an arrangement is a joint venture or a joint operation, and the accounting treatment for each type of joint arrangement.

**IFRS 12 Disclosure of Interests in Other Entities:** This standard sets out the disclosure requirements for interests in other entities, including information about the entity's nature, the risks associated with the entity, and the entity's financial position and performance.

**IFRS 13 Fair Value Measurement:** This standard sets out the principles for measuring fair value and the required disclosures about fair value measurements. It applies to the measurement of fair value in the context of IFRS, but not to determining fair value to establish the selling price in a transaction between willing parties.

**IFRS 14 Regulatory Deferral Accounts:** This standard sets out the accounting treatment for regulatory deferral accounts, which are assets or liabilities that arise from recognising deferred income or expenses in the financial statements required by regulatory authorities.

**IFRS 15 Revenue from Contracts with Customers:** This standard sets out the principles for the recognition of revenue from contracts with customers, including the determination of the transaction price, the allocation of the transaction price to the performance obligations in the contract, and the recognition of revenue when (or as) the entity satisfies a performance obligation. It replaces IAS 11 Construction Contracts and IAS 18 Revenue.

**IFRS 16 Leases:** This standard sets out the accounting treatment for leases, including lessees' recognition of lease assets and lease liabilities and the presentation of leased and leased liabilities on the balance sheet. It replaces IAS 17 Leases.

**IFRS 17 Insurance Contracts:** This standard sets out the accounting treatment for insurance contracts, including the recognition of insurance contract assets and insurance contract liabilities, the measurement of insurance contract assets and insurance contract liabilities, and the presentation of the results of insurance contracts in the financial statements. It replaces IFRS 4 Insurance Contracts.

**IFRS 18: IFRS 18 Presentation and Disclosure in Financial Statements effective from Jan 1, 2027.** In order to fulfill investors demand for better and important information regarding company's financial statements, IASB issued IFRS 18 Presentation and Disclosure in Financial Statements on 09<sup>th</sup> April, 2024. IFRS18 replaces IAS1 Presentation of Financial Statements which lacked detailed information on classification of income and expenses, subtotals within each classification and aggregation/disaggregation of information. This indeed contributed to diversity in practice among entities. Consequently, investors faced difficulties in analysing and comparing financial performance across different companies and ultimately difficulty in making informed decisions.

## 1.2.4 First time adoption of IFRS

When a company decides to start using IFRS for its financial reporting, the first set of financial statements it produces under IFRS is considered its "first IFRS financial statements." In such circumstances, the standard IFRS 1/ IndAS 101 applies.

The objective of this IFRS (International Financial Reporting Standard) is to make sure that when a company starts using IFRS for the first time, the financial statements it prepares are cost effective and of really good quality. The other objectives include:

- a. It wants the information in these financial statements to be easy for people to understand and compare with other periods. So, anyone looking at the financial statements can see clearly what is going on and compare the company's performance over time.
- b. It also wants these financial statements to be a good starting point for the company to use IFRS properly in the future. Think of it like laying a solid foundation for building a house. These financial statements should set the right standards for the company's future financial reporting.
- c. Lastly, it is important that these high-quality financial statements don't cost too much to prepare. The benefits of having clear, comparable financial information

should outweigh the costs of producing it. So, it is about making sure the company gets good value for money when they are getting their financial statements ready.

IFRS 1 emphasises the principle of fully applying all IFRS standards effective as of the closing balance sheet or reporting date of the company's first IFRS financial statements. However, adopting this principle in full retrospect can be exceedingly challenging and burdensome. To alleviate this challenge, IFRS 1 provides certain optional exemptions and mandatory exceptions from retrospective application.

According to IFRS 1, companies are required to:

- i. Identify their first IFRS financial statements.
- ii. Prepare an opening balance sheet at the transition date to IFRS.
- iii. Choose accounting policies that comply with IFRS effective at the end of the initial IFRS reporting period and apply those policies retrospectively to all periods presented in the first IFRS financial statements.
- iv. Implement mandatory exceptions to retrospective application.
- v. Evaluate whether to utilise any optional exemptions from retrospective application.
- vi. Provide comprehensive disclosures explaining the transition to IFRS, including reconciliations from previous GAAP to IFRS for equity and total comprehensive income.

#### **1.2.4.1 The opening IFRS balance sheet**

The opening IFRS balance sheet serves as the initial point for all subsequent accounting under IFRS and is crafted at the transition date, marking the commencement of the earliest period with comprehensive comparative information as outlined in IFRS.

According to IFRS 1, the opening IFRS balance sheet must:

- i. Incorporate all assets and liabilities stipulated by IFRS.
- ii. Omit any assets and liabilities prohibited by IFRS.
- iii. Arrange all assets, liabilities, and equity components in alignment with IFRS classifications.
- iv. Evaluate all items based on IFRS measurement criteria.
- v. Be formulated and exhibited within the entity's initial IFRS financial statements.

These fundamental guidelines are adhered to unless overridden by one of the optional exemptions or mandatory exceptions, which may alter the recognition, classification, or measurement as stated above.

IFRS applies when a company prepares its first financial statements using IFRS. It also applies to any interim financial reports (like quarterly reports) that cover part of the period included in those first financial statements. If the company's previous financial statements were prepared based on national rules that did not fully align with IFRS, or if they followed IFRS but did not explicitly say so, or if they followed only some IFRS

rules, those would not count as the first IFRS financial statements. Similarly, if the company only used IFRS internally for its own purposes or prepared partial financial statements for consolidation purposes, those would not count either. If the company did not prepare any financial statements previously, then its first financial statements under IFRS automatically become its first IFRS financial statements.

## Recap

- ◊ IndAS- Indian version of IFRS
- ◊ IFRS- formulated by the International Accounting Standards Board (IASB)
- ◊ IFRS- internationally recognised accounting standard
- ◊ IndAS- formulated by the ICAI
- ◊ GAAP- set of widely accepted accounting rules and standards utilised for financial reporting
- ◊ IFRS 1/ IndAS 101- first time adoption of IFRS

## Objective Questions

1. What does IndAS stand for?
2. IndAS is primarily designed for businesses in which country?
3. How many countries approximately utilise IFRS?
4. Which organisation formulates IFRS?
5. How often do companies following IndAS report financial statements?
6. What does GAAP stand for?
7. What is the maximum amortization period for intangible assets under Indian GAAP?
8. Which standard deals with first time adoption of IFRS?

## Answers

1. Indian Accounting Standards
2. India
3. 144
4. IASB
5. Annually
6. Generally Accepted Accounting Principles
7. 10 years
8. IFRS 1/IndAS 101

## Self-Assessment Questions

1. Distinguish between IFRS and IndAS.
2. Compare and contrast US GAAP and Indian GAAP.
3. What are the objectives of IFRS?
4. Write a short note on first time adoption of IFRS.
5. What are the guidelines that must be considered while developing opening balance sheet when IFRS is adopted for the first time?

## Assignments

1. Compare and contrast the key features of IndAS (Indian Accounting Standards) and IFRS (International Financial Reporting Standards). Highlight the similarities and differences in their scope, objectives, regulatory framework, and implementation in the corporate environment. Evaluate the impact of adopting IndAS versus IFRS on financial reporting practices and the global competitiveness of Indian businesses.
2. Discuss the significance of IFRS 1 (or IndAS 101) in the transition process of companies towards using International Financial Reporting Standards (IFRS) or Indian Accounting Standards (IndAS). Explain the objectives of IFRS 1 and how it aims to ensure high-quality financial reporting for companies adopting IFRS or IndAS for the first time.

3. Evaluate the challenges faced by companies when preparing their first set of financial statements under IFRS or IndAS, as outlined in IFRS 1. Discuss the optional exemptions and mandatory exceptions provided by IFRS 1 to alleviate the burden of full retrospective application of IFRS or IndAS standards.

## Suggested Readings

1. Jain, V. K., & Singh, H. (2020). *Relevance of IFRS in India. International Journal of Management (IJM)*. IAEME Publication.
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BLOCK

# ACCOUNTING STANDARDS

## Accounting Standards for Assets

### Learning Outcomes

After completing this unit, the learner will be able to:

- ◊ gain insights on the concept of inventory as per Ind AS 2
- ◊ familiarise the accounting treatment of Property, Plant, and Equipment as per Ind AS 16
- ◊ get awareness on the measurement of intangible assets as per Ind AS 38

### Prerequisites

Accounting, as a language of business, communicates the financial results of an enterprise to its various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, comparisons become difficult. In order to ensure transparency, consistency, comparability, adequacy, and reliability of financial reporting, it is essential to standardise accounting principles and policies. Hence, there is a need for commonly accepted and practiced accounting standards. The accounting standards provide the framework for comparing the financial statements of different enterprises. The meaning, objectives, and importance of Accounting standard, the concept of Ind AS etc. were discussed in detail in the previous semester. The present unit covers the Indian Accounting Standards for assets focusing on Ind AS 2, Ind AS 16, and Ind AS38.

### Keywords

Accounting Standards for Inventory, Accounting Standards for Property, Plant, and Equipment, Accounting Standards for Intangible assets

## Discussion

### 2.1.1 Asset based Accounting Standards

Asset based accounting standards ensure fair measurement, timely recognition, de-recognition, and amortization of various assets, whether tangible or intangible, owned by an entity irrespective of its size and legal form. The following are the important asset based accounting standards:

- a. Inventories (Ind-As 2)
- b. Property, plant and equipment (Ind-As 16)
- c. Intangible Asset (Ind-As 38)
- d. Impairment of Asset (Ind-As 36)
- e. Borrowing cost (Ind-As 23)
- f. Investment property (Ind-As 40)

### 2.1.2 Inventories (Ind-AS 2)

This standard deals with the determination of the value at which inventories are carried in the financial statements, including the ascertainment of cost of inventories and any write-down value thereof to net realisable value. The value of inventory is determined as the cost or net realisable value whichever is lower.

#### Scope

This standard applies to all inventories that are:

- i. Held for sale in the normal operation of business.
- ii. Used in the process of production for sale.
- iii. Kept in the form of materials or supplies to be consumed in the production process.
- iv. Kept in the form of materials or supplies to be used in the rendering of services.

This standard does not apply to the following:

- i. Work in progress (incomplete production) under a construction contract.
- ii. Financial instruments, such as stocks, bonds, futures, option contracts etc..
- iii. Biological assets related to agriculture activity and agricultural produce at the point of harvest. For example, trees in a plantation, sheep, cattle, agricultural products at the point of harvest, etc..

#### Key terms used in this Accounting standard

##### a. Inventories are assets:

- i. Held for sale in the ordinary course of business (example - finished goods)
- ii. Purchased and held for resale. (example, merchandise purchased by a retailer

and held for resale, or land and other property held for resale)

- iii. In the process of production for such sale (example - work in progress)
- iv. In the form of materials or supplies to be consumed in the production process or in the rendering of services (example - raw material)

**b. Net Realisable Value:**

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

**c. Fair value:**

It is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Costs related to inventories**

The value of inventory is determined as the cost or net realisable value whichever is lower. Cost related to inventories as per Ind AS 2 includes the following:

- i. Purchase costs which includes costs that are directly related to purchase of inventory (covers purchase price, duties, delivery and handling costs etc.) after deducting trade discounts, rebates etc..
- ii. Conversion costs linked to the unit of production and indirect costs incurred in converting raw materials into finished products.
- iii. Other costs such as cost of administration, inventory handling, selling and distribution etc..

Ind AS 2 also provides guidance on the techniques for the measurement of the cost of inventory, such as the standard cost method or retail value method. It also outlines acceptable methods of determining cost, including:

- i. Specific identification method- directly linking the cost with specific item of inventory and is used for items which cannot be interchanged.
- ii. FIFO- the cost of item is allocated in the order of purchase.
- iii. Weighted average cost method- the cost of items is calculated by dividing the cost of all the items by the number of items.

### 2.1.3 Property, Plant, and Equipment (Ind-As 16)

One fundamental problem in financial reporting is how to account periodically for performance when many of the expenditures and entity incurs in the current period also contribute to future accounting periods. Expenditure on Property, Plant and Equipment (PP&E) is the best example of this difficulty.

Ind AS 16 prescribes the accounting treatment for Property, Plant and Equipment (PP&E). The standard specifies the following:

- i. Recognition of the asset.
- ii. Determination of their carrying amounts.



- iii. Depreciation charges.
- iv. Impairment of losses to be recorded.

## Scope

All Property, Plant and Equipment are within the scope of Ind AS 16 except as follows:

- i. PP&E classified as held for sale in accordance with Ind AS 105.
- ii. Biological assets related to agricultural activity.
- iii. Recognition and measurement of exploration and evaluation of assets (e.g. drilling rights, vehicles, and drilling rigs - Covered by Ind AS 106)
- iv. Mineral rights and mineral reserves such as oil, natural gas, and similar non-regenerative resources

## Definitions:

- a. **Property, Plant, and Equipment (PP&E):** Property, Plant, and Equipment are tangible items that are held for use in the production or supply of goods or services, for rental to others or for administrative purposes and are expected to be used during more than one accounting period.
- b. **Cost:** Cost is the amount paid or the fair value of any other consideration given to acquire an asset at the time of its acquisition or construction.
- c. **Carrying amount:** Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and impairment losses.
- d. **Impairment loss:** It is the amount by which the carrying amount of an asset exceeds its recoverable amount. The recoverable amount is the higher of an asset's net selling price and its value in use.

## Recognition

The following conditions are to be satisfied for recognising the cost of an item of Property, Plant and Equipment;

- a. it is probable that future economic benefits associated with the item will flow to the entity;
- b. the cost of the item can be measured reliably.

Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this standard when they meet the definition of Property, Plant and Equipment. Otherwise, such items are classified as inventory.

An entity should evaluate under the recognition principle all its Property, Plant and Equipment costs at the time they are incurred. These costs include:

- a. **Initial cost:** Cost incurred initially to acquire or construct an item of PP&E.
- b. **Subsequent cost:** Cost incurred for the day-to-day servicing of Property, Plant and Equipment, or the cost incurred for replacing part of such an item.

## Accounting Treatment

### I. Measurement at Recognition (Initial measurement)

An item of Property, Plant and Equipment that qualifies for recognition as an asset should be measured at its cost.

**Element of cost:** The cost of an item of Property, Plant and Equipment comprises:

- i. Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- ii. Any cost directly attributable to bringing the asset to the working condition and the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

Example of directly attributable costs includes;

- a. Cost of employee benefits arising directly from the construction or acquisition of the item of PP&E
- b. Cost of site preparation.
- c. Initial delivery and handling costs.
- d. Installation and assembly costs.
- e. Cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (e.g., sample produced when testing equipment)
- f. Professional fees.

Examples of costs that are not costs of an item of Property, Plant and Equipment are:

- a. Cost of opening a new facility.
- b. Cost of introducing a new product or service (including costs of advertising and promotional activities).
- c. Cost of conducting business in a new location or with a new class of customer (including costs of staff training)
- d. Administration and other general overhead costs.

Costs not included in the carrying amount of an item of Property, Plant and Equipment are:

- a. Cost incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity.
- b. Initial operating losses, such as those incurred while demand or the item's output builds up; and
- c. Cost of relocating or reorganising part or all of an entity's operations.

### Self-constructed Asset

The cost of a self-constructed asset is determined using the same principles as

applicable to a purchased asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale. All internal profits are eliminated in arriving at such cost. Similarly, the cost of an abnormal amount of wasted material, labour or other resources incurred in self-constructing an asset is not included in the cost of an asset.

## Exchange of Assets

If an item of PP&E is acquired in exchange of an item of non-monetary asset or a combination of monetary and non-monetary assets, the cost of such an asset is measured at fair value unless:

- a. The exchange transaction lacks commercial substance or
- b. The fair value of the asset received or the asset given up is not measurable.

## II. Measurement after Recognition (Subsequent measurement)

After initial recognition, an entity may choose either the cost model or the revaluation model as per its accounting policy and should apply that policy to an entire class of PP&E.

- ◊ Cost model: After recognition as an asset, an item of PP&E should be carried at its cost less any accumulated depreciation and any accumulated impairment losses.
- ◊ Revaluation model: After recognition as an asset, an item of PP&E, whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluation shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

If an asset's carrying amount is increased as a result of a revaluation, the increase should be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. If an asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease should be recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

## Depreciation

Every part of an item of Property, Plant and Equipment with a cost that is significant in relation to the total cost of the item must be depreciated separately. There are situations where, over a period, an asset has increased in value, i.e., its current value is greater than the carrying amount in the financial statements (for example in case of land). You might think that in such situation it would not be necessary to depreciate the asset. These standard states, however, that this is irrelevant, and depreciation should still be charged

to each accounting period, based on the depreciable amount, irrespective of a rise in value.

## Depreciable amount and Depreciation period

The depreciable amount of an asset should be allocated on a systematic basis over its useful life. The following factors should be considered when estimating the useful life of a depreciable asset.

- i. Expected physical wear and tear.
- ii. Expected usage by the entity.
- iii. Obsolescence.
- iv. Legal or other limits on the use of the assets.

Once decided, the useful life should be reviewed at least every financial year end and depreciation rates should be adjusted for the current and future periods if expectations vary significantly from the original estimates. The effect of the change should be disclosed in the accounting period in which the change takes place.

Depreciation of an asset begins when it is available for use. Depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

Land and buildings are separable assets and are accounted for separately, even when they are acquired together. Land normally has an unlimited useful life and is therefore not depreciated (exceptions, such as quarries and sites used for landfill). Buildings normally have a limited useful life and are depreciable asset.

## Impairment

To determine whether an item of PP&E is impaired, an entity applies Ind AS 36- Impairment of asset. Compensation from third parties for items of Property, Plant and Equipment that were impaired, lost or given up should be included in profit or loss when the compensation becomes receivable.

## Derecognition (Elimination from Balance Sheet)

The carrying amount of an item of Property, Plant and Equipment shall be derecognised:

- i. On disposal; or
- ii. When no future economic benefit is expected from its use or disposal.

## Disclosure requirement

The financial statement should disclose, for each class of PP&E:

- i. Measurement basis used for determining gross carrying amount.
- ii. Depreciation method used.



- iii. Gross carrying amount and accumulated depreciation at beginning and end of the period. Accumulated impairment losses are aggregated with accumulated depreciation.
- iv. Reconciliation of carrying amount at the beginning and end of period.
- v. Property, Plant, and Equipment pledged as security for liabilities.
- vi. Amount of expenditure recognised in the course of construction.
- vii. Contractual commitments for the acquisition of Property, Plant and Equipment.
- viii. Amount of compensation from third parties for items of Property, Plant and Equipment.

#### 2.1.4 Intangible Asset (Ind AS 38)

According to Ind AS 38 an intangible asset is “an identifiable non-monetary asset without physical substance”. People can interpret this definition in many different ways, just as they need and therefore, Ind AS 38 contains good guidance on how to apply it.

Ind AS 38 applies to all intangible assets that are not specifically dealt with in any other standards. This standard prescribes the accounting treatment of intangible assets, including:

- i. The definition of an intangible asset.
- ii. Recognition of an asset.
- iii. Determination of the carrying amount.
- iv. Determination and treatment of impairment losses.
- v. Requirements for disclosure.

This standard does not apply to certain assets. Some of such assets are:

- i. Financial assets, as defined in Ind AS 32.
- ii. Exploration and evaluation of asset-covered by Ind AS 106.
- iii. Intangible assets held for sale in the ordinary course of business (Ind AS 2).
- iv. Deferred tax assets (Ind AS 12).
- v. Goodwill arising in a business acquisition (Ind AS 103).
- vi. Leases (Ind AS 17)
- vii. Assets arising from employee benefits (Ind AS19)
- viii. Intangible assets that are non-current assets held for sale (Ind AS 105)

Intangible asset has the following characteristics:

- i. **An identifiability:** An intangible asset must be separate i.e., it should be capable of being separated from the entity and sold/transferred. For example, license to operate buses on a route, mining rights granted by the government to a mining company, etc..
- ii. **Control over a resource:** Entities have the capacity to control the future economic benefit of an intangible asset.

iii. **Future economic benefits:** include revenue from the sale of products or services or other benefits resulting from the use of the asset by the entity.

Common examples of an intangible assets are computer software, copyrights, licenses, films, patents, market share, import quotas, marketing rights, franchises, goodwill, etc..

## Accounting Treatment Recognition of intangible asset

An intangible asset should be recognised if:

- i. Future economic benefit from the asset is probable.
- ii. Cost can be measured reliably.

### Measurement of intangible assets:

It includes:

#### I. Measurement of intangible assets at initial recognition

Intangible assets may be acquired through different modes. Therefore, the initial measurement depends upon the mode through which it is acquired by the entity. The different modes are.

- i. **Separate acquisition:** In the case of separate acquisition initial measurement depend on cost. Cost includes the following:
  - a. Purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates and
  - b. Any directly attributable cost of preparing the asset for its intended use (including cost of material and services used or consumed in generating the intangible asset, cost of employee's benefit, professional and legal fees, cost of testing, fees to register a legal right, amortization of patents and licenses that are used to generate the intangible asset, etc..)
- ii. **Acquired in Business Combination:** Here initial measurement depends on the fair value at the acquisition date.
- iii. **Acquisition by way of a government grant:** In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. In such case, the initial measurement depends on Fair value or nominal amount plus directly attributable expenditure.
- iv. **Internally generated goodwill:** Self-generated goodwill is not measured and recognised.
- v. **Exchange of Asset:** Here measurement is on fair value; if not possible, then carrying amount of asset given up.
- vi. **Internally generated intangible assets other than goodwill:** To assess whether an internally generated intangible asset (example, company's customer lists, brand name, data, or workforce) meets the criteria for recognition, an entity classifies the generation of the asset into:
  - a. **Research phase:** Expenditure on research should be recognised as an expense

when it is incurred.

**b. Development Phase:** Development expenditure qualifying for recognition is measured at cost and is capitalised. Examples of development expenditure are design cost, construction cost, salaries and wage of employees engaged, design of tools, moulds involving new technology, cost of the producing product, masters for training materials, and other directly attributable costs to the generation of an intangible asset, etc..

The cost of an internally generated intangible asset is the sum total of all expenditures incurred from the date when the intangible asset first meets the recognition criteria and the conditions relating to the development phase.

Examples of expenditures that are not part of the cost of an intangible asset:

- i. The cost of introducing a new product or service (including costs of advertising and promotional activities)
- ii. Costs of conducting business in a new location or with a new class of customer (including costs of staff training) and
- iii. Administration and other general overhead costs.

## **II. Measurement of intangible assets after recognition**

Measurement of intangible assets after recognition may be either at (i) Cost model (ii) Revaluation model.

### **i. Cost model**

After initial recognition, intangible assets should be carried at cost less accumulated amortisation and impairment losses.

Note: Amortisation refers to allocating the cost of an intangible asset over a period of time. Impairment loss is a recognised reduction in the carrying amount of an asset that is triggered by a decline in its fair value.

### **ii. Revaluation model**

After initial recognition, intangible assets should be carried at a revalued amount (based on fair value) less any accumulated amortisation and impairment losses.

Here fair value should be measured by referring to active market. Such active markets are expected to be uncommon for intangible assets. Examples where they might exist includes production quotas, fishing licences, taxi licences etc.. The revaluation model may be applied to an intangible asset that was received by way of government grant and recognised as nominal amount. But this model does not allow the revaluation of intangible assets that have not previously been recognised as asset or the initial recognition of intangible assets at amount other than cost.

## **Classification of intangible assets based on useful life:**

The accounting for an intangible asset is based on its useful life. Intangible assets are classified as:

## Intangible asset with finite life

An intangible asset with finite life have limited period of benefit to the entity.

These assets are amortised on a systematic basis over the useful life. Amortisation should begin when the asset is available for use and ceases at the earlier of the date that the asset is classified as held for sale. The amortisation period and the amortisation method of this asset shall be reviewed at least at each financial year-end. Such changes shall be accounted for as changes in accounting estimates in accordance with Ind AS 8.

The residual value of these assets shall be assumed to be zero unless:

- ◆ There is a commitment by a third party to purchase the asset at the end of its useful life; or
- ◆ There is an active market for the asset and
  - ◊ Residual value can be determined by reference to that market; and
  - ◊ It is probable that such a market will exist at the end of the asset's useful life

## Intangible asset with infinite life

An intangible asset with Infinite life has no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. These assets are not amortised but tested for impairment annually.

## Treatment of Revaluation Gains and Losses

If an intangible asset's carrying amount is increased, it should be credited directly to other comprehensive income under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease should be recognised in profit or loss. However, the decrease should be recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset. The following illustration makes it clear:



### Illustration 2.1.1

An intangible asset is measured by an entity at fair value. The asset was revalued upwards by ₹35000 in 2019, and there is a revaluation surplus of ₹35000 in the statement of financial position. At the end of 2020, the asset is valued again, and a downward valuation of ₹ 40000 is required. How is downward revaluation accounted for?

Here, the downward valuation of ₹40000 can be first set off against the revaluation surplus of ₹35000. The revaluation surplus will be reduced to ₹0 and a charge of ₹5000 is made as an expense in 2020 and it should be recognised in profit and loss account.

### De- recognition

An intangible asset should be de-recognised on disposal or when no future economic benefits are expected from its use or disposal. The gain or loss that arises from such de-recognition should be included in profit or loss.

### Disclosure requirements

The financial statement should disclose, for each class of intangible assets (internally generated or other) the following:

- ◊ Useful life or amortisation rate.
- ◊ Amortisation method.
- ◊ Gross carrying amount.
- ◊ Accumulated amortisation and impairment losses.
- ◊ Basis for determining that an intangible has an indefinite life.
- ◊ Description and carrying amount of internally generated intangible assets.
- ◊ Certain special disclosures about intangible assets acquired by way of government grants.
- ◊ Contractual commitments to acquire intangible assets.
- ◊ Information about intangible assets whose title is restricted.

### Recap

- ◊ Ind AS 2- Inventories
- ◊ Ind AS 16- Property, Plant, and Equipment (PP&E).
- ◊ Ind AS 38- Intangible assets
- ◊ Inventories- Measured at cost or net realizable value whichever is lower.
- ◊ Property, Plant and Equipment- tangible items that are held for use in the production or supply of goods or services, and are expected to be used for more than one period.

- ◊ At the time of initial measurement- an item of Property, Plant and Equipment are measured at its cost.
- ◊ After initial recognition- an item of Property, Plant and Equipment are measured either at the cost model or the revaluation model.
- ◊ Depreciable amount of PP&E should be allocated on a systematic basis over its useful life.
- ◊ Ind AS 38- applies to all intangible assets that are not specifically dealt with in any other standards.
- ◊ Intangible Asset- identifiable non-monetary asset without physical substance.
- ◊ Initial recognition of intangible asset- depends upon the mode through which it is acquired by the entity.
- ◊ Measurement of intangible assets after recognition may be either at Cost model or Revaluation model.

## Objective Questions

1. Which Indian Accounting Standard deals with Property, Plant and Equipments?
2. What is fair value?
3. How is inventory valued as per Ind AS 2?
4. What is the term that is used to denote an identifiable non-monetary asset without physical substance?
5. State the fulform of PP&E.
6. What are the costs linked to the unit of production and indirect costs incurred in converting raw materials into finished products known as?
7. Which Ind AS deals with intangible assets?
8. List out the two models for the measurement of the intangible assets after recognition.

## Answers

1. Ind AS 16
2. Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date
3. Cost or net realisable value whichever is less
4. Intangible asset
5. Property, Plant and Equipment
6. Cost of conversion
7. Ind AS 38
8. Cost model and Revaluation model

## Self-Assessment Questions

1. Write a short note on the various costs involved in the valuation of inventory as per Ind AS 2.
2. What is an intangible asset as per Ind AS 38?
3. How does net realisable value differ from fair value?
4. Explain the measurement of inventory as per Ind AS 2.
5. Briefly explain the scope of Ind AS 16.
6. State the factors that should be considered when estimating the useful life of a depreciable asset.
7. What are the characteristics of an intangible asset?
8. Explain the classification of intangible assets based on useful life.

## Assignments

1. Explain how net realisable value is determined as per IndAS 2 and discuss its impact in the valuation of inventory.
2. A company is transitioning to Ind AS reporting and needs guidance on the measurement of inventories. Discuss the criteria for the initial measurement and subsequent measurement of intangible assets as per Ind AS 38.
3. Explain the initial recognition aspects and subsequent measurement principles for items of Property, Plant, and Equipment for a company which is opting to shift to IndAS 16.
4. Discuss the criteria for recognition of intangible assets under Ind AS 38. Explain what constitutes an identifiable intangible asset and the criteria for initial recognition.

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# Unit 2

## Accounting for Impairment of Assets, Borrowing Costs, Investment Property and Revenue from Contracts with Customers

### Learning Outcomes

At the conclusion of this unit, the learner will be able to:

- ◊ acquaint with the accounting for impairment of assets.
- ◊ familiarise the measurement of investment property.
- ◊ gain insights on the concept of borrowing costs.
- ◊ get awareness on how and when revenue should be recognised as per Ind AS 115.

### Prerequisites

Assets need to be defined and measured in order to accurately portray an entity's financial status, performance, and cash flows. Understanding borrowing costs and how to capitalise them affects an entity's financial status even more, particularly when those costs are related to the acquisition, creation, or use of qualifying assets. Accurate revenue recognition depends on finding performance requirements in contracts and figuring out when and how much revenue should be recognised. The financial statements' openness is immediately impacted by these choices. Therefore, ensuring that financial statements satisfy specific standards requires a thorough understanding of revenue recognition, asset impairment loss calculation, and borrowing cost capitalisation. This fundamental understanding enables accurate reporting, assisting stakeholders in making decisions based on reliable and transparent information. The present unit deals with IndAS 36, IndAS 23, IndAS 40, and Ind AS 115.

## Keywords

Impairment of Assets, Borrowing costs, Investment property, Revenue from contracts with customers

## Discussion

### 2.2.1 Accounting for Impairment of Assets (Ind AS 36)

An impaired asset is an asset whose market value is below its book value. An entity shall assess, at the end of each reporting period, whether there is any indication that an asset may be impaired. If any such indication exists, the entity should estimate the recoverable amount of the asset. For example, a production plant in recent years invested a large amount in its plant and equipment. If the required test of impairment indicates that a loss must be recorded on its plant and equipment, its book value must be reduced and the resulting loss is reported on its income statement.

Generally, impairment of an asset occurs when a company pays more than book value for an asset and later lowers the value of those assets. So, in accounting, impairment describes a permanent reduction in the value of a company's assets, typically a fixed asset or an intangible asset.

## Objective

The objective of this standard is to prescribe the guidance to determine whether an asset is impaired and how the impairment should be recognised. This standard also specifies when an entity should reverse an impairment loss and prescribes disclosure requirements.

## Scope

This standard shall be applied in accounting for the impairment of all assets, other than:

- i. Inventories (Ind AS2).
- ii. Assets arising from construction contracts (Ind AS 11).
- iii. Deferred tax assets, for example, carryover of losses (Ind AS 12).
- iv. Assets arising from employees' benefits, for example, health insurance, life insurance, etc.. (Ind AS19).
- v. Financial assets that are within the scope of Ind AS 39, for example, financial instruments.
- vi. Biological assets related to agricultural activity (Ind AS 41).
- vii. Deferred acquisition costs and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of Ind AS 104 Insurance contracts.



viii. Non-current asset classified as held for sale in accordance with Ind AS 105. This standard applies to financial assets classified as:

- a. Subsidiaries as defined in Ind AS 27, for example, consolidated financial statements.
- b. Associates, as defined in Ind AS 28, for example, Investments in associates.
- c. Joint ventures, as defined in Ind AS 31, for example, interest in joint ventures

## Definitions

The following terms are used in this Standard with the meanings specified.

i. Impairment loss: It is the amount by which the carrying amount of an asset or a cash generating units exceeds its recoverable amount.

$$\text{Impairment loss} = \text{Carrying amount} - \text{Recoverable amount}$$

ii. Recoverable amount of an asset or a cash-generating unit: is the higher of its fair value less costs to sell and its value in use.

$$\text{Recoverable amount} = \text{Fair value less costs to sell or value in use whichever is higher}$$

iii. Cash generating units: is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

iv. Cost of the disposal: are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.

v. Corporate assets are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash generating units.

vi. Value in use: is the present value of the future cash flows.

## Identification of assets that may be impaired

An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. For assessing the indication of impairment, a firm should consider both external indicators and internal indicators.

### Examples of External indicators:

The decline in the market value of an asset, change in technology, market, economic or legal environment, increase in interest rate, etc..

### Examples of Internal indicators:

Evidence of physical damage, assets performance is declining, discontinuance or restructuring plan, etc..

If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method, or the residual value for the asset, needs to be reviewed and adjusted in accordance with the Standards applicable to the asset, even if no impairment loss is recognised for the asset.

### **Measuring recoverable amount**

As per this standard, recoverable amount is the fair value less costs to sell or value in use whichever is higher. If either the fair value less costs to sell or value in use exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount. Sometimes it will not be possible to determine fair value less costs to sell. In this case, the entity may use the asset's value in use as its recoverable amount.

### **Measurement of Fair value less costs to sell**

If asset is traded in an active market

Fair value less costs to sell = the asset's market price - the costs to sell (disposal).

Note:

Here asset's market price is the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis.

Example for Cost to sell is legal costs, stamp duty and similar transaction taxes, cost of removing the asset, and direct incremental costs to bring an asset into a condition for its sale.

### **Measurement of Value in use**

While calculating value in use the following factors are to be considered:

- i. Estimate of future cash flows that an entity is expected to receive from the asset.
- ii. Expectation about possible variation in the amount or timing of those future cash flows.
- iii. The time value of money.
- iv. The price for bearing the uncertainty inherent in the asset.
- v. Other factors, such as liquidity.

So we can calculate the value in use with the help of:

- a. Estimated future cash flows and
- b. Discount rate

### **Estimated future cash flows**

Estimation of future cash flows are based on:

- i. Management's best estimates of the range of economic condition that will exist over the remaining useful life of the asset.
- ii. Most recent financial budgets and forecasts approved by management for a maximum period of five years.

## Discount rate

The discount rate (rates) shall be a pre-tax rate that reflects current market assessments of:

- i. The time value of money and
- ii. The risks specific to the asset for which the future cash flow estimates have not been adjusted.

## Recognising and measuring an impairment loss

We know that impairment is the fall or reduction in the value of asset. The value of an asset fall can be because of internal factors and external factors. These internal factors or external factors which result in the falls of asset value are called indicators of impairment loss which was discussed earlier in this unit.

At the end of every reporting period, the company has to check whether there are any external or internal indicators of impairment. If there are any such indicators, then the entity should carry out certain examinations to recognise impairment loss, if any.

For example, there is an asset in our firm and we know the carrying amount and the maximum benefit that we get from the asset. Suppose the carrying amount is ₹100. Maximum benefit from the asset is the recoverable amount and it is higher of value in use and fair value less cost to sell. If value in use is ₹90 and fair value less cost of sale is ₹110, then the recoverable amount is ₹110, because here fair value less cost to sell is more than value in use. In this case is there is no impairment, because we know that impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount. Here the recoverable amount is more than the carrying amount. So, there is no impairment, because the promise what we are showing in the Balance Sheet still seems to be reasonable. We said minimum ₹100 (carrying amount) is the benefit what we are going to get. Here we get the benefit of ₹110. So there is no impairment.

Imagine if the carrying amount is ₹100 and the recoverable amount is ₹90. In this case, there is an impairment loss, because here the carrying amount is more than the recoverable amount. The difference between two will be called impairment loss. So,

Impairment loss = Carrying amount - Recoverable amount

Here ₹100 - ₹90 = ₹10 is the impairment loss.

For calculating the recoverable amount, we find out the value in use and fair value less cost to sell. The Indian Accounting Standard IndAS 36 says “Recoverable amounts should be computed only when there is an indication of impairment”. If the recoverable amount of an asset is lower than its carrying amount and that reduction is an impairment loss. Impairment loss should be recognised in the profit or loss unless the asset is carried at the revalued amount in accordance with Ind AS 38. Once impairment loss is recognised, the depreciation charge for the subsequent period is based on the revised carrying amount. Once the impairment loss is recognised then the journal entry will be:

- i. For showing the impairment loss
 

Impairment loss A/c	Dr.
To Asset a/c	
- ii. For closing impairment loss
 

Profit and Loss A/c	Dr.
To Impairment loss A/c	

### **Identifying the cash generating unit**

Recoverable amount of an asset should be estimated individually. If it is not possible, the firm should calculate the recoverable amount for the cash generating unit to which the asset belongs. If it is difficult to allocate an asset to cash generating units on a reasonable basis, the entity should identify the units to which assets can be allocated on a reasonable and consistent basis. The following illustrative example explains this:

There is an airline company and it applies for licence to operate aircraft. So there is a licence between city A and city B and another licence between city A and C. The company has many aircrafts and these aircrafts operate in between the above cities. When we look at the assets that the company own, all individual aircrafts are capable of generating cash inflows which may be independent of cash flows generated by other aircraft. Merely owning an aircraft without having a licence, does not give the entity an opportunity to generate cash. Similarly, a licence without having an aircraft does not give the entity an opportunity to generate cash.

In this scenario an aircraft and licence together are essential to be able to generate cash, which means that these together would constitute a cash generating unit.

From the above it is clear that if an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit.

### **Impairment loss for a cash-generating unit**

An impairment loss shall be recognised for a cash-generating unit if, and only if, the recoverable amount of the unit is less than the carrying amount of the unit. The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit in the following order:

- i. First, it should be allocated to goodwill
- ii. Then, to other assets of the unit on a pro rata basis.

The carrying amount of any asset in the cash generating unit should not be reduced below its recoverable amount, which is the highest of its fair value less cost to sell or its Value in use and zero.

### **Reversing an impairment loss**

Reversal of impairment loss simply means the recovery of the previously recognised impairment loss. For example, if the carrying amount of an asset is ₹100 and the recoverable amount is ₹ 90, then there is an impairment loss of ₹ 10. If the recoverable

amount is increased to ₹ 110, then there is reversal of impairment loss.

A reversal of an impairment loss should be recognised in profit or loss unless the asset is carried at the revalued amount in accordance with other Indian Accounting Standard, in which case the reversal is treated as a revaluation increase in accordance with that standard.

It should be noted that impairment loss of goodwill may never be reversed.

### **Disclosure requirement**

- a. The following disclosures are required in the financial statements.
  - i. The amount of impairment losses recognised in profit or loss during the period.
  - ii. The amount of reversals of impairment losses recognised in profit or loss during the period.
  - iii. The amount of impairment losses on revalued assets recognised in other comprehensive income during the period.
  - iv. The amount of reversals of impairment losses on revalued assets recognised in other comprehensive income during the period.
- b. When Impairment loss of an individual asset or a cash generating unit is recognised or reversed the following matters are also disclosed:
  - i. The situation that led to the loss being recognised or reversed.
  - ii. Amount of loss recognised or reversed.
  - iii. Details on the nature of asset and the reportable segment.
  - iv. Whether the recoverable amount is the Fair value less cost to sell or value in use.
  - v. Basis of determining selling price or the basis of discount rate used to determine value in use.
- c. If the recoverable amount is based on value in use or fair value less cost to sell, the following should be disclosed:
  - i. Description of the key assumption used.
  - ii. A description of the approach to determine the values assigned to each assumption.
  - iii. The period over which the cash flow has been projected.
  - iv. The growth rate and the discount rate.

### **2.2.2 Borrowing cost (Ind AS 23)**

Before discussing Ind AS 23, we need to have a clear picture about the borrowing cost. Suppose a situation where we need a shed for the installation of machinery, and started the construction of the shed on 1 September 2018. We borrowed ₹ 50 lakh from a financial institution. The construction was completed on 1 January, 2020. We had bought machinery by taking another loan of ₹ 25 lakh from a nationalised bank. The

financial institution and bank charged an interest of ₹ 5 lakh for the above said loans. This interest is a borrowing cost. Hence it is clear that **borrowing cost** is the interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Ind AS 23 provide guidance on how to measure borrowing costs, particularly when the costs of acquisition, construction or production are funded by an entity's general borrowings.

## Core principle

- i. Borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of the asset.
- ii. Other borrowing costs are recognised as expenses.

## Scope

- i. An entity shall apply this standard in accounting for borrowing costs.
- ii. The standard does not deal with the actual or imputed cost of equity, including capital not classified as a liability.

For example: Dividend paid on equity shares, cost of issuance of equity, cost on irredeemable preference share capital will not be included as borrowing cost.

\***Imputed cost:** An imputed cost is a cost that is incurred by virtue of using an asset instead of investing in it or undertaking an alternative course of action. It is an invisible cost not incurred directly. For example, to get a full-time 3-year college education, one may need to forgo the opportunity of working full time and earning ₹25,000 per year in that period. The ₹25,000 is the imputed cost.

- i. The standard does not apply to borrowing costs directly attributable to the acquisition, construction, or production of:
  - a. A qualifying asset measured at fair value, for example, a biological asset, or
  - b. Inventories that are manufactured or otherwise produced in large quantities on a repetitive basis and that take a substantial period to get ready for sale. For example, Hair oil, Shampoo, etc.

## Definitions

This standard uses the following terms:

**Borrowing cost:** Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. It includes:

- i. **Interest:** Interest is calculated using the effective interest method as described in Ind AS 109, financial instruments.
- ii. **Finance charges:** Financial charges in respect of finance leases as described in Ind AS - 17 Leases.
- iii. **Exchange difference:** Exchange difference arising from foreign currency borrowings to the extent they are recognised as an adjustment of interest costs.



**Qualifying Assets:** Qualifying assets are those assets that require a substantial time to bring to their intended use or saleable condition.

From the above example of the construction of the shed, the shed is a qualifying asset because it takes a substantial time (period of 16 months) to bring the shed for its intended use. Suppose the purchased machinery is used for production in the next day, then it is not a qualifying asset as it takes no time for its intended use.

From this, it is clear that financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

## Recognition

An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

From the example of shed construction, the borrowing cost (interest charges) from the period of 1 September 2018 to 1 January 2020 should be capitalised. It should be added with the cost of shed and the total cost is shown in the Balance Sheet. This is because the shed is a qualifying asset. The borrowing cost incurred for the purchase of machinery (not qualifying asset) is treated as expense and it should be shown in the profit and loss account.

## Commencement of capitalisation

For the commencement of capitalisation, three conditions need to be satisfied. They are:

- ◆ Expenditure must be incurred.
- ◆ Borrowing cost must be incurred.
- ◆ Necessary activities should be in progress.

## Suspension of capitalisation:

We suspend the capitalisation of borrowing cost when:

- ◆ Active development is interrupted during extended period. But when such interruption is necessary for active development then there will be no suspension of capitalisation.

## Cessation of capitalisation

An entity shall cease capitalising when the asset is materially ready for its intended use or sale or when the construction is completed in part and the complete part can be independently used. Capitalisation should not cease when there is a brief interruption in activities or when it is delayed and that delay are inherent in the asset acquisition process.

