PART - A : ACCOUNTING FOR PARTNERSHIP FIRMS AND COMPANIES

UNIT – I: ACCOUNTING FOR PARTNERSHIP FIRMS

CHAPTER-1

BASICS OF PARTNERSHIP

Topic-1 Meaning of Partnership, Partnership Deed & Partners' Capital Accounts

Concepts Covered • *Meaning of Partnership,* • *Features/Characteristics of Partnership,* • *Concept and contents of Partnership deed,* • *Methods of maintaining Capital Accounts of Partners*

Revision Notes

- **Meaning of Partnership:** According to Indian Partnership Act, 1932, "Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all." The Act also explains that persons who have entered into partnership with one another are individually called "partners" and collectively "a firm."
- **Characteristics of Partnership:**
  - **(i) Association of two or more than two persons:** It is essential for the Partnership that there must be at least two persons who are competent for agreement because less than two persons does not establish partnership.
  - **(ii) Maximum number of partners:** Rule 10 of Company (Miscellaneous) Rules, 2014 says that no association of partnership shall be formed, consisting of more than 50 persons for the purpose of carrying on any business.
  - **(iii) Existence of an agreement:** Partnership is the outcome of an agreement between two or more persons to carry on business. This agreement may be oral or in written. The Partnership Act, 1932 (Section 5) clearly states that "the relation of partnership arises from contract and not from status."
  - **(iv) Existence of business:** Partnership Act, 1932 [Section 2(6)] states that a "Business" includes every trade, occupation and profession. Business of course, must be lawful and its main object should be to earn profit.
  - **(v) Sharing of Profit:** The agreement between partners must be to share profits and losses of the business. Thus sharing of profit and losses is important. If some persons join hands for the purpose of some charitable activity, it will not be termed as partnership.
  - **(vi) Liability of Partners:** Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm done while he is a partner. His private assets can also be used for paying off firm's debts.
- **Partnership Deed**

  According to Section 5 of the Indian Partnership Act, 1932, The relation of partnership arises from contract and not from status; and in particular,the members of Hindu undivided family carrying on a family business such, or a Burmese Buddhist husband and wife carrying business as such, are not partners in such business. Partnership Deed is an agreement between two or more than two partners for determining their mutual contractual relationship and its limitation for better and effective operation of business. It contains rules and conditions for operation of business. It can be registered or unregistered. It should be comprehensive to avoid disputes later on.
- **Contents of Partnership Deed**
  - **(i)** Name and address of all Partners
  - **(ii)** Name and address of the Firm
  - **(iii)** Nature and place of the Business
  - **(iv)** Capital to be contributed by each Partner

Fundamental Fact

Partnership Business in India is regulated by the India Partnership Act 1932.

(v) Rate of Interest on Capital
(vi) Drawings allowed to the Partners
(vii) Rate of Interest on Drawings
(viii) Profit and Loss Sharing Ratio
(ix) Partner's Salary and Commission
(x) Method of Valuation of Goodwill
(xi) Settlement on Dissolution of Firm
(xii) Duration of Partnership
(xiii) Methods of valuation of Assets and Liabilities
(xiv) Lending and Borrowing by the Partners
(xv) Admission and Retirement of Partners
(xvi) Duties of Partners
(xvii) Death of a Partner and his legal representative
(xviii) Insurance and its distribution
(xix) Relinquishment of Partnership
(xx) Arbitration Clause
(xxi) Maintenance of Accounts and their Audit
(xxii) Settlement of Disputes of the business
(xxiii) Treatment of loss arising out of insolvency of one or more partners

► **Applicable provisions of the Indian Partnership Act, 1932 in the absence of Partnership Deed:**

(i) Interest on partner's loan will be paid @ 6% p.a.
(ii) If deed is silent no interest on capital is to be allowed.
(iii) If deed is silent no interest on drawings is to be charged.
(iv) If deed is silent no salary or remuneration or commission is to be allowed to any partner.
(v) If deed is silent profit will be distributed equally.

Example 1

Q. Ram and Shyam are partners in a partnership firm. Partnership deed is not present. Some issues arrived in their firm due to absence of partnership deed. Help them to resolve the following issues giving proper judgement:

(i) Shyam has advanced a loan of ₹ 1,00,000 to the firm and demanding interest @ 12% p.a. on loan but Ram is ready to charge interest @ 6% p.a.
(ii) Ram is an active partner and manages almost every managing activity. So he is demanding remuneration for his work but Shyam is refusing.
(iii) Shyam wants to charge interest on capital @ 10% p.a. but Ram is refusing for it.
(iv) Ram wants to charge interest on drawings @ 12% p.a. but Shyam is refusing.

Ans. (i) Ram is correct in the first issue. In the absence of partnership deed, interest on partner's loan is allowed @ 6% p.a.
(ii) In this issue, Ram will not be paid any remuneration as in the absence of partnership deed, no salary to be paid to partner.
(iii) Interest on capital will not be charged in the absence of partnership deed. So Ram is correct.
(iv) Interest on drawings will not be charged in the absence of partnership deed. So Shyam is correct.

► **Methods of Maintaining Capital Accounts of Partners**

There are two methods by which the capital accounts of partners can be maintained. These are:

(i) **Fluctuating Capital:** Fluctuating capital is a type of capital account which changes/fluctuates every time when there is addition in capital or withdrawal of capital. Interest on capital, profit, salary, commission all appear on the credit side and interest on drawings, drawings appear on the debit side.

(ii) **Fixed Capital:** Fixed capital account will always show a credit balance, the original capitals invested by the partners remain constant unless additional capital is introduced or withdrawal by an agreement. All entries relating to drawings,interest on capitals, interest on drawings, salary to partners, share of profits/losses are made in separate account which is called as Current Account. The current account may show a debit or credit balance.

Fundamental Fact

LLP Stands for Limited Liability Partnership in which the liability of all the partners (except one partner) is limited.

Topic-2 Preparation of Profit and Loss Appropriation Account and Treatment of Goodwill

Concepts Covered • *Division of profits among partners,* • *Preparation of profit and loss appropriation account,* • *Calculation of appropriation and charge items,* • *Adjustment of past adjustments,* • *Guarantee of profit,* • *Treatment of goodwill*

Revision Notes

- **Division of Profits among Partners**

  The net profit as shown by the Profit and Loss Account of a partnership firm requires certain adjustments with regard to interest on capitals, interest on drawings, etc., if provided under the terms of agreement. In fact, it is an extension of the Profit and Loss Account and is credited with the net profits and interest on drawings and debited with interest on capital, salary to partners, etc. The balance (if any) will be distributed among the partners in their agreed ratio.
- **Journal Entries regarding Profit and Loss Appropriation Account are as follows:**

1. Transfer of balance of Profit and Loss Account:

(a) If Profit & Loss Account shows a credit balance (Net Profit):

Profit & Loss A/c Dr.
  To Profit & Loss Appropriation A/c
(Being transfer of net profit to Profit & Loss Appropriation A/c)

(b) If Profit & Loss Account shows debit balance (Net Loss):

Profit & Loss Appropriation A/c Dr.
  To Profit & Loss A/c
(Being transfer of net loss to Profit & Loss Appropriation A/c)

2. Interest on Capitals:

(a) For crediting interest on capital to Partners' Capital Accounts:

Interest on Capital A/c Dr.
  To Partners' Capital/Current A/cs
(Being interest on capital at ____% p.a. allowed to partners)

(b) For transferring interest on capital to Profit and Loss Appropriation Account:

Profit & Loss Appropriation A/c Dr.
  To Interest on Capital A/c
(Being interest on capital transferred to Profit & Loss Appropriation A/c)

3. Partners' Salary/Commission:

(a) For crediting salary/commission to Partners' Capital Accounts:

