

Financial Accounting

DEACC105

Edited by
Dr. Sukhpreet Kaur



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Financial Accounting

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Dr. Sukhpreet Kaur**

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Unit 1: Introduction To Accounting

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Objectives

- After studying this unit, you will be able to:
- apply basics of accounting in certain situations.
- identify how accounting is an information system.
- analyze the requirement of financial statements for different users.
- prepare the accounting transaction as per rules specified by accounting bodies,
- measure the importance of accounting in real life.
- compare the constraints of accounting to get profitable results.
- use the basis in computing and recording the business events.

Introduction

Accounting is the process of recording financial transactions pertaining to a business. The accounting process includes summarizing, analysing and reporting these transactions to oversight agencies, regulators and tax collection entities. The financial statements used in accounting are a concise summary of financial transactions over an accounting period, summarizing a company's operations and its financial position.

According to American Institute of Certified Public Accountants Associations, "Accounting is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted."

1.1 Accounting Information System

An accounting information system (AIS) involves the collection, storage and processing of financial and accounting data used by internal users to report information to investors, creditors and tax authorities.

It is generally a computer-based method for tracking accounting activity in conjunction with information technology resources.

An AIS combines traditional accounting practices, such as the use of Generally Accepted Accounting Principles (GAAP) or IFRS, with modern information technology resources.

Objectives of Accounting?

1. To keep systematic records.
2. To protect business properties.
3. To ascertain the operation profit and loss.
4. To ascertain the financial position of business.
5. To facilitate rational decision making.

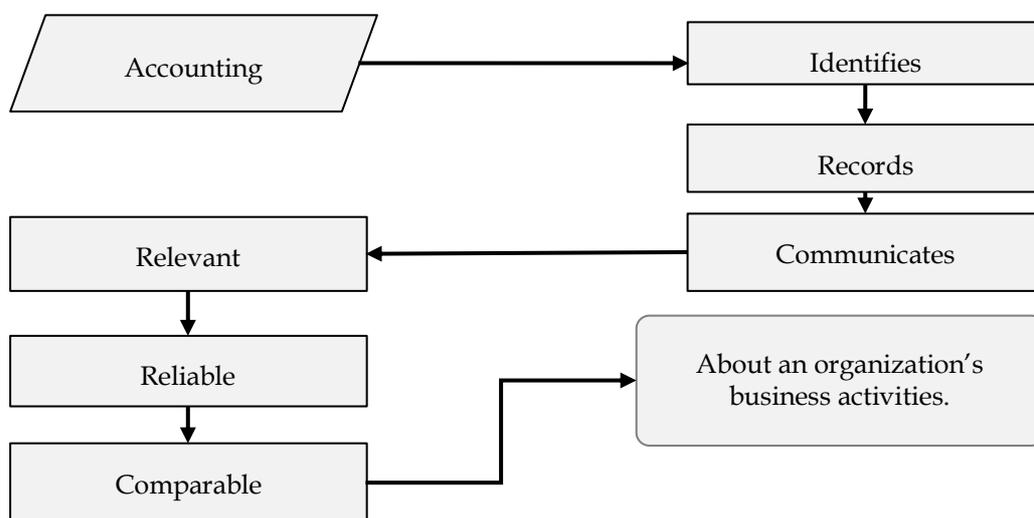


Fig 1. Accounting as an Information System

Difference between Bookkeeping and Accounting.

BASIS	BOOKKEEPING	ACCOUNTING
Definition	Bookkeeping is mainly related to identifying, measuring and recording financial transactions.	Accounting is the process of summarizing, interpreting and communicating financial transactions which were classified in the ledger account.
Decision Making	Management can't take a decision based on the data provided by bookkeeping.	Depending on the data provided by the accountants, the management can take critical business decisions.
Objective	The objective of bookkeeping is to keep the records of all financial transactions proper and systematic.	The objective of accounting is to gauge the financial situation and further communicate the information to the relevant authority.

Preparation of Financial Statements	Financial statements cannot be prepared during the bookkeeping process.	Financial statements are prepared during the accounting process.
Skills Required	Bookkeeping doesn't require any special skill sets.	Accounting requires special skills due to analytical and complex structure.
Analysis	The process of bookkeeping does not require any analysis.	Accounting uses bookkeeping information to analyse and interpret the data and then compiles it into reports.
Types	Basically, there are two types of bookkeeping - single entry and double entry bookkeeping.	The accounting department does preparations of a company's budgets and plans loan proposals.
Bookkeepers and Accountants	Bookkeepers are required to be accurate in their work and knowledgeable about financial topics. Bookkeeper's work is usually overseen by an accountant.	Accountants with sufficient experience and education can obtain the title of Certified Public Accountant (CPA).

1.2 Users of Accounting Information

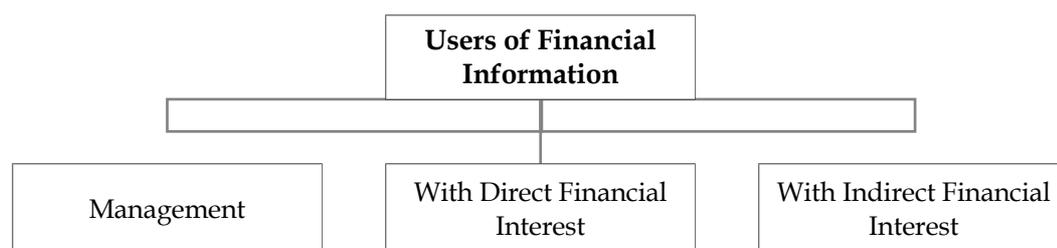


Fig 2: Users of Financial Information

1. Management: Management requires all the timely and useful information of business organization to planning and control the business affairs. Further, they can use the information for better decision making and performance measurement.

2. Users with direct financial interest: Users with direct interest in financial interest are existing and potential Investors who measures and analyze the past performance of company and its growth prospects with the help of published financial statement. Also, the existing and potential creditors has keen interest in financial information to make credit decisions, They want to understand the creditworthiness of company, that they have enough cash to pay interest charge or not. In addition to this, profitability, liquidity and financial position of the company can be adjudged from financial reports. Employees also have direct interest as they want to know about their job security and promotion.

3. Users with indirect financial interest: Bankers use accounting information when deciding whether or not to make a loan for the person or business who applied. Stockbrokers and other financial advisers base investment recommendations on accounting information. Also, Government regulators use accounting information to determine, if firms are complying with various laws and regulations.



Caution: These are the users of financial information. Let us study more about users of financial/accounting information.

	Task: Identify the users as per purpose mentioned below.	
Purpose	Identify and write the Users	
To Evaluate Operations of the Firm, To Make Investment Decisions.	1.	
To Plan and Control.	2.	
To Use in Contact Negotiations.	3.	
To Evaluate Credit Ratings.	4.	
To Evaluate Tax Liabilities, To Approve New Issues of Stocks and Bonds.	5.	

1.3 Need of Accounting Information

In the business world, accounting is utilized in much greater depth, but each individual encounters some activities in his/her everyday life that requires knowledge of accounting principles. Most basic framework of business. Without an accounting education, students would be unprepared for the real world.

1. In the business world, accounting is one discipline of study that all people, regardless of job position, should have some knowledge.
2. Accounting is the backbone of the business financial world.
3. People in the business world have been held more accountable for their financial practices. E.g. Enron, WorldCom, Satyam.
4. Accounting provides necessary information for decisions to be taken initially and it facilitates the enterprise to pave way for the implementation of actions.
5. It exhibits the financial track path and the position of the organization.
6. Being business in the dynamic environment, it is required to face the ever-changing environment.
7. In order to meet the needs of the ever-changing environment, the policies are to be formulated for the smooth conduct of the business.
8. It equips the management to discharge the obligations at every moment.
9. Obligations to customers, investors, employees to restructure.



Example: These are the two ways in which accounting can be used. First, A used accounting to help plan his business. That is, he used accounting to project the expected profits. Second, after A operated his business for a day, he used accounting to determine if, in fact, he had made a profit. In general, accounting is used during all phases of planning and operating a business.

1.4 Qualitative Characteristics of Accounting

Accounting is an art as well as science

It is an art because it records, classifies, and summarizes the financial transactions which helps in understanding the financial performance and financial position of the business. It is also a science due to structured knowledge based basic principles.

Recording of financial transactions only

Transactions in an organization which can be expressed in terms of money are to be recorded in the book of accounts. All such events which can not be expressed in monetary terms do not find a place in the

accounting records of a firm. Another important aspect of the concept of money measurement is that the records of the transactions are to be kept not in the physical units but in the monetary unit.

Classifying the transactions

Classifying the transactions in different groups make the work easy of finance manager and accountant as well. Categories like, Assets, Liabilities, Expenses, Revenues, Equity is framed and transactions related to same are posted.

Summarizing the transactions

Summarizing the transactions in different financial reports helps to find the business real financial performance and financial position. To get the results more accurately and effectively summarization is considered as important feature.

Analysing

After recording, classifying and summarizing the financial events, management will analyze the each aspect mentioned in financial reports for decision making. They can judge from the figures to continue with same strategies or make any possible changes in same.

Communication of results

Analysis and interpretation will proceed the financial information to be published and presented to users of financial statements. Without communicating the results, the process of accounting is incomplete.

Services can be availed with the help of accounting.

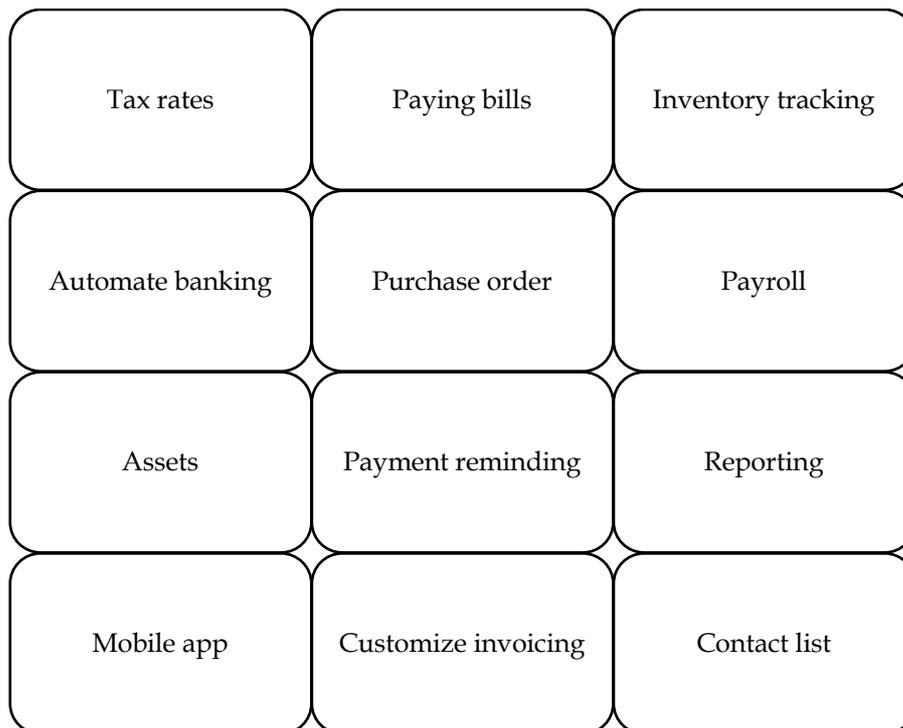


Fig 3: Services in accounting

1.5 Accounting Cycle

Accounting cycle is a systematic process of extracting the financial information for a specified period till presentation of it. It is a simple and easy process to follow for getting an adequate information for a particular business. It initiates with identification of source documents for business events and finalizes with publication of financial statements. To understand it very clearly, we can emphasize on each step of accounting cycle. Here, is the diagrammatic representation of accounting cycle.

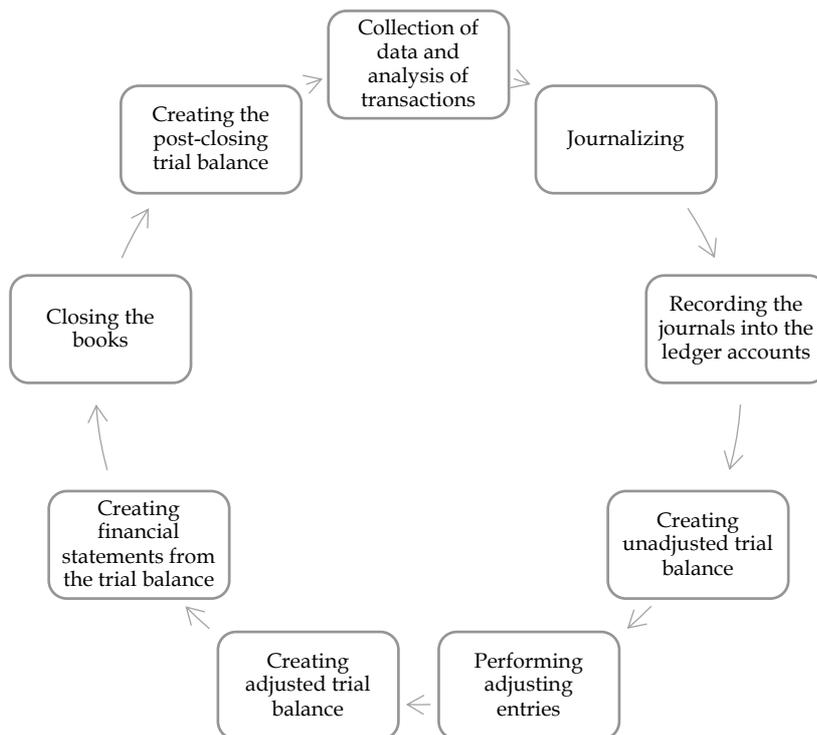


Fig 4: Accounting Cycle

1.6 Rules of Accounting

here are some specific rules for accounting which are framed by accounting bodies and needs to follow for decision making. Let us discuss about these.

1. Golden Rules of Accounting- It goes with three basic accounts that you can say types of accounts. It consists of Personal, Real and Nominal Accounts. There are some basics behind it. One must keep this in consideration while recording the business transactions in books of accounts.

Type of Account	Debit Rule	Credit Rule
Personal Account	Receiver	Giver
Real Account	What Comes In	What Goes Out
Nominal Account	Expenses/Losses	Incomes/Gains

2. Modern Rules of Accounting- Instead of keeping the above three accounts in consideration, now we adhere the other aspect of accounting. In accounts classification is done for each business transactions. Modern rules are prepared on these aspects.

Basis	Capital	Assets	Liability	Expense	Income
Debit	Decrease	Increase	Decrease	Increase	Decrease
Credit	Increase	Decrease	Increase	Decrease	Increase

1.7 Advantages of Accounting

1. Provides complete and scientific records- Accounting is based on generally accepted principles and a scientific way of presentation of business transactions in books of accounts. As such, accounting is a complete and systematic recording of all business transactions. The limitations of humans, that they cannot keep all transactions in mind, is overcome by accounting because each and every business transaction can be recorded and analyzed through same.

2. Information regarding performance and position- Accounting facilitates proper feed back to the management. It helps the management in planning as well as control of different activities of the business enterprise. It also helps the management to evaluate the performance of the business enterprise and takes timely action to remove the shortcomings in the management.

3. Enables comparison- Profit & Loss Account shows net profit earned or net loss sustained by the business. If the accounts are maintained properly, records relating to various expenses, sales, gross profit and net profit etc. can be compared. As such, accounting helps in inter- firm and intra- firm comparison. Comparison of accounts of two different enterprises for the same year is known as inter-firm comparison and comparison of two different periods for the same business enterprise is known as intra- firm comparison.

4. Evidence in legal matters- The business transactions are recorded in the books of accounts supported by authenticated documents viz. vouchers etc. Thus, the accounts can be used as an evidence in the court of law.

5. Valuation of business- In case of sale of business or conversion of one business into another, true and fair value of the business is calculated. Through accounting, the correct picture can be depicted in Balance Sheet and as such the purchase price can be determined. Balance Sheet shows the value of assets & liabilities of the business which can be used to calculate its net worth.

1.8 Limitations of Accounting

1. Permits alternative treatments- There exists an application of alternative methods in determining depreciation of assets and valuation of stock etc. Information regarding the activities of the business is expressed in a misleading way if an alternative method is used to achieve a particular object.

2. Influenced by personal judgement- Accounting information is not without personal influence or bias of the accountant. In measuring income, accountant has a choice between different methods of inventory valuation, depreciation methods, treatment of capital and revenue items etc. Hence, due to the lack of objectivity income arrived at may not be correct in certain cases.

3. Ignores non monetary information- As per accounting principles, only the events measurable in terms of money are recorded in the books of accounts. But events of great importance, if not measurable in terms of money, are not accounted for. For that reason, recorded accounting information fails to exhibit the exact financial position of a business concern.

4. Does not provide detailed analysis- Exhibited accounting information cannot always exhibit a true and fair picture of a business concern owing to limitations of the accounting principles used. For example, Fixed assets are shown after deducting depreciation. In the case of inflation, the value of fixed assets shown in the accounts does not correspond to the real position.

5. Does not disclose the present value of the business- Accounting information may not be used as the only test of managerial performance as profits can be manipulated or misrepresented.

1.9 Branches of Accounting

The main objectives of accounting are to record the business transactions and to provide the necessary information to the internal and external users of the financial statements. In order to achieve the above objectives, the accounting is classified into various branches.

1. Financial Accounting- It is the original form of accounting. It refers to the recording of daily business financial transaction. Recording of the transaction is done in such a way that the profit of the business may be ascertained after a definite period and the picture of the financial position of the business may be presented.

2. Cost Accounting- As the name indicates, this accounting is related with the ascertainment of cost of the product in a period. Under this system, record of raw materials used in production, wages and labor paid and other expanses incurred on production are kept to control the costs.

3. Management Accounting- The accounting which provides the necessary information to the management is called management accounting. Under this, the analysis and interpretation of the

accounts, prepared by financial accounting, are done in a manner so that the managers may forecast, plan for future and frame the policy.

4. Tax Accounting- Under tax accounting, the accountants prepare the accounts as per the provisions of taxation. The accounts prepared as per taxation provisions may differ from the accounts prepared as per financial accounting.

5. Inflation Accounting- The financial statements are prepared based on historical cost which do not present the true picture of the financial position and correct profit or loss of the business due to inflation. Thus, the fresh financial statements are prepared keeping in mind the price level changes under inflation accounting.

6. Human Resource Accounting- Human Resource Accounting means the accounting for human being as now in an organization human being is treated as an asset like other physical assets. It is recorded in the books like other assets. HRA deals with the measurement of costs on recruiting, selecting, hiring, training, placing and development of the employees in one side and on the other side it deals with the present economic value of the employees. For the determination of the value of human being different methods are used under HRA.

7. Responsibility Accounting- Responsibility accounting is a special technique of management under which accountability is established according to the responsibility delegated to the various levels of management. A management information and reporting system is instituted to give adequate feedback in terms of the delegated responsibility. Under this system, units of an organization, under a specified authority in a person, are developed as responsibility center and evaluated individually for their performance.

1.10 Cash Basis of Accounting

The cash basis of accounting recognizes revenues when cash is received, and expenses when they are paid. This method does not recognize accounts receivable or accounts payable. Many small businesses opt to use the cash basis of accounting because it is simple to maintain. It's easy to determine when a transaction has occurred. The cash method is also beneficial in terms of tracking how much cash the business has at any given time. You can look at your bank balance and understand the exact resources at your disposal.

1.11 Accrual Basis of Accounting

Accrual accounting is a method of accounting where revenues and expenses are recorded when they are earned, regardless of when the money is actually received or paid. For example, you would record revenue when a project is complete, rather than when you get paid. This method is more commonly used than the cash method. The upside is that the accrual basis gives a more realistic idea of income and expenses during a period, therefore providing a long-term picture of the business that cash accounting can't provide. The downside is that accrual accounting doesn't provide any awareness of cash flow; a business can appear to be very profitable while in reality it has empty bank accounts. Accrual basis accounting without careful monitoring of cash flow can have potentially devastating consequences.



What is the difference between Cash Basis and Accrual Basis of Accounting?

Summary

- Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money transactions and events which are, in part at least, of a financial character and interpreting the results thereof.
- Objectives of accounting are, to keep systematic records, protect business properties, ascertain the operation profit and loss, ascertain the financial position of business and facilitate rational decision making.
- External and Internal Users needs the accounting information for their own decisions either to check the creditworthiness of company or market value.
- In the business world, accounting is utilized in much greater depth, but each individual encounters some activities in his/her everyday life that requires knowledge of accounting principles. Most basic framework of business. Without an accounting education, students would be unprepared for the real world.
- Recording, classifying and summarizing the financial events, management will analyse each aspect mentioned in financial reports for decision making. They can judge from the figures to continue with same strategies or make any possible changes in same.
- There are some specific rules for accounting which are framed by accounting bodies and needs to follow for decision making. Business can follow either golden rules or modern rules of accounting.
- Accounting plays an important role in the determination of profit, financial position, tax liability, valuation of goodwill and shares and comparative study.
- Financial accounting, cost accounting, management accounting, responsibility accounting, tax accounting, inflation accounting, etc. are the branches of accounting. Accounting is an art as well as a science.
- Accrual Basis of Accounting is considered most viable method than cash basis of accounting.

Keywords

- **Accounting Cycle:** It is a collective process of identifying, analyzing, and recording the accounting events of a company.
- **Accounting Process:** It includes the recording of financial transactions, ledger posting, preparation of financial statements and analyzing and interpretation of them.
- **Financial Interest:** The interest in company's profits and other rate of returns for investment purpose.

Self-Assessment

1. The users of accounting are and external.
2. The accounting which provides the necessary information to the management is called
3. Accounting records all the transactions which can be expressed either in
4. The objective of the accounting is to only recording of the financial transactions of the business and determination of profit or loss. _____
5. The profits are calculated with the help of management accounting. _____
6. The type or branch of accounting that generates reports for the use of external parties such as creditors, investors and government agencies is known as:
 - A) Financial Accounting
 - B) Tax Accounting
 - C) Managerial Accounting
 - D) Forensic Accounting
7. Which one of the following is not an external user of accounting information?

- A) Creditors
 - B) Investor
 - C) Manager
8. Customer Liability are arisen from which of the following events?
- A) Present event
 - B) Future event
 - C) Past event
 - D) None of them
9. Which of the following shows summary of a company's financial position at a specific date?
- A) Profit & Loss Account
 - B) Cash Flow Statement
 - C) Balance Sheet
10. Net income equal to Revenues minus
- A) Gains
 - B) Depreciation
 - C) Expenses
 - D) Capital expenditures
11. _____ is the first phase of accounting cycle
- A) Identifying an economic event or transaction
 - B) Preparing journals
 - C) Posting entries to ledger accounts
 - D) Making decisions about business.
12. Book-keeping work is performed by:
- A) Senior Staff
 - B) Junior Staff
 - C) Company Secretary
 - D) None of these
13. Where book-keeping ends, _____ starts.
- A) Accounting
 - B) Transactions
 - C) Auditing
 - D) None of these
14. Main objectives of accounting are:
- A) To maintain accounting records
 - B) To calculate the results of operations
 - C) To ascertain the financial position
 - D) All of the above
15. refers to the recording of daily business financial transaction.
- A) Financial Accounting
 - B) Cost Accounting
 - C) Management Accounting
 - D) Tax Accounting

Review Questions

1. "Accounting is the process of recording, classifying and summarizing of accounting transactions." Explain.
2. Who are the users of accounting information?
3. State the important branches of accounting.
4. Is there any differences between book-keeping and accounting?
5. List down the advantages and limitations of accounting?
6. Distinguish between cash basis and accrual basis of accounting?
7. Discuss the accounting cycle in detail.

8. What is the purpose of accounting?
9. Discuss the relevance of rules of accounting?
10. Discuss, how accounting is an information system?

Answers: Self-Assessment

- | | | |
|----------------|--|--------------------------|
| 1. Internal | 2. Management Accounting | 3. Money terms |
| 4. False | 5. False | 6. Financial Accounting |
| 7. Manager | 8. Past event | 9. Balance Sheet |
| 10. Expenses | 11. Identifying an economic event or transaction | 12. Junior Staff |
| 13. Accounting | 14. All of above | 15. Financial Accounting |

Further Readings



Books

1. FINANCIAL ACCOUNTING by P.C. TULSIAN, PEARSON
2. FINANCIAL ACCOUNTING by HANIF AND MUKHERJEE, MCGRAW HILL EDUCATION
3. ADVANCED ACCOUNTANCY by S.N. MAHESHWARI AND S.K. MAHESHWARI, VIKAS PUBLISHING HOUSE
4. FINANCIAL ACCOUNTING PART-I & II, B.COM (REGULAR) 1ST SEM. PBI. UNI. by JUNEJA C. MOHAN, ARORA J.S., AGGARWAL MANAV, KALYANI PUBLISHERS



Online Links

1. www.caknowledge.com
2. www.iedunote.com
3. www.toppr.com

Unit 02: Accounting Principles

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2.11 Convention of Prudence (Conservatism)

2.12 Convention of Materiality

2.13 Convention of Full Disclosure

Summary

Keywords

Self-Assessment

Review Questions

Further Readings

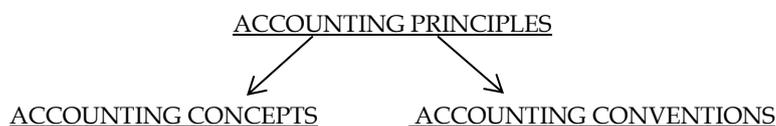
Objectives

After studying this unit, you will be able to:

- define accounting concepts and conventions.
- use accounting concepts and conventions in preparing accounting books and financial statements.
- use financial information to support business processes and practices.
- apply analytical skills to analyze and solve business problems, to avail business opportunities.

Introduction

The business enterprise's financial transactions and activities are reported in a business language that is then routed by accounting. The art of accountancy controls the entire accounting system. Accounting is carried out using basic rules that are completely governed by definitions and conventions.



Generally Accepted Accounting Principles

GAAP refers to a general collection of accounting principles, rules and procedures provided by the Board of Financial Accounting Standards (FASB). GAAP is a combination of authoritative principles and ways of documenting and disclosing accounting information that are widely recognized. The objective of GAAP is to enhance the transparency, accuracy and comparability of the communication of financial information. If the financial statements are not prepared on the basis of these principles, there will be low acceptability and difficulty to understand them, and the comparison will be impossible and unreliable.

International Financial Reporting Standards

In order to ensure that financial statements can be consistent, accessible and comparable around the world, the International Financial Reporting Standards (IFRS) set universal guidelines. The International Accounting Standards Board publishes IFRS (IASB). They determine how businesses need to keep and monitor their accounts, classify types of transactions, and other financial impact events.



Caution

There are various bodies, national and international, who from time to time frame guidelines, define terms, formulate principles and standards to be used in the field of Accounting and finance, industry, firms, business groups have to follow these, both as legal provisions and as convenience.



Case Study

In 2004, the Brazilian economy experienced significant growth, with the country's gross domestic product (GDP) growing by 5.2 per cent – the highest growth rate since 1994.2 Brazil attracted close to \$18 billion in foreign direct investment (FDI). At the same time, outward investment from Brazil amounted to \$9.5 billion.3 As of June 2006, there were 31 Brazilian companies listed on the New York Stock Exchange. Integrating into global capital markets and facilitating the mobilization of capital and fostering investor confidence call for national corporate transparency requirements which are consistent with international best practices, including in the area of corporate financial reporting. These trends have underpinned efforts aimed at converging national accounting and reporting standards to International Financial Reporting Standards (IFRS) in Brazil. To this end, various reforms in the area of accounting are being undertaken in the country. At present, Brazil is gradually converging its accounting standards and the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). The main institutions leading the convergence process are the Brazilian Securities Commission (CVM), the Brazilian Institute of Independent Auditors (IBRACON) and the Central Bank of Brazil. A number of developments have recently advanced the country's progress towards IFRS. In March 2006, the Central Bank of Brazil announced that, as of 2010, all financial institutions under its supervision will be required to prepare their consolidated financial statements in accordance with IFRS. The Brazilian Securities and Exchange Commission has promoted efforts by companies listed in capital markets in Brazil to gradually adopt IFRS. For example, the CVM has been working more closely with IBRACON to accelerate convergence with IFRS. Companies listed on Sao Paulo Stock Exchange's New Market (launched in December 2000) are required to provide financial statements prepared in accordance with IFRS or to the United States generally accepted accounting principles (GAAP), in addition to those that are prepared under Brazilian accounting standards. The Committee of Accounting Pronouncements was recently set up in Brazil, whose declared objective will be to achieve full adoption of IFRS in the country. However, despite the significant changes that have occurred in the Brazilian accounting system in recent years, there are still important differences between Brazilian accounting standards and IFRS. Some practical and operational factors, such as the legal environment and economic, tax, cultural and educational issues, tend to place obstacles in the path of convergence of Brazilian accounting standards and IFRS. Economic and tax issues particularly affect the process of convergence of Brazilian accounting and IFRS, because the accounting system in Brazil is strongly tied to tax laws and regulations that establish rules for recognition, measurement and disclosure of business transactions. This chapter provides a brief overview on the development of accounting systems in Brazil and its current status, discusses the salient features of regulatory frameworks and enforcement, outlines some of remaining major differences of accounting rules in Brazil with regard to IFRS and summarizes

main lessons learned through the recent process of reforming of accounting system to conform to IFRS.

Source: https://unctad.org/system/files/official-document/diaeed20081_en.pdf

2.1 The Nature and Purpose of Accounting Conventions

Principles or accepted practice which apply generally to transactions. They have an influence in determining, which assets and liabilities are recorded on a balances sheet, how assets and liabilities are valued, what income and expenditure is recorded in the income statements and at what amount income and expenditure is recorded?

The answer to all above mentioned questions is accounting principles. If organization follows, ready solutions are provided for that.

2.2 Basic Concepts and Conventions

A. Accounting Concepts

The term 'concept' is used to connote accounting postulates, that is necessary assumptions and conditions upon which accounting is based. These are the theories on how and why certain categories of transactions should be treated in a particular manner.

B. Accounting Conventions

Accounting Conventions are the common practices which are universally followed in recording and presenting accounting information of business. It helps in comparing accounting data of different business or of same units for different periods.

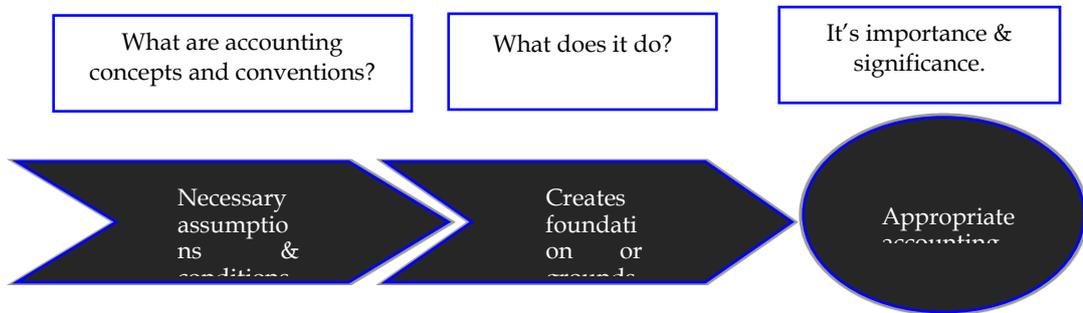
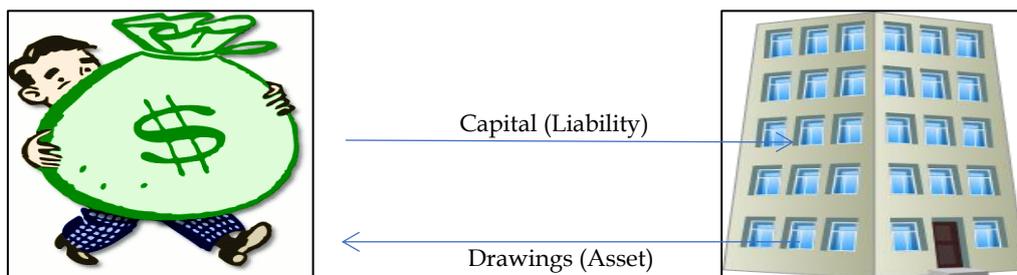


Fig 1: Accounting Concepts and Conventions

2.3 Business Entity Concept

In business entity concept, the business and its owner(s) are two separate entities. The books of accounts are prepared from the point of view of the business. The personal transactions of the owner are not recorded.



Owner and business organizations are two separate entities.



Example: A Car purchased by the owner for personal use is not Recorded in the Books of Account of the Business.

2.4 Money Measurement Concept

In accounting, a record is made only of those transactions or events which can be measured and expressed in terms of money. The transactions which are not in the expression of monetary terms cannot be registered in the book of accounts as transactions.



Note: Non-Monetary Transactions are not recorded in Business.



Example: 10 machines, 15 Kg of raw material, 8 fork-lift trucks, 40 lorries and so on. The early mentioned items are not expressed in terms of money instead they are illustrated only in numbers. The worth of the items is getting differed from one to the other. To record the above enlisted items in the book of accounts, all the assets should be converted into money.

2.5 Going Concern Concept

Going Concern Concept dealt with the quality of long lasting status of the business enterprise. This is a reason it is also known as long term assets concept. In addition, it is assumed that the entity is a going concern, i.e., it will continue to operate for an indefinitely long period in future and transactions are recorded from this point of view.

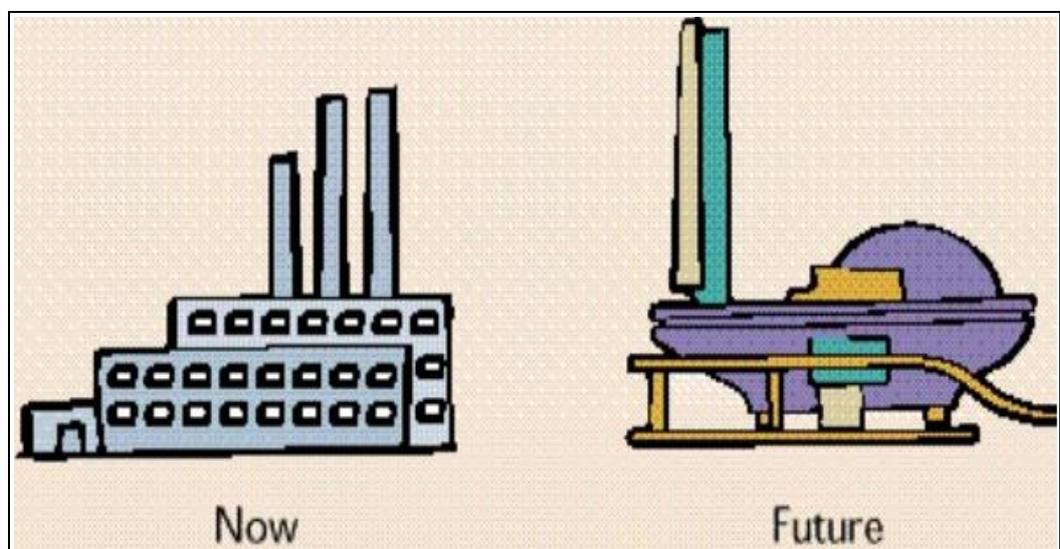


Figure 1 Quality of long lasting status



Case Study

An entity has borrowings of \$10m which became immediately repayable in full on 31 March 20X2. The entity is already in breach of its agreed overdraft and the bank has refused to renew the borrowings. The entity has also been unsuccessful in applying to other financial institutions for re-financing. It is highly unlikely that the entity will be successful in renewing or re-financing the \$10m borrowings and, in such an event, the directors will have no alternative but to cease to trade. The bank have already indicated that they are shortly going to commence legal proceedings to force the company to cease trading and sell off its assets to generate funds to pay off some of the borrowings. In order to avoid the entity’s credit rating suffering any further decline, the directors have refused to make disclosures in the financial statements and have prepared the financial statements for the year ended 31 March 20X2 on the going concern basis. In this example it is clear that the going concern basis is inappropriate in the entity’s circumstances. The directors have no realistic alternative but to liquidate in order to raise funds to pay back the bank and the bank have already confirmed that they will commence legal proceedings to force the entity into selling off assets to raise finance to repay their borrowings. In this instance the auditor would issue an adverse opinion. An adverse opinion states that the financial statements do not present fairly (or give a true and fair view). This opinion will be expressed regardless of whether or not the financial statements include disclosure of the inappropriateness of management’s use of the going concern basis of accounting.

Source: ACCA GLOBAL

2.6 Cost Concept

Under this concept, the transactions are recorded only in terms of cost rather than in market value. An asset acquired by a concern is recorded in the books of accounts at historical cost (i.e., at the price actually paid for acquiring the asset). The market price of the asset is ignored. The main reason is that the market value of the asset is subject to fluctuations due to demand and supply forces. The entry of market value of the asset will require the frequent update of information to the tune of changes in the market. The market value can be bifurcated into two categories, viz, Realizable value and Replacement value. Realizable value is the value of the asset at the moment of sale or realization. Replacement value is another value which considered at the moment of replacing the old asset with the new one.

		2019	2020
Historical Cost of		\$555	\$555
		Rs. 30,000	Rs. 30,000
Market Value of		\$555	\$250
		Rs. 30,000	Rs. 10,000

Figure 2 Asset to be recorded at cost price or market value



Example: A business buys a machinery worth Rs. 1,00,000 in cash. In the accounting records, the value of the building will be entered at its **cost** price, i.e. Rs. 1,00,000. After four years, the recorded value of the building will be different.

2.7 Realization Concept

In realization concept, profit is considered to be earned when goods or services are provided/ transferred to customers. Thus, it is incorrect to record profit when order is received, or when the customer pays for the goods. It is also called revenue realization principle. More precisely, the revenue is recorded in accounting when the sales have taken place. Revenue is considered to be made

when title of ownership of goods passes from the seller to buyer and the buyer become legally liable to pay.



Figure 3 Income is only recorded when it is received and not earned.



Example: If ABC Enterprise expects XYZ Enterprise to purchase few items from their company in future, than it can not record, it as a sales transaction in the books of accounts. The transaction will be recorded only when there is actual transfer of goods by ABC Enterprise to XYZ Enterprise and in return payment of it.

2.8 Accrual Concept

Accrual concept is applied, when revenue is recognized and the customer has attained ownership. The period of costs incurred and arisen should be same. This concept provides a more accurate financial picture. The accrual accounting is useful in business, where there are a lot of credit transactions, which simply means that there was no exchange of cash. In other words, when transactions are recorded as they occur, even if payment has not been made, it is known as accrual based accounting. This method is more appropriate in assessing the financial health of the organization.

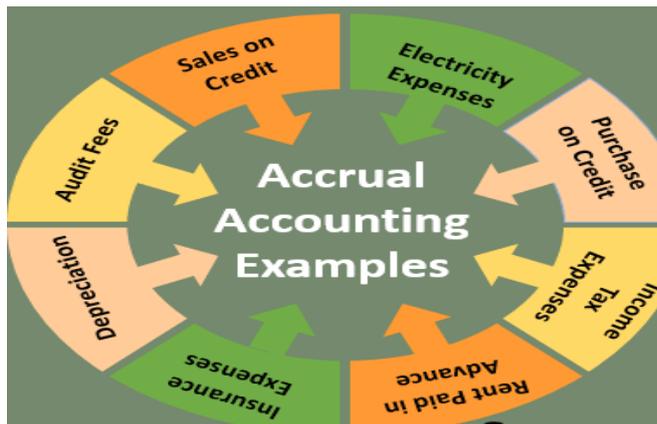


Figure 4 When the revenue is earned and cost incurred



Example: A company who uses accrual accounting records sales as soon as it sends an invoice/bill to a customer. Ramaya compnay has total monthly sales of Rs.1,00,000. About 70% of these sales are in cash and rest on credit. Under accrual accounting, accountants treat the credit transactions as sales and the profit generated include both cash and credit sales.

2.9 Periodicity Concept

For measuring the financial results of a business after a certain period of time or continuously, the working life of an undertaking is divided into convenient short periods called accounting period. The life period of the business is long, which is classified into the operating periods which are smaller in duration. The accounting period may be either calendar year of Jan.-Dec. or financial year of April-March. The operating period of one firm may be shorter than the other one. According to the

Companies Act, 2013, the accounting period should not exceed more than 15 months. Based on periodicity assumption, the financial statements could be prepared and presented in weekly, monthly, quarterly, annually or in other artificial time frames. To implement this principle more successfully, an organization needs to identify the period of the time frame that financial statements are required to prepare.

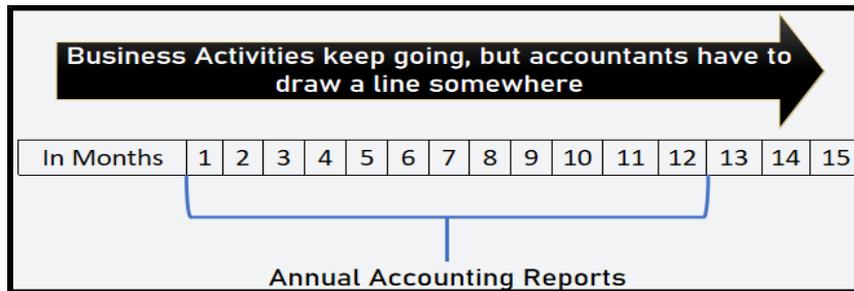


Figure 5 Accounting period can be extended to 15 months for measuring financial performance



Did You Know?

The construction companies, when construct the buildings, the project never completes in 12 or 15 months. Still, they need to follow the accounting principles and prepare the financial reports. Although the financial results can be ascertained but an idea can be generated for same.

2.10 Convention of Consistency

The nature of recording the transactions should not be changed at any cause or moment. The accounting practices and methods should remain consistent from one accounting period to another. Whatever accounting practice is followed by the business enterprise, should be followed on a consistent basis from year to year. It should be maintained throughout the life period of the firm.



Example: If a firm follows the straight-line method of charging the depreciation since its inception should be followed without any change. The firm should not alter the method of charging the depreciation from one method to another. If any change has to be incorporated, the valid reason for change should be emphasized.

2.11 Convention of Prudence (Conservatism)

In an organization, accountant should always be on side of safety. So they assume, anticipate no profits but provide for all losses. The conservatism gives paramount importance to all possible eventualities of the firm and wont give any emphasis on the anticipation of the firm. Also, instead it without considering the future profits. According to this convention, the entire status of the firm should be presented in detail without hiding anything and which has to furnish the required information to various parties involved in the process of the firm.

“Anticipate No Profits but Provide for all Losses”



Example: Making Provision for Bad and Doubtful Debts. Showing Depreciation on Fixed Assets, but not appreciation. Stock valuation sticks to rule of the lower of cost and net realizable value.

2.12 Convention of Materiality

Only those transactions, important facts and items are shown which are useful and material for the business. The firm need not record immaterial and insignificant items. The convention of materiality is to make financial statements meaningful, only material fact i.e. important and relevant information should be supplied to the users of accounting information. Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

Illustration

Company XYZ Ltd. bought 6 months supplies of stationary worth \$600.

Question

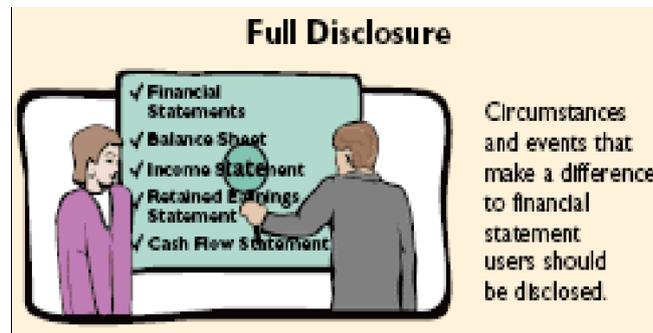
Should the Company spread the cost of this stationary for 6 months by expending off \$100 per month to the income statement?

Solution

Based on this concept, as the amount is so small or immaterial, it can be expended off in the next month instead of tediously expending it in the next 6 months.

2.13 Convention of Full Disclosure

As per convention of full disclosure, financial statements and their notes should present all information that is relevant and material to the user understanding of the statements. This requires that all material and relevant facts concerning financial statements should be fully disclosed. There should be full, fair and adequate disclosure of accounting information. Adequate means sufficient set of information to be disclosed. Fair indicates an equitable treatment of users. Full refers to complete and detailed presentation of information. Thus, the convention of disclosure suggests that every financial statement should fully disclose all relevant information.



Summary

- GAAP refers to a general collection of accounting principles, rules and procedures provided by the Board of Financial Accounting Standards (FASB).
- IFRS determines businesses need to keep and monitor their accounts, classify types of transactions, and other financial impact events.
- **The term 'concept' is used to connote accounting postulates, that is necessary assumptions and conditions upon which accounting is based.**
- Accounting Conventions are the common practices which are universally followed in recording and presenting accounting information of business.
- In business entity concept, the business and its owner(s) are two separate entities.
- In accounting, a record is made only of those transactions or events which can be measured and expressed in terms of money.
- Going Concern Concept dealt with the quality of long lasting status of the business enterprise.
- Under this concept, the transactions are recorded only in terms of cost rather than in market value.
- In realization concept, profit is considered to be earned when goods or services are provided/ transferred to customers.
- Accrual concept is applied, when revenue is recognized and the customer has attained ownership.

- For measuring the financial results of a business after a certain period of time or continuously, the working life of an undertaking is divided into convenient short periods called accounting period.
- **The accounting practices and methods should remain consistent from one accounting period to another.**
- **Anticipate No Profits but Provide for all Losses.**
- The convention of materiality is to make financial statements meaningful, only material fact i.e. important and relevant .
- Financial statements and their notes should present all information that is relevant and material to the user understanding of the statements.

Keywords

Assets: These are application of funds of organization or are resources to generate economic benefits.

Equity: Equity is the investment done by investors in company and money is used by company for its expansion or development purposes.

Liabilities: These are obligations which are to be paid from company resources.

Self-Assessment

1. Which of the following represents unit of measurement concept?
 - a Recognizing income on delivery of goods and on acceptance by the customer
 - b Recording the value of fixed assets at historical cost
 - c Recognizing that every transactions has a debit and credit
 - d Recording revenues and expenditure on monetary basis

2. Making a provision for bad and doubtful debts is in consonance with which of the following principles?
 - a Full disclosure principle
 - b Materiality principle
 - c Revenue recognition principle
 - d Conservatism principle

3. In presenting the financial statements for the year ended 31 March 2020, a company valued the inventories at cost or market price whichever is lower as in the previous year ended 31 March 2019. Which of the following concepts has been adopted by the company in presenting the financial statements?
 - a Materiality concept
 - b Consistency concept
 - c Cost concept
 - d Going concern concept

4. The Basic accounting equation is
 - a $\text{Asset} = \text{Expense} + \text{Income}$
 - b $\text{Assets} = \text{Cash} + \text{Capital}$
 - c $\text{Assets} = \text{Capital} + \text{Liabilities}$
 - d $\text{Assets} = \text{Expenses} + \text{Capital}$

5. Which financial statement displays the revenues and expenses of a company for a period of time?
 - a Income Statement
 - b Balance Sheet
 - c Cash Flow Statement
 - d All of the Above

6. Which principle specifies that cost or expenses should be recorded at the same time as the revenue to which they correspond?
- Prudence Principle
 - Matching Principle
 - Going Concern Principle
 - Consistency Principle
7. The four principal qualitative characteristics of useful financial statements are:
- Understand ability, Relevance, Reliability, Comparability
 - Timeliness, Relevance, Reliability, Comparability
 - Understand ability, Relevance, Reliability, Simplicity
 - Understand ability, Relevance, Accuracy, Comparability
8. The recognition of intangible assets allows their amortization over the period during which economic benefits are derived. Which principle is put into practice in this statement?
- Going concern concept
 - Matching concept
 - Prudence concept
 - Accrual concept
9. **Financial statements mainly help in**
- Assumption of economic events
 - Anticipation of economic events
 - Recording of economic events
 - Communication of economic events
10. Accounting records all the transactions which can be expressed either in
11. Every financial transaction of the business has and recorded at two places.
12. enables the comparison of the profit or performance of a business in a year with the performance of another year.
13. The revenues are recognized only at the moment of
14. is a liability which arises only on the happening of an uncertain event.
15. = total assets - total liabilities.

Answers: Self-Assessment

- | | | |
|----------------------------|--------------------------|-----------------|
| 1. d | 2. d | 3. b |
| 4. c | 5. a | 6. a |
| 7. a | 8. b | 9. d |
| 10. money or money's worth | 11. dual effect | 12. consistency |
| 13. realization | 14. consistent liability | 15. capital |

Review Questions

- "Accounting is the process of recording, classifying and summarizing of accounting transactions." Explain.
- The entire accounting system is governed by the practice of accountancy. What are the key principles used in accounting?
- Discuss Money Measurement concept.
- What are the key assumptions of going concern concept?
- "Every debit transaction is appropriately equated with the transaction of credit." Define.

6. Clearly discuss the material and immaterial transactions of business.
7. "Liability is defined as currently existing obligations which a business enterprise requires to meet sometime in future." Explain.
8. What are the key accounting conventions?

Further Readings



Books

1. FINANCIAL ACCOUNTING by P.C. TULSIAN, PEARSON
2. FINANCIAL ACCOUNTING by HANIF AND MUKHERJEE, MCGRAW HILL EDUCATION
3. ADVANCED ACCOUNTANCY by S.N. MAHESHWARI AND S.K. MAHESHWARI, VIKAS PUBLISHING HOUSE
4. FINANCIAL ACCOUNTING PART-I & II, B.COM (REGULAR) 1ST SEM. PBI. UNI. by JUNEJA C. MOHAN, ARORA J.S., AGGARWAL MANAV, KALYANI PUBLISHERS



Online Links

1. www.caknowledge.com
2. www.iedunote.com
3. www.toppr.com

Unit 03: Business Income

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Business Income

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Summary

Keywords

Self Assessment

Review Questions

Answers: Self Assessment

Further Readings

Objectives

After studying this unit, you will be able to:

- Recognize the concept of business income for different types of businesses.
- Use the objective for measuring business income.
- Compute the net income periodically.
- Discuss the constraints in measuring income caused by continuity issue.
- Recognize the concept of accrual accounting.
- Compare and contrast the revenue and costs for accounting.

Introduction

Business income is a type of earned income and classified as ordinary income for tax purposes. It encompasses any income realized as a result of an entity's operations. In its simplest form, business income is an entity's net profit or loss, which is calculated as its revenue from all sources minus the costs of doing business.



Example: Fees received by a person from the regular practice of a profession are business income. Rents received by a person in the real estate business are business income.

Business Income

Business income is a term commonly used in tax reporting. According to the Internal Revenue Service (IRS), "Business income may include income received from the sale of products or services".

However, business expenses and business losses can offset business income. The net result can be either positive or negative in any given year.

In addition to this, the way in which business income is taxed differs for each of the most common types of businesses. The common businesses are sole proprietorship, partnerships, and corporations.

- A sole proprietorship is not a legally separate entity from its owner. Therefore, business income from a sole proprietorship is reported on Schedule C of the Profit or Loss from business.
- A partnership is an unincorporated business that is jointly held between two or more individuals. However, the partnership itself does not pay income tax. All partners receive a Schedule K-1 and report their share of the partnership's income on their own individual income tax returns.
- A corporation is a legally separate entity from any individual who owns it.

3.1 Measurement of Business Income

Every business wants to measure their income and for these various measures are to be adopted. Most common, the basic term used in organizations to measure business income is profitability analysis. Moreover, profitability and liquidity are two major goals of a business. To survive, a business must earn a profit. Profit means, net income, it can be defined more adequately from business point of view.

Net income is the increase in shareholders' funds, that results from business operations. Also, net income is when revenue is higher than expenses of business.

Revenues	Expenses
Revenues are increase in shareholders' funds, from business activities.	Expenses are decrease in shareholders' funds, resulting from cost incurred on production of goods or other indirect activities.
Revenue is like Cash + Credit sales from business.	All cash payments are not considered as business expenses.
Revenue should be directly from business activities but not from business investments.	Like: prepaid expenses are assets for business, dividend are not business expenses.

3.2 Objectives of Measurement

Every aspect has some goals and simultaneously, there are some objectives of measurement of business income.

1. Historical income figure is the base for future projections.
2. Ascertainment of a net income is necessary to give portion of profit to employees.
3. To evaluate the activities, which give higher return on scarce resources are preferred. It helps to increase the wealth of a firm.
4. Ascertainment of a net income is necessary to give portion of profit to employees.
5. To evaluate the activities, which give higher return on scarce resources are preferred. It helps to increase the wealth of a firm.

3.3 Features of Accounting Income

There are few characteristics income, which makes it viable for accounting measurement.

1. Matching revenue with related cost or expenses is a matter of accounting income.
2. Accounting income is based on an accounting period concept.
3. Expenses are measured in terms of a historical cost and determination of expenses is based on a cost concept.
4. It is based on a realization principal.
5. Revenue items are considered to ascertain a correct accounting income.

3.4 Net Income

One of the most significant accounting concepts is "Concept of Income". With concept of income, different types of income are recorded and valued. Similarly, measurement of a business income is an important function of an accountant.

In General term, payment received in lieu of services or goods are called income, for example, salary received by any employee, is his income. There may be different type of incomes like Gross income, Net income, National Income, and Personal income, but we are here more concerned for a business income.

So, in simple words, surplus revenue over expenses incurred is called as "Net Income." But while recording and measuring the business income, various issues are occurred like, accounting period, continuity and many more. Now, let us discuss these issues in detail in specific context to measurement.

3.5 Accounting Period Issue

For the measurement of any income concerns, a span of time is required. Creditors, investors, owners, government, and all stakeholders require systematic accounting reports at regular and proper intervals.

The maximum interval between reports is one year, as it helps a businessman to take any corrective action. Although different accounting periods can be considered for the measurement of income. An accounting period concept is directly related to matching concept and realization concept. In the absence of any of them, we could not measure income of the concerns.

