Centre for Distance & Online Education
(CDOE)

BACHELOR OF COMMERCE

BCOM 201

FINANCIAL ACCOUNTING-II

Guru Jambheshwar University of Science & Technology, Hisar – 125001

CONTENTS

Course: **Financial Accounting-I**	
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Lesson No: **1**	

Royalty Accounts

STRUCTURE

1.0 LEARNING OBJECTIVE

After reading the lesson the students should be able to:

(i) Understand the meaning of royalty, differentiate royalty and rent, and explain the various terms related to royalty accounts such as lessor, lessee, dead rent and short working.

(ii) Prepare the royalty accounts in the books of both lessor and lessee.

1.1 INTRODUCTION

Royalty is a periodical payment based on output or sale for the use of a fixed asset or right to its owner. The payment which is made by one person to another for the use of a certain asset is known as Royalty. The person who makes the payment to the owner of the asset is known as lessee and the owner of the asset to whom payment is made is called as lessor or landlord. Thus, royalty is paid by the publisher to the writer of the book, by the manufacturer to the patentee or to the owner of oil-wells.

According to J. R. Batliboi

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

Royalty account is a nominal account in nature and is synonymous with rent account. Since, it is a nominal account, it is debited in the books of lessee as ordinary business expenditure and credited in the books of landlord as income for him. Royalty account is closed at the end of every accounting year by transferring to Profit and Loss Account.

1.2 DIFFERENCE BETWEEN RENT AND ROYALTY

The major differences between rent and royalty are as follows:

1. Rent is paid for the use of tangible assets such as building, machinery, whereas royalty is paid for the use of intangible assets or special right such as mines, patent right.
2. Rent is fixed, but the amount of royalty is not fixed and depends on number of articles produced or sold.

1.3 IMPORTANT TERMS IN CONNECTION WITH ROYALTY

1. **Landlord or Lessor**:- The person who is the owner of the assets and surrender the right of its use to some other person and receives the consideration as royalty is called ‘Lessor’.
2. **Lessee**:- The person who pays the royalty in consideration for the use of that asset is called ‘Lessee’.
3. **Minimum or Dead or Fixed Rent** :- It is the minimum amount of rent which the lessee is required to pay to landlord whether he (lessee) has desired any benefit or not out of the right or property rented out to him by the lessor. Thus, such minimum rent is fixed at the time of agreement between the two parties. The fixation of such a rent is in the interest of landlord

because it guarantees the receipt of the minimum amount in case of low output or sales. So a lessee has to pay minimum rent or royalty, whichever is more. Minimum rent is generally fixed that is why it may be known as Dead or Fixed or Flat Rent but some time it may vary also according to the terms of the agreement.

4. **Short working**: - The excess of minimum rent over royalty calculated on the basis of output or sales is termed as short working.

Short working = Minimum Rent - Royalty

For example if minimum Rent is fixed Rs. 10,000 and actual royalty for Ist and IInd year of output is Rs. 4,000 and 9,500/- respectively, so short working will be Rs. 6,000/- and Rs. 500/- for Ist and IInd year respectively.

5. **Recoupment of short working**: - Usually in the first few years of the royalty agreement, the work does not gather the required momentum because of the time taken in the preparation for starting the production, so short workings may arise in first few years. Keeping this in view, royalty agreement may contain a clause that short working can be recouped by the lessee in the following manner:-

(i) **Without any time limit**: - According to this clause in the agreement the time limit for the recoupment of short workings is not mentioned. So, the short workings, then, may be recouped throughout the period of the lease. In such a case the amount of un-recouped shortworkings will be transferred to the Profit & Loss Account only in the last year of the period of lease and not earlier.

(ii) **When short workings can be recouped in a fixed period** :- There may be a clause in the agreement that the short workings can be recouped in the given first few years of the lease such as first three years, first four years or first five years. For example if a coal mine is leased on Ist Jan. 2000 for a period of 10 years and if short workings can be recouped only during the first 4 years of the lease, the short workings will be recouped upto 2003 only and not afterwards. The balance of short workings in 2003 and thereafter will be transferred to Profit & Loss Account.

(iii) **When short workings can be recouped in the next few years**:- In this clause of agreement, the period allowed for recoupment of each year's short working is calculated from the year during which the short workings arose. For example, if a mine is leased on Ist Jan 1990 for a period of 20 years and if it is given in the agreement that short workings can be recouped in the subsequent 3 years, then short workings of 1990 can be recouped upto 1993 and short workings of 1991 can be recouped upto 1994 and of 1992 upto 1995 and so on. If short workings which could not be recouped during the stipulated period of 3 years that short workings will be transferred to Profit & Loss Account in the year in which the right of recoupment lapses.

1.4 ACCOUNTING PROCEDURE

The following points need to be noted down before preparing the Royalty Accounts:-

1. Name of Landlord and Lessee.
2. Period of Lease.
3. Commencement of agreement.
4. Royalty Rates.
5. Minimum Rent.
6. Right of recoupment of short workings.
7. Mode of payment to Landlord.

A calculation table may be prepared before making the Journal entries which makes easy solution, The format of table is as follows:-

Year	Output	Royalty	Short working	Short working recouped	Unrecouped Short workings transferred to P&L Account	Amount paid to Landlord
		Rs.	Rs.	Rs.	Rs.	Rs.

1.4.1 Journal entries in the books of lessee

There may be three types of situations in order to pass Journal entries in the books of lessee:-

1. When minimum Rent is more than Royalty.
2. When minimum Rent is equal to Royalty.
3. When minimum Rent is less than Royalty.

Ist Case

When Minimum Rent is more than Royalty:-

(i) When Royalty is due :-

Royalty A/c Dr.
Short workings A/c Dr.
    To Landlord A/c
(Being Royalty and Short workings due to Landlord)

(ii) When payment is made :-

Landlord A/c Dr.

To Cash/Bank

(Being Cash paid to Landlord)

(iii) Closing entry at the end of the year :-

Profit & Loss A/c Dr.

To Royalty A/c

(Being Royalty Account transferred to Profit & Loss A/c.)

IInd Case

When Minimum Rent and Royalty are equal

(i) When Royalty is due :-

Royalty A/c Dr.

To Landlord A/c

(Being Royalty due)

(ii) When payment is made:-

Landlord A/c Dr.

To Cash/Bank

(Being Payment made to Landlord)

(iii) For closing Royalty A/c at the end of the year

Profit & Loss A/c Dr.

To Royalty A/c

(Being Royalty Account transferred to Profit & Loss a/c.)

IIIrd Case

When Minimum Rent is less than Royalty and Short working recouped.

(i) For Royalty due

Royalty A/c Dr.

To Landlord A/c

(Being Royalty due to Landlord)

(ii) For payment & recouped of short working

Landlord A/c Dr.

To Cash/Bank

To Short working (Recouped)

(Being payment made to landlord and shortworking recouped)

(iii) For closing Royalty a/c and unrecouped short working :-

Profit & Loss A/c Dr.

To Royalty A/c

To Short working (Unrecouped)

(Being Royalty & Unrecouped short working transferred to Profit& Loss A/c.)

Kinds of Royalties

1. Royalties in connection with mines.
2. Royalties regarding oil-wells.
3. Royalties regarding Brick Making
4. Royalties regarding Patents.
5. Royalties regarding copyright.

Illustration-1: Bengal Coal Ltd., leased in a colliery on Ist Jan. 2001 at a minimum rent of Rs. 15,000 merging into a royalty of Re 1 per ton with a right to recoup shortworkings over the first three years of the lease. The output for the first four years of the lease was 8,000, 13,000, 21,000 and 18,000 tones respectively. Pass necessary journal entries in the books of the company and show the necessary ledger accounts.

Solution:

Calculation Table

Year	Output	Royalty	MinimumRent	Short Workings	Short Workings Recouped	Unrecoued S.W transfer to P & L A/C.	Paid to Landlord
2001	8,000	8,000	15,000	7,000	-	-	15,000

2002	13,000	13,000	15,000	2,000	-	-	15,000
2003	21,000	21,000	15,000	-	6,000	3,000	15,000
2004	18,000	18,000	15,000	-	-	-	18,000

2001	Royalties A/c Dr.		8,000	
Dec 31	Shortworking A/c Dr.			7,000
	To Landlord A/c			
	(Being royalties and short working due to landlord)			15,000
Dec 31	Landlord A/c Dr.		15,000	
	To Cash A/c			15,000
	(Being payment made to landlord)			
Dec 31	Profit & Loss A/c Dr.		8,000	
	To Royalties A/c			8,000
	(Being Royalties A/c trans- ferred to Profit & Loss A/c.)			
2002	Royalties A/c Dr.		13,000	
Dec.31	Shortworking A/c Dr.		2,000	
	To Landlord A/c			
	(Being royalties and short workings due to landlord)			15,000
Dec 31	Landlord A/c Dr.		15,000	

	To Cash A/c (Being cash paid to landlord)			15,000
Dec 31	Profit & Loss a/c Dr. To Royalties A/c (Being Royalties A/c transferred to Profit & Loss A/c)		13,000	13,000
2003 Dec 31	Royalties A/c Dr. To Landlord A/c (Being royalties due to landlord)		21,000	21,000
Dec 31	Landlord A/c Dr. To Cash A/c To Short working A/c (Recouped) (Being cash paid to landlord & excess royalty utilized for recouping the Short working)		21,000	15,000 6,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c To Short working A/c (Unrecouped) (Being royalties & Unrecouped shortworkings transferred to		24,000	21,000 3,000

	Profit & Loss A/c)			
2004 Dec 31	Royalties A/c Dr. To Landlord A/c (Being Royalties due to landlord)		18,000	18,000
Dec 31	Landlord A/c Dr. To Cash A/c (Being cash paid to landlord)		18,000	18,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalty A/c. transferred to Profit & Loss A/c)		18,000	18,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c To Short working A/c (Unrecouped) (Being royalties & Unrecouped Short workings transferred to Profit & Loss A/c)		24,000	21,000 3,000

2004 Dec 31	Royalties A/c Dr. To Landlord A/c (Being Royalties due to landlord)		18,000	18,000
Dec 31	Landlord A/c Dr. To Cash A/c (Being cash paid to landlord)		18,000	18,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalty A/c. transferred to Profit & Loss A/c)		18,000	18,000

Ledger Accounts

Royalties Account

2001		Rs.	2001		Rs.
Dec.31	To Landlord A/c.	8,000	Dec.31	By P & L a/c	8,000
2002		8,000	2002		8,000
Dec.31	To Landlord A/c.	13,000	Dec.31	By P & L a/c	13,000
2003		13,000	2003		13,000
Dec.31	To Landlord A/c.	21,000	Dec.31	By P & L a/c	21,000
2004		21,000	2004		21,000
Dec.31	To Landlord A/c.	18,000	Dec.31	By P & L a/c	18,000
		18,000			18,000

Shortworking Account

2001		Rs.	2001		Rs.
Dec	To Landlord A/c.	7,000	Dec 31	By Bal. c/d	7,000

31					
		7,000			
2002			2002		7,000
Jan 1	To Bal. b/d	7,000			
Dec 31	To Landlord A/c.	2,000	Dec 31	By Bal. c/d	9,000
2003		9,000	2003		9,000
Jan 1	To Bal. b/d	9,000	Dec 31	By Landlord A/c	6,000
			Dec 31	By P & L A/c	3,000
		9,000			9,000

Landlord Account

2001		Rs.	2001		Rs.
Dec 31	To Cash A/c.	15,00 0	Dec 31	By Royalties A/cBy Short	8,00 0
			Dec 31	Working A/c	7,000
		15,000			15,000
2002			2002		
Dec 31	To Cash A/c	15,000	Dec 31	By Royalties A/c	13,000
				By Short Working A/c.	2,000
		15,000			15,000
2003			2003		
Dec 31	To Cash A/c	15,000	Dec 31	By Royalties A/c	21,000
	To Short Working A/c. (recouped)	6,000			
		21,000			21,000
2004			2004		
Dec 31	To Cash A/c	18,000	Dec 31	By Royalties A/c	18,000
		18,000			18,000

Preparation of Minimum Rent A/c:- When it is asked to prepare a Minimum Rent Account in the question, the first entry will be split into two journal entries and other entries will remain same:-

Journal entries when Minimum Rent Account is to be opened:-

(i) Royalties A/c Dr.
Shortworking A/c Dr.

To Minimum Rent
(Being Royalties A/c & Shortworking A/c transferred to Minimum Rent A/c)

(ii) Minimum Rent A/c Dr.

To Landlord A/c
(Being Minimum Rent due to Landlord)

(iii) Landlord A/c Dr.

To Cash A/c
(Being Payment made to Landlord)

(iv) Profit & Loss A/c Dr.

To Royalties A/c
(Being Royalties A/c transferred to P & L A/c)

So, Minimum Rent Account is opened only for those years when Royalty is less than Minimum Rent or Shortworking arises and this account is opened only when it is asked to prepare in the question otherwise there is no need toprepare it.

Payment of Royalty half yearly and payment of current year Royalty duringthe next year

When Royalty is payable half yearly, Minimum Rent should also be calculated for half year to compare it with Royalty. In such cases Royalty A/c and Shortworking A/c are transferred to Profit & Loss A/c at the end of the year.

Similarly some times the current year Royalty is paid in the next year. Insuch cases the entry of Royalty will be passed in the same year but actual paymentof Royalty will be made in the year of payment.

Illustration -2: Hari Ltd., obtained a Coal mine on lease for 15 years from Ist Jan 1990 on a Royalty of Rs. 2 per ton of the output, payable half yearly on 30th June & 31st Dec. every year. The

Minimum Rent was fixed at Rs. 8,000 per half year with a power to recoup shortworkings over the first two years of the lease.

The output was as follows:-

30th June	1990	800 tons
31st Dec	1990	3600 tons
30th June	1991	5000 tons
31st Dec	1991	6000 tons
30th June	1992	3650 tons
31st Dec	1992	10,000 tons

Hari Ltd. prepare its final accounts annually on 31st Dec. every year andthe Royalty which was due on 31st Dec. 1991 was, infact, paid on 20th January, 1992. Prepare necessary ledger accounts in the books of Hari Ltd., and also show the items in Profit & Loss A/c and Balance Sheet.

Solution

ANALYTICAL TABLE

Half year ending on	Output in tonns	Royalty @Rs.2/- Per Ton Rs.	Minimum Rent Rs.	Short Workings Rs.	Short Workings Recouped ded Rs.	Unrecouped Shortworkings transferred to P&L A/c	Payment to Land-lord
30.06.90	800	1,600	8,000	6,400	-	-	8,000
31.12.90	3,600	7,200	8,000	800	-	-	8,000
30.06.91	5,000	10,000	8,000	-	2,000	-	8,000
31.12.91	6,000	12,000	8,000	-	4,000	1,200	8,000
30.06.92	3,650	7,300	8,000	700	-	700	8,000
31.12.92	10,000	20,000	8,000	-	-	-	20,000

Books of Hari Ltd.Royalty Account

1990		Rs.	1990		Rs.
Jun 30 Dec 31	To Landlord A/cTo Landlord A/c	1,60 0 7,200	Dec 31	By P & L A/c	8,80 0
		8,800			8,800
1991			1991		
Jun 30	To Landlord A/c	10,000	Dec 31	By P & L A/c	22,000
Dec 31	To Landlord A/c	12,000			
		22,000			22,000
1992			1992		
Jun 30	To Landlord A/c	7,300	Dec 31	By P & L A/c	27,300
Dec 31	To Landlord A/c	20,000			
		27,300			27,300

Shortworking A/c

1990		Rs.	1990		Rs.
Jun 30 Dec 31	To Landlord A/cTo Landlord A/c	6,40 0 800	Dec 31	By Balance c/d	7,200
		7,200			7,200
1991			1991		
Jan 1	To Balance b/d	7,200	Jun 30	By Landlord A/c	2,000
			Dec 31	By Landlord A/c	4,000
			Dec 31	By P& L A/c	1,200
		7,200			7,200
1992			1992		
Jun 30	To Landlord A/c	700	Dec 31	By P & L a/c	700

Landlord A/c

1990		Rs.	1990		Rs.
Jun 30	To Cash A/c	8,000	Jun 30	By Royalty A/c	1,600

Dec 31	To Cash A/c	8,000	Jun 30	By S.W. A/c	6,400
			Dec 31	By Royalties	7,200
			Dec 31	By S.W. A/c	800
		16,000			16,000
1991			1991		
Jun 30	To Cash A/c	8,000	Jun 30	By Royalty A/c	10,000
Jun 30	To S.W.(recouped)	2,000	Dec 31	By Royalty A/c	12,000
Dec 31	To S.W.(recouped)	4,000			
Dec 31	To Bal. b/d	8,000			
		22,000			22,000
1992			1992		
Jan 20	To Cash A/c	8,000	Jan 01	By Bal. b/d	8,000
Jun 30	To Cash A/c	8,000	Jun 30	By Royalty A/c	7,300
Dec 31	To Cash A/c	20,000	Jun 30	By S.W. A/c	700
			Dec 31	By Royalty A/c	20,000
		36,000			36,000

Profit & Loss a/c

1990		Rs.			
Dec 31	To Royalty a/c	8,800			
		8,800			
1991					
Dec 31	To Royalty a/c	22,000			
Dec 31	To S.W. a/c	1,200			
		23,200			
1992					
Dec 31	To Royalty a/c	27,300			
Dec 31	To S.W a/c	700			
		28,000			

Balance Sheet as on 31st Dec. 1990

	Rs.		Rs.

		Shortworkings (Balance)	7,200

Balance sheet as on 31st Dec. 1991

	Rs.		Rs.
Landlord (Amount Due)	8,000		

Recoupment of Shortworkings in the next or subsequent or following few years:

Illustration-3: Bharat Coal Co. took a mine on lease from Vijay Yadav for a period of ten years from 1st January 1991, upon the terms of a royalty of 75 paise per ton with a minimum rent of Rs.15,000 in the first year and then increasing every year by Rs.2,000 ,till it reaches Rs.19,000 when it becomes fixed for all the coming years . Bharat Coal Co. was granted the right of recouping shortworkings of any year in the subsequent three years.

The output was as follows:-

Years	1991	1992	1993	1994	1995
Output	8,000	18,000	24,000	36,000	44,000
(in tons)					

Show Journal Entries in the books of Bharat Coal when:-

(a) there is no Minimum Rent Account, and

(b) there is a Minimum Rent Account

Solution:

Analytical Table

Year	Output in tons	Royalty Rs.	Minimum Rent Rs.	Short workings Rs.	S.W Recouped Rs.	Unrecouped S.W. transfer to P&L a/c Rs.	Payment to Vijay Yadav Rs.
1991	8,000	6,000	15,000	9,000	-	-	15,000
1992	18,000	13,500	17,000	3,500	-	-	17,000
1993	24,000	18,000	19,000	1,000	-	-	19,000
1994	36,000	27,000	19,000	-	8,000	1,000	19,000
1995	44,000	33,000	19,000	-	4,500	-	28,500

(a) When there is no Minimum Rent a/c :-

In the Books of Bharat Coal Co.,

Journal

			Rs.	Rs.
1991 Dec 31	Royalties A/c Dr. Shortworking A/c Dr. To Vijay Yadav A/c (Being Royalties & shortworkings due to landlord)		6,000 9,000	15,000
Dec 31	Vijay Yadav A/c Dr. To Cash A/c (Being cash paid to landlord)		15,000	15,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalties A/c transferredto Profit & Loss A/c)		6,000 6,000	

1992 Dec 31	Royalties A/c Dr. Shortworkings A/c Dr. To Vijay Yadav A/c (Being Royalties & shortworkings due to landlord)		13,500 3,500	 17,000
Dec 31	Vijay Yadav A/c Dr. To Cash A/c (Being cash paid to landlord)		17,000	 17,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalties A/c transferredto Profit & Loss A/c)		13,500	 13,500
1993 Dec 31	Royalties A/c Dr. Shortworkings A/c Dr. To Vijay Yadav A/c (Being Royalties and shortworkings due to landlord)		18,000 1,000	 19,000
Dec 31	Vijay Yadav A/c Dr. To Cash A/c (Being cash paid to landlord)		19,000	 19,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalties A/c transferredto Profit & Loss A/c)		18,000	 18,000
1994 Dec 31	Royalties A/c Dr. To Vijay Yadav A/c (Being Royalties due to landlord)		27,000	 27,000
Dec 31	Vijay Yadav A/c Dr. To Cash A/c To Shortworkings A/c (Being cash paid to landlord and shortworkings recouped)		27,000	 19,000 8,000

Dec 31	Profit & Loss A/c Dr. To Royalties A/c To Shortworkings A/c (recouped) (Being royalties A/c & Unrecouped shortworkings transferred to Profit & Loss A/c)		28,000	27,000 1,000
1995 Dec 31	Royalties A/c Dr. To Vijay Yadav A/c (Being Royalties due to landlord)		33,000	33,000
Dec 31	Vijay Yadav A/c Dr. To Cash A/c To Shortworkings A/c (Being cash paid and shortwork-ings recouped)		33,000	28,500 4,500
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalties A/c transferredto Profit & Loss Account)		33,000	33,000

(a) When there is a Minimum Rent Account:-

1991 Dec 31	Minimum Rent A/c Dr. To Vijay Yadav A/c(Being minimum rent to Landlord)		15,000	15,000
1991 Dec31	Royalties A/c Dr. Shortworkings A/c Dr. To Minimum Rent A/c (Being Royalties A/c & shortwor--kings A/c transferred to Minimum Rent A/c)		6,000 9,000	15,000

Dec 31	Vijay Yadav A/c Dr. To Cash A/c (Being cash paid to landlord)		15,000	15,000
Dec 31	Profit & Loss A/c Dr. To Royalties A/c (Being Royalties A/c transferredto Profit & Loss A/c)		6,000	6,000
1992 Dec 31	Minimum Rent A/c Dr. To Vijay Yadav A/c (Being Minimum Rent due tolandlord)		17,000	17,000
Dec 31	Royalties A/c Dr. Shortworkings A/c Dr. To Minimum Rent A/c (Being Royalties A/c & shortwork-ings A/c transferred to Minimum Rent A/c)		13,500 3,500	17,000
Dec 31	Vijay Yadav A/c Dr. To Cash A/c (Being cash paid to landlord)		17,000	17,000
Dec 31	Profit & Loss A/c To Royalties A/c (Being Royalties A/c transferredto Profit & Loss A/c)	Dr.	13,500	13,500
1993 Dec 31	Minimum Rent A/c Dr. To Vijay Yadav A/c (Being minimum rent due tolandlord)		19,000	19,000
Dec 31	Royalties A/c Dr. Shortworkings A/c Dr.		18,000 1,000	

	To Minimum Rent A/c (Being Royalties & Shortworkings A/c transferred to minimum rent A/c)			19,000
Dec 31	Vijay Yadav a/c Dr.		19,000	
	To Cash a/c (Being cash paid to landlord)			19,000
Dec 31	Profit & Loss A/c Dr.		18,000	
	To Royalties A/c (Being Royalties A/c transferred toProfit & Loss A/c)			18,000

Stoppage of work due to strike and lockout

If the minimum rent was not attained due to stoppage of work, the Royalty agreements usually contain a provision that the amount of Minimum Rent will be reduced for that year. Provision for the reduction of Minimum Rent may be any of the following types:-

(i) Minimum Rent is to be reduced proportionately according to the length ofstoppage of work due to strike or lockout.

(ii) In the year of stoppage, the Minimum Rent is to be reduced by a certainpercentage.

(iii) In some agreements, it is mentioned that in the year of strike, actualroyalties earned for the year will discharge all rental obligations.

Illustration- 4: Haryana Steel Ltd., obtained a lease from Y Ltd., for a coal mineon Ist Jan 1990 on the following terms:-

1. Royalty at Re. 1 per tonne.
2. Minimum Rent Rs. 12,000 p.a.
3. Recoupment of shortworkings of each year during three years following, subject to a maximum of Rs. 2,500 p.a.
4. In the event of strike, the minimum rent would be taken pro-rata on thebasis of actual working days but in the event of lockout, the lessee would enjoy a concession in respect of minimum rent for 50% of the period of lockout.

Besides the above, Haryana Steel Ltd., have been granted a cash subsidy equal to 25% of the unrecoupable shortworkings by the Central Govt.

5. Working upto first 6 years is as follows:-

1990	Actual Royalty	Rs.	7,000
1991	Actual Royalty	Rs.	10,200
1992	Actual Royalty	Rs.	16,100
1993	Actual Royalty	Rs.	13,600
1994	Actual Royalty	Rs.	10,800(Strike for 73 days)
1995	Actual Royalty	Rs.	9,700(Lockout for 4 months)

Show the Ledger Accounts in the Books of Haryana Steel Ltd.

Solution:

Analytical Table

Year	Royalties	M.R.	S.W.	S.W. Recouped	S.W. Unrecouped	Cash Subsidy	Transferred to P&l a/c	Payment to Lanlord
1990	7,000	12,000	5,000	-	-	-	-	12,000
1991	10,200	12,000	1,800	-	-	-	-	12,000
1992	16,100	12,000	-	2,500	-	-	-	13,600
1993	13,600	12,000	-	1,600	900	225[1]	675	12,000
1994	10,800	9,600[2]	-	1,200	600	150[1]	450	9,600
1995	9,700	10,000[3]	300	-	-	-	-	10,000

Notes: (1) Cash Subsidy is 25% of Irrecoverable shortworkings.

(2) Minimum Rent is reduced for 73 days i.e.

$$12,000 \times \frac{73}{365} = \text{Rs. } 2,400$$

Rs. 12,000 - Rs. 2,400 = Rs. 9,600

(1) Minimum Rent for lockout period for 4 months is Rs. 12,000

$$\times \frac{4}{42} = \text{Rs. } 4,000$$

Therefore, concession in Minimum Rent will be 50% of Rs.4,000 i.e. Rs. 2,000.

Rs. 12,000 - Rs. 2,000 = Rs. 10,000

Books of Haryana Steel Ltd.,Royalties Account

1990 Dec 31	To Y Ltd.,	7,000	1990 Dec 31	By P & L A/c	7,000
1991		7,000	1991		7,000
Dec 31	To Y Ltd.,	10,200	Dec 31	By P & L A/c	10,200
1992		10,200	1992		10,200
Dec 31	To Y Ltd.,	16,100	Dec 31	By P & L A/c	16,100
1993		16,100	1993		16,100
Dec 31	To Y Ltd.,	13,600	Dec 31	By P & L A/c	13.600
1994		13,600	1994		13,600
Dec 31	To Y Ltd.,	10,800	Dec 31	By P & L A/c	10,800
1995		10,800	1995		10,800
Dec 31	To Y Ltd.,	9,700	Dec 31	By P & L A/c	9,700
		9,700			9,700

Shortworkings Account

1990 Dec31	To Y Ltd.	5,000	1990 Dec31	By bal. c/d.	5,000
		5,000			5,000
1991 Jan01	To bal. b/d	5,000	1991		
Dec31	To Y Ltd.	1,800	Dec31	By bal. c/d	6,800
		6,800			6,800
1992 Jan01	To bal. b/d	6,800	1992 Dec31	By Y Ltd.	2,500
				By bal c/d	4,300
		6,800			6,800
1993 Jan01	To bal. b/d	4,300	1993 Dec31	By Y Ltd.	1,600
			Dec31	By Cash (Subsidy)	225
			Dec31	By P & L A/c	675
			Dec31	By bal. c/d	1,800

		4,300			4,300
1994			1994		
Jan01	To bal. b/d	1,800	Dec31	By Y Ltd.	1,200
			Dec31	By Cash (Subsidy)	150
			Dec31	By P & L A/c	450
		1,800			1,800
1995			1995		
Jan01	To Y Ltd.	300	Dec31	By bal c/d	300
		300			300

Y Ltd. Account

1990			1990		
Dec31	To Cash A/c	12,000	Dec31	By Royalties A/c	7,000
			Dec31	By shortworkings A/c	5,000
		12,000			12,000
1991			1991		
Dec31	To Cash A/c	12,000	Dec31	By Royalties A/c	10,200
			Dec31	By shortworkings A/c	1,800
		12,000			12,000
1992			1992		
Dec31	To Cash A/c	13,600	Dec 31	By Royalties A/c	16,100
	To shortworkings A/c	2,500			
		16,100			16,100
1993			1993		
Dec31	To Cash A/c	12,000	Dec 31	By Royalties A/c	13,600
	To shortworkings A/c	1,600			
		13,600			13,600
1994			1994		
Dec31	To Cash A/c	9,600	Dec 31	By Royalties A/c	10,800
	To shortworkings A/c	1,200			

		10,800			10,800
1995 Dec31	To Cash a/c	10,000	1995 Dec 31	By Royalties A/c By S.W. A/c	9,700 300
		10,000			10,000

1.4.2 Journal Entries in the Books of Landlord

In the books of the lessor or landlord the accounting treatment will be the reverse of what we have done so far. The following entries will be recorded:

(I) When the royalties received are less than the Minimum Rent and shortworkings are recoverable out of future years

(a) Lessee's Account Dr.

To Royalties Receivable A/c

To Royalties Reserve A/c

(Being Minimum Rent due from Lessee)

(b) Cash A/c Dr.

To Lessee's A/c

(Being cash received from Lessee)

(c) Royalty Receivable A/c Dr.

To Profit & Loss A/c

(Being Royalty receivable A/c transferred to Profit& Loss a/c)

(II) When Royalties and Minimum Rent both are equal

(a) Lessee's A/c Dr.

To Royalties Receivable A/c

(Being Royalties due from Lessee)

(b) Cash A/c Dr.

To Lessee's A/c

(Being cash received from Lessee)

(c) Royalty Receivable A/c Dr.
To Profit & Loss A/c
(Being Royalties A/c transferred to Profit & Loss A/c)

(III) When the Royalties received are more than the Minimum Rentand power to recoup the shortworkings

(a) Lessee's A/c Dr.
To Royalties Receivable A/c
(Being Royalties due from Lessee)

(b) Cash A/c Dr.
Royalties Reserve A/c Dr.

To Lessee's A/c
(Being cash received & shortworkings recouped)

(c) Royalties Receivable A/c Dr.
Royalties Reserve A/c Dr.

To Profit & Loss A/c

(Being royalty & unrecouped shortworkings transferred toProfit & Loss A/c)

Illustration-5 : On Ist Jan., a Coal Co., took a Coal mine on lease for 15 years as the terms of paying a Minimum Rent of Rs. 10,000 per year, merging into a royalty of 50 paise per tonne. The output was as under:-

Year	Ist	2nd	3rd	4th
Output(in tonne)	16,000	18,000	20,000	22,000

In terms of the lease provided that the dead rent not merged in Royaltycould be deducted out of future royalty in excess of the minimum, provided this recovery was made in the three years following the year in which the shortworking arose. Record these transactions in the books of the landlord.

Solution:

CALCULATION TABLE

Year	Output (in tonnes)	Royalty Receivable @.50p per Ton	Minimum Rent Rs.	Royalty Reserve Rs.	Royalty Reserve Utilised Rs.	Royalty Reserve Transferred to P & L A/c Rs.	Amount Received Rs.
1.	16,000	8,000	10,000	2,000	-	-	10,000
2.	18,000	9,000	10,000	1,000	-	-	10,000
3.	20,000	10,000	10,000	-	-	-	10,000
4.	22,000	11,000	10,000	-	1,000	1,000	10,000

Books of Landlord (lessor)JOURNAL

1st Year Dec31	Lessee's A/c Dr.		10,000	
	To Royalty Receivable A/c			8,000
	To Royalty Reserve A/c			2,000
	(For amount of royalty receivable earned and the excess of minimum rent transferred to royalty reserve A/c)			
Dec31	Cash A/c Dr.		10,000	
	To Lessee's A/c			10,000
	(For amount received from the lessee)			
Dec31	Royalty receivable A/c Dr.		8,000	
	To Profit & Loss A/c			8,000
	(For royalty receivable account transferred to Profit & Loss A/c)			

2nd year Dec31	Lessee's A/c Dr.		10,000	
	To Royalty Receivable A/c To Royalty Reserve A/c (For amount of royalty receivable earned and the excess of minimum rent transferred to royalty reserve a/c)			9,000 1,000
Dec31	Cash A/c Dr.		10,000	
	To Lessee's A/c (For amount received from the lessee)			10,000
Dec31	Royalty receivable A/c Dr.		9,000	
	To Profit & Loss A/c (For royalty receivable account transferred to Profit & Loss A/c)			9,000
3rd year Dec31	Lessee's A/c Dr.		10,000	
	To Royalty Receivable A/c(For royalty receivable earned)			10,000
Dec31	Cash A/c Dr.		10,000	
	To Lessee's A/c (For amount received from the lessee)			10,000
Dec31	Royalty receivable A/c Dr.		10,000	
	To Profit & Loss A/c (For royalty receivable account transferred to Profit & Loss A/c)			10,000

4th year Dec31	Lessee's A/c To Royalty receivable A/c(For royalty receivable earned)	Dr.	11,000	11,000
Dec31	Cash A/c Royalty Reserve A/c To Lessee's A/c (For royalty reserve written off to theextent of shortworkings recouped bylessee and the balance received in cash)	Dr. Dr.	10,000 1,000	11,000
Dec 31	Royalty Receivable A/cRoyalty reserve A/c To Profit & Loss A/c (For royalty receivable and the amount of royalty reserve A/c to the extent of irrecoverable shortworkings transferredto Profit & Loss A/c)	Dr. Dr.	11,000 1,000	12,000

Ledger Lessee's A/c

Dr. Cr.

1st year Dec31	To Royalty Receivable A/c To Royalty Reserve A/c	Rs. 8,000 2,000	1st Year Dec31	By Cash A/c	Rs. 10,000
		10,000			10,000
2nd year Dec31	To Royalty Receivables A/c To Royalty Reserve A/c	9,000 1,000	2nd year Dec31	By Cash A/c	10,000
		10,000			10,000

3rd year Dec31	To Royalty Receivable A/c	10,000	3rd year Dec31	By Cash A/c	10,000
4th year Dec31	To Royalty Receivable A/c	11,000	4th year Dec31	By Cash A/c By Royalty Reserve A/c	10,000 1,000
		11,000			11,000

Royalty Receivable Account

1st year Dec31	To P & L A/c	Rs. 8,000	1st year Dec31	By Lessee's A/c	Rs. 8,000
		8,000			8,000
2nd year Dec31	To P & L A/c	9,000	2nd year Dec31	By Lessee's A/c	9,000
		9,000			9,000
3rd year Dec31	To P & L A/c	10,000	3rd year Dec31	By Lessee's A/c	10,000
		10,000			10,000
4th year Dec31	To P & L A/c	11,000	4th year Dec31	By Lessee's A/c	11,000
		11,000			11,000

Royalty Reserve Account

1st year Dec31	To bal c/d	Rs. 2,000	1st year Dec31	By Lessee's A/c	Rs. 2,000
2nd year Dec31	To bal c/d	3,000	2nd year Jan 1 Dec31	By bal b/d By Lessee's A/c	2,000 1,000
		3,000			3,000
3rd year Dec31	To bal c/d	3,000	3rd year Jan 1	By bal b/d	3,000
4th year Dec31 Dec31	To Lessee's A/c To P & L A/c	1,000 1,000	4th year Jan 1	By bal. b/d	3,000

Dec31	To bal c/d	1,000			
		3,000			3,000
			5th year		
			Jan 1	By bal b/d	1,000

Sub lease

Sometimes the terms of the original lease may empower the lessee to sublet a part of the land or mine to another person as a sub-lease.

It is usual that the terms of agreement between A(original lessee) and B (original lessor) will be quite different to those between A (original lessee) and C (sub lessee).

The position of A will be two-fold: as lessee paying royalties to B as landlord receiving royalties to C. First, as lessee A will prepare the following Accounts:

(i) Royalty payable Account.
(ii) Lessor or landlord's Account i.e., the account of B.
(iii) Shortworkings Recoverable Account.

Secondly, as landlord A will maintain the following accounts:-

(i) Royalty Receivable Account.
(ii) Sub-lessee Account i.e. the account of C.
(iii) Royalty Reserve Account.

A will prepare two analytical tables in his books. First Analytical Table for the calculation of the royalties payable to B and the second Analytical Table for the calculation of royalties receivable from C.

Illustration-6 : A obtained on Ist Jan 1990, from B a lease of some coal bearing land. The term being a royalty of Rs. 0.50 per ton of coal raised subject to a minimum rent of Rs. 2,000 p.a. with a right of recoupment of shortworkings over the first four years of the lease.

A granted a sub-lease of part of the land to C and a royalty of Rs. 0.75 per ton merging into a minimum rent of Rs. 1,000 p.a. with a right of recoupment of shortworkings during the two years following the shortworkings.

The output for the first five years as follows:

Year	A(tons)	C(tons)	Total output(tons)
1990	2,200	800	3,000
1991	2,320	1,080	3,400
1992	2,600	1,400	4,000

1993	2,800	1,800	4,600
1994	3,600	2,400	6,000

Give the necessary Ledger Accounts in the books of A .

Solution:

Royalties Payable Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Dec31	To B (@ 50P.on 2,200 + 800 tons)	1,500	1990 Dec31	By Royalties receiveable A/c (@ 50P. on 800 tons)	400
				By Production A/c	1,100
		1,500			1,500
1991 Dec31	To B (@50P.on 2,320 + 1,080 tons)	1,700	1991 Dec31	By Royalties receiveable A/c (@ 50P. on 1,080 tons)	540
				By Production A/c	
		1,700			1,700
1992 Dec31	To B (@50P. on 2,600 + 1,400tons)	2,000	1992 Dec31	By Royalties receiveable A/c	700
				By Production A/c	1,300
		2,000			2,000
1993 Dec31	To B (@50P. on 2,800 + 1,800tons)	2,300	1993 Dec31	By Royalties receiveable A/c	900
				By Production A/c	1,400
		2,300			2,300
1994 Dec31	To B (@50P. on 3,600 + 2,400tons)	3,000	1994 Dec 31	By Royalties receiveable A/c	1,200
				By Production A/c	1,800
		3,000			3,000

The royalties paid on account of production done by C has been credited to Royalties payable account so that amount application on own production (i.e. production done by A) only is transferred to the Production Account)

Shortworkings Account

1990		Rs.	1990		Rs.
Dec31	To B (Rs.2,000 - Rs.1,500)	500	Dec31	By bal c/d	500
		500			500
1991			1991		
Jan01	To bal b/d	500	Dec31	By bal c/d	800
Dec31	To B (Rs.2,000 - Rs. 1,700)	300			
		800			800
1992			1992		
Jan01	To bal b/d	800	Dec31	By bal c/d	800
		800			800
1993			1993		
Jan01	To bal b/d	800	Dec31	By B	300
			Dec31	By P & L A/c (Irrecoverable Shortworkings)	500
		800			800

B's Account

1990		Rs.	1990		Rs.
Dec31	To Bank a/c	2,00 0	Dec31	By Royalty Payable A/c	1,500
				By Short Workings A/c	500
		2,000			2,000
1991		Rs.	1991		Rs.
Dec31	To Bank A/c	2,000	Dec31	By Royalty Payable A/c	1,700
				By Short Workings A/c	300
		2,000			2,000
1992			1992		
Dec31	To Bank A/c	2,000	Dec31	By Royalty	

				Payable A/c	2,000
		2,000			2,000
1993			1993		
Dec31	To Short Workings A/c	300	Dec31	By Royalty Payable A/c	2300
Dec31	To Bank A/c	2,000			
		2,300			2,300
1994			1994		
Dec31	To Bank a/c	3,000	Dec31	By Royalty Payable a/c	3,000

Royalties Receivable Account

1990		Rs.	1990		Rs.
Dec31	To Royalties Payable A/c	400	Dec31	By C(on 800 tons @ 75P.)	600
Dec31	To P & L A/c	200			
		600			600
1991			1991		
Dec31	To Royalties Payable A/c	540	Dec31	By C(on 800 tons @ 75P.)	810
Dec31	To P & L A/c	270			
		810			810
1992			1992		
Dec31	To Royalties Payable A/c	700	Dec31	By C(on 800 tons @ 75P.)	1,050
Dec31	To P & L A/c	350			
		1,050			1,050
1993			1993		
Dec31	To Royalties Payable A/c	900	Dec31	By C(on 800 tons @ 75P.)	1,350
Dec31	To P & L A/c	450			
		1,350			1,350
1994			1994		
Dec31	To Royalties Payable A/c	1,200	Dec31	By C(on 800 tons @ 75P.)	1,800
Dec31	To P & L A/c	600			
		1,800			1,800

Shortworkings Suspense Account

1990 Dec31	To Bal. c/d	Rs. 40 0	1990 Dec31	By C	Rs.
		400		(Rs.1,000-600)	400
1991			1991		400
Dec31	To Bal. c/d	590	Jan 1	By Bal. b/d	400
			Dec31	By C (Rs.1,000-810)	190
		590			590
1992			1992		
Dec31	To C	50	Jan 1	By Bal. b/d	590
	To P & L A/c(Ir-recoverable short-workingss of 1990)	350			
	To Bal c/d	190			
		590			590
1993		Rs.	1993		Rs.
Dec31	To C	190	Jan 1	By Bal. b/d	190
		190			190

C's Account

1990		Rs.	1990		Rs.
Dec31	To Royalty Receivable A/c	600	Dec31	By Bank A/c	1,00 0
Dec31	To Shortworkings Suspense A/c	400			
		1,000			1,000
1991			1991		
Dec31	To Royalty Receivable A/c	810	Dec31	By Bank A/c	1,000
Dec31	To Shortworkings Suspense A/c	190			
		1,000			1,000
1992			1992		
Dec31	To Royalty Receivable A/c	1,050	Dec31	By Shortworkings Suspense A/c	50

				By Bank A/c	1,000
		1,050			1,050
1993 Dec31	To Royalty Receivable A/c	1,350	1993 Dec31	By Shortworkings Suspense A/c By Bank A/c	190 1,160
		1,350			1,350
1994 Dec31	To Royalty Receivable A/c	1,800	1994 Dec31	By Bank A/c	1,800
		1,800			1,800

Production Account

		Rs.			Rs.
1990 Dec 31	To Royalty Payable A/c	1,100			
1991 Dec 31	To Royalty Payable A/c	1,160			
1992 Dec 31	To Royalty Payable A/c	1,300			
1993 Dec 31	To Royalty Payable A/c	1,400			
1994 Dec 31	To Royalty Payable A/c	1,800			

Profit & Loss Account

		Rs.			Rs.
			1990 Dec31	By Royalty Receiable A/c	200
			1991 Dec31	By Royalty Receiable A/c	270
			1992		

			Dec31	By Royalty Receiable A/c	350
			Dec31	By Shortworkings Suspense A/c	350
1993		Rs.	1993		Rs.
Dec31	To Shortwork-Ings	500	Dec31	By Royalty Receiable A/c	450
			1994 Dec31	By Royalty receiable a/c	600

Royalties regarding Brick-making and Nazrana paid to landlord

The royalty for brick-making is paid on sand taken out at the rate of per cubic feet to the owner of the land.

Sometimes, in addition to royalty, landlord charges from the lessee a lumpsum amount in the very beginning which is known as Nazrana or Advance Royalty. In such a case a Nazrana Account is opened separately and whole of the amount divided by the period of the lease is debited to Profit & Loss A/c every year the amount so arrived.

Illustration-7 : A Brick Co., acquired on a 20 years lease, a large plot of land from Anoop for the purpose of geeing earth. The lease provides that:-

(a) A premium or Nazrana of Rs. 10,000 is to be paid to the landlord onIst Jan, 1982 when the period of the lease commenced; and

(b) An annual royalty of 20 paise per 100 cubic feet of earth taken out isto be paid to him subject to a minimum rent of Rs. 2,000 per year, any shortworkings to be recouped out of future excess royalty. This annual royalty is to be paid on 31st Dec. each year.