Salary/Commission A/c Dr.
  To Partners' Capital/Current A/cs
(Being ₹____Salary/Commission allowed to _____ partner for _____months)

(b) For transferring partners' salary/commission to Profit and Loss Appropriation Account:

Profit and Loss Appropriation A/c Dr.
  To Salary/Commission A/c
(Being Salary/Commission transferred to Profit and Loss Appropriation Account)

4. Interest on Drawings:

(a) For charging interest on drawings:

Partners' Capital/Current A/cs Dr.
  To Interest on Drawings A/c
(Being interest on drawings at _____% p.a. charged)

(b) For transferring interest on Drawings to Profit & Loss Appropriation Account:

Interest on Drawings A/c Dr.
  To Profit & Loss Appropriation A/c
(Being interest on drawings transferred to Profit & Loss Appropriation A/c)

5. Transfer of Profit to Reserve:

Profit & Loss Appropriation A/c Dr.
    To Reserve A/c
(Being profit transferred to Reserve A/c)

6. Share in Profit:

Profit & Loss Appropriation A/c Dr.
    To Partners' Capital/Current A/cs
(Being distribution of profit among partners)

Proforma of Profit & Loss Appropriation Account
Dr. for the year ending ______________ Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Partner's Capital A/c	....	By Net Profit	
(Salaries)		(Profit shown by Profit & Loss A/c)	....
To Partner's Capital A/c		By Partner's Capital/Current A/c	
(Commission)	....	(Interest on Drawings)	....
To Partner's Capital A/c			
(Interest on Capital)	....		
To General Reserve A/c	....		
To Profit transferred to:			
Partners' Capital/Current A/cs	....		
	....		....

Profit and Loss Appropriation Account is prepared only when there are certain adjustments related to partnership and for ascertaining net profits to be distributed among the partners. It determines the individual profits of all partners.

Example 2

On 1.4.2013, Brij and Nandan entered into partnership to construct toilets in government girls schools in the remote areas of Uttarakhand. They contributed capitals of ₹ 10,00,000 and ₹ 15,00,000 respectively. Their profit sharing ratio was 2 : 3 and interest allowed on capitals as provided in the partnership deed was 12% per annum. During the year ended 31.3.2014, the firm earned a profit of ₹ 2,00,000.

Prepare Profit and Loss Appropriation A/c of Brij and Nandan for the year ended 31.3.2014.

Ans. **In the books of Brij and Nandan**
Profit & Loss Appropriation Account
Dr. for the year ended 31st March, 2014 Cr.

Particulars		Amount (₹)	Particulars	Amount (₹)
To Interest on Capital:			By Net Profit b/d	2,00,000
Brij's Capital A/c	80,000			
Nandan's Capital A/c	1,20,000	2,00,000		
		2,00,000		**2,00,000**

Working Notes:

Interest on capital of Brij = ₹ 1,20,000
Interest on capital of Nandan = ₹ 1,80,000
Proportionate profit = ₹ 1,20,000 / ₹ 3,00,000 × ₹ 2,00,000 = ₹ 80,000
= ₹ 1,80,000 / ₹ 3,00,000 × ₹ 2,00,000 = ₹ 1,20,000

► **Interest on Capital**

Interest on Capital will be calculated at the rate as agreed by partners as follows:

$$\text{Interest on Capital} = \frac{\text{Capital Invested} \times \text{Rate of Interest} \times \text{Period (months)}}{100 \times 12}$$

From the above formula, interest will be provided for the full year on the capital at the beginning and interest on additional capital brought during the year will be calculated from the date of introduction till the end of the year.

If in a question, closing capital is given instead of opening capital then drawings and share of loss written off will be added and additional capital and share of profit will be deducted to find opening balance and on such balance interest will be calculated.

Calculation of opening balance of capital:		₹
Capital at the end of the year (Closing Capital)		———
Add: Drawings made during the year	———	
Share of loss debited for the year	---------	---------
Less: Additional capital introduced during the year	———	
Share of profit credited for the year	---------	---------
Capital at the beginning of the year (Opening capital)		---------

Note:

If percentage of interest on capital is not mentioned in partnership deed, partners will not receive any interest on capital. In the case of loss, interest on capital will not be considered. If profit of firm is not sufficient, then interest on capital will not be more than the amount of profit. If interest on capital is agreed to be charged on profit then full interest on capital will be provided even if there is no sufficient profit or there is loss in the firm. If there is an agreement of interest on capital but it is not clear whether it is appropriation of profit or charge of profit then in such case, interest will be provided only when there is profit and it will not be given in case of loss.

Interest on Drawings

The following methods are used for the calculation of interest on drawings made by partners:

(1) Simple Interest Method: In this method, interest is calculated on each amount of drawings from the date of drawings till the closing date of accounts and then the total interest is found which is calculated on different drawings. Thus, interest is calculated as follows:

$$\text{Interest on Drawings} = \frac{\text{Drawings Amount} \times \text{Rate} \times \text{Time (in months)}}{100 \times 12}$$

(2) Product Method: In this method, it is calculated as under:

$$\text{Interest on Drawings} = \frac{\text{Total of Product} \times \text{Rate} \times 1}{100 \times 12}$$

(3) Average Period Method: This method is used when a partner(s) withdraws uniform amounts at uniform time intervals.

$$\text{Interest on drawings} = \frac{\text{Total drawings} \times \text{Rate of Interest}}{100} \times \frac{\text{Average Period}}{12}$$

$$\text{Average Period} = \frac{\text{(Number of months after first drawing + Number of months after last drawing)}}{2}$$

Case (A). When Equal Amount was withdrawn at regular intervals every month:

(1) When drawings are made in the beginning of every month:

$$\text{Average period} = \frac{\text{(Number of months after first drawing + Number of months after last drawing)}}{2}$$

$$= \frac{12+1}{2} = 6.5 \text{ months}$$

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest} \times 6.5}{100 \times 12}$$

(2) When drawings are made in the middle of every month:

$$\text{Average Period} = \frac{11.5 + 0.5}{2} = 6$$

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest} \times 6}{100 \times 12}$$

(3) When drawings are made at the end of every month:

$$= \frac{11+0}{2} = 5.5 \text{ months}$$

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest} \times 5.5 \text{ months}}{100 \times 12}$$

Case (B). When Fixed Amount is withdrawn Quarterly-:

(1) When amount was withdrawn at the beginning of each quarter:

$$\text{Average Period} = \frac{\text{No. of months after first drawings} + \text{No. of months after last drawings}}{2}$$

$$\text{Average Period} = \frac{12+3}{2} = 7.5 \text{ months}$$

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest} \times 7.5 \text{ months}}{100 \times 12}$$

When amount was withdrawn at the end of each quarter:

$$\text{Average Period} = \frac{9+0}{2} = 4.5 \text{ months}$$

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest} \times 4.5}{100 \times 12}$$

(2) When amount was withdrawn in the middle of every quarter:

$$\text{Average period} = \frac{10.5+1.5}{2} = 6$$

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest} \times 6 \text{ months}}{100 \times 12}$$

NOTE: If the date of withdrawal is not given, interest on total drawings for the year is calculated for six months on average basis.

NOTE: If percent of interest on drawings is not mentioned in partnership deed, firm would not charge any interest for drawings of partners.

- **Salary or Commission and Rent paid to a Partner**

It is to be allowed to a partner if the partnership agreement provides for the same. Salary or commission to a partner is an appropriation of the profits and not a charge against the profits, *i.e.*, they are to be allowed only if there are profits and hence, must be transferred to the debit of Profit and Loss Appropriation Account and not to the debit of Profit and Loss Account.

