UNIT – I: PARTNERSHIP ACCOUNTS

CHAPTER-1

FUNDAMENTALS OF PARTNERSHIP

Topic-1

Basics of Partnership

Concepts Covered • *partnership-definition, features, partnership deed- contents, rules applicable in the absence of it, profit and loss appropriation account and journal entries related to it, partners capital account-its format and journal entries related to it.*

Revision Notes

- **Definition of Partnership:**

  According to Section 4 of the Indian Partnership Act, 1932,
  "Partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

- **Features/Characteristics of Partnership:**
  - **Two or more persons:** There must be at least two persons to form a partnership who work for a common purpose. Maximum number of partners can not be more than 50.
  - **Agreement:** There must be an agreement between two or more persons. It may be written or oral. The written agreement among the partners is known as the Partnership Deed.
  - **Profit motive:** Making profits should be the objective of the business. The partners should share the profits as well as the losses of the business.
  - **Governing Act:** Partnership business must be governed as per the rules of the Indian Partnership Act, 1932.
  - **Lawful Business:** Business should be lawful or legal in the eye of law.
- **Partnership Deed:** A document that contains the terms of agreement between the partners.
- **Contents of Partnership Deed:**
  - Name and Address of all partners
  - Name of the firm
  - Nature of the business
  - Amount of capital contributed by each partner
  - Drawings
  - Accounting period of the firm
  - Rate of interest on capital and interest on drawings
  - Profit sharing ratio
  - Duration of partnership, commencement of the partnership
  - Rights and duties of partners
  - Partners' salary, commission, etc.
- **Rules applicable in the absence of Partnership Deed:**
  - Profits and losses are to be shared equally amongst the partners.
  - Partners are not entitled for interest on capital invested in the firm.
  - No interest on drawings will be charged on amount withdrawn by partners.
  - Interest on partner's @ 6%. p.a.
  - Partners are not entitled for salary, commission and remuneration.
  - No new partner is to be introduced without the written consent of all the existing partners.
- **Preparation of Profit & Loss Appropriation Account:** After determination of the net profit by preparing the Profit & Loss Account, Profit & Loss Appropriation Account is prepared to show distribution of net profit among partners. It is an extension of Profit & Loss Account. Format of Profit & Loss Appropriation Account is given below:

PROFIT & LOSS APPROPRIATION ACCOUNT

Dr. **for the year ended......** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Profit & Loss A/c (in case there is any loss) (Loss transferred from P & L A/c To Interest on Capital To Salaries to Partners To Commission to Partners To Reserves To Divisible or Distributable Profit transferred to Capital A/c of Partners or Current A/c of Partners		By Profit & Loss A/c (Profit transferred from P & L A/c) By Interest on Drawings	

- **Journal Entries** for various items shown in Profit & Loss Appropriation Account:
- **For allowing Interest on Capital:**

(i) Interest on Capital A/c Dr.
  To Partner's Capital/Current A/c
(Being interest on capital allowed to partner(s) @ .... % per annum)

(ii) On closure of interest on capital A/c
Profit & Loss Appropriation A/c Dr.
  To Interest on Capital A/c
(Being the interest on capital allowed transferred to Profit & Loss Appropriation Account)

- **For charging Interest on Drawings:**

(i) Partner's Capital/ Current A/c Dr.
  To Interest on Drawings A/c
(Being the interest charged on drawings)

(ii) On closure of interest on drawings A/c
Interest on Drawings A/c Dr.
  To Profit & Loss Appropriation A/c
(Being the interest charged on drawings transferred to Profit & Loss Appropriation Account)

- **For Salary or Commission Payable to Partner:**

(i) Partner's Salary/Commission A/c Dr.
  To Partner's Capital/Current A/c
(Being salary/commission credited to partners' capital accounts)

(ii) On closure of salary/commission:
Profit and Loss Appropriation A/c Dr.
  To Partner's Salary/Commission A/c
(Being salary/commission transferred to P & L App. A/c)

- **For transferring a part of profit to reserve:**

Profit & Loss Appropriation A/c Dr.
  To Reserve A/c
(Being a part of divisible profit transferred to reserve)

- **For transfer of credit balance of Profit & Loss Appropriation A/c:**

Profit & Loss Appropriation A/c Dr.
  To Partner's Capital/ Current A/c

(Being the balance profit transferred to Capital Accounts of partners in their profit sharing ratio)

- **Methods of calculating Interest on Drawings:** There are two methods of calculating interest on drawings:

(i) Simple method formula $= \text{Amount of Drawings} \times \frac{\text{Rate}}{100} \times \frac{\text{Months}}{12}$

(ii) Product method formula $= \text{Total of products} \times \frac{\text{Rate of interest}}{100} \times \frac{1}{12}$

- **Partner's Capital Account:** In partnership, the partners' capital account can be prepared by two methods. First is Fixed Capital Account Method and second is Fluctuating Capital Account Method. Under the Fixed Capital

Account Method, two accounts are opened **(i)** Capital Account, **(ii)** Current Account. On the other hand under Fluctuating Capital Account Method, only partner's capital account is opened.

➢ **Format of Partners' Capital Account:**

Under Fixed capital method: Two accounts are prepared which are as:

(i) Partners' Capital Account

(ii) Partners' Current Account

Dr. **Partners' Capital Account (When the capitals are Fixed)** **Cr.**

Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To Cash/Bank A/c (Permanent withdrawal of capital) To Balance c/d (Closing Balance) To Balance c/d (Balancing figure)				By Balance b/d (Opening balance) By Cash/Bank A/c (Additional capital) / Fresh capital introduced) By balance c/d (balancing figure)			

Dr. **Partners' Current Account** **Cr.**

Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To Balance b/d (in case of Debit Balance) To Drawings To Interest on Drawings To Profit & Loss Appropriation A/c (Share of loss) To Balance c/d (Balancing figure)				By Balance b/d (in case of credit balance) By Interest on Capital By Salary By Commission By P & L Appropriation A/c (Share of profit) By Balance c/d (balancing figure)			

Under Fluctuating Capital Method: Only Partners' Capital Account is opened and all the adjustments are made in capital account.

Dr. **Partner's Capital Account** **Cr.**

Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To Drawings To Interest on Drawings To Profit & Loss Appropriation A/c (Share of loss) To Balance c/d (Closing Balance)				By Balance b/d (opening balance) By Cash/Bank A/c (additional capital) By Interest on Capital By Salary By Commission By Profit & Loss Appropriation A/c (If share of profit)			

Note: In the absence of any instruction, the Partner's Capital Account should be prepared under Fluctuating Capital Account Method.

Difference Between Fixed Capital Account and Fluctuating Capital Account

S. No.	Basis	Fixed Capital Account	Fluctuating Capital Account
(i)	**Change in Capital**	The balance of capital account generally remains fixed during the life of the firm except when additional capital is introduced or capital is withdrawn.	The balances of the capital accounts are not fixed. It fluctuates during an accounting period.
(ii)	**Accounts maintained**	A capital account and a current account are maintained for every partner of the firm.	Only one account i.e., capital account is maintained for each partner of the firm.

Difference Between Drawings Against Capital and Drawings Against Profit

S. No.	Basis	Drawings against Capital	Drawings against Profit
(i)	**Debit**	Debited to Capital A/c	Debited to Drawings A/c
(ii)	**Part**	Part of Capital Account	Part of Current Account
(iii)	**Effect**	It reduces the amount of capital.	It reduces the profit of the firm.

- **Interest on Partner's loan:**
  (i) If any partner has given loan to the firm, he is entitled to receive interest on such loan at an agreed rate of interest.
  (ii) If there is no agreement regarding the rate of interest, he is entitled to receive interest on loan @ 6% per annum.
  (iii) Interest on partner's loan is a charge against profits and hence interest is allowed whether there are profits or not.

  Journal Entries:
  Interest on Partner's Loan A/c Dr.
  To Partner's Loan A/c
  (Being the interest on Partner's Loan A/c provided at rate of ..... per annum)
  Profit & Loss A/c Dr.
  To Interest on Partner's Loan A/c
  (Being interest on loan transferred to Profit & Loss A/c)
- **Interest on loan by the firm to a partner:** Whenever the firm advances loan to partner, the firm takes interest on it. It is a gain for the firm and is recorded in credit side of Profit & Loss Account.
  Journal Entries:
  Partner's Capital/ Current A/c Dr.
  To Interest on Partner's Loan A/c
  (Being interest charged on loan)
  Interest on Partner's Loan A/c Dr.
  To Profit & Loss A/c
  (Being interest transferred to Profit & Loss A/c)

Key Terms

- **Capital**: Capital refers to the financial assets required for a business to produce the goods or services it offers to its customers.
- **Drawings:** Whenever the partner of firm takes something from the firm either in cash or in kind for personal use is called drawings.
- **Interest on Capital:** Interest on capital is always allowed at a fixed percentage on the opening balance of capital.
  $$\text{Interest on Capital} = \frac{(\text{Opening Capital} \times \text{Rate})}{100}$$
- **Opening capital** = The opening capital is the adjusted balance presented toward the start of a bookkeeping period.
- **Opening Capital**= Closing capital + Drawings – Additional capital – Profit + Loss (if any)

Topic-2 Guarantee of Profits and Past Adjustments

Concepts Covered • *guarantee of profit to a partner and past adjustments.*

Revision Notes

- **Guarantee of Profit to a Partner:** Sometimes a partner is given a guarantee of minimum amount of profit in respect of his share in profits of a business. Guarantee of minimum profits to a partner may be given by
  - All partners in a certain ratio
  - Any one of the partners

  When the profits of the firm are not sufficient, deficiency of the guaranteed amount will be borne by the partners who have given guarantee to that partner:
- **Past Adjustments:** Sometimes, after the accounts of the partnership firm have been closed in the financial year, it is discovered that there have been some errors and omissions in the accounts. In such a case, instead of altering the old accounts, an adjustment entry for errors and omissions is made in the beginning of next year. Adjustments are required for the following errors and omissions,
  - When interest on capital or drawings have been omitted,

- When profits and losses have been distributed among the partners in a wrong proportion,
- When salary or commission payable to a partner has been omitted,
- When there is a change in profit sharing ratio of the partners.

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CHAPTER-2

GOODWILL

Topic-1 Concept of Goodwill

Concepts Covered • *goodwill- meaning, definition, nature, features, factors affecting goodwill, classification, need of valuation of goodwill*

Revision Notes

➢ **Meaning of Goodwill:**

Goodwill refers to the name and reputation earned by a business firm over the years through the quality of products and efficiency of management.

➢ **Definition of Goodwill:**

"Goodwill is nothing more than the probability that the old customers will resort to the old place."

— **(Lord Eldon)**

"The term goodwill is generally used to denote the benefit arising from connection and reputation."

— **(Lord Lindley)**

➢ **Nature of Goodwill:**

Goodwill is an intangible asset since it has no physical existence and cannot be seen or touched. But it is not a fictitious asset because fictitious assets do not have a value whereas goodwill has a value in case of profit making concerns.

➢ **Features/ Characteristics of Goodwill**

(i) Intangible asset

Goodwill is an intangible asset like patents, copyright etc and it is not subject to any depreciation.

(ii) Helps in earning excess profit

Goodwill helps in earning extra profits by gaining the confidence of customers.

(iii) Fluctuates from time to time

The value of goodwill depends upon the internal and external factors of a business which keeps on changing from time to time.

(iv) Sold with entire business only

The value of goodwill can be realized only when the entire business is sold subject to one exception (Admission or retirement of a partner).

➢ **Factors affecting goodwill**

The various factors which affect the goodwill of the firm are as follows.

(i) Location of a business

When the business is located at a convenient or a prominent place, it will have a larger market share which increases the profits and goodwill.

(ii) Competition of business

When the business is facing competition from dealers of similar goods, it will have a negative effect on the value of goodwill.

(iii) Tenure of Business

An old business is well known to its customers and thus will have a higher amount of goodwill. The number of customers will be more in case of old business as compared to a new business.

(iv) Degree of Risk

It is one of the important factors which affect the goodwill of a firm. When the risk involved is high, the value of goodwill will be less.

(v) Amount of capital

The amount of capital invested in the business affects the value of goodwill. If two business firms earn the same amount of profit, the business with lesser capital invested will enjoy more goodwill.

(vi) Management efficiency

If the business is run by efficient and skilful people the profits will keep on increasing which also increases the value of goodwill.

(vii) Import license

If the business firm holds an import license than the goodwill will be more because it will be very difficult for other firms to enter into this market.

(viii) Monopolist

If the business firm is a monopoly seller of the product he will enjoy more profits as compared to others and thus his goodwill would be more.

(ix) Profit earning trend

When the profits of the business firm are increasing continuously than its goodwill would be more. On the other hand, if the profits are decreasing over a period of time than its goodwill would be less.

(x) Miscellaneous Factors

Among the miscellaneous factors, it consists of

(a) Political Situation of the country.

(b) Effect of advertisement and publicity.

(c) Rules and regulations of the government.

(d) Industrial Relations.

(e) Popularity of the product in the market.

➢ **Classification of Goodwill:**

- **Purchased goodwill:** It is the goodwill which is acquired by making a payment. For example, when a business is purchased, the excess of purchase consideration over its net assets is referred to as purchased goodwill. It is shown on the assets side of the Balance Sheet.
- **Self generated goodwill:** It is internally generated goodwill which arises from a number of characteristics which an ongoing business possesses. It is not shown in the books of accounts.