Based on matching concept, expenses should be matched with the revenue and the result will be income or loss of the accounting period. Sometimes, accountants found difficulty in assigning revenues and expenses to a short period of time and, not all transactions can be assigned to a one time. Accountants generally interpret that period, which are same for comparison purpose.

Measurement of Business Income

Financial statements may be prepared for any time period, usually a calendar year. In addition to, period with less than one year is called interim period and period with 12 month is called fiscal year. Fiscal year can be same as calender year or can be different as per requirement of business.

3.6 Continuity Doctrine

Despite of accounting period concern, continuity issue also effect the measurement of net income or business income and it complies with Going Concern Concept. Accountants too assume that, if going concern concept applies then the entity will be continued for long time period.

According to this concept, it is assumed that business will continue for a long time. In fact, there are number of aspects which can be taken into consideration for considering the going concern concept or continuity concept. Thus, charging depreciation on a Fixed Asset is based on this concept.

The continuity issue also relates to the estimated number of accounting periods in the business entity's life.



Case Study:

SITUATION

On Sunday, January 8, 2017, the temperature in Cleveland, OH dropped significantly, which caused a water pipe to burst in the hallway of our building, right outside the entry to our Cleveland office. No one was in the building at the time, and the water poured out for about 45 minutes before it was shut off. The water pooled primarily in our office space

resulting in damage to floors, walls, and some equipment. When all was said and done, the total amount of water removed from our office space alone, was approximately 15,000 gallons. The rest of the water literally went down the elevator and main stairway – flooding three of the floors below. At 4:00 AM ET, both our director of consulting and operations manager were notified of the incident by building management. Over the course of the next few days, building management and restoration crews requested that we limit access to the office as they worked on the clean-up and the damage assessment processes.

ACTION

Our business continuity program manager activated our Crisis Management Team (CMT) so they could assess the situation, review and activate necessary business continuity plans, confirm next steps, and communicate with all employees. Our business continuity program coordinator sent an alert through our emergency notification system to notify Cleveland-based employees of the situation, activation of remote work strategies, and when to expect the next communication update. Employees were asked to respond to the active survey question confirming receipt of the notification and an ability to work remotely. Quickly and seamlessly, our team knew what to do and when to do it. We had planned, and we were prepared.

As our team worked remotely, our facilities representative met with the building manager to assess the situation more thoroughly. As the extent of the damage and the required repairs were better understood, employees were updated on the situation and told that remote work strategies would remain active through the remainder of the week, at a minimum. The number one concern remained the health and safety of employees, and until testing proved otherwise, the CMT assumed the presence of a heightened level of mold and other contaminants.

Being part of a professional services (consulting) organization, we have the ability to quickly activate a remote work strategy. And over the past few years, enabled by an ISO 22301-certified management system, we identified and eliminated as many single points of failure as possible, in the dependency on the Cleveland office, driving a high level of resilience. However, if the nature of your business requires that your employees be on-site to perform their job responsibilities, it's even more critical that you have well-socialized and exercised plans and strategies in place – ensuring that your employees know where to go, what to do, and how to communicate when a disruption does occur.

RESULT

Because we had prepared for a loss of facility (our Cleveland office, in this case), the transition to working from home was smooth. During the planning process, we pro-actively mitigated the impact of a facility loss with a company-wide policy that every employee takes their laptop home with them every night. This policy may not be possible for every organization but identifying dependencies and pro-actively developing actionable business continuity plans ensures that your organization can effectively respond to a disruption, recover resources, and sustain critical organizational activities until you can resume normal operations.

As of this posting, more than a month after the pipe burst, our team is back in the Cleveland office (albeit we are working in an active construction project!). We were reminded of something important – re-construction is a slow process given the dependency on the claims handling process in a multi-tenant building (and others might benefit from taking the reconstruction timeline, influenced by the claims handling process, into account when estimating how long they may be away from their primary workplace). For more on the relationship of business continuity and insurance in general, check out this video for a discussion on the differences.

But, most importantly, even though we faced a business interruption, our clients and the delivery of our services were not impacted. That is the value of business continuity.

FINAL THOUGHTS

An effective business continuity program builds strategies and plans that can be implemented immediately and address any kind of disruptive incident. Creating business continuity plans around a loss of resources, rather than planning for specific threats (e.g., floods, power outage), enables an organization to better address a wide-range of potential events. Although Avalution had not planned for a pipe burst specifically, our business continuity team had developed a plan for the loss of access to our facility, which we rehearsed and validated via multiple exercises to ensure we could properly respond. For more information of this specific topic, check out: Effective Business Continuity: Program vs Plan. Business continuity and IT disaster recovery planning is all that we do. If you're looking for help with building or improving your business continuity program, we can help. Please contact us today to get started. We look forward to hearing from you!

Source: <https://avalution.com/or-high-water-a-business-continuity-case-study/>

3.7 Matching Issue

Matching concept is applied when revenues and expenses are to be matched for said period of time. The only problem arises in application of this concept when recognition of revenue during the year and allocation of expired cost to the period should be matched. Most frequent criteria, which are used in recognition of the revenue are mentioned below.

- Point of Sale: Transfer of ownership title to a buyer is point of sale, in case of sale of commodity.
- Receipt of Payment: Criteria of cash basis is widely used by the professionals in which revenue is earned at the time of collection of cash.
- Instalment Method: Instalment method is widely used in retail trading specially in consumer durable. In this system, revenue earned is treated in the same manner as is used in any other credit sale.
- Gold Mines: The accounting period in which gold is mined is the period of revenue earned.

The cash basis of accounting recognizes revenues when received in cash and expenses when paid in cash. But it is again having a matching issue and there must be some appropriate accounting period for measuring net income.



Matching Rule: Revenues must be assigned to the accounting period, in which the goods are sold, and expenses must be assigned to the accounting period, in which they are used to produce revenue.

3.8 Computation of Business Income

After recording and measuring the business income, the concept is not complete. The income must get adequate computation and valuation, for appropriate decision making. For this concern, different approaches are considered for computation and major approaches which are adopted by organizations are as follow:

1. Balance Sheet Approach

2. Transaction Approach

1. Balance Sheet Approach: In this approach of computation, comparison of the closing values (assets minus outsider's liabilities) of a firm with the values at the beginning of that accounting period are considered. In addition to this, an addition to capital will be subtracted and addition of drawings will be added while computing the business income of a firm. Since, income is calculated with the help of Balance Sheet hence called as Balance Sheet approach.



Example: If stockholders equity increased by Rs. 5 million with Rs. 2 million caused by the issuance of new shares of stock, and Rs. 1 million distributed as dividends, the net

income would have been Rs. 4 million. We can verify the calculation with the following: net income of Rs. 4 (an addition to equity) plus new investor money of Rs. 2 (an addition to equity) = Rs. 6 of additions to equity, minus dividends of Rs. 1 (a decrease to equity) = Rs. 5 (the net increase to equity).

2. Transaction Approach: In this approach of computation, transactions are mostly related to production or the purchase of goods and the sale of goods and all these transactions directly or indirectly related to the revenue or to the cost. Therefore, surplus collection of the revenue by selling goods, spent over for production, or purchasing the goods is the measure of income. This system is widely followed by the enterprises where double entry system adopted.

3.9 Basis of Measurement of Income

There are two basics which are considered for measurement of income.

1. Accrual Basis: In an accrual basis accounting, incomes are recognized in a company's books at the time when revenue is actually earned and expenses are recorded and when liabilities are incurred. Further, expenses are compared with revenues on the income statement when the expenses expire or title has been transferred to the buyer and not at the time when the expenses are paid.
2. Cash Basis: In a cash basis accounting, revenues and expenses are recognized at the time of physical cash actually received or paid out.



Accrual Accounting

It attempts to record the financial effects on an enterprise of transactions and other events, in the period of occurrence rather than in period of receipts or payments. Accrual accounting is an application of matching rule.

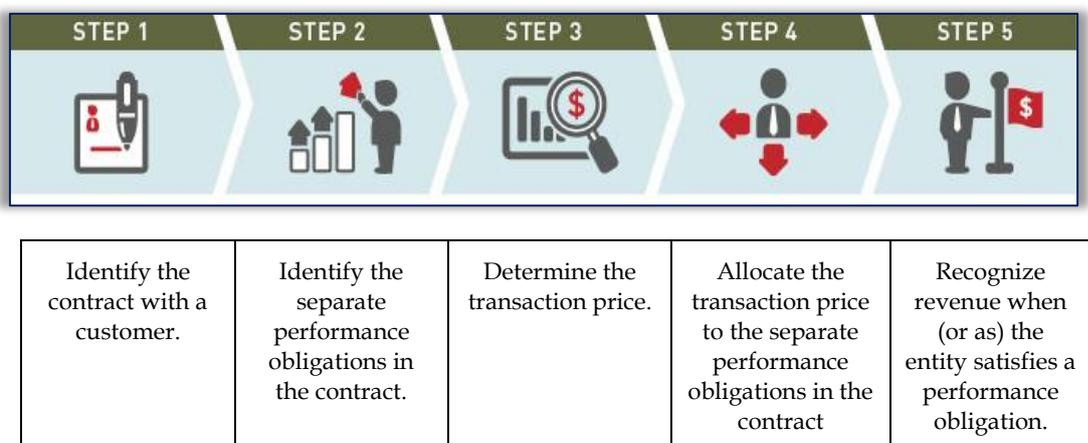
3.10 Adjustment Process

Adjusting entries are used to apply accrual accounting to transactions that span more than one accounting period. Adjusting entries involve at least one balance sheet account and one income statement account. Adjusting entries should never inculcate the cash account balance.

3.11 Revenue Recognition

Revenue recognition and realization concept applies, when services are rendered in other time period and revenue generated for same is in another period. Accountants must apply a proper procedure for recognition of revenue in adequate period of time. Following is the process, which is followed for recognizing the revenue in organizations.

Process of Recognition

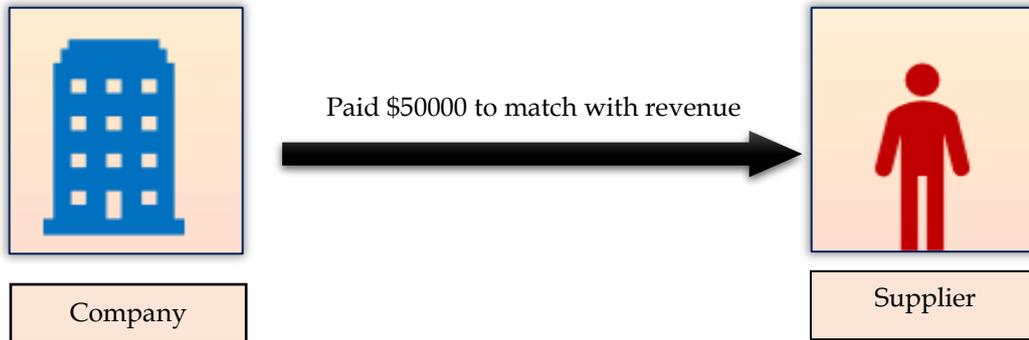


Example: Richella. sells a pool table to bar on December 31 for Rs. 5,000. The pool table was not paid for until January 15th and it was not delivered to the bar until January 31. According to the revenue recognition principle, Richella should not record the sale in December. Even though the sale was realizable in that the sale for Rs. 5,000 was initiated, it was not earned until January when the pool table was delivered.

3.12 Expense Recognition

An expense is recognizing if, it is estimated that future economic benefit associated with the item will flow to or from the entity. Moreover, the item has a cost or value that can be measured with reliability, prudence, neutrality, free from error and faithfully represented.

Expense Recognition Principle



\$50000 is said as Expense Recognition



Example: The store spent Rs. 50,000 on new flower seeds. After two months, the newly bloomed flowers sold for Rs. 100,000. Since the original expense is directly related to the revenue produced from selling the flowers, the expense would be recognized and recorded on the financial statements in the period the flowers were sold. In other words, the flower shop should match the Rs. 50,000 cost of seeds with the Rs. 100,000 revenue from the flowers at the end of the generated revenues period.

Summary

- Business income is an entity's net profit or loss, which is calculated as its revenue from all sources minus the costs of doing business.
- Net income, is the increase in shareholders funds, that results from business operations. Also, net income is when revenue is higher than expenses of business.
- Matching revenue with related cost or expenses is a matter of accounting income.
- Creditors, investors, owners, government and all stakeholders require systematic accounting reports at regular and proper intervals.
- The continuity issue also relates to the estimated number of accounting periods in the business entity's life.
- The cash basis of accounting recognizes revenues when received in cash and expenses when paid in cash.
- Adjusting entries involve at least one balance sheet account and one income statement account.
- Revenue recognition and realization concept applies, when services are rendered in other time period and revenue generated for same is in other period.
- An expense is recognizing if, it is estimated that future economic benefit associated with the item will flow to or from the entity.

Keywords

Business Income

Business income is a term commonly used in tax reporting. According to the Internal Revenue Service (IRS), "Business income may include income received from the sale of products or services".

Balance Sheet Approach

In this approach of computation, comparison of the closing values (assets minus outsider's liabilities) of a firm with the values at the beginning of that accounting period are considered.

Transaction Approach

In this approach of computation, transactions are mostly related to production or the purchase of goods and the sale of goods and all these transactions directly or indirectly related to the revenue or to the cost.

Self Assessment

1. _____ is used for tax reporting purpose.
 - A. Business Income
 - B. Accounting Income
 - C. Both of above
2. Revenues minus expenses, is called as _____.
 - A. Net Loss
 - B. Net Profit
 - C. Both of above
3. Business income is taxed differs for each of the most common types of businesses. The common businesses are _____.
 - A. Sole proprietorship
 - B. Partnerships
 - C. Corporations
 - D. All of above
4. A corporation is a legally _____ entity from any individual who owns it.
 - A. Joint
 - B. Separate
 - C. Mixed
5. _____ analysis is used to measure the business income.
 - A. Liquidity
 - B. Solvency
 - C. Profitability
 - D. Activity
6. Accountants generally interpret that time period, which are same for comparison purpose. Which issue is being discussed in this statement?
 - A. Accounting period
 - B. Continuity
 - C. Revenue recognition
7. Continuity issue also effect the measurement of net income or business income and it compiles with _____.
 - A. Going Concern Concept
 - B. Business Entity Concept
 - C. Dual Aspect Concept
 - D. Accounting Period Concept
8. Matching concept is applied when _____ are to be matched for said period of time.

- A. Assets and Liabilities
 B. Revenues and Expenses
 C. Contingent Liabilities
 D. All of the above
9. _____ is widely used in retail trading specially in consumer durable.
10. In _____ basis accounting, incomes are recognized in a company's books at the time when revenue is actually earned.
11. The _____ basis of accounting recognizes revenues when received in cash and expenses when paid in cash.
12. In _____ approach comparison of the closing values of a firm with the values at the beginning of that accounting period are considered.
13. In _____ approach of computation, transactions are mostly related to production or the purchase of goods and the sale of goods.
14. Adjusting entries are used to apply _____ accounting to transactions.
15. _____ income figure is the base for future projections.

Answers: Self Assessment

- | | | |
|-----------------|-------------|----------------------|
| 1. A | 2. C | 3. D |
| 4. B | 5. C | 6. A |
| 7. A | 8. B | 9. Instalment method |
| 10. accrual | 11. cash | 12. Balance sheet |
| 13. transaction | 14. accrual | 15. Historical |

Review Questions

1. Discuss the business income and accounting income with the help of relevant example?
2. Why it is necessary to measure the business income? Discuss its objectives?
3. Discuss the various issues arises in measurement of business income in detail? Give examples for better clarity.
4. Which criteria is adopted for measuring income under matching concept?
5. Which approach is better followed by accountants in computing the business income? Discuss the approaches in detail.
6. Distinguish between accrual basis of accounting and cash basis of accounting.
7. Describe the concept of revenue recognition and expense recognition?

Further Readings



1. FINANCIAL ACCOUNTING by P.C. TULSIAN, PEARSON
2. FINANCIAL ACCOUNTING by HANIF AND MUKHERJEE, MCGRAW HILL EDUCATION
3. ADVANCED ACCOUNTANCY by S.N. MAHESHWARI AND S.K. MAHESHWARI, VIKAS PUBLISHING HOUSE
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1. www.caknowledge.com
2. www.iedunote.com
3. www.toppr.com

Unit 04: Financial Accounting Standards

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Introduction

- 4.1 Concept
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Summary

Keywords

Self Assessment

Answers for Self Assessment

Review Questions

Further Readings

Objectives

After studying this unit, you will be able to:

- Apply the provisions for accounting standards.
- Comprehend the significance of accounting standards in real world situation.
- Know the procedure to issue accounting standards.
- Apprehend the provisions of Ind AS 101.
- Enhance the importance of IFRS.

Introduction

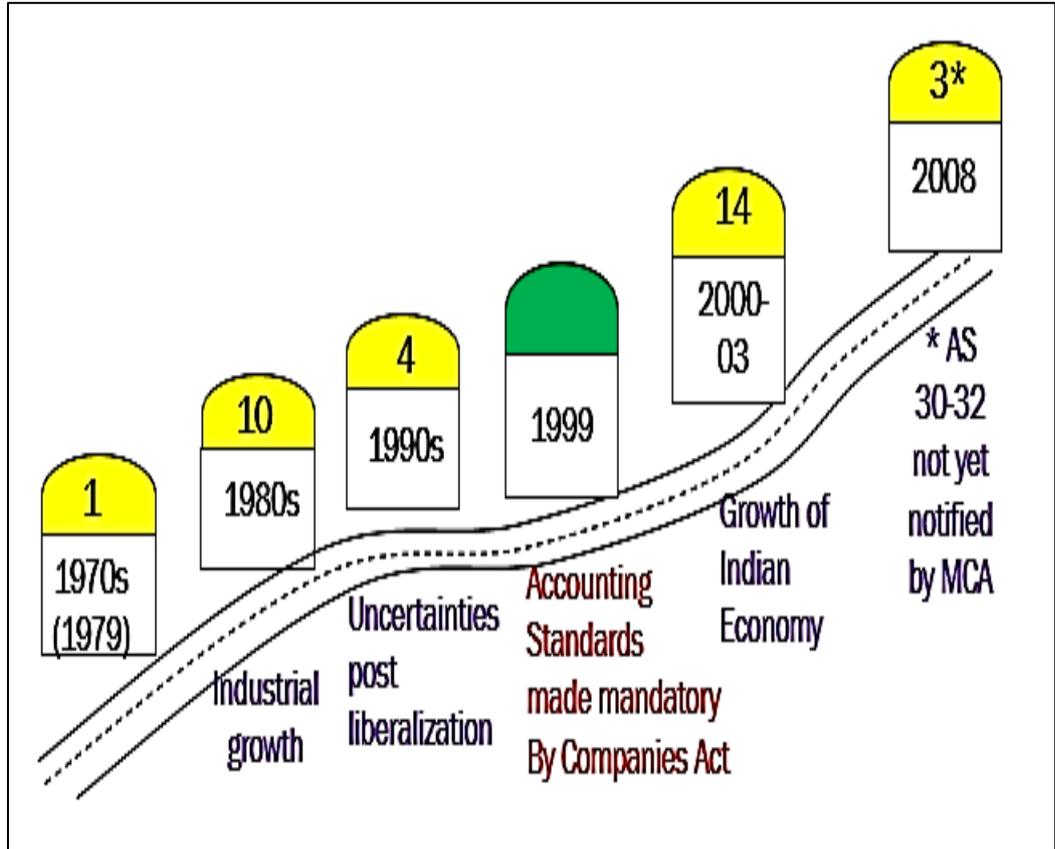
The Financial Accounting Standard Board, accomplishes its mission through a comprehensive and independent process that encourages broad participation and objectively considers all stakeholder views and is subject to oversight by the Financial Accounting Foundation's Board of Trustees. The *Rules of Procedure* describe the FASB operating procedures, including the due process activities that are to be open to public participation or observation to provide transparency into the standards-setting process.

4.1 Concept

An accounting standard is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices. Accounting standards improve the transparency of financial reporting in all countries.

Companies follow the International Financial Reporting Standards, which are set by the International Accounting Standards Board and serve as the guideline for non U.S. GAAP companies reporting financial statements. Accounting standards apply to the full breadth of an entity’s financial picture, including assets, liabilities, revenue, expenses and shareholders' equity.

4.2 Journey of Accounting Standards in India

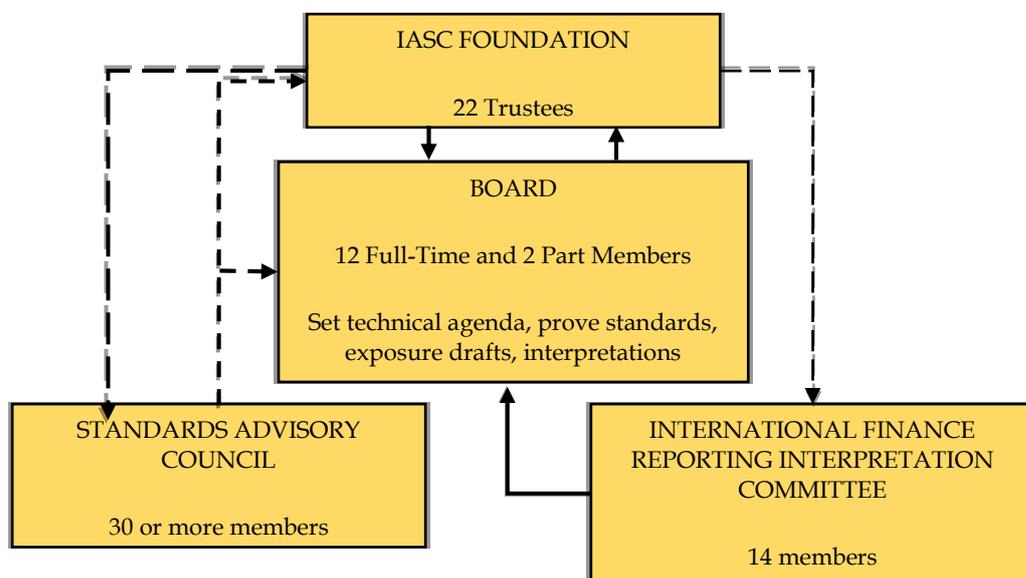
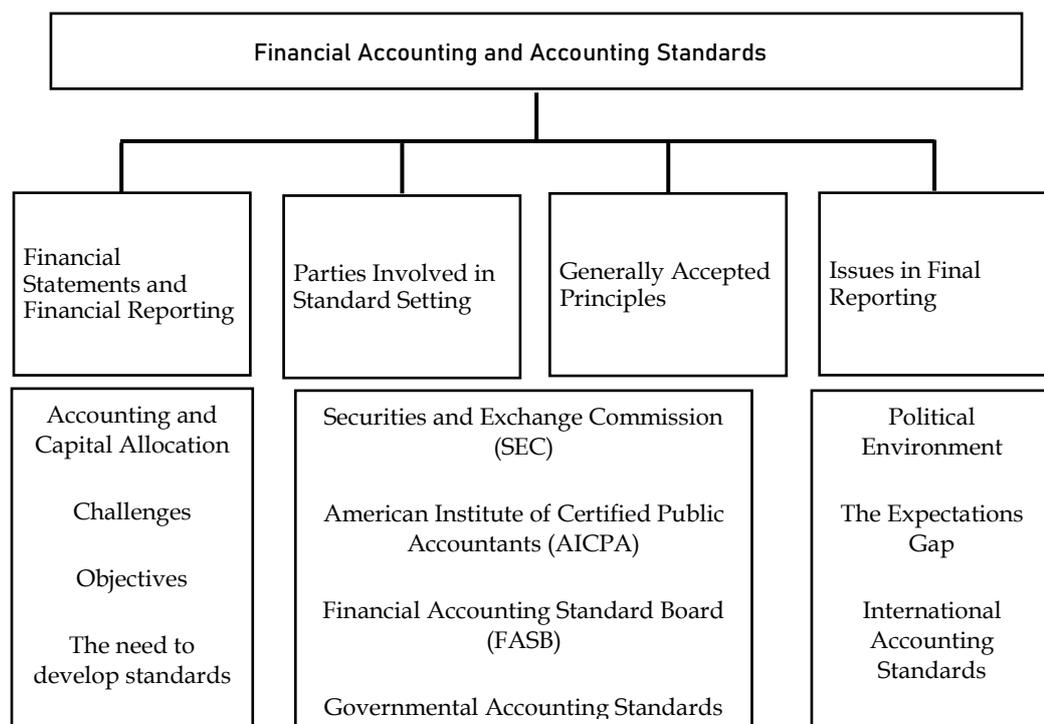


Accounting Standards is in growing stage from 1970s to 1990s. Then, in 1999, accounting standards are made mandatory to apply for companies registered under Companies Act. Once the listed companies use the standards in preparation of financial statements, growth initiated of Indian Economy.

4.3 Standard Setting Organization

There are various bodies which redirect the guidelines for setting standards. The International Accounting Standard Committee with 22 trustees appoint the Board members and advice to interpretation committee and reports to SAC. The members of IASC further appointed by Board members. The board members are specialist in setting technical agendas, making drafts and interpretations. SAC also advice to IASC foundation for any modifications in rules or guidelines for standards. Further, International Finance Reporting Interpretation Committee, is appointed by Board members and their role is to analyze the various reports for standard setting.

4.4 Financial Accounting and Accounting Standards



Financial Accounting and Accounting Standards involve the reporting of financial statements as per GAAP or IFRS. All these requirements are to be fulfilled by the certain bodies involved in preparation and filling issues in reporting. The bodies as SEC, AICPA, FASB and GAS all are involved in looking various challenges and objectives, which are essential to develop standards and capital allocation requirements by listed and unlisted companies. Different issues as such political influence on financial reporting or expectation gap of users. All these are quite important for setting accounting standards.

	<p>Caution: The International Accounting Standards (IAS) constitute a single set of high-quality accounting standards, which help in the preparation of consolidated financial statements, including the balance sheet, income statement, statement of changes in the financial position, cash flow statement and explanatory notes.</p>
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4.5 Benefits of Accounting Standards

There are several benefits of applying accounting standards in preparation of accounting standards.

- **Attains Uniformity in Accounting:** One of the main advantages of relying on financial accounting standards is the fact that there will be an unparalleled level of consistency in the market. This is because all public companies that rely on investors will usually have to obey the exact same set of principles. One of the main advantages of relying on financial accounting standards is the fact that there will be an unparalleled level of consistency in the market. This is because all public companies that rely on investors will usually have to obey the exact same set of principles.
- **Improves the Credibility and Reliability of Financial Statements:** Financial statements of business enterprises are used by a diverse group of users for making sound economic decisions such as shareholders, suppliers, trade creditors, customers, employees, taxation authorities, and other interested parties. It is necessary, therefore, that the financial statements, the users use and upon which they rely, present a fair picture of the position and progress of the enterprise. It is the function of accounting standards to create this general sense of confidence by providing a structural framework within which credible financial statements can be produced.
- **Prevents Frauds and Accounting Manipulations:** All standards in accounting, focus on fair representation that must be met through reasonable estimates and judgment-call valuations. Although the mere use of the word “reasonable” often gives some room for different interpretations, governing agencies tend to monitor subjective estimates closely. These pertain to things like inventory valuation methods and recording procedures that could give the company a comparative advantage. For instance, a company could value its inventory at an extremely low cost to make their cost of goods sold account lower. In turn, the net income would spike. Fortunately, accounting standards prevent such manipulations.
- **Benefits to Accountants and Auditors:** Accountants and auditors, must work in an environment where they face the threat of stern sanctions. The risks to auditors of these developments are considerable, whether in terms of uncovered financial exposure to liability or adverse effects on professional reputation resulting from unfavorable publicity. Particularly dangerous are cases of undetected fraud, and of audited accounts, which are held to be misleading due to insufficient disclosure or use of inappropriate accounting principles. Given the increasing risks, the accounting profession realized that it needed to know what accounting standards are to prevail.
- **Determining Managerial Accountability:** Accounting standards facilitate in determining specific corporate accountability and regulation of the company and thus help in measuring the effectiveness of management’s stewardship. They help in assessing managerial skill in maintaining and improving the profitability of the company, they depict the progress of the company, its solvency and liquidity and generally they are important factors increasing the effectiveness of management’s performance of its duties and of its leadership. The guidelines of relevance and appropriateness to intended use may be so crucial in each setting that a departure from uniformity of practice (with full disclosure) may be justified. An accounting standard should significantly reduce the amount of manipulation of the reported accounting numbers that is likely to occur in the absence of the standard.
- **Reform in Accounting Theory and Practice:** Financial accounting has lacked, especially in the past, a coherent logical conceptual framework and structure for accounting measurements. This encouraged the emerging intelligentsia of accounting to develop accounting theories, to improve existing practices or to rectify their defects. Financial accounting has lacked, especially in the past, a coherent logical conceptual framework and structure for accounting measurements. This encouraged the emerging intelligentsia of accounting to develop accounting theories, to improve existing practices or to rectify their defects.

4.6 What do Standard Include?

- **Objective:** The objective for standard is to prescribe accounting treatment for a type of transaction/event. As number of events occur in an organization, which event is mapping with which standard has to be compiled with care and caution.
- **Definitions:** Various important terms are used in issuing accounting standards, which needs to be followed by accountants and auditors while preparation of annual reports.
- **Recognition:** This concept is quite important for measuring adequate income and expenses for particular period of time, so when to include an item in FS is most important aspect to carry.
- **Measurement:** At what value, the assets of an organization should be measured and in addition, which method to be followed for measuring the value is also considered. Like, the consistency concept says that one should be consistent in following the methods to compute the depreciation value of particular asset.
- **Presentation:** In which financial statement, data needs to be showcase is most essential to evaluate the appropriate financial performance and financial position of a company.
- **Disclosure:** Additional explanation in notes to accounts is mandatory as per accounting principles to be done. All the elements mentioned in financial statements should be clearly disclosed for better understanding of facts and figures mentioned in financial statements.

4.7 Procedure for Issuing Accounting Standards

Although is a detailed procedure for issuing accounting standards, but for the beginners, here we are discussing simple and brief procedure to issue accounting standards.

- It must determine the broad areas in which accounting standards need to be formulated and their priority.
- Study groups represented by the members of the institute and others (included based on the specific subjects) must assist ASB in the preparation of the accounting standards.
- ASB will ascertain the views of the representatives of the Government, public sector undertakings, industries and other organizations while formulating the accounting standards.
- After such consultations, the exposure draft of the proposed standard will be prepared and issued for comments by the members of the Institute and the public at large.
- The proposed draft of the accounting standards should include, statement of accounting principles, definition used in the standards, presentation and disclosure requirement, class of enterprises and effective date to which the standards will apply.
- Accounting Standards Board must finalize the proposed standards after taking into consideration the comments received and submit the finalized draft to the ICAI council.

Let us discuss, the process in detail here. The organization in which the FASB operates, FASB sets the mission, that how the mission is accomplished and related principles that guide the Board's standards-setting activities. The operating procedures of the FASB, including the responsibilities of the Chairman, the composition of the FASB technical staff, the role of advisory groups, the Emerging Issues Task Force and public forums in due process. Our various forms of communications, including the form and content of Accounting Standards Updates, Exposure Drafts, and Concepts Statements. Moreover, protocols for meetings of the FASB and voting

Financial Accounting

requirements are discussed. Various rules governing public announcements and the kinds of information made broadly available to the public. A key principle guiding the Board's work is to issue standards when the expected benefits of a change justify the perceived costs of that change. The FASB has developed a plain-language Cost-Benefit Analysis summary that explains how the consideration of benefits and costs is integrated throughout the FASB standards-setting process. It explains how the FASB gathers information about potential costs and benefits of standards, as well as how the cost-benefit analysis differs from an analysis of economic consequences. A high-level overview of the standards-setting process as established by the Rules of Procedure. The nature and extent of the Board's specific research and outreach activities will vary from project to project, depending on the nature and scope of the reporting issues involved. The Board identifies financial reporting issues based on requests/recommendations from stakeholders or through other means. The FASB decides whether to add a project to the technical agenda based on a staff-prepared analysis of the issues. The Board deliberates at one or more public meetings the various reporting issues identified and analyzed by the staff. The Board issues an Exposure Draft to solicit broad stakeholder input. The Board holds a public roundtable meeting on the Exposure Draft, if necessary. The staff analyzes comment letters, public roundtable discussion, and all other information obtained through due process activities. The Board re-deliberates the proposed provisions, carefully considering the stakeholder input received, at one or more public meetings. The Board issues an Accounting Standards Update describing amendments to the Accounting Standards Codification.

4.8 Indian AS 101 - First time adoption of Indian Accounting standards

Accounting standards are issued by ICAI from time to time to ensure the accuracy and reliability of financial statements. Today country borders are no barriers for businesses or investments. Hence, India is moving towards convergence of accounting standards with IFRS, known as Ind AS. When an entity adopts the Indian accounting standards for the first time, the presentation of the financial statements will depict all the changes as per the converged standards. Therefore, the board has issued this standard to ensure smooth application.

	X Ltd. is required to adopt Ind AS from April 1, 2016, with comparatives for one year, i.e., for 2019- 20. What will be its date of transition?
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Response-The date of transition for X Ltd. will be April 1, 2019 being the beginning of the earliest comparative period presented. To explain it further, X Ltd. is required to adopt an Ind AS from April 1, 2020, and it will give comparatives as per Ind AS for 2019-20. Accordingly, the beginning of the comparative period will be April 1, 2019 which will be considered as date of transition.

4.9 Phases of INDAS 101

Phase-I	Phase-I	Phase-II
<ul style="list-style-type: none"> • Voluntary • 1st April 2015 	<ul style="list-style-type: none"> • Mandatory • 1st April 2016 	<ul style="list-style-type: none"> • Mandatory • 1st April 2017

Ind AS 101, is the First-time adoption accounting standard, which is optional for many for companies in 2015 but later from 2016 it was made compulsory for every company. Every organization who is preparing their financial statements as per accounting principles and are following accounting standards, have to adopt this Ind AS 101, for the said purpose.

4.10 Objective of Ind AS 101

The objective of Ind AS 101 is to ensure that an entity's first Ind AS financial statements, and its interim financial reports for part of the period covered by those financial statements that is transparent and comparable. The cost does not exceed the benefits and the statements provide a suitable starting point for accounting in accordance with Indian Accounting Standard. It contain high quality information that:

- is transparent for users and comparable over all periods presented.
- provides a suitable starting point for accounting in accordance with Ind AS; and
- can be generated at a cost that does not exceed the benefits.

4.11 Application of Ind AS 101

This standard applies to the first Ind AS financial statements and each interim financial report if any. But this standard does not apply to changes in accounting policies for an organization that already applies Ind AS. Such changes are subject of requirements of Ind AS 8 or specific transitional requirements of other Ind AS.

This standard shall be applied by a company in:

- Its first Ind AS financial statements each interim financial report, if any, that it presents in accordance with Ind AS 34, Interim Financial Reporting, for part of the period covered by its first Ind AS financial statements.
- This Ind AS does not provide exemptions from the presentation and disclosure requirements in other Ind AS.
- An entity's first Ind AS financial statements shall include at least three Balance Sheet, two Statements of profit and loss, two Statements of cash flows and two Statements of changes in equity and related notes, including comparative information for all statements presented.
- This Ind AS does not provide exceptions from the presentation and disclosure requirements in other Ind AS.
- The Ind AS established two types of exemptions from the requirement that an entity must apply each Ind AS in preparation of Opening Ind AS Balance sheet. Prohibit retrospective application of some aspects of Ind AS.
- Grant exemptions from some requirements of Ind AS.

What is the procedure for Ind AS 101?

1. Choose accounting policies and consider changes in estimates
2. Recognize all assets and liabilities whose recognition is required by Ind AS
3. Derecognize all assets or liabilities whose recognition is not allowed by Ind AS
4. Reclassify assets, liabilities or components of equity, as necessary
5. Apply Ind AS for measuring all recognized assets and liabilities
6. Consider mandatory and optional exemptions

Mandatory exceptions under Ind AS 101

Use of estimates	Hedge accounting	De-recognition of financial assets and financial liabilities	Some aspects of accounting for non-controlling interests
Classification and measurement of financial assets	Impairment of financial assets	Embedded derivatives	Government loans

There are some exceptions under Ind AS 101, which are to be mandatory followed by companies while following Ind AS 101. As the exceptions are mentioned in above table and needs to kept in consideration by the accountants and auditors while preparing financial statements. As hedge

Financial Accounting

accounting for minimization of risk and losses cannot be applied in Ind AS 101. Simultaneously, de recognition of financial assets and liabilities is being done by company, then they cannot apply the Ind AS 101.



Did you know? What is the major difference between Ind AS 101 and IFRS 1?

Any additional recognition of assets or liability which was not in previous GAAP then resulting change will be adjusted through:

IN IND AS: Retained Earning, Good will or Capital Reverse

IN IFRS: Retained Earning or Goodwill

Some optional exemptions is in addition in IND AS i.e., Long term foreign currency monetary items and Service Concession Arrangements relating to toll roads. There are some short-term exemptions from IFRS in IFRS 1 Appendix E. No such short-term exemptions in IND AS 101.

In IND AS	In IFRS
Balance Sheet	Statement of Financial Position
Statement of profit and loss	Statement of comprehensive income

4.12 International Financial Reporting Standards

A set of accounting standards which are developed by International Accounting Standards Board (IASB), for the preparation of public company financial statements. It is applied globally, to reduce the differences between accounting standards. IFRS also applied for international acquisitions and for standard quality of MIS. It enhance confidence among the global stakeholders.

IFRS are designed to bring consistency to accounting language, practices and statements and to help businesses and investors make educated financial analyses and decisions. The IFRS foundation sets the standards to bring transparency, accountability and efficiency to financial markets around the world fostering trust, growth and long-term financial stability in the global economy. Companies benefit from the IFRS because investors are more likely to put money into a company if the company's business practices are transparent.

IFRS principles

There are certain principles which are to be followed while following these in preparation of financial statements. These are important for companies to follow, so that accuracy can be ascertained while determining financial results. Let us discuss them in detail.

- **Accrual Accounting-** Accrual basis accounting is the standard approach to recording transactions for all larger businesses. This concept differs from the cash basis of accounting, under which revenues are recorded when cash is received, and expenses are recorded when cash is paid. For example, a company operating under the accrual basis of accounting will record a sale as soon as it issues an invoice to a customer, while a cash basis company would instead wait to be paid before it records the sale. Similarly, an accrual basis company will record an expense as incurred, while a cash basis company would instead wait to pay its supplier before recording the expense.
- **Materiality-** Materiality refers to the impact of an omission or misstatement of information in a company's financial statements on the user of those statements. If it is probable that users of the financial statements would have altered their actions if the information had not been omitted or misstated, then the item is considered to be material. If users would not have altered their actions, then the omission or misstatement is said to be immaterial.

Unit 04: Financial Accounting Standards

- **Reporting Frequency**-Reporting frequency defines how often you update an objective, measure or initiative in clear point. Typically, an element is added with the default reporting frequency of monthly. This can easily be changed to quarterly or annual, for example, if you will be inputting data less frequently.
- **Going Concern**- The going concern concept of accounting implies that the business entity will continue its operations in the future and will not liquidate or be forced to discontinue operations due to any reason. A company is a going concern if no evidence is available to believe that it will or will have to cease its operations in foreseeable future. An example of the application of going concern concept of accounting is the computation of depreciation on the basis of expected economic life of fixed assets rather than their current market value.
- **Consistency**- In accounting, consistency requires that a company's financial statements follow the same accounting principles, methods, practices and procedures from one accounting period to the next. This allows the readers of the financial statements to make meaningful comparisons between years. Consistency does allow a company to make a change to a more preferred accounting method. However, the change and its effects must be clearly disclosed for the benefit of the readers of the financial statements. The Financial Accounting Standards Board refers to consistency as one of the characteristics or qualities that makes accounting information useful.
- **Aggregation**- IFRS 17 requires an entity to identify portfolios of contracts subject to similar risks and being managed together. This aggregation of insurance contracts is done when contracts are issued and is not subsequently revised.
- **Comparative Information**- The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

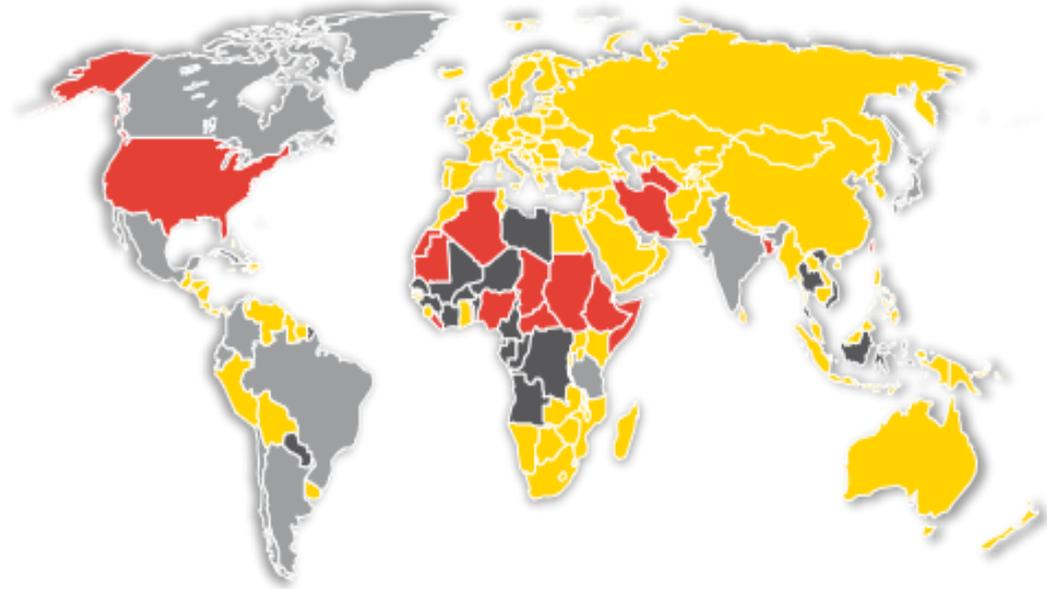

CASE STUDY

1. Identify the contract(s) with a customer: The contract consists of the agreement that the bartender will exchange the beer with the customer for \$5.00. 2) Identify the performance obligations in the contract: The bartender is obligated to serve the customer the beer that he or she ordered. 3) Determine the transaction price: In this situation, the price is \$5.00. 4) Allocate the transaction price to the performance obligations in the contract: The transaction price of \$5.00 is directly allocated to the performance obligation of serving the beer to the customer. 5) Recognize revenue when (or as) the entity satisfies a performance obligation: The revenue is recognized when the bartender gives the beer to the customer.

2. Identify the contract(s) with a customer: The contract goes back to the contract from the previous situation. The contract can be identified as the agreement to purchase the beer and a coupon towards two pretzels for \$7.00. 2) Identify the performance obligations in the contract: The obligation consists of Bier Haus providing the beer and the coupon that can be used towards pretzels at a later date. 3) Determine the transaction price: The transaction price for this scenario is \$3.11. 4) Allocate the transaction price to the performance obligations in the contract: The price allocated to this portion of the contract is the portion allocated to the pretzels, which is \$3.11. 5) Recognize revenue when (or as) the entity satisfies a performance obligation: Bier Haus will recognize the \$3.11, which was a liability until it was earned at the time of coupon redemption.

<http://kb.icai.org/pdfs/PDFFile5b279225d177f1.11874452.pdf>

Outlook of IFRS



- IFRS required or permitted
- Local GAAP based on legacy IAS
- No action taken/date set for adoption
- In process of adopting or converting to IFRS

The above mentioned image is reflecting the outlook of IFRS I.e. adopted in certain regions. There are certain regions which are already permitted to apply IFRS and many are still using GAAP based on legal rules. Many of nations are there, who still have not applied for IFRS adoption for preparation of IFRS and many are in process of adoption of IFRS.



Phase wise implementation of IFRS

	Phase I	Phase II	Voluntary adoption
Year of adoption	2016-17	2017-18	2015-16 & thereafter
Comparative year	2015-16	2016-17	2014-15 & thereafter
Covered companies:			
(a) Listed	All with net worth >500 Cr	All listed or in process of listing	Any company would adopt voluntarily
(b) Unlisted	All with net worth >500 Cr	All with net worth = 250 Cr to 500	
(c) Group companies	Applicable to holding, subsidiaries, joint ventures, or associates of companies covered in (a) and (b) above. This may also impact fellow subsidiary companies while preparing CFS of the holding company.		

4.13 Convergence

The convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally. The mixture of IND GAAP and IFRS is named as Ind

Unit 04: Financial Accounting Standards

AS, which generally followed by companies which are not fully prepared for following IFRS in preparation of financial statements. The concept of harmonization is applied which specifies every nation should adopt the accounting standards peacefully.

**Indian Companies (Converged)**

COMPANIES	SECTOR
Infosys, Wipro, NIIT	IT
Mahindra and Mahindra, Tata Motors	Auto
Bombay Dyeing	Textile
Dr. Reddy's Lab	Pharma
Bharti Airtel	Telecom

Difference GAAP, IAS and IFRS

Basis	GAAP	IAS	IFRS
Name	Generally Accepted Accounting Principles	International Accounting Standards	International Financial Reporting Standards
Year of Implication	1973	1973-2001	2001
Brief overview	A set of commonly accepted accounting guidelines and rules issued by the FASB that publicly traded companies follow for financial reporting	A set of older, world-wide standards issued by the IASC and IASB for both listed and unlisted companies	A set of world-wide standards issued by the IASB for both listed and unlisted companies [Note: after the restructure of IASC which became IFRS the IAS were adopted with any new standards issued by IASB]
Overall Approach	Rule-based	Principle-based	Principle-based
Who is affected?	Us public companies & private companies that issue public statements	Listed & Unlisted companies in countries that have adopted the standards	Listed & Unlisted companies in countries that have adopted the standards

Summary

- Accounting standard is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices.
- The bodies as SEC, AICPA, FASB and GAS all are involved in looking various challenges and objectives, which are essential to develop standards and capital allocation requirements by listed and unlisted companies.
- Accounting standards facilitate in determining specific corporate accountability and regulation of the company and thus help in measuring the effectiveness of management's stewardship.
- The operating procedures of the FASB, including the responsibilities of the Chairman, the composition of the FASB technical staff, the role of advisory groups, the Emerging Issues Task Force and public forums in due process.

Financial Accounting

- When an entity adopts the Indian accounting standards for the first time, the presentation of the financial statements will depict all the changes as per the converged standards.
- The objective of Ind AS 101 is to ensure that an entity's first Ind AS financial statements, and its interim financial reports for part of the period covered by those financial statements that is transparent and comparable.
- A set of accounting standards which are developed by International Accounting Standards Board (IASB), for the preparation of public company financial statements.
- The convergence of accounting standards refers to the goal of establishing a single set of accounting standards that will be used internationally.

Keywords

FASB: Financial Accounting Standard Board

SEC: Securities and Exchange Commission

AICPA: American Institute of Certified Public Accountants

FASB: Financial Accounting Standard Board

GASB: Governmental Accounting Standard Board

Self Assessment

1. Accounting Standards Board of India was established in the year _____.
A. 1970
B. 1972
C. 1973
D. 1977
2. What is the aim of accounting standards in India?
A. To make financial statements more comparable
B. To ensure uniformity in accounting policies
C. To guide the judgement of professional accountants
D. All above
3. As per Indian GAAP financial statements are presented at _____.
A. Market Value
B. Fair Value
C. Cost
4. IASB was established in year _____.
A. 1977
B. 2001
C. 2013
D. 2019

Unit 04: Financial Accounting Standards

5. The accounting standards are mandatory for _____.
- A. Sole trader
 - B. Firms
 - C. Companies
 - D. All above
6. Which is rule based principle?
- A. GAAP
 - B. IAS
 - C. IFRS
7. Which are the IFRS principles?
- A. Materiality
 - B. Consistency
 - C. Accrual
 - D. All above
8. _____ is a common set of principles, standards and procedures that define the basis of financial accounting policies and practices.
- A. Accounting Standard
 - B. Accounting Principles
9. In accounting, which concept requires that a company's financial statements follow the same accounting principles, methods, practices and procedures from one accounting period to the next _____
- A. Consistency
 - B. Going Concern
 - C. Materiality
10. Accounting Standard Board of India was set up by _____.
11. The convergence of Indian Accounting Standards with IFRS began in _____.
12. Mandatory implementation of Ind AS 101 initiates in _____.
13. The _____ describe the FASB operating procedures, including the due process activities that are to be open to public participation or observation to provide transparency into the standards-setting process.
14. Accounting standards and Accounting Principles are one and same thing.
- A. True
 - B. False
15. Accounting standards cannot over ride the statute.

- A. True
- B. False

Answers for Self Assessment

- | | | | | |
|-------------------|----------|--------------------------|-------|----------|
| 1. D | 2. D | 3. B | 4. B | 5. C |
| 6. A | 7. D | 8. A | 9. A | 10. ICAI |
| 11. April
2011 | 12. 2016 | 13. Rule of
Procedure | 14. B | 15. A |

Review Questions

1. What do you mean by accounting standards?
2. Discuss the growth and development stages of accounting standards?
3. List out the organizations which generally set the accounting standards and their role in setting of standards in detail?
4. Discuss the advantages of accounting standards?
5. How the standards are issued, discuss in detail?
6. What is Ind AS 101? Explain its phases and objectives with the help of example?
7. Where and how the Ind AS 101 applies? Discuss in detail.
8. What do you mean by IFRS?
9. Discuss the IFRS principles along with its application in detail?
10. Distinguish between GAAP, IAS and IFRS, with examples.



Further Readings

1. Financial Accounting By P.C. Tulsian, Pearson
2. Financial Accounting By Hanif And Mukherjee, Mcgraw Hill Education
3. Advanced Accountancy By S.N. Maheshwari And S.K. Maheshwari, Vikas publishing House
4. Financial Accounting Part-I & II, B.Com (Regular) 1st Sem. Pbi. Uni. By Juneja C.Mohan, Arora J.S., Aggarwal Manav, Kalyani Publishers



Web Links

- www.caknowledge.com
- www.iedunote.com
- www.toppr.com

Unit 5-ACCOUNTING PROCESS

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Summary

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Objectives

After studying this unit, you will be able to:

- use accounting terms.

- apply the rules of debit and credit.
- record transactions in the journal.
- post the business transactions in ledger.
- access the closing balances of each account separately.
- comprehend the importance of trial balance in business.

Introduction

While learning about accounting records and ledger posting, it is important to understand the various types of accounts and how they're treated in accounting. The accounting method is so well-organized, precise, thorough, and scientific that it is widely used. The most popular method of accounting data for an enterprise, according to Keller, M.J. Keller in *Intermediate Accountancy*, is the double entry system. Each transaction's entry is made up of two sections, a "debit" and a "credit," as the name implies. A double entry system is one in which each transaction has an effect on at least two accounts. Each debit has a credit in this method. Any monetary transaction or transaction calculated in terms of monetary value is registered. These transactions are registered in two accounts, as implied by the name.

The entire accounting process is divided into two main divisions, personal accounts and impersonal accounts are basically divided into two groups. Impersonal accounts are further divided into two groups: Real accounts and Nominal accounts.

5.1 Concept

Every activity has different components, and some of these elements are registered in this framework. If a company acquires something, it may have been purchased by a gift. The total amount debited must equal the total amount credited when recording each transaction. The terms 'Debit' and 'Credit' indicate whether the transaction should be recorded on the left or right side of the account. An account resembles the letter 'T' in the English language in its most simple form. The simple type of account is known as T-account because of its shape. The left side of a T' account (usually abbreviated as Dr.) is known as debit, and the right side is known as credit (as usually abbreviated Cr.).



CASE STUDY: ICAI told to Hasten Process for Double-entry Accounting System.

"There is a need to set up a separate committee for converting the single-entry accounting system to double entry. The process is rather slow. It should be hastened," Mr. K. Rahman Khan, Honorary Deputy Chairman, Rajya Sabha, and member of the Institute of Chartered Accountants of India (ICAI), said.

While stating that the accounting system has already been converted to double entry in local bodies, Mr. Khan added that the institute should play a vital role in monitoring governmental expenditure. 'A chartered accountant's responsibility should not be limited to his clients alone. He owes it to the society. The institute and the custodian of government expenditure - Comptroller and Auditor General of India have already resolved to affect the conversion. Various governments across the globe now follow the double entry accounting system. We need to switch to double entry quickly," he added.

He clarified his statement by stating: "I am not saying that the Government accounts are not perfect. We need to ensure better transparency. The double entry accounting system would help measure cost escalation, go into the details of total public expenditure and so on." The Vice-President of ICAI, Mr. G. Ramasamy, said that the Governmental outgo towards the Mahatma Gandhi National Rural Employment Guarantee Act Scheme totalled over 42,000 crore and there were over 6 lakh panchayats in the country preparing their expenditure statement. "The institute is supporting the panchayat prepare the statement," he said.

On implementation of International Financial Reporting Standards (IFRS), he said by July 31, all approvals would be in place. The institute has started programme to enlighten professionals and jump start the process in India, launched certification course on IFRS. "In the first phase, we have started with Nifty companies with a turnover of over 1,000 crores."

The institute, he said has inked MOU with its various international counterparts to augment bilateral relationships. "We recently interacted with professional bodies in West Asia, discussed

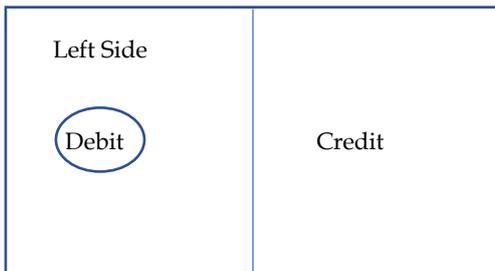
the need for improving networking ties between members and professionals of the two countries. We are looking to enter into mutual recognition agreements with the professional bodies in Canada, Singapore and New Zealand among others," he said.