(1) Commission as a percentage of net profit before charging such commission

$$= \text{Net Profit before Commission} \times \frac{\text{Rate of Commission}}{100}$$

(2) Commission as a percentage of net profit after charging such commission

$$= \frac{\text{Net Profit before commission} \times \text{Rate of commission}}{100 + \text{Rate of commission}}$$

Note: Charges such as interest on partners' loans, manager's salary and commission must be deducted from profit before transferring it to the Profit and Loss Appropriation Account.

Rent Paid to a Partner: It is a charge against the profit and not an appropriation out of profits. It is therefore, debited to Profit and Loss Account and credited to Partner's Current Account in case of fixed capitals or to Partner's Capital Account, when capitals are fluctuating.

Example 3

Himanshu and Mayank are partners in a partnership firm. They share profits in ratio of 5 : 3.

Himanshu withdrew the following amounts during the year to pay his personal expenses:

1st May, 2018	**₹ 20,000**
1st June, 2018	**₹ 10,000**
1st Nov., 2018	**₹ 5,000**
1st Dec., 2018	**₹ 5,000**

Calculate interest on drawings @ 6% p.a. on 31st March, 2019.

Ans. **Calculation of Interest on Drawings**

Date	Amount (₹)	Period (Months)	Product (₹)
May 1, 2018	20,000	11	2,20,000
June 1, 2018	10,000	10	1,00,000
Nov. 1, 2018	5,000	5	25,000
Dec. 1, 2018	5,000	4	20,000
			3,65,000

$$\text{Interest on Drawings} = \text{Total Product} \times \text{Rate} \times \frac{1}{12}$$

$$= 3,65,000 \times \frac{6 \times 1}{100 \times 12} = ₹\ 1,825$$

- **Interest on Partner's Loan to Firm:** The firm pays interest on loan at the rate as mentioned in the deed. But, if the partnership deed is silent on this point, the partner is entitled to get interest at the rate of 6% per annum as per section 13 (d) of Indian Partnership Act.
- **Sharing of Profit & Loss**
  Generally, profit or loss of the firm is divided among partners according to the ratio mentioned in partnership deed. Distribution of profits made by the firm as per different methods is given below:
  (1) **In a Fixed ratio:** The ratio may be in numbers, fractions or in percentage, like A, B and C are partners and share profit or loss in ratio of 2: 3: 5 or $\frac{1}{2}:\frac{3}{5}:\frac{5}{6}$, etc.
  (2) **In ratio of Capital:** If, according to deed, profit and loss is to be divided in the ratio of capital then in such case, the deed should mention any one method of determining it out of the following methods:
  (a) In the ratio of original capital,
  (b) In the ratio of capital at the beginning of the year,
  (c) In the ratio of capital at the end of each year,
  (d) In the ratio of average capital for each year.
  (3) **In equal ratio:** If nothing is mentioned in deed about profit sharing ratio then profit and loss will be divided equally among all partners, like the profit and loss sharing ratio among A, B, C is 1: 1: 1.
  (4) **Division of Profit and Loss in separate ratio:** In partnership deed, if profit ratio and loss ratio is agreed separately then in such case, profit will be divided in one ratio and loss will be divided in another agreed ratio.
- **Past Adjustments:** Sometimes after preparing the accounts of the firm, it is found that mistakes related to interest on capital, interest on drawings, salary to partner, etc. are committed or omitted or any amount is wrongly entered. Therefore, for the purpose to correcting these omissions or mistakes, adjustment entries are passed through Profit and Loss Adjustment Account in which adjustments in respect to each and every omission are to be made. However, an adjustment entry can also be passed in Journal.
  These entries are recorded for the errors made in past. Therefore, they are called Past Adjustments. Following are some types of omissions or errors given below:
  1. Interest on Capital
  2. Interest on Drawings
  3. Salary to Partners
  4. Commission to Partners
  5. Interest on Capitals or Drawings provided at higher or lower rate
  Adjustment through Profit & Loss Adjustment Account (Journal Entries for adjustment):
  Following journal entries shall be passed through Profit & Loss Adjustment Account:
  1. Adjusting entries for the items which were to be credited to the Partners' Capital or Current Accounts.
  Profit & Loss Adjustment A/c Dr.
  To Partners' Capital/Current A/cs
  (Being adjustment made for __________ previously omitted, now carried out)
  2. Adjusting entries for the items which were to be debited to the Partners' Capital or Current Accounts.
  Partners' Capital /Current A/cs Dr.
  To Profit & Loss Adjustment A/c
  (Being adjustment made for ____________ previously omitted, now carried out)
  3. For the net profit/ loss on account of above adjustments:
  (a) In case of profit:
  Profit & Loss Adjustment A/c Dr.

To Partners' Capital /Current A/cs

(Being profit on adjustments transferred to partners' capital/current accounts)

(b) In case of loss:

Partners' Capital / Current A/cs Dr.

To Profit & Loss Adjustment A/c

(Being loss on adjustment transferred to partners' capital/current accounts)

Adjustment without Preparation of Profit & Loss Adjustment Account:

In this method, a statement showing the adjustments is made in which all the omissions are to be carried out and errors are rectified. The net impact of all these adjustments is to be examined and on that basis a single adjusting journal entry is to be passed.

Adjustment Chart

Particulars	A	B	C
(+) Interest on Capital	+	+	+
(+) Partner's Salary / Commission	+	+	+
(–) Interest on Drawings	(–)	(–)	(–)
Excess amount taken back in their P & L sharing ratio	+	+	+

Note:

- Assumed that there are three partners.
- Assumed that all errors are related to omission.
- + means Cr. the partner's capital account.
- – means Dr. the partner's capital account.

Example 4

Monu, Nitin and Paras are partners in a firm. They invested ₹ 50,000 each as capital three years ago. At that time, Paras agreed to look after the business as Monu and Nitin were busy. The profits for the past three years were ₹ 15,000, ₹ 25,000 and ₹ 50,000 respectively. While going through the books of accounts; Monu noticed that the profits had been distributed in the ratio of 1 : 1 : 2 . When he enquired from Paras about this, Paras answered that since he looked after the business he should get more profit. Monu disagreed and it was decided to distribute profit equally for the last three years.

You are required to make necessary corrections in the books of accounts of Monu, Nitin and Paras by passing an adjustment entry.

Ans.

In the Books of Monu, Nitin and Paras
Journal Entry

Date	Particulars	L.F.	Amount Dr. (₹)	Amount Cr. (₹)
	Paras's Capital A/c Dr.		15,000	
	To Monu's Capital A/c			7,500
	To Nitin's Capital A/c			7,500
	(Being profit adjusted)			

Working Note:

Statement Showing Adjustment of Profits

Particulars	Monu (₹)	Nitin (₹)	Paras (₹)	Total (₹)
1. Profit wrongly distributed in the ratio 1 : 1 : 2 (Dr.)	22,500	22,500	45,000	90,000
2. Profit to be shared correctly in the ratio 1 : 1 : 1 (Cr.)	30,000	30,000	30,000	90,000
Adjustment	**7,500**	**7,500**	**(15,000)**	—

- **Guarantee of Profits:** Guarantee is an assurance given to the partner(s) of the firm that at least a fixed amount shall be given to him irrespective of the actual earnings. If actual share of profit works out to be less than the guaranteed amount in that case, the deficit amount shall be borne either by the firm or by any partner, as the case may be. If actual amount of profit works out to be more than the guaranteed amount in that case, he is entitled to receive that actual amount.

(i) When Guarantee is given by all the partners in Old Ratio or Specific Ratio:

(a) Amount guaranteed to a partner is transferred to Profit and Loss Appropriation A/c.

(b) Then the remaining profits are distributed among old partners / remaining partners in remaining ratio.

(ii) When Guarantee is given by one partner to another partner:

(a) Guaranteed amount is calculated according to his share.