Topic-2 Modes of Valuation of Goodwill

Concepts Covered • *average profit method, super profit method, capitalisation method.*

Revision Notes

➢ **Need for Valuation of Goodwill:**

- When there is a change in the profit sharing ratio among the existing partners.
- When a new partner is admitted.
- When a partner retires or dies.
- When firm is amalgamated with another firm.
- When business is sold.
- **Average Profit Method:** Goodwill is calculated by taking the average profit for a specified number of years and multiplying it with the number of years' of purchase.

$$\text{Goodwill} = \text{Average profit} \times \text{No. of years' purchased}$$

$$\text{Average profit} = \frac{\text{Total actual profit}}{\text{Total no. of years}}$$

- **Super Profit Method:** Super profit is the profit earned by the business that is in excess of the normal profit. Goodwill is determined by multiplying the super profit by the number of years' purchased.

$$\text{Goodwill} = \text{Super profit} \times \text{No. of years' purchased}$$

$$\text{Super profit} = \text{Actual average profit} - \text{Normal profit}$$

$$\text{Average profit} = \text{Total actual profit/ No. of years } (\textit{Additional Formula})$$

$$\text{Normal profit} = \text{Capital employed} \times \frac{\text{Normal rate of return}}{100}$$

- **Capitalisation Method:** Under this method, goodwill can be calculated by two ways:
  - **Capitalisation of Average Profit:** Under this method, first of all we calculate the average profit and this average profit should be multiplied with 100 and divided by normal rate of return.

$$\text{Goodwill} = \left(\frac{\text{Average Profit} \times 100}{\text{Normal rate of return}}\right) - \text{Capital Employed Or Net Assets}$$

  - **Capitalisation of Super Profit:** Under this method, first of all we calculate the super profit and then we assess the capital needed for earning super profit on the basis of normal rate of return. Following formula is used to calculate goodwill:

$$\text{Goodwill} = \left(\frac{\text{Super profit} \times 100}{\text{Normal rate of return}}\right)$$

- **Weighted Average Profit Method:** This method is a modified version of Average Profit Method. Under this method each year's profit is assigned a weight. The highest weight is attached to the profit of the most recent year. There after each profit is multiplied by the assigned weight and the formula is:

$$\text{Weighted Average Profit} = \frac{\text{Total product}}{\text{Total of weight}}$$

$$\text{Goodwill} = \text{Weighted Average Profit} \times \text{No. of years' purchased.}$$

Key Terms

- **Super Profit:** The excess of actual average profit over normal profit is called Super Profit.
- **Number of years' purchased:** It means for how many years the firm will earn the same amount of profits because of its past efforts after change of ownership.

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CHAPTER-3

ADMISSION OF A PARTNER

Topic-1 Admission of a Partner: Basic Concepts and treatment of Goodwill

Concepts Covered • *Reconstitution of a firm, sacrificing ratio, gaining ratio, accounting treatment of goodwill*

Revision Notes

- **Reconstitution of partnership firm :**
  Reconstitution of the partnership firm is done in many ways and admission of a new partner is one of the ways to reconstitute a firm. With the admission of a new partner, existing agreement comes to an end and a new agreement among all the partners comes into existence. The partnership can also be reconstituted by changing the profit sharing ratio among the existing partners. All assets and liabilities are revalued and profit or loss is distributed among the old partners in old ratio. The basic rule that gaining partner has to compensate the sacrificing partner to the extent of his gain, shall always prevail.
  New profit sharing ratio : When a new partner is admitted, old partners sacrifice a share of their profit to the new partner. So their share of profit reduces. Hence the need of calculating new profit sharing ratio arises. The ratio in which all the partners (including the new partner) will share the profits and losses is called new profit sharing ratio.

$$\boxed{\text{New Profit Sharing Ratio} = \text{Old Profit Sharing Ratio} - \text{Sacrificing Ratio}}$$

  Sacrificing Ratio : It is the ratio in which existing partners sacrifice their share to a new or gaining partner.

$$\boxed{\text{Sacrificing Ratio} = \text{Old Share of Profit Ratio} - \text{New Share of Profit Ratio}}$$

Gaining ratio : Gaining ratio is the ratio in which continuing partners take the outgoing (retire or deceased) partner's share. This ratio is also applicable when there is a change in the existing profit sharing ratio of the partners.

Gaining ratio = New Profit Sharing Ratio – Old Profit Sharing Ratio

➢ **Accounting treatment of Goodwill :**

At the time of admission of a partner, there are three ways adopted by the firm for the treatment of goodwill.

(1) When Premium for goodwill is paid privately : If a new partner is paying amount of goodwill directly to the old partners, outside the business, no entry will be passed for this purpose.

(2) When new partner brings his share of goodwill in cash : In this method, there are two alternatives :

(i) When the amount of goodwill brought in by new partner is retained in the business :

Following two entries will be passed for this purpose :

(a) Cash/Bank A/c Dr.
To Premium for Goodwill A/c (Individually)
(Being amount of Goodwill brought in by new partner)

(b) Premium for Goodwill A/c (Individually) Dr.
To Sacrificing Partners' Capital/Current A/cs
(Being amount of Goodwill distributed to the old partners in their sacrificing ratio)

(ii) When goodwill brought in by new partner is withdrawn by the sacrificing partners :

Cash/Bank A/c Dr.
To Sacrificing Partner's Capital A/c (Individually)
(Being amount of Goodwill brought in by new partner in cash)

Sacrificing Partners' Capital A/cs (Individually) Dr.
To Cash/Bank A/c
(Being amount of goodwill withdrawn by the old partners)

(3) When new partner does not bring his share of goodwill in cash :

New Partner's Capital/Current A/c Dr.
To Sacrificing Partners' Capital/Current A/cs
(Being current A/c of new partner debited for his share of goodwill and Current A/c of old partners credited in sacrificing ratio.)

(4) When a new partner brings only a part of premium of goodwill in cash :

(a) Bank A/c Dr.
To Premium for Goodwill A/c
(Being part of his share of goodwill brought in by new partner)

(b) Premium for Goodwill A/c Dr.
New Partner's Capital/Current A/c Dr.
To Sacrificing Partners' Capital/Current A/cs
(Being goodwill credited in sacrificing ratio)

➢ **Writing off goodwill already appearing in the books :**

If any goodwill is already existing in the balance sheet at the time of admission of a new partner, it should be written off by all old partners in their old profit sharing ratio by passing this entry :

Old Partners' Capital/Current A/cs Dr.
To Premium for Goodwill A/c
(Being goodwill already appearing in books now written off)

➢ **Hidden Goodwill :**

Hidden or inferred goodwill is the excess of desired total capital of the firm over the actual combined capital of all partners. The following steps are taken for calculating hidden goodwill :

- Find out the total capital of new firm on the basis of capital contributed by the new partner.
- Find out the existing capital of new firm by adding all partners capital (including new one).
- Goodwill is assumed to be the excess of the total capital of the new firm over the existing total capital of all the partners.

Key Terms

- **Reconstitution of a partnership firm** : It means a change in the relationship among the partners as a result of which the existing agreement comes to an end and a new agreement comes into existence.
- **Gaining ratio** : It is the ratio in which continuing partners receive some share of profit from the outgoing partners.
- **Sacrificing ratio** : It is the ratio to which existing partners sacrifice their share to a new partner.

Topic-2 Accounting Treatment of Other Items

Concepts Covered • *Revaluation account, Journal entries for revaluation account, Accounting treatment of Reserves and Accumulated Profits/Losses, Adjustment of Capital Accounts*

Revision Notes

- **Revaluation Account :**

When a new partner is admitted to the business, the assets and liabilities of the firm are revalued. For this purpose, a special kind of account is prepared. This account is called Revaluation Account. It is also called as Profits & Loss Adjustment Account. This is a Nominal Account in nature.

Format of Revaluation Account :

Dr. **Revaluation Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Decrease in value of assets	—	By Increase in value of assets	—
To Increase in value of liabilities	—	By Decrease in value of liabilities	—
To Unrecorded liabilities	—	By Unrecorded assets	—
To Profit on Revaluation transferred to old Partners' Capital/Current A/cs	—	By Loss on Revaluation transferred to Old Partners' Capital/Current A/cs	—

- **Journal Entries for Revaluation Account :**

(i) For decrease in the value of assets :
Revaluation A/c Dr.
To Assets A/c
(Being decrease in the value of assets)

(ii) For increase in the value of assets :
Assets A/c Dr.
To Revaluation A/c
(Being increase in the value of assets)

(iii) For increase in the value of liabilities :
Revaluation A/c Dr.
To Liabilities A/c
(Being increase in the value of liabilities)

(iv) For decrease in the value of liabilities.
Liabilities A/c Dr.
To Revaluation A/c
(Being decrease in the value of liabilities)

(v) For profit on Revaluation :
Revaluation A/c Dr.
To Old Partners' Capital/Current A/cs
(Being profit on revaluation transferred to partners' capital account in old profit sharing ratio)

(vi) For loss on Revaluation :
Old Partners' Capital/Current A/cs Dr.
To Revaluation A/c
(Being loss transferred to old partners' capital account in old ratio)

- **Accounting treatment of Reserves and Accumulated Profits/Losses :**

At the time of admission of a partner if there is any General Reserve, Reserve Fund or the balance of Profit & Loss Account appearing in the balance sheet, it should be transferred to old partners' capital/current accounts in their old profit sharing ratio (New partner does not share in these reserves). For this purpose, the following Journal entry is passed :

Profit & Loss A/c	Dr.
General Reserve A/c	Dr.
Workmen Compensation Reserve A/c	Dr. (Excess)
Investment Fluctuation Reserve A/c	Dr. (Excess)
To Old Partners' Capital/Current A/cs	

(Being the reserves and profit transferred to old partners' capital accounts in old profit sharing ratio)

If there is any debit balance of Profit & Loss A/c appearing in the assets side of Balance sheet, it must be transferred to the debit side of partner's capital A/c. The Entry will be :

Old Partners' Capital/Current A/cs	Dr.
To Profit & Loss A/c	

(Being balance of Profit and Loss A/c transferred to capital accounts of old partners in old profit sharing ratio)

OR

Old Partners' Capital/Current A/cs	Dr.
To Deferred Revenue Expenditure A/c	

(Being deferred revenue expenditure transferred to old partners' capital accounts in old ratio)

- **Adjustment of Capital Accounts :**

Sometimes on the admission of a new partner, it is decided that the capitals of the old partners will be adjusted on the basis of new partner's capital to make them proportionate to their share of profits. Adjustment of capital is of two types :

(i) Adjustment of old partners' capital on the basis of new partner's capital.

(ii) Calculation of new partner's capital on the basis of old partners' capital.

- **Adjustment of Capital on the basis of new partner :**

Following steps are taken to make adjustment in capital on the basis of new partner's capital :

Step 1 : Find out total capital of the firm on the basis of new partner's capital.

Total capital of the firm = Capital of new partner × Reciprocal of his share

Step 2 : On the basis of total capital of the firm, find out new capital of each partner in new profit sharing ratio.

Step 3 : Find out the present capital of the old partners. (after all adjustments like reserves, profit, etc.)

Step 4 : Find out the surplus/deficit by comparing new capital and present capital. If any partner's capital is less than new capital he/she has to bring the capital to make it proportionate.

If any partner's present capital is more than new capital then he/she has to withdraw the excess in order to make the capital proportionate.

- **Journal Entry :**

(1) When present capital is less and fresh capital is introduced :

Bank / Cash A/c	Dr.
To Partner's Capital A/c	

(2) When excess capital is withdrawn permanently :

Partner's Capital A/c	Dr.
To Cash /Bank A/c	

- **Calculation of new partner's capital on the basis of old partners' capital :**

If the new partner brings capital in proportion to his share in profit, the capital which he is required to bring is determined on the basis of the total capital of old partners which is calculated after all the adjustments. For this purpose following steps are taken :

Step 1 : Find out the total adjusted capital of the old partners.

Step 2 : Find out new capital of firm,

i.e., Total adjusted capital × Reciprocal of total share of old partners.

Step 3 : On this find the new partner's capital :

Total capital of the firm × New partner's share

- **Change in Profit Sharing Ratio :**

  Change in the profit sharing ratio among the existing partners means it is reconstitution of the firm without admission of a new partner. A change in profit sharing ratio in a partnership firm means one (or more) partner(s) acquire share of profit in the business from other partner.

- **Adjustment of Accumulated Profits and Losses/Reserve through Capital Account only :**

  Sometimes the partners may decide that existing balances of Profit & Loss Account or Reserve should continue to appear at the same amount in the balance sheet of the reconstituted firm. In such a case, an adjustment is made directly in Partner's Capital Account through adjustment entry.

  For adjustment entry, following steps should be followed :

  Step 1 : Calculate net effect of Reserves and Accumulated Profits/Losses.

  Step 2 : Calculate gain/loss of share.

  Step 3 : Calculate share of gaining/sacrificing partner in Profit & Loss or Reserve.

  Step 4 : Pass the following entry :

In case of net profit		In case of net loss	
Gaining Partner's Capital A/c	Dr.	Sacrificing Partners' Capital A/c	Dr.
To Sacrificing Partners' Capital A/c		To Gaining Partner's Capital A/c	

Key Terms

- **Revaluation Account :** It is a nominal account in nature. It shows changes in the value of assets and liabilities at the time of reconstitution of partnership.
- **Adjustment of Capital :** After admission, the capital of all partners will be adjusted to make their capital proportionate to their respective share of profit.