The quantity of earth extracted by the lessee in 1982, 1983 and 1984 was 8,00,000; 9,00,000 and 12,00,000 cubic feet respectively.

Enter these transactions in the ledger of the three years in the books of ABrick Co.

Solution:

Analytical table

Year	Output	Royalties	Minimum Rent	S.W.	S.W. recouped	Unrecouped S.W transferred to P & L a/c	Payment to land lord
1982	8,00,000	1,600	2,000	400	-	-	2,000
1983	9,00,000	1,800	2,000	200	-	-	2,000
1984	12,00,000	2,400	2,000	-	400	-	2,000

Lease premium or Nazrana Account

Dr.					Cr.
1982 Jan01	To Cash A/c	Rs. 10,000	1982 Dec31 Dec31	By P & L A/c By Bal c/d	Rs. 500 9,500
		10,000			10,000
1983 Jan01	To Cash A/c	9,500	1983 Dec31 Dec31	By P & L A/c By Bal c/d	500 9,000
		9,500			9,500
1984 Jan01	To Cash A/c	9,000	1984 Dec31 Dec31	By P & L A/c By Bal c/d	500 8,500
		9,000			9,000

Royalties Account

Dr.					Cr
1982 Dec31	To Anoop	Rs.	1982 Dec31	By P & L a/c	Rs.
		1,600			1,600
1983 Dec31	To Anoop	1,800	1983 Dec31	By P & L a/c	1,800
		1,800			1,800
1984 Dec31	To Anoop	2,400	Dec31	By P & L a/c	2,400
		2,400			2,400

Shortworking Account

Dr.					Cr
1982 Dec31	To Anoop	Rs. 400	1982 Dec31	By Bal. c/d	Rs. 400
		400			400
1983 Jan01	To Bal b/d	400	1983 Dec31	By Bal. c/d	600
Dec31	To Anoop	200			
		600			600
1984 Jan01	To Bal b/d	600	1984 Dec31	By Anoop	400
			Dec31	By Bal c/d	200
		600			600

Anoop's Account

Dr.					Cr.
1982 Dec31	To Cash A/c	Rs. 2,00 0	1982 Dec31	By Royalties A/c	Rs. 1,60 0
			Dec31	By S.W. A/c	400
		2,000			2,000
1983 Dec31	To Cash A/c	2,000	1983 Dec31	By Royalties A/c	1,800
			Dec31	By S.W. A/c	200
		2,000			2,000
1984 Dec31	To S.W.A/c	400	1984 Dec31	By Royalties A/c	2,400
Dec31	To Cash A/c	2,000			
		2,400			2,400

No right to recoup shortworkings

Sometimes nothing is mentioned in the question about the recoupment of shortworkings. In such cases, shortworkings account is not to be opened at all and the landlord is to be paid the amount of royalties or the minimum rent, whichever be the higher. There is no need to calculate the short-workings in such type of problems.

1.5 CHECK YOUR PROGRESS

a. When the lessor receives payment, the credits—
b. Royalty earned by the lessee is credited to—
c. The balance of royalty payable account is transferred to—
d. The balance of royalty‟s receivable account is transferred to —
e. Royalty account is in the nature of………..

1.6 SUMMARY

Royalty is a periodical payment based on output or sale for the use of a certain asset or right like mine, copyright or patent to its owner. Royalty account is a nominal account in nature and is synonymous with rent account. Before preparing the royalty accounts, a few points like name of landlord and lessee, period of lease commencement of agreement, royalty rates, minimum rent, right of recoupment of shortworkings and mode of payment to landlord should be noted down. While passing journal entries in the books of lessee, these may be three situations- when minimum rent is more than royalty equal to royalty and less than royalty. In the books of the lessor or landlord, the accounting treatment will be the reverse of lessee. Sometimes, the terms of the original lease may empower the lessee to sublet a part of land or mine to another person as a sub-lease.

1.7 KEYWORDS

Royalty: It is a periodical payment based on output or sale for the use of a fixedasset or right to its owner.

Lessor: The person who is the owner of the assets and surrenders the right to its use to some other person and receives the consideration as royalty is known as lessor.

Minimum Rent: It is the minimum amount that the lessor or landlord must receivewhatever be the production or sales in a particular year.

Shortworking: The excess of minimum rent over royalty calculated on the basisof output or sales is known as shortworking.

Lessee: The person who pays the royalty in consideration for the use of that assetis called lessee.

1.8 SELF ASSESSMENT TEST

Q.1 What do you understand by Royalty? How does it differfrom Rent?

Q.2 What is shortworking? Give the rules of accounts inthis connection.

Q.3 Explain the following terms:

(a) Minimum Rent

(b) Sub -Lease

(c) Royalty Reserve

(d) Advance Royalty

(e) Re-coupment of Shortworkings

Q.4 Pass the journal entries in the books of Lessee when:

(a) Royalty is more than the minimum rent.

(b) Royalty is less than the minimum rent.

Q.5 Parbhat Coal Company took a lease of coal mine for a period of 10 years from 1st January, 1979 upon the terms of a royalty of 80 paise per ton with a minimum rent of Rs. 10,000 per annum with power to recoup shortworking over the first five years of the lease.

Years	1978	1979	1980	1981	1982
Output(Tons)	6,000	7,000	10,200	12,000	14,000

Give journal entries and write up the Minimum Rent A/c, Royalty A/c, Landlord’s A/c and Shortworkings A/c in the books of Manoj Coal Co.

Q.6 Rama Coal Company took a coal mine on lease for a period of 20 yearsfrom 1st Jan., 1992 on a royalty of Rs. 2 per tonne of the output payable halfyearly on 30th June and 31st December. The Minimum Rent was fixed at Rs. 24,000 per year with power to recoup shortworkings over the first three yearsof the lease.

The output was as follows:-

Half year ending 30th June, 1992	2,000tons
Half year ending 31st December, 1992	2,500tons
Half year ending 30th June, 1993	5,000tons

Half year ending 31st December, 1993	8,000tons
Half year ending 30th June, 1994	11,000tons
Half year ending 31st December, 1994	4,500tons

Rama Coal Company prepares its final accounts annually on 31st Dec. every year and the royalty which was due on 31st Dec., 1993 was in fact paid on 10thJan. 1994.
You are required to record the above transactions in the ledger of the Rama Coal Company and also to show the items in the Profit & Loss A/c and BalanceSheet.

Q.7 X leased a coal mine from Y on a royalty of 75 paise per ton with a minimum rent of Rs. 24,000 per annum. Each year's excess of minimum rent over the actual royalties was recoupable during the subsequent three years.

The lease, however, stipulated that in the event of strike, the minimum rent would be reduced proportionately.

The output was as follows:

1989	6,000tons
1990	18,000tons
1991	36,000tons
1992	50,000tons
1993	44,000tons(Strike for 2 months)
1994	20,000tons(Strike for 73 days)

Prepare necessary accounts in the books of X. Also show the amounts in each year's P & L A/c and Balance sheet.

Q.8 The Binnie Colliery Company are lessee of a mine at a dead rent of Rs. 2,000 per annum merging into a royalty of 35 paise per ton. Dead Rent paid in excess of actual royalties is recoupable thereout during the five years succeeding the year in respect of which such excess was paid. In the event of a strike if theactual royalty was less than the dead rent, it was to discharge all rental obligations. The first year in respect of which the dead rent was payable expired on 31st December 1980. The excess paid in comparison to royalty in respect of first year was Rs. 2,000 excess paid in second year was Rs. 1,450 and excess paid third year was Rs. 350. In the fourth year actual royalties amounted to Rs. 2,750, in the fifth year Rs. 3,250, in the sixth year Rs. 3,600 and in the seventh year (in consequent of a strike) Rs. 1,850 only. Pass the necessary journal entries to record these transactions in the books of Binnie Colliery Company.

Q.9 On 1st Jan., 1990 Tagore & Co., took a mine on lease. Under this lease there is payable a royalty of 80 paise per ton merging in a minimum rent of Rs.10,000 per year with a right to recoup shortworkings over the first five years of the lease, but (1) the right to recoup shortworkings will not be in that year in which output will be less than 6,000tons. (2) In the year in which royalty will be more than minimum rent, only 40% of the excess will be used for recoupment of shortworkings.

During the first five years the coal raised was as below:-

Year	1990	1991	1992	1993	1994
Output in tons	5,000	8,000	12,000	15,000	20,000

Prepare necessary accounts in the books of Tagore & Co.

Q.10 X Co. Ltd. hold a lease of minerals from Y for a period of 20 years from1st Jan., 1989. Under this lease there is payable a royalty of 25 paise a ton merging in a minimum rent of Rs. 1,000 a year, payable half-yearly on 30th June and 31st Dec. They granted a sub-lease for 15 years from 1st July, 1989 to Z Co. Ltd., of one-half of the area for a royalty of 50 paise a ton merging in a minimum rent of Rs. 750 a year, payable half-yearly on 30th June and 31st Dec.

Q.11 X Co. Ltd. are entitled under the lease from Y to recoup Shortworkings outof subsequent excess workings throughout the term of lease, but the sub-lease only allows Z Co. Ltd. to recoup shortworkings out of excess workings, in any ofthe three half-years immediately following that in which the shortworkings occurred. Minerals were worked as follows:

	By X Co. Ltd.	By Z Co. Ltd.
Half-year ended 30.06.1989	500tons	-
Half-year ended 30.12.1989	625tons	375tons
Half-year ended 30.06.1990	2,150tons	450tons
Half-year ended 30.12.1990	3,150tons	450tons
Half-year ended 30.06.1991	2,800tons	900tons

Show the necessary accounts in the Books of X which are balanced on 30th June.

Q.12 On 1st January, 1981, Shri Som Nath acquired on lease certain oil wells at a minimum rent of Rs. 24,000 per annum, merging into a royalty of Re.1 per ton of oil taken out. The shortworkings were recoverable in the next two years, but on the condition that if full shortworkings could not be recovered in the next year of the shortworkings, Som Nath will lose his right to recover 50% of the unrecovered balance of shortworkings.

The output of the first four years was 6,000 tons in first year, 15,000 tons in the second year, 30,000 tons in the third year and 28,000 tons in the fourthyear.
Open the necessary accounts in the books of Shri Som Nath.

Q.13 X, the owner of a patent of Sewing Machines, granted on 1st July, 1985, a licence for its manufacture to Y at a royalty of Rs. 20 per machine manufactured subject to a minimum rent of Rs. 50,000 per annum for the first two years and Rs. 60,000 per annum thereafter. If in any year the royalties calculated on the machines manufactured amounted to less than the minimum rent, Y has the right to recoup from the surplus during the next two years.

Number of machines manufactured was follows:

Upto 30th June, 1986	2,000 Machines
Upto 30th June, 1987	2,200 Machines
Upto 30th June, 1988	2,750 Machines
Upto 30th June, 1989	3,300 Machines
Upto 30th June, 1990	3,500 Machines

Assuming that the annual accounts are closed on 30th June, pass the journal Entries in the books of Y and prepare shortworkings account.

1.9 ANSWERS TO CHECK YOUR PROGRESS

a) Lessee account
b) Royalty receivable account.
c) Production account.
d) Profit and loss account
e) Nominal account

1.10 REFERENCES/SUGGESTED READINGS

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3. Principles of Financial Accounting by P.C. Gupta and C.L. Chaturvedi, Shree MahavirBook Depot, New Delhi.
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Course: **Financial Accounting-I**	
Course Code: **BCOM 201**	Author: **Prof. Suresh K. Mittal**
Lesson No: **2**	

Consignment Accounts

STRUCTURE

2.0 LEARNING OBJECTIVES

After going through this lesson, the learner should be able to:

- Know the meaning and features of Consignment.
- Understand the valuation of stock on Consignment.
- Know the meaning of normal and abnormal loss.
- Know the accounting treatment of Consignment

2.1 Introduction

Most of the time it happens that a manufacturer or a wholesale dealer does not find ready market in his own place becomes desirous of seeking a good market elsewhere. Even when there is a good market for his goods in his own place, he is often interested to make his goods popular elsewhere. For this purpose the merchant employs a leading dealer at the place where he wants to push his goods to act as his agent and sell goods on his behalf and risk as agent on commission. Goods so sent to a person are known as Consignment. The person who sends such goods is known as the Consignor and the person to whom the goods are sent is known as the Consignee. Such goods sent to the Consignee remain the property of the Consignor. The Consignee to whom the goods are sent does not buy them, but, merely undertakes to sell them on behalf of the consignor. He is not responsible for any loss or damage to the goods, if such loss or damage is caused for no fault of the Consignee. The consignee, as the selling agent, is entitles to a commission for selling the goods; expenses may be incurred by both parties; and periodically or on completion of the consignment, settlement is effected between the parties. If any goods remain unsold then they are generally returned to the consignor.

2.1.1 CONSIGNMENT ACCOUNTS: MEANING, FEATURES AND OBJECTIVES

The act of sending goods by a merchant to an agent for sale on commission basis is known as consignment. The sender of goods is known as 'Consignor' and the agent who receives the goods for sale is known as 'Consignee'. The relationship that exists between the consignor and the consignee is that of a principal and an agent. Since the consignee sells the goods entirely on behalf of the consignor, the profit or loss on the sale of goods belongs to the consignor, not the consignee.

The expenses incurred by the consignee are reimbursed by the consignor and the consignee is entitled to receive remuneration for the services rendered by him. Such remuneration is known as 'commission' which is usually calculated on the total sales made by the consignee. According to J.R. Batliboi "A consignment may be defined as a shipment of goods by a trader to an agent for sale on commission, on the sole risk and account of the former."

Features of Consignment:

The main features of consignment are as follows:

1. Different from Sale: Consignment of goods is different from sale as it is mere a transfer of goods. Therefore, the consignee does not become the debtor of the consignor unless and until he has sold the goods consigned.

2. Relationship: The relationship between the consignor and the consignee is that of 'Principal' and an 'Agent'.

3. Ownership of Goods: The legal ownership of the goods is transferred to the consignee, but it remains vested in the consignor till the goods are sold by the consignee.

4. Risk: The risk attached to the goods sent on consignment lies with the consignor till the goods are sold by the consignee. The consignee is not responsible for any type of loss of the goods.

5. Commission Based: The consignor pays the commission or remuneration to the consignee which is usually based on the total value of sales made by him.

6. Law of Agency: Consignment is governed and regulated by law of agency as the relationship between the consignor and the consignee is that of a principal and an agent.

7. Expenses: Almost all the expenses including sales expenses are usually borne by the consignor even though they have been paid by the consignee.

Need, Importance and Objectives of Consignment:

1. To increase the sales: A wholesaler or a producer does not possess the knowledge of customs and other circumstances prevailing in the different cities of the country and in abroad. Therefore, he cannot sell the goods conveniently at different places. The agents are well aware about their markets and can sell the goods profitably. Thus, the consignment is necessary to increase the sales.

2. To reduce the cost: The act of consignment is cost saving. It dispenses with the need of branch opening at distant places with heavy cost implications.

3. To fill up the gap between buyer and seller: If the buyer and the seller are living at different places far away from each other, the goods can be supplied promptly through the agent already appointed for this purpose.

4. To take the advantage of price variation: The prices prevailing at different places differ due to the imbalance in demand and supply along with some other reasons related to the goods, but it is not possible to get the advantage of price variation for the producer or the wholesaler by selling his goods personally. It is possible only if he sells his goods at different places through his agents.

5. To create new market: A producer is always interested in creating new domestic as well as foreign markets in order to increase the sales of his goods. But it is not practically possible for the producer to create new markets by personally visiting the venues where he seeks such an opportunity. Therefore, he can create new markets by appointing agents having the knowledge of the customs and the conditions of the areas concerned.

6. To avail other services: The goods are sent on consignment to avail some additional services of an agent e.g. to use his warehousing facilities, to avail his advertising services, to take advantages of his goodwill and specific skill etc.

Expenses on Consignment:

The expenses incurred on consignment are categorised in the following two types:

(i) Non-Recurring or Direct Expenses: The expenses incurred whether by the consignor or the consignee up to the period goods reach to the god own of the consignee are termed as non-recurring expenses. These expenses are also called direct expenses as they increase the value of goods. Examples of such expenses are: freight, carriage, octroi, custom duty, insurance of goods in transit, loading and unloading charges etc.

(ii) Recurring or Indirect Expenses: The expenses which are incurred usually by the consignee after the goods reach to his god own are termed as recurring expenses. These expenses are also called indirect expenses as they do not increase the value of goods. Examples of such expenses are: godown rent, storage charge, advertisement expense, selling expenses etc.

The difference between recurring and non-recurring expenses is of special importance at the time of valuing the unsold stock and abnormal loss of goods. The non recurring expenses form a part of cost of goods and therefore, must be included in the cost of unsold stock and abnormal loss of goods proportionately.

Advance:

Generally, the consignor asks the consignee to send some amount in advance as a security in respect of goods to be sent by him on consignment. Usually, the amount of advance is determined by a certain percentage of the value of goods to be sent on consignment. This amount may be sent before or after receiving the goods in form of cash, bank draft or bills of exchange by the consignee. When the consignee is unable to make the payment of advance money, the consignor can draw a bill of exchange on the consignee and discount it from bank. The amount of such discount is usually debited to the profit and loss account instead of consignment account.

Account Sales:

An account sale is the periodical summary statement sent by the consignee to the consignor. It contains details regarding –

(a) Sales made,

(b) Expenses incurred on behalf of the consignor,

(c) Commission earned,

(d) Unsold inventories left with the consignee,

(e) Advance payment or security deposited with the consignor and the extent to which it has been adjusted,

(f) Balance payment due or remitted.

It is a summary statement and is different from Sales Account.

Difference between a Sale and a Consignment:

Sr. No.	**Consignment**	**Sale**
1	When goods are sent on Consignment, only the possession is transferred to the consignee but the property in the goods remains with the consignor.	When goods are sold by one to another, the property in the goods immediately passes to the buyer.
2	When goods are Consigned by one to another, it becomes a relationship of a Principal and an Agent between the Consignor and the Consignee.	When goods are sold by one to another, it becomes a relationship of a buyer and seller or a Debtor and a Creditor between the two persons.
3	When goods are sent on Consignment the goods are returnable, if they remain unsold.	When goods are sold, the buyer cannot return the goods to the seller.
4	The risk in the goods is not transferred to the consignee despite the transfer of possession of goods. Any damage or loss to the goods is therefore borne by consignor.	The risk is immediately transferred to the buyer even when the goods are still in the possession of the seller.
5	The expenses, in respect of freight, cartage, insurance, etc. are met by the consignor in a consignment transaction.	The expenses are borne by the purchaser unless otherwise provided in the agreement.

6	The transfer of possession (i.e. delivery of goods) is essential in a consignment transaction.	The goods may be delivered at a later date.

2.1.2 Commission or Consignee's Remuneration

When the goods are sold by the consignee, he is paid a commission for his services at a fixed rate on the proceeds of the goods sold by him. In addition to this commission, he is to be reimbursed for all expenses incurred by him in connection with the consignment sales. There are three types of commission which is given below:

Ordinary Commission: This is a fee payable by consignor to consignee for sale of goods when the consignee does not guarantee the collection of money from ultimate customer. The % of such commission is generally lower.

Del -Credere Commission: Usually the consignor advises the consignee to sell the goods consigned to him for cash only, because if such goods are sold on credit by the consignee and if any amount becomes irrecoverable from the debtors the loss will fall upon the consignor. As the consignee acted as an agent only in effecting the sales, he does not become responsible for any debts. But sometimes an arrangement is made between the consignor and the consignee whereby the later guarantees payment and undertakes responsibility for bad debts. For this the consignee receives an additional commission known as ''Del Credere Commission'' on the total sales. When del-credere commission is given to the consignee, the consignee will make payment to the consignor, whether he himself receives the payment or not from the purchaser(s).

Over-riding Commission: It is an extra commission allowed by the consignor to the consignee to promote sales at higher price then specified or to encourage the consignee to put hard work in introducing new product in the market. Depending on the agreement it is calculated on total sales or on the difference between actual sales and sales at invoice price or any specified price.

2.1.3 Accounting Treatment of Consignment

In accounting treatment relating to consignment transactions, the following points will be discussed:

- Accounts to be opened in the Books of Consignor.
- Accounts to be opened in the Books of Consignee.
- Journal Entries in the Books of Consignor and Consignee.

2.1.3.1 Accounts to be opened in the Books of Consignor:

The transactions relating to each consignment are recorded in such a way that the profit or loss of each consignment can be ascertained separately. It requires the preparation of a special account known as consignment account. A consignment account is a nominal account prepared to find out the profit or loss of a consignment. If goods are consigned to several consignees, consignor maintains as many consignment accounts as there are consignees. Then to distinguish different consignment accounts the names or places of consignees are added to consignment accounts. For example, a consignment account may be styled as Consignment to Kolkata Account or Consignment to Kerla Account. A proper record of all the transactions relating to a particular consignment is necessary to be kept in order to ascertain the profit or loss on each consignment separately. For this purpose, the consignor usually maintains the following accounts:

(1) Consignment Account.

(2) Consignee's Account.

(3) Goods Sent on Consignment Account.

(4) Stock on Consignment Account.

(1) Consignment Account: A consignment account is a nominal account prepared to find out the profit or loss of a consignment. If goods are consigned to several consignees, consignor maintains as many consignment accounts as there are consignees. Then to distinguish different consignment accounts the names or places of consignees are added to consignment accounts. For example, a consignment account may be styled as Consignment to Kolkata Account or Consignment to Kerla Account.

Performa of Consignment Account

Particular	**Amount**	**Particular**	**Amount**

To Consignment stock (opening balance if any) To Goods Sent on Consignment To Cash/bank (Expenses incurred by the consignor) To Consignee's Personal Account (Expenses paid by the Consignee-total amount) (Commission, including del-credere payable to the consignee) To Stock Reserve (Difference in the value of closing stock marked at Pro-forma invoice or loaded price & cost price) To Goods Sent on Consignment (Difference between cost price and Pro-forma invoice price on the goods returned by the consignee) To General Profit and Loss Account (For Consignment profit)		By Consignee's Personal Account (Amount of gross proceeds (sales) realized by the Consignee) By Goods Sent on Consignment (Difference in cost of goods sent and the Performa Invoice price) By Abnormal loss (Whether insured or not) By Goods sent on Consignment (Returned by the Consignee) By Stock Reserve (Difference between the cost and pro-forma invoice price on the opening balance of consignment) By General Profit and Loss Account (For consignment loss)	

In addition to the consignment account, the consignor also prepares the personal account of the consignee to ascertain the amount due by the consignee. This account is debited with the amount of sales affected by the consignee and credited with the amount of any advance received from him, expenses incurred by him and commission payable on sales. The balance in this account is the amount due by the consignee.

(2) Consignee's Account: Consignee's Account is a personal account in nature and therefore, this is debited with gross sale proceeds and credited with consignee's expenses, commission due to him, advance money received and the amount received in final settlement etc. In case, the consignee has not remitted the balance due by him in full, he will be a debtor whereas if he has remitted more than the balance due by him, he will be a creditor. The specimen of Consignee's Account is given below:

Dr. Consignee's Account Cr.

Date	Particulars	Amount	Date	Particulars	Amount
		(₹₹)			(₹₹)
	To Consignment A/c:			By Cash or Bank A/c	………..
	Cash Sales ………..			By Bills Receivable A/c	………..
		……….		By Consignment A/c (Expenses)	………..
	Credit Sales ………..			By Consignment A/c (Commission)	………..
				By Cash or Bank A/c (Final Payment) Or By Balance c/d (if any)	………..

(3) Goods Sent on Consignment Account: Goods Sent on Consignment Account is a real account. This is credited for the cost of goods sent on consignment and debited with the amount of goods returned by the consignee. The closing balance of this account is transferred to the trading account. The specimen of Goods Sent on Consignment Account is given below:

Dr. Goods Sent on Consignment Account Cr.

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
		(₹)			(₹)
	To Trading A/c:	……….		By Consignment A/c	………..
		………..			………..

(4) Stock on Consignment Account: This is also a real account and is debited with the value of unsold stock. The balance of this account is carried forward to the next accounting period. The specimen of Stock on Consignment Account is given below:

Dr. Stock on Consignment Account Cr.

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
		(₹)			(₹)
	To Consignment A/c:	……….		By Balance c/d	………..
		………..			………..

All the above accounts are maintained in respect of each of the consignments separately.

2.1.3.2 Journal Entries in the Books of Consignor:

1. When goods are consigned or dispatched: it is to be reiterated that when goods are sent to the consignee, the transaction does not result in a sale and only the possession of the goods changes. Therefore, the personal account of consignee is not debited and also sales account is not credited. The following entry is recorded by the consignor:

1.Consignment Account Dr.

To Goods Sent on Consignment Account

2. Expenses incurred by consignor: when consignor incurs some expenses relating to the consignment following entry is recorded:

Consignment Account Dr.

To Supplier Account/Bank/Cash

3. When advance is received from the consignee: The consignee may remit some advance to consignor. The following entry is recorded:

Bank/Cash Account Dr.

To Consignee's Personal Account

4. On receipt of account sales from the consignee: Account sales contain details of sales made by consignee, expenses incurred by consignee. Following entries are recorded:

For sales proceeds:

Consignee's Personal Account Dr.

To Consignment Account

For expenses incurred by consignee:

Consignment Account Dr.

To Consignee's Personal Account

5. Cash or cheque or bank draft or bill of exchange/promissory note received from the consignee as settlement:

Cash/Bank/Bills Receivable Account Dr.

To Consignee's Personal Account

6. For bad debts: The accounting entry for bad debts will depend on whether del-credere commission is paid to the consignee.

i. When del-credere commission is not paid to the consignee:

Consignment Account Dr.

To Consignee's Personal Account

ii. When del-credere commission is paid to the consignee:

No entry is recorded as bad debts are to be borne by consignee.

7. For the goods taken over by the consignee:

Consignee's Personal Account Dr.

To Consignment Account

8. For unsold consignment stock: In case some of the goods sent on consignment are still unsold at the time of preparing final accounts, the unsold inventory is recorded as consignment stock with following entry:

Consignment Stock Account Dr.

To Consignment Account

9. For commission payable to consignee:

Consignment Account Dr.

To Consignee's Personal Account

2.1.3.3 Accounts to be opened in the Books of Consignee:

A proper record of all transactions relating to a particular consignment is necessary to be maintained separately by the consignee. For this purpose, he usually opens the following accounts:

- Consignor's Account
- Commission Account

Consignor's Account: Consignor's Account is a personal account in nature. The sales made by the consignee, expenses incurred by him, his commission and the amount payable to the consignor are recorded in this account. In case some advance amount is paid to him, he will be a debtor whereas if some amount is payable to him, he will be a creditor. The specimen of Consignor's Account is given below:

Dr. **Consignor's Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Bills Payable A/c	……….		By Cash A/c	………..
	To Cash or Bank A/c	……….		(Cash Sales)	
	To Commission A/c	……….		By Debtors (Credit Sales)	……….
	To Cash or Bank A/c (Expenses)	……….		By Balance c/d (Proportionate security for unsold goods)	……….

2. Commission Account: Commission Account is a nominal account in nature and credited with the amount of commission receivable from the consignor. The closing balance of this account is transferred to the profit and loss account. The specimen of Commission Account is given ahead:

Dr. **Commission Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Profit and Loss A/c	……….		By Consignor's A/c	………..
		………..			………..

2.1.3.4 Journal Entries in the Books of Consignee:

Consignment in not equivalent to a sale with the result the consignee is not be debtor until the sales are made to him. Thus no entry is made when goods are received by him on consignment. He may however, record the details of the goods received in a separate book, called Consignment Inward Book. The scheme of journal entries in consignee's books is as under.

(i) For advance made to the consignor

Consignor Account Dr.

To Bank or Bills Payable Account

(ii) For payment of expenses in respect of consignment

Consignor Account Dr.

To Cash or Bank Account

(iii) For Cash sale of goods

Bank Account Dr.

. To Consignor Account

(iv) For credit sales

Consignment Debtors Account Dr

To Consignor Account

(v) For commission earned by him

Consignor Account Dr.

To Commission Account

(vi) For bad debts when no del credere commission is paid

Consignor Account Dr.

To Consignment Debtors Account

(vii) Bad debts arising when he is entitled to Del credere Commission

Bad Debts Account Dr.

To Consignment Debtors Account

Note: It is always appropriate to transfer bad debts to Commission Account.

Commission Account Dr.

To Bad Debts Account

(viii) For payment to consignor

Consignor Account Dr.

To Cash or Bank Account

2.2 Valuation of Stock on Consignment or Unsold Stock

The unsold stock remained with the consignee has to be valued at cost or market price whichever is lower. Non-recurring expenses are the expenses which are incurred to bring the goods to the go down of the consignee. For example, packing and forwarding charges, railway freight, octroi duty, insurance in transit, cartage of goods from railway station to the god owns of the consignee etc. But expenses incurred thereafter, for example godown rent, insurance charges to cover risks of loss while goods are in godown, salesmen's salary, advertising expenses, etc., are not considered for determining cost of goods remaining unsold. Cost of stock is not affected whether a particular expense is paid by the consignor or by the consignee. However, if the question does not give details of various expenses incurred, it should be assumed that expense paid by the consignor of non-recurring nature whereas those paid by the consignee are not so. However, if it is assumed that the unsold stock will realize less than cost, the net realizable value (i.e. realizable value minus estimated expense including consignee's commission) is to be considered for the purpose. If the net realizable value is found to be less than cost, the stock must be written down accordingly since it is based on the principle of conservation i.e. anticipated losses must be provided for in the books. For determining the cost price of unsold stock, the following procedure will be adopted.

1.	First of all, total cost of unsold stock is ascertained as follows:	
	Purchase price of unsold goods	………..
	Add: Proportionate share of non-recurring expenses incurred by the consignor	
	Add: Proportionate share of non-recurring expenses incurred by the consignee	………..
	Total cost of unsold stock	………..

		………..
2.	After that, the net realisable value is determined as follows: Market Value of unsold stock Less: Realisation expenses Net Realisable Value	 ……….. ……….. ………..
3.	At the end, the value of unsold stock will be determined by comparing the cost of unsold stock and net realisable value whichever is less.	

Note: For valuing the closing stock, if the detail of expenses is not given in the question, it is advised to consider only the proportionate expenses incurred by the consignor and the expenses of the consignee are ignored.

Illustration: A of Mumbai consigned 400 calculators @ ₹ 150 each to B of Patna. He also paid freight of ₹ 500 and transit insurance of ₹ 400.

B incurred the following expenses: Octroi ₹ 200, Carriage ₹ 200, Unloading Charges ₹ 300, Godown Rent ₹ 300 and selling Expenses ₹ 150.

300 calculators were sold by B @ ₹ 200 each. Find out the value of Closing Stock (a) if Market Price is ₹ 180 per calculator (b) if Market Price is ₹ 140 per calculator.

Solution:	₹
Cost of 100 calculators @ ₹ 150	15,000
Add: Proportionate Expenses by Consignor (A) $\left\{\frac{900}{400} \times 100\right\}$	225
Add: Proportionate Expenses by Consignee (B)	175
(Octroi, Carriage, Unloading) $\frac{700}{400} \times 100$	
Total Cost of Unsold Stock	15,400

(a) Value of Stock if Market Price is ₹ 180 each:

Total Market Price = 100 x ₹ 180 = ₹ 18,000

Valuation of Stock: Market Price or Cost Price whichever is less

Here, the Cost Price is less than the Market Price.

Thus, the value of Closing Stock is ₹ 15,400

(b) Value of stock if Market Price is ₹ 140 each:

Total Market Price = 100 x ₹ 140 = ₹ 14,000

Here, the Market Price is less than the Cost Price

Thus, the value of Closing Stock is ₹ 14,000

2.2.1 Return of Goods from the Consignee

Consigned goods can be returned by the consignee because of many reasons like poor quality or not up to the specimen or destroyed in transit etc. In such a situation, the question arises is the valuation of returned goods. Consigned goods returned by the consignee to the consignor are valued at the price at which it was consigned to the consignee. Expenses incurred by the consignee to send those goods back to the consignor are not taken into consideration while valuing it because only those expenses are included in the cost of goods which help to bring the goods into present location and condition i.e. the saleable condition.

2.3 Loss of Goods

During the course of consignment transactions, loss of goods may occur. It may occur during transit or after the delivery of goods to the consignee at his godown. In this case, the consignor has to bear the loss, not the consignee. From the accounting point of view, the losses are classified as normal and abnormal. Therefore, in the books of consignor, the accounting treatment for normal and abnormal losses is different. In case the goods sent on consignment are lost or damaged in transit or otherwise, the loss is that of the consignor and not of the consignee. Accordingly the consignor will have to make the entries for such loss. There may be two types of losses viz. Normal loss and abnormal loss.

2.3.1 Normal Loss:

Normal loss is natural, unavoidable and inherent in the nature of goods or commodities or articles sent on consignment. This type of loss is a part of the cost of the consignment, so the consignor does not make separate entry for such a loss. However, the normal loss has to be taken into consideration while valuating the unsold consignment stock in the hand of the consignee. The accounting treatment of normal loss is to charge the total cost of the goods to the remaining goods after the normal loss. In other words, the value of the unsold stock is calculated in proportion to the total cost of the goods consigned. Suppose 1,000 kg of apples are consigned to a wholesaler, the cost being Rs.3 per kg, plus Rs. 400 of freight. It is concluded that a loss of 15% is unavoidable. The cost per kg will be Rs. 3,400/850 or Rs. 4. If the inventories are 100 kg its value will be Rs. 400.

Accounting Treatment

Normal loss refers to the inherent and unavoidable loss which is due to the very nature of the goods consigned. This may arise due to natural causes like evaporation, leakage, drying, etc. No effort can prevent this loss. Normal loss is treated by ignoring it and the value of remaining stock absorbs the loss.

Therefore, if there is no stock remaining unsold, there will be no treatment for normal loss. But when there is some stock remaining unsold, the cost of the stock on consignment will be ascertained by applying the following formula:

Cost of the Stock on Consignment = $\frac{Cost\ of\ goods\ received\ by\ the\ consignee\ \times Unsold\ goods\ (in\ units)}{Net\ quantity\ received\ (after\ normal\ loss)\ by\ the\ consignee\ (in\ units)}$

Therefore, in case of normal loss, the value of unsold stock should be calculated on the basis of the total quantity consigned minus the quantity so lost.

Illustration: Suppose 1,050 tons of coal is consigned at ₹ 40 per tonne, and the freight paid thereon amounted to ₹ 10,000. If the quantity sold is 600 tons and that of unsold is 400 tons, calculate the cost of unsold stock.

Solution: The example indicates that there is a normal loss of 50 tons,

Cost of unsold stock of 400 tons will be calculated as follows:	₹
Cost of 1,050 tons (1,050 × ₹ 40)	42,000
Add: Freight	10,000

Total cost of 1,050 tones = 52,000

Since the normal loss is of 50 tons, the cost of 1,050 tons becomes the cost of 1,000 tons. When cost of 1,000 tons is ₹ 52,000

Then cost of 400 tons will be = ₹ 52,000 × $\frac{400}{1,000}$ = ₹ 20,800

Cost of Closing Stock = ₹ 20,800

2.3.2 Abnormal Loss:

In addition to the normal loss which is inherent in the nature of certain goods, there are also some abnormal losses also which occur in connection with the goods consigned due to accident, theft, fire, negligence, carelessness etc. For example, if a part of the stock is stolen, it will surely reduce the value of the stock as well as the profit on consignment. In order to ascertain the correct profit on a consignment, the abnormal losses should be debited to the Profit and Loss Account and credited to the Consignment Account. It should also be remembered that when the amount of abnormal loss is covered by the insurance company, the Consignment Account will be credited at first with the full cost of the goods so lost, damaged or destroyed. And when the claim is recovered from the insurance company, the amount is adjusted in the Abnormal Loss Account. Any balance of abnormal loss which is not covered by the insurance company will be debited to Profit and Loss Account. But, if any part of the damaged goods is sold for cash, it is credited to the Abnormal Loss Account before the balance is transferred to Profit and Loss Account.

While calculating the cost of goods lost, damaged or destroyed, the proportionate expenses incurred up to the time the loss has occurred should also be taken into consideration. Therefore, it is clear that all the expenses incurred after the occurrence of such abnormal loss will be ignored while calculating the cost of abnormal loss. Value of abnormal loss should always be calculated on cost price.

Abnormal loss of stock in consignment is caused by theft, accident, fire, pilferage, abnormal breakage, carelessness etc. Abnormal loss is calculated just the same way as the valuation of stock on consignment after taking into consideration the proportionate expenses incurred on it and is credited to consignment account and debited to profit and loss account. In case the stock is insured, consignment account is credited with the full cost of the goods so lost and abnormal loss account is debited. Any amount realized on account of damaged goods should be credited to abnormal loss account. The amount of claim receivable from the insurance company is debited to insurance company account and credited to abnormal loss account and the balance of abnormal loss is debited to profit and loss account. Later, when the amount is received from the insurance company, cash account is debited and insurance company account is credited. The journal entries will be as follows:

(i) If not covered by Insurance Company

Profit and Loss A/c (Abnormal Loss A/c) Dr.

To Consignment A/c

(ii) (a) If covered by Insurance Company

Abnormal Loss A/c Dr.

To Consignment A/c

(b) For amount received from the insurance company.

Insurance Company A/c Dr.

To Abnormal Loss A/c

(c) Balance of loss not covered by insurance company.

Profit and Loss A/c Dr.

To Abnormal Loss A/c

The amount of the loss is ascertained like the value of closing stock except that expenses incurred only after the loss had taken place have to be 'ignored' while calculating the 'cost' of the loss because no part of such expenses can be said to have been incurred on the lost goods.

Illustration: 500 sewing machines were consigned by X to Y at ₹ 200 each. X paid freight and insurance of ₹ 10,000. During transit 50 sewing machines were totally destroyed by fire. Insurance company paid ₹ 5,000 for claim of loss. Y took the delivery of remaining 450 sewing machines and paid ₹ 900 for octroi. 400 sewing machines were sold at ₹ 300 each. Selling expenses of Y were ₹ 1,000. Y was entitled to a commission of 5%. Y settled the account by a bank draft.

Prepare ledger accounts in the books of X.

Solution:

Working Note:

1. Value of Abnormal Loss:

		₹
Cost of 10 calculators = 10 × ₹ 200		2,000
Add: Expenses by Consignor = $\frac{1,000}{100} \times 10$		100
		2,100

2. Value of Closing Stock:

(a) In Transit:

		₹
Cost of 20 calculators = (10 × ₹ 200)		4,000
Add: Expenses by Consignor =₹ $\frac{1,000}{100} \times 20$ =	200	
		4,200

(b) In Hand:

		₹
Cost of 10 calculators = (10 × ₹ 200) =	2,000	
Add: Expenses by Consignor = ₹ $\frac{1,000}{100} \times 10$ =	100	
Add: Direct Expenses by Consignee (A) = ₹ $\frac{490}{70} \times 10$ =	70	
		2,170

Normal Loss and Abnormal Loss

When both losses normal and abnormal are given in the question, first of all, it is ascertained whether normal loss has occurred before or after the abnormal loss. If the normal loss has occurred before the abnormal loss or both have occurred in transit, the quantity of normal loss is deducted at first from the total quantity of the goods consigned for the valuation of abnormal loss.

Illustration: Rahim of Mumbai consigned 4,000 kgs. oil to Raju of Chennai. Each kg oil cost ₹10. Rahim paid ₹ 800 for carriage, ₹ 1,400 for freight and ₹ 1,250 for insurance in transit. During transit 400 kgs. oil was accidently destroyed for which insurance company paid ₹ 2,000 directly to the consignor in full settlement of the claim.

Raju reported that 3,000 kgs. oil was sold @ ₹ 15 per kg. Expenses incurred were as follows: Godown Rent ₹ 800 and Salesman's Salary ₹ 1,200. He was entitled to a commission of 5% on sales. He also reported a loss of 50 kgs. oil due to leakage in transit.

Prepare necessary accounts in the books of Rahim assuming that Raju settled his account by means of a bank draft.

Solution:

In the books of Rahim (Consignor)

Dr. **Consignment Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Good sent on Consignment A/c	40,000		By Raju (Sales)	45,000
	To Cash A/c (Expenses)	3,450		By Abnormal Loss A/c	4,400
	To Raju (Expenses)	2,000		By Stock on Consignment A/c	6,050
	To Raju (Commission 5% on ₹ 45,000)	2,250			
	To Profit and Loss A/c	7,750			
		55,450			55,450

Dr. **Goods Sent on Consignment A/c** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Trading A/c	40,000		By Consignor's A/c	40,000
		40,000			40,000

Dr. **Abnormal Loss A/c** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Consignment A/c	4,400		By Insurance Company	2,000
				By Profit & Loss A/c	2,400
		4,400			4,400

Dr. **Raju's A/c** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Consignment A/c (Sales)	45,000		By Consignment A/c (Expenses)	2,000
				By Consignment A/c (Commission)	2,250
				By Bank A/c (Balancing Figure)	40,750
		45,000			45,000

Dr. **Stock on Consignment A/c** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
		(₹)			(₹)
	To Consignment A/c	6,050		By Balance c/d	6,050
		6,050			6,050

Workings:

(1) Calculation of Abnormal Loss:

Loss of 400 Kgs. is an Abnormal Loss and Loss of 50 kgs. is a Normal Loss. As both these losses have occurred in transit, normal loss will be considered at first and the value of abnormal loss will be considered thereafter.

Cost of 3,950 kgs. Oil = ₹ 43,450 (40,000 + 3,450)

Hence, Cost of 400 Kgs. = $\left\{\frac{43{,}450}{3{,}950} \times 400\right\}$ = ₹ 4,400

(2) Calculation of Closing Stock:

Quantity of Unsold Stock (3,550 – 3,000) = 550 Kgs.

Cost of 3,950 kgs. oil = 43,450

Hence, Cost of 550 Kgs. = $\frac{43{,}450}{3{,}950} \times 550$ = ₹ 6,050

2.4 Some Other Topics under Consignment Account

2.4.1 Consigning the Goods at Invoice Price

Sometimes, the consignor may prefer to send the goods to the consignee at a higher price than the cost price and, accordingly, prepares the 'Proforma Invoice' by adding some amount in the cost price. It is also called loaded price. This is done with a view to keep the profit secret from the consignee. When the goods are sent at invoice price, the consignment account is debited with the invoice price of the goods consigned. In order to ascertain the true profit or loss, the sale proceeds should be compared with the cost of goods, not with the invoice price. Hence, in order to bring down the value of the consignment at the cost price, the consignment account is credited with the difference between the invoice price and the cost price of the goods consigned and the corresponding debit is given to the Goods Sent on Consignment Account.

For example, A of Ahmedabad consigned goods to B of Bahadurgarh costing ₹ 10,000 on an invoice price of ₹ 12,000. Here, the proforma invoice will be prepared for 12,000 and the same amount will be debited to the consignment account. In this example, the following entries will be passed in the books of the consignor:

		₹	₹
1. When goods are sent on Invoice Price			
Consignment A/c	Dr. (with Invoice Price)		12,000
To Goods Sent on Consignment A/c			12,000
2. When the Invoice Price is brought down to its Cost Price			
Goods Sent on Consignment A/c	Dr. (with difference)	2,000	
To Consignment A/c			2,000

Objectives and Advantages of Consigning the Goods at Invoice Price

The goods are consigned at invoice price keeping in view the following points:

1. For keeping the profit on consignment secret so that the consignee may not demand more commission and may not likely to become the competitor in the same business.
2. For providing incentive to the consignee to realise the highest price as possible.
3. For putting the consignee in a position to charge a uniform price.
4. For keeping an effective control on sales price as well as on the stock on consignment.