(b) Deficiency is distributed among the partners who guaranteed in remaining ratio and subtracted from their respective shares.

(iii) When Guarantee is given by a partner to the firm:

(a) Deficient amount in guarantee made by a partner is calculated.

(b) His Capital A/c is then debited with the deficient amount and Profit & Loss A/c is credited with the deficient amount.

(c) This total of new profit, *i.e.*, original and deficient amount is distributed among all partners in their profit and loss sharing ratio.

- **Goodwill:** Goodwill is an intangible asset. It is created due to reputation of the firm and extra earning capacity of the firm. A firm having goodwill will earn more than normal profit. The extra earning capacity of the firm may be due to location of the business, reputation of partners or special benefits to the firm.

- **Factors affecting Goodwill of firm:**

(i) Competent and Capable Management
(ii) Favourable Location
(iii) Favourable Contracts
(iv) Past Performance of Business
(v) Quality of Products
(vi) Nature of Business

- **Need for valuation of Goodwill:** The need for valuation of Goodwill in partnership arises under the following circumstances:

(i) On admission of a new partner
(ii) On retirement/death of a partner
(iii) When there is a change in the profit sharing rate among the partner
(iv) If Goodwill is sold at the time of dissolution of the firm.

- **Methods of Valuation of Goodwill:**

(i) Average Profit Method

Under this method, goodwill is valued on the basis of average profits of past few years. Value of goodwill is certain number of years purchased price of average profits. For calculating average profits, profits of previous four or five years are considered. Before calculating average profits, past profits may require some adjustments. Such adjustments may be of the following nature:

(a) Any non-recurring or casual income will be deducted from profit.

(b) Any abnormal loss or non-recurring expense will be added back to profit.

(c) Profits will be corrected for any mistakes detected at the time of valuation.

(d) Average profits of past years will be increased for any expected income in future.

(e) Similarly, average profits will be reduced for any expected expense in future.

$$\text{Goodwill} = \text{Average Profit} \times \text{No. of Years' Purchases}$$

Normally simple average profit will be calculated, but in case past profits show a constant increasing or decreasing trend, it is better to calculate weighted average.

(ii) Super Profit Method

Under this method, goodwill is calculated on the basis of annual super profit. The formula for calculation of goodwill is as under:

$$\text{Goodwill} = \text{Annual Super Profit} \times \text{Number of Years' Purchase}$$

where actual average profit is calculated by average profit method and normal profit is calculated as follows:

$$\text{Normal Profit} = \frac{\text{Average Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$\text{Super Profit} = \text{Actual Average Profit} - \text{Normal Profit}$$

Note: If amount of normal profit is more than the average profit, then super profit will be zero and so, the value of goodwill will also be zero.

(iii) Capitalisation Method

Under this method, goodwill is computed by capitalizing profits. Capitalised profit can be computed by the following two methods:

(a) Capitalisation of Average Profit Method: In this method, Capitalised Value or Normal Capital Employed of business is determined by capitalizing average profit earned at the normal rate of profit.

$$\text{Capitalised Value} = \frac{\text{Actual Average Profit} \times 100}{\text{Normal Rate of Return}}$$

Net Assets = All Assets (other than goodwill, non-trade investments and fictitious assets) at their current values minus outside liabilities.

Goodwill = Capitalised Value – Net Assets or Capital Employed

(b) Capitalisation of Super Profit Method: Under this method, we first calculate the super profits and then calculate the capital needed for earning such super profits on the basis of normal rate of return.

This capitalized value is the value of goodwill. The formula is:

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$$

CHAPTER-2
RECONSTITUTION OF PARTNERSHIP FIRM: CHANGE IN PROFIT SHARING RATIO

Revision Notes

- **Change in Profit Sharing Ratio:** When one or more partners acquire an interest in the business from another partner or partners, it is said to bring a change in the profit sharing ratio in the partnership firm.
- **The following adjustments are required at the time of change in profit sharing ratio:**
  (i) Determination of sacrificing ratio and gaining ratio;
  (ii) Accounting treatment of Goodwill;
  (iii) Revaluation of assets and reassessment of liabilities;
  (iv) Accounting treatment of reserves, accumulated profits or losses.
- At the time of change in profit sharing ratio, it is important to determine the sacrificing ratio and gaining ratio of partners because the gaining partners compensate the sacrificing partners by paying them appropriate amount of Goodwill.
- **Sacrificing ratio:** It is the ratio in which the partner/partners has/have agreed to sacrifice their share of profit in favour of other partner/partners.

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

- **Gaining ratio:** It is the ratio in which the partners gain an additional share in future profits.

$$\boxed{\text{Gaining ratio} = \text{New share} - \text{Old share}}$$

- **Accounting Treatment for Goodwill**
  If the partners decide to change their profit sharing ratio, the gaining partner must compensate the sacrificing partner by way of payment to him as goodwill in the gaining ratio.
  Following entry will be passed when there is a change in profit sharing ratio:
  Gaining Partner's Capital A/c Dr.
  To Sacrificing Partner's Capital A/c
  (Being adjustment made for Goodwill)

Fundamental Fact

A business partnership is like a marriage. But marriages are complicated, business partnerships even more so. In fact, whereas 50% of marriages end in divorce, the number is closer to 80% for business partnerships. And it's exponentially more difficult if you happen to have more than one partner.

- **Revaluation of Assets and Re-assessment of Liabilities**
  At the time of change in profit sharing ratio, the value of assets and liabilities are revalued and the difference between the existing value and revalued amount is transferred to Revaluation Account. In the end, balance of Revaluation Account is transferred to Partners' Capital/Current Accounts.
- **Accounting Treatment of Reserves, Accumulated Profits or Losses**
  At the time of change in profit sharing ratio, if any reserve or accumulated profit/loss exist in the books of the firm. It is transferred to Partners' Capital/Current A/c.
  Following entry will be passed:
  (i) For transfer of Reserves and Accumulated Profits:
  Reserve/P & L A/c ss Dr.
  Workmen's Compensation Reserve A/c Dr.
  Investments Fluctuation Reserve A/c Dr.
  To All Partners' Capital/Current A/cs

(ii) For transfer of Accumulated Losses:

All Partners' Capital/Current A/cs Dr.

To Profit and Loss A/c

To Deferred Revenue Expenditure A/c

Example 1

Q. A, B and C were partners in a firm sharing profits and losses equally. Because of increase in business activities. B had to devote more time. B demanded that his share in the profits of the firm be increased, to which A and C agreed. The new profit sharing ratio was agreed to be 1: 2: 1. For this purpose, the Goodwill of the firm was valued at two years' purchase of the average profits of last five years. The profits of the last five years were as follows:

Years	Profit (₹)
I	4,00,000
II	4,80,000
III	7,33,000
IV (Loss)	33,000
V	2,20,000

You are required to:

(i) Calculate the Goodwill of the firm.

(ii) Pass the necessary Journal Entry for the treatment of Goodwill on change in profit sharing ratio of A, B and C.