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CHAPTER-4

RETIREMENT AND DEATH OF A PARTNER

Topic-1 Retirement/Death of a Partner and Adjustment with Regard to Goodwill

Concepts Covered • *Calculation of gaining, sacrificing and new profit sharing ratio. Adjustment with regard to goodwill. Hidden Goodwill computation.*

Revision Notes

- **Retirement of a partner :**

  When a partner leaves or retires from the firm, it is known as retirement of a partner. On retirement or death of a partner, the existing partnership agreement comes to an end and a new partnership agreement comes into existence. Section 32(1) of the Indian Partnership Act, 1932 states that a partner may retire :

  - With the consent of all partners.
  - In accordance with the express agreement among the partners.
  - By issuing a proper notice to all the partners.

- **New Profit Sharing Ratio :**

  New share of Continuing Partners = Old Share + Acquired Share from outgoing partner / Gaining Ratio

- **Gaining Ratio :**
Gaining Ratio refers to the ratio in which the continuing partners gain from the retiring or deceased partner's share of profit. It is calculated as :
Gaining Ratio = New share of continuing partners – Old share

- **Adjustment with regard to Goodwill :**
When a partner retires, the continuing partners acquire his share of profit. They have to compensate the retiring partner for his share in the goodwill in their gaining ratio. Following two cases are there for the treatment of goodwill:
(i) When goodwill does not appear in the books of accounts — In this case following entry is passed :
Continuing Partners' Capital /Current A/cs Dr.
To Retiring/ Deceased Partner's Capital /Current A/cs
(Goodwill adjusted in gaining ratio)
(ii) When goodwill appears in the books of accounts :
(i) All Partners' Capital /Current A/cs Dr. (Old ratio)
To Goodwill A/c
(Existing value of goodwill written off)
(ii) Continuing Partners' Capital / Current A/cs Dr. (Gaining ratio)
To Outgoing Partner's Capital / Current A/c
(Goodwill adjusted on partner's retirement)

- **Hidden Goodwill :**
Sometimes, the firm agrees to settle the account of retiring partner by paying him a lump sum amount. The amount paid to him in excess of his adjusted capital shall be treated as Hidden Goodwill.

Topic-2 Accounting Treatment

Concepts Covered • *Adjustment of accumulated profits and reserves, Revaluation of Assets and Re-assessment of liabilities, Adjustment with regard to share of profits. Preparation of deceased partner's executor's Account.*

Revision Notes

- **Adjustment of Accumulated Profits and Reserve :**
If at the time of retirement of a partner, there is any balance of General Reserve, Reserve Fund or any undistributed amount of Profit & Loss Account appearing in the Balance Sheet, it should be transferred to the capital accounts of all partners in their old profit sharing ratio. Following entry will be passed for this Purpose :

- **For distributing Reserve and Accumulated Profits :**
General Reserve A/c Dr.
Reserve Fund A/c Dr.
Profit & Loss A/c Dr.
To All Partners' Capital A/c (Old ratio)
(Being Undistributed Profits and Reserves transferred to partners' capital account)

- **For distributing Accumulated Losses :**
All Partners' Capital A/c (Old ratio) Dr.
To Profit & Loss A/c Dr.
(Being accumulated losses transferred to partners' capital accounts)

- **Adjustment with regard to share of profits :**
If the death of a partner occurs on any day during the year, the executors of the deceased partner will also be entitled to share the profits earned by the firm from the beginning of the year till the date of his death. Such profits may be ascertained from any of the following methods:
(i) On last year's Profit or average of past years' profits
(ii) On turnover or Sales basis.
On time basis : In this method, we have to take into consideration the profits of the last year and the time for which he remained a partner during the current year. On the basis of last year's profit, we shall calculate the proportionate profit up to the date of death and then calculate the deceased partner's share.

On the turnover or sales basis : In this method, we have to take into consideration the profit and total sales of the year. Then the profits of the current year is estimated on the basis of the sales for the last year and sales upto the date of death.

➢ **Entry for Profit :**

Case 1 : When there is no change in the ratio of continuing partners :

Profit & Loss Suspense A/c Dr.
To Deceased Partner's Capital A/c
(Being profit transferred to deceased partner's capital account).

Case 2 : When there is change in the ratio of continuing partners :

Continuing Partners' Capital A/cs Dr.
To Deceased Partner's Capital A/c
(Being profit transferred to deceased partner's capital account).

Note : In case of loss, deceased partner's capital account is to be debited and Profit & Loss Suspense Account is to be credited.

➢ **Preparation of Revaluation Account :**

At the time of retirement, the assets and liabilities are revalued and Revaluation Account is prepared in the same way as is done in case of admission of a partner. The only difference is that in case of retirement any profit or loss on revaluation is transferred to all partners' capital account in old profit sharing ratio.

➢ **Payment of the amount due to retiring partner :**

(i) If the amount is paid in cash or by cheque.

Entry :

Retiring Partner's Capital A/c Dr.
To Cash or Bank A/c

(ii) If the amount is not paid in cash, the amount due to him will be transferred to Loan A/c.

Entry :

Retiring Partner's Capital A/c Dr.
To Retiring Partner's Loan A/c

➢ **Calculation of the total amount due to representative of the deceased partner :**

(1) Amount standing to the credit of his Capital A/c
(2) Share in the value of goodwill of the firm
(3) Interest on capital (if profit)
(4) Share of profit on the revaluation of assets and liabilities
(5) Share of undistributed Reserves and Profits
(6) Share of profit up to the date of his death.

➢ **Amount to be debited in deceased partner's Capital Account :**

(1) Drawings
(2) Interest on Drawings
(3) Share of loss on Revaluation Account
(4) Share of undistributed loss such as debit balance of Profit & Loss A/c

➢ **Format of Deceased Partner's Capital A/c**

Dr. **Partner's Capital Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Revaluation A/c (Share of loss) To Share in Accumulated Losses To Cash A/c (Drawings till death) To Interest on Drawings A/c To Goodwill A/c (Share in existing goodwill written off) To Deceased Partner's Executor's A/c (Balancing figure)		By Balance b/d By Profit & Loss Suspense A/c (Share in profit till death) By Salary/Commission By Revaluation A/c (Share in profit) By Share in Accumulated Profits By Interest on Capital A/c	
	××		××

Key Terms

- **Death of a Partner :** A partnership will come to an end immediately whenever a partner dies. The firm may continue with remaining partners.
- **Profit & Loss Suspense Account :** Special kind of account which is prepared to adjust the deceased partner's share of profit upto the date of his death.
- **Revaluation Account :** Revaluation account is a nominal account prepared for the purpose of distributing and transferring the profit or loss arising out of increase or decrease in the book value of assets and/ or liabilities at the time of admission, retirement or death of a partner.

CHAPTER-5

DISSOLUTION OF A PARTNERSHIP FIRM

Revision Notes

- **Meaning of Dissolution of a partnership Firm:** Dissolution of a partnership Firm means business of the firm comes to an end. It brings an end to the existence of the firm. Assets of the firm are sold and liabilities are paid off.
- **Dissolution of Partnership:** It means the reconstitution of the firm due to change in business relationship among the partners but the firm continues its business.
- **Types of Dissolution of a firm :** A partnership firm can be dissolved in the following ways :
  - Dissolution by Agreement (Section 40)
  - Compulsory Dissolution (Section 41)
  - Dissolution on happening of certain event (Section 42)
  - Dissolution by Notice (Section 43)
  - Dissolution by Order of Court (Section 44)
- **Difference between Dissolution of a partnership Firm and Dissolution of a Partnership :**

S.No.	Dissolution of a partnership Firm	Dissolution of Partnership
I.	It refers to the dissolution of partnership between all the partners of the firm.	It refers to a change in the existing agreement between the partners.
II.	In case of dissolution of firm, the firm does not continue its business.	In case of dissolution of partnership, the firm continues its business.
III.	Dissolution of firm necessarily means the dissolution of partnership also.	Dissolution of partnership does not necessarily mean the dissolution of firm.
IV.	In case of dissolution of the firm, books of accounts have to be closed.	In case of dissolution of partnership, books of accounts are prepared on regular basis.

- **Settlement of accounts under Section 48 :**
  Section 48 of the Indian Partnership Act, 1932 deals with the settlement of accounts at the time of dissolution of firm.
- **Treatment of losses :** First of all, the amount of loss including the deficiency of capital shall be paid out of profits, next out of capital of partners and at last, if necessary will be paid by partners in their profit sharing ratio.
- **Application of Assets** : Amount realised from the sale of the assets of the firm shall be applied in the following ways :
  - In paying firm's debt to the third parties.
  - In paying to each partner, the loan advanced by him.
  - Thereafter, the balance of partners' capital accounts will be returned.
  - The remaining amount, if any, will be distributed among partners in their profit sharing ratio.
- **Payment of Firm's debts and Private debts under Section 49 :** Firms debts are the debts incurred by the firm whereas private debts are incurred by the partners under their individual capacity.
  Firm's assets are first utilized for settlement of firm's debt and the surplus is used towards payment of partner's private debt to the extent of his share in profits of the firm. Private debts of the partners are first paid out of private property of the partners and the surplus, if any, used to pay off the firm's debts.

- **Accounting treatment on Dissolution of the Firm :** When a firm is dissolved, assets are realised, liabilities are paid off and the balance, if any, is distributed among the partners. In case of deficiency, it is borne by the partners. Following accounts are prepared at the time of dissolution of the firm :
  - Realisation Account
  - Partner's Loan Account
  - Partner's Capital Account
  - Bank or Cash Account
- **Realisation Account :** Realisation account is a special kind of account, which is prepared at the time of dissolution of the firm. This account is prepared to find out the profit or loss on the sale of assets and repayment of liabilities and realisation expenses.

Dr. **Realisation Account** **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Sundry Assets (Excluding Cash/Bank, Fictitious assets, Debit Balance of Profit & Loss Account A/c and Loan to partner)		By Sundry Liabilities (Excluding Loan from partners, Credit Balance of Profit Loss Account)	
To Bank A/c (Amount paid for discharging liabilities)		By Provision on any Asset (Such as provision for doubtful debits, provision for Depreciation)	
To Bank/Cash A/c (Expenses on realisation)		By Bank/Cash A/c (Amount received on sale of assets)	
To Partner's Capital A/c (Liability taken over by partner)		By Bank/Cash A/c (Amount received from unrecorded assets)	
To Bank Cash A/c (Amount paid for unrecorded Liabilities)		By Partner's Capital A/c (Assets taken over by partner)	
To Partners' Capital A/c (For profit)		By Partners' Capital A/c (loss)	

- **General Entries :**
  - **For transfer of Assets :**
    Realisation A/c Dr.
    To Sundry Assets A/c
    (Being assets transferred to Realisation A/c at book value)
  - **For transfer of Liabilities :**
    Sundry Liabilities A/c Dr.
    To Realisation A/c
    (Being liabilities transferred to Realisation A/c at book value)
  - **For Sale of Assets :**
    Cash/Bank A/c Dr.
    To Realisation A/c
    (Being assets sold)
  - **For transfer of Provisions :**
    Provision for Bad Debts A/c Dr.
    Provision for Depreciation A/c Dr.
    Machinery Replacement A/c Dr.
    Investment Fluctuation Fund A/c Dr.
    To Realisation A/c
    (Being various Reserves and Provisions transferred to Realisation A/c)
  - **For Undistributed Profits :**
    General Reserve A/c Dr.
    Reserve Fund A/c Dr.
    Contingency Reserve A/c Dr.
    Profit & Loss A/c Dr.
    Workmen Compensation Reserve A/c Dr.
    To Partners' Capital A/cs
    (Being undistributed Profits transferred to Capital Accounts of Partners)

- **For Liabilities paid :**
  Realisation A/c Dr.
  To Cash/Bank A/c
  (Being liabilities paid in cash)
- **For Assets taken over by a partner :**
  Partner's Capital A/c Dr.
  To Realisation A/c
  (Being assets taken over by partner)
- **For Liability taken over by a partner :**
  Realisation A/c Dr.
  To Partner's Capital A/c
  (Being liability taken over by partner)
- **For Realisation Expenses :**
  Realisation A/c Dr.
  To Cash/Bank A/c
  (Being realisation expenses paid in cash)
- **For Profit on Realisation A/c :**
  Realisation A/c Dr.
  To Partners' Capital A/cs
  (Being profit transferred to Partners' Capital A/c)
- **For Loss on Realisation A/c :**
  Partners' Capital A/cs Dr.
  To Realisation A/c
  (Being loss transferred to Partners' Capital A/c)

➢ **Partner's Loan Account :** If a partner has given loan to the firm, his loan will be paid after the payment of outside liabilities. Therefore, partner's loan account will not be transferred to the Realisation Account and his loan account will be prepared separately and paid off by passing the following entry :

Partner's Loan A/c Dr.
To Bank A/c
(Being amount of partner's loan paid off)

➢ **Partners' Capital Accounts :** After the transfer of profit or loss on realisation, undistributed profits, reserves, etc. to the capital accounts of the partners, the balance of capital accounts are closed in the following manner :

- **On bringing cash by partners for deficiency in capital :**
  Bank/Cash A/c Dr.
  To Partner's Capital A/c
  (Being required cash brought by partner)
- **On payment to Partner :**
  Partner's Capital A/c Dr.
  To Bank/Cash A/c
  (Being excess cash paid to partner)

➢ **Cash or Bank Account :** In the end of the dissolution process, Cash or Bank A/c is prepared. On the debit side of this account entries for opening balance, received from sale of assets and amount brought in by the partners are shown and on credit side, entries for payment of liabilities, expenses and amount paid to partners are shown. After the claims of the partners are settled, no balance should be left in the Bank/Cash Account.