Valuation of Stock on Consignment: When Goods are Consigned at Invoice Price

When the goods are consigned at invoice price and there is any stock left unsold, it is also valued at the invoice price plus proportionate direct expenses incurred or the market price whichever is less. Once the stock on consignment is valued at the invoice price, it is but natural that the value of the same should be brought down to the cost otherwise the consignment account will not show the correct profit or loss. For this purpose, the consignment account is debited with the difference between the invoice price and the cost of the remaining unsold stock and the same amount is credited to a new account called Consignment Stock Reserve Account. In such a situation, the following entries will be passed in the books of the consignor:

Consignment A/c Dr. (with difference)

To Stock Reserve A/c

Illustration: On 1st January, 2017, P and Co. of Delhi consigned to Q and Co. of Mumbai 200 bicycles invoiced at ₹ 75 each which was 25% above the cost price. P and Co. incurred ₹ 1,000 on freight and insurance and received ₹ 5,000 as security from Q and Co. Q and Co. paid ₹ 500 as octroi and cartage, ₹ 200 for rent and ₹ 400 on insurance.

On 31st, 2017, Q and Co. sold 150 bicycles for ₹ 15,000. Q and Co. is entitled to an ordinary commission of 5% and a del-credere commission of 2% on sales. Q and Co. remitted the amount due through a bank draft.

Pass journal entries in the books of P and Co.

Solution: **Journal**

Date	**Particulars**	**L.F.**	**Amount (Dr.)**	**Amount (Cr.)**
2017			₹	₹
Jan. 1	Consignment A/c Dr.		15,000	
	To Goods Sent on Consignment A/c			15,000
	(For goods sent on consignment at invoice price)			
Jan. 1	Consignment A/c Dr.		1,000	
	To Bank A/c			1,000

	(For expenses paid)			
Jan. 1	Bank A/c Dr. To Q and Co. (For advance payment received)		5,000	5,000
Jan. 1	Consignment A/c Dr. To Q and Co. (For expenses paid by the consignee)		1,100	1,100
May 31	Q and Co. Dr. To Consignment A/c (For goods sold by the consignee)		15,000	15,000
May 31	Consignment A/c Dr. To Q and Co. (For commission due on sales i.e. 7% of ₹ 15, 000)		1,050	1,050
May 31	Stock on Consignment A/c Dr. To Consignment A/c (For the value of unsold stock)		4,125	4,125
May 31	Goods Sent on Consignment A/c Dr. To Consignment A/c (For adjustment of excess price over cost price)		3,000	3,000
May 31	Consignment A/c Dr. To Stock Reserve A/c		750	750

	(For excess of invoice price over cost price for unsold stock)			
May 31	Consignment A/c Dr. To Profit and Loss A/c (For profit on consignment transferred to Profit and Loss Account)		3,225	 3,225
May 31	Goods Sent on Consignment A/c Dr. To Trading A/c (For cost of goods transferred to Trading Account)		12,000	 12,000
May 31	Bank A/c Dr. To Q & Company (For balance amount received from Q & Company)		9,100	 9,100

Working Note:

1. Value of Closing Stock: **₹**

Invoice Price of 50 Bicycles @ ₹ 75 each 3,750

Add: Proportionate Share of Consignor's Expenses ₹ 1,000 × $\frac{50}{200}$ 250

Add: Proportionate Share of Consignee's Expenses ₹ 500 × $\frac{50}{200}$ 125

4,125

2. Calculation of Cost Price of one Bicycle: **₹**

Let cost be 100

Profit Loading 25

Invoice Price (Cost + Profit) 125

In Invoice Price 125 then cost is 100

In Invoice Price 1 then cost is $\frac{100}{125}$

If Invoice Price 75 then cost is = $\frac{100}{125} \times 75$ 60

3. **Excess Price over Cost Price = 75 – 60 = ₹ 15 per bicycle**

Total Amount = ₹ 15 x 200 = ₹ 3,000

4. **Calculation of Profit:**

Dr. **Consignment Account** **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
	(₹)		(₹)
To Goods Sent on Consignment A/c	15,000	By Q and Company (Sales)	15,000
To Bank A/c (Expenses)		By Stock on Consignment A/c	4,125
To Q and Company (Expenses)	1,000	By Goods Sent on Consignment A/c (Adjustment)	3,000
To Q and Company (Commission)	1,100		
To Stock Reserve A/c	1,050		
To Profit and Loss A/c	750		
	3,225		
	22,125		22,125

5. Amount Received from Consignee:

Dr. **Q & Company's A/c** **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
	(₹)		(₹)

To Consignment A/c (Sales)	15,000	By Bank A/c	5,000
To Balance c/d (Proportionate Advance) $₹\left[\frac{5,000}{200} \times 50\right]$	1,250	By Consignment A/c (Expenses)	1,100
		By Consignment A/c (Commission)	1,050
		By Bank A/c (Balancing Figure)	9,100
	16,250		16,250

2.4.2 Over-Riding Commission

Over-riding Commission is an extra commission allowed to the consignee to promote the sales at higher price than the price fixed by the consignor or to encourage the consignee to put hard work in introducing a new product in the competitive market. This is allowed over and above the normal commission as per the terms and conditions of the agreement. Usually, the over-riding commission is calculated on the excess sales proceeds over the sales as per specified price. However, it may be allowed on the total sales too, if it is mentioned in the question. When it is calculated on the excess sales proceeds, the following formula is used:

Over-riding commission = $\frac{Total\ actual\ sales - Total\ Sales\ at\ specified\ price}{100} \times Rate$

Illustration: On 1st January, 2017, P of Hisar consigned to Q of Rohtak goods for sale at invoice price. Q is entitled to a commission of 5% on invoice price and 25% on any surplus price realised. Goods costing ₹ 15,000 were consigned to Q at the invoice price of ₹ 20,000. The consignment expenses were ₹ 1,500. On 31st March, 2017, an account sales was received from Q showing that he had affected sale of ₹ 18000 in respect of 3/4th of the quantity of goods consigned to him. His actual expenses amounted to ₹ 800. Q accepted a bill drawn by P for ₹ 7,000 and remitted the balance due from him in cash.

Give Consignment Account and Q’s Account in the books of P.

Solution:

Books of P

Dr. **Consignment Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
		(₹)			(₹)
	To Goods sent on Consignment A/c (Invoice Price)	20,000		By Q (Sales)	18,000
	To Cash A/c (Expenses)	1,500		By Stock on Consignment A/c 1/4 of (₹ 20,000 + ₹1,500) (Invoice Price)	5,375
	To Q (Expenses)	8,00			
	To Q (Commission)	1,500		By Goods Sent on Consignment A/c (Loading)	5,000
	To Stock Reserve A/c (1/4 of ₹ 5,000)	1,250			
	To Profit & Loss A/c	3,325			
		28,375			28,375

Dr. **Q’s A/c** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
		(₹)			(₹)
	To Consignment A/c	18,000		By Consignment A/c	800

	(Sales)			(Expenses)	
				By Consignment A/c (Commission)	1,500
				By B/R A/c	7,000
				By Cash A/c (Balancing Figure)	8,700
		18,000			18,000

Workings:

Calculation of Commission: ₹

(i) 5% Commission on Invoice Price ₹ 20,000 × $\frac{3}{4}$ = ₹ 15,000 × $\frac{5}{100}$ 750

(ii) 24% Commission on Surplus of Invoice Price $\frac{25}{100}$ × (₹18,000 – ₹15,000) 750

1500

2.4.3 Consignment under Goods and Service Tax (GST) Regime

Under CGST Act 2017, supply of goods by 'Principal' to his 'Agent' even without consideration is treated as a supply and shall be liable to GST. Therefore, transfer of goods by the consignor to the consignee for sale is treated as supply and will be taxable under GST. As per rules, GST will need to be charged either on:

Open market value of goods sent on consignment

or

90% of the sales price to be charged by the consignee to the end customer.

It is at the option of the consignor.

Further, the consignee should charge GST from the end customer at the time of selling the goods to them. However, the consignee can avail the input credit of GST charged by the consignor while filling his returns. In addition, the consignee has to charge GST at the prescribed rate on the commission from the consignor. However, consignor can avail the input credit of GST charged while filing his returns.

As supply under consignment has become taxable, working capital of the consignee will be blocked as GST need to be paid at the time of receiving the goods from the consignor. Further, the working capital of consignor is also blocked as GST on the commission is needed to be paid to the consignee along with the amount of commission paid to him.

	Journal entries in the books of consignor	Journal entries in the books of consignee
1	**When goods are sent on Consignment:** Consignment A/c (Amount of goods sent) Dr. Consignee A/c (Amount of GST) Dr. To Goods Sent on Consignment A/c To Output GST A/c (Amount of GST) (For Goods sent on Consignment)	**When goods are received, the consignee need not to make any entry for goods received but the following entry will be passed to book GST credit:** Input GST A/c To Consignor A/c (For credit of GST taken on receipt of goods from consignor)
2	When Advance payment is received from Consignee: Cash / Bank or Bills Receivable A/c To Consignee's A/c (For advance payment received from consignee)	When Advance Payment is made to Consignor: Consignor's A/c Dr. To Cash / Bank or Bills Payable A/c (For advance payment made to the consignor)
3.	**When bill receivable is discounted:** Cash / Bank A/c Dr.	

	Discount A/c Dr. Input GST (If any) Dr. To Bills Receivable A/c (For bills receivable discounted)	No Entry
4.	**When expenses are incurred by Consignor:** Consignment A/c (Amount of Expenses) Dr. Input GST (If any) (Amount of GST) Dr. To Cash A/c (For expenses Paid)	No Entry
5. (a)	**When expenses are incurred by Consignee:** Consignment A/c (Amount of Expenses) Dr. Input GST (if any) (Amount of GST) Dr. To Consignee's A/c (For expenses paid by consignee)	**When expenses are incurred by Consignee on behalf of Consignor:** Consignor's A/c (Expenses plus GST) Dr. To Cash A/c (Expenses plus GST) (For expenses paid on behalf of consignor) **Note:** Input of GST on these expenses will be taken by the Consignee as shown in the entry No. 5 passed in the books of Consignor.
5. (b)	**No Entry**	**When Commission is due to Consignor:** Consignor's A/c Dr. To Commission A/c (Amount of Commission)

		To Output GST A/c (Amount of GST) (For Commission due from Consignor)
6.	**When Commission is due to Consignee:** Consignment A/c (Amt. of Commission) Dr. Input GST (if any) (Amount of GST) Dr. To Consignee A/c (For commission due to consignee)	**When goods are sold by Consignee on behalf of Consignor:** Cash/Bank A/c (Cash Sales including GST) Dr. Consignment Debtors A/c Dr. (Credit Sales including GST) To Consignor's A/c (Amount of Sales) To Output GST A/c (Amount of GST) (For goods sold)
7.	**When goods are sold by Consignee:** Consignee A/c Dr. To Consignment A/c (For goods sold by consignee)	**No Entry**
8.	**When Stock on Consignment given in the beginning:** Consignment A/c Dr. To Stock on Consignment A/c (For recording the consignment stock in the beginning)	**No Entry**

9.	**When Stock on consignment given at the end:** Stock on Consignment A/c Dr. To Consignment A/c (For recording the consignment stock at the end)	**No Entry**
10.	**When there is a Profit on Consignment:** Consignment A/c Dr. To Profit & Loss A/c (For Profit on Consignment)	**No Entry**
11.	**When there is a Loss on Consignment:** Profit & Loss A/c Dr. To Consignment A/c (For Loss on Consignment)	**No Entry**
12.	**When goods sent on Consignment are transferred to Trading Account:** Goods Sent on Consignment A/c To Trading A/c (For goods sent on consignment transferred to trading account)	**No Entry**
13.	**When discount is transferred to Profit and Loss Account:**	

	Profit and Loss A/c Dr. To Discount A/c (For discount transferred to profit and loss account)	**No Entry**
14.	**No Entry**	**When Commission earned is transferred to Profit and Loss Account:** Commission A/c Dr. To Profit & Loss A/c (For commission transferred to profit and loss account)
15.	**When account of consignee is settled and the balance amount is received:** Cash or Bank or Bill Receivable A/c Dr. To Consignee (For final settlement of consignee's account)	**When account of Consignor is settled and the balance is paid off:** Consignor Dr. To Cash or Bank or Bills Payable A/c (For final settlement of consignor's account)
16.	**No Entry**	**When amount of bills payable is paid:** Bills Payable A/c Dr. To Cash A/c (For payment of bills payable)
17.	**For payment of GST:** Output GST A/c To Input GST A/c	**Payment of GST:** Output GST A/c Dr. To Input GST A/c

	To Bank A/c (For GST set off and balance (if any) paid to the Government)	To Bank A/c (For GST set off and balance (if any) paid to the Government)

Illustration: (With GST) on 10th March 2018 Mohan & Co. of Delhi consigned 60 cases of goods to Sohan & co. of Chennai at ₹ 500 each (market price ₹ 600 each) for sale on commission @ 5% on gross sale proceeds. The GST rate is 12% Mohan & Co. paid ₹ 2,000 as freight. Sohan & Co. took the delivery on 16th March 2018 and paid ₹ 1000 for octroi, ₹ 1,500 for clearing charges and ₹ 500 for godown charges

20 cases were sold @ 800 per case, 30 cases @ 850 per case and remaining for ₹ 7,500 by the Sohan and co. as per account sales sent by him on 31st July 2018 and remitted the sales proceeds after deducting expenses and commission etc. Amount of Output IGST was paid on 20th April, 2018. Give journal entries and prepare necessary accounts in the books of both the parties.

Solution:

In the books of Mohan & Co. (Consignor)

Journal Entries

Date	**Particulars**	**L.F.**	**Amount (Dr.)**	**Amount (Cr.)**
			₹	₹
2018				
Mar. 10	Consignment A/c Dr.		30,000	
	Sohan & Co.		4,320	
	To Goods Sent on Consignment A/c			30,000
	To Output IGST A/c (12% on ₹ 36,000)			4,320
	(For goods sent on consignment)			

	Note: GST is charged on market value of goods sent on consignment as per GST rules.			
Mar. 10	Consignment A/c Dr. To Cash A/c (For expenses paid)		2,000	 2,000
Mar. 16	Consignment A/c Dr. To Sohan & Co. (For expenses paid by the consignee)		3,000	 3.000
Apr. 20	Output IGST A/c Dr. To Bank A/c (For output IGST paid to the Government)		4,320	 4,320
July 31	Sohan & Co. To Consignment A/c (For goods sold by consignee)		49,000	 49,000
July 31	Consignment A/c Dr. Input IGST A/c Dr. To Sohan & Co. (For 5% commission on sales proceeds of ₹ 49,000)		2,450 294	 2,744
July 31	Bank A/c Dr. To Sohan & Co. (For balance amount received from consignee)		47,576	 47,576

July 31	Consignment A/c Dr. To Profit & Loss A/c (For profit on consignment transferred to profit and loss A/c)		11,550	 11,550
July 31	Goods sent on Consignment A/c Dr. To Trading A/c (For goods sent on consignment transferred to trading a/c)		30,000	 30,000

Dr. **Consignment Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2018		(₹)	2018		(₹)
Mar. 10	To Goods sent on Consignment A/c	3,000	July 31	By Sohan & Co.	49,000
Mar. 10	To Cash A/c (Expenses)	2,000			
Mar. 16	To Sohan & Co.	3,000			
July. 31	To Sohan & Co.	2,450			
July. 31	To Profit & Loss A/c (Profit Transferred)	11,550			
		49,000			49,000

Dr. **Sohan & Co.'s Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**

		(₹)			(₹)
Mar. 10	To Output IGST	4,320	Mar. 16	By Consignment A/c	3,000
July 31	To Consignment A.c	49,000	July 31	By Consignment A/c	2,450
			July 31	By Input IGST A/c	294
			July 31	By Bank A/c	47,576
				(Balancing Figure)	
		53,320			53,320

Dr. **Goods sent on Consignment Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**
2018		(₹)	2018		(₹)
July 31	To Trading A/c	30,000	Mar. 10	By Consignment A/c	30,000
		30,000			30,000

Dr. **Output IGST Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amoun t**
2018		(₹)	2018		(₹)
Apr. 20	To Bank A/c	4,320	Mar. 10	By Sohan & Co.	4,320
		4,320			4,320

Dr. **Input IGST Account** **Cr.**

Date	**Particulars**	**Amount**	**Date**	**Particulars**	**Amount**

2018		(₹)	2018		(₹)
July 31	To Sohan & Co.	294	July 31	By Balance c/d	294
		294			294

In the books of Sohan & Co. (Consignment)

Journal Entries

Date	**Particulars**	**L.F.**	**Amount (Dr.)**	**Amount (Cr.)**
			₹	₹
2018 Mar. 10	Input IGST A/c Dr. To Mohan & Co. (For IGST charged by consignor on goods sent on consignment)		4,320	 4,320
Mar. 16	Mohan & Co. Dr. To Bank A/c (For expenses paid)		3,000	 3,000
July 31	Bank A/c Dr. To Mohan & Co. To Output IGST (For expenses paid by the consignee)		54,880	 49,000 5,880
July 31	Mohan & Co. Dr.		2,744	

	To Commission A/c To Output IGST A/c (For 5% Commission on sale proceeds)			2,450 294
July 31	Mohan & Co. To Bank A/c (For remittance of balance amount due to consignor)		47,576	 47,576
July 31	Output IGST A/c Dr. To Input IGST A/c Dr. To Bank A/c (For Input IGST set off against Output IGST and balance of IGST collected paid to the Government)		6,174	 4,320 1,854

Dr. **Mohan & Co.'s Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2018		(₹)	2018		(₹)
Mar. 16	To Bank A/c	3,000	Mar. 10	By Input IGST	4,320
July 31	To Commission A/c	2,450	July 31	By Bank A/c	49,000
July 31	To Output IGST A/c	294			
July 31	To Bank A/c	47,576			
		53,320			53,320

Dr. **Output IGST Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount

2018		(₹)	2018		(₹)
July 31	To Input IGST A/c	4,320	July 31	By Bank A/c	5,880
July 31	To Bank A/c	1,854	July 31	By Mohan & Co.	294
		6,174			6,174

Dr. **Input IGST Account** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2018		(₹)	2018		(₹)
Mar. 10	To Mohan & Co.	4,320	July 31	By Output IGST A/c	4,320
		4,320			4,320

2.5 Check Your Progress

A. State whether the following statements are True or False

1. The relationship that exists between the consignor and consignee is that of a principal and an agent.
2. Consignment Account is a nominal account in nature.
3. There is no difference between consignment and sale.
4. Abnormal losses are always higher than normal losses.

B. Fill in the blanks

1. ________________ is a commission for undertaking the responsibility for collection of debts.
2. The expenses incurred by the consignee are termed as__________________.
3. Invoice price is always higher than_____________________.

2.6 SUMMARY

The act of sending goods by a merchant to an agent for sale on commission basis is known as consignment. The sender of goods is known as 'Consignor' and the agent who receives the goods for sale is known as 'Consignee'. The relationship that exists between the consignor and the consignee is that of a principal and an agent. The consignor usually maintains the following accounts:

(1) Consignment Account.

(2) Consignee's Account.

(3) Goods Sent on Consignment Account.

(4) Stock on Consignment Account.

A proper record of all transactions relating to a particular consignment is necessary to be maintained separately by the consignee. For this purpose, he usually opens the following accounts:

- Consignor's Account
- Commission Account

2.7 KEYWORDS

Consignor: The sender of goods.

Consignee: The agent who receives the goods for sale.

Over-riding Commission: Commission allowed to the consignee to promote the sales at higher price.

Normal Loss: Inherent and unavoidable loss due to the nature of goods.

Non-Recurring Expenses: Expenses incurred up to the goods reach to the godown of consignee.

2.8 SELF-ASSESSMENT TEST

1. What do you mean by Consignment? Discuss the characteristics and advantages of consignment.
2. Elaborate the accounts to be opened in the books of consignor with hypothetical figures.
3. Discuss the accounts to be opened in the books of consignee with hypothetical figures.

4. Explain the Journal Entries to be made in the books of consignor and consignee.

5. Write notes on the following:

   i) GST

   ii) Valuation of Closing Stock

2.9 Answers to Check Your Progress

Check Your Progress A

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

Check Your Progress B

1. Del-Credere Commission
2. Recurring Expenses
3. Cost Price

2.10 REFERENCES/SUGGESTED READINGS

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2. ArulaNandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
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4. Shukla M.C. & Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
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Course Code: **BCOM 201**	SLM Conversion By**: Ms. Chand Kiran**
Lesson No: **3**	

JOINT VENTURE

STRUCTURE

3.0 LEARNING OBJECTIVE

After reading this lesson, you should be able to

a) Define a joint venture and explain its feature

b) Differentiate between joint venture, partnership and consignment.

c) Account for joint venture transactions under different methods.

3.1 INTRODUCTION

Complexities of a business as huge funds requirements, lack of technical expertise, sometimes make it difficult to undertake a business assignment individually like constructing a big building. The alternative available is that two or more persons join hand to take up that assignment. Joining hand may be for finance, for technical know-how, for sharing risk etc. When two or more persons join together to carry out a specific business and share the profits on predetermined basis, it is known as a *Joint Venture*. Joint venture is defined as a partnership confined to a particular adventure, speculation, course of trade or voyage, and in which partners, either latent or known use no firm or social name, and incur no responsibility beyond the limits of the adventure. For example, Mr. John and Mr. Ibrahim agreed to construct a bridge for Municipal Corporation. They pool their resources and technical knowhow. After they completed this project, the profits arising thereof will be shared by them in proportion to their contribution. Whey they are undertaking this project, they are free to carry on their own business as usual unless otherwise agreed. As the project ends, the relationship between the parties i.e. co-ventures ceases. So life of joint venture depends on the duration in which a project completes. Joint venture is neither a partnership nor it is consignment.

3.2 MEANING OF JOINT VENTURE

A joint venture is usually a temporary partnership without the use of a firmname, limited to carrying out a particular business plan in which the persons concerned agree to contribute capital and to share profits or losses. The parties in a joint venture are known as co-venturers and their liability is limited to the adventure concerned for which they agree to contribute capital and share profits or losses. A joint venture may consist of a joint consignment of goods, speculation in shares, underwriting of shares or debentures, construction of a building, or any similar form of enterprise.

3.2.1 FEATURES OF A JOINT VENTURE

The main features of a joint venture are specifically made clear:

a) Two or more person are needed.
b) It is an agreement to execute a particular venture or a project.
c) The joint venture business may not have a specific name.
d) It is of temporary nature. So the agreement regarding the ventureautomatically stands terminated as soon as the venture is complete.

e) The co-ventures share profit and loss in an agreed ratio. The profitsand losses are to be shared equally if not agreed otherwise.

f) The co-ventures are free to continue with their own business unlessagreed otherwise during the life of joint venture.

3.2.2 DIFFERENCES BETWEEN JOINT VENTURE, PARTNERSHIP ANDCONSIGNMENT

In joint venture and partnership some business is carried on by two or more persons and the profits are shared by all of them. But there are some basic differences between the two which are given below:

Partnership Venture	Joint Venture
-A Partnership firm always has a name	There is no need of firm's name.
-It is of a continuous nature.	It comes to an end as soon as the work is complete.
-Separate set of books have to be maintained.	There is no need for a separate set of books, the account can be maintained even in one of the co-venturer's books only.
- No partner can carry on a similar business.	The co-venturers are free to carry on the business of a similar nature.
-Though the registration of partnership is not compulsory desirable	There no need for registration at all.
- A minor can also be admitted to the benefits of the firm.	A minor cannot be a co-venturer as he is incompetent to enter into a contract.

Consignment and joint venture are in the nature of an agreement between different parties but there are many points of differences between the two. Some of these are given below:

Joint Venture	Consignment
-Number of co-ventures is usually two but it can also be more than two.	Normally two persons are involved, the consignor and the consignee.
- The relationship between co-venturers is that of partnership. Co-venturers are the owners.	The relationship between the consignor and the consignee is that of principal and agent.
- The relationship comes to an end as soon as the venture is completed.	The arrangement may continue for a long time.
- All the co-venturers contribute funds to a common pool.	The funds are provided by the consignor.
- It may be for sale of goods or for carrying on any other activity like construction of building, investment in shares etc.	It is generally connected with sale of movable goods.
- The profit is shared by all the co-venturers.	The profit belongs to the consignor only. The consignee is entitled only to his commission.
- There is joint ownership	The consignor owns the goods.

Joint ventures' as mentioned earlier are beneficial under the situations where there are limitations which cannot be overcome by single party. By launching joint venture two or more parties can pool their financial resources to undertake a very big venture. Where experience or technical knowledge is a limitation co-ventures can also pool their expertise. Since joint ventures are normally big projects, if under unfavorable conditions there are losses then these losses are also shared thus loss to individual party is lessened.

3.3 METHODS OF RECORDING JOINT VENTURE TRANSACTIONS

Joint venture accounts can be kept under any of the following three methods:

A) Each co-venture records the transaction in his own books and opens "Joint Venture Account" and accounts of his fellow partners.

B) One common Joint Venture Account on memorandum basis is prepared to find the profit or loss made on trading. It is not a part of the double entry system. Under this system each one of the partners open only one account which is of the nature of personal account. The account is called. "Joint venture with a/c."

C) Ventures' agree to keep a separate set of books and a person is made in charge of recording of all transactions. Generally this method is not adopted.

A) Each co-venturer records the transactions

Under this system the "Joint Venture Account" is opened and debited with the value of goods bought and expenses incurred. Cash account or the party which has supplied the goods or incurred the expenses will be credited. When the sales proceeds are received, the party receiving it, will debit cash (for Debtors) account and credit the Joint Venture Account. The other parties will debit the recipient party and credit the Joint Venture Account.

Sometimes, a bill of exchange is drawn by one of the parties and is discounted. In such a case the discount on the bill should be charged to Joint Venture Account. Joint Venture Account will now show the profit or loss on trading. Under this system, each (Joint venturer) partner will open two accounts

i.e. (i) Joint Venture Account (ii) The account of other parties.

Journal Entries:

The following journal entries will be passed:

1) For Investment in Joint Venture

Joint Venture A/c Dr.

To Cash/Good A/c

(Being the amount of goods supplied or cash put in for Joint Venture)

2) As goods are supplied by the Co-venturer or cash is invested in Joint Venture by him

Cash A/c (For cash sent) Dr.

Joint Venture A/c Dr.

To Co-venture A/c (for goods sent)

(Being goods supplied or cash invested by the other partner)

3) For recording sale of joint venture goods

Cash A/c Dr.

To Joint Venture A/c

(Being Sale of goods made)

4) On sale of joint venture goods by the other party

Co-Venturer A/c Dr.

To Joint Venture A/c

(Being Joint Venture goods sold by the other partner)

5) a) For receipt of Bill of Exchange from the other partner

Bills receivable A/c Dr.

To Co-Venturer A/c

(Being bill receivable received)

b) For discounting the bill of exchange

Bank A/c Dr.

Joint Venture A/c Dr.

To Bills Receivable A/c

(Being bill discounted and discounting charges debited to Joint Venture A/c).

6) Entries in the books of other partner Acceptor's books regarding acceptance of bills of exchange

Co-venturer A/c Dr.

To Bills Payable A/c(Being acceptance given)

7) On discounting the bills of exchange by other party i.e. Drawer

Joint venture A/c Dr.

To Co-Venturer A/c

8) On commission charged under Joint Venture

Joint Venture A/c Dr.

To commission A/c

9) On Commission charged by other partner

Joint Venture A/c Dr.

To Co-Venturer A/c

(Being Commission on sale effected by other partners)

10.) When some products are left unsold and transferred to his own stock.

Purchase A/c Dr.

To Joint Venture A/c

(Being the unsold goods taken)

11) If the other partner has taken the unsold goods, the entry will be:-

The Co-venturer A/c Dr.

To Joint Venture A/c

(Being the unsold goods taken by the other partner)

12) Now Joint Venture Account will be closed. If it shows profit then the profitwill be divided in the agreed ratio. The entry will be

Joint Venture A/c

To P & L A/c (own share)

To Co-venturers A/c (their share)

(Being the profit on Joint Venture shared by the parties)

Format of Two accounts to be maintained

Joint Venture Account

Dr. **Particulars**	**Amount Rs.**	**Particulars**	Cr. **Amount Rs.**
To Cash A/c (purchased) To Cash A/c (Expenses) To Purchase A/c (Material supplied) To Outstanding Expenses A/c To Profit transferred to: Profit & Loss A/c Co-venturers A/c		By Cash A/c By Co-venturerA/c (Goods taken over)	

Co-venturer's Personal Account

Particulars	Rs.	Particulars	Rs.
To Joint Venture A/c		By Bills Receivables	
(Good taken over)			
To Cash a/c		By Joint Venture A/c	
	-------------		-------------
	-------------		-------------

Illustration - 1

X and Y entered into Joint Venture to sell a consignment of timber sharing profits and losses equally. X provides timber from stock at mutually agreed value of Rs. 50000. He pays expenses amounting to Rs. 2500. Y incurs further expenses on cartage, storage and collieage of Rs. 6500 and receives cash for sales Rs. 30,000. He also takes over goods to the value of Rs. 10000 for his own use. At the close, X takes over the balance stock in hand which is valued at Rs. 11000.

Pass Journal Entries to record the above transactions and open the necessary ledger accounts in the books of X and Y.

Journal entries in the Books of X

Particulars		L.F.	Dr. Rs.	Cr. Rs.
Joint Venture A/c	Dr.		52,500	
To Purchase A/c				50,000
To Bank A/c				2,500
(Being timber provided and expenses incurred)				
Joint Venture A/c	Dr.		6,500	
To Y				6,500
(Being expenses incurred by Y)				
Y	Dr.		30,000	

To Joint Venture a/c			
(Being the sale proceeds by Y)			30,000
Y	Dr.	10,000	
To Joint Venture A/c			10,000
(Y takes over the goods for his use)			
Purchase A/c	Dr.	11,000	
To Joint Venture A/c			11,000
(Being unsold goods taken)			
Y	Dr.	4,000	
Profit and Loss A/c	Dr.	4,000	
To Joint Venture A/c			8,000
(Being the loss on Joint Venture shared equally)			
Bank A/c	Dr.	37,500	
To Y			37,500
(Being draft received from Y)			

Ledger Account Joint

Venture A/c

Particulars	Rs.	Particulars	Rs.
To Purchase	50,000	By Y (sale proceeds)	30,000
To Bank (expenses)	2,500	By Y (goods for his use)	10,000
To Y (expenses)	6,500	By Purchases (goods)	11,000
		By Y (loss)	4,000
		By Profit and Loss A/c	4,000
		(Ratio being 1:1)	
	59,000		59,000

Y's Account

Particulars	**Rs.**	**Particulars**	**Rs.**
To Joint Venture (Sale)	30,000	By Joint Venture (Expenses)	6,500
To Joint Venture (goods)	10,000	By Bank	37,500
To Joint Venture (goods)	4,000	(Final Settlement)	
	44,000		44,000

Journal Entries in the Books of Y

Particulars		**L.F.**	**Dr. Rs.**	**Cr. Rs.**
Joint Venture A/c	Dr.		52,500	
To X				52,500
(Being the goods supplied and expenses incurred)				
Joint Venture A/c	Dr.		6,500	
To Bank				6,500
(Being the expenses paid)				
Bank	Dr.		30,000	
To Joint Venture A/c				30,000
(Being the receipt of sale proceeds)				
Drawing A/c	Dr.		10,000	
To Joint Venture A/c				10,000
(Being the goods withdrawn for own use)				
X	Dr.		11,000	
To Joint Venture A/c				11,000
(Being the taking over the balance stock in hand by X)				
X	Dr.		4,000	

Profit and Loss A/c	Dr.	4,000	
To Joint Venture A/c			8,000
(For sharing of loss in equal ratio)			
X	Dr.	37,500	
To Bank			37,500
(Being the draft remitted X)			

Joint Venture A/c

Dr. Cr.

Particulars	Rs.	Particulars		Rs.
To X (goods supplied)	50,000	By Bank (by sales)		30,000
To X (expenses)	2,500	By Drawing of goods		10,000
To Bank (expenses)	6,500	By (Balance stock taken by X)		11,000
		By X	4000	
		P & LA/c	4000	
		(Loss)		8,000
	59,000			59,000

X's A/c

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Joint Venture A/c	11,000	By Joint Venture A/c	52,500
		(Good and expenses)	
To Joint Venture A/c (Loss)	4,000		
To Bank	32,500		52,500
	52,500		

B) Memorandum Joint Venture Account Method

In the method discussed above each co-venturer records all transactions relating to the joint venture in the Joint Venture Account opened in his books. But, under the Memorandum Joint Venture Account Method each co-venturer will record only those transactions relating to the joint venture which are directly concerned with him and not those of others.

a) Under this method each co-venturer opens a Joint Venture Account including the name of the other co-venturer. The heading of the account is 'Joint Venture with (name of co-venturer) Account'. The Joint Venturer with (name of co-venturer) Account is a personal account and it does not show any profit or loss. The following entries will be made in this account :

i) Joint Venture with................................ Account Dr.

To cash/Bank/Creditors Account

(Being payments by cheque or cash or liabilities incurred on Joint Venture)

ii) Cash/Debtors Accounts Dr.

To Joint Venture................ Account

(Being sale Cash/Credit made on account of Joint Venture)

b) A separate 'Joint Venture Memorandum Account' is prepared to ascertain profit or loss in Joint Venture. It is just like profit and loss account, all the expenses and losses are debited to it and all incomes and gains are credited to it. All the items of personal accounts will also appear on the same side of 'Joint Venture Memorandum Account'. The balance of Joint Venture Memorandum Account shows profits or loss on joint venture and each party makes an entry for his share of profits or losses. The journal entry is as under :

Joint Venture with...................... Account Dr.

To Profit and Loss Account

(Being profit earned on Joint Ventures)

Or

Profit and Loss Account Dr.

To Joint Venture with.................... Account

(Being loss effected on Joint Venture)

Illustration - 2

A and B entered into a Joint venture involving the buying and selling ofold railway material with an agreement to share profit or loss equally. (*The amount is in Rs. Hundreds*). The cost of the material purchased was Rs. 30,000 which was paid by A, who drew bill of Rs. 20,000 on B at three months' period.

The bill was discounted by A at cost of Rs. 160. The transactions relating to the ventures were:

1) A paid Rs. 200 for carriage, Rs. 600 for commission on sales and Rs.100 for travelling expenses (ii) B paid Rs. 80 for travelling expenses and Rs. 120 for sundry expenses (iii) Sales made by A amounted to Rs. 21,400 less allowance for faulty goods Rs. 400 and (iv) Sales made by B were Rs. 15,000.

The remaining goods were retained by A and B for their private use and thesewere charged to them as Rs. 1600 and Rs. 2400 respectively. A was credited with sum of Rs. 300 to cover the cost for warehousing and insurance. The expenses in connection with the discounting to the bill were to be treated as a charge against the venture. Prepare the ledger accounts in the books of boththe parties and also the memorandum joint venture account.

Solution

Dr. **Memorandum Joint Venture A/c** Cr. (Rs. In 000)

Particulars	**Rs.**	**Particulars**	**Rs.**
To Materials	30,000	By Sales	36,000
To discount on Bill	160	(21000 + 15000)	

To carriage	200	By stock taken by		
To Commission	600	A	1600	4,000
To Travelling (100+8)	180	B	2400	
To Sundry expenses	120			
To Warehousing expenses	300			
To Profit				
A : 4220				
B : 4220	8,440			
	40,000			40,000

In the Books of A

Joint Venture with B A/c

(Rs. in 000)

Dr. Cr.

Particulars		Rs.	Particulars	Rs.
To Bank (material)		30,000	By Bank (sales)	21,000
To discount on bill		160	By Stock taken	1,600
To Bank			By Balance c/d	12,980
Carriage	200			
Commission	600			
Travelling exp.	100			
Warehousing	300	1,200		
By Profit & Loss A/c		4,220		
		35,580		35,580
To Balance b/d		12,980		

In the Books of B

Joint Venture with A A/c

Dr. Cr.

(Rs. in '000)

Particulars		Rs.	Particulars	Rs.
To Bank			By Bank (Sales)	15,000
Travelling Exp.	80		By Stock taken	2,400
Sundry Exp.	120	200		
To Profit & Loss A/c		4,220		
To Balance c/d		12,980		
		17,400		17400
			By Balance b/d	12980

Sometimes the co-venturers invest money in Joint venture business and receive back the amounts on different dates. It is quite usual for them to agree to calculate interest at a certain rate. Each co-venturers is entitled to receive interest on the amounts invested by him and pay interest on the amounts received by him. Only net interest receivable from or payable to the conventurer is recorded in the joint venture account. Thus, the net amount of interest is also taken into amount before ascertaining the profit or loss on joint venture.

Illustration 3

A and B enter into a joint venture sharing profits and losses equally. A purchased goods for Rs. 5,000 for cash on January 1, 1999. On the same day Bought goods for Rs. 10,000 on credit and spend Rs. 1,000 on freight etc. Further expenses were incurred as follows:

On 1.2.1999	Rs. 1,500 by B
On 12.3.1999	Rs. 500 by A

Sales were made by each one of them as follows:

15.1.1999	Rs. 3,000 by A

13.1.1999	Rs. 6,000 by B
15.2.1999	Rs. 3,000 by A
1.3.1999	Rs. 4,000 by B

Creditors for goods were paid as follows

1.2.1999	Rs. 5,000 by A
1.3.1999	Rs. 5,000 by B

On March 31, 1999 the balance of stock was taken over by B at Rs. 9,000. The accounts between the co-venturers were settled by cash payment on this date. The co-venturers are entitled to interest at 12% per annum. Prepare necessary ledger accounts in the books of venturers as per Memorandum Joint Venture Account Method.

Solution:

Memorandum Joint Venture Account

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To A (cost of goods)	5,000	By A (sales)	6,000
To B (Cost of goods)	10,000	By B (sales)	10,000
To B (Freight etc.)	1,000	By B (interest)	50
To A (expenses)	500	By B (stock taken)	9,000
To B (expenses)	1,500		
To A (interest)	135		
Profit transferred			
A : 3457			
B : 3458	6,915		
	25,050		25050

Joint Venture with B Account

Dr. Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1999			1999		
Jan. 1	To Bank A/c (Purchase)	5,000	Jan 15	By Bank A/c (Sales)	3,000
Feb. 1	To Bank A/c (Creditors)	5,000	Feb. 15	By Bank A/c (Sales)	3,000
Mar. 1	To Bank A/c (Expenses)	500	Mar. 15	By Bank A/c (Final settlement)	8,902
Mar. 31	To Interest a/c	135			
Mar. 31	To Profit & Loss A/c	3,457			
		14,092			14,902

B's Books

Joint Venture with A Account

Dr. **Cr.**

Date	Particulars	Rs.	Date	Particulars	Rs.
1999			1999		
Jan 1	To Bank A/c (Freight)	1,000	Jan 31	By Bank (Sales)	6,000
Feb. 1	To Bank A/c (Exp)	1,500	Mar. 31	By Bank (sales)	4,000
Mar. 1	To Bank A/c (Crs)	5,000	Mar. 31	By Goods A/c Stock taken over	9,000
Mar. 31	To Profit & Loss A/c	3,458	Mar. 31	By Interest A/c	50

Mar. 31	To Bank A/c	8,092	
	(Amt. Paid in		
	Final Statement)	19,050	19,050

Calculation of Interest:

Payment by A

Date	Amount	Month	Product (Rs.)	
1.1.99	Rs. 5,000	3	15,000	(5,000 x 3)
1.3.99	Rs. 500	1	500	(500 x 1)
1.2.99	Rs. 5,000	2	10,000	(5,000 x 2)
			25,000	

Interest = 25,500 x $\frac{12}{100}$ x $\frac{1}{12}$ = Rs. 255

Receipts by A

15.1.99	Rs. 3,000	2.5	7,500	(3,000 X 2 ½)
15.2.99	Rs. 3,000	1.5	4,500	(3,000 x 1 ½)
			12,000	

Interest = 12,000 x 12/100 x 1/12 = 120 Net Interest due = 265 - 120 = Rs. 135

Payment by B

1.1.99	Rs. 1,000	3	3,000
1.2.99	Rs. 1,500	2	3,000
1.3.99	Rs. 5,000	1	5,000
			11,000

Interest = 11,000 x 12/100 x 1/12 = Rs. 110

Receipts by B

31.1.99	Rs. 6,000	2	12,000
1.3.99	Rs. 4,000	1	4,000
			16,000

Interest = 16,000 x 12/100 x 1/12 = Rs. 160 Net

Interest due from B = 160 - 110 = Rs. 50

C) Separate Books

Recording of transactions is done not in books of parties but in a separateset of books. Co-venturer first contributes to a common bank account and then all payments are made through it. Accounts of parties are also opened. Profit or Loss on Joint Venture is transferred to the respective partner's accounts in due ratios. Finally, the books are closed with the close of the venture.

Three main accounts opened under separate set of accounts are:

1. Joint Venture Account
2. Joint Bank Account, and
3. Personal Capital Accounts of Joint Venturers.

The following entries will be passed under this system

1) When cash is invested by Joint Venturer

Joint Bank A/c Dr.

To Capital Accounts of Joint Venturers.

(Being cash invested by Joint Venturers and deposited into the Bank)

2) When purchases are made for joint venture out of bank A/c

Joint Venture A/c Dr.

To Joint Bank A/c

(Being Purchase made for Joint Venture)

3) When expenses are incurred for joint venture out of Bank A/c

Joint Venture A/c Dr.

To Joint Bank A/c

(Being expenses incurred for Joint Venture Account)

4) When sales are made

Joint Bank A/c Dr.

To Sales

(Being sales made and receipts from sales deposited into Bank)

5) When some products are left unsold and are taken away by Joint Venturers

Capital accounts of Joint Venturer A/c Dr.

To Joint Venture A/c

(Being unsold stock taken by Joint Venturers)

6) (a) For Profit on Joint Venture account

Joint Venture A/c Dr.

To capital accounts of Joint Venturers A/c

(Being profit earned on Joint Venturers)

6 (b) The reverse entry will be passed in cases of losses on Joint Venture.

Illustration 4

X and Y enter into joint venture to underwrite public issue of Reliance Ltd. They agree to guarantee the subscription at par on 1,00,000 shares of Rs. 10 each of Reliance Ltd. and sharing profits and losses in the ratio of 2:3. The terms with the company are 4.5 % commission payable in cash and 6,000 fully paid shares of the company. They agreed to pay expenses in connection with the issue of shares. The expenses incurred are advertisement Rs. 5,000; Printing and stationery Rs. 2,000 and postage Rs. 600. All expenses are paid by X. The public subscribed to 88,000 shares only. The remaining shares under the agreement were duly taken by X and Y who provided the necessary cash equally. The commission is received in cash and is shared by the co-venturers in the ratio of 4:5. The entire holding of the joint venture is then sold in the market through brokers as follows:

25% at a price of Rs. 9 per share,

50% at a price of Rs. 8.75 per share,

15% at a price of Rs. 8.50 per share and

the remaining 10% is taken over by A and B equally at an agreed price of Rs. 8 per share.

Prepare the Joint Venture Account, Joint Bank Account, Shares Account and the Accounts of X and Y showing the final statement.