Ans. Step 1: Calculation of Goodwill:

$$\text{Average Profits} = \frac{₹\,4{,}00{,}000 + ₹\,4{,}80{,}000 + ₹\,7{,}33{,}000 - ₹\,33{,}000 + ₹\,2{,}20{,}000}{5}$$

$$= \frac{₹\,18{,}00{,}000}{5} = ₹\,3{,}60{,}000$$

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

$$= ₹\,3{,}60{,}000 \times 2 = ₹\,7{,}20{,}000$$

Step 2: Calculation of Sacrificing Ratio:

$$\text{Sacrificing Ratio} = \text{Old Ratio} - \text{New Ratio}$$

$$A = \frac{1}{3} - \frac{1}{4} = \frac{4-3}{12} = \frac{1}{12} \text{ (Sacrifice)}$$

$$B = \frac{1}{3} - \frac{2}{4} = \frac{4-6}{12} = \frac{-2}{12} \text{ (Gain)}$$

$$C = \frac{1}{3} - \frac{1}{4} = \frac{4-3}{12} = \frac{1}{12} \text{ (Sacrifice)}$$

Step 3: Calculation of Proportionate amount of Goodwill adjusted among partners:

$$A = ₹\,7{,}20{,}000 \times \frac{1}{12} = ₹\,60{,}000$$

$$B = ₹\,7{,}20{,}000 \times \frac{2}{12} = ₹\,1{,}20{,}000$$

$$C = ₹\,7{,}20{,}000 \times \frac{1}{12} = ₹\,60{,}000$$

Step 4: Journal entry to adjust the goodwill among partners on change in profit sharing ratio:

Journal Entry

Date	Particulars	L.F.	Amount Dr. (₹)	Amount Cr. (₹)
	B's Capital A/c Dr.		1,20,000	
	To A's Capital A/c			60,000
	To C's Capital A/c			60,000
	(Being adjustment made for goodwill among the partners)			

[2]

CHAPTER-3
RECONSTITUTION OF A PARTNERSHIP FIRM: ADMISSION OF A PARTNER

Topic-1 Admission of a Partner and Treatment of Goodwill

Concepts Covered • *Concept of admission of a new partner* • *Rights acquired by the new partner* • *Calculation of new profit sharing ratio* • *Change in profit sharing Ratio* • *Accounting treatment of goodwill*

Revision Notes

- **Admission of a Partner:** When a new partner enters into the partnership with the consent all the existing partners, it is called admission of a partner.
- **Rights acquired by the new partner**
  1. **Right to Share in Firm's Assets:** It is the right of new partner on the firm's assets and liabilities on behalf of capital which is brought by him/her.
  2. **Right to Share the Future Profits of the Firm:** Old Partners of the firm sacrifice some profit according to the new profit sharing ratio in favour of incoming partner.

Fundamental Fact

If you need to bring in a business partner, make sure your partner brings along some money.

- **Modification in Profit Sharing Ratio:** When a new partner enters into the partnership firm, old partners sacrifice some part of their old share. So there is a need to modify or recalculate profit sharing ratio and the sacrificing ratio.
- **New Profit Sharing Ratio:** New Profit Sharing Ratio is the ratio in which old partners including the new partner, share the profits or losses of the firm.

  Below given cases will elaborate how to calculate new profit sharing ratio:

  Case 1: If in the question, only new partner's share is given, presumed that the old partners will continue to share the remaining profits in the old profit sharing ratio. The new partner's share is deducted from the total share of the firm and the remaining share is divided amongst the old partners in their old profit sharing ratio.

  Case 2: If in the question, the old partners' sharing ratio and new partner's sharing ratio is given, then the new share of old partners will be calculated by deducting the share given to the new partner from their original share.

  Case 3: If in the question, the old partners' sharing ratio is equal, then the new share of old partners will be calculated by deducting the equal share given to the new partner from their original share.

  Case 4: If in the question, surrender fraction value of old partners is given, then in this case, shares surrendered by the old partners in favour of a new or incoming partner are added, it is the share of the new or incoming partner. The share surrendered by the old partners is deducted from their respective share to determine the old partners' share in the reconstituted firm.
- **Sacrificing Ratio:** It is the ratio in which old partners sacrifice their share of profit in favour of incoming partner. It is calculated in the ways given below:

  Case 1: If in the question, old and new profit sharing ratios are given, then the new share of the old partners is deducted from their old share. The difference is known as sacrifice. The ratio in which the old partners sacrifice their share towards new partner is called the sacrificing ratio.

  Case 2: If in the question, old profit sharing ratio and new partner's share is given then the new partner's share is deducted from the total profit and the balance of profit left is divided among old partners in their old profit sharing ratio to get their new shares. New shares are deducted from the old shares respectively which gives us sacrifice made by each old partner. Ratio is established among these sacrificed shares which becomes the sacrificing ratio. In this case, it must be noted that the old profit sharing ratio is also the sacrificing ratio.

Case 3: If in the question, sacrificing ratio of old partners is given, then the ratio given will be the sacrificing ratio.

Case 4: If in the question, receiving of share is predefined on the basis of sacrificing ratio, then sacrifice of old partners is deducted from their old share to calculate new share.

Case 5: If in the question, old partners agree to share in different relative ratio in the new firm after the admission of the new partner, the combined share of the old partners in the new firm will be shared among them in new agreed relative ratio.

Example 1

Ravi and Balveer are partners sharing profits and losses in the ratio of 7: 3. Ravi sacrifices $2/10^{th}$ from his share and Balveer sacrifices $1/10^{th}$ from his share in favour of Priya, a new partner. Calculate new profit sharing ratio and sacrificing ratio.

Ans. Old ratio = 7: 3

$$\text{Ravi's new share} = \frac{7}{10} - \frac{2}{10} = \frac{5}{10}$$

$$\text{Balveer's new share} = \frac{3}{10} - \frac{1}{10} = \frac{2}{10}$$

$$\text{Priya's share} = \frac{2}{10} + \frac{1}{10} = \frac{3}{10}$$

New profit sharing ratio = 5: 2: 3

Sacrificing ratio = 2: 1

Accounting Treatment of Goodwill

- **Case 1:** When new partner brings his share of goodwill in cash
  - Paid Privately → No Entry
  - Paid through firm →
    (i) Cash A/c Dr.
        To Premium A/c
    (ii) Premium A/c Dr.
        To S.Partners' Capital A/cs
    (iii) If G/W withdrawn:
        S. Partners' Capital A/cs Dr.
        To Cash/Bank A/c
- **Case 2:** When new partner is unable to bring goodwill in cash →
    N. Partner's Capital/Current A/c Dr.
        To S. Partners' Capital A/c
- **Case 3:** When new partner brings only a portion of goodwill in cash →
    (i) Cash A/c Dr.
        To Premium A/c
    (ii) Premium A/c Dr.
        N. Partner's Capital A/c Dr.
        To S. Partners' Capital A/c
- **Case 4:** When new partner brings goodwill in kind →
    (i) Assets A/c Dr.
        To Premium A/c
    (ii) Premium A/c Dr.
        To S. Partners' Capital A/cs
- **Case 5:** When goodwill is hidden →
    N. Partner's Capital A/c Dr.
        To Sacrificing Partners' Capital A/cs

Key Words

Goodwill in kind: When a partner brings his share of goodwill in the form of any asset instead of cash, it is called goodwill in kind.

Hidden goodwill: When goodwill of the firm is not disclosed directly and is calculated on the basis of capitals of the partners, it is called hidden goodwill.

Topic-2 Revaluation of Assets and Liabilities, Treatment of Accumulated Profits and Losses and Adjustment of Partners' Capital Accounts

Concepts Covered • *Accounting Treatment of Revaluation of Assets and Reassessment of Liabilities,* • *Accounting Treatment of Accumulated Profits and losses,* • *Adjustment of Partners' Capital Accounts.*

Revision Notes

- On admission of a new partner, assets and liabilities are revalued.
- The treatment of revaluation of assets and reassessment of liabilities is done in same manner as done in case of change in profit sharing ratio.
- Profit or loss on revaluation of assets and reassessment of liabilities is transferred to the old partners' capital/current accounts in old profit sharing ratio.
- All the accumulated profit or loss and reserves are also transferred to the old partners' capital/current accounts in their old profit sharing ratio.

Example 2

Ram and Mohan were partners in a firm sharing profits in the ratio of 4:1 on 01-04-2021, they admitted Sohan as a new partner for 1/3th shows in profits of the firm.

The Profit and Loss A/c on the date of admission showed balance of ₹ 32,000 (Dr.) the firm also had a reserve of ₹ 1,00,000.