Source: <https://www.thehindubusinessline.com/todays-paper/tp-economy/ICAI-told-to-hasten-process-for-double-entry-accounting-system/article20034321.ece>

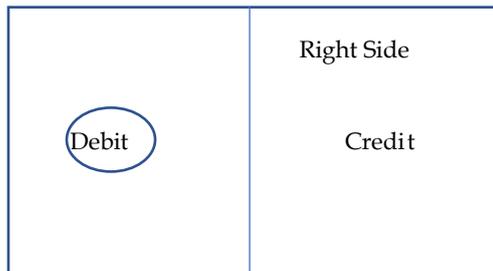
5.2 The T - Account

The T account refers to entering of amount on one side of specific account either on left side or right side. The account decides the side of account based upon its nature. As, if it is an asset or expense account, it will enter at left side I.e., Debit and if it is a liability or income, it will enter at right side then, I.e. Credit.

1. Account Title



2. Account Title



5.3 Rules of Debit and Credit

If there is a shift on one hand, everybody is aware of it. The other side would almost certainly be affected. Due to the principle of dual aspect, this transition occurs. A debit transaction is one that is entered/recorded on the account's left-hand side, while a credit transaction is one that is recorded/entered on the account's right-hand side. Depending on the essence of the account, both debit and credit result in a rise or decrease. As a result of the above debit and credit laws, it is clear that,

1. An rise in assets is reported on the left-hand side of the account, while a decline in assets is reported on the right-hand side.
2. For capital and liabilities, the increase is recorded on the right side of the account, while the decrease is recorded on the left.

The double-entry bookkeeping method is built based on the simple accounting equation. It shows how assets were funded, whether by borrowing capital from others (liability) or paying your own money (shareholders' equity).

Assets		=	Liabilities		+	Owner's Equity	
↑ Debit +	↓ Credit -		↓ Debit -	↑ Credit +		↓ Debit -	↑ Credit +

5.4 The Double - Entry System

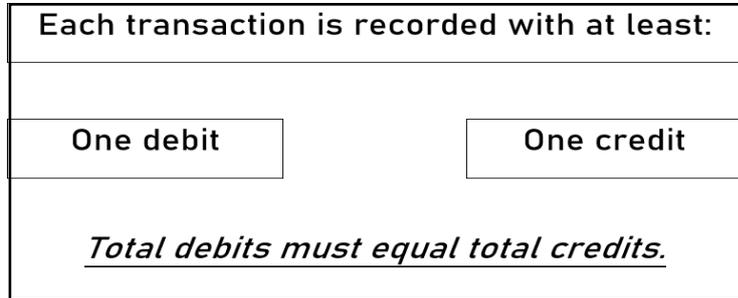
It's the only idea that depicts both sides of a single transaction. The entire rule of business is based solely on the players' collective agreement sharing policy. What method is used to reach a shared agreement?

All this business theory is based on reciprocal consent between the parties from one occasion to the next. The company is solely responsible for paying salaries based on the laborer's services. Is there some sort of mutual benefit sharing arrangement in place? The company uses the laborer's services

by paying him a salary. Similarly, the workers are paid on a regular basis for their contributions to the company.

Payment of Wages = Laborer' service

Laborer services are obtained by the payment of wages and the mutual distribution of benefits in terms of a company's accounting. There are two forms of accounting terminology for this: debit and credit. Any debit transaction is correctly equated with a credit transaction.. Finally, the funds collected are put to use in the form of assets. It means that the company's overall funds generated are equal to its total investments. It ensures that the firm's total liabilities are equal to its total assets.



5.5 Journal

A journal keeps track of all company activities on a regular basis. All transactions involving people, expenses, properties, liabilities, and incomes are reported in the journal. A journal does not provide a complete image of the basic elements of bookkeeping, such as properties, liabilities, proprietorship accounts, expenses, and wages, since it is held in one place.

Due to the nature of business transactions, multiple entries for a single type of transaction are needed, such as sales, acquisitions, cash receipts and payments, expenditures, and so on, are made during the accounting year. As a result, the entries are dispersed around the Journal.

To determine the cumulative impact of different transactions on a specific account, the entire journal must be examined. It is a list in chronological order of all the transactions for a business.

- Identify transaction from source documents.
- Specify accounts affected.
- Apply debit/credit rules.
- Record transaction with description.



What is a journal entry?

Journal entries are entries that are systematically registered in the journal book according to the golden rules of accounting.



What does a journal entry include?

The journal includes the following elements:

- date of the transaction
- title of the account debited.
- title of the account credited.
- amount of the debit and credit.
- description of the transaction.
- currency signs are omitted.

5.6 Format of Journal

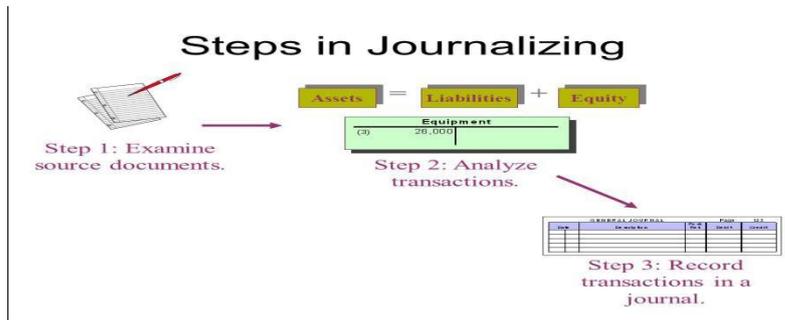
This is the columnar format which is followed while recording the business transactions or events. It should be in chronological order.

Date	Particular	L.F.	Debit (₹)	Credit (₹)

5.7 Steps in Journal

Following steps are followed by accountants while recording the business transactions in journal books. It should be followed consistently, so may no event can be missed out while entering in business books.

- Step 1** Determine the accounts that are involved in a particular transaction.
- Step 2** Determine the nature of particular accounts.
- Steps 3** Determine can debit and credit rules apply to each of the accounts.
- Step 4** Determine the account should be credited and which should be debited.
- Step 5** In the 'Date column,' mention the particular transaction date.
- Step 6** Identify the details of the accounts to be debited on the line separating the 'Date column' and the 'Particulars column,' along with the abbreviation 'Dr.' against the account name in the 'Particular column,' and the amount to be debited in the 'Debit Amount column,' quite close to the left-hand side.
- Step 7** After the next column, list the names of the accounts to be credited, followed by the word "To" a few spaces to the right, and the sum to be credited against the name of the account in the "Credit Amount column."
- Step 8** Write 'Narration' (i.e., a brief description of transaction) within brackets in the next line in the 'Particular column'.
- Step 9** Draw a line across the entire 'Particular column to separate one Journal Entry from the other.



5.8 Analysis of a business transaction in journal

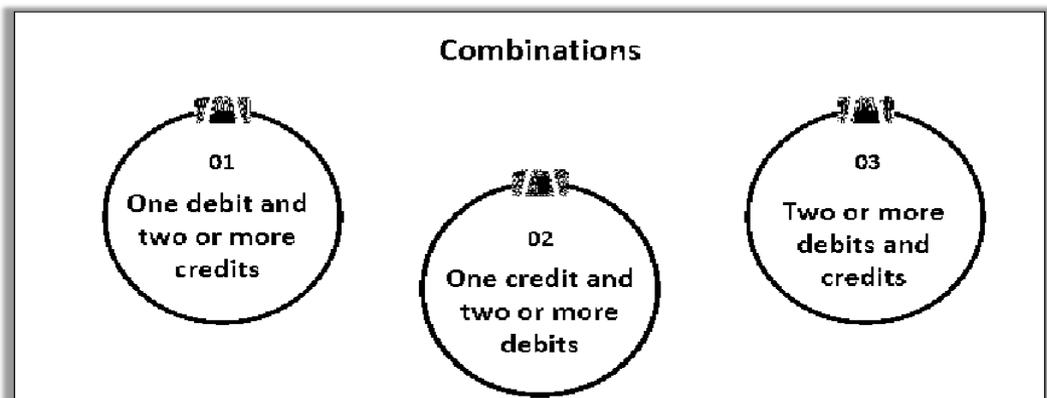
1. Purchased furniture for cash	2. Machinery sold in cash
3. Rent paid	4. Interest received
5. Outstanding salaries	6. Paid to Surinder

Transaction	Accounts Involved	Nature of Accounts	Debit/ Credit
Purchased furniture for cash	Furniture Account	Real Account	Debit
	Cash Account	Real Account	Credit
Machinery sold in cash	Cash Account	Real Account	Debit
	Machinery Account	Real Account	Credit
Rent paid	Rent Account	Nominal Account	Debit
	Cash Account	Real Account	Credit
Interest received	Cash Account	Real Account	Debit
	Interest Account	Nominal Account	Credit
Outstanding salaries	Salary Account	Nominal Account	Debit
	Outstanding Salary Account	Personal Account	Credit
Paid to Surinder	Surinder's Account	Personal Account	Debit
	Cash Account	Real Account	Credit

5.9 Compound Journal Entry

A compound journal entry is an accounting entry in which there is more than one debit, more than one credit or more than one of both debits and credits. It is essentially a combination of several simple journal entries and they are combined for any reasons.

An example of a compound journal entry is a payroll entry, where there is a debit to salaries expense, another debit to payroll taxes expense, and credits to cash and a variety of deduction accounts.



Journal				
Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
1/May/2019	Arun a/c dr. To Cash a/c To Discount a/c		5300	5250 50
2/ May/2019	Cash a/c dr. To Somesh a/c To Komesh a/c		2300	1900 400
3/May/2019	Purchase a/c dr. Furniture a/c dr. Raman a/c dr. Salary a/c dr. Rent a/c dr. To Cash a/c		4000 3000 2090 7000 1400	18090

5.10 Opening Entry

An opening entry is the initial entry used to record the transactions occurring at the start of an organization. The contents of the opening entry typically include the initial funding for the firm, as well as any initial debts incurred, and assets acquired.

Journal				
Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
1/June/2019	Cash a/c dr. Bank a/c dr. Stock a/c dr. Bills Receivable a/c dr. Debtors a/c dr. Building a/c dr. Investment a/c dr. Furniture a/c dr. To Bills Payable a/c To Creditors a/c To Ram Loan a/c To Capital a/c (Bal. Fig.)		6000 17000 3000 7000 3000 70000 30000 4000	5000 9000 13000 113000

5.11 Record the Business Transactions in Journal

Let us illustrate few business transactions based upon some assumptions for practice.

- 12/1/2019. Started business with Cash ₹ 2, 00,000.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
12/01/2019	Cash a/c dr. To Capital a/c (Being business started)		2,00,000	2,00,000

2. 12/2/2019. Purchased Goods from Amit Suppliers on credit of ₹ 1, 50,000.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
12/02/2019	Purchases a/c dr. To Amit Suppliers a/c (Being goods purchased on credit)		1,50,000	1,50,000

3. 12/3/2019 Deposit Cash into Bank ₹ 25,000.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
12/03/2019	Bank a/c dr. To Cash a/c (Being cash deposited into bank)		25,000	25,000

4. 12/4/2019. Sold goods to Dynamic Traders Pvt. Ltd. of ₹ 1, 30,000.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
12/04/2019	Dynamic Traders a/c dr. To Sales a/c (Being goods sold on credit)		1,30,000	1,30,000

5. 12/5/2019. Received a cheque of ₹ 1, 27,000 from Dynamic Traders Pvt. Ltd.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
12/05/2019	Bank a/c dr. Discount allowed a/c dr. To Dynamic Traders a/c (Being account settled)		1,27,000 3,000	1,30,000

6. 12/6/2019. Issued a cheque of ₹ 1, 00,000 as a partial payment to Amit Suppliers.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
12/06/2019	Amit Suppliers a/c dr. To Bank a/c (Being amount paid)		1,00,000	1,00,000

5.12 Other Important Transactions

- Trade discount.
- Cash discount.
- Interest on capital.
- Interest charged on Drawings.
- Depreciation charged on Fixed Assets.
- Bad Debts.
- Bad Debts Recovered.

1. **Trade discount** - Its accounting treatment is not shown in account. The discount calculated not shown in journal entry. Like, goods purchased from R & Sons for ₹ 1,00,000 at trade discount of 10%.

$$1,00,000 - 10\% * 1,00,000 = 90,000$$

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Purchases a/c dr. To R & Sons a/c (Being goods purchased on credit)		90,000	90,000

2. **Cash discount** - Its accounting treatment is shown in account. The discount amount needs to be shown in journal entry. Like, goods purchased from R & Sons for ₹ 1,00,000 at cash discount of 10%.

$$1,00,000 - 10\% * 1,00,000 = 90,000$$

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Purchases a/c dr. To R & Sons a/c To Discount a/c (Being goods purchased on credit at cash discount)		1,00,000	90,000 10,000

3. **Interest on capital** - Its accounting treatment should be shown in a journal entry. It is treated as an income for an investor and as an expense for company. The capital received by company is an investment made by investors and if they pay something i.e., call money in advance, it their right to receive the interest on that amount.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Interest on Capital a/c dr. To Capital a/c (Being interest on capital charged to company)		*****	*****

4. **Interest on drawings** - Its accounting treatment should be shown in a journal entry. It is treated as an expense for an investor and as an income for company. The capital received by company is an

investment made by investors and if they take something back from company, it is their right to receive the interest on that amount I.e., income for company.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Capital/ Drawings a/c dr. To Interest on Drawings a/c (Being interest on drawings charged by company)		*****	*****

5. **Depreciation charged on Fixed Assets** - It is a non-cash expense but still needs to be treated in journal entry to assess the correct position of fixed assets. Like, depreciation of 10% charged on Machinery worth ₹ 50,000.

$$50,000 * 10\% = 5,000$$

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Depreciation a/c dr. To Machinery a/c (Being depreciation charged against asset)		5,000	5,000

6. **Bad Debts** - It happens when debtors make default in making payment for credit sales held in past. It is an expense for the company and needs to be treated to know the exact amount to be received from debtors.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Bad Debts a/c dr. To Debtors a/c (Being bad debts)		****	****

7. **Bad Debts Recovered** - It is alike sunk amount received from debtors. It is an income for company I.e. amount recovered from debtors against bad debts.

Date of transaction	Particulars	L.F.	Debit (₹)	Credit (₹)
01/01/2019	Cash/ Bank a/c dr. To Bad debts recovered a/c (Being bad debts recovered)		****	****



A Businessman Is Inquiring

1. How much does he owe the products' suppliers/creditors?
2. How much money does he have to get from the customers?
3. How much money was spent on transactions and sales over a specific time period?
4. How much money was spent/incurred on various expenditures such as wages, leasing, carriage, stationery, and so on?
5. How much profit or loss did you make during the specific term?



Discuss the company's financial position on particular date?

Solution: To make managerial decisions, it is critical to have a summarized/grouped record of all transactions relating to a specific individual, event, or expenditure.



Pass Necessary Journal Entries in the Books of Narender for the Month of March 2020	
<u>Transactions</u>	<u>Journal Entries</u>
1. An old machinery appearing in books exchanged for a new machinery of Rs. 5,000.	New Machinery a/c dr. 5000 To old machinery a/c 5000
2. Issued a cheque for Rs. 1,000 in favor of landlord for a rent for the month of March.	Rent a/c dr. 1000 To bank a/c 1000
3. Paid electricity bill of Rs. 450 by cheque.	Electricity bill a/c dr. 450 To bank a/c 450
4. The goods destroyed by theft Rs. 3,000.	Loss by theft a/c dr. 3000 To purchases a/c 3000
5. Paid wages for the installation of machinery Rs. 5,000.	Exp for Mach a/c dr. 5000 To cash a/c 5000
6. Accrued interest Rs. 1100.	Interest a/c dr. 1000 To accrued interest a/c 1000
7. Goods worth Rs. 4,000 given away by way of charity.	Charity a/c dr. 4000 To purchases a/c 4000
8. Goods taken by Proprietor worth Rs. 10,000 for personal use.	Drawing's a/c dr. 30,000 To purchases a/c 30,000

5.13 Ledger

A ledger is a set of financial records. All business transactions of the company are reported in the ledger, which contains the various personal, actual, and nominal accounts.

The ledger is the company's only book of accounting. It is appropriately referred to as the 'King of Books.' A book known as a 'ledger,' i.e., a confidential head of accounts, will improve the mechanics of collecting, organizing, and analyzing all related transactions in one location.

The main purpose of the ledger is to identify and summarize all transactions identified mostly in journal and other books of original entry under the specified head/set of accounts, so that each account at the end of the accounting period includes all transaction information relevant to it

As a result, a ledger is a list of accounts that can be described as a summary statement that shows the net effect of all transactions relating to an individual, asset, expenditure, or income that occurred within a given period.

5.14 Relationship between Journal and Ledger

A business entity's most useful books are the journal and ledger. The following are the points of difference between the two:

- The ledger is the main accounting book, while the journal is a book of first entries.

Ledger Posting:

Dr.		Ravi's Account				Cr.	
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
2020 April 1	To Sales Account		1,000				

Dr.		Sales's Account				Cr.	
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
				2020 April 1	By Ravi's Account		1,000



Example

Let us use the information of previous task for ledger posting. Here, from previous journal entries, we can know the following are the ledgers that have to be made for.

New Machinery	Old Machinery	Rent	Bank	Electricity bill	Loss by Theft	Purchases	Expense for Machinery
---------------	---------------	------	------	------------------	---------------	-----------	-----------------------



Pass the following various journal entries and post into ledger.	
<u>Transactions</u>	<u>Journal Entries</u>
1. Jan 1, 2020 Mr. Sundar has started business with a capital of Rs. 50,000	Cash a/c dr. 50,000 To Sundar's Capital a/c 50,000
2. Jan 2, 2020 Goods purchased Rs. 10,000	Purchases a/c dr. 10,000 To Cash a/c 10,000
3. Jan 5, 2020 Goods sold Rs. 5,000	Cash a/c dr. 5,000 To Sales a/c 5,000
4. Jan, 10, 2020 Goods purchased from Mittal & co Rs.10,000	Purchases a/c dr. 10,000 To Mittal & Co. a/c 10,000
5. Jan, 11, 2020 Goods sold to Ganesh & co Rs. 10,000	Ganesh & Co. A/c dr. 10,000 To Sales a/c 10,000
6. Jan, 12, 2020 Goods returned to Mittal & co Rs. 1,500	Mittal & Co. A/c dr. 1500 To Purchase return a/c 1500

7. Jan 20, 2020 Goods returned from Ganesh Rs. 2,000	Sales return a/c dr. 2000 To Ganesh a/c 2000
8. Jan 31, 2020 Office Rent paid Rs. 500	Office Rent a/c dr. 500 To Cash a/c 500
9. Feb 2, 2020 Interim Dividend paid Rs. 3000	Interim Dividend a/c dr. 3000 To Cash a/c 3000
10. Feb 8, 2020 Cash withdrawn from bank Rs. 2,000	Cash a/c dr. 2000 To Bank a/c 2000

Ledger posting for above journal entries

1. Cash Account	2. Sundar Capital Account	3. Purchase Account	4. Sales Account
5. Mittal & Co. Account	6. Ganesh & Co Account	7. Sales Return Account	8. Purchase Return Account
9. Office Rent Account	10. Interim Dividend Account	11. Bank Account	

Let us start preparing the various ledgers as mentioned in the table.

Dr Cr **Cash Account**

Date	Particulars	₹	Date	Particulars	₹
Jan 1	To Sundar Capital	50,000	Jan 2	By Purchase	10,000
Jan 5	To Sale	5,000	Jan 31	By Office Rent	500
Feb 2	To Interim Dividend	3,000		By Balance c/d	49,500
Feb 8	To Bank	2,000			
		60,000			60,000

Dr Cr **Sundar Capital Account**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	50,000	Jan 1	By Cash	50,000
		50,000			50,000

Dr Cr **Purchase Account**

Date	Particulars	₹	Date	Particulars	₹
Jan 2	To Cash	10,000		By Balance c/d	20,000
Jan 10	To Mittal & Co	10,000			
		20,000			20,000

Dr Cr **Sale Account**

Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	15,000	Jan 5	By Cash	5,000
			Jan 11	By Ganesh	10,000
		15,000			15,000
				By Balance b/d	15,000

Dr		Sales Return Account		Cr	
Date	Particulars	₹	Date	Particulars	₹
Jan 20	To Ganesh	2,000		By Balance c/d	2,000
		2,000			2000
	To Balance b/d	2000			

Dr		Purchase Return Account		Cr	
Date	Particular	₹	Date	Particulars	₹
	To Balance c/d	1,500	Jan 12	By Mittal & Co	1,500
		1,500			
				By Balance b/d	1,500

Dr		Mittal & Co. Account		Cr	
Date	Particulars	₹	Date	Particulars	₹
Jan 12	To Purchase Return	1,500	Jan 10	By Purchase	10,000
	To Balance c/d	8,500			
		10,000			10,000
				By Balance b/d	8,500

Dr		Ganesh & Co. Account		Cr	
Date	Particulars	₹	Date	Particulars	₹
Jan 11	To Sale	10,000	Jan 20	By Sale Return	2,000
				By Balance c/d	8,000
		10,000			10,000
	To Balance b/d	8,000			

Dr		Office Rent Account		Cr	
Date	Particulars	₹	Date	Particulars	₹
Jan 31	To Cash	500		By Balance c/d	500
		500			500
	To Balance b/d	500			

Dr		Interim Divided Account		Cr	
Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	3,000	Feb 2	By Cash	3,000
		3,000			3,000
				By Balance b/d	3,000

Dr		Bank Account		Cr	
Date	Particulars	₹	Date	Particulars	₹
	To Balance c/d	2,000	Feb 2	By Cash	2,000
		2,000			2,000
				By Balance b/d	2,000

5.18 T Balance

After every accounting period, a T Balance or Trial Balance report is created for the purpose of listing ending balance in each account. A trial balance is a two-column system that lists all of the accounts' names and balances in the order they appear in the ledger.

The debit balances are listed on the left, and the credit balances are listed on the right. There is a corresponding credit or series of credits of an equivalent sum given to some other account or accounts for any debit or series of debits given to one or more accounts, and vice versa. If this isn't the case, the books of accounts are mathematically incorrect.

5.19 Objectives of Preparing Trial Balance

- To estimate the arithmetical correctness of the accounts .
- Helpful in preparing final accounts.
- To serve as an aid to the management.



Purposes of the Preparing the Trial Balance

- To frame a statement of disclosure of final accounting balances of different ledger accounts on a specific date.
- To prepare a statement of accounting cross-checking device when publishing entries that are primarily based on the double entry accounting concept. It aids in the accountant's structured entry posting.
- It assists the enterprise for the preparation of Trading & Profit and Loss Accounts for the year ended -----and the Balance sheet as on dated-----.
- It gives you a glimpse of the accounting balances of different ledger accounts for the time span you specify.

5.20 Methods of Preparation of Trial Balance

There are various methods considered by organizations for preparation of trial balance.

1. **Total method:** The debit and credit totals of each account are displayed in the two number columns in this form (one for the debit total and the other for the credit total).
2. **Balance method:** 2.The difference in each quantity is extracted using this process. If the debit side of an account is greater than the credit side, the difference is recorded in the Trial Balance's debit column; if the credit side is greater, the difference is recorded in the Trial Balance's credit column.
3. **Combined Method:** As the name implies, both the above-mentioned methods, namely the balance and complete methods, are used in this form. Because of the time and labor waste, this approach is no longer used.

5.21 Preparation of Trial Balance with the Help of Balances

The ledger accounts are still not provided, but a list of account balances is. We can plan the Trial Balance with the aid of these balances. To plan a Trial Balance, keep the following rules in mind:

1. On the debit side of the Trial Balance, the balances of all assets and drawing accounts are registered.
2. The credit side of the Trial Balance records the balances of both liabilities and capital accounts.
3. The debit side of the Trial Balance shows the amounts of both company expenses and losses.
4. The credit side of the Trial Balance shows the balances of both wages and gains.
5. The credit and debit sides of the Trial Balance show the balances of sales and sale returns, respectively.

5.22 Format of Trial Balance

TRIAL BALANCE OF AS ON			
Serial No.	Name of the Account	Dr. Balance Rs.	Cr. Balance Rs.

5.23 Errors while Preparing Trial Balance

Certain errors may occur when accounting transactions are recorded in primary and secondary books of accounts. The sum on both sides of the trial balance would not tally if there are any accounting errors. Some of the mistakes are simple to identify. However, there are certain defects that the trial balance does not detect.

In other terms, despite these mistakes, a trial balance will agree. Since you would not be aware of the mistakes, they are difficult to spot. Principle errors, omission errors, commission errors, compensating errors, and so on are examples of such errors. Errors can be divided into two categories.

A. Errors which cannot be Located by Trial Balance

1. **Error of Omission:** These errors occur when any business transaction is completely or partially omitted from the recording in the books of original records. Example: Goods, sold of Rs. 10,000 to Mr. Ram, is not entered anywhere in the original books so its effect will not appear on the ledger and trial balance. Thus, such type of errors can not be located by trial balance.
2. **Error of Commission:** Such type of errors are found when one account is debited or credited in the place of another account. Example: Cash received from Shyam Rs. 10,000 has been credited in the name of Ram. Such type of errors do not affect the agreement of the totals of the debit and credit side of the trial balance, but they affect the result of the business.
3. **Error of Principle:** These errors occur when there is wrong classification between the capital and revenue nature incomes or expenditures. Example: The purchases of furniture of Rs. 20,000, are entered in the book of purchases while it should be in furniture account. Such errors can not be located by trial balance.
4. **Compensating Error:** When two errors of the same account occur and the effect of one error is compensated by the effect of other error it is called compensating error. Example: If purchase of Rs. 10,000 from Ajay is credited only by Rs. 1,000 while the purchases from Vijay for Rs. 1,000 is credited by Rs. 10,000. Thus, such type of errors do not affect on the agreement of the Trial Balance.

A. Errors which can be Located by Trial Balance

1. Totals of the subsidiary books or ledger accounts.
2. Balancing of an account of the ledger.
3. Wrong posting of any amount in any account.
4. Posting of any account may be in the wrong side of the account.
5. Balance of any account may be omitted in writing in the Trial Balance.
6. Wrong total of the Trial Balance.

5.24 Suspense Account

The trial balance displays the suspense A/c. When mistakes are discovered, the account is debited or credited to correct the mistake, and the anticipation account is credited or debited as well. As a result, the suspense account is closed automatically.

When it's difficult to spot mistakes right away, the discrepancy is placed into a separate account called the suspense account.

5.25 Preparation of Trial Balance

From the given information, we can prepare the trial balance. Let us try.

Particulars	₹	Particulars	₹
Interest on Capital	24,000	Salaries	1,28,000
Creditors	6,00,000	Capital	8,00,000
Discount Received	23,000	Drawings	2,46,000
Loan	1,74,000	Machinery	3,00,000
Purchase Returns	40,000	Bills Payable	20,000
Sales Return	6,000	Furniture	6,00,000
Advertisement	1,63,000	Debtors	5,00,000
Commission Received	20,000	Bank Loan	2,00,000
Rent	10,000	Patents	60,000
Purchases	19,00,000		
Sales	32,60,000		
Opening Stock	12,00,000		

Solution: Trial Balance

Particulars	L.F.	Dr.	Cr.
		(₹)	(₹)
Interest on Capital		24,000	-
Creditors		-	6,00,000
Discount Received		-	23,000
Loan		-	1,74,000
Purchase Returns		-	40,000
Sale Returns		6,000	-
Advertisement		1,63,000	-
Commission Received		-	20,000
Rent		10,000	-
Purchases		19,00,000	-
Sales		-	32,60,000
Opening Stock		12,00,000	-
Salaries		1,28,000	-
Capital		-	8,00,000
Drawings		2,46,000	-
Machinery		3,00,000	-
Bills Payable		-	20,000
Furniture		6,00,000	-
Debtors		5,00,000	-
Bank Loan		-	2,00,000
Patents		60,000	-
Total		51,37,000	51,37,000

Summary

- Journal is the first book of initial entries in which all financial-related business transactions are registered and then posted to ledger accounts.
- Personal, Real, and Nominal Accounts are the three types of accounts.
- The entire law of business revolves around the players' mutual agreement sharing policy.
- A personal account is one that deals with a due balance to or from these persons for a specific period of time.

- Real Accounts is the account that specifically deals with asset movement.
- An account that deals with the amount of expenditures incurred or income received is known as a nominal account.
- It contains all of the company's costs and losses, as well as its profits and gains.
- The ledger is a preliminary book of accounting transactions in which each account is kept separately by allocating different pages for exclusive documentation.
- The process of choosing transactions from a journal based on accounts and writing them into ledger accounts is known as posting.
- A Trial Balance is a two-column schedule that lists all of the accounts' names and balances in the order they appear in the ledger.
- In primary and secondary books of accounts, there may be mistakes in recording accounting transactions.
- When it's difficult to spot mistakes right away, the discrepancy is placed into a separate account called the suspense account.

Keywords

- Journal: The primary book in which the business transactions are recorded at first time.
- Nominal A/c: Accounts which are relating to the revenues, incomes, expenses and losses of the business are called nominal accounts.
- Personal A/c: Accounts which are related to person, firms, companies and representatives.
- Process of Accounting: It includes the recording of transactions into Journal, classifying into Ledger and summarizing into Trial Balance and Final Accounts.
- Real A/c: Accounts which are related to all the assets accounts are included into it.
- Balancing: Balancing of an account is the difference between the total of debits and total of credits of an account.
- Ledger Posting: It is a process of recording the transactions under one group from the early process of journalizing.
- Ledger: It is the classification of accounts in which various accounts are maintained

Self Assessment

1. Journalising is the process of entering transactions in_____.
2. Another name for Journal is_____.
3. Transactions, when recorded in Journal, are known as_____.
4. The explanation of a Journal entry is known as_____.
5. In a Journal entry preposition_____ is used before the name of the account to be credited.
6. Journal is a_____ of original entries for accounting data.
7. The journal is known as the_____.
8. The process of transferring the entries from Journal to Ledger accounts is called_____.
9. Ledger contains various_____ in it.
10. The process of transfer of entries from Journal and special purpose books to ledger is called_____.
11. Ledger is also called_____.
12. Ledger is a_____ book of accounting system.
13. Classification of transactions is being done only on the basis of preparing the _____.
14. If the balance of the debit side of the ledger is more than the credit side it is called as Debit balance ledger. (True/False)

- 15. Without journalizing, ledger is not meaningful. (True/False)
- 16. Left hand side of ledger account is credit side. (True/False)
- 17. Every transaction must be recorded at two places or accounts. (True/False)
- 18. Outstanding rent is an example of nominal A/c. (True/False)
- 19. Real account deals with especially the movement of assets. (True/False)
- 20. Rent is a personal A/c. (True/False)

Review Questions

1. Journalize the following transactions with narration:

Date	Particulars	Amount (Rs.)
June, 1, 2019	Receive cash from Ramu	2,500
June, 3, 2019	Purchase goods for cash	4,000
June, 6, 2019	Sold goods to Hari	5,000
June, 8, 2019	Bought furniture from Raju	500
June, 10, 2019	Paid for office stationery	150

2. Ram has purchased goods on credit from M/s Royals for Rs. 15,000. The portions of the goods were found to be damaged which worth of Rs. 5,000. Ram immediately returned the damaged goods to Royals. Identify the various types of accounts involved and pass the journal entries with regards to the nature of accounts involved.

3. Pass the necessary opening entry on 1st January, 2020 in the books of Gopinath.

Particulars	Amount (Rs.)
Cash in hand	3,000
Cash at Bank	16,000
Stock in trade	30,000
Furniture & Fittings	5,000
Sundry Debtors	21,000
Sundry Creditors	18,000
Loan from Ganesh & Co.	9,000

- 4. Distinguish between material and immaterial transactions of business.
- 5. Journalise the following transactions:
 - a. Started business with cash Rs. 3,00,000.
 - b. Bought Goods on credit for Rs. 5,000.
 - c. Sold Goods for cash Rs. 12,000 and on credit Rs. 8,000
- 6. Explain the process of journalizing the transactions with suitable examples.
- 7. What are compound entries? Explain with suitable examples.
- 8. The following are the transactions of Kumar Swami for the month of January. Journalize these transactions.

Date	Particulars	Amount
Jan, 1, 2020	Capital paid into Bank	3,00,000
Jan, 1, 2020	Bought Stationery for cash	400
Jan, 2, 2020	Bought Goods for cash	25,000
Jan, 3, 2020	Bought Postage Stamps	1000
Jan, 5, 2020	Sold Goods for Cash	10,000
Jan, 6, 2020	Bought Office Furniture from Mahendra Bros.	40,000
Jan, 11, 2020	Sold goods to Jacob	12,000
Jan, 12, 2020	Received cheque from Jacob	12,000
Jan, 14, 2020	Paid Mahendra Bros. by cheque	40,000
Jan, 16, 2020	Sold goods to Ramesh & Co	5,000
Jan, 20, 2020	Bought from S. Seth & Bros	15,000
Jan, 23, 2020	Bought Goods for cash from S.Narain & Co	22,000
Jan, 24, 2020	Sold Good to P.Prakash	17,000
Jan, 26, 2020	Ramesh & Co. Paid on account	2,500
Jan, 28, 2020	Paid S.Seth & Bros. by cheque in full settlement	14,800
Jan, 31, 2020	Paid Salaries	2,800
Jan, 31, 2020	Rent is due to S. Sharma but not yet paid	2,000

9. What are the key steps in balancing a ledger a/c?
10. State the relation between journalizing and ledger posting with suitable examples.
11. Why is ledger known as the primary book or the principal -book of accounts?
12. Can profit of the business and its financial position be known without maintaining ledger?
13. What is the rule for posting the debit account from the journal into the ledger account?
14. Why is ledger prepared?
15. Prepare the account of X & Co. from the following:

Date	Particulars	Amount
Jan, 1, 2020	Balance due from X & Co.	1,000
Jan, 3, 2020	Cash sales to X & Co.	700
Jan, 4, 2020	Bought furniture from X & Co.	250
Jan, 6, 2020	Murthy returned goods to X & Co.	200
Jan, 9, 2020	Murthy returned goods	200

Jan, 10, 2020	Return of goods from X & Co.	150
Jan, 20, 2020	X & Co. settled his account by cheque and received discount	20

16. Discuss the errors occur while preparing trial balance?

Answers: Self Assessment

1. The journal	2. Original book of entries	3. Entries	4. Narration
5. To	6. Primary book	7. Book of original entry	8. Posting
9. Accounts	10. Posting	11. Principal Book of Account	12. Reference book
13. Ledger accounts	14. True	15. True	16. False
17. True	18. True	19. True	20. False

Further Readings



- Khan and Jain, "Management Accounting".
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Unit 06- Depreciation Accounting

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Summary

Keywords

Self Assessment

Answers: Self Assessment

Review Questions

Further Readings

Objectives

After studying this unit, you will be able to:

- Use conceptual framework of depreciation in corporate world.
- Access the factors affecting depreciation.
- Apply depreciation and amortization while computing asset value.
- Comprehend the methods of depreciation.
- Evaluate depreciation through SLM and WDV methods.

Introduction

Depreciation accounting is mainly based on the concept of income. The concept of income is matching of revenues with expenses. The goods purchased are frequently matched through immediate sale or within a year. The crux of the concept of income is that the expenses are to be matched against the revenues. The aim of matching is done to determine the volume of profit or loss of the transaction. If the assets are nothing but long-term assets procured by the enterprise, they should be matched against the revenues of them. The matching of expenditure of the assets incurred by the firm at the time of purchase against the revenues is the core task of the firm. Fixed assets like plant and machinery etc. are used in the business for the purpose of production or providing services. With the passage of time and utilization, value of such fixed assets decreases. Value of portion of fixed assets utilized for generating revenue must be charged during a particular accounting year to ascertain the true cost. This portion of cost of fixed asset allocated is called depreciation.

6.1 Definition

Depreciation means reduction in value of asset or in the utility due to passage of time, natural wear and tear, exhaustion of the subject matter.

In simple words, depreciation is the permanent decrease in the value of the fixed assets. It is a matching in between the fixed charge expense against the current year's revenue.

According to Dickens, "Depreciation is the permanent and continuous diminution in the quality/quantity/value of the asset."

According to Institute of Cost and Management Accountants, "Depreciation is the reduction in the value of a fixed asset occasioned by physical wear and tear, obsolescence or the passage of time."

According to Pickles, "Depreciation may be defined as the permanent continuous diminution in the quality, quantity or value on an asset."

According to Spicer & Pegler, "Depreciation may be defined as a measure of the exhaustion of the effective life of an asset from any cause during a given period."

According to Cropper, "Depreciation is the diminution in the value of assets owing to wear and tear, efflusion of time, obsolescence or similar causes."

From the above definitions, it follows that an asset gradually declines on account of use and passage of time and this causes permanent reduction in the value and utility of asset. Such reduction in the value or utility of asset is called depreciation. In other words, expired cost or utility of asset is depreciation.



Fig.1- Impact of asset value after depreciation

6.2 Features of Depreciation

Depreciation has the following characteristics:

1. Depreciation is charged in case of fixed assets only. e.g., building, plant and machinery, furniture etc. There is no depreciation in case of current assets - such as stock, debtors, bills receivable etc.
2. Depreciation causes perpetual, gradual and continual fall in the value of assets.

3. Depreciation occurs on account of use of asset. In certain cases, however, depreciation may occur even if the assets are not used, e.g., leasehold, property, patent, copyright etc.
4. Depreciation is a charge against revenue of an accounting period.
5. The amount of depreciation of an accounting year cannot be determined precisely – it has to be estimated. In certain cases, however, it may be ascertained exactly, e.g., leasehold property, patent right, copyright etc.
6. Total depreciation of an asset cannot exceed its depreciable value (cost less scrap value).
7. Depreciation includes loss of value of assets due to passage of time, usage or obsolescence.
8. Depreciation is a continuing process till the end of the useful life of assets.
9. Depreciation is an expired cost and hence must be deducted before calculating taxable profits.
10. Depreciation is a non-cash expense. It does not involve any cash flow.
11. Depreciation is the process of writing-off the capital expenditure already incurred.



Items which are not covered under fixed assets:

- Forests, plantations and similar regenerative natural resources.
- Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-generative resources.
- Expenditure on real estate development, and
- Livestock

6.3 Objectives for Providing Depreciation

To have an effective matching against the revenues on every year, the amount of purchase has to be stretched. The stretching of expenses into many years is known as depreciation. There are few objectives of providing depreciation:

- **To ascertain the true results of operations**-In cost terminology, overhead charges include all indirect costs. Depreciation is one among them. The asset engaged in production loses its value due to physical wear and tear. The said reduction in value of asset would be included in the cost of production. As a revenue expense its inclusion gives true cost of production. Depreciation is a charge included in the profit and loss account. True and correct profit can be arrived at only by charging depreciation. Depreciation is not visible. It is never paid to an outside party. Yet, it is desirable to charge depreciation on the fixed assets as these assets are used for earning profit. Depreciation must be deducted from the income earned to calculate a correct income.
- **To present true and fair value of the fixed asset**-A balance sheet reveals the financial position of its entity. Fixed assets should appear in the balance at their correct value. If assets are shown without any charge for depreciation, their value would be overstated. Consequently, the balance sheet will not show the correct state of business. Assets stated at their written down value will give a correct picture.
- **To accumulate funds for the replacement of the asset**-Occurrence of depreciation is gradual and not sudden. So, ample time is available to plan for replacement of existing assets at a future date. It is wiser to replace an asset than to incur additional expenditure on its maintenance and repair. By way of provision for depreciation the initial cost of the equipment is spread equitably over its period of usefulness. Amount of depreciation gets accumulated during the asset's working life. It provides necessary funds so that replacement can be effected without financial strain.

6.4 Causes of Depreciation

There are various reasons for the depreciation to occur in a specific period of time.

1. **Wear and Tear**-The long term assets are becoming less efficient and poor quality in operations due to the continuous usage of the asset.
2. **Exhaustion**- Nothing will be left due to the continuous extraction of resources. The resources in the oil wells, mine fields will be completely exhausted due to incessant extraction.

This has to be replaced by a new method of exploration. Investment in new exploration methods requires depreciation as a charge against the revenues of the wells/fields.

3. **Obsolescence**-To replace the old machinery with new machinery, before the expiry of the economic life period of the asset in order to maintain the efficiency and economy of the asset. The typewriter was replaced by the electronic typewriter during the yester periods of office automation. To replace the old typewriter which is neither efficient nor economical, it should be replaced by the new electronic typewriter through the depreciation charge on the old one.

4. **Efflux of Time**- With the passage of time, usage of asset is continual and it results into wear and tear of asset, which results to depreciation.

5. **Accidents**-The value of the asset mainly depends upon the efficiency and economy; which gets affected due to accident.



Example: Oil & Natural Gas Corporation Ltd. (ONGC) indulges in the process of new oil exploration projects through research projects. The new projects should then be identified and invested by huge initial investment outlay through the current revenues out of the existing projects on account of replacement due to depletion of resources.

6.5 Factors Affecting Depreciation

Depreciation is not an attempt to record the changes in the market value of the asset but a systematic allocation of the total cost of depreciable asset (capital expenditure) to expenses (revenue expenditure) over the useful life of the asset because market value of some assets may increase in short run but even then the depreciation process continues. Based on the matching principle a reasonable portion of capital expenditure (i.e. the cost of the asset) should be charged to revenue during the useful life of an asset.

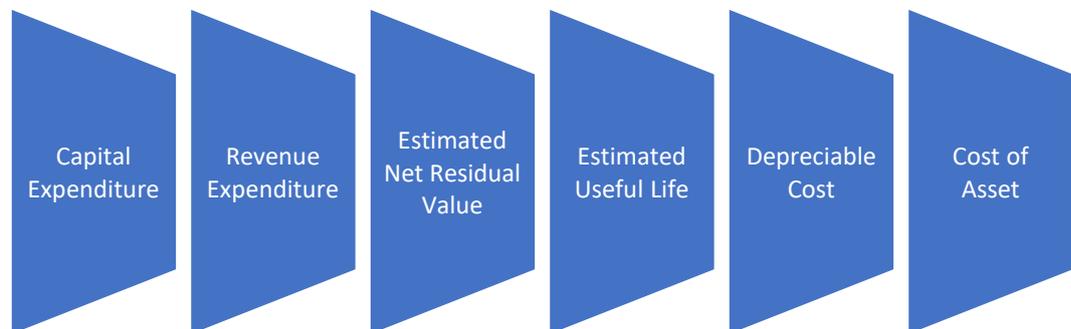


Fig 2: Factors affecting depreciation

1. **Actual Cost of the Asset**- Actual cost or historical cost means the acquisition cost of the asset and includes all incidental expenses which are necessary to bring the asset to its present condition and location. Examples of such expenses are installation charges, freight inwards or expenses incurred for improvements of such assets and which are of capital nature.

2. **Estimated Useful Life of the Asset**-The period over which a depreciable asset is expected to be used by the enterprise or the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

3. **Estimated Residual or Scrap Value of the Asset**-Residual or scrap value is the expected value which may be realized when the asset is sold or exchanged at the end of its estimated useful life. When residual value is significant, it should be taken into consideration for computing depreciation. However, an insignificant residual value can be ignored for computation of depreciation.

4. **Depreciable Cost**-Depreciation is a continuous process, but we don't record depreciation daily. Actually, the total amount of depreciation to be charged on any asset is an advance expenditure which has been paid by the enterprise at the time of acquisition of such asset.

5. **Revenue Expenditure**- Revenue expenditure or operating expenses constitute those costs which do not lead to asset creation. Under normal circumstances, operating expenses are incurred through business operations. Regardless, business entities must learn to manage such expenses to ensure profitability and sustainability of their business venture.

6. **Capital Expenditure**—Capital expenditures refer to funds that are used by a company for the purchase, improvement, or maintenance of long-term assets to improve the efficiency or capacity of the company. Long-term assets are usually physical, fixed and non-consumable assets such as property, equipment, or infrastructure, and that have a useful life of more than one accounting period.



CASE STUDY

The various authorities dealing with the controversy between capital and revenue expenditure came for review before the Hon'ble Madras High Court in *Chelpark Co. Ltd. v. Commissioner* (1991) 191 ITR 249 (Mad) and the Hon'ble High Court observed as below : "Whether a particular item of expenditure incurred by the assessee is of capital or revenue nature is a vexed question always invariably presenting difficulties. Decisions of the highest Court and other High Courts laying down tests for making a distinction between capital expenditure and revenue expenditure are legion. However, despite laying down the tests, a caution has also been administered by those decisions that the tests laid down are not exhaustive and that it is also not easy to reconcile the reasoning given in them. Even so, it has uniformly been emphasised in all the decisions that the character of the expenditure will have to be decided on the facts and circumstances of each case not by the application of rigid tests, but deriving support from many aspects of the whole lot of circumstances and the ultimate answer would depend upon a commonsense appreciation of the guiding features."

Source: Chelpark Company vs. Commissioner of Income Tax (Madras High Court)

6.6 Relevance in Industry

Depreciation expense is an operating expenses and/or cost of goods sold, but it is worthy of special mention due to its unusual nature. Depreciation results when a company purchases a fixed asset and expenses it over the entire period of its planned use, not just in the year purchased. Certain depreciation schedules to be followed for tax reasons. Depreciation is a noncash expense in that the cash flows out when the asset is purchased, but the cost is taken over a period of years depending on the type of asset.



Notes

Example

A sidewalk florist operates a cash only business. During the most recent year, this florist had cash revenues of Rs. 100,000. Its expenses included Rs. 70,000 of cash expenses and Rs. 8,000 of depreciation expense on its truck that was purchased in an earlier year. During the year there were no other revenues or expenses, and the florist's cash balance increased by Rs. 30,000. The florist's income statement will report net income of Rs. 22,000 (revenues of Rs. 100,000 minus expenses of Rs. 78,000).

Solution

The florist's statement of cash flows prepared under the indirect method will begin with net income of Rs. 22,000. It will then add the Rs. 8,000 of depreciation expense. The result is cash provided by operating activities of Rs. 30,000—which agrees to the business's change in its cash balance. The Rs. 8,000 of depreciation expense was not a source of cash, even though it appears as a positive amount on the statement of cash flows.

6.7 Methods of Charging Depreciation

There are various methods of charging depreciation. Different companies use different methods as per their policies or what their accountants decide. Out of all, the most common used methods are SLM and WDV.

1. **Depletion or Output method**—Depletion method of depreciation is mostly used by the companies that have assets that are natural resources like oil, gas, coal, mines, quarries or other wasting assets. This method is named as 'depletion method' because the reduction of a natural resource or asset is known as depletion of that resource or asset and thus is used to depreciate assets that are natural resources. Such assets are also referred as wasting assets because their value

deteriorates with the increasing extraction of resources. For example in case of a coal mine, more the coal is extracted more will be the depletion of the mine etc.

$$\text{Depletion Charge} = \frac{\text{Depletion Base} - \text{Salvage Value}}{\text{Total Units expected to be extracted}} \times \text{Units Extracted during the period}$$

2. **Machine hour rate method**-Machine hour rate is useful for calculating the value of different overheads fastly. Because depreciation is one of main overhead of the business, so, we can use machine hour rate method for calculating the value of depreciation. As per machine hour rate method of depreciation, we calculate the total life of any fixed asset on the basis of its working hours life. After this, we divide actual cost of fixed assets with life of fixed assets in hours. After dividing, we will obtain the depreciation rate per hour. This method will apply mostly on the machines.

Annual Depreciation

$$= \{ \text{Working of Machine in a Year} \} \times \text{Hourly Depreciation Rate}$$

(Calculate in hours)

3. **Sum of digits method**-The sum of the years' digits method is used to accelerate the recognition of depreciation. Doing so means that most of the depreciation associated with an asset is recognized in the first few years of its useful life. This method is also called the SYD method. The method is more appropriate than the more commonly-used straight-line depreciation if an asset depreciates more quickly or has greater production capacity in its earlier years than it does as it ages. The total amount of depreciation is identical no matter which depreciation method is used - the choice of depreciation method only alters the timing of depreciation recognition.

Annual Depreciation = Number of years of estimated life remaining at the beg. of the year / SYD

4. **Annuity method**-The annuity method of depreciation is a process used to calculate depreciation on an asset by calculating its rate of return as if it was an investment. This method requires the determination of the internal rate of return (IRR) on the cash inflows and outflows of the asset.

5. **Sinking fund method**-Sinking fund method is a method of calculating depreciation for an asset in which apart from calculating depreciation, it also keeps aside a fund for replacing the asset at the end of its useful life. This method is used when the assets that need to be replaced are of high cost.

$$A = \frac{\left(1 + \frac{r}{m}\right)^{n \times m} - 1}{\frac{r}{m}} \times P$$

6. **Insurance policy method**-This method is similar to Depreciation Fund Method. Under this method an Insurance policy is taken from an insurance company. The policy is taken for such a period that it matures when the asset is to be replaced. The procedure is same as the Depreciation Fund Method except that the amount of investment will be in the form premium paid on the insurance policy. The premium is paid at the beginning of each year and debited to Depreciation Fund Policy Account. The annual depreciation will be equal to the amount of annual premium and is debited to Profit and Loss Account and credited to Depreciation Fund Account at the end of the accounting year. Generally interest is not recorded yearly in this method. When the policy matures, the agreed sum is received from the Insurance Company and is used to purchase the new asset.

7. **Diminishing Balance or Written down method**-This method also has the same methodology in charging depreciation on the fixed assets like fixed percentage. Though it bears similar approach in charging depreciation, it is different in application from the straight line method. Under this method, the depreciation is charged on the value of the asset available at the beginning of the year. This method will be discussed in detail.

8. **Straight line method**-Under this method, depreciation is calculated as a fixed proportion on the original value of the asset. The depreciation is charged as fixed in volume on the original value of the asset at which it was purchased. The original value of the asset is nothing but the purchase value of the asset. This method will be discussed in detail.

6.8 Straight Line Method of Depreciation

With the straight-line depreciation method, the value of an asset is reduced uniformly over each period until it reaches its salvage value. Straight line depreciation is the most commonly used and straight forward depreciation method for allocating the cost of a capital asset. It is calculated by simply dividing the cost of an asset, less its salvage value, by the useful life of the asset.

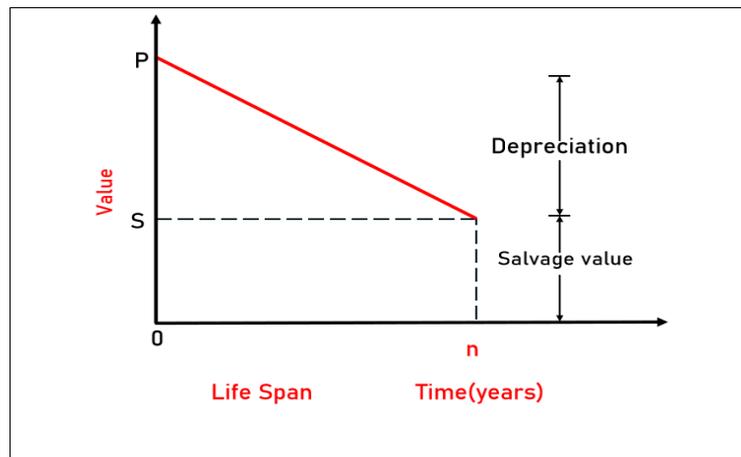


Fig 6.3: SLM affect on asset value

6.9 Important terms used for SLM

There are few terms which are specifically used for calculating depreciation and asset value under straight line method.

- **Salvage value**-Salvage value is the estimated book value of an asset after depreciation is complete, based on what a company expects to receive in exchange for the asset at the end of its useful life. As such, an asset's estimated salvage value is an important component in the calculation of a depreciation schedule.
- **Cost of asset**-The original cost of an asset takes into consideration all of the items that can be attributed to its purchase and to putting the asset to use.
- **Depreciation method**- The method to choose by the company officials for computing the correct value of asset and depreciation levied on it.
- **Useful life**-Useful life is the estimated lifespan of a depreciable fixed asset, during which it can be expected to contribute to company operations. This is an important concept in accounting, since a fixed asset is depreciated over its useful life.

6.10 Straight Line Method - Formula

The following formula is used for calculating the annual depreciation under SLM.

$$\text{Depreciation} = (\text{Cost of the machine} - \text{Scrap value}) / \text{Economic Life period of the asset in years}$$

6.11 Steps to Calculate Straight Line Depreciation

Following steps are followed for calculating depreciation amount using SLM:

- Determine the cost of the asset.
- Subtract the estimated salvage value of the asset from the cost of the asset to get the total depreciable amount.
- Determine the useful life of the asset.
- Divide the sum of step (2) by the number arrived at in step (3) to get the annual depreciation amount.



Example: Income statement – the depreciation expense is calculated by taking the purchase price(80), deducting the scrap value(30) and dividing the difference by 4 years. This gives us a depreciation expense of 12.5 a year. So the, impact of Depreciation is shown below:

$$\text{Depreciation} = \frac{80 - 30}{4} = 12.5$$

6.12 Advantages of Straight Line Method

Following are the benefits to companies for using SLM while computing asset value and depreciation amount:

- The simplicity of this method makes it easy to understand and apply.
- Full depreciable cost of the asset in case of asset depreciation up to zero value or net scrap value can be facilitated.
- Same amount of depreciation charged in profit and loss account every year makes it easy to compare the profits for different years.
- This method is useful for the assets whose usage is consistent every year and whose useful span can be accurately guessed.
- This method can be easily applied to long term assets.

6.13 Disadvantages of Straight Line Method

Although this method is quite easy to use but still there are few drawbacks of it, which are as follow:

- When the comparison for two years is done for the usage of asset, this method does not reflect accurately the difference of usage in the asset.
- Matching of cost and revenue is not necessary when this method is used for long term assets
- Rapidly developing technologies in software accounting field restricts the usage of straight line depreciation method for certain depreciable assets.