Solution:

Joint Venture Account

Dr. Cr.

Particulars		Rs.	Particulars	Rs.
To			By Joint A/c	45,000
Advertisement	5000		(commission)	
Printing	2000		By shares a/c	60,000
Postage	600	7,600	(commission)	
To Shares A/c		23,400		
(Loss on sale)				
To profit transferred to				
X:	29,600			
Y:	44,400	74,000		
		1,05,000		1,05,000

Joint Bank Account

Dr. Cr.

Particulars		Rs.	Particulars	Rs.
To X (contribution)		60,000	By Shares A/c	1,20,000
To Y (contribution)		60,000	By X (commission)	20,000
To Joint Venture		45,000	By Y (commission)	25,000
(Commission)			By X (final settlement)	70,000
To Shares A/c (sale for			By Y (final settlement)	72,000
cash) 25%	40,500			

50%	78,750			
15%	22,950	1,42,200		
		3,07,200		3,07,200

Share Account

Particulars	Rs.	Particulars	Rs.
To Joint Bank a/c	1,20,000	By Joint Bank A/c (Sale of Shares)	40,500
To Joint Venture (commission)	60,000	By Joint Bank A/c (sale of shares)	78,750
		By Joint Bank A/c (Sale of shares)	22,950
		By X (shares taken over)	7,200
		By Y (shares taken over)	7,200
		By Joint Venture A/c	23,400
	1,80,000		1,80,000

X's Account

Particulars	Rs.	Particulars	Rs.
To Joint Bank A/c (Commission)	20,000	By Joint Venture A/c (Expenses)	7,600
To Shares A/c	7,200	By Joint Bank A/c (Commission)	60,000
To Joint bank A/c (Final Settlement)	70,000	By Joint Venture A/c (Profit)	29,600
	97,200		97,200

Y's Account

Particulars	Rs.	Particulars	Rs.
To Joint Bank A/c (Commission)	25,000	By Joint Bank A/c (Commission)	60,000
To Shares A/c	7,200	By Joint Venture A/c (Profit)	44,400
To Joint Bank A/c (Final Settlement)	72,200		
	1,04,400		1,04,400

Working Notes

1. Distribution of commission received in cash 4.5 % of Rs. 10,00,000 = Rs. 45,000

   Xs shares 4/9 x 45,000 = Rs. 20,000 Y's shares 5/9 x 45,000 = Rs. 25,000

2. Treatment of shares received

   Shares received by way of commission 6,000

   Shares not subscribed by public 12,000

   Total Number of shares received 18,000

a) Sold for cash

25% of 18,000 i.e. 4,500 shares sold @ Rs. 9 per share Rs. 40,500

50% of 18,000 i.e. 9,000 shares sold @ Rs. 8.75 per share Rs. 78,750

15% of 18,000 i.e. 2,700 shares sold @ Rs. 8.50 per share Rs. 22,950.

b) Dividend amongst X and Y

10 % of the remaining shares i.e. 1,800 shares are taken over equally by X and Y at an agreed price of Rs. 8 per share.

X : 900 shares @ Rs. 8 per share = Rs. 7200

Y : 900 shares @ Rs. 8 per share = Rs. 7200

3.4 CHECK YOUR PROGRESS

a. Joint venture account is a ____________.

b. The parties to joint venture are called ________________.

c. When co-ventures initially contribute for a joint venture which account should be debited in case when separate set of books are maintained.

d. X maintains all records in his books. X spends Rs.10000 in Cash on account of joint venture. Which account would be credited in the Books of X.

e. If any stock is taken over by the venturer, it will be treated as an ______________.

3.5 SUMMARY

A joint venture is a contractual arrangement between two or more partiesto undertake an economic activity, which is subject to joint control, i.e., agreed sharing of power to govern the financial and operating policies of an economic activity, so as to obtain benefits from it. A joint venture arises because of the limitations of a person due to constraint of available time, money expertise to execute a job etc. Despite broad similarities between joint venture and partnership, the two types of business differ considerably. A joint venture can also be distinguished from the consignment although both forms of business arise because of inherent limitations of a person to undertake a business effectively on his own. It is necessary to maintain proper accounts of all transactions of joint venture so that correct profit or loss on joint venture maybe ascertained. The main methods of recording joint venture transactions are by creating an independent set of books of the joint venture which do not formpart of the accounting system of an co-venturer, to record all the transactions of the joint venture, whether, entered by himself or by his co-venturer and to record only those transactions of the joint venture in which he himself features.

3.6 KEYWORDS

Joint Venture: When two or more persons joint together to carry out a specific business and share the profits or losses on predetermined basis, it is known as a joint venture.

Co-venturer Account: It is a personal account and debited with sales made by the co-venturer or goods taken by him and is credited with assets given by him for the venture and expenses paid by him.

Memorandum Joint Venture Account: The profit or loss of the venture is computed in an account which is not part of the double entry mechanism and is termed as Memorandum Joint Venture Account.

3.7 SELF ASSESSMENT TEST

1. Define a joint venture and give its various features. Name the different methods used to record joint venture transactions.

2. Distinguish joint venture from consignment and partnership.

3. Give the various journal entries to be passed in case where separate set of books are maintained for recording joint venture transactions.

4. What is a Memorandum Joint Venture Account? Give the various journal entries when accounts are maintained under this method.

5. Give the various journal entries to be passed in case where no separate set of books are maintained for recording joint venture transactions.

6. Ramesh and Suresh entered into a joint venture to purchase and sell hosiery goods. Profit and losses were to be shared equally. Ramesh financed the venture and Suresh undertook the sales on a commission of 5% on the sales proceeds. Ramesh purchased goods to the value of Rs. 50,000 less 5% trade discount, paid freight Rs. 1,500 and advanced Rs. 1,200 to Suresh to meet expenses. Suresh expended for carriage Rs. 300, rent Rs. 450, advertisement Rs. 200 and sundries Rs. 150. Sales made by Suresh amounted to Rs. 67,500. It was agreed that Ramesh should receive Rs. 2,500 as interest.

   Remaining unsold goods costing Rs. 2,500 were retained by Suresh and those were charged to him at a price to show the same rate of gross profit (without charging any expenditure) as that made on the total sales (excluding those goods taken).

   Give journal entries in the books of Ramesh and Suresh and also prepare the necessary ledger accounts in their books.

7. Vikas and Vishal entered into a joint venture of underwriting 1,00,000 shares of Rs. 10 each at par issued by a joint stock company. The consideration for underwriting the shares was 2,500 other shares of Rs. 10 each fully paid to be issued to them.

   The public took up 90,000 shares and the remaining 10,000 shares of the guaranteed issued were taken up by Vikas and Vishal who provide cash equally for the purchase of remaining shares. The entire share holding of the joint venture was then sold through other brokers: 50% at a price of Rs. 10 less brokerage 50 paise per share; 20% at Rs. 9.50 less brokerage 50 paise per share and the balance were taken up by Vikas and Vishal equally at Rs. 9 per share. Expenses on account of joint venture were: advertisement Rs. 750 and other expenses Rs. 250. You are required to prepare; (a) Joint Venture Account; (b) Joint Bank Account; and (c) Accounts of Vikas and Vishal.

8. A and B entered into a joint venture for the purchase and sale of materials auctioned by the Government. A agreed to provide funds for the purchase of materials, and B to devote his time. The profit and loss was to be shared equally, subject to a credit of Rs. 500 to A by way of interest on his capital. A purchased materials worth Rs. 50,000; and drew a bill at two months for Rs. 20,000 on B which was duly accepted by the latter. The bill was discounted at a cost of Rs. 260. The various expenses relating to the venture were:

a) A paid Rs. 250 for carriage, Rs. 100 for brokerage, and Rs. 50 for miscellaneous expenses.

b) B paid Rs. 300 for commission, Rs. 200 for insurance, and Rs. 100 for miscellaneous expenses.

c) The total sales amounted to Rs. 72,000 (cash). There was, however, some stock of unsold goods which was taken over by both the parties, at Rs. 200 by A and at Rs. 300 by B. B paid the amount due to A. The expenses in connection with the discounting of the bill were to be treated as a charge against the venture.

Prepare Joint Venture Account in the books of A and B separately and a Memorandum Joint Venture Account.

9. C of Calcutta and D of Delhi entered into a joint venture for the purpose of buying and selling second-hand motor cars, C to make purchases and D to effect sales. The profit or loss was to be shared as to C two-fifths and D three-fifths. A sum of Rs. 10,000 was remitted by D to C towards the venture.

C purchased 10 cars for Rs. 8,000, paid Rs. 4,350 for their reconditioning and sent them to Delhi. His other expenses were -Buying Commission 2½ per cent and Sundry Expenses Rs. 350.

D took delivery of the cars by paying Rs. 750 for railway freight and Rs. 375 for octroi. He sold four cars at Rs. 1,600 each, two at Rs. 1,800 each and three at Rs. 2,250 each. He retained the remaining car for himself at an agreed value of Rs. 2,100. His expenses were-Insurance Rs. 150; Garage Rent Rs. 250; Brokerage Rs. 685; Sundries Rs. 450.

Each party's ledger contains a record of his own transactions on joint account. Prepare a statement showing the result of the venture and the account of the venture in each party's ledger as it will finally appear, assuming that the matter was finally settled between the parties.

3.8 ANSWERS TO CHECK YOUR PROGRESS

a. Nominal Account
b. Co-venturers
c. Joint Bank A/c
d. Cash Account
e. Income of the joint venture

3.9 REFERENCES/SUGGESTED READINGS

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7. Financial Accounting by Shashi K. Gupta, Nisha Aggarwal and Neeti Gupta, Kalyani Publishers, Ludhiana.

Course Code: **BCOM 201**	Author: **Prof. Suresh Kumar Mittal**
Lesson No: **4**	SLM Conversion By**: Ms. Chand Kiran**

BRANCH ACCOUNTING

STRUCTURE

4.0 LEARNING OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning and types of Branches.
- To know the need and nature of Branch Accounting.

- To understand the different systems of Branch Accounting.

4.1 INTRODUCTION TO BRANCH ACCOUNTING

Every business organization aims to increase its sales volume and profits for which a business organization takes different steps/actions. One of the actions is to open the branches. The branches are controlled by the head office and branches may locate in the home country or outside the country. A branch means any subordinate subdivision of a business. As per Companies Act, a branch is any establishment carrying on either the same or substantially the same activity as that is carried on by the head office of the company. For example Tata 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. It must also be noted that the concept of a branch means existence of head office which controls all the branches.

4.1.1 NATURE OF BRANCH ACCOUNTING

- It is a system where separate books of accounts are maintained for each branch.
- In this system Head office and each branch is treated as a separate entity.
- It helps to ascertain the performance of each branch separately which helps to take the necessary action.
- It Increases the expenses of the company because of manpower, Infrastructure or operational expenses.
- It ascertains the profit or loss of each branch.

4.1.2 TYPES OF BRANCHES

The branches can be divided into following categories:

- Dependent Branches
- Independent Branches
- Foreign Branches

Dependent Branches:

Dependent branches are those branches which are not keeping the full system of accounting. The following are the key features of branch accounting:

- The dependent branches are not allowed to make any purchases and they sell goods received from the head office only.
- 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.

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 realized and can have the bank account on their own name.

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.

4.1.3 DIFFERENCE BETWEEN BRANCH ACCOUNTING AND DEPARTEMENTAL ACCOUNTING

BASIS OF DIFFERENCE	DEPARTMENTAL ACCOUNTING	BRANCH ACCOUNTING
Linkage	Departments are attached with the main organization under a single roof.	Branches are separate from the main organization.
Results of	Departments are the results of fast human life.	Branches are the outcomes of the tough competition and expansion of the business.
Geograpgical	Departments are not geographically	Branches are geographically separated.

location	separated.	
Types	There is no classification of departments.	The branches may be dependent or independent.
Allocation of expenses	Allocation of departmental common expenses is a tough job.	There is no need of allocation of branch expenses.
Reconciliation	In departmental accounts, no reconciliation is required because there is no central account division.	To find out the net result of organization the reconciliation of different branch is a main job.
Trading	Departmental trading with their head office is conducted under the same roof although each department deals with separate line of activity.	Branch trading is conducted in different parts of the country under the head office dealing with usually the same line of activity.
Prfoitability	The profitability position of department is seen within the larger picture of a parent organizational profits.	The profitability of each branch is equally important and seen separately.
Methods of preparation of accounts	There are only two methods: Separate set of books are maintained Separate set of books are not maintained.	There are various methods of preparation of accounts like Stock and debtors system Debtors system Final accounts system Wholesale price system
Accounts maintained	The accounts maintained are; Departmental trading and profit and loss account General profit and loss	The accounts maintained are: Branch stock account Branch adjustment account Branch debtors account Branch expenses

	account	account
Functional division	Functional division is possible in case of departmental concerns.	It is not possible in case of branch.
Control	The chief executive who is to keep a constant watch over the department supervisor closely and supervises effectively.	Control is impracticable in case of a far off branch since it is not possible for the head office to keep instant watch.
Reconciliation of results	Departmental accounting presents the trading results of each individual department.	Branch accounts present the trading results of each individual branches.
Nature	Departmental accounting is practically a segment of accounts.	Branch accounts are a condensation of accounts.
Expensive	These are comparatively less costly as a small team of accountants can be appointed to maintain the accounts.	Branch accounts are costly to maintain as it involves a big team of accountants to maintain accounts for each branch.

4.1.4 SYSTEMS OF ACCOUNTING

As we discussed earlier dependent branches do not keep a complete set of books. The head office is responsible to keep the books of accounts for dependent branches. The following are the key methods which are adopted by head office to keep the branch accounts:

4.1.4.1 Debtors or Direct System:

This system of accounting is used for those branches which are small in size. Under this system, the head office simply opens a Branch Account for each branch in which it records all transactions relating to the branch. Branches are also not required to ascertain profit or loss as no information relating to the cost of sales is given to them.

Journal Entries under Debtors or Direct System:

Situation	Journal
To record Opening Balances of Branch Assets	Branch A/c Dr. To Branch Assets A/c
To record Opening Balances of Branch Liabilities	Branch Liabilities A/c Dr. To Branch A/c
When goods are supplied by the Head Office/ another Branch to Branch	Branch A/c Dr. To Goods sent to Branch A/c
When goods are returned by the Branch / Branch Customers directly to the Head Office	Goods Sent to Branch A/c Dr. To Branch A/c
When goods are supplied by the Branch to another Branch as per instructions of Head office	Goods Sent to Branch A/c Dr. To Branch A/c
When goods are supplied by the Head office but not received by the Branch head	Goods-in Transit A/c Dr. To Branch A/c
When the Head Office meets the branch expenses or sends cash to the Branch for meeting expenses	Branch A/c Dr. To Cash/Bank A/c
When remittances are received by the Head Office from the Branch/ Branch Customers	Cash/Bank A/c Dr. To Branch A/c
When remittances are sent by the Branch but not received by the Head office	Cash in-transit A/c Dr. To Branch A/c
When the balance in Goods sent to Branch Account is transferred	Goods sent to Branch A/c Dr. To Purchases A/c

	(in case of Trading concerns) or, To Trading A/c (in case of manufacturing concerns)
To record the closing balances of Branch Assets	Branch Assets A/c (Individually) Dr. To Branch A/c
To record the closing balances of Branch Liabilities	Branch A/c Dr. To Branch Liabilities (Individually)
To record Profit & Loss (a) If credit side exceeds the debit side (b) If debit side exceeds the credit side	Branch A/c Dr. To General Profit & Loss A/c General Profit & Loss A/c Dr. To Branch A/c

Performa of Branch Account:

Particulars	Amount	Particulars	Amount
To Opening Balance Stock Debtors Petty Cash Furniture Prepaid expenses To goods sent to branch A/c To Bank A/c (for expenses)		By opening balances O. S. expenses Creditors By bank A/c Cash sales Collections from debtors By goods sent to branch A/c (for goods returned by branch)	
To closing balances		By closing balances	

O. S. expenses Creditors To profit transferred to profit and loss A/c		Stock Debtors Petty Cash Furniture (less depreciation) Prepaid expenses By loss transferred to profit and loss A/c	

Example:

Godrej Ltd. has a branch at Delhi. Branch remits daily cash receipts to the Head Office and all expenses of the branch are paid by the Head Office directly. Pass journal entries and prepare Branch Account in the books of Head Office from the following particulars as on 31st March, 2019.

		₹
Stock at Branch on 1st April, 2018		25,000
Goods Supplied to Branch during the year		2,40,000
Goods returned by Branch		14,000
Cash sent to branch for		
Rent		4,500
Salaries	12,000	
Advertisement	3,500	
Cash sent to Branch for petty expenses	1,800	
Cash received from the branch during the year	2,51,000	
Cash sent by branch on 28th March, 2019 still in transit	12,000	
Stock at branch on 31st March, 2019	32,000	
Balance of Petty Cash on 31st March, 2019	500	
Outstanding Rent on 31st March, 2019	1,500	
Outstanding Salaries on 31st March, 2019		3,000

Books of Head Office

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			₹	₹
	Delhi Branch A/c Dr. To Opening Stock at Branch A/c (Opening balance of branch stock)		25,000	25,000
	Delhi Branch A/c Dr. To Good Supplied to Branch A/c (Goods sent to branch)		2,40,000	2,40,000
	Good Supplied to Branch A/c Dr. To Delhi Branch A/c (Goods returned by branch)		14,000	14,000
	Delhi Branch A/c Dr. To Cash A/c (Amount sent to branch for expenses)		20,000	20,000
	Delhi Branch A/c Dr. To Cash A/c (Amount sent to branch for petty expenses)		1,800	1,800
	Cash A/c Dr. To Delhi Branch A/c (Cash received from branch)		2,51,000	2,51,000
	Cash in Transit A/c Dr. To Delhi Branch A/c (Cash sent by branch still in transit)		12,000	12,000
	Closing Stock A/c Dr. Petty Cash A/c Dr. To Delhi Branch A/c (Closing balances at branch)		32,000 5,00	32,500

	Delhi Branch A/c Dr. To Outstanding Rent A/c To Outstanding Salary A/c (Rent and salary outstanding at branch)		4,500	1,500 3,000₹
	Delhi Branch A/c Dr. To General Profit & Loss A/c Profit transferred to General Profit & Loss A/c		18,200	18,200
	Goods Supplied to Branch A/c Dr. To Trading A/c (Balance of Goods supplied to branch transferred to Trading A/c)		2,26,000	2,26,000

Dr. **Delhi Branch Account** **Cr.**

Particulars	**Amount**	**Particulars**	**Amount**
	₹		₹
To Opening Stock A/c	25,000	By Goods Supplied to Branch A/c	
To Goods Supplied to Branch A/c	2,40,000	(Goods returned by branch)	14,000
To Cash A/c (Expenses)	20,000	By Cash A/c	2,51,000
To Cash A/c (Petty Cash)	1,800	By Cash in Transit A/c	12,000
To Outstanding Rent A/c	1,500	By Closing Stock A/c	32,000
To Outstanding Salary A/c	3,000	By Petty Cash A/c	500
To General Profit & Loss A/c	18,200		
	3,09,500		3,09,500

Example: Vinod Limited has a branch at Goa. Goods are invoiced to Branch at cost plus 25%. The expenses of the Branch are paid by Head Office. Branch keeps a Sales Journal and the debtor's ledger only. From the information supplied by the Branch, prepare Trading and Profit & Loss Account of the Branch for the year ending 31st December, 2019 and show the account of the Branch as it would appear in the books of the Head Office.

	₹
Opening Stock at Cost Price	1,18,000

Closing Stock at Invoice Price	1,03,000
Credit Sales	2,35,000
Cash Sales	96,000
Receipts from Debtors	2,56,000
Debtors on 31st December, 2019	58,000
Goods received from Head Office	2,26,000
Goods in transit from Head Office on 31st December, 2019	22,000
Expenses paid by Head Office for the Branch	49,000

Solution:

Trading and Profit & Loss Account

For the year ending 31st December, 2019

Particulars		**Amount**	**Particulars**		**Amount**
		₹			₹
To Opening Stock		1,18,000	By Sales:	₹	
To Goods Supplied from	₹		Cash Sales	96,000	
H.O,	2,26,000		Credit Sales	2,35,000	3,31,000
Add: Goods in Transit	22,000		By Goods in Transit	22,000	
	2,48,000		Less: 25/125 of ₹ 22,000	4,400	17,600
Less: 25/125 of ₹ 2,48,000	49,600	1,98,400	By Closing Stock	1,03,000	
To Gross Profit c/d		1,14,600	Less: 25/125 of 1,03,000	20,600	82,400
		4,31,000			4,31,000
To Expenses		49,000	By Gross Profit b/d		1,14,600
To Net Profit transferred to General Profit & Loss A/c		65,600			
		1,14,600			1,14,600

Dr. **Goa Branch Account** **Cr.**

Particulars		Amount	Particulars		Amount
To Balance b/d:	₹	₹			₹
Stock	1,18,000		By Goods sent to Branch A/c		
Debtors	79,000		(25/125 of ₹ 2,48,000)		49,600
		1,97,000	By Cash A/c:		
To Goods sent to Branch A/c:				₹	
Goods received by			Cash Sales	96,000	
Branch	2,26,000		From Debtors	2,56,000	3,52,000
Add: Goods in transit	22,000		By Balance c/d:		
To Cash A/c (Expenses)		2,48,000	Stock	1,03,000	
To Stock Reserve A/c:		49,000	Debtors	58,000	
25/125 of ₹1,03,000	20,600		Goods in Transit	22,000	1,83,000
Add: Adjustment for					
Goods in transit					
(25/125 of ₹ 22,000)	4,400				
To General Profit & Loss A/c		25,000			
		65,600			
		5,84,600			5,84,600

4.1.4.2 Stock and Debtor System:

When there is large number of transactions, this method is particularly maintained by the Head Office to make efficient control over the branches. Under this method, the number of accounts are opened which are mentioned below:

(a) Branch Stock Account (at invoice price);

(b) Branch Debtors Account;

(c) Branch Adjustment Account (for recording loading for goods and for ascertaining gross profit)

(d) Branch Profit and Loss Account (for ascertaining branch net profit)

(e) Goods Sent to Branch Account.

In addition to above, there are certain accounts which may also be opened; viz (a) Branch Expense Account; (b) Branch Cash Account; (c) Branch Fixed Asset Account (d) Abnormal Loss / Lost-in-Transit Account etc. Under this method, the most important account is the Branch Adjustment Account which helps to ascertain Gross Profit. It takes only the loading on Opening Stock, Closing Stock, and Goods Sent to Branch, Goods Returned by Branch, any abnormal loss, Surplus of stock etc.

Apparent Profit and Apparent Loss

An unusual increase or decrease in the value of stock arises at Branch Stock Account due to inaccurate prediction of the expected selling price of the goods which are invoiced by the H.O. Usually H.O. sent goods after charging certain percentage of profit. But in reality, the said goods are sold either at a higher or at a lower price rather than the price fixed by the H.O. for which Branch Stock Account shows either a surplus of stock which is known here as Apparent Profit or a Shortage of stock which is known as Apparent Loss. The said apparent profit or loss should be recorded as under.

(a) For Apparent Profit

Branch Stock A/c …………………….. Dr.

To Apparent Profit A/c

Apparent Profit A/c …………………….... Dr.

To Branch (Stock) Adjustment A/c

(b) In case of Apparent Loss, the entry will be reversed

Journal Entries under Stock and Debtor System:

No.	Transactions	Journal Entry
1	Goods sent to Branch by HO	Branch Stock Account (total Value of goods) Dr. To Goods sent to Branch (at Cost) To Branch Adjustment A/c (loading, if any)
2	Goods returned by Branch to HO	Goods sent to Branch Account (at Cost) Dr.

		Branch Adjustment A/c (loading, if any) Dr. To Branch Stock A/c (total value of goods)
3	Assets provided by HO to Branch either by way of fresh purchase or by way of transfer from HO	Branch Assets Account Dr. To (Main) Cash Account/Vendor Account [or] To (HO) Assets Account (in case of transfer)
4	Cash sent to Branch for expenses	Branch Cash Account Dr. To (Main) Cash Account
5	Cash Sales at the Branch	Branch Cash Account Dr. To Branch Stock Account
6	Credit Sales at the Branch	Branch Debtors Account Dr. To Branch Stock Account
7	Collection from Branch Debtors	Branch Cash Account Dr. To Branch Debtors Account
8	Sales Returns at the Branch	Branch Stock Account Dr. To Branch Debtors Account
9	Discounts / Bad Debts etc.	Branch Expenses Account Dr. To Branch Debtors Account
10	Various expenses incurred at Branch	Branch Expenses Account Dr. To Branch Cash Account
11	Branch Expenses directly met by HO	Branch Expenses Account Dr. To (Main) Cash Account
12	Remittances made by Branch to Head Office	(Main) Cash Account Dr. To Branch Cash Account
13	Goods Lost in Transit/Stolen etc.	Goods Lost in Transit A/c (at cost) Dr. Branch Adjustment (loading if any) Dr. To Branch Stock Account (total value of goods)
	At the End of the Year : Closing Entries	
14	Recording Closing Stock at Branch Excess of Sale Price over Invoice Price	Closing Stock at Branch Account (incl. Loading) Dr. To Branch Stock Account Branch Stock Account Dr. To Branch Adjustment Account
15	Recording Unrealised Profit on Closing Stock i.e. Stock Reserve (after this entry,	Branch Adjustment Account Dr. To Stock Reserve (closing)

	the Branch Adjustment Account will show Gross Profit)	**Note :** Stock Reserve on Opening Stock is credited to Branch Adjustment A/c.
16	Recording Gross Profit at Branch	Branch Adjustment Account Dr. To Branch P & L Account
17	Depreciation on Branch Assets, (if any)	Branch Expenses Account Dr. To Branch Assets Account
18	Transfer of Branch Expenses	Branch P & L Account Dr. To Branch Expenses Account
19	Recording Net Profit at Branch	Branch P & L Account Dr. To General P & L Account

Example: Alpha Limited Delhi invoices goods to their Branch at Patna at 20% above cost. Head Office pays all branch expenses except petty expenses which are met by the Branch. From the following particulars, prepare necessary accounts under the Stock and Debtors system in the Head Office books:

₹

Stock at Invoice Price on 1st April, 2016	2,91,000
Branch's Debtors on 1st April, 2016	1,02,000
Petty Cash on 1st April, 2016	9,000
Goods Sent to Branch at Invoice Price	11,40,000
Cash Sales	4,76,000
Credit Sales	7,77,000
Goods returned by Branch	66,000
Allowances to Customers	8,000
Discount Allowed	11,000
Goods returned by Customers	35,000
Bad debts	13,500
Salaries and Wages	83,000

Rent & Rates	22,000
Selling & Advertisement Expenses	41,000
Cash received from Debtors	6,23,000
Stock at Invoice Price on 31st March, 2017	1,41,000
Petty Cash Balance on 31st March, 2017	6,500

Also verify the profit by preparing a Branch Account under direct method.

Dr. **Delhi Branch Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance b/d (Opening Stock)	2,91,000	By Cash A/c (Cash Sales)	4,76,000
To Goods sent to Branch A/c	11,40,000	By Branch Debtors A/c (Credit Sales)	7,77,000
To Branch Debtors A/c (Sales Return)	35,000	By Goods sent to Branch A/c	
		(Returned by Branch)	66,000
		By Shortage A/c (Balancing figure)	6,000
		By Balance c/d (Closing Stock)	1,41,000
	14,66,000		14,66,000

Dr. **Branch Adjustment Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Stock Reserve A/c		By Stock Reserve A/c	
(20/120 of ₹ 1,41,000)	23,500	(20/120 of ₹ 2,91,000)	48,500
To Shortage A/c (20/120 of ₹6,000)	1,000	By Goods sent to Branch A/c	
To Branch Profit & Loss A/c		[20/120 of ₹10,74,000	
(Gross Profit transferred)	2,03,000	(11,40,000 – 66,000)] (Return)	1,79,000
	2,27,500		2,27,500

Dr. **Branch Expenses Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹

To Petty Expenses	2,500	By profit & Loss A/c	1,81,000
To Allowances to Customers	8,000		
To Discount Allowed	11,000		
To Bad Debts	13,500		
To Salaries & Wages	83,000		
To Rent & Rates	22,000		
To Selling & Advertisement Expenses	41,000		
	1,81,000		1,81000

Dr. Branch Profit & Loss Account Cr.

Particulars	Amount	Particulars	Amount
	₹		₹
To Branch Expenses A/c	1,81,000	By Branch Adjustment A/c (Gross Profit)	2,03,000
To Shortage in Stock (₹6,000 – ₹1,000)	5,000		
To Net Profit	17,000		
	2,03,000		2,03,000

Dr. Branch Debtors Account Cr.

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance b/d	1,02,000	By Allowances A/c	8,000
To Credit Sales	7,77,000	By Discount A/c	11,000
		By Sales Return A/c	35,000
		By Bad Debts A/c	13,500
		By Cash A/c (Received from debtors)	6,23,000
		By Balance c/d (balancing figure)	1,88,500
	8,79,000		8,79,000

Dr. Branch Petty Cash Account Cr.

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance b/d	9,000	By Petty Expenses A/c	
		(Balancing figure)	2,500
		By Balance c/d	6,500
	9,000		9,000

Dr. Branch Account Cr.

Particulars		Amount	Particulars		Amount
		₹			₹
To Balance b/d (1st April, 2016):			By Stock Reserve A/c		
Stock	2,91,000		(20/120 of ₹ 2,91,000)		48,500
Debtors	1,02,000		By Goods sent to Branch A/c		
Petty Cash	9,000	4,02,000	(Returned by Branch)		66,000
To Goods sent to Branch A/c		11,40,000	By Goods sent to Branch A/c		
To Cash A/c:			[20/120 of ₹10,74,000		1,79,000
			(11,40, 000 – 66,000)]		
Salaries and Wages	83,000		By Cash A/c:	₹	
Rent & Rates	22,000		Cash Sales	4,76,000	
Selling & Advertisement			Cash Received		
Expenses	41,000	1,46,000	From Debtors	6,23,000	10,99,000
To Stock Reserve A/c			By Balance c/d (31st March, 2007):		
(201/20 of ₹1,41,000)		23,500	Stock	1,41,000	
To General Profit & Loss A/c		17,000	Debtors	1,88,500	
			Petty Cash	6,500	3,36,000
		17,28,500			17,28,500

4.1.4.3 Final Accounts System:

The profit or loss of a dependent branch can also be worked out by preparing a Memorandum Branch Trading and Profit & Loss Account. This account is prepared on the basis of cost of goods sent to the branch (not the invoice price). Apart from the Branch Trading and Profit & Loss Account, the head office also maintains the Branch Account. But, under this system, the Branch Account is in the nature of a personal account which shows only the mutual transactions between the head office and the branch, the balance of Branch Account, therefore, represents the net assets of the branch.Under this method, the profit or loss of the branch is ascertained by preparing the Branch Trading and Profit and Loss Account in place of Branch Account.

a) At cost price

Branch Trading and Profit & Loss account

Particulars	**Amount**	**Particulars**	**Amount**
To opening stock at branch(at cost)	Xxx	By sales made at branch	Xxx
To goods sent from head office xxx		(net of returns)	
	Xxx	-cash	Xxx
Less: Goods returned to H.o. xxx	Xxx	-credit	Xxx
To Purchase (made directly by branch if any)		By closing stock at branch	Xxx
	Xxx	(at cost)	
To direct expense at branch (if any)	Xxx		Xxx
To Gross Profit c/d	Xxx		
		By gross profit b/d	Xxx
	Xxx		
To various expenses incurred at branch			
(including bad debts if any)	Xxx		
	xxx		xxx
To general profit & loss acc.			
(net profit transferred)			

(b) At Invoice Price

If goods are invoiced above cost, the loading (i.e., profit element) on Opening Stock, Goods Sent from Head office (net of returns) and Closing Stock are reversed, to ascertain the true profits.

4.1.4.4 Wholesale Price System:

Sometimes the manufacturing organizations (head office) sell their products through wholesalers as well as through own branches. In case the head office decides two prices (i) Wholesale price; and (ii) retail price. Goods are supplied to the whole-seller and branches at wholesale price, that is, cost plus profit. The branches are supposed to sell these goods at retail price which is greater than the wholesale price. It means the branches earn more profit than the head office. But the total profit (Retail price-cost) cannot be considered as branch profit. The real profit of the branch shall be the difference between the wholesale price and retail price.

The wholesale price means cost plus profit. Therefore in the books of head office Branch Stock Account shall be maintained at wholesale price. At the end of the accounting period, the problem arises only when the goods received from head office remains unsold at branch, because it includes a part of profit which has been charged by the head office. To calculate the proportion of profit, the value of unsold goods shall be reduced from wholesale price to cost price. For instance, the cost price of a product is ₹100, the retail price is ₹160, and the wholesale price is ₹150. Now, under retail profit basis there will be a profit of ₹60 (i.e., ₹160 - ₹100) earned by the branch. But if it is sold under wholesale basis, the amount of profit will be ₹50. Usually, it is the usual practice to debit branch with wholesale profit basis to know the usual profit made by a branch. For this purpose, H.O. Trading account will be credited with goods sent to branch at wholesale price. At the same time, closing stock at branch should be valued as per wholesale price basis. For this, H.O. should make proper reserve on closing stock at branch. The journal entry will be

Profit & Loss A/c ……………… Dr. (Wholesale price - Cost price.)

To Stock Reserve A/c

Example: A head office fixes selling price for its goods at 200% of the cost. Goods are sent to the branch at 25% less than the selling price and to other dealers at 20% less than the selling price. Calculate the profit at the head office and at branch separately from the following information:

	₹	₹
Opening Stock	36,000	7,200
Purchases	2,40,000	–
Goods sent to Branch	67,500	–

Goods sent to Other Dealers	72,000	–
Sales to Customers	1,80,000	92,000
Expenses	40,000	4,000

Solution:

Cost Price, Say = ₹100

Selling Price = ₹200

Branch Price = ₹150 (200 – 200 x 25%)

Dealer's Price = ₹160 (200 – 200 x 20%)

Trading & Profit & Less Account

For the year ended ……..

Particulars	H.O.	Branch	Particulars	H.O.	Branch
	₹	₹		₹	₹
To Opening Stock	36,000	7,200	By Goods sent to Branch	67,500	–
To Purchases	2,40,000	–	By Goods Sent to other dealers	72,000	–
To Goods received from H.O.		67,500	By Sales	1,80,000	92,000
To Gross Profit c/d	1,39,500	23,000	By Closing Stock (Bal. figure)	96,000	5,700
	4,15,500	97,700	By Gross Profit b/d	4,15,500	97,700
To Expenses	40,000	4,000	By Stock Reserve	1,39,500	23,000
To Stock Reserve	1,900	–		2,400	
To Net Profit	1,00,000	19,000			
	1,41,900	23,000		1,41,900	23,000

Working Notes:

1. Calculation of Gross Profit:

	₹
H.O. Gross Profit on goods sent to Branch ₹ 67500 × $\frac{50}{150}$ =	22,500
Gross Profit on goods sent to Other Dealers ₹ 72,000 × $\frac{60}{160}$ =	27,000
Gross Profit on goods sold to Customers ₹ 1,80,000 × $\frac{100}{200}$ =	90,000

Total Gross Profit 1,39,500

2. Branch : Gross Profit on goods sold by branch = ₹ 92,000 × $\frac{50}{200}$ = ₹ 23,000

3. Unrealised Profit against opening branch stock = ₹ 7,200 × $\frac{50}{150}$ = ₹ 2,400

4. Unrealised Profit against closing branch stock = ₹ 5,700 × $\frac{50}{150}$ = ₹ 1,900

4.2 INDEPENDENT BRANCHES

When there are voluminous transactions in a Branch, they prepare the accounts independently. They purchase and sell goods independently and also sell the goods which are sent by H.O. As the branches are owned by H.O., the profit or loss so made by the branch is enjoyed by H.O. These branches prepare a Trial Balance, Trading and Profit and Loss Account and a Balance Sheet at the end of the year. As such, they maintain a Head Office Account and on contrary H.O. maintain a Branch Account. All sorts of transactions, e.g., remittance of cash, transfer of goods etc. are to be passed through these accounts.

Needless to say that where H.O. receives the accounts from the branches, it incorporates profit of the branches as –

Branch A/c……………………….. Dr.

To Profit & Loss A/c

Sometimes, the balance of branch account in H.O. books and H.O. accounts in branch books do not agree. If that be so, the same must be adjusted accordingly i.e., Goods-in-Transit or Cash-in-Transit etc. At last the Branch Balance Sheet is amalgamated with H.O. Balance Sheet by eliminating inter-branch/H.O. transaction as per the respective heads of assets and liabilities.

INDEPENDENT BRANCHES

Accounting Steps:

S No.	Transaction	HO Books	Branch Books
1.	Goods sent by H.O. to Branch	Branch A/c Dr. To Goods Sent to Branch A/c	Goods Recd. from H.O. A/c. Dr. To H.O. A/c

2.	Goods returned by Branch to H.O.	Goods Sent to Branch A/c Dr. To Branch A/c	HO A/c. Dr. To Goods Recd. From H. O. A/c
3.	Branch Expenses incurred at Branch Office	—	Expenses A/c Dr. To Cash / Bank A/c
4.	Branch expenses paid for by the Head Office	Branch A/c Dr. To Cash/Bank A/c	Expenses A/c. Dr. To H.O. A/c
5.	Purchases made from parties other than H.O. by Branch	—	Purchases A/c Dr. To Bank/ Creditors A/c
6 .	Sales effected by the Branch		Cash/Debtors A/c Dr. To Sales A/c
7.	Collection from Debtors received directly by the H.O.	Cash/Bank A/c Dr. To Branch A/c	H.O. A/c Dr. To Sundry Debtors A/c
8.	Payment by H.O. for Purchase made by the Branch	Branch A/c Dr. To Bank A/c	Purchases/Creditors A/c Dr. To H.O. A/c
9.	Purchase of Asset by Branch	—	Sundry Assets A/c Dr. To Bank/Liability
10.	Asset account maintained at H.O. and asset purchased by Branch	Branch Asset A/c Dr. To Branch A/c	H.O. A/c Dr. To Bank/Creditors A/c
11.	Depreciation when asset account is maintained by H.O.	Branch A/c Dr To Branch Asset A/c	Depreciation A/c Dr. To H.O. A/c
12.	Remittance of Funds by H.O. to Branch	Branch A/c Dr. To Bank A/c	Bank A/c Dr. To H.O. A/c
13.	Remittance of Funds to H.O. by Branch	Bank A/c Dr. To Branch A/c	Ho A/c Dr. To Bank A/c
14.	Transfer of Goods between different branches	Recipient Branch A/c Dr. To Supplying Branch A/c	(i) Supplying Branch A/c Dr. To Goods recd. from H.O. A/c (ii) Goods recd. from H.O. A/c Dr. To H.O. A/c
15.	Charging the Branch service charges by H.O.	Branch (Expenses) A/c Dr. To Service Charges A/c	Expense A/c Dr. To H.O. A/c
16.	Cash-in-transit	Cash-in-transit A/c. Dr. To Branch A/c.	Cash-in-transit A/c. Dr. To H.O. A/c.

17.	Goods-in-transit	Goods-in-transit A/c. Dr. To Branch A/c.	Goods-in-transit A/c. Dr. To H.O. A/c.

4.3 FOREIGN BRANCH

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate. Since the accounts are maintained in Foreign Currency they have to be translated into Reporting Currency i.e. the currency in which the Head Office transacts. Exchange rate of Reporting Currency in not stable in relation to foreign currencies due to international demand and supply effects on various currencies. Therefore, different rates are assigned to different transactions and balances upon translation.

Profit / Loss on Translation: Profit or Loss arising out of change in Exchange rate should be Credited/ Debited to the Profit and Loss Account for the current period.

Entries:

(a) For loss in Exchange :

Branch Profit & Loss A/c. Dr.

To, Difference in Exchange A/c.

(b) For Profit in Exchange :

Difference in Exchange A/c. Dr.

To, Branch Profit & Loss A/c

4.4 CHECK YOUR PROGRESS

1. The main establishment located at the main place of activity is called ____________.
2. Branch Account is ____________ in nature.
3. The subsidiary establishments located at various places are called ____________.
4. The Debtor System is generally adopted when the branch size is ____________ .
5. Stock and Debtor System is generally adopted when the branch is ____________ .

4.5 SUMMARY

Every business organization aims to grow in sales volume and profits for which a business organization takes different steps/actions. One of the actions is to open the different branches. The branches are controlled by the head office and branches may locate in the home country or outside the country. A branch means any subordinate subdivision of a business and may be dependent branches, independent branches and foreign branches. Dependent branches do not keep a complete set of books. The head office is responsible to keep the books of accounts for dependent branches. The following are the methods to keep the branch accounts:

1. Debtors or Direct System
2. Stock and Debtor System
3. Final Accounts System
4. Wholesale Price System

4.6 KEYWORDS

Dependent Branches: Branches which do not keep the complete record of accounts. Their complete accounts are maintained by Head Office.

Goods in Transit: The goods sent by the head office which do not reach the branch till closing of accounts.

Inter-Branch Transactions: Transactions which took place between all the branches.

Foreign-Branch: If head office opens a branch in foreign country, then it is called Foreign Branch.

Branch Adjustment Account:A account which is prepared for making the adjustment of Profit Margin included in different items of goods.

4.7 SELF ASSESSMENT TEST

Q1**)** What do you mean by Branch? Why there is need of Branches? Discuss the types of Branches?

Q2) Explain the objectives of maintaining the accounts of branches in detail.

Q3) Elaborate the different methods of keeping the accounts of dependent branches by the head office.

Q4) What do you mean by foreign branch? Explain the rules for the conversion of foreign branch currency to home currency?

Q5) What journal entries are made in the books of head office under Stock and Debtors System?

4.8 ANSWERS TO CHECK YOUR PROGRESS

Answers of learning activities:

1. Head Office
2. Nominal
3. Branch
4. Small
5. Large

4.9 REFERENCES/SUGGESTED READINGS

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Hire Purchase and Instalment Purchase System

STRUCTURE

5.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of Hire Purchase System and Instalment Purchase System.

- Understand the advantages and disadvantages of Hire Purchase System.
- Know the accounting treatment of Hire Purchase System and Instalment Purchase System.
- Distinguish between Hire Purchase System, Instalment Purchase System

  and Credit Sales.

5.1 Introduction

It is not always possible by a purchaser to meet up the higher demand for goods due to immediate cash payment. To meet this demand the concept of Hire Purchase is very popular in the market.When a person wants to acquire an asset but is not sure to make payment within a stipulated period of time he may pay in instalments if the vendor agrees. This enables the purchaser to use the asset while paying for it in instalments over an agreed period of time. This type of a business deal is known as hire purchase transaction.Here, the customer pays the entire amount either in monthly or quarterly or yearly instalments, while the asset remains the property of the seller until the buyer squares up his entire liability. For the seller, the agreed instalments include his interest on the assets given on credit to the purchaser. Therefore, when the total amount is paid in instalments over a period of time is certainly higher than the cash down price of the article because of interest charges. So, Hire purchase is a system for purchasing merchandise such as cars, furniture, etc., in which the buyer takes possession of the merchandise on payment of a deposit and completes the purchase by paying a series of regular instalments while the seller retains the ownership of the merchandise until the final instalment is paid.