Pass the necessary journal entries to record the above transactions.

Ans.

In the books of Ram and Mohan

Journal Entries

Date	Particulars	L.F.	Amount Dr. (₹)	Amount Cr. (₹)
	Ram's Capital A/c Dr.		25,600	
	Mohan's Capital A/c Dr.		6,400	
	To Profit & Loss A/c			32,000
	(Being Accumulated Loss Transferred)			
	Reserve A/c Dr.		1,00,000	
	To Ram's Capital A/c			80,000
	To Mohan's Capital A/c			20,000
	(Being reserve transferred to Partner Capital A/c in old profit sharing ratio)			

- **Adjustment of Capital**

  At the time of admission of a new partner, the partners may agree that their capitals should also be adjusted so as to be proportionate to their profit sharing ratio.

  The capitals of partners may be adjusted in any of the following ways:

  (1) Adjustment of the capitals of the old partners on the basis of new partner's capital

  Steps:

  (i) Calculate the total capital of the firm on the basis of new partner's capital and his share in profits.
  Total Capital/New Capital = New partner's capital × Reciprocal of the proportion of his share in profit.

  (ii) Calculate the new capitals of all partners by dividing total capital by new ratio.

  (iii) Prepare Old Partners' Capital A/cs (after all the adjustments regarding Revaluation, General Reserve, Goodwill, etc.) and find out the actual balances of their capitals.

  (iv) Compare the new capitals as in (ii) with old capital balances as in (iii) and work out surplus or deficiency.

(v) Surplus or Shortage/deficiency in old partners' capitals will either be adjusted through Cash/Bank or Current A/c or the case may be. It must be always remembered that in the absence of any agreement among the partners, the surplus or deficiency of capital accounts of the partners should be transferred to Cash/Bank Account and not to the Current Accounts.

► If adjusted through Cash/Bank A/c then surplus capital will be paid to the respective partner(s) and deficiency in capital will be brought/contributed by the respective partner(s). The following entries may be passed in different situations:

(a) If there is deficiency in capital (*i.e.* existing capital is less than required capital):

Cash/Bank A/c Dr.

To Respective Partners' Capital A/cs

(Being more capital brought in by partner(s) to meet capital requirement for their share in profits)

(b) If there is surplus in capital (*i.e.* existing capital is more than required capital):

Respective Partners' Capital A/cs Dr.

To Cash/Bank A/c

(Being excess amount of capital withdrawn by partner(s) for proportionate share in profits)

► If the surplus or deficiency adjusted through partners' current accounts instead of undertaking actual cash transactions. The following entries may be passed in different situations:

(a) **If there is deficiency in capital:**

Respective Partner's Current A/c Dr.

To Respective Partner's Capital A/c

(Being deficiency in capital adjusted through current accounts)

(b) **If there is surplus in capital:**

Respective Partner's Capital A/c Dr.

To Respective Partner's Current A/c

(Being excess capital transferred to partners' current account)

(vi) If goodwill is not brought in cash, it can be adjusted either (i) through new partner's capital A/c—this will reduce his original capital contributed by him or (ii) if it is adjusted through new partner's current A/c—this will not affect the original capital contributed by him.

Key Words

Investment fluctuation fund: The fund which is created out of the profits in order to meet the fluctuation risk in the market value of the investment.

Employee's provident fund: It is a scheme for providing monetary benefits to all the salaried individuals after their retirements it is a liability of the firm.

(2) Finding the new partner's sufficient capital on the basis of the old partners' capital or the total capital of the firm

Steps:

(i) Prepare old Partners' Capital A/cs (after all adjustments regarding Revaluation, General Reserve, Goodwill, etc.).

(ii) Calculate the total capital of the firm as follows:

Total Capital of the firm = (Combined adjusted capital of old partners) × (Reciprocal of the combined proportion of their share of profit)

(iii) New partner's capital will be equal to his share of the total capital.

(iv) If, goodwill is not brought in cash by the new partner, it should be debited to his Capital Account. This will make the calculation of his sufficient capital more accurate and simple.

Two examples of above given cases are:

(1) **When Old Partners' capitals are to be adjusted on the basis of New Partner's Capital:**

For example, C and D are partners with capitals of ₹ 5,000 and ₹ 10,000. Their Profit sharing ratio is 3: 2. E is admitted for $1/5^{th}$ share for which he brings ₹ 10,000 as his capital but does not bring his share of goodwill in cash and firm's goodwill is determined at ₹ 20,000. So, E's share of goodwill is ₹ 4,000 (20,000 × 1/5). Total capital of the firm will be 50,000 (*i.e.* 10,000 ×5/1).

(2) **When new Partner brings Capital on the basis of Old Partners' Capitals (after adjustment):**

For example, the combined capital of P and Q after all adjustments is ₹ 1,00,000. R is admitted for $1/5^{th}$ share and brings proportionate capital but does not bring his share of goodwill in cash. Goodwill of the firm is valued at ₹ 50,000. R will bring in capital ₹ 25,000 (₹ 1,00,000 × 5/4 × 1/5).

Example 3

Geet and Preet were partners in a firm sharing profits in the ratio of 7: 3. On 1st April, 2019 they admitted Meet as a new partner for 1/4th share in profits of the firm. Meet brought ₹ 4,30,000 as his capital and ₹ 25,000 for his share of goodwill premium. The Balance Sheet of Geet and Preet as on 1st April, 2019 was as follows:

Balance Sheet of Geet and Preet as at 1st April, 2019

Liabilities		Amount (₹)	Assets		Amount (₹)
Capitals:			Land and Building		3,50,000
Geet	8,00,000		Machinery		4,50,000
Preet	3,50,000	11,50,000	Debtors	2,20,000	
General Reserve		1,00,000	*Less*: Provision	20,000	2,00,000
Workmen's Compensation Fund		1,00,000	Stock		3,60,000
Creditors		1,60,000	Cash		1,50,000
		15,10,000			**15,10,000**

It was agreed that:

(i) The value of Land and Building will be appreciated by 20%.

(ii) The value of Machinery will be depreciated by 10%.

(iii) The liabilities of Workmen's Compensation Fund was determined at ₹ 50,000.

(iv) Capitals of Geet and Preet will be adjusted on the basis of Meet's capital and actual cash to be brought in or to be paid off as the case may be.

Prepare Revaluation Account, Partners' Capital Accounts and the Balance Sheet of the new firm.

Ans. **In the Books of Geet, Preet and Meet**

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

Particulars		Amount (₹)	Particulars	Amount (₹)
To Machinery A/c		45,000	By Land and Building A/c	70,000
To Profit on Revaluation transferred to Partners' Capital A/cs:				
Geet	17,500			
Preet	7,500	25,000		
		70,000		**70,000**

Dr. **Partners' Capital Accounts** **Cr.**

Particulars	Geet (₹)	Preet (₹)	Meet (₹)	Particulars	Geet (₹)	Preet (₹)	Meet (₹)
To Cash A/c (balancing figure)	37,000	23,000	—	By Balance b/d	8,00,000	3,50,000	
To Balance c/d	9,03,000	3,87,000	4,30,000	By General Reserve A/c	70,000	30,000	
				By Workmen's Compensation Fund A/c	35,000	15,000	
				By Cash A/c			4,30,000
				By Premium for Goodwill A/c	17,500	7,500	
				By Revaluation A/c (Profit)	17,500	7,500	
	9,40,000	**4,10,000**	**4,30,000**		**9,40,000**	**4,10,000**	**4,30,000**