➢ **Realization expenses**
These are paid during the process of dissolution of a firm. It is an expense of the firm. It is also possible that any partner may agree to pay these expenses in exchange of some amount (in ₹) of commission and the following entries are passed:

- **When the realization expenses are paid by the firm.**
  Realization A/c Dr
  To Cash/Bank A/c
- **When the realization expenses are paid by the partners.**
  Realization A/c Dr
  To concerned partner's capital A/c
- **When the firm pays a fixed amount (in ₹) to a partner for dissolving the firm and the following entries are passed.**
  Paying the Amount (in ₹) to the partner

Realization A/c Dr.
To Concerned Partner's capital A/c
When the expenses are paid by the firm on behalf of the partner.
Concerned Partner's Capital A/c Dr.
To Bank/ Cash A/c

- **When the firm pays a fixed Amount (in ₹) to the partner as remuneration but dissolution expenses are borne by the firm.**

  1. When the remuneration is paid to the partner.
  Realization A/c Dr.
  To Concerned Partner's Capital A/c
  2. When the expenses of dissolution are paid.
  Realization A/c Dr.
  To Bank /Cash A/c

- **When the realization expenses are borne by one partner (A) and paid by another partner (B)**

  A's capital A/c Dr.
  To B's capital A/c
  Note. When nothing is mentioned in the question regarding the payment of realization expenses, it is assumed that the firm has to pay for it.

- **When the realization account is closed.**

  The balance of realization account is profit or loss. Profit arises when the total of the credit side is more than the total of debit side. Loss arises when the total of debit side is more than the total of credit side. The profit or loss is transferred to the partners' capital account in their profit sharing ratio and the following entry is passed.
  1. In case of profit (always in old ratio)
  Realization A/c Dr.
  To partners' capital A/c
  2. In case of loss (always in old ratio)
  Partner's capital A/c Dr.
  To realization A/c

❑❑

UNIT – 2: JOINT STOCK COMPANY ACCOUNTS

CHAPTER-6

ACCOUNTING FOR SHARE CAPITAL

Topic-1 Issue of Shares for Cash and for Considerations other than Cash

Concepts Covered • *Meaning of share, types of share, Difference between Equity Share and Preference Share, Issue of Shares for Cash-Issue of shares at par and premium, Utilisation of Securities Premium Reserve Account, Issue of Shares for Consideration other than Cash, Calls in Arrears, Calls in Advance, over-subscription and under-subscription of shares.*

Revision Notes

➢ **Meaning of Share :**

According to Section 2 (84) of the Companies Act, 2013," Share means a share in the share capital of a company and includes stock. The capital of a company is divided into a number of small units. Each unit is called a share."
There are two types of shares :

(a) Equity Share, (b) Preference Share.

- **Equity Share :** An equity share is a share which is not a preference share. These shares do not carry any preferential right. But they are the actual owners of the company.
- **Preference Share :** According to Section 43(b) preference share is one which carries the following two rights :

(a) The right to receive dividend at a fixed rate before any dividend is paid on the equity shares.

(b) On the winding up of the company, the right to get their capital before anything is paid to equity share holders.

➢ **Difference between Equity Share and Preference Share :**

S. No.	Basis of Difference	Equity Share	Preference Share
(i)	Rate of dividend	The rate of dividend on Equity Share is not fixed.	Preference Shares are paid dividend at a fixed rate.
(ii)	Voting right	Equity Shareholders enjoy voting rights.	Preference Shareholders do not have any voting rights.
(iii)	Status	They are actual owner of the company	They are just like creditors of the company.

➢ **Issue of Shares for Cash :**

A company limited by shares can issue its shares for cash and for consideration other than cash. Issue of shares for cash can be of two types : Issue of Shares at Par and Issue of Shares at Premium.

- **Issue of Share at Par :** Shares are said to be issued at par when they are issued at a price equal to the face value of the share. For example, if a share of ₹ 10 is issued at ₹ 10, it is said that the share issued at par.

➢ **Accounting Entries for Issue of Shares for Cash :**

On the receipts of Application Money :

Bank A/c Dr.
    To Share Application A/c
(Being application money received)
Share Application A/c Dr.
    To Share Capital A/c
(Being application money transferred to share capital A/c)

- **Entries on Allotment :**

  Share Allotment A/c Dr.
      To Share Capital A/c
  (Being amount due on allotment)
  Bank A/c Dr.
      To Share Allotment A/c
  (Being allotment money received)

- **Entries on First Call :**

  Share First Call A/c Dr.
      To Share Capital A/c
  (Being first call money due)
  Bank A/c Dr.
      To Share First Call A/c
  (Being first call money received)

- **Entries on Second Call :**

  Share Second Call A/c Dr.
      To Share Capital A/c
  (Being second call money due)
  Bank A/c Dr.
      To Share Second Call A/c
  (Being second call money received)

Issue of Share at Premium : When a company issues a share at a price which is higher than its face value, it is said to be issued at premium. For example, if a share of the face value of ₹ 10 is issued at ₹ 14, ₹ 4 will be the premium on the share. The premium on issue of share is a capital profit so it should be transferred to a separate account called "Securities Premium Reserve Account".

➢ **Utilisation of Securities Premium Reserve Account :**

Under Section 52(2) of the Companies Act, 2013, the amount of securities premium reserve will be used only for the following purposes :

- To write off the preliminary expenses of the company.

- To write off the expenses, commission or discount allowed on issue of debenture.
- To issue fully paid up bonus shares to the shareholders of the company.
- To buy back of its own share and other securities of the company.

➢ **Accounting Entries for Securities Premium :**

Normally, it is mentioned in the question about securities premium when it is receivable. But in the absence of any information, it is assumed that premium is due along with allotment money.

- **If the amount of premium is received along with application money:**

Bank A/c Dr.
To Share Application A/c
(Being application money received)
Share Application A/c Dr.
To Share capital A/c
To Securities Premium Reserve A/c
(Being application money transferred share capital)

- **If it is received on allotment :**

Share Allotment A/c Dr.
To Share capital A/c
To Securities Premium Reserve A/c
(Being allotment money due)
Bank A/c Dr.
To Share Allotment A/c
(Being allotment received with securities premium money)

➢ **Issue of Shares for Consideration other than Cash :**

Sometimes, a company can issue shares for other purposes other than for cash. It is known as issue of shares for consideration other than cash. It can be of following types :

- **Issue of Shares to Promoters :** Promoters of a company may be issued shares in the company for the services rendered by them. For this purpose, following entry will be passed :

Incorporation Costs/ Formation Exp. A/c Dr.
To Share Capital A/c
(Being shares issued to promoters for bearing incorporation expenses)

➢ **Issue of Shares for Purchase of Assets :**

When a company purchases some assets from the vendor. For this, company can make the payment for the assets in shares. Following entries are made for this purpose :

- **When assets are purchased from the vendor :**

Sundry Assets A/c Dr.
To Vendor's A/c
(Being assets purchased from vendor)

- **When shares are issued to vendors (at par)**

Vendor's A/c Dr.
To Share Capital A/c
(Being assets purchased from vendor)

$$\text{Number of shares issued} = \frac{\text{Amount payable}}{\text{Issue price of share}}$$

- **When shares are issued to vendors at premium :**

Vendor's A/c Dr.
To Share Capital A/c
To Securities Premium Reserve A/c
(Being shares issued to vendor at premium)

$$\text{Number of shares issued} = \frac{\text{Amount payable}}{\text{Issue price of share including premium amount}}$$

➢ **Calls in Arrears :** The portion of called up capital which is not paid by the shareholders within a specified time is called as Calls in Arrear. There are two alternative methods for dealing with the Calls in Arrears :

- **When Calls in Arrears Account is opened :** In this method, separate Call-in Arrears Account is opened. This amount is transferred to newly opened "Calls in Arrears A/c". Following entries are passed :

On non-receipt of Call Money when due :

Calls in Arrears A/c Dr.

To Share Call A/c

(Being call money that remains unpaid)

On receipt of Calls in Arrears at a subsequent date :

Bank A/c Dr.

To Calls in Arrears A/c

(Being call amount received)

- **When Calls in Arrears Account is not opened :** In this method, the actual amount received from the shareholders is credited to Call Account. Amount of Calls in Arrears will be shown as a deduction from the amount of called up and paid up capital on the Equity and Liabilities part of the Balance Sheet.

➢ **Interest on Calls in Arrears :** In case of calls in arrears, if the Articles of Association of a Company is silent, then Table of the Companies Act, 2013 shall apply and interest @ 10% p.a. will be charged on Calls in Arrears.

- **When interest is received :**

  Bank A/c Dr.

  To Interest on Calls in Arrears A/c

  (Being amount of interest on calls in arrears received)

- **Interest transferred to Statement of Profit Loss :**

  Interest on Calls in Arrears A/c Dr.

  To Statement of Profit & Loss

  (Being the interest transferred to Statement of Profit & Loss)

➢ **Calls in Advance :**

When a company accepts money paid by some of its allottes for the calls not yet due, such amount is known as Calls in Advance. It is shown on Equity and Liabilities part of the Balance sheet under the head Current Liabilities.

- **Accounting entries passed to record are :**

  Bank A/c Dr.

  To Calls in Advance A/c

  (Being amount of calls in advance received)

  Calls in advance A/c Dr.

  To Share...... Call A/c

  (Being calls in advance amount adjusted against the money due)

➢ **Interest on Calls in Advance :** Interest on Calls in Advance is given by the company @ 12% p.a. Following entry will be passed for this :

Interest on Calls in Advance A/c Dr.

To Bank A/c

(Being interest on calls in advance paid)

Statement of Profit & Loss Dr.

To Interest on calls in advance A/c

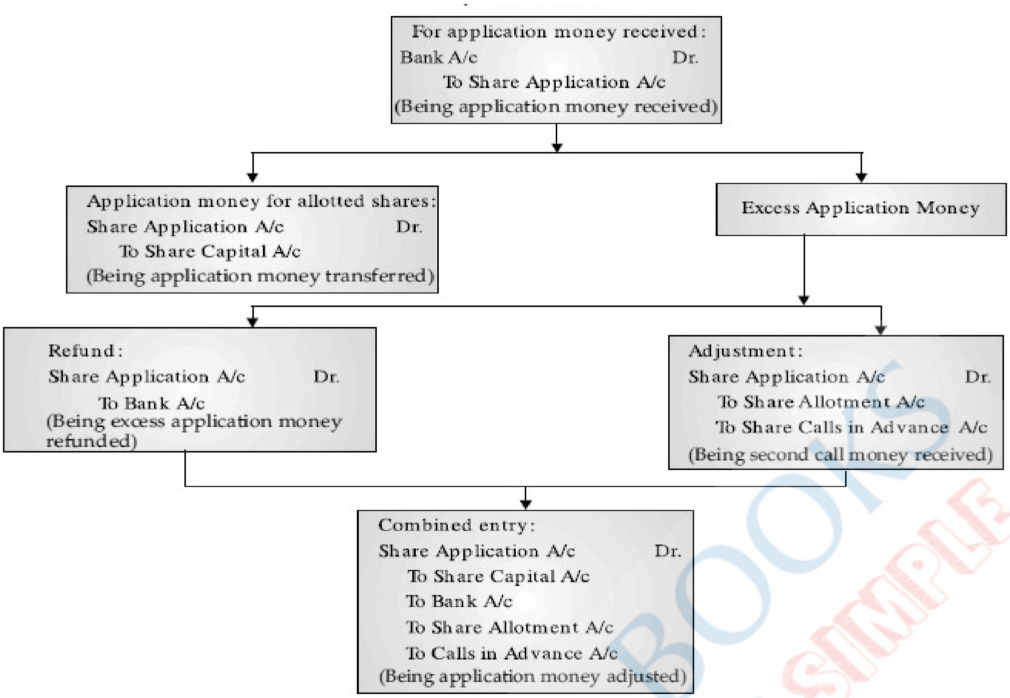
(Being interest transferred to statement of Profit & Loss)

➢ **Over Subscription of Shares :**

When the application for more shares is received than the number of shares offered for issue. It is known as Over Subscription. A company can not allot shares more than offered for subscription. In such a case, the Board of Directors will have to allot shares on pro-rata basis. It means that smaller number of shares are allotted to each applicant according to the number of share applied by him. In case of over subscription, following three alternatives are available :

- Board of Directors can make full allotment to some applicants and reject the others.
- They can make a pro-rata allotment.
- They can adopt a combination of the above two alternatives.

Journal Entries



- **Under Subscription of Shares :**
When the number of shares applied for is less than the number of shares offered for issue, it is known as Under Subscription. This is subject to the qualification, that minimum subscription has at least been received.

Key Terms

- **Authorised Capital :** As per the Section 2(8) of the Companies Act, 2013, Authorised Capital is the maximum amount of share capital which a company is authorised to issue by its Memorandum of Association.
- **Issued capital :** It is that part of authorised capital that is offered to public for subscription.
- **Reserve Capital :** That part of subscribed share capital that a company resolves by a special resolution, not to call except in the event of wound up.
- **Pro-rata :** Pro-rata is a situation where number of applied shares are more but actual allotted shares are less than the applied shares.