5.1.1 Meaning and Definitions of Hire Purchase System

Hire Purchase is a kind of dealing under which the purchase of goods and assets is done on the basis of payment in instalments. These instalments can be monthly, quarterly, half- yearly or annual. In the begining, the purchaser gets only the possession of goods i.e. the right to use the goods but not the ownership. The ownership remains with the seller until the purchaser has paid the last instalment. In case of non-payment of any instalment, the goods are often taken back by the seller. In such a case, the instalments already paid by the purchaser are forfeited considering them as hire charges for using the goods. Therefore, this system is called Hire Purchase System and the purchaser is known as 'Hire Purchaser' whereas the seller is 'Hire Seller' or 'Hire Vendor'. The hire purchase transactions are governed by Hire Purchase Act, 1972.

Definitions:

According to Section 2 (C) of Hire Purchase Act, 1972, " Hire Purchase Agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

(i) possession of goods is delivered by owner thereof to a person on condition that such person pays the agreed amount in periodical instalments;

(ii) the property in the goods is to pass to such person on payment of the last of such instalments; and

(iii) such person has a right to terminate the agreement at any time before the property so passes".

According to William Pickles, "Hire Purchase System means a system in which payment of asset is made in instalments. During the period of instalments, the ownership of the asset remains with the vendor. The payments received before the receipt of last payment, are treated as hire and the purchaser cannot take possession of the ownership of asset until the last instalment has been paid."

According to J. R. Batliboi, "Under the Hire Purchase System, goods are delivered to a person who agrees to pay the owners by equal periodical instalments, such instalments are to be treated as hire of these goods, until a certain fixed amount has been paid, when these goods become the property of the hirer."

Characteristics of Hire Purchase System

The main characteristics of the hire purchase system are as follows:

1. Credit Sales: The goods are sold on credit basis and the payment for the goods is received in instalments.

2. Ownership of Goods: The ownership of the goods lies in the seller until the payment of the last instalment.

3. Payment in Instalments: In this system, the payment is made in instalments. The term and the amount of the instalments are mutually fixed by the hire purchaser and the seller. Often these instalments are monthly, quarterly, half- yearly or annual.

4. Delivery of Goods: The delivery of the goods is made to the hire purchaser at the time of the hire purchase agreement. The agreement should be in a written form and signed by the concerned parties.

5. Right to Use the Goods: Although the ownership of the goods remains with the seller till the payment of last instalment, the hire purchaser has the right to use the goods which he gets immediately on signing the agreement.

6. Responsibility of Hire Purchaser to Keep the Goods in Good Condition: As the hire purchaser does not become the owner of the goods even he must take care of the goods like his own goods. If the goods are damaged in any manner despite the minute observation made by the hire purchaser, the seller is liable for their repair.

7. Default in Payment of Instalments:

(i) Return of Goods: If any instalment is not paid by the hire purchaser, the seller has the right to take his goods back because the ownership rights over the goods remain with him till the payment of last instalment.

(ii) Right to Forfeit Instalments Received: If the hire purchaser does not pay any instalment, the seller can forfeit the instalments paid by him considering them as the hire charges of the goods.

(iii) Right to Claim for Outstanding Instalments: The seller has also got the legal right to claim for the outstanding instalments which become due at the time of receiving the goods back.

8. No Better Title to Third Party: As the hire purchaser keeps the goods as a Bailee until he has paid all the instalments, he cannot sell or pledge the goods. If he does so, the person who takes the goods on mortgage or purchases the goods from the hire purchaser cannot have the better title to goods, implying that if the hire purchaser does not pay the instalments, the seller can take back the goods from the concerned third party as well.

9. Right to Purchase the Goods under Rebate: The Act gives right to the higher purchaser to purchase the goods under rebate by sending a 14 days' notice to the Hire Vendor.

10. Right to Terminate the Agreement by Hire Purchaser: The hire purchaser can terminate the agreement by sending a written notice of 14 days to the seller. In this case, he is exempted from the payment of the instalments due to him by returning the goods to the seller.

11. Legal Status: Although it is a credit sale, the hire purchase system is governed by Hire Purchase Act, 1972 rather than Sale of Goods Act, 1930.

Advantages of Hire Purchase System

Hire Purchase System is beneficial not only for the hire purchaser and the hire vendor but also for the society at large. The advantages of this system are as follows:

A. Advantages to Purchaser:

1. **Facility of Payment in Instalments:** The price of the goods is paid in convenient periodic instalments which facilitate the hire purchaser.
2. **Use of Expensive Goods Possible:** This system enables even the people belonging to middle class to fulfil their long availed dreams of using expensive goods i.e. refrigerator, motor cycle, car etc.
3. **Encouragement to Savings:** The hire purchase system encourages the habit of savings among the purchasers as the price has to be paid in periodic instalments.
4. **Free Repairs:** The responsibility of the normal repairs of the goods lies with the vendor until the payment of the last instalment. Thus, the hire purchaser relishes the benefit of free repairs of the goods.
5. **Facility to Return the Goods:** If the utility of the goods reduces for the hire purchaser, he can return them by getting the agreement cancelled.

B. Advantages to Seller:

1. **Increase in Sales:** Owing to the characteristic of paying for the goods in periodic instalments, the hire purchase system boosts up the sales as well as the income of the hire seller.
2. **Convenient to Collect Instalments:** The hire seller does not have to face any difficulty in recovering the amount of instalments as the hire purchaser keeps paying off the instalments in due time owing to the fear of repossession of goods and the forfeiture of instalments already paid.
3. **Close Relation between Purchaser and Seller:** The regular transactions between the buyer and the seller lead towards a healthy rapport between them which is ultimately conducive in knowing the quality of the goods dealt in.

4. **Easy to Get Loan:** If the hire seller is in need of money, he can easily borrow it as he becomes credible in the eyes of the money lenders in the wake of his getting regular instalments from the hire purchaser.

5. **Sale of Other Goods:** This system also promotes the sale of the other goods dealt in by the same hire vendor due to his healthy rapport with the hire purchaser and regular meetings with him.

C. Advantages to Society:

1. **Increase in Standard of living:** Due to the hire purchase system, the middle class people can also have their access to the expensive goods. The possession of these goods raises their standard of living and the society becomes prosperous.

2. **Increase in Production:** Owing to the characteristic of the payment in periodic instalments, the hire purchase systems help in increasing the national production as well as national income.

3. **Increase in Employment:** This system fights with the problem of unemployment as the increased production is directly proportional to increase in employment.

4. **Increase in Revenue:** The increase in sales and production results in increased sales tax, excise duty and export which in turn increases revenue.

Disadvantages of Hire Purchase System

In addition to so many advantages, the hire purchase system also has some disadvantages to the hire seller, the hire vendor and the society as well. They are as follows:

A. Disadvantages to Purchaser:

1. **Purchase of Unnecessary Goods:** Sometimes, the hire purchaser buys the goods beyond his limit in the temptation of being facilitated by the payment in instalments but later on feels difficulty in paying them.

2. **Excess Payment:** Under this method, the hire purchaser has to make excess payment for the goods purchased as the hire purchase price is more than the cash price due to the inclusion of interest in it.

3. **Fear to Return the Goods:** In case of default in any instalment, the hire purchaser constantly remains in the fear of repossession of goods and forfeiture of the instalments already paid.

4. **No Right to Sell or Pledge the Goods:** In case of need of money, the hire purchaser has no right to sell or pledge the goods as the ownership of the goods remains with the hire vendor till the payment of last instalment.

5. **Mental Tension:** Sometimes, hire purchaser has to face mental tension due to non-payment of any instalment or uncertainty in the payment of remaining instalments.

B. Disadvantages to Seller:

1. **More Expensive:** This system is more expensive for the hire seller due to the excessive work load of accounting and constant correspondence with the customers.

2. **Requirement of More Capital:** Under this system, the increased sale of goods does not mean the equal revenue realisation as some amount always remains hanging in balance with the customers in form of due instalments. Hence, a huge amount of capital is required for the smooth running of the business.

3. **Difficulty in Collecting the Instalments:** On the face of it, it seems very easy to recover the amount of instalments in due time from the customers, but it is comparatively far more difficult on the ground level.

4. **Difficulty in Getting the Goods Back:** In case of any default in the payment of instalments, it is very difficult to take the goods back and the hire seller entangles in unnecessary disputes and litigation which is the wastage of both time and money.

5. **Unnecessary Burden of Repairing:** The hire vendor has to bear the burden of repairing until the payment of the last instalment which sometimes may be duplicate and may lead towards unnecessary disputes and court cases.

6. **To Bear the Loss of Depreciation of Goods:** In case of the breach of agreement, the hire vendor can take his goods back, but suffers the loss of depreciation on them. The amount of which in some cases is more than the amount realised in form of instalments plus down payment.

C. Disadvantages to Society: Under the temptation of hire purchase system, the middle class people may develop in themselves a tendency of purchasing luxurious items and being compelled to make the payment of instalments in due time, they have to curtail their genuine needs which in turn is harmful for the peace and harmony of the society.

Distinction between 'Hire Purchase System' and 'Credit Sales'

Sr. No.	Basis of Distinction	Hire Purchase System	Credit Sales
1.	Transfer of Ownership	The ownership is transferred only after the payment of last instalment.	The ownership is transferred at the time of purchase.
2.	Method of Payment	The payment of price is always made in periodic instalments.	The payment of price is usually made in lump sum otherwise it can be made according to the terms and conditions agreed upon.
3.	Nature of Contract	It is a hire purchase contract, not a contract of sale.	It is a contract of sale.
4.	Act	It is governed by the provisions of 'Hire Purchase Act, 1972'	It is governed by the provisions of 'Sale of Goods, 1930'.
5.	Right to Re-possess the Goods	In case of default in the payment of instalments, the hire vendor has a right to re-possess the goods.	The seller has no right to repossess the goods, however can only claim for the outstanding dues.
6.	Parties	The parties involved in this system are called 'hire vendor' and 'hire purchaser'.	The parties involved in credit sales are called 'seller' and 'purchaser'.
7.	Responsibility of Repairs	The responsibility of repairs lies with the hire vendor,	In case of credit sales, this responsibility lies with the purchaser.
8.	Transfer of Better Title	The third party cannot get better	The third party can get

		title to the goods until the last instalment has been paid.	better title to the goods.
9.	Right to Terminate the Contract	The hire purchaser has a right to terminate the contract. In case of termination of contract, he will not be required to make payment of remaining instalments but will return the. goods.	The buyer of the goods has no right to terminate the contract. He is bound to pay the price of goods.
10.	Repair of Goods	The ownership lies with the vendor; therefore, he is responsible for the repair of the goods.	The purchaser is responsible for the repair of the goods.
11.	Right to Sell or Pledge the Goods	The hire purchaser has no right to sell or pledge the goods because he is not the owner of the goods.	The purchaser is the owner of the goods. Therefore, he can sell or pledge the goods.
12.	Termination of Contract	The hire purchaser can terminate the contract by giving back the goods to the vendor. In such a case, he will not be required to pay the remaining instalments.	The purchaser cannot terminate the contract. He is bound to pay the price of goods.

5.1.2 Accounting Treatment of Hire Purchase System

For making the accounting treatment, the goods sold under hire purchase system may be divided into the following two categories:

1. Goods of Considerable Value: The accounts relating to goods of considerable value may be kept by two methods in the books of the hire purchaser:

(a) Total Asset Value Method: Under this method, the transaction of hire purchase is treated as an ordinary transaction and hence, the asset account is debited and the hire vendor’s account as credited with the total cash price. The amount of depreciation and amount due to vendor are deducted from total cash price of the asset while showing it in the balance sheet. The depreciation is always charged at cash price.

(b) Asset Accrual Method: Under this method, asset is not debited with the total cash price; rather, it is debited with only that much of amount which is paid by the hire purchaser every year. As long the hire purchaser makes the payment of instalments, so long he purchases the asset.

Note: First method is more commonly used in practice; therefore, the first method should be used in the absence of any specific information.

Entries under First Method (Total Asset Value Method)

Date	Entries in the books of Hire-Purchaser	Entries in the books of Hire-Vendor
Ist Year beginning, say IstJan	Asset A/c Dr. To Vendor's A/c (Cash price of the asset purchased)	Hire Purchaser's A/c Dr. To Hire Sales A/c (Cash price of the goods sold)
IstJan	Vendor's A/c Dr. To Cash A/c (Down payment at the time of signing the agreement)	Cash A/c Dr. To Hire Purchaser's A/c (Down payment received at the time of signing the agreement)
Ist Year at the end, say 31st Dec.	Interest A/c Dr. To Vendor's A/c (Interest due)	Hire Purchase's A/c Dr. To Interest A/c (Interest due)
31st Dec.	Vendor's A/c Dr. To Cash A/c (Payment of Instalment)	Cash A/c Dr. To Hire Purchaser's A/c (Amount of instalment received)
31st Dec.	Depreciation A/c Dr. To Asset A/c	No Entry

	(Depreciation charged on the cash price of the asset)	
31st Dec.	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Interest and depreciation transferred to Profit & Loss A/c)	Interest A/c Dr. To P & L A/c (Interest transferred to P & L A/c)
31st Dec.	No Entry	Hire Sales A/c Dr. To Trading A/c (Transfer of hire sales to Trading A/c)

The first two entries in the books of the hire purchaser and the vendor; and the last entry in the books of the vendor, are passed only in the first year and the remaining entries will be repeated in the following years.

Necessary Accounts in the Books of Hire Purchaser

1. Asset Account: It is a real account in nature. In its debit side 'To Vendor A/c' and in its credit side 'By Deprecation A/c' are written.

2. Vendor's A/c: It is a personal account in nature. This is credited with cash price of asset and the amount of interest and is debited by writing 'To Cash A/c' on paying the amount of instalment.

3. Interest Account: It is a nominal account in nature. This account is debited with the amount of interest by writing 'To Vendor's A/c' and is closed by transferring its balance to profit and loss account at the end of the year.

4. Depreciation Account: It is also a nominal account in nature. In its debit side, 'To Assets A/c' is written with the amount of depreciation. This account is closed by transferring its balance to profit and loss account at the end of the year.

Necessary Accounts in the Books of Vendor

1. Purchaser's Account: It is a real account in nature. This account is debited with the cash price of asset and the amount of interest. On receiving the amount of instalments, this is credited by writing 'By Cash A/c'.

2. Interest Account: In its credit side, 'By Hire Purchaser's A/c' is written with the due amount of interest. This account is closed by writing 'To Profit and Loss A/c' at the end of the year.

Calculation of Interest

The computation of interest is very necessary while solving the question. It may be computed by applying any one of the following methods:

1. By Table

2. By Hire Vendor's Account

The following table is prepared for calculating the interest under this method:

(1) Particulars	(2) Cash Price	(3) Principal	(4) Interest	(5) Instalment
Particulars about instalments	(₹) Cash Price of the Asset	(₹) Amount of Instalment excluding interest	(₹) Amount of Interest	(₹) Amount of Instalment including Interest

When Interest is Included in Instalments

Illustration:

On I[st] January, 2018 Darshan purchased a Computer from Vipin Agency on 'hire purchase system'. The cash price of the computer was ₹ 34,018. Payment was to be made as under:

₹ 10,000 on delivery and further instalments of ₹ 10,000 each at the end of each year. The Vendor charges interest @ 12% p.a. Darshan provides depreciation @ 10% p.a. on diminishing balance method.

Pass journal entries and prepare necessary accounts in the books of both the parties.

Solution:

Calculation of Interest

Particulars	Cash	Principal	Interest	Instalment

	Price			
	₹	₹	₹	₹
Cash Price of Computer	3,4018.00			
(-) Amount paid at the time of delivery	10,000.00 24,018.00	10.000.00		10,000.00
(-) Cash price paid in 1^{st} Instalment	7,117.84 16,900.16	7,117.84	24,018 × 12/100× 1 = 2,882.16	10,000.00
(-) Cash price paid in 2^{nd} Instalment	7,972.00 8,928.16	7,972.00	16,900.16 × 12/100× 1 = 2,028.00	10,000.00
(-) Cash price paid in 3^{rd} Instalment	8,928.16 Nil	8,928.16 34,018.00		10,000.00 40,000.00
			10,000 – 8,928.16 = 1,071.84 5,982.00	

When Interest is not included in Instalments

Illustration:

Solution:

On 1^{st} January, 2012 Avtar purchased a computer from Hind Motors on hire-purchase system. The particulars are as follows:

(a) Cash price ₹ 40,000.

(b) ₹ 16,000 to be paid on signing the agreement.

(c) Balance amount will be paid in four instalments of ₹ 6,000 including interest.

(d) Interest to be charged on outstanding balance @ 10% p.a.

(e) Depreciation to be charged @ 10% p.a. by fixed instalment method.

Prepare Computer A/c and Vendor's A/c in the books of Hire Purchaser. Show how the Computer A/c would appear in the balance sheet of purchaser?

Solution:

Calculation of Interest

Particulars	**Cash Price**	**Principal**	**Interest**	**Instalment**
	₹	₹	₹	₹
Cash Price of Computer	40,000			
Less: Amount paid at the time of delivery	16,000	16,000	-	16,000
	24,000			
Less : Cash price paid in 1st Instalment	6,000	6,000	24,000 × 10/100 = 2,400	8,400
	18,000			
Less: Cash price paid in 2nd Instalment	6,000	6,000	18,000 × 10/100 = 1,800	7,800
	12,000			
Less: Cash price paid in 3rd Instalment	6,000	6,000	12,000 × 10/100 = 1,200	7,200
	6,000			
Less: Cash price paid in 4th Instalment	6,000	6,000	6,000 × 10/100 = 600	6,600
	Nil	40,000	6,000	46,000

5.1.3 Computation of Cash Price

Sometimes, the cash price of the asset is not given in the question. In such a case, first of all the cash price is calculated because the calculation of interest and depreciation is always made on the cash price. The computation of cash price may be made by any of the following two methods:

1. Calculation of Cash Price by Annuity Table

2. Calculation of Cash Price by Arithmetical Method

1. **Calculation of Cash Price by Annuity Table:** In order to calculate the cash price by this method, it is necessary to fulfil the following two conditions:

(a) The amount of each instalment (including interest) must be equal.

(b) The annuity value must be given in the question.

The annuity table gives the present value of the annuity of ₹ 1 for a number of years at a certain rate of interest. For example, if it is given in the annuity table that the present value of ₹ 1 for 5 years @ 10% is ₹ 3.79079, then its meaning is that we must invest ₹ 3.79079 at present in order to get annual payment of ₹ 1 for 5 years. The following formula is used under this method:

Formula

Cash Price = (Annuity Value × Amount of One Instalment) + Cash Down Payment (if any)

2. Calculation of Cash Price by Arithmetical Method: The calculation of cash price on the basis of annuity table can only be made when the instalments are of equal amount. If the annuity table is not given or the amount of instalment is not equal, then the cash price can be calculated by arithmetical method in the following manner:

Step 1. First, cash price of Last instalment should be calculated:

$$\frac{\text{Amount of last Instalment} \times 100}{100 + \text{Rate of Interest}}$$

Step 2. After this, the cash price of last instalment should be added to the instalment immediately preceding the third instalment because the interest of this instalment is included in this combined value. The cash price of this combined value should also be calculated by above method in the following manner:

$$\frac{\text{Combined Value of two Instalments} \times 100}{100 + \text{Rate of Interest}}$$

Step 3. The cash price of the two instalments calculated as above should be added to the instalment immediately preceding the second instalment (i.e., in first instalment). Thereafter, the cash price of combined value of all these three instalments should be calculated by above method.

The above process will be repeated till the cash price of the first instalment is to be calculated.

Note: The total cash price of asset will be found out by adding the down payment in the above calculated cash price of all instalments.

5.1.4 Return of Goods due to Non-Payment of Instalments

Under the hire purchase system, the vendor remains to be the owner of the goods till the payment of last instalment. If the hire purchaser makes the default in the payment of instalments, then the vendor has the right to take back the goods sold. In such a case, the hire purchaser and the vendor make the following entries in their books:

Default and Repossession: If a hire purchaser fails to pay an installment on the stipulated date, the hire purchaser is said to be at default. In case of default by, the hire purchaser, the hire vendor may repossess the goods. Repossession means taking back the possession of goods by the hire vendor. Subject to agreement, the repossession may be either complete or partial.

Complete Repossession: The hire vendor closes Hire Purchaser's Account by transferring balance of Hire Purchaser Account to Goods Repossessed Account. The hire purchaser closes the Hire Vendor's Account by transferring the balance of Hire Vendor Account to Hire Purchase Asset and then finding the profit and loss on repossession in Asset Account. After repossession, the vendor may incur expenses on repossessed stock and may sell the same in due course of time.

Partial Repossession: In case of a partial repossession, only a part of the asset is taken back by the hire vendor and other part is left with the hire purchaser. The Journal Entries are as usual up to the date of default (excepting entry for payment) in the books of both the parties. As a portion of the asset is still left with the hire purchaser, neither party closes the account of the other in their respective books. Assets are repossessed at a mutually agreed value (based on agreed rate of depreciation which is an enhanced rate). If the repossessed value is less than the book value of the asset, the difference is charged to the Profit and Loss Account of the hire purchaser as 'loss on surrender'. For the remaining portion of the asset lying with the hire purchaser, the (Hire Purchaser) applies the usual rate of depreciation and shows the Asset Account at its usual written-down value.

A. Entries in the Books of Hire Purchaser

1. Entry for the Interest becoming due in the year of default:

Interest A/c Dr.

To Vendor's A/c

(Interest due on instalment)

2. If the vendor takes back the entire goods, then the balance of vendor account (including interest) is transferred to Asset Account for which the following entry is passed:

Vendor's A/c Dr.

To Asset A/c

(Balance of vendor's A/c transferred to asset A/c)

3. Entry for Depreciation up to above date, is passed as under:

Depreciation A/c Dr.

To Asset A/c

(Depreciation charged till default date)

4. After providing depreciation on asset and passing the above entry, the balance of asset account is transferred to profit and loss by passing the following entry:

Profit & Loss A/c Dr.

To Asset A/c

(Loss on asset transferred)

B. Entries in the Books of Vendor

1. On Repossession of Goods:

Goods Returned A/c or Goods Repossessed A/c Dr.

To Hire Purchaser's A/c

(Goods returned by hire purchaser)

2. **For Expenses incurred on the Repair of Goods Repossessed:**

Goods Returned A/c Dr.

To Cash A/c

(Amount paid for improving the goods returned)

3. **For the Re-Sale of Goods Repossessed:**

Cash A/c Dr.

To Goods Returned A/c

(Resale of returned goods)

4. **Any balance of Goods Repossessed Account will represent either Profit or Loss:**

(a) In case of Profit:

Goods Returned A/c Dr.

To Profit & Loss A/c

(Profit on returned goods)

(b) In case of Loss:

Profit & Loss A/c Dr.

To Goods Returned A/c

(Loss on returned goods)

5.1.5 Transfer of Asset to Third Party during Hire-Purchase Period

Sometimes, the Hire Purchaser with the permission of the vendor transfers the asset to third party before paying all the instalments. In such a case, the third party pays some amount to the hire purchaser in lieu of instalments already paid by him and he also takes the responsibility for the payment of remaining instalments. The following entries are passed for this:

A. Entries in the books of Hire Purchaser:

1. **For receiving the Amount from Third Party:**

Cash A/c Dr.

To Asset A/c

(Amount received from third party)

2. For closing the Vendor's Account:

Vendor's A/c Dr.

To Asset A/c

(Vendor's A/c closed by transferring its balance to asset A/c)

3. For transferring the balance of Asset Account to Profit and Loss Account:

(a) In case of Profit:

Asset A/c Dr.

To Profit & Loss A/c

(Asset A/c closed)

(b) In case of Loss:

Profit & Loss A/c Dr.

To Asset A/c

(Asset A/c closed)

B. Entries in the books of Vendor:

1. For transferring the balance of Hire Purchaser's Account to Third Party's Account:

Third Party's A/c Dr.

To Hire Purchaser's A/c

(The transfer of balance due from hire purchaser to Third Party's A/c)

C. Entries in the books of Third Party:

1. For the total value to be paid for the asset:

Asset A/c Dr. (Total amount payable to both parties)

To Hire Purchaser's A/c (Amount payable to hire purchaser)

To Actual Vendor's A/c (Amount payable to vendor)

(Asset purchased from hire purchaser and amount due to actual vendor)

2. For making the Payment of Amount:

Hire Purchaser's A/c Dr.

Vendor's A/c Dr.

To Cash A/c

(Amount paid to hire purchaser and vendor)

3. For Interest becoming due:

Interest A/c Dr.

To Vendor's A/c

(Interest due)

4. For making the Payment of Instalment:

Vendor's A/c Dr.

To Cash A/c

(Instalment paid to vendor)

5. For charging Depreciation:

Depreciation A/c Dr.

To Asset A/c

(Depreciation charged)

5.1.6 Sale of Asset by Hire Purchaser

Sometimes, after the purchase of the asset, the hire purchaser does not remain in the need of asset or he feels difficulty in making the payment of instalments. In such a case, he sells the goods to the third party with the permission of the vendor, and makes the payment to the vendor in lump-sum amount from the realised value. The profit or loss arising from the sale of asset is transferred to profit and loss account. The hire purchaser makes the following entries in case of sale of asset:

1. **For the Amount received on Sale of Asset:**

Cash A/c Dr.

To Asset A/c

(Asset sold)

2. **For the Profit on Sale of Asset:**

Asset A/c Dr.

To Profit & Loss A/c

(Profit on sale of asset)

3. On the date of sale of asset, the Vendor's Account is credited with the amount of interest up to that date and after that the amount due to the vendor is paid to him in lump-sum. For the payment to Vendor:

Vendor's Dr.

To Cash A/c

(Vendor's A/c settled)

When Vendor also charges Insurance Premium in addition to Interest from Purchaser

The ownership of asset remains with the vendor till the payment of last instalment. Sometimes, the vendor gets the asset insured from safety point of view and recovers the premium paid from the hire purchaser. The hire purchaser makes the payment of this amount along with the instalment. The entry of premium in the books of the hire purchaser is made in similar manner as that of the interest. At the end of the year, this account is transferred to profit and loss account. The following entries are passed relating to this:

A. In the Books of Hire Purchaser:

1. **For the Amount of insurance premium becoming due:**

Insurance Premium A/c Dr.

To Vendor's A/c

(Insurance premium due)

2. For the payment of insurance premium:

Vendor's A/c Dr.

To Cash A/c

(Insurance premium paid)

B. In the Books of Vendor:

1. For the payment of Insurance premium:

Hire Purchaser's A/c Dr.

To Cash A/c

(Insurance premium paid in cash)

2. For recovering the insurance premium from Hire Purchaser:

Cash A/c Dr.

To Hire Purchaser's A/c

(Insurance premium received from hire purchaser)

5.1.7 Provision for Free Repair by the Vendor

Sometimes, the goods are sold on the guarantee that the vendor will provide free repairs to these goods for a specified period. In such a situation, the vendor transfers some of the amount of cash price to Maintenance Suspense Account or Repair Reserve Account instead of transferring to sales account. As long as the vendor incurs expenses on repair, this account is debited.

Example:

On 1st January, 2014, A sold a computer to B. The cash price of computer is ₹ 30,000. A agreed to repair the computer free of charge for a period of two years. The estimated expenses of repairs are ₹ 350 in the first year and ₹ 570 in the second year. The actual expenses of repairs amounted to ₹ 410 in the first year and ₹ 470 in the second year. Pass the necessary journal entries in the books of A.

Solution:

1. Entry at the time of Sale:

1st Jan, 2014

Hire Purchaser's A/c Dr. 30,000

To Hire Sales A/c 30,000

2. **For transferring the estimated amount of repairs for Two Years from Sales A/c to Repair Reserve A/c:**

1st Jan, 2014

Hire Sales A/c Dr. 920

To Repair Reserve A/c 920

3. **For actual expenses incurred on repairs in the First Year:**

31st Dec, 2014

Repair Reserve A/c Dr. 410

To Cash A/c 410

4. **For the transfer of excess of actual expenses over estimated expenses to Profit and Loss Account in the First Year:**

31st Dec, 2014

Profit & Loss A/c Dr. 60

To Repair Reserve A/c 60

5. **For actual expenses incurred on repairs in the Second Year:**

31st Dec, 2015

Repair Reserve A/c Dr. 470

To Cash A/c 470

6. **For the transfer of savings to Profit and Loss Account as the actual expenses are less than the estimated expenses in the Second Year:**

31st Dec 2015

Repair Reserve A/c Dr. 100

To Profit & Loss A/c 100

5.1.8 Entries According to Asset Accrual Method

The vendor always prepares his accounts according to first method but the hire purchaser may prepare his accounts according to this method. Under this method, the asset account is not debited with full cash price at the very beginning of first year. However, asset account is debited each year with that amount of cash price, which is included in each instalment. It is to be noted that the calculation of depreciation is made on full cash price of asset. The following entries are passed under this method:

1. **For the Down Payment becoming due:**

Asset A/c Dr. (Down payment due)

To Vendor's A/c

(Asset purchased)

2. For paying Down Payment:

Vendor's A/c Dr. (Down payment paid)

To Cash A/c

(Down payment made)

3. For Principal Amount of First Instalment becoming due:

Asset A/c Dr. (Principal amount of instalment)

To Vendor's A/c

(Asset purchased)

4. For Interest becoming due:

Interest A/c Dr. (Amount of interest due)

To Vendor's A/c

(Interest due)

5. For making the payment of First Instalment (including interest):

Vendor's A/c Dr. (Instalment with interest paid)

To Cash A/c

(Instalment paid in cash)

6. For Depreciation charged on asset:

Depreciation A/c Dr. (Depreciation on cash price of asset)

To Asset A/c

(Depreciation charged)

7. For closing the Nominal Accounts:

Profit & Loss A/c Dr.

To Depreciation A/c (Amount of depreciation)

To Interest A/c (Amount of interest)

(Depreciation & interest A/c's closed)

Illustration:

The Chennai Transport Co., purchased a Motor Car from Mumbai Motor Co., on hire-purchase agreement on 1st January, 2017 paying cash ₹ 10,000 and agreeing to pay three further instalments of ₹ 10,000 each on 31st December each year. The cash price of the car is ₹ 37,250 and the Mumbai Motor Co. charges interest at 5% per annum. The Chennai Transport Co. writes off 10% p.a. depreciation on the reducing balance method.

Prepare Journal of Chennai Transport Company, if the accounts are maintained on 'Asset Accrual Basis'.

Solution:

Calculation Table

Particulars	Cash Price	Principal	Interest	Instalment
	₹	₹	₹	₹
Cash Price of Motor Car	37,250.00			
Less: Down Payment	10,000.00	10,000.00		10,000.00
	27,250.00		-	
Less : Cash price in 1st Instalment	8,637.50	8,637.50	27,250 × 5/100 = 1,362.50	10,000
	18,612.50			
Less: Cash price in 2nd Instalment	9,069.37	9,069.37	18,612.50 × 5/100 = 930.63	10,000
	9,543.13			
Less: Cash price in 3rd Instalment	9,543.13	9,543.13	10,000 – 9,543.13 = 456.87	10,000

	Nil	37,250	2,750	40,000

Books of Chennai Transport Company

Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
			₹	₹
2017 Jan. 1	Motor Car A/c Dr. To Mumbai Motor Company A/c (Motor Car purchased)		10,000.00	 10,000.00
Jan. 1	Mumbai Motor Company's A/c Dr. To Bank A/c (Advance payment to vendor)		10,000.00	 10,000.00
Dec.31	Motor Car A/c Dr. To Mumbai Motor Company's A/c (Cash price of 1st Instalment ₹ 10,000 – less interest ₹ 1,362.50)		8,637.50	 8,637.50
Dec.31	Interest A/c Dr. To Mumbai Motor Company's A/c (Interest due)		1,3262.50	 1,362.50
Dec.31	Mumbai Motor Company's A/c Dr. To Bank A/c (Payment of Ist instalment)		10,000.00	 10,000.00
Dec.31	Depreciation A/c Dr. To Motor Car A/c (Depreciation charged @ 10% on ₹ 37,250)		3,725.00	 3,725.00
Dec.31	Profit & Loss A/c Dr. To Depreciation A/c To Interest A/c (Depreciation and interest transferred to P & L A/c)		5,087.50	 3,725.00 1,362.50
2018 Dec.31	 Motor Car A/c Dr. To Mumbai Motor Company's A/c (Cash price of 2nd Instalment, i.e., ₹ 10,000 less interest ₹ 930.63)		 9,069.37	 9,069.37
Dec.31	Interest A/c Dr.		930.63	

	To Mumbai Motor Company's A/c (Interest due)			930.63
Dec.31	Mumbai Motor Company's A/c Dr. To Bank A/c (Payment of 2nd Instalment)		10,000.00	10,000.00
Dec.31	Depreciation A/c Dr. To Motor Car A/c (Depreciation charged @ 10% on ₹ 37,250 – 3,725, i.e., ₹ 33,525)		3,352.50	3,352.50
Dec.31	Profit & Loss A/c Dr. To Depreciation A/c To Interest A/c (Depreciation and interest transferred to P & L A/c₹)		4,283.13	3,352.50 930.63
2019 Dec.31	Motor Car A/c Dr. Interest A/c To Mumbai Motor Company's A/c (Motor car purchased and interest due)		9,543.13 456.87	10,000.00
Dec.31	Mumbai Motor Company's A/c Dr. To Bank A/c (Payment of 3rd instalment)		10,000.00	10,000.00
Dec.31	Depreciation A/c Dr. To Motor Car A/c (Depreciation charges @ 10% on ₹ 33,525 – 3,352.50, i.e., ₹ 30,172.50)		3,017.25	3,017.25
Dec.31	Profit & Loss A/c Dr. To Depreciation A/c To Interest A/c (Depreciation and interest transferred to P & L A/c₹)		3,474.12	3,017.25 456.87

5.2 Introduction and Meaning of Instalment Payment System

Instalment payment system like hire purchase system is a system of sale in which the payment is made in instalments. 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 instalment, then the seller cannot repossess the goods. He can only sue the buyer for unpaid instalments.

Definition of Instalment Payment System

According to J.R.Batliboi, "Under an agreement to purchase and pay by instalments, the goods become the properly of the purchaser immediately when he receives the delivery of the same."

In words of William Pickles, "Though hire purchase and instalment system appear similar from outside because under both the systems, payment is made to the seller in instalments, but there is vast difference between the two. First system is a hire transaction which takes the form of a sale at the end, but second method, i.e., instalment payment system is a transaction of immediately sale, under this system instead of making payment in a lump-sum, payment is made during a prescribed period by instalments and provision is made for payment of interest also."

Characteristics of Instalment Payment System

1. **Contract of Credit Sale:** It is a contract of credit sale.
2. **Payment in Instalments:** The payment of price of goods is agreed to made in instalments.
3. **Transfer of Ownership:** The ownership of goods is transferred immediately to the buyer on signing the contract of sale.
4. **Delivery of Goods:** The delivery of goods is made to the buyer on signing the contract of sale.
5. **In case of default of Payment of Instalments:** In case of default in the payment of instalments by the buyer, the seller cannot take back the goods and forfeit the instalments already received. He can only sue for the unpaid instalments and interest.
6. **Right of Sale or Mortgage of Goods:** The buyer becomes the owner of the goods on signing the contract of sale. Therefore, the buyer can sell or mortgage the goods even before the payment of all the instalments.

Difference between Hire Purchase System and Instalment Purchase System:

Basis	**Hire Purchase System**	**Instalment Purchase System**
Nature of Transaction	Initially, it is similar to a contract of hire and subsequently, it transforms into sales.	It is an agreement of sale of goods and services from the very beginning.

Transfer of Ownership	In the case of hire purchase, ownership of goods is transferred to the hirer on payment of all instalments (to the hire vendor).	The title to the goods transfers at the time of signing the agreement.
Repossession of Goods	On non-payment of any instalment, the seller can take back the goods from the hirer and repossess the goods sold under hire purchase system.	On non-payment of any instalment or all instalments, the seller cannot take back the goods from the buyer. But, the seller can take legal action against the buyer.
Return of Goods	With advance intimation, the hire purchaser may return the goods without obligation for further payment except for instalment overdue.	Goods cannot be returned except for seller's default.
Risk	Risk is on the hire seller till the payment of last instalment. On the payment of all instalments, risk transfers to the hire purchaser.	Risk is not on the seller of goods and services.

5.2.1 Accounting Entries in Instalment Payment System

Under instalment payment system, in first entry of buyer's book, Asset account with cash price of asset and interest suspense account with total interest amount included in all instalments are debited and the vendor account is credited with hire purchase price. After this, in second entry, interest account with the amount of interest of that year is debited and interest suspense account is credited at the end of the year. Remaining entries are passed in a similar manner to those entries which are passed under hire purchase system. The entries to be passed under this method can be explained as follows:

Entries in the books of Hire-Purchaser	Entries in the books of Hire-Vendor
At the time of Agreement: Asset A/c Dr. (Total cash price) Interest Suspense A/c Dr. (Total interest) To Vendor's A/c (H.P.P.) (Asset purchased under instalment payment system)	**At the time of Agreement:** Purchaser's A/c Dr. (H.P.P.) To Sales A/c (Total cash price) To Interest Suspense A/c (Total interest) (Goods sold on instalment payment system)
Down Payment: Vendor's A/c Dr. To Cash A/c (Down payment made on delivery)	**Down Receipt:** Cash A/c Dr. To Purchaser's A/c (Down payment received on delivery)
At the end of Each Year: Interest A/c Dr. To Interest Suspense A/c (Interest due)	At the end of Each Year: Interest Suspense A/c Dr. To Interest A/c (Interest due)
Vendor's A/c Dr. To Cash A/c (Instalment paid)	Cash A/c Dr. To Purchaser's A/c (Amount of instalment received)
Depreciation A/c Dr. To Asset A/c (Depreciation charged on the cash price of the asset)	No Entry
Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Transfer of interest and depreciation to P & L A/c)	Interest A/c Dr. To Profit & Loss A/c (Amount of interest transferred to P & L A/c)
No Entry	At the end of First Year only. Sales A/c Dr.

	To Trading A/c (Transfer of sales to Trading A/c)

Illustration:

On 1st January, 2015 Amrit Transport purchased two trucks from Delhi Motor Ltd. on instalment payment system. Amrit Transport paid ₹ 5,00,000 cash and agreed to pay three further instalments of ₹ 4,00,000 each at the end of each year. The cash price of the trucks was ₹ 14,95,000. Amrit Transport charges depreciation @ 15% p.a. on the diminishing balance method.

Assuming that Delhi Motor Ltd. charges interest @ 10% p.a. Give journal entries in the books of Amrit Transport.

Solution:

Calculation of Interest

Particulars	**Cash Price**	**Principal**	**Interest**	**Instalment**
	₹	₹	₹	₹
Cash Price of trucks	14,95,000			
Less: Cash down payment	5,00,000	5,00,000	-	5,00,000
	9,95,000			
Less : Cash price paid in 1st Instalment	3,00,500	3,00,500	10% on ₹ 9,95,000 = 99,500	4,00,000
	6,94,500			
Less: Cash price paid in 2nd Instalment	3,30,550	3,30,550	10% on ₹ 6,94,500 = 69,450	4,00,000
	3,63,950			
Less: Cash price paid in 3rd Instalment	3,63,950	3,63,950	₹ 4,00,000 – 3,63,950 = 36,050	4,00,000
	Nil	14,95,000	2,05,000	17,00,000

Books of Amrit Transport

Journal

Date	Particulars	L.F.	Amount (Dr.)	Amount (Cr.)
2015			₹	₹
Jan. 1	Trucks A/c Dr. Interest Suspense A/c Dr. To Delhi Motor Ltd.'s A/c (Trucks purchased on instalment payment system)		14,95,000 2,05,000	 17,00,000
Jan. 1	Delhi Motor Ltd.s' A/c Dr. To Cash A/c (Down payment made)		5,00,000	 5,00,000
2015 Dec.31	Interest A/c Dr. To Interest Suspense A/c (Interest due)		99,500	 99,500
Dec.31	Delhi Motor Ltd.'s A/c Dr. To Cash A/c (Payment of the 1st Instalment)		4,00,000	 4,00,000
Dec.31	Depreciation A/c Dr. To Trucks A/c (Depreciation charged @ 15% on ₹ 14,95,000)		2,24,250	 2,24,250
Dec.31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Interest and depreciation transferred to P & L A/c)		3,23,750	 99,500 2,24,250
2016 Dec.31	Interest A/c Dr. To Interest Suspense A/c (Interest due)		69,450	 69,450
Dec.31	Delhi Motor Ltd.'s A/c Dr. To Cash A/c (Payment of 2nd Instalment)		4,00,000	 4,00,000
Dec.31	Depreciation A/c Dr. To Trucks A/c (Depreciation charged @ 15% on ₹ 12,70,750)		1,90,613	 1,90,613
Dec.31	Profit & Loss A/c Dr.		2,60,063	

	To Interest A/c To Depreciation A/c (Transfer of interest and depreciation to P & L A/c)			69,450 1,90,613
2017 Dec.31	Interest A/c Dr. To Interest Suspense A/c (Interest due)		36,050	36,050
Dec.31	Delhi Motor Ltd.'s A/c Dr. To Cash A/c (Payment of 3rd instalment)		4,00,000	4,00,000
Dec.31	Depreciation A/c Dr. To Trucks A/c (Depreciation charges @ 10% on ₹ 10,80,137)		1,62,021	1,62,021
Dec.31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Transfer of interest and depreciation to P & L A/c)		1,98,071	36,050 1,62,021

5.3 Check Your Progress

A. State whether the following statements are True or False

1. Goods/assets do not pass to Hire Purchaser even if last instalment remains unpaid.
2. In Instalment Payment System, the goods/assets ownership passes immediately on the signing of the contract.
3. The Hire Vendor has no right to repossess the goods in case of default by the Hire Purchaser.
4. In Hire Purchase System, the provisions of Hire Purchase Act, 1972 are applicable.

B. Fill in the blanks

1. _______________ is the price at which the goods can be purchased immediately by making the payment in a lump sum amount.
2. Vendor's Account is a _________________ in nature.
3. Under _______________ , the buyer becomes the owner of the goods immediately on signing the ________________.
4. ______________________ has no right to sell or pledge the goods/assets.

5.4 Summary

Hire Purchase is a kind of dealing under which the purchase of goods and assets is done on the basis of payment in instalments. These instalments can be monthly, quarterly, half- yearly or annual. At the outset, the purchaser gets only the possession of goods i.e. the right to use the goods but not the ownership. The ownership remains with the seller until the purchaser has paid the last instalment. Instalment payment system like hire purchase system is a system of sale in which the payment is made in instalments. Under this system, the buyer becomes the owner of the goods immediately on signing the contract of sale.

5.5 Keywords

Hire Vendor: A person who delivers the goods along with possession to the Hire Purchaser under an agreement.

Down Payment: The initial payment made by the Hire Purchaser to the Hire Vendor.

Possession: The Hire Vendor transfers only possession of the goods to the Hire Purchaser not the ownership.

Cash Price: The amount to be paid by the buyer on outright purchase in cash.

Hire Purchase Installment: The Hire Purchaser has to pay a specific amount after a regular interval up to certain period.

Installment Payment System: The ownership of the goods is passed immediately to the buyer on signing the agreement.

5.6 Self-Assessment Test

1. What do you mean by Hire Purchase System? Discuss the process, advantages and dis-advantages of Hire Purchase System.
2. Pass Journal entries in the books of Hire Purchaser and Hire Vendor with hypothetical figures.
3. Elaborate the advantages and limitations of Accounting.