Balance Sheet
as at 1st April, 2019

Liabilities		Amount (₹)	Assets		Amount (₹)
Capital Accounts:			Land and Building	3,50,000	
Geet	9,03,000		*Add:* Appreciation	70,000	4,20,000
Preet	3,87,000		Machinery	4,50,000	
Meet	4,30,000	17,20,000	*Less*: Depreciation	(45,000)	4,05,000
Claim for Workmen's Compensation		50,000	Debtors	2,20,000	
Creditors		1,60,000	*Less*: Provision	(20,000)	2,00,000
			Stock		3,60,000
			Cash		5,45,000
		19,30,000			**19,30,000**

Working Notes:

			₹	₹
(1)	General Reserve A/c	Dr.	1,00,000	
	To Geet's Capital A/c			70,000
	To Preet's Capital A/c			30,000
	(Being general reserve distributed in old ratio)			
(2)	Workmen's Compensation Fund	Dr.	1,00,000	
	To Claim on Workmen's compensation A/c			50,000
	To Geet's Capital A/c			35,000
	To Preet's Capital A/c			15,000
	(Being Workmen's Compensation Fund distributed in old ratio after adjustment of claim)			
(3)	Cash A/c	Dr.	4,55,000	
	To Meet's Capital A/c			4,30,000
	To Premium for Goodwill A/c			25,000
	(Being Capital and goodwill premium brought in by Meet)			
(4)	Premium for Goodwill A/c	Dr.	25,000	
	To Geet's Capital A/c			17,500
	To Preet's Capital A/c			7,500
	(Being goodwill premium distributed in their sacrificing ratio)			

Calculation of Capital:

Capital brought in for 1/4th share = ₹ 4,30,000

Total Capital of firm = ₹ 4,30,000 × 4 = ₹ 17,20,000

New Ratio:

$$\text{Geet} = \frac{3}{4}\times\frac{7}{10}=\frac{21}{40}$$

$$\text{Preet} = \frac{3}{4}\times\frac{3}{10}=\frac{9}{40}$$

$$\text{Meet} = \frac{10}{40}$$

New Ratio: 21: 9: 10

$$\text{Geet's Share} = \frac{21}{40} \times ₹\ 17{,}20{,}000 = ₹\ 9{,}03{,}000$$

$$\text{Preet's Share} = \frac{9}{40} \times ₹\ 17{,}20{,}000 = ₹\ 3{,}87{,}000$$

Cash Balance = ₹ 1,50,000 + ₹ 4,55,000 – ₹ 37,000 – ₹ 23,000 = ₹ 5,45,000

CHAPTER-4
RECONSTITUTION OF A PARTNERSHIP FIRM: RETIREMENT AND DEATH OF A PARTNER

Revision Notes

- **Meaning of Retirement**

  Retirement of a partner means a partner leaving or separating from a partnership firm due to certain reasons. On retirement, the old partnership agreement comes to an end and a new partnership agreement comes into existence between the remaining partners.

- Retirement involves a few preconditions that have been clearly laid down by Section 32(1) of the Indian Partnership Act, 1932. It states that a partner may retire:

  (1) On a dispute with other partners of the firm;

  (2) Having no interest in commercial/business activities;

  (3) Old age, illness or physical weakness;

  (4) To do other work or desire to do some profitable business;

  (5) Other reason.

  As against above, a partner can be removed from the partnership firm due to his fraudulent or illegal behaviour against the firm.

- **Death of A Partner**

  Partnership comes to an end with the death of a partner but the firm may continue its business with new partnership agreement. The legal representative of the deceased partner has the right over the capital balance of deceased partner, profit for the period till he was alive, salary, commission and interest on capital (if permitted in the deed). Apart from the above, he has the right over the goodwill, reserves and funds.

  There is no distinction between the death of a partner and retirement of a partner from the accounting point of view. The problem which arises in case of death of a partner is similar to that of retirement of a partner except that the death of a partner may occur at any time, whereas, the date of retirement of a partner is fixed. Generally, adjustments done in case of death of a partner are similar to those done at the time of retirement of a partner. Important difference from the legal point is that a retiring partner settles his account with firm himself, whereas on the event of the death of a partner, the accounts are settled by his legal executor.

- **Amount Payable to the Legal Executor of the Deceased Partner**

  The legal executor of a deceased partner is entitled to receive the following amounts apart from the deceased partner's capital balance. Therefore, these amounts are credited in the legal executor's account of the deceased partner.

  (1) Credit balance of capital and current account.

  (2) Salary, commission, interest, etc. up to the date of death.

  (3) Proportionate share in profit of firm till the date of death.

  (4) Proportionate share in goodwill of the firm.

  (5) Proportionate share in undistributed profits and reserves of the firm as shown in the balance sheet.

  (6) Proportionate share in the profit on revaluation of assets and liabilities.

  After crediting the above items in the Executor's Account of the deceased partner, the following items are debited in his account (if any):

  (1) Debit capital balance of deceased partner.

  (2) Drawings of deceased partner and interest on drawings.

  (3) Share of Goodwill written off.

  (4) Share in the loss on revaluation of assets and liabilities.

  (5) Share in undistributed loss.

  After adjusting the above items, the balance of capital account of the deceased partner is paid to his successor as per any one of the following ways: (i) in lump-sum, or (ii) in instalments.

- **Legal Provisions Regarding the Payment to the Successor of the Deceased Partner**

The amount due is paid to the executor as follows:

(1) If procedure of payment is mentioned in the partnership deed, then payment will be made accordingly.

(2) In the absence of clear instructions in partnership deed, payment of due amount will be made in cash, immediately.

(3) If immediate payment is not possible, then as per Section 37 of Indian Partnership Act, 1932, payment can be made by any one of the following two options:

(i) Interest at 6 % p.a. on the amount due from the date of death to the date of payment, **or**

(ii) Share in the amount of profit earned by the firm by using the amount due of the deceased partner from the date of death to the date of payment.

- **Gaining Ratio**

Gaining ratio is the ratio in which continuing partners will receive the share of the retired/deceased partner. *i.e.*, it is the ratio in which the share of the retiring partner is taken over by the other partners. In other words, "Gaining Ratio is the difference between new profit sharing ratio and old profit sharing ratio."

The retiring partner acquires the amount of goodwill from the remaining partners on the basis of this ratio.

- **Calculation of Gaining Ratio**

(1) **If new and old profit sharing ratio is given in question:** In such cases, Gaining Ratio is calculated by subtracting old share of each partner from his new share. Thus,

$$\text{Gaining Ratio} = \text{New Ratio} - \text{Old Ratio}$$

(2) **If new profit sharing ratio is not given in question:** In such case, it is assumed that the remaining partners will continue to share in the old ratio as existed between them prior to the retirement of a partner, which means they gain in the old ratio.

Example 1

Q. X, Y and Z are partners sharing profits in the ratio of 3 : 2 : 1. X retired and surrendered his 1/4th share in favour of Y and remaining in favour of Z.

(i) Calculate new profit sharing ratio of Y and Z.

(ii) Gaining ratio of Y and Z.

Ans. (i)

$$\text{New Share} = \text{Old Profit Share} + \text{Gaining Share}$$

$$Y = \frac{2}{6} + \left[\frac{1}{4} \times \frac{3}{6}\right] = \frac{2}{6} + \frac{1}{8} = \frac{8+3}{24} = \frac{11}{24}$$

$$Z = \frac{1}{6} + \left[\frac{3}{4} \times \frac{3}{6}\right] = \frac{1}{6} + \frac{3}{8} = \frac{4+9}{24} = \frac{13}{24}$$

New share of Y and Z = 11 : 13

(ii)

$$\text{Gaining Ratio} = \text{New Profit Share} - \text{Old Profit Share}$$

$$Y = \frac{11}{24} - \frac{2}{6} = \frac{11-8}{24} = \frac{3}{24}$$

$$Z = \frac{13}{24} - \frac{1}{6} = \frac{13-4}{24} = \frac{9}{24}$$

Gaining ratio of Y and Z = 3 : 9 = 1 : 3

- **Accounting treatment of Goodwill:**

In case of retirement/death, retiring partner or legal heirs or executors of the deceased partner claim the share of goodwill of the firm because retiring or deceased partner must have worked to earn goodwill for the firm. After retirement or death, remaining partners in addition to their old profit share will also get the share of retiring or deceased partner, so, proper compensation should be given by the remaining partners to the retiring partner or executors of the deceased partner. Based on the golden rule that "gaining partners should compensate the sacrificing partners to the extent of their gain' should be complied with."