Problem: 1

Original Value of Investment= Rs. 1,00,000

Scrap Value= Rs. 10,000

Life of the asset= 5 Years

Solution

$$\begin{aligned} \text{Depreciation} &= 1,00,000 - 10,000 / 5 \text{ years} \\ &= 90,000 / 5 \text{ years} \\ &= \text{Rs. } 18,000 \end{aligned}$$

To understand the methodology of straight line depreciation, the following table will illustrate the process

Value of the asset (Begin) (₹)	Depreciation (₹)	Value of the asset (End) (₹)
1 st year - 1,00,000	18,000	82,000
2 nd year - 82,000	18,000	64,000
3 rd year - 64,000	18,000	46,000
4 th year - 46,000	18,000	28,000
5 th year- 28,000	18,000	10,000 (Scrap Value)*

The scrap value of the asset is exposed to realize only at the end of the life period of the asset i.e. 5 years.

Problem: 2

Anil purchased a machine on 1 Jan 2018 for ₹400,000. The useful life of the machine is 3 years and its estimated residual value is ₹40,000. At the end of its useful life, the machine is sold for ₹50,000.

Prepare the necessary ledger accounts in the books of Anil for the year ending 31st December every year using SLM for depreciation.

Solution

$$\begin{aligned} \text{Depreciation} &= (\text{Cost of Asset} - \text{Net Residual Value}) / \text{Useful life} \\ &= (400000 - 40000) / 3 \\ &= 120000 \text{ p.a.} \end{aligned}$$

Depreciation a/c

Date	Particulars	Amount	Date	Particulars	Amount
31, dec, 2018	To Machinery a/c	1,20,000	31, dec, 2018	By Profit & Loss a/c	1,20,000
31, dec, 2019	To Machinery a/c	1,20,000	31, dec, 2019	By Profit & Loss a/c	1,20,000
31, dec, 2020	To Machinery a/c	1,20,000	31, dec, 2020	By Profit & Loss a/c	1,20,000

Mr. Ramesh purchased a second hand machine for Rs. 24,000 on 1st April, 2018. He spend Rs. 10,000 on its overhaul and installation. Depreciation is written off 10% p.a. on the original cost. On 30th June, 2020 machine was found to be unsuitable and sold for Rs. 19,000. Prepare the machine account from 2018 to 2020 assuming that accounts are closed on 31st December, every year.

6.14 Written Down Value Method of Depreciation

Written down value or the reducing balance method of depreciation is a method in which depreciation is calculated at a fixed percentage on the original cost in the first year. However, in the subsequent years, depreciation is calculated at the same fixed percentage not on the original cost but on the written down values gradually reducing during the expected working life of the Asset due to charge of depreciation. The rate of depreciation is a fixed percentage but in this case the amount allocated every year gradually decrease.

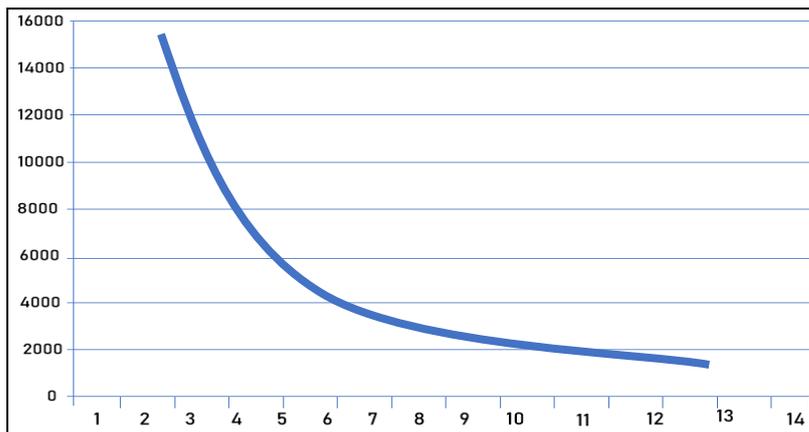


Fig 6.4: WDV affect on asset value

6.15 Important terms used in Written Down Value Method

There are few terms which are specifically used for calculating depreciation and asset value under written down value method.

- **Reducing Value**-The reducing-balance method, also known as the declining balance method. In the initial years of an asset's service, apply the same depreciation rate each year to what's called the "adjusted basis" of the property.
- **Cost of asset**-The original cost of an asset takes into consideration all of the items that can be attributed to its purchase and to putting the asset to use.
- **Fixed percentage of depreciation on asset value**- The amount of depreciation applied is different but the percentage applied on asset value is same and fixed year on year.

6.16 Written Down Value Method - Formula

The following formula is used for calculating the annual depreciation under WDV.

$$\text{Depreciation expense} = \text{Book value} \times \text{rate}(\%)$$

****Book value = Cost Price - Accumulated Depreciation**



Example:

A company purchased a Machinery costing \$12,000 with a useful life of 5 years and residual value is \$2000. Rate of depreciation is 20%. Calculate the depreciation and value of machinery of each year.

Solution:

A	B	C	D
Year	Depreciation	Depreciation	Value at End of Year
1	20%(\$12000-\$2000)	\$2,000	\$8,000
2	20%*(\$8000)	\$1,600	\$6,400
3	20%*(\$6400)	\$1,280	\$5,120
4	20%*(\$5120)	\$1,024	\$4,096
5	20%*(\$4096)	\$819	\$3,277

6.17 Advantages of Written Down Value Method

Following are the benefits to companies for using WDV while computing asset value and depreciation amount:

- This method is simple to understand and easy to operate. A separate calculation need not be made in respect of every addition to the main asset.
- The amount of annual depreciation reduces with the reducing balance of the asset.
- The amount of depreciation is higher in the earlier years when the machine is efficient, and the cost of repairs is low and vice versa. This helps in eliminating huge variations in annual profits or losses.
- This method takes care of the obsolescence problem related to the assets as the major part of depreciation is charged in the earlier year Due to this feature replacement of the assets before the end of its estimated useful life becomes easy and feasible.
- This method is recognized by tax authorities and other legal bodies.

6.18 Disadvantages of Written Down Value Method

Although this method is quite easy to use but still there are few drawbacks of it, which are as follow:

- Under this method the book value of an asset cannot be reduced to zero.
- The rate of depreciation has to be very high if the written down value is to be brought down to its estimated scrap value.
- This method is not suitable for an asset having a very short life. The calculation of the rate of the depreciation becomes very difficult and creates problems in this case.

Problem 3

Life of the asset (n) = 3 years

Expected scrap value at the end of 3 years = Rs. 12,800

Original Investment = Rs. 2,00,000.

The percentage of depreciation to be charged is 60%

Find out the value of the asset as on a particular date using WDV.

Solution:

Particulars	Amount (Rs.)
The value of the Asset at the beginning of 1st Year	2,00,000
(-) Depreciation 60% on Rs. 2,00,000 (Original value)	(1,20,000)
Value of the asset at the beginning of 2nd Year	80,000
(-) Depreciation 60% on Rs. 1,20,000.(Book Value)	(48,000)
Value of the asset at the beginning of 3rd Year	32,000
(-) Depreciation 60% on Rs. 32,000 (Book Value)	(19,200)
Value of the asset at the end of the year	12,800

6.19 Difference between SLM and WDV

Basic For Comparison	SLM	WDV
Meaning	In this method of depreciation, the cost of the asset is spread equally over the life years by writing off a fixed amount every year.	In this method of depreciation, a fixed rate of depreciation is charged on the book value of the asset over its useful life.
Calculation of depreciation	On original cost	On written down value of the asset
Annual depreciation charge	Remains fixed during then useful life	Reduces every year
Value of asset	Completely written off	Not completely written off
Amount of depreciation	Initially lower	Initially higher
Impact of repairs and depreciation on P&L A/C	Increasing trend	Remains constant

Problem 4

Cost of equipment = ₹ 8,000

Estimated useful life = 4 years

Scrap value at the end of useful life = ₹ 500

Depreciation rate for reducing balance method = 50%

Solution:

(i) Computation of Depreciation under SLM:

$$\begin{aligned} \text{Dep.} &= ₹ 8000 - ₹ 500 / 4 \text{ years} \\ &= ₹ 1875 \end{aligned}$$

(ii) Rate of depreciation for reducing balance method is 50%

$$\text{Dep.} = \text{Net Book value} * 50\%$$

For better understanding of calculation of depreciation and asset value is below:

	Straight-line	Reducing Balance
	₹	₹
Cost	8000	8000
Depreciation-year 1	<u>1875</u>	<u>4000</u>
Net book value	6125	4000
Depreciation-year 2	<u>1875</u>	<u>2000</u>
Net book value	4250	2000
Depreciation-year 3	<u>1875</u>	<u>1000</u>
Net book value	2375	1000
Depreciation-year 1	<u>1875</u>	<u>500</u>
Net book value	<u>500</u>	<u>500</u>

6.20 Amortization and its application

Amortization is an accounting term that refers to the process of allocating the cost of an intangible asset over a period of time. It also refers to the repayment of loan principal over time.

In business, amortization allocates a lump sum amount to different time periods. Amortization is also applied to capital expenditures of certain assets under accounting rules, particularly intangible assets, in a manner analogous to depreciation. In tax laws, amortization refers to the cost recovery system for intangible property. In computer science, amortized analysis is a method of analysing the execution cost of algorithms over a sequence of operations.

6.21 Depletion

The term 'Depletion' refers to the physical deterioration by the exhaustion of natural resources, like, quarries, mines, oil-wells, etc. is depleted/reduced. In case of such assets, usually depreciation is charged on the basis of quantity produced.

Summary

- Depreciation means reduction in value of asset or in the utility due to passage of time, natural wear and tear, exhaustion of the subject matter.
- Depreciation is charged on fixed assets only. e.g., building, plant and machinery, furniture etc. There is no depreciation on current assets – such as stock, debtors, bills receivable etc.
- Depreciation is a non-cash expense. It does not involve any cash flow.
- To have an effective matching against the revenues on every year, the amount of purchase has to be stretched. The stretching of expenses into many years is known as depreciation.
- Based on the matching principle a reasonable portion of capital expenditure (i.e. the cost of the asset) should be charged to revenue during the useful life of an asset.

- Depreciation expense is an operating expenses and/or cost of goods sold, but it is worthy of special mention due to its unusual nature.
- Straight line depreciation is the most commonly used and straight forward depreciation method for allocating the cost of a capital asset. It is calculated by simply dividing the cost of an asset, less its salvage value, by the useful life of the asset.
- Salvage value is the estimated book value of an asset after depreciation is complete, based on what a company expects to receive in exchange for the asset at the end of its useful life.
- Written down value or the reducing balance method of depreciation is a method in which depreciation is calculated at a fixed percentage on the original cost in the first year.
- Amortization is an accounting term that refers to the process of allocating the cost of an intangible asset over a period of time.
- The term 'Depletion' refers to the physical deterioration by the exhaustion of natural resources.

Keywords

- **Depreciation**- It is the reduction in the value of a fixed asset occasioned by physical wear and tear, obsolescence or the passage of time.
- **Revenue expenditure**- It is an operating expenses constitute those costs which do not lead to asset creation.
- **Capital expenditure**- It refer to funds that are used by a company for the purchase, improvement, or maintenance of long-term assets to improve the efficiency or capacity of the company.

Self Assessment

1. Value of portion of fixed assets utilized for generating revenue must be charged during a particular accounting year to ascertain the true cost, is called as _____.

- A. Depletion
- B. Depreciation
- C. Amortization
- D. Obsolesce

2. Depreciation means reduction in value of _____or in the utility due to passage of time.

- A. Equity
- B. Reserves]
- C. Liability
- D. Asset

3. The physical deterioration by the exhaustion of natural resources is called _____.

- A. Depletion
- B. Depreciation
- C. Amortization
- D. Obsolesce

4. Amortization refers to the cost recovery system for _____property.

- A. Intangible
- B. Tangible
- C. Current
- D. Contingent

5. Items which are not covered under fixed assets for depreciation is/are_____.

- A. Forests

- B. Wasting assets
- C. Livestock
- D. All above
6. With the straight-line depreciation method, the value of an asset is reduced _____ over each period.
- A. Continuously
- B. Uniformly
- C. Periodically
- D. Flexibly
7. Straight line depreciation is applied on asset, until it reaches its _____ value.
- A. Realization
- B. Nominal
- C. Book
- D. Salvage
8. Original Value of Investment= Rs. 1,00,000; Scrap Value= Rs. 10,000; Life of the asset= 5 Years. What is depreciation?
- A. Rs. 18,000
- B. Rs. 90,000
- C. Rs. 20,000
- D. Rs. 2000
9. Original Value of Investment= Rs. 80; Scrap Value= Rs. 30; Life of the asset= 4 Years. What is depreciation?
- A. Rs. 20
- B. Rs. 12.5
- C. Rs. 7.5
- D. Rs. 27.5
10. SLM is calculated by simply dividing the cost of an asset, _____ its salvage value, by the useful life of the asset.
- A. Add
- B. Divide
- C. Multiply
- D. Less
11. Written Down Value Method of depreciation is also known as _____.
- A. Increasing value
- B. Diminishing value
- C. Parallel line
- D. Uniform rate
12. Written down depreciation is calculated at a _____ percentage on the value of asset each year.
- A. Fluctuating
- B. Subsequent
- C. Flexible
- D. Fixed
13. In WDV, the amount of depreciation _____ each year.

- A. Reduces
 B. Increase
 C. Remains same
 D. Changes

14. Cost of equipment = ₹ 8,000; Estimated useful life = 4 years; Depreciation rate for reducing balance method = 50%. Calculate depreciation under WDV method.

- A. Rs. 4250
 B. Rs. 2000
 C. Rs. 3750
 D. Rs. 4000

15. A company purchased a Machinery costing Rs. 12,000 with a useful life of 5 years and residual value is Rs. 2000. Rate of depreciation is 20%. Calculate depreciation amount using WDV.

- A. Rs. 400
 B. Rs. 1000
 C. Rs. 2400
 D. Rs. 2000

Answers: Self Assessment

- | | | | | |
|-------|-------|-------|-------|-------|
| 1. B | 2. D | 3. A | 4. A | 5. D |
| 6. B | 7. D | 8. A | 9. B | 10. D |
| 11. B | 12. D | 13. A | 14. D | 15. D |

Review Questions

- Why is it being considered as a cumbersome task in matching?
- What are the items which are not covered under fixed assets?
- Discuss the various methods of charging depreciation with examples?
- Distinguish between SLM and WDV with examples?
- Mr. Shiv purchased a machine for Rs. 90,000 on 1st April 2018. Its probable working life was estimated at 3 years and its probable scrap value at the end of that time is Rs. 10,000. You are required to compute the depreciation amount and asset value for 3 years.
- Ms. Rabia is a trader. She bought furniture costing Rs. 2,20,000 for his new branch on 1st April, 2017. As the furniture bought was superior quality material. The auditors estimated its residual value at Rs. 20,000 after a working life of ten years. Further additions were made into the same category on 1st Oct, 2018 and 1st April, 2019 costing Rs. 16,800 and Rs. 19,000 (with a scrap value of Rs. 800 and Rs. 1000 respectively). The trader closed his accounts on 31st March every year and apply straight line method of depreciation. Show the depreciation and furniture value at the closing of each year for 4 years.
- On 1st April, 2018, a firm purchases machinery worth Rs. 3,00,000. On 1st October, 2019 it buys additional machinery worth Rs. 60,000 and spends Rs. 6,000 on its erection. The accounts are closed normally on 31 March each year. Assuming the annual depreciation to be 10%, show the machinery account for 3 years under the written down value method.
- Golden Transport Company, New Delhi purchased 3 Trucks at Rs. 4,00,000 each on 1st Jan 2017 from the dealer. The company decided to charge 20% deprecation on the basis of original cost of trucks. Prepare Trucks A/c for 3 years and find out its w.d.v. at the end of 3rd year.
- What do you mean by term amortization? Also, discuss its application?
- Discuss the advantages and disadvantages of SLM and WDV?



Further Readings

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R. L. Gupta and Radhaswamy, "Advanced Accountancy".

S. N. Maheswari, "Management Accounting".

V. K. Goyal, "Financial Accounting", Excel Books, New Delhi



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Unit 07: Inventory Valuation

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Introduction

- 7.1 Concept and Meaning
- 7.2 Methods of Recording Inventory
- 7.3 Difference between Perpetual Inventory System and Periodic Inventory System
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- 7.14 Measurement of inventories and Techniques to measure cost
- 7.15 Disclosure in Ind AS 2

SUMMARY

Keywords

Self Assessment

Answers: Self Assessment

Review Questions

Further readings

Objectives

After this Unit, student will be able to:

- Recognize the concept of inventory valuation.
- Cognize the methods of recording and valuation of inventories.
- Comprehend the suitability of inventory valuation techniques.
- Appreciate the suitability of FIFO, LIFO and WAC in real life.
- Use accounting treatment of FIFO, LIFO and WAC in corporate world
- Review the provisions for valuation of inventories as per Ind AS 2.
- Apprehend the suitability and applicability of inventory valuation.

Introduction

Inventory valuation is the monetary amount associated with the goods in the inventory at the end of an accounting period. The valuation is based on the costs incurred to acquire the inventory and get it ready for sale.

Inventories are the largest current business assets. Inventory valuation allows you to evaluate your Cost of Goods Sold (COGS) and, ultimately business profitability.

Inventory valuation is an accounting practice that is followed by companies to find out the value of unsold inventory stock at the time they are preparing their financial statements. Inventory or stock is an asset for an organization, and to record it in the balance sheet, it needs to have a financial value. This value can help you determine inventory turnover ratio, which in turn will help to plan the purchasing decisions.



Example, If you run a shoe business and you're left with 50 pairs of shoes at the end of the year, then you need to calculate their financial value and record it in your balance sheet.

7.1 Concept and Meaning

The meaning of the word "inventory is "stock" of goods. To the finance manager, inventory connotes the value of raw materials, consumable, spares, work-in-progress, finished goods and scrap in which a company's funds have been invested. It constitutes the second largest items after fixed assets in the financial statements, particularly of manufacturing organization. Inventory is the term for the goods available for sale and raw materials used to produce goods available for sale. Inventory represents one of the most important assets of a business because the turnover of inventory represents one of the primary sources of revenue generation and subsequent earnings for the company's shareholders.

According to, International Accounting Standard-2 (IAS-2), 'Inventories' mean tangible property held, for sale in the ordinary course of business, in the process of production for such sale, or for consumption in the production of goods or services for sale.



Fig 7.1: Understanding concept of Inventory

Objectives of Inventory Valuation

Although inventory itself is an important part of business. But in order to maintain it at adequate level, there are few objectives for it. Besides to measure liquidity position and locate wastage, companies value the stock to check income and financial position of companies.

- **Determination of Income-** To calculate accurate profit or loss for a certain period, it is necessary to value inventory properly. Profit is the excess of sales over cost of sales. Cost of Sales is equal to Opening stock plus Purchases plus Direct Expenses minus closing stock. Hence, if stock is not valued correctly, profit will not be accurate. Survival of a business depends upon its capacity to earn income. Cost is ascertained by the inventory equation. The cost, which is the cost of goods sold, is deducted from sales revenue. Proper determination of gross profit, therefore, necessitates correct valuation of closing inventory.
- **Determination of Financial Position-** At the end of the accounting period, position of various assets and liabilities is presented in the Balance Sheet. Inventory is one of the items of assets shown in Balance Sheet. If inventory is not valued properly, correct financial position of the business will not be reflected in Balance Sheet.

Basic Principle of Inventory Valuation

As per the AS 2, there is one basic principle for inventory valuation. This principle comes from the conservative system of accounting. As per basic principle, inventory should be valued at the lower of cost or net realizable value. Moreover, the principle states that, record it at the lower amount amongst the two in accordance with the conservative cost approach. To understand this principle, let us discuss the concept of cost and net realizable value as follow:

- **Cost-** Cost of the inventory includes the cost of purchase of the materials. In this, add the cost of conversion. These will be the direct expenses of the manufacturing process like direct material and direct labor etc. Any other costs to bring the inventory to its current condition will form a part of this cost. Abnormal losses, storage, distribution and selling costs will be avoided.
- **Net Realizable Value-** It is the estimated price of a finished good after deducting the costs to make the sale. In the case of raw materials, it will be the replacement cost of the raw materials, i.e. their market price and for WIP it will be the selling price minus the cost of conversion.

7.2 Methods of Recording Inventory

The records of quantity and value of inventory can be made in two ways.

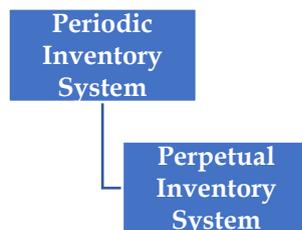


Fig 7.2: Methods of Inventory Valuation

- **Periodic Inventory System-** In the periodic inventory system, the inventory verification is done by an actual physical count of the inventory on any given date. To determine the closing stock a physical count of the inventory (numbers, weight etc.) will be taken. The valuation of the inventory is done using one of the various inventory pricing methods, i.e. LIFO, FIFO, Average Cost etc. Formula used to compute inventory under periodic system is:

$$\text{Opening Stock (known) + Purchases during the year (known) - Closing Stock (counted) = COGS (balancing figure)}$$

In big business houses, annual stock taking may even take a week at the end of the year in finalising the stock in hand on continuous basis. For stock taking, stock sheets are used. The firms evolve such stock sheet on which all the relevant information like particulars of inventory, numbers of units, price per unit, total value, etc. can be listed. This method offers the advantage of *simplicity*. However, the limitation of this method is that *discrepancies and losses* in inventory will never come to light as it makes no accounting for theft, losses, shrinkage and wastage.

- **Perpetual Inventory System-** Perpetual Inventory System, require continuous recording of the stock. This means the inventory is recorded after every issue or purchase/receipt of raw materials, final goods, work in progress etc. To ensure the accuracy, physical counts of the inventory are done a few times in a year, which helps in cross-check the inventory and validity of the perpetual inventory system. In the perpetual inventory system, the value of the closing stock will be determined by the cost of goods issued and cost of goods sold. Formula used to compute inventory under perpetual system is:

$$\text{Opening Stock (Value known) + Purchases during the year (known) - COGS (known) = Closing Stock (Balancing Figure)}$$

The stores ledger will give the balance of raw materials, work-in-progress and finished goods on hand. The management helps in ascertaining the discrepancies immediately and

also, provide for continuous stock-taking which helps in comparing the physical balance with book balance. The main advantage is that it *provides details about the quantity* and value of stock of each item all times. Thus it provides a basis for control. The main drawback of this system is that it requires elaborate organisation and records and, therefore, it is more *expensive*.

7.3 Difference between Perpetual Inventory System and Periodic Inventory System

Continuous stock taking	Periodic stock taking
Permanent personnel are required.	Person from other department or temporary committee can be appointed.
Held throughout the year.	Generally held once in a year.
Normal and routine work will not be affected.	All work will be paralysed.
Discrepancies can be rectified without delay.	There is delay in taking actions.
All items are not checked. Items are selected at random and selection of items is kept secret.	All items are checked.
It's a costly affair.	It is a cheaper method.

7.4 Significance of Inventory Valuation

There are several benefits of computing inventory for companies to have better control on costs and determine the profits. Following are few of it:

1. **Helps Determine Income-** To calculate the gross profit or loss for the year, companies match the cost of goods sold to the direct revenue of an accounting period. Inventory valuation will have a major impact on income determination if valuations are over or understated, this can be explained as:
 - When closing inventory is overstated, net income for the accounting period will be overstated.
 - When opening inventory is overstated, net income for the accounting period will be understated.
 - When closing inventory is understated, net income for the accounting period will be understated.
 - When opening inventory is understated, net income for the accounting period will be overstated.

So, inventory valuation (closing inventory) has a direct impact on income determination of a firm. The misstatement or miscalculation of inventory can overstate or understate the profits of the firm.

2. **Helps Determine Financial Position-** Inventory is not only a part of the Profit and Loss statement but also of the Balance Sheet, Inventories are considered as Current Assets of a firm. So it is very important to have precise and correct inventory valuation. If the calculated value of the inventory is wrong it will represent a wrong financial position on the date of the balance sheet.
3. **Liquidity Analysis-** Inventory is a current asset because the firm is not expected to hold it for a long period of time. There is a lot of turnovers when it comes to stock. So inventory actually is a significant portion of the working capital of a company. It is important to value it correctly

so the current ratio and liquid ratios can be calculated accurately. These ratios are important to check for the liquidity of a company.

4. **Statutory Compliance-** Inventory valuation is not statutory compliance under the Companies Act 2013. In accordance with the Accounting Standard (AS2), all firms now have to disclose the valuation of each class of inventory. The disclosure must include accounting policies adopted for the inventory valuation. The total amount of the inventories along with the classifications (raw materials, WIP, finished goods etc.)

7.5 Methods of Inventory Valuation

There is a requirement to record inventory and also to value it. To compute inventory and show it in financial statements, it must be adhere at adequate methods.

- **Specific Identification-** Under this method, every item in your inventory is tracked from the time it is stocked to when it is sold. It is usually used for large items that can be easily identified and have widely different features and costs associated with these features. The primary requirement of this method is that you should be able to track every item individually with RFID tag, stamped receipt date or a serial number. While this method introduces a high degree of accuracy to the valuation of inventory, it is restricted to valuing rare, high-value items for which such differentiation is needed.
- **Market Price-** Under this concept, 'market prices/value' is considered as the 'net realisable value' which is equal to the estimated selling price in the ordinary course of business minus the cost of completion. This method of valuation of inventories is particularly followed where the inventories are damaged or partially obsolete.
- **Valuation of closing stock-** Under this method, inventories will be valued based on last purchase cost as the reference point for calculating the stock value. This costing method is suitable when you to value the closing balance based on the latest cost.
- **Weighted Average cost-** Under the weighted average cost method, the weighted average is used to determine the amount that goes into the cost of goods sold and inventory. This method is commonly used to determine a cost for units that are indistinguishable from one another and it is difficult to track the individual costs. Weighted average cost per unit is calculated as follows
- **Base stock-** The base stock method is a valuation technique for the inventory asset, where the minimum amount of inventory needed to maintain operations is recorded at its acquisition cost, while the LIFO method is applied to all additional inventory.
- **Inflated price-** In such cases, the material are issued at an inflated price (a price higher than the actual cost) so as to recover the cost of natural wastage of materials from the production. In this way, the total cost of the materials is recovered from the production.
- **LIFO-** Under this inventory valuation method, the assumption is that the newer inventory is sold first while the older inventory remains in stock. This method is hardly used by businesses since the older inventories are rarely sold and gradually lose their value. This results in significant loss to the business. The only reason to use LIFO is when businesses expect the inventory cost to increase over time and lead to a price inflation. By moving high-cost inventories to cost of goods sold, the reported profit levels businesses can be lowered. This allows businesses to pay less tax.
- **FIFO-** This method is based on the premise that the first inventory purchased is the first to be sold. The remaining assets in inventory are matched to the assets that are most recently purchased or produced. It is one of the most common methods of inventory valuation used by businesses as it is simple and easy to understand. During inflation, the FIFO method yields a higher value of the ending inventory, lower cost of goods sold, and a higher gross profit. Unfortunately, the FIFO model fails to present an accurate depiction of the costs when there is a rapid hike in prices. Also, unlike the LIFO method, it does not offer any tax advantages.
- **HIFO-** HIFO takes the view that you will sell your most expensive goods first. This is probably true of salespeople working on commission! It thus gives a short-term bump to revenue. But gross profit and taxable income drops because COGS is higher, and ending inventory is lower.

7.6 Process of Inventory Valuation

There is a detailed and lengthy process, which is followed properly to value or compute the inventory in an organization. The goods i.e. raw material being shipped to factory or production houses. Afterwards, they are shifted at their appropriate places for production and if something needs to be stored for future contingencies, that raw material is shifted at warehouses. Then after production goes complete and goods are converted into finished form, the quality is tested by committee and if all tests are appropriate then, they are sent for distribution in market. Further, the goods which are kept at warehouses are simultaneously used for production purpose. In this way, the proper procedure is followed to compute the goods purchased. Goods sold and goods stored in warehouses. Following picture shows it more clearly:

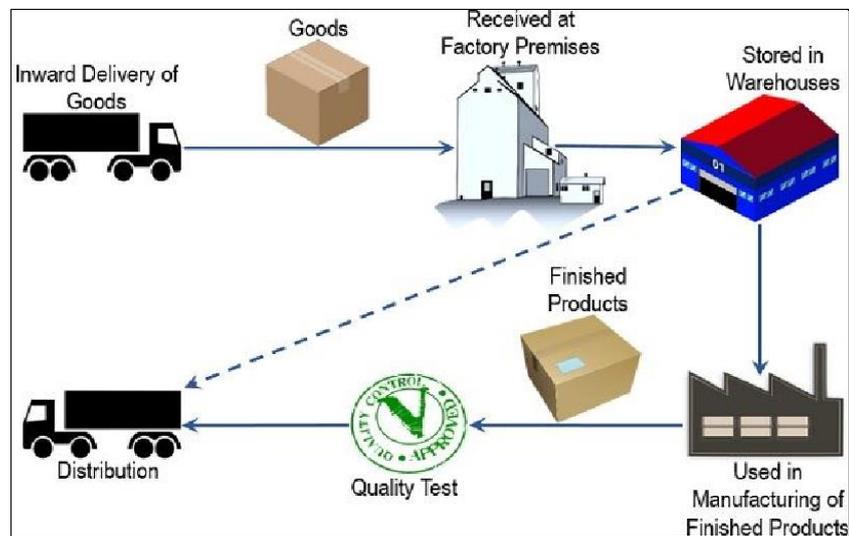


Fig 7.3: Procedure to compute Inventory

7.7 FIFO: First In First Out

FIFO is based on the assumption that the materials which are purchased first are issued first. Issues of inventory are priced in order of their purchases. Inventory issues/sales are priced on the same basis until the first lot of material of goods purchased is exhausted.

First In, First Out, known as FIFO, is an asset-management and valuation method in which assets produced or acquired first are sold, used, or disposed of first. For tax purposes, FIFO assumes that assets with the oldest costs are included in the income statement's cost of goods sold (COGS). The remaining inventory assets are matched to the assets that are most recently purchased or produced.

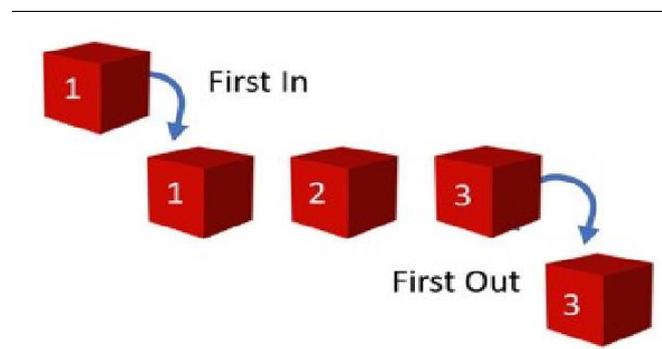


Fig 7.4: FIFO

How First In, First Out (FIFO) Works

The FIFO method is used for cost flow assumption purposes. In manufacturing, as items progress to later development stages and as finished inventory items are sold, the associated costs with that product must be recognized as an expense. Under FIFO, it is assumed that the cost of inventory purchased first will be recognized first. The dollar value of total inventory decreases in this process because inventory has been removed from the company's ownership.

Special Considerations

Typical economic situations involve inflationary markets and rising prices. In this situation, if FIFO assigns the oldest costs to cost of goods sold, these oldest costs will theoretically be priced lower than the most recent inventory purchased at current inflated prices. This lower expense results in higher net income. Also, because the newest inventory was purchased at generally higher prices, the ending inventory balance is inflated.

FIFO Computation

To calculate COGS (Cost of Goods Sold) using the FIFO method, determine the cost of your oldest inventory. Multiply that cost by the amount of inventory sold. The "inventory sold" refers to the cost of purchased goods (with the intention of reselling), or the cost of produced goods (which includes labor, material & manufacturing overhead costs). Keep in mind that the prices paid by a company for its inventory often fluctuate. These fluctuating costs must be taken into account.

Advantages of FIFO

There are several benefits of FIFO which are followed by companies.

- The method is easy to understand and universally accepted and trusted.
- It follows the natural flow of inventory as it makes bookkeeping easier with less chance of mistakes.
- There are chances of less waste as the goods bought first are sold first.
- Remaining products in inventory will be a better reflection of market value.
- There are chances of higher profit as the goods bought later are sold later and chances of profitability are more.
- Financial statements are harder to manipulate as the market price reflect in company accounts .
- Easy to operate as it provides the prices of materials do not fluctuate frequently.
- It is a realistic method because it takes into account the normal procedure of issuing goods/inventory, i.e., the materials are issued to production in the order of their receipts.
- As it is based on historical cost, no unrealized profit enters into the financial statements for the period.

Disadvantages of FIFO

Though many benefits are there for FIFO but still there are some drawbacks of it, following are those disadvantages:

- The FIFO method can result in higher income tax for a business to pay because the gap between costs and profit is wider.
- A company also needs to be careful with the FIFO method in that it is not overstating profit.
- When product costs rise and these later numbers are used in the cost of goods calculation instead of the actual costs.
- Because of violent changes in prices of materials, it involves somewhat complicated calculations and, therefore, increase the changes of clerical errors.
- The prices of issues of materials may not reflect current market prices and, therefore, during the period of inflation, the charge to production is unreasonably low.
- Comparison between different jobs executed by the firm becomes sometimes difficult.

Suitability of FIFO

- FIFO method is considered more suitable during the periods of falling prices.
- This method is suitable when the size of purchases is large but not much frequent.
- The moderate fluctuations in the prices of materials, and easy comparison between different jobs are also the important conditions for the use of this method.

7.8 Accounting Treatment of FIFO

Problem 1

T Co. Recorded stores ledger and followed FIFO. The transactions occur are as followed:

1. 1st = Purchased 20 units @ Rs. 150 each
2. 7th = Purchased 30 units @ Rs. 200 each
3. 8th = Issued 40 Units
4. 15th = Purchased 40 units @ Rs. 250 each
5. 20th = Issues 30 units
6. 24th = Purchased 20 units @ Rs. 300 each

Solution

Date	Acceptance			Dispatch			Balance		
	Quantity	Unit Cost	Price	Quantity	Unit Cost	Price	Quantity	Unit Cost	Price
1	20	150	3,000				20	150	3,000
7	30	200	6,000				20	150	3,000
							30	200	6,000
8				40		7,000	10	200	2,000
				(20)	150	(3,000)			
				(20)	200	(4,000)			
15	40	250	10,000				10	200	2,000
							40	250	10,000
20				30		7,000	20	250	5,000
				(10)	200	(2,000)			
				(20)	250	(5,000)			
24	20	300	6,000				20	250	5,000
							20	300	6,000
	110		25,000	70		14,000			

$$(250 \times 20) + (300 \times 20) = 11,000$$

Problem 2

- 1). 01.03.19 Opening stock 100 units @ \$1.75
- 2). 05.03.19 Purchased 150 units @ \$1.50
- 3). 12.03.19 Purchased 300 @ \$1.60
- 4). 08.03.19 Issued 200 units.
- 5). 18.03.09 Issued 250 units.

Assuming this business used the FIFO method, what would the rates be for the above issues of inventory?

Solution

Date	Receipts			Issued			Balance		
	Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
1/3/19							100	1.75	175
5/3/19	150	1.5	225				100 150	1.75 1.5	175 225
8/3/19				200 --100 --100	1.75 1.5	175 150	50	1.5	75
12/3/19	300	1.6	480				50 300	1.5 1.6	75 480
18/3/19				250 --50 --200	1.5 1.6	75 320	100	1.6	160

7.9 LIFO: Last In First Out

Under this method, it is assumed that the material/ goods purchased in the last are issued first for production and those received first issued/sold last. In case a new delivery is received before the first lot is fully used, price become the 'last-in' price and is used for pricing issued until either the lot is exhausted, or a new delivery is received.

The last in, first out (LIFO) method is used to place an accounting value on inventory. The LIFO method operates under the assumption that the last item of inventory purchased is the first one sold. The trouble with the LIFO scenario is that it is rarely encountered in practice. If a company were to use the process flow embodied by LIFO, a significant part of its inventory would be very old, and likely obsolete. Nonetheless, a company does not actually have to experience the LIFO process flow in order to use the method to calculate its inventory valuation.

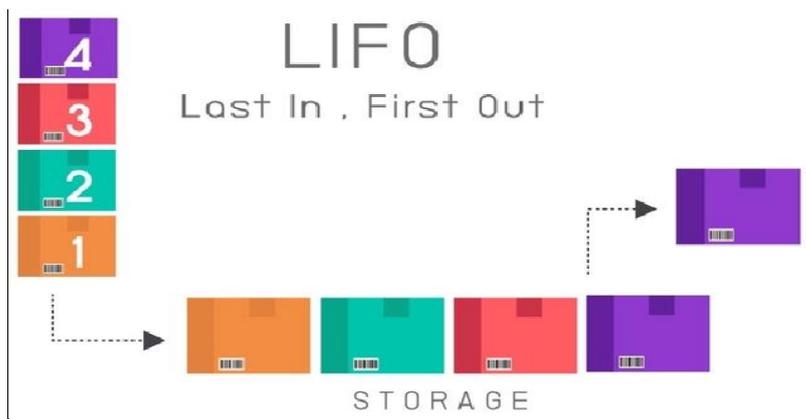


Fig 7.5: Last In First Out

How Last In, First Out (LIFO) Works

The LIFO method is used in the COGS (Cost of Goods Sold) calculation when the costs of producing a product or acquiring inventory has been increasing. This may be due to inflation. Although the LIFO accounting method may mean a decrease in profits for a business, it can also mean less corporate tax a company has to pay.

Special Considerations

The cost of inventory increases over time, which is a reasonable assumption in times of inflating prices. To use LIFO, the cost of the most recently acquired inventory will always be higher than the cost of earlier purchases, so the ending inventory balance will be valued at earlier costs, while the most recent costs appear in the cost of goods sold. By shifting high-cost inventory into the cost of

goods sold, a company can reduce its reported level of profitability, and thereby defer its recognition of income taxes. Since income tax deferral is the only justification for LIFO in most situations, it is banned under international financial reporting standards

LIFO Computation

To compute the inventory using LIFO, one should counting of inventory at the beginning of a year. Adding purchases, cost of labor and other costs, and subtracting inventory at the end of the year.

Advantages of LIFO

There are several benefits of LIFO which are followed by companies.

- LIFO matches most recent costs against current revenues.
- Tax benefits and improvement in cash flows.
- Minimizes write-downs to market.
- Physical flow of inventory.

Disadvantages of LIFO

Though many benefits are there for LIFO but still there are some drawbacks of it, following are those disadvantages:

- Reduced earnings in inflationary times.
- Understatement of inventory.
- Problem of LIFO liquidation.
- Manipulation of income.

Suitability of LIFO

This method is most suitable for materials which are of a bulky and non-perishable type.

7.10 Accounting Treatment of LIFO

Problem 3

- 1). 01.03.19 Opening stock 100 units @ \$1.75
- 2). 05.03.19 Purchased 150 units @ \$1.50
- 3). 12.03.19 Purchased 300 @ \$1.60
- 4). 08.03.19 Issued 200 units.
- 5). 18.03.09 Issued 250 units.

Assuming this business used the LIFO method, what would the rates be for the above issues of inventory?

Solution

Date	Receipts			Issued			Balance		
	Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
1/3/19							100	1.75	175
5/3/19	150	1.5	225				100 150	1.75 1.5	175 225
8/3/19				200 --150 --50	1.5 1.75	225 87.5	50	1.75	87.5
12/3/19	300	1.6	480				50 300	1.75 1.6	87.5 480
18/3/19				250 --250	1.6	400	50 50	1.75 1.6	87.5 80



Differences between FIFO and LIFO

BASIS	FIFO	LIFO
1. Meaning	Inventory valuation assumes stock bought first is sold first	Inventory valuation assumes stock bought last is sold first
2. Goods that remain in inventory	Goods bought later	Goods bought earlier
3. Valuation of stock in hand	At current prices	At historical prices
4. Valuation of COGS	At historical prices	At current prices
5. Impact of Inflation	Higher profits reported and higher tax cost	Lower profits reported and lower tax cost
6. Impact of Deflation	Lower profits reported and lower tax cost	Higher profits reported and higher tax cost
7. Statutory of recognition	Permitted by IFRS and US GAAP	Permitted by GAAP
8. Acceptance	Widely accepted	Less accepted

7.11 Weighted Average Cost (WAC)

In accounting, the Weighted Average Cost (WAC) method of inventory valuation uses a weighted average to determine the amount that goes into COGS and inventory. The weighted average cost method divides the cost of goods available for sale by the number of units available for sale. The WAC method is permitted under both GAAP and IFRS accounting.

The weighted average method is used to assign the average cost of production to a product. Weighted average costing is commonly used where, inventory items are so intermingled that it is impossible to assign a specific cost to an individual unit. The accounting system is not sufficiently sophisticated to track FIFO or LIFO inventory layers and inventory items are so commoditized that there is no way to assign a cost to an individual unit.

$$\text{WAC per unit} = \frac{\text{Cost of goods available for sale}}{\text{Units available for sale}}$$

The net result of using weighted average costing is that the recorded amount of inventory on hand represents a value somewhere between the oldest and newest units purchased into stock. Similarly, the cost of goods sold will reflect a cost somewhere between that of the oldest and newest units that were sold during the period. The weighted average method is allowed under both generally accepted accounting principles and international financial reporting standards.

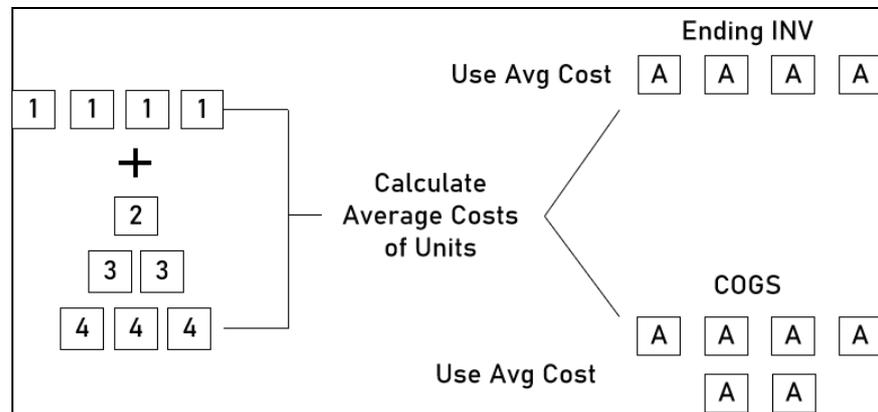


Fig 7.6: Weighted Average Cost

Weighted Average Cost Computation

Weighted average differs from finding the normal average of a data set because the total reflects that some pieces of the data hold more “weight,” or more significance, than others or occur more frequently.

- Determine the weight of each data point.
- Multiply the weight by each value.
- Add the results of step two together.

Advantages of Weighted Average Method

Many of benefits are there for using WAC instead of FIFO and LIFO.

- Easily track inventory value.
- Less paperwork for you.
- Consistency.
- Assigns an equal unit cost to each unit of inventory.
- It does not produce widely fluctuating profits when inventory costs are fluctuating, as FIFO and LIFO do.

Disadvantages of Weighted Average Method

Though benefits, some of drawbacks are there, which makes it unsuitable to use.

- It does not match recent costs with current revenue, as well as LIFO, does.
- It does not produce an ending inventory amount that contains costs as recent as those included under.
- Simplicity and conveniences are lost when there is too much change in the prices of materials.
- An average price is not based on actual price incurred, and therefore is not realistic. It follows only arithmetical convenience.

Suitability of WAC

- When companies are purchasing inventory stock on a regular basis.
- When your inventory has a relatively fast turnover.

- Even with a high reorder frequency, average costing is easily processed because one aren't tracking every purchase or its respective price and volume.
- Inventory items are so blended or identical to each other it is impossible to assign specific costs to individual units.



Example, In coffee roasting, one batch of coffee beans may be mixed with another batch of the same beans. The difficulty in accounting for the separate coffee beans suggests the company would use a weighted average cost approach.



Industries suited to weighted average costing

- Manufacturing is not the only industry suited to average costing.
- Agricultural sector is often used because produce such as fruit, vegetables and grain or any other product grown in pastures and mass harvested, cannot be accounted for individually.
- Likewise, some animal products are also collected in large quantities making it difficult to differentiate them on an individual basis. For these types of products, weighted average costing makes it simpler to allocate costs.
- The manufacture of chemicals or the extraction, collection and storage of liquid fuels and related products makes it necessary for chemical, gas and petroleum industries to utilize weighted average costing.

7.12 Accounting Treatment of WAC

Problem 4

- 1). 01.03.19 Opening stock 100 units @ \$1.75
- 2). 05.03.19 Purchased 150 units @ \$1.50
- 3). 12.03.19 Purchased 300 @ \$1.60
- 4). 08.03.19 Issued 200 units.
- 5). 18.03.09 Issued 250 units.

Assuming this business used the Weighted Average method, what would the rates be for the above issues of inventory?

Solution

Date	Receipts			Issued			Balance		
	Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
1/3/19							100	1.75	175
5/3/19	150	1.5	225				250 (100+150)	1.60 400/250	400 (175+225)
8/3/19				200	1.60	320	50	1.6	80
12/3/19	300	1.6	480				350 (50+300)	1.6 560/350	560 (80+480)
18/3/19				250	1.6	400	100	1.6	160

7.13 Ind AS 2

According to, International Accounting Standard-2 (IAS-2), 'Inventories' mean tangible property held;

- (a) for sale in the ordinary course of business,
- (b) in the process of production for such sale, or
- (c) for consumption in the production of goods or services for sale.

Objectives of Ind AS 2

The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard deals with the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.



Exceptions

- Financial instruments covered in Ind AS 32 and Ind AS 109.
- Biological assets.
- Producers of agricultural and forest products.
- Commodity broker-traders.

7.14 Measurement of inventories and Techniques to measure cost

Inventories shall be measured at the lower of cost and net realizable value. Standard cost method or the retail method, used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and revised in the light of current conditions.

The retail method is used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. An average percentage for each retail department is often used.



Recognition as an expense

When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

7.15 Disclosure in Ind AS 2

1. The accounting policies adopted in measuring inventories, including the cost formula used
2. The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity.
3. The carrying amount of inventories carried at fair value less costs to sell, the amount of inventories recognised as an expense during the period.
4. The amount of any write-down of inventories recognised as an expense in the period in accordance.
5. The amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period in accordance.
6. The circumstances or events that led to the reversal of a write-down of inventories in accordance

7. The carrying amount of inventories pledged as security for liabilities.

Summary

- Inventory valuation is the monetary amount associated with the goods in the inventory at the end of an accounting period.
- To the finance manager, inventory connotes the value of raw materials, consumable, spares, work-in-progress, finished goods and scrap in which a company's funds have been invested.
- According to, International Accounting Standard-2 (IAS-2), 'Inventories' mean tangible property held, for sale in the ordinary course of business, in the process of production for such sale, or for consumption in the production of goods or services for sale.
- As per basic principle, inventory should be valued at the lower of cost or net realizable value.
- In the periodic inventory system, the inventory verification is done by an actual physical count of the inventory on any given date.
- Perpetual Inventory System, require continuous recording of the stock.
- FIFO is based on the assumption that the materials which are purchased first are issued first.
- To calculate COGS (Cost of Goods Sold) using the FIFO method, determine the cost of your oldest inventory. Multiply that cost by the amount of inventory sold.
- The LIFO method operates under the assumption that the last item of inventory purchased is the first one sold.
- To compute the inventory using LIFO, one should counting of inventory at the beginning of a year. Adding purchases, cost of labor and other costs, and subtracting inventory at the end of the year.
- In accounting, the Weighted Average Cost (WAC) method of inventory valuation uses a weighted average to determine the amount that goes into COGS and inventory.

Keywords

- Cost- It includes the cost of purchase of the materials and the cost of conversion.
- Net Realizable Value- It is the estimated price of a finished good after deducting the costs to make the sale.
- Periodic inventory system- The inventory verification is done by an actual physical count of the inventory on any given date.
- Perpetual Inventory System- It require continuous recording of the stock.

Self Assessment

1. For a company, inventory is:

- A. Raw material
- B. Work in progress
- C. Finished Goods
- D. All above

2. Inventory should be valued at the lower of _____ or net realizable value.

- A. Purchase price
- B. Discount
- C. Sale price

D. Cost

3. To determine the closing stock a physical count of the inventory, which method will be taken?

- A. Periodic Inventory System
- B. Perpetual Inventory System
- C. Isolated Inventory System
- D. Initial Inventory System

4. Which method of inventory is adopted to record every issue or purchase/receipt of raw materials, final goods, work in progress?

- A. Periodic
- B. Perpetual
- C. Isolated
- D. Initial

5. FIFO means_____.

- A. Fill In Fill Out
- B. First In First Out
- C. Fast In Fast Out
- D. Freight In Freight Out

6. The FIFO method is used for _____ assumption purposes.

- A. Broad area
- B. Sale price
- C. Cash flow
- D. Cost flow

7. FIFO method is considered more suitable during the periods of _____prices.

- A. Falling
- B. Rising
- C. Stable
- D. Fluctuating

8. This method is suitable when the size of purchases is _____ but not much frequent.

- A. Large
- B. Small
- C. Heavy
- D. Light

9. LIFO is termed as_____

- A. Least In First Out

- B. Last In First Out
- C. Long In First Out
- D. Last In For Out

10. The LIFO accounting method may mean a _____ in profits for a business.

- A. Fluctuations
- B. Stability
- C. Increase
- D. Decrease

11. This method is most suitable for materials which are _____.

- A. Perishable
- B. Non-Perishable
- C. Reliable
- D. Relevant

12. The weighted average cost method divides the _____ available for sale by the number of units available for sale.

- A. Finished goods
- B. Cost of goods
- C. Raw material
- D. Inventory

13. According to, International Accounting Standard-2 (IAS-2), 'Inventories' mean tangible property held _____.

- A. For sale in ordinary course of business
- B. For sale in extraordinary course of business
- C. For purchase in ordinary course of business
- D. For purchase in extraordinary course of business

14. What are the exceptions in Ind S2?

- A. Agricultural products
- B. Forests products
- C. Biological assets
- D. All above

15. _____ costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation.

- A. Standard
- B. Nominal
- C. Consistent

D. Average

Answers: Self Assessment

- | | | | | |
|-------|-------|-------|-------|-------|
| 1. D | 2. D | 3. A | 4. B | 5. B |
| 6. D | 7. A | 8. A | 9. B | 10. D |
| 11. B | 12. B | 13. A | 14. D | 15. A |

Review Questions

1. Define the term Inventory? Also, discuss its objectives?
2. Discuss and distinguish between the methods of recording inventory?
3. What are the benefits of inventory valuation?
4. Discuss the methods of inventory valuation with the help of examples?
5. What do you mean by FIFO? How it works? Also, discuss the benefits and drawbacks of it?
6. Assuming this business used the FIFO method, what would the rates be for the above issues of inventory?

1. 01.06.19 Opening stock 10 units @ \$175
2. 05.06.19 Purchased 15 units @ \$150
3. 12.06.19 Purchased 30 @ \$160
4. 08.06.19 Issued 20 units.
5. 18.06.09 Issued 25 units.
7. Discuss the LIFO advantages and disadvantages and its suitability?
8. Define WAC and how it is computed?
9. Compute stores ledger using FIFO, LIFO and WAC methods.

March 1	100 units	@ Rs. 10
12	100 units	@ Rs. 9.80
15	50 units	@ Rs. 9.60
20	100 units	@ Rs. 9.40

Units sold during the month were as follows:

March 10	80 units
14	100 units
30	90 units

No opening inventories

10. What are the objectives and disclosure of Ind AS 2?

Further readings



1. Khan and Jain, "Management Accounting".
2. M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.
3. R. L. Gupta and Radhaswamy, "Advanced Accountancy".

4. S. N. Maheswari, "Management Accounting".

5. V. K. Goyal, "Financial Accounting", Excel Books, New Delhi.



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UNIT 08: FINAL ACCOUNTS

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Objectives

Introduction

- 8.1 Capital and Revenue
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- 8.9 Marshalling of Assets and Liabilities

Summary

Keywords

Self Assessment

Review Questions

Answers: Self Assessment

Further readings

Objectives

After this Unit, student will be able to:

- Appreciate the concept of capital and revenue.
- Describe the circumstances under which a revenue expenditure is to be capitalized.
- Compare and contrast capital receipt and revenue receipt, capital profit and capital loss.
- Comprehend the trading and profit and loss account and key adjustments.
- Apprehend the balance sheet and its key adjustments.

Introduction

A businessman is interested to know the net result of his business operations after a certain period. But neither the trial balance nor the books of accounts reveal the net results of the business. For this, the financial statements are prepared. But before, how to prepare these statements, it is all the more necessary to know about the nature of expenditure and receipts i.e. capital and revenue. This will help in recording correctly the items in financial statements. Trading and profit and loss account, balance sheet and key adjustments related to them are important aspect of every business. Every organisation prepares its final accounts after a particular period to know its financial results and financial position. Final accounts mean profit and loss account and the balance sheet. Profit and loss account also contains one more account, known as trading account, and if the business is manufacturing any item or article, then manufacturing account is also there. All these accounts are prepared only after preparing trial balance.

8.1 Capital and Revenue

Capital and revenue both are important aspect of business. To consider these terms in computing and recording data in financial statements, one must have adequate knowledge of these terms. Before starting the business terms, let us understand the importance of these two terms.

- To ascertain the net result of the trading activity for an accounting year.
- To ascertain the financial position of the business as at the end of the accounting year.