4. What is Instalment Payment System? Distinguish between Hire Purchase System and Instalment Payment system in detail.

5. Explain the different methods of computation of Cash Price under Hire Purchase System.

5.7 Answers to Check Your Progress

Check Your Progress A

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

Check Your Progress B

1. Cash Price
2. Personal Account
3. Instalment Payment System, Contract of Sale
4. Hire Purchaser

5.8 References/Suggested Readings

- R. Narayanaswamy, "Financial Accounting", Prentice Hall of India, New Delhi.
- ArulaNandam M.A. & Raman K.S.,**Advanced Accountancy**, Himalaya Publishing House, Delhi.
- Gupta R.L. and RadhaSwamyM.,**Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
- Shukla M.C. & Grewal S.,**Advanced Accounts,** S. Chand &Company Ltd, New Delhi.
- Study material of Institute of Chartered Accountant of India (ICAI), New Delhi.

Course: **Financial Accounting-II**	
Course Code: **BCOM 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **6**	SLM Conversion By**: Ms. Chand Kiran**

PARTNERSHIP ACCOUNTS: DEED, ACCOUNTS, GOODWILL, JOINT LIFE POLICY AND CHANGE IN PROFIT SHARING RATIO

STRUCTURE

6.10 References/Suggested Readings

6.0 LEARNING OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning of Partnership and Characteristics of Partnership.
- To know the meaning and contents of Partnership Deed.
- Know the types of Partnership Accounts.
- Understand the meaning and methods of valuation of Goodwill.
- Understand the types of Joint Life Policy.

6.1 INTRODUCTION

You know as the business expands, one needs more capital and more number of persons to manage the business and share its risks. In such a situation, businessman usually adopts the partnership form of organization in which two or more persons come together to establish business and share its profits. The present chapter discusses some basic aspects of partnership such as meaning and characteristics of partnership, valuation of goodwill, partnership deed, change in profit sharing ratio, and Joint Life Policy etc.

6.2 MEANING OF PARTNERSHIP

A partnership is like a proprietorship in many ways except that it has two or more co-owners. The partners share the profits and losses according to a sharing pattern already agreed. Section 4 of the Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. Persons who have entered into partnership with one another are individually called 'partners' and collectively called 'firm'. The name under which the business is carried is called the 'firm's name'. A partnership firm has no separate legal entity, apart from the partners constituting it.

6.2.1CHARACTERISTICS OF PARTNERSHIP

The following are the key characteristics of a partnership firm:

1. **Two or More Persons:**A partnership firm should have at least two persons and their objective should be the same. The Partnership Act does not put any restrictions on maximum number of partners. However, Companies Act prohibits partnership consisting of more than 20 members. If a firm is engaged in the banking business, it can have a maximum of 10 partners while in case of any other business, the maximum number of partners can be 20.
2. **Agreement:** Partnership is the result of an agreement between two or more persons to do business and share its profits/losses. It is not necessary that such agreement is in written form.
3. **Business**: The partnership agreement should be for some business purpose. For example, if Sachin and Sunder jointly purchase a plot of land, they become the joint owners of the property and not the partners. But if they are in the business of purchase and sale of land for the purpose of making profit, they will be called partners.
4. **Mutual Agency**: Mutual agencyis the legal ability of each partner, acting as an agent of the business, to enter into and bind it to contracts within the scope of the partnership. However, the firm would not be bound if any partner makes any transaction outside the purpose of an accounting business.
5. **Sharing of Profits:** The partners must come together to share profits and losses of the business. Thus, sharing of profits and losses is important. If some persons join hands for the purpose of some charitable activity, it will not be termed as partnership.
6. **Liability of Partnership**: Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner. Not only that the liability of a partner for acts of the firm is also unlimited. This implies that his private assets can also be used for paying off the firm's debts.

6.2.2 PARTNERSHIP DEED

Partnership comes into existence as a result of agreement among the partners. The agreement can be either oral or written. The Partnership Act does not require that the agreement must be in written. But wherever it is in written, the agreement is called 'Partnership Deed'. It generally contains the details about the objective of business, capital of each partner, ratio in which the profits and the losses will be shared by the partners and entitlement of partners to interest on capital, interest on loan, etc. The partnership Deed usually includes the following:

(i) Name and address of the firm.

(ii) Names and addresses of all partners.

(iii) Date of commencement of partnership.

(iv) Capital to be contributed by each partner.

(v) Whether interest is to be allowed on capitals.

(vi) Whether any partner is to be allowed salary.

(vii) The profit-sharing ratio.

(viii) The duties of each partner.

(ix) Mode of settlement of accounts in case of retirement/death of a partner.

(x) Interest on Capital.

(xi) Interest on Drawings.

(xii) Remuneration of Partners

(xiii) Valuation of Goodwill.

Normally, the partnership deed covers all matters affecting relationship of partners among themselves. However, if there is no written (Partnership Deed) agreement, the provisions of the Indian Partnership Act, 1932 shall apply.

Provisions Applicable in the Absence of Partnership Agreement/Partnership Deed:

- Interest is not allowed on Partners' Capitals or charged on Drawings.
- Partner is not entitled to salary or remuneration for the work done for the firm.
- Interest @ 6% p.a. is allowed on the loans advanced by any partner.
- Profit or loss is distributed equally among the partners.

6.2.3 PARTNERSHIP ACCOUNTING

Accounting treatment for partnership firm is similar to that of a sole proprietorship business with the exception of the following aspects:

• Maintenance of Partners' Capital Accounts;

• Distribution of Profit and Loss among the partners;

• Adjustments for Wrong Appropriation of Profits in the Past;

• Reconstitution of the Partnership Firm; and

• Dissolution of Partnership Firm.

The first three aspects mentioned above have been taken up in the following sections of this chapter. The remaining aspects have been covered in the subsequent lessons.

- **Maintenance of Partners' Capital Accounts:**

  The Partners' Capital Accounts may be maintained according to Fixed Capital Method or Fluctuating Capital Method**.**

  Fixed Capital Method: Under this method, the capital of partners *remains unchanged* except in special circumstances. In case of the fixed capital, *two* accounts are maintained for each partner, *viz.*, (*i*) Fixed Capital Account and (*ii*) Current Account. All adjustments regarding drawings, interest on drawings, salary, and interest on capital, commission and share of profit or loss are recorded in *Current Account*.

  Fluctuating Capital Method: Under the fluctuating capital method, only one account, i.e. capital account is maintained for each partner. All the adjustments such as share of profit and loss, interest on capital, drawings, interest on drawings, salary or commission to partners, etc are recorded directly in the capital accounts of the partners. This makes the balance in the capital account to fluctuate from time to time. That's the reason why this method is called fluctuating capital method.

- **Distribution of Profit and Loss among the Partners:**

  The profits and losses of the firm are distributed among the partners in an agreed ratio. However, if the partnership deed is silent, the firm's profits and losses are to be shared equally by all the partners. In case of partnership, however, certain adjustments such as interest on drawings, interest on capital, salary to partners, and commission to partners are required to be made. For this purpose, it is customary to prepare a Profit and Loss Appropriation Account of the firm and ascertain the final figure of profit and loss to be distributed among the partners, in their profit sharing ratio.

- ***Profit and Loss Appropriation Account*:**

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. It shows how the profits are appropriated or distributed among the partners. The journal entries for preparation of Profit and Loss Appropriation Account and making various adjustments through it are given as follows:

Journal Entries:

1. Transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account:

(a) If Profit and Loss Account shows a credit balance (net profit):

Profit and Loss A/c Dr.

To Profit and Loss Appropriation A/c

(b) If Profit and Loss Account shows a debit balance (net loss)

Profit and Loss Appropriation A/c Dr.

To Profit and Loss A/c

2. Interest on Capital:

(a) For crediting interest on capital to partners' capital account:

Interest on Capital A/c Dr.

To Partner's Capital/Current A/c

(b) For transferring interest on capital to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c

- Interest on Drawings:

(a) For charging interest on drawings to partners' capital accounts:

Partners Capital/Current A/c's (individually) Dr.

To Interest on Drawings A/c

(b) For transferring interest on drawings to Profit and Loss Appropriation Account:

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

4. Partner's Salary:

(a) For crediting partner's salary to partner's capital account:

Salary to Partner A/c Dr.

To Partner's Capital/Current A/c's (individually)

(b) For transferring partner's salary to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.

To Salary to Partner's A/c

5. Partner's Commission:

(a) For crediting commission to a partner, to partners' capital account:

Commission to Partner A/c Dr.

To Partner's Capital/Current A/c's (individually)

(b) For transferring commission paid to partners to Profit and Loss Appropriation Account.

Profit and Loss Appropriation A/c Dr.

To Commission to Partners Capital/Current A/c

6. Share of Profit or Loss after appropriations:

If Profit:

Profit and Loss Appropriation A/c Dr.

To Partner's Capital/Current A/c's (individually)

If Loss:

Partner's Capital/Current A/c's (individually) Dr.

To Profit and Loss Appropriation A/c

The Performa of Profit and Loss Appropriation Account is given as follows:

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Profit & Loss (if there is a loss)		Profit & Loss (if there is a profit)	
Interest on capital		Interest on drawings	
Salary to partner		Partner's capital (Distribution of Loss)	
Commission to partner			
Interest on partner's loan			
Partner's capital a/c			

(Distribution of profits)

- **Calculation of Interest on Capital:**

Interest on drawings can be calculated by the following methods:

1. ***Direct Method:***Under direct method simple interest is to be calculated by taking the principal amount, period and rate of interest.
2. ***Product Method:*** Under this method the amount of interest is calculated by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest**.**

- **Calculation of Interest on Drawings:**
  The following are the methods of calculating interest on drawings:
  1. Simple Average method
  2. Product method

Simple Average Method:

A fixed amount may be withdrawn every month/half yearly/annually. The interest has to be calculated for the period for which the amount has been utilized for personal purposes by the partners. The following example explains the computation of interest on drawings by using simple average method.

Product method:

Under this method the amount of interest is calculated by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest**.**

Guarantee of Profit to a Partner:

Sometimes a partner is admitted into the firm with a guarantee of certain minimum amount by way of his share of profits of the firm. Such assurance may be given by all the old partners in a certain ratio or by any of the old partners, individually to the new partner. The minimum guaranteed amount shall be paid to such new partner when his share of profit as per the profit-sharing ratio is less than the guaranteed amount.

Adjustments for Wrong Appropriation of Profits in the Past:

Sometimes a few omissions or errors in the recording of transactions or the preparation ofsummary statements are found after the final accounts have been prepared and the profitsdistributed among the partners. The omission may be in respect of interest on capitals, interest on drawings, interest on partners' loan, partner's salary, partner's commission or outstanding expenses. There may also be some changes in the provisions of partnership deed or system of accounting having impact with retrospective effect. All these acts of omission and commission need adjustments for correction of their impact**.**

The following procedure may be helpful in recording necessary adjustments:

1. If, interest on capital is one of the items of omissions, then first verify the partners' capital at the beginning. This can be done by deducting partners' share of current year's profit from their capitals at the end and adding their drawings thereto.

2. Work out the amounts of omitted items that are to be credited to partners' capital accounts such as interest on capital, salaries to partners, etc. The following journal entry for the adjustment is recorded:

Profit and Loss Adjustment A/c Dr.

To Partners' Capital A/c (individually)

3. Work out the amounts of omitted items which are to be debited to the Partners' Capital Accounts such as interest on drawings. The following adjustment entry recorded:

Partners' Capital (individually) A/c Dr.

To Profit and Loss Adjustment A/c

4. Work out the balance of the Profit and Loss Adjustment Account. The credit balance of the Profit and Loss Adjustment Account reflects to the profit and the debit balance and the loss. This is to be distributed among the partners.

5. The balance of the Profit and Loss Adjustment Account as worked out in point 4 above be transferred to the partners' capital accounts in their profit sharing ratio. Thus, the Profit and Loss Adjustment Account will stand closed. It will involve the following journal entry:

If it is a credit balance (profit)

Profit and Loss Adjustment A/c Dr.

To Partners' Capital (individually) A/c

If it is a debit balance (loss)

Partners' Capital (individually) A/c Dr.

To Profit and Loss Adjustment A/c

The adjustment can also be made directly in the Partners' Capital Accounts without preparing a Profit and Loss Adjustment Account. In such a situation, we shall prepare a statement to find out the net effect of omissions and commissions and then to debit the capital account of the partner who had been credited in excess and credit the capital account of the partner who had been debited in excess.

6.2.4 VALUATION OF GOODWILL

Goodwill

Goodwill is the value of benefit or advantage that a business has because of the factors that help in increasing its profitability. It may be because of its location, favorable contracts, access to supplies and customer loyalty, etc.

Purchased Goodwill

Purchased Goodwill means the goodwill for which a consideration has been paid.

Self-Generated Goodwill

Self-generated Goodwill is the goodwill that has been generated by the business because of which it is able to earn higher profits.

Methods of Calculating Goodwill

The following are the key methods of calculating goodwill:

1. Average Profit Method
2. Super Profit Method
3. Capitalization Method

1. Average Profit Method

Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill is calculated as follows:

Value of goodwill = Average Profit × Number of year of purchase.

Weighted Average Profit Method

It is calculated by multiplying the profit for each year with the weight assigned to it. The amounts so arrived at are totaled and divided by the total of weights. The weighted average profit is multiplied by the number of years of purchase.

Goodwill = Weighted Average Profit × No. of Years' Purchase

Example: Calculate the amount of goodwill on the basis of two year's purchase of average profit of last 5 years. The profit and losses for the last five years are as under:

		₹
1st Year		20,000
2nd Year		16,000
3rd Year		28,000
4th Year	(Loss)	12,000
5th Year		42,000

Solution:

Total Profits of last 5 years:

₹ 20,000 + ₹ 16,000 + ₹ 28,000 – ₹ 12,000 + ₹ 42,000 = ₹ 94,000.

Average Profit = $\frac{\text{Total Profit}}{\text{No.of Years}}$ = ₹ $\frac{94,000}{5}$ = ₹ 18,800

Goodwill = Average Profit ₹ No. of Years of Purchase = 18,800 ₹ 2 = ₹ 37,600.

Gopal purchased Ravi's business from 1st January, 2018. The Profits disclosed by Ravi's business for the last four years were as follows:

2015 – ₹ 74,000

2016 – ₹ 66,000 (After charging an Abnormal loss ₹ 12,000)

2017 – ₹ 1,28,000 (Including an Abnormal gain of ₹ 10,000)

2018 – ₹ 88,000 (Excluding ₹ 8,000 as insurance premium of firm's property which is done in this year.)

Calculate the value of firm's goodwill on the basis of 2 years purchase of the average profit for the last four years.

Solution:

1. Calculation of Total Profits of last four years:

	₹	₹
Profit for 2015	--------	74,000
Profit for 2016	66,000	
Add: Abnormal Loss	12,000	78,000
Profit for 2017	1,28,000	
Less: Abnormal gain	10,000	1,18,000
Profit for 2018	88,000	
Less: Insurance Premium	8,000	80,000
Total Profits		3,50,000

2. Calculation of Average Profit = $\frac{\text{Total Profit}}{\text{No.of Years}}$ = ₹ $\frac{3,50,000}{4}$ = ₹ 87,500

3. Value of Goodwill = Average Profit ₹ No. of Years of Purchase = 87,500 × 2 = ₹ 1,75,000.

2. **Super Profit Method**

The goodwill under the super profits method is ascertained by multiplying the super profits by certain number of years' purchase. The steps involved under the method are:

1. Calculate the average profit,
2. Calculate the normal profit on the capital employed on the basis of the normal rate of Return.
3. Calculate the super profits by deducting normal profit from the average profits, and
4. Calculate goodwill by multiplying the super profits by the given number of years' purchase.

Normal profit = $\frac{\textbf{Capital employed X Normal rate of return}}{\textbf{100}}$

Super Profit = Actual Profit – Normal Profit

Goodwill = Super Profit × No. of Years' Purchase

Example: The profits of a firm during last 5 years were as follows: 2004 – ₹ 45,000; 2005 – ₹ 55,000; 2006 – ₹ 80,000; 2007 – ₹ 60,000; 2008 – ₹ 90,000.The capital invested in the firm is ₹ 5,00,000. A reasonable return in such a business is 10%. Find out the value of goodwill on the basis of 3 years purchase of the average super profits of last five years.

Solution:

(a) Total profits of last 5 years:

₹ 45,000 + ₹ 55,000 + ₹ 80,000 + ₹ 60,000 + ₹ 90,000 = ₹ 3,30,000

(b) Average Profit = $\frac{\text{Total Profit}}{\text{No.of Years}}$ = ₹ $\frac{3,30,000}{5}$ = ₹ 66,000

(c) Normal Profit = Capital invested × $\frac{\text{Normal Rate of Return}}{100}$

= 5,00,000 × $\frac{10}{100}$ = ₹ 5 0,000

(d) Super Profit = Average Profit – Normal Profit = ₹ 66,000 – ₹ 50,000 = ₹ 16,000

(e) Value of Goodwill: Super Profit × No. of Years of Purchase = ₹ 16,000 × 3 = ₹ 48,000

3. Capitalization Method

Under this method the goodwill can be calculated in two ways:

(a) By capitalizing the average profits

(b) By capitalizing the super profits

(a)Capitalization of Average profit*:* In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed. The key steps involved in this method are as follows:

1. Computation of average profit

Average Profits × 100/Normal Rate of Return

2. Computation of capital employed

Capital Employed = Total Assets (excluding goodwill) – outside liabilities

3. Computation of goodwill

Goodwill = Capitalized value of profits – Capital employed.

(b)Capitalization of Super Profit

Under this method, super profit is capitalized at the normal rate of return.

Goodwill = Super Profit × $\frac{\textbf{100}}{\textbf{Normal Rate of Return}}$

Example: Calculate the value of goodwill according to the capitalization method from the following figures:

(a) Average Profit = ₹ 65,000

(b) Normal Rate of Return = 13%

(c) Capital Employed = ₹ 3,70,000

Solution:

1. As per the Capitalisation of Super Profit Method:

Average Profit = ₹ 65,000

Normal Profit = $\frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$

$= \frac{3,70,000 \times 13}{100}$ = ₹ 48,100

Super Profit = Average Profit – Normal Profit = ₹ 65,000 – ₹ 48,000 = ₹ 16,900

Value of Goodwill = $\frac{\text{Super Profit} \times 100}{\text{Normal Rate of Return}} = \frac{16,900 \times 100}{13}$ = ₹ 1,30,000

2. As per the Capitalisation of Average Profit Method:

Average Profit = ₹ 65,000

Capitalised Value of Average Profit: Actual Average Profit × $\frac{100}{NormalRateofReturn}$

$= \frac{65,000 \times 100}{13}$ = ₹ 5,00,000

Actual Capital Employed = ₹ 3,70,000

Goodwill = Capitalised Value of Actual Average Profit – Actual Capital Employed = 5,00,000 – 3,70,000 = ₹ 1,30,000

6.3 JOINT LIFE POLICY

Life Insurance Policy

Life Insurance policy is a policy issued by the life insurance company which is taken by the firm on the lives of partners. The main purpose of taking this policy is to make a provision for the payment of amount due to deceased partner on the death of a partner; otherwise the payment is to be made by selling the assets of the firm. The insurance policies to be taken on the lives of partners are of following two types:

1. Joint Life Insurance Policy: When an insurance policy is taken jointly on the lives of all partners, then it is known as joint life insurance policy. The premium of such a policy is paid by the firm. The insurance company pays the full amount of insurance policy to the firm on the death of a partner. There are following four methods of dealing with the premium paid for joint life insurance policy:

A. Premium is treated as Business Expense: Under this method, the premium paid is treated as business expense and is debited to profit and loss account. On the death of a partner, the joint life policy account is credited with amount to be received from insurance company which is to be written off by transferring to the capital account of partners in their profit sharing ratio including the deceased partner. The following entries are passed under this method:

1. For making the payment of Premium:

Joint Life Policy Premium A/c Dr.

To Bank A/c

(Payment of Premium)

2. For transferring the premium of Profit and Loss Account:

Profit and Loss A/c Dr.

To Joint Life Policy Premium A/c

(Premium transferred to Profit & Loss A/c)

Above entries will be passed every year upto the date of maturity. In case of death of a partner or on the maturity of the policy, the following entries will be passed:

3. For amount of insurance claim due:

Insurance co's. A/c Dr.

To Joint Life Policy A/c

(Insurance claim due on death or maturity)

4. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co's. A/c

(Amount of claim received)

5. For distributing the amount among partners:

Joint Life Policy A/c Dr.

To All Partners' Capita[A/cs

(Amount of joint life policy transferred to partners'capital a/cs in their

profit sharing ratio)

But the above method has the drawback and it does not disclose the true net profit or loss of the firm because on one side the premium paid is treated as business expense and is debited to profit and loss account and the other side the amount of joint life policy is not shown in the balance sheet whereas it is actually an asset of the firm.

B. Premium is treated as an Asset: Under this method, the premium paid is treated as an asset. The joint life policy account is shown as an asset in the balance sheet. The following entries are passed under this method:

1. For making the payment of premium:

Joint Life Policy A/c Dr.

To Bank A/c

(Payment of premium)

Above entry will be passed every year up to the date of maturity. In case of death of a partner or on the maturity of the policy, the following entries will be passed:

2. For amount of insurance claim due:

Insurance Co.'s A/c Dr.

To Joint Life Policy A/c

(Amount of claim due on death or maturity)

3. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co.'s A/c

(Amount of claim received)

4. For transferring the balance of Joint Life Policy Account:

Joint Life Policy A/c Dr.

To All Partners' Capital A/cs

(Balance of joint life policy a/c transferred to Partners' Capital A/cs)

The drawback of this method is that the joint life policy account is shown at a higher value than its surrender value in the balance sheet. Therefore, the balance sheet as well as profit and loss account does not disclose true position of the business.

C. Surrender Value of Policy is treated as an Asset: Under this method, the surrender value of policy is treated as an asset. The joint life policy account is debited and bank account is credited with the amount of premium paid. At the end of the year, the amount of premium in excess of surrender value is treated as a loss and is credited to joint life policy amount and is debited to profit and loss account as it reduces the balance in joint life policy account. The credit balance of joint life policy account depicts the profit which is transferred to the capital account of partners in their profit sharing ratio. The advantage of this method is that the surrender value is shown in the balance sheet. But the drawback of this method is that the premium paid is not shown in the profit and loss account at its full value. The following entries are passed under this method:

1. For making the payment of premium:

Joint life Policy A/c Dr.

To Bank A/c

(Payment of premium)

2. For the Joint Life Policy Account brought down to its surrender value:

Profit and Loss A/c Dr.

To Joint Life Policy A/c

(Joint life policy a/c brought down to its surrender value)

Above two entries will be passed every year up to the date of maturity. In case of death of a partner or on the maturity of the policy the following entries will be passed:

3. For amount of insurance claim due:

Insurance Co.'s A/c Dr.

To Joint Life Policy A/c

(Insurance claim due on death or maturity)

4. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co.'s A/c

(Insurance claim received)

5. For transferring the balance of joint life policy account:

Joint Life Policy A/c Dr.

To All Partners' Capital A/cs

(Balance of joint life policy a/c transferred to Partners' Capital A/cs)

D. Premium is treated as an Investment and Preparation of Joint Life Policy Account and Joint Life Policy Reserve Account: Under this method, the premium paid is treated as an investment and the following procedure is adopted for accounting treatment:

1. The premium paid is debited to joint life policy account.
2. An amount equal to premium paid is debited to profit and loss appropriation account and credited to joint life policy reserve account at the end of each year.
3. The joint life policy account and joint life policy reserve account are so adjusted that each account shows a balance equal to surrender value of the policy.

On the death of a partner, the joint life policy account is credited with the amount received from the insurance company. Joint life policy reserve account is closed by transferring its credit balance to joint life policy account and then joint life policy account is also closed by transferring it to the capital accounts of partners in their profit sharing ratio. Under this method, the surrender value of policy is shown in the asset side and joint life policy reserve account in the credit side of balance sheet.

The major advantage of this method is that the surrender value is shown in the balance sheet and the premium paid is fully written in the profit and loss adjustment account. The following entries are passed under this method:

1. For making the payment of premium:

Joint Life Policy A/c Dr.

To Bank A/c

(Payment of premium)

2. For creating the joint life policy reserve account:

Profit & Loss Appropriation A/c Dr.

To Joint Life Policy Reserve A/c

(Amount equal to premium provided out of divisible profit)

3. For the joint life policy account brought down to its surrender value:

Joint Life Policy Reserve A/c Dr.

To Joint Life Policy A/c

(Joint life policy a/c brought down to its surrender value)

Above entries will be passed every year up to the date of maturity. In case of death of a partner or on the maturity of the policy, the following entries will be passed:

4. For amount of insurance claim due:

Insurance Co.'s A/c Dr.

To Joint Life Policy A/c

(Claim due on death or maturity)

5. For receiving the amount of insurance claim:

Bank A/c Dr.

To Insurance Co's A/c

(Insurance claim received)

6. For closing the joint life policy reserve account:

Joint Life Policy Reserve A/c Dr.

To Joint Life Policy

(Closing of joint life policy reserve a/c)

7. For distributing the amount of joint life policy amongst partners:

Joint Life Policy A/c Dr.

To All Partners' Capital A/c

(Amount of joint life policy distributed amongst partners')

6.4 CHANGES IN PROFIT SHARING RATIO

A. At the time of Admission of a Partner:

1. **When only new partner's share is given:** When only new partner's share is given and it is not clear that in what ratio the new partner gets his share from the old partners, then it is presumed that there will be no change in the profit sharing ratio of old partners. Hence, the old partners will share their profit or loss in the same ratio as they were sharing before the admission of new partner.

Example: Deepak and Ravi share profit and loss in the ratio of 3:2. They admitted Rohit as a partner for 1/4th Share. Calculate the new profit sharing ratio of partners.

Solution:

Total Profit of Firm = 1

Rohit' Share = $\frac{1}{4}$

Thus, Remaining Profit = $1 - \frac{1}{4} = \frac{3}{4}$

Hence, Deepak's New Share = $\frac{3}{4} \times \frac{3}{5} = \frac{9}{20}$

Ravi's New Share = $\frac{3}{4} \times \frac{2}{5} = \frac{6}{20}$

Rohit's Share = $\frac{1}{4}$

Hence, New Profit Sharing Ratio will be = $\frac{9}{20} : \frac{6}{20} : \frac{1}{4}$ = 9 : 6 : 5

2. **When new partner acquire his share from old partners in a certain ratio:** In this case, the share acquired by the new partner will be deducted from the share of old partner. The remaining share of old partner will be treated as new share of old partners. This can be calculated with the help of the following formula:

New Ratio = Old Ratio – Sacrifice Ratio

Example: X and Y are partners in a firm sharing profit and losses in the ratio of 3:2. A new partner Z is admitted. X surrenders 1/5th of his profit in favour of Z and Y surrenders 2/5th of his share in favour of Z. Calculate the new profit sharing ratio of partners.

Solution:

Sacrifice by X for Z = $\frac{3}{5} \times \frac{1}{5} = \frac{3}{25}$

Sacrifice by Y for Z = $\frac{2}{5} \times \frac{2}{5} = \frac{4}{25}$

Total Share of Z = $\frac{3}{25} + \frac{4}{25} = \frac{7}{25}$

X's New Share = $\frac{3}{5}-\frac{3}{25}=\frac{15}{25}-\frac{3}{25}=\frac{12}{25}$

Y's New Share = $\frac{2}{5}-\frac{4}{25}=\frac{10}{25}-\frac{4}{25}=\frac{6}{25}$

Hence New Profit Sharing Ratio of X, Y and Z will be = $=\frac{12}{25}:\frac{6}{25}:\frac{7}{25}$ = 12 : 6 : 7

3. **When the share of sacrifice by old partners is given:** When the shares of sacrifice by old partners are given in the question, then the new profit sharing ratio is calculated by deducting the share of sacrifice from the old profit sharing ratio of old partners. It can be understood from the following illustration:

Example: 'A' and 'B' are partners sharing profit and loss in the ratio of 4:3. They admitted 'C' for $3/10^{th}$ share in the firm. He acquires $\frac{2}{10}$ share from 'A' and $\frac{1}{10}$ share from 'B'. Calculate the new profit sharing ratio of partners.

Solution:

New Ratio = Old Ratio – Sacrifice Ratio

A's New Share = $\frac{4}{7}-\frac{2}{10}=\frac{40}{70}-\frac{14}{70}=\frac{26}{70}$

B's New Share = $\frac{3}{7}-\frac{1}{10}=\frac{30}{70}-\frac{7}{70}=\frac{23}{70}$

Hence, the new profit Sharing of A, B and C will be: $\frac{26}{70}:\frac{23}{70}:\frac{3}{10}$ = 26 : 23 : 21

B. At the time of Retirement/Death of a Partner:

At the time of retirement of a partner, the new profit sharing, in different circumstances, is calculated by the following methods:

1. **When Profit Sharing ratio of Remaining Partners is not given on the Retirement of Partner:** If the profit sharing ratio of remaining partners is not given in the question on the retirement of a partner, then the ratio left except the retiring partner's share, will be the new profit sharing ratio of remaining partners.

Example: X, Y and Z are partners in a firm sharing profits and losses in the ratio of 3:2:1. Calculate new profit sharing ratio, if:

(a) X retires.

(b) Y retires.

(c) Z retires.

Solution:

In the above situations the new profit sharing ratio will be as follows:

(a) When X retires, the new profit sharing between Y and Z will be 2:1.

(b) When Y retires, the new profit sharing between X and Z will be 3:1.

(c) When Z retires, the new profit sharing between X and Y will be 3:2.

2. **When Remaining Partners receive the share of Retiring Partner in a certain ratio:** If it is given in the question that the remaining partners receive the share of retiring partner in a certain ratio, then the new profit sharing ratio is calculated by adding this share in the old ratio of remaining partners. It has been explained in the following illustration.

Example: A, B and C are partners in a firm sharing profits and losses in the ratio of 2:2:1. A retires and B and C receive his share in the ratio of 3:2. Calculate new profit sharing ratio.

Solution:

A's share will be divided between B and C in the ratio of 3:2.

Therefore, B's Gain = $\frac{3}{5}$ of $\frac{2}{5} = \frac{6}{25}$

C's Gain = $\frac{2}{5}$ of $\frac{2}{5} = \frac{4}{25}$

Hence, B's New Share = $\frac{2}{5} + \frac{6}{25} = \frac{16}{25}$

C's New Share = $\frac{1}{5} + \frac{4}{25} = \frac{9}{25}$

The New profit Sharing Ratio between B and C will be 16:9.

6.5 CHECK YOUR PROGRESS

1. Partnership is an agreement between two or more persons who combine their assets ____________ .
2. The difference between partnership and____________ is that of ownership.
3. Liability of partners in a partnership business is ____________ .
4. In absence of an agreement income sharing ratio between partners is ______ .
5. In the absence of an agreement among the partners, rules laid down in____________ will be applied.

6.6 SUMMARY

Business man's when needs more capital and more manpower to manage the business and share its risks than businessman usually adopts the partnership form of organization in which two or more persons come together to establish business and share its profits. As per Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'. Persons who have entered into partnership are individually called ‘partners’ and collectively called ‘firm’. The name under which the business is carried is called the ‘firm’s name’. A partnership firm has no separate legal entity, apart from the partners constituting it. Partnership comes into existence as a result of agreement among the partners. The agreement can be either oral or written. But wherever it is in written, the agreement is called ‘Partnership Deed’. It generally contains the details about the objective of business, capital of each partner, ratio in which the profits and the losses will be shared by the partners and entitlement of partners to interest on capital, interest on loan, etc.Goodwill is the value of benefit or advantage that a business has because of the factors that help in increasing its profitability. It may be because of its location, favorable contracts, access to supplies and customer loyalty, etc. The following are the key methods of calculating goodwill:

- Average Profit Method
- Super Profit Method
- Capitalization Method

6.7 KEYWORDS

Partnership: Relationship between persons who agreed to share the profits or losses of a business.

Partnership Deed: An agreement which contains the terms of the agreement between the partners.

Fixed Capital: The capital of partners remains unchanged.

Goodwill: The reputation or advantage that a business has.

Joint Life Policy: An insurance policy taken out by the partnership firm on the joint lives of partners.

6.8 SELF-ASSESSMENTTEST

Q.1 What do you understand by Partnership? Explain the characteristics of Partnership in detail.

Q.2 Define the term Partnership Deed. Discuss the contents of Partnership Deed.

Q.3 Explain the provisions applicable in the absence of Partnership Deed.

Q.4 What do you mean by the term Goodwill? Discuss the method of Valuation of Goodwill.

Q.5 What do you understand by Joint Life Policy? Explain the objectives and accounting treatment of Joint Life Policy.

Q.6. The expected net profits of Sai Limited are ₹ 1,32,000 per year. Average capital invested in the firm is ₹ 6,20,000. The rate of return expected from capital in this case of business is 15%. The remuneration of the partners is estimated to be ₹ 15,000 for the year. Find out the value of goodwill on the basis of three year's purchase of super profits.

6.9 ANSWERS TO CHECK YOUR PROGRESS

1. To carry on business
2. Sole proprietorship
3. Unlimited
4. Equal
5. Partnership Act

6.10 References/Suggested Readings

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Course: **Financial Accounting-II**	
Course Code: **BCOM 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **7**	SLM Conversion By**: Ms. Chand Kiran**

PARTNERSHIP ACCOUNTS: ADMISSION OF A PARTNER

STRUCTURE

7.0 LEARNING OBJECTIVES

After going through this lesson, you should be able:

- To know the need of admitting of a new partner in the firm.
- To understand the meaning and computation of sacrificing ratio.
- To know the revaluation of assets and liabilities.

- To know the adjustment of undistributed profits/losses, reserves and capital accounts of partners.

7.1 INTRODUCTION

When a business organization requires additional capital or managerial help or both for expansion of the business it may admit a new partner to increase its resources. In case of a sole proprietorship, it is converted into a partnership on the admission of a new person as an owner of the business enterprise. According to the Partnership Act, 1932, no new partner can be introduced into a firm without the consent of all the existing partners. On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Amit and Sunil are partners sharing profit in the ratio of 5:3. On April 1, 2019 they admitted Neha as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Neha as partner, the firm stands reconstituted.

7.1.1 ADJUSTMENTS AT THE TIME OF ADMISSION OF A PARTNER

On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio.

(ii) Adjustment of Goodwill.

(iii) Adjustment for revaluation of assets and liabilities.

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

Calculation of a New Profit Sharing Ratio

The new partner acquires his share in profits from the old partners. It means, on the admission of a new partner, the old partners sacrifice a share of their profit in favor of the new partner. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The new partner acquires his/her share of future profits either from one or more existing partners**.** Following cases may arise for the calculation of new profit sharing ratio:

Case 1: Only the new partner's share is given.

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio.

Case 2: When new partner acquired his/her share of the profit from the existing partner in a particular ratio.

It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Case 3: Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificed share of the each partner is ascertained by multiplying the existing partner share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined.

Calculation of Sacrificing Ratio:

At the time of admission of a partner, existing partners have to surrender some of their share in favor of the new partner. The ratio in which they agree to sacrifice their share of profits in favor of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partner for acquiring the share of profit which they have surrendered in the favor of the new partner.Sacrificing Ratio is calculated as follows:

Sacrificing Ratio = Existing Ratio – New Ratio

7.1.2 ACCOUNTING TREATMENT OF GOODWILL AT THE TIME OF ADMISSION OF A NEW PARTNER

The new partner acquires his/her share profit from the old partners. This will result in the reduction of the share of existing partners. Therefore, he/she compensates the existing partners for the sacrifices. He/she compensates them by making payment in cash or in kind. The payment is equal to his/her share in the goodwill.

As per accounting rules goodwill should be recorded in the books only when some consideration in money has been paid for it. Thus, if a new partner does not bring necessary cash for goodwill, no goodwill account can be raised in the books. He/she should pay for goodwill in addition to his/her contribution for capital.

From accounting point of view, there may be different situations related to treatment of goodwill which are discussed below:

- When the amount of goodwill is paid privately by the new partner.
- When the new partner brings his/her share of goodwill in cash.
- When the new partner does not bring his/her share of goodwill in cash.

- **When the amount of goodwill is paid privately by the new partner:**

If the goodwill premium is paid privately by the new partner to the old partners outside the business then the same is not recorded in the books of accounts and hence no journal entry is recorded.

- **When the new partner brings his/her share of goodwill in cash:**

When, the new partner brings his/her share of goodwill in cash. The amount brought in by the new partner is transferred to the existing partner in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partner, it will be written off immediately in existing ratio among the partners. The journal entries are as follows:

(i) The existing goodwill in the books of the firm will be written off in existing profit ratio as;

Old Partners Capital A/c Dr.

To Goodwill A/c

(Existing goodwill written off in the old profit sharing ratio)

(ii) For bringing cash for Capital and goodwill

Cash/Bank A/c Dr.

To Premium for Goodwill A/c

To New partner's Capital A/c

(Cash brought in for capital and goodwill)

(iii) For amount of goodwill transferred to existing partner capital account:

Premium for Goodwill A/c Dr.

To Old Partner's Capital/current A/c

(The amount of goodwill credited to existing partner's capitals in sacrificing ratio)

The amount of goodwill is withdrawn by the existing partners:

(iv) Existing Partners Capital/current A/c Dr.

To Cash/Bank A/c

(The amount of goodwill withdrawn by the existing partners)

It is to be noted that sometimes partner's withdraw only 50% or 25% amount of goodwill. In such a case, entry will be made for the withdrawn amount only.

When the new partner does not bring his/her share of goodwill in cash:

When the goodwill of the firm is calculated and the new partner is not able to bring his/her share of goodwill in cash, goodwill will be adjusted through new partner's capital accounts. In this case new partner's capital account is debited for his/her share of goodwill and the existing partner's capital accounts are credited in their sacrificing ratio. The journal entry is as under:

New Partner's Capital A/c Dr.

To Existing Partner's Capital A/c

(New partner's share in goodwill credited to existing partner's in sacrificing ratio)

Goodwill appears in the books of the firm and new partner does not bring his/her share of goodwill in cash:

If the goodwill account appears in the books of the firm, and the new partner is not able to bring goodwill in cash. In this case, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their existing profit sharing ratio.

New partner brings in only a part of his share of goodwill

When new partner is not able to bring the full amount of his/her share of goodwill in cash and brings only a part of cash. In this case, the amount of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him.

The journal entries is as

Bank A/c Dr.

To Premium for Goodwill A/c

(Part Amount of goodwill brought by new partner)

Premium for Goodwill A/c Dr.

New Partner's Capital A/c Dr.

To Existing Partner's Capital A/c [individually in sacrificing ratio]

(Credit given to sacrificing partner by new partner's in full share of goodwill)

7.2 REVALUATION OF ASSETS AND LIABILITIES

At the time of admission of a new partner, it is always desirable to ascertain whether the assets of the firm are shown in books at their current values. In case the assets are overstated or understated, these are revalued. Similarly, a revaluation of the liabilities is also done so that these are brought in the books at their correct values. At times there may be some unrecorded assets with the business, these are also recorded and similarly if there is any unrecorded liability which the firm has to pay, the same is also recorded**.** For this purpose a 'Revaluation Account' is prepared. This account is credited with all increases in the value of assets and decrease in the value of liabilities. It is debited with decrease on account of value of assets and increase in the value of liabilities. The balance of this account shows a profit or loss on revaluation which is transferred to the old partner's capital account in old profit sharing ratio The following journal entries made for this purpose are:

(i) For increase in the value of assets:

Asset A/c Dr.

To Revaluation A/c

(Increase in Value of Assets)

(ii) For decrease in the value of Asset

Revaluation A/c Dr.

To Asset A/c

(Decrease in the value of assets)

(iii) For increase in the value of Liabilities:

Revaluation A/c Dr.

To Liabilities A/c

(Increase in the value of Liabilities)

(iv) For decrease in the value of Liabilities:

Liabilities A/c Dr.

To Revaluation A/c

(Decrease in the value of Liabilities)

(v) For unrecorded Assets

Asset A/c Dr.

To Revaluation A/c

(Unrecorded asset recorded at actual value)

(vi) For unrecorded Liability:

Revaluation A /c Dr.

To Liability A/c [unrecorded]

(Unrecorded Liability recorded at actual value)

(vii) For transfer of gain on revaluation:

Revaluation A/c Dr.

To Existing Partner’s Capital/Current A/c

(Profit on revaluation transferred to capital account in existing ratio)

(viii)For transfer of loss on revaluation:

Existing Partner’s Capital/Current A/c Dr.

To Revaluation A/c

(Loss on revaluation transferred to capital account in existing ratio)

Performa of Revaluation account is given as under:

Revaluation account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Assets (Decrease in Value) Liabilities (Increase in Value)		Assets (Increase in Value) Liabilities (Decrease in Value)	

Liabilities (unrecorded) Profits transferred to Capital A/c (Individually in Existing Ratio)		Assets (unrecorded) Loss transferred to Capital A/c (Individually in Existing Ratio)	

Example: Hari and Prem are partners in a firm sharing profit and losses in the ratio of 2:1. Their balance sheet as on 31st December, 2016 was as follows:

Liabilities		Amount	Assets	Amount
		₹		₹
Creditors		61,000	Land and Building	2,50,000
Bank Overdraft		26,000	Plant & Machinery	1,75,000
Provision for Bad & Doubtful Debts		5,000	Stock	1,20,000
Capital Accounts:	₹		Debtors	95,000
Hari	4,23,000		Bills Receivable	38,000
Prem	2,05,000	6,28,000	Cash in hand	42,000
		7,20,000		7,20,000

They admitted Sandeep as Partner for $\frac{1}{4}$th share of profits on the following terms:

1. Sandeep will bring ₹ 1,75,000 as capital and ₹ 15,000 as share of goodwill.
2. Land & Building was to be revalued at ₹ 3,00,000.
3. The value of Plant and Machinery was to be reduced by 12%.
4. Provision for doubtful debts was to be increased to ₹ 7,400.
5. Prepaid insurance has not been shown in the balance sheet ₹ 2,200.
6. The amount of goodwill was to be withdrawn by the old partners.

Pass necessary journal entries and prepare Revaluation A/c, Capital A/cs and, Opening Balance Sheet of new firm.

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			₹	₹

	Land and Building A/c Dr. Prepaid Insurance A/c Dr. To Revaluation A/c (Increase in the value of assets)		50,000 2,200	 52,200
	Revaluation A/c Dr. To Plant & Machinery A/c To Provision for Bad & Doubtful Debts A/c (Decrease in the value of assets)		23,400	 21,000 2,400
	Revaluation A/c Dr. To Hari's Capital A/c To Prem's Capital A/c (Profit on revaluation transferred to Old Partner's Capital A/cs in old ratio)		28,800	 19,200 9,600
	Cash A/c Dr. To Sandeep's Capital A/c To Premium or Goodwill A/c (Amount of capital and Premium or Goodwill brought in cash by Sandeep)		1,90,000	 1,75,000 15,000
	Premium or Goodwill A/c To Hari's Capital A/c To Prem's Capital A/c (Premium or Goodwill credited to Old Partner's Capital A/cs in t heir sacrificing ratio i.e. 2:1)		15,000	 10,000 5,000
	Hari's Capital A/c Dr. Prem's Capital A/c Dr. To Cash A/c (Premium or Goodwill withdrawn by old partners)		10,000 5,000	 15,000

Dr. Revaluation Account Cr.

Particulars	Amount	Particulars	Amount

	₹		₹
To Plant & Machinery A/c	21,000	By Land & Building A/c	50,000
To Provision for Bad & Doubtful debts A/c	2,400	By Prepaid Insurance A/c	2,200
To Profit transferred to: ₹			
Hari's Capital A/c 19,200			
Prem's Capital A/c 9,600	28,800		
	52,200		52,200

Dr. Partner's Capital Account Cr.