Topic-2 Forfeiture, Reissue of Shares and Disclosure of Share Capital in Company's Balance Sheet

Concepts Covered • *forfeiture of shares at par and premium, reissue of forfeited shares, disclosure of share capital*

Revision Notes

- **Forfeiture of Shares :** If any shareholder fails to pay the amount due on allotment or any call within the specified period, the company may cancel his share. This process is called Forfeiture of Shares. The shares can be forfeited only if the Articles of Association of the companies allow them to be forfeited. If no rules are given in Articles, the provision of Table F of the Companies Act, 2013, regarding forfeiture apply. After the forfeiture, the name of the shareholder is removed from the Register of members.

- **Entries on Forfeiture of Shares :** Forfeiture of Shares can be of two types :
  - Forfeiture of Shares which were issued at par
  - Forfeiture of Shares which were issued at premium.
- **Forfeiture of Shares which were issued at par :** For the Forfeiture of shares, the share capital is reduced and Share Capital A/c is debited with the amount called up for forfeited shares. The entry will be :

  Share Capital A/c Dr. [Number of shares forfeited × Called up value per share]
  To Share Allotment A/c [Amount not received on allotment]
  To Share Calls A/c [Amount not received on calls]
  To Share Forfeiture A/c [Amount received so far]
  (Being forfeiture of shares issued at par)
- **Forfeiture of Shares which were issued at premium :** Under this two conditions may arise :
  - **When forfeiture takes place after the premium is received :** Section 52 of Companies Act, 2013, if premium has been collected, it cannot be cancelled even if that share is forfeited later on. In such a case, Securities Premium Account will not be debited.
  - **When forfeiture takes place before the premium is received.** When a share is forfeited on which the premium has become due but not received, in such a case, the Securities Premium Reserve A/c will be debited with the full amount of premium. The entry will be :

    Share Capital A/c Dr. [Amount called up so far excluding premium]
    Securities Premium Reserve A/c Dr. [When premium is not received]
    To Share Allotment A/c [Amount not received]
    To Share Call A/c [Amount not received]
    To Share Forfeiture A/c [Amount received on share]
    (Being forfeiture of shares issued at premium)
- **Reissue of Forfeited Shares :**
  The directors cancel or reissue the forfeited shares. Shares forfeited can be reissued at par, premium or discount. Following entries are passed on the Reissue of Forfeited Shares :
  - If the Forfeited Shares are reissued at par :

    Bank A/c Dr.
    To Share Capital A/c
    (Being shares reissued at par)
  - If the Forfeited Shares are reissued at premium :

    Bank A/c Dr.
    To Share Capital A/c
    To Securities Premium Reserve A/c
    (Being shares reissued at premium)
  - If the Forfeited Shares are reissued at discount :

    Bank A/c Dr.
    Share Forfeiture A/c Dr.
    To Share Capital A/c
    (Being shares reissued at discount)

  After the reissue of forfeited shares, the credit balance left in the Share Forfeiture A/c must be transferred to Capital Reserve A/c. The journal entry will be :

  Share Forfeiture A/c Dr.
  To Capital Reserve A/c
  (Being balance of Share Forfeiture A/c transferred to Capital Reserve)
- **Disclosure of Share Capital :** As per Schedule III of Companies Act, 2013 share capital is to be disclosed in the company's Balance Sheet in the following manner :

Extract of Balance Sheet of ....
as at ....

Particulars	Note No.	Amount Current year (₹)	Amount Previous year (₹)
I. Equity and Liabilities : **Shareholders' Funds :** (a) Share Capital (b) Reserves and Surplus (c) Money received against Share Warrants	 1		

As per schedule III disclosure requirement pertaining to share capital are to be provided in Notes to Account.

Notes to Accounts :

Particulars	Amount (₹)	Amount (₹)
1. Share Capital : Authorised Capital : .... Equity Shares of ₹ .... each ...... Preference Shares of ₹ .... each **2. Issued Capital** .... Equity Shares of ₹ .... each ...... Preference Shares of ₹ .... each **3. Subscribed Capital :** Subscribed and Fully Paid Capital : .... Equity Shares of ₹ .... each .... Preference Shares of ₹ .... each *Less* : Calls in Arrears (i) By Directors and Officers of the company (ii) By others *Add* : Forfeited Shares.		

Key Terms

- **Forfeiture of Shares :** If any shareholder fails to pay the amount due on allotment or any call within the specified period, the directors may cancel his shares. It is called Forfeiture of Shares.
- **Reissue of Shares :** After forfeiture of shares, the directors can again issue the forfeited shares. It is called Reissue of Shares.
- **Capital Reserve :** Capital Reserve is that reserve which is created out of capital profits.

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CHAPTER-7

ISSUE OF DEBENTURES

Revision Notes

- **Meaning of Debenture :**

  Debenture is a document acknowledging a company's indebtedness issued under the seal of the company. It contains a contract for the repayment of the principal sum at a specified date with fixed interest rate.

  According to section 2(30) of the Companies Act, 2013 "Debenture includes stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not."

  Characteristics or Features of Debenture :
  - Debenture is a document issued by the company acknowledging a debt.
  - It is issued under the common seal of a company.
  - It contains a contract for the repayment of principal sum at specified rate.
  - Rate of interest on debenture is fixed.
- **Bond :**

  Bond is an instrument of acknowledgement of debt. It is very much similar to that of debenture but bonds can be issued without predetermined rate of interest. These days, bonds can be issued by non-government and semi government organisations.
- **Types or Kinds of Debentures :**
  - **Secured or Mortgage Debentures :** These debentures are those debentures on which a charge is created on the assets of the company for the purpose of payment. The charge which is created on a particular asset is called fixed charge. The charge which is created on all assets of the company in general is called a floating charge.
  - **Unsecured or Naked Debentures :** These are those debentures on which no security is given. The holders of such debentures are treated as unsecured creditors at the time of liquidation of the company.

- **Registered Debentures :** Registered Debentures are those which are payable only to those holders whose names and addresses are recorded in the register of the company.
- **Bearer Debentures :** Bearer Debentures are those debentures which are payable to the bearer or holder of the debentures. These are transferable by mere delivery and the company does not keep any record of name and addresses of debenture holders.
- **Redeemable Debentures :** Redeemable Debentures are those debentures which will be repaid by the company at the end of a specified period either in lump sum or in installments during the lifetime of the company. Most of the debentures are generally of this type.
- **Irredeemable or Perpetual Debentures :** These are those debentures which are not repayable by the company during its life time. These debentures are payable only at the time of liquidation of the company or on the expiry of a long period.
- **Convertible Debentures :** Holders of these debentures are given an option to convert them into equity or other securities at a stated rate of exchange after a certain period either at the option of the company or the debenture holders.
- **Non Convertible Debentures :** These Debenture holders do not have right or option to convert debentures into equity shares or security at a specified period of time.

➢ **Distinction between Shares/Debentures :**

S. No.	Shares	Debentures
(i)	A Share is a part of the capital of the company, therefore, the shareholders are the owners of the company.	A Debenture is a part of the loan and the Debenture holders are the creditors of the company.
(ii)	Shareholders get dividend from the company.	Debenture holders get interest from the company.
(iii)	A Share is always unsecured.	A Debenture may be secured.
(iv)	Shares cannot be issued at discount.	Debentures can be issued at discount.
(v)	Shareholders can vote in the company	Debenture holders cannot vote.
(vi)	Shares cannot be converted into debentures	Debentures can be converted into shares.

➢ **Issue of Debentures :** The procedure for the issue of debentures is very much similar to that of the issue of shares. Debentures can be issued at par, premium or discount.

➢ **Accounting entries for Issue of Debentures for Cash :**

Following entries will be passed at the time of Issue of Debentures :

(1) On receipt of application money :

Bank A/c Dr.
To Debenture Application A/c
(Being application money received)

(2) On transfer of application money to Debentures A/cs :

Debenture Application A/c Dr.
To Debenture A/c
(Being application money transferred)

(3) On Refund of rejected application

Debenture Application A/c Dr.
To Bank A/c
(Being application money refunded)

(4) On making allotment money due :

Debenture Allotment A/c Dr.
To Debentures A/c
(Being allotment money due)

(5) On receipt of allotment money :

Bank A/c Dr.
To Debenture Allotment A/c
(Being allotment money received)

➢ **Issue of Debentures at Premium :**

When the debentures are issued at a price more than their face value, they are said to have been issued at premium. Premium on Issue of Debenture is shown in the liabilities side of the Balance Sheet under the head—"Reserves and Surplus".

Debenture Allotment A/c Dr.
To Debenture A/c
To Securities Premium Reserve A/c
(Being debenture issued at premium)
Bank A/c Dr.
To Debenture Allotment A/c
(Being allotment money received including premium)

➢ **Issue of Debentures at Discount :**

When a company issues debentures at a price less than their face value, the debentures are said to have been issued at a discount. Discount allowed on issue of debentures is a capital loss, therefore, it must be shown as deduction from Reserves and Surplus in liabilities side of Balance Sheet.

Debenture Allotment A/c Dr.
Discount on Issue of Debenture A/c Dr.
To Debenture A/c
(Being debentures issued at discount)
Bank A/c Dr.
To Debenture Allotment A/c
(Being allotment money received)

➢ **Issue of Debentures as Collateral Security :**

Sometimes, when a company takes a loan from a bank or some other party, the company may have to issue debentures as subsidiary or secondary security in addition to the principal security. In other words, collateral security means secondary security in addition to the principal security. There are two methods of dealing with such debentures in the books of accounts of the company.

- **First method :** In this method, no entry needs to be passed in the books of the company, as the debentures are not actually issued, but are only given away as collateral security. As such under this method entry is passed only for taking a loan. If the loan is taken from a bank, the entry will be :

  On taking loan :

  Bank A/c Dr.
  To Bank Loan A/c
  (Being Bank loan taken)

- **Second method :** In this method, the entry for issuing debenture as collateral security is also recorded with the entry for taking the loan.

  (i) On taking a loan :

  Bank A/c Dr.
  To Bank Loan A/c
  (Being bank loan taken)

  (ii) On Issuing of Debentures as Collateral Security :

  Debenture Suspense A/c Dr.
  To Debenture A/c
  (Being Debentures issued as collateral security)

➢ In the Balance Sheet, the Debenture Suspense Account will be shown as a deduction from the Debenture Account on the Equity and Liabilities side.

➢ **Issue of Debenture for Consideration other than Cash**

Sometimes, when a company purchases some assets from the vendor, the company may decide to issue debentures to vendors in payment of purchase consideration. Such an issue of debentures to vendors is known as Issue of Debentures for consideration other than Cash. Debentures can be issued at par, premium or at a discount.

On Purchase of Assets :

Assets A/c Dr.
To Vendor's A/c
(Being assets purchased from vendor)

For the Issue of Debentures to Vendor at par :

(1) Vendor's A/c Dr.
To Debenture A/c
(Being debentures issued to vendor at par)

For the Issue of Debenture at Premium :

Vendor's A/c Dr.
To Debenture A/c
To Securities Premium Reserve A/c
(Being debentures issued to vendor at premium)

For the Issue of Debentures to Vendor at Discount :

Vendor's A/c Dr.
Discount on Issue of Debenture A/c Dr.
To Debenture A/c
(Being debentures issued to vendor at discount)

➢ **Accounting for Issue of Debentures considering the Terms and Conditions of Redemption :**

Debentures may be redeemed either at par or at premium, according to the terms laid down at the time of issue. After taking into account the three possibilities of issue (*i.e.*, at par, at discount, at premium) and two possibilities of redemption (*i.e.*, at par or at premium), a company can issue debentures in the following six ways :

- **When debentures are Issued at Par and are Redeemable at Par :** For example, if a debenture of ₹ 100 is issued at ₹ 100 and is redeemable at ₹ 100, the following entries will be passed :

Entries for Issue	₹	₹	Entries for Redemption	₹	₹
Bank A/c Dr. To Debenture Application & Allotment A/c (Being application money received)	100	100	Debentures A/c Dr. To Debenture holders' A/c (Being debenture amount transferred to debenture-holders' account)	100	100
Debenture Application & Allotment A/c Dr. To Debentures A/c (Being application money transferred)	100	100	Debenture holders' A/c Dr. To Bank A/c (Being debenture holders' paid)	100	100

- **When debentures are Issued at a Discount and are Redeemable at Par : For example, if a debenture of ₹ 100 is issued at ₹ 95 and is redeemable at ₹ 100, the following entries will be passed :**

Entries for Issue	₹	₹	Entries for Redemption	₹	₹
Bank A/c Dr. To Debenture Application & Allotment A/c (Being money received)	95	95	Debenture A/c Dr. To Debenture holders' A/c (Being debenture amount transferred to debenture-holders' account)	100	100
Debenture Application & Allotment A/c Dr. Discount on Issue of Debentures A/c Dr. To Debentures A/c (Being transfer to debenture account)	95 5	100	Debenture holders' A/c Dr. To Bank A/c (Being debenture holders' paid)	100	100

'Discount on Issue of Debentures' is a Capital Loss and will be written off during the life time of the debentures. It will be written off against Securities Premium Reserve, Capital Profit (if any) or Surplus i.e., Statement of Profit and Loss.

- **When debentures are Issued at Premium and are Redeemable at Par : For example, if a debenture of ₹ 100 is issued at ₹ 105 and is redeemable at ₹ 100, the following entries will be passed :**

Entries for Issue	₹	₹	Entries for Redemption	₹	₹
Bank A/c Dr. To Debenture Application & Allotment A/c (Being money received)	105	105	Debentures A/c Dr. To Debenture holders' A/c (Being debenture amount transferred to debenture-holders' account)	100	100
Debenture Application & Allotment A/c Dr. To Debenture A/c To Securities Premium Reserve A/c (Being transfer to debenture account)	105	100 5	Debenture holders' A/c Dr. To Bank A/c (Being debenture holders' paid)	100	100

Securities Premium Reserve A/c has a credit balance and is a Capital Profit, and therefore, to be shown on the Equity and Liabilities side under the head, "Reserves and Surplus".