Hence, an income statement is called Profit and Loss Account for ascertaining the net result and a position statement called Balance Sheet for determining the financial position. The Profit and Loss Account and Balance Sheet together are called Final Accounts.

Before preparing the final accounts, another statement called Trial Balance is prepared in order to check the arithmetical accuracy of the books of account. The Trial Balance also forms the basis for the preparation of the Final Accounts. All items appearing in the Trial Balance are transferred either to the Profit and Loss Account or to the Balance Sheet.

As per rules, items of revenue nature are shown in the Profit and Loss Account and items of capital nature in the Balance Sheet. In other words, whether an item will appear in Profit and Loss Account or in the Balance Sheet depends upon the revenue and capital nature of the item.

If any item is wrongly classified i.e., if any item of revenue nature is treated as a capital item or vice versa, the ascertainment of profit will be incorrect.



Example

The revenues earned during an accounting year are Rs. 1,00,000 and the costs shown are Rs. 80,000. The profit will work out as Rs. 20,000.

On rechecking you found that a revenue item of Rs. 5,000 (an expenditure on repairs of machinery) had been treated as a capital item (added to cost of machinery) and hence not included. It means the actual costs are Rs. 85,000 and not 80,000. So, the correct profit is Rs. 15,000.

In other words, the profit worked out earlier was overstated. Thus, it can also be stated that if any capital expenditure is wrongly classified as revenue expenditure, it would result in an understatement of profits.

8.2 Expenditures

On the basis of items of expenditure, the expenditure can be classified into three categories:

1. Capital Expenditure,
2. Revenue Expenditure, and
3. Deferred Revenue Expenditure

We incur expenditure on various items every day. Like to buy food items, stationery, cosmetics, utensils, furniture, etc. Some of them are consumables and some are durables.

The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same thing is true of business also.

In business you incur expenditure on two types of items: routine items like stationery, postage, repairs, salaries, etc., where the benefit is available for a short period, fixed assets like machinery, building, furniture, etc., whose benefit is available over a number of years.

In accounting terminology, the first category of expenditure is called revenue expenditure and the second one is called capital expenditure.

Capital Expenditure

When the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure.

1. Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. Brokerage or commission paid in connection with the acquisition of an asset, freight and cartage paid for

transportation of machinery, expenses incurred on its installation, legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.

2. Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.
3. Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, and (c) improvement in its revenue earning capacity.
4. Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.
5. Cost of experiments which ultimately result in the acquisition of a patent. However, the cost of experiments which are not successful is treated as a deferred revenue expenditure which is written off with in two to three years.

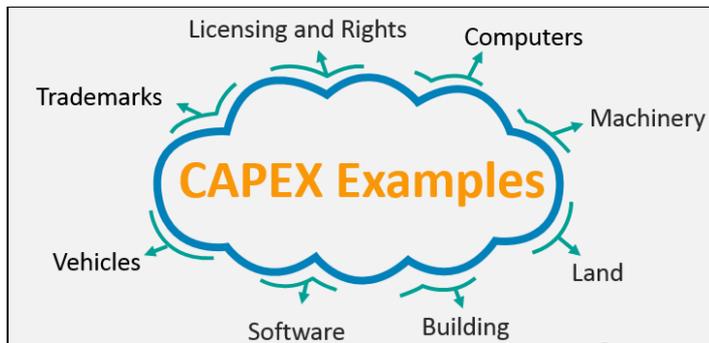


Fig 8.1: Examples of Capital Expenditure

Revenue Expenditure

When the benefit of expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. Thus, all expenses which are incurred during the regular course of business are regarded as revenue expenditures. These may be as follows:

1. Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.
2. Expenditure incurred for buying goods for resale or raw materials for manufacturing.
3. Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, etc.
4. Depreciation on fixed assets, can be termed as revenue loss.
5. Interest on loans borrowed for running the business. You should note that any interest on loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.
6. Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages. etc.

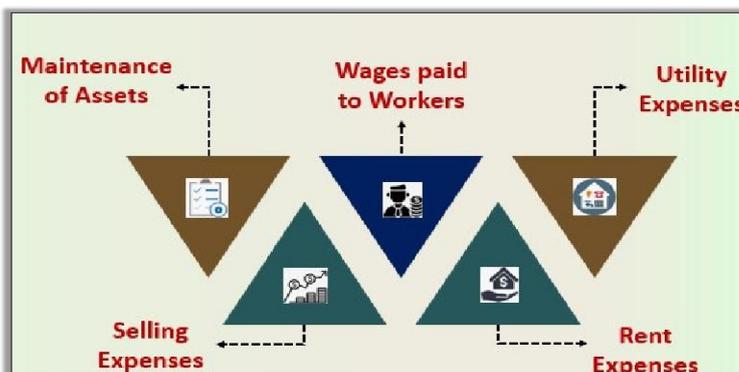


Fig 8.2: Examples of Revenue Expenditure

Deferred Revenue Expenditure

Deferred revenue expenditure is the expenditure which is originally revenue in nature, but the amount spent is so large that the benefit is received for not a year but for many years. A proportionate amount is charged to profit and loss account of each year and balance is carried forward to subsequent years as deferred revenue expenditure. It is shown as an asset in the balance sheet, e.g., heavy expenditure incurred on advertisements.

8.3 Capital Receipts and Revenue Receipts

Capital receipts are the receipts which are not received in the ordinary course of business. These are non-recurring receipts. Money obtained from the sale of fixed assets or investments, issue of shares or debentures, loans taken are some of the examples of capital receipts. Capital receipts are shown as liability reduced from assets appearing in the balance sheet.

Revenue receipts are receipts obtained in the normal course of business. It is a receipt against supply of goods or services. The money obtained from sales, interest, dividend, transfer fees etc. are examples of revenue receipts. Revenue receipts are credited to profit and loss account.



1. An old machinery is purchased for Rs. 1,00,000 and Rs. 25,000 has been spent to bring it in working condition.

Answer: Both the above expenses are capital expenditures as Rs. 1,00,000 has been spent to acquire the asset and Rs. 25,000 has been spent to make the machinery productive. The machinery will now be used for many years and its cost is Rs. 1,25,000.

2. A building is purchased for Rs. 10,00,000 and Rs. 1,00,000 has been spent as expenses like brokerage, stamp duty, registration charges and on other legal expenses.

Answer: Both the above expenditures are capital expenditures as Rs. 10,00,000 has been spent for the purchase of asset and Rs. 1,00,000 for all the incidental expenses for buying the asset. The cost of the building is now Rs. 11,00,000.

3. Repairs to building.

Answer: It is revenue expenditure because it is incurred for maintaining the building. Both the reason for repairs and the amount are not important.

4. Amount spent for the replacement of defective and worn out parts of an old plant.

Answer: It is revenue expenditure as it is incurred to keep the plant in normal working condition. No new asset comes into existence.

5. Heavy expenditure incurred on advertisements.

Answer: Normally, advertisement is revenue expenditure. But, as heavy expenditure is incurred, it will be treated as deferred revenue expenditure. The benefits of it will be received for many years. Proportionate amount will be written off every year by debiting profit and loss account and the remaining amount will be shown in the balance sheet on the asset side.

6. New equipment for existing machinery were bought for Rs. 30,000 to increase the production by 25%.

Answer: The above expenditure is capital expenditure as it increases the production capacity and thereby increases the earning capacity of the business.

7. Expenditure for repainting the factory shed.

Answer: As repainting is a normal expenditure made for maintenance of the factory, it is revenue expenditure. It is a recurring expense and no new asset comes into existence.

8. Traveling expenses of directors for a trip abroad for purchasing imported machinery.

Answer: As the traveling expenses is incidental expenditure to purchase machinery, it should be treated as capital expenditure and should be added to the cost of machinery. In this case, if directors purchase the machinery, it would be deferred revenue expenditure and would be written off over a reasonable period of say 3 to 5 years.

8.4 Final Accounts

Every organisation prepares its final accounts after a particular period to know its financial results and financial position. Final accounts means profit and loss account and the balance sheet. Profit and loss account also contains one more account, known as trading account, and if the business is manufacturing any item or article, then Manufacturing account is also there. All these accounts are prepared only after preparing trial balance. Final Accounts are the composition of trading account, profit and loss account, balance sheet.



Fig 8.3: Components of Final Accounts

Objectives of Preparing Final Accounts

There are few objectives for preparing final accounts:

- to know the operational results i.e. final accounts are prepared to know the profit or loss during a particular period through the profit and loss account which is also known as income statement, and
- to ascertain the financial position of the business on a particular date through the balance sheet, also known as position statement.

Trading and Profit & Loss Account

In the Trading and Profit & Loss Account all those accounts are disclosed which affect the profit or loss of the business. In other words, all the nominal accounts of the Trial Balance are used to prepare the Trading and Profit & Loss Account. In the left hand side, all the expenses incurred during a period and in the right hand side all the incomes earned during a period are disclosed. This account contains two parts:

1. Trading Account
2. Profit & Loss Account

8.5 Trading Account

Trading account is a statement which is prepared by a business firm. It is a part of the final accounts of the entity. In other words, the trading account gives details of total sales, total purchases and direct expenses relating to purchase and sales. There are few terms used while preparing trading account.

- **Opening Stock:** It is a stock of goods or raw materials available at the opening of the accounting period, which is nothing but a closing stock of the yester accounting period utilized for trading during the current year.
- **Purchases:** Purchase of goods or raw materials is either for resale or manufacturing.
- **Closing Stock:** It is a stock nothing but an outcome of lesser volume of sales than the aggregate of opening stock and purchases.
- **Material consumed:** $\text{Material consumption} = \text{Opening stock} + \text{Purchases} - \text{Closing stock}$

Format of Trading Account

TRADING ACCOUNT (Horizontal Format) <i>for the year ended.....</i>			
Dr.			Cr.
Particulars	Rs.	Particulars	Rs.
To Opening Stock	xxx	By Sales	xxx
To Purchases	xxx	Less: Returns inwards	(xxx)
Less: Returns outwards (xxx)	xxx	By Closing Stock	xxx
To Fright & Carriage	xxx	By Gross Loss c/d*	xxx
To Customs & Insurance	xxx		
To Wages	xxx		
To Gas, Water & Fuel	xxx		
To Factory Expenses	xxx		
To Royalty on Production	xxx		
To Cargo Expenses	xxx		
To Shipping Expenses	xxx		
To Import Duty	xxx		
To Custom Duty			
To Dock Charges			
To Octroi			
To Commission on Purchases			
To Gross Profit c/d*			
	xxx		xxx

* Either of two will appear

Accounting Treatment of Trading Account

Problem 1

Particulars	Amount	Particulars	Amount
Opening stock	50,000	Purchase return	20,000
Purchases: Cash	1,20,000	Carriage Inward	10,000
: Credit	1,00,000		
Sales: Cash	40,000	Marine Insurance on purchase	6,000
: Credit	1,00,000		
Other direct expenses	4,000	Sales return	30,000
Closing stock	10,000		

SOLUTION:

Dr	₹	Cr	₹
To Opening Stock	50,000	By Cash Sales	40,000
To Cash Purchase	1,20,000	Add: Credit Sales	1,00,000
Add: Credit Purchase	1,00,000	By Total Sales	1,40,000
To Total Purchase	2,20,000	Less: Sales Return	30,000
Less: Purchase Return	20,000	By Net Sales	1,10,000
To Net Purchase	2,00,000	By Closing Stock	10,000
To Carriage Inwards	10,000	By Gross Loss c/d	1,50,000
To Marine Insurance	6,000		
To Other Direct Expenses	4,000		
	2,70,000		2,70,000
To Gross Loss B/d	1,50,000		

8.6 Profit & Loss Account

Profit & Loss Account is the second part of Trading and Profit & Loss Account. Trading Account shows the gross profit which is the difference of sales and cost of sale. Thus, it can not be treated as net profit while the businessman wants to know how much net profit has earned from the operating activities during a period.

For this purpose, Profit & Loss Account is prepared keeping in mind all the operating and non-operating incomes and losses of the business. In the debit side all the expenses and losses are disclosed and in the credit side all the incomes are disclosed. The excess of credit side over debit side is called net profit while the excess of debit side over credit side shows net loss.



Items not shown in Profit and Loss Account

- **Drawings:** A drawing includes any money that is taken from the business account for personal use. This can be the equivalent of a salary, or it can be as simple as lunch paid for with your company credit card. However, drawings don't only cover cash withdrawals.
- **Income Tax:** While the tax liability will appear as an expense in the profit and loss account, the provision for income-tax will be shown in the Balance Sheet as a current liability and the Advance Tax paid will be shown as an advance on the asset side of the balance sheet.
- **Trade Discount:** A trade discount is a routine reduction from the regular, established price of a product. The use of trade discounts allows a company to vary the final price based on each customer's volume or status. Trade discounts are not recorded in a separate account by either the seller or the buyer.

Format of Profit and Loss Account

Profit and Loss Account for the year ended			
Dr.		Cr.	
Particulars	Rs.	Particulars	Rs.
To Trading A/c (Gross Loss)	x x x	By Trading A/c (Gross profit)	x x x
To Salaries	x x x	By Commission earned	x x x
To Rent & rates	x x x	By Rent received	x x x
To Stationeries	x x x	By Interest received	x x x
To Postage expenses	x x x	By Discount received	x x x
To Insurance	x x x	By Net Loss	
To Repairs	x x x	(Transferred to Capital A/c)	x x x
To Trading expenses	x x x		
To Office expenses	x x x		
To Interest paid	x x x		
To Bank charges	x x x		
To Sundry expenses	x x x		
To Commission paid	x x x		
To Discount allowed	x x x		
To Advertisement	x x x		
To Carriage outwards	x x x		
To Travelling expenses	x x x		
To Distribution expenses	x x x		
To Repacking charges	x x x		
To Bad debts	x x x		
To Depreciation	x x x		
To Net Profit (transferred to Capital A/c)	x x x		
	x x x		x x x

Accounting Treatment of Profit and Loss Account**Problem 2**

Gross Profit from the trading account	1,00,000	
Manager salary	30,000	
Office lighting	5,000	
Office rent	15,000	
Local Taxes	1,000	
Salary paid to salesman	20,000	
Commission charges paid	10,000	
Legal charges paid	10,000	
Bad debts	1,500	
Advertising charges	25,000	
Package charges	7,500	
Discount allowed	3,000	
Discount received		4,000
Dividend received		2,000
Rent received		1,000
Depreciation charges	10,000	
Repairs and Maintenance	2,500	
Interest on loans	1,500	500

Solution

	₹		₹
To Manager salary	30,000	By Gross profit B/d	1,00,000
To office lighting	5,000	By Discount received	4,000
To office rent	15,000	By dividend received	2,000
To salary paid salesman	20,000	By rent received	1000
To commission charges	10,000	By interest received	500
To legal charges	3,000	By Net loss c/d*	24,500
To bad debts	1,500		
To advertising charges	25,000		
To package charges	7,500		
To depreciation charges	10,000		
To repair and maintenance	2,500		
To interest on loan	1,500		
To Local Taxes	1000		
	1,32,000		1,32,000

8.7 Adjustments in Final Accounts

Few adjustments are there, which sometimes are not shown in trial balance. For every type of element, one needs to treat it twice. Might be one time in Profit and Loss account and other time at Balance Sheet. Let us discuss few of them:

Outstanding Incomes	1. Given Outside TB	1. P&L- Cr. Side and Balance Sheet- Asset Side
	2. Given Inside TB	2. Balance Sheet- Asset Side

Outstanding Expenses	1. Given Outside TB 2. Given Inside TB	1. Add in related items and Balance Sheet- Liability Side 2. Balance Sheet- Liability Side
Prepaid Expenses	1. Given Outside TB 2. Given Inside TB	1. Less from related items and Balance Sheet- Liability Side 2. Balance Sheet- Liability Side

8.8 Balance Sheet

After the determination of the net profit of the business through the Trading and Profit and Loss Account, the businessman wants to know the financial position of the business. For this purpose, they prepares a statement which is called the Balance Sheet.

The Balance Sheet depicts the financial position of the business on a fixed date. It is prepared with those balances of Trial Balance which are left out (personal and real accounts) after taking out the nominal accounts' balances to prepare the Trading and Profit and Loss Account. A Balance Sheet has two sides – assets side and liabilities side.

Objectives of Balance Sheet

- **To Reveal the Financial Position:** The main purpose of preparing balance sheet is to know the short term and long term financial position of the firm.
- **To Show the Picture of Assets And Liabilities:** Balance sheet is prepared to know the value of assets and liabilities of the company at the end of the year.
- **Information About Debtors And Creditors:** Balance sheet provides true picture of trade debtors and creditors for the specific period.
- **To Reveal Liquidity Position:** Balance Sheet shows actual cash and bank balances in a year with the company.
- **To Show Solvency Position:** Balance Sheet shows actual equity and liabilities balances in a year with the company.
- **To Provide Financial Information:** Balance sheet provides true and reliable financial information to the management, government, shareholders, lenders etc.

8.9 Marshalling of Assets and Liabilities

Order of presenting the assets and liabilities in the balance sheet is called marshalling of assets and liabilities. A balance sheet may be prepared by marshalling the assets and liabilities in the following orders:

A. Balance Sheet prepared in Liquidity Order

B. Balance Sheet prepared in Permanency Order

A. Balance Sheet prepared in Liquidity Order

As per liquidity order, items easily convertible in cash and to be paid in short term are listed first then the items have long term stability.

Balance sheet as at _____			
Liabilities	₹	Assets	₹
Bills Payable	XXXX	Cash in hand at Bank	XXXX
Loans		Investments	
Trade Capital		Bills	
		Receivables	
		Debtors	
		Stock (Closing)	
		Stores	
		Furniture and Fixtures	
		Plant & Machinery	
		Land & Buildings	

Balance Sheet prepared in Permanency Order

As per permanency order, items not easily convertible in cash and to be paid in long term are listed first then the items have short term availability or liquid.

Balance sheet as at _____			
Liabilities	₹	Assets	₹
Capital Trade	XXXX	Land & Building	XXXX
Creditors Loan		Plant & Machinery	
Bills Payable		Furniture & Fixtures	
		stock (Closing)	
		Debtors	
		Bills Receivables	
		Investments	
		Cash at Bank	
		Cash in Hand	



Terms used

- **Provisions:** Provisions are an amount set aside to cover a probable future expense, or reduction in the value of an asset. In financial reporting, provisions are recorded as a current liability on the balance sheet and then matched to the appropriate expense account on the income statement.
- **Contingent Liabilities:** A contingent liability is a liability that may occur depending on the outcome of an uncertain future event. A contingent liability is recorded if the contingency is likely and the amount of the liability can be reasonably estimated. The liability may be disclosed in a footnote on the financial statements unless both conditions are not met.
- **Preliminary Expenses:** Preliminary expenses are the expenses that are incurred before the incorporation, initial stage and commencement of the business. The expenses incidental for the formation of a company also regarded as preliminary expense. These are considered as deferred revenue expenditure.

Format of Balance Sheet

Balance Sheet			
As on.....			
Assets	\$	Liabilities	\$
Liquid Assets:		Current Liabilities:	
Cash in hand	XXXX	Bank Overdraft	XXXX
Cash at bank	XXXX	Bills Payable	XXXX
Bills Receivable	XXXX	Trade Creditors	XXXX
Debtors	XXXX	Long Term Liabilities:	
Current Assets:		Mortgage Loan	XXXX
Stock	XXXX	Capital	XXXX
Prepaid Insurance	XXXX		
Fixed Assets:			
Furniture and Fixtures	XXXX		
Motor Vehicles	XXXX		
Plant & Machinery	XXXX		
Land and Building	XXXX		
	XXXX		XXXX

Accounting Treatment of Balance Sheet

Problem 3

<i>Particulars</i>	<i>Debit (A+E)</i>	<i>Credit (L+I)</i>
Sundry debtors	15,000	—
Opening stock	50,000	—
Land and building	10,000	—
Capital	—	25,000
Rent received	—	6,000
Cash in hand	16,000	—
Cash at bank	40,000	—
Wages	30,000	—
Sundry creditor	—	70,000
B/R	20,000	—
Interest given	2,000	—
Bad debts	5,000	—
Repairs	3,000	—
Sales	—	17,000
B/P	—	40,000
Furniture/Fixture	15,000	—
Depreciation	10,000	—
Rent and taxes	8,000	—
Salaries	20,000	—
Drawing	20,000	—
Purchase	10,000	—
Office expenditure	25,000	—
Plant and machinery	57,000	—
Total	53,600	53,600

Solution

Trading and P & L A/c			
Particulars	Amount	Particulars	Amount
To Opening stock	50,000	By Sales	17,0000
To Wages	30,000	By gross loss	10,000
To Purchase	10,0000		
Total	18,0000	Total	18,0000
To gross loss	10,000	By Other income	
By other exp		• Rent given	6,000
Interest given	2,000	By net loss	77,000
Bad debts	5,000		
Repairs	3,000		

Particulars	Amount	Particulars	Amount
Depreciation	10000		
Rent and tax	8000		
Salaries	20000		
Office Exp.	25000		
Total	83000	Total	83000

Balance Sheet			
Liability	Amount	Assets	Amount
Capital	250000	Fixed Assets:	
Less drawing	20000	Land and Building	100000
Less net loss	77000	Furniture and Fitting	15000
	153000	Plant and Machinery	57000
Current liability:		Current assets:	
Sundry Creditor	70000	Cash in Hand	16000
Bills payable	40000	Cash at Bank	40000
		Sundry Debtor	15000
		Bills Receivable	20000
Total	263000	Total	263000

Summary

- Items of revenue nature are shown in the Profit and Loss Account and items of capital nature in the Balance Sheet.
- When the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure.
- When the benefit of expenditure is not likely to be available for more than one year, it is treated as revenue expenditure.
- Deferred revenue expenditure is the expenditure which is originally revenue in nature, but the amount spent is so large that the benefit is received for not a year but for many years.
- Capital receipts are the receipts which are not received in the ordinary course of business. These are non-recurring receipts.
- Revenue receipts are receipts obtained in the normal course of business. It is a receipt against supply of goods or services.

- Trading account gives details of total sales, total purchases and direct expenses relating to purchase and sales.
- The excess of credit side over debit side is called net profit while the excess of debit side over credit side shows net loss.
- The Balance Sheet depicts the financial position of the business on a fixed date.
- Order of presenting the assets and liabilities in the balance sheet is called marshalling of assets and liabilities.

Keywords

- **Opening Stock:** It is a stock of goods or raw materials available at the opening of the accounting period, which is nothing but a closing stock of the yester accounting period utilized for trading during the current year.
- **Purchases:** Purchase of goods or raw materials is either for resale or manufacturing.
- **Closing Stock:** It is a stock nothing but an outcome of lesser volume of sales than the aggregate of opening stock and purchases.
- **Drawings:** A drawing includes any money that is taken from the business account for personal use. This can be the equivalent of a salary, or it can be as simple as lunch paid for with your company credit card. However, drawings don't only cover cash withdrawals.
- **Income Tax:** While the tax liability will appear as an expense in the profit and loss account, the provision for income-tax will be shown in the Balance Sheet as a current liability and the Advance Tax paid will be shown as an advance on the asset side of the balance sheet.
- **Trade Discount:** A trade discount is a routine reduction from the regular, established price of a product. The use of trade discounts allows a company to vary the final price based on each customer's volume or status. Trade discounts are not recorded in a separate account by either the seller or the buyer.

Self Assessment

1. When the benefit of an expenditure is available over a number of years it is considered as _____.
A. Revenue Expenditure
B. Capital Expenditure
C. Deferred Revenue Expenditure
D. Direct Expenditure
2. Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc. are considered as _____.
A. Revenue Expenditure
B. Deferred Revenue Expenditure
C. Direct Expenditure
D. Capital Expenditure
3. Expenses which are incurred during the regular course of business are regarded as _____.
A. Revenue Expenditure
B. Capital Expenditure
C. Deferred Revenue Expenditure
D. Direct Expenditure

4. Depreciation on fixed assets is _____
- A. Revenue Loss
 - B. Revenue Expenditure
 - C. Capital Loss
 - D. Capital Expenditure
5. An old machinery is purchased for Rs. 1,00,000 and Rs. 25,000 has been spent to bring it in working condition. Which expenditure is this?
- A. Deferred Revenue
 - B. Revenue
 - C. Direct
 - D. Capital
6. Final Accounts are the composition of _____
- A. Balance Sheet
 - B. Trading Account
 - C. Profit and Loss Account
 - D. All above
7. Material consumption = Opening stock + _____ - Closing stock
- A. Incomes
 - B. Expenses
 - C. Sales
 - D. Purchases
8. Trading Account shows the _____ which is the difference of sales and cost of sale.
- A. Gross Profit
 - B. Net Profit
 - C. Operating Profit
 - D. Non Operating Profit
9. Items not shown in Profit and Loss Account Format is/ are _____
- A. Drawings
 - B. Trade Discount
 - C. Income Tax
 - D. All above
10. To ascertain the financial position of the business on a particular date through the balance sheet, also known as _____.
- A. Nominal Statement
 - B. Operations Statement
 - C. Performance Statement

D. Position Statement

11. Objectives of financial statements is/are _____.

- A. To reveal financial position
- B. To reveal liquidity position
- C. To reveal solvency position
- D. All above

12. Order of presenting the assets and liabilities in the balance sheet is called _____ of assets and liabilities.

- A. Fluctuation
- B. Subsequency
- C. Adequacy
- D. Marshalling

13. Prelimnery Expenses are considered as _____ in Balance Sheet.

- A. Fictitious assets
- B. Fixed assets
- C. Intangible assets
- D. Current assets

14. Assets= Liabilities + _____

- A. Revenues
- B. Incomes
- C. Expenses
- D. Equity

15. A balance sheet may be prepared by marshalling the assets and liabilities in the _____ order.

- A. Liquidity
- B. Permanency
- C. Solvency
- D. Both Liquidity and Permanency

Review Questions

1. What do you mean by Capital expenditure and revenue expenditure? Differentiate between the terns with examples.
2. New equipment for existing machinery were bought for Rs. 30,000 to increase the production by 25%. Explain the impact of capital or revenue expenditure on the mentioned statement.
3. Distinguish capital receipt from revenue receipt.
4. Discuss final statements and its objectives?
5. What do you mean by marshalling of assets and liabilities?
6. Calculate the Gross Profit , if Opening stock Rs. 11,500; Purchases Rs. 1,05,000 ; Wages Rs. 3,500 and Sales Rs. 1,40,000.

7. Calculate the cost of materials consumed if, Opening Stock- Raw materials Rs. 4,500; Work in Progress Rs. 12,000; Finished Goods Rs. 14,800; Sales Rs. 50,000; Purchases Rs. 24,500; Carriage inwards Rs. 500; Closing stock – Raw Materials Rs. 1,500; Work in Progress Rs. 4,800; Finished Goods Rs. 2,700.

8. From the following balances draw up a Trading and Profit and Loss Account and Balance Sheet:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Capital	30,000	Machinery	20,100
Bank Overdraft	7,500	Cash in hand	1,500
Fixture & Fitting	8,250	Opening stock	67,500
Bills Payable	10,500	Creditors	60,000
Debtors	94,500	Bill receivable	7,500
Purchases	75,000	Sales	1,93,500
Returns from customers	1,500	Returns to Creditors	1,650
Salaries	13,500	Manufacturing Wages	6,000
Commission	8,250	Trade Expenses	2,250
Discount (Cr.)	6,000	Rent	3,300

Additional Information:

The Closing Stock amounted to Rs. 78,000.

9. Draw the format of Profit and Loss account with hypothetical figures.

10. Explain the terms:

- a. Provisions
- b. Contingent Liabilities

Answers: Self Assessment

1 B	2 D	3 A	4 A	5 D
6 D	7 D	8 A	9 D	10 D
11 D	12 D	13 A	14 D	15 D

Further readings



1. Khan and Jain, "Management Accounting".
2. M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.
3. R. L. Gupta and Radhaswamy, "Advanced Accountancy".
4. S. N. Maheswari, "Management Accounting".

5. V. K. Goyal, "Financial Accounting", Excel Books, New Delhi.



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UNIT 9: DISSOLUTION OF PARTNERSHIP FIRM

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Objectives

After studying this unit, you will be able to:

- Cognize the concept of partnership
- Apprehend the features of dissolution of partnership
- Apply Garner Vs Murray Rule in firm
- Compute the firm's growth during insolvency of partnership
- Recognize the conceptual framework of sale of limited company
- Comprehend the piecemeal distribution concept in partnership

Introduction

Section 39 provides that the dissolution of partnership between all the partners of a firm is called the "dissolution of the firm". It follows that if the dissolution of partnership is not between all the partners, it would not amount to "dissolution of firm", but it would nevertheless be "dissolution of partnership". Thus, dissolution of firm always implies dissolution of partnership, but dissolution of partnership need not lead to dissolution of firm. Dissolution of partnership may involve merely a

change in the relation of the partners and not the dissolution of the firm. Thus, a reconstitution of a firm involves a change in the relation of partners whereas in the case of dissolution of firm, there is complete severance of relationship between all partners.



Example: A, B and C were partners in a firm and C died or was adjudged insolvent, the partnership firm would come to an end, but if the partners had agreed that the death, retirement, insolvency of the partner would not dissolve the firm on the happening of these contingencies, the 'partnership' would certainly come to an end although the 'firm' or as the Act calls it, a 'reconstituted firm', might continue under the same name.

9.1 Meaning of Partnership

A partnership is that it has two or more co-owners. The partners share the profits and losses according to a sharing pattern already agreed. Persons who have entered into partnership with one another are individually called 'partners' and collectively called 'firm'. A partnership firm has no separate legal entity, apart from the partners constituting it.

Both, sole proprietorship and partnership are convenient ways of separating the business owner's commercial activities from their personal activities. But legally, there is no economic separation between the owners and the businesses.

9.2 Dissolution of Partnership

Dissolution of the partnership (owing to retirement, death or bankruptcy of a partner), merely involves change in the relation of the partners but it does not end the firm. Dissolution of partnership changes the existing relationship between partners but the firm may continue its business as before. The dissolution of partnership may take place in any of the following ways:

- (1) ***Change in existing profit sharing ratio among partners-*** Adjustment of capital and change in profit sharing ratio among existing partners. One of the forms of reconstitution of the firm is change in profit sharing ratio among existing partners. Here there is no change in the partners carrying on the business of the firm.
- (2) ***Admission of a new partner-*** When new partner is admitted he acquires his share in profits from the old partners. In other words, on the admission of a new partner, the old partners sacrifice a share of their profit in favour of the new partner.
- (3) ***Retirement of a partner-*** A partner who cut his connection with the firm is called a retiring partner or outgoing partner. Retirement of a partner leads to reconstitution of a partnership firm as the original agreement between the partners comes to an end. The business may continue with a new agreement with the remaining partners.
- (4) ***Death of a partner-*** On the death of a partner, the partnership ceases to exist. But the firm may not cease to exist as the other remaining partners may decide to continue the business. In case of death of a partner, the treatment of various items is similar to that at the time of retirement of the partner.
- (5) ***Insolvency of a partner-*** Where a partner in a firm is adjudicated an insolvent he ceases to be a partner on the date on which the order of adjudication is made, whether or not the firm is hereby dissolved.
- (6) ***Completion of the venture, if partnership is formed-*** Sometimes, partnership is created for some specific task and if it is completed, then the partnership comes to end by default.
- (7) ***Expiry of the period of partnership, if partnership is for a specific period of time-*** During the creation of a partnership, the partners may agree on the duration of this arrangement. This would mean the partnership was created for a fixed duration of time. Hence such a partnership will not be a partnership at will, it will be a partnership for a fixed term. After the expiration of such a duration, the partnership shall also end.

9.3 Dissolution of a firm

On dissolution of the firm, the business of the firm stops its affairs and wind up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm. Dissolution of a firm takes place in any of the following ways:

1. **Dissolution by Agreement:** A firm is dissolved with the consent of all the partners or in accordance with a contract between the partners.

2. **Compulsory Dissolution:** A firm is dissolved compulsorily in the following cases:

- when all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract;
- when the business of the firm becomes illegal; or
- when some event has taken place which makes it unlawful for the partners to carry on the business of the firm in partnership, e.g., when a partner who is a citizen of a country becomes an alien enemy because of the declaration of war with his country and India.

3. **On the happening of certain contingencies:** Subject to contract between the partners, a firm is dissolved :

- if constituted for a fixed term, by the expiry of that term;
- if constituted to carry out one or more ventures, by the completion thereof;
- by the death of a partner;
- by the adjudication of a partner as an insolvent.

4. **Dissolution by Notice:** In case of partnership at will, the firm may be dissolved if any one of the partners gives a notice in writing to the other partners, signifying his intention of seeking dissolution of the firm.

5. **Dissolution by Court:** At the suit of a partner, the court may order a partnership firm to be dissolved on any of the following grounds:

- when a partner becomes insane;
- when a partner becomes permanently incapable of performing his duties as a partner;
- when a partner is guilty of misconduct which is likely to adversely affect the business of the firm;
- when a partner persistently commits breach of partnership agreement;
- when a partner has transferred the whole of his interest in the firm to a third party;
- when the business of the firm cannot be carried on except at a loss; or
- when, on any ground, the court regards dissolution to be just and equitable.



What are the various types of capital?

Answer: The capital may be fixed or fluctuating:

- Fixed Capital Account: Two separate accounts are kept for each partner, i.e. 'capital account' and 'current account'.
- Fluctuating Capital Account: Only one account for each partner is kept, i.e. capital account.

9.4 Distinction between Dissolution of Partnership and Dissolution of Firm

<u>Basis</u>	<u>Dissolution of Partnership</u>	<u>Dissolution of Firm</u>
1. Termination of business	The business is not terminated.	The business of the firm is closed.
2. Settlement of assets and liabilities	Assets and liabilities are revalued and new balance sheet is drawn.	Assets are sold and liabilities are paid-off.

3. Court's intervention	Court does not intervene because partnership is dissolved by mutual agreement.	A firm can be dissolved by the court's order.
4. Economic relationship	Economic relationship between the partners continues though in a changed form.	Economic relationship between the partners comes at an end.
5. Closure of books	Does not require because the business is not terminated.	The books of account are closed.
6. Other dissolution	It may or may not involve dissolution of the firm.	It necessarily involves dissolution of partnership.

9.5 Settlement of Accounts

Usually the Deed of Partnership contains an accounting clause according to which the final accounts between partners are settled. In the absence of such an agreement, s.48 provides as follows:

1. **Treatment of Losses**- Losses, including deficiencies of capital, shall be paid :

- first out of profits,
- next out of capital of partners, and
- lastly, if necessary, by the partners individually in their profits sharing ratio.

2. **Application of Assets**- The assets of the firm, including any sum contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:

- in paying the debts of the firm to the third parties;
- in paying each partner proportionately what is due to him/her from the firm for advances as distinguished from capital (i.e. partner's loan);
- in paying to each partner proportionately what is due to him on account of capital; and
- the residue, if any, shall be divided among the partners in their profit sharing ratio

9.6 Realisation Account

The Realisation Account is prepared to record the transactions relating to sale and realisation of assets and settlement of creditors. Any profit or loss arising out of this process is shared by partners' in their profit sharing ratio. Partners' accounts are also settled and the Cash or Bank account is closed.

9.7 Format of Realisation Account

Particulars	Amt. (₹)	Particulars	Amt. (₹)
Assets		Liabilities	
To Land and Building	—	By Sundry Creditors	—
To Plant and Machinery	—	By Bills Payables	—
To Furniture and Fitting	—	By Bank Overdraft	—
To Bills Receivables	—	By Outstanding Expenses	—
To Sundry Debtors	—	By Provision for Doubtful Debts	—
To Cash/ Bank	—	By Cash/Bank (Sale Proceed of Assets)	—
(Payment of Liabilities)		By Partner's Capital Account	—
To Partner's Capital A/c	—	(Assets Taken by the Partner)	
(Liability Assumed by the Partner)		By Loss (Transferred to Partners Capital Account)	—
To Profit (Transferred to Partner's Capital Account in their Profit Sharing Ratio)	—		
Total	—	Total	—

**Problem:**

X and Y are equal partners in a firm. They decided to dissolve the partnership on December 31, 2019 when the balance sheet stood as under:

Liabilities		₹	Assets		₹
Creditors		54,000	Cash at bank		22,000
Reserve for Dep. on Plant		20,000	Sundry debtors		24,000
Loan		80,000	Stock		84,000
Capital Account			Furniture		50,000
			Plants		94,000
X	1,20,000		Leasehold lands		1,20,000
Y	1,20,000	2,40,000			
		3,94,000			3,94,000

Assets were realised as follows: Leasehold land 1,44,000; Furniture 45,000; Stock 81,000; Plant 96,000; Sundry debtors 21,000. The creditors were paid 51,000 in full settlement. Expenses of realisation amounted to 6,000. Show the ledger accounts to record the dissolution measures.

Solution:Realisation Account

Particulars		₹	Particulars		₹
To Sundry Assets:			By Creditors		54,000
S Debtors	24,000		By Loan		80,000
Plants	94,000		By Bank		
Stock	84,000		S Debtors	21,000	
Leasehold land	1,20,000		Plants	96,000	
Furniture	50,000	3,72,000	Stock	81,000	
To Bank a/c			Leasehold land	144,000	
Creditors	51,000		Furniture	45,000	3,87,000
Loan	80,000				
Realisation Exp.	6,000	1,37,000			
To Profit on Realization:					
X	6,000				
Y	6,000	12,000			
		5,21,000			5,21,000

9.8 Insolvency of Firm

In case one partner or more than one partners are insolvent and the remaining (solvent) are required to compensate the loss (deficiency) of insolvent partner, the problem arises as how to compensate that deficiency or in what ratio the solvent partners are required to compensate. This deficiency is to be compensated in two ways:

- This deficiency is to be shared by solvent partners in their profit sharing ratio like other business losses.
- To be shared according to Garner Vs. Murray rule, according to this rule, the loss is to be shared among the solvent partners in the ratio of their opening capitals.



Example: A, B and C were partners, sharing profits and losses equally, with capital contribution of 30,000, 15,000 and 3,000, respectively. On dissolution it is found that, after paying the debts of the firm and advances made by the partners, the assets are 21,000. Thus, the deficiency comes to 27,000

(i.e., total capital – assets), which is to be met by the partners equally. Now the total assets available are 48,000. This amount will be distributed rateably among the partners. However, in actual practice it will not be necessary for A and B to pay 9,000 each in cash but notional adjustment may be made so that C, whose capital contribution was only 3,000 will have to pay 6,000. Now the total assets available for distribution between A and B would be 21,000 + 6,000 = 27,000, A getting 21,000 and B 6,000.

9.9 Garner v/s Murray Rule

The Garner vs Murray Rule is applied during Insolvency of Partnership. Following consideration should be kept in mind while applying the rule.

- Realization Account should be prepared in the usual manner and its profit or loss should be transferred to the Capital Accounts of all the partners (including insolvent partners) in the profit-sharing ratio.
- Solvent partners should bring in cash equal to their respective shares of the loss (if any) on realisation.
- The ratio of the Last Agreed Capitals of the solvent partners should be calculated.
- If any amount is received from the private estate of an insolvent partner, it should be credited to his Capital Account.
- The irrecovered debit balance after making all adjustments (including the share of any profit or loss on realisation) should be transferred to the Capital Accounts of solvent partners (other than one having a debit balance in his Capital Account as on the date of dissolution), in the ratio of their Last Agreed Capitals.
- The solvent partner having a debit balance in his Capital Account should bring in the necessary cash to the balance off his account.
- The solvent partner having a credit balance in his Capital Account should draw out the necessary cash to the balance off his account.



Problem

Long, Short and Thin were carrying on business in partnership sharing profits and losses in the ratio 3:2:1 respectively. They decided to dissolve the firm on 31st December, 2019 on which date their Balance Sheet stood as follows:

Liabilities		Rs.	Assets		Rs.
Creditors		47,000	Land & Building		57,000
Long's Loan A/c		10,000	Stock		50,000
Capital Accounts			Debtors		50,000
Long	90,000		Cash		3,000
Short	10,000		Profit and Loss A/c		1,500
Thin	10,000	1,10,000	Short's Current A/c		2,000
Long's Current A/c		1,500	Thin's Current A/c		5,000
		1,68,500			1,68,500

Land and Building were sold for Rs. 40,000 and Stock and Debtors realized Rs. 30,000 and Rs. 42,000 respectively. The Goodwill was sold for Rs. 600, the expenses of realization amounted to Rs. 1,200. Thin is insolvent and a final dividend of 50 paise a rupee is received from his estate in full settlement. Prepare the necessary accounts closing the books of the firm applying the ruling given in Garner Vs. Murray.

Solution

Realization Account			
Particulars	Rs.	Particulars	Rs.
To Sundry Assets:		By Sundry Creditors:	57,000
Land & Building	57,000	By Cash A/c	
Stock	50,000	Sale of Land and Building	40,000
Debtors	50,000	Stock	30,000
To Cash (Expenses)	1,200	Debtors	42,000
To Cash (Sundry creditors)	57,000	Goodwill	600
		By Loss on Realization:	
		Long	22,800
		Short	15,200
		Thin	7,600
	2,05,200		45,600
			2,05,200

Partner's Capital Account							
Particulars	Long (Rs.)	Short (Rs.)	Thin (Rs.)	Particulars	Long (Rs.)	Short (Rs.)	Thin (Rs.)
To Profit & Loss A/c	750	500	250	By Balance b/d	90,000	10,000	10,000
To Short's Current A/c	-	2,000	-	By Long's Current A/c	1,500	-	-
To Thin's Current A/c	-	-	5,000	By Cash A/c	-	7,842	1,425
To Loss on Realization	22,800	15,200	7,600	By Long's Capital A/c	-	-	1,283
To Thin's Capital	1,283	142	-	By Short's Capital A/c	-	-	142
To Cash A/c	66,667	-	-				
	91,500	17,842	12,850		91,500	17,842	12,850

Cash Account			
Particulars	Rs.	Particulars	Rs.
To Balance	3,000	By Realization (Expenses)	1,200
To Realization (Sale of assets)	1,12,600	By Sundry Creditors	47,000
To Short's Capital	7,842	By Long's Loan A/c	10,000
To Thin's Capital	1,425	By Long's Capital A/c	66,667
	1,24,867		1,24,867



Dissolution of Partnership and Dissolution of Firm

According to Section 39 of the Indian Partnership Act, 1932, "The Dissolution of partnership between all the partners of a firm is called the Dissolution of the firm." Dissolution of a Firm is the complete breakdown of a partnership and partners do not continue the firm. Dissolution of the Partnership means a reconstitution of the firm due to the retirement of a partner and the remaining partners provide for the continuance of the firm in pursuance of an express or implied agreement to that agreement to that effect. On Dissolution of a firm, the firm's assets are realised, and the liabilities are discharged because the firm is to be closed, whereas on Dissolution of a partnership, the share of the outgoing partner is ascertained, and the firm is not closed.

9.10 Insolvency of Partners

If a partner's capital account shows a debit balance on the dissolution of the firm, he is to pay the debit balance to the firm to settle this account. But if such a partner insolvent, i.e., unable to satisfy his debt to the firm, then his deficiency which he is not able to bring will be borne by the other solvent partners in accordance with decision in Garner vs. Murray.

In this case it was ruled, in the absence of any agreement to the contrary, the deficiency of the insolvent partner's capital account must be borne by the firm. The effect of this ruling is to make a distinction between an ordinary loss due to trading or realisation of assets and loss on account of insolvency of a partner.

The loss in case of insolvency is a capital loss should be borne by other solvent partners in their capitals. Another ruling is that the solvent partners should bring in cash equal to their share of loss on realisation. This ruling has been given to bring the capitals accounts of the solvent partners to the figures they stood before transferring the loss of realisation.

9.11 Fixed and Fluctuating Capitals

While determining the capital ratio of the solvent partners, distinction should be observed between fixed and fluctuating capitals.

- If the capitals of the partners have been agreed to be fixed, then no adjustment is required for accumulated profits or losses, interest on capitals, drawings etc. and deficiency of the insolvent partner is borne by the solvent partners in proportion to their agreed fixed capitals.

Date/ Sr. no.	Particulars	L.F	Debit	Credit
	Solvent Partners' Current a/c Dr. To Insolvent Partners' Capital a/c (Being transfer of the deficiency of the insolvent partner to the solvent partners' current accounts in proportion to their agreed fixed capitals)			

- If the capital accounts are maintained on fluctuating basis, then capital accounts should be adjusted for reserves, profit or losses, interest on capitals, drawings and unrecorded assets and liabilities on the date of the balance sheet just before the dissolution of the firm.

Date/ Sr. no.	Particulars	L.F	Debit	Credit
	Solvent Partners' Capital a/c Dr. To Insolvent Partners' Capital a/c (Being transfer of the deficiency of the insolvent partner to the solvent partners' capital accounts)			

Capital accounts

Particulars	X	Y	Z	Particulars	X	Y	Z
To Realisation a/c (Loss)	19,600	9,800	14,700	By balance b/d	68,000	46,000	3,000
To Z's Capital a/c (Rs. 4,976 in the ratio of 75,600 : 49,800)	3,000	1,976		By P &L a/c	2,000	1,000	1,500
To bank a/c	72,600	47,824		By Reserve Fund	5,600	2,800	4,200
				By Bank (Realisation loss brought in)	75,600	49,800	8,700
				By Bank	19,600	9,800	
				By X's Capital a/c (126/209 share of Z's deficiency)			1,024
				By Y's capital a/c (83/209 share of Z's deficiency)			3,000
	95,200	59,600	14,700		95,200	59,600	1,976
							14,700

9.12 Sale to a Company

Conversion of a partnership means changing the status of the partnership firm into a joint stock company. A new company is formed to take over the business of the firm. Conversion is just like a sale of partnership business to a new company. Need for conversion of partnership into a company :

- Liability of the shareholders will become limited.
- The company can collect more fund for expansion of its business.
- The entity of the company will be separate from its members. The admission, death, insolvency of the members will not affect the continuity of the company.
- To take advantage of less rate of income-tax.
- To enjoy the benefits of large production.
- To have continuous existence of the business unit.

9.13 Purchase Consideration

It is the amount paid by the purchasing company to the vendor firm for taking over its assets and liabilities. The company may take over all assets or liabilities or any of them.

9.14 Methods of calculation of Purchase consideration

- **Lumpsum method:** When a fixed amount or lumpsum is given by the purchasing company of the vendor firm, it is called lump sum method.
- **Net payment method:** Under this method, the purchase consideration is the total of all the payments made by the company to the vendor firm in the form of shares, debentures and cash.
- **Net assets method:** Under this method, the total of assets taken over by the company at agreed value is calculated and the agreed value of liabilities assumed is deducted.

9.15 Gradual Realisation of Assets and Piecemeal Distribution

On a gradual realisation of assets, the cash realised is distributed in the following order to avoid the excess payment to any partner. Expenses of realisation are to be paid in the first instance as these get preference over unsecured creditors. Then the debts of the firm to third parties must be paid out in full prior to any partner being paid any amount in respect of his loan and capital; secured creditors should get preference over unsecured creditors.

After the creditors have been paid off, the amount due to a partner as loan should be paid. When the loans are due to more than one partner, the cash available should be paid rateably. After the payment of outside liabilities and loans due to the partners, the capitals of the partners are paid by two methods:

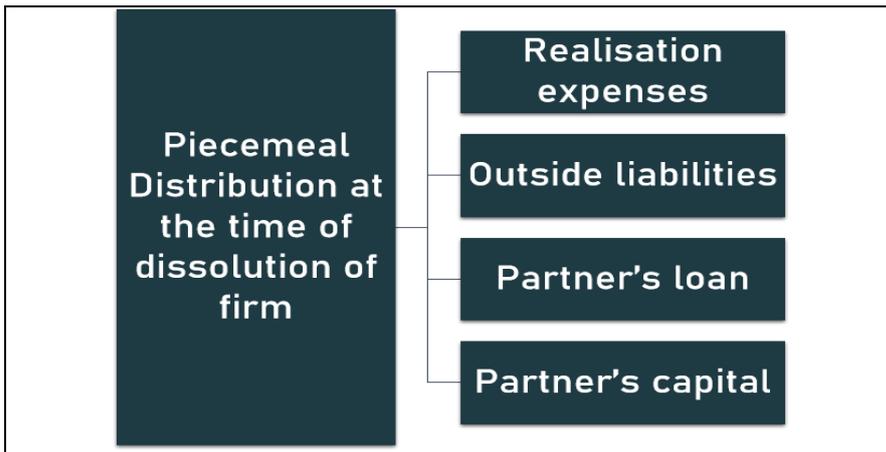
1. **Proportionate Capital Method:** If the capitals of the partners are in the ratio of their profit-sharing arrangement, then each of them is paid out according to his capital ratio at each distribution. If the capitals of the partners are not in the profit-sharing ratio, then the first cash available for distribution amongst the partners should be paid to those partners whose capitals are more than their profit-sharing ratios to bring their capitals to their profit sharing levels. Cash available for distribution amongst the partners cannot be distributed according to the profit and loss sharing ratio unless the capitals of the partners are in the profit and loss sharing ratio because that will not leave the unpaid balances of the capital accounts in the profit and loss sharing ratio of the partners.

2. **Maximum Loss Method:** An alternative method of piecemeal distribution of cash amongst partners is to calculate the maximum possible loss on every realisation after the outside liabilities and the partners' loans have been paid. The amount available for distribution amongst partners is compared with the number of capitals payable to partners and the maximum possible loss is ascertained on the assumption that in future assets will not realize any amount.

The maximum loss so ascertained is deducted from the capitals of the partners in the profit and loss sharing ratio and the balance left in the capital accounts after the deducting the maximum possible loss will be the amount payable to the partners. But if a partner's share of maximum possible loss is more than the amount standing to the credit of his capital account, he should be treated as insolvent and his deficiency should be debited to the capital accounts of the other partners in their proportion of their capitals which stood on the dissolution date as stated in the case of Garner vs. Murray.

Piece meal Distribution

Piecemeal distribution at the time of dissolution of partnership firm, is considered as one of important method for settlement of partners account. For this purpose, the realisation of assets and payment of certain expenses along with outsiders liabilities is done through proper procedure. The partners outstanding dues like loan also adjusted and at last partners capital account is prepared for the settlement.



Summary

- Dissolution of partnership between all the partners of a firm is called the dissolution of the firm.
- Persons who have entered into partnership with one another are individually called 'partners' and collectively called 'firm'.
- Dissolution of partnership changes the existing relationship between partners but the firm may continue its business as before.
- The dissolution of partnership among all partners of a firm is called dissolution of the firm.
- Realisation Account is prepared to record the transactions relating to sale and realisation of assets and settlement of creditors.
- Garner vs Murray Rule is applied during Insolvency of Partnership.

- Conversion of a partnership means changing the status of the partnership firm into a joint stock company. A new company is formed to take over the business of the firm. Conversion is just like a sale of partnership business to a new company.
- Purchase Consideration is the amount paid by the purchasing company to the vendor firm for taking over its assets and liabilities.

Keywords

- **Lumpsum method:** When a fixed amount or lumpsum is given by the purchasing company of the vendor firm, it is called lump sum method.
- **Net payment method:** Under this method, the purchase consideration is the total of all the payments made by the company to the vendor firm in the form of shares, debentures and cash.
- **Net assets method:** Under this method, the total of assets taken over by the company at agreed value is calculated and the agreed value of liabilities assumed is deducted.

Self Assessment

1. Persons who have entered into partnership with one another are individually called 'partners' and collectively called '_____'.

- A. Company
- B. Firm
- C. Sole Trader
- D. None of above

2. Dissolution of partnership changes the existing relationship between _____.

- A. Firm and Partners
- B. Company
- C. Firm
- D. Partners

3. In dissolution by _____, a firm is dissolved with the consent of all the partners.

- A. Agreement
- B. Existence
- C. Coherence
- D. Compulsion

4. When the business of the firm becomes illegal it is _____ dissolution.

- A. Compulsory
- B. Coherence
- C. Agreement
- D. Actual

5. When a partner becomes permanently incapable of performing his duties as a partner, it is dissolution by _____.

- A. Compulsion
- B. Agreement
- C. Direction

D. Court

6. Two separate accounts are kept for each partner in _____ type of capital.

- A. Freeze
- B. Fluctuating
- C. Flexible
- D. Fixed

7. Economic relationship between the partners comes at an end in dissolution of _____.

- A. Company
- B. Firm
- C. Sole Trader
- D. None of above

8. The _____ Account is prepared to record the transactions relating to sale and realisation of assets and settlement of creditors.

- A. Recognition
- B. Realisation
- C. Revaluation
- D. None of above

9. Deficiency in realisation account is to be shared by solvent partners in their _____ sharing ratio.

- A. Equal
- B. Fixed
- C. Capital
- D. Profit

10. If any amount is received from the private estate of an insolvent partner, it should be credited to his _____ Account.

- A. Saving
- B. Partner
- C. Capital
- D. Profit

11. Dissolution of the _____ means a reconstitution of the firm due to the retirement of a partner and the remaining partners provide for the continuance of the firm.

- A. Company
- B. Firm
- C. Partners
- D. Partnership

12. The loss in case of insolvency is a _____ loss should be borne by other solvent partners in their capitals.

- A. Partnership
- B. Nominal
- C. Revenue
- D. Capital

13. _____ of a partnership means changing the status of the partnership firm into a joint stock company.

- A. Conversion
- B. Dissolution
- C. Nominal
- D. Operations

14. The amount paid by the purchasing company to the vendor firm for taking over its assets and liabilities, is known as _____.

- A. Amalgamation
- B. Business Purchase
- C. Consideration
- D. Purchase Consideration

15. The total of all the payments made by the company to the vendor firm in the form of shares, debentures and cash, is _____ method.