Particulars	Hari	Prem	Sandeep	Particulars	Hari	Prem	Sandeep
	₹	₹	₹		₹	₹	₹
To Cash A/c	10,000	5,000	–	By Balance b/d	4,23,000	2,05,000	–
To Balance c/d	4,42,200	2,14,600	1,75,000	By Revaluation A/c	19,200	9,600	–
				By Cash A/c	–	–	1,75,000
				By Premium A./c			
				Goodwill A/c	10,000	5,000	–
	4,52,200	2,19,600	1,75,000		4,52,200	2,19,600	1,75,000

Opening Balance Sheet

Liabilities	Amount	Assets	Amount
	₹		₹
Creditors	61,000	Land & Building	3,00,000
Bank Overdraft	26,000	Plant & Machinery	1,54,000
Provision for Bad & Doubtful Debts	7,400	Stock	1,20,000
Capital Accounts: ₹		Debtors	95,000
Hari 4,42,200		Bills Receivable	38,000
Prem 2,14,600		Cash in hand	2,17,000
Sandeep 1,75,000	8,31,800	Prepaid Insurance	2,200
	9,26,200		9,26,200

7.2.1 MEMORANDUM OF REVALUATION ACCOUNT

At the time of admission of a partner after revaluation of assets and liabilities, if all the partners do not want to show the revised value of assets and liabilities in their new balance sheet, then under such circumstances the revaluation A/c is reopened, which is known as Memorandum revaluation A/c. In such case, all entries passed through revaluation account are reversed. The memorandum revaluation A/c is closed by transferring the balance to all the partners including new one in new profit sharing ratio.

Performa of Memorandum Revaluation Account

Decrease in Assets		Increase in Assets	
Increase in Liabilities		Decrease in Liabilities	
Unrecorded Liabilities		Unrecorded Assets	
Outstanding Expenses		Accrued Incomes	
Profit : A's Capital A/c		Loss: A's Capital A/c	
B's Capital A/c		B's Capital A/c	
Decrease in Assets		Increase in Assets	
Increase in Liabilities		Decrease in Liabilities	
Unrecorded Liabilities		Unrecorded Assets	
Outstanding Expenses		Accrued Incomes	
Profit : A's Capital A/c		Loss: A's Capital A/c	
B's Capital A/c		B's Capital A/c	
C's Capital A/c		C's Capital A/c	

Example: In the above example, if the partners decided that the revised values of assets and liabilities are not to be recorded in the books then, pass journal entries and prepare Memorandum Revaluation Account and also Balance Sheet.

Solution:

Ist Part

Journal

Date	Particulars		L.F.	Amount Dr.	Amount Cr.
				₹	₹
	Land and Building A/c	Dr.		50,000	
	Prepaid Insurance A/c	Dr.		2,200	
	To Memorandum Revaluation A/c				52,200
	(Increase in the value of assets)				
	Memorandum Revaluation A/c	Dr.		23,400	
	To Plant & Machinery A/c				21,000
	To Provision for Bad & Doubtful Debts A/c				2,400
	(Decrease in the value of assets)				
	Memorandum Revaluation A/c	Dr.		28,800	
	To Hari's Capital A/c				19,200
	To Prem's Capital A/c				9,600
	(Profit on revaluation transferred to Old Partner's Capital A/cs in old ratio)				

2nd Part

Date	Particulars		L.F.	Debit Amount	Credit Amount
				₹	₹
	Memorandum Revaluation A/c	Dr.		52,200	
	To Land and Building A/c				50,000
	To Prepaid Insurance A/c				2,200
	(Reversal of first original entry)				
	Plant & Machinery A/c	Dr.		21,000	
	Provision for Bad & Doubtful Debts A/c	Dr.		2,400	
	To Memorandum Revaluation A/c				23,400
	(Reversal of second original entry)				

	Hari's Capital A/c Dr.		14,400	
	Prem's Capital A/c Dr.		7,200	
	Sandeep's Capital A/c Dr.		7,200	
	To Memorandum Revaluation A/c			28,800
	(Loss on revaluation transferred to All 'Old' Partner's Capital A/cs in their new ratio i.e. 2:1:1)			

Note: The other entries will remain same as shown in earlier example.

Dr. Memorandum Revaluation Account Cr.

Particulars	Amount	Particulars	Amount
Ist Part	₹		₹
To Plant & Machinery A/c	21,000	By Land & Building A/c	50,000
To Provision for Bad & Doubtful debts A/c	2,400	By Prepaid Insurance A/c	2,200
To Profit transferred to: ₹			
Hari's Capital A/c 19,200			
Prem's Capital A/c 9,600	28,800		
	52,200		52,200
2nd Part			
To Land & Building A/c	50,000	By Plant & Machinery A/c	21,000
To Prepaid Insurance A/c	2,200	By Provision for Bad & Doubtful Debts A/c	2,400
		By Loss transferred to: ₹	
		Hari's Capital A/c 14,400	
		Prem's Capital A/c 7,200	
		Sandeep's Capital A/c 7,200	28,800
	52,200		52,200

Dr. Partner's Capital Account Cr.

Particulars	Hari	Prem	Sandeep	Particulars	Hari	Prem	Sandeep
	₹	₹	₹		₹	₹	₹
To Cash A/c	10,000	5,000	–	By Balance b/d	4,23,000	2,05,000	–
To Mem. Rev. A/c	14,400	7,200	7,200	By Mem. Rev. A/c	19,200	9,600	–

To Balance c/d	4,27,800	2,07,400	1,67,800	By Cash A/c	–	–	1,75,000
				By Premium A./c			
				Goodwill A/c	10,000	5,000	–
	4,52,200	2,19,600	1,75,000		4,52,200	2,19,600	1,75,000

Opening Balance Sheet

Liabilities		Amount	Assets	Amount
		₹		₹
Creditors		61,000	Land & Building	2,50,000
Bank Overdraft		26,000	Plant & Machinery	1,75,000
Provision for Bad & Doubtful Debts		5,000	Stock	1,20,000
Capital Accounts:	₹		Debtors	95,000
Hari	4,27,800		Bills Receivable	38,000
Prem	2,07,400		Cash in hand	2,17,000
Sandeep	1,67,800	8,03,000		
		8,95,000		8,95,000

7.2.2 TREATMENT OF UNDISTRIBUTED PROFIT/LOSSES AND RESERVES

Sometimes a firm may have accumulated profits not yet transferred to capital accounts of the partners. These are usually in the firm of general reserve, reserve fund and/or Profit and Loss Account balance. The new partner is not entitled to have any share in such accumulated profits. These are distributed among the partners by transferring it to their capital accounts in old profit sharing ratio. Similarly, if there are some accumulated losses in the form of a debit balance of profit and loss account appearing in the balance sheet of the firm.

For this purpose the following journal entries are made as:

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr

Profit & Loss A/c(Profit) Dr.

To Partner's Capital A/c

(Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio)

(ii) For distribution of loss

Partner’s Capital A/c Dr.

ToProfit and Loss A/c [Loss]

(Profit & Loss transferred to all partners capitals A/c in existing profit sharing ratio)

7.3 ADJUSTMENTS OF PARTNER’S CAPITAL

Sometimes, at the time of admission, the partners agree that their capitals should also be adjusted so as to be proportionate to their profit sharing ratio. In such a situation, if the capital of the new partner is given, the same can be used as a base for calculating the new capitals of the old partners. The capitals thus ascertained should be compared with their old capitals after all adjustments relating to goodwill reserves and revaluation of assets and liabilities, etc. have been made; and then the partner whose capital falls short, will bring in the necessary amount to cover the shortage and the partner who has a surplus, will withdraw the excess amount of capital.The partners can decide to maintain their new capital on the following basis:

On the Basis of new Partner’s Capital and his Profit Sharing Ratio

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner’s capital and his profit sharing ratio. Therefore the capital of other partners is ascertained by dividing the total capital as per his profit sharing ratio.If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account.

The journal entries are made as under:

(i) When excess amount is withdrawn by the partner or transferred to current account.

Existing Partner’s Capital A/c Dr.

To Bank A/c or Partner Current A/c

(Excess amount is withdrawn by the partner or transferred to current account)

(ii) For bringing in the Deficit amount or Balance transferred to current account.

Bank A/c or Partner Current A/c Dr.

To Existing Partner's Capital A/c

(Bringing the Deficit amount or Balance transferred to current account)

X and Y are partners in a firm sharing profits and losses in the ratio of 3:1. Their balance sheet on 31st March, 2018 was as follows:

Liabilities		Amount	Assets	Amount
		₹		₹
Sundry Creditors		92,000	Cash in hand	12,000
Capital Accounts:	₹		Sundry Debtors	62,000
X	2,50,000		Stock	1,00,000
X	1,00,000	3,50,000	Furniture and fixtures	45,000
			Investments	78,000
			Plant & Machinery	1,45,000
		4,42,000		4,42,000

They agreed to admit Z as partner on the following terms:

1. Plant & Machinery is to be depreciated @ 10%.
2. Stock is to be reduced by 5%.
3. Furniture and Fixtures are to be taken at 90% of their value.
4. Provision for doubtful debts is to be made @ 5%.
5. Market value of Investments is ₹ 85,100.
6. Z will bring ₹ 24,000 as Premium for Goodwill for 1/5th share of profits of the firm and he is to bring in capital sufficient to make it proportionate to his share in profit after the above adjustments.

Pass Journal Entries, and prepare necessary accounts and opening balance sheet of the new firm.

Solution:

Journal

Date	Particulars		L.F.	Debit Amount	Credit Amount
				₹	₹
	Revaluation A/c	Dr.		27,100	

	To Plant & Machinery To Stock A/c To Furniture and Fixtures A/c To Provision for Doubtful Debts A/c (Decrease in the value of assets)			14,500 5,000 4,500 3,100
	Investments A/c Dr. To Revaluation A/c (Increase in the value of assets)		7,100	 7,100
	X's Capital A/c Dr. Y's Capital A/c Dr. To Revaluation A/c (Loss on revaluation transferred to Old Partner's Capital A/cs in their old ratio)		15,000 5,000	 20,000
	Cash A/c Dr. To Premium or Goodwill A/c (Amount of goodwill brought in cash by Z)		24,000	 24,000
	Premium or Goodwill A/c Dr. To X's Capital A/c To Y's Capital A/c (Premium or Goodwill credited to Old Partner's Capital A/cs in t heir sacrificing ratio i.e. 3:1) Cash A/c Dr. To Z's Capital A/c (Amount of capital brought in cash by new partner)		24,000 88,500	 18,000 6,000 88,500

Dr. **Revaluation Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Plant & Machinery A/c	14,500	By Investments A/c	7,100
To Stock A/c	5,000	By Loss transferred to: ₹	
To Furniture and Fixture A/c	4,500	X's Capital A/c 15,000	
To Provision for Doubtful Debts A/c	3,100	Y's Capital A/c 5,000	20,000
	27,100		27,100

Dr. **Partner's Capital Account** **Cr.**

Particulars	X	Y	Z	Particulars	X	Y	Z
	₹	₹	₹		₹	₹	₹
To Revaluation A/c	15,000	5,000	–	By Balance b/d	2,50,000	1,00,000	–
To Balance c/d	2,53,000	1,01,000	–	By Premium or Goodwill A/c	18,000	6,000	–
	2,68,000	1,06,000	–		2,68,000	1,06,000	–
To Balance c/d	2,53,000	1,01,000	88,500	By Balance A/c (after adjustments)	2,53,000	1,01,000	–
				By Cash A/c	–	–	88,500
	2,53,000	1,01,000	88,500		2,53,000	1,01,000	88,500

Opening Balance Sheet

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		92,000	Cash in hand	₹	1,24,500
Capital:	₹		Sundry Debtors	62,000	
X	2,53,200		Less: Provision for Bad Debits	3,100	58,900
Y	1,01,000		Stock		95,000
Z	88,500	4,42,500	Furniture and Fixtures		40,500
			Investments		85,100
			Plant & Machinery		1,30,500
		5,34,500			5,34,500

On the Basis of the Existing Partner's Capital Account Balances

Sometimes the capital of the new partner is calculated on the basis of existing partners. The partner is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

The following is the balance sheet of A, B and C sharing profits and losses in proportion of 6:5:3.

Liabilities		Amount	Assets	Amount
		₹		₹
Creditors		18,900	Cash	1,890
Bills Payable		6,300	Debtors	26,460
General Reserve		10,500	Stock	29,400
Capital Accounts:	₹		Furniture	7,350
A	35,400		Land & Building	45,150
B	29,850		Goodwill	5,250
C	14,550	79,800		
		1,15,500		1,15,500

They agreed to take D into partnership and give him 1/8th share on the following terms:

1. That Furniture will be depreciated by ₹ 920.
2. An old customer, whose account was written off as bad, has promised to pay ₹ 2,000 in full settlement of his full debt.
3. That a provision of ₹ 1,320 be made for outstanding repair bills.
4. That the value of Land and Building having appreciated be brought upto₹ 54,910.
5. That D will bring in ₹ 14,070 as his share of goodwill in cash.
6. That D will bring in ₹14,700 as his capital.
7. That after making the above adjustments, the capital accounts of old partners be adjusted on the basis of the proportion of D's capital to his share in business i.e. actual cash to be paid off or brought in by old partner's as the case may be.

Pass the necessary Journal Entries, and prepare the balance sheet of the new firm.

Solution:

Journal

Date	Particulars		L.F.	Debit Amount	Credit Amount
				₹	₹
	General Reserve A/c	Dr.		10,500	
	To A's Capital A/c				4,500
	To B's Capital A/c				3,750
	To C's Capital A/c				2,250
	(Transfer of general reserve to Old Partner's Capital A/cs)				

	Revaluation A/c Dr. To Furniture A/c To Provision for Repair A/c (Decrease in the value of assets and increase in the value of liabilities)		2,240	 920 1,320
	Debtors A/c Dr. Land & Building A/c Dr. To Revaluation A/c (Increase in the value of assets)		2,000 9,760	 11,760
	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Profit on revaluation transferred to Old Partner's Capital A/cs in old ratio i.e. 6:5:3)		9,520	 4,080 3,400 2,040
	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Goodwill A/c (Existing goodwill written off from the books)		2,250 1,875 1,125	 5,250
	Cash A/c Dr. To Premium or Goodwill A/c To D's Capital A/c (Amount of goodwill and capital brought in by D)		28,770	 14,070 14,700
	Premium or Goodwill A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (D's share of goodwill transferred to Old Partner's Capital A/cs in sacrificing ratio)		14,070	 6,030 5,025 3,015
	Cash A/c Dr. To C's Capital A/c		1,320	 1,320

	(Deficit of cash brought in by C)			
	A's Capital A/c Dr. B's Capital A/c Dr. To Cash A/c (Excess cash paid to A and B)		3,660 3,400	 7,060

Dr. **Revaluation Account** **Cr.**

Particulars		Amount	Particulars	Amount
		₹		₹
To Furniture A/c		920	By Debtors A/c	2,000
To Provision for Repairs A/c		1,320	By Land & Building A/c	9,760
To Profit transferred to:	₹			
A	4,080			
B	3,400			
C	2,040	9,520		
		11,760		11,760

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	D	Particulars	A	B	C	D
	₹	₹	₹	₹		₹	₹	₹	₹
To Goodwill A/c	2,250	1,875	1,125	–	By Balance b/d	35,400	29,850	14,550	–
To Balance c/d	47,760	40,150	20,730	14,700	By General Reserve A/c	4,500	3,750	2,250	–
					By Revaluation A/c	4,080	3,400	2,040	–
					By Premium or Goodwill A/c	6,030	5,025	3,015	–
					By Cash A/c	–	–	–	14,700
	50,010	42.025	21,855	14,700		50,010	42,025	21,855	14,700
To Cash c/d	3,660	3,400	–	–	By Balance b/d	47,760	40,150	20,730	14,700
To Balance c/d	44,100	36,750	22,050	14,700	By Cash A/c	–	–	1,320	–
	47,760	40,150	22,050	14,700		47,760	40,150	22,050	14,700

Opening Balance Sheet

Liabilities	Amount	Assets	Amount
	₹		₹

Creditors	18,900	Cash	24,920
Bills Payable	6,300	Debtors	28,460
Provision for Repairs	1,320	Stock	29,400
Capital Accounts: ₹		Furniture	6,430
A 44,100		Land & Building	54,910
B 36,750			
C 22,050			
D 14,700	1,17,600		
	1,44,120		1,44,120

Dr. **Cash Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance b/d	1,890	By A's Capital A/c	3,660
To Premium or Goodwill A/c	14,070	By B's Capital A/c	3,400
To D's Capital A/c	14,700	By Balance c/d	24,920
To C's Capital A/c	1,320		
	31,980		31980

7.4 CHECK YOUR PROGRESS

1. New partner can be admitted in the partnership with the ____________of the all partners.
2. Goodwill of a business can be sold only by________the business.
3. Admission of a partner is termination of agreement and not of firm.________
4. Excess of the proportionate investment is the cost of for the old partners.
5. Goodwill is distributed among old partners according to income sharing ratio.

7.5 SUMMARY

When a business organization requires additional capital or managerial help or both for expansion of the business it may admit a new partner to increase its resources. In case of a sole proprietorship, it is converted into a partnership on the admission of a new person as an owner of the business enterprise. According to the Partnership Act, 1932, no new partner can be introduced into a firm without the consent of all the existing partners. On the admission of a new partner, the following adjustments become necessary:

(i) Adjustment in profit sharing ratio.

(ii) Adjustment of Goodwill.

(iii) Adjustment for revaluation of assets and reassessment of liabilities.

(iv) Distribution of accumulated profits and reserves; and

(v) Adjustment of partners' capitals.

7.6 KEYWORDS

Sacrificing Ratio: The ratio in which old partners surrender their profits for new partner.

Revaluation Account: An account for the adjustment of valuation of assets and liabilities.

Memorandum Revaluation Account: An account prepared to show the assets and liabilities at their old values even after the revaluation.

Goodwill: The reputation or advantage that a business has.

7.7 SELF ASSESSMENT TEST

Q.1 Why there is need of admission of a new partner? Discuss the adjustments at the time of admission of a new partner.

Q.2 What is Goodwill? Explain the accounting treatment of goodwill at the time of admission of a partner.

Q.3 What do you understand by Revaluation account? Explain the objectives and Performa of Revaluation account.

Q.4 What is Memorandum of Revaluation Account? How it differs from Revaluation Account.

Q.5 Writes notes on the following:

i) Sacrificing Ratio

ii) Change in Profit sharing Ratio

iii) Undistributed Profits/losses

Q.6. Seeta and Geeta are partners in a firm sharing profits and losses in the ratio of 2:1. On 31st December, 2019 their balance sheet was as follows:

Liabilities		Amount	Assets	Amount
		₹		₹
Capital Accounts:	₹		Land & Building	5,00,000
Seeta	7,05,000		Plant & Machinery	3,40,000
Geeta	3,20,000	10,25,000	Investments	65,000
Creditors		49,000	Stock	88,000
Bills Payable		51,000	Debtors	70,000
Provision for Bad & Doubtful Debts		2,500	Bills Receivable	42,000
Taxation Reserve		71,000	Cash in hand	1,07,000
General Reserve		37,500	Advertisement Expenses	24,000
		12,36,000		12,36,000

They admit Anita into partnership on the following terms:

1. Provision on Debtors is to be increased by ₹ 2,800.
2. Land & Building and Plant & Machinery should be revalued at ₹ 5,25,000 and ₹ 3,29,000 respectively.
3. Prepaid Insurance ₹ 3,100 has not been shown in balance sheet.
4. Market value of Investments in ₹ 72,000. Seeta has taken over the Investments at this value.
5. New profits sharing ratio of partners will be 3:2:1.
6. Anita will bring ₹ 1,95,000 as per capital and her share of goodwill.
7. Goodwill is to be valued at twice of the average profit of the last 4 years which were ₹ 86,000, ₹ 78,000, ₹ 62,000 and ₹98,000 respectively.
8. 60% of the amounts of goodwill are withdrawn by old partners.

   Give Journal Entries. Prepare Revaluation A/c, Capital A/cs and opening Balance Sheet of the new firm.

7.8 ANSWERS TO CHECK YOUR PROGRESS

1. Consent
2. Selling
3. A dissolution
4. Goodwill
5. Old

7.9 REFERENCES/SUGGESTED READINGS

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Course: **Financial Accounting-II**	
Course Code: **BCOM 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **8**	SLM Conversion By**: Ms. Chand Kiran**

PARTNERSHIP ACCOUNTS: RETIREMENT AND DEATH OF A PARTNER

STRUCTURE

8.0 LEARNING OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning and calculation of Gaining Ratio.
- To understand the accounting treatment of goodwill, undistributed profits/losses and reserves.
- To know the revaluation of assets and liabilities.
- To know the calculation of amount payable to retiring/ deceased partners.

8.1 INTRODUCTION

When one or more partners leave the firm and the remaining partners continue the business of the firm, is known as retirement of a partner. Anexisting partner may decide to retire from the partnershipdue to some reasons like old age, poor health, strained relations etc. Due to retirement, theexisting partnership comes to an end and the remaining partners form a newagreement and the partnership firm is reconstituted with new terms andconditions. At the time of retirement the retiring partner's claim is settled. There are three ways in which a partner may retire fromthe firm, viz., (i) he may retire at any time with the consent of all other partners; (ii) where thereis an agreement between the partners about retirement, and retirement in accordance with the terms of the agreement; (iii) where the partnership is at will, a partner may retire by givingto his partners a notice of his intention to retire.

8.1.1 ADJUSTMENTS AT THE TIME OF RETIREMENT AND DEATH OF A PARTNER

Calculation of New Profit Sharing Ratio:

As soon as a partner retires the profit sharing ratio of the continuing partnersget changed. The share of the retiring partner is distributed amongst thecontinuing partners. In the absence of information, the continuing partnerstake the retiring partner's share in their profit sharing ratio or in an agreedratio.

Various cases of new ratio are illustrated as follows:

(i) Retiring partner's share distributed in Existing Ratio

In this case, retiring partner's share is distributed in existing ratio amongstthe remaining partners. The remaining partners continue to share profits andlosses in the existing ratio.

(ii) Retiring partner's share distributed in Specified proportions

Sometimes the remaining partners purchase the share of the retiring partnerin specified ratio. The share purchased by them is added to their old shareand the new ratio is arrived at.

(iii) Retiring Partner's share is taken by one of the partners

The retiring partner's share is taken up by one of the remaining partners.In this case, the retiring partner's share is added to that of partner's existingshare. Only his/her share changes. The other partners continue to shareprofit in the existing ratio.

Calculation of Gaining Ratio:

Sacrificing ratio is calculated in the case of admission of a new partner; and the gaining ratio is computed at the time of retirement or death of a partner.The gaining ratio of each remaining partner is calculated by deducting the old shareof profit from the new share of profit.

Gaining Ratio = New Ratio – Existing Ratio

This is always that portion of the share of profitof the retiring or deceased partner which has been acquired.

Distinguish between Sacrificing Ratio and Gaining Ratio:

Difference	**Sacrificing Ratio**	**Gaining Ratio**
1. Meaning	It is the ratio in which old partners agree to sacrifice their share of profit in favorof new partner.	It is the ratio in which continuing partner acquires the share of profit from outgoing partner.
2. Calculation	Sacrificing Ratio = Old Ratio – New Ratio	Gaining Ratio = New Ratio – Old Ratio

3. Time	It is calculated at the time of admission of new partner/partners.	It is calculated at the time of retirement/death of old partner/partners.
4. Objective	It is calculated to ascertain the share of profit and loss given up by the existing partners in favor of new partners/partner.	It is calculated to ascertain the share of profit and loss acquired by the remaining partners from the retiring or deceased partner.
5. Effect	It reduces the profit share of the existing partners.	It increases the profit share of the remaining partners.

8.1.2 ACCOUNTING TREATMENT OF GOODWILL

At the time of retirement or death of a partner the retiring partner is entitled to his share ofgoodwill because the goodwill has been earned by the firm with the efforts of all the existingpartners. The valuation of goodwill will be done as per the agreement among the partners. It is possible that firm will earn abnormal profit in near future because of the existing goodwill of the firm. Therefore, the retiring/deceased partner should be compensated for the same bythe continuing partners in their gaining ratio. As per Accounting Standard,goodwill is recorded in the books only when some consideration in moneyis paid for it. Therefore, goodwill is recorded in the books only when it ispurchased and the goodwill account cannot be raised on its own. Therefore, in case of retirement of a partner, the goodwill is adjustedthrough partner’s capital accounts. The retiring partner’s capital account iscredited with. his/her share of goodwill and remaining partner’s capitalaccount is debited in their gaining ratio.

The journal entry is made as under:

Remaining Partners’ Capital A/c Dr.

To Retiring Partner’s Capital A/c

(Retiring partner’s share of goodwill adjusted toremaining partners in the gaining ratio)

When the Goodwill Account already appears in the Books

If at the timeof retirement/death of a partner, goodwill appears in the Balance Sheet ofthe firm, it will be written off by debiting all the partners' capital accountin their existing profit sharing ratio and crediting the goodwill account. Insuch a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)

To Goodwill A/c

(Existing goodwill written-off in the old profit sharing ratio)

8.1.3 REVALUATION OF ASSETS AND LIABILITIES

At the time of retirement of a partner the assets and liabilities of the firmare revalued and Revaluation Account is prepared in the same way as incase of admission of a partner. This is done to adjust the changes in valueof assets and liabilities at the time of retirement/death of a partner. Anyprofit or loss due to revaluation is divided amongst all the partners includingretiring/deceased in their existing profit sharing ratio. Following journalentries are made for this purpose:

(i) For increase in value of assets:

Assets A/c Dr.

To Revaluation A/c

(Increase in the value of assets)

(ii) For decrease in value of assets:

Revaluation A/c Dr.

To Assets A/c

(Decrease in the value of asset)

(iii) For increase in value of Liabilities:

Revaluation A/c Dr.

To Liabilities A/c

(Increase in the value of liabilities)

(iv) For decrease in value of Liabilities:

Liabilities A/c Dr.

To Revaluation A/c

(Decrease in the value of liabilities)

Revaluation account is prepared to record the change in the value of assetsor liabilities. It will reveal profit or loss on revaluation. This profit or lossis divided amongst all partners including the retiring/deceased partner inexisting profit sharing ratio.

(v) For Profit on Revaluation:

Revaluation A/c Dr. (Individually)

To Partner's Capital A/c

(Profit on revaluation divided amongst allpartners in their existing profit sharing ratio)

(vi) For loss on Revaluation:

Partner's Capital A/c Dr. (Individually)

To Revaluation A/c

(Loss on revaluation borne by all partnersin their existing profit sharing ratio)

Example: A, B and C are partners in a firm sharing profits and loses in the ratio of their capitals. Their balance sheet as on 31st December, 2019 is given below:

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		5,000	Cash at Bank		1,000
Capital Accounts:	₹		Sundry Debtors	10,000	
A	30,000		Less: Provision	1,000	9,000
B	40,000		Stock		8,000
C	30,000	1,00,000	Furniture		10,000

General Reserve	10,000	Plant & Machinery	25,000
		Land & Building	62,000
	1,15,000		1,15,000

C retires and the remaining partners agree to settle his account on the following terms:

1. The value of goodwill of the firm was fixed at ₹ 21,000. The share of C should be adjusted into the accounts of A and B who agree to share future profits and losses in the ratio of 3:4.
2. The value of Furniture and Plant and Machinery was to be depreciated @ of 15% and 20% respectively.
3. The Stock was revalue at ₹ 6,500.
4. The value of Land and Building is to be appreciated by 20%.

Pass necessary journal entries in the books of the firm to give effect to these arrangements and also prepare the Balance Sheet of the new firm.

Solution:

Journal

Date	Particulars		L.F.	Debit Amount	Credit Amount
				₹	₹
	Revaluation A/c	Dr.		8,000	
	To Stock A/c				1,500
	To Furniture A/c				1,500
	To Plant & Machinery				5,000
	(Decrease in the value of assets)				
	Land & Building A/c	Dr.		12,400	
	To Revaluation A/c				12,400
	(Increase in the value of land & building)				
	General Reserve A/c	Dr.		10,000	
	To A's Capital A/c				3,000
	To B's Capital A/c				4,000
	To C's Capital A/c				3,000
	(Transfer of general reserve to Capital A/cs of all partners in old ratio)				
	Revaluation A/c	Dr.		4,400	
	To A's Capital A/c				

	To B's Capital A/c To C's Capital A/c (Transfer of profit on revaluation to Capital A/cs in old ratio)			1,320 1,760 1,320
	A's Capital A/c Dr. B's Capital A/c To C's Capital A/c (C's share of goodwill distributed between A and B in their gaining ratio)		2,700 3,600	6,300
	C's Capital A/c Dr. To C's Loan A/c (Balance of capital of C transferred to his loan account)		40,620	40,620

Dr. Revaluation Account Cr.

Particulars		Amount	Particulars	Amount
		₹		₹
To Stock A/c		1,500	By Land & Building A/c	12,400
To Furniture A/c		1,500		
To Plant & Machinery		5,000		
To Profit transferred to:	₹			
A's Capital A/c	1,320			
B's Capital A/c	1,760			
C's Capital A/c	1,320	4,400		
		12,400		12,400

Dr. Partner's Capital Account Cr.

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To C's Capital A/c	2,700	3,600	–	By Balance b/d	30,000	40,000	30,000
To C's Loan A/c	–	–	40,620	By General Reserve A/c	3,000	4,000	3,000
To Balance c/d	31,620	42,160	–	By Revaluation A/c	1,320	1,760	1,320
				By A's Capital A/c	–	–	2,700
				By B's Capital A/c	–	–	3,600
	34,320	45,760	40,620		34,320	45,760	40,620

Balance Sheet of New Firm

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		5,000	Cash at Bank		1,000
C's Loan		40,620	Sundry Debtors	10,000	
Capital Accounts:₹			Less: Reserves	1,000	9,000
A	31,620		Stock		6,500
B	42,160	73,780	Furniture		8,500
			Plant & Machinery		20,000
			Land & Building		74,400
		1,19,400			1,19,400

8.1.4 TREATMENT OF UNDISTRIBUTED PROFIT/LOSS AND RESERVES

All the balances of Accumulated Reserves, funds and undistributed amountof Profit or Loss appearing in the balance sheet of the firm on the date ofretirement/death is distributed amongst all partners including retiring/deceasedpartner in their old profit sharing ratio. The following entries are made:

(i) For distribution of undistributed profit and reserve.

Reserves A/c Dr.

Profit and loss A/c (Profits i.e. credit balance) Dr.

To All partners' capital A/c (individually)

(Reserves and undistributed profit transferred to partner's capital A/c in old profit sharingratio)

(ii) For distributing losses among all partners in the old ratio

All Partners, Capital A/c Dr.

To P&L A/c (accumulated losses, i.e. debit balance)

To Deferred Revenue Expenditure A/c

The surplus available on some specific funds like workmen's compensation fund or investment fluctuation fund to meet certain obligations in future will be transferred to capital accounts of all the partners in their old ratio. For the purpose, the following journal entries are recorded:

Workman's Compensation Fund A/c Dr.

Investment Fluctuation fund A/c Dr.

To All Partners' capital A/c

(Surplus available on workmen's compensation fund and investment fluctuation fund transferred to partner's capital A/c in old profit sharing ratio).

8.1.5 AMOUNT PAYABLE TO RETIRING PARTNER

When a partner retires from business, his claim against the firm is determined by preparing his capital account incorporating therein all the adjustments in respect of his share of goodwill, accumulated profits or losses, profit/loss on revaluation of assets and liabilities, etc. Now the settlement of the claim depends on the provisions of the partnership deed. If nothing is given in the problem to be solved in respect of settlement of claim, the amount of claim is usually transferred to the Retiring partner's Loan Account for which the following entry is passed:

Retiring Partner's Capital A/c Dr

To Retiring Partner's Loan A/c

The retiring partners' claim consists of

Particulars	**Amount**
Items to added • The credit balance of Capital Account • His/her share in the Goodwill of the firm • His/her share in the Revaluation Profit • His/her share in General Reserve and Accumulated Profit	

• Interest on Capital	
Total	
(B) Items to be Deducted • His/her share in the Revaluation loss • His/her Drawings and Interest on Drawings up to the date of retirement • His/her share of any accumulated losses • Loan taken from the firm	
Total	
Retiring Partner's Interest (A – B)	

- The total amount so calculated is the claim of the retiring partner. He/she is interested in receiving the amount at the earliest. Total payment may be made immediately after his/her retirement. However, the resources of the firm may not be available to make the payment to the retiring partner in lump sum. The firm makes payment to retiring partner in installments.

(i) Payment in Lump Sum

Retiring partners' claim is paid either out of the funds available with thefirm or out of funds brought in by the remaining partners.The following journal entry is made for disposal of-the amount payable tothe retiring partner:

On payment of cash in lump sum:

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

(Amount paid to the retiring partner)

Payment in Installments

In this case the amount due to retiring partner is paid in installments. In the absence of anyagreement, section 37 of the Indian Partnership Act, 1932 is applicable. An installment consists of two parts:

(i) Principal Amount of installment due to retiring partner.

(ii) Interest at an agreed rate.

Interest due on loan amount is credited to retiring partners' loan account. Installment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.

(i) On part payment in cash and balance transferred to his/her loan account.

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

To Retiring Partner's Loan A/c

(Part payment made and balance transferred to loan A/c)

(ii) Total amount due transferred to loan A/c

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

(Total amount due transferred to loan A/c)

(iii) For interest due

Interest on loan A/c Dr.

To Retiring Partners' Loan A/c

(Interest due on loan)

(iv) For payment of installment

Retiring Partners' Loan A/c Dr.

To Cash/Bank A/c

(Installment inclusive of interest paid)

On 30th June, 2019 the balance sheet of A, B and C who were sharing profits and losses in the proportion to their capital stood as follows:

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		17,400	Cash at Bank		1,000
Capitals:	₹		Customers	23,500	
A	40,000		Less: Provision	1,200	22,300
B	30,000		Stock		21,700
C	20,000	90,000	Machinery		35,000
		12,600	Land & Building		40,000
		1,20,000			1,20,000

On this date B decided to retire and for this purpose it was agreed that:

1. Goodwill of the entire firm was fixed at ₹25,200 and B's share of it be adjusted into the accounts of A and C who will share future profits in the ratio of 4:3.
2. Land & Building is appreciated by 10%.
3. Machinery will be reduced by 20%.
4. The provision for bad debts is no longer necessary.
5. The entire capital of the firm as newly constituted will be fixed at ₹70,000, which will remain between A and C in the proportion of 4:3. Such excess or deficit to be paid off or brought in cash, as the case may be.

Pass journal entries. Prepare capital accounts and the Balance Sheet of the new firm.

Solution:

Journal

Date	Particulars		L.F.	Debit Amount	Credit Amount
				₹	₹
	Profit & Loss A/c	Dr.		12,600	
	To A's Capital A/c				5,600
	To B's Capital A/c				4,200
	To C's Capital A/c				2,800
	(Undistributed profits transferred to Partner's Capital A/cs in their old ratio 4:3:2)				

	Revaluation A/c Dr. To Machinery (Decrease in the value of asset)		7,000	7,000
	Land & Building A/c Dr. Provision for Bad Debts A/c Dr. To Revaluation A/c (Increase in the value of assets and decrease in the amount of provision for bad debts)		4,000 1,200	5,200
	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Revaluation A/c (Loss on revaluation transferred to Partners' Capital A/cs in their old ratio 4:3:2)		800 600 400	1,800
	A's Capital A/c Dr. C's Capital A/c Dr. To B's Capital A/c (B's share of goodwill adjusted to the accounts of continuing partner's in their gaining ratio 8:13)		3,200 5,200	8,400
	B's Capital A/c Dr. To B's Loan A/c (Transfer of B's Capital A/c to B's Loan A/c)		42,000	42,000
	A's Capital A/c Dr. To Bank A/c (Excess amount of capital paid to A)		1,600	1,600
	Bank A/c Dr. To C's Loan A/c (Deficit amount of capital brought in by C)		12,800	12,800

Dr. Partner's Capital Account Cr.

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To Revaluation A/c	800	600	400	By Balance b/d	40,000	30,000	20,000
To B's Capital A/c	3,200	–	5,200	By Profit & Loss A/c	5,600	4,200	2,800
To B's Loan A/c	–	42,000	–	By A's Capital A/c	–	3,200	–
To Balance c/d	41,600	–	17,200	By C's Capital A/c	–	5,200	-
	45,600	42,600	22,800		45,600	42,600	22,800
To Bank A/c	1,600	–	–	By Balance b/d	41,600	–	17,200
To Balance c/d	40,000	–	30,000	By Bank A/c	–	-	12,800
	41,600	–	30,000		41,600	–	30,000

Balance Sheet of New Firm

Liabilities		Amount	Assets	Amount
		₹		₹
Sundry Creditors		17,400	Cash at Bank	12,200
B's Loan		42,000	Customers	23,500
Capital Accounts:₹			Stock	21,700
A	40,000		Machinery	28,000
B	30,000	70,000	Land & Building	44000
		1,29,400		1,29,400

Example: A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1. They had taken a Joint Life Policy of ₹ 2,00,000, whose surrender value of Ist January, 2019 was ₹42,000. On this date the Balance Sheet of firm stood as follows:

Liabilities		Amount	Assets	Amount
		₹		₹
Sundry Creditors		65,000	Cash at Bank	2,06,000
Outstanding Expenses		5,880	Sundry Debtors	80,000
Reserve Fund		33,000	Stock	65,000
Capitals Accounts:	₹		Investments	40,000
A	3,00,000		Computers	25,000

B	2,85,000		Machinery	1,10,000
C	1,37,120	7,22,120	Factory Building	3,00,000
		8,26,000		8,26,000

B retired on the above date and the new profit sharing ratio between A and C will be 4:3. The revaluation of assets and liabilities is to be adjusted in following way:

1. To make a provision of 5% on Sundry Debtors for doubtful debts.
2. To depreciate Computers by 20% and Machinery by 5%.
3. Factory building to be revalued at ₹3,35,000.
4. Stock to be appreciated by 10%.
5. Salaries outstanding (not provided for as yet) was ₹2,200.
6. Goodwill of the firm is valued at ₹87,500 and the adjustment in this respect are made without raising a goodwill A/c. The joint life insurance policy was also not to appear in the Balance Sheet.
7. A and C decided that their capitals will be in their new profit sharing ratio. For this cash to be brought in or paid off to the partners B's A/c will be transferred to his loan account.
8. B is paid off ₹1,59,920 on the date of retirement and the remaining amount was to be paid in four equal installments together with interest at the rate of 12% p.a. on the outstanding balance.

Pass necessary Journal entries; prepare Revaluation A/c, Capital A/cs, New Balance Sheet and B's Loan A/c for 4 years.

Solution:

Journal

Date	Particulars	L.F.	Debit Amount	Credit Amount
			₹	₹
	Revaluation A/c Dr.		8,000	
	To Provision for Doubtful Debts A/c			1,500
	To Computers A/c			1,500
	To Machinery A/c			5,000
	To Outstanding Salaries A/c			
	(Decrease in the value of assets and increase in the value of liabilities)			
	Factory Building A/c Dr.		12,400	
	Stock A/c			
	To Revaluation A/c			12,400

	(Increase in the value of assets)			
	Revaluation A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Profit on revaluation transferred to Partner's Capital A/cs in old ratio)		10,000	3,000 4,000 3,000
	Reserve Fund A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Reserve Fund transferred to Capital A/cs of Old Partners' A/cs in old ratio)		4,400	1,320 1,760 1,320
	A's Capital A/c Dr. C's Capital A/c To B's Capital A/c (Goodwill adjusted in the gaining ratio 3:4)		15,000 20,000	35,000
	A's Capital A/c Dr. C's Capital A/c To B's Capital A/c (B's share in the surrender value of joint life policy adjusted in gaining ratio 3:4)		7,200 9,600	16,800
	B's Capital A/c Dr. To Bank A/c (Cash paid to B)		1,59,920	1,59,920
	B's Capital A/c Dr. To Bank A/c (Balance of B's Capital A/c transferred to B's Loan A/c)		2,00,000	2,00,000
	A's Capital A/c Dr. To Bank A/c (Amount paid to A to bring his capital to profit sharing ratio)		60,920	60,920

	Bank A/c Dr. To C's Capital A/c (Amount brought by C to raise his capital to profit sharing ratio)		60,920	60,920

Dr. Revaluation Account Cr.

Particulars		Amount	Particulars	Amount
		₹		₹
To Provision for Doubtful Debts A/c		4,000	By Factory Building A/c	35,000
To Computer A/c		5,000	By Stock A/c	6,500
To Machinery A/c		5,500		
To Outstanding Salaries A/c		2,200		
To Profit transferred to:	₹			
A's Capital A/c	9,920			
B's Capital A/c	9,920			
C's Capital A/c	4,960	24,800		
		41,500		41,500

Dr. Partner's Capital Account Cr.

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To B's Capital A/c				By Balance b/d	3,00,000	2,85,000	1,37,120
(Goodwill)	15,000	–	20,000	By Revaluation A/c	9,920	9,920	4,960
To B's Capital A/c				By Reserve Fund A/c	13,200	13,200	6,600
(Life Policy)	7,200	–	9,600	By A's Capital A/c			
To Balance c/d	3,00,920	3,59,920	1,19,080	(Goodwill)	–	15,000	–
				By C's Capital A/c			
				(Goodwill)	–	20,000	–
				By A's Capital A/c			
				(Life Policy)	–	7,200	–
				By C's Capital A/c			

	3,23,120	3,59,920	1,48,680	(Life Policy)	–	9,600	–
To Bank A/c	–	1,59,920	–		3,23,120	3,59,920	1,48,680
To B's Loan A/c	–	2,00,000	–	By Balance b/d	3,00,920	3,59,920	1,19,080
To Bank A/c	60,920		–	By Bank A/c	–	–	60,920
To Balance c/d	2,40,000		–				
	3,00,920	3,59,920	1,80,000		3,00,920	3,59,920	1,80,000

Balance Sheet of New Firm

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		65,000	Cash at Bank		46,080
Outstanding Expenses		5,880	Sundry Debtors	80,000	
Outstanding Salaries		2,200	Less: Provision	4,000	76,000
B's Loan		2,00,000	Stock		71,500
Capital Accounts:₹			Investments		40,000
A	2,40,000		Computers		20,000
C	1,80,000	4,20,000	Machinery		1,04,500
			Factory Building		3,35,000
		6,93,080			6,93,080

Dr. B's Loan Account Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2009			₹	2009			₹
Dec.31	To Bank A/c			Jan.1	By B's Capital A/c		2,00,000
	(50,000 + 24,000)		74,000	Dec.31	By Interest A/c		
Dec. 31	To Balance c/d		1,50,000		(12% on 2,00,000)		24,000
			2,24,000				2,24,000
2010				2010			
Dec.31				Jan.1	By Balance b/d		1,50,000
	To Bank A/c			Dec.31	By Interest A/c		
Dec.31	(50,000 + 18,000)		68,000		(12% on 1,50,000)		18,000

	To Balance c/d		1,00,000				1,68,000
2011			1,68,000				
Dec.31				2011			
	To Bank A/c			Jan.1	By Balance b/d		1,00,000
Dec.31	(50,000 + 12,000)		62,000	Dec.31	By Interest A/c		
	To Balance c/d		50,000		(12% on 1,00,000)		12,000
2012			1,12,000				1,12,000
Dec.31				2012			
	To Bank A/c			Jan.1	By Balance b/d		50,000
	(50,000 + 6,000)		56,000	Dec.31	By Interest A/c		
					(12% on 50,000)		6,000
			56,000				56,000

8.2 Accounting Treatment of Joint Life Insurance Policy

Usually, firm takes joint as well as individual life insurance policies on the lives of partners, the premium of which is paid by the firm. The retiring partner is also entitled to share the proceeds of life insurance policy. This share is given out of surrender value of the policy. The surrender value is that amount which is given by insurance company to the firm when the life policy is surrendered before the maturity of policy. At the time of retirement of a partner, the joint life insurance policy can be recorded in following two ways:

1. **If Premium is considered as Revenue Expenditure:** If the joint life policy premium is considered as revenue expenditure, then the following entry is passed with its surrender value:

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			₹	₹
	Joint Life Policy A/c Dr. To All Partners' Capital A/cs (Surrender value of joint life policy credited to all partners accounts in old ratio)			

If, after the retirement, the remaining partners decide that the joint life policy will not be shown in the books, then this account is written off by passing the following entry:

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			₹	₹
	Continuing Partners' Capital A/cs Dr. To Joint Life Policy A/c (Existing joint life policy written off to continuing partners in their new ratio)			

2. **If Premium is considered as Capital Expenditure:** If the joint life policy premium is considered as capital expenditure, then the joint life policy has already been shown in the balance sheet. Therefore, no further treatment is made of joint life policy at the time of retirement of a partner. However, if the remaining partners decide that the joint life policy will not be shown in the books, then it is written off by passing the following entry:

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			₹	₹
	Continuing Partners' Capital A/cs Dr. To Joint Life Policy A/c (Existing joint life policy written off to continuing partners in their gaining ratio)			

Example: Firm A B C consisted of three partners A, B and C, sharing profits and losses in the ratio of 5:3:2. The partner A died on February 20, 2019. The profit and loss account for the period up to the date of death and the Balance Sheet as on that date were prepared:

Liabilities		Amount	Assets	Amount
		₹		₹
Capitals Accounts:	₹		Goodwill	6,000
A	12,000		Machinery	35,000
B	16,000		Furniture	6,000
C	12,000	40,000	Stock	9,000

Loan from A	5,000	Debtors	15,000
General Reserve	7,000	Bank	3,000
Creditors	22,000		
	74,000		74,000

In addition to the assets shown above, the firm had three Life Insurance Policies in the name of each partner, at an insured value of ₹ 20,000 each, the premium of which were charged to the Profit & Loss Account.