- **When debentures are Issued at Par and are Redeemable at Premium :** Sometimes the debentures are issued with specific condition that the company will pay a premium at the time of their redemption. Although, such premium will be paid at the time of actual redemption, but as it is a known loss, the company records such loss at the time of issue by debiting an account called, "Loss on Issue of Debentures A/c". It is done in keeping with the convention of conservatism.
  For example, if a debenture of ₹ 100 issued at ₹ 100 and is redeemable at ₹ 105, the following entries will be passed :

Entries for Issue	₹	₹	Entries for Redemption		
Bank A/c Dr. To Debenture Application & Allotment A/c (Being application money received)	100	 100	Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debenture holders' A/c (Being debenture amount transferred to debenture-holder's account)	100 5	 105
Debenture Application & Allotment A/c Dr. Loss on Issue Debentures A/c Dr. To Debenture A/c To Premium on Redemption of Debenture A/c (Being transfer to debenture account)	 100 5	 100 5	Debenture holders' A/c Dr. To Bank A/c (Being debenture holders' paid)	105	 105

Loss on Issue of Debenture A/c is a loss on account of promise to pay debentures at premium at the time of their redemption. This is a Capital Loss and is written off from Security Premium Reserve or from Statement of Profit and Loss gradually every year during the lifetime of the debentures. The entry for writing off will be :

Statement of Profit and Loss Dr.
To Loss on Issue of Debentures A/c

The balance of 'Loss on Issue of Debentures A/c' is shown as 'Unamortized Expenses' on the assets side of the Balance Sheet.

'Premium on Redemption of Debentures A/c' is a Personal Account and shows a credit balance. It is a liability on the part of the Company and appears under the head : 'Non-Current Liabilities' under sub-head 'Other Long Term Liabilities' on the Equity and Liability side of the balance sheet each year, until the debentures are repaid. At the time of Redemption of Debentures, this account is debited and closed off.

- **When Debentures are Issued at Discount and are Redeemable at Premium :** For example, if a debenture of ₹ 100 is issued at ₹ 98 and is redeemable at ₹ 105 the following entries will be passed :

Entries for Issue	₹	₹	Entries for Redemption	₹	₹
Bank A/c Dr. To Debenture Application & Allotment A/c (Being money received)	98	 98	Debenture A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debenture holders' A/c (Being debenture amount transferred to debenture-holders' account)	100 5	 105
Debenture Application & Allotment A/c Dr. Discount on Issue of Debentures A/c Dr. Loss on Issue of Debentures A/c Dr. To Debenture A/c To Premium on Redemption A/c (Being transfer to debenture account)	98 2 5	 100 5	Debenture holders' A/c Dr. To Bank A/c (Being debentureholders' paid)	105	 105

Both, the amount of discount allowed ₹ 2 and premium on redemption ₹ 5 are Capital Losses and therefore, total amount to be written off during the year is ₹ 7.

- **When Debentures are Issued at Premium and are Redeemable at Premium : For example, if a debenture of ₹ 100 is issued at ₹ 106 and is redeemable at ₹ 110, the following entries will be passed :**

Entries for Issue	₹	₹	Entries for Redemption	₹	₹
Bank A/c Dr. To Debenture Application & Allotment A/c (Being money received)	106	 106	Debentures A/c Dr. Premium on Redemption of Debentures A/c Dr. To Debenture holders' A/c (Being debenture amount transferred to debenture holders' account)	100 10	 110
Debenture Application & Allotment A/c Dr. Loss on Issue of Debenture A/c Dr. To Debenture A/c To Securities Premium Reserve A/c To Premium on Redemption of Debentures A/c (Being transfer to debenture account)	 106 10	 100 6 10	Debenture holders' A/c Dr. To Bank A/c (Being debenture holders' paid)	110	 110

On the Equity and Liabilities side, Securities Premium Reserve will be shown under the head "Reserves and Surplus" and Premium on Redemption will be shown under the head "Non-Current Liabilities" under the sub-head 'Other Long-term Liabilities'.

➤ **Interest on Debentures :**

Interest on Debentures is usually paid half-yearly. Interest on debentures is a charge against the profits of the company. It is to be paid regularly even if the company incurs a loss or does not earn profits. The rate of interest payable on debentures is prefixed. For example, if the rate of interest is 15% p.a., the name given to debentures will be 15% Debentures." As per Income Tax Act, a company is required to deduct income tax at the prescribed rate from the gross amount of debenture interest before any amount is paid to the debenture holders. The tax thus deducted is to be deposited with the income tax authorities on behalf of the debenture holders.

Following entries are passed for Interest on Debentures :

(i) When interest is due and Tax is Deducted at Source (TDS) :
Interest on Debentures A/c Dr.
To Debenture holder's A/c
To Income Tax Payable A/c
(Being interest due to debenture holders and tax deducted at source)

(ii) When interest is paid to the debenture holders :
Debenture holder's A/c Dr.
To Bank A/c
(Being interest paid)

(iii) On payment of Tax Deducted at Source :
Income Tax Payable A/c Dr.
To Bank A/c
(Being depositing the amount of TDS with income tax authorities)

(iv) On transfer of debenture interest to Statement of Profit and Loss at the end of the year :
Statement of Profit & Loss Dr.
To Interest on Debentures A/c
(Being interest transferred to Statement of P & L)

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CHAPTER-8

REDEMPTION OF DEBENTURES

Topic-1 Redemption of Debentures : Introduction

Concepts Covered • *Redemption of Debentures, Debenture Redemption Reserve, Debenture Redemption Investment*

Revision Notes

- **Redemption of Debentures :**
  Redemption of Debenture means repayment of amount of debentures to the debenture holders.
- **Debenture Redemption Reserve :**
  According to section 71(4) of the Companies Act, 2013, unlisted companies are required to set aside an amount out of profit for Redemption of Debentures to a separate account. This account is known as Debenture Redemption Reserve.

  Listed company (a company whose share is freely traded in a stock exchange) is not required to create any Debenture Redemption Reserve.

  Unlisted companies are required to create DRR equal to at least 10% of outstanding debentures out of divisible profits. Hence, they can redeem 90% of their debentures out of capital.

  Exemption from transferring amount to DRR.

  As per rule 18 (7) of Companies Rule, 2013, following companies would not be required to create DRR :

  (i) All India Financial Institutions regulated by Reserve Bank of India.
  (ii) Other Financial Institutions regulated by Reserve Bank of India (Banking Companies).
  (iii) National Housing Bank.
  (iv) DRR is not required to be created on fully convertible debentures.
- **Debenture Redemption Investment :** As per Companies Rules 18(7) every unlisted company is required to maintain DRR — shall deposit or invest in specified securities on or before 30th April of each year atleast 15% of the nominal value of its debentures redeeming during the year ending 31st March of the next year.

Key Terms

- **Divisible Profit :** Portion of Profit that can be legally distributed as a dividend to the shareholders.
- **Financial Institution :** Corporation that focuses on dealing with financial institutions.
- **National Housing Bank :** It is an apex regulatory body for overall regulation and licensing of housing finance companies in India.

Topic-2 Methods of Redemption of Debentures

Concepts Covered • *Redemption of Debentures out of Profits, Redemption of Debentures out of Capital, Redemption of Debentures in Lump-sum , Redemption of Debentures in annual Instalments by Draw of Lots.*

Revision Notes

- **Redemption of Debentures out of Profits :**
  Redemption out of Profits means that an amount equal to debentures issued (*i.e.*, 100% of the amount of debentures) is transferred from Surplus in Statement of Profit and Loss to a newly opened account named Debenture Redemption Reserve. It is called Redemption out of Profits.

Journal Entries :

(i) For transfer of profits to Debenture Redemption Reserve:
Statement of Profit and Loss Dr.
To Debenture Redemption Reserve A/c
(Being profit transferred to DRR)

(ii) For making investment in specified securities:
Debenture Redemption Investment A/c Dr.
To Bank A/c
(Being investment made in specified securities)

(iii) For amount payable on redemption:
Debentures A/c Dr.
To Debenture holders' A/c
(Being amount due on redemption)

(iv) For encashment of investment:
Bank A/c Dr.
To Debenture Redemption Investment A/c
To Interest on DRI A/c
(Being investment encashed)

(v) For amount paid on redemption:
Debenture holders' A/c Dr.
To Bank A/c
(Being amount paid on redemption)

(vi) When all debentures are redeemed, balance transferred to General Reserve:
Debenture Redemption Reserve A/c Dr.
To General Reserve A/c
(Being DRR transferred to General Reserve)

- **Redemption of Debentures out of Capital :** Listed company can redeem its 100% debentures out of capital while an unlisted company can redeem maximum 90% of its debentures out of capital.
Methods of Redemption of Debentures
- **Redemption of Debentures in Lump-sum :** Under this method, the company redeems whole of its debentures in lump-sum at the expiry of a specified period. Such redemption can be made at par or premium according to terms of issue.
It is necessary for an unlisted company to transfer an amount equal to 10% of the face value of debentures outstanding from Surplus in Statement of Profit & Loss to Debenture Redemption Reserve.
When all debentures are redeemed in lump-sum, the DRR balance is transferred to General Reserve.
The Journal entries in this method are as follows:

(i) On transfer of profits from Surplus in statement of Profit and Loss
Statement of Profit and Loss Dr.
To Debenture Redemption Reserve A/c
(Being profit transferred to DRR)

(ii) On Redemption of Debentures
Debentures A/c Dr.
To Debenture holders' A/c
(Being amount of debentures due for redemption)

(iii) Debenture holders' A/c Dr.
To Bank A/c
(Being amount of debentures paid)

(iv) When all the debentures are redeemed
Debenture Redemption Reserve A/c Dr.
To General Reserve A/c
(Being balance of DRR transferred to General Reserve)

- **Redemption of Debentures in annual installments by Draw of Lots :**
According to this method, the debentures are redeemed in annual installments. The serial number of debentures which should be redeemed each year are selected by lottery. This procedure is known as 'Drawing of Lots'. In this case, 10% amount of outstanding debentures (for unlisted company) is transferred to DRR before redemption begins.
Proportionate amount of DRR is transferred to General Reserve in case of redemption in installments.

Key Terms

- **Redemption of Debentures out of Profit :** It means that amount equal to debentures issued *i.e.*, 100% is transferred to DRR.
- **Redemption of Debentures out of Capital :** When no profits are set aside for Redemption of Debentures, it is called Redemption out of Capital.

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CHAPTER-9

FINAL ACCOUNTS OF COMPANIES

Revision Notes

- **Financial Statements**
  - **Balance Sheet :** A Balance Sheet discloses the financial position of the business firm at the end of the accounting period. It shows the accounts of various assets, equity and liabilities. Balance sheet is also called Position Statement. It shows the movement of the funds throughout the year. It shall give "True and Fair View" of the financial status of the company and must be in the form set out in Part I of Schedule III of the Companies Act, 2013.
  - **Statement of Profit and Loss :** It discloses the net profit of the business operations *i.e.*, net profit earned or net loss suffered during the accounting period. It is also known as Income Statement.
  - **Amendment in AS-4 Regarding Proposed Dividend :** As per the amendment made in Accounting Standard 4, dividend proposed for a year is not a liability till it has not been approved by the shareholders. Thus, proposed dividend of current year is not shown as a short-term provision in the current Balance Sheet of a company but disclosed in Notes to Accounts under Contingent Liabilities.
  - All capital losses to be written off in the year in which they occur unless otherwise mentioned.

Proforma of Balance Sheet :

Name of the Company
Balance Sheet
as at .... (₹ in ....)

Particulars	Note No.	Figures as at the end of Current Reporting Period	Figures as at the end of Previous Reporting Period
I. EQUITY AND LIABILITIES			
1. Shareholders' Funds :			
(a) Share Capital			
(b) Reserves and Surplus			
*(c) Money Received against Share Warrants			
2. Share Application Money Pending Allotment			
3. Non-current Liabilities :			
(a) Long-term Borrowings			
*(b) Deferred Tax Liabilities (Net)			

*(c) Other Long-term Liabilities			
(d) Long-term Provisions			
4. Current Liabilities :			
(a) Short-term Borrowings			
(b) Trade Payable			
(c) Other Current Liabilities			
(d) Short-term Provisions			
Total			
II. ASSETS			
1. Non-current Assets			
(a) Property, Plant and Equipment and Intangible Assets			
(i) Property, Plant and Equipment			
(ii) Intangible Assets			
*(iii) Capital Work-in-Progress			
*(iv) Intangible Assets under Development			
(b) Non-current Investments			
*(c) Deferred Tax Assets (Net)			
(d) Long-term Loans and Advances			
(e) Other Non-current Assets			
2. Current Assets :			
(a) Current Investments			
(b) Inventories			
(c) Trade Receivables			
(d) Cash and Cash Equivalents			
(e) Short-term Loans and Advances			
(f) Other Current Assets			
Total			

* Marked items will not be evaluated.

Statement of Profit and Loss

The title of 'Profit and Loss Account' has been changed to 'Statement of Profit and Loss'. It shows the net result of business operations.

Proforma of Statement of Profit and Loss :

Name of the Company
Statement of Profit and Loss
for the year ending ....

(₹ in ....)