The accounting treatment of goodwill depends upon the two broader situations *viz.* whether or not goodwill already appears in the books of firm.

(1) **When goodwill is not appearing in the books:**

In this case, retiring or deceased partner's capital account is to be credited with his share of goodwill and gaining partners' capital accounts are to be debited in gaining ratio by way of the following journal entry:

Gaining Partners' Capital/Current A/cs Dr. (In gaining ratio)
To Retiring /Deceased Partner's Capital/Current A/c (Share of outgoing partner)
(Being retiring/deceased partner's share of goodwill debited to gaining partners capital accounts in gaining ratio)

(2) When goodwill is already appearing in the books:
In this case, the old goodwill should always be written off among all partners in their old profit sharing ratio by way of the following journal entries:

(i) All Partners' Capital /Current A/cs Dr. (In old ratio)
To Goodwill A/c (Value of old goodwill)
(Being old goodwill written off among all partners in their old ratio)

(ii) Gaining Partners' Capital/Current A/cs Dr. (In gaining ratio)
To Retiring /Deceased Partner's Capital/Current A/c (Share of outgoing partner)
(Being retiring/deceased partner's share of goodwill adjusted in gaining partners' capital accounts)

- **Hidden Goodwill**
If the firm has agreed to settle the account of retiring partner by paying him a lump-sum amount, then amount paid to him in excess of his adjusted capital shall be treated as his share of goodwill. *For example*—A, B and C are partners. A retires and his capital account after making adjustments for reserves and profit on revaluation exists at ₹60,000. B and C have agreed to pay him ₹90,000 in full settlement of his claim. It implies that ₹30,000 (₹90,000 – ₹60,000) is A's share of goodwill of the firm. This will be treated by debiting ₹30,000 to B and C's Capital Accounts in their gaining ratio and crediting A's Capital A/c.

- **Revaluation of Assets and Reassessment of Liabilities**
At the time of retirement or death of a partner, Assets are revalued and liabilities are reassessed in order to show them at their current value. As learnt in case of admission of a partner, a Revaluation Account is prepared in order to ascertain net gain (loss) on revaluation of assets or reassessment of liabilities and bringing unrecorded items into firm's books and the same is transferred to the capital account of all partners including retiring/deceased partner in their old profit sharing ratio.
Note: (I) A Profit & Loss Adjustment A/c can be prepared instead of Revaluation A/c.
(II) In case, it is desired that assets and liabilities should continue to appear at the old values, then a Memorandum Revaluation A/c is opened instead of Revaluation A/c as explained in case of Reconstitution of a Partnership firm.

- **Adjustment of Accumulated Profits And Reserves**
The accumulated profits if shown in the balance sheet of the firm, are credited to all partners' capital account and in case of accumulated loses, these are debited to all partners' capital account in their old profit sharing ratio.

- **Determination and Payment of Total Payable Amount to Retiring Partner**

(1) Determination of payable amount: If a partner retires on the last day of the accounting year or first day of the next accounting year, then amount payable is determined by adjusting his capital and current account with the revaluation of assets and liabilities shown in the balance sheet of last year. But if a partner retires on any date during the accounting year, then the following is included in the determination of amount payable to him:
- Balance of capital and current account as shown in the date of last balance sheet.
- Interest, salary, bonus, commission, etc. payable from the date of last balance sheet till the date of retirement.
- Share in firm's goodwill.
- Share in undistributed profit, loss and reserves.
- Share in the profit or loss on revaluation of assets and liabilities.
- Share of profit or loss from the date of last balance sheet to the date of retirement, which may be calculated according to the instructions given in question or on the basis of time or on the basis of sale.

(2) Payment of payable amount: Amount payable to retiring partner after making all the above adjustments is made according to the provisions of partnership deed. Generally, such payment can be made in lump-sum or in instalments or in the form of annuity.

- **Lump-sum payment system:** Amount payable to the retiring partner can be paid in cash or through bank, if the financial position of the firm is strong. The amount payable to the retiring partner in this method, will be as follows:
The following journal entry will be passed:
Out of firm's own resources:
If all the partners agree and the firm has sufficient cash available, then lump-sum amount may be paid in cash.
Retiring Partner's Capital A/c Dr.
To Cash /Bank A/c
(Being the amount due paid to the retiring partner)

(i) By receiving additional amount from remaining partners: In case, if sufficient cash is not available in the firm, then cash may be received from remaining partners upon mutual consent to pay lump-sum amount to the retiring partner.

The following entries will be passed in this respect:

(a) For cash brought in by the remaining partners:

Cash/Bank A/c Dr.
 To Continuing Partners' Capital A/cs
(Being insufficient cash brought in by the remaining partners)

(b) For paying lump-sum amount to the retiring partner:

Retiring Partner's Capital A/c Dr.
 To Cash/Bank A/c
(Being the amount due to the retiring partner paid)

(ii) By payment through bank loan: When partners are not able to bring cash then loan from bank or financial institution can be raised by mortgaging firm's assets so as to make lump-sum payment to the retiring partner. The following entry will be passed:

Retiring Partner's Capital A/c Dr.
 To Bank Loan A/c
(Being the amount due to the retiring partner paid)

- **Instalment payment system:** In this system, amount payable to the retiring partner is treated as loan and is transferred to his loan account which is paid accordingly and conveniently in predecided instalments along with interest due. Interest due on loan is paid according to the condition of partnership deed or on a mutual agreement basis. If nothing is mentioned about rate of interest then interest @ 6% p.a. is paid on the amount of loan outstanding and the balance of loan account of retiring partner will be continuously shown on the liabilities side of balance sheet till all the outstanding amount of the loan is paid by the firm. In this system, cash or bank balance is not required in huge amounts, therefore, this system is considered to be more practical. Sometimes, the question is silent in respect of settlement of the final claim then in such case, this system of payment is more suitable. The following journal entries are passed for the amount payable through this system:

(i) For transferring amount payable to loan account at the beginning of the first year:

Retiring Partner's Capital A/c Dr.
 To Retiring Partner's Loan A/c
(Being the amount due to the retiring partner transferred to their loan account)

(ii) For making some payment immediately:

Retiring Partner's Loan A/c Dr.
 To Cash/Bank A/c
(Being payment made as against the loan account of the retiring partner)

(iii) For making interest due at the end of the year:

Interest A/c Dr.
 To Retiring Partner's Loan A/c
(Being Interest being due on the retiring partner's Loan Account)

(iv) For making instalment payment:

Retiring Partner's Loan A/c Dr.
 To Cash/Bank A/c
(Being payment made as against the loan account of the retiring partner)

(v) For transferring interest to Profit & Loss Account:

Profit & Loss A/c Dr.
 To Interest A/c
(Being interest on the retiring partner's loan account transferred to the profit and loss account)

- **Adjustment of Capital Accounts:** After the retirement of a partner, sometimes the remaining partners may wish to adjust their capitals in accordance with their new profit sharing ratio or on some other agreed basis. For the purpose of adjustment, the final balances of remaining partners' capital accounts have to be found out. After that, the final balances in their capital accounts have to be compared with their new capitals (or their required capitals); the partner whose capital falls short