According to the partnership deed, on the death of a partner, the assets and liabilities are to be revalued by a valuer. The revalued figures were:

1. Goodwill ₹ 21,000; Machinery ₹ 45,000; Debtors are subject to provision for Doubtful Debts at 10%; and Furniture at ₹ 7,000.
2. Provision for taxation to be created for ₹ 1,500.
3. Death claim for policy in the name of A will be realised in full and the surrender value of the other two policies was ₹ 7,500 each.
4. Deceased partner is entitled to his share in reserves.

The business will be continued by B and C, henceforth sharing profits and losses equally. The net balance due to A is transferred to his Executor's Account, which will be paid off later.

Show the Revaluation Account, Capital Accounts and the new Balance Sheetof the firm.

Dr. **Revaluation Account** **Cr.**

Particulars		Amount	Particulars	Amount
		₹		₹
To Provision for Doubtful Debts A/c		1,500	By Machinery A/c	10,000
To Provision for Taxation A/c		1,500	By Furniture A/c	1,000
To Profit transferred to:	₹			
A's Capital A/c	4,000			
B's Capital A/c	2,400			
C's Capital A/c	1,600	8,000		
		11,000		11,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹

To Goodwill A/c	3,000	1,800	1,200	By Balance b/d	12,000	16,000	12,000
To A's Capital A/c	-	–	–	By General Reserve A/c	3,500	–	–
(Goodwill)	–	4,200	6,300	By B's Capital A/c			
To A's Executor's A/c	44,500	–	–	(Goodwill)	4,200	–	–
To Balance c/d	–	22,900	13,100	By C's Capital A/c			
				(Goodwill)	6,300	–	–
				By Revaluation A/c	4,000	2,400	1,600
				By Life Policy A/c	17,500	10,500	7,000
	47,500	28,900	20,600		47,500	28,900	20,600

Dr. **A's Executor's Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance c/d	49,500	By A's Loan A/c	5,000
		By A's Capital A/c	44,500
	49,500		49,500

Balance Sheet

Liabilities		Amount	Assets		Amount
		₹			₹
Provision for Taxation		1,500	Bank		23,000
Creditors		22,000	Debtors	15,000	
A's Executor's A/c		49,500	Less: Provision	1,500	13,500
General Reserve		3,500	Stock		9,000
Capital Accounts:	₹		Life Policies (Surrender Value)		15,000
A	22,900		Furniture		7,000
B	13,100	36,000	Machinery		45,000
		1,12,500			1,12,500

8.3 Determination of Amount Payable to Deceased Partner:

The key difference between the retirement and death of partner is that normally the retirement takes place at the end of an accounting period whereas death can occur at any time. On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner, When the partner dies the amount payable to him/her is paid to his/her legal representatives. Section 37 of the Partnership Act provides that if the amount is not paid immediately, the executors of the deceased partner would be entitled, at their choice, to receive interest @ 6% p.a. from the date of death to the date of actual payment.

The deceased partners' claim consists of:

Particulars	**Amount**
(A) Items to be credited • The amount standing to the credit to the capital account of the deceased Partner • Interest on capital, if provided in the partnership deed up to the date of death • Share of goodwill of the firm • Share of undistributed profit or reserves • Share of profit on the revaluation of assets and liabilities • Share of profit up to the date of death • Share of Joint Life Policy	
Total	
(B) Items to be Deducted • His/her share in the Revaluation loss • His/her Drawings and Interest on Drawings up to the date of retirement • His/her share of any accumulated losses	

• Loan taken from the firm	
Total	
Deceased Partner's Claim (A – B)	

Calculation of profit up to the date of death of a partner.

If the death of a partner occurs during the year, the representatives of thedeceased partner are entitled to his/her share of profits earned till the dateof his/her death. Such profit is ascertained by any of the following methods:

(i) Time Basis

(ii) Turnover or Sales Basis

On the Basis of Time

There are two methods used in ascertainment of profit on the basis of time:

1. **On the basis of average profit of certain years*:*** Under this method the calculation of profitis based on the average annual profit for the past few years say, 3 to 5 years. Then, theprofit for the proportionate period is found out.

2. **On the basis of last year's profit:** Calculation of profit is based on the last year's profit.

On the Basis of Turnover

Under this method, the share of profit is calculated on the basis of the profit and the total salesof the last year. Thereafter, the profit up to the date of death is estimated on the basis of the saleof the last year.

Settlement of Executor's Account:

After the death of a partner the total amount due to him is transferred to his, executor's accountand paid off as per the provisions of the partnership deed immediately or in installments together with interest on outstanding balance. As explained earlier the amount due to the deceasedpartner should include the amount standing to the credit of his Capital Account, a share in theaccumulated profits, goodwill, joint life policy (if any), profit on revaluation of assets/liabilities,etc.

The following entries should be passed for disposal of amount due to the deceased partner:

(a) The amount standing to the credit of deceased partner's capital is transferred to hisexecutor's account, by recording the following entry:

Deceased partner's capital A/c Dr

To Deceased partner's executor's A/c

Deceased partner's executor's account will be settled as per the agreement between thefirm and executor's of the deceased partner.

(b) When the full amount is paid in cash, following entry is recorded:

Executor's A/c Dr

To Cash/Bank A/c

(c) When the settlement is made in installments, the following entries are made:

(i) For interest due:

Interest on executor's A/c Dr

To Executor's A/c

(ii) For payment of installment on loan account

Executor's A/c Dr

To Cash/Bank A/c

8.4 CHECK YOUR PROGRESS

1. When a partner withdraws his capital from the partnership firm, it is called __________
2. Amount payable to the retiring partner is ~~of the firm, w~~hich will be paid in full or in installment.

3. The payment made to the retiring partner in installments is known as.____________
4. Amount due to retiring partner reduces due to the ~~to him.~~________
5. Goodwill may be ~~if all the partn~~ers are agreed, that it should not remain in the books.

8.5 SUMMARY

When one or more partners leave the firm and the remaining partners continue todo the business of the firm, it is known as retirement of a partner. Thus, due to some reasons like old age, poor health, strained relations etc., anexisting partner may decide to retire from the partnership. At the time of retirement the retiring partner's claim is settled.The following adjustments are made at the time of Retirement and Death of a Partner:

Calculation of New Profit Sharing Ratio:

As soon as a partner retires the profit sharing ratio of the continuing partnersget changed. The share of the retiring partner is distributed amongst thecontinuing partners. In the absence of information, the continuing partnerstake the retiring partner's share in their profit sharing ratio or in an agreedratio.

Calculation of Gaining Ratio:

As we calculate the sacrificing ratio in the case of admission of a new partner,we have to calculate the gaining ratio at the time of retirement or death of a partner.The gaining ratio of each remaining partner is calculated by deducting the old shareof profit from the new share of profit. Gaining Ratio = New Ratio – Existing Ratio

Accounting Treatment of Goodwill:

At the time of retirement or death of a partner the retiring partner is entitled to his share ofgoodwill because the goodwill has been earned by the firm with the efforts of all the existingpartners. Therefore, in case of retirement of a partner, the goodwill is adjustedthrough partner's capital accounts. The retiring partner's capital account iscredited with. his/her share of goodwill and remaining partner's capitalaccount is debited in their gaining ratio.

Revaluation of Assets and Liabilities:

At the time of retirement of a partner the assets and liabilities of the firmare revalued and Revaluation Account is prepared in the same way as incase of admission of a partner. This is done to adjust the changes in valueof assets and liabilities at the time of retirement/death of a partner. Anyprofit or loss due to revaluation is divided amongst all the partners includingretiring/deceased in their existing profit sharing ratio.

Treatment of Undistributed Profit/Loss and Reserves:

All the balances of Accumulated Reserves, funds and undistributed amountof Profit or Loss appearing in the balance sheet of the firm on the date ofretirement/death is distributed amongst all partners including retiring/deceasedpartner in their old profit sharing ratio.

8.6 KEYWORDS

Gaining Ratio: The ratio in which the remaining partners shares increases after retirement/ death of a partner.

Revaluation Account: Account for the adjustment of valuation of assets and liabilities.

Goodwill: The reputation or advantage that a business has.

Undistributed Profits: The profits which are not distributed among partners.

8.7 SELF ASSESSMENT TEST

Q.1 What is goodwill? Discuss how it is treated at the time of death of a partner.

Q.2 What do you understand by Gaining Ratio? How it differs from sacrificing Ratio?

Q.3 What is Revaluation account? Why there is need of preparation of Revaluation account at the time of retirement of a partner.

Q.4 What do you mean by Joint Life Policy? Discuss the objectives and accounting treatment of Joint Life Policy.

Q.5 M, N and R were Partners sharing profits and losses in the ratio of 3:2:1. On 30th April, 2018 their balance sheet was as follows:

Liabilities	Amount	Assets	Amount
	₹		₹
Creditors	36,000	Cash in Hand	62,000

Bills Payable	25,000	Stock	1,12,000
Outstanding Expenses	8,000	Debtors	80,000
General Reserve	48,000	Computers	25,000
Bank Loan	50,000	Furniture	35,000
Capital A/cs: ₹		Land & Building	2,50,000
M 1,95,000			
N 1,10,000			
R 92,000	3,97,000		
	5,64,000		5,64,000

On the above date R retired on the following terms:

1. The Goodwill of the firm was valued at ₹66,000.
2. The value of Land & Building should be appreciated by ₹36,000.
3. Outstanding expenses to be brought down to ₹5,600.
4. Depreciate Computers @ 20% and Furniture @ 15%.
5. Create a provision @ 5% for doubtful debts on Debtors.
6. R, be paid ₹55,000 in cash and the balance be transferred to his loan account.

Pass necessary journal entries in the books of the firm to give effect to these arrangements and also prepare the Balance Sheet of the new firm.

Q.6. The Balance Sheet of A, B and C who were sharing profits and losses in proportion of their capital stood as follows on 31st December, 2004:

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		6,900	Cash at Bank		5,500
Investment Fluctuation Fund		7,500	Sundry Debtors	5,000	
Capitals Accounts:	₹		Less: Provision	100	4,900
A	18,000		Stock		8,000
B	13,500		Investments		11,500
C	9,000	40,500	Land & Building		25,000
		54,900			54,900

B retired on the above date and the following was agreed upon:

1. The Stock is depreciated by 6%.
2. That the Provision for Doubtful Debts be brought up to 5% on Debtors.
3. The Land and Building be appreciated by 20%.
4. That a provision of ₹770 be made in respect of outstanding legal charges.
5. Investments are brought down to ₹8,500.
6. That the Goodwill of the firm be fixed at ₹10,800 and B's share of goodwill will be adjusted into the accounts of A and C who are going to share future profits in the ratio of 5:3 (No Goodwill Accounts is to be raised).
7. That the entire capital of the firm as newly constituted be fixed at ₹28,000 between A and C in the proportionate of 5:3. The capital accounts of both will be adjusted on this basis and the deficit or excess to be brought in or paid off in cash as the case may be.

Pass journal entries and show the Balance Sheet after transferring B's share to a separate Account in his name.

8.8 ANSWERS TO CHECK YOUR PROGRESS

1. Retirement of a partner.
2. The liability
3. Annuity
4. Payment
5. Written off

8.9 REFERENCES/SUGGESTED READINGS

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Course: **Financial Accounting-II**	
Course Code: **BCOM 201**	Author: **Dr. Suresh Kumar Mittal**
Lesson No: **9**	SLM Conversion By**: Ms. Chand Kiran**

PARTNERSHIP ACCOUNTS: DISSOLUTION OF PARTNERSHIP AND ACCOUNTING TREATMENT

STRUCTURE

9.0 LEARNING OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning of dissolution of partnership and partnership firm.
- To understand the modes of dissolution of firm.

- To know the accounting treatment at the time of dissolution of firm.
- To know the rules and accounting treatment in case of insolvency of partners.

9.1 INTRODUCTION

When the relationship between the partners discontinues, it is called dissolution of partnership and when it relates to the business of partnership, it is called dissolution of the firm. According to the Partnership Act,1932, the dissolution of partnership between all the partners of a firm is called the dissolution of the firm. Therefore, the act distinguishes between the dissolution of partnership and dissolution of the firm. For example, where X, Y and Z were partners in a firm and Z died or was declared 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. 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 end of relationship between all partners.

9.2 MEANING OF DISSOLUTION OF PARTNERSHIP AND PARTNERSHIP FIRM

Dissolution of Partnership: The dissolution of partnership means termination of the old partnership agreement and may or may not result into closing down of the business as the retiring partners may agree to carry on the business under a new agreement. The partnership is deemed to have been dissolved in any of the following circumstances:

i) Expiry of the period of partnership

ii) Completion of the venture for which it was formed

iii) Admission of a partner

iv) Retirement of a partner

v) Death of a partner

vi) Insolvency of a partner

In all the above-mentioned cases, the old partnership comes to an end but the business may be carried on in the same name and style with a new partnership coming into existence.

Dissolution of Partnership Firm: Dissolution of partnership firm means that the firm closes down its business and the assets of the firm are sold and liabilities are paid. Dissolution of a partnership firm may take place without the intervention of court or by the order of a court, in any of the ways specified later in this section. It may be noted that dissolution of the firm necessarily brings in dissolution of the partnership.

9.2.1 MODES OF DISSOLUTION OF FIRM

There are essentially two modes of dissolution of the firm i.e. (a) Dissolution without the order of the court, and (b) Dissolution by theorder of the court**.**

Dissolution without the order of the court:

A Partnership firm is dissolved without the order of the court in any one of the following ways:

1. Dissolution by Agreement: A firm is dissolved:

(a) With the consent of all the partners or

(b) In accordance with a contract between the partners.

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

(a) When all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract;

(b) When the business of the firm becomes illegal; or

(c) 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:

(a) If constituted for a fixed term, by the expiry of that term;

(b) If constituted to carry out one or more ventures, by the completion thereof;

(c) By the death of a partner;

(d) By the declaration 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.

Dissolution by Court:

Under Section 44, the court can order dissolution of the firm on the following grounds:

(a) When a partner becomes insane;

(b) When a partner becomes permanently incapable of performing his duties as a partner;

(c) When a partner is guilty of misconduct which is likely to adversely affect the business of the firm;

(d) When a partner persistently commits breach of partnership agreement;

(e) When a partner has transferred the whole of his interest in the firm to a third party;

(f) When the business of the firm cannot be carried on except at a loss; or

(g) When, on any ground, the court regards dissolution to be just and equitable.

9.2.2 DISTINGUISH BETWEEN DISSOLUTION OF PARTNERSHIP AND PARTNERSHIP FIRM

BASIS FOR	DISSOLUTION OF PARTNERSHIP	DISSOLUTION OF FIRM

BASIS FOR	DISSOLUTION OF PARTNERSHIP	DISSOLUTION OF FIRM
Meaning	Dissolution of a partnership refers to the discontinuance of the relation between partner and other partners of the firm.	Dissolution of firm implies that entire firm ceases to exist, including the relation among all the partners.
Nature	Voluntary	Voluntary or Compulsory
Business	Business of the firm continues as before.	Business of the firm comes to an end.
Economic relationship	Continues to exist but in a changed form.	Comes to an end.
Account	Revaluation account is created.	Realisation account is prepared.
Books of accounts	Books of accounts are not closed	Books of accounts are closed.

6.2.3 ACCOUNTING TREATMENT AT THE TIME OF DISSOLUTION OF FIRM

Usually the Partnership Deed contains an accounting clause according to which the final accounts between partners are settled. In the absence of such an agreement, the following procedure is used:

- The losses, including losses on capital, must be paid, first from profits, next out of capital and lastly, if necessary, by contribution of each partner in proportion to his share in profits.

- The assets of the firm, including sums contributed by partners to make up deficiency of capital, shall be applied as follows: (a) in paying debts of the firm to outsiders; (b) in paying each partner for advances made by him to the firm as distinct from capital; (c) in paying each partner, amount due for capital contribution, and (d) the residue in paying each partner in accordance with his share in the profits of the firm.
- If a partner becomes insolvent or otherwise cannot pay his share of the contribution, the solvent partners must share rateably the available assets (including their own contribution to the capital deficiency).

Treatment of Firm's Debts and Private Debts:

Where both the debts of the firm and private debts of a partner co-exist, the following rules, as stated in Section 49 of the Act, shall apply.

(a) The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims, which can be utilized for payment of their private liabilities.

(b) The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilized for payment of the firm's debts, in case the firm's liabilities exceed the firm's assets.

It may be noted that the private property of the partner does not include the personal properties of his wife and children. Thus, if the assets of the firm are not adequate enough to pay off firm's liabilities, the partners have to contribute out of their private assets.

Realization Account:

As we discussed earlier that in case of dissolution of a partnership firm the business activities of a firm comes to an end and the firm get dissolved. As soon as the partners decide to discontinue the business of the firm, it becomes necessary to settle its accounts. For this purpose, all the assets have to be sold and the liabilities are to be paid off. For this purpose a separate account called 'Realization Account' is opened. The following journal entries are made to transfer all the assets and liabilities in the Realization Account:

Journal Entries:

1. For transfer of assets

All asset accounts excluding cash, bank and the fictitious assets, if any are closed by transfer to the debit of Realisation Account at their book values. It may be noted that sundry debtors are transferred at gross value and the provision for doubtful debts is transferred to the credit side of Realisation Account along with liabilities. The same thing will apply to fixed assets, if provision for depreciation account is maintained.

Realisation A/c Dr.

To Assets A/c

2. For transfer of liabilities

All external liability accounts including provisions, if any, are closed by transferring them to the credit of Realisation account.

Liabilities A/c Dr.

To Realisation A/c

3. For sale of assets

Bank A/c Dr.

To Realisation A/c

4. For an asset taken over by a partner

Partner's Capital A/c Dr.

To Realisation A/c

5. For payment of liabilities

Realisation A/c Dr.

To Bank A/c

6. For a liability which a partner takes responsibility to discharge

Ralisation A/c Dr.

To Partner's Capital A/c

7. For settlement with the creditor through transfer of assets when a creditor accepts an asset in full and final settlement of his account, journal entry needs to be recorded. But, if the creditor accepts an asset only as part payment of his/her dues, the entry will be made for cash payment only.

Realisation A/c Dr.

To Bank A/c

However, when a creditor accepts an asset whose value is more than the amount due to him, he/she will pay cash to the firm for the difference for which the entry will be:

Bank A/c Dr.

To Realisation A/c

8. For payment of realisation expenses

(a) When some expenses are incurred and paid by the firm in the process of realisation of assets and payment of liabilities:

Realisation A/c Dr.

To Bank A/c

(b) When realisation expenses are paid by a partner on behalf of the firm:

Realisation A/c Dr.

To Partner's Capital A/c

(c) When a partner has agreed to undertake the dissolution work for an agreed remuneration bear the realisation expenses:

(i) If payment of realisation expenses is made by the firm

Partner’s Capital A/c Dr.

To Bank A/c

(ii) If the partner himself pays the realisation expenses, no entry is required

(iii) For agreed remuneration to such partner

Realisation A/c Dr.

To Partner’s Capital A/c

9.Forrealisation of any unrecorded assets including goodwill, if any

Bank A/c Dr.

To Realisation A/c

10.For settlement of any unrecorded liability

Realisation A/c Dr.

To Bank A/c

11.For transfer of profit and loss on realisation

(a) In case of profit on realisation

Realisation A/c Dr.

To Partners’ Capital A/c (individually) A/c

(b) In case of loss on realisation

Partners’ Capital A/c (individually) Dr.

To Realisation A/c

12.For transfer of accumulated profits in the form of reserve fund or general reserve:

Reserve Fund/General Reserve A/c Dr.

To Partners’ Capital A/c

13.For transfer of fictitious assets, if any, to partners' capital accounts in their profit sharing ratio:

Partners' Capital A/c Dr.

To Fictitious Asset A/c

14.For payment of loans due to partners

Partner's Loan A/c Dr.

To Bank A/c

15.For settlement of partners' accounts

If the partner's capital account shows a debit balance, he brings in the necessary cash for which the entry will be:

Bank A/c Dr.

To Partner's Capital A/c

The balance is paid to partners whose capital accounts show a credit balance and the following entry is recorded.

Partners' Capitals A/cs Dr.

To Bank A/c

It may be noted that the aggregate amount finally payable to the partners must equal to the amount available in bank and cash accounts. Thus, all accounts of a firm are closed in case of dissolution.Performa of the Realisation Account is given below:

Realisation Account

Particulars	**Amount**	**Particulars**	**Amount**
Land and Building		Sundry creditors	

Plant and Machinery Furniture and Fittings Bills receivables Sundry debtors Cash/Bank (payment of liabilities) Cash/Bank (payment of unrecorded liabilities) Partner's capital account (liability assumed by the partner) Profit (transferred to partners' capital account's in their profit sharing ratio)		Bills payables Bank overdraft Outstanding expenses Provision for doubtful debts Cash/Bank (sale of assets) Partner's capital account (assets taken by the partner) Loss (transferred to partners capital accounts)	
Total		**Total**	

Example: A, B and C were partners in a firm sharing profits and losses in the ratio of 3:2:1. On 31st December, 2018 their Balance Sheet was as follows:

Liabilities		Amount	Assets	Amount
		₹		₹
Bank Loan		26,000	Cast at Bank	35,000
Creditors		20,000	Debtors	15,000
B's Loan		10,000	Stock	32,000
Capital Accounts:	₹		Furniture	10,000
A	1,94,000		Computer	20,000
B	1,50,000		Patents	8,000
C	1,00,000	4,44,000	Plant	80,000
			Building	3,00,000

	5,00,000		5,00,000

The firm was dissolved on 1st January, 2009. Assets were realised as under: Debtors ₹14,000, Stock ₹ 29,000, Patents ₹ 3,500, Plant ₹71,000 and Building ₹3,10,000. A took over Furniture for ₹9,500 and C took over Computer for ₹21,000. Creditors were paid off at a discount of 5%. Realisation expenses amounted to ₹2,100.

Pass Journal Entries and prepare necessary Ledger Accounts.

Solution.

Journal

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
			₹	₹
	Realisation A/c		4,65,000	
	To Debtors A/c			15,000
	To Stock A/c			32,000
	To Furniture A/c			10,000
	To Computer A/c			20,000
	To Patents A/c			8,000
	To Plant A/c			80,000
	To Building A/c			3,00,000
	(Transfer of various assets to Realisation A/c at their book value)			
	Creditors A/c Dr.		20,000	
	Bank Loan A/c Dr.		26,000	
	To Realisation A/c			46,000
	(Transfer of outside liabilities to Realisation A/c at their book value)			
	Bank A/c Dr.		4,27,500	
	To Realisation A/c			4,27,500
	(Assets realised in cash)			
	A's Capital A/c Dr.		9,500	
	C's Capital A/c Dr.		21,000	
	To Realisation A/c			30,500

	(Assets taken over by the partners)			
	Realisation A/c Dr. To Bank A/c (Payment of outside liabilities)		45,000	 45,000
	Realisation A/c Dr. To Bank A/c (Payment of realisation expenses)		2,100	 2,100
	B's Loan A/c Dr. To Bank A/c (Payment of B's Loan)		10,000	 10,000
	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Realisation A/c (Loss on realisation transferred to Partners' Capital A/cs in their profit sharing ratio 3:2:1)		4,050 2,700 1,350	 8,100
	A's Capital A/c Dr. B's Capital A/c Dr. C's Capital A/c Dr. To Bank A/c (Final payment made to the partners)		1,80,450 1,47,300 77,650	 4,05,400

Ledger Accounts

Dr. Realisation Account Cr.

Liabilities	Amount	Assets	Amount
	₹		₹
To Debtors A/c	15,000	By Creditors A/c	20,000
To Stock A/c	32,000	By Bank Loan A/c	26,000
To Furniture A/c	10,000	By Bank A/c (Assets realised): ₹	
To Computer A/c	20,000	Debtors 14,000	
To Patents A/c	8,000	Stock 29,000	
To plant A/c	80,000	Patents 3,500	
To Building A/c	3,00,000	Plant 71,000	
To Bank A/c (Liabilities paid): ₹		Building 3,10,000	4,27,500

Creditors	19,000		By A's Capital A/c (Assets taken)		9,500
Bank Loan	26,000	45,000	By C's Capital A/c (Assets taken)		21,000
To Bank A/c (Expenses)		2,100			
A	1,94,000	5,12,100			5,04,000
B	1,50,000		By Loss Transferred to:		
C	1,00,000		A's Capital A/c	4,050	
		5,12,100	B's Capital A/c	2,700	
			C's Capital A/c	1,350	8,100
					5,12,100

Dr. **B's Loan Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Bank A/c	10,000	By Balance b/d	10,000
	10,000		10,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To Realisation A/c				By Balance b/d	1,94,000	1,50,000	1,00,000
(Assets taken)	9,500	–	21,000				
To Realisation A/c							
(Loss)	4,050	2,700	1,350				
To Bank A/c							
(Final Payment)	1,80,450	1,47,300	77,650				
	1,94,000	1,50,000	1,00,000		1,94,000	1,50,000	1,00,000

Dr. **Bank Account** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance b/d	35,000	By Realisation A/c (liabilities paid)	45,000

To Realisation A/c (Assets realised)	4,27,500	By Realisation A/c (Expenses)	2,100
		By B's Loan A/c	10,000
		By A's Capital A/c	1,80,450
		By B's Capital A/c	1,47,300
		By C's Capital A/c	77,650
	4,62,500		4,62,500

Accounting Treatment of Reserve or Provision

From the point of view of dissolution of firm, the reserves or provisions may be divided into three parts:

1. **General Reserve:** If general reserve, reserve fund, credit balance of profit and loss account etc are given in the balance sheet, then these are not transferred to realisation account. These have been transferred to partners' capital accounts in the profit sharing ratio. The entry is passed as under:

   General Reserve A/c Dr.

   Reserve Fund A/c Dr.

   Profit & Loss A/c Dr.

   Workmen's Compensation Fund A/c Dr.

   To Partners' Capital A/cs

   (Transfer or undistributed profits to Patners' Capital A/cs in their profit sharing ratio)

2. **Loss or Nominal Assets:** If the debit balance of profit and loss account or nominal assets such as advertisement expenses etc are given in the asset side of balance sheet, then these have been transferred to partners' capital accounts by passing the following entry:

   Partners' Capital A/cs Dr.

   To Profit & Loss A/c

   To Advertisement Expenses A/c

   (Transfer to undistributed losses or nominal assets a Partners' Capital A/cs in their profit sharing ratio)

3. **Special Reserve or Provision:** The reserve or provision which is created to achieve a specific objective is called special reserve, such as provision for doubtful debts, provision for depreciation, investment fluctuation fund etc. These reserves are not transferred to partners' capital accounts. However, these are closed by transferring to realisation account. The following entry is passed for this:

(a) For transfer of special reserves or provisions which have credit balance:

Provision for Doubtful Debts A/c Dr.

Provision for Discount on Debtors A/c Dr.

Provision for Depreciation A/c Dr.

Joint Life Policy Reserve A/c Dr.

Investment Fluctuation Reserve A/c Dr.

To Realisation A/c

(Transfer of special reserve or provision to Realisation A/c)

(b) For transfer of special reserve or provision which has debit balance:

Realisation A/c Dr.

To Provision for Discount on Creditors A/c

Example: P, Q and R are partners sharing profits and losses equally. On 31-3-2015 their balance sheet stood as follows:

Liabilities		Amount	Assets	Amount
		₹		₹
Bills payable		16,000	Cash at Bank	15,000
Creditors		1,19,000	Debtors	1,25,000
Loan from Q		25,000	Stock	2,90,000
General reserve		30,000	Furniture	40,000
P's Current Account		15,000	Machinery	1,20,000
Q's Current Account		15,000	R's Current Account	30,000
Capital Accounts:	₹			
P	2,00,000			
Q	1,00,000			
R	1,00,000	4,00,000		
		6,20,000		6,20,000

The firm was dissolved on the above mentioned date. P agreed to pay creditors at par. Q took over the entire Furniture for ₹36,000. The remaining assets were sold for ₹ 5,53,000. Bills Payable were retired for a discount of ₹ 100 received for payment before the due dates of maturity. Expenses of dissolution amounted to ₹ 1,200.

Prepare important ledger accounts and cash book. The current accounts and the capital accounts may be prepared in columnar.

Solution:

Dr. Realisation Account Cr.

Particulars	Amount	Particulars	Amount
	₹		₹
To Debtors A/c	1,25,000	By Bills Payable A/c	16,000
To Stock A/c	2,90,000	By Creditors A/c	1,19,000
To Furniture A/c	40,000	By Q's Current A/c (Furniture)	36,000
To Machinery A/c	1,20,000	By Bank A/c (Debtors, Stock and Machinery)	5,53,000
To P's Current A/c (Creditors)	1,19,000		
To Bank A/c (Bills Payable 16,000–100)	15,900		
To Bank A/c (Expenses)	1,200		
	7,11,100		7,24,000
To Profit transferred to: ₹			
P's Current A/c 4,300			
Q's Current A/c 4,300			
R's Current A/c 4,300	12,900		
	7,24,000		7,24,000

Dr. Q's Loan Account Cr.

Particulars	Amount	Particulars	Amount
	₹		₹
To Bank A/c	25,000	By Balance b/d	25,000
	25,000		25,000

Dr. Partner's Capital Account Cr.

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	30,000	By Balance b/d	15,000	15,000	–
To Realisation A/c				By general Reserve A/c	10,000	10,000	10,000
(Furniture)	–	36,000		By Realisation A/c			
To P's Capital A/c				(Creditors)	1,19,000	–	–
(Transfer)	1,48,300	–	–	By Realisation A/c			
				(Profit)	4,300	4,300	4,300

				By Q's Capital A/c (Transfer)	–	6,700	–
				By R's Capital A/c (Transfer)	–	–	15,700
	1,48,300	36,000	30,000		1,48,300	36,000	30,000

Dr. **Partner's Capital Account** **Cr.**

Particulars	P		Q	R	Particulars	P	Q	R
	₹		₹	₹		₹	₹	₹
To Q's Current A/c	–		6,700	–	By Balance b/d	2,00,000	1,00,000	1,00,000
To R's Current A/c	–		–	15,700	By P's Current A/c	1,48,300	–	–
To Bank A/c (Settlement)	3,48,300		93,300	84,300				
	3,48,300		1,00,000	1,00,000		3,48,300	1,00,000	1,00,000

Dr. **Cash Book (Bank Column Only)** **Cr.**

Particulars	Amount	Particulars	Amount
	₹		₹
To Balance b/d	15,000	By Realisation A/c (Bills Payable)	15,900
To Realisation A/c (Debtors, Stock and Machinery)	5,53,000	By Realisation A/c (Expenses)	1,200
		By Q's Loan A/c	25,000
		By P's Capital A/c	3,48,300
		By Q's Capital A/c	93,300
		By R's Capital A/c	84,300
	5,68,000		5,68,000

Treatment of Goodwill

The Act provides that in settling the accounts of a firm after dissolution, goodwill shall, subject to contract between the partners. Where the goodwill of a firm is sold after dissolution, a partner may carry on a business competing with that of the buyer and he may advertise such business but subject to agreement between him and the buyer, he may not (a) use the firm's name; (b) represent himself as carrying on business of the firm; or (c) solicit the custom of persons who were dealing with the firm before its dissolution. There is nothing special in treatment of goodwill on dissolution of a firm. On dissolution of a firm:

- If goodwill appears in the Balance Sheet, it is treated like any other asset and is transferred to realisation account.
- If goodwill does not appear in the balance sheet, no entry is passed for this.
- If something is realized or Goodwill is purchased by any one of the partners, then either Cash Account is debited or Partner's Capital A/c is debited and Realization Account is credited.

9.3 INSOLVENCY OF PARTNER/PARTNERS

The firm is normally dissolved when one or more partners become insolvent. The procedure for closing the books under insolvency is almost the same as under simple dissolution i.e. marketable assets and external liabilities are transferred to a newly opened Realisation Account and they are realized and paid off through the same account and the loss or profit on realisation transferred to the capital accounts of the partners. Thereafter if the capital account of a partner shows a debit balance, he should pay the amount to the firm. But in case the partner is insolvent he will not be able to pay at least the full amount. The sum not recoverable from the insolvent partner is a loss to the firm. Now the question arises in which ratio this loss should be borne by the solvent partners? Prior to the decision in Garner vs. Murray case this was also treated as normal loss and borne by the solvent partners in their profit sharing ratios. But in Garner vs. Murray case it was decided that such a loss was nota trading loss but a capital loss which should be borne by the solvent partners in the ratio of their capitals on the date of dissolution, for which the solvent partners should bring the realisation loss in cash so that their capital accounts may show the balance as on the date of dissolution. Let us now learn how to compute the amount of deficiency of an insolvent partner to be borne by the solvent partners in case of fixed and fluctuating capitals.

Fixed Capital:

If the capital accounts of the partners are kept on fixed basis, each partner will have two accounts- one capital account and the other current account. 'The capital account of each partner will show a fixed balance (the same balance) year after year. All entries relating to drawings, profit or loss, interest on capital or drawings etc. will be made in the current account of each partner. The current account of a partner may show a debit balance or a credit balance but the capital account of each partner will show the same fixed credit balance year after year. Hence the deficiency of the insolvent partner will be borne by the solvent partners in the ratio of their fixed capitals.

Fluctuating Capital:

If the capital accounts of partners are kept on fluctuating basis, there will be only one capital account and all entries relating to drawings, profit or loss. Interest on capital or drawings is made in the capital account. Thus, the balance in the capital accounts of each partner will fluctuate every year and every time an entry is made. Under such situation, the deficiency of the insolvent partner will be borne by the solvent partners in the ratio of their capitals as on the date of insolvency. This means that all the accumulated profits or losses should first be divided among all the partners including the insolvent one in their profit sharing ratios which will make the capital accounts of the partners as on the date of insolvency. But no other entry need be made. That is why when realisation loss is debited to the partners the Garnervs. Murray decision requires the solvent partners to bring the realisation loss in cash.

Example: A, B, C and D are partners in a firm sharing profits and losses in the ratio of 4:1:2:3. The following was their balance sheet as at 31-3-2004:

Liabilities		Amount	Assets		Amount
		₹			₹
Sundry Creditors		3,00,000	Sundry Debtors	3,50,000	
Capital Accounts:	₹		Less: Provision for Bad Debts	50,000	3,00,000
A	7,00,000		Stock		2,00,000
D	3,00,000	10,00,000	Cash in hand		1,40,000
			Other Assets		3,10,000
			Capital A/cs:	₹	
			B	2,00,000	
			C	1,50,000	3,50,000
		13,00,000			13,00,000

The firm was dissolved on the following terms:

1. A is to take over Sundry Debtors at 80% of book value.
2. D is to take over Stock at 95% of the book value.
3. C is to discharge Sundry Creditors.
4. Other assets realised ₹ 3,00,000 and expenses of realisation come to ₹30,000.
5. B is found insolvent and ₹21,900 is realised from his estate.

Prepare Realisation Account, Capital Accounts of the partners and the Cash Account. Strictly apply the decision in Gamer Vs. Murray case.

Solution:

Dr. RealisationAccount Cr.

Particulars	Amount	Particulars		Amount
	₹			₹
To Debtors A/c	3,50,000	By Creditors A/c		3,00,000
To Stock A/c	2,00,000	By Provision for Doubtful debts A/c		50,000
To Other Assets A/c	3,10,000	By A's Capital A/c (Debtors)		2,80,000
To C's Capital A/c (Creditors)	3,00,000	By D's Capital A/c (Stock)		1,90,000
To Cash A/c (Expenses)	30,000	By Cash A/c (Assets realised)		3,00,000
	11,90,000			11,20,000
		By Loss transferred to:	₹	
		A's Capital A/c	28,000	
		B's Capital A/c	7,000	
		C's Capital A/c	14,000	
		D's Capital A/c	21,000	7,00,000
	11,90,000			11,90,000

Dr. Partner's Capital Account Cr.

Particulars	A	B	C	D	Particulars	A	B	C	D
	₹	₹	₹	₹		₹	₹	₹	₹
To Balance c/d	–	2,00,000	1,50,000	–	By Balance b/d	7,00,000	–	–	3,00,000
To Realisation A/c	2,80,000	–	–	1,90,000	By Realisation A/c	–	–	3,00,000	–
To Realisation A/c (Loss)	28,000	7,000	14,000	21,000	By Cash A/c (Solvent Partners)	28,000	–	–	21,000
					By Cash A/c	–	21,900	–	–
To B's Capital A/c (Insolvency loss)	1,29,570	–	–	55,530	By A's Capital A/c (7/10)	–	1,29,570	–	–

To Cash A/c	2,90,430	–	1,36,000	54,470	By D's Capital A/c (3/10)	–	55,530	–	–
	7,28,000	2,07,000	3,00,000	3,21,000		7,28,000	2,07,000	3,00,000	3,21,000

Dr. **Cash Account** **Cr.**

Particulars		Amount	Particulars		Amount
		₹			₹
To Balance b/d		1,40,000	By Realisation A/c		30,000
To Realisation A/c		3,00,000			
To Capital A/cs:	₹		To Capital A/cs:	₹	
A	28,000		A	2,90,430	
D	21,000		C	1,36,000	
B	21,900	70,900	D	54,470	4,80,900
		5,10,900			5,10,900

9.4 CHECK YOUR PROCESS

1. At the time of admission partnership firm is dissolved if business is. ____________
2. All the accounts are settled among ____________ at the time of dissolution of a business.
3. ____________ may also dissolve a firm, if a partner a suit, that one of the partners is of mind Unsound.
4. Partners are liable for settle the account of accounts payable even from their ____________ if they are solvent.
5. Loan of partner will be paid off, before the settlement of. ____________

9.5 SUMMARY

According to the Partnership Act,1932 "The dissolution of partnership between all the partners of a firm is called the dissolution of the firm" Therefore, the act distinguishes between the dissolution ofpartnership and dissolution of the firm.Thus, a reconstitution of a firm involves a change in the relation of partners whereas in the caseof dissolution of firm, there is complete severance of relationship between all partners.There are essentially two modes of dissolution of the firm i.e. (a) Dissolution without the order of the court, and (b) Dissolution by theorder of the court.Usually the Deed of Partnership contains on the basis of which the finalaccounts between partners are settled. In the absence of such an agreement, the following rules will be applicable:

- The lossesmust be paidfrom profits first, next out of capital and lastly, if necessary, by contribution of each partner in profit sharing ratio.
- The assets of the firm, including sums contributed by partners to make up deficiency of capital in the sequence i.e. (i) in paying debts of the firm to outsiders; (b) in paying each partner for advances made by him to the firm; (c) amount on account of capital contribution, and (d) the surplus is paid if any in their profit sharing ratio.
- If a partner becomes insolvent or otherwise cannot pay his share of the contribution, the solvent partners have to pay.
- The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims.
- The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilized for payment of the firm's debts if required.
- As soon as the partners decide to discontinue the business of the firm, all the assets have to be sold and the liabilities are to be paid off and for this purpose a separate account called 'Realization Account' is opened.

9.6 KEYWORDS

Dissolution of Partnership Firm: Discontinuation of the relationship between all the partners of the firm.

Realization Account: Account to know the profit/loss of firm on the realization of assets and payment of liabilities.

9.7 SELF ASSESSMENT TEST

Q.1 What do you mean by dissolution of partnership and partnership firm? Also distinguish between the two.

Q.2 Elaborate the modes of Dissolution of Firm.

Q.3 What is Realization Account? Prepare a Performa of Realization Account.

Q.4 Write a detailed note on accounting treatment in case of insolvency of partners.

Q.5 A, B and C are partners sharing profits and losses in the ratio of 5:3:2. On 31st December, 2005 their Balance Sheet was follows:

Liabilities		Amount	Assets		Amount
		₹			₹
Creditors	30,000		Cash in Hand		17,000
Less: Provision for Discount	2,000	28,000	Debtors	50,000	
General Reserve		20,000	Less: Provision for bad debts	5,000	45,000
Reserve Fund		32,000	Stock		1,00,000
Investment Fluctuation Fund		7,500	Investments		40,000
Life Policy Fund		16,000	Furniture		20,000
Capital Accounts:	₹		Computer		30,000
A	3,15,500		Joint Life Policy		45,000
B	1,81,000		Machinery		2,00,000
C	1,50,000	6,46,500	Building		2,53,000
		7,50,000			7,50,000

On the above date the partners decided to dissolve the firm. Following transactions took place:

1. The assets were realised as follows; Stock ₹ 88,000, Furniture ₹ 14,000. Machinery ₹ 1,93,500 and Building ₹ 2,72,000.
2. Life Insurance policy surrendered for ₹ 34,000.
3. Creditors were settled @ 10% discount.
4. Investments were taken over by A for ₹ 29,000.
5. B took over the Computer @ 20% more than the book value.
6. Debtors realised 80% of book value.
7. Realisation expenses amount to ₹ 1,800 are met by B.

Give Journal Entries and draw up the necessary Ledge Account to close the books of the firm.

9.8 ANSWER TO CHECK YOUR PROGRESS

1. Discontinued
2. Partners and creditors
3. Court
4. Private sources

5. Partner's capital

9.9 REFERENCES/SUGGESTED READINGS

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