## Types of borrowing cost

There are two type of borrowing cost. They are:

- i. Specific borrowing cost: If funds are specifically borrowed to obtain a particular asset, the amount qualifying for capitalisation is the actual cost less income earned on the temporary investment of those borrowing.
- ii. General borrowing cost: If funds are borrowed generally and used to obtain an asset, the amount of borrowing cost to be capitalised should be determined by applying the weighted average of the borrowing cost to the expenditure on that asset.

The amount capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

## Disclosure requirement

As per this standard an entity shall disclose the following:

- i. The amount of borrowing cost capitalised during the period.
- ii. The capitalisation rate used to determine the amount of borrowing cost eligible for capitalisation.

### 2.2.3 Investment property (Ind AS 40)

Ramu purchased land and it is held for appreciation (increase in value over time). He also constructed a building and let out for rent. Here the land and building are examples of investment property. If Ramu purchased land intended for sale in the near future and the building was constructed for a third party (or leased to a third party under a finance lease), then it is not an example of an investment property. From this example, it is clear that investment property is a property that an entity holds to earn rental income or capital appreciation. The said example also mentions that investment property differs from other property, which is used in the production or supply or for administrative purposes or held for sale in ordinary course of business.

## Objective

Ind AS 40 prescribe the accounting treatment for investment property and related disclosure requirements.

## Scope

- i. Ind AS 40 should be applied in the recognition, measurement and disclosure in investment property.
- ii. This standard does not apply to
  - ◆ Biological assets related to agricultural activity, which is covered under Ind AS 41 and Ind AS 16.
  - ◆ Mineral rights and mineral reserves such as oil, natural gas and similar non-



regenerative resources, because these are applied as per industries standard.

The Investment property could be held by

- ◊ The owner, or
- ◊ The lessee under a finance or an operating lease

## Definitions

- i. **Investment property:** - is property (land or building – or part of a building – or both) held to earn rental or for capital appreciation or both, rather than for
  - a. Use in the production or supply of goods or services or for administrative purpose or
  - b. Sale in the ordinary course of business
- ii. **Owner-occupied property:** - is property held (by the owner or by the lessee as a right –of – use asset) for use in the production or supply of goods or services or for administrative purposes.  
(Ind AS 16 ‘Property, Plant and Equipment’ applies to owner-occupied property and  
Ind AS 116 ‘Leases’ applies to Owner-Occupied property held by a lessee as a right of use asset.)
- iii. **Fair value:** - is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

## Classification of property as an investment property or owner-occupied property

Investment property is held to earn rentals or capital appreciation or both. Therefore, an investment property generates cash flows largely independent of the other assets held by an entity. This distinguishes investment property from the owner-occupied property.

### Practical examples of Investment Property

The following are examples of investment property:

- a. Land held for long-term capital appreciation rather than for short-term sale in the ordinary course of business.
- b. Land held for a currently undetermined future use. (For example, if an entity has not determined that it will use the land as owner-occupied property or for short-term sale in the ordinary course of business, the land is regarded as held for capital appreciation)
- c. A building owned by the entity and lent out under one or more operating leases.
- d. A building that is vacant but is held to be leased out under one or more operating leases.
- e. Property that is being constructed or developed for future use as an investment property.

## Practical examples of not Investment property

The following items are not examples of investment property and are therefore outside the scope of this standard:

- a. Property intended for sale in the ordinary course of business (for example, property acquired exclusively with a view to subsequent disposal in the near future or for resale).
- b. Property being leased to another entity under a finance lease.
- c. Biological assets related to agricultural activity.
- d. Mineral rights and Mineral reserves such as oil, natural gas, and similar non – generative resources.

## Accounting Treatment

### Recognition

The recognition criteria for investment property are the same as for Property, Plant, and Equipment under Ind AS 16. An owned investment property shall be recognised as an asset when, and only when:

- a. It is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
- b. The cost of the investment property can be measured reliably.

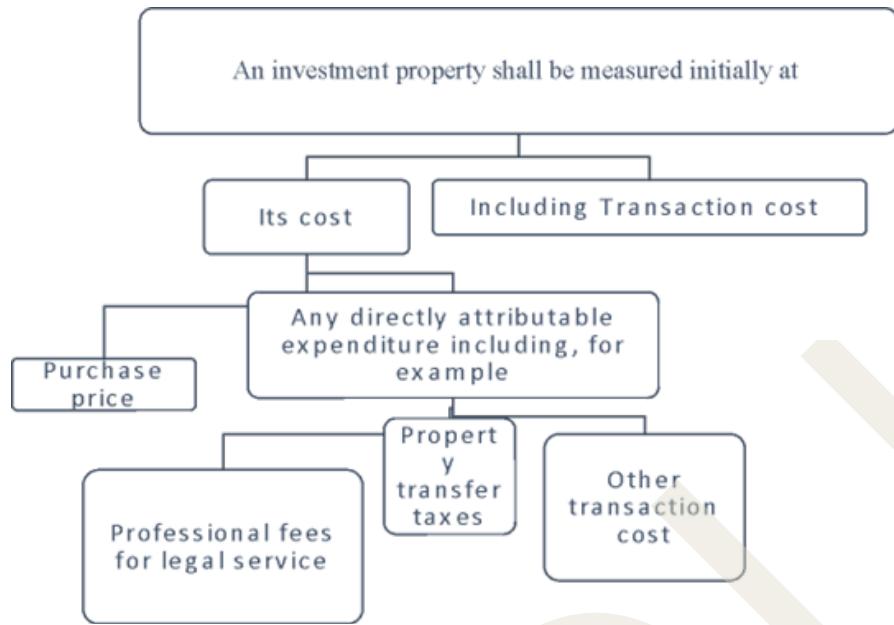
### Measurement at recognition (Initial measurement)

Owned investment property should be measured initially at cost plus any directly attributable expenditure. That is the cost of a purchased investment property comprises: -

- i. Its purchase price and
- ii. Directly attributable expenditure, for example, professional fees for legal service, property transfer taxes, and other transaction costs.

The cost of an investment property is not increased by:

- i. Start-up costs. (Unless they are necessary to bring the property to the condition necessary for it to be capable of operating in the manner intended by management),
- ii. Operating losses incurred before the Investment property achieves the planned level of occupancy, or
- iii. Abnormal amounts of wasted material, labour, or other resources incurred in constructing or developing the property.



**figure 2.2.1 Initial measurement**

The following illustration explains the initial measurement of an investment property.

# I

## Illustration 2.2.1

ABC Ltd purchased a commercial office space as an investment property, in the Universal Trade centre commercial complex for ₹3 crores. However, for purchasing the same, the company had to obtain membership in the Universal Trade centre commercial complex Association by paying ₹ 2.5 Lakh as one-time joining fee. ABC Ltd wants to write off the one-time joining fees paid as an expense under membership and subscription charges and value the investment property at ₹ 3crores. Would you advise a change if the office space was purchased with the intention of using it as an administrative centre of the company?



### Solution

Cost of Investment property: -

As per Ind AS 40, the cost of a purchased investment property comprises its purchase price and any directly attributable expenditure. Accordingly, on initial recognition, the one-time joining fees of ₹ 2.5 Lakh should be added to the purchase price. Therefore, the investment property should be measured at ₹ 30,250,000 (i.e., cost of the commercial office space + one-time joining fee). Writing off the amount of ₹ 2.5Lakh to the profit and loss a/c is not appropriate.

## Use as administrative Office

If the property is used as an administrative centre, it is not an investment property, but rather an 'owner-occupied property'. Hence Ind AS 16 will be applicable.

Even under Ind AS 16, all direct costs relating to the acquisition of the asset should be added to the purchase price. Hence, the cost of the asset under Ind AS 16 would be ₹30,250,000

## Measurement after recognition (Subsequent measurement)

An entity shall choose either the fair value model or the cost model to all of its investment property.

### Fair value model

After initial recognition, an entity that chooses the fair value model shall measure all of its investment property at fair value. For this, the entity should

- ◊ Revalue all its investment property to 'fair value' at the end of each financial year, and
- ◊ Recognise the gain or loss arising from a change in the fair value of investment property in profit or loss for the period.

If an entity has previously measured an investment property at fair value, it shall continue to measure the property at fair value until disposal (or until the property becomes owner-occupied property or the entity begins to develop the property for subsequent sale in the ordinary course of business) even if comparable market transactions become less frequent or market prices become less readily available.

### Cost model

After initial recognition, an entity that chooses the cost model shall measure all of its investment properties in accordance with IAS 16's requirements for that model, other than those that meet the criteria to be classified as held for sale in accordance with Ind AS 105. Investment properties that meet the criteria to be classified as held for sale shall be measured in accordance with Ind AS 105.

## Why investment properties are treated differently from other properties?

The investment properties are treated differently from other properties because an investment property is held primarily because it is expected to be increased in value. It generates economic benefits for the entity because it will eventually be sold at a profit.

The most relevant information about an investment property is its fair value. Depreciation is largely irrelevant. Therefore, it is appropriate to remeasure an investment property to fair value each year and to recognise gains and losses in profit or loss for the period

## Disposal (De-recognition)

An investment property shall be de-recognised (eliminated from the Balance Sheet)



on disposal or when the investment property is permanently withdrawn from use and no future economic benefits are expected from its disposal. The following chart makes it clear that the gains or losses arising from the retirement or disposal of investment property shall be recognised as profit or loss. Compensation from third parties for an investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

## Disclosure

An entity shall disclose:

- i. Its accounting policy for measurement of investment property.
- ii. When classification is difficult, the criteria it uses to distinguish investment property from the owner-occupied property and from property held for sale in the ordinary course of business.
- iii. The methods and assumptions applied in determining the fair value of investment property.
- iv. The extent to which the fair value of investment property is based on a valuation (For example if the valuation is done by a professionally qualified person with experience, it shall be disclosed or if there has been no such valuation, that fact also be disclosed)
- v. The amounts recognised in profit or loss for
  - a. Rental income from investment property
  - b. Operating expenses in relation to investment property
- vi. Contractual obligation to purchase, construct or develop investment property.
- vi. In addition to the general disclosures required above, an entity is required to disclose:
  - a. The depreciation methods used
  - b. The useful life or the depreciation rates used
  - c. The gross carrying amount and the accumulated depreciation at the beginning and end of the period.

### 2.2.4 Revenue from contracts with customers (Ind AS 115)

Vinu's Pizza hut sells pizzas for ₹300 each. One of Vinu's customers, Balu, ordered 10 pizzas. Thus, Vinu earn revenue of ₹3000. This is an example for a contract with customer that earns revenue.

Ind AS 115 is the accounting standard that explains how and when a revenue is to be recognised. The standard mentions that revenue should be recognised as and when the transfer of goods or services takes place with a customer. It provides useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer.

Before going to the details of Ind AS 115, it is to be mentioned that the Ministry of

Corporate Affairs has notified the new revenue recognition standard- Ind AS115 which replaces existing Ind AS 11 (Construction contract) and Ind-AS 18 (Revenue recognition)

## Scope

An entity should apply this standard to all customer contracts except:

- i. Lease contract-Ind AS 17
- ii. Insurance contract- Ind AS 104
- iii. Financial Instruments and other contractual rights or obligations under Ind AS 109, Ind AS 110, Ind AS 111, Ind AS 27 etc.
- iv. Non- monetary exchanges between entities doing similar business to facilitate sales to customers. For example, this standard would not apply to a contract between two oil companies that agree to an exchange of oil to fulfil demand from their customers in different specified locations on a timely basis.

## Definitions

- i. **Contract:** “An agreement between two or more parties that creates enforceable rights and obligations”. From the example of Vinu’s pizza hut, the agreement between Vinu and Balu is a contract.
- ii. **Customer:** “A party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.” From the above example Balu is the customer.
- iii. **Income:** Increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
- iv. **Revenue:** Income arising in the course of an entity’s ordinary activities. In the above example it is ₹3000.
- v. **Transaction price:** “The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer excluding amounts collected on behalf of third parties.”
- vi. **Performance Obligations:** “A promise in a contract with a customer to transfer to the customer either goods or services that is distinct or a series of distinct goods or services.”
- vii. **Stand-alone selling price:** “The price at which goods or services would be sold separately to a customer”

Following example make clear the concept of Transaction price, performance obligation and stand-alone selling price.

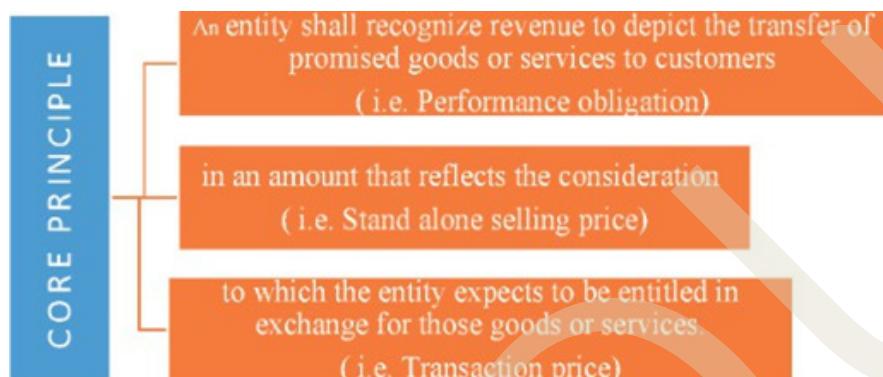
ABC Ltd is a distributor of computer equipment. The entity enters into a contract with a customer to sell a server, a colour printer and a one- year maintenance service for ₹6000, which is the transaction price. The combined stand-alone selling price of the three performances (that is server ₹3000, Printer ₹1200- and one-year maintenance



contract ₹1800) is ₹6000. The promise to sell server, colour printer and one year maintenance service is an example for performance obligation.

## Recognition

The core principle of this standard is that an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The following picture makes it clear:



**figure: 2.2.2 Core principle of Ind AS 115**

There are five steps involved in the recognition of revenue. They are:

### i. Identify the contract with the customer

In order to identify, the following five points are satisfied.

- a. Parties to contract have approved the contract and are committed to perform their respective obligations.
- b. Entity can identify payment terms for the goods or services to be transferred.
- c. Entity can identify each party's rights regarding goods/services to be transferred.
- d. Contract has commercial substance.
- e. It is probable that the entity will collect the consideration.

### ii. Identify the performance obligations in the contract

A performance obligation is a promise (explicit or implicit) to transfer to a customer either

- ◊ Good or service or
- ◊ A series of distinct goods or service that are similar and have the same pattern of transfer. In the above example of ABC Ltd, the promise to sell server, colour printer and one year maintenance service is an example for performance obligation.

Determining performance obligation: Performance Obligations are identified at contract inception and determined based on:

- ◊ Contractual terms
- ◊ Customary business practices

Satisfaction of performance obligations: An entity shall recognise revenue when the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when the customer obtains control of that asset.

### iii. Determine the “Transaction price” for the contract

When a performance obligation is satisfied, an entity shall recognise as revenue the amount of the transaction price that is allocated to that performance obligation.

Transaction price is the amount of consideration to which entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example sales taxes).

While determining the transaction price an entity shall consider the terms of the contract and its customary business practice to determine the transaction price. In the above example of ABC Ltd. the amount of ₹6000 for server, colour printer and one-year maintenance service is the transaction price.

### iv. Allocate the transaction price to each specific performance obligation:

Entity should allocate the transaction price to each performance obligation identified in a contract on a relative stand-alone selling price basis (It is the price at which an entity would sell a promised good or service separately to a customer). In the above example of ABC Ltd, the price allocated to server ₹3000, Printer ₹1200- and one-year maintenance contract ₹1800 is an example for allocation of transaction price. If the price is directly not available it should be estimated by using the following methods.

- a. **The adjusted market assessment approach:** Estimate the price from competitor's price for similar goods or service.
- b. **Expected cost plus a margin approach:** Forecast the expected cost of a satisfying performance obligation and then adding appropriate margin for a goods or services.
- c. **Residual approach:** Total transaction price less sum of observable standalone selling prices of other goods and services.

### v. Recognise the revenue when the entity satisfies each performance obligation

The transaction price allocated to each performance obligation is recognised in two ways either

- ◊ **Over the period of time:** -Means revenue is recognised as and when the performance obligations are satisfied.
- ◊ **At a point in time:** - Means revenue is recognised when complete control is transferred. Revenue is recognised over the period of time if any of the following conditions are met:
  - Customer simultaneously receives and consumes all of the benefit that you provide. For example, cleaning people clean your home every day, so you are simultaneously consuming the benefit of the services every day

but revenue recognised over the period of time.

- The entity's work creates or enhances an asset controlled by the customer. Eg. I have a building on which paint work is done. So, value of building increases, but revenue is recognised over the period of time.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. Here alternative use means the property is specifically being made for the customer. In that case revenue is recognised over the period of time and does not have at the point of time.
- If none of the conditions are satisfied, revenue is recognised at the end, when control is transferred. Here revenue is recognised at a point in time.

There are two methods for recognising revenue. They are:

- ◊ **Output method:** This method recognise revenue on the basis of direct measurements of the value to the customer of the goods/services transferred to date relative to the remaining goods or services promised under the contract.
- ◊ **Input methods:** This method recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labour hours expended, costs incurred, time elapsed or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation.

## Disclosure requirement

Ind AS 115 prescribes a set of disclosure requirements including both qualitative and quantitative information about the nature, amount, timing and uncertainty of revenue and cash flows from contract with customer, especially information about:

- i. Disaggregated information: Revenue recognised from contract with customer, including disaggregation of revenue into appropriate categories.
- ii. Contract balances: including opening and closing balances of receivables, contract assets and contract liabilities and a description of its significant changes.
- iii. Performance obligations: including when the entity typically satisfies its performance obligation and transaction price that is allocated to the remaining performance obligations and explanation of when revenue is expected to be recognised.
- iv. Significant judgments and changes in judgements: made in applying the requirement of those contracts, and
- v. Asset recognised: from cost to obtain or fulfil a contract with a customer.

## Recap

- ◊ IndAS-36- Accounting for impairment of assets.
- ◊ IndAS 23- Borrowing cost.
- ◊ IndAS 40- Investment property.
- ◊ IndAS 115- Revenue from contract with customers.
- ◊ Impaired asset - asset whose market value is below its book value.
- ◊ Impairment loss = Carrying amount — Recoverable amount.
- ◊ Reversal of impairment loss - recovery of the previously recognised impairment loss
- ◊ Borrowing costs - interest and other costs that an entity incurs in connection with the borrowing of funds.
- ◊ Qualifying assets - assets that require a substantial time to bring to their intended use or saleable condition.
- ◊ Investment property - land or building – or part of a building – or both held to earn rental or for capital appreciation or both.
- ◊ Owner-occupied property - is property held by the owner or by the lessee as a right –of – use asset for use in the production or supply of goods or services or for administrative purposes.
- ◊ Revenue should be recognised as and when the transfer of goods or services takes place with a customer
- ◊ Transaction price- amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer excluding amounts collected on behalf of third parties.
- ◊ Performance Obligations- A promise in a contract with a customer to transfer to the customer either goods or services that is distinct or a series of distinct goods or services.
- ◊ Stand-alone selling price- The price at which goods or services would be sold separately to a customer.

## Objective Questions

1. Which standard replaces existing Ind AS 11 (Construction contract) and Ind-As 18 (Revenue recognition)?
2. What is the term which is used to denote the income arising in the course of an entity's ordinary activities?
3. What is the term which is used to denote the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer?
4. What is the price at which goods or services would be sold separately to a customer known as?
5. What is the promise to transfer goods or services to a customer known as?
6. At what method revenue is recognised on the basis of the entity's efforts?
7. What is the property held for use in the production or supply of goods or services or for administrative purposes known as?
8. What is to be done when an investment property is disposed or permanently withdrawn from use?

## Answers

1. Ind AS115 (Revenue from contract with customers)
2. Revenue
3. Transaction price
4. Stand-alone selling price
5. Performance obligation
6. Input method
7. Owner – occupied property
8. De-recognized

## Self-Assessment Questions

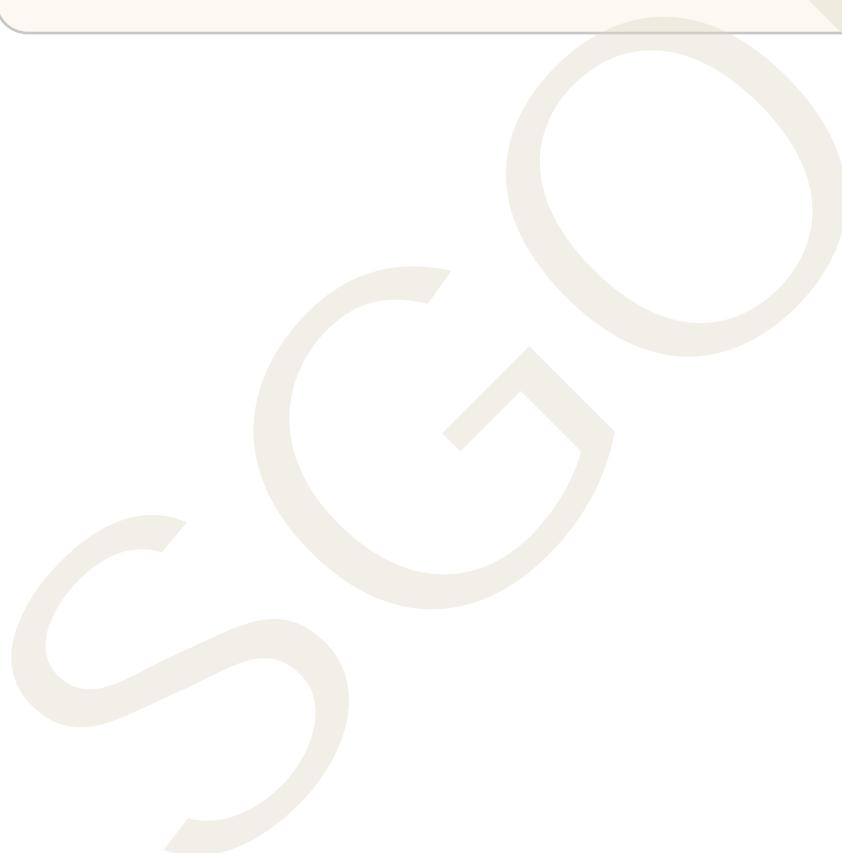
1. Explain Borrowing cost.
2. What do you mean by an impaired asset?
3. When should revenue be recognised as per Ind AS 115?
4. Briefly explain the steps involved in the recognition of revenue.
5. Differentiate investment property and owner-occupied property.
6. How can impairment in assets be identified?
7. Write a short note on the capitalisation of borrowing cost.
8. Discuss the scope of Ind AS 23.

## Assignments

1. Define and differentiate investment property from other types of property as per Ind AS 40. Discuss the criteria and examples for recognizing property as investment property.
2. Prepare an example for following Ind AS Revenue from contracts with customers.
3. Outline the steps involved in assessing impairment of assets as per Ind AS 36. Discuss the indicators of impairment and the procedures for measuring and recognizing impairment losses.
4. Explain the fair value model and the cost model as per Ind AS 40 for the measurement of investment property. Compare and contrast these models, highlighting their implications on financial reporting.

## Suggested Readings

1. Goel, D. K. (2018). *Advanced Financial Accounting*. Vikas Publishing House.
2. Chatterjee, B. K. (2016). *Advanced Financial Accounting* . Vikas Publishing House.
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# Unit 3

## Accounting for Income Tax, Employee Benefits and Provisions, Contingent Liabilities, and Contingent Assets

### Learning Outcomes

After studying this unit, learners able will be able to:

- ◊ acquaint skills in the calculation of deferred tax assets and deferred tax liabilities
- ◊ be aware of employee benefits & provisions
- ◊ gain insights on how the provisions, contingent liabilities and contingent assets are recognized and measured as per IndAS 37

### Prerequisites

Three essential accounting standards—IndAS 12, 19, and 37—combine to handle different but related facets of financial reporting. The goal of IndAS 12 is to identify an entity's current tax assets and liabilities by laying out the accounting method for income taxes. It discusses the distinctions between taxable profit and accounting profit and offers guidelines for income tax recognition, measurement, presentation, and disclosure. Measurement, recognition, and disclosure of employee benefits are outlined in IndAS 19, which guarantees financial reporting transparency and offers insights into an organisation's personnel obligations. Entities must make provisions for liabilities and expenses, contingent liabilities, and contingent assets in accordance with IndAS 37. Understanding this standard is essential because it affects how commitments and uncertainties are taken into account, which has an effect on an organisation's performance and financial situation. In order to ensure accurate and transparent financial statements and help investors, stakeholders, and regulators evaluate the financial performance and health of a company, it is essential to understand these standards.

## Keywords

Accounting for income tax, Employee benefits and provisions, Contingent assets and Liabilities

## Discussion

### 2.3.1 Income Tax (Ind AS 12)

Taxes on income are one of the significant items in the statement of profit and loss of an entity. The objective of Ind AS 12 is to prescribe the accounting treatment for taxes on income. This standard also addressed the reconciliation of the legal tax liability (actual tax payable per tax regulations) with the tax liability and expenses for accounting disclosure purposes.

#### Scope

This standard shall be applicable to accounting for all income taxes, including domestic, foreign, and withholding taxes, as well as the income tax consequences of dividend payments.

**Definitions:** for the purpose of this standard, the following terms are used with the meanings specified:

- i. **Accounting income (loss):** is the net profit or loss for a period, as reported in the statement of profit and loss, before deducting income tax expense or adding income tax savings.
- ii. **Taxable income (tax loss):** is the amount of the income (loss) for a period, determined in accordance with the tax laws, based upon which income tax payable (recoverable) is determined.
- iii. **Tax expense (Tax saving):** is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period.
- iv. **Current tax:** is the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period.
- v. **Deferred tax liabilities:** the amount of income tax payable in respect of the taxable profit for a period.
- vi. **Deferred tax assets:** are the amount of income taxes recoverable in the future period in respect of:
  - a. Deductible temporary differences;
  - b. The carry-forward of unused tax losses and
  - c. The carry forward of unused tax credits.
- vii. **Timing differences:** It is the differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in

one or more subsequent periods.

(Note: Example for timing difference, machinery purchased for scientific research related to business is fully allowed as a deduction in the first year for tax purposes whereas the same would be charged to the statement of profit and loss as depreciation over its useful life. The total depreciation charged on the machinery for accounting purposes and the amount allowed as a deduction for tax purposes will ultimately be the same, but periods over which the depreciation is charged and the deduction is allowed will differ)

Permanent differences are the differences between taxable income and accounting income for a period that originate in one period and do not reverse subsequently. (For instance, if for the purpose of computing taxable income, the tax laws allow only a part of an item of expenditure, the disallowed amount would result in a permanent difference)

**viii. Tax base:** the amount attributed to that asset or liability for tax purposes.

## Recognition

### Recognition of current tax liabilities and assets

Taxes to the extent unpaid for current and prior periods will be recognised as a liability. If the amount already paid for current and prior periods exceeds the actual amount due, then it will be recognised as an asset. When a tax loss is used to recover the current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be measured. The following example makes it clear:

### I Illustration 2.3.1

In 2020, Manu Ltd has a taxable profit of ₹660000. In the previous year (2019), income tax on 2019 profits had been estimated as ₹180000. Any under or over payments are not settled until the following year's tax payment is due. What would be the tax payable and the charge for 2020 if the tax due on 2019 profits was subsequently agreed with the tax authorities as: (a) ₹210000? Or (b) ₹150000? (Assume a 30% tax rate). Calculate the tax charge and liability.

### S Solution

a) If the Tax due on 2019 profit is ₹210000

Tax due on 2020 profit is $(₹660000 \times 30\%)$	= 198000
Add: Underpayment for 2019 (210000 — 180000)	= 30000
Tax charge and liability	<u><u>= 228000</u></u>

b) If the Tax due on 2019 profit is ₹150000

Tax due on 2020 profit is (above)	= 198000
Less: Overpayment for 2019 (180000 — 150000)	= 30000
Tax charge and liability	<u>= 168000</u>

### Recognition of current tax

Current tax should be recognised when taxable profits are earned in the period which it relates in the following manner:

- A current tax expense or income item should be recognised in the income statement.
- A current tax liability should be recognised to the extent that the amounts owing are unpaid to tax authorities.
- A current tax asset should be recognised to the extent that the amount already paid exceeds the amount due.

### Measurement of current tax assets or liabilities

Current tax liabilities or assets will be measured at the amount to be recovered or paid to the tax authorities at the tax rate and laws that have been enacted by the end of the reporting period.

### Tax base

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. The following example makes it clear.

Example 1. If a company has recognised plant and machinery for ₹100 and charges depreciation of ₹30 for the first year but under the tax rule a depreciation charge of ₹40 is allowed, the carrying amount of the asset at the end of the first year is ₹ 70 whereas its tax base is ₹60.

Example 2. Interest receivable has a carrying amount of ₹100, the related interest revenue will be taxed on a cash basis. Then the tax base of the interest receivable is nil.

Example 3. Trade receivables have a carrying amount of ₹100. The related revenue has already been included in taxable profit (tax loss). Then tax base of the trade receivable is ₹100.

The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of the revenue that is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

The following example makes it clear:

Example 1. Current liabilities include interest revenue received in advance, with a carrying amount of ₹100. The related interest revenue was taxed on a cash basis. The

tax base of the interest received in advance is nil.

Example 2. Current liabilities include accrued expenses with a carrying amount of ₹100. The related expense will be deducted for tax purposes on a cash basis. Then tax base of the accrued expenses is nil.

Example 3. Current liabilities include outstanding expenses of ₹100 and if the related expense has already been deducted for tax purposes, the tax base of outstanding expense is ₹100.

## **Difference in accounting profit and taxable profit**

Entities pay income tax on their taxable profits. The taxable profit shall be different from the accounting profit. The main reasons for these differences are; (a) differences in the calculation of depreciation as per the income tax Act and Companies Act. (b) disallowance of certain expenditures under the income tax Act which is further allowed in subsequent years on a payment basis. Thus, the difference arises in accounting profit and taxable profit. As a result, the carrying amount of an asset or liability as per financial statements differs from its tax base. There are two types of differences. They are:

### **a. Permanent differences**

Occurs when certain items of revenue or expenses are excluded from the computation of taxable profit. The differences are not going to be settled in subsequent years.

### **b. Temporary Differences**

It is the differences between the carrying amount of an asset or liability as per financial statements and its tax base. These differences are going to be settled in subsequent years.

Types of temporary differences: There are two types of temporary differences. They are:

- i. Taxable temporary differences: These are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of the future period when the carrying amount of the asset or liability is recovered or settled. The following are the example of circumstances that give rise to taxable temporary differences:
  - ◊ Transactions affecting profit or loss.
  - ◊ Transaction affecting the balance sheet.
- ii. Deductible temporary difference: These are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of the future period when the carrying amount of the asset or liability is recovered or settled. The following are the examples of circumstances that give rise to taxable temporary differences:
  - a. Retirement benefits costs are deducted from accounting profit as the service is provided by the employee. They are not deducted in determining taxable profit until the entity pays the retirement benefits.

- b. Accumulated depreciation in the financial statements is greater than the accumulated depreciation allowed for tax purposes.
- c. Research costs are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.

### Recognition of deferred tax assets

A deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that they are recoverable from future taxable profits. A recent loss is considered evidence that a deferred tax asset should not be recognised. The initial recognition of an asset or liability other than in a business combination which, at the time of the transaction, does not affect accounting profit or taxable profit.

### Measurement of deferred tax

Deferred tax liabilities or assets will be measured at the expected tax rates in the period in which the asset is realised or liability paid, based on the tax laws that have been enacted at the end of the reporting period.

#### I Illustration 2.3.2

ABC Ltd acquired a building for ₹10 Lakh on January 2020. The asset is depreciated at 25% a year on the straight-line basis, and local tax legislation permits the management to depreciate the asset at 30% a year for tax purposes. Calculate any deferred tax liability that might arise on the building at December 31, 2020, assuming a tax rate of 30%.

#### S Solution

Carrying value of the building = 1000000 - 25%	= 750000
Tax base (value of building for tax purposes)= 1000000 - 30%	= 700000
Temporary difference = Carrying value - tax base = 750000 -70000	= 50000
Deferred tax liability = $50,000 \times 30\%$	<hr/> = 15000

#### I Illustration 2.3.3

PK Ltd has worked out the current year's (as of 31-03-2021) tax provision of ₹1000000. There is an additional demand of ₹200000 arising out of final tax liability for the previous year 2019-2020. The balance of deferred tax liability as of 31-03-2021 is ₹ 400000 and on 31-03- 2020 – ₹390000. Determine tax expenses for the year ending 31-03-2021.



## Solution

Current tax	= 1000000
Add: Additional tax demand	= 20000
Less: Reversal of deferred tax liability = 400,000 - 390,000	= 10000
Tax expenses	= ₹ 1010000



## Illustration 2.3.4

ABC Ltd acquired an asset. The depreciable amount of assets as on 31-3-2020 is ₹300000 and as on 31-03-21 is ₹270000. The tax base of the depreciable asset as on 31-03-2020 is ₹300000 and as on 31-03- 2021 is ₹225000. Compute deferred tax liability assuming a tax rate of 30%



## Solution

The depreciation amount at the beginning and the tax base at the beginning are the same i.e. ₹300,000 each.

Depreciation amount at 31-03-2021	= 270000
The tax base of depreciable assets	= 225000
Temporary difference = 270000 - 225000	= 45000
Deferred tax liability $45000 \times 30\%$	= ₹13500



## Illustration 2.3.5

From the following information compute deferred tax liability/ tax asset for the year 2020-2021: (Assume a tax rate of 30%).

Depreciable amount as on 31-03-2020	₹ 860000
Depreciable amount as on 31-03-2021	₹ 840000
Tax base on depreciable asset:	
As on 31-03-2020	₹850000
As on 31-03-2021	₹820000

# S

## Solution

Tax liability at the beginning (860000 -850000)	= 10000
Tax on tax liability @30% = $10000 \times 30\%$	= 3000
Tax liability at the end (840000-820000)	= 20000
Tax on tax liability @ 30% = $20,000 \times 30\%$	<u>= 6000</u>
Deferred tax liability (3000 + 6000)	<u>= ₹9000</u>

# I

## Illustration 2.3.6

From the following information compute deferred tax liability/ deferred tax asset assuming a tax rate of 30%.

Depreciation at the beginning	₹930000
Depreciation at the end	₹780000

Tax base on depreciable assets:

At the beginning	₹990000
At the end	₹705000

# S

## Solution

Tax asset at the beginning 990000 - 930000	= 60000
Tax on tax asset @30% = $60000 \times 30\%$	= 18000
Tax liability at the end (780000 -705000)	= 75000
Tax on tax liability @ 30% = $75000 \times 30\%$	<u>= 22500</u>
Deferred tax liability (22500 -18000)	<u>= ₹4500</u>

(Note: here at the beginning tax base is more than the depreciable amount. So, there is a tax asset at the beginning. At the end, depreciable amount is more than the tax amount. So, there is a tax liability at the end)

### 2.3.2 Employee benefits (Ind AS 19)

In this day and age, more and more companies have employees for work. Employee benefits play an important role in the lives of employees and their families and have a significant financial and administrative impact on a business organisation. Most of

the companies offer a lot of employment benefits in the form of incentives, providing overtime payment, insurance or in non-financial form like giving training and development for employees to develop their career, etc..

## Objective

The objective of Ind AS19 is to prescribe the accounting and disclosure for employee benefits. The standard requires an entity to recognise:

- ◊ A liability when an employee has provided service in exchange for employee benefits to be paid in the future and
- ◊ An expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

## Scope

This standard shall be applied by an employer in accounting for all employee benefits, except those to which Ind AS 102, 'share-based payment' applies.

## Definition

For the purpose of this standard, the following terms are used with the meanings specified.

- i. **Employee benefits:** are all forms of consideration given by an entity in exchange for service rendered by employees.
- ii. **Equity Compensation plans:** are formal or informal arrangement under which an entity provides equity compensation benefit for one or more employees.
- iii. **Vested employee benefits:** are employee benefits that are not based on condition on future employment.
- iv. **Plan assets:** consist of assets held by long term employee benefit fund and qualifying insurance policies.
- v. **Return on plan assets:** Comprises interest, dividends, and other revenue derived from the plan assets, together with realised and unrealised gains, or losses on the plan assets, less any cost of administering the plan and less any tax payable.

## Types of employment benefit

Employee benefits include:

- i. Short term employee benefits.
- ii. Post-employment benefits
- iii. Other long-term employee benefits.
- iv. Termination benefits

### i. Short-term employee benefit:

Short-term employee benefits are those expected to be settled wholly before twelve months after the end of the annual reporting period during which employee services are

rendered, but do not include termination benefits. Examples of Short-term employee benefits are wages, salaries, and social security contributions paid annual leave, paid sick leave, profit sharing, and bonuses paid to current employees.

## Recognition and measurement

When an employee has rendered service to an entity during an accounting period, the entity shall recognise the undiscounted amount of short-term employee benefits expected to be paid in exchange for that service:

- a. As a liability (accrued expense) after deducting any amount already paid.
- b. As an expense, unless another Standard requires or permits the inclusion of the benefits in the cost of an asset.

For example: If any employee was present on 15 August, in fact when that day was a holiday and his presence on 15 August gave him a right to either take a leave on any day after 2 October or take cash for it. According to Ind AS 19 company should recognise an expense for the presence of employees on 15 August. Or if that employee was working on any under-construction Asset/Project then that expense should be capitalised as explained in Ind AS -2 /Ind AS 16.

### ii. Post-employment Benefits

Post-employment benefits are employee benefits (other than termination benefits and short- term employee benefits) that are payable after the completion of employment. Examples: pension, another retirement benefit, post-employment life insurance, and post-employment medical care, etc.

The accounting treatment for a post-employment benefit plan depends on the economic substance of the plan and results in the plan being classified as either a defined contribution plan or a defined benefit plan:

- ◊ Defined contribution plans: A retirement plan in which both the employee and employer can contribute to the employee's individual account. (Example-contributory pension scheme.) Here the entity's obligation is limited to the amount it agrees to contribute to the fund and effectively places actuarial and investment risk on the employee
- ◊ Defined benefit plan: A retirement plan in which employers guarantee a specific retirement benefit amount for each participant that is based on factors such as the employee's salary and years of service (for example, a Statutory pension scheme). These plans create an obligation on the entity to provide agreed benefit to current and past employees and effectively places actuarial and investment risk on the entity.

## Recognition and measurement of post-employment benefits

Rules for recognition and measurement of defined contribution plans are given below:

- a. Contributions to a defined contribution plan should be recognised as an expense in the period they are payable.
- b. Any liability or unpaid contributions that are due at the end of the period should be recognised as a liability.
- c. Any excess contribution paid should be recognised as an asset, but only to the extent that prepayment will lead to a reduction in future payments or a cash refund.

### **iii. Other long-term employee benefits:**

Other long-term benefits are all employee benefits other than short-term employee benefits, post-employment benefits, and termination benefits. It includes long-service leave, jubilee or other long-service benefits, long-term disability benefits, etc..

### **Recognition and measurement of other long-term employee benefits:**

This standard stipulates a simplified accounting method for other long-term benefits and does not require re-measurements in other comprehensive income. The net total of the following amounts should be recognised in the profit and loss statement:

- a. Service cost
- b. Net interest on the net defined benefit liability (or asset)
- c. Past service cost

### **iv. Termination Benefits**

Termination benefits are cash and other services paid to employees when their employment has been terminated. The most common termination benefits are a severance payment (an amount paid to an employee on the early termination of a contract.), extended health insurance coverage and assistance in finding a new job, etc.

### **Recognition and measurement of termination benefit**

An employer should recognise termination benefits as a liability and as an expense at the earlier of the following dates:

- i. The employer can no longer withdraw the offer for those benefits.
- ii. The employer recognises restructuring cost per Ind AS 37 and involves payment of termination benefits.

## **2.3.3 Provisions, Contingent Liabilities, and Contingent Assets (Ind AS 37)**

Let's say Devu & Co has filed a lawsuit against Marva Ltd. If there is a decent chance that Devu & Co will win the case, it has a contingent asset. From this, it is clear that a contingent asset is a potential economic benefit that is dependent on future events out of a company's control. Not knowing for certain whether these gains will materialise, or being able to determine their precise economic value. This potential asset will generally be disclosed in its financial statement, but not recorded as an asset until the lawsuit is settled.

Based on this same example, Marva Ltd would need to disclose a potential contingent

liability in its notes and then later record it in its accounts, should it lose the lawsuit and be ordered to pay damages. From this, it is clear that contingent liability is a liability that may occur depending on the outcome of an uncertain future event. It is recorded if the contingency is likely and the amount of the liability can be reasonably estimated.

While studying the Balance Sheet, you often might have noticed an entry known as provisions, which was listed on the liabilities side of a Balance Sheet. Provisions in accounting refer to the amount that is generally put aside from the profit in order to meet a probable future expense or a reduction in the asset value although the exact amount is unknown. Ind AS 37 provide appropriate recognition criteria and measurement bases applied to provision, contingent liabilities, and contingent assets.

## Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities, and contingent assets and to specify the information to be disclosed in the notes to the financial statement.

## Scope

Ind AS 37 shall be applied by all entities in accounting for provision, contingent liabilities, and contingent assets, except those resulting from:

- i. Financial instrument carried at fair value (Ind AS 39).
- ii. Executory contract (for example, contracts under which both parties have partially performed their obligations to an equal extent).
- iii. Insurance contracts with policyholders (IFRS 4).
- iv. Events or transactions covered by any other IAS (for example, income taxes and lease obligations).

## Definitions

For the purpose of this standard, the following terms are used with the meanings specified.

- a. Provisions: A liability of uncertain timing or amount.
- b. Liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- c. An obligating event: is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation:
  - i. A legal obligation is an obligation that derives from the (a) contract, (b) Legislation: or (c) other operation of law.
  - ii. A constructive obligation is an obligation that derives from an entity's actions.

## Recognition

### a. Provision

The Standard defines a provision as a liability of uncertain timing or amount and prescribes conditions that have to be satisfied for recognition of a provision.

### Recognition of provision

A provision shall be recognised when:

- ◊ An entity has a present obligation (legal or constructive) that is a result of past events;
- ◊ It is probable that a payment will be required to settle the obligation;
- ◊ A reliable estimate can be made of the amount of the obligation.

This standard also mentions that no present obligation exists at the end of the reporting period, the entity discloses a contingent liability unless the possibility of an outflow of resources embodying economic benefit is remote.

The following example makes it clear:

### I

### Illustration 2.3.7

The entity is an Electrical component manufacturer. The Electrical manufacturer has specified a delivery schedule, non-adherence to which will entail a penalty. As on March 31, 2021, the reporting date, the manufacturer has a delivery scheduled for June 2021. However, the manufacturer is aware that he will not be able to meet the delivery schedule in October 2021. Determine whether the entity has a present obligation as at March 31, 2021 requiring recognition of provision.

### S

### Solution

In this case, there is no present obligation arising out of a past event as the goods are scheduled for delivery in October 2021 and there is no delay as at March 31, 2021. Hence, there is no present obligation to pay the penalty in the current year. Therefore, no provision can be recognised in the instant case.