- A. Lump sum
- B. Share exchange
- C. Net asset
- D. Net payment

Review Questions

- 1. Distinguish between Dissolution of Partnership and Dissolution of Firm?
- 2. How to prepare Realisation Account?
- 3. Discuss Garner vs Murray Rule for Insolvency of Partnership?
- 4. The following is the Balance sheet of A, B and C on December 31, 2018:

Particulars	Amount	Particulars	Amount
Creditors	20,000	Cash	6,000
Reserve Fund	15,000	Stock	20,000
A's Capital	25,000	Plant and Tools	20,000
B's Capital	15,000	Sundry Debtors	10,000
		Bills Recievable	10,000
		C's Capital Overdrawn	9,000

Total	75,000	Total	75,000
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C is insolvent and his estate pays Rs. 2,000. It is decided to wind up the partnership. The assets realized are as follow:

Sundry debtors Rs. 7,500; Bills recievable Rs. 7,000; Stock Rs. 16,000; Plant and Tools Rs. 14,000. The cost of winding up is Rs. 2,500. Give accounts to close the books of the firm taking the capitals as fixed.

5. Write a short note on accounting treatment of goodwill?

6. L, M & O were partners in a firm sharing profits and losses in the ratio of 2:1:1 respectively on the date of dissolution their balance sheet was as follows:

Particulars	Amount	Particulars	Amount
Creditors	28,000	Sundry Assets	80,000
L's Capital	20,000		
M's Capital	20,000		
N's Capital	12,000		
Total	80,000	Total	80,000

The assets realized 68,000 & it was received in installments of 28,000, 20,000 & 20,000. Prepare a statement showing distribution of cash by using proportionate capital method.

7. What do you mean by purchase consideration? Discuss its methods in detail?

8. Discuss the accounting treatment of Fixed and Fluctuating Capital?

9. Explain the circumstances for dissolution of firm in detail?

10. Discuss the Piecemeal distribution in detail?

Self Assessment Answers

1. B	2. D	3. A	4. A	5. D
6. D	7. B	8. B	9. D	10. C
11. D	12. D	13. A	14. D	15. D

Further Readings



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Unit 10: Accounting for Hire-Purchase and Installment Systems**CONTENTS**

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Summary

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Objectives

After studying this unit, you will be able to:

- recognize the conceptual framework of hire purchase system.
- compute the cash price and interest and hire purchase price.
- distinguish between hire purchase system and installment system.

Introduction

Mr. Rohit wants to buy a car but he is not able to pay the full amount in one time. He went into a contract with the dealer that he will pay 50,000 as down payment and the rest of amount in equal installments. The dealer agreed with the contract but he said that he will transfer the ownership of the car only after receiving the last installment. These types of purchase agreements are called hire purchase agreements.

There are two systems of deferred payments, namely.

1. Hire Purchase System, and
2. Installment Payment System.

10.1 Meaning and Nature of Hire Purchase

A hire purchase agreement is defined in the Hire Purchase Act, 1972 as a peculiar kind of transaction in which the goods are let on hire with an option to the hirer to purchase them, with the following stipulations:

- Payments to be made in installments over a specified period.
- The possession is delivered to the hirer at the time of entering into the contract.

- The property in goods passes to the hirer on payment of the last installment.
- Each installment is treated as hire charges so that if default is made in payment of any installment, the seller becomes entitled to take away the goods.
- The hirer/purchaser is free to return the goods without being required to pay any further installments falling due after the return.

10.2 Definition HPP

According to J.R. Batliboi "Under the Hire Purchase System, goods are delivered to a person, who agree to pay the owners equal periodical installment, such installment to be treated as hire of those goods, until a certain fixed amount has been paid, when these goods become the property of the hirer".



Components of HPP

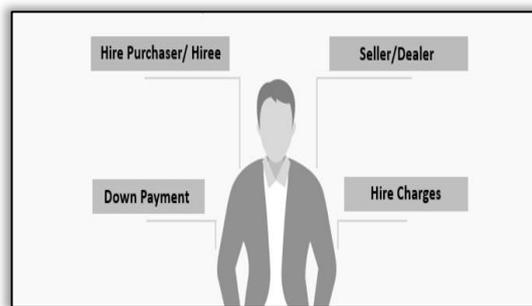


Fig 1: Components of Hire Purchase Price

Characteristics of Hire Purchase System

There are many of features of Hire Purchase System, which are used by users for availing benefits out of it:

1. **Sale of Goods on Credit** - The sale of goods is on credit basis. The customers can purchase the goods of their necessity and can pay the pending amount later on
2. **Payment in Installments** - Some amount is usually paid on signing the agreement and the balance is paid in periodic installments.
3. **Total payments being more than Cash Price** - The Total sum payable by the purchaser known as hire purchase price is always more than cash price i.e the amount for which the article can be purchased on full payment of the goods, the excess is the interest for deferred payment and hire purchase charge.
4. **Possession of Goods** - The hire purchaser acquires the right to use the goods immediately on signing the hire purchase agreement.
5. **Right to use the Goods** - The Purchaser acquire to right to use the goods immediately after taking them in his possession.
6. **Title or Ownership of Goods** - The title or ownership of the goods remains with the vendor till the last installment is received from the purchaser.
7. **For not making the payment of Installment** - If the purchaser fails to make the payment of pending dues, the seller has right of repossession of goods or forfeiture of rreceived installment and right of receiving the outstanding installments from purchaser.
8. **Responsibility of Maintenance of Goods in good condition** - It is the prime responsibility of purchaser to keep the goods in good condition and pay the instalments on time to seller.
9. **Responsibility for Repairs** - The goods should be maintained in good condition and if any repairs required for same, that should be maintained as per one of requirement of Hire Purchase System.

10. **No right to Sell or Pledge the Goods** - The seller do not have any right to sell or pledge the goods in case of no default for payment. Also, the buyer can not do so, a the ownership for goods had not transferred till last payment.

10.3 Advantages of Hire Purchase System

There are many benefits of Hire Purchase System for both the parties involved in this. Even the HPP is beneficial for society as well. Let us discuss the advantages of this in detail:

1. Advantages to Buyer:

- **East method of Payment:** Rather than one big lump sum, you can spread the purchase cost of high ticket items. These include items such as cars, where you can pay over a period of 3 to 5 years typically.
- **Encouragement to Savings:** Hire purchase is a simple way of financing and typically relatively easy to obtain. Buyers are encouraged to save the money and pay in easy installments for their necessities.
- **Free repair:** As the ownership is not transferred till last payment, so any damage occur to product will be get repaired by seller as free or low cost.
- **Purchases of Valuable Goods:** The interest rate on hire purchases is fixed for the duration of the agreement. So the buyer can even purchase any valuables.

2. Advantages to Seller:

- **Increase in Sales:** It helps in getting the higher sales from society, as this system is affordable for ones, who can not pay lump sum amount at once. By paying the amount in installments sales get increase.
- **Increase in Income:** By increae in sales, income also get increase. As the seller are charging some amount of interest on cash price as well.
- **Easy realization of installments:** The seller can realize the amount of product from buyer easily, as the ownership is with seller till last payment. Seller can get all installments from buyer or can recover the amount by repossessing the goods.
- **Close relation between Buyer and Seller:** The relation between buyer and seller improves by this sytem. The buyer and seller met each month for payment of installments and evencan purchase the more goods from same seller.
- **Possibility of Sale of Other goods:** With the ease of payment and close relation between buyer and seller, it is quite possible that buyer will purchase the other goods from same seller as well. If their is no default in making payment, seller also seek the buyer wiyh same intent.

3. Advantages to Society:

- **Increase in Production:** With the ease in making payments and acquiring goods, prduction also increases. This way, while purchasing the goods at bulk, there is economies of scale.
- **Increase in Employment:** With the increase in production, the employment also increases. This helps is earning and get better life. This also helps in removing poverty line.
- **Increase in Standard of Living:** The employment rate is increasing with the help of this system, so there was simultaneous increase in earning and standard of living.

10.4 Disadvantages of Hire Purchase System

1. Disadvantages to Purchaser:

- **High Price:** Many of times seller charge high price of goods from buyer by adding inappropriate rate of interest. The actual price of goods paid by buyer is higher than actual price to be paid as per accounting rules.

- **Fear of Repossession of Goods:** If the buyer is not able to pay installments of the goods anytime, there is always a fear in mind of buyer for repossession of goods. As the ownership of goods transfer from seller to buyer only at last installment.
- **Purchase of Unnecessary Goods:** This is utmost issue with most of buyers, as in lieu of installments, they sort to purchase unnecessary goods which inculcate the habit of more spending.
- **Mental Disturbance:** In order to pay monthly installments, there is always a mental disturbance created in minds of buyers. As there is a fear of repossession as well.
- **No Ownership on Goods:** The ownership of goods is transferred at payment of last installment, even the buyer can use the goods till but ownership will remain with seller only.

2. Disadvantages to Seller:

- **Need of More Capital:** There is always a need of capital with seller in order to met the demand of buyers. In lieu of this, they have to opt for loan also.
- **Difficulty in Realizing installments:** Many of times buyers do not pay the installments on due date and seller faces a problem in realizing the amount of sold goods. Although the ownership remains with seller but realizing the amount always create mental disturbance with seller.
- **Difficulty in Repossession of Goods:** The goods are in usage position and many of times damaged or broken, so seller in case of default of payment takes repossession, still there is difficulty in recovering the amount because of condition of goods. Also, sometimes buyer denies to return the goods to seller and request for extension in time for payment.
- **More expenditure on Accounting:** The seller has to maintain records for each buyer regarding installments paid and due. Much more expenditure has to levy on maintaining accounts for this.
- **Bear of Loss of Depreciation of goods:** The goods are used by buyer as possession is with buyer, so wear and tear is common. Seller has to bear the loss of depreciation of goods in case of repossession.



Hire Purchase Price

The hire purchase price can be computed by adding chargeable interest into cash price of the goods. The hire purchase price is the total amount paid by buyer to seller in easy installments. The formula used to compute this is as follow:

$$\text{Cash Price} + \text{Total Interest} = \text{Hire Purchase Price}$$

10.5 Necessary Accounts in the Books of Hire Purchaser

The hire purchaser has to submit its record in various accounts and that will help in getting the authentic facts and figures for each transaction occur in an organization. Here is the detail for these accounts:

- **Assets Account:** Asset account will be debited with the full amount of Cash Price of the assets since the object of the hire-purchaser is to be the owner of the asset and, as a result, the same should be treated like 'credit purchase of an asset' in the books of the hire-purchaser.
- **Vendor's Account:** The hire-vendor treats the hire purchase sale like an ordinary sale. He debits the hire purchaser with the full cash price and credits the Sales Account. Interest is debited to the hire purchaser when instalments become due. Cash received is, of course, credited to the hire purchaser.
- **Interest Account:** Hire purchase interest in suspense (or Hire purchase undue interest) are interest calculated and factored into the assets that are acquired and paid to the Hire purchase creditors over a period. They are reflected in the Balance sheet as an current asset and to be written off each month as it is due.

- **Depreciation Account:** The object of the purchaser is to become the owner of the assets after paying the last installment. Therefore, depreciation should be charged every year on the cash price of the asset acquired under hire-purchase agreement even if the ownership is not transferred

Necessary Accounts in the Books of Vendor

As the organization prepares necessary accounts in books of hire purchaser, simultaneously some are prepared in books of vendor also. Let us discuss about that:

- **Purchaser's Account:** The hire-vendor values the goods received and credits the account of the hire-purchaser, transferring any balance in the account of the hire-purchaser to Profit and Loss Account. The value of the goods received is debited to Goods Repossessed Account.
- **Interest Account:** Hire purchase interest in suspense (or Hire purchase undue interest) is interest calculated and factored into the assets that are acquired and paid to the Hire purchase creditors over a period. They are reflected in the Balance sheet as an current asset and to be written off each month as it is due.

10.6 Calculation of Interest

The interest is calculated on cash price and in each installment the amount of interest is added and in total of cash price and interest, which purchases is paying each month, sums upto hire purchase price. The interest calculated in equal in each installment paid.

1.Particulars	2.Cash Price	3.Principal	4.Interest	5.installment
Particulars about installments	Cash Price of the Assets	Amount of installment excluding Interest	Amount of Interest	Amount of installment including interest

Installment Payment System

Installment payment system like hire purchase system is a system of sale in which the payment is made in installment. Under this system, the buyer becomes the owner of the goods immediately on signing the contract of sale. If the buyer makes default in the payment of installment, then the seller cannot reposses the goods. He/ She can only sue the buyer for unpaid installments.

As per J.R. Batliboi, "Under an agreement to purchase and pay by installments, the goods become the property of the purchaser immediately when he/she receives the delivery of the same."

10.7 Characteristics of Installment Payment System

Under the installment purchase system, there is an outright sale of goods with the buyer having the facility to pay the purchase price in a certain number of agreed installments. In this system, a certain amount is paid as a down payment amount at the time of signing the agreement. The buyer makes certain down payment at the time of signing an agreement and the balance is paying in installment over a period of time.

Under installment payment system, contract of credit sale, payment in installments, transfer of ownership, delivery of goods, in case of default of payment of installment, right of sale or mortgage of goods are the few features that are possessed by this system.

(1) The installment purchase system is just like an outright credit sale of goods. Under this system of purchase, the buyer acquires possessions of the goods immediately at the time of agreement and not after paying the last installment which is the case with hire purchase system.

(2) The buyer makes the payment in different installments over a period of time as agrees upon in the agreement. The Buyer is required to make payment in installment over a period of time which

ranges from 1 year for products like television or air conditioners to 20 years in case of purchase of apartments.

(3) Under the installment purchase system, the buyer gets the immediate possession as well as the ownership of goods. Since ownership has passed the buyer cannot return the goods to the seller if he or she does not like the product.

(4) The seller can not responses the good if the buyer made default in the payment of installment but he/she can sue against the buyer for the recovery of the amount due.

(5) In case of default in the payment of installment, the total amount of installments already paid by the buyer can not be forfeited. In case of default in respect of the last Installment, the seller has no right to take back the goods. The seller can only sue the buyer for the unpaid balance.

(6) Under the installment system, the buyer can sell or mortgage the goods even before clearing all the installments. The buyer can also transfer the goods even if he or she has not paid the last installment because the owner has already passed at the time of the agreement.

(7) The risk of goods/assets are to be borne by the buyer just after signing the agreement. If the buyer fails to make the future payment, the seller cannot repossess the goods but he can sue against the buyer for the amount receivable.

(8) The buyer of the goods under an installment purchase system has no right to return the goods to the seller. In this system, the installment price includes both the cash price and the amount of interest for delayed payment

Hire Purchase vs Installment Sale

Though both the system of consumer credit are very popular in financing and look similar, there is clear distinction between the two.

- In an installment sale, the contract of sale is entered into the goods are delivered and the ownership is transferred to the buyer but the price is paid in specified installments over a period of time.
- In hire purchase, the hirer can purchase the goods at any time during the term of the agreement and he has the option to return the goods at anytime without having to pay the rest of the installments.
- But in installment payment financing there is no such option to the buyer.

Difference between Hire Purchase System and Credit Sale

S.No.	Basis of Difference	Hire Purchase	Credit Sale
1.	Act	Purchase Act 1972	Sales of goods Act,1930
2.	Nature of Contract	Hire purchase contract	Contract of Sale
3.	Mode of payment	Installment	Cash
4.	Transfer of Ownership	After the payment of last installment.	On signing the contract of Sale
5.	Right of repossession of Goods	Default in the payment.	Cannot repossess the goods.
6.	Repair of Goods	Vendor	Purchaser
7.	Right to Sell or Pledge the Goods	No right to sell or pledge the goods	Sell or Pledge.
8.	Termination of Contract	Purchaser can terminate the Contract	Purchaser cannot terminate the contract.

Accounting Treatment of Hire Purchase Transactions

In case of a hire purchase transaction the accounts are prepared by both the hire purchaser and vendor.

Accounting Treatment in the Books of Hire Purchaser

Ram Ltd. bought on 1.1.20 a machine from Shyam Ltd. Under a hire purchase system of payment under which three annual installments of 2,412 would be paid. There is no down payment, and the cash price is 6,000, the rate of interest would be 10% and depreciation@ 10% p.a. would be charged on straight line basis. Prepare machinery A/c and vendor A/c in the books of Ram Ltd.

Solution

In the books of Ram Ltd. Shyam Ltd Account					
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
				By Machine A/c	6,000
31.12.20	To Cash A/c	2,412	31.12.20	By Interest A/c	600
	To Balance c/d	4,188			
		6,600			6,600
31.12.21	To Cash A/c	2,412	01.01.21	By Balance b/d	4,188
	To Balance c/d	2,194	31.12.21	By Interest A/c	418
		4,606			4,606
31.12.22	To Cash A/c	2,412	01.01.22	By Balance c/d	2,194
				By Interest (Balancing figure)	218
		2,412			2,412

Machine Account					
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
01.01.20	To Shyam Ltd	6,000	31.12.20	By Depreciation A/c	600
				By Balance c/d	5,400
		6,000			6,000
01.01.21	To Balance b/d	5,400	31.12.21	By Depreciation A/c	600
				By Balance c/d	4800
		5,400			5,400
01.01.22	To Balance b/d	4,800	31.12.22	By Depreciation A/c	600
				By Balance c/d	4,200
		4,800			4,800

Forfeiture of Goods by the Vendor or Repossession of Goods

Possession of goods means physical holding of goods. Under hire purchase agreement, the vendor transfers the possession of goods. He does not transfer the ownership, and if the hirer fails to pay

even the last installment he has 'the legal right to recover the possession of the goods. This act of recovery of possession is termed as 'repossession'.

The legal position of the hire vendor and hire purchaser (hirer) in case of default is complicated. The Hire Purchase Act of 1972 did codify this issue first, but as this Act was not put to operation, the legal position is not very clear.

In case the purchaser fails to pay any of the installments, the hire vendor can take back the possession of the goods, The amount already paid to the vendor as a part of the payment for the asset is treated as the hire charge. So, far as the repossession of goods is concerned the vendor can either take back the whole of the asset or a part of it.

1. **Complete repossession:** Under the circumstance the hire vendor closes the books of the Hire-Purchaser's Account by transferring to Repossess Goods Account. Similarly, the hire-purchaser also closes the account of Hire-Vendor Account by transferring to the balance of Asset Account.

2. **Partial repossession:** Sometimes the hire vendor may not repossess the entire goods. Then Hire Vendor Account is debited with the agreed value of the seized goods and the Asset Account is credited with the same value. Now the Asset Account shows the value of the portion left with the buyer; of course, less depreciation.



Rights of the Hire Vendor

1. **Rights of hire vendor to terminate hire purchase agreement:** Where the hirer makes more than one default in payment of installment as provided in the agreement, the hire vendor (the owner) shall be entitled to terminate the agreement by giving the notice of termination in writing.
2. **Rights of the hire vendor on termination:** Where a hire purchase agreement is terminated, the hire vendor (the owner) shall be entitled:
 - to enter the premises of the hirer and seize the goods,
 - to retain the hire charges already paid and to recover the arrears of hire charges due,
 - to claim damages for non-delivery of the goods.



Restrictions on the Owner

1. **Rights of hirer in case of seizure of goods by the owner:** Where the owner seizes the goods lent under a hire purchase agreement, the hirer may recover from the owner the amount, if any, by which the hire purchase price falls short of the aggregate of two amounts:
 - the amounts paid in respect of the hire purchase price up to the date of seizure; and
 - the value of the goods on the date of seizure.
2. **Restrictions on owner's right to repossess:** Where goods have been let under a hire purchase agreement, and the statutory amount of the hire purchase price has been paid, the owner shall not enforce any right to recover possession of the goods from the hirer otherwise than by 'verdict of any competent court.



Problem

On 1st April, 2019 machinery is purchased on the hire purchase system, the payment to be made Rs 10,000 down (i.e., on the signing of the contract) and Rs 10,000 annually for three years. The cash price of the machinery is Rs 34,860 and the rate of interest is 10% per annum.

Solution

<i>Date of Payment</i>	<i>Amount Payable</i> ₹	<i>Interest</i> ₹	<i>Amount towards Cash Price</i> ₹
01.4.2009	10,000	—	10,000
31.3.2010	10,000	2,486	7,514
31.3.2011	10,000	1,735	8,265
31.3.2012	10,000	919	9,081

Cash price of the machinery -	34,860 (Rs.)
Less: Down Payment -	10,000
	24,860
Add: Interest on Rs. 24,860 @ 10% for 1 year	2,486
	27,346
Less: Amount of first installment	10,000
	17,346
Add Interest for 2 nd year on Rs. 17,346	1,735
	19,081
Less: Amount of second installment	10,000
	9,081
Add Interest for 3 rd year- amount necessary to make up Rs 10,000	919
	10,000
Less: Amount of third (final) installment	10,000
	X

Problem

A colour T.V. set whose cash price is Rs 14,100 is sold on hire purchase basis for 12 quarterly payments of Rs 1,500 each, the first payment being made at the end of the first quarter. The total of all payments is Rs 18,000. The cash price is Rs 14,100. Hence Rs 3,900 is the interest for all the 12 quarters. To ascertain the interest for every quarter, Rs 3,900 will be allocated in the ratio of amounts outstanding during each quarter. Thus

Solution

	Amount Outstanding (Rs)	Ratio	Interest (Rs)	Cash Price (Rs)
First Quarter	18,000	12	600	900
Second Quarter	16,500	11	550	950
Third Quarter	15,000	10	500	1,000
Fourth Quarter	13,500	9	450	1,050
Fifth Quarter	12,000	8	400	1,100
Sixth Quarter	10,500	7	350	1,150
Seven Quarter	9,000	6	300	1,200
Eighth Quarter	7,500	5	250	1,250
Ninth Quarter	6,000	4	200	1,300
Tenth Quarter	4,500	3	150	1,350
Eleventh Quarter	3,000	2	100	1,400
Twelfth Quarter	1,500	1	50	1,450
		78	3,900	14,100

Summary

- Each installment is treated as hire charges so that if default is made in payment of any installment, the seller becomes entitled to take away the goods.
- The hirer/purchase is free to return the goods without being required to pay any further installments falling due after the return.
- The title or ownership of the goods remains with the vendor till the last installment is received from the purchaser.
- Hire purchase is a simple way of financing and typically relatively easy to obtain. Buyers are encouraged to save the money and pay in easy installments for their necessities.
- The seller can realize the amount of product from buyer easily, as the ownership is with seller till last payment. Seller can get all installments from buyer or can recover the amount by repossessing the goods.
- Cash Price + Total Interest = Hire Purchase Price
- Installment payment system like hire purchase system is a system of sale in which the payment is made in installment.
- Possession of goods means physical holding of goods. Under hire purchase agreement, the vendor transfers the possession of goods.

Keywords

- **Complete repossession:** Under the circumstance the hire vendor closes the books of the Hire-Purchaser's Account by transferring to Repossess Goods Account. Similarly, the hire-purchaser also closes the account of Hire-Vendor Account by transferring to the balance of Asset Account.
- **Partial repossession:** Sometimes the hire vendor may not repossess the entire goods. Then Hire Vendor Account is debited with the agreed value of the seized goods and the Asset Account is credited with the same value. Now the Asset Account shows the value of the portion left with the buyer; of course, less depreciation.
- **Hire purchase price:** The hire purchase price can be computed by adding chargeable interest into cash price of the goods. The hire purchase price is the total amount paid by buyer to seller in easy installments.
- **Installment payment system:** Installment payment system like hire purchase system is a system of sale in which the payment is made in installment.

Self Assessment

1. The dealer agreed with the contract, but he said that he will transfer the ownership of the car only after receiving the last installment. Which type of purchase agreements is refer here in the statement?
 - A. Instalment
 - B. Hire purchase
 - C. Sale
 - D. Implied sale

2. The two systems of deferred payments are _____
 - A. Sale and Implied Sale
 - B. Sale and Instalment
 - C. Implied Sale and Hire Purchase
 - D. Hire Purchase and Instalment

3. Under hire purchase system, the property in goods passes to the hirer on payment of the _____ installment.

- A. Last
 - B. First
 - C. Half
 - D. One Third
4. Under hire purchase system, interest is calculated on _____.
- A. Outstanding Balance
 - B. MRP
 - C. Cash Price
 - D. Hire Purchase Price
5. If the firm stops making repayments and the goods or assets are taken away from them as a result, this is known as:
- A. Cancellation
 - B. Forfeiture
 - C. Repossession
 - D. Annulment
6. Cash price plus interest is _____.
- A. Instalment Price
 - B. Hire Purchase Price
 - C. MRP
 - D. Retail Price
7. The difference between hire purchase price and the cash price is called _____.
- A. Instalment Price
 - B. Hire Charges
 - C. Instalment Price
 - D. Cash Price
8. Under hire purchase system who has the right of sell _____.
- A. Buyer
 - B. Hirer
 - C. Hire Vendor
 - D. Debtor
9. What is transferred to hirer, under hire purchase system :
- A. Ownership of assets
 - B. Possession of assets
 - C. Ownership and Possession of asset
 - D. None of these

10. Cash Price + Total Interest = ?

- A. Hire Purchase Price
- B. Cash Price
- C. Down Payment
- D. Hire Charges

11. The buyer becomes the owner of the goods immediately on signing the contract of sale is _____.

- A. Instalment
- B. Hire purchase
- C. Sale
- D. Implied sale

12. Repossession of goods are _____.

- A. Complete and Short
- B. Complete and Partial
- C. Short and Partial
- D. Complete, Partial and Short

13. _____ of goods means physical holding of goods.

- A. Recognition
- B. Possession
- C. Revaluation
- D. Repossession

14. In case of a hire purchase transaction the accounts are prepared by both the _____ and vendor.

- A. Hire purchaser
- B. Seller
- C. Purchaser
- D. Firm

15. Installment payment system like hire purchase system is a system of sale in which the payment is made in _____.

- A. Collectively
- B. Lump sum
- C. Instalments
- D. Periodically

Answers for Self Assessment

1. B 2. D 3. A 4. A 5. C
6. B 7. B 8. C 9. B 10. A
11. A 12. B 13. B 14. A 15. C

Review Questions

- Ram Ltd. bought on 1.1.04 a machine from Shyam Ltd. Under a hire purchase system of payment under which three annual installments of 2,412 would be paid. There is no down payment and the cash price is 6,000, the rate of interest would be 10% and depreciation @ 10% p.a. would be charged on straight line basis. Prepare machinery A/c and vendor A/c in the books of Ram Ltd.
- Ram Ltd. bought on 1.1.04 a machine from Shyam Ltd. Under a hire purchase system of payment under which three annual installments of 2,412 would be paid. There is no down payment and the cash price is 6,000. The rate of interest would be 10% and depreciation @ 10% p.a. would be charged on straight line basis. Pass the necessary journal entries in the books of hire purchaser when the asset is recorded at cash price actually paid.
- X purchased from Y three cars costing 1,00,000 each on hire purchase system. Payment was to be made; 60,000 down and balance in three equal installments together with interest at 15% per annum. X provides depreciation at 20% per annum on diminishing balance method. X paid the first installment at the end of the first year but could not pay the second installment, Y took possession of all the three cars. He spent 18,000 on repairs and sold them for 1,50,000. Show the necessary ledger account in the books of both the parties.
- What journal entries are to be made in the books of the buyer and seller, When the goods are sold on hire purchase system? And the seller takes the possession of the goods on default of payment of installments by the hire buyer.
- Distinguish between Hire Purchase and Instalment System of accounting.
- Make a distinguish between hire purchase and lease transactions.
- Discuss the benefits and drawbacks of Hire Purchase System?
- Mention the details of various accounts prepared in Hire Purchase System in Books of Hire Purchaser?
- Mention the details of various accounts prepared in Hire Purchase System in Books of Hire Vendor?
- Discuss the rights and restrictions of hire vendor?

**Further Readings**

- I.M. Pandey, *Financial Management*, Vikas Publishing, New Delhi
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**Web Links**

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Unit 11: Branch Accounting 1

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- 11.11 Final Accounts Method

Summary

Keywords

Self Assessment

Answer for Self Assessment

Review Questions

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Objectives

After studying this unit, you will be able to:

- cognize the concept of branch accounting.
- use accounting treatment of branch accounts.
- know the importance of debtor's method in accounting treatment of dependent branches.
- comprehend the conceptual framework and compute the profit and loss of stock and debtor's method, final accounts method and wholesale branch method.

Introduction

A branch means any subordinate sub-division of a business. As per the sec. 29, of Companies Act, 2013, " A branch is any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company. " For example, Bata has its branches all over the country. Each branch is treated as a separate profit centre and hence the profit or loss of each branch is computed separately. The head office of the firm has to keep strict control over various activities of each branch and ensure its smooth functioning.

11.1 Branch Accounting

Branch accounting is a book keeping system in which separate accounts are maintained for each branch or operating location of an organization. Typically found in geographically dispersed corporations, multinationals and chain operators, it allows for greater transparency in the transactions, cash flows and overall financial position and performance of each branch.

11.2 How Branch Accounting Works?

- In branch accounting, each branch is treated as an individual profit or cost centre.
- It records inventory, accounts receivable, wages, equipment, expenses such as rent and insurance, and petty cash.
- Like any double-entry book keeping system, the ledger keeps a tally of assets and liabilities, debits and credits, and ultimately, profits and losses for a set period.

11.3 Where Branch Accounting Applies

Branch accounting used for a company operating divisions, which usually have more autonomy than branches, as long as the division is not set up legally as a subsidiary company. A branch is not a separate legal entity, although it can be referred to as an "independent branch" because it keeps its own accounting books.

However, branch accounting is not the same as departmental accounting. Departments may have their own accounts, but they usually operate from the same physical location. A branch, by its nature, is a geographically separate entity



Pros and Cons of Branch Accounting

Advantage- Better accountability and control since the profitability and efficiency of different locations can be closely tracked.

Disadvantage- Branch accounting may involve added expenses for an organization in terms of manpower, working hours and infrastructure.

- A separate account coding structure must be maintained for each operating unit.
- It may be necessary to appoint branch accountants to ensure accurate financial reporting and compliance with head office procedures and processes.

11.4 Types of Branches

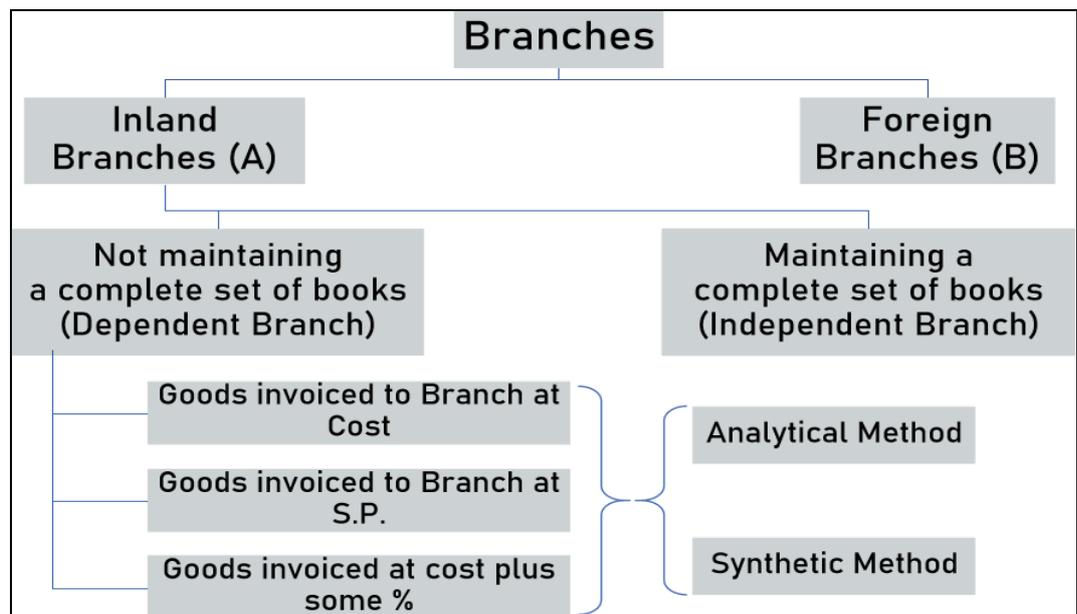


Fig 1: Various kinds of branches

11.5 Dependant Branches

These are the branches which are not keeping the full system of accounting. The dependent branches are not allowed to make any purchases and they sell goods received from the head office. Goods are supplied by the head office to such branches either at cost price or at invoice price. All the major expenses are paid by the head office. Normally the goods are sold for both the cash and credit.

A branch which is dependent upon Head Office mainly for "Goods and Cash". Books of accounts relating to such branch also will be maintained by Head Office.

11.6 Features of Dependent Branch

Dependent branches has number of features which are used by organizations for making appropriate records along with the branch records.

1. Branch receives goods from Head Office.
 - Only those goods supplied by Head office will be dealt (sold) by branch.
 - However, in case of need/emergency, the branch may be allowed to make local purchase after getting consent from Head Office.
 - For those purchases, payments may be directly made by Head office or funds transferred to branch.
2. Goods may be supplied to Head office at Cost price / Invoice price
3. Branch normally makes cash sales. In some cases, branch is allowed to make credit sales also to regular/approved customers (with the consent of Head office).
4. Cash sales and collection from debtors are periodically remitted to Head office.
5. Branch accounts will be maintained by Head Office. However Branch maintains memorandum books like petty cash, debtors etc.
6. Branch expenses like salary, rent etc. are paid/met by Head office.
7. Head office separately sends cash to branch for meeting expenses.
8. Branch while remitting cash to head office, deducts some portion (towards expenses) and balance will be remitted.

11.7 Accounting for Dependant Branch

Branches and Head Office both has to maintain different and various books of accounts in order to maintain data and information.

● **Accounting by Branches**

Such branches do not maintain complete accounting for their transactions, except few essential books such as Cash Book, Sales Book, Stock Register etc.

● **Accounting by HO**

Accounts for branch transactions are maintained in HO books. Branches supply the necessary information to the HO.



Types of Dependent Branch

There are different types of dependent branches, for the smooth functioning of work at HO and Branch level.

Service Branch- All branches which are executing orders on behalf of head office. These branches are busy in executing all the orders for the sake of head office.

Retail Branch- These are dependent branches, are concerned with the head office for selling goods, produced by HO itself or purchase from outside in bulk and are sent to retail selling branches for selling them out as like.

11.8 Accounts of Dependent Branch

Various methods are applied by accountants in order to maintain proper records in books of accounts. Most often the following methods are used by dependent branches in order to maintain data.

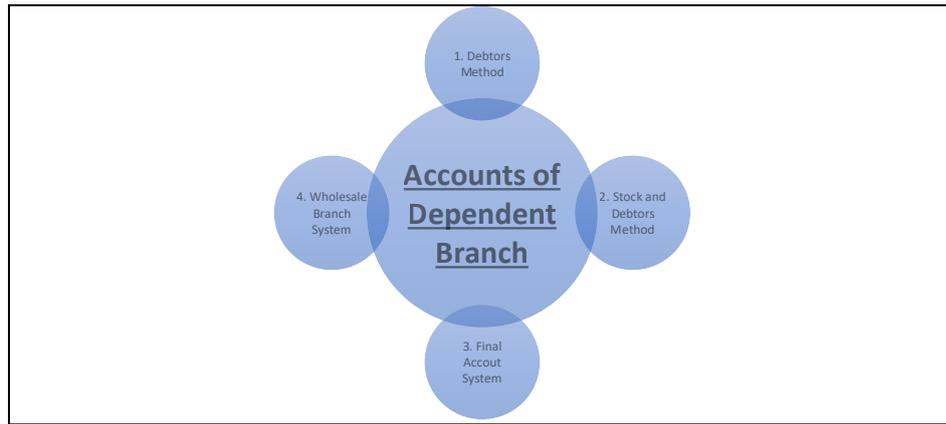


Fig 2: Accounts of Dependent Branch

11.9 Debtors Method

This system the head office simply opens a branch account which records all the transactions relating to a particular branch. Branches are also not required to ascertain profit or loss as no information relating to the cost of sales is given to them. Under debtor system the goods may be invoiced to branch at cost or invoice price.

Performa of Branch Account- Debtors Method

Problem

The GM Ltd. Delhi has a sales branch in Karnal. From the following figures, prepare Karnal Branch Account and also ascertain the profit or loss of the branch.

Unit 11: Branch accounting 1

<u>PARTICULARS</u>	<u>AMOUNT (Rs.)</u>
Goods sent to Branch	50,000
Cash sent to Branch for expenses	3,500
Cash received from the Branch	52,000
Stock at Branch on 31 st December	5,500
Petty cash in hand at Branch	500

SolutionKarnal Branch Account

<u>PARTICULARS</u>	<u>AMOUNT</u>	<u>PARTICULARS</u>	<u>AMOUNT</u>
To goods sent to branch a/c	50,000	By cash	52,000
To bank a/c	3,500	By stock at branch a/c	5,500
To profit transferred to P/L a/c	4,500	By cash at branch a/c	500
TOTAL	58,000	TOTAL	58,000

**Problem**

ABC & Co. of Delhi have a branch at Mumbai. Goods are sent by the head office at invoice price which is at a profit of 20% on invoice price. All expenses of the branch are paid by the head office. From the following particulars, prepare branch account in the head office books when goods are shown at an invoice price.

<u>PARTICULARS</u>	<u>AMOUNT (Rs.)</u>	<u>PARTICULARS</u>	<u>AMOUNT (Rs.)</u>
A. OPENING BALANCES		B. REMITTANCES MADE TO HO	
Stock at invoice price	11,000	Cash sales	2,650
Debtors	1,700	Cash collected from debtors	21,000
Cash	100	Goods returned by HO at invoice price	400
Goods sent to Branch at invoice price	20,000	C. CLOSING BALANCES	
D. EXPENSES MADE BY HO		Stock at invoice price	13,000
Rent	600	Debtors at end	2,000
Wages	200	Petty Cash	25
Salary	900		

Solution

Mumbai Branch Account

Particulars		₹	Particulars		₹
To Balance b/d:			By Cash Sales		2,650
Stock	11,000		By Cash Collected from debtors		21,000
Debtors	1,700		By Goods returned by branch		400
Petty cash	100	12,800	By Adjustments for Goods sent		
To Goods sent to Branch A/C		20,000	to Branch A/C		4,000
To Bank A/C (Expenses):			By Stock Reserve A/C (11000*20%)		2,200
Rent	600		By Closing balance		
Wages	200		Stock	13,000	
Salary, etc.	900	1,700	Debtors	2,000	
To Adjustments for Goods returned		80	Petty cash	25	15,025
To Stock reserve A/C (2200+400)		2,600			
To Net Profit transferred to					
General Profit & Loss A/C		8,095			
		45,275			45,275

11.10 Stock and Debtors System

Under Stock and Debtors System, the head office does not open a Branch Account in its books. It maintains a few control accounts for recording the various branch transactions. At the end of the accounting year, head office prepares the Branch Adjustment Account and the Branch Profit & loss Account.

1. Important terms used:

- **Branch Stock:** It is unsold goods at a Branch at the beginning/end of the year. □
- **Branch Debtors:** These are debtors of the branch. □
- **Goods Sent or supplied to Branch:** It is the goods supplied by the Head Office to its Branch for sale. It may be recorded at Cost or Invoice Price.



Invoice Price and Loading

- When consignor does not want to reveal the cost of goods to consignee, therefore, invoices goods at higher price than cost, this is invoice price.
- The difference between invoice price and cost price is loading.

2. How to eliminate loading

The following journal entries needs to be passed in books of HO for eliminating the loading:

1. To remove loading from net goods sent to branch	2. To remove loading from the amount of closing stock at branch
<p>Goods sent to branch a/c dr.</p> <p>To branch a/c</p>	<p>Branch a/c dr.</p> <p>To branch stock a/c</p>

3. Accounts maintain by HO

There are following accounts which are maintained by HO alongwith the purose from accounting point of view.

ACCOUNTS	PURPOSE
1. Branch Stock Account at Invoice Price	To ascertain any Shortage or Surplus.
2. Branch Debtors Account	To ascertain the Closing Debtors.
3. Branch Expenses Account	To ascertain the Total Expenses at the Branch.
4. Branch Adjustment Account	To ascertain Gross Profit/Gross Loss.
5. Branch Profit and Loss Account	To ascertain Net Profit/ Net Loss.
6. Goods sent to Branch Account	To ascertain the Net Cost of Goods Sent to Branch.
7. Branch Cost Account	To record all Cash transactions of the Branch.
8. Branch Fixed Asset Account	To record all transactions relating to Branch Fixed Accounts.



Problem

ABC Co. has its branch at Jaipur. Goods are invoiced to the branch at selling price, being cost plus 25% (on cost). Prepare Branch stock A/c, Branch Expenses A/c, Branch Debtors A/c, Branch Adjustments A/c, Reserve A/c, Goods supplied to Branch A/c, Stock Reserve A/c and also Branch A/c.

PARTICULARS	AMOUNT	PARTICULARS	AMOUNT
Goods supplied to HO (At cost to HO)	15,200	Cash recieved from Debtors	5,000
Cash sales	17,400	Discount allowed to customers	200
Credit sales	5,600	Goods returned by customers	100
Rent and rates (Paid by HO)	900	Goods spoiled	50
Wages (Paid by HO)	760	Opening stock (At invoice price)	3,000
Sundry Expenses (Paid by HO)	100	Opening debtors	2,000

Solution

In the Books of Head Office

(A) Branch Stock Account

Particulars	₹	Particulars	₹
To Balance b/d	3,000	By Cash (sales)	17,400
To Supplies from Head office (125% of 15,200)	19,000	By Branch Debtors A/c (Credit sales)	5,600
Branch Debtors (Returns by debtors)	100	By Branch Adjustment A/c	
To Net profit transferred to General Profit & Loss A/c	950	(Spoilage of goods)	50
	23,050		23,050

(B) Branch Expenses Account

Particulars	₹	Particulars	₹
To Cash: Rent & Rates	900	By Branch Adjustment A/c (Transfer)	1,960
Wages	760		
Sundry expenses	100		
To Branch debtors A/c: Discount allowed	200		
	1,960		1,960

(C) Branch Debtors Account

Particulars	₹	Particulars	₹
To Balance b/d	2,000	By Cash	5,000
To Branch Stock A/c (credit sales)	5,600	By Discount (Branch expenses) A/c	200
		By Branch stock A/c (Returns)	100
		By Balance c/d	2,300
	7,600		7,600

(D) Branch Adjustment Account

Particulars	₹	Particulars	₹
To branch stock A/c (spoilage of goods)	50	By good supplied to branch A/c	3,800
To branch expenses A/c	1,960	By stock reserve A/c	600
To net profit transferred to general Profit & Loss A/c	2,390		
	4,400		4,400

(E) Goods Supplied to Branch Account

Particulars	₹	Particulars	₹
To Branch Adjustment A/c	3,800	By Branch stock A/c	19,000
To purchases A/c	15,200		
	19,000		19,000

(F) Stock Reserve Account

Particulars	₹	Particulars	₹
To branch adjustment a/c	600	By Balance b/d	600

(G) Jaipur Branch Account

Particulars	₹	Particulars	₹
To opening stock	3,000	By Cash (cash sales)	17,400
To opening debtors	2,000	By Received from branch debtors	5,000
To goods sent to branch	19,000	By Closing debtors a/c (3)	2,300
To cash : Rent & Rates	900	By Adjustment for opening stock	600
Wages	760	By Adjustment for goods sent	3,800
Sundry expenses	100		
To net profit transferred to general Profit & Loss a/c (1)	3,340		
	29,100		29,100

Working Notes:

- (1) According to branch stock and debtors system, total net profit transferred to General profit & Loss A/c is ₹ 3,340 i.e. ₹ 950 from Branch stock A/c and ₹ 2,390 from Branch adjustment A/c.
- (2) Profit is separated by using 25% on cost or 20% on sale basis i.e., 1/5 of selling price.
- (3) For closing debtors balance, see Branch Debtors A/c.

**Accounting Treatment of Important Terms**

Transactions	Accounting treatment	Accounting entries
Normal loss	Losses within expected level Not assigned cost	No entry
Abnormal loss	Excess loss over the expected level Assigned cost	Dr. Abnormal loss Cr. Process account
Abnormal gain	Gain resulted when the actual loss is less than the normal or expected loss	Dr. Process account Cr. Abnormal gain

11.11 Final Accounts Method

Under this method, the profit and loss at the branch is ascertained by preparing the Memorandum Branch Trading and Profit & Loss Account in place of Branch Account. Under this method, if branch account is prepared that is of personal nature, not of nominal nature.

The Branch Trading and Profit & Loss Account is prepared exactly on the same basis as in case of other normal concerns. It is noted that opening stock, goods sent to branch, goods returned by branch and closing stock is shown.

**Problem**

A-one Ltd., Bhopal has a branch at Madras to which the goods are sent at cost plus 25%. The Madras branch keeps its own sales ledger and remits all cash received to the head office every day. All expenses are paid by the head office. The transactions for Madras Branch during the year ending December 31, 2008 were as follows.

	₹		₹
Stock (1-1-2008)	11,000	Return inwards	500
Debtors (1-1-2008)	100	Cheques sent to branch:	
Petty cash	100	Rent	600
Cash sale	2,650	Wages	200
Credit sales	23,950	Salary and other expenses	900
Goods sent to branch	20,000	Stock (31-12-2008)	13,000
Collection on ledger account	21,000	Debtors (31-12-2008)	2,000
Goods returned to H. O.	300	Petty cash (31-12-2008)	
Bad debts	300	(including misc. income ₹ 25 not remitted)	
Allowance to customers	250		125

Prepare the Memorandum Branch Trading and Profit and Loss A/c and Madras branch A/c for the year ending Dec 31, 2008.

Solution

Profit & Loss A/c (H.O.) Dr

To Stock Reserve A/c

(Reserve created for the difference in the wholesale price and cost price of Branch closing stock)

Independent Branches

Independent branches are those branches which are keeping the full system of accounting. They are allowed to purchase goods from the open market and also supply to the head office, if necessary. They can pay their expenses from the cash realised and can have the bank account on their own name.

When the size of the branches is very large, their functions become complex. In such a situation, it is desirable or practicable for each branch to establish its own double entry book-keeping system quite separate from those of head office, under this system of branch accounting, the branches, are treated as separate, independent units. These types of branches are known as Independent Branches.

This type of branch records all the transactions in its own books, extracts its own trial balance and prepares its own Trading and Profit and Loss Account. A copy of the trial balance so prepared will be forwarded to the head office and the head office will incorporate the same in its books of accounts so that consolidated Profit and Loss Account and a Balance Sheet can be prepared for the business as a whole.

Foreign Branches

When a branch is located out of the home country, it is called foreign branch. Foreign branches keep their accounts in the foreign currency.

A foreign branch is another location of your company that operates entirely in another country. Think of it as an extension of your main office, similar to adding on an extension to your current office, but on a global scale. A subsidiary, on the other hand, is a new business in a foreign country.

Summary

- Branch accounting is a book keeping system in which separate accounts are maintained for each branch or operating location of an organization.
- The dependent branches are not allowed to make any purchases and they sell goods received from the head office. Goods are supplied by the head office to such branches either at cost price or at invoice price.
- Branches do not maintain complete accounting for their transactions, except few essential books such as Cash Book, Sales Book, Stock Register etc.
- In Debtors Method, the head office simply opens a branch account which records all the transactions relating to a particular branch.
- Under Stock and Debtors System, the head office does not open a Branch Account in its books. It maintains a few control accounts for recording the various branch transactions.
- When consignor does not want to reveal the cost of goods to consignee, therefore, invoices goods at higher price than cost, this is invoice price.
- The difference between invoice price and cost price is loading.
- Under final accounts method, the profit and loss at the branch is ascertained by preparing the Memorandum Branch Trading and Profit & Loss Account in place of Branch Account.
- Goods are supplied to the whole-seller and branches at wholesale price, that is, cost plus profit.
- Independent branches are those branches which are keeping the full system of accounting. They are allowed to purchase goods from the open market and also supply to the head office.
- When a branch is located out of the home country, it is called foreign branch. Foreign branches keep their accounts in the foreign currency.

Keywords

- **Dependent Branch:** A branch which is dependent upon Head Office mainly for "Goods and Cash". Books of accounts relating to such branch also will be maintained by Head Office.

Financial Accounting

- **Service Branch-** All branches which are executing orders on behalf of head office. These branches are busy in executing all the orders for the sake of head office.
- **Retail Branch-** These are dependent branches, are concerned with the head office for selling goods, produced by HO itself or purchase from outside in bulk and are sent to retail selling branches for selling them out as like.
- **Invoice Price:** When consignor does not want to reveal the cost of goods to consignee, therefore, invoices goods at higher price than cost, this is invoice price.
- **Loading:** The difference between invoice price and cost price is loading.

Self Assessment

1. A _____ is any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company.
 - A. Firm
 - B. Branch
 - C. Company
 - D. LLP
2. Each branch is treated as a separate _____ and hence the profit or loss of each branch is computed separately.
 - A. Cost centre
 - B. Investment centre
 - C. Revenue centre
 - D. Profit centre
3. A branch is not a separate legal entity, although it can be referred to as an " _____ branch" because it keeps its own accounting books.
 - A. Independant
 - B. Dependant
 - C. Indian
 - D. Foreign
4. The _____ branches are not allowed to make any purchases and they sell goods received from the head office.
 - A. Independant
 - B. Dependant
 - C. Indian
 - D. Foreign
5. When a branch is located out of the home country, it is called _____ branch.
 - A. Independant
 - B. Dependant
 - C. Indian
 - D. Foreign
6. A branch means any _____ sub-division of a business.
 - A. Consolidate
 - B. Trading
 - C. Substitute
 - D. Subordinate
7. Under _____ system the goods may be invoiced to branch at cost or invoice price.

-
- A. Debtors
B. Stock and Debtors
C. Wholesale
D. Final Account
8. _____ branches are maintaining a complete set of books.
A. Dependant
B. Independant
C. Foreign
D. Nominal
9. Books of accounts relating to dependant branch will be maintained by _____.
A. Branch
B. Court
C. Income Tax Officer
D. Head Office
10. A branch which is dependent upon Head Office mainly for " _____".
A. Goods
B. Cash
C. Goods and Cash
D. None of above
11. Under _____ System, the head office does not open a Branch Account in its books.
A. Debtors
B. Stock and Debtors
C. Wholesale
D. Final Account
12. When consignor does not want to reveal the cost of goods to consignee, therefore, invoices goods at higher price than cost, this is _____ price.
A. Sale
B. Consignment
C. Cost
D. Invoice
13. The difference between invoice price and cost price is _____.
A. Loading
B. Subsidy
C. Profit
D. Sale price
14. Under Final Account method, branch account is prepared that is of _____ nature, not of nominal nature
A. Real
B. Ordinal
C. Solvent
D. Personal
15. Goods are supplied to the whole-seller and branches at wholesale price, that is, _____.

Financial Accounting

- A. Cost price
- B. Profit
- C. Invoice price
- D. Cost plus Profit

Answer for Self Assessment

1. B 2. D 3. A 4. B 5. D
6. D 7. A 8. B 9. D 10. D
11. B 12. D 13. A 14. D 15. D

Review Questions

1. Discuss the purpose of preparing branch accounts?
2. Describe the term Loading? Explain the necessary journal entries for loading and removal of it in books of HO?
3. Explain the stock and debtors method in detail, alongwith its accounting treatment?
4. Distinguish between Wholesale method and Final Accounts method in Branch accounting?
5. How many types of branches are there? What entries are made in the books of company to incorporate branch's trial balance?
6. Explain the causes of difference in the balances shown by the H.O. and the Branch.
7. How are normal and abnormal losses are treated in the branch account?
8. What are the different systems of accounting of dependent branches?
9. Delhi Traders, Delhi opened a branch at Baroda on 1st January 2019. The following information is available in respect of the branch for the year 2019. Prepare Branch Account to show the profit/loss from the branch for the year 2019

Particulars	Amount	Particulars	Amount
Goods sent to the branch	70,000	Office Expenses of the branch paid by the Head Office	10,000
Cash sales at the branch	40,000	Cash remittances to branch towards petty cash	6,000
Credit sales at the branch	60,000	Petty cash at branch on 31.12.2019	500
Salaries of the branch paid by the Head Office	25,000	Debtors at branch as on 31.12.2019	5,000
		Stock at branch on 31.12.2019	27,000

10. X Ltd. operates a retail branch at Mumbai. All purchases are made by the head office in Calcutta, goods being charged out to the Branch at selling price which is cost plus 25%. All the expenses of branch are paid through head office cheques. Cash collected from customers as also the ready money sales are daily banked to the credit of the head office. From the following particulars of the

Unit 11: Branch accounting 1

branch write up the necessary accounts to arrive at the branch profit or loss in the head office books by using stock and debtors system

Particulars	Amount	Particulars	Amount
Debtors at start	15,000	Debtors at end	19,000
Invoiced Inventory at beginning	30,000	Invoiced Inventory at end	28,000
Ready money sales during the year	1,30,000	Return to H.O. at Invoiced Amount	5,000
Salaries	12,000	Bad debts	4,000
Cash Received on Ledger Account	1,20,000	Normal Leakage and Spoilage	4,000
Rent etc.	10,000	Discount and Allowances	6,000

**Further Readings**

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- Khan and Jain, *Management Accounting*.
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**Web Links**

- www.futureaccountant.com

Unit 12: Branch Accounting- II

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Objectives

After studying this unit, you will be able to:

- describe the features of the accounting system of an independent branch.
- apply adjustment in the books of head office and branch for certain peculiar items relating to independent branches.
- know the concept of consolidation of branch accounts in head office accounts.
- incorporate the branch accounts in books of head office.

Introduction

A branch means any subordinate sub-division of a business. As per the sec. 29, of Companies Act, 2013, "A branch is any establishment carrying on either the same or substantially the same activity as that carried on by the head office of the company." For example, Bata has its branches all over the country. Each branch is treated as a separate profit centre and hence the profit or loss of each branch is computed separately. The head office of the firm has to keep strict control over various activities of each branch and ensure its smooth functioning.