Particulars	Note No.	Figures for the Current Reporting Period	Figures for the Previous Reporting Period
I. Revenue from Operations			
II. Other Income			
III. Total Revenue (I + II)			
IV. Expenses :			
Cost of Materials Consumed			
Purchases of Stock-in-Trade			
Changes in Inventories of Finished Goods			
Work-in-Progress and Stock-in-Trade			
Employee's Benefit Expenses			
Finance Costs			
Depreciation and Amortisation Expenses			
Other Expenses			
Total Expenses			
V. Profit before Exceptional and Extraordinary Items and Tax (III – IV)			
VI. Exceptional Items			
VII. Profit before Extraordinary Items and Tax (V – VI)			
VIII. Extraordinary Items			
IX. Profit before Tax (VII – VIII)			
X. Tax Expenses :			
(1) Current Tax			
(2) Deferred Tax			
XI. Profit/Loss for the Period from Continuing Operations (IX – X)			
XII. Profit/Loss from Discontinuing Operations			
XIII. Tax Expense of Discontinuing Operations			
XIV. Profit/Loss from Discontinuing Operations (After tax) (XII – XIII)			
XV. Profit/Loss for the Period (XI – XIV)			
XVI. Earnings per Equity Share :			
(1) Basic			
(2) Diluted			

Key Terms

- **Position Statement :** It shows the accounts of various assets, equity and liabilities on a particular date.
- **Statement of Profit & Loss :** It shows net results of the business operations *i.e.*, net profit or net loss of the business.

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UNIT – 3: FINANCIAL STATEMENT ANALYSIS

CHAPTER-10
FINANCIAL STATEMENT ANALYSIS: COMPARATIVE AND COMMON SIZE STATEMENTS

Topic-1

Comparative Statements

Concepts Covered • *Meaning of Analysis of Financial Statements, Comparative Statement, Significance of Comparative Statements, Limitations of Comparative Statements, Types of Comparative Statements, Comparative Balance Sheet, Comparative Statement of Profit & Loss or Comparative Income Statement*

Revision Notes

- **Financial Statement Analysis :** It is the process of critical evaluation of the financial information to understand and make decisions regarding the operations of the business.
- **Comparative Statements :** These statements show the financial position and profitability of an organisation for different period of time in a comparative way so that the position of the organisation can be found out for two or more periods. It is the study of individual items or components of financial statement of two or more years of the enterprise itself.
- **Significance/Objectives of Comparative Statements :**
  (i) These statements make the data more simpler and understandable.
  (ii) These statements show the trend.
  (iii) These statements depict the strong and weak points of the concern.
  (iv) These statements help in forecasting.
- **Limitations of Comparative Statements :**
  (i) Historical Records : It is an analysis of historical records i.e., analysis of post financial statements.
  (ii) Qualitative Elements are ignored : These Statements consider only those items which can be measured in terms of money.
  (iii) Changes in Price Level are ignored : These statements ignore the change in price level so it is meaningless.
- **Types of Comparative Statements :**
  (i) Comparative Balance Sheet **(ii)** Comparative Statement of Profit & Loss
- **Comparative Balance Sheet :** According to Faulke, "Comparative Balance Sheet Analysis is the study of the trend of some items or group of some comprised items in Balance Sheet of the same business enterprise of different dates."

  The Comparative Balance Sheet shows increase and decrease in absolute terms as well as in percentage in various Assets, Liabilities, Capital and thus provides information regarding progress of the business firm.

Format of comparative balance sheet—

Comparative Balance Sheet
as on ....

Particulars	Note No.	Current Year A (₹)	Previous Year B (₹)	Absolute change (increase/ decrease) C = A – B (₹)	Percentage change (increase/ decrease) (%) $D = \frac{C}{B} \times 100$
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(a) Share Capital					
(b) Reserves and Surplus					
2. Non Current Liabilities					
(a) Long-Term Borrowings					
(b) Long-Term Provisions					
3. Current Liabilities					
(a) Short-Term Borrowings					
(b) Trade Payables					
(c) Short-Term Provisions					
(d) Other Current Liabilities					
Total					
II. ASSETS					
1. Non Current Assets					
(a) Property, Plant and Equipment and Intangible Assets					
(i) Property, Plant and Equipment					
(ii) Intangible Assets					
(b) Non-Current Investments					
(c) Long-Term Loans and Advances					
2. Current Assets					
(a) Current Investments					
(b) Inventories					
(c) Trade Receivables					
(d) Cash and Cash Equivalents					
(e) Short-Term Loans and Advances					
(f) Other Current Assets					
Total					

- **Comparative Statement of Profit & Loss or Comparative Income Statement :** Comparative Statement of Profit and Loss is the Income Statement which is prepared in such a form so as to reflect the operating activities of the business for two or more accounting periods. It helps in assessing and reviewing the operational efficiency, deciding future action and formulation of effective planning. The generally accepted format of the Comparative Income Statement is given below :

Comparative Statement of Profit & Loss
For the year ended 31.03.....

Particulars	Note No.	Previous Year (₹)	Current Year (₹)	Absolute change (₹)	Percentage change (%)
		A	B	(B – A) = C	$D = \frac{C}{A} \times 100$
I. Revenue from Operations					
II. Other Income					
III. Total Revenue (I + II)					
IV. Expenses					
Cost of Material Consumed					
Purchases of Stock-in-Trade					
Change in Inventories of Finished Goods shifted to next line Work-in-Progress and Stock- in-Trade					
Employees Benefit Expenses					
Finance Costs					
Depreciation and Amortisation Expenses					
Other Expenses					
Total Expenses					
V. Profit Before Tax (III–IV)					
VI. *Less* : Tax					
VII. Profit After Tax (V –VI)					

Key Terms

- **Revenue from Operations :** Revenue earned from the operating activities, *i.e.*, activities done by enterprises to earn profit.
- **Other Income :** Income earned from activities other than principal revenue generating activities, *i.e.*, operating activities. Examples of other revenue can be Rent and Interest Receipts.
- **Cost of Material Consumed :** Total value of material used in manufacturing process which includes the value of Opening Inventory as well as Purchase of Material during the year and excludes the Closing Inventory of material.
- **Employee Benefit Expenses :** Expenses made by company for the benefit of employees, e.g., Staff Welfare Expenses, Bonus, etc.
- **Depreciation :** Reduction in value of Tangible (Fixed) Assets over a time.
- **Amortisation :** Reduction in value of Intangible (Fixed) Assets over a time.
- **Horizontal Analysis :** Analysis of each amount of Financial Statement over a horizon of many years.

Topic-2 Common Size Statements

Concepts Covered • *Common Size Statements-Meaning, Objectives, Limitations, Types*

Revision Notes

- **Common size statements :** A common size financial statement displays all items as percentages of a common base figure rather than as absolute numerical figures.
- **Objectives of Common Size Statements :** Following are the objectives of Common Size Statements :
  - These Statements provide a common base for comparison.
  - These Statements present the change in various items in relation to Revenue from Operations, Total Assets or Total Liabilities.
  - These Statements establish a relationship between various items of the Statement of Profit and Loss to Revenue from Operations and various items of Balance Sheet to Total Assets or Total Equity & Liabilities.

- **Limitations of Common Size Statements :**
  - Cannot eliminate the effect of window dressing.
  - Don't provide real information in case of seasonal fluctuation.
  - Ignore qualitative information.
  - Liquidity and Solvency position cannot be measured.
- **Types of Common Size Statements :**
  - Common Size Balance Sheet
  - Common Size Profit & Loss or Income Statement
- **Common-Size Balance Sheet :** In a Common-Size Balance Sheet, each item of Assets is converted into percentages to Total Assets (*i.e.*, 100) and each item of Equity and Liabilities is converted into percentage to Total Equity and Liabilities (*i.e.*, 100). Thus, the Balance Sheet is converted into percentage form and the converted Balance Sheet is called as 'Common Size Balance Sheet'.
- **Format of a Common Size Balance sheet :**

Common Size Balance Sheet
as on ....

Particulars	Note No.	Absolute Amount		Absolute Change	
		Previous Year (₹)	Current Year (₹)	Previous year (%)	Current year (%)
(1)	(2)	(3)	(4)	(5)	(6)
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds					
(a) Share Capital					
(i) Equity Share Capital					
(ii) Preference Share Capital					
(b) Reserves and Surplus					
2. Non-Current Liabilities					
(a) Long-Term Borrowings					
(b) Long-Term Provisions					
3. Current Liabilities					
(a) Short-Term Borrowings					
(b) Trade Payables					
(c) Other Current Liabilities					
(d) Short-Term Provisions					
Total				**100**	**100**
II. ASSETS					
1. Non-Current Assets					
(a) Property, Plant and Equipment and Intagible Assets.					
(i) Property, Plant and Equipment					
(ii) Intangible Assets					
(b) Non-Current Investments					
(c) Long-Term Loans and Advances					
2. Current Assets					
(a) Current Investments					
(b) Inventories					
(c) Trade Receivables					
(d) Cash and Cash Equivalents					
(e) Short-Term Loans and Advances					
(f) Other Current Assets					
Total				**100**	**100**

Note : It does not include line items of Balance Sheet, accounting treatment of which are not to be evaluated.

- **Common Size Statement of Profit & Loss :**
  A Common Size Statement of Profit & Loss is a statement in which the figure of Revenue From Operations is assumed to be equal to 100 and other figures are expressed as percentage of Revenue From Operations.
- **Format of Common Size Statement of Profit & Loss**

Common Size Statement of Profit & Loss
For the year ended 31st March ....

Particulars	Note No.	Absolute Amount		Percentage Change	
		Current Year (₹)	Previous Year (₹)	Current Year (%)	Previous Year (%)
I. Revenue From Operations **II.** *Add :* Other Income **III.** Total Revenue (I + II)					
IV. *Less* : Expenses Cost of Material Consumed Purchase of Stock-in-Trade Changes in Inventories of Finished Goods Work-in-Progress Stock-in-trade Employee Benefit Expenses Finance Costs Depreciation and Amortisation Expenses Total Expenses **V.** Profit Before Tax (III – IV) **VI.** *Less* : Tax **VII.** Profit After Tax (V -VI)					

Key Terms

- **Vertical Analysis :** Analysis of each amount of Financial Statement as a percentage of other amounts for one accounting year.
- **Window Dressing:** Manipulating the financial data by company to improve its appearance of Financial Statements.

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UNIT – 4: CASH FLOW STATEMENT

CHAPTER-11

CASH FLOW STATEMENT

Revision Notes

- **Cash Flow Statement :** A Cash Flow Statement is a statement which shows inflow and outflow of cash during a particular period. It is a summary of sources and application of cash during a particular period of time on the basis of Operating, Financing and Investing Activities.

- **Objectives of Cash Flow Statement :**
  - To ascertain the Sources of Cash (Receipts) and Application of Cash (Payments) from Operating, Investing and Financing Activities of the enterprise.
  - To ascertain net change in Cash and Cash Equivalents.
  - To highlight the major activities that have provided cash and that have used cash during a particular period of time.

- **Importance of Cash Flow Statement :**

  Following are the importance of Cash Flow Statement :
  - It is useful for short-term financial planning.
  - It is useful in preparing cash budget.
  - It is helpful in ascertaining cash flow from various activities separately.
  - It explains the deviations of cash from earnings.

- **Limitations of Cash Flow Statement :**
  - It ignores non-cash transactions.
  - It is historical in nature.
  - There is possibility of window-dressing.
  - It is not suitable for judging the liquidity.

Operating Activities

Cash Inflow

(i) Cash Sales
(ii) Cash received from Debtors
(iii) Cash received as Commission
(iv) Cash received as Fees
(v) Cash received as Royalty

Cash Outflow

(i) Cash Purchases
(ii) Payment to Creditors
(iii) Cash Operating Expenses
(iv) Payment of Wages
(v) Income Tax paid

Investing Activities

Cash Inflow

(i) Proceeds from Sale of Fixed Assets
(ii) Proceeds from Sale of Non-current Investments
(iii) Interest received on Debentures
(iv) Dividend received on Shares

Cash Outflow

(i) Purchase of Fixed Assets
(ii) Purchase of Non-current Investments
(iii) Cash advances and loans made to third party (other than advances and loans made by a financial enterprise wherein it is operating activity).

(v) Cash receipt from the repayment of advances or loans made to third parties (except in case of financial enterprise).

Financing Activities

Cash Inflow

(i) Proceeds from Issue of Shares in Cash
(ii) Proceeds from Issue of Debentures in Cash
(iii) Loans raised (Long-term or Short-term)
(iv) Increase in Balance of Bank Overdraft or Cash Credit

Cash Outflow

(i) Payment for Buy-back of Equity Shares
(ii) Payment for Redemption of Preference Shares
(iii) Payment for Redemption of Debentures
(iv) Repayment of Loans (Long-term and Short-term)
(v) Payment of Dividend
(vi) Payment of Interest
(vii) Payment of Share Issue Expenses
(viii) Decrease in Balance of Bank Overdraft or Cash Credit

➢ **Procedure of Preparing Cash Flow Statement :** The Institute of Chartered Accountants of India has issued Accounting Standard–3 (Revised), for preparing a Cash Flow Statement. This Accounting standard has been made mandatory in respect of accounting periods commencing on or after 1st April, 2001 for certain enterprises. These enterprises are :

- Enterprises whose equity and debt securities are listed with a recognized Stock Exchange in India.
- All other commercial, industrial and business enterprises, whose turnover for the accounting period exceeds ₹ 50 crore.