## Measurement of provision

The amount recognised as a provision should be the best estimate of the expenditure to settle the obligation, at the balance sheet date. This is the amount that is to be paid to settle the obligation or to transfer it to a third party at the Balance Sheet date. The estimates are determined by the judgement of management supplemented by experience of similar transactions and in some cases, reports from experts.

### b. Contingent liabilities

A contingent liability is:



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◊ A present obligation that arises from past events but is not recognised because:

- It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.
- The amount of the obligation cannot be measured with sufficient reliability.
- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

### Recognition of contingent liability

An entity should not recognise contingent liabilities in the financial statements, instead, it is required to be disclosed them by way of notes below the Balance Sheet.

#### c. Contingent assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity.

#### Recognition of contingent asset

An entity shall not recognise a contingent asset. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. A contingent asset, where an inflow of economic benefits is probable, shall be disclosed.

## I

### Illustration 2.3.8

An automobile dealer also owns a workshop that it uses for servicing automobiles under warranty. In preparing its financial statements, the automobile dealership needs to ascertain the provision of warranty that it would be required to provide a year-end. The entity's past experience with warranty claims is:

- i. 40% of automobiles sold in a year have zero defects
- ii. 35% of automobiles sold in a year have normal defects
- iii. 25% of automobiles sold in a year have significant defects

The cost of rectifying a "normal defect" in an automobile is ₹10000. The cost of rectifying a significant defect in an automobile is ₹30000. Compute the amount of "provision for warranty" needed at year-end.

## S

### Solution

The expected value of the provision for warranty needed at year-end

$$= (40\% \times 0) + (35\% \times 10000) + (25\% \times 30000) = ₹11000$$

## Recap

- ◊ IndAS 12- Income tax
- ◊ IndAS 19- Employee benefits
- ◊ Ind AS 37- Provisions, contingent liabilities, and contingent assets
- ◊ Provisions - liability of uncertain timing or amount.
- ◊ Tax base - amount attributed to a particular asset or liability for tax purpose.
- ◊ If the amount already paid for current and prior periods exceeds the actual amount due, then it will be recognised as an asset
- ◊ A deferred tax asset is recognised for all deductible temporary differences to the extent that it is probable that they are recoverable from future taxable profits.
- ◊ Deferred tax liabilities or assets will be measured at the expected tax rates in the period in which the asset is realised or liability paid based on the tax laws
- ◊ Employee benefit - are all forms of consideration given by an entity in exchange for service rendered by employees.
- ◊ Short-term employee benefits -are expected to be settled before 12 months.
- ◊ Post-employment benefits- are payable after the completion of employment.
- ◊ Other long-term benefits - are all employee benefits other than short-term employee benefit, post-employment benefit and termination benefit.
- ◊ Termination benefits - are cash and other services paid to employees when their employment has been terminated.

## Objective Questions

1. Which Indian Accounting standard that deals with provision, contingent liabilities, and contingent assets?
2. What is the asset that usually arises from unplanned or other unexpected events?
3. What is the liability for uncertain timing or amount?
4. State the obligation that derives from (a) contract, (b) Legislation: or (c) other operation of law.

5. Which Indian Accounting standard that deals with income tax?
6. What is the aggregate of current tax and deferred tax charged or credited to the statement of profit and loss for the period?
7. What is the amount of income tax determined to be payable in respect of the taxable income for a period?
8. What are the differences between taxable income and accounting income for a period?

## Answers

1. IndAS 37
2. Contingent assets
3. Provisions
4. Legal obligation
5. Ind AS 12
6. Tax expense (Tax saving)
7. Current tax
8. Timing differences

## Self-Assessment Questions

1. Differentiate between accounting profit and taxable profit.
2. Explain the different types of employment benefits.
3. What is the objective of Ind As 19?
4. What do you mean by provision?
5. Distinguish between contingent asset and contingent liability.
6. Write a short note on timing differences.
7. What is an obligation that derives from an entity's actions?
8. Explain Ind As 12.

## Assignments

1. How does Ind AS 12 address the recognition, measurement, presentation, and disclosure of income tax in financial statements? Discuss the key principles and requirements.
2. Conduct a brief analysis of Indian accounting standards and their effects on financial reporting and practices of modern business organisation in Kerala.
3. Explain the concept of deferred tax assets and liabilities as per Ind AS 12. Provide examples of temporary and permanent differences and their impact on the recognition of deferred taxes.
4. Explain the differentiation between provisions, contingent liabilities, and contingent assets as per Ind AS 37. Provide scenarios illustrating each and their impact on financial statements.

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BLOCK

## HIRE PURCHASE AND INSTALMENTS

# Unit 1

## Introduction to Accounts of Hire Purchase and Instalment System

### Learning Outcomes

After completing the unit, the learner will be able to:

- ◊ familiarise the concept of hire purchase and installment systems.
- ◊ get awareness on the features of hire purchase.
- ◊ distinguish between hire purchase and instalment payment systems.

### Prerequisites

In today's competitive market, there are a large number of products offered for sale in the market. Customers used to buy such products with a view to satisfying their various needs. Every customer may not be able to purchase these articles by paying ready cash. There are different methods for transferring the possession and ownership of goods from the seller to the purchaser. Goods are sold for cash (where ready payment is made immediately) as well as for credit (where the payment is made on a future date). In the case of a cash sale, both the possession and ownership are transferred from the seller to the buyer immediately after making payment. Some trading concerns adopt two techniques to sell their goods under easy terms and conditions which includes Hire purchase system and Installment purchase system that is going to be explained in the present unit.

### Keywords

Hire purchase system, Possession, Ownership, Down payment, Interest, Default and repossession, and Instalment system

## Discussion

### 3.1.1 Hire purchase system

Raja purchased a car from Ramu, a car dealer on 1 January 2020. Raja paid ₹100000 ready cash and agreed to pay the balance amount in three instalments each on 31 December of every year. The price of the car is ₹372500 and Ramu charges interest at 5% per annum. In this case, there is an arrangement between Ramu and Raja, such that Raja buys the car, but payment is made in instalments. The ownership of the goods will be with Ramu till the payment is completely cleared. This arrangement is known as Hire Purchase agreement.

From the above example, it is clear that Hire Purchase System is a special system of purchase and sale. When goods are purchased on the hire purchase system, the purchaser pays the price in instalments, these instalments may be monthly, yearly or of any other period. Goods are delivered to the purchaser and purchaser becomes the owner of these goods only on the payment of the last installments. All the installments are treated as hire till the last installment is paid off.

The term 'hire purchase' has been originated in the United Kingdom and this is similar to Rent- to-own system in the U.S.A. Hire purchase is an arrangement for buying expensive consumer goods, where the buyer makes an initial down payment and pays the balance plus interest in instalments. It is a system of purchase wherein the seller gives the physical possession of the goods to the buyer immediately after signing of the agreement on the condition that the purchase price should be paid by the buyer in a specific number of instalments and the ownership of the goods will be transferred after the receipt of all instalments.

According to the Hire Purchase Act of 1972, the term Hire purchase can be defined as "an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement, and it includes:

- i. Possession of goods is delivered by the owner thereof to a person on the condition that such persons pay the agreed amount in periodic payments.
- ii. The ownership of the goods is to pass to such a person on the payment of the last of such instalments.
- iii. Such a person has a right to terminate the agreement at any time before the property to passes.

There are two parties to the hire purchase agreement. One is the **hire vendor**, who is the seller and the other is the **hire purchaser**, the buyer. The hire purchaser exercises the option of purchasing. He may even return the goods if he is not satisfied with their quality or performance. In some of the hire-purchase contracts, there are three parties: the seller, the financier and the hirer.

Under the hire purchase system, the payment for the goods will be made by the hire purchaser in instalments. Each instalment includes a portion of cash price and interest. If the buyer stops the payment of instalment, the goods will be repossessed by the seller.

In the above example, if Raja makes any default in payment of instalment, then Ramu will take back (repossess) the goods, and can file a suit in the court of law for recovery of price. Similarly, Raja has the right to terminate the agreement at any time before the ownership passes. So, it is clear that the hire vendor has the right to file a suit in the court of law for recovery of price and the hire purchaser has the right to terminate the agreement any time before the ownership passes.

### 3.1.1.1 Features of the Hire Purchase System

The following are the main features of the hire purchase system:

- i. **Agreement:** There is an agreement between the seller and the purchaser.
- ii. **Possession:** The possession of goods immediately passes from the seller to the buyer on signing the agreement.
- iii. **Instalments:** The buyer will make payment in instalments over a period of time.
- iv. **Constituents of hire purchase instalment:** Each instalment consists partly of a financial charge (interest) and partly of capital payment (cash price) and is treated as a hire charge till the instalment is paid.
- v. **Option to return the goods:** The buyer has the option to return the goods to the seller and can terminate the agreement if the buyer does not want to pay the rest of the instalments.
- vi. **Repossession:** If there is any default in payment of any instalment, the seller has a right to repossess the goods sold on hire purchase and forfeit the amount already received either as a down payment or in instalments.
- vii. **Ownership:** The ownership of the goods will remain with the seller and passes to the buyer on payment of the last instalment.

### 3.1.1.2 Hire Purchase Agreement

Hire purchase agreement is an agreement in writing and signed by hire purchaser and the hire vendor. The agreement must contain a description of the goods, the hire purchase price of the goods, the date of commencement of the agreement, the number of instalments, the interest, and the amount to be paid in each instalment, etc..

### 3.1.1.3 Terms used in Hire Purchase Agreements

- i. **Hire purchaser/ hirer:** - A hire purchaser is a person who possesses (receives) the goods under the hire purchase agreement. In the above example, Raja is the hire purchaser.
- ii. **Hire vendor:** - A person who sells the goods under the hire purchase agreement. In the above example, Ramu is the hire vendor.
- iii. **Cash price:** - It is the price of the goods which are sold under the contract of sale. In the above example, it is ₹372500
- iv. **Hire purchase price:** - It is the price at which goods are sold under the hire

purchase system. It includes the cash price of the goods and interest. In our example it is ₹400000 (i.e.,  $100000 + 100000 \times 3$ )

- v. **Hire charges/Interest:** - It is the difference between the hire purchase price and cash price. In our example, it is ₹27500 ( $400000 - 372500$ )
- vi. **Instalment money:** This is the part of hire purchase price paid by the hire purchaser in periodic intervals. In our example, it is ₹100000
- vii. **Down payment:** - It is the initial payment made by the hire purchaser to the hire vendor at the time of entering into the hire purchase agreement. In our example, it is ₹100000

### 3.1.1.4 Advantages and disadvantages of hire purchase system

From the above example, it is clear that Raja (hire purchaser) enjoys some advantages from hire purchase:

- i. He gets immediate delivery and use of assets without paying the entire amount.
- ii. As the payment is spread over a period of time, he can utilise the expensive assets without much financial burden.
- iii. Raja is not worried about the depreciation of the assets, because there is no obligation to buy the asset.
- iv. As all the expenditures are known in advance, fixed rental payment makes budgeting easier.
- v. Small-scale companies and entrepreneurs can benefit from Hire Purchase. Expensive and important assets can be hired and later owned. This ensures that they can start using the asset from the very first day and use the money earned to own the same assets.

However, hire purchase system is not free from disadvantages. They are:

- i. Long duration of the rental payment system is a liability to Raja.
- ii. Similarly, high interest rate is a burden to the hire purchaser which in effect increases the price.
- iii. The hire purchaser gets the ownership of the goods only after a long period and he can modify the asset only after getting the ownership.

### 3.1.2 Instalment Purchase System

If you purchase a Motorbike on the hire purchase system, the ownership is transferred only after paying the last instalment. But in some cases, the ownership of the goods passes to the buyer at the time of signing the contract. Such a system is known as an instalment system.

An instalment purchase system is a contract used to finance the acquisition of assets. Under this system, the buyer pays the seller the full purchase price by making a series of partial payments over time. The payments include stated or imputed interest. The buyer takes title to the property at the initiation of the agreement. The seller retains a security interest in the property until all of the specified payments have been made.

### 3.1.2.1 Features of Instalment System

The following are the features of instalment system:

- i. The ownership and possession over the property is transferred immediately.
- ii. The buyer makes the payment of the purchase price in instalments.
- iii. The seller has the right to file suit against the buyer or take recovery of the property if the buyer makes default in the payment of instalments.

### 3.1.3 Difference between Hire Purchase and Instalment System

Basis	Hire Purchase	Instalment System
Time of ownership	Ownership is said to transfer only on payment of last instalment	Ownership is said to have transferred at the very inception of the agreement
Right to terminate	Hire purchaser has the right to terminate the agreement and return the goods	Buyer does not have the right to terminate the instalment purchase agreement
Charges	Monthly payment here is termed as Hire charges	Monthly payment here is termed as instalment
Risk, repairs etc.	All the risks are borne by the Hire vendor till the last payment by the hirer	The risk is borne by the buyer from the day itself.
Right to sell	Such rights lie with the hire vendor because they are the owners	It is with the buyer because he becomes the owner on day one itself
Default	The hire vendor has the right to forfeit the money paid to date	The seller cannot forfeit the instalments already received. Seller can only sue for the unpaid balance.

## Recap

- ◊ Hire purchase- An agreement between two parties called hire vendor and hire purchaser.
- ◊ Seller- Hire vendor
- ◊ Buyer - Hire purchaser
- ◊ Hire purchase- Seller delivers the goods to the buyer without transferring the ownership of goods.
- ◊ When the buyer completes all the instalments, hire purchaser gets the ownership of goods.
- ◊ Hire charges- Monthly payment made under hire purchase system.
- ◊ Instalment system- Ownership and possession is immediately transferred.
- ◊ Instalment- Monthly payment made under instalment system.

## Objective Questions

1. In which system, the seller of goods delivers the goods to the buyer without transferring ownership of the goods?
2. How are payments made in the hire purchase system?
3. What happens to the goods if the buyer stops paying the instalments in a hire purchase system?
4. What is instalment?
5. What term is used to denote a person who sells under a hire purchase agreement?
6. Which price includes the cash price of the goods and interest?
7. What is the name of the initial payment made by the hire purchaser to the hire vendor at the time of entering into the hire purchase agreement?
8. What is the difference between the hire purchase price and the cash price?

## Answers

1. Hire purchase system
2. Instalments
3. Goods can be repossessed by the vendor
4. Monthly payments made in instalment system
5. Hire vendor
6. Hire purchase price
7. Down payment
8. Hire charges

## Self-Assessment Questions

1. Distinguish between hire purchase system and instalment system.
2. What are the characteristics of hire purchase?
3. How is cash price different from hire purchase price in hire purchase?
4. Who is a hire vendor?
5. Differentiate hire charges and instalments.
6. Explain instalment system.
7. State the features on instalment system.
8. What are the merits and demerits in hire purchase system?

## Assignments

1. Explain the Hire Purchase system with the help of examples and list out the items falling under hire purchase.
2. Discuss the advantages and disadvantages of the hire purchase system for both the buyer and the seller.
3. Discuss situations where a hire purchase arrangement might be more advantageous than an outright purchase or leasing.
4. Analyse the legal implications and procedures in case of default or breach of contract by either party in a hire purchase agreement.

## Suggested Readings

1. Radhaswamy, M., & Raman, S. (2018). *Advanced Accountancy* (Vol. 1 and 2). Sultan Chand & Sons.
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# Unit 2

## Accounts of Hire Purchase System

### Learning Outcomes

After studying this unit, the learner will be able to:

- ◊ acquaint knowledge on the accounting entries in the books of the purchaser and vendor
- ◊ get awareness on the accounting treatment in the case of default and repossession.
- ◊ gain insights on complete and partial repossession.

### Prerequisites

Hire purchase is an arrangement for buying expensive consumer goods, where the buyer makes an initial down payment and pays the balance plus interest in instalments. It is a system of purchase wherein the seller gives the physical possession of the goods to the buyer immediately after signing of the agreement on the condition that the purchase price should be paid by the buyer in a specific number of instalments. Ownership of the asset is passed to the hirer upon the conclusion of the hire purchase agreement, or following the last payment. After then, the hirer registers the item at its full value and deletes the obligation from their books. After the asset is removed and any outstanding payments are acknowledged, the hire purchase account is closed by the vendor.

Throughout the term of the hire purchase agreement, this accounting treatment represents the progressive transfer of ownership as well as the reporting of income and liabilities. To ensure openness and adhere to accounting rules, it is imperative that all parties accurately record and report these transactions.

## Keywords

Accounts of Hire Purchase system, Default in Payment, Complete and Partial Repossession

## Discussion

### 3.2.1 Hire purchase system

As we have studied earlier, there are two parties to a hire purchase agreement i.e., the Hire purchaser and the hire vendor. Both these parties have to maintain books of accounts and record all the transactions relating to the particular hire purchase. Let us now see how accounting records are maintained in the books of

1. Hire purchaser and
2. Hire vendor

#### 3.2.1.1 In the Books of the Hire Purchaser

To have a proper accounting record, some information is required with regard to the hire purchase transactions. They are:

- i. Date of purchase of the asset.
- ii. Date of closing the books.
- iii. Cash price of an asset.
- iv. Amount of down payment.
- v. Number and amount of each instalment.
- vi. Rate of interest.
- vii. Method and rate of depreciation.

There are three methods of recording hire purchase transactions in the books of hire purchasers. They are:

- i. Full cash price method
- ii. Actual cash price method
- iii. Interest suspense method

Here we discuss only the first two methods. The third method is not popular.

#### Full cash price method

Under this method, the full cash price of the asset is debited to the Asset Account and credited to the Hire Vendor Account, therefore, it is also called Full Cash Price Method.

## Journal entries

- i. When an asset is acquired on hire purchase  
Asset A/c Dr (Full cash price)  
To Hire vendor A/c
- ii. When a down payment is made  
Hire vendor A/c Dr (Down payment)  
To Cash A/c
- iii. When interest becomes due  
Interest A/c Dr (Interest on the outstanding balance)  
To Hire vendor A/c
- iv. When an instalment is paid  
Hire vendor A/c Dr (Amount of instalment.)  
To Cash A/c
- v. When depreciation is charged on an asset  
Depreciation A/c Dr (Depreciation on cash price)  
To Asset A/c
- vi. For Transfer of interest and Depreciation to profit and loss A/c  
Profit and Loss A/c Dr  
To Interest A/c  
To Depreciation A/c

Entries 3 to 6 will be repeated for all subsequent instalments.

With the help of the journal entries, we can prepare the Asset Account and the Hire vendor's Account. Look at the illustrations and see how the entries are passed and ledger accounts made in the books of the hire purchaser.

### Disclosure in the Balance Sheet

#### Assets

Fixed assets:

Asset (at cash price)	xxxx
<u>Less</u>	
Depreciation	xxxx

#### Liabilities

Hire purchase creditors:

Balance in hire vendor's A/c	xxxx
Interest accrued	xxxx
	xxxx

## I

### Illustration 3.2.1

On 1 April 2017, Devu & Co. purchased a machine from Adani enterprises on hire purchase basis. The cash price of the machine was ₹25000. The payment was to be made



₹5000 on the date of the contract and the balance in 4 annual instalments of ₹5000 plus interest at 5% per annum payable on 31 December each year, the first instalment being payable on 31-12-2017.

Show journal entries and ledger accounts in the books of Devu & Co assuming the accounts are closed on 31 December and depreciation at 10% p.a. written off on the original cost. Also, show how the items will appear in the Balance sheet of relevant periods.



## Solution

- a. Hire purchaser - Devu & Co
- b. Hire vendor - Adani enterprises
- c. Date of Purchase - 1 April 2017
- d. Down payment - ₹5000
- e. Date at which the installment become due - December 31- 2017, 2018, 2019, and 2020
- f. Date of closure of accounts - December 31
- g. Cash price - ₹25000
- h. Number of Instalment - 4
- i. Amount of instalment ₹5000 + Interest =  

$$1^{\text{st}} - 5000 + 750 = ₹5750$$

$$2^{\text{nd}} - 5000 + 750 = ₹5750$$

$$3^{\text{rd}} - 5000 + 500 = ₹5500$$

$$4^{\text{th}} - 5000 + 250 = ₹5250$$
- j. Interest Rate - 5% per annum
- k. Depreciation Rate - 10% per annum
- l. Method of depreciation - Original cost method

### Journal entries in the books of Devu Co.

Date	Particulars	Amount (Dr.)	Amount (Cr.)
2017 April 1	Machinery A/c To Adani enterprises A/c (Cash price of Machinery purchased on hire purchase basis credited to Adani enterprise)	Dr 25000	25000
2017 April 1	Adani Enterprises A/c To Cash A/c (Amount of down payment paid)	Dr 5000	5000

Dec 31	Interest A/c To Adani enterprise A/c (Interest due to the vendor for 9 months)	Dr	750	750
Dec 31	Adani enterprises A/c To Cash A/c (Amount of instalment paid)	Dr	5750	5750
Dec 31	Depreciation A/c To Machinery A/c (Depreciation on machinery for 9 months)	Dr	1875	1875
Dec 31	Profit and loss A/c To Interest A/c To Depreciation A/c (Interest and depreciation transferred to P/L A/c)	Dr	2625	750 1875
2018	Interest A/c To Adani enterprise A/c (Interest due to the vendor for the year)	Dr	750	750
Dec 31	Adani enterprises A/c To Cash A/c (Amount of instalment paid)	Dr	5750	5750
Dec 31	Depreciation A/c To Machinery A/c (Depreciation on machinery)	Dr	2500	2500
Dec 31	Profit and loss A/c To Interest A/c To Depreciation A/c (Interest and depreciation transferred to P/L A/c)	Dr	3250	750 2500
2019	Interest A/c To Adani enterprise A/c (Interest due to the vendor for the year)	Dr	500	500
Dec 31	Adani enterprises A/c To Cash A/c (Amount of instalment paid)	Dr	5500	5500
Dec 31	Depreciation A/c To Machinery A/c (Depreciation on machinery for the year)	Dr	2500	2500

Dec 31	Profit and loss A/c To Interest A/c To Depreciation A/c (Interest and depreciation transferred to P/L A/c)	Dr	3000	500 2500
2020	Interest A/c To Adani enterprise A/c (Interest due to the vendor for the year)	Dr	250	250
Dec 31	Adani enterprises A/c To Cash A/c (Amount of instalment paid)	Dr	5250	5250
Dec 31	Depreciation A/c To Machinery A/c (Depreciation on machinery for the year)	Dr	2500	2500
Dec 31	Profit and loss A/c To Interest A/c To Depreciation A/c (Interest and depreciation transferred to P/L A/c)	Dr	2750	250 2500

**Note:**

Down payment does not include interest

$$1. \text{ 1}^{\text{st}} \text{ year interest} - \text{For 9 months} = 20000 \times \frac{5}{100} \times \frac{9}{12} = 750$$

$$2. \text{ 2}^{\text{nd}} \text{ year interest-For 12 months} = 15000 \times \frac{5}{100} = 750$$

$$3. \text{ 3}^{\text{rd}} \text{ year interest-For 12 months} = 10000 \times \frac{5}{100} = 500$$

$$4. \text{ 4}^{\text{th}} \text{ year interest -For 12 months} = 5000 \times \frac{5}{100} = 250$$

5. Calculation of depreciation

$$\text{First-year—for 9 months} = 25000 \times \frac{10}{100} \times \frac{9}{12} = 1875$$

$$2^{\text{nd}}, 3^{\text{rd}}, \text{ and } 4^{\text{th}} \text{ year depreciation} = 25000 \times \frac{10}{100} = 2500$$

**Machinery Account**

Dr.				Cr.		
Date	Particulars	Amount	Date	Particulars	Amount	
1.4.17	To Adani enterprise A/c	25000	31.12.17	By Depreciation A/c	1875	
		25000		By Balance c/d	23125	
		23125			25000	
1.1.18	To balance b/d	23125	31.12.18	By Depreciation A/c	2500	
		23125		By balance c/d	20625	
					23125	

1.1.19	To balance b/d	20625	31.12.19	By Depreciation A/c By balance c/d	2500 18125
1.1.20	To balance b/d	18125	31.12.20	By Depreciation A/c By balance c/d	2500 15625
1.1.21	To balance b/d	15625			18125

### Adani enterprises A/c

Dr.	Particulars	Amount	Cr.	Particulars	Amount
1.4.17	To Cash A/c	5000	01.4.17	By Machinery A/c	25000
31.12.17	To Cash A/c	5750	31.12.17	By Interest A/c	750
31.12.17	To Balance c/d	15000			25750
		25750			
31.12.18	To Cash a/c	5750	01.1.18	By Balance b/d	15000
31.12.18	To Balance c/d	10000	31.12.18	By Interest A/c	750
		15750			15750
31.12.19	To Cash A/c	5500	1.1.19	By Balance b/d	10000
31.12.19	To Balance b/d	5000	31.12.19	By Interest A/c	500
		10500			10500
31.12.20	To Cash A/c	5250	01.1.20	By Balance b/d	5000
		5250	31.12.20	By Interest A/c	250
		5250			5250

### Interest Account

31.12.17	To Adani enterprises A/c	750	31.12.17	By Profit &loss A/c	750
31.12.18	To Adani enterprises A/c	750	31.12.18	By Profit &loss A/c	750
31.12.19	To Adani enterprises A/c	500	31.12.19	By Profit &loss A/c	500
31.12.20	To Adani enterprises A/c	250	31.12.20	By Profit &loss A/c	250

### Depreciation Account

31.12.17	To Machinery A/c	1875	31.12.17	By Profit &loss A/c	1875
31.12.18	To Machinery A/c	2500	31.12.18	By Profit &loss A/c	2500
31.12.19	To Machinery A/c	2500	31.12.19	By Profit &loss A/c	2500
31.12.20	To Machinery A/c	2500	31.12.20	By Profit &loss A/c	2500

### Balance sheet of Devu & Co

Liabilities	Amount	Assets	Amount
<b>As on 31.12.17</b>		<b>As on 31.12.17</b>	
Hire vendor- Adani enterprises	15000	Machinery at cost	25000
		Less depreciation	1875
			23125
<b>As on 31.12.18</b>		<b>As on 31.12.18</b>	
Hire vendor- Adani enterprises	10000	Machinery	23125
		Less depreciation	2500
			20625
<b>As on 31.12.19</b>		<b>As on 31.12.19</b>	
Hire vendor- Adani enterprises	5000	Machinery	20625
		Less depreciation	2500
			18125
<b>As on 31.12.20</b>		<b>As on 31.12.20</b>	
Hire vendor- Adani enterprises	0000	Machinery	18125
		Less depreciation	2500
			15625

#### **Actual cash price paid method**

Under this method, the asset is recorded at the cash price actually paid, and does not treat the hire purchaser as owner until he makes the payment of the last instalment. So, no entry is passed when the asset is purchased unless it involves a down payment. The entries are passed as and when the instalment becomes due and the amount is paid towards the price of the article.

It should be noted that, since the hire purchaser is using the whole asset, depreciation must be charged on the full cash price. The journal entries are as follows.

i. When the asset is purchased

No entry

ii. When the down payment is made

Asset A/c                    Dr (Down payment amount)  
                                  To bank a/c

iii. When the instalment becomes due

Asset A/c                    Dr (cash price part of instalment)  
Interest A/c                Dr (interest on instalment)

                                  To Hire vendor

iv. When instalment is paid

Hire vendor                Dr  
                                  To Bank A/c

v. When depreciation is charged

Depreciation A/c        Dr  
                                  To Asset A/c

vi. When interest and depreciation accounts are closed by transfer to profit and loss A/c

Profit and Loss A/c      Dr.  
                                    To Interest A/c  
                                    To Depreciation A/c

**Note:** The asset account is debited with the amount of cash price paid (not full cash price), the depreciation is charged on the full cash price. The Balance Sheet will reflect the amount of cash price debited to the asset account minus depreciation charged.

## I

### Illustration 3.2.2

Taking information from Illustration 3.2.1, give journal entries in the books of hire purchaser

## S

### Solution

#### Journal entries in the books of Devu & co

Date	Particulars	Amount(Dr)	Amount(Cr)
01.04.17	Machinery A/c                      Dr To Bank A/c (Down payment is made)	5000	5000
31.12.17	Machinery A/c                      Dr Interest A/c                              Dr To Adani enterprise A/c (First instalment due)	5000 750	5750
31.12.17	Adani enterprises A/c              Dr To Cash A/c (First instalment paid)	5750	5750
31.12.17	Depreciation A/c                      Dr To Machinery A/c (Annual depreciation charged)	1875	1875
31.12.17	Profit and loss A/c                      Dr To Interest A/c To Depreciation A/c (Annual charges transferred to profit & loss A/c)	2625 750	1875
31.12.18	Machinery A/c                      Dr Interest A/c                              Dr To Adani enterprises (Second instalment due)	5000 750	5750

31.12.18	Adani enterprises A/c To Cash A/c (Second instalment paid)	Dr	5750	5750
31.12.18	Depreciation A/c To machinery A/c (Annual depreciation charged)	Dr	2500	2500
31.12.18	Profit and loss A/c To Interest A/c To Depreciation A/c (Annual charges transferred to profit & loss A/c)	Dr	3250	750 2500
31.12.19	Machinery A/c Interest A/c To Adani enterprise A/c (Third instalment due)	Dr Dr	5000 500	5500
31.12.19	Adani enterprise A/c To Cash A/c (Third instalment paid)	Dr	5500	5500
31.12.19	Depreciation A/c To Machinery A/c (Annual depreciation charged)	Dr	2500	2500
31.12.19	Profit and loss A/c To Interest A/c To Depreciation A/c (Annual charges transferred to profit & loss A/c)	Dr	3000	500 2500
31.12.20	Machinery A/c Interest A/c To Adani enterprise A/c (Fourth instalment due)	Dr Dr	5000 250	5250
31.12.20	Adani enterprise A/c To Cash A/c (Fourth instalment paid)	Dr	5250	5250
31.12.20	Depreciation A/c To Machinery A/c (Annual depreciation charged)	Dr	2500	2500
31.12.20	Profit and loss A/c To Interest A/c To Depreciation A/c (Annual charges transferred to profit & loss A/c)	Dr	2750	250 2500

**Note:** Depreciation has been charged on the original cost method @ 10% p.a. at the full cash price of ₹25000.

### 3.2.1.2 In the book of hire vendor

You know that in the case of the hire purchase system the ownership in the goods does not pass from the hire vendor to the hire purchaser, until the payment of the last instalment. But in actual practice, the hire vendor treats the sales as ordinary sales. So, the hire vendor debits the hire purchaser's A/c with full cash price and credit is given to the sales A/c. The interest amount is debited to the hire purchaser's A/c as and when the instalments become due. Instalment amounts received are credited to the hire purchaser's A/c and debited to Cash/Bank A/c. The journal entries passed are as follows.

- i. When the asset is sold on hire purchase

Hire purchaser A/c Dr (Full cash price)  
To Sales A/c

- ii. When down payment is received

Cash A/c Dr (Down payment)  
To Hire purchaser A/c

- iii. When interest becomes due

Hire purchaser A/c Dr (Interest on unpaid balance)  
To Interest A/c

- iv. When instalment is received

Cash A/c Dr (Amount of instalment)  
To Hire purchaser A/c

- v. For closing interest account

Interest A/c Dr  
To Profit and Loss A/c

- vi. For Closing Hire Purchase Account

Hire Purchase Sales A/c Dr.  
To Trading A/c

**Note:** (a) Entries 3, 4 & 5 will be repeated in the subsequent years

(b) No entry is required for depreciation.

## I

### Illustration 3.2.3

Taking the information given in Illustration 3.2.1, give journal entries and show the relevant accounts in the books of the hire vendor and show the Balance Sheet of the relevant period.



## Books of Adani enterprises

## Journal

Date	Particulars	Amount(Dr)	Amount(Cr)
01.4.17	Devu & Co A/c Dr To Sales A/c (Machinery sold on hire purchase basis)	25000	25000
01.4.17	Cash A/c Dr To Devu & Co A/c (Received down payment)	5000	5000
31.12.17	Devu & Co A/c Dr To Interest A/c (Interest due from purchaser for 9 months)	750	750
31.12.17	Cash A/c Dr To Devu & Co A/c (Amount of instalment received)	5750	5750
31.12.17	Interest A/c Dr. To Profit & Loss A/c (Interest transferred to profit & loss A/c)	750	750
31.12.18	Devu & Co A/c Dr To Interest A/c (Interest due from purchaser)	750	750
31.12.18	Cash A/c Dr To Devu & Co A/c (Amount of instalment received)	5750	5750
31.12.18	Interest A/c Dr. To Profit & Loss A/c (Interest transferred to profit & loss A/c)	750	750
31.12.19	Devu & Co A/c Dr To Interest A/c (Interest due from purchaser)	500	500
31.12.19	Cash A/c Dr To Devu & Co A/c (Amount of instalment received)	5500	5500
31.12.19	Interest A/c Dr. To Profit & Loss A/c (Interest transferred to profit & loss A/c)	500	500
31.12.20	Devu & Co A/c Dr To Interest A/c (Interest due from purchaser)	250	250

31.12.20	Cash A/c To Devu & Co A/c (Amount of instalment received)	Dr	5250	5250
31.12.20	Interest A/c To Profit & Loss A/c (Interest transferred to profit & loss A/c)	Dr.	250	250

**Ledger  
Devu & Co. A/C**

Date	Particulars	Amount	Date	Particulars	Amount
1.4.17	To Sales	25000	01.4.17	By Cash A/c	5000
31.12.17	To Interest A/c	750	31.12.17	By Cash A/c	5750
		25750		By Balance c/d	15000
01.01.18	To Balance b/d	15000	31.12.18	By Cash	5750
31.12.18	To Interest A/c	750		By Balance c/d	10000
		15750			15750
01.01.19	To Balance b/d	10000	31.12.19	By Cash	5500
31.12.19	To Interest A/c	500		By Balance c/d	5000
		10500			10500
01.01.20	To Balance b/d	5000	31.12.20	By Cash A/c	5250
31.12.20	To Interest	250			5250
		5250			5250

**Interest A/c**

31.12.17	To Profit & loss A/c	750	31.12.17	By Devu& co A/c	750
31.12.18	To Profit & loss A/c	750	31.12.18	By Devu& co A/c	750
31.12.19	To Profit & loss A/c	500	31.12.19	By Devu& co A/c	500
31.12.20	To Profit & loss A/c	250	31.12.20	By Devu& co A/c	250

**Calculation of interest and cash price**

We have already learned that, when goods are sold on hire purchase, the price charged by the vendor is always higher than the cash price. The excess price i.e., the difference between the hire purchase price and the cash price, includes the interest. Thus, the hire purchase price consists of 1) cash price and 2) Interest.

Ascertainment of any of these two gives the answer for the other. For example, if we ascertain the total interest, we can easily ascertain the cash price by deducting the interest from the H.P. price.

**Calculation of interest**

While calculating interest we may be faced with different situations:



- i. When the rate of interest, total cash price and instalments are given
- ii. When total cash price and instalments are given but the rate of interest is not given.
- iii. When the Rate of interest and cash price is not given
- iv. When the amount of instalment and period of instalment are unequal.

**i. When the rate of interest, total cash price and instalments are given**

In this situation, the total amount of interest is to be calculated first. The total interest is the difference between the HP price and the cash price. The following steps should be followed for calculating the amount of interest on each instalment:

- a. Deduct the down payment from the cash price to calculate the outstanding cash price at the time of the first instalment.
- b. Calculate the interest on the first instalment by applying the rate of interest to the outstanding cash price at the time of the first instalment.
- c. Deduct the interest from the amount of the first instalment to get the cash price included in the first instalment.
- d. Calculate the outstanding cash price at the time of the second instalment by subtracting the amount of cash price of the first instalment from the outstanding cash price at the time of the first instalment (1) – (3)
- e. Calculate the interest on the second instalment by applying the rate of interest to the outstanding cash price at the time of the second instalment
- f. Deduct the interest from the second instalment to get the cash price included in the second instalment.
- g. Deduct the cash price of the second instalment from the balance due after the first instalment. This is the amount outstanding after the second instalment is paid.
- h. Repeat the above steps till the last instalment is paid.



### Illustration 3.2.4

X Ltd. purchases machinery on H.P basis from Y Ltd. on January 1, 2021. The cash price of the machine is ₹29800. ₹8000 is paid at the signing of the agreement and the balance is to be paid in three annual instalments of ₹8000 each. The rate of interest is 5% per annum. Calculate the amount of interest included in each instalment.



### Solution

Total interest = Hire purchase price - Cash price

Hire purchase price = Down payment + instalments

$$\begin{aligned}
 &= 8000 + 3 \times 8000 \\
 &= 8000 + 24000 = ₹32000
 \end{aligned}$$

$$\begin{aligned}\text{Cash price} &= ₹29800 \\ \text{Total interest} &= 32000 - 2980 = ₹2200\end{aligned}$$

### Calculation of interest for each instalment

#### i. Outstanding cash price at the time of the first instalment

$$\begin{aligned}\text{Total cash price - down payment} &= 29800 - 8000 \\ &= ₹21800\end{aligned}$$

#### ii. Interest in the first instalment

$$\begin{aligned}\text{Outstanding cash price} \times \frac{\text{rate of interest}}{100} &= 21800 \times \frac{5}{100} = ₹1090\end{aligned}$$

#### iii. Cash price of the first instalment

$$\begin{aligned}\text{Instalment - Interest on the first instalment} &= 8000 - 1090 \\ &= ₹6910\end{aligned}$$

#### iv. Outstanding cash price at the time of the second instalment

Outstanding cash price at the time of the first instalment - Cash price of the first instalment

$$= 21800 - 6910 = 14890$$

#### v. Interest in the second instalment

$$= 14890 \times \frac{5}{100} = ₹745$$

#### vi. Cash price of the second instalment

$$= 8000 - 745 = ₹7255$$

#### vii. Outstanding cash price at the time of the third instalment

$$14890 - 7255 = 7635$$

#### viii. Interest in the last instalment

$$\begin{aligned}&= \text{Instalment - outstanding cash price at the time of the last instalment} \\ &= ₹8000 - 7635 = ₹365\end{aligned}$$

### Verification

$$7635 \times \frac{5}{100} = ₹381.75 \text{ rounded off as } 382$$

**Note:** The amount calculated in step 8, i.e., 365 and 382 is not the same. But the difference is small i.e., ₹17 (382 - 365)

For the calculation of interest, the following table would be helpful

	Total cash price	Instalment	Interest	Cash price
Total cash price	29800			
Less down payment	(-8000)	8000		8000
The amount outstanding at the time of 1 <sup>st</sup> Instalment	21800	8000	$21800 \times \frac{5}{100} = 1090$	8000 - 1090
Less: Cash price of first instalment	(-6910)			= 6910
The amount outstanding at the time of 2 <sup>nd</sup> instalment	14890	8000	$14890 \times \frac{5}{100} = 745$	8000 - 745
Less: Cash price of the second instalment	(-7255)			= 7255
The amount outstanding at the time of 3 <sup>rd</sup> instalment	7635	8000	$8000 - 7635 = 365$	7635

**Note:** If you calculate interest and cash price with the help of the above table, it makes your task easier.)

ii. **When total cash price and instalments are given but the rate of interest is not given**

In this situation, the following steps are to be followed:

- Calculate the total interest (Total interest = Hire purchase price - cash price)
- Calculate the amount of outstanding balance at the beginning of the first year (amount of outstanding balance = Hire purchase price - Down payment)
- Calculate the amount of outstanding balance at the beginning of each year by deducting the instalments of the relevant periods.
- Calculate the ratio of the outstanding balance.
- Apply the ratio to the total interest and calculate the interest on each instalment. With the help of the below example, it will become clear.

## I

### Illustration 3.2.5

Avinash enterprises purchased machinery on a hire purchase basis. The cash price of the machine was ₹74500. He paid ₹20000 on signing the agreement and the balance in three annual instalments of ₹20000 each. Calculate the interest for each year.

# S

## Solution

1. Total interest = Hire purchase price - Cash price

Hire purchase price = Down payment + Total of all instalments

$$= 20000 + 3 \times 20000$$

$$= 20000 + 60000 = 80000$$

Cash price = 74500

$$\text{Total interest} = 80000 - 74500 = 5500$$

2. Amount of outstanding balance at the beginning

$$1^{\text{st}} \text{ year} = \text{H.P price} - \text{Down payment} = 80000 - 20000 = 60000$$

$$2^{\text{nd}} \text{ year} = 60000 - 1^{\text{st}} \text{ instalment} = 60000 - 20000 = 40000$$

$$3^{\text{rd}} \text{ year} = 40000 - 2^{\text{nd}} \text{ instalment} = 40000 - 20000 = 20000$$

3. Thus the ratio of outstanding amount = 60000: 40000: 20000 = 6: 4: 2

4. The total interest of 5500 should be divided in the ratio of 6:4:2

$$1^{\text{st}} \text{ year interest} = 5500 \times \frac{6}{12} = 2750$$

$$2^{\text{nd}} \text{ year interest} = 5500 \times \frac{4}{12} = 1833$$

$$3^{\text{rd}} \text{ year interest} = 5500 \times \frac{2}{12} = 917$$

### iii. When the rate of interest and cash price are not given

When the rate of interest and cash price are not given, we calculate the interest included in each instalment by forming equations and solving them. The following example would make it clear:

# I

## Illustration 3.2.6

TATA Motors sell two-wheelers on the hire purchase system. The terms of payment are ₹2000 on delivery, ₹2080 at the end of the 1<sup>st</sup> year, ₹1920 at the end of the 2<sup>nd</sup> year and ₹1760 at the end of the 3<sup>rd</sup> year, inclusive of interest. Calculate the amount of interest included in each instalment.

# S

## Solution

Suppose the cash price is X and interest is Y

Therefore,

1<sup>st</sup> instalment

$$X + 3Y = 2080 \text{ ----- (i)}$$

2<sup>nd</sup> instalment

$$X + 2Y = 1920 \text{ ----- (ii)}$$



$$3^{\text{rd}} \text{ instalment} \quad X + Y = 1760 \text{ ----- (iii)}$$

$$\text{Adding (ii) and (iii) equation} \quad 2X + 3Y = 3680 \text{ ----- (iv)}$$

$$\text{Deducting (i) from (iv)} \quad X + 0 = 1600$$

$$X = 1600$$

Therefore, cash price paid each time is ₹1600. Now the calculation of interest in each instalment are as follows:

#### Calculation of interest

No. of instalment	Instalment paid	Cash price	Interest (instalment paid - cash price)
1	2080	1600	480
2	1920	1600	320
3	1760	1600	160

#### iv. When the amount of instalment and period of instalment are unequal.

In this situation, the time gap between different instalments must be noted first. Thereafter, outstanding balance standing at the time of payment of each instalment is multiplied by the time duration. Now we get products. Finally, the amount of total interest is split in the ratio of these products. The following example would make it clear:

## I

### Illustration 3.2.7

National traders purchased a machine on Hire purchase basis. The cash price of the machine was ₹ 91000 and H.P price was ₹100000. Payment was to be made as given below:

₹20000 at the time of delivery

₹30000 after 5 months

₹30000 after 11 months

₹12000 after 19 months

₹8000 after 24 months

Machine was purchased on 1 July 2020 and the date of payment of each instalment is counted from this date. Calculate the interest included in each instalment.