12.1 Concept

Independent Branches are those which make purchases from outside, get goods from Head Office, supply goods to Head Office and fix the selling price by itself. Thus an independent Branch enjoys a good amount of freedom.

When the size of the branches is very large, their functions become complex. In such a situation, it is desirable or practicable for each branch to establish its own double entry book-keeping system quite separate from those of head office, under this system of branch accounting, the branches, are treated as separate, independent units. These types of branches are known as Independent Branches.

This type of branch records all the transactions in its own books, extracts its own trial balance and prepares its own Trading and Profit and Loss Account. A copy of the trial balance so prepared will be forwarded to the head office and the head office will incorporate the same in its books of accounts so that consolidated Profit and Loss Account and a Balance Sheet can be prepared for the business as a whole.



Fig 1: Independent Branch

12.2 Procedure for Maintaining Accounts of an Independent Branch

Independent Branch, like the Head Office, keeps all its records separately and independently on Double Entry System. Independent Branches are those which make purchases from outside, get goods from Head Office, supply goods to Head Office and fix the selling price by itself. Thus an independent Branch enjoys a good amount of freedom.

Independent Branch, which has its own accounting system 'prepares a Trial Balance and sends a copy of it to the Head Office. After the receipt of Trial Balance from Branch, Head Office passes incorporating entries in order to prepare Branch Trading and Profit and Loss Account and a combined Balance Sheet.

12.3 Characteristics of an Independent Branch

Independent Branches possess various features, which helps the branch and head office in maintaining records.

- Independent Branch keeps a complete set of books. Such Branch gets goods from Head Office and from outside parties. It has its own Bank Account. Thus, the Branch keeps full system of accounting.
- It prepares its own Trial Balance, Trading and Profit and Loss Account and Balance Sheet and copies of these statements are sent to Head Office for incorporating in the Head Office Books.
- The books contain an account called "Head Office Account" or "Head Office Current Account" which is credited with everything received from the Head Office and debited with everything sent to Head Office.
- There may be inter-branch transactions. That is, goods transferred by one Branch to another Branch of the same Head Office.
- In spite of the independent status, the Branch cannot function without resources, and the resources, specially at the initial stage, are provided by the Head Office.
- Thus, the investments made by the Head Office seen from the Head Office Account are a personal Account in nature. The balance of these Accounts on any date will be equal to the difference between the assets and liabilities at the Branch on that date.

12.4 Accounting Entries

Accounting Entries, in the books of Branch, for Normal Transactions	
1. Purchases made at Branch	Purchases Account Dr. To Cash/Creditors Account
2. Sales effected at Branch	Cash/Debtors Account Dr. To Sale Account
3. Payment of expenses at Branch	Expenses Account Dr. To Cash Account
4. Any income received by the Branch	Cash/Bank Account Dr. To Concerned Income Account

Accounting Entries for Transactions between Branch and Head Office				
	Branch Book		Head Office Book	
1. Goods supplied to Branch by Head Office	Goods Supplied by Head Office A/c To Head Office A/c	Dr.	Branch Account To Goods Supplied to Branch Account	Dr.
2. Cash received from Head Office	Cash Account To Head Office A/c	Dr.	Branch Account To Bank Account	Dr.
3. Goods returned to Head Office by Branch	Head Office A/c To Goods Supplied by Head Office A/c	Dr.	Goods Supplied to Branch A/c To Branch Account	Dr.
4. Cash sent to Head Office by Branch	Head Office Account To Cash account	Dr.	Bank Account To Branch Account	Dr.
5. When asset purchased by Branch and the Asset Account is kept by Head Office	Head Office Account To Cash account	Dr.	Branch Asset Account To Branch Account	Dr.
6. Depreciation of the above	Depreciation A/c To Head Office A/c	Dr.	Branch Account To Branch Asset A/c	Dr.
7. Head Office expenses chargeable to Branch	Expense Account To Head Office A/c	Dr.	Branch Account To Profit & Loss A/c	Dr.

12.5 Peculiar Items in Independent Branches

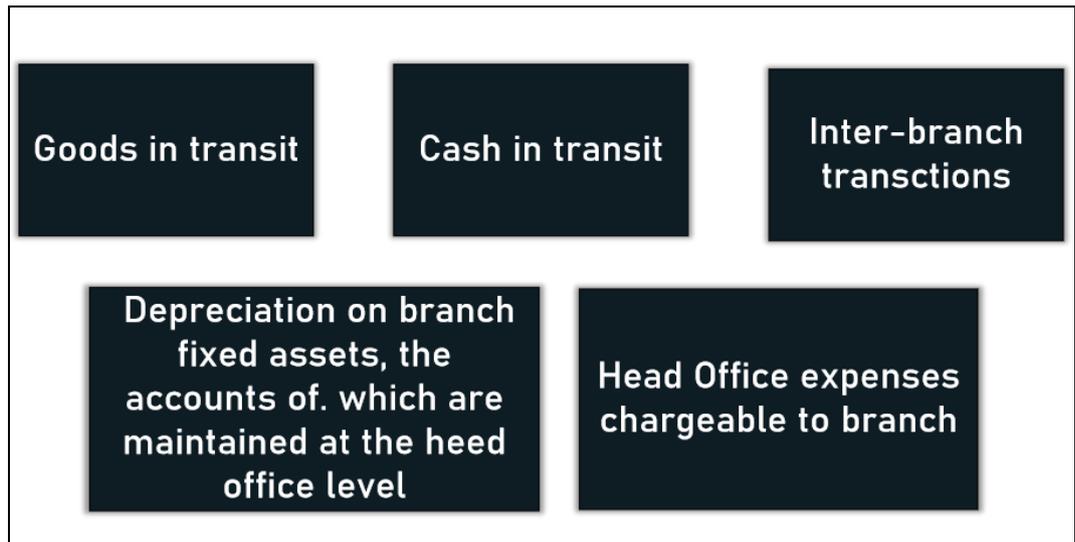


Fig 2: Important items in Independent Branches

1. Goods in Transit

Goods in transit refers to merchandise and other types of inventory that have left the shipping dock of the seller, but not yet reached the receiving dock of the buyer. The concept is used to indicate whether the buyer or seller of goods has taken possession, and who is paying for transport. Following journal entries needs to pass in books of accounts.

- If the head office decides to pass the adjustment entry, it will be as:

Goods in Transit A/c Dr.
To Branch A/c

- If, however, the adjustment is made in branch books, the entry will be:

Goods in Transit A/c Dr.
To Head Office A/c

2. Cash in Transit

In accounting terms, cash in transit is any item you record on your income statement that hasn't yet shown up on your bank statement. Cash in transit is a way of adjusting the cash balance to account for checks received or paid that have not yet cleared. Following journal entries needs to pass in books of accounts.

- In case the head office decides to pass the adjustment entry, it will be as:

Cash in Transit A/c Dr.
To Branch A/c

- If, however, the adjustment is made in the branch books, the entry will be:

Cash in Transit A/c Dr.
To Head Office A/c

3. Head Office Expenses Chargeable to Branch

The head office always does some work on behalf of the branch and it is, therefore, usual to charge the branch at the end of the year with a reasonable amount for service rendered by the head office.

- If the head office so, decides to charge some expenses to the branch, the journal entry passed in the books of the head office is as:

Branch A/c Dr.
To Expenses A/c

(Being head office expenses chargeable to branch)

- The branch will also pass a corresponding entry in its books as:

Head Office Expenses A/c Dr.

To Head Office A/c

(Being head office expenses chargeable to branch)

4. Depreciation on Branch Fixed Assets, Accounts Maintained by Head Office

Normally an entry for the, depreciation on fixed assets is passed by debiting the Depreciation Account and crediting the Fixed Asset Account. But in this situation, the branch cannot credit the Fixed Asset Account because the accounts for its fixed assets are maintained at the head office level.

- Hence. the entry passed for depreciation on such fixed assets is different from the normal entry for depreciation. It is as:

Depreciation A/c Dr.

To Head Office A/c

(Being depreciation on fixed assets)

- Hence. it makes the journal entry for depreciation on branch fixed assets when their accounts are maintained by the head office:

Branch A/c Dr.

To Branch Fixed Assets A/c

(Being depreciation on branch fixed assets)

5. Inter-branch Transactions

A transaction that takes place in a branch of your bank may involve accounts that are maintained in another branch. For example, a customer has an account in the Head Office branch and approaches another branch of the bank for a cash withdrawal.

- In the books of the head office

Receiving Branch A/c . Dr.

To Sending Branch A/c

- In the books of the sending branch

Head Office A/c Dr.

To Goods Sent to H.O. A/c

- In the books of the receiving branch

Goods from H. O. A/c Dr.

To Head Office A/c

12.6 Consolidated Financial Statements

A combines financial statements for Home Office and Branches. A balance sheet for distribution to creditors, stockholders and government agencies. Adjusted trial balances of the home office and of the branches.

12.7 Consolidation of Branch Accounts

Consolidation of branch accounts, is one of the important and sensitive aspect of the financial statements. Preparation of the consolidated financial statements as a whole (after consolidation of accounts of branches) is the responsibility of the management.

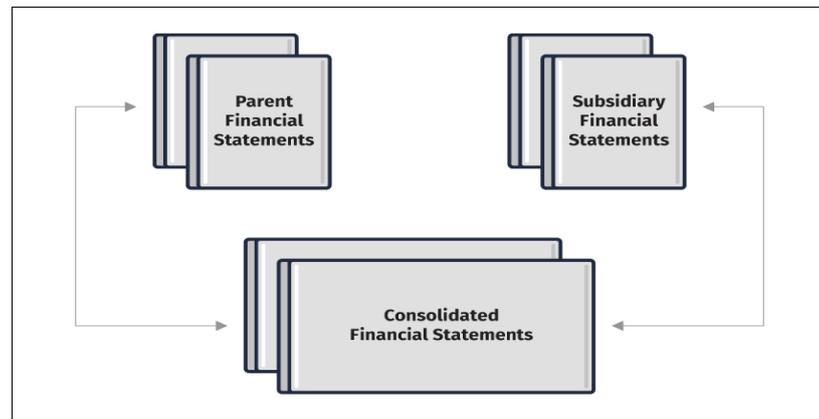
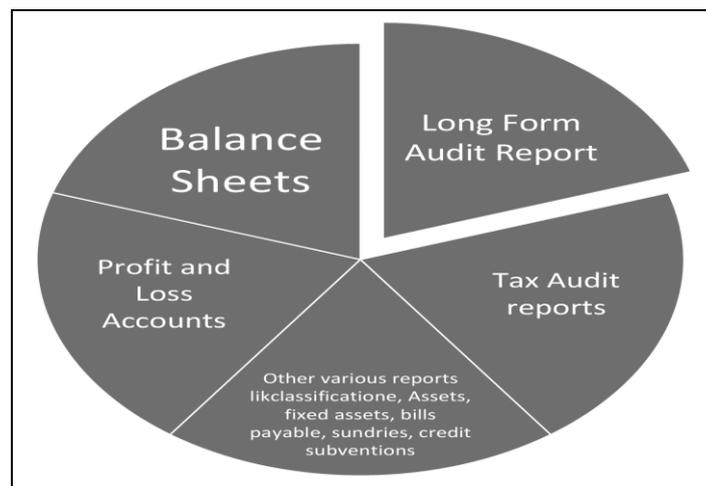


Fig 3: Consolidated Financial Statements



Which documents required for consolidation of financial statements?

The following documents are required by Branch and Head office for consolidation of financial statements:



12.8 Incorporation of Branch Trial Balance in the Head Office Books

Just because an independent branch keeps full system of accounting and prepares its own final accounts 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 shall also be included in the General Profit and Loss Account which shows 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 the combined (consolidated) Balance Sheet of the head office and its branches.

For incorporation of the branch profit or loss, the head office may either pass various entries to include all revenue items and prepare Branch Trading and Profit & Loss Account or pass one entry for profit or loss made by the branch after working it out with the help of a Memorandum Branch Trading and Profit & Loss Account. Thus, it becomes necessary for the head office to incorporate the branch balances in the head office books by means of suitable journal. An incorporation of branch balances involves two steps:

- i) incorporation of branch profit or loss, and
- ii) incorporation of branch assets and liabilities.

The first method is called 'detailed incorporation'. The first method is called 'detailed incorporation' and the second method is called 'abridged incorporation'.

12.9 Detailed Incorporation

As stated earlier, under this method, the head office prepares a proper Branch Trading and Profit & Loss Account and makes entries for all revenue items before incorporating the branch assets and liabilities in its books. The entries passed under this method are as:

12.10 Journal Entries for Consolidation

Various journal entries are passed for consolidation of financial statements under Independent Branches.

1) For items on the debit side of the Trading Account- This entry is passed for the total amount of items like opening stock, net purchases, wages, goods received from H.O., carriage inwards etc.

Branch Trading A/c Dr.
To Branch A/c

2) For items on the credit side of the Trading Account- This entry is passed for the total amount of items like net sales, closing stock, etc.

Branch A/c Dr.
To Branch Trading A/c

3) For branch gross profit- In case of gross loss, the entry will be reserved.

Branch Trading A/c Dr.
To Branch Profit & Loss A/c

4) For items on the debit side of the Profit and Loss Account- This entry is passed for the total amount of items like salaries, rent, bad debts, repairs, depreciation, etc.

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

5) For items on the credit side of the Profit & Loss Account- This entry is passed for total amount of items like interest received, discount received, commission received, etc.

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

6) For branch net profit- If there is net loss, the entry will be reversed.

Branch Profit & Loss A/c Dr.
To General Profit & Loss A/c

7) For branch assets- Each asset should be debited individually.

Branch Assets A/c Dr.
To Branch A/c

8) For Branch liabilities- Each liability credited individually. This should not include H.O. A/c balance

Branch A/c Dr.
To Branch Liabilities A/c

12.11 Abridged Incorporation

Incorporation of branch balances in the head office books can also be effected with the help of a short cut method known as the 'abridged incorporation'.

Under this method, a Memorandum Branch Trading and Profit & Loss Account is prepared and a journal entry for the net profit or net loss. Thus, the six entries passed under the detailed incorporation method are replaced by just one entry which is as :

Branch Account A/c Dr.

To General Profit & Loss A/c



In case, of net loss, the above entry shall be reversed.

12.12 Closing entries in Branch books

At the end of the accounting period, the branch books have to be closed. For this purpose, the branch can pass the usual closing entries for transferring all revenue items to its Trading and Profit & Loss Account and ascertaining its net profit or net loss.

The amount of net profit or net loss should be transferred to the Head Office Account by passing the necessary journal entry.

- In case of net profit

Profit and Loss A/c Dr.
To Head Office A/c

- In case of net loss

Head Office A/c Dr.
To Profit and Loss A/c

The branch prepare its Balance Sheet by showing the Head Office Account balance on the liabilities side as this account would normally show a credit balance. If, however, the Head Office Account shows a debit balance, the same will appear on the assets side of the Balance Sheet.

The accounts pertaining to assets and liabilities can also be closed, if required, by transferring their balances to the Head Office Account. For this purpose, the following two journal entries will be passed in the branch books.

- For transfers of assets

Head Office A/c Dr.
To Assets A/c

- For transfer of liabilities

Liabilities A/c Dr.
To Head Office A/c

As a result of the above entries, the Head Office Account shall also be closed as it will not show any balance.

Summary

- Independent Branches are those which make purchases from outside, get goods from Head Office, supply goods to Head Office and fix the selling price by itself.
- Independent Branch enjoys a good amount of freedom.
- Independent Branches prepares its own Trial Balance, Trading and Profit and Loss Account and Balance Sheet and copies of these statements are sent to Head Office for incorporating in the Head Office Books.
- Goods in transit refers to merchandise and other types of inventory that have left the shipping dock of the seller, but not yet reached the receiving dock of the buyer.
- Cash in transit is a way of adjusting the cash balance to account for checks received or paid that have not yet cleared.
- A combines financial statements for Home Office and Branches, is called Consolidated Financial Statements.
- Under Detailed Incorporation, the head office prepares a proper Branch Trading and Profit & Loss Account and makes entries for all revenue items before incorporating the branch assets and liabilities in its books.

- Incorporation of branch balances in the head office books can also be effected with the help of a short cut method known as the 'abridged incorporation'.

Keywords

- **Inter-branch transactions:** In these transactions, goods transferred by one Branch to another Branch of the same Head Office.
- **Goods in Transit:** The concept is used to indicate whether the buyer or seller of goods has taken possession, and who is paying for transport.
- **Cash in Transit:** It is a way of adjusting the cash balance to account for checks received or paid that have not yet cleared.
- **Abridged Incorporation:** Incorporation of branch balances in the head office books can also be effected with the help of a short cut method.

Self Assessment

1. Independent Branch, like the Head Office, keeps all its records separately and independently on _____.
 A. Single Entry System
 B. Double Entry System
 C. Consolidated Basis
 D. Standalone Basis
2. Independent Branches are those which make purchases from _____.
 A. Outside
 B. Head Office
 C. Both Outside and Head Office
 D. None of above
3. Independent branches keep _____ system of accounting.
 A. Frill
 B. Strict
 C. Coherence
 D. Freeze
4. The investments made by the Head Office seen from the Head Office Account are a _____ account in nature.
 A. Personal
 B. Nominal
 C. Real
 D. Actual
5. If purchases are made at Branch on its own, then journal entry for same in books of branch will be _____.
 A. Head office a/c dr. To Branch a/c

- B. No entry needs to be passed
- C. Purchases a/c dr. To Head Office a/c
- D. Purchases a/c dr. To Cash a/c
6. If the head office decides to pass the adjustment entry for goods in transit, it will be as:
- A. Head Office a/c dr. To Goods in transit a/c
- B. Branch a/c dr. To Goods in transit a/c
- C. Goods in transit a/c dr. To Head Office a/c
- D. Goods in transit a/c dr. To Branch a/c
7. In case the head office decides to pass the adjustment entry for cash in transit, it will be as:
- A. Head Office a/c dr. To cash in transit a/c
- B. Branch a/c dr. To cash in transit a/c
- C. Cash in transit a/c dr. To Head Office a/c
- D. Cash in transit a/c dr. To Branch a/c
8. The entry passed for depreciation on such fixed assets is _____ from the normal entry for depreciation, in books of head office.
- A. Same
- B. Different
- C. Separated
- D. None of above
9. Independant branches prepares its own _____.
- A. Trial Balance
- B. Profit and Loss Account
- C. Balance Sheet
- D. All above
10. If goods transferred by one Branch to another Branch of the same Head Office, it is known as _____.
- A. Transfer pricing
- B. Intra branch transactions
- C. Inter branch transactions
- D. Transfer of goods
11. _____ of branch accounts, is one of the important and sensitive aspect of the financial statements.
- A. Issue
- B. Cancellation
- C. Sub division
- D. Consolidation

12. Preparation of the consolidated financial statements as a whole is the responsibility of the _____.

- A. Court
- B. Branch
- C. Shareholders
- D. Management

13. Under _____ method, the head office prepares a proper Branch Trading and Profit & Loss Account.

- A. Detailed Incorporation
- B. Dissolution
- C. Abridged
- D. Operational Role

14. Incorporation of branch balances in the head office books can also be effected with the help of a short cut method known as the '_____ '.

- A. Detailed Incorporation
- B. Dissolution
- C. Abridged Incorporation
- D. Operational Role

15. Which one journal entry is passed in abridged incorporation method?

- A. Branch a/c dr. To Net Profit & Loss a/c
- B. Branch a/c dr. To Operating Profit & Loss a/c
- C. Branch a/c dr. To Gross Profit & Loss a/c
- D. Branch a/c dr. To General Profit & Loss a/c

Answers for Self Assessment

- | | | | | |
|-------|-------|-------|-------|-------|
| 1. B | 2. C | 3. A | 4. A | 5. D |
| 6. D | 7. D | 8. B | 9. D | 10. C |
| 11. D | 12. D | 13. A | 14. C | 15. D |

Review Questions

1. Discuss the concept of Independent Branch in detail.
2. Define Independent Branch and discuss its features in detail?
3. Discuss and explain the accounting entries between head office and branch while preparing the books in case of Independent Branch?
4. Explain the accounting treatment of Goods in Transit and Cash in Transit with its journal entries.

5. Discuss the concept of Inter branch transaction and its accounting treatment.
6. How the branch can incorporate its accounts in books of head office?
7. Distinguish between detailed incorporation and abridged incorporation?
8. Explain the journal entries for consolidation, in context to detailed incorporation?
9. While preparing the books of accounts using abridged incorporation, explain its closing entries prepared in books of branch?
10. What is the accounting treatment of depreciation on branch fixed assets in books of head office?



Further Readings

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Unit 13: Computerized Accounting Systems I

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Summary

Keywords

Self Assessment

Answers for Self Assessment

Review Questions

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Objectives

After studying this unit, you will be able to:

- comprehend the conceptual framework of tally.erp9
- recognize the features of tally.erp9
- apply the software for company creation
- cognize the relevant information using computerised accounting
- apprehend the configure and features settings in tally.erp9

Introduction

Tally Solutions Pvt. Ltd. is a multinational technology business based in India that specialises in enterprise resource planning software. Bangalore, Karnataka, is the company's headquarters. More than 1.8 million clients utilise the company's software, according to the corporation.

Shyam Sunder Goenka and his son Bharat Goenka co-founded Tally Solutions, then known as Peutronics, in 1986, and it was incorporated in 1991. Shyam Sunder Goenka ran a business that sold raw materials and machine parts to textile mills and industries in southern and eastern India. He urged his son, Bharat Goenka, 23, a Maths graduate, to design a software application that would handle financial accounting for his firm because he couldn't locate software that could manage his books of accounts. The accounting software's original version was released as an MS-DOS

application. It was called Peutronics Financial Accountant and only contained basic accounting features.

Tally Solutions became the official name of the company in 1999. Tally released Tally 8.1, a concurrent multi-lingual edition, and Tally 9 in 2006. Tally.ERP 9, a business management tool, was published in 2009. The corporation created the Vriddhi programme in 2015 to certify and classify its business partners. Tally Solutions also announced the release of Tally.ERP 9 R in 2015. The company had one million customers as of 2016. Tally Solutions was selected as a GST Suvidha Provider in 2016 to provide an interface between the new GST server and taxpayers, and the company released its revised GST compliance software in 2017. Tally Prime was released by the firm in 2020.

13.1 Concept

Tally ERP 9 is utilised in a variety of fields and can help with a variety of problems. Companies may manage their sales level, revenue generation, profit computation, and so on, just as they can in Sales Management. Accountants can manage their accounts in accounting, from journal entry to financial statements, according to accounting norms established by governing authorities. Tally.ERP 9 assists in managing return on investment in financial management. Tally.erp9 is used in Inventory Management to manage stocks, whether they are opening or closing, rejection inward or outward. Tally.erp9's order processing feature can also be utilised in Purchase Management to manage stock levels. Tally software can be used to manage payments to be paid or received in Payables Management.

13.2 Tally.ERP 9

Tally is a financial management programme. It was created in India. Tally Solutions Pvt. Ltd. is the company's name. The software is extremely popular, with operations in over 94 countries across Africa, Asia, the Middle East, and Europe. Sri S.S Goenka was the one who initially launched tally in 1986 under the tagline "Power of Simplicity." Tally was the first programme that didn't require any code.

13.3 Features of Tally

There are various features of Tally used in various disciplines and used by companies and its users in managing and handling accounts and other features.

- **User Defined Security Levels:** The password for Tally Vault encrypts and protects data against unauthorised access. The User Management options can be used to define and grant user-level access and controls.
- **Internal Backup and Restore:** Tally. ERP9 enables management to generate real-time, accurate reports, allowing them to make timely and informed decisions that benefit the organization's overall productivity and growth.
- **Import Export of Data:** Tally Prime allows you to not only manage your business data but also export it quickly. Without leaving the screen where you're working, you can export masters and transactions from anywhere in the product. You can also export the reports in a variety of formats, depending on your needs.
- **Graphical Analysis of Data:** Tally software combines various ledgers into a single ledger, including the General Ledger, Sales Ledger, and Purchase Ledger. To make account management easier, the ledgers have been divided into groups. The concept of unified ledgers allows you to enter data and create entries at the same time.
- **Ability to Publish Reports and Documents on the Internet:** Before making key business decisions, business owners can see the Balance Sheet and Profit and Loss Statement in just one click at any time. Tally.ERP 9 offers data on party payment performance, item profitability, cash flow, fund flow, and many more useful reports for making educated decisions.
- **Multi-lingual Capability:** Tally.ERP9 gives users the unique ability to keep track of their accounts in any Indian language, view them in another, and print them in yet another Indian language.

- **Data Reliability:** Tally ERP9 is suitable for every type of business and eliminates the requirement for a company to adjust its operating style in order to adapt to the application's nature.
- **User Defined Security Levels:** Because of Tally's improved audit capabilities, the user can have a limitless number of periods and budgets. This feature allows the user to easily track changes and make fixes. The user can get powerful access control by using security levels.
- **Multi-Directory of company management:** Tally ERP9 has a specific Auditors' Edition that includes auditing and compliance capabilities exclusively for Chartered Accountants.
- **Print Preview:** Tally software allows users to manage billing information from top to bottom, including receivables and payables. It aids businesses in allocating payments for invoices and those that are past due. Using billing information, the software can also help distinguish between good and bad clients.
- **Data Synchronization:** The synchronisation feature of Tally's ERP software aids in the management of centrally placed data from two or more business locations. You are in charge of defining and enforcing the rules. Even when fresh voucher data is input, the data is synchronised.
- **Remote Login Access:** You require remote access to business reports or the addition of new business transactions. When accessing corporate data from distant places, security is a common worry. You can make critical business choices with Tally.ERP 9 by securely accessing company data and making modifications as needed.
- **License Management:** Tally. ERP 9 gives you the freedom to manage data from various enterprises under the same licence. By forming a Group Company in the ERP software, users can receive consolidated information. One of the most important features of Tally's ERP Software is that it allows users to view the financial health of their Group Companies and even compare financial reports.
- **Control Centre:** One of the distinguishing elements of ERP software is budgets and controls. Businesses usually divide their budgets among multiple departments or cost centres, and they prefer to keep track of the varied expenses that occur in each unit. Businesses can set budgets for cost centres and track spending against those budgets using Tally.ERP 9. Businesses can specify credit limitations for parties, and Tally.ERP 9 alerts the user before passing transactions if the transaction exceeds the stated restrictions.
- **Support Centre:** Instant statements and reports are made possible by real-time processing, which enables for immediate posting and updating of books of accounts as soon as transactions are entered. It also provides a multi-user, real-time environment.
- **Look and Feel:** Tally. ERP9 has the ability to generate immediate reports for any period of time, whether it's a month, a year, or at any moment in time, as well as the ability to move between accounting and inventory reports inside the same company or between firms.
- **Tax Deducted at Source (TDS):** The software calculates interest and taxes in a variety of ways that are unique to each transaction. The user can acquire a thorough report of the interest obtained after the computation is completed. The report assists in determining the balance amounts that should be received.
- **Reduces Application Size:** Tally. ERP9 gives users the ability to manage multiple firms with endless degrees of classification and grouping. It even has the ability to dig down from the report level to the transaction level.



Use of Short Cut Keys using Tally.ERP9

CTRL+A	Save
ALT+D	Delete

ALT+E	Export
F2	Change Date
Alt+ F2	Change Period
F11	Features
F12	Configure

13.4 Company Creation in Tally.ERP9

When we first start accounting with Tally, the first and most important thing to learn is how to create a firm in Tally ERP 9. You can create numerous companies in Tally if you have multiple businesses. At a single price, you can get ERP 9 software Tally.

ERP 9 has progressed beyond the concept of accounting software to include the management of statutory compliance through the updating of statutory files on the Tally solution website. Tally.net capabilities allow users to operate Tally remotely, process payroll, and many other features are updated on a regular basis by Tally solutions. GST) is the most recent enhancement, with Tally version Tally compatibility. Release 6 of ERP.

Steps	Actions	Instructions to be followed
Step 1	To open Tally Software	Double click on tally icon from your desktop.
Step 2	To go to Create Company Screen	To do this Select Create company from the Company Info. Menu using up and down arrow key and press Enter Key.
Step 3	To fill up the Details in Company Creation Screen	In this company creation screen, you should enter all the details of the company that you been asked for.

Fig 1: Steps for Company Creation in Tally.ERP9

13.5 How to Create Company in Tally - Setting up of Company in Tally ERP 9

This Tally ERP 9 tutorial will show you how to form a company in Tally using simple steps. To get started with Tally ERP 9, you must first form a company. The essential information about the firm, books, and currency details are all required while creating a corporation in Tally.

Step 1: After login to Tally, double click on the option create company under company information.

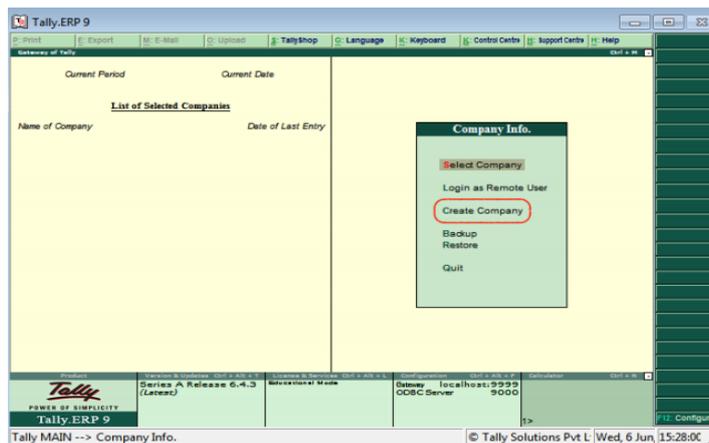


Fig 2: Home page of company creation in Tally.erp9

Step 2: The company creation window displays on the screen as show below image.

The screenshot shows the 'Company Creation' window in Tally.ERP 9. The window is divided into several sections:

- Directory:** C:\Users\Public\Tally.ERP9\Data
- Name:** [Redacted]
- Books and Financial Year Details:** Financial year begins from: 1-4-2018, Books beginning from: 1-4-2018
- Primary Mailing Details:** Mailing name, Address, Country (India), State (Not Applicable), Pincode.
- Security Control:** TallyVault password (if any), Repeat password, Use security control (No), (Warning: Forgetting TallyVault password will render your data inaccessible.)
- Contact Details:** Phone no., Mobile no., Fax no., E-mail, Website.
- Base Currency Information:** Base currency symbol (₹), Formal name (INR), Suffix symbol to amount (No), Add space between amount and symbol (Yes), Show amount in millions (No), Number of decimal places (2), Word representing amount after decimal (paise), No. of decimal places for amount in words (2).

Fig 3: Company creation details



Use the enter key or Tab key or Arrow key or Mouse to navigation between the fields in Tally.

Step 3: On company creation screen, update the following details:

- **Directory:** It is a path where the company data will be stored on system. By default, the tally directory will updated as C:\Users\Public\Tally.ERP9\Data and you can change the path as per your requirements.
- **Name:** Update the name of company that identifies in Tally ERP 9. Primary Mailing Details. The mailing name of company will be automatically updated as per the given name of company, however the mailing name can be changed as per the requirements.
- **Address:** Update the complete address details of company.
- **Statutory Compliance for:** Choose the country name as India from the given list of countries.
- **State:** Choose the state from the given list of states.
- **Pin Code:** Update the Pin Code of company, where it is located.

The screenshot shows the 'Company Creation' window in Tally.ERP 9 with updated details:

- Directory:** C:\Users\Public\Tally.ERP9\Data
- Name:** Tutorial Kart
- Books and Financial Year Details:** Financial year begins from: 1-4-2018, Books beginning from: 1-4-2018
- Primary Mailing Details:** Mailing name: Tutorial Kart, Address: Amaravathi, Vijawada
- Security Control:** TallyVault password (if any), Repeat password, Use security control (No), (Warning: Forgetting TallyVault password will render your data inaccessible.)
- Contact Details:** Phone no., Mobile no., Fax no., E-mail: admin@tutorialkart.com, Website: www.tutorialkart.com
- Base Currency Information:** Base currency symbol (₹), Formal name (INR), Suffix symbol to amount (No), Add space between amount and symbol (Yes), Show amount in millions (No), Number of decimal places (2), Word representing amount after decimal (paise), No. of decimal places for amount in words (2).

An 'Accept?' dialog box with 'Yes' and 'No' options is visible at the bottom right of the window.

Fig 4: Updated page of company creation

13.6 Other Important Details

- **Contact Details:** User must enter the Telephone No: Update Company landline/ Telephone number; E-Mail: Update the company e-mail id; Mobile No: Mobile number for contacting and Fax no: Update the Fax number in case of necessity in business terms.
- **Website:** Update the official website address of company Books and Financial Year Details. Financial Year From: Update the financial year starting date, all Indian companies financial year start from 1st April and ends on 31st March. Tally considers the 12 months from the date given for financial year. The financial year will be automatically displayed on Tally system, if FY starts in middle of year, you can specify the exact date from here. Books Beginning from: Specify the books beginning date.
- **Security Control:** Security control can be accessed through *Tally Vault Password*: By enabling Tally vault password, the company data is secured in an encrypted form. The data is not accessible without the password, if you lost the password that will be not recovered. *Use Security Control*: Enabling security control helps only authorized users are allowed to enter/edit/delete the vouchers on Tally. This data field is for security purpose. By enabling this field, Tally ERP 9 convert tally data into an encrypted format. To encrypt means convert data from recognised format to unrecognised format. By entering the Tally Vault password we can prevent unauthorized access of company data. Now in Latest Tally ERP 9. There is a password strength indicator, which will help you to set a strong password. Red colour indicates a weak password whereas peach-orange colour is fair; yellow is good and green colour indicates a strong password.



Forgetting tally vault password will render the data inaccessible.



Use security control helps the user?

By enabling this data field, we will have complete control over the data and will be able to allocate people to certain tasks, such as data entry operators who will only be able to access the voucher entry screens. Billing clerks might be assigned to only have access to Sales invoice vouchers. Financial managers can be assigned to have access to financial data and reports, with the administrator controlling their access. We'll be prompted for the administrator's name and password in this data box.

- **Base Currency Information:** Much information provided here should be fix with due care as Base Currency Symbol; Formal Name: INR (India Rupees); Suffix Symbol to Amount: No; Add spaces between the amount and symbol: Yes; Show amount in Millions: Yes; Number of decimal Places: 2; Word representing amount after decimal: Paisa; No of decimal places for amount in words. After updating all the required details of company, choose Yes to save the entered details in Tally

13.7 Configure and Features Settings

The configuration and features settings in Tally.erp9 should be accessed as per user needs and client demand.

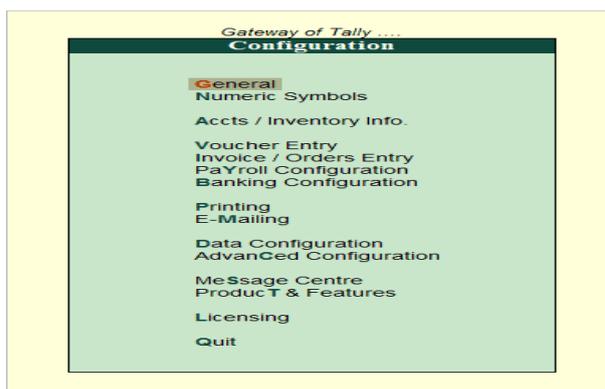


Fig 5: Configuration settings in Tally.erp9

13.8 Configuration Menu

F12 configurations are application-specific settings that can be found on all Tally screens. ERP 9 is an enterprise resource planning system. These settings can be adjusted and managed as needed to meet changing requirements. For example, if you wish to keep track of your purchases in debit/credit mode, you can do so in the F12 configurations. Configuration options have an impact on all of the firms in the same Tally. Setting the settings for one company in the ERP 9 directory will effect the setup of other firms in that data directory.

General	Banking Configuration
Numeric Symbols	Printing
Accounts/Inventory Info.	E-Mailing
Voucher Entry	Data Configuration
Invoice/Orders Entry	Advanced Configuration
Payroll Configuration	Product & Features
Licensing	

Fig 6: Settings in Configuration



You can configure Country Details, Style of Names, Style of Dates, Numbers and many other details in the General configuration screen. Go to Gateway of Tally, then press F12. The other details and settings that can be done as shown in image below.

Company		List of Countries
Country Details		India / SAARC
Use accounting terminology of (SAARC countries include India, Pakistan, Sri Lanka, Bangladesh, Nepal, Bhutan and Maldives)	India / SAARC	International
Naming Style		Gateway of Tally
Default appearance of names in reports	Name Only	Configurati
Default appearance of stock item names in reports	Name Only	General
Format of Dates		Numeric Symbols
Short date format	dd-mm-yy	Accts / Inventory
Separator between day, month, and year	-	Voucher Entry
Format of Numbers		Invoice / Orders t
Character to use for decimals	.	PaYroll Configura
Separator to use for thousands	,	Banking Configur
Add sign before currency/unit symbol	? No	Printing
Show amount in millions	? No	E-Mailing
Table Configuration		Data Configurati
In vouchers, show only stock item names (without quantity)?	No	AdvanCed Config
Apply keyword filter to list of items	? Yes	Product & Featu
Apply for all columns	? Yes	Licensing
Show tables with masters only in current language?	No	Quit
Import/Export Configuration		
Ignore errors during data import	? No	
(Applicable for importing vouchers in XML format /SOAP request)		
Overwrite vouchers, instead of duplicating, during import?	No	
(New vouchers are created if GUIDs do not match)		
Export base currency symbol along with amount?	No	
Open file after export	? Yes	
Other Options		
Show graphs in monthly reports	? Yes	
Use separate menu for final A/c statements	? No	
Enable sound notification for alerts	? Yes	
Always show information panel	? No	

Fig 7: Configuration settings in Tally.ERP9

1. General

- Use Accounting Terminology of Select India/SAARC or International.
- Default appearance of names in reports, by default, the appearance of ledger name is set to Name Only . You can change it as required.
- Default appearance of stock item names in reports, by default, appearance of stock item name is set to Name Only . You can change it as required.
- Short date format, by default, date format is dd-mm-yy. You can change the date format by selecting from the list.
- Separate between day, month, and year, by Default, hyphen ('-') is the separator. You can change it as required.
- Character to use for decimals can specify a character for the decimal point.
- Separator to use for thousands can specify a character as the separator.
- Add sign before currency/unit symbol. If the option is set it to Yes , a Negative sign will appear before the currency symbol, e.g. (-)₹ 20. If the option is set it to No , a Negative sign will be placed after the currency symbol, for example, ₹(-)20.
- Show amount in millions, if the same option provided under Base Currency Information of company creation/alteration screen is, Set to Yes , then you set this option to Yes to view the numbers in Millions and Set to No , then you set this option to No to view the numbers in Lakhs.



If you change any configuration under Style of Dates and Configuration of numbers, you need to restart the application for those changes to take effect.

- In vouchers, show only stock item names (without quantity). Set this to Yes, to view only the stock item name in the List of Stock Items during voucher entry.
- Apply keyword filter to list of items. Set this option to Yes , to reduce the list to the extent of matching keywords entered. Then select the required details from the reduced List of Tables based on the full or partial search keywords, like Company name, Ledger name, Item name and so on.
- Apply for all columns. Set this option to Yes , to apply the keyword filter to all columns displayed in the List of Table . If the option is set it to No , it will search only in the first column of the table.



The option Apply for all columns appears only when the option Apply keyword filter to list of items is enabled.

- Show tables with masters only in current language. Set this option to, Yes , to view the masters only in English language while recording transactions and No , to view the masters created with aliases in all languages while recording transactions.
- Ignore errors during data import. By default, this option is set to No . If you set this option to Yes, data will get imported even if it has errors. This is applicable only for import of files in XML format.
- Overwrite vouchers, instead of duplicating, during import. By default, this option is set to No . Set it to Yes to overwrite the existing vouchers while importing data instead of duplicating the same.
- Export base currency symbol along with amount, enable it to export the currency symbol along with amount in XML format.
- Open file after export enable it to view the folder or file to which the data is exported, immediately after completing the export process.
- Show graphs in monthly reports by default this option is set to Yes. The reports are configured to display the Graphs in accordance with the numeric information. The graphs will not be displayed in the reports if this option is set to No .

- Use separate menu for final A/c statements by default, this option is set to No . Set this option to Yes , to view a separate menu for Final Accounts on Gateway of Tally . Under this menu, Balance Sheet, Profit & Loss A/c, Cash Flow, Funds Flow and Ratio analysis options are available.
- Enable sound notification for alerts. Set this option to Yes , to turn on an audio alert which will beep whenever a transaction has been saved or discarded.
- Always show information panel. Set this option to Yes , to view the Information Panel in all the screens or reports. You can hide this panel by clicking the Ctrl+N [x] close button.

2. Accounts and Inventory Info Configuration

You can configure the details you want in the masters over and above those provided by default. You can access the F12: Configure screen from accounts masters and inventory masters when required.

1. Go to Gateway of Tally>F12: Configure > Accts/Inventory Info. The Master Configuration screen appears as shown below:

<u>Master Configuration</u>			
Provide aliases along with name		? Yes	
Provide language aliases for name		? No	
<u>Accounts</u>		<u>Inventory</u>	
Provide advanced information in masters	? Yes	Allow advanced entries in masters	? Yes
Provide addresses for ledger accounts	? Yes	Provide part numbers for stock items	? Yes
Provide contact details	? No	Add description for stock items	? Yes
Add notes for ledger accounts	? No	Add remarks for stock items	? Yes
Add description for ledger accounts	? No	Use alternate units for stock items	? Yes
		Enable standard rates for stock items	? Yes
		Specify default ledger allocation for invoicing	? Yes
		Enable component list details (Bill of Materials)	? Yes
		Provide address for Godowns	? No

Fig 8: Configuration page settings in Tally.erp9

3. Enable the option provide language aliases for names, to enter the alias names in any of the Indialanguages in the master .
4. Enable the option provide addresses for ledger accounts, to enter the mailing details in the ledger master. It is useful for Customer ledgers, Party ledgers or Bank Accounts. Mailing Details like Name , Address , State , PIN Code and PAN / IT No. is entered in this section.
5. Enable the option provide advanced information in masters, to enter some of the advanced information in the ledger and group master. This information will be reflected in the reports.
6. Enable the options, if required.
7. Press Ctrl+A to accept.

3. Voucher Entry Configuration

You can customise the voucher entries in Tally.ERP 9, both the accounting and inventory vouchers, by enabling required options in the Voucher Configuration screen.

1. Go to Gateway of Tally > F12: Configure > Voucher Entry . The Voucher Configuration screen appears as shown below:
2. Enable the required options.
3. Press Ctrl+A to accept.

Voucher Entry Configuration			
Accounts		Inventory	
Skip Date field during creation for faster entry	? Yes	Provide reference number in stock journal	? No
Use single entry mode for payment/receipt/contra vouchers	? Yes	Show compound unit of item based on rate	? No
Use payment/receipt as contra voucher	? No	Show full details of compound unit	? No
Use Cr/Dr instead of To/By during entry	? No	Warn on negative stock balance	? Yes
Enable cheque printing for contra voucher	? No	Show balances as on voucher date	? No
Warn on negative cash balance	? Yes	Show Godown-wise details	? Yes
Preallocate bills for payment/receipt/journal voucher	? No	Show batch-wise details	? Yes
Allow cash accounts in journal vouchers	? No	Payroll	
Allow expenses/fixed assets in purchase vouchers	? No	Allow cost centre allocation in payroll vouchers	? No
Allow income accounts in sales vouchers	? No	Statutory	
Show inventory details	? Yes	Allow modification of tax details for VAT	? No
Show cost centre/employee details	? Yes		
Show table of bills for selection	? Yes		
Show final balances of bill	? Yes		
Show bill-wise details	? Yes		
Expand into multiple lines	? Yes		
Show current balances of ledgers	? Yes		
Show balances as on voucher date	? No		
Show forex gain/loss as on voucher date	? No		

Fig 9: Configuration settings for Voucher Entry

13.9 Company Features / F11

When you start a company with Tally, the key elements needed to record your business transactions are pre-configured. You can customise the Company Features to meet your specific business needs, such as inventory management, tax-based invoicing, and payroll management. You can enter transaction data according to the preferences you've established. In most cases, you can enable or disable other features incrementally by pressing F11 at any time.

- **Maintain your books of accounts:** Other accounting capabilities, such as cost centre and interest calculations, can be enabled depending on your company's bookkeeping needs. TallyPrime also assists with all such business preferences and many more if your sales transactions need to be preserved bill by bill.
- **Manage your stock/inventory:** You can set up your inventory-related preferences if you use inventory in your business. You can manage your inventory independently in TallyPrime or opt to update your books of accounts using stock information. Depending on your business operations, you can set up other Inventory features such as Price Levels, Batches, Job Work, Job Costing, and so on.
- **Set up statutory features:** You can put up your tax details for invoicing purposes if your firm needs to comply with legislative obligations. TallyPrime allows you to define details for GST, VAT, Excise, Service Tax, TDS, and TCS, if they apply to your company. The statutory details you define here will be referenced in all invoices you make.
- **Tally Software Services (TSS):** TallyPrime has everything you need to access your company data on the move, whether you're travelling or at a client location. To see critical reports from any other device, enable the Reports in Browser capability. You may also access your company's data from anywhere and synchronise data from different places.
- **Payroll management:** Is it necessary for you to manage employee salaries and pay heads in your business? If so, you can enable the Payroll option for your organisation, as well as the statutory features that go with it.
- **Other features:** You can add as many company addresses as you need if your firm has various addresses and you need to use them in invoicing. For auditing purposes, you can also keep track of individual users' interactions with the coupons. All of these requirements can be met at the corporate level.

13.10 Settings in Features/F11

A. Accounting

1. **Maintain Accounts:** Is set to Yes, by default. When you create a company in Tally Prime, the key features required for your bookkeeping needs are all set. You can create a ledger, record sales/purchase transactions, and view the transaction details in your reports.

2. **Enable Bill-wise entry:** Is set to Yes, by default. You can maintain your credit sales and purchase amounts in separate bills for tracking against the payments and receipts. When this option is Yes, the ledger master displays Maintain Balances bill by bill for sundry debtors and creditors. Refer to Maintain Credit Sales Bill by Bill for more information. You can also use this option for bills related to non-Revenue accounts.

3. **Enable Cost Centres:** Set Show more features to Yes. Is set to No, by default. Enable Cost Centres if you need to allocate expenses to different cost centres. Refer to Cost Centre Allocations for more information.

4. **Enable Interest Calculation:** Set Show more features to Yes. Is set to No, by default. Enable Interest Calculation to calculate interest automatically based on the interest rate and the calculation parameters. This is useful when interest rates change from time to time. Refer to Interest Calculations for more information.

B. Inventory

1. **Maintain Inventory:** Is set to Yes, by default. Tally Prime provides the basic inventory features by default to maintain your stock or inventory. You can create masters such as stock items, stock groups, units and so on. If you do not need to track any inventory, set this option to No. Refer to Inventory Management for more information.

2. **Integrate Accounts with Inventory:** Is set to No, by default. Using Tally Prime, enable this option to include the stock or inventory balance from your inventory records. Stock records may contain errors caused by wrong allocation to items. Using this feature, you can finalise your financial reports without having to wait for the reconciliation of stocks. You can drill down from Balance Sheet to Stock Register. Disable this option to maintain accounts and inventory separately.

3. **Enable multiple Price Levels:** Set Show more features to Yes. Is set to No, by default. If you maintain different prices for your stock items, depending on your business type, you can create multiple price levels for your stock items. Refer to Using Price Lists for more information.

4. **Enable Batches:** Set Show more features to Yes. Is set to No, by default. If you sell or purchase your stock in different lots or batches, you will need to store them accordingly. In Tally Prime, you can assign batches to your stock when recording transactions. Refer to Manage Inventory Batch-wise for more information.

5. **Maintain Expiry Date for Batches:** Set Show more features to Yes. Is set to No, by default. Depending on the kind of inventory your business deals with, you may need to specify expiry dates for the batches. For perishable goods like medicines or food items, you can specify the date of expiry for each batch.

6. **Enable Job Order Processing:** Set Show all features to Yes. Is set to No, by default. If your business manages Job Work, you will need to track movement of your materials. In Job Work, you need to maintain record of raw materials, scraps and by products and view their details. Refer to Job Work for more information.

7. **Enable Cost Tracking:** Set Show all features to Yes. Is set to No, by default. If you want to analyse the running cost and profitability of the item being tracked through manufacturing, sales, purchase, and so on, set this option to Yes. Item cost tracking helps you effectively track and ascertain the procurement cost, landing costs, manufacturing or production costs, order cost or profit, and job cost or profit. Refer to Item Cost Tracking for more information.

8. **Use Discount column in invoices:** Set Show more features to Yes. Is set to No, by default. If you provide discounts to your parties on sale or purchase of items, you can manage trade discount for each item during the corresponding voucher entry.

9. **Use separate Actual and Billed Quantity columns in invoices:** Set Show more features to Yes. Is set to No, by default. In case the billed quantity is usually different from the actual

quantity of stock items when recording transactions, you can track such details by setting this option to Yes.

3. Taxation

1. **Enable Goods and Services Tax (GST):** Is set to No. by default. If your business is under the GST regime, you can specify the GST Details for your company. You can set this option to No, if your business does not require to follow GST norms.

2. **Enable Tax Deducted at Source (TDS):** Is set to No. by default. If your business is under the TDS regime, set this option to Yes and specify the TDS details for your company.

3. **Enable Tax Collected at Source (TCS):** Set Show more features to Yes. Is set to No, by default. If your business is under the TCS regime, set this option to Yes and specify the TCS details for your company.

4. **Enable Value Added Tax (VAT):** Set Show all features to Yes. Is set to No, by default. If your business is under the VAT regime, set this option to Yes and specify the VAT Details for your company.

5. **Enable Excise:** Set Show all features to Yes. Is set to No, by default. If your business is under Excise, set this option to Yes, and provide the Excise details for your company.

6. **Enable Service Tax:** Set Show all features to Yes. Is set to No, by default. If you pay service tax as part of your business transaction, set this option to Yes. You can specify the Service Tax details for your company.

4. Payroll

1. **Maintain Payroll:** Set Show more features to Yes. Is set to No, by default. The Payroll features in TallyPrime help you maintain the payroll information, such as employees, salaries, pay heads and so on. Set this option to Yes, to record payroll-related details and the track them through the payroll statements. Refer to Payroll for more information.

2. **Enable Payroll Statutory:** Set Show more features to Yes. Is set to No, by default. If your business maintains payroll information and you also need to track payroll-related statutory information, set this option to Yes.

Summary

- Tally Solutions Pvt. Ltd. is an Indian multinational technology company, that provides enterprise resource planning software.
- The Tally Vault password encrypts and safeguards data from unauthorized access.
- Tally software inculcates multiple ledgers including General ledger, Sales ledger, and Purchase Ledger into a single ledger.
- Tally.ERP9 provides flexibility to manage data of multiple businesses operated within the same license.
- Tally.ERP9 allows users to maintain multiple companies and with unlimited levels of classification & grouping capabilities.
- Tally.ERP 9 has outgrown from the concept of just accounting software to managing statutory compliance by updating statutory files available at Tally solution website.
- Forgetting tally vault password will render the data inaccessible.
- F12 configurations are application centric configurations that are present across all screens of Tally.ERP 9.
- If user change any configuration under Style of Dates and Configuration of numbers, then it need to restart the application for those changes to take effect.

Keywords

- **Tally:** Tally is an accounting software.
- **ERP:** Enterprise Resource Planning

- **Security Control:** Security control can be accessed through *Tally Vault Password*: By enabling Tally vault password, the company data is secured in an encrypted form.
- **TSS:**Tally Software Services

Self Assessment

1. Tally is an _____ software.
 - A. Finance
 - B. Accounting
 - C. Essential
 - D. Computer

2. Tally introduced with a slogan of “ _____ ”
 - A. Power of Accounting
 - B. Power of Investment
 - C. Power of Importance
 - D. Power of Simplicity

3. Tally was the first _____ software.
 - A. Codeless
 - B. Dependant
 - C. Computer
 - D. Direct

4. Ctrl+A is a function of _____.
 - A. Delete
 - B. Save
 - C. Alter
 - D. Export

5. Alt +D is a function of _____.
 - A. Delete
 - B. Save
 - C. Alter
 - D. Export

6. Tally is free while working at _____ mode.
 - A. Business
 - B. Trading
 - C. Active
 - D. Educational

7. The shortcut used for company creation in Tally.erp9 is _____.
- A. C
 - B. S
 - C. R
 - D. P
8. To have security control while creating company is_____
- A. Mandatory
 - B. Optional
 - C. Default
 - D. None of above
9. To select a created company, ____ function key is to be used.
- A. F4
 - B. F3
 - C. F2
 - D. F1
10. To create a company one should go to _____ tab.
- A. Creation Info
 - B. Inventory Info
 - C. Accounts Info
 - D. Company Info
11. Debit and Credit Note at Invoice Mode should be _____ in accounting features.
- A. May be
 - B. Yes
 - C. No
 - D. No option
12. Which function is used for "Features" option?
- A. F9
 - B. F10
 - C. F12
 - D. F11
13. Which function is used for "Configure" option?
- A. F9
 - B. F10
 - C. F12
 - D. F11

14. All important functions appear in _____ in Tally.erp9.

- A. Inventory Vouchers
- B. Accounting Vouchers
- C. Company Creation
- D. Gateway of Tally

15. Which option should be Yes in accounting vouchers?

- A. Separate Accounts and Inventory
- B. Integrate Inventory Only
- C. Integrate Accounts Only
- D. Integrate Accounts and Inventory

Answers for Self Assessment

1. B 2. D 3. A 4. B 5. A
 6. D 7. A 8. B 9. D 10. D
 11. B 12. D 13. C 14. D 15. D

Review Questions

1. Discuss the term Tally.erp9?
2. What are the main features of Tally to various users?
3. How the company creation can done using Tally software?
4. Discuss the emergence of Tally software and its importance?
5. What are the major configure settings in Tally.erp9?
6. Discuss the general configuration settings in detail?
7. Highlight the important features i.e. F11 used in Tally.erp9?
8. What features are essential in Taxation to implement while doing F11 settings?
9. List the basic shortcuts used by companies while working on Tally?
10. What is the importance of F11 and F12 in Tally?