XYZ Ltd.
Cash Flow Statement (Indirect Method)
for the year ended ....
(as per Accounting Standard–3 Revised)

Particulars		**₹**	**₹**
A. Cash Flow from Operating Activities :			
Net Profit before Tax (See Note No. 1)		....	
Adjustments for Non-Cash and Non-Operating Items :			
Add : Depreciation	....		
Preliminary Expenses/Discount on Issue of Debentures written off	....		
Goodwill, Patents and Trademarks Amortised	....		
Interest on Long-term Borrowings	....		
Loss on Sale of Fixed Assets	....	....	
Less : Interest Income	(...........)		
Dividend Income	(...........)		
Rental Income	(...........)		
Profit on Sale of Fixed Assets	(...........)	(...........)	
Operating Profit before Working Capital Changes		....	
Add : Decrease in Current Assets	....		
Increase in Current Liabilities	....	....	
Less : Increase in Current Assets	(...........)		
Decrease in Current Liabilities	(...........)	(...........)	
Cash generated from Operations		....	
Less : Income Tax paid (Net of Tax Refund received)		(...........)	
Net Cash Flow from (or used in) Operating Activities		....	....
B. Cash Flow from Investing Activities :			
Proceeds from Sale of Tangible Fixed Assets		....	
Proceeds from Sale of Intangible Fixed Assets like Goodwill		....	
Proceeds from Sale of Non-Current Investments		....	
Interest and Dividend Received		....	
Rent Received		....	
Purchase of Tangible Fixed Assets		(...............)	
Purchase of Intangible Fixed Assets like Goodwill		(...............)	
Purchase of Non-Current Investments		(...............)	

Net Cash Flow (or used in) from Investing Activities		....
C. Cash Flow from Financing Activities :		
Proceeds from Issue of Shares and Debentures	....	
Proceeds from Other Long-term Borrowings	....	
Proceeds from Short-term Borrowings :		
(i) Increase in the Balance of Bank Overdraft and Cash Credit	....	
(ii) Decrease in the Balance of Bank Overdraft and Cash Credit	....	
Final Dividend Paid	(...............)	
Interim Dividend Paid	(...............)	
Interest paid on Long-term Borrowings	(...............)	
Repayment of Loans (Whether Short-term or Long-term)	(...............)	
Redemption of Debentures	(...............)	
Net Cash Flow from (or used in) Financing Activities		....
Net Increase (or Decrease) in Cash & Cash Equivalents (A+B+C)		....
Add : Cash and Cash Equivalents in the beginning of the year		....
Cash and Cash Equivalents at the end of the year		....

Working Note 1 :

Calculation of Net Profit before Tax

Particulars	**₹**
Net Profit of the Current Year (After Appropriations)	....
Add : Transfer to Reserves (all transfers to Reserves from balances of the Statement of Profit & Loss)	....
Dividend Paid (Proposed Dividend of the Previous year)	....
Interim Dividend paid during the year	....
Provision for Tax made during the current year	
Profit before Tax	....

- **Effect of Amendment (Regarding Proposed Dividend in AS-4) in Cash Flow Statement :**
  - **(a)** Dividend proposed for the previous year will be an Outflow of Cash, unless otherwise stated, on the assumption that the proposed amount has been approved by the shareholders in the AGM.
  - **(b)** No effect is given to proposed dividend for the current year as it is not provided for and is a Contingent Liability.
  - **(c)** Any unpaid dividend is transferred to Dividend Payable Account/Unpaid Dividend Account which is shown in the Balance Sheet of the current year as other Current Liabilities under Current Liabilities.

Key Terms

- **Operating Activities :** These are the main revenue generating activities of an enterprise which ascertain the Net Profit/Loss of the enterprise.
- **Investing Activities :** Investing Activities of an enterprise refer to acquisition (purchase) and disposal (sale) of long-term assets and other investments which are not included in cash equivalents.
- **Financing Activities :** Financing Activities are those activities that result in the changes in size not composition of the owner's capital (including preference share capital in the case of a company) and borrowings of the business firm.
- **Cash Equivalents :** These are short-term highly liquid investments that are readily convertible into known amounts of cash.
- **Proposed Dividend :** Recommended dividend by Board of Directors in AGM on the basis of estimated profit.

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UNIT – 5: RATIO ANALYSIS

CHAPTER-12

ACCOUNTING RATOS

Revision Notes

- **Ratio :** Relationship between two figures, expressed in arithmetical term is called as ratio.
  Ratio may be expressed in the following ways :
- **Proportion/Simple Ratio :** It is expressed by the simple division of one number by another like 2 : 1 or 1 : 1, etc.
- **Percentage :** In this type, the relation between two figures is expressed in percentage like 20%, 10% etc.
- **Analysis of Different Ratios :**

I. Liquidity Ratios				
1. Current Ratio	$\frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$	Current Assets = Current Investments + Inventories (Excluding Spare parts and Loose Tools) + Trade Receivables + Cash and Cash Equivalents + Short-term Loans and Advances + Other Current Assets Current Liabilities= Short-term Borrowings + Trade Payable+ Other Current Liabilities + Short-term Provisions.	2 : 1	High Current Ratio shows the ability of the firm to pay Short-term Liabilities. Low Ratio shows poor liquid condition of the firm.
2. Quick Ratio or Liquid Ratio or Acid-Test Ratio	$\frac{\textbf{Quick / Liquid Assets}}{\textbf{Current Liabilities}}$	Liquid Assets = Current Assets – Inventories – Prepaid Expenses.	1 : 1	High Quick Ratio shows that firm has ability to meet liquid obligations in time.

II. Solvency Ratios				
1. Debt to Equity Ratio	$\frac{\textbf{Debt / Long-term Debt}}{\textbf{Equity / Shareholders' Funds}}$	Debt = Long-term Borrowings + Long-term Provisions Equity/Shareholders' Funds = Share Capital + Reserves and Surplus OR Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Trade Investments + Long-term Loans and Advances) + Working Capital – Non-Current Liabilities (Long-term Borrowings + Long-term Provisions) where, Working Capital = Current Assets – Current Liabilities	Ratio of 2 : 1 is considered satisfactory. Generally a Low Ratio is considered favorable.	This ratio indicates the proportionate claims of owners and outsiders on firm's assets. High Ratio shows claims of outsiders are greater but Low Ratio shows outsiders claims are less.

2. Debt to Total Assets Ratio	$\frac{\textbf{Debt}}{\textbf{Total Assests}}$	Total Assets = Non-Current Assets + Current Assets Debts = Long-term Borrowings + Long-term Provisions	Higher the Ratio, lower the borrowing capacity of a firm.	This ratio attempts to measure company's financial leverage.
3. Proprietary Ratio	$\frac{\textbf{Shareholders' Funds / Equity}}{\textbf{Total Assets}}$	Shareholders' Funds = Share Capital + Reserves and Surplus OR Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Trade Investments + Long-term Loans and Advances) + Working Capital – Non-Current Liabilities (Long-term Borrowings + Long-term Provisions).	Higher the ratio, better the solvency, lower the ratio, lesser the solvency of the firm.	This ratio indicates the extent to which the assets of company can be lost without affecting interest of creditors.
4. Interest Coverage Ratio or Debt Service Ratio	$\frac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long – term Debts}}$	Interest included Interest on only Long-term Borrowings.	Higher the ratio more safer the Long-term Lenders, lower the ratio more risk for Long-term Lenders.	It indicates the number of times interest is covered by the available profit.
III. Activity Ratios				
1. Inventory Turnover Ratio	$\frac{\text{Cost of Revenue from Operations}}{\textbf{Average Inventory}}$	Cost of Revenue From Operations = Revenue from Operations – Gross Profit Average Inventory = $\frac{\textbf{(Opening Inventory + Closing Inventory)}}{2}$	There is no rule of thumb for interpreting this ratio. But higher the ratio, better it is.	It measures the velocity of conversion of Stock into Sales. High Ratio indicates Efficient Management and low ratio shows Inefficient Management.
2. Trade Receivables Turnover Ratio	Net Credit Revenue from Operations/ Average Trade Receivables	Net Credit Revenue from Operations = Total Revenue from Operations, *i.e.*, Sales – Cash Revenue from Operations *i.e.*, Cash Sales Average Trade Receivables $= \frac{\text{(Opening Receivables + Closing Receivables)}}{2}$ Trade Receivables = Debtors + Bills Receivables	No rule of thumb but higher ratio shows Efficient Management.	It indicates the number of times the debtors are turned over during a year.
3. Trade Payables Turnover Ratio	$\frac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$	Net Credit Purchase = Total Purchases – Cash Purchases. Average Trade Payable $= \frac{\text{Opening Payables + Closing Payables}}{2}$ Trade Payable = Creditors + Bills Payable	Higher ratio is better for firm.	This ratio indicates the velocity with which the creditors are turned over in relation to purchase.

4. Working Capital Turnover Ratio	$\frac{\text{Revenue From Operations}}{\text{Working Capital}}$	Working Capital = Current Assets – Current Liabilities	Higher ratio indicates efficient utilisation of Working Capital, low ratio shows Inefficient Management.	This ratio indicates the velocity of the utilisation of Net Working Capital. It indicates the number of times Working Capital is turned over in the course of business in one year.
IV. Profitability Ratios				
1. Gross Profit Ratio	$\frac{\text{Gross Profit}}{\text{Revenue from Operations (Net Sales)}} \times 100$	Gross Profit = Revenue from Operations – Cost of Revenue from Operations. Cost of Revenue from Operations = Opening Inventory (Excluding Spare Parts and Loose Tools) + Net Purchases + Direct Expenses – Closing Inventory (excluding Spare Parts and Loose Tools) Or Cost of Material Consumed (including Direct Expenses) + Change in Inventories of WIP and Finished Goods.	Higher the ratio, good for the business, lower ratio, not good for the business.	It reflects the efficiency with which a firm produces its products. It should be higher to cover all expenses and to pay Dividends and Interests.
2. Net Profit Ratio	$\frac{\text{Net Profit}}{\text{Net Revenue from Operations (Net Sales)}} \times 100$	Net Profit = Gross Profit + Other Incomes – Indirect Expenses – Tax.	Higher the ratio better the Profitability of the firm.	This ratio indicates the single word of management in Manufacturing, Administration, Selling and other Activities of the Firm. It is the overall measurement of firm's profitability.
3. Operating Ratio	Cost of Goods Sold or $\frac{\text{Cost of Revenue from Operations} + \text{Operating Expenses}}{\text{Revenue from Operations (Net Sales)}} \times 100$	Operating Expenses = Office, Administration, Selling and Distribution Expenses, Employees Benefit Expenses, Depreciation and Amortisation	Lower the ratio better it is.	It is a yardstick for operating efficiency. Higher ratio is less favourable.
4. Operating Profit Ratio	$\frac{\text{Net Operating Profit}}{\text{Revenue from Operations}} \times 100$	Net Operating Profit = Net Profit after Tax + Non-Operating Expenses/Losses – Non-Operating Incomes Or Gross Profit + Operating Income – Operating Expenses. Non-Operating Expenses = Interest on Long-term Borrowings + Loss on Sale of Fixed or Non-Current Assets. Non-Operating Income = Interest and Dividend received on Investments + Profit on Sale of Fixed Assets or Non-current Assets.	Higher the ratio, better the results.	This ratio measures the overall efficiency of the business.

5. Earning per Share	$\dfrac{\text{Net Income after Tax and Preference Dividend}}{\text{Number of Equity Shares}}$	Net Income = Gross Profit + Other Incomes – Indirect Expenses – Tax	Higher the ratio, more the earning per shareholders.	This ratio measures the earnings for Equity Shareholders after Tax and Preference Dividend.
6. Price Earning Ratio	$\dfrac{\text{Maket value of of Equity Share}}{\text{EPS}}$	EPS $= \dfrac{\text{Net Income after Interest Tax and Preference Dividend}}{\text{Number of Equity Shares}}$	Generally, High P/E ratio means that investors are anticipating Higher growth in future.	It is used by investors to determine the relative value of company's share.
7. Return on Investment (ROI)	$\dfrac{\text{Net Profit before Interest, Tax and Dividend}}{\text{Capital Employed}} \times 100$	Capital Employed : **1. Liabilities Side Approach :** Shareholders' Funds (Share Capital + Reserves and Surplus) + Non-Current Liabilities (Long-term Borrowings + Long-term Provisions) **2. Assets Side Approach** : Non-Current Assets (Tangible Assets + Intangible Assets + Non-Current Investment + Long-term Loans and Advances) + Working Capital.	Higher the ratio better the results.	This ratio is the most important ratio to measure the Overall Profitability of the firm. It indicates the extent to which the main object of business is achieved.

Key Terms

- **Cross Sectional Analysis :** Comparison of a firm's ratio with some selected firms at same point of time is called Cross Sectional Analysis.
- **Time Series Analysis** : When ratios of the same firm over a period of time are compared, it is known as Time Series Analysis.
- **Quick Assets :** Assets which can be easily converted into cash are known as Quick Assets. Cash in hand, Cash at Bank, Debtors, Marketable Securities etc. are the examples of it.
- **Solvency Ratio :** These ratios are calculated to ascertain the ability of the firm to pay its Long-term Liabilities in time. Sound Solvency Ratios ensure Long-term Financial stability of the business.
- **Turnover Ratios :** These ratios are also known as Performance Ratios or Activity Ratios. These ratios indicate how efficiently and profitably the Total Capital, Working Capital, Fixed Assets and Inventory of the business are used.
- **Profitability Ratios :** Such ratios measure various aspects of the profitability or the capacity to earn a stable return of a business firm.