## S

### Solution

Step 1. Calculation of total interest:

$$\text{Total interest} = \text{Hire purchase price} - \text{Cash price}$$

$$= 100000 - 91000 = 9000$$

Step 2. Calculation of interest in each instalment by-product method

Particulars	Amount	Period	Product = Outstanding amount × Period
Hire purchase price	100000		
Less: Down payment	<u>20000</u>		
Balance due	80000	5 months	400000
Less Amount paid at the end of 5 months	<u>30000</u>		
Balance due	50000	6 months	300000
Less Amount paid at the end of 11 months	<u>30000</u>	(11 - 5)	
	20000	8 months	160000
Balance due		(19-11)	
Less: Amount paid at the end of 19 months	<u>12000</u>		
Balance due	8000	5 months	40000
Less: Amount paid at the end of 24 months	<u>8000</u>		
Balance due	Nil	(24-19)	

Ratio of product = 400000: 300000: 160000:40000 = 40:30:16:4

Interest included in the 1<sup>st</sup> instalment =  $9000 \times \frac{40}{90} = 4000$

Interest included in the 2<sup>nd</sup> instalment =  $9000 \times \frac{30}{90} = 3000$

Interest included in the 3<sup>rd</sup> instalment =  $9000 \times \frac{16}{90} = 1600$

Interest included in the 1<sup>st</sup> instalment =  $9000 \times \frac{4}{90} = 400$

v. Calculation of cash price

Sometimes, the cash price of the asset is not given. We already learned that, while preparing the asset A/c, it will be debited with a cash price of the asset and the calculation of interest and depreciation is made on cash basis. Therefore it is essential to calculate the cash price. The different method of calculation of cash price are as follows: -

- Working back method (without the help of annuity table)
- Annuity table method

**Working back method**

Under this method, first, we calculate the interest on the last instalment. For example, in a hire purchase transaction, apart from the down payment, 3 instalments are payable; the interest is calculated first on the 3<sup>rd</sup> instalment, then on the 2<sup>nd</sup> instalment, and lastly on the 1<sup>st</sup> instalment. There is no interest on the down payment.

The steps involved in this method are as follows (assuming there are three yearly instalments):

- i. Calculate the interest included in the third instalment by using the following formula. Interest = Total amount due at the time of instalment x  $\frac{\text{Rate of interest}}{100 + \text{rate}}$
- ii. Deduct interest from 3<sup>rd</sup> instalment. Then we will get the outstanding cash price of the third (last) instalment.
- iii. Add the cash price calculated under step 2 to the instalment amount of the second year. And calculate the interest on the sum so obtained by using the formula provided in step 1. Subtract this from the total amount due at the end of the second year. Then we will get the outstanding cash price of the second instalment.
- iv. Add the cash price calculated under step 3 to the instalment amount of the first year and calculate the interest on the sum so obtained. Subtract this amount of interest from the total amount due at the end of the first year. Then we will get the outstanding cash price of the first instalment.
- v. Add the down payment, if any, to the cash price calculated under step 4. Then we will get the total cash price.

The following example will help you understand the calculation of cash price:

## I

### Illustration 3.2.8

Mr. Aman purchased a smartphone on hire purchase system from Tinu Ltd on 1-1-2021 with an agreement to pay ₹2500 on signing the contract and the balance in 3 instalments.

₹3250 at the end of first year

₹3000 at the end of second year.

₹2750 at the end of third year.

Interest is charged at the rate of 10% p.a. Calculate the cash price.

## S

### Solution

	Amount	Interest
Total amount due on 3 <sup>rd</sup> instalment (last)	2750	
Less: Interest	250	$2750 \times \frac{10}{110} = 250$
The outstanding cash price of 3 <sup>rd</sup> instalment	2500	
Add: 2 <sup>nd</sup> instalment	3000	
The amount due on the 2 <sup>nd</sup> instalment	5500	$5500 \times \frac{10}{110} = 500$
Less: Interest	500	
The outstanding cash price of 2 <sup>nd</sup> instalment	5000	
Add: 1 <sup>st</sup> instalment	3250	

The amount due on 1 <sup>st</sup> instalment	8250	$8250 \times \frac{10}{110} = 750$
Less: Interest	750	
Outstanding cash price of 1 <sup>st</sup> instalment	7500	
Add: Down payment	2500	
Total cash price	10000	Total interest-1500

So total cash price ₹10000 and total Interest ₹1500

### Annuity table Method

Under this method the cash price can be ascertained with the help of annuity table. In the annuity table the rate of interest is given in the rows and the years in the columns. To get the present value of each instalment the amount of each instalment is multiplied by the table values. Then the total of these present values is added to down payment to get the cash price.

## I

### Illustration 3.2.9

X Ltd. purchased a machine on hire purchase system. The payment is made as follows.

Down payment- ₹70000

1<sup>st</sup> instalment - ₹53000

2<sup>nd</sup> instalment - ₹49000

3<sup>rd</sup> instalment - ₹55000

The payments are made at the end of 1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> year respectively. The rate of interest is 10% p.a. The annuity table shows that the present value of ₹1 for 1<sup>st</sup>, 2<sup>nd</sup>, and 3<sup>rd</sup> years are .9090, .8264, .7513, respectively. Calculate the cash price of the machine.

## S

### Solution

	(1) Amount of Instalment	(2) Present value of Re.1	(1) × (2) Present value of the instalment (Rounded figure)
Down payment	70000	1	70000
1 <sup>st</sup> instalment	53000	.9090	48180
2 <sup>nd</sup> instalment	49000	.8264	40495
3 <sup>rd</sup> instalment	55000	.7513	41325
			200000

Total cash price = ₹200000



### 3.2.2 Default and Repossession

Suppose you purchased a motorbike costing ₹90000/- on hire purchase system from Hero Motors. Payment was to be made ₹30000/- down and the remainder in 3 equal instalments together with interest of 15% per annum. If you paid the first instalment, but could not pay the next, then you made a default. You have an obligation to pay the last instalment and failed to meet the obligation. So, Hero Motors took possession of the Motorbike.

From the above example, it is clear that “default” is the failure to meet the obligation. Under a hire purchase agreement, the hirer has an obligation to pay up to the last instalment, so that the ownership of goods smoothly passes to him. If he fails to meet this obligation, the hire vendor has the right to recover or take possession of the goods without any compensation. This act of recovery of possession is termed as “repossession”.

#### Accounting for Default and Repossession

When the hire purchaser does not pay the installment, the hire vendor reserves the right to repossess the goods and to forfeit the installment already paid. The hire vendor repossesses either the complete goods hired out or part of the goods. Repossession of complete goods is known as “complete repossession” and repossession of part of the goods is known as “partial repossession”

#### Complete Repossession (Full repossession)

Under complete repossession, the hire purchaser closes the hire vendor's accounts by transferring the balance of the hire vendor's account to the Asset A/c. The Asset A/c is also closed by transferring the balance to the Profit and Loss A/c. Similarly, the hire vendor closes the books of the hire-purchaser's account by transferring it to 'Repossess Goods Accounts.'

#### Journal entries in the books of hire purchaser

Hire purchaser keeps two accounts. i. Asset A/c and ii. Hire vendor's A/c.

At the time of complete repossession, both accounts are to be closed.

All the entries (except the entry for payment) are passed as usual up to the date of default, including the entry for depreciation. Additional entries are as follows:

- i. For interest due in the year of default  
Interest A/c              Dr  
                                To Vendor A/c
- ii. For closing the accounts of the vendor  
Hire vendor A/c           Dr (with the balance)  
                                To Assets A/c
- iii. For closing Asset Account  
Profit & Loss A/c      Dr (if loss)  
                                To Asset A/c

**Note:** Generally, there is a loss to the hire purchaser. In case of profit, the above entry will be reversed.

## Journal entries in the books of hire vendor

The hire vendor keeps only one account, i.e., the hire purchaser's A/c. At the time of repossession, the Hire purchaser's A/c is closed by transferring the balance to the "Goods repossessed A/c". Goods Repossessed A/c is closed by transferring the profit or loss on the sale of repossessed goods to a Profit and Loss Account.

All the entries (except the entry for payment) are passed as usual up to the date of default. Additional entries are as follows.

**Note:** In case of profit the above entry will be reversed.

## Illustration 3.2.10

On January 1, 2019 Delhi Transport Ltd purchased a truck on hire purchase from Tata motors for ₹28000 (cash price). Payment was to be made as ₹7500 cash down and agreed to pay the balance in three instalments of ₹7500 at the end of each year. Rate of interest @5% p.a. The rate of depreciation for the asset was 10% p.a.

Delhi transport Ltd made the down payment and paid the first instalment. But they could not pay the second instalment and Tata motors took repossession of the truck. Tata motors spend ₹300 on repairs and disposed of the asset for ₹15350. Open ledger accounts in the books of both the parties.



**In the books of Delhi Transport Ltd. (Hire Purchaser)**

**Tata motor A/c**

Dr	Particulars	Amount	Date	Particulars	Amount
1.1.19	To Cash A/c (down payment)	7500	1.1.19	By Truck A/c	28000
31.12.19	To Cash A/c (First instalment)	7500	31.12.19	By interest A/c	1025
31.12.19	To balance c/d	14025			
		<b>29025</b>			<b>29025</b>
31.12.20	To Truck A/c- default amount (Balancing figure)	14726	1.1.20	By balance b/d	14025
		31.12.20		By interest A/c	701
		<b>14726</b>			<b>14726</b>

**Truck Account**

Dr.	Particulars	Amount	Date	Particulars	Cr.
1.1.19	To Tata Motors A/c	28000	31.12.19	By Depreciation (10% on 28,000)	2800
		28000	31.12.19	By balance c/d	25200
1.1.20	To balance b/d	25200	31.12.20	By Depreciation (10% on 25200)	2520
		31.12.20		By Tata motors A/c	14726
		31.12.20		By Profit & loss A/c (Loss-balancing figure)	7954
		25200			25200

**In the books of Tata motors, A/c (Hire Vendor)**

**Delhi transport Ltd A/c**

Dr.	Particulars	Amount	Date	Particulars	Amount	Cr.
1.1.19	To Sale A/c	28000	1.1.19	By Cash A/c (down payment)	7500	
31.12.19	To Interest A/c (5% on 20500)	1025	31.12.19	By cash (1 <sup>st</sup> instalment)	7500	
		29025	31.12.19	By balance c/d	14025	
1.1.20	To balance b/d	14025	31.12.20	By Goods repossessed A/c	29025	
31.12.20	To Interest A/c	701			14726	
		14726			14726	

**Goods Repossessed Account**

Dr.	Particulars	Amount	Date	Particulars	Amount	Cr.
31.12.20	To Delhi Transport Ltd A/c	14726	31.12.20	By Cash A/c (Sale)	15350	
31.12.20	To Cash A/c (Repairs)	300				
31.12.20	To P&L A/c (Profit on sale)	324				
		15350			15350	

**Partial repossession**

Sometimes the hire vendor may not repossess the entire goods. But he repossesses a part of the goods called “partial repossession”. In this case, some part of the asset is still left with the hire purchaser.

In the case of partial repossession, there should be an agreement between the vendor and the purchaser relating to the valuation of the goods repossessed. The vendor's account is debited and the asset account is credited in the books of the hire purchaser with the agreed value of goods repossessed. Since the entire goods are not repossessed, the asset account will have a balance for the goods not repossessed, which will be equal to the depreciated value of the assets not repossessed. The vendor's account will show a balance which will represent the amount due to the purchaser.

In the absence of an agreed value, the depreciated value of the asset as on the date of repossession may be taken as an agreed value.



The journal entries are as usual up to the date of default in the books of both parties. The additional entries are as follows.

### **Journal entries in the books of Hire purchaser**

- i. For goods taken away

Hire Vendor's A/c Dr. (With the agreed value of goods repossessed)  
To Asset A/c

- ii. For loss on Repossession

Profit & loss A/c Dr.  
To Asset A/c

**Note:**

- a. Loss on repossession = Book value of goods repossessed on the date of repossession - Agreed value of goods repossessed
- b. In case of profit on repossession, the reverse entry may be passed.

### **Journal entries in the books of Hire vendor**

- i. For goods repossessed

Goods repossessed A/c Dr. (Agreed value of goods repossessed)  
To Hire purchaser's A/c

(Journal entries 2, 3, 4 and 5 are the same as in the case of complete repossession).

## I

### **Illustration 3.2.11**

Akash Transport Co. purchased three trucks costing ₹90000 each from Devu Distributors on 1 Jan, 2019 on hire purchase system. Payment was to be made, for each truck ₹30000 down and the remainder in 3 equal instalments together with interest at 15% per annum payable on 31 December each year. Akash transport Co. writes off 20% depreciation each year on the diminishing balance method. It paid the first instalment at the end of the first year, but could not pay the next. Devu distributors agree to leave one truck with the purchaser adjusting the value of the other two trucks against the amount due. The re-possession was done on the basis of 30% depreciation on the diminishing balance method.

Repossessed goods are repaired at a cost of ₹2000 and were then sold for ₹92000/- Calculate the value of repossessed stock and show the necessary accounts in the books of both parties.



## Solution

### In the books of Akash Transport Co. Devu Distributers Account

Dr.	Particulars	Amount	Cr.	Particulars	Amount
1.1.19	To Cash (30000×3) (down payment)	90000	1.1.19	By Truck A/c (90000×3)	270000
31.12.19	To Cash A/c (First instalment)	87000	31.12.19	By Interest A/c	27000
31.12.19	To Balance c/d	120000			
		<b>297000</b>			<b>297000</b>
31.12.20	To Truck A/c (Agreed value reposessed)	88200	1.1.20	By Balance b/d	120000
	To balance c/d	49800	31.12.20	By Interest $\frac{15}{100}$ /c (120000× $\frac{15}{100}$ )	18000
		<b>138000</b>			<b>138000</b>

### Trucks Account

Dr.	Particulars	Amount	Cr.	Particulars	Amount
1.1.19	To Devu distributers (90000×3) A/c	270000	31.12.19	By Depreciation (270000×20%)	54000
			31.12.19	By balance c/d	216000
		<b>270000</b>			<b>270000</b>
1.1.20	To balance b/d	216000	31.12.20	By Depreciation (216000×20%)	43200
			31.12.20	By Devu distributers A/c	88200
			31.12.20	By Profit & loss A/c (Loss-balancing figure)	27000
				By balance c/d (One truck, ₹90000 less depreciation for 2 years @20%)	57600
					<b>216000</b>



**In the books of. Devu distributers**  
**Akash Transport Co Account**

Dr					Cr
Date	Particulars	Amount	Date	Particulars	Amount
1.1.19	To Sale A/c (90000×3)	270000	1.1.19	By Cash A/c (down payment)	90000
31.12.19	To Interest A/c	27000	31.12.19	By cash (1 <sup>st</sup> instalment)	87000
			31.12.19	By balance c/d	120000
		297000			297000
1.1.20	To balance b/d	120000	31.12.20	By Goods reposessed A/c	88200
31.12.20	To Interest A/c	18000	31.12.20	By balance c/d	49800
		138000			138000

**Good Repossessed A/c**

Dr					Cr.
Date	Particulars	Amount	Date	Particulars	Amount
31.12.20	To Akash Transport co. A/c	88200	31.12.20	By Cash A/c (Sale)	92000
31.12.20	To Cash A/c (Repairs)	2000			
31.12.20	To P&L A/c (Profit on sale)	1800			
		92000			92000

**Working notes: -**

i. **Calculation of 1<sup>st</sup> instalment price and interest:**

$$\text{Total cost of 3 trucks} = 90000 \times 3 = 270000$$

$$\text{Less: Down payment} = 30000 \times 3 = 90000$$

$$\text{Balance in 3 equal instalment} \quad \underline{180000}$$

$$\text{So, the first instalment cash price} \quad = 180000 \times \frac{1}{3} = 60000$$

$$\text{First instalment interest} \quad = 180000 \times \frac{15}{100} = 27000$$

$$\text{So, first instalment price} = \text{cash price} + \text{interest} = 60000 + 27000 = 87000$$

ii. **Calculation of agreed value of Truck reposessed:**

$$\text{Cost of 2 trucks} - 90000 \times 2 = 180000$$

### Depreciation

1 <sup>st</sup> year $180000 \times \frac{30}{100}$	=54000
2 <sup>nd</sup> year $180000 - 54000 = 126000 \times \frac{30}{100}$	= <u>37800</u>
	<u>91800</u>

$$\text{Value of repossessed truck} = 180000 - 91800 = 88200$$

### iii. Calculation of the book value of truck Repossessed:

Cost of 2 truck	= 180000
Less: Depreciation for 2019 @ 20%	<u>36000</u>
	144000
Less: Depreciation for 2020 @ 20%	= 28800

$$\text{Book value of Truck repossessed} = \underline{115200}$$

### iv. Calculation of Loss on Repossession:

Book value on the date of repossession	= 115200
Less: agreed value of repossessed truck	= <u>88200</u>
	<u>27000</u>

- i. Truck A/c shows a balance of ₹57600 represent the books value of Truck left with the Hire purchaser.
- ii. Vendor's A/c shows a credit balance of ₹49800 and Hire Purchaser A/c shows a debit balance of the same amount. This means the buyer can retain one truck but he has to pay ₹49800 to the vendor.

## Recap

- ◊ Popular methods used to record hire purchase transactions in the books of hire purchaser -Full cash price method and Actual cash price method.
- ◊ Under Full cash price method - Asset account will be debited with full cash price, and treat the hire purchaser as owner of the asset
- ◊ Under Actual price method - The asset is recorded at the cash price actually paid.
- ◊ Under Actual price method - Hire purchaser is not treated as the owner until he makes the payment of last instalment
- ◊ Total interest = Hire purchase price - cash price.

- ◊ Methods for calculating cash price - Working back method and Annuity table method.
- ◊ Repossession of goods - The right of vendor to take back the goods in case of default in price by the hire purchaser
- ◊ Complete Repossession - Repossession of complete goods
- ◊ Partial Repossession - Repossession of part of the goods

## Objective Questions

1. What price is debited in the asset account under hire purchase system?
2. In which account the amount of interest is credited by the hire purchaser?
3. On which price, hire purchaser charge depreciation?
4. Under which method, asset account will be debited with full cash price and treat the hire purchaser as owner of the asset
5. Under which method, the hire vendor treats the sales in hire purchase system as ordinary sales?
6. Who has the right to repossess the goods under the hire purchase system?
7. What account does the hire vendor operate in order to deal with repossession?
8. What is it called if the hire vendor takes away all the goods on which there is a default of instalment?

## Answers

1. Cash price
2. Hire vendor account
3. Cost price
4. Full cash price method
5. Actual price method
6. Hire vendor
7. Goods repossessed account
8. Complete repossession.

## Self-Assessment Questions

1. Distinguish complete repossession and partial repossession.
2. Write a short note on default and repossession.
3. Explain the various methods of recording hire purchase transactions in the books of hire purchasers.
4. Under full cash price method, which account is credited when asset is acquired on hire purchase?
5. What are the steps to be followed to calculate the interest when the rate of interest, total cash price and instalments are given?
6. Under full cash price method, which account is debited when instalment is paid?
7. What are the different methods of calculating the cash price?
8. What are the steps to be followed to calculate the interest when total cash price and instalments are given but the rate of interest is not given?

## Assignments

1. Monica purchased on 1st January, 2015 two Maruti vans from Neeru on hire purchase system. The cash price was payable as ₹24000 down for each van and the balance in 3 equal instalments together with interest @10 per cent per annum. The amount of last instalment including interest was ₹70400. Depreciation was to be provided at 20 per cent per annum under reducing balances. Monica paid the two instalments on 31-12-2016 but could not pay the instalment due on 31-12-2017. Neeru repossessed one Maruti van adjusting its value against the amount due. The repossession was done on the basis of 25% depreciation on original cost method. Neeru spent ₹10000 on van repossessed and sold it for ₹62000. Show the necessary accounts in the books of both the parties.  
(Answer: Loss on default- ₹31440, Profit on repossession-₹22000)
2. Discuss whether the business should consider a hire purchase agreement for acquiring the required equipment, providing reasons for your recommendation.
3. Anil acquired on 1 January, 2001 a machine under a Hire-Purchase agreement which provides for 5 half-yearly instalments of ₹6000 each, the first instalment being due on 1 July, 2001. Assuming that the applicable rate

of interest is 10 percent per annum, calculate the cash value of the machine. (Answer: ₹81697)

4. On January 1, 2021, HP M/s acquired a Van on hire purchase from Venu's. The terms of the contract were as follows:

- The cash price of the van was ₹150000.
- ₹50000 were to be paid on signing of the contract.
- The balance was to be paid in annual instalments of ₹30000 plus interest.
- Interest chargeable on the outstanding balance was 5% p.a.
- Depreciation at 10% p.a. is to be written off using the straight-line method. You are required to give Journal Entries and show the relevant accounts in the books of HP M/s from January 1, 2021, to December 31, 2023.

5. Z Ltd. purchased 3 milk vans from Super Motors costing ₹75000 each on hire purchase system. Payment was to be made: ₹40000 down and the remainder in 3 equal instalments together with interest @ 10%. Y Ltd. writes off depreciation @ 15% on the diminishing balance. It paid the instalment at the end of the 1<sup>st</sup> year but could not pay the next. SuperMotor agreed to leave one milk van with the purchaser, adjusting the value of the other two milk vans against the amount due. The milk vans were valued on the basis of 30% depreciation annually on written down value basis. Y Ltd. settled the seller's dues after three months. You are required to give Journal Entries in the books of Z ltd.

## Suggested Readings

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# Unit 3

## Accounts of Installment Purchase System

### Learning Outcomes

After studying this unit, the learner will be able to:

- ◊ realise the concept of the instalment purchase system.
- ◊ acquaint knowledge on the journal entries to be made in the book of the purchaser.
- ◊ gain insights on the journal entries to be made in the book of the seller.

### Prerequisites

Hire purchase is widely used due to the current economic climate, where many lack the cash on hand to pay for things. In contrast to hire purchase, under instalment system, the ownership and possession are transferred right away when the contract is signed. Because there is no need to pay the entire amount up front, many people prefer to purchase goods in installments, which benefits businesses by increasing sales. While the installment system allows for greater sales flexibility, it also necessitates rigorous accounting to ensure that revenue and expenses are matched correctly throughout the course of the payment plan.

Accurate accounting has implications for tax liabilities and legal compliance, benefiting both parties by managing tax obligations and legal aspects tied to the installment arrangement. The accounting adjustments that must be made in the buyer and seller's books under the installment system are covered in this unit.

## Keywords

## Installment purchase system, Accounting treatment of installment payment system

## Discussion

### 3.3.1 Accounting treatment of Instalment payment system

We have already discussed the instalment payment system and the difference between the hire purchase system and the instalment payment system. We know that, under the installment system, the price of the article is paid in instalments along with interest on the unpaid balance. The buyer gets both possession and ownership of the goods at the time of signing the agreement. This is a credit sale. If the buyer fails to pay any installment, the seller has no right to take back the goods. He can only sue the buyer for the amount.

## Accounting treatment:

Under this system, the seller will treat the transaction as a credit sale and the buyer treats it as a credit purchase. Hence the buyer credits the seller with the full amount payable to him including interest and debits the Asset account with cash price and Interest Suspense account with total interest. The buyer maintains the Asset account in a manner similar to the hire purchase system. The seller debits the buyer with the full amount and credit the Sale account with cash price and the Interest Suspense account with total interest.

## Journal entries in the books of buyer

- i. When an asset is purchased on instalment payment system.
  - Asset A/c Dr. (Cash price)
  - Interest suspense A/c Dr. (Difference between total price and cash price)
    - To Vendor's A/c (with total instalment purchase price)
- ii. When down payment is made.
  - Vendor A/c Dr.
  - To Cash A/c
- iii. For interest due at the time of instalment
  - Interest A/c Dr.
  - To Interest Suspense A/c
- iv. For payment of instalment
  - Vendor's Dr.
  - To Cash A/c

v. For depreciation at the end of the accounting year

Depreciation A/c      Dr  
To Asset A/c

vi. For transfer of interest and depreciation to Profit and loss A/c.

Profit and loss A/c      Dr.  
To Interest A/c  
To Depreciation A/c

(Note: Entries 3 to 6 will be repeated in the subsequent years).

### Journal entries in the books of vendor

i. When goods are sold on instalment payment system.

Buyer's A/c      Dr (Total price)  
To Sales A/c (Cash price)  
To Interest suspense A/c (Total interest)

ii. When down payment is received.

Cash A/c      Dr.  
To Buyer's A/c

iii. For interest due at the end of the year.

Interest suspense A/c Dr.  
To interest A/c

iv. For receipt of the amount of instalment.

Cash A/c      Dr.  
To Buyer's A/c

v. For closing interest A/c

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

I

### Illustration 3.2.1

On 1 Jan 2016 Clarion Industries purchased on instalment basis a machinery from Sole Export Co. agreeing to pay five annual instalments of ₹5000 each payable on 31 December each year. There is no down payment. Interest is charged at 5% per annum and is included in the annual instalments. It was decided to depreciate the machinery @ 10% p.a. on reducing balance method.

You are required to:

i. Ascertain cash price and show Interest Suspense Account, Machinery Account and Sole Export co. A/c in the books of buyer.

ii. Show Clarion Industries account and interest suspense A/c in the books of Vendor.



## Solution

### Computation of cash price

Year	Instalment ₹	Total amount due at the beginning of the year	Interest = Amount due $\times \frac{5}{105}$	Principal cash price (Amount due - Interest)
2020	5000	5000	238 (5000 $\times \frac{5}{105}$ )	4762
2019	5000	9762 (5000+4762)	465	9297
2018	5000	14297 (5000+9297)	681	13616
2017	5000	18616 (5000+ 13616)	886	17730
2016	5000	22730 (5000+ 17730)	1082	21648

Total cash price = ₹21648

Total Interest = 238+465+681+886+1082 = ₹3352

### In the books of Clarion Industries Machinery Account

Date	Particulars	Amount	Date	Particulars	Amount
1.1.16	To Sole Expert Co	21648	31.12.16	By Depreciation (21648 $\times 10\%$ )	2165
				By balance c/d	19483
		21648			21684
1.1.17	To balance b/d	19483		By Depreciation A/c	1948
				By balance c/d	17535
1.1.18	To balance b/d	19438		By Depreciation A/c	19438
		17535		By balance c/d	1754
1.1.19	To balance b/d	17535		By Depreciation A/c	15781
		15781		By balance c/d	17535
1.1.20	To balance b/d	15781		By Depreciation A/c	1578
		14203		By balance c/d	14203
				By Depreciation A/c	1420
				By balance c/d	12783
					14203

### Interest suspense Account

Date	Particulars	Amount	Date	Particulars	Amount
1.1.16	To Sole Expert Co	3352	31.12.16	By Interest A/c	1082
				By balance c/d	2270
1.1.17	To balance b/d	3352	31.12.17		3352
		2270		By Interest A/c	886
1.1.18	To balance b/d	2270	31.12.18	By balance c/d	1384
		1384		By Interest A/c	2270
1.1.19	To balance b/d	1384	31.12.19	By balance c/d	681
		703		By Interest A/c	703
1.1.20	To balance b/d	703	31.12.20	By balance c/d	1384
		238		By Interest A/c	465
					238
					703
					238

### Sole Export Co Account

Date	Particulars	Amount	Date	Particulars	Amount
31.12.16	To Cash A/c	5000	1.1.16	By Machinery A/c	21648
		20000		By Interest suspense A/c	3352
31.12.17	To Cash A/c	25000	1.1.17	By balance b/d	25000
		5000			20000
31.12.17	To balance c/d	15000	1.1.18		20000
		20000		By balance b/d	15000
31.12.18	To Cash A/c	5000	1.1.18		15000
		10000		By balance b/d	15000
31.12.18	To balance c/d	15000	1.1.19		10000
		5000		By balance b/d	10000
31.12.19	To Cash A/c	5000	1.1.19		10000
		5000		By balance b/d	5000
31.12.19	To balance c/d	10000	1.1.20		5000
		5000		By balance b/d	5000
31.12.20	To Cash A/c	5000			5000
		5000			5000

**In the books of Sole Export Co**

**Clarion Industries Account**

<b>Date</b>	<b>Particulars</b>	<b>Amount</b>	<b>Date</b>	<b>Particulars</b>	<b>Amount</b>
1.1.16	To Sales A/c	21648	31.12.16	By Cash A/c	5000
1.1.16	To Interest suspense A/c	3352	31.12.16	By balance c/d	20000
		25000			25000
1.1.17	To balance b/d	20000	31.12.17	By Cash A/c	5000
		20000	31.12.17	By balance c/d	15000
1.1.18	To balance b/d	15000	31.12.18	By Cash A/c	5000
		15000	31.12.18	By balance c/d	10000
1.1.19	To balance b/d	10000	31.12.19	By Cash A/c	5000
		10000	31.12.19	By balance c/d	5000
1.1.20	To balance b/d	5000	31.12.20	By Cash A/c	5000
		5000			5000

**Interest Suspense Account**

<b>Date</b>	<b>Particulars</b>	<b>Amount</b>	<b>Date</b>	<b>Particulars</b>	<b>Amount</b>
1.1.16	By Interest A/c	1082	31.12.16	By Clarion Industries	3352
	By balance c/d	2270			3352
		3352			2270
1.1.17	By Interest A/c	886	31.12.17	By balance b/d	2270
	By balance c/d	1384			2270
		2270			1384
1.1.18	By Interest A/c	681	31.12.18	By balance b/d	1384
	By balance c/d	703			1384
		1384			703
1.1.19	By Interest A/c	465	31.12.19	By balance b/d	703
	By balance c/d	238			703
		703			238
1.1.20	By Interest A/c	238	31.12.20	By balance b/d	238
		238			238

## Recap

- ◊ Instalment system- buyer gets both possession and ownership of the goods at the time of signing the agreement.
- ◊ The price of the article is paid in instalments along with interest on the unpaid balance.
- ◊ Seller - treat the transaction as a credit sale
- ◊ Buyer - treats the transaction as a credit purchase.
- ◊  $\text{Interest} = \text{total price} - \text{cash price}$
- ◊ The buyer credits the seller with the full amount payable to him including interest
- ◊ The buyer debits the Asset account with cash price and Interest Suspense A/c with total interest.
- ◊ The seller debits the buyer with the full amount
- ◊ The seller credit the Sale account with cash price and the Interest Suspense account with total interest.

## Objective Questions

1. Under which system the buyer gets title to the property at the conclusion of the agreement?
2. Under which system the seller retains a security interest in the property until all of the specified payments have been made?
3. How does the seller treat a transaction under instalment purchase system?
4. How does the buyer treat a transaction under instalment purchase system?
5. Which principle is applied in the instalment system?
6. Which Act governs the instalment system?
7. What type of contract is an instalment purchase?

## Answers

1. Instalment payment
2. Instalment system
3. As a credit sale
4. As a credit purchase
5. Own at once and pay in instalment
6. Sale of Goods Act
7. Sale

## Self-Assessment Questions

1. Explain the concept of instalment system.
2. Under the Instalment system, which account is credited with the total interest received by the seller?
3. List out the two differences between the hire purchase system and the instalment payment system.
4. State the similarities between the hire purchase system and the instalment payment system.
5. Write journal entries in the books of the buyer for interest due at the time of instalment.
6. To which account is the full amount of interest credited when the buyer is debited with the full amount of interest at the time of sale in the installment payment system?

## Assignments

1. Visit an industry or organisation in your locality, and ask them, whether they bought any asset on the instalment system. If yes, examine how they record assets account on the seller's account. Write a short note about the visit.
2. On 1 January 2018, Lazza Ice cream Co. bought Refrigerator on instalment system. The cash price of Refrigerator was ₹11175 and payment was to be made as follows: An amount of ₹3000 was to be paid on the signing of the agreement and the balance in 3 instalments of ₹3000 each at the end

of each year. 5% interest is charged by the Refrigerator Co. per annum. The company has decided to write off 10% depreciation annually on the diminishing balance method. Open necessary ledger accounts in the books of Lazza Ice cream Co. and Refrigerator Co.

(Answer: Total interest ₹825, In the book of Lazza ice cream co, Refrigerator A/c balance on 31- 12- 2020 - ₹8146)

3. Anil purchased on instalment basis a truck from Binoy on 1 January 2019, for a sum of ₹80000. On signing the contract, a sum of ₹20000 is to be paid and the balance in three instalments of ₹20000 each. The cash price of the truck is ₹74500. Interest charged is 5% p.a. Depreciation charged by the buyer is 10% p.a. on diminishing balance method. Pass journal entries in the books of the seller and buyer.
4. Sunil purchased on instalment basis a truck from Dijo on 1 January 2019, for a purchase price of ₹100000. The amount was payable in 4 instalments with 12% interest p.a. on the outstanding balance, the first instalment being payable on the date of sale. Depreciation charged by the buyer is 20% p.a. on diminishing balance method. Pass journal entries in the books of the seller and buyer.

## Suggested Readings

1. Radhaswamy, M., & Raman, S. (2018). *Advanced Accountancy* (Vol. 1 and 2). Sultan Chand & Sons.
2. Shukla, M. C., Grewal, T. S., & Gupta, S. C. (2019). *Advanced Accounts* (Vol. 1 and 2). S. Chand Publishing.
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7. Gupta, R. L., & Radhaswamy, M. (2018). *Advanced Accountancy: Theory, Method and Application* (Vol. 1 and 2). Sultan Chand & Sons.

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BLOCK

# ROYALTY ACCOUNTS

# Unit 1

## Introduction to Royalty Accounts

### Learning Outcomes

After studying this unit, learner will be able to:

- ◊ gain insights on the meaning of the term “Royalty”.
- ◊ familiarise the concept of minimum rent.
- ◊ get awareness on recoupment of short working.

### Prerequisites



Let us meet Mr. Gupta who is an author by profession. He has written a book which he wants to print and publish. He contacted a company called Himalaya publishers and entered into an agreement with them to print and publish his book. Gupta gave Himalaya publishers the legal right for publication. Himalaya publishers will give a periodic sum to the author as consideration. This periodic sum which is paid as a consideration for the use of these kinds of special rights is called Royalty. In the above example Himalaya publishers is using the right of Mr. Gupta over his written work. The user of the right, that is, Himalaya publishers is technically known as the lessee and Mr. Gupta, the author who is the owner of this right is technically known as the lessor. The unit deals with the concept of Royalty.

## Keywords

Royalty, Minimum rent, Short workings, Recovery, Ground rent

## Discussion

### 4.1.1 Meaning and Definition of Royalty

Royalty is the consideration paid to the owner of an asset by the person to whom the asset is given for use. According to William Pickles, “royalty is the remuneration payable to a person in respect of the use of an asset, whether hired or purchased from such person, calculated by reference to and varying with quantities produced or sold as a result of such asset”.

Although royalty is similar to rent, it differs in certain aspects. Some of the examples of royalty are:

- ◊ Amount received by owner of a quarry while transferring the right to another party to extract crushed rocks - Mine Royalty
- ◊ Amount received by an inventor while transferring the right to use his invention (patent) - Patent Royalty
- ◊ Amount received by an author, artist or designer while transferring exclusive right to copy his works by another - Copyright Royalty

### Difference between Rent and Royalty

Royalty	Rent
The term Royalty refers to the payment made for exclusive use of both tangible and intangible assets.	Rent refers to the payment made towards use of tangible asset only. i.e., Building, machinery, etc.
The payment of Royalty is made on the basis of output or sale.	Rent is paid for a specific period say per month, per year, per day or per hour, etc.
The payment of Royalty varies as per sales or output.	Rent is always fixed
The parties involved in Royalty are known as lessee, lessor, patent holder, patentee, publisher, author etc.	There are only two parties involved in rent the landlord and the tenant

In case of Royalty agreement, there is a clause of making minimum payment, the landlord must be paid minimum rent or actual royalty whichever is higher.	In case of rent the question of minimum rent does not arise.
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### 4.1.2 Terms used in connection with Accounting for Royalty

#### a. Minimum rent /dead rent: -

In the initial days of every business, the production or sale may be low. Therefore, in order to safeguard the interest of the lessor, minimum rent clause is included in the Royalty agreement. Minimum rent may be defined as “The minimum amount which is payable by the lessee to the lessor, irrespective of production or sale”. The assured and mutually agreed periodical minimum amount paid by lessee to lessor is known as minimum rent. It is the minimum rent below which lessor never accepts from the lessee. This is also known as certain rent, dead rent, fixed rent, flat rent, contract rent, etc.. Fixation of minimum interest is beneficial from the point of view of lessor as it guarantees a minimum rent even if the sales or output is low. It boosts up the initiative of lessee as he is bound to pay a minimum rent to the lessor.

If the actual royalty payable is more than the minimum rent, the lessee is obliged to pay the higher amount i.e., actual royalty to the landlord. The rule to be followed is minimum rent or actual royalty whichever is higher. For Example, Royalty per ton of production agreed up on is ₹10 and the minimum rent is ₹ 20000. Suppose, the actual production is 1000 tons, then the actual Royalty payable would come to ₹10000. In this case the minimum rent of ₹20000 will have to be paid by the lessee. On the other hand, if the actual production is 3000 tons, then the actual Royalty payable would come to ₹30000. Thus, either the minimum rent or actual royalty whichever is higher will have to be paid by the lessee.

#### b. Short workings

The excess of minimum rent over royalty is called ‘Short workings’. Short working is a loss to the lessee.

$$\text{Short workings} = \text{Minimum rent} - \text{Actual royalty}$$

Or

$$\text{Minimum rent} = \text{Short workings} + \text{Actual royalty}$$

Short workings arise during the initial periods of lease or due to abnormal conditions as the activity level is not satisfactory during those periods. Short workings are carried forward and shown on the asset side of balance sheet till it is recouped. If there is no provision for recouping short workings, or the time allowed for recoupment is over, at that moment the balance of short workings which was not being recouped is transferred to Profit and Loss account.

For example, P leased a mine from Q at a Minimum Rent of ₹24000 p.a. merging a royalty of ₹2 per ton of coal raised. The quantity raised for the 1<sup>st</sup> year is ₹8000 tons



and that of the 2<sup>nd</sup> year ₹16000 tons. Here, P will have to pay ₹24000 for the 1<sup>st</sup> year to Q, i.e., the Minimum Rent [as actual royalty ( $16000 = 8000 \times 2$ ) is less than Minimum Rent]. On the contrary, he will have to pay ₹32000 to Y for the 2nd year [since actual royalty ( $32000 = 16000 \times 2$ ) is more than the Minimum Rent]. In this example, short working is there in the first year as actual royalty is less than the minimum rent ( $24000 - 16000 = 8000$ ), but in the second year there is no short working as the actual royalty is more than the minimum rent.

### c. Recoupment of short working (Recovery)

Lessor usually gives a right to the lessee to carry forward and set off the short workings in subsequent years against the excess or surplus of royalties over the Minimum Rent.

Methods of recoupment of short working:

Restricted or Fixed right	Unrestricted or floating or fluctuating right
<ul style="list-style-type: none"> <li>◊ The lessee obtains the right to recoup the loss (short working) for a fixed period</li> <li>◊ Any short working beyond this period is not reimbursed.</li> </ul>	<ul style="list-style-type: none"> <li>◊ Lessor guarantees the lessee to compensate the loss (short working) of any year in the next or following or subsequent two or more years.</li> </ul>

### d. Surplus

The excess of Royalties over minimum rent is called surplus. This surplus is being utilised only for recoupment of short workings.

$$\text{Surplus} = \text{Royalty} - \text{Minimum Rent}$$

### e. Ground Rent or Surface Rent

The amount paid by the lessee to the landlord either yearly or half yearly in addition to minimum rent is called ground rent.

## Recap

- ◊ Royalty- Payment made for exclusive use of both tangible and intangible assets.
- ◊ Payment of Royalty- On the basis of output or sale.
- ◊ Minimum rent or actual royalty whichever is higher must be paid to the landlord.
- ◊ Minimum rent- Assured and mutually agreed periodical minimum amount paid by lessee to lessor.
- ◊ Two methods of recoupment of short working- Restricted or Fixed right and Un restricted.

- ◊ Restricted or Fixed right-Lessee obtains the right to recoup the loss (short working) for a fixed period.
- ◊ Unrestricted or floating or fluctuating right- Lessor guarantees the lessee to compensate the loss (short working) of any year in the next or following or subsequent two or more years.
- ◊ Ground rent- Rent paid to the landlord in addition to the minimum rent.
- ◊ Surplus=Actual rent-Minimum Rent

## Objective Questions

1. What type of account is royalty account?
2. What is the term that is used to denote the excess of minimum rent over royalty payable for the year?
3. On which basis is royalty calculated?
4. To which account is the irrecoverable short workings transferred?
5. Which term is used to denote the excess of actual royalty over the minimum rent?
6. How is short working adjusted?
7. What is the payment made towards use of only tangible asset known as?
8. What is ground rent?

## Answers

1. Nominal A/c
2. Short working
3. Production or sales
4. Profit and Loss A/c
5. Surplus
6. Carry forward and set off the short workings in subsequent years against the excess or surplus of royalties
7. Rent
8. Rent paid to the landlord in addition to the minimum rent

## Self-Assessment Questions

1. What do you mean by royalty?
2. Distinguish between rent and royalty.
3. Explain the concept of recoupment of short working in royalty account.
4. How is ground rent different from minimum rent?
5. Explain the meaning of surplus in royalty accounts.
6. What is short working?
7. List out three examples of royalty.
8. What is the objective of dead rent?

## Assignments

1. Identify and list 5 industries where royalty is used. Explain its significance in accounting.
2. How is restricted method of recoupment different from unrestricted method? Explain using an example.
3. Prepare a case study involving a company engaged in royalty-based transactions.
4. Analyse a sample royalty contract and identify the key accounting considerations for both the lessor and lessee.

## Suggested Readings

1. Aggarwal, D. R., & Aggarwal, S. (2019). *Advanced Accounting*. New Delhi, India: Vikas Publishing House Pvt Ltd.
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# Unit 12

## Preparation of Royalty Accounts

### Learning Outcomes

After studying this unit, learner will be able to:

- ◊ learn adjustments of minimum rent in the event of strike and lockouts.
- ◊ familiarise the government subsidy in case of strike or lockouts.
- ◊ gain insights on the circumstances of creating provision on short workings.
- ◊ prepare minimum rent account, short workings and royalty accounts

### Prerequisites

In normal royalty-based business, the user must pay a royalty to the owner of the asset or object over which the owner has certain privileges. The owner and the user of such property or rights prepare a royalty agreement. Payments paid by the lessee for royalty are considered a regular business expense and will be deducted from the royalty account. Based on output or production, royalties absolutely go to manufacturing or production.

Lease agreements often stipulate minimum rent obligations, ensuring a consistent revenue stream for lessors. The concept of minimum rent was developed to protect the lessor. But during certain circumstances, the payment of minimum rent creates a burden upon the shoulder of lessee. Strikes, lock outs, etc. are some of such circumstances. During such situations, creation of provisions, government subsidies etc. comes to the rescue of the lessee where some adjustments are made to reduce the minimum rent.

So, all these transactions are recorded in the books, lessee and lesser. In this unit, we will discuss journal entries and related accounts, and on the adjustments of minimum rent during the circumstances of strike, lock down etc.

## Keywords

Minimum rent, Royalty account, Short working account, Strikes, Lockout, Provision for short working, Government subsidy

## Discussion

### 4.2.1 Accounting Treatments in Royalty

In the preceding unit, we covered the essential terminology associated with royalty. The accounting treatment in the books of the lessor and in the books of the lessee is explained in this unit.

#### Accounting entries in the books of User (Lessee/Licensee/Publisher)

When minimum rent account is not opened	When minimum rent account is opened
<b>1. For Royalties payable</b> a. When actual Royalty is less than minimum rent. Royalty a/c Dr. Short workings a/c Dr. To Landlord a/c	<b>1. For minimum rent is payable</b> a. When actual Royalty is less than minimum rent. Minimum rent a/c Dr. To Landlord a/c
b. When actual Royalty is more than Minimum rent Royalty Account Dr. To Landlord Account	b. When actual Royalty is more than minimum rent No Entry
Landlord a/c Dr. To short workings a/c (S.W. if any recouped during the period)	<b>2. For Royalty payable</b> Royalty (payable) a/c Dr. Short workings a/c Dr. To Minimum rent a/c

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**2. For payment of Royalty**

Landlord a/c Dr.  
To Bank a/c

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**3. For payment of Royalty**

Landlord a/c Dr.  
To Bank a/c

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**4. For transfer of Royalty**

Profit and Loss a/c Dr.  
To Royalty a/c

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**4. For transfer of Royalty**

Profit and Loss a/c Dr.  
To Royalty a/c

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**5. When short working is not completely recovered**

Profit and Loss a/c Dr.  
To Short working a/c

---

**5. For transfer of short working**

Profit and Loss a/c Dr.  
To short working a/c

---

For example, actual royalty payable is ₹600000 and the minimum rent is ₹900000

**When minimum rent account is not opened the entry will be**

Royalty a/c	Dr. 600000
Short workings a/c	Dr. 300000
To Landlord a/c	900000

**When minimum rent account is opened the entry will be**

i. Minimum rent a/c	Dr 900000
To Landlord a/c	900000
ii. Royalty (payable)a/c	Dr. 600000
Short workings a/c	Dr. 300000
To Minimum rent a/c	900000

If entries (i) and (ii) are combined, the entry will be:

Royalty (payable) a/c	Dr. 600000
Short workings a/c	Dr. 300000
To Landlord a/c	900000

From the above example it is clear that the result would be the same without opening the minimum rent account.

Thus, it is found that the same result can be achieved under both circumstances that is with or without maintaining the minimum rent account. So, the purpose of maintaining minimum rent account is the following:

- ◊ In the year of short workings, minimum rent account is debited and landlord account credited. Thus, it is easy to identify the specific year when the performance was not upto the minimum level and identify the causes for those short workings and steps taken by lessee.

- ◊ Minimum rent may vary from year to year, according to the lease agreement. In such a situation minimum rent account can also be opened.

### Accounting Entries in the books of Landlord (Lessors/authors/patent owner)

When minimum rent account is not opened	When minimum rent account is opened
<b>1. For Royalty receivable</b> Lessee's a/c Dr. To Royalties (receivable) a/c To short working suspense a/c	<b>1. For Royalty receivable</b> Lessee's a/c Dr. To Royalties (receivable) a/c Short workings suspense a/c Dr. To Lessee's a/c
<b>ii. For receipt of Royalty</b> Bank a/c Dr. To Lessee's a/c	<b>ii. For receipt of Royalty</b> Bank a/c Dr. To Lessee's a/c
<b>iii. For transfer of Royalty</b> Royalties (receivable) a/c Dr. To Profit and Loss a/c	<b>iii. For transfer of Royalty</b> Royalties (receivable) a/c Dr. To Profit and Loss a/c
<b>iv. For transfer of short working (non- recovery of short working)</b> Short working suspense a/c Dr. To Profit and Loss a/c	<b>iv. For transfer of short working (non- recovery of short working)</b> Short working suspense a/c Dr. To Profit and Loss a/c

### 4.2.2 Preparation of Analytical table

Before passing journal entries in the books of lessor and lessee, we should get a clear idea about short workings, surplus, short workings recouped and not recouped. For this purpose we have to prepare a table known as analytical table.

Example: A company leased a colliery on 1 January, 2017 at a minimum rent of ₹9000 merging into a royalty of 50 paise per ton with power to recoup short workings over the first three years. The production has been 12000 tons, 19000 tons, 21000 tons, respectively.

**Analytical Table**

Year	Production in tones	Minimum rent	Royalty	Short Working	Surplus	S.W. recouped	S.W. not recouped	Paid to landlord
2017	12000	9000	6000	3000	--	--	---	9000
2018	19000	9000	9500	---	500	500	2500	9000
2019	21000	9000	10500	---	1500	1500	1000	9000

- ◊ Short workings = Minimum rent – Royalty
- ◊ Surplus = Royalty – Minimum rent, surplus is being utilised for set off losses of earlier years.
- ◊ Short working not recouped is shown in second last column in the above table.

# I

## Illustration 4.2.1

A company leased a colliery on 1 January, 2017 at a minimum rent of ₹ 25000 merging into a royalty of ₹1.50 per ton with power to recoup short workings over the first four years. The output was 12000 tons, 15000 tons, 18000 tons, 20000 tons respectively. Pass the necessary journal entries for each of the four years in the books of the company.

# S

## Solution

**ANALYTICAL TABLE**

Year	Production	Minimum rent	Royalty	Short Working	Surplus	S.W. recouped	S.W. not recouped	Paid to landlord
2017	12000	25000	18000	7000	--	--	7000	25000
2018	15000	25000	22500	2500	--	--	9500	25000
2019	18000	25000	27000	--	2000	2000	7500	25000
2020	20000	25000	30000	--	5000	5000	2500	25000

**Journal Entries (in the books of lessee)**

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2017 Dec 31	<b>For Royalties payable</b> (When actual Royalty is less than minimum rent) Royalty a/c Dr. Short workings a/c Dr. To Landlord a/c		18000 7000	25000
	<b>For payment of Royalty</b> Landlord a/c Dr. To Bank a/c		25000	25000
	<b>For transfer of Royalty</b> Profit and Loss a/c Dr. To Royalty a/c		18000	18000

2018 Dec 31	<b>For Royalties payable</b> (When actual Royalty is less than minimum rent)			
	Royalty a/c	Dr.	22500	
	Short workings a/c	Dr.	2500	25000
	To Landlord a/c			
	<b>For payment of Royalty</b>			
	Landlord a/c	Dr.	25000	25000
	To Bank a/c			
	<b>For transfer of Royalty</b>			
	Profit and Loss a/c	Dr.	22500	22500
	To Royalty a/c			
2019 Dec 31	(When actual royalty is more than minimum rent)			
	Royalty a/c	Dr.	27000	27000
	To Landlord a/c			
	<b>For payment of Royalty</b>			
	Landlord a/c	Dr.	27000	25000
	To Bank a/c			2000
	To Short working a/c			
	<b>For transfer of Royalty</b>			
	Profit and Loss a/c	Dr.	27000	27000
	To Royalty a/c			
2020 Dec 31	(When actual royalty is more than minimum rent)			
	Royalty a/c	Dr.	30000	30000
	To Landlord a/c			
	<b>For payment of Royalty</b>			
	Landlord a/c	Dr.	30000	25000
	To Bank a/c			5000
	To Short working a/c			
	<b>For transfer of Royalty</b>			
	Profit and Loss a/c	Dr.	2500	2500
	To Royalty a/c			

### In the books of Lessor

#### Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2017 Dec 31	Lessee a/c Dr. To Royalties (receivable) a/c		25000	18000

	To short working allowable a/c (Royalty ₹1.50 per ton on 12000 tons)		7000
2018	Bank a/c Dr. To Lessee's a/c (Amount received on account of Royalties)	25000	25000
Dec 31	Royalties (receivable)a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)	18000	18000
	Lessee a/c Dr. To Royalties (receivable)a/c To short working allowable a/c (Royalty ₹1.50 per ton on 15000 tons)	25000	22500 2500
	Bank a/c Dr. To Lessee's a/c (Amount received on account of Royalties)	25000	25000
	Royalties (receivable)a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)	22500	22500
2019 Dec	Lessee a/c Dr. To Royalties (receivable) a/c (Royalty ₹1.50 per ton on 18000 tons)	27000	27000
31	Short working allowable a/c Dr. To Lessee a/c (Adjustment of surplus against S.W. allowable account)	2000	2000
	Bank a/c Dr. To Lessee's a/c (Amount received on account of Royalties)	25000	25000
	Royalties (receivable) a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)	27000	27000

2020 Dec 31	Lessee a/c Dr. To Royalties (receivable) a/c (Royalty ₹1.50 per ton on 20000 tons)		30000	30000
	Short working allowable a/c Dr. To Lessee a/c (Adjustment of surplus against S.W. allowable account)		5000	5000
	Bank a/c Dr. To Lessee's a/c (Amount received on account of Royalties)		25000	25000
	Royalties (receivable)a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)		30000	30000
	Short working allowable a/c Dr. To Profit and Loss a/c (S.W. which cannot be recouped transferred to Profit and Loss a/c )		2500	2500

## I Illustration 4.2.2

The Raniganj Coal Ltd. got the lease of a colliery on the basis of 50 paise per ton with minimum rent of ₹5000 p.a. The tenant has a right to recoup short workings during the first four years of the lease. The production in tons was as follows: 2017- 2000 tons, 2018 - 6000 tons, 2019 – 10000 tons, 2020 – 18000 tons, 2021 – 20000 tons Pass journal entries in the books of the company.



### Solution

Year	Production	Minimum rent	Royalty	Short Working	Surplus	S.W. recouped	S.W. not recouped	Paid to landlord
2017	2000	5000	1000	4000	--	--	--	5000
2018	6000	5000	3000	2000	--	--	--	5000
2019	10000	5000	5000	--	--	--	--	5000
2020	18000	5000	9000	--	4000	4000	2000	5000
2021	20000	5000	10000	--	5000	--	--	10000

## Journal Entries in the books of Raniganj Coal Ltd

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2017 Dec 31	<b><i>For Royalties payable</i></b> Royalty a/c Dr. Short workings a/c Dr. To Landlord a/c		1000 4000	5000
	<b><i>For payment of Royalty</i></b> Landlord a/c Dr. To Bank a/c		5000	5000
	<b><i>For transfer of Royalty</i></b> Profit and Loss a/c Dr. To Royalty a/c		1000	1000
2018 Dec 31	<b><i>For Royalties payable</i></b> Royalty a/c Dr. Short workings a/c Dr. To Landlord a/c		3000 2000	5000
	<b><i>For payment of Royalty</i></b> Landlord a/c Dr. To Bank a/c		5000	5000
	<b><i>For transfer of Royalty</i></b> Profit and Loss a/c Dr. To Royalty a/c		3000	3000
2019 Dec 31	<b><i>For Royalties payable</i></b> Royalty a/c Dr. To Landlord a/c		5000	5000
	<b><i>For payment of Royalty</i></b> Landlord a/c Dr. To Bank a/c		5000	5000
	<b><i>For transfer of Royalty</i></b> Profit and Loss a/c Dr. To Royalty a/c		5000	5000
2020 Dec 31	<b><i>For Royalties payable</i></b> Royalty a/c Dr. To Landlord a/c		9000	9000
	<b><i>For payment of Royalty</i></b> Landlord a/c Dr. To Bank a/c		9000	5000
	To Short working a/c (short working recouped and payment made to landlord)			4000

2021 Dec 31	<b>For transfer of Royalty</b>			
	Profit and Loss a/c	Dr.	11000	9000
	To Royalty a/c			2000
	To Short working			
	(un recouped short working and royalty transferred to P/L a/c)			
	<b>For Royalties payable</b>			
	Royalty a/c	Dr.	10000	10000
	To Landlord a/c			
	<b>For payment of Royalty</b>			
	Landlord a/c	Dr.	10000	10000
	To Bank a/c			
	<b>For transfer of Royalty</b>			
	Profit and Loss a/c	Dr.	10000	10000
	To Royalty a/c			

## I

### Illustration 4.2.3

Y company is lessee of a mine on a royalty of ₹1.50 per ton of coal raised with minimum rent to X of ₹10000 p.a. with power to recoup short workings during the first two years of the lease only.

The output for the first three years were:

Year	2018	2019	2020
Output (tonnes)	4000	8000	7000

Pass necessary journal entries in the books of Landlord.



### Solution

#### Analytical Table

Year	Output	Royalty	Minimum Rent	S.W	S.W.recouped	S.W.unrecouped	Amt paid
2018	4000	6000	10000	4000	-	-	10000
2019	8000	12000	10000	-	2000	2000	10000
2020	7000	10500	10000	-	-	-	10500

**In the books of X**  
**Journal**

<b>Date</b>	<b>Particulars</b>	<b>L.F.</b>	<b>Debit (₹)</b>	<b>Credit (₹)</b>
2018 Dec 31	Y company a/c Dr. To Royalties (receivable) a/c To short working allowable a/c (Royalty ₹1.50 per ton on 4000 tons)		10000 10000 6000	6000 4000 10000
	Bank a/c Dr. To Y company a/c (Amount received on account of Royalties)			6000
	Royalties (receivable) a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)			6000
2019 Dec 31	Y company a/c Dr. To Royalties (receivable) a/c (Royalty ₹1.50 per ton on 8000 tons)		12000	12000
	Short working allowable a/c Dr. To Y company a/c (Adjustment of surplus against S.W. allowable account)		2000	2000
	Bank a/c Dr. To Y company a/c (Amount received on account of Royalties)		10000	10000
	Royalties (receivable) a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)		12000	12000
	Short working allowable a/c Dr. To Profit and Loss a/c (S.W. which cannot be recouped)		2000	2000
2020 Dec 31	Y company a/c Dr. To Royalties (receivable) a/c (Royalty ₹1.50 per ton on 7000 tons)		10500	10500



Bank a/c To Y company a/c (Amount received on account of Royalties)	Dr.	10500	10500
Royalty a/c To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)	Dr.	10500	10500

### Y Company Account

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To Royalties (receivable) a/c	6000	2018 Dec 31	By Bank	10000
	To Short working allowable	4000			10000
		10000			12000
2019 Dec 31	To Royalties (receivable) a/c	12000	2019 Dec 31	By Short working allowable	12000
		12000		By Bank	10000
		10500		By Bank	10500
2020 Dec 31	To Royalties (receivable) a/c	10500	2020 Dec 31		10500

### Royalties (receivable) a/c

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To Profit and Loss a/c	6000	2018 Dec 31	By Y company	6000
		6000			6000
2019 Dec 31	To Profit and Loss a/c	12000	2019 Dec 31	By Y company	2000
		12000			12000
2020 Dec 31	To Profit and Loss a/c	10500	2020 Dec 31	By Y company	10500
		10500			10500

### Short workings Allowable Account

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To Balance c/d	4000	2018 Dec 31	By Y company	4000
		4000			4000
2019 Dec 31	To Y company To Profit and Loss a/c	2000	2019 Jan 1	By Balance b/d	4000
		2000			4000
		4000			4000

# I

## Illustration 4.2.4

Bharath coal company took a coal mine on lease from Raj Coal Co, for 20 years from 1 April, 2017 on a royalty of 80 paise per ton. The minimum rent was fixed at ₹10000 p.a. with power to recoup short working over the first four years of the lease. The output was as follows:

Year 2017 2018 2019 2020 2021

Tons 6000 7000 16000 20000 30000

Draft journal entries and show the necessary ledger accounts in the books of the lessee. Accounts are closed on 31 March every year.

### Analytical table

Year	Output Tonnes	Royalty 80 paise	Minimum rent	Short workings	surplus	S.W. recouped	S.W. Not recouped	paid to landlord
2017	6000	4800	10000	5200	--	--	--	10000
2018	7000	5600	10000	4400	--	--	--	10000
2019	16000	12800	10000	--	2800	2800	--	10000
2020	20000	16000	10000	--	6000	6000	800	10000
2021	30000	24000	10000	--	14000	--	--	24000

### Journal Entries in the books of Lessee (Bharath coal company)

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017 March 31	<b>For short workings and royalty due</b> Royalty a/c Dr. Short workings a/c Dr. To Raj coal co. a/c		4800 5200	10000
	<b>For payment of Royalty</b> Raj coal co. a/c Dr. To Bank a/c		10000	10000
	<b>For transfer of Royalty</b> Profit and Loss a/c Dr. To Royalty a/c		4800	4800
2018 March 31	<b>For short workings and royalty due</b> Royalty a/c Dr. Short workings a/c Dr.		5600 4400	

	To Raj coal co. a/c		10000
	<b><i>For payment of Royalty</i></b>		
	Raj coal co. a/c Dr.	10000	10000
	To Bank a/c		
	<b><i>For transfer of Royalty</i></b>		
	Profit and Loss a/c Dr.	5600	5600
	To Royalty a/c		
2019	<b><i>For royalty due</i></b>		
March 31	Royalty a/c Dr.	12800	12800
	To Raj coal co. a/c		
	<b><i>For payment of Royalty</i></b>		
	Raj coal co.a/c Dr.	12800	10000
	To Bank a/c		2800
	To Short workings a/c		
	<b><i>For transfer of Royalty</i></b>		
	Profit and Loss a/c Dr.	12800	12800
	To Royalty a/c		
2020	<b><i>For royalty due</i></b>		
March 31	Royalty a/c Dr.	16000	16000
	To Raj coal co. a/c		
	<b><i>For payment of Royalty and short working recouped</i></b>		
	Raj coal co.a/c Dr.	16000	10000
	To Bank a/c		6000
	To Short workings a/c		
	<b><i>For transfer of Royalty</i></b>		
	Profit and Loss a/c Dr.	16800	16000
	To Royalty a/c		800
	To short working a/c		
2021	<b><i>For royalty due</i></b>		
March 31	Royalty a/c Dr.	24000	24000
	To Raj coal co. a/c		
	<b><i>For payment of Royalty</i></b>		
	Raj coal co. a/c Dr.	24000	24000
	To Bank a/c		
	<b><i>For transfer of Royalty</i></b>		
	Profit and Loss a/c Dr.	24000	24000
	To Royalty a/c		

### Royalty Account

Date	Particulars	Amount	Date	Particulars	Amount
2017 March 31	To Raj coal co.	4800	2017 March 31	By Profit and Loss	4800
		<b>4800</b>			<b>4800</b>
2018 March 31	To Raj coal co.	5600	2018 March 31	By Profit and Loss	5600
		<b>5600</b>			<b>5600</b>
2019 March 31	To Raj coal co.	12800	2019 March 31	By Profit and Loss	12800
		<b>12800</b>			<b>12800</b>
2020 March 31	To Raj coal co.	16000	2020 March 31	By Profit and Loss	16000
		<b>16000</b>			<b>16000</b>
2021 March 31	To Raj coal co.	24000	2021 March 31	By Profit and Loss	24000
		<b>24000</b>			<b>24000</b>

### Short Workings Account

Date	Particulars	Amount	Date	Particulars	Amount
2017 March 31	To Raj coal co.	5200	2017 March 31	By balance c/d	5200
		<b>5200</b>			<b>5200</b>
2017 April 1	To balance b/d	5200	2018 March 31	By balance c/d	9600
2018 March 31		4400			<b>9600</b>
		<b>9600</b>			<b>9600</b>
2018 April 1	To balance b/d	9600	2019 March 31	By Raj coal co	2800
		<b>9600</b>			<b>9600</b>
2019 April 1	To balance b/d	6800	2020 March 31	By Raj coal co	6000
		<b>6800</b>			<b>6000</b>
				By profit and loss	800
					<b>6800</b>

### Raj Coal Co. a/c (Landlord Account)

Date	Particulars	Amount	Date	Particulars	Amount
2017 March 31	To Bank	10000	2017 March 31	By Royalty	4800
		<b>10000</b>		By Short workings	5200
2018 March 31	To Bank	10000	2018 March 31	By Royalty	5600
		<b>10000</b>		By Short workings	4400
2019 March 31	To Bank	10000	2019 March 31	By Royalty	12800
	To Short workings	2800			<b>12800</b>
		<b>12800</b>			
2020 March 31	To Bank	10000	2020 March 31	By Royalty	16000
	To Short workings	6000			<b>16000</b>
		<b>16000</b>			
2021 March 31	To Bank	24000	2021 March 31	By Royalty	24000
		<b>24000</b>			<b>24000</b>

### Journal in the books of Raj Coal company

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
2017 Dec 31	Bharath company a/c Dr. To Royalties (receivable) a/c To short working allowable a/c (Royalty 80 paise per ton on 6000 tons)		10000	4800 5200
	Bank a/c Dr. To Bharath company a/c (Amount received on account of Royalties)		10000	10000
	Royalties (receivable) a/c Dr. To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)		4800	4800
2018 Dec 31	Bharath company a/c Dr. To Royalties (receivable) a/c To short working allowable a/c (Royalty 80 paise per ton on 7000 tons)		10000	5600 4400

2019 Dec 31	Bank a/c	Dr.	10000	10000
	To Bharath company a/c			
	(Amount received on account of Royalties)			
	Royalties (receivable) a/c	Dr.	5600	5600
	To Profit and Loss a/c			
	(Transfer of Royalties receivable a/c to Profit and Loss a/c)			
	Bharath company a/c	Dr.	12800	12800
	To Royalties (receivable) a/c			
	(Royalty 80 paise per ton on 16000 tons)			
	Short working allowable a/c	Dr.	2800	2800
2020 Dec 31	To Bharath company a/c (Adjustment of surplus against S.W. allowable account)			
	Bank a/c	Dr.	10000	10000
	To Bharath company a/c			
	(Amount received on account of Royalties)			
	Royalties (receivable) a/c	Dr.	12800	12800
	To Profit and Loss a/c			
	(Transfer of Royalties receivable a/c to Profit and Loss a/c)			
	Bharath company a/c	Dr.	16000	16000
	To Royalties (receivable) a/c			
	(Royalty 80 paise per ton on 20000 tons)			
	Short working allowable a/c	Dr.	6000	6000
	To Bharath company a/c (Adjustment of surplus against S.W. allowable account)			
	Bank a/c	Dr.	10000	10000
	To Bharath company a/c			
	(Amount received on account of Royalties)			
	Royalties (receivable) a/c	Dr.	16000	16000
	To Profit and Loss a/c			
	(Transfer of Royalties receivable a/c to Profit and Loss a/c)			
	Short working allowable a/c	Dr.	800	800
	To Profit and Loss a/c			
	(S.W. which cannot be recouped)			

2021 Dec 31	Bharath company a/c	Dr.	24000	24000
	To Royalties (receivable) a/c (Royalty 80 paise per ton on 30000 tons)			
	Bank a/c	Dr.		
	To Bharath company a/c (Amount received on account of Royalties)		24000	24000
	Royalties (receivable) a/c	Dr.		
	To Profit and Loss a/c (Transfer of Royalties receivable a/c to Profit and Loss a/c)			

### Bharath A/c

Date	Particulars	Amount	Date	Particulars	Amount
2017 Dec 31	To Royalties(receivable)	4800	2017 Dec 31	By Bank	10000
Dec 31	To short working allowable	5200			<b>10000</b>
		<b>10000</b>			
2018 Dec 31	To Royalties(receivable)	5600	2018 Dec 31	By Bank	10000
Dec 31	To short working allowable	4400			<b>10000</b>
		<b>10000</b>			
2019 Dec 31	To Royalties (receivable)	12800	2019 Dec 31	By short working	2800
				By bank	10000
		<b>12800</b>			<b>12800</b>
2020 Dec 31	To Royalties (receivable)	16000	2020 Dec 31	By short working	6000
				By bank	10000
		<b>16000</b>			<b>16000</b>
2021 Dec 31	To Royalties (receivable)	24000	2021 Dec 31	By bank	24000
		<b>24000</b>			<b>24000</b>

### Royalties (receivable) a/c

Date	Particulars	Amount	Date	Particulars	Amount
2017 Dec 31	To Profit and Loss	4800	2017 Dec 31	By Bharath Company	4800
		4800			4800
2018 Dec 31	To Profit and Loss	5600	2018 Dec 31	By Bharath Company	5600

2019 Dec 31	To Profit and Loss	5600	2019 Dec 31	By Bharath Company	5600
		12800			12800
		12800			12800
2020 Dec 31	To Profit and Loss	16000	2020 Dec 31	By Bharath Company	16000
		16000			16000
		24000			24000
2021 Dec 31	To Profit and Loss	24000	2021 Dec 31	By Bharath Company	24000
		24000			24000

### Short working allowable a/c

Date	Particulars	Amount	Date	Particulars	Amount
2017 Dec 31	To balance c/d	5200	2017 Dec 31	By Bharath company	5200
		5200			5200
2018 Dec 31	To balance c/d	9600		By balance b/d	5200
		9600			4400
		9600	Dec 31	By Bharath company	9600
2019 Dec 31	To Bharath company	2800	2019 Jan 1	By balance b/d	9600
		6800			9600
2020 Dec 31	To Bharath company	9600			6800
		6000	2020 Jan 1	By balance b/d	6800
		800			6800
		6800			6800

### 4.2.3 Minimum Rent

Royalty agreements are usually associated with a clause that the lessor or landlord must receive a minimum amount whatever be the production or sales in a particular period. Such minimum amount is known as minimum rent or dead rent or fixed rent. The fixation of such rent is in the interest of the landlord because it guarantees him the receipt of the minimum amount in case of low output or sales. Further, it gives incentives to the lessee to increase the production or sales. Since the guarantee is for the payment of a minimum amount, it has the effect of paying actual royalty based on output or sales or minimum rent, whichever is higher.

For example, M/s. Delhi Publications printed a book on Advanced Financial Accounting at a minimum rent of ₹200000 per annum, royalty being payable @ ₹75 per copy sold and the number of copies sold in the first year is 2000 and in the second year is 4000. In this case, M/s Delhi Publishers will have to pay ₹200000 (i.e., minimum rent) to the authors in the first year since the royalty works out to be only ₹150000 for 2000 copies @75 per copy sold. In the second year ₹300000 as royalty for 4000 copies @₹75 per copy sold will be paid to the authors even though the minimum rent is ₹200000.



## 4.2.4 Adjustment of Minimum Rent in the Event of Strike and Lockouts

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

- i. Non-application of the condition of minimum rent: in such a case the clause of minimum rent is not applied. Actual royalties will discharge all rental obligations. There will not be any short workings or surplus.
- ii. Reduction in the amount of minimum rent: if there is any clause in the agreement, regarding reduction in the amount of minimum rent, it can take the following form:
  - a. Minimum rent is reduced proportionately to the length of the stoppage of work during the relevant year.
  - b. Minimum rent can be reduced by a fixed percentage or by a fixed amount in the year of stoppage.

### 4.2.4.1 Creation of Provision against Short workings

Sometimes, it may not be possible to recoup the short workings out of the future payments of royalty due to some factors physical or economic, even though the period to recover the same still has not lapsed. In such cases, provision against short workings should be created in the year in which short workings arise with the amount of short workings of that by passing the following entry:

Profit and Loss Account Dr.  
To Provision against Short workings Account  
(Provision against short workings created)

When short workings are actually recovered, the balance in the Provision against Short workings Account should be reduced by transfer to the Profit and Loss Account by passing the following entry:

Provision against Short working Account Dr.  
To Profit and Loss Account (Recoupment of short workings)

In case it is clear that short workings are no longer recoupable, the following entry is to be passed:

Provision against Short working Account Dr.  
To Short working Account  
(Provision against short workings eliminated on account of irrecoverable short

workings)

After short workings are recouped, the excess provision against short workings is credited to Profit and Loss Account as a prior period adjustment because Profit and Loss Account was debited when provision against short working was created. Entry for excess provision is:

Provision against Short working Account Dr.

To Profit and Loss Account

(Transfer of excess provision after short workings are recouped)

Sometimes a limit is prescribed for recoupment of short workings and recoupment beyond this limit is not possible.

The above method of creation of provision against short workings is adopted when the amount of short workings is substantial and chances of recovery of short workings are uncertain.

#### 4.2.5 Impact of Strike, Lockout in Case of Royalty Accounts

Strike and lockout may take place and continue in a business for a long period. In these circumstances, as the production is not there the lessee finds it difficult to pay the minimum rent to the lessor. In order to help the lessee in these circumstances, the lessor gives a relief by way of reducing the minimum rent. The amount of minimum rent is to be adjusted by entering into an agreement. Minimum rent can be reduced in any of the three ways:

- i. Actual royalty earned will become the minimum rent; In this case there will neither be short working nor will there be any recoupment. If the actual royalty payable is ₹10000 and the minimum rent is ₹15000, the minimum rent will come down to actual rent, that is, ₹10000
- ii. Minimum rent is to be reduced proportionately having regard to the length of stoppage of work. In this case the amount of minimum rent will be reduced proportionately having regard to the length of stoppage. For example,

The minimum rent - ₹15000 Strike period 3 months

Reduced minimum rent will be  $15000 \times 9/12 = ₹ 11250$

- iii. A certain percentage of minimum rent would be reduced. Example: 20% or 30% and the like.

#### 4.2.6 Government subsidy in case of strike or lockouts

For subsidy due from government the journal entries in the books of lessee:

Government A/c Dr.

To Short workings A/c

(Subsidy due from the government)



For receipt of subsidy from government

Bank A/c      Dr.  
To Government A/c  
(Receipt of subsidy from government)

### 4.2.7 Preparation of Minimum Rent Account

Minimum Rent Account is prepared if minimum rent is more than royalty and it is specifically asked to be prepared in the question.

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#### Illustration 4.2.5

From the given analytical table prepare minimum rent account.

**Analytical Table**

Year	Royalty	Minimum Rent	Surplus	S.W.	S.W. Recouped	S.W. un Recouped	Amount to pay
2019	4000	18000	-	14000	-	-	18000
2020	9600	18000	-	8400	-	-	18000
2021	18800	18000	800	-	800	21600	18000

S

#### Solution

As minimum rent account is prepared at the time of short workings, it is prepared for the year 2019 and 2020.

**Minimum Rent A/c**

Date	Particulars	Amount	Date	Particulars	Amount
2019 Dec 31	To Landlord	18000	2019 Dec 31	By Royalty	4000
		<b>18000</b>		By Short workings	14000
2020 Dec 31	To Landlord	18000	2020 Dec 31	By Royalty	9600
		<b>18000</b>		By Short workings	8400

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#### Illustration 4.2.6

On 1 January 2018, Mital collieries Ltd. took a piece of land on lease. A minimum rent of ₹2000 in the first year, ₹3000 in the second year and thereafter ₹5000 p.a. is to

be merging into a royalty of 50 paise per ton, with power to recoup short workings over the first three years of the lease only. The figures of annual output for the years from 1 January 2018 to 31 December, 2021, were 1000, 6000, 12000 and 20000 tons respectively. Open the necessary accounts in the books of the Lessee.

### Analytical table

Year	Output	Royalty @50 paise	Minimum rent	Surplus	S.W.	S.W. recouped	S.W. un recouped	s.w. c/f	Amount payable
2018	1000	500	2000	-	1500	--	1500	1500	2000
2019	6000	3000	3000	--	-	-	--	1500	3000
2020	12000	6000	5000	1000	-	1000	500	-	5000
2021	20000	10000	5000	5000	-	--	--	-	10000

### Royalties Account

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To Landlord	500	2018 Dec 31	By Profit & Loss A/c	500
		500			500
2019 Dec 31	To Landlord	3000	2019 Dec 31	By Profit & Loss A/c	3000
		3000			3000
2020 Dec 31	To Landlord	6000	2020 Dec 31	By Profit & Loss A/c	6000
		6000			6000
2021 Dec 31	To Landlord	10000	2021 Dec 31	By Profit & Loss A/c	10000
		10000			10000

### Landlord's Account

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To cash	2000	2018 Dec 31	By royalties	500
		2000			1500
2019 Dec 31	To cash	3000	2019 Dec 31	By Short workings	2000
		3000			3000
2020 Dec 31	To Short workings	1000	2020 Dec 31	By royalties	6000
		5000			6000
2021 Dec 31	To cash	6000	2021 Dec 31	By Royalties	10000
		10000			10000

### Short Workings Account

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To Landlord	1500	2018 Dec 31	By balance c/d	1500



2019 Dec 31	To balance b/d	1500	2019 Dec 31	By balance c/d	1500
		1500			1500
2020 Dec 31	To balance b/d	1500	2020 Dec 31	By Landlord	1000
			Dec 31	By profit and loss	500
		1500			1500

## I

### Illustration 4.2.7

A coal company takes a lease of a mine for the term of 4 years from 1 January 2017, paying a minimum rent of ₹50000 per year merging in a royalty of 25 paise per ton. Short working can be recouped during the first four years. Coal is raised as follows:

Years	2017	2018	2019 (3 months strike)	2020
Out put	160000	180000	140000	250000

There are three provisions in case of strike

- In the year of strike minimum rent reduced to 60%.
- In the year of strike minimum rent reduced proportionately having regard to stoppage.
- In the year of strike, actual royalty earned will become the minimum rent.

Prepare analytical table for all the three cases

## S

### Solution

**CASE I-** In the year of strike minimum rent reduced to 60%.

Year	Production in tons	Royalty 25 paise per ton	Minimum rent	Short Workings	Surplus	S.W. recouped	S.W. not recouped	Raj Co.
2017	160000	40000	50000	10000				50000
2018	180000	45000	50000	5000				50000
2019	140000	35000	<b>30000</b>		5000	5000		<b>30000</b>
2020	250000	62500	50000		12500	10000		52500

In the year 2019 because of strike minimum rent is reduced to 60%.

Therefore ₹50000 x 60% = ₹30000 is the reduced minimum rent in 2019.

**CASE II -** In the year of strike minimum rent is reduced proportionately having regard to stoppage.

Year	Production in tons	Royalty 25 paise per ton	Minimum rent	Short Workings	Surplus	S.W. recouped	S.W. not recouped	Raj Co.
2017	160000	40000	50000	10000				50000
2018	180000	45000	50000	5000				50000
2019	140000	35000	<b>37500</b>	2500				<b>37500</b>
2020	250000	62500	50000		12500	12500	5000	50000

In the year 2019 because of strike minimum rent is reduced proportionately having regard to the stoppage. Therefore, the minimum rent in that year =  $50000 \times \frac{9}{12} = ₹37500$

**CASE III** - In the year of strike, actual royalty earned will become the minimum rent.

Year	Production in tons	Royalty 25 paise per ton	Minimum rent	Short Workings	Surplus	S.W. recouped	S.W. not recouped	Raj Co.
2017	160000	40000	50000	10000				50000
2018	180000	45000	50000	5000				50000
2019	140000	35000	<b>35000</b>					<b>35000</b>
2020	250000	62500	50000		12500	12500	2500	50000

In 2019 as actual royalty earned will become the minimum rent, the minimum rent is ₹35000

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### Illustration 4.2.8

P obtained a lease from B for a coal mine on 1 January, 2015 on the following terms and conditions:

- Royalty at ₹1 per tonne coal raised.
- Minimum Rent ₹24000 p.a
- Recoupment of each year short workings in the three years following, subject to a maximum of ₹5000 p.a.
- In the event of strike, the minimum rent would be taken on pro-rata basis of actual working days, but in the event of lockout, the lessee would enjoy concession in respect of minimum rent for 50% of the period of lockout.

Besides the above, P has been granted a right to receive cash subsidy equal to 25% of the un recoupable short workings from the Government up to the first 5 years of the lease. Show ledger accounts in the books of P

Working for the first six years are as follows:

Year	Actual Royalty
2015	13000
2016	19400
2017	32100
2018	27200
2019	21800 (strike period 73 days)
2020	19000 (lockout period 4 months)

$$\text{Minimum rent for strike period 2019} = 24000 - 24000 \times \frac{73}{365} \\ = 24000 - 4800 = 19200$$

$$\text{Minimum rent for lockout period 2020} = 24000 - (24000 \times \frac{4}{12} \times 50\%) \\ = 24000 - 4000 = 20000$$

**Analytical Table**

Years	Royalty	Minimum rent	Short working	Surplus	Recoupm	s.w. not recouped	Cash subsidy	S.W. c/d	S.W. Written off	Actual pay
2015	13000	24000	11000	--	--	--	11000			24000
2016	19400	24000	4600	--	--	--	15600			24000
2017	32100	24000	--	8100	5000	--	10600			27100
2018	27200	24000	--	3200	3200	2800	700	4600	2100	24000
2019	21800	<b>19200</b>	--	2600	2600	2000	500	-	1500	19200
2020	19000	<b>20000</b>	1000		--	1000	1000			20000

2018: Short workings recouped =  $5000 + 3200 = 8200$  Short workings irrecoverable =  $11000 - 8200 = 2800$

Cash subsidy =  $2800 \times 25\% = 700$

Amount to be written off to profit and loss account =  $2800 - 700 = 2100$

2019: Short working irrecoverable =  $4600 - 2600 = 2000$

Cash subsidy =  $25\% \text{ of } 2000 = 500$

Amount to be written off to profit and loss account =  $2000 - 500 = 1500$

### In the Books of Lessee

#### Landlord Account

Date	Particulars	Amount	Date	Particulars	Amount
2015 Dec 31	To Bank	24000	2015 Dec 31	By Royalty	13000
		<b>24000</b>		By short workings	11000
2016 Dec 31	To Bank	24000	2016 Dec 31	By Royalty	19400
		<b>24000</b>		By short workings	4600

2017 Dec 31	To short workings	5000	2017 Dec 31	By Royalty	32100
Dec 31	To bank	27100			<b>32100</b>
		<b>32100</b>			<b>32100</b>
2018 Dec 31	To short workings	3200	2018 Dec 31	By Royalty	27200
Dec 31	To bank	24000			<b>27200</b>
		<b>27200</b>			<b>27200</b>
2019 Dec 31	To short workings	2600	2019 Dec 31	By Royalty	21800
Dec 31	To bank	19200			<b>21800</b>
		<b>21800</b>			<b>21800</b>
2020 Dec 31	To bank	20000	2020 Dec 31	By Royalty	19000
			Dec 31	By short workings	1000
					<b>20000</b>

### Short Workings Account

Date	Particulars	Amount	Date	Particulars	Amount
2015 Dec 31	To Landlord	11000	2015 Dec 31	By balance c/d	11000
		<b>11000</b>			<b>11000</b>
2016 Dec 31	To balance b/d	11000	2016 Dec 31	By balance c/d	15600
Dec 31	To Landlord	4600			<b>15600</b>
		<b>15600</b>	2017 Dec 31	By Landlord	5000
2017 Dec 31	To balance b/d	15600	Dec 31	By balance c/d	10600
		<b>15600</b>			<b>15600</b>
2018 Dec 31	To balance b/d	10600	2018 Dec 31	By profit and loss	2100
			Dec 31	By Landlord	3200
			Dec 31	By Government	700
			Dec 31	By balance c/d	4600
		<b>10600</b>			<b>10600</b>
2019 Dec 31	To balance b/d	4600	2019 Dec 31	By profit and loss	1500
			Dec 31	By Landlord	2600
			Dec 31	By Government	500
		<b>4600</b>			<b>4600</b>
2020 Dec 31	To Landlord	1000	2020 Dec 31	By balance c/d	1000
		<b>1000</b>			<b>1000</b>

## Government Account

Date	Particulars	Amount	Date	Particulars	Amount
2018 Dec 31	To short workings	700	2018 Dec 31	By Bank	700
		700			700
2019 Dec 31	To short workings	500	2019 Dec 31	By Bank	500
		500			500

## Recap

- ◊ Minimum rent account - Prepared if minimum rent is more than royalty.
- ◊ Minimum rent- Assured and mutually agreed periodical minimum amount paid by lessee to lessor.
- ◊ Minimum rent - Dead rent.
- ◊ Short workings- Excess of minimum rent over actual royalty.
- ◊ Short workings- Calculated on basis of output or sale.
- ◊ Minimum rent needs to be adjusted in case of stoppage of work due to abnormal reasons.
- ◊ When short workings are actually recovered, the balance in the Provision against Short workings Account should be reduced by transfer to P&L A/c.
- ◊ When recoupment is not possible due to physical or economic factors- Provision against short workings is created in the year in which short workings arise.
- ◊ During strike, lock outs etc.- Minimum rent can be reduced in any of the three ways:
  - Actual royalty earned will become the minimum rent.
  - Minimum rent is to be reduced proportionately.
  - A certain percentage of minimum rent would be reduced.

## Objective Questions

1. What is the consideration paid to the owner of an asset by the person to whom the asset is given for use known as?
2. What is the alternative term for Dead rent?
3. If the royalty is less than minimum rent, the balance of royalty account at the end of the year has to be transferred to which account?
4. List one basis for calculating minimum rent at the time of stoppage of work due to strike or lockout?
5. Which account is created when the short workings cannot be recouped due to some factors physical or economic, even though the period to recover the same still has not lapsed?
6. How is short workings calculated?
7. When do you prepare minimum rent account?

## Answers

1. Royalty
2. Minimum Rent
3. Profit and Loss Account
4. Fixed percentage by a fixed amount in the year of stoppage
5. Provision against short working account
6. Calculated on basis of output or sale
7. When minimum rent is more than royalty



## Self-Assessment Questions

1. Explain the circumstance when Provision against short working account needs to be created.
2. What are the methods that can be followed to reduce minimum rent during the period of strikes, lock outs etc.?
3. What do you mean by short workings?
4. Explain the significance of fixing minimum rent.
5. What do you mean by recoupment of short workings?
6. What are the journal entries to be passed when government subsidy is obtained during the period of strikes, lock outs etc.?
7. Write a short note on the adjustment of Minimum Rent in the event of Strike and Lockouts.
8. Draft the journal entries at the time of strike and lockout.

## Assignments

1. Mr. Kiran, a scientist holds a patent for manufacture of health care gadget. In 2017, he grants Good life private Ltd. the right to use the patent for a royalty of ₹10 per unit manufactured subject to minimum rent of ₹14000 in the first year, ₹18000 in second year and thereafter ₹30000 per year. Any short working is recoverable out of the excess royalties of two years subsequent to the year in which such short working arise. Write up necessary Ledger Accounts in the books of Good life Pvt. Ltd.

Output for the first five years is:

Year	2017	2018	2019	2020
Out put	1200	1400	3200	3300

Income tax was 20%.

You are required to prepare Royalty account, short workings account and Kiran Account from 2017-2020. (Answer- Short working not recouped- ₹4000)

2. Visit any nearby mining factory in your district and compare normal production and strike-related production, as this will affect the entire business. Make a brief report. Compare different government subsidy programs globally and their effectiveness in mitigating financial losses

during such circumstances.

3. Akhil took a mine under a lease. Royalty is 50 paise per ton and minimum rent is ₹12000 per annum. Each year's short workings are recoverable during the subsequent two years. If in any year the normal rent was not attained due to strike. The minimum rent was to be regarded as having been reduced proportionately having regard to the length of the stoppage.

Years	2017	2018	2019	2020	2021
Out put	20000	18000	26000	12000	26000

During the year 2020, there was a strike for five months. Pass journal entries in the books of lessor and lessee.

(Answer- Minimum rent for 2020- ₹7000)

4. Explore case studies or examples highlighting instances where the minimum rent was adjusted due to strikes or lockouts.

5. A company leased a colliery on 1 January, 2017 at a minimum rent of ₹20000 merging into a royalty of ₹1.50 per ton with power to recoup short workings over the first four years. The output was 9000 tons, 12000 tons, 16000 tons, 20000 tons respectively. Pass the necessary journal entries for each of the four years in the book of the company and prepare books of accounts.

(Answer- 1<sup>st</sup> year short workings - ₹6500, 2<sup>nd</sup> year short workings - ₹2000, 3<sup>rd</sup> year - short workings recouped - ₹4000, 3<sup>rd</sup> year - short workings not recouped - ₹10000. Amount paid 1<sup>st</sup> year - ₹20000, Amount paid 2<sup>nd</sup> year - ₹20000, Amount paid 3<sup>rd</sup> year ₹20000, Amount paid 4<sup>th</sup> year ₹30000)

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5  
BLOCK

## BRANCH ACCOUNTS

## Introduction to Branch Accounts

### Learning Outcomes

After studying this unit the learner will be able to:

- ◊ familiarise with the meaning and objectives of Branch accounts.
- ◊ gain insights on the features of Branches.
- ◊ get awareness on different types of Branch accounts.

### Prerequisites

As a business grows, it may establish branches in various towns and cities to make its goods and services available across a wide area. Specialised accounting techniques must be used for controlling various branch activities and for their smooth operation. Although a branch is located some distance away from the head office, it conducts all of its business under the direction and control of that office. As a result, the head office and the branch must regularly obtain information about the branch's profit or loss in order to exercise greater control over it. Hence, branch accounting is needed to figure out how profitable each branch is for a certain accounting period, whether the branch should be expanded or closed, how much cash and stock each branch needs, and how much stock each branch has at the end of an accounting period.

### Keywords

Branch Accounts, Dependent Branch, Independent Branch

## Discussion

### 5.1.1 Meaning of Branch

Businesses must make their products available across a wider geographic area in order to increase sales, and they may typically divide their company into different divisions or parts. Branch is an extension or sub-division of an existing business. It is a chain of shops functioning at different localities under the control of the head office. It may also be a full-fledged manufacturing unit. The different divisions that are located under the same roof are not branches. Such divisions are known as departments.

### 5.1.2 Features of Branch

The following are the key features of a branch:

- a. A branch is a local office which is a part of a central office known as head office
- b. A branch does not have a separate legal entity.
- c. All branches are controlled by head office.
- d. Branches are opened to increase sales in various areas which cannot be directly served from head office.
- e. Capital in each branch is invested by the head office for acquisition of various assets.
- f. The basic purpose of branch accounting is to ascertain the branch income, branch expenses, branch asset and liabilities.
- g. Separate accounts are kept for each branch.
- h. Branch account is nominal ledger account, prepared for a particular accounting period.
- i. Branch accounts help the head office to evaluate the performance of each branch.

### 5.1.3 Types of branches

From the accounting point of view and on the basis of degree of control exercised by the head office, branches can be divided into the following categories. They are:

- a. Dependent branches
- b. Independent branches
- c. Foreign branches.

**i. Dependent Branches**

Those branches that do not keep full system of accounting are called Dependent branches. Such branches do not maintain books of accounts by itself but wholly depend on head office. All the transactions which take place between the head office and the

branches are recorded in the books of head office. The branch maintains only cash book and records of its debtors. The main features of these branches are:

- a. The branch sells only those goods which are received from head office.
- b. All goods are supplied by the head office. In some circumstances, with the permission from head office, the branch may be allowed to make purchases from the local parties for which payments are made directly by the head office.
- c. Goods are supplied by the head office to such branch either at cost price or invoice price.
- d. Normally branches makes cash sales. In some cases, branch is allowed to make credit sale to approved customers with the consent of head office.
- e. All major expenses of branch are paid by the head office. However, petty expenses are met by branch manager.
- f. The amount received from cash sales and collection from debtors is periodically remitted to head office.
- g. Branch accounts will be maintained by head office. However, branch maintains memorandum records like cash book, stock register, debtor's accounts, petty cash book etc.

### **ii. Independent Branches**

The branches that keep full system of accounting are called independent branches. When the size of the branch is very large, their working becomes very complex. In such cases, the branches prepare their accounts independently. They also purchase and sell goods for cash and credit independently in addition to the goods that are supplied by the head office. This is discussed in detail later.

### **iii. Foreign Branches**

When a branch is located outside the country, it is called a foreign branch. Such branches will keep their books of accounts in terms of foreign currency, which has to be converted into the currency of the country in which the head office is located. For example, if an Indian company has a branch in U.S.A, the branch Trial Balance will be in U.S dollars. The Trial Balance must be converted into rupees before it is incorporated in the head office books.

## **5.1.4 Meaning and Objectives of Branch Accounting**

Branch accounting is a system in which separate Trial Balance, Profit and Loss account and Balance Sheet are prepared for each branch. These branches are geographically separated from the rest of the business, and each branch has its own profit center and cost center.

Normally the objectives of keeping Branch Accounts are determined by the owner of the business. The primary goal of maintaining branch accounts depends on the nature of the business and the unique requirements of a particular branch. There are some general objectives for branch accounting.



They are as follows:

- a. To find out the profit or loss for each accounting period.
- b. To find out the actual financial position of each branch at the end of the accounting period.
- c. To estimate the requirement of goods and cash for each branch.
- d. To evaluate the progress and performance of each branch and make suggestions.
- e. To help in controlling each branch.
- f. To ascertain whether the branch should be expanded or closed.
- g. To ascertain whether the branch is yielding a satisfactory rate of return on capital invested.
- h. To assess the prospects for expansion of business in each branch.
- i. To meet the audit requirement under section 228 of the Companies Act 1956.

## Recap

- ◊ Branch - A division of an enterprise, geographically separated from the rest of the business.
- ◊ Branch - An extension and profit center of the head office.
- ◊ For ascertaining the profit, proper accounting records are maintained both in the books of branch as well as head office.
- ◊ Branch accounting - The profitability and efficiency can be tracked at the branch level.
- ◊ Types of branches - Dependent branches, independent branches and foreign branches.
- ◊ Dependent branches – Does not maintain separate books of accounts and wholly depend on head office.
- ◊ Independent branches - Prepare their accounts independently and maintain complete system of accounting.
- ◊ Foreign branches - Located and operated outside the country.

## Objective Questions

1. What do you mean by a branch?
2. Which branch does not maintain separate books of accounts and wholly depends on the head office?
3. Which branches are located and operated outside the country?
4. What is the name of main establishment located at the main place of activity?
5. Mention the name of subsidiary establishments located at various places.
6. What is a department?
7. State the primary goal of maintaining branch accounts.
8. What is a branch accounting?

## Answers

1. An extension and profit center of the head office
2. Dependent branch
3. Foreign branch
4. Head office
5. Branch
6. Different divisions that are located under the same roof
7. To find out the profit or loss for each accounting period
8. System in which separate Trial Balance, Profit and Loss account and Balance Sheet are prepared for each branch

## Self-Assessment Questions

1. How does a branch differ from a department?
2. What are the features of a branch?
3. Differentiate between a dependent branch and an independent branch.
4. Explain the different types of branches.
5. What do you mean by branch accounting?
6. List out the objectives of branch accounting.
7. Discuss the concept of a branch.

## Assignments

1. Differentiate branch accounting with other means of expansion, such as franchises or subsidiaries. Emphasise on the unique characteristics of branch accounting.
2. Determine and discuss about the risks that branches face when carrying out their daily business. Explain how can these be properly reduced.
3. Identify a branch of an established organisation in your area of interest and analyse how the books of accounts of the branch are maintained.
4. Examine the risks that the head office encounters when conducting business through branches. How may these risks affect the organisation's overall financial stability?

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# Unit 12

## Accounting for Dependent Branches

### Learning Outcomes

After studying this unit, the learner will be able to:

- ◊ Familiarise with the meaning of dependent branches.
- ◊ Acquaint skills in preparation of accounts under the debtors system.
- ◊ Gain insights on the preparation of accounts under stock and debtors system.

### Prerequisites

Many business concerns open branches at various places to promote sales. As the branches are separated from the head office, the head office is interested to know the position of the branches. So, the accounts are prepared separately and the head office can easily access the financial position of each branch. A thorough knowledge about the way in which the head office and the branches interact with one another and the manner in which the books of accounts are maintained is essential for every business having branches, to be successful in the business venture.

### Keywords

Debtors system, Invoice Price Method, Stock and Debtors system

## Discussion

### 5.2.1 Introduction

As has been stated earlier, dependent branch does not maintain books of accounts and wholly depend on head office. All the transactions which take place between the head office and the branches are recorded in the books of head office. Following are the important methods of maintaining accounting records.

- a. Debtors' system.
- b. Stock and debtors' system.
- c. Final Account system.
- d. Whole sale branch system.

Here we discuss the first two systems.

### 5.2.2 Debtors System

Under this system, the head office prepares a branch account for each branch, in which it records all transaction relating to the branch. The branch account is a combination of Trading and Profit and Loss account and Balance Sheet of the branch. This account being a nominal account, the main purpose of this method is to ascertain the profit or loss made by each branch. This method is followed when the size of the branch is small.

Head office may send goods to the branch either at cost price or at selling (invoice) price. So, there are two methods of preparing the branch account in this case:

- A. Cost price method.
- B. Invoice price method.

#### 5.2.2.1 Cost price method

Under this method, goods are sent to the branch at cost price. Cost price means purchase price plus purchase expenses incurred on the goods.

The following are the journal entries in the books of head office:

- i. To record opening balances of assets like stock, petty cash and other assets
  - Branch A/c Dr.
  - To Br. Stock A/c
  - To Br. Debtors A/c
  - To Br. Petty cash A/c
  - To Br. Other asset (individually) A/c
- ii. To record opening balances of branch liabilities
  - Branch liabilities A/c (individually) Dr.
  - To Branch A/c



- iii. For goods sent to branch
 

Branch A/c	Dr.
To Goods sent to branch A/c	
- iv. For return of goods to head office
 

Goods sent to branch A/c	Dr.
To Branch A/c	
- v. For Goods sent by Branch to another Branch at instruction from head office
 

Goods sent to Branch A/c	Dr.
To Branch A/c	
- vi. For amount sent to branch to meet expenses like salary, rent, petty cash, etc.
 

Branch A/c	Dr.
To Cash/ Bank A/c	
- vii. For amount received from branch in respect of cash sales or cash received from debtors including received directly from debtors
 

Cash/ Bank A/c	Dr.
To Branch A/c	
- viii. For closing balance of assets at the branch
 

Br. Stock A/c	Dr.
Br. Debtors A/c	
Br. Petty cash A/c	
Br. Other asset (individually) A/c	
To Branch A/c	
- ix. For closing balance of liabilities at the branch.
 

Branch A/c	Dr.
To Branch liabilities (individually) A/c	
- x. For transfer of balance in goods sent to branch account to trading a/c
 

Goods sent to Branch A/c	Dr.
To Trading A/c	
- xi. For transfer of profit at the branch
 

Branch A/c	Dr.
To General Profit and loss A/c	

(Note: In the case of loss, reverse entry will be passed)

It should be noted that the sales, discount, bad debts, expenses paid by branch and return from debtors to the branch are not direct transactions between the branch and the head office. So according to this system, they are not taken care of while preparing the Branch Account in the books of the head office

Similarly, losses due to wastages and other losses of stock due to normal or abnormal reasons are also completely ignored under this method.

The main problem of this method is that it does not provide full information for analysis of branch profit and loss. To overcome this problem, a separate branch Trading and Profit and Loss account has to be prepared, which is a memorandum account not forming part of the full system of accounting.

In short, branch account is debited with the opening balance of branch assets, goods sent to branch account, cash sent for expenses of the branch and branch liabilities at the end and credited by branch liabilities at the beginning, cash received for remittance, goods returned to head office, and closing balances of branch assets. The difference between the two sides will be profit or loss of the branch.

Specimen of Branch Account in head office books

**Branch Account**

<b>Particulars</b>	<b>Amount</b>	<b>Particulars</b>	<b>Amount</b>
To Balance b/d		By Balance b/d	
Stock A/c	xxxx	Creditors A/c	xxxx
Debtors A/c	xxxx	Outstanding Expenses A/c	xxxx
Petty Cash A/c	xxxx	By Bank (remittances to H.O)	xxxx
(Other)assets A/c	xxxx	(Cash received by the branch remitted to Head office)	
To Goods sent to Branch A/c	xxxx	By Goods sent to branch A/c	xxxx
To Bank A/c (Remittances by H.O):	xxxx	(Goods returned by branch)	
Cash sent for expenses	xxxx	By Balance c/d (closing balance of branch assets)	
Petty cash	xxxx	Stock A/c	xxxx
To Balance c/d (closing balance of branch liabilities)	xxxx	Debtors A/c	xxxx
Creditors A/c	xxxx	Petty cash A/c	xxxx
Outstanding Expenses A/c	xxxx	(Other) assets A/c	xxxx
To General P& L (if profit)	xxxx	By Gen. P&L A/c (if loss)	xxxx
	xxxx		xxxx



## I Illustration 5.2.1

Minu & Co of Bangalore has their branch at Calicut which sells goods for cash only. The following are the transactions between the Head Office and Branch for the year ending 31 December 2020.

	₹
Opening stock at branch on 1 Jan 2020	200000
Goods supplied to Branch	500000
Cash sent to Branch for:	
Rent	₹2000
Other expenses	₹1000
Cash received from branch during the year	600000
Closing stock at 31 December 2020	150000
Closing balance of petty Cash	100

From the above information, pass necessary journal entries and prepare Calicut branch Account in the head office books.

## Solution

### Journal entries in the books of head office

Date	Particulars	Amount (Dr.)	Amount (Cr.)
01-01-2020	Calicut Branch A/c Dr To Br. Stock A/c (Opening balances recorded)	200000	200000
	Calicut Branch A/c Dr To Goods sent to branch A/c (Good sent to branch)	500000	500000
	Calicut Branch A/c Dr To Cash A/c (Cash sent to branch for meeting expenses)	3000	3000
	Cash A/c Dr To Calicut branch A/c (Cash received from the branch)	600000	600000
31-12-2020	Br. Stock A/c Dr Br. Petty cash A/c Dr To Calicut Branch A/c (Closing balances recorded)	150000 100	150100
	Calicut branch A/c Dr To General Profit and loss A/c (Profit transferred to General Profit and Loss A/c)	47100	47100

### Calicut Branch Account

Date	Particulars	Amount	Date	Particulars	Amount
01 - 01 - 2020	To Balance b/d		31-12-2020	By cash A/c	600000
	Br. Stock A/c	200000		Balance c/d	
	Goods sent to branch A/c	500000		Br. Stock A/c	
	Cash A/c			150000	
	Rent 2000			Petty cash A/c	
	Other exp. 1000	3000		100	
	General P/L	47100			
	Profit A/c				
	(balancing figure.)				
		750100			750100

#### Calculation of missing figures

When any information relating 'Goods Sent to Branch', closing debtors or opening debtors, branch stock etc. are missing, then the missing information must be ascertained first. To ascertain any information relating to stock and debtors, Memorandum Stock A/c and Memorandum Branch Debtors A/c may be prepared.

#### Treatment of certain branch transactions

##### i. Petty expenses paid by the branch out of petty cash

Petty expenses, paid by the branch manager out of petty cash are not shown in the branch account. Branch account is debited with the opening balance of petty cash and further sum sent by head office to the branch. At the closing time, the branch account is credited with the closing balance of petty cash.

##### ii. Expenses incurred by branch

Expenses actually paid by branch are not shown in the branch account. But the amount remitted by head office to branch for meeting expenses is debited in branch account. If actual amount spent by Branch is less, the cash balance is shown as a part of closing balance, on the credit side of the Branch Account.

##### iii. Depreciation of fixed assets

Depreciation of fixed assets is not shown in the branch account. But the closing balance of the fixed assets will be shown on the credit side of the branch account after deduction of the amount of depreciation.

##### iv. Credit sales, bad debts, sales returns, allowances, and discounts allowed relating to branch

These items are related to the debtors account and will not be shown in the branch account. However, these items are considered while calculating the amount of opening or closing debtors or the amount received from debtors which are shown in the branch account.

v. Purchase of fixed assets by the branch

When the branch has purchased any fixed asset for cash, then on one hand branch account will be credited by the head office and on the other hand the remittance from the branch to head office is to be reduced by the amount. If the branch has purchased fixed asset on credit basis, the liability arising from such purchases should be shown on the debit side of branch account as closing balance of liability.

vi. Sale of fixed asset

If the sale is for cash, cash remittances from the branch will increase but asset will reduce in value to be shown on the credit side of the branch account. Loss or profit arising from sale of fixed asset will not be shown in the branch account.

**Accounting treatment of branch receiving goods from head office at cost price and making cash and credit sale**

Note: Sometimes closing debtors or opening debtors is not given in the question. In such case, Total Debtors account is opened to find out the missing figures.

Specimen of Total Debtors Account:

**Total Debtors Account**

Date	Particulars	Amount	Date	Particulars	Amount
01-01-2020	To balance b/d ,, Credit sales A/c ,, Bills receivable dishonored A/c	xxxx xxxx xxxx	31-12-2020	By cash A/c ,, Returns Inwards A/c ,, Allowances A/c ,, Discount A/c ,, Bad debts A/c ,, Bills receivable received A/c ,, Balance c/d	xxxx xxxx xxxx xxxx xxxx xxxx xxxx xxxx

## I

### Illustration 5.2.2

Bharath Co. has its Head office at Delhi and Branch at Kanpur. This Branch sells for cash as well as credit. With the help of the following transactions which took place between Head office and the Branch office in the year 2020, prepare Branch Account and Debtors Account in the books of Head office.

Opening stock	100000
Closing stock	60000
Opening debtors	50000
Opening balance of petty cash	300
Goods supplied to branch	350000
Credit sales	300000
Cash sales	200000
Cash received from debtors	100000
Cash sent to Branch for Expenses	20000
Goods returned by the branch	5000
Goods returned by customers	30000
Allowed discount to customers	5000
Bad debts	15000

# S

## Solution

### In the books of Head office Kanpur Branch Account

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance b/d			By cash	
	Stock 100000			Cash sales	
	Debtors 50000			200000	
	Petty cash <u>300</u>	150300		Cash received from debtors	
				100000	300000
	Goods sent to branch	350000		Goods sent to branch (returns)	5000
	Cash (expenses)	20000		Balance c/d	
	General P/L (Profit-balancing figure)	44700		Br. Stock	60000
				*Br. Debtors	<u>200000</u>
		<b>565000</b>			260000
					<b>565000</b>

\*Calculation of closing debtors

#### Branch Debtors Account

Date	Particulars	Amount	Date	Particulars	Amount
	To balance b/d ,, Credit sale	50000 300000		By cash ,, Return Inward ,, Discount ,,Bad debts ,, *Balance c/d (Balancing figure)	100000 30000 5000 15000 200000
		<b>350000</b>			
					<b>350000</b>

#### 5.2.2.2 Invoice price method

Sometimes company wants an effective control on stock and to hide its profit margin from branch employees. In such cases head office sends goods to the branch on the invoice price instead of cost price. In the invoice price, there are two prices included. One is cost price and second is a profit percentage. The difference between cost price and invoice price is the loading or profit added. Under invoice price method goods supplied to branch, goods returned by branch, opening and closing stock are all recorded at the invoice price and finally the load is removed by passing adjusting entries. In addition to the entries as passed under cost price method, the following adjustment entries also will be passed if the goods are supplied at invoice price.

- ◊ For adjustment of loading in opening stock at branch
 

Stock reserve A/c	Dr.
To Branch A/c	
- ◊ For removing loading in goods sent to branch
 

Goods sent to Branch A/c	Dr.
To Branch A/c	
- ◊ For removing loading in goods returned by the branch to H.O
 

Branch A/c	Dr.
To Goods sent to Branch A/c	
- ◊ For adjusting loading in closing stock
 

Branch A/c	Dr.
To Stock Reserve A/c	

Under invoice price method, the Branch A/c will appear as follows

### Branch Account

Particulars	Amount	Particulars	Amount
To Balance b/d (Asset in the beginning)		By balance b/d (Liabilities in the beginning, if any)	
Stock A/c (at invoice price)	xxx	By Bank A/c	xxx
Debtors A/c	xxx	Cash sales	xxx
Petty cash A/c	xxx	Cash received from debtors	xxx
Any other asset A/c	xxx	By Goods sent to branch A/c (Returns, at invoice price)	xxx
To Goods sent to branch A/c (at invoice price)	xxx	By Stock Reserve A/c (loading in opening stock)	xxx
To Bank A/c (expenses paid by the H.O)	xxx	By Goods sent to Branch A/c (loading in goods sent to Branch)	xxx
To Stock Reserve A/c (loading in closing stock)	xxx	By Balance c/d	xxx
To Goods sent to Branch A/c (Loading in returns from branch)	xxx	Stock A/c (invoice price)	xxx
To Balance c/d (Liabilities at the end, if any)	xxx	Debtors A/c	xxx
To Profit and loss A/c (Profit, if any)	xxx	Petty cash A/c	xxx
		Any other asset	xxx
		By P&L A/c (Loss, if any)	xxx

Note: The balance of Goods sent to branch account will be transferred to the credit of Trading Account. The Branch stock account is an asset which will be shown in the Balance Sheet and Branch Stock Reserve Account will be shown as a deduction from Branch Stock Account. In the next trading period, both the Branch Stock Account and Branch Stock Reserve Account will be transferred to Branch account.



### Illustration 5.2.3

General Merchants Ltd, Kanpur has a branch at Allahabad. Goods are invoiced to the branch at cost plus 25%. Branch is instructed to deposit cash every day in the head office account with the bank. All expenses are paid through cheques by the head office except petty cash expenses which are paid by the branch manager. Prepare Branch Account in the books of head office after taking into account the following information also.

Stock at invoice price on 1 April 2020	82000
Stock at invoice price on 31 March, 2021	96000
Debtors on 1 April 2020	31700

Debtors on 31 March 2021	42150
Furniture on 1 April 2020	23400
Cash sales	401300
Credit sales	372100
Goods invoiced to branch by head office	
Furniture purchased on 1 October, 2020 by branch manager, payment having been made out of cash sales and collection from debtors	628000
Expenses paid by head office	2500
Petty expenses paid by branch	132000
	10450
Depreciation is provided on branch furniture @ 10% per annum on diminishing balance method.	

# S

## Solution

### In the books of Head Office Allahabad branch Account

Date	Particulars	Amount	Date	Particulars	Amount
1-1-2020	To Balance b/d			By Branch stock	
	Stock A/c 82000			Reserve (loading in opening stock)	16400
	Debtors A/c 31700				
	Furniture A/c <u>23400</u>	137100			
	To Goods sent to branch A/c	628000		By bank A/c (Cash deposited by branch)	750000
	To Bank A/c (expenses)	132000			
	To Branch stock reserve (Loading in closing stock)	19200		By Goods sent to branch A/c (loading)	125600
	To General P/L A/c	137285		By Balance c/d	
				Br. Stock 96000	
				Br. Debtors 42150	
				Br. Furniture 23435	
				(Written down value)	161585
		1053585			1053585

Working notes:

- If cost is 100 profit is 25. Hence invoice price is ₹125/- Then loading will be  $\frac{25}{125}$  i.e.  $\frac{5}{20}$  or 20%

2. Computation of loading in stock

- Loading in opening Stock  $82000 \times 20\% = 16400$
- Loading on closing stock  $96000 \times 20\% = 19200$
- Loading on goods sent to branch  $628000 \times 20\% = 125600$

### 3. Collection from branch debtors:

Branch debtors Account

Particulars	Amount	Particulars	Amount
To balance b/d	31700	By Bank –*collected from Debtors (balancing figure)	361650
To credit sales	372100	By Balance c/d	42150
	<b>403800</b>		<b>403800</b>

### 4. Cash deposited by branch with bank

Cash sale	401300
* Cash collected from debtors	<u>361650</u>
	762950
Less: Furniture purchased	2500
Petty expenses	<u>10450</u>
Cash deposited by the branch =	<u>12950</u>
	<u>750000</u>

### 5. Written down value of furniture on 31 March 2021

Written down value on 1 April, 2020	23400
Add: Addition made during the year	2500
	<u>25900</u>
Less: depreciation for the year	
Furniture ₹23400 @10% for 12 months =	2340
Furniture ₹2500 @ 10% for 6 months =	125
	(2465)
Written down value of furniture =	<u>23435</u>

### 5.2.3 Stock and Debtors System

As we have studied earlier, in the debtors system, only Branch A/c is prepared to ascertain profit or loss of branch. Under Stock and Debtors System, instead of one branch a/c, head office maintains several accounts relating to the transactions of the branch. The various accounts to be prepared are:

- Branch Stock A/c

- ii. Branch Debtors A/c
- iii. Branch Expenses A/c
- iv. Branch Adjustment A/c
- v. Goods sent to branch A/c
- vi. Branch Cash A/c
- vii. Branch Fixed Asset A/c
- viii. Branch Profit & Loss A/c

This system is used when goods are sent to the branch at invoice price and the size of the branch is large.

Let us now study the working of each account opened by Head office under stock and debtors system.

### i. Branch Stock A/c

This account shows all branch transactions relating to goods (stock). Branch stock account is debited with the opening value of stock, goods sent to branch and sales returns if any. It is credited with the sales (cash and credit), returns of goods to Head office, normal loss if any and closing stock at branch. All these items are recorded at the invoice price. Hence, if the figure of any of these items is given at cost, the same should be converted into invoice price before recording it in the branch stock account. Normally the total on two side of the account must be the same. In case there is a difference, it may be taken as either surplus or shortage. If the total debit is more than total credit, the difference is said to be Shortage which is put on the credit side, and transferred to Profit and Loss A/c at cost price. If the total credit is more than total debit, the difference is said to be Surplus which is put on the debit side, and transferred to Profit and Loss A/c at cost price. So, there is a load on this surplus or shortage, and this is transferred to Branch Adjustment A/c.

Following is the format of Branch Stock A/c:

Particulars	Amount	Particulars	Amount
To balance b/d (opening balances)	xxx	By Goods sent to Branch A/c (Returns from branch)	xxx
,, Goods sent to Branch A/c	xxx	,, Cash A/c (Cash sales)	xxx
,, Branch debtors A/c (sales return)	xxx	,, Branch Debtors A/c (credit sales)	xxx
,, Branch Adjustment A/c. (Load on surplus of stock)	xxx	,, Branch Adjustment A/c (Normal loss at invoice price)	xxx
,, Branch P/L A/c (Cost of surplus of stock)	xxx	,, Branch Adjustment A/c (Load in shortage of stock)	xxx
		,, Branch P/L A/c (Cost of shortage of stock)	xxx
		,, Balance c/d (closing balances)	xxx
	xxx		xxx

### ii. Branch debtors A/c

This account is prepared when the branch sells goods on credit. Opening balance of debtors, credit sales, etc. are shown on the debit side. Cash received from debtors, discount allowed, sales returns, bad debts, etc. are shown on the credit side. This account is prepared to find out the missing figures like opening balance of debtors, closing balance of debtors, credit sales, cash received from debtors etc. Following is the format of Branch debtors A/c.

#### **Branch Debtors A/c**

<b>Particulars</b>	<b>Amount</b>	<b>Particulars</b>	<b>Amount</b>
To balance b/d (opening balance)	xxx	By Cash ,, Bills receivable A/c	xxx
,, Branch stock A/c (credit Sales)	xxx	,, Branch stock A/c (returns by debtors) ,, Branch Expenses A/c: ,, Bad debts A/c ,, Discount allowed A/c ,, Balance c/d (closing balance)	xxx xxx xxx xxx xxx xxx
	xxx		xxx

#### **iii. Branch Expenses A/c**

This account records all branch expenses such as bad debts, discount, salaries, rent, petty cash expenses, depreciation on branch fixed assets etc.. This account is closed by transferring the balance to Branch Profit and Loss a/c.

Following is the format:

#### **Branch Expenses A/c**

<b>Particulars</b>	<b>Amount</b>	<b>Particulars</b>	<b>Amount</b>
To Bank A/c (or cash)		By Branch Profit and Loss A/c (Transfer)	xxx
Salaries	xxx		
Rent	xxx		
Petty expenses	xxx		
,, Branch debtors A/c	xxx		
Bad debts	xxx		
Discount	xxx		
,, Branch Fixed Assets	xxx		
Depreciation	xxx		
	xxx		xxx

#### **iv. Branch Adjustment A/c**

This account is prepared for ascertaining the amount of gross profit earned by the branch. This is done by eliminating the profit element or the 'loading' included in the value of opening and closing stock at branch, goods sent to branch, less returns made by branch to head office and in surplus or shortage in branch stock etc.. The balance of the account represents gross profit or loss which is then transferred to

### Branch Profit and Loss Account.

Following is the format.

#### Branch Adjustment A/c

Particulars	Amount	Particulars	Amount
To Branch Stock (loading on shortage or loss)	xxx	By Branch stock (loading on surplus)	xxx
,, Stock reserve (Loading in Closing stock)	xxx	,, Stock reserve (loading in opening stock)	xxx
,, Goods sent to branch A/c (loading in goods returned by branch)	xxx	,, Goods sent to branch (loading on goods sent)	xxx
,, Branch stock A/c (Normal loss at invoice price)	xxx		
,, Branch P&L A/c (Gross profit)	xxx		
	xxx		xxx

#### v. Goods sent to branch A/c

This account is prepared for ascertaining the exact value of the goods sent to the branch during the accounting period. For this, the account is credited with the value of goods sent, loading on goods returned and debited with goods returned to head office, and loading on goods sent to branch. It is closed by transferring the balance to Trading A/c.

#### Goods sent to Branch A/c

Particulars	Amount	Particulars	Amount
To Branch Stock (return to Head office)	xxx	By Branch stock (Goods sent)	xxx
,, Branch adjustment A/c (Loading in goods sent)	xxx	By Branch Adjustment A/c (loading in returns)	xxx
,, Trading A/c (balance transferred)	xxx		
	xxx		xxx

#### vi. Branch Cash A/c

If cash receipts are immediately remitted to H.O and cash is sent to the branch for meeting expenses, Branch Cash A/c need not be opened. This account is generally opened when the branch is allowed to hold cash and use it for branch expenses and remit the balance to H.O after certain interval.

#### Branch Cash A/c

Particulars	Amount	Particulars	Amount
To Balance b/d	xxx	By Branch Expenses A/c	xxx
,, Bank A/c (remittance from H.O)	xxx	By Branch Fixed Asset A/c (If purchased by branch)	xxx
,, Branch debtors (receipt)	xxx	By Bank A/c (remittance to H.O)	xxx
		By Balance c/d	xxx
			xxx

### vii. Branch Fixed Asset A/c

Head office maintains separate account for each type of assets. These accounts are prepared in the usual manner debited with the opening value of asset and purchase of asset if any. It is credited with the depreciation. The balance represents the closing value of asset.

Following journal entries are made relating to various types of transactions under this method:

i. When goods are sent to branch

Branch stock A/c      Dr. (cost price /invoice price)  
To Goods sent to branch A/c

Note: Reverse entry will be passed for goods returned by branch to Head office.

ii. For removing loading when goods are sent to the branch at invoice price

a. For removing loading in opening stock

Stock reserve A/c      Dr. (Load)  
To Branch Adjustment A/c

b. For removing loading in goods sent to branch A/c

Goods sent to Branch A/c      Dr. (Load)  
To Branch Adjustment A/c

c. For removing loading in goods returned to Head office

Branch Adjustment A/c      Dr. (Load)  
To Goods sent to branch A/c

d. For removing loading in closing stock

Branch Adjustment A/c      Dr. (Load)  
To Stock reserve A/c

iii. When sales are made by the branch

a. For cash sales

Cash A/c      Dr.  
To Branch stock A/c

- b. For credit sales
  - Branch debtor's A/c Dr.
  - To Branch stock A/c
- iv. When cash is received from debtors
  - Cash A/c Dr.
  - To Branch debtor's A/c
- v. For discount allowed, allowances and bad debts
  - Branch expenses A/c Dr.
  - To Branch Debtors A/c
- vi. For goods returned to branch by customers (or debtors)
  - Branch stock A/c Dr.
  - To Branch debtor's A/c
- vii. For goods returned by branch debtors direct to head office
  - Goods sent to Branch A/c Dr. (Cost price)
  - Branch Adjustment A/c Dr. (Loading)
  - To Branch debtors A/c. (Invoice price)
- viii. For normal loss of stock
  - Branch Adjustment A/c Dr. (invoice price)
  - To Branch Stock A/c
- ix. For abnormal loss (loss by fire, theft, natural calamities etc.), waste or leakage or shortage of stock
  - Branch Adjustment A/c Dr. (Loading)
  - Branch Profit and Loss A/c Dr. (cost price)
  - To Branch stock A/c (Invoice price)
- x. For surplus of stock
  - Branch stock A/c Dr. (invoice price)
  - To Branch Adjustment A/c (loading)
  - To Branch Profit and Loss A/c (cost)
- xi. For branch expenses paid in cash
  - Branch expenses A/c Dr.
  - To Cash A/c
- xii. For transfer of branch expenses
  - Branch Profit and Loss A/c Dr.
  - To Branch expenses A/c

xii. For insurance claim recoverable

Insurance claim A/c Dr.

To Branch Profit and Loss A/c

xiii. For transferring gross profit of branch

Branch Adjustment A/c Dr.

To General Profit and Loss A/c

(Note: for gross loss pass reverse entry)

xiv. For transfer of net profit to general profit and loss account

Branch Profit and Loss A/c Dr.

To General Profit and Loss A/c

(Note: for transfer of loss to general profit and loss account, reverse entry will be passed)

xv. For closing the goods sent to branch account

Goods sent to Branch A/c Dr.

To Trading A/c

## I

### Illustration 5.2.4

Vinayak traders Hyderabad, opened a branch at Anathpur on 1-07- 2019. The goods were sent by the head office to the branch invoiced at selling price of the branch which was 125% of the cost price of the head office.

Following are the particulars relating to the transactions of Anathpur branch:'

Particulars	Amount
Goods sent to branch (at cost to Head Office)	280800
Sales: Cash	125000
Credit	175000
Cash collected from Debtors	156000
Discount allowed	4000
Spoiled cloth in bales written off at invoice price	500
Goods returned by debtors to branch	5000
Cash sent to branch for:	
Salaries:	3000
Freight outward :	11,000
Other expenses including godown rent:	6000
Stock on 30 June, 2009 at invoice price	55500

Ascertain the profit or loss for the Anathpur Branch for the year ended 30-06-2020 by preparing Accounts under Stock and Debtors System.

**In the Books of Vinayak Trader  
Branch Stock Account**

Particulars	Amount	Particulars	Amount
To Goods sent to branch A/c *1	351000	By Cash A/c (sales)	125000
To Branch debtor's A/c (Returns)	5000	By Branch Debtors A/c (credit sale)	175000
		By Branch Adjustment A/c (Loading on abnormal loss)*2	100
		By Branch P&L A/c (Cost of abnormal loss) *2	400
		By Balance c/d	55500
	356000		356000

Working notes

\*1. Here head office sent goods to branch at invoice price, which was 125% of the cost price. In this problem goods sent to branch is given at cost price i.e., 280800

$$\text{So, invoice price} = 280800 \times \frac{125}{100}$$

$$= 351000$$

\*2. Spoiled cloth in bales written off is treated as abnormal loss

Here invoice price 500 is given in the question

$$\text{So, cost price} = 500 \times \frac{100}{125} = 400$$

Loading = Invoice price - cost price

$$500 - 400 = 100$$

Journal entry:

Branch Adjustment A/c	Dr. 100 (loading)
Branch Profit and Loss A/c	Dr. 400 (cost price)
To Branch Stock A/c	500 (invoice price)

**Goods sent to branch account**

Particulars	Amount	Particulars	Amount
To Branch Adjustment A/c (load on goods sent to Branch) *3		By Branch Stock A/c	351000
To Trading A/c (balancing figure)	70200 280800 <b>351000</b>		
			<b>351000</b>

\*3. Load on goods sent to branch = Invoice price - cost price  
= 351000 - 280800 = 70200

### Branch debtor's account

Particulars	Amount	Particulars	Amount
To Branch Stock A/c	175000	By Cash A/c	156000
		By Branch Stock A/c	5000
		By Branch Expenses A/c	
		(Discount allowed)	4000
		By Balance c/d	10000
	<b>175000</b>		<b>175000</b>

### Branch expenses account

Particulars	Amount	Particulars	Amount
To Cash A/c:		By Branch P&L A/c	24000
Salary	3000	(balancing figure)	
Freight outward	11000		
Other expenses	6000		
Branch Debtors A/c (discount)	4000		
	<b>24000</b>		<b>24000</b>

### Branch adjustment account

Particulars	Amount	Particulars	Amount
To Branch Stock A/c (load on abnormal loss) *2	100	By Goods sent to branch A/c (load) *3	70200
To Stock Reserve A/c (load on closing stock) *4	11100		
To Branch P&L A/c (Gross Profit- balancing figure)	59000		
	<b>70200</b>		<b>70200</b>

\*4 Load on closing stock = Invoice price - Cost price

Invoice price= 55500

Cost price =  $55500 \times \frac{100}{125} = 44400$

Load =  $55500 - 44400 = 11100$

### Branch Profit and loss Account

Particulars	Amount	Particulars	Amount
To Branch Expenses A/c	24000		
To Branch Stock A/c (cost of spoilage)	400	By Branch Adjustment A/c (Gross profit)	59000
To General Profit and loss A/c (Net profit)	34600		
	<b>59000</b>		<b>59000</b>



Note: It should be noted that if there is any theft or spoilage of goods at the branch, it should be treated in accounts in the same way as the shortage of goods. If, however, some amount is received from the insurance company for such abnormal losses of stock, the same will be credited to the branch profit and loss account.

## Recap

- ◊ Debtors' system- The head office prepares a Branch Account for each branch.
- ◊ Head office sends goods to branch at cost price or at invoice price.
- ◊ Goods are sent at invoice price- goods supplied, returned, opening and closing stock are recorded at the invoice price.
- ◊ Debtors' system does not provide full information for analysis of branch profit and loss.
- ◊ Branch adjustment A/c - Ascertaining the branch gross profit/ gross loss.
- ◊ Branch profit and loss A/c- Ascertaining the net profit/net loss.
- ◊ Stock and Debtors System -When goods are sent to the branch at invoice price and the size of the branch is large.

## Objective Questions

1. At what price head office supply goods to dependent branches?
2. Which type of branches generally adopts the debtors system?
3. Under which system, credit sales, discount, bad debts, expenses paid by branch and return from debtors to the branch are not taken in the branch account?
4. What is the treatment of actual petty expenses incurred by the branch under the debtors system?
5. At what price head office send goods to branch, if the company wants to hide its profit margin from branch employees?
6. Under which pricing method, the goods supplied to branch, goods returned by branch, opening and closing stock are recorded at the invoice price?
7. How is load removed under invoice price method?
8. What is the loading on the invoice price when Goods sent to branch at cost plus 25%?

## Answers

1. Either at Cost or Invoice price
2. Small branches
3. Debtors system
4. Will not be recorded
5. Invoice price
6. Invoice price method
7. By passing adjusting entries
8. 20% ( $25 \times 125/100$ )

## Self-Assessment Questions

1. Distinguish between Cost price method and Invoice price method.
2. Explain the adjustment of loading in opening stock and closing stock under stock and debtors system.
3. What are the different accounts maintained under Stock and Debtors system?
4. Explain the different methods of preparing the branch account for dependent branches.
5. Differentiate Debtors system and Stock and Debtors system.
6. When is the actual stock with the branch less than the balance shown by the branch stock account?
7. Which side of the debtors account shows cash received from debtors, discount allowed, sales returns, etc.?
8. Which account is prepared for ascertaining the amount of gross profit/gross loss earned by the branch under stock and debtors' system?



## Assignments

1. Menon and Company of Mumbai has a branch at Kochi. Goods are sent by the H.O at invoice price which is at the profit of 25% on cost price. All expenses of the branch are met by the Head office. Prepare Branch Account in the Head office books when goods are shown at invoice price from the following particulars:

Opening balance:	₹
Stock at Invoice price	11000
Debtors	100
Petty Cash	100
Goods sent to branch at invoice price	20000
Expenses made to Head office	600
Rent	200
Wages	900
Salary etc.	2650
Cash sales	300
Credit sale	300
Cash collected from Debtors	250
Goods returned by branch at invoice price	500
Bad debt	300
Allowance to customers	250
Return inwards	13000
Balance at the end	2000
Stock at invoice price	125
Debtors at the end	125
Petty cash including miscellaneous income ₹25, not remitted	125

(Answer- Profit ₹9715)

2. The Delhi Gas Co., Delhi has a sales branch in Agra and charge all goods sent to the branch at cost price plus 33%. It is arranged that all cash received by the branch is to be paid daily to the head office A/c with the Popular Bank Ltd. with the necessary advice sent to the Head Office. From the following particulars, prepare Branch A/c in the head office ledger showing the actual profit of the branch for the year ending 31 December 2020

Stock 1.1.2020	12000	Rent, Rates and Taxes	3200
Goods sent to the branch, less Return	80000	Salaries and wages	4800
Debtors 1.1.2020	1500	Debtors 31 December	1600
Cash sent to Head office	77100	2020	Stock 31 December 2020 14800

(Answer- Profit ₹11300)

3. Give journal entries for the following transactions in the books of the head office.

- ◊ Goods sent by the head office on 28 December worth ₹150 to its Kanpur branch not received by the branch up to December 31.
- ◊ Goods sent by Bombay branch to Kanpur branch for ₹300 are yet to be recorded.
- ◊ Kanpur branch paid ₹3000 for a machine purchased by the head office in Kanpur.
- ◊ Provide depreciation at 10% on branch furniture ₹20000 when Kanpur branch account is maintained in the head office books.
- ◊ A remittance of ₹ 8500 made by Kanpur Branch to the head office on 28 December was received by the latter on 4 January.
- ◊ Bombay branch paid ₹100 dividend to a local shareholder on behalf of the head office.
- ◊ The Kanpur branch collected ₹2000 from a Kanpur customer of head office

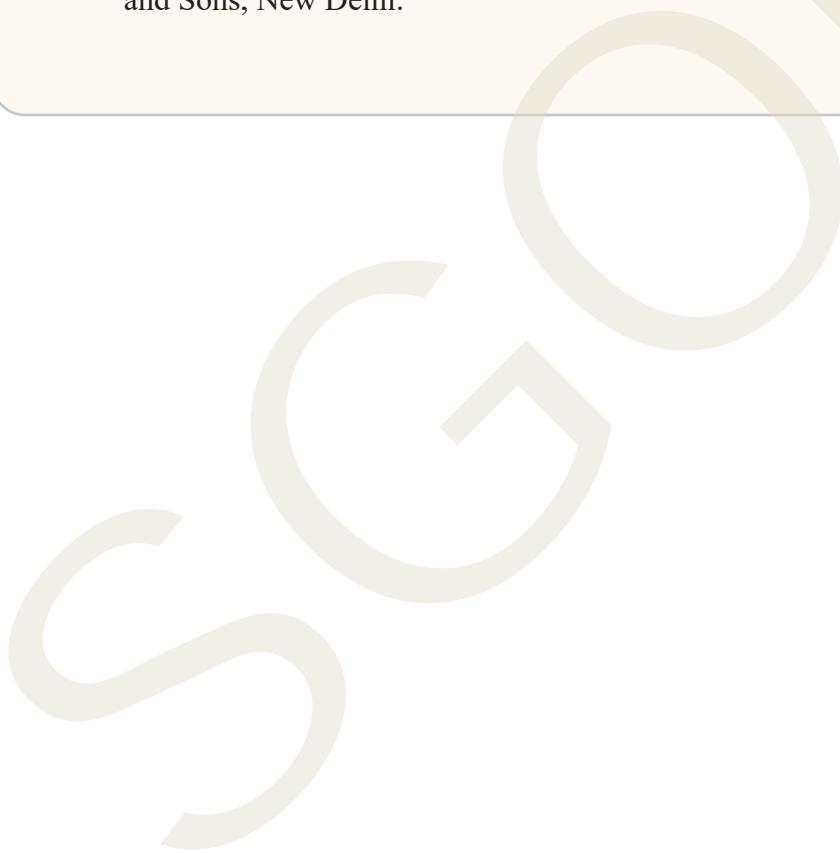
4. The following balances are extracted from the books of the branch.

Stock on 1 Jan 2020	₹ 39000	Wages	₹ 8000
Head office credit Sundry debtors.	42000	Salaries	2500
Purchases.	15000	Carriage and Freight	1200
Goods received from head office.	34500	Rent, Rates etc.	1200
Returns to head office	42500	Office Expenses. Cash	300
Sales.	2000	at hand Cash at bank	350
Sundry creditors.	96000	Stock on 31 Dec .1995	1450
	6000		42600

The Head office sent goods worth ₹7500 to the Branch on 30 December 2020, but the Branch received the same on 7 January 2021. The branch remitted to Head office ₹4500 on 27 December 2020, but the money was received by Head office on 2 January, 2021. The Branch Account in Head Office books showed a debit balance of ₹54000 on 31 December 2020. Branch Plant and Machinery Account appeared in the Head Office books at ₹24000 on 31 December 2020 which was to be depreciated by 5%. Make necessary journal entries in the books of the head office and the branch for reconciling their accounts.

## Suggested Readings

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# Unit

## Accounting Records for Independent Branch

### Learning Outcomes

After studying this unit, the learner will be able to:

- ◊ Familiarise with the meaning of independent branches.
- ◊ Get awareness on cash in transit and goods in transit.
- ◊ Gain an insight in to the incorporation of branch trial balance.
- ◊ Acquaint skills in the preparation of consolidated financial statement.

### Prerequisites

We know that dependent branch is usually a small branch which does not keep full system of accounting. The main accounting records for such branches are maintained at the head office level. But when the size of the branches is very large, their working become very complex. In such cases the branch functions as an independent unit and enjoys certain amount of operational autonomy. Such branches are termed as independent branches. An independent branch keeps a separate and complete set of books under double entry system. They create their own balance sheet, profit and loss account, and trial balance. The present unit deals with the preparation of books of accounts by the independent branches.

### Keywords

Cash in Transit, Goods in transit, Incorporation of branch trial balance.

## Discussion

### 5.3.1 Independent Branch

An independent branch maintains an independent and complete set of books on double entry system. They prepare their own Trial balance, Profit and Loss Account and Balance sheet. At the end of the accounting year, their summarised results and the assets and liabilities are incorporated in the books of the head office.

As already stated, an independent branch enjoys certain amount of operational autonomy. Besides receiving goods from the head office, it may also purchase goods from the open market locally. It follows its own sales policy. Expenses are met by the branch out of its own fund. It does not remit cash to head office immediately, but deposit in a bank in its own account and uses the same for paying expenses, purchasing goods etc. Cash may be sent to head office if there is a surplus or if the head office is in need of funds. Thus, for all practical purpose, branch act as an independent business unit.

The main features of the accounting system of this branch are as follows:

- i. The branch maintains complete set of books on double entry system.
- ii. The branch maintains a Head office A/c in its books. All transactions between Head office and Branch are recorded in this account. Head office also maintains a Branch Account. These two accounts are personal in nature. Branch A/c shows a debit balance and Head office A/c shows a credit balance of this account.
- iii. At the end of the accounting period, branch prepares its Trial Balance and final accounts, and sent its copies to the head office.
- iv. On receiving the final accounts from the branch, the Head office reconciles the balances in Head office A/c as shown in the branch trial balance with the Branch a/c balance in its books. If there is any difference, the same is to be adjusted by passing adjustment entries.
- v. After passing the adjustment entries, the Head office passes necessary journal entries to incorporate the branch Trial Balance in its books.

Some peculiar items:

The following items require some special accounting treatment in case of an independent branch.

- a. Cash in transit
- b. Goods in transit
- c. Head office expenses chargeable to branch
- d. Depreciation on branch fixed assets
- e. Inter- branch transactions

**a. Cash in transit**

Sometimes the branch is remitting cash to the head office before the close of the accounting year, say on 28 December, and the accounts are closed on 31 December. While remitting cash to the head office, the branch will debit the head office account but if the remittance is received by the head office after the closing date of accounting year, say on 3 January, then head office will not give credit for the same amount of remittance on 31 December. So, the two balances i.e., H.O A/c (in branch books) and Branch A/c (in H.O books) will differ. These cash amounts which are on the way are called 'Cash in Transit'. In order to reconcile these balances, the following adjusting entry should be passed.

i. If adjustment is made in the books of Head office

ii. If adjustment is made in the books of Branch.

Cash in transit A/c Dr.  
To Head office

**b. Goods in transit**

Suppose the head office sent goods to the branch on 28 December but those goods were received by the branch on 3 January. In such case the H.O will pass the journal entry on the day of sending. But the branch will pass the journal entry only when it receives the goods. Similarly, when Branch returns goods to the H.O, it immediately debits the H.O A/c and credits Goods returned to H.O A/c. But the H.O will pass the entry only when it receives the goods. It is quite possible that goods sent in the later part of the accounting year may not have been received by the closing date of the accounting year by the head office or the branch as the case may be. Such goods are called 'Goods in transit'. In order to reconcile these balances, an adjusting entry will be passed in the book of branch or head office

i. If adjustment is made in the books of Head office

ii. If adjustment is made in the books of Branch

### Goods in transit A/c

Cash in transit and Goods in transit will be shown as an asset in the balance sheet

Note: It should be noted that the above adjusting entries should be passed either in the books of H.O or in the books of branch but not in the books of both parties.

**c. Head office expenses chargeable to branch**

If ~~some~~ some services such as administration or technical are rendered by the head office to

the branch, then a proportionate charge for such expenses will be made to each branch by the head office and entry for the same will be as follows:

In the book of Head office

Branch A/c              Dr.  
                        To P&L A/c

iii. In the books of Branch

P&L A/c              Dr.  
                        To Head office A/c

d. **Depreciation on Branch fixed asset.**

Branch Asset A/c may be maintained at Head office or at Branch. The entries for depreciation are as under:

i. If the branch fixed asset account is maintained at Head office.

In this case entries regarding the purchase or sale of assets are made in the Head office books only. For example, when fixed asset is purchased by the branch, the H.O debits the branch fixed Asset A/c and credits Bank A/c or Branch A/c (if purchased by the branch). But depreciation for fixed asset is charged to branch because the assets are used by the branch. For depreciation, the journal entry is:

◊ In the books of Head office.

Branch A/c              Dr.  
                        To Branch fixed Asset A/c (For charging depreciation)

◊ In the books of Branch

Depreciation A/c      Dr.  
                        To Head office A/c  
(For charging depreciation)

ii. If the Branch Fixed Asset A/c is maintained at Branch:

When a fixed asset is purchased, the branch debits Head office A/c and credits Bank A/c (or suppliers A/c). The H.O debits Branch fixed asset A/c and credit Branch A/c. But for depreciation on Branch Fixed assets, no entry is passed in the books of H.O.

In the books of branch, the following entry is passed for depreciation:

Depreciation A/c      Dr.  
                        To Branch Fixed Asset A/c

e. **Inter – Branch Transfers:**

When an organisation has more than one branch, transactions between branches may take place. That is, goods or cash may be sent by one branch to another or expenses may be incurred by one branch on behalf of another. Such transactions are called “inter-

branch transactions". These transactions take place under the instructions from the Head office. As such the sending branch assumes that the goods or cash is sent to Head office and receiving branch assumes that it is received from the H.O. Hence, entries are passed on the same basis in the books of the branches and the head office. These are as follows:

i. In the books of Head office

ii. In the books of Sending Branch

iii. In the books of Receiving Branch

## I Illustration 5.3.1

Kalyan Traders having its Head office at Chennai with Branches at Calicut and Kannur closes its annual accounts on 31 December, when the following transactions have taken place.

- i. Remittances of ₹45000 made by Calicut Branch to its Head Office on 30 December, received by Head office on 6 January (next year).
- ii. Goods valuing ₹22000 dispatched by Kannur Branch on 27 December, under instructions from the head office and received by the Calicut branch on 30 December
- iii. Depreciation amounting to ₹11000 on Calicut branch Fixed Assets when accounts of such assets are maintained at the head office.
- iv. Goods worth ₹90000 dispatched by Head Office to Kannur Branch on 30 December, received by that branch on 7 January (next year).
- v. Calicut Branch paid ₹4000 dividends to a local shareholder on behalf of the Head office
- vi. A sum of ₹6000 being arrears of call money was received by the Kannur branch from a shareholder in November but was not communicated to the head office till 3 January. (Next year).
- vii. Calicut branch draws a bill receivable for ₹50000 on Kannur branch which sends its acceptance



## In the books of Head office

## Journal entries

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Cash in Transit A/c To Calicut Branch (Cash remitted by Calicut branch still in transit)	Dr.	45000	45000
	Calicut Branch A/c To Kannur Branch A/c (Goods transferred from Kannur to Calicut branch under Head office instruction.)	Dr.	22000	22000
	Calicut Branch A/c To Calicut fixed Asset A/c (Depreciation charged on Calicut branch fixed asset)	Dr.	11000	11000
	Goods in transit A/c To Kannur branch A/c (Goods sent by Head office still in transit)	Dr.	90000	90000
	Dividend A/c To Calicut Branch A/c (Dividend paid by Calicut branch on behalf of Head office)	Dr.	4000	4000
	Kannur Branch A/c To Calls in arrears A/c (Calls in arrear received by Kannur branch on behalf of head office)	Dr.	6000	6000
	Calicut branch A/c To Bills payable A/c (Bill drawn by Calicut branch on Kannur branch)	Dr.	50000	50000
	Bill receivable To Kannur branch (Bills accepted by Kannur branch)	Dr.	50000	50000

## 5.3.2 Incorporation of Branch Trial Balance

It has already been stated that an independent branch prepares its own Trial Balance

and Trading and Profit and Loss A/c. The branch submits a copy of its Trial Balance to the head office. It does not mean that its year-end results will not form part of the final accounts of the head office. In fact, as in case of dependent branches, the profit or loss made by an independent branch should also be included in the General Profit and Loss account which shows the profit or loss of the company as a whole. Similarly, its assets and liabilities shall also be shown as part of the assets and liabilities of the company. This is done by preparing a combined Balance Sheet of head office and its branches. Thus, it becomes necessary for the head office to incorporate the branch Trial Balances into the head office books. The process by which Consolidated Balance Sheet of the whole business is prepared is known as the incorporation of branch Trial Balance.

Incorporation of Branch Trial Balance can be divided into two parts.

- a. Incorporation of branch profit
- b. Incorporation of branch assets and liabilities

#### **a. Incorporation of Branch Profit**

For the purpose of incorporation of profit, the Head office may apply any of the following two methods.

- i. Detailed incorporation method
- ii. Abridged incorporation method

#### **Detailed Incorporation Method**

Under this method, a Trading and Profit & Loss A/c of the branch is prepared by Head office according to double entry principle in order to incorporate all revenue transactions of the branch. The required journal entries are:

- i. For items on the debit side of the Trading Account

Branch Trading A/c	Dr.
To Branch A/c	

(This entry is passed for incorporating the total amount of items appearing on the debit side of the trading A/c like opening stock, net purchases, wages, goods from head office, carriage inwards etc.)

- ii. For items on the credit side of the Trading Account.

Branch A/c	Dr.
To Branch Trading A/c	

(This entry is passed for incorporating the total amount of items appearing on the credit side of the trading A/c like sales less returns, closing stock, etc.)

- iii. For branch gross profit

Branch Trading A/c	Dr.
To Branch Profit and Loss A/c	

(In case of gross loss, the entry will be reversed)

iv. For items on the debit side of the Profit and Loss Account.

Branch Profit and Loss A/c              Dr.

To Branch A/c

(This entry is passed for incorporating the total amount of items appearing on the debit side of the profit and loss Account like salaries, rent, bad debts, repairs, depreciation, etc.)

v. For items on the credit side of the Profit and Loss Account

Branch A/c              Dr.

To Br. Profit and Loss A/c

(This entry is passed for incorporating the total amount of items appearing on the credit side of the trading A/c like interest received, discount received, commission received etc.)

vi. For branch net profit

Branch Profit and Loss A/c      Dr.

To General Profit and Loss A/c

(If there is net loss, the entry will be reversed)

### **Incorporation of Branch Asset and liabilities**

For incorporating the branch assets and liabilities, the following entries will be passed.

i. For Branch Assets:

Branch Asset A/c              Dr. (Individually)

To Branch A/c

ii. For Branch Liabilities:

Branch A/c              Dr.

To Branch Liabilities a/c (Individually)

After incorporation of assets and liabilities i.e., after passing the entries as given above, the Branch A/c (in the Head office books) will be closed. At the commencement of the next accounting year the journal entries passed for incorporation of assets and liabilities will be reversed. Now the balance in the Branch A/c is the difference between branch assets and branch liabilities.

**I****Illustration 5.3.2**

Bangalore Branch of Ganesh Ltd, Mumbai, sends the following Trial balance to Mumbai on 31 December, 2020. Prepare:

- I. Trading and Profit & loss Account, Head Office Account and Balance sheet in the Books of Branch.
- II. Pass necessary journal entries to incorporate Bangalore branch balances in the Head Office Books, and prepare Bangalore Branch Account in the books of head office.

The closing stock at Branch on 31 December, 2020 was ₹18000

**Bangalore Branch Trial Balance**

Particulars	Debit	Credit
Stock on 1.1.2020	20000	
Furniture	3000	
Goods from Mumbai	100000	
Purchases	20000	
Returns Inwards	2000	
Salaries	12000	
General Expenses	2000	
Rent	1080	
Bad debts	320	
Carriage	300	
Sundry Debtors	18000	
Bank Balance	8000	
Allowances to customers	400	
Bills Receivable	8000	
Sales		174000
Returns to Mumbai		800
Sundry creditors		10000
Head Office Account		10300
	<b>195100</b>	<b>195100</b>

## I. In the books of Kanpur Branch

## Branch Trading and Profit and Loss A/c for the year ended 31.12.2020

Particulars	Amount	Particulars	Amount
To Opening Stock	20000	By Sales	174000
,, Purchases	20000	Less Return	2000
,, Goods from H.O	100000	,, Closing stock	18000
Less: Returns	800		
,, Carriage inwards	300		
,, Gross profit c/d	50500		
	190000		190000
To Salaries	12000	By Gross profit b/d	50500
,, General expenses	2000		
,, Rent	1080		
,, Bad debts	320		
,, Allowances	400		
,, Net profit (transferred to H.O)	34700		
	50500		50500

## Head Office A/c

Dr	Cr.		
Particulars	Amount	Particulars	Amount
To balance c/d	45000	By balance b/d	10300
		By P&L A/c	34700
	45000		45000

## Balance Sheet As at 31-12-2020

Assets	Amount	Liabilities	Amount
Head office A/c	45000	Furniture	3000
Creditors	10000	Bank	8000
		Debtors	18000
		Stock	18000
		Bills receivable	8000
	55000		55000

Note:

- Head office balance is treated just as the capital and shown in the balance sheet.
- Items such as Goods supplied by Head office and goods returned to Head office will not be shown in the Head office A/c again because they have already been recorded

II. In the books of Head office book

Journal

Date	Particulars	L.F.	Amount(Dr.)	Amount(Cr.)
2020 Dec 31	Branch trading A/c Dr. To Bangalore branch A/c (Opening stock ₹20000, Purchases ₹20000, Good received less return ₹99200, Carriage inward ₹300 incorporated)		139500	139500
	Bangalore Branch Account Dr. To Branch Trading A/c (Sales less return ₹172000 and closing stock ₹18000 incorporated)		190000	190000
	Branch Trading Account Dr. To Branch Profit and Loss A/c (Gross profit transferred to Profit & Loss Account)		50500	50500
	Branch Profit and Loss A/c Dr. To Bangalore Branch Account (Salaries ₹12000, General Expenses ₹2000, Rent ₹1080, Bad Debts ₹320 and Allowance ₹400 incorporated)		15800	15800
	Branch Profit and Loss A/c Dr. To General Profit and Loss A/c (Branch profit transferred to General profit and loss Account)		34700	34700
	Branch Asset A/c Dr. To Bangalore Branch A/c (Furniture ₹3000, Bank ₹8000, Debtors ₹18000, Stock ₹18000 and Bill receivable ₹8000 incorporated)		55000	55000
	Bangalore Branch A/c Dr. To Branch Liabilities (Sundry Creditors ₹10000 incorporated)		10000	10000



## Bangalore Branch Account

Dr.

Cr.

Particulars	Amount	Particulars	Amount
To Balance b/d	10300	By Branch Trading A/c	139500
To Branch Trading A/c	190000	By Branch P&L A/c	15800
To Branch liabilities	10000	By Branch Asset A/c	55000
	<b>210300</b>		<b>210300</b>

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**Note:**

- a. In the books of Bangalore branch, the Head Office A/c shows a credit balance of ₹10300 which indicate that the branch balance in the book of H.O must be ₹10300 debit.
- b. After incorporating the trial balance, the Bangalore branch is closed.
- c. Asset and liabilities of Head office are not available. Hence balance sheet of branch alone is prepared.

## **Abridged incorporation method**

Under this method, a Memorandum Trading and Profit and Loss A/c is prepared to ascertain branch profit or loss and pass a journal entry for the net profit or loss. Thus, six journal entries passed under the detailed incorporation method are replaced by just one entry. The journal entry is:

Branch A/c Dr.

### To General Profit & Loss A/c.

(Branch net profit incorporated)

Note: In case of loss, the above entry should be reversed.

## I Illustration 5.3.3

From the information given in illustration 5.3.2, prepare Memorandum Branch Trading and Profit and Loss Account. Pass the necessary journal entries to incorporate the Bangalore branch balances and prepare Bangalore Branch Account in the books of the head office under Abridged method.

## Solution

### In the books of Head office.

**Memorandum Bangalore Branch Trading and Profit and loss A/c for the year  
ended 31-12-2020**

Particulars	Amount	Particulars	Amount
To Opening Stock	20000	By Sales	174000
,, Purchases	20000	Less Return	<u>2000</u>
		,, Closing stock	18000



,,Goods from H.O	100000	99200		
Less: Returns	<u>800</u>			
,, Carriage inwards		300		
,, Gross profit c/d		50500		
		190000		190000
To Salaries		12000	By Gross profit b/d	50500
,, General expenses		2000		
,, Rent		1080		
,, Bad debts		320		
,, Allowances		400		
,, Net profit (transferred to H.O)		34700		
		50500		50500

Note: After finding out the net profit, the following journal entries are passed for incorporation

#### Journal

Date	Particulars	L.F.	Amount(Dr.)	Amount (Cr.)
2020 Dec 31	Bangalore branch A/c Dr. To General Profit and loss A/c (Branch net profit incorporated)		34700	34700
	Branch Asset A/c Dr. To Bangalore Branch A/c (Furniture ₹3000, Bank ₹8000, Debtors ₹18000, Stock ₹18000 and Bill receivable ₹8000 incorporated)		55000	55000
	Bangalore Branch A/c Dr. To Branch Liabilities (Sundry Creditors ₹10000 incorporated)		10000	10000

#### Bangalore Branch Account

Particulars	Amount	Particulars	Amount
To balance b/d	10300	By Branch Asset A/c	55000
To General profit and loss A/c	34700		
To Branch liabilities	10000		
	<b>55000</b>		<b>55000</b>

Note:

- a. Under the abridged method, individual items of Trading and Profit and Loss A/c are not incorporated in the books of Head office. Only the net profit of the branch is incorporated. The profit is ascertained with the help of a Memorandum Trading and Profit and Loss A/c.
- b. Branch Asset and Liabilities are incorporated in the same manner as in the case of detailed incorporation method.

### 5.3.3 Closing Entries in the Books of Branch

At the end of the accounting period, the branch books have also to be closed. There are two methods for closing the books of branch. They are:

- i. First method

Under this method, all the items of Trial Balance are closed by transferring them to Head office A/c. Separate entries being passed for revenue items and for assets and liabilities. Usual entries are passed in the Branch Books for depreciation on fixed assets, bad debts, outstanding income and expenses, etc.

It should be noted that, in order to close the items having debit balances, they must be credited and H.O A/c. must be debited. In order to close the items having credit balances, they must be debited and H.O A/c must be credited. This is made clear from the following entries:

- a. For revenue items on the debit side of the branch Trading and Profit and Loss A/c

Head office A/c	Dr.
To Opening stock A/c	
" Purchase A/c	
"Sales return A/c	
"Goods received from Head office A/c	
"Wages A/c	
"Carriage A/c	
"Depreciation A/c	
"Rent A/c	
"Salaries A/c	

- b. For revenue items on the credit side of the Branch Trading and Profit and Loss A/c

Sales A/c	Dr.
Purchase return A/c	Dr.
Return to Head office A/c	Dr.

Discount received A/c	Dr.
Closing Stock A/c	Dr.
To Head office A/c	
c. For closing Branch Assets	
Head office A/c	Dr.
To Cash at bank A/c	
To Cash in transit A/c	
To Debtors A/c	
To Closing stock A/c	
d. For closing branch liabilities	
Outstanding expenses A/c	Dr.
Creditors A/c	Dr.
To Head office A/c	

## I

### Illustration 5.3.4

Mumbai Head office has a branch at Hyderabad. From the following particulars prepare journal entries to close the books of the branch. Also show Head Office Account.

#### Hyderabad Branch trial balance as at 31 December 2020

Particulars	Amount	Particulars	Amount
Stock on 1 Jan 2020	82000	Sales	349500
Purchases	128000	Head office A/c	140000
Wages	65500	Discount	1500
Manufacturing Expenses	34000	Purchase Returns	3000
Salaries	55000	Creditors	27000
Rent	17000		
Debtors	40000		
General expenses	20000		
Goods received from H.O	72000		
Cash at bank	7500		
	521000		521000

#### Additional Information

- Closing Stock at Branch ₹ 143500
- The Branch fixed assets maintained in H.O books were: Machinery ₹250000, furniture ₹10000. Depreciation is to be charged at 10% on Machinery and 15% on furniture.
- A remittance of ₹40000 made by the Branch on 28 December, 2020 was received by the H.O on 5 January 2021.
- Rent due ₹1500

**In the books of Hyderabad Branch  
Journal**

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2020 Dec 31	Depreciation A/c Dr. To Head Office A/c (The depreciation on Branch Fixed Asset whose accounts are maintained in Head office)		26500	26500
	Cash –in- transit A/c Dr. To Head office A/c (Cash remitted to H.O but not received till 31 December)		40000	40000
	Rent A/c Dr. To Rent Outstanding A/c (The amount unpaid on 31 Dec in respect of rent)		1500	1500
	Head office A/c Dr. To Opening stock „ Purchases „ Wages „ Manufacturing Expenses „ Salaries „ Rent ( 17000+1500) „ General expenses „ Goods received from Head Office „ Depreciation (Debit balances of revenue items transferred to Head office A/c)		501500	82000 128000 65500 34000 55000 18500 20000 72000 26500
	Sales A/c Dr. Discount A/c Dr. Purchase Return A/c Dr. Closing stock A/c Dr. To Head office A/c (Credit balances of revenue items transferred to Head office A/c and closing stock brought into the books)		349500 1500 3000 143500	497500

Head Office A/c	Dr.	231000	
To Closing stock A/c			143500
,, Debtors A/c			40000
" Cash at bank			7500
,, Cash – in- Transit			40000
(Asset transferred to Head office account)			
Creditor A/c	Dr.	27000	
Outstanding Rent	Dr.	1500	
To Head Office A/c			28500
(Liabilities transferred to Head office Account)			

## Working Notes:

1. Journal entries 1 to 3 relates to usual entries for additional information and 4 to 8 for closing entries
2. Calculation of depreciation

10% of Machinery ₹250000 = 25000

15% of Furniture ₹ 10000 =1500

$$\text{Total depreciation} = 25000 + 1500 = 26500$$

### 3. Cash- in – transit treated as asset

## Head Office Account

Dr.

Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2020	To sundries – revenue	501500		By balance b/d	140000
Dec	item (Debit)			By Cash –in –transit	40000
31	To Sundries – Assets	231000		By Depreciation	26500
				By Sundries –	497500
				revenue items (credit)	
				By Sundries –	28500
				Liabilities	
		732500			732500

## ii. Second Method

Under this method the branch prepares its own Trading and profit and loss A/c and then to transfer the net profit or net loss to the head office account. Asset and liabilities are closed by transferring to H.O A/c as under the first method. The following are the journal entries:

a. For closing the net profit

Note: if loss, the entry should be reversed.



For closing Asset A/c

Head office A/c Dr.

To Asset A/c (individually)

For closing Liabilities A/c

Liabilities A/c Dr.

To H. O A/c

After passing the above entries, the Head office A/c will be closed

## I Illustration 5.3.5

From the information given in Illustration 5.3.4, pass necessary journal entries in the books of Hyderabad branch to close the books. Also prepare the H.O A/c.

## S Solution

Here Hyderabad branch prepare its own trading and Profit & Loss A/c and transfer only the net profit or loss to the H.O A/c. Asset and liabilities are closed by transferring to H.O A/c as under the first method. So, first we can start from Trading and Profit and Loss A/c.

### In the books of Hyderabad branch Trading and Profit & Loss account

For the year ended at 31 December 2020

Particular	Amount	Particulars	Amount
To Opening stock	82000	By Sales	349500
,, Purchases	128000	,, Closing Stock	143500
Less: returns	3000		
,, Goods from H.O	125000		
,, Wages	72000		
,, Manufacturing expenses	65500		
,, Gross profit c/d	34000		
	114500		
	493000		493000
,, Salaries	55000	By Gross Profit b/d	114500
,, Rent	17000		1500
Add: Outstanding	1500	By Discount	
,, General expenses	18500	,, Net Loss	
,, Depreciation	20000	transferred to H.O	4000
Furniture	1500		
Machinery	25000		
	26500		
	120000		120000

**In the books of Hyderabad branch  
Journal**

Date	Particulars	Amount (Dr.)	Amount (Cr.)
2020 Dec 31	Depreciation A/c Dr. To Head Office A/c (The depreciation on Branch Fixed Asset whose accounts are maintained in Head office)	26500	26500
	Cash –in- transit A/c Dr. To Head office A/c (Cash remitted to H.O but not received till 31 <sup>st</sup> December)	40000	40000
	Rent A/c Dr. To Rent Outstanding A/c (The amount unpaid on 31 Dec in respect of rent)	1500	1500
	Head office A/c Dr. To Profit and Loss A/c (Branch transfer only the net loss to H.O A/c)	4000	4000
	Head office A/c Dr. To Sundry Assets A/c (Total Asset transferred to H.O A/c )	231000	231000
	Sundry liabilities A/c Dr. To Head office A/c (Total liabilities transferred to Head office A/c)	28500	28500

**Head office A/c**

Date	Particulars	Amount	Date	Particulars	Amount
2020 Dec 31	To Profit and loss A/c (Net loss transferred) To Sundries –Assets	4000 231000 235000		By balance b/d By Cash –in –transit By Depreciation By Sundries Liabilities	140000 40000 26500 28500 235000

Note:- Asset and liabilities are shown in total in journal as well as in Head office A/c.

### 5.3.4 Preparation of Consolidated Financial Statement

As stated earlier, after receiving the branch trial balance, Head office will incorporate the items in the trial balance in its own books. Then a combined Trading and Profit and Loss A/c and Consolidated Balance Sheet are prepared.

#### I

#### Illustration 5.3.6

Following is the Trial Balance of Deva Ltd. And its Calicut branch as on December 31, 2020:

Particulars	Head office	Calicut branch	Particulars	Head office	Calicut branch
Stock on 1 Jan 2020	45000	16400	Creditors	20300	5400
Purchases	110000	25600	Goods sent to branch	14400	-----
Wages	80800	13100	Sales	330200	69900
Manufacturing Expenses	35400	6500	H.O Account	-----	28000
Machinery: Head office	100000	-----	Capital in	200000	-----
Branch	50000	-----	Shares of ₹10 each		
Furniture: Head office	5000		Discount earned	1100	300
Branch	2000		Purchase return	2500	600
Rent	6000	3700			
Salaries	32000	11000			
Debtors	38000	8000			
General expenses	18000	4000			
Goods receives from Head office	-----	14400			
Cash	10300	1500			
Branch Account	36000	-----			
	568500	104200		568500	104200

Additional information:

- Depreciation is to be allowed at 10% on machinery and at 15% on furniture.

2. Rent still payable in respect of 2020 is ₹300 (for Branch).

3. Closing stock at head office was ₹38700 and at Calicut branch ₹28700

Prepare combined Trading and profit and Loss A/c and Consolidated Balance Sheet for the year ending 31 December 2020

## S Solution

Here we prepare the combined Trading and Profit and loss A/c in a columnar form. So, there are two amount columns. They are Head office amount column and Calicut branch amount column.

### Combined Trading and Profit and loss A/c for the year ended 31 December 2020

Dr.					Cr.
Particulars	Head office	Calicut branch	Particulars	Head office	Calicut branch
To Opening stock	45000	16400	By Goods sent to Branch	14400	----
,, Purchases less return	107500	25000	,, Sales	330200	69900
,, Goods received from Head Office	-----	14400	,, Closing stock	38700	28700
,, Wages	80800	13100			
,, Manufacturing Expenses	35400	6500			
,, Gross Profit c/d	114600	23200			
	<b>383300</b>	<b>98600</b>		<b>383300</b>	<b>98600</b>
,, Rent (paid and Outstanding)	6000	4000	By Gross Profit B/d	114600	23200
,, Salaries	32000	11000	,, Discount earned	1100	300
,, General expenses	18000	4000	,, Net Loss	-----	800
,, Depreciation Machinery 10% Furniture 15%	10000	5000			
	750	300			
,, Net Profit	48950				
	<b>115700</b>	<b>24300</b>		<b>115700</b>	<b>24300</b>

Note: Here Head Office shows a Net Profit of ₹48950 and Calicut branch shows a Net Loss of ₹800

### Combined Balance sheet of Deva Ltd as at 31 December 2020

Liabilities	Amount	Assets	Amount
Share capital of ₹10 each fully paid	200000	Fixed Assets:	
Profit and loss A/c		Machinery: H.O 100000	
Profit at HO. 48950	48150	Branch 50000	
Less Loss at branch 800		-----	150000
Creditors		Less: Depreciation	
H.O 20300		(10000+5000) 15000	135000
Branch 5400	25700	-----	
Rent Outstanding at branch	300	Furniture: H.O 5000	
		Branch 2000	
		7000	
		Less: Depreciation 1050	5950
		(750 + 300) -----	
		Current Asset	
		Stock: H.O 38700	67400
		Branch 28700	
		-----	
		Debtors: H.O 38000	
		Branch 8000	46000
		-----	
		Cash: H.O 10300	
		Branch 1500	
		In transit (*1) 8000	19800
		-----	
	274150		274150

Working Note:

\*1. In Calicut Branch, Head Office Account shows a credit balance of ₹28000. Whereas the Calicut Branch Account in Head office Books shows a debit balance of ₹36000. It is assumed that the difference represent cash in transit. So, cash in transit ₹8000 (36000 — 28000) shown in the asset side of Balance sheet.

## Recap

- ◊ Incorporation of branch trial balance -preparing the consolidated balance sheet of the whole business.
- ◊ Incorporating branch trial balance - Detailed incorporation method and abridged incorporation method
- ◊ Detailed incorporation method - the Head office prepares a Branch Trading and Profit & Loss Account
- ◊ Abridged incorporation method- Head office prepares a Memorandum Branch Trading and Profit & loss Account.
- ◊ Detailed incorporation method- All the items of Trial Balance are closed by transferring them to head office account. Separate entries are passed for revenue items and for assets and liabilities.
- ◊ Under both methods - assets and liabilities are closed by transferring to the head office accounts.
- ◊ At the end of the accounting period, the branch prepares a combined trading and profit and loss account a consolidated balance sheet to find the net profit or loss and to determine the financial position.

## Objective Questions

1. Under the detailed incorporation method, which account is credited for incorporating the total amount of items appearing on the credit side of the Trading Account?
2. What is an independent branch?
3. Under the detailed incorporation method, which account is debited for incorporating the total amount of items appearing on the debit side of Profit and Loss Account?
4. How do you close the assets and liabilities accounts of a branch?
5. What is the preparation of consolidated balance sheet under branch accounting called?
6. In the books of the head office, to which account is cash-in-transit adjusted?
7. What is cash-in-transit?
8. Which term is used to denote the transactions that take place between branches?

## Answers

1. Branch Trading Account
2. Branch that maintains an independent and complete set of books on double entry system
3. Branch Profit and Loss Account
4. By transferring it to the Head office Account
5. Incorporation of Branch Trial Balance
6. Branch a/c
7. Cash amounts which are on the way either from head office to branch or vice versa
8. Inter-branch transfers

## Self-Assessment Questions

1. Write a short note on
  - a. Stock and debtors system
  - b. Independent branch
  - c. Inter branch transactions
2. Which account is debited while closing branch net profit?
3. Write necessary journal entries for incorporating branch trial balance in the Head Office book.
4. Which account is debited while closing branch liabilities?
5. Write a short note on Depreciation of branch fixed asset.
6. Distinguish between cash-in-transit and goods-in-transit.
7. Which account is debited while closing branch net loss?
8. How inter-branch transfers are settled in the books of the head office and branches?

## Assignments

1. Visit a large organisation having number of branches in your locality. See how they maintained their books of accounts. Also check how they incorporate their branch accounts with their books of accounts.
2. Following are the balances appearing in the books of head office and branches that keep their own books and prepares its own P&L account as on 31 March 2021, after the ascertainment of profit and making all adjustments except those referred to below:

	Head office		Branch office	
	Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹
Capital		100000		
Fixed Assets	36000		16000	
Stock	34200		10740	
Debtors and creditors	7820	3960	4840	1920
Cash	10740		1420	
Profit and loss		14660		3060
Branch office account	29860			
Head office account				28020
	118620	118620	33000	33000

Pass necessary journal entries to record the following adjustments:

- a. It was argued that the branch should be charged with ₹300 for administration services rendered by the head office during the year
- b. Goods valued at ₹440 had been forwarded by the head office to the branch and invoiced on 30 March, but were neither received by the branch nor dealt with in their books till next month
- c. Stolen stock in transit from the head office to the branch and charged to the branch by the head office but not credited to the head office in the branch books as the branch manager declined to admit any liability, ₹400 (not covered by insurance).

3. Examine the differences between the branch accounting treatment of cash in transit and items in transit. Draw attention to the ways in which they are recorded differently and similarly, as well as how they affect financial statements and underlying concepts.

4. You are required to prepare the Trading and Profit and Loss Account and Consolidated Balance Sheet of Bright Ltd. in Kolkata and its branch at Delhi. Give journal entries for incorporation of Delhi Branch Accounts in the H.O book and show the Branch Account in Head office books after incorporating therein the asset and liabilities. The Trial Balance as on 31 Dec 2013 are as under.

Particulars	H.O		Branch		H.O		Branch	
	Dr.	₹	Dr.	₹	Cr.	₹	Cr	₹
Manufacturing expenses	30000		10000		-----		-----	
Salaries	30000		10000		-----		-----	
Wages	100000		40000		-----		-----	
Cash in hand	10000		2000		-----		-----	
Purchases	150000		80000		-----		-----	
Capital	-----		-----		200000		-----	
Goods received from Head office.	-----		15000		-----		-----	
Rent	8000		4000		-----		-----	
General expenses	20000		5000		-----		-----	
Sales	-----		-----		450000		150000	
Goods sent to branch	-----		-----		15000		-----	
Purchases return	-----		-----		5000		1000	
Opening stock	50000		30000		-----		-----	
Discount earned	-----		-----		2000		1000	
Machinery – H.O	150000		-----		-----		-----	
Machinery- Branch	50000		-----		-----		-----	
Furniture –H.O	7000		-----		-----		-----	
Furniture – Branch	3000		-----		-----		-----	
Debtors	40000		15000		-----		-----	
Creditors	-----		-----		30000		5000	
H. O Account	-----		-----		-----		54000	
Branch A/c	54,000		-----		-----		-----	
	702000		211000		702000		211000	

Closing stock at H.O was ₹40000 and at branch ₹30000. Depreciation is to be provided on machinery @ 20% and furniture @ 15%. Rent outstanding is ₹500 (for branch)

Ans

	H.O ₹	Branch ₹
Gross profit	180000	6000
Net profit	92950	---
Net loss		22950
Balance sheet total (305500)		

## Suggested Readings

1. Shukla, M.C., Grewal, T.S., & Gupta, S.C. (2020). *Advanced Accounts*. S. Chand and Co. Ltd., New Delhi.
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6  
BLOCK

# ACCOUNTING FOR CONSIGNMENT

# Unit 1

## Introduction to Consignment Accounts

### Learning Outcomes

After studying this unit, learners will be able:

- ◊ to familiarise the concept of consignment.
- ◊ to gain insights on the accounting treatment in the books of the consignor.
- ◊ to acquaint with the accounting treatment in the books of the consignee.

### Prerequisites

Globalisation removed geographical boundaries of business operations and thereby even a small concern is able to sell their products throughout the world. In order to sustain in the present competitive world, businessmen need to go for mass production, and only then will they be able to sell their products at a cheap price without compromising the quality. Once the organisations enjoyed the benefits of large-scale, they are more concerned about how to increase their sales. Thus, sales are made directly or indirectly. In the case of direct sales, businessmen or manufacturers appoint salesmen to sell their products directly. So, they are able to exercise control over the sales directly. But through direct selling, it is not possible for producers to reach everywhere to sell their products. So, they resort to some sort of indirect selling methods in which they sell their products at different places with the help of agents by paying commission. This system of indirect selling is called consignment.

## Keywords

Consignment, Consignor, Consignee, Del-credere commission, Over-riding commission, Proforma invoice, Account sales.

## Discussion

### 6.1.1 Meaning of Consignment

An arrangement for transfer of goods from one person to another person for the purpose of sales is termed as consignment. It refers to the practice wherein a manufacturer or wholesale dealer dispatches goods to an agent, who then sells these goods on behalf of the sender, assuming the risk and responsibility, typically on a commission basis. The sender of goods is known as the consignor and the recipient is called the consignee. The goods sent are called 'goods sent on consignment'. The ownership of goods sent on consignment remains in the hands of the consignor and possession of goods rests in the hands of the consignee. Thus, consignment can be defined as the dispatch of goods (or transfer of goods) by the consigner to an agent called consignee for the purpose of storage and sales.

### 6.1.2 Features of Consignment

The following are the key features of consignment:

- i. There are two parties to a transaction of consignment, namely, the consignor and the consignee.
- ii. The relationship between consignor and consignee is that of a principal and agent.
- iii. Consignment of goods by the consigner to the consignee is not sale of goods but only transfer of possession of the goods.
- iv. Sale proceeds belong to the consignor and consignees get commission for their services.
- v. The goods are to be treated as the property of the consignor until it is sold to third parties.
- vi. Unsold goods on consignment are returned by the consignee to the consignor.

### 6.1.3 Need for Consignment

The need for consignment is as follows:

- i. The manufacturers do not know about the local markets while making efforts to market their products. While appointing agents, it becomes easy to sell the products as the consignees are familiar with the local market and can easily

market the products.

- ii. For the manufacturer, selling directly is expensive, but selling indirectly through consignment is more economical.
- iii. Consignment form of selling is suitable in foreign trade. The products of manufacturers can be sold in other countries with the help of agents in those countries.

#### 6.1.4 Distinction between Consignment and Sales

The goods consigned to the agent cannot be treated as sales at the time of the consignment. They are treated as sales only when these are sold by the consignee. The following are some of the differences between a consignment and sales.

Consignment	Sales
Consignment is transfer of goods from one person to another on a commission basis.	Sales means transfer of property from seller to buyer at a price.
Ownership is not transferred to the agent.	Ownership is transferred to the buyer.
Principal and agent relationship exist between the consignor and consignee.	Creditor and debtor relationship exist between the seller and buyer.
Expenses incurred by consignee during consignment are met by consignor.	Expenses incurred after sale is met by the buyer.
An order is not essential for consignment.	An order is essential for sales.
Contract of consignment must be in writing.	Contract of sale may be oral or in writing.
Commission is the consideration for consignment.	Profit is the consideration of sale.
Unsold goods on consignment are returned by the consignee to the consignor.	Goods cannot be returned by the buyer unless it is defective or unless any agreement exists between the buyer and the seller.
Consignment transactions are regulated by Law of Agency	Sale transactions are regulated by the Sale of Goods Act

## 6.1.5 Important Terms

### a. Proforma invoice

When the consignor sends the goods to the consignee, the consignor makes out a statement showing the particulars of goods such as the quality, quantity, price, markings, packing etc. and this statement is called “Proforma invoice”. Even though it looks like a regular invoice, it does not make the consignee responsible to pay the amount mentioned in it.

### b. Account sales

It is statement prepared by the consignees and sent to the consignor encompassing the details of goods sold by the consignee, expenses, commission and advance deducted showing net balance payable to the consignor. It makes the consignee accountable to the consignor.

### c. Recurring and Non-recurring expenses

Both consignor and consignee have to incur some expenses for dispatching and selling goods. These expenses are of two types- non-recurring expenses and recurring expenses.

#### ◊ Non-recurring expenses

The expense incurred which is non-repetitive in nature for bringing the goods from the place of the consignor to the place of the consignee are called non-recurring expenses. These expenses are incurred only once on a particular assignment. These expenses increase the value of goods. These expenses may be paid either by the consignor or the consignee on behalf of the consignor.

Non-recurring expenses of the consignor	Non-recurring expenses of the consignee
i. Packing ii. Transport or carriage iii. Forwarding iv. Dock dues v. Handling charges vi. Freight vii. Insurance	i. Unloading charges ii. Railway dues iii. Dock dues iv. Import duty or Customs duty v. Octroi vi. Carriage to godown/shop

#### ◊ Recurring Expenses

These expenses are incurred after it reaches the consignee's godown. These expenses are recurring (repeating) in nature and occur regularly at fixed intervals. These expenses do not increase the value of goods

Recurring expenses of the consignor	Recurring expenses of the consignee
i. Bank charges ii. Expenses on damaged goods	i. Godown rent and storage charges ii. Insurance charges iii. Brokerage iv. Advertising v. Salary to salesmen vi. Expenses on goods returned vii. Expenses on goods damaged viii. Commission on sales ix. Establishment expenses

#### d. Advance

Advance of payment is made by the consignee to the consignor for the part of the value of goods consigned. Advance may be in the form of a cheque or a draft. If consignee is not able to advance money, a bill of exchange may be drawn by the consignor on the consignee. The consignor discounts the bill with his bank and gets money. The advance given by the consignee will be deducted from the sale proceeds.

#### e. Commission

The consignee gets commission as his remuneration for the goods sold on consignment. Commissions may be of three types.

- ◊ **Simple commission:** - Commission is paid on the basis of total sales. Total sales mean cash sales plus credit sales.
- ◊ **Over-riding commission:** - This is the commission paid to the consignee for selling the goods at a price higher than the selling price.
- ◊ **Del-credere commission:** - An additional commission is given to the consignee for assuming responsibility for bad debts. In this case, the agent is responsible for the bad debts, but not for loss due to a dispute between the buyer and the seller. Del-credere commission is payable on total sales and not merely on credit sales. If commission were to be paid on credit sales, the agent would be tempted to record all sales as credit sales.

#### f. Consignment account

Consignment account is a nominal account that is used to record transactions relating to the goods sent on consignment by the consignor to the consignee. It keeps track of the financial activity related to a specific consignment, with the balance reflecting the profit or loss generated from that particular consignment. Consignment account is opened by the consignor to know profit or loss on each consignment. Separate consignment account is prepared for each consignment. Consignee's account is prepared to know the amount due by or due to the consignee.

#### g. Goods sent on consignment

A goods sent on consignment is a real account which includes the goods transferred by the consignor to the consignee for the purpose of selling. However, the ownership

of these goods remains with the consignor until they are sold to the end customer or buyer by the consignee. Goods are consigned by the consignor to the consignee either at cost or at a higher price (called invoice price). When goods are sent at cost price, the consignor prepares the proforma invoice at the cost price. Sometimes, the consignor sent goods to the consignee at a price which is higher than the cost price which is known as the invoice price. The main purpose of this is to keep the real profit a secret from the consignee.

#### **h. Loss of goods**

In a consignment transaction there are chances that some goods may be lost. These losses might occur during transit, either before or after the consignee receives the goods, or at the godown of the consignee. Such losses can be classified into two-

- ◊ Normal loss-

Normal losses are the losses that are inherent and unavoidable. It occurs due to the inherent characteristics of goods like loss due to evaporation, sublimation, drying up of goods etc.. It is not shown while preparing consignment account. This is included in the value of goods sold and closing stock by inflating the rate per unit.

- ◊ Abnormal loss

Abnormal loss stems from accidents, deliberate damage, or negligence. They arise from rare or accidental incidents like theft or goods destruction by fire. Such losses are debited to abnormal loss account and credit to the consignment account.

These are some of the main concepts in the preparation of consignment accounts. The accounting treatments related to consignment are discussed further in the next unit.

## **Recap**

- ◊ Consignment- Arrangement of the transfer of goods from consignor to consignee for selling.
- ◊ Relationship between consignor and consignee - Principal and agent.
- ◊ Proforma invoice- Statement showing the particulars of goods sent by the consignor to the consignee.
- ◊ Account sale- Statement prepared by consignee showing net balance payable to the consignor.
- ◊ Non recurring expenses- Incurred for bringing the goods from the place of the consignor to the place of the consignee.
- ◊ Recurring Expenses- Incurred after the shipment reaches the consignee's godown.
- ◊ Del-credere commission- Additional commission given to make the consignee responsible for bad debts.

- ◊ Over-riding commission- Commission paid for selling goods at a higher price.
- ◊ Consignment account- Nominal account which shows profit or loss of a particular consignment.
- ◊ Goods sent on consignment- Real account.
- ◊ Normal losses- Inherent and unavoidable.
- ◊ Abnormal loss- Occurs from accidents, deliberate damage, or negligence.

## Objective Questions

1. Which type of account is a Consignment account?
2. Which is the type of commission paid for selling goods at a higher price?
3. Who prepares a proforma invoice?
4. Which type of commission is paid to consignee for bearing the risk of bad debt?
5. What is the term which denotes expenses that are incurred after the goods reach the consignee's godown?
6. What term is used to denote the expense incurred which is non-repetitive in nature for bringing the goods from the place of the consignor to the place of the consignee?
7. Name the statement prepared by consignee showing details of the goods sold by the consignee, expenses, commission and advance deducted showing net balance payable to the consignor.
8. What is proforma invoice?

## Answers

1. Nominal
2. Over-riding
3. Consignor
4. Del-credere
5. Recurring
6. Non-recurring
7. Account sales
8. Statement showing the particulars of goods sent by the consignor to the consignee



## Self-Assessment Questions

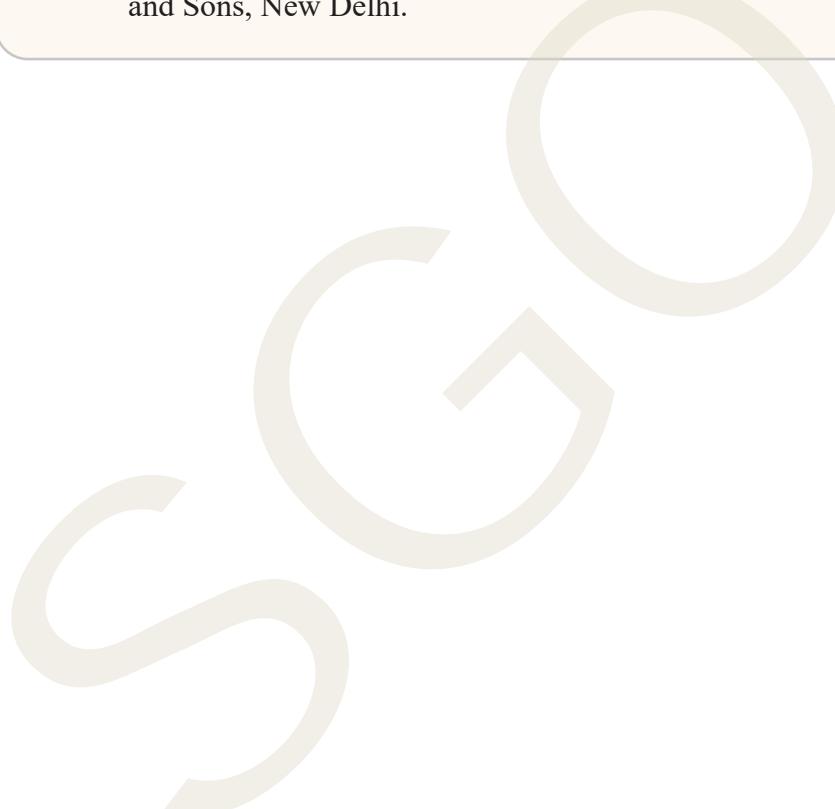
1. Why is a consignment account prepared by the consignor?
2. What do you mean by non-recurring expenses in consignment?
3. Explain consignment.
4. Distinguish between consignment and sales.
5. Write a short note on the various types of commission paid by the consignor to the consignee.
6. How does a proforma invoice differ from account sales?
7. State the features of consignment.
8. What do you mean by non-recurring expenses in consignment? State any two recurring expenses.

## Assignments

1. Explain the concept of consignment in accounting. Describe the roles of the consignor and consignee in a consignment transaction.
2. Evaluate the advantages and disadvantages of consignment arrangements for both parties involved. Provide examples to illustrate your points.
3. Analyse the risks associated with consignment arrangements for both the consignor and consignee. How can these risks be mitigated or managed effectively?
4. Compare and contrast consignment accounting with other methods of inventory management and sales transactions. Highlight the distinct features and benefits of consignment arrangements.

## Suggested Readings

1. Gupta, R.L. & Radhaswamy, M. (2015). *Advanced Accounting*. Sultan Chand and Sons, New Delhi.
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# Unit 12

## Preparation of Consignment Accounts

### Learning Outcomes

After studying this unit, learners will be able:

- ◊ to gain insights on the valuation of unsold stock in consignment.
- ◊ to create awareness on the accounting treatment of normal loss and abnormal loss in consignment.
- ◊ to acquaint skills in the preparation of consignment account when the goods are sent at invoice price

### Prerequisites

Consignment deals with the distribution of goods from the consignor to the consignee without transferring the ownership. The increasing size of the market creates difficulty for manufacturer and wholesalers to establish direct relationship with customers at far off places which necessitates the need for consignment. The need for consignment and the important terminologies in the consignment were discussed in the previous unit.

It is possible that the consignee did not sell every item that the consignor shipped. Additionally, there is a possibility that the goods were lost as a result of theft, accidents, etc.. The preparation of consignment account becomes challenging in these situations. Precise information regarding the value of goods that are delivered, received, sold, and leftover, in addition to related expenses and any losses sustained, is essential for accurately creating consignment accounts. This guarantees that the consignment activities and the associated financial condition are accurately and fairly depicted in the financial statements.

Since consignment accounts need the accounting treatment for both normal and abnormal losses as well as the computation of the cost of unsold stock, they are produced with great care and attention. The present unit deals with these aspects.

## Keywords

Consignment account, Goods sent on consignment, Normal loss, Abnormal loss, Value of unsold stock.

## Discussion

### 6.2.1 Accounting Treatments in Consignment

In the preceding unit, we covered the essential terminology associated with consignment transactions. The accounting treatment in the books of the consignor and in the books of the consignee is explained in this unit.

#### 6.2.1.1 In the Books of Consignor

The accounting entries to be recorded in the books of the consignor are as follows:

- a. Entry for sending goods  
Consignment a/c Dr.  
To Goods sent on consignment a/c (Goods sent on the consignment basis)
- b. Entry for consignor's expenses  
Consignment a/c Dr.  
To Cash /Bank a/c (Expenses for consignment)
- c. For expenses incurred by consignee  
Consignment a/c Dr.  
To Consignee's a/c (Expenses for consignment by consignee)
- d. Entry for advance received from consignee  
Cash/Bank/B.R. a/c Dr.  
To Consignee a/c (Receipt of advance)
- e. On consignee accepting a bill of exchange  
Bill receivable a/c Dr.  
To Consignee's a/c (Acceptance of bill by the consignee)
- f. Entry for sales  
Consignee's a/c Dr.  
To Consignment a/c (Sale of goods)



### 6.2.1.2 In the Books of Consignee

When a consignee receives goods from the consignor no entry is passed in his books and does not record the expenses incurred by the consignor for dispatch of goods. The accounting entries to be recorded in the books of the consignee are as follows:

- a. On dispatch of goods by the consignor - no entry
- b. On payment of expenses by the consignor - no entry
- c. On the consignee accepting the bill of exchange  
Consignor's personal a/c Dr.  
To Bills payable a/c (Acceptance of bill by consignee)
- d. On expenses incurred by the consignee on the consignment  
Consignor's personal a/c Dr.  
To Cash/Bank a/c (Expenses on consignment)
- e. On sales being affected  
Cash or Bank a/c Dr.  
To Consignor's personal a/c (Sale of goods)
- f. On commission being earned  
Consignor's personal a/c Dr.  
To Commission a/c (Commission received by the consignee)
- g. On making payment to the consignor  
Consignor's personal a/c Dr.  
To Bank a/c (Settlement of accounts of consignor)

## Illustration 6.2.1

Krishna sent on 1 April 2019 to Ram goods costing ₹60000 and spent ₹400 on packing etc.. On 3 April Ram spent ₹500 on freight and cartage, ₹600 on godown rent and ₹1000 on insurance. On 31 December 2019, he sends his account sales (along with the amount due to Ram) showing that the entire goods are sold for ₹78000. The terms of the consignment entitle Ram to a commission of 5%. Show the necessary journal entries in the books of the consignor. Also, prepare ledger accounts.



## Solution

### In the books of Krishna

#### Journal Entries

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2019 April 1	Consignment a/c Dr. To Goods sent on consignment a/c (Goods sent on the consignment basis)		60000	60000
April 1	Consignment to Ram a/c Dr. To Cash/Bank a/c (Expenses for consignment)		400	400
April 3	Consignment a/c Dr. To Ram a/c (Expense incurred by Ram)		2100	2100
Dec 31	Ram a/c Dr. To Consignment a/c (Sale of goods)		78000	78000
Dec 31	Consignment a/c (5% on 78000) Dr. To Ram a/c (Commission recorded)		3900	3900
Dec 31	Consignment a/c Dr. To Profit and Loss a/c (Profit transferred)		11600	11600
Dec 31	Goods sent on consignment a/c Dr. To Trading a/c (Goods sent on consignment transferred to Trading a/c)		60000	60000

#### Consignment to Ram a/c

Date	Particulars	Amount	Date	Particulars	Amount
2019 April 1	To Goods sent on consignment a/c	60000	2019 Dec 31	By Ram a/c (Sale proceeds)	78000
April 1	To Bank a/c	400			
Dec 31	To Ram a/c (expenses)	2100			
Dec 31	To Ram a/c (commission)	3900			
Dec 31	To Profit and Loss a/c	11600			
		78000			78000

### Goods sent on consignment a/c

Date	Particulars	Amount	Date	Particulars	Amount
Dec 31	To Trading a/c	60000	Dec 31	By consignment a/c	60000
		60000			60000

### Ram a/c

Date	Particulars	Amount	Date	Particulars	Amount
Dec 31	To Consignment a/c (sale proceeds)	78000	Dec 31	By consignment a/c (expense)	2100
				By consignment a/c (commission)	3900
		78000		By balance c/d	72000
		72000			78000
	To Balance b/d				

## I

### Illustration 6.2.2

On 1 April 2021 Shyam & co. consigned goods costing ₹25000 to their agent Mohan on which Shyam & co. pay freight and insurance charges ₹1500, drawing on him a bill of exchange at 90 days for ₹20000. They discounted the bill at mercantile bank being charged ₹200 thereon. On December 31 they received from their agent an account sale informing that the entire consignment has been sold for ₹85000 that expenses amounting to ₹700 have been incurred and showing as a deduction the agreed commission of 2% on the amount realised. A draft on the bank was enclosed for the balance due.

Give journal entries in the books of consignee.

## S

### Solution

#### In the books of Mohan

#### Journal entries

Date	Particulars	L.F.	Debit	Credit
2021 April 1	Shyam & co. a/c To Bills payable a/c (Acceptance of 90 days bill)		20000	20000
				20000
Dec 31	Cash or Bank a/c To Shyam & co. a/c (Goods sold on behalf of consignor)		85000	85000
Dec 31	Shyam & co. a/c To Cash/ Bank a/c (Expenses incurred on behalf of Shyam & co. a/c)		700	700
Dec 31	Shyam & co. a/c To Commission a/c (85000 x 2%) (Commission due on sales)		1700	1700

## 6.2.2 Valuation of unsold stock (at cost price)

It may not be possible that the total of consigned goods is sold out by the consignee. The unsold stock in the hands of a consignee in an accounting period is brought into the accounts of the consignor. The unsold stock in the hands of the consignee should be valued at cost price or market price whichever is less. The cost includes proportionate non-recurring expenses incurred by the consignor as well as the consignee to bring the goods to the godown. The freight, customs duty, insurance, transit, loading and unloading charges are also added to the value of goods. The expenses of recurring nature incurred after the goods reach the godown of the consignee such as godown rent, insurance of godown, advertisement, salaries of salesmen, etc. should be ignored.

Cost price of consignment stock = cost price of closing stock + proportionate non-recurring expenses.

The journal entry to record the value of unsold stock in the books of the consignor is as follows:

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

(Value of unsold stock recorded)

No entry is to be recorded in the books of the consignee since the consignor is the owner of the goods and not the consignee.

## 6.2.3 Consignment losses

When consignor dispatches goods to the consignee, he may incur two types of losses:

- i. Normal loss
- ii. Abnormal loss

The concepts of normal loss and abnormal loss were discussed in the previous unit. The accounting treatment of the normal and abnormal losses is explained below:

### Normal losses

Normal loss is treated as part of the cost. Its value is borne by good units. No entry is required for the treatment of normal loss but the value of remaining stock is inflated by the cost of units lost.

Cost of unsold stock=

$$\frac{\text{Total cost of goods sent} + \text{Total non-recurring expenses}}{\text{Total units of goods sent} - \text{normal loss units}} \times \text{closing stock in units}$$



# I

## Illustration 6.2.3

Goods consigned 1000 kg @ ₹20 per kg. Freight and carriage paid by the consignor ₹5000. The Consignee sold 650 kg @ ₹40/kg and incurred ₹2000 as unloading expenses, ₹4000 as godown rent and ₹1500 as selling expenses. Normal loss due to leakage is 100 kg. Calculate the cost of unsold stock.

# S

## Solution

Valuation of unsold stock:

Cost of 1000 kg @ ₹20 per kg	-	20000
Add: Non-Recurring Expenses		
Freight and carriage 5000		
Unloading expenses 2000	-	7000
		27000
Total		
(1000 – 100) normal loss	-	900

Closing Stock in Unit = 1000 - 650 - 100 = 250

Cost of unsold stock =

$$\begin{aligned}
 & \frac{\text{Total cost of goods sent} + \text{Total non-recurring expenses}}{\text{Total units of goods sent} - \text{normal loss units}} \times \text{closing stock in units} \\
 & = \frac{20000 + 7000}{1000 - 100} \times 250 \\
 & = ₹7500
 \end{aligned}$$

### Abnormal losses

Abnormal loss is not treated as a part of the cost. This loss can be divided into two:

- Loss in transit:** - This is the loss occurred before it reaches the consignee's place. Proportionate share of consignor's expenses is added with the value of stock lost. The consignee's expenses are not included.
- Loss at consignee's place:** - The value of such loss is the cost of goods destroyed by adding proportionate expenses of consignor and proportionate non-recurring expenses of consignee with value of stock lost.

The abnormal loss is to be debited to Abnormal loss account and credited to Consignment account and is closed by transferring to P&L account.

The journal entries are:

a. When the loss is irrecoverable

Abnormal loss a/c Dr.

To Consignment a/c (Value of abnormal loss recorded)

Profit and Loss a/c Dr.

To Abnormal loss a/c (Irrecoverable loss transferred)

b. When the loss is insured and full amount is recoverable

Abnormal loss a/c Dr.

To Consignment a/c (Value of abnormal loss recorded)

Insurance company a/c Dr.

To Abnormal loss a/c (Loss transferred to insurance company)

c. When the loss is partly recoverable

Abnormal loss a/c Dr.

To Consignment a/c (Value of abnormal loss recorded)

Insurance company/Bank a/c Dr.

Profit and Loss a/c Dr.

To Abnormal loss a/c (Loss partly recoverable and balance transferred to P&L account)

## I

### Illustration 6.2.4

Goods sent on consignment 2000 kg @ ₹10 per kg. Expenses paid by the consignor include freight ₹1000 and insurance ₹600. 400 kg were destroyed in transit due to an accident. Claim admitted by the insurance company was ₹3000. The consignee sold 1400 kg @ ₹40 per kg and incurred the following expenses: unloading ₹400, godown rent ₹1000 and selling expenses ₹600.

Pass journal entries relating to loss in transit and unsold consignment stock in the books of the consignor.

## S

### Solution

#### a. Calculation of amount of Abnormal loss

Cost of 400 kgs. Lost in transit @ ₹10 per kg	4000
Add: Proportionate non-recurring expenses: $\frac{1600}{2000} \times 400$	320
Amount of Abnormal loss	4320

### b. Calculation of value of unsold stock

Cost of 2000 kg @ ₹10 per kg	20000
Add: Non recurring expenses prior to loss:	
Freight	1000
Insurance	600
Total cost of 2000 kg	21600
Less: Value of abnormal loss as calculated above	(4320)
Value of remaining 1600 kgs. (2000-400)	17280
Add: Non recurring expenses after the loss:	
Cost of 1600 kgs.	400
	17680
	=2210
Cost of unsold stock	$= \frac{17680}{1600} \times 200$

### c. Calculation of loss to be transferred to P&L a/c

Abnormal loss:	4320
Less: Claim admitted	(3000)
Loss to be transferred to P&L a/c	1320

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
	Abnormal loss a/c Dr. To Consignment a/c (Goods lost in transit)		4320	4320
	Insurance claim a/c Dr. To Abnormal loss a/c (Insurance claim accepted for loss in transit)		3000	3000
	Profit and Loss a/c Dr. To Abnormal loss a/c (Excess of abnormal loss over admitted claim transferred)		1320	1320
	Consignment stock a/c Dr. To Consignment a/c (Cost of unsold stock recorded)		2210	2210

### 6.2.4 Invoice Price Method

Instead of sending the goods on consignment at cost price, the consignor may send it at a price higher than the cost price. This price is known as invoice price or selling price.

This is done to keep the profits on consignment as secret. Thus, the consignee could not know the actual profit made on consignment.

The following adjustment entries have to be passed in order to eliminate the effect of excess price and to find out the correct profit or loss on consignment. The entries will be recorded in the books of consignor only.

- a. To remove excess price in the opening stock

Stock reserve a/c      Dr.

    To Consignment a/c

(Excess value of opening stock brought down to cost price)

- b. To remove the excess price in goods sent on consignment

Goods sent on consignment a/c      Dr.

    To Consignment a/c

(Adjustment of difference between the invoice price and cost price)

- c. To remove the excess price in goods return

Consignment a/c      Dr.

    To Goods sent on consignment a/c

(Value of goods brought down to cost price)

- d. To remove the excess price in closing stock

Consignment a/c      Dr.

    To Consignment stock reserve a/c

(Adjustment of excess value of stock)

## I Illustration 6.2.5

Anand consigned 50 mini toy cars to Swaroop to be sold at Swaroop's risk. The cost of one mini toy car was ₹1200, but the invoice price was ₹1600. Anand paid freight ₹2000 and insurance. Swaroop received the consignment and accepted a 3 months' draft drawn upon him by Anand for ₹40000.

Swaroop disposed of 40 toy cars at ₹1640 each. The expenses incurred by Swaroop were: Godown rent ₹1050 and advertisement ₹250. Swaroop is entitled to a commission at 5% on sales including del-credere commission of 1%.

Prepare ledger accounts in the books of Anand.

### Consignment to Swaroop a/c

Date	Particulars	Amount	Date	Particulars	Amount
	To Goods sent on consignment a/c	80000		By Swaroop a/c (sale proceeds)	65600
	To Bank a/c (freight and insurance)	2000		By Goods sent on Consignment a/c (loading)	20000
	To Swaroop's a/c (expenses)	1300		By Consignment stock a/c	16000
	To Swaroop's a/c (commission)	3280			
	To Consignment stock reserve a/c	4000			
	To Profit and Loss a/c	11020			
		101600			101600

### Goods sent on consignment a/c

Date	Particulars	Amount	Date	Particulars	Amount
	To Consignment a/c (excess of invoice price over cost = $80000 \times \frac{1600}{1200}$ )	20000	Dec 31	By Consignment a/c (invoice value)	80000
		60000			
	To Trading a/c	80000			80000

### Consignment stock a/c

Date	Particulars	Amount	Date	Particulars	Amount
	To Consignment a/c	16000		By Balance c/d	16000
		16000			16000
	To Balance b/d	16000			

### Consignment stock reserve a/c

Date	Particulars	Amount	Date	Particulars	Amount
	To Balance c/d	4000		By Consignment a/c	4000
		4000			4000
				By Balance b/d	4000

### Bills receivable a/c

Date	Particulars	Amount	Date	Particulars	Amount
	To Swaroop	40000		By bank	40000

### Swaroop's a/c

Date	Particulars	Amount	Date	Particulars	Amount
	To Consignment a/c (sale proceeds)	65600		By Bills receivable	40000
				By Consignment a/c (expense)	1300
				By Consignment a/c (commission)	3280
				By Balance c/d	21020
		65600			65600
	To Balance b/d	21020			

## Recap

- ◊ Unsold stock- Valued at cost price or market price, whichever is less.
- ◊ Cost price of consignment stock = Cost price of closing stock + proportionate non- recurring expenses.
- ◊ Normal losses- Unavoidable and inherent losses.
- ◊ Abnormal loss- Loss or damage of goods caused by abnormal or unexpected reasons.
- ◊ With the value of stock lost, a proportionate share of consignor's expenses is added.

## Objective Questions

1. What term is used to denote the loss in goods which are unavoidable?
2. What term is used to denote the loss in goods which are due to unexpected reasons?
3. How is the amount of unsold stock valued in consignment?
4. In which circumstance is a consignment said to be made at invoice price?
5. How is a normal loss treated in consignment?
6. Which type of costs is taken while computing the cost of unsold stock in consignment?
7. To which account is the final profit or loss on consignment transferred?

## Answers

1. Normal
2. Abnormal
3. Cost or market price whichever is lower
4. When goods are consigned at a price higher than the cost price
5. Normal loss is treated as part of the cost
6. Cost price of closing stock and proportionate non-recurring expenses
7. Profit and loss account

## Self-Assessment Questions

1. Write a short note on consignment losses.
2. How is the value of unsold stock computed? Explain.
3. State the journal entry in the books of the consignee when commission is earned by the consignee from the consignor.
4. Discuss on the accounting treatment when the loss is insured and the full amount is recoverable.
5. What do you mean by invoice price in consignment? Explain its accounting treatment.
6. What will be the journal entry in the books of the consignor when goods are sent by the consignor to consignee?
7. State the journal entry when advance is received by the consignee from the consignor in the books of the consignor.
8. What is the journal entry when the loss is partly recoverable?

## Assignments

1. Madhuri consigned 1000 boxes of chocolate costing ₹100 each to Sukumar. Madhuri paid for carriage ₹1000, freight ₹3000, loading charges ₹1000. Sukumar sold 700 boxes at ₹140 per box and paid expenses such as clearing charges ₹850, warehousing charges ₹1700, and packing and selling expenses ₹600. It is found that 50 boxes have been lost in transit and 100 boxes are still in transit. Sukumar is entitled to a commission of 10% on gross sales. Prepare Consignment account and Sukumar's account in the books of Madhuri.

(Answer- Net profit: ₹11700, Value of goods in transit: ₹10500, Value of closing stock: ₹15900)

2. X consigned 1000 kgs of oil to Y at ₹200 per kg incurring ₹5000 as expenses. 100 kgs were lost in transit. Y spent ₹1000 as non-recurring expenses and ₹3000 as recurring expenses. Y sold 600 kgs and 5 kgs were lost due to breakage in Y's godown which was considered to be normal. Calculate the amount of abnormal loss and the value of stock on consignment.

(Answer- Value of closing stock: ₹61142, Amount of abnormal loss: ₹20500)

3. Helen sent out goods costing ₹80000 to Nikhil so as to show 20% profit on invoice price. 40% goods were lost in transit. 60% of the goods received were sold half at invoice price and the balance at 25% above the invoice price. Rate of commission is 10% on sales at invoice price plus 50% of gross sales less all commission exceeds sales at invoice price. Calculate the amount of commission.

(Answer: Total commission- ₹3900)

4. X consigned 5000 kg of castor oil to Y on 1 January 2020. The cost of oil was ₹460 per kg. X paid ₹200000 for packing and freight. During transit 125 kg were accidentally destroyed for which insurers paid, directly to the consignors, ₹45000 in full settlement of claims. Y took delivery of the consignment on the 10 January. On 31 March 2020, Y reported that 3750 kg were sold at ₹600, the expenses being on godown rent ₹30000, on advertisement ₹40000 and salary to salesman ₹64000. Y is entitled to commission of 3% plus 1 ½ % del-credere. A party which had bought 500 kg was able to pay only 80% of the amount due from it. Y reported a loss of 50 kg due to leakage. Assuming that Y paid the amount due by bank draft, show the accounts in the books of both the parties. Books of accounts are closed by the parties on 31 March.

(Net profit: ₹120320, Value of closing stock- ₹543070)



## Suggested Readings

1. Gupta, R.L. & Radhaswamy, M. (2015). *Advanced Accounting*. Sultan Chand and Sons, New Delhi.
2. Shukla, M.C., Grewal, T.S., & Gupta, S.C. (2020). *Advanced Accounts*. S. Chand and Co. Ltd., New Delhi.
3. Maheshwari, S.N. (2022). *Studies in Advanced Accounting*. Sultan Chand and Sons, New Delhi.
4. Gupta, S.K., Aggarwal, N., & Gupta, N. (2015). *Financial Accounting*. Kalyani Publishers, Ludhiana.
5. Pillai, R.S.N. & Bagavathi. (2012). *Fundamentals of Advanced Accounting*. S. Chand.
6. Gupta, R.L. & Gupta, V.K. (2016). *Financial Accounting*. Sultan Chand and Sons, New Delhi.

SGOU

## MODEL QUESTION PAPER SETS



SREENARAYANA GURU  
OPEN UNIVERSITY



MODEL QUESTION PAPER  
SET - 01

SREENARAYANAGURU OPEN UNIVERSITY

QP CODE: .....

Reg. No : .....  
Name : .....

SECOND SEMESTER BACHELOR OF COMMERCE (B. COM) EXAMINATION  
DISCIPLINE CORE - 3- B21CM03DC: ADVANCED FINANCIAL ACCOUNTING  
(CBCS - UG)  
2023-24 - Admission Onwards

Time: 3 Hours

Max Marks: 70

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SECTION A

**Answer any ten questions in a word or sentence each. Each question carries 1 mark.**

1. What do you mean by IndAS?
2. List out two recurring and non-recurring expenses that occur in a consignment transaction?
3. How is dependent branch different from independent branch?
4. According to IndAS 2, explain the concept of net realizable value of an asset?
5. Who are the parties involved in a hire purchase agreement?
6. How is dead rent different from ground rent?
7. How is the amount of unsold goods valued in consignment?
8. Which Ind AS deals with intangible assets?
9. Name two Inter- branch transactions?
10. Explain PP&E according to IndAS 16.
11. What is hire purchase price?
12. Which year did IASB release IFRS?
13. What journal entry should be made in the consignor's books to record the abnormal loss on consignment?
14. What do you mean by a foreign branch?
15. Which organisation formulates IndAS?

**(10×1=10 marks)**

## SECTION B

**Answer any five questions in one or two sentences each. Each question carries 2 marks.**

16. How does IndAS differ from IFRS in the preparation of Balance sheet?
17. Ammu enterprises purchased machinery on hire purchase basis. The cash price of the machine was ₹74500. He paid ₹20000 on signing the agreement and the balance in three annual instalments of ₹20000 each. Calculate the total interest to be paid for the transaction.
18. What is del-credere commission? How is it calculated?
19. What is borrowing cost as per Ind AS 23?
20. How does cash in transit differ from goods in transit?
21. Govind Publishers printed a book at minimum rent of ₹2,50,000 per annum royalty being payable @ ₹70 per copy sold. No. of copies sold in the first year 2,500. Find short working.
22. State the key objectives of branch accounting.
23. What are the different ways through which minimum rent can be reduced due to the impact of strikes and lockouts in the case of royalty accounts?
24. Explain the accounting treatment for default and repossession under hire purchase.
25. What do you mean by “first time adoption of IFRS”? Explain.

**(5×2=10 marks)**

## SECTION C

**Answer any four questions in one page each. Each question carries 5 marks.**

26. What are the key differences between Indian Generally Accepted Accounting Principles (GAAP) and US GAAP, and how do these variances impact financial reporting practices in different jurisdictions?
27. Rekha enterprises purchased a machine on Hire purchase basis. The cash price of the machine was ₹ 91000 and H.P price was ₹100000. Payment was to be made as given below:

- ₹20000 at the time of delivery
- ₹30000 after 5 months
- ₹30000 after 11 months
- ₹12000 after 19 months
- ₹8000 after 24 months

Machine was purchased on 1 July 2020 and the date of payment of each instalment is counted from this date. Calculate the interest included in each instalment.

28. Write a short note on IndAS 37.

29. What is minimum rent? Explain the adjustment of minimum rent at the time of strike and lockouts.

30. Shyam Enterprises based in Mumbai operates a branch in Pune, which exclusively deals in cash sales. The transactions between the Main Office and Branch for the fiscal year ending on 31 December 2023 are as follows:

	₹
Opening stock at branch on 1 Jan 2023	350000
Goods supplied to Branch	550000
Cash sent to Branch for:	7500
Salary	₹6000
Other expenses	₹1500
Cash received from branch during the year	630000
Closing stock at 31 December 2023	250000

From the above information, pass necessary journal entries and prepare Pune branch Account in the head office books.

31. Why is the adoption and convergence with IFRS essential for boosting capital formation? What are the reasons and significance of implementing comparable global accounting standards in India?

32. Prakash dispatched 3200 units of merchandise @ ₹15 per unit to Arjun. The consignor incurred expenses including transportation charges of ₹1500 and insurance costs of ₹800. Unfortunately, 500 units were damaged during transit due to an unforeseen incident. The insurance company compensated ₹3600 for the claim. The consignee sold 2400 units @ ₹40 per unit and faced additional expenses such as handling charges of ₹300 and warehouse rental fees of ₹1100. Record journal entries concerning the loss during transit and the remaining unsold consignment inventory in the records of the consignor.

33. Explain the accounting treatment of PP&E as per IndAS 16.

**(4×5=20 marks)**

## SECTION D

**Answer any two questions in three pages each. Each question carries 15 marks.**

34. On 1 September 2021, PQR Corporation purchased a computer system from XYZ Technologies on hire purchase basis. The cash price of the computer system was ₹50,000. The payment was to be made ₹15,000 on the date of the contract and the balance in 5 annual instalments of ₹7,000 plus interest at 10% per annum payable on 31 August each year, the first instalment being payable on 31-08-2022. Formulate journal entries and ledger accounts in the books of PQR Corporation, assuming the accounts are closed on 31 August and depreciation at 14% p.a. written off on the

original cost. Also, depict how the items will appear in the Balance sheet of relevant periods.

35. Discuss the concept of consignment in business transactions, highlighting its key features and necessities. Compare and contrast consignment and sales. Explain the accounting treatments in consignment in the books of consignor and consignee.
36. Surya limited is lessee of a mine on a royalty of ₹1.50 per ton of coal raised with minimum rent to X of ₹11000 p.a. with power to recoup short workings during the first three years of the lease only.

The output for the first five years was:

Year	2019	2020	2021	2022	2023
Output (tonnes)	5400	7500	9000	8600	9100

Pass necessary journal entries in the books of lessor and lessee and prepare necessary books of accounts.

37. Sunrise Traders, based in Mumbai, established a satellite location in Nashik on 1 July 2019. The merchandise was dispatched from the main office to the branch invoiced at a selling price determined by the branch, which was 125% of the main office's cost price. The following details pertain to the transactions conducted at the Nashik branch:

Goods sent to branch (at cost to Head Office)	329400
Cash sales	315800
Credit sales	140400
Cash received from Debtors	137900
Discount allowed	4000
Goods returned by debtors to branch	5000
Cash sent to branch for:	
Rent:	4300
Salary:	20000
Petty cash at branch as on 30 June 2019	800
Stock on 30 June, 2019 at invoice price	85400

Ascertain the profit or loss for the Nashik branch for the year ended 30-06-2020 by preparing accounts under stock and debtors system.

**(2×15=30 marks)**



MODEL QUESTION PAPER  
SET - 02

SREENARAYANAGURU OPEN UNIVERSITY

QP CODE: .....

Reg. No : .....

Name : .....

SECOND SEMESTER BACHELOR OF COMMERCE (B. COM) EXAMINATION  
DISCIPLINE CORE - 3 - B21CM03DC: ADVANCED FINANCIAL ACCOUNTING  
(CBCS - UG)  
2023-24 - Admission Onwards

Time: 3 Hours

Max Marks: 70

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SECTION A

**Answer any ten questions in a word or sentence each. Each question carries 1 mark.**

1. Which accounting standards was replaced by IFRS?
2. How does cost price differ from invoice price?
3. According to IndAS 2, state the meaning of fair value of an asset?
4. What is it called if the hire vendor takes away all the goods on which there is a default of instalment?
5. Explain Stand-alone selling price according to IndAS 115.
6. Which Act governs the instalment system?
7. How is short working adjusted in royalty accounts?
8. What is a dependent branch?
9. Which Ind AS deals with PP&E?
10. Which organisation formulates IFRS?
11. State the relationship that exists between a consignor and a consignee in consignment.
12. What is GAAP?
13. In consignment, who prepares a proforma invoice?
14. Under a hire purchase system, to which account is the amount of interest credited by the hire purchaser?
15. Distinguish between recurring and non-recurring costs in consignment?

**(10×1=10 marks)**

## SECTION B

**Answer any five questions in one or two sentences each. Each question carries 2 marks.**

16. How does IndAS differ from IFRS in terms of the period of reporting?
17. Differentiate proforma invoice and account sales.
18. What are the various costs related to inventories as per Ind AS 2?
19. Explain how branch accounts are prepared as per debtors system? State the different methods of preparing the branch accounts under the debtors system.
20. Distinguish between contingent asset and contingent liability.
21. How is a provision recognised as per IndAS37?
22. What is short working? How is short workings computed while preparing royalty accounts?
23. What do you mean by an impaired asset?
24. Why is a consignment account prepared by the consignor?
25. Explain the term “IFRS.”

**(5×2=10 marks)**

## SECTION C

**Answer any four questions in one page each. Each question carries 5 marks.**

26. Write a short note on the measurement of intangible assets at initial recognition as per IndAS 38.
27. Explain the various types of employee benefits as per IndAS 19.
28. Distinguish between Hire purchase and Instalment system.
29. From the given analytical table, open the necessary accounts in the books of the Lessee.

**Analytical Table**

Year	Royalty	Minimum Rent	Surplus	S.W.	S.W. Recouped	S.W. un Recouped	Amount to pay
2021	5600	17500	-	11900	-	-	17500
2022	11600	17500	-	5900	-	-	17500
2023	18800	17500	1300	-	1300	16500	17500

30. Saleem Co. has its Head office at Mumbai and Branch at Kerala. With the help of the following transactions which took place between Head office and the Branch office in the year 2023, prepare Branch Account and Debtors Account in the books of Head office.



Opening stock	115000
Closing stock	65500
Opening debtors	55000
Opening balance of petty cash	300
Goods supplied to branch	460000
Credit sales	330000
Cash sales	225000
Cash received from debtors	106000
Cash sent to Branch for Expenses	35000
Goods returned by the branch	5000
Goods returned by customers	33000
Allowed discount to customers	5600
Bad debts	16500

31. Gautham consigned 3200 kg @ ₹15 per kg to Visakh. Expenses paid by the consignor include freight ₹1500 and insurance ₹800. 500 kg were destroyed in transit due to an accident. Claim admitted by the insurance company was ₹3600. The consignee sold 2400 kg @ ₹40 per kg and incurred the following expenses: unloading charges ₹300, and godown rent ₹1100. Pass journal entries relating to loss in transit and unsold consignment stock in the books of the consignor.

31. Distinguish between consignment and sales.

32. Raj entrusted 50 mobile phones to Ravi for sale on Ravi's account. The cost of each mobile phone was ₹8000, but the selling price was marked at ₹10000 each. Raj paid transportation charges of ₹3000 and arranged insurance. Ravi accepted a 60-day bill drawn upon him by Raj for ₹60000. Ravi sold 40 mobile phones at ₹10500 each. His expenses included shop rent of ₹2000 and promotional expenses of ₹1500. Ravi is entitled to a commission of 4% on sales, inclusive of a del-credere commission of 2%. Prepare ledger accounts in Raj's books.

(4×5=20 marks)

## SECTION D

**Answer any two questions in three pages each. Each question carries 15 marks.**

33. Discuss the importance of IFRS convergence for businesses in India, highlighting its benefits. Explain the objectives and key provisions of IFRS 1 regarding the preparation of first-time IFRS financial statements.

34. LMN Inc. entered into a hire purchase agreement with OPQ Furnishings on 1 May 2023 to acquire furniture valued at ₹35,000. LMN Inc. paid ₹7,000 upfront and agreed to pay the remaining balance in four annual instalments of ₹7,000 each, along

with 9% interest per annum, payable on 30 April each year. The first instalment was due on 30 April 2024. Prepare journal entries and ledger accounts for LMN Inc., assuming the books are closed on 30 April annually. Account for depreciation at a rate of 20% per annum on the original cost. Show how these transactions will reflect in the Balance sheet for the relevant periods.

35. Alpha Corporation leased a warehouse from Beta Realty for 20 years from 1 April, 2019 on a royalty of 70 paise per ton. The minimum rent was fixed at ₹10000 p.a. with power to recoup short working over the first four years of the lease. The output was as follows:

Year	2019	2020	2021	2022	2023
Tons	7600	6000	15000	18500	25000

Prepare journal entries and ledger accounts for Alpha Corporation, assuming the accounts are closed on 31 March every year.

36. Surya Enterprises, based in Bangalore, established a branch in Mysore on 1 July 2019. The merchandise was dispatched by the main office to the branch invoiced at a selling price consistent with the branch's pricing policy, which was set at 125% of the cost price of the main office. The following details outline the transactions of the Mysore branch

Particulars	Amount
Goods sent to branch (at cost to Head Office)	270000
Sales: Cash	115000
Credit	175000
Cash collected from Debtors	156000
Discount allowed	3400
Goods returned by debtors to branch	5000
Cash sent to branch for:	
Branch expenses : 8500	
Freight outward : 12000	20500
Stock on 30 June, 2019 at invoice price	44000

Ascertain the profit or loss for the Mysore Branch for the year ended 30-06-2020 by preparing Accounts under Stock and Debtors System.

**(2×15=30 marks)**

## സർവ്വകലാശാലാഗീതം

വിദ്യയാൽ സ്വത്രന്തരാക്കണം  
വിശ്വപ്രതരം മാറണം  
ഗഹപ്രസാദമായ് വിളങ്ങണം  
സുരൂപ്രകാശമേ നയിക്കണം

കൂദിരുട്ടിൽ നിന്നു തെങ്ങങ്ങളെ  
സുരൂവാമിയിൽ തെളിക്കണം  
സ്നേഹദീപ്തിയായ് വിളങ്ങണം  
നീതിവെജയത്തി പാറണം

ശാസ്ത്രവ്യാപ്തിയെന്നുമേകണം  
ജാതിഭേദമാകെ മാറണം  
ബോധരശ്മിയിൽ തിളങ്ങുവാൻ  
അതാനകേന്ദ്രമേ ജൂലിക്കണം

കുരീപ്പും ശ്രീകുമാർ

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