Further Readings

- GST Using Tally.ERP9, by TALLY EDUCATION PRIVATE LIMITED, 2019.
- Official Guide To Financial Accounting Using Tally.Erp 9 With Gst, by Tally Education Pvt. Ltd., 2018.
- Tally ERP 9 (Power Of Simplicity), by SHRADDHA SINGH, 2014



Web Links

- <https://tallysolutions.com>

Unit 14: Computerized Accounting Systems 1

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Objectives

Introduction

- 14.1 Ledger as Principle Book of Accounts
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- 14.4 Create Single Ledger in Tally.ERP 9
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- 14.11 Inventory Vouchers
- 14.12 Shut a Company
- 14.13 Generating Reports

Summary

Keywords

Self Assessment

Answer for Self Assessment

Review Questions

Further Readings

Objectives

After studying this unit, you will be able to:

- access the software Tally.erp9 for ledger creation.
- create the stock items using tally.erp9.
- apply the accounting rules for voucher creation using tally.erp9.
- use the relevant data in generating reports in tally.erp9 for decision making.

Introduction

Tally Solutions Pvt. Ltd. is a multinational technology business based in India that specialises in enterprise resource planning software. Bangalore, Karnataka, is the company's headquarters. More than 1.8 million clients utilise the company's software, according to the corporation.

Shyam Sunder Goenka and his son Bharat Goenka co-founded Tally Solutions, then known as Peutronics, in 1986, and it was incorporated in 1991. Shyam Sunder Goenka ran a business that sold raw materials and machine parts to textile mills and industries in southern and eastern India. He urged his son, Bharat Goenka, 23, a Maths graduate, to design a software application that would handle financial accounting for his firm because he couldn't locate software that could manage his books of accounts. The accounting software's original version was released as an MS-DOS application. It was called Peutronics Financial Accountant and only contained basic accounting features.

Tally Solutions became the official name of the company in 1999. Tally released Tally 8.1, a concurrent multi-lingual edition, and Tally 9 in 2006. Tally.ERP 9, a business management tool, was published in 2009. The corporation created the Vriddhi programme in 2015 to certify and classify its business partners. Tally Solutions also announced the release of Tally.ERP 9 R in 2015. The company had one million customers as of 2016. Tally Solutions was selected as a GST Suvidha Provider in 2016 to provide an interface between the new GST server and taxpayers, and the company released its revised GST compliance software in 2017. TallyPrime was released by the firm in 2020.

14.1 Ledger as Principle Book of Accounts

A journal is a memorandum book used to keep track of transactions throughout time. Total purchases, total sales, debtors, creditors, incomes, and costs on a specific date may not be known as journal. And, in order to obtain information on the above, the entries in the diary are classified according to their nature in a separate book known as the ledger.

An account is a detailed record of changes in a specific asset, liability, expense, loss, gain, or capital over the course of an accounting period. All of these distinct accounts are kept in a loose leaf binder, which is referred to as a ledger.



Utility of a Ledger

- The ledger is a master record of all a business unit's accounts.
- It is a primary book in the double-entry accounting system that contains all relevant data.
- Separate accounts are maintained depending on their nature, so all information relating to transactions, such as to whom what is payable, from whom what is receivable, and the situation of the business's assets and liabilities, can be retrieved through ledgers.
- The ledger assists us in preparing the trial balance in order to ensure the account's arithmetical accuracy.
- Furthermore, the ledger aids us in the preparation of the Trading, Profit and Loss Account, and Balance Sheet.

14.2 Creating Ledger in Tally.ERP 9

- *Ways to create ledger:*
- In Tally, there are two main techniques to build a ledger. Creating a Single Ledger is one option. Another option is to use Multiple Ledgers to create it. By hitting ALT + C, you can create a ledger from the voucher screen. Additionally, we can use the Single Ledger option to create one or two ledgers. When we need to create more ledgers, on the other hand, we can do so quickly with the help of a feature called Multiple Ledgers.
- *Method 1: Single Ledger Creation in Tally:*

Step 1: From Gateway of Tally, go to Accounts Info

Step 2: Go to Ledger

Step 3: Under single ledger, Select the option Create

Step 4: Fill the particulars in the Ledger Creation screen displayed:

Name: The ledger's name appears in the first box. Enter the ledger's name, such as Furniture A/c; Party ledger account (sales). Every ledger must be operated in by a group. Furniture A/c, for example, will be in the Fixed Assets group, and party ledger account (sales) will be in the Sundry Debtors group, as these are receivables that the company will realise at a later date. The following factors have an impact on inventory values: If we have stock to maintain, this must be set to yes.

Mailing details: Details like Name, Address, Country and Bank Details for the ledger has to be filed [Note: It is for the ledgers such as debtors and creditors which require these kinds of details.]

Tax Registration Details: Tax registration details include, PAN/IT No., Registration Type; GSTIN/UIN.; Set/Alter GST details

[Note: Similar to mailing details, these details are also of people and not for ledgers like furniture, building etc.]

Opening balance: This is the opening balance of the ledger if any. Any balance of the ledger which is being carried forward from the previous year will have to be entered as the opening balance.

- **Method 2: Multiple Ledger Creation in Tally:**

The process is almost the same as the single ledger method. Only one step is different.

Step 1: From Gateway of Tally, go to Accounts Info.

Step 2: Go to Ledger

Step 3: Under Multiple ledgers, Select the option Create

Step 4: Fill the particulars in the Ledger Creation Screen:

Under Group: This option is identical to the Single Ledger Method's Under option. For example, the Fixed Assets group will include furniture, air conditioning, and electrical and fittings, while the Investment group will include shares, fixed deposit accounts, and so on. This works well if we generate ledgers under only one group. This method of ledger construction is similarly ineffective for building a Sundry Debtors and Sundry Creditors ledger because we must also provide GST information for individual creditors and debtors when creating a ledger account for them.

14.3 Best Method to Create Ledger in Tally.ERP 9

The choice of whether to generate ledgers using a single ledger or multiple ledger technique is entirely up to the users, as it is entirely dependent on their needs. Only one thing to keep in mind is that when using the Single Ledger Method to create ledgers, we acquire more information than when using the Multiple Ledger Method. Because there are no alternatives such as Inventory values are affected, Mailing Details, and Tax Registration Details in the Multiple Ledger Method. We can either modify each ledger individually while passing accounting entries, or we may go to each ledger individually and edit them. To summarise, choose your strategy carefully to save time and money.



Why is Grouping so Important at Ledger Creation in Tally.ERP 9?

Tally uses groups or headings to determine the type of ledger, whether the ledger account affects the income side or is of an expense nature, or is it an item that will provide benefits or returns to the business, such as Assets, or is it an item that creates a liability for the business that must be settled using the company's current assets. As a result, it becomes important to enter the ledger under the erroneous head or group so that Tally can properly account for it.



To pass entry for expense says machinery repair expense.

Step 1: Creating ledger	We have to create two ledgers here: 1. Machinery maintenance (Expense Ledger) 2. Party Ledger (To credit with the expense amount)
Step 2: Deciding on the Grouping	Machinery maintenance is in nature of expense and so it will have to be grouped under Indirect expenses Party ledger under Sundry creditors (Liability) as a business has to repay creditors after the credit period lapses
Step 3: Passing a Journal entry	From Gateway of Tally we need to navigate to Accounting vouchers and select "F - 7" Journal to pass the entry. Entry will be like : 1. Debiting Expense Account (Machinery repairs) 2. Crediting Party Ledger Account

14.4 Create Single Ledger in Tally.ERP 9

Now we'll take a step-by-step approach to creating a single ledger. In this case, we'll construct a ledger called Axis Bank Account under Bank Account. The date that is necessary for ledger is determined by the features that we have chosen. If the company's accounting features (F11) are set to "NO" for all options, the ledger screen displays only the most basic information.

Tally.ERP 9 creates two ledger accounts, Cash in Hand and Profit & Loss Account, on its own. We can design ledger accounts based on an organization's needs. In Tally, we can't make another profit and loss account, but we can make as many cash accounts as we want with different names (Petty Cash).

How to create ledger account in Tally ERP 9

Path: Gateway of Tally -> Accounts Info -> Ledgers -> Single Ledger -> Choose Create

Step 1: From Gateway of Tally Screen, click on accounts info

Step 2: In the next screen, choose "Ledger"

Step 3: In the next ledger screen, choose the option create under single ledger

Step 4: On ledger creation screen, update the following details



1. Name: Enter the name of ledger account, and the name should be unique.
2. Under: Choose the group name from list of group, that pertains to ledger account.

Fig 1: Selecting group for ledger

After maintaining all the required details, choose Yes option under Accept to save the configured details in Tally.ERP 9 and then, follow path;

Path: Gateway of Tally -> Accounts Info -> Ledgers -> Single Ledger -> Choose Create

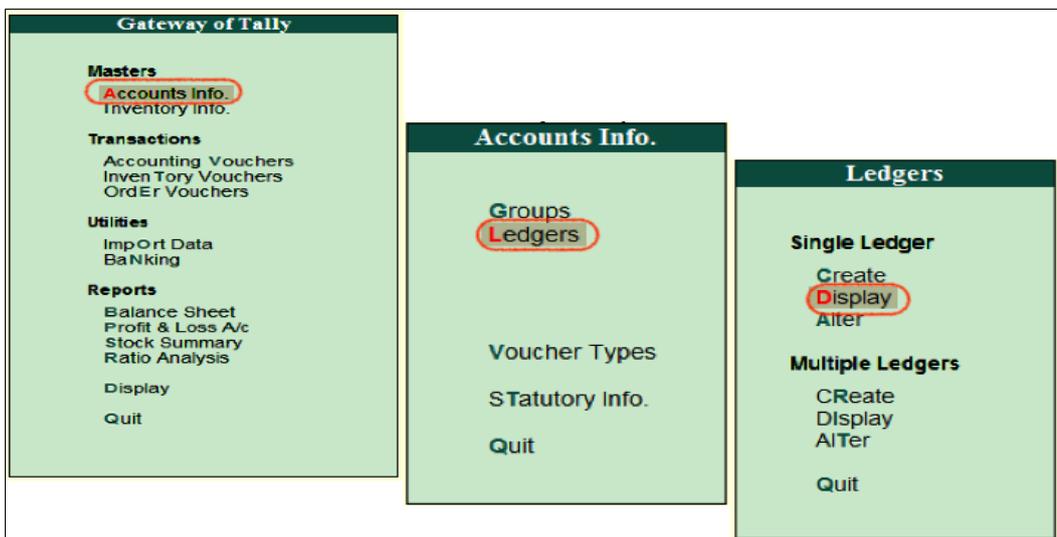


Fig 2: Path for Creation of ledger

Then, Choose the ledger account from list of ledgers:

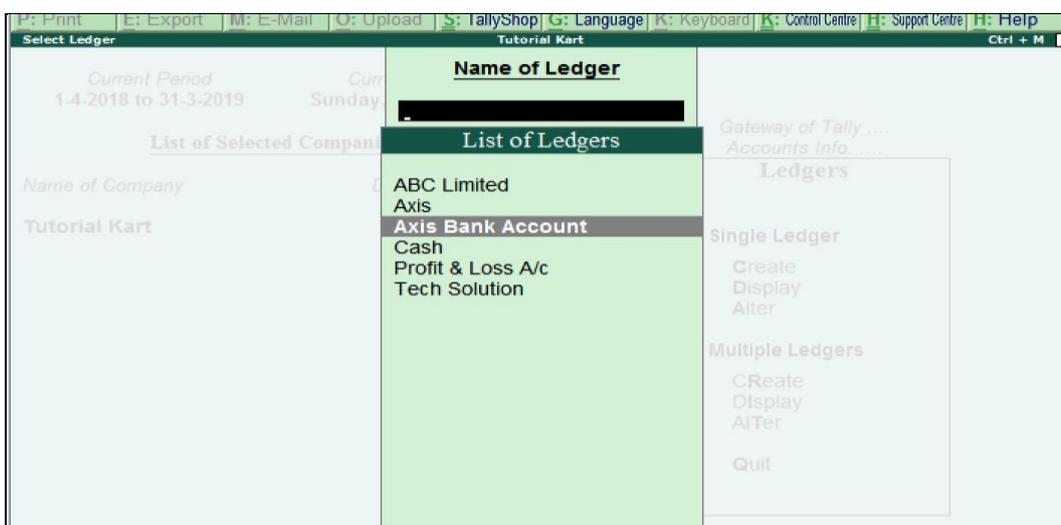


Fig 3: List of ledgers

Now the complete details of ledger account display in the screen as shown below image.

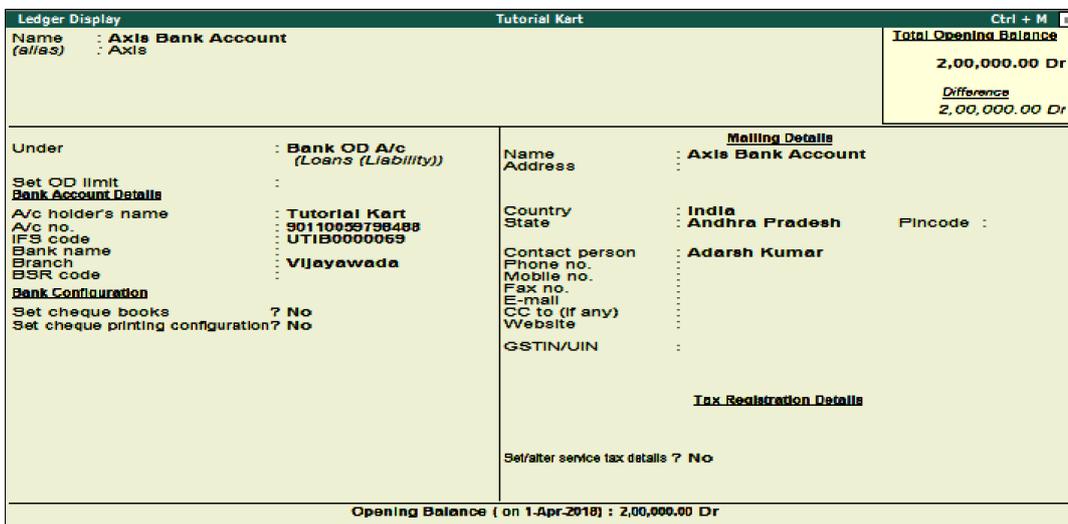


Fig 4: Details of Ledger created

14.5 Alter Single ledger in Tally

Path: Gateway of Tally -> Accounts Info -> Ledgers -> Single Ledger -> Choose Alter

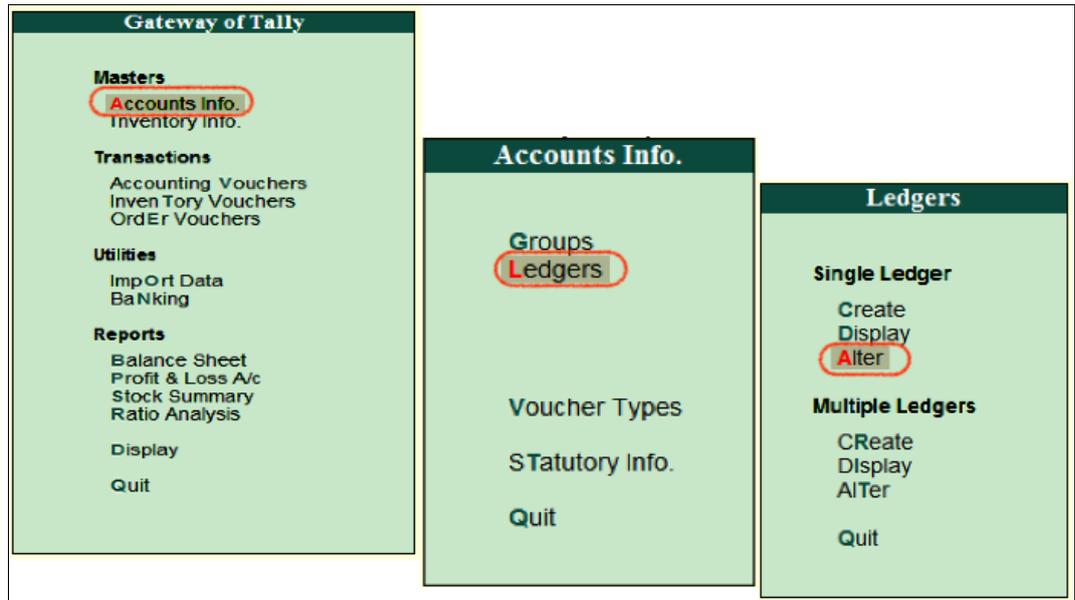


Fig 5: Path to alter the ledger

Now modify/ alter the required details for ledger account and click on A:Accept to save the changed details in Tally ERP 9.

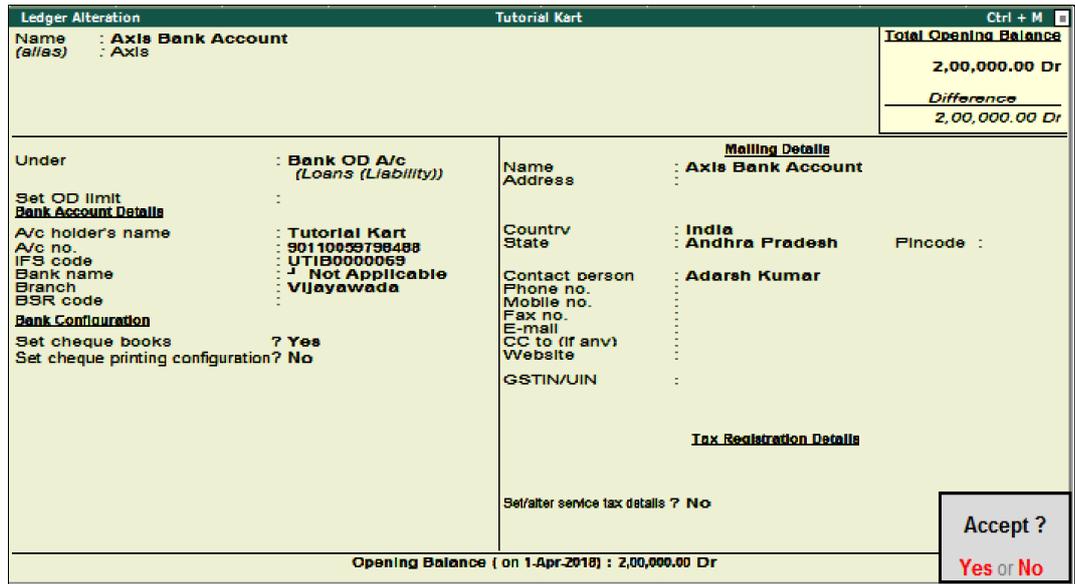


Fig 6: Page for alteration in created ledger

14.6 Ledger Groups

Groups are collections of ledgers with similar characteristics. Account groups are used to identify the hierarchy of Ledger Accounts, which aids in the creation of useful and compliant reporting. You can use this to create reports that are both meaningful and law-compliant. Accounts are classified at the highest level into Capital or Revenue, and then further into Assets, Liabilities, Income, and Expenditure.

There are 28 pre-defined Groups in Tally.ERP 9. There are 15 Primary Groups and 13 Sub-Groups among them. You can also make your own groups as Sub-groups or Primary groups. To create a

virtual accounting tree, groups can be sub-classified to an infinite depth. The Ledger Account is the lowest level. Ledgers are used to pass all voucher entries. You have the ability to build the necessary chart of accounts. You have the option of grouping the Ledger accounts under the appropriate Groups while generating the chart of accounts, or you can change them later.



Fig 7: Groups in ledger



Tally.ERP 9 has pre-defined ledgers for Cash (under Cash-in-hand group) and for the Profit & Loss A/c (under primary group).

14.7 Stock Items in Tally

In Tally, stock items are referred to goods or services that a company manufactures or trade. Stock items in Tally can be created by two methods, i.e.

- Single stock item
- Multiple stock items

Let us understand this concept with the help of an example:

Groups	Name of Items	Unit	Opening Qty	Rate	Amount
Music System	Sony Blue Ray Player	Nos	10	25,000	250,000
	Philips DVD player	Nos	5	15,000	75,000
	Sony 5.1 Music System	Nos	2	20,000	40,000
Television	Sony 32 Inch Tv	Nos	3	25,000	75,000
	LG 32 Inch Tv	Nos	4	20,000	80,000

	MI 32 Inch Tv	Nos	2	15000	30,000
	MI 42 Inch TV	Nos	2	20000	40,000

14.8 How to create single stock item in Tally

Path: Gateway of Tally.ERP 9 > Inventory Info > Stock Items > Single stock item > Create

Step 1: From the initial screen of Tally, i.e. Gateway of Tally, choose inventory info.

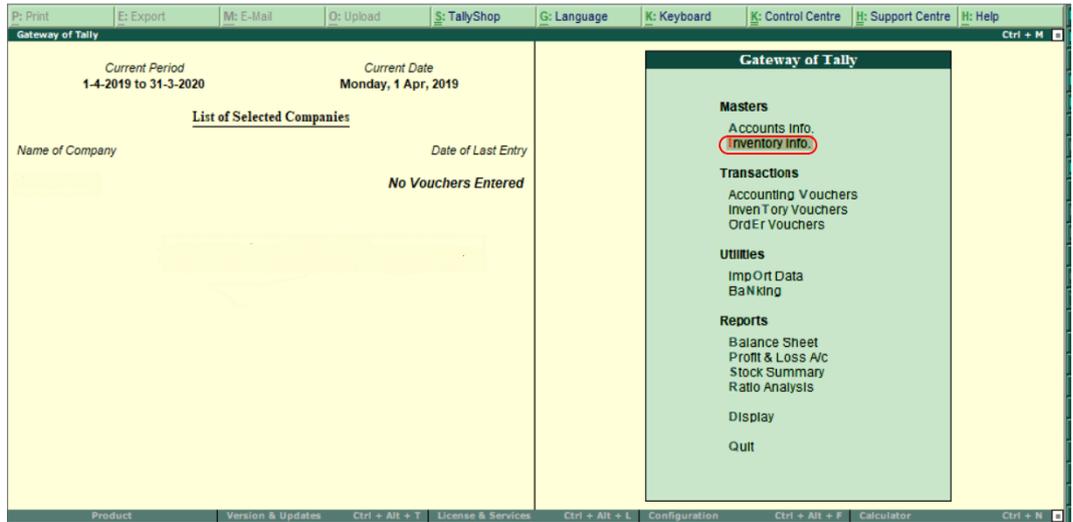


Fig 8: Creation of stock item

Step 2: Next screen, choose "Stock items"

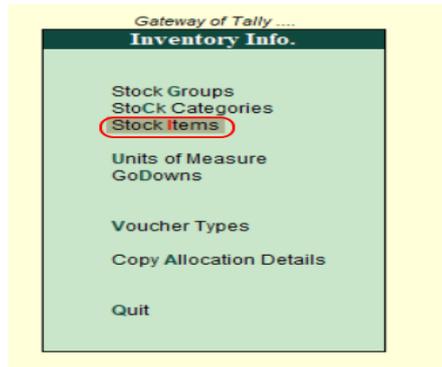


Fig 9: Path to create stock item

Step 3: Under single stock item, choose create.



Fig 10: Creation of stock item

Unit 14: Computerized Accounting Systems 1

Step 4: In next screen, single stock creation enter the following details.

- Name: Enter the name of stock item
- Alias: It can be short name of stock item or another name or product id.
- Under: Enter the stock group under which this stock item to be specified
- Category : Enter the stock category of stock item
- Units: Units of measure to count the stock item
- Opening Balance: Enter the opening balance of stock item
- Quantity: Enter quantity of stock item

Stock Item Creation		ABC Company	
Name	: Brand A - 19" TFT		
(alias)	:		
Under	: Brand A	Tax Information	
Units	: Nos.	Rate of Duty (eg 5)	: 16.50
		Tariff Classification	:
Opening Balance	: Quantity	Rate per	Value
	: 5 Nos.	8,000.00 Nos.	40,000.00

Fig 11: Initials for stock item

- Rate: When you are entering the rate values for stock item, a new window opens as shown below. Update the following details.
- Godown: Choose Godown from the list of Godowns.
- Rate: Enter the rate of stock item
- Per & Amount values are automatically calculated based on quantity and rate amount.

Fig 12: Addings details for stock items

After entering the required details, press enter to continue. Choose “yes” to save the details in Tally.ERP 9.

S.No.	Name of Item	Under	Category	Units	Opening Qty	Rate	per	Amount
1.	Philips Dvd Player	Music System	Music Player	No's	5 No's	15,000.00	No's	75,000.00
2.	Sony 5.1 Music System	Music System	Music Player	No's	2 No's	20,000.00	No's	40,000.00
3.	Sony 32 Inch Tv	Television	32 Inches Tv	No's	3 No's	25,000.00	No's	75,000.00
4.	LG 32 Inch Tv	Television	32 Inches Tv	No's	4 No's	20,000.00	No's	80,000.00
5.	MI 32 Inch Tv	Television	32 Inches Tv	No's	2 No's	15,000.00	No's	30,000.00
6.	MI 42 Inch Tv	Television	42 Inches Tv	No's	2 No's	20,000.00	No's	40,000.00

Fig 13: Display page for stock items created

14.9 Accounting Vouchers

A voucher is a piece of paper that provides the details of a financial transaction and is used to record it in the books of accounts. You can use the relevant Tally voucher to input the details into the ledgers and update the company's financial position for each transaction.

In Tally's Gateway, the voucher entering choices may be found under Transactions. Payroll and Order Vouchers are two independent features that can be enabled depending on your needs. Payroll Vouchers may be turned on in F1: Accounting Features, while Order Vouchers can be turned on in F2: Inventory Features.

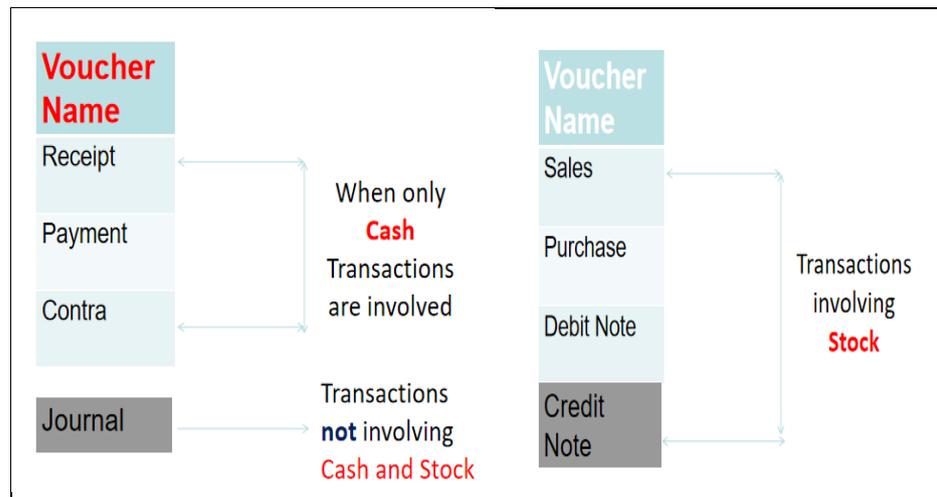


Fig 14: Voucher Name and its details

14.10 Voucher Entry

This option allows you to configure the vouchers entries in Tally.ERP 9, both the Accounting and Inventory Vouchers can be configured from this menu for additional information. Go to Gateway of Tally > F12: Configure > Voucher Entry

By default, the above configuration options are displayed in the Voucher Entry Configuration screen, which can be changed as per requirements.

Voucher Entry Configuration			
Accounts		Inventory	
Skip Date field in Create Mode (faster entry!)	? Yes	Use Ref. Number in Stock Journal	? No
Use Single Entry mode for Pymt/Rcpt/Contra	? Yes	Show Compound Unit of Item based on Rate	? No
Use Payment/Receipt as Contra	? No	Show Full Details of Compound Unit	? No
Use Cr/Dr instead of To/By during entry	? No	Warn on Negative Stock Balance	? Yes
Use Cheque Printing for Contra	? No	Show Balances as on Voucher Date	? No
Warn on Negative Cash Balance	? Yes	Show Godown-wise Details	? Yes
Pre-Allocate Bills for Payment/Receipt/Journal	? No	Show Batch-wise Details	? Yes
Allow Cash Accounts in Journals	? No		
Allow Expenses/Fixed Assets in Purchase Vouchers	? No		
Allow Income Accounts in Sales Vouchers	? No		
Show Inventory Details	? Yes		
Show Table of Bill Details for Selection	? Yes		
Show Bill-wise Details	? Yes		
Expand into multiple lines	? Yes		
Show Ledger Current Balances	? Yes		
Show Balances as on Voucher Date	? No		
Show Forex Gain/Loss as on Voucher Date	? No		

Fig 15: Configuration settings for Voucher entry



Depending upon the Company Features, options get added in Voucher Entry configuration. For instance, if you enable Allow Multi Currency option in F11 : Accounting Features, Show Forex Gain/Loss as on Voucher Date option gets added in voucher entry configuration.

Important Features in Accounting Vouchers

- **Skip Date field in Creation Mode (faster entry!)-**By default, the Cursor skips the Date field during Voucher creation. If you do not want to skip the date field then set this option to No
- **Use Single Entry Mode for Pymt/Rcpt/Contra-**By default, Tally.ERP 9 displays single entry mode for payment/receipt/contra entry. If you want to display it in double entry mode, then set this option to No
- **Use Payment / Receipt as contra-**By enabling this option, you can enter contra in payment as well as receipt voucher
- **Use Cr/Dr instead of To/By during Entry-**By enabling this option, you can change To/By to Cr/Dr in the Voucher Entry screen
- **Use Cheque Printing for Contra-**By enabling this option, you can print the Cheques from Contra Voucher itself while making the inter bank transfers and Cash withdrawals. The Cheque printing option will appear the for the Bank which is Credited
- **Warn on Negative Cash Balance-**By Default, Tally.ERP 9 displays a Negative Cash balance warning Message. If you set it to No, this error message will not be displayed
- **Pre-Allocate Bills for Payment/Receipt-**By enabling this option, you can pre-allocate the bills before specifying the Ledger amount
- **Allow Cash Accounts in Journal-**By enabling this option, you can select cash and also bank account in Journal
- **Allow Expenses / Fixed Assets in Purchase Voucher-**By enabling this option, you can select the expenses and also Fixed Asset ledger in Purchase Voucher Entry
- **Allow income accounts in Sales Voucher-**By enabling this option, you can select the income ledger in sales voucher entry

- **Show inventory Details**-By default, Tally.ERP 9 displays inventory details in the voucher entry screen. If you set it to No, the inventory details will not be displayed
- **Show Table of Bill details for selection**-By default, Tally.ERP 9 displays Pending Bills list of a ledger account in the voucher entry screen. If you set it to No, the pending bills list will not be displayed
- **Show Bill-wise Details**-By default, Bill-wise details of a ledger account are displayed in the Voucher entry screen. If you set it to No, Bill wise details will not be displayed
- **Expand into Multiple Lines**-This is a sub-option of the Show bill-wise Details option. When you enter credit days in the Bill-wise Details screen, Tally.ERP 9 displays the due date below the credit days. By default, it displays both credit days and Due date in the voucher entry screen. If you set it to No, it will display only credit days
- **Show ledger current balance**-By default, Tally.ERP 9 displays the ledger current balance up to last voucher entry date. If you set it to No, the ledger current balance will not be displayed
- **Show balance as on voucher date**-By default, Tally.ERP 9 displays the ledger current balance up to Last voucher entry date. If you set it to Yes, it will display the ledger balance up to current voucher entry date
- **Show Forex Gain/Loss as on voucher Date**-By default, Tally.ERP 9 displays the Forex Gain/Loss balance up to the Last voucher entry date. If you set it to Yes, it will display the Forex Gain/Loss balance up to current voucher entry date

14.11 Inventory Vouchers

- **Use Reference number in Stock Journal**-By enabling this option, you can add the voucher reference field in Stock Journal also
- **Show Compound Unit of Item based on Rate**-By enabling this option, you will be allowed to show the compound unit of item based on the unit provided in the Rate Per column.



Compound Unit created as Kgs of 1000 grms. When the Quantity is typed as 12-250, the Quantity will be displayed as 12-250 kgs and unit in Rate per as Kgs. Enable the option Show Compound Unit of Item based on Rate, and type the required Unit in Rate Per column to change the compound unit of the Item, i.e., if grms is typed in Rate Per column, the Quantity will automatically change to 12,250 grms

- **Show Full Details of Compound Unit**-Enabling this option will display full details of compound unit in the Quantity field. If Kgs is typed in Rate Per field, the Quantity field will display as 12 Kgs.250 grms.
- **Warn on Negative stock balance**-By default, Tally.ERP 9 displays a warning message for negative stock balance. If you set it to No, the error message will not be displayed.
- **Honor Expiry Dates usage for Batches**-By default, Tally.ERP 9 displays expiry batches in the List of Active batches during Voucher Entry. If you set it to No, expiry batches will not be displayed in the List of Active batches.
- **Show Balances as on Voucher Date**-By default, Tally.ERP 9 displays the Stock Item balance up to the Last voucher entry date. If you set it to Yes, it will display the Stock Item balance up to current voucher entry date.
- **Show Godown-wise Details**-This option is used only in the case of Rejection in and Rejection out vouchers. By default, Tally.ERP 9 displays the Godown details in Rejection in/out vouchers. If you set it to No, the godown details will not be displayed in Rejection in/out vouchers.
- **Show Batch-Wise Details**-This option is used to display batch information pertaining to Stock Items during Voucher Entry. If you set it to No, the Batch-Wise details will not be displayed.

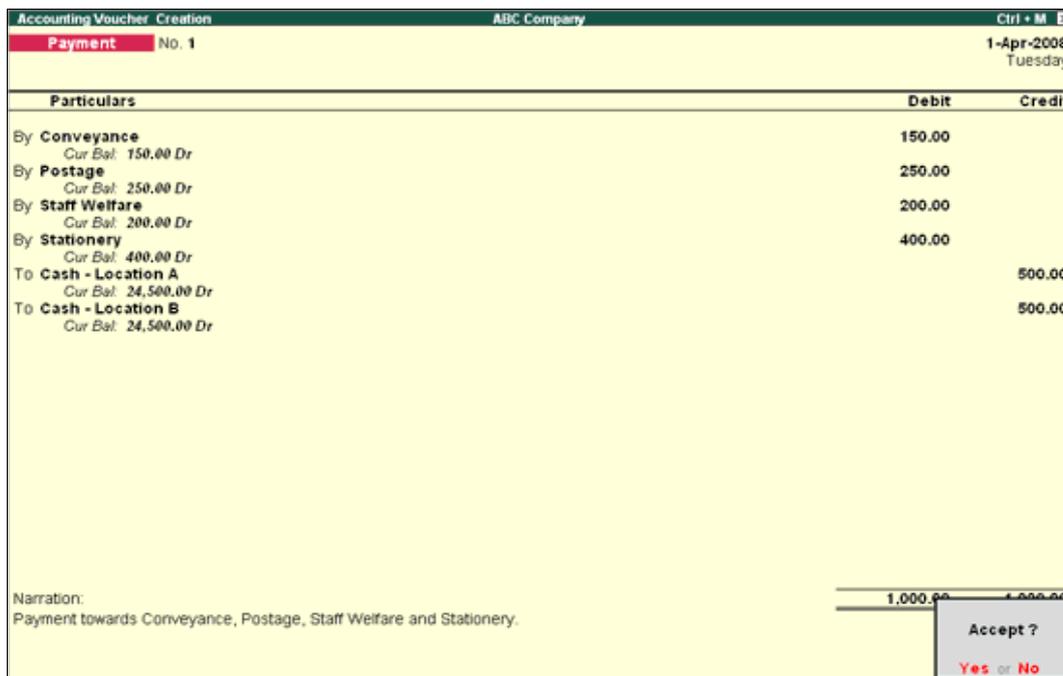


Fig 16: Display screen for voucher entry

14.12 Shut a Company

Shut a Company is to unload it. It does not mean that you have deleted it. Simply select it again to load and work on it again. You can shut a company in two ways - either using the button F1: Shut Cmp (Alt + F1) or pressing Enter on Shut Company menu option on the Company Info. Menu.

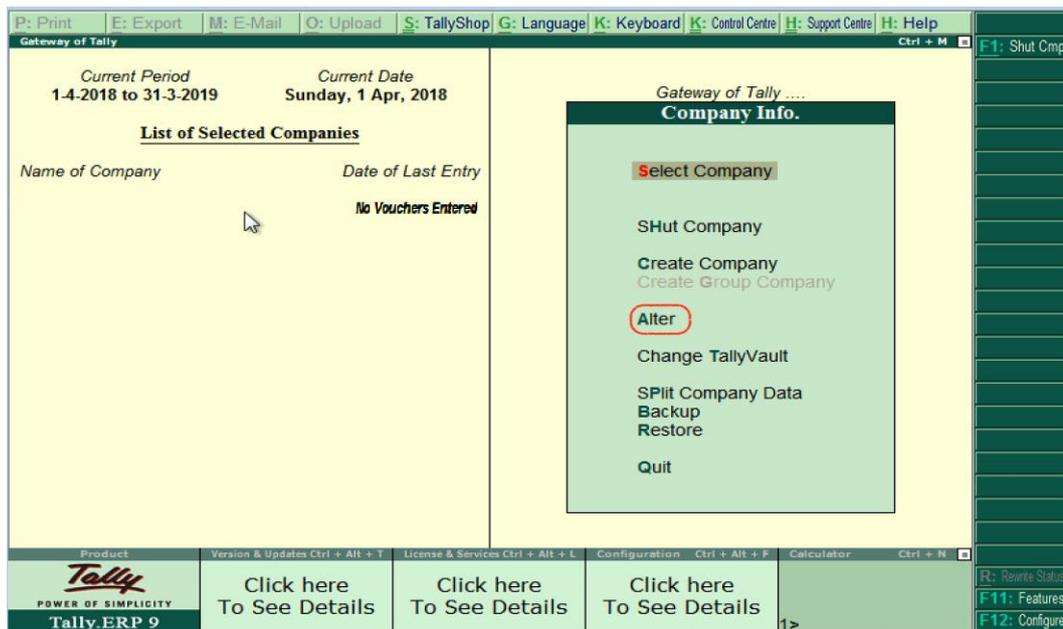


Fig 17: Shut or delete the created company

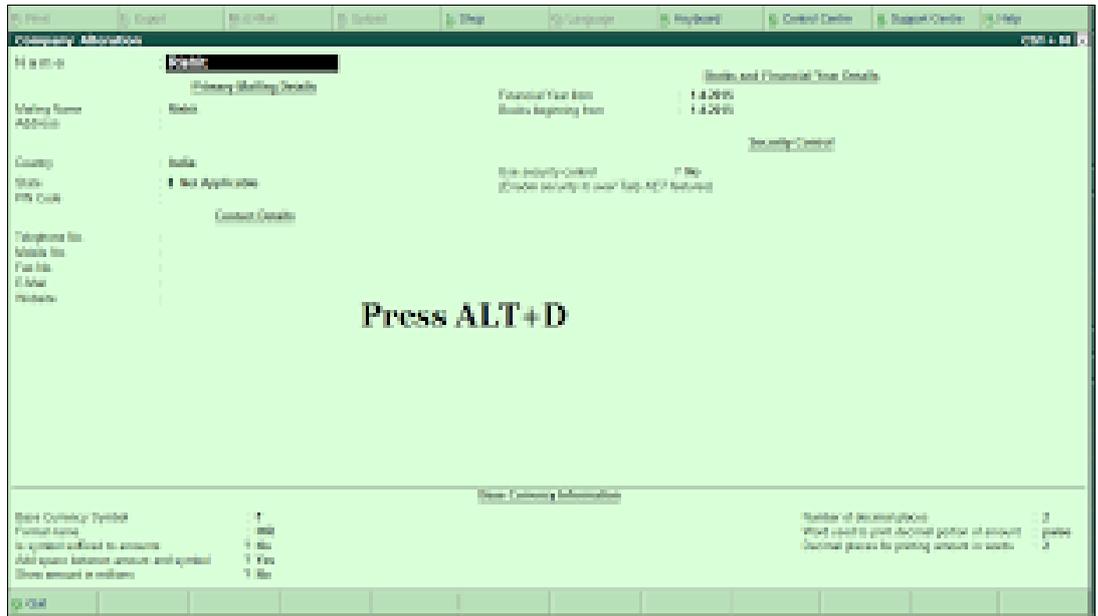


Fig 18: Option to press to delete the created company



Fig 19: Final option to delete

14.13 Generating Reports

Reports serve a vital role in helping firms manage their day-to-day operations more efficiently. Tally.ERP 9 recognises this need and offers a variety of useful reports. Tally reports are a great way to keep track of your finances. ERP9 is designed to handle all aspects of accounting, inventory management, and statutory compliance.

- **Balance Sheet in Tally.ERP 9**

The Balance Sheet provides a comprehensive view of a company's financial status. The Tally Balance Sheet. ERP 9 displays a company's assets and liabilities. A business owner can access the Balance Sheet via the Gateway of Tally screen. Tally's F12 option allows you to customise the Balance Sheet. Tally ERP 9. For enterprises, ERP 9 also includes a Schedule VI Balance Sheet. For every given date, the Balance Sheet can be examined. Stock valuations can be defined in a variety of ways, including FIFO, LIFO, Average Cost, Average Price, and many others.

- **Profit & Loss Account in Tally.ERP 9**

Tally's Profit & Loss report. ERP 9 displays a company's net profit or loss over a specified time period. By default, this Tally report takes into account the time period from the start of the books to the entry date of the last voucher. Tally's Profit & Loss report. F12 setup is accessible within the report to configure ERP 9. According to the rules, a business owner can view Schedule VI Profit & Loss account or P&L statement in a vertical style.

- **Cash Flow/Fund Flow Report in Tally.ERP 9**

Tally.ERP 9 has a Cash Flow report that may be used to see cash influx and outflow over the course of an accounting quarter. This report assists business owners in understanding and making decisions about their cash flow status for a certain period. Similarly, Tally.ERP 9's Fund Flow report gives monthly information on the sources of funds and their net flow status.

- **Ratio Analysis Report in Tally.ERP 9**

In Tally, the Ratio Analysis report is a useful tool for financial analysis. ERP 9 is an enterprise resource planning system. The report's many ratios provide a comprehensive picture of a company's financial situation. Debt Equity Ratio, Quick Ratio, Return on Working Capital, Return on Investment, and so on are examples of these metrics. This is one of Tally's most important reports.

- **Outstanding Report in Tally**

Tally allows a business owner to view receivables by ledger and bill. ERP 9 is an enterprise resource planning system. He can view an ageing analysis that he can use based on due dates or bill dates. A firm can connect with parties or manage finances to make payments based on the amount of time that has elapsed (ageing). The user may see and comprehend the details of bills for which payment is due thanks to the bill-by-bill ageing details.

- **Stock Summary Report in Tally.ERP 9**

The Stock Summary report shows the current stock or stock in hand situation for a given day. A business owner can see item-by-item rates, quantity, and value of available stocks in this Tally report. Tally's Stock Summary report. Business owners can also see gross profit at the item level based on landing cost and sales price in ERP 9. It also displays the current status of stocks in various godowns. By taking into account buy and sales orders that have yet to be processed, the user can assess the net stock position.

- **Stock Ageing Analysis Report in Tally.ERP 9**

This is a report for Tally. ERP 9 enables organisations to distinguish between sluggish and fast moving goods. This Tally report assists business owners in making decisions about stock acquisition and whether or not to liquidate equities based on their age. Tally. ERP 9 allows you to specify various time periods based on your business needs, such as 0-30 days, 31-60 days, and so on. This study also includes stock valuations for business owners.

- **GST Reports in Tally.ERP 9**

In GST, Tally.ERP 9 provides GSTR-1, GSTR-2, GSTR-3B and e-Way Bill related reports. The GSTR-1 report in Tally.ERP 9 is designed exactly as the form of GSTR-1 to make life easy for users.

Business owners can see -

- Details of transactions participating in GSTR-1
- Transactions not relevant for returns
- Transactions not participating because of incomplete information or mismatches
- Serial number-wise details of values as mentioned in GSTR-1

A user can navigate from any value up to the actual transaction itself. Users can correct transactions under Incomplete/mismatch in the Information section and allow these transactions to participate in GST returns. This way, Tally ensures that a user files the most accurate GST returns. A similar experience is given for GSTR-2 and GSTR-3B.

• E-Way Bill Reports in Tally.ERP 9

Tally.ERP 9 gives comprehensive e-Way Bill reports to make life simpler for users. A user can view-

- Transactions which have been exported for e-Way Bills
- Transactions which are yet to be exported for e-Way Bills
- E-Way Bill details of all the transactions for which e-Way Bills have already been generated.

Apart from all of the above mentioned Tally reports, there are many more reports in Tally.ERP 9 all of which help businesses to access their financial analysis in the easiest manner and take quick business decisions.

1. Go to Gateway of Tally > Display > Balance Sheet.

Balance Sheet		ABC Company		Ctrl + M
ABC Company		ABC Company		
Liabilities	as at 18-May-2015	Assets	as at 18-May-2015	
Capital Account		Fixed Assets	12,00,000.00	
Loans (Liability)		Current Assets	32,99,704.70	
Current Liabilities	18,93,081.99			
Profit & Loss A/c	5,91,622.71			
Opening Balance				
Current Period	<u>5,91,622.71</u>			
Difference in opening balances	20,15,000.00			
Total	44,99,704.70	Total	44,99,704.70	

Fig 20: Balance Sheet Display

2. Press F12 to configure the Balance Sheet .

3. Press Ctrl+A to accept.

While providing the opening balance in ledgers, an equivalent contrary balance will appear as Difference in opening balances in order to match the assets and liabilities, or debit and credit balances. The entry passed for the difference will affect the closing balance, but the Balance Sheet will display the difference in the amount. To balance the difference in the opening balance, you have to adjust it with the opening balance of another ledger.



If the Difference in opening balances is Rs 5000/- on the debit side, you must adjust this with Rs 5000/- credit to the opening balance of another ledger.



When a value in Liabilities or Assets becomes negative, it will appear based on the type of its group balance. Assets with credit balance will appear in Liabilities , and Liabilities with debit balances will appear in Assets. If you want to view the Balance Sheet as per the statutory requirement, you have to configure the Balance Sheet as per Schedule VI .

- **Profit or Loss, both as Liability:** Set this to No , to move the Profit & Loss Account to the Assets side of the Balance Sheet .



The Profit or Loss, both as Liability option is available in horizontal form.

Unit 14: Computerized Accounting Systems 1

Show Percentages-Set this option to Yes in the balance sheet configuration screen. Press Alt+F1 to view the detailed Balance Sheet. Each line is expressed as a percentage of the total amount of the Balance Sheet. In Detailed mode, the Balance Sheet appears as shown below.

ABC Company		ABC Company	
as at 31-Mar-2009		as at 31-Mar-2009	
Liabilities		Assets	
Capital Account	24,00,000.00 363%	Fixed Assets	2,00,000.00 0.30%
Capital Account	24,00,000.00	Capital Goods	2,00,000.00
Loans (Liability)	12,00,000.00 1.81%	Current Assets	6,59,65,112.25 99.88%
Loan From Bank	12,00,000.00	Closing Stock	2,51,66,005.25
Current Liabilities	2,32,81,966.25 35.18%	Loans & Advances (Asset)	66,000.00
Duties & Taxes	1,34,586.75	Sundry Debtors	3,07,23,732.00
Sundry Creditors	2,31,22,704.50	Cash-in-Hand	74,53,050.00
CST Deferred Account	3,200.00	Bank Accounts	25,52,825.00
Interest Payable Account	16,275.00	CST Refund Granted Ac	2,000.00
Tax Deferred A/c	5,200.00	Entry Tax	3,500.00
Branch / Divisions	8,600.00 0.01%	Unadjusted Forex Gain/Loss	12,558.00 0.02%
Branch/ Division	8,600.00		
Suspense A/c			
Refund Claim on Exports			
Profit & Loss A/c	3,52,87,104.00 53.17%		
Opening Balance	2,26,300.00		
Current Period	3,90,60,804.00		
Total	6,61,77,670.25 100%	Total	6,61,77,670.25 100%

Fig 21: Balance Sheet Display as percentages

Summary

- Tally Solutions Pvt. Ltd. is a multinational technology business based in India that specialises in enterprise resource planning software.
- Journal is a memorandum book to record transactions date wise.
- The ledger is a master record of all the accounts of a business unit.
- There is a total of 2 major ways to create a ledger in Tally. One way is to create a Single Ledger. Another way is to create it with Multiple Ledgers.
- Groups are collection of ledgers of the same nature.
- In Tally, stock items are referred to goods or services that a company manufactures or trade.
- A voucher is a document that contains details of a financial transaction and is required for recording the same into the books of accounts.
- Reports play an important role for businesses to help manage their day-to-day business operations efficiently.
- The Balance Sheet gives a complete glance at the financial position of a business. The Balance Sheet in Tally.ERP 9 shows the assets and liabilities of a company.
- The Profit & Loss report in Tally.ERP 9 shows a company's net profit or loss in a given period.

Keywords

- **Ledger:** It is a principal book of double entry system of accounting which provides all important information.

- **Voucher:** It is a document that contains details of a financial transaction and is required for recording the same into the books of accounts.
- **Stock Summary:** The Stock Summary report displays the current position of stocks or stock in hand for a particular date.
- **Cash Flow report:** In Tally.ERP 9 it has been provided to help get a view of cash inflow and outflow during an accounting period.

Self Assessment

1. Which option is used while creating ledger in Tally.erp9?
 - A. Accounts Info
 - B. Accounting Vouchers
 - C. Inventory Info
 - D. Inventory Vouchers

2. To create ledger using shortcut key, user should access _____.
 - A. Ctrl+D
 - B. Alt+C
 - C. Ctrl+L
 - D. Ctrl+C

3. _____ and _____ ledgers are created in Tally.erp9 by default.
 - A. Cash and Profit & Loss
 - B. Assets and Liabilities
 - C. Bank and Cash
 - D. Balance Sheet and Cash Flow

4. Alt+D option in Tally.erp9 is used to _____ any command.
 - A. Delete
 - B. Save
 - C. Alter
 - D. Export

5. Can user make changes in created ledgers?
 - A. Yes
 - B. No

6. For stock item creation, user should go at _____.
 - A. Accounts Info
 - B. Accounting Vouchers
 - C. Inventory Info
 - D. Inventory Vouchers

7. After inventory info, user should click at _____ for creating stock items.
- A. Stock items
 - B. Stock groups
8. Stock item created by user should be under always _____ group.
- A. Mandatory
 - B. Primary
 - C. Secondary
 - D. Created
9. To display a created company, user has to click at _____.
- A. Alter option
 - B. Display option
 - C. Stock item
 - D. Stock group
10. Which is the stock item out of following?
- A. Cash
 - B. Ink
 - C. Aman
 - D. Bank
11. Which voucher/s can be created , if only cash transactions are involved?
- A. Receipt
 - B. Payment
 - C. Contra
 - D. All above
12. Which voucher is created, if no cash or stock is involved?
- A. Receipt
 - B. Payment
 - C. Contra
 - D. Journal
13. In total there are _____ vouchers in tally.erp9.
- A. 9
 - B. 10
 - C. 8
 - D. 11
14. Debit Note and Credit Note vouchers in Tally.erp9 are used for _____.

Financial Accounting

- A. Sale of goods
 - B. Purchase of goods
 - C. Selection of goods
 - D. Return of goods
15. For creating vouchers , user should click at_____.
- A. Accounts info
 - B. Inventory info
 - C. Accounting vouchers
 - D. Inventory vouchers
16. Which financial statements can be created at tally.erp9?
- A. Balance Sheet
 - B. Profit and Loss
 - C. Trial Balance
 - D. All above
17. Report generated in tally.erp9 can be _____.
- A. Email
 - B. Print
 - C. Export
 - D. Email, Print and Export
18. If user wants to export the report, one should use_____ option for authenticity.
- A. PDF
 - B. HTML
 - C. JPEG
 - D. PNG
19. Export location in tally.erp9 is_____.
- A. Default
 - B. Drive at System
 - C. Tally.erp9 only
 - D. No option

Answer for Self Assessment

1. A 2. A 3. A 4. D 5. A
6. C 7. A 8. B 9. B 10. B

11. D 12. D 13. C 14. D 15. C
16. D 17. D 18. A 19. B

Review Questions

1. Define Ledger? Discuss the utility of ledger in Tally.erp9?
2. Distinguish between Journal and Ledger?
3. What do you mean by grouping of ledger?
4. Discuss the steps to create the ledgers?
5. How the company can create various vouchers in Tally.erp9?
6. Define voucher entry? Discuss the vouchers used in Tally in detail?
7. Discuss various reports generate in Tally.erp9 along with their usage?
8. How can the created company get deleted? Explain in detail.
9. Discuss the important facts in inventory vouchers?
10. Discuss the various features in accounting vouchers?



Further Readings

- GST Using Tally.ERP9, by TALLY EDUCATION PRIVATE LIMITED, 2019.
- Official Guide To Financial Accounting Using Tally.Erp 9 With Gst, by Tally Education Pvt. Ltd., 2018.
- Tally ERP 9 (Power Of Simplicity), by SHRADDHA SINGH, 2014.



Web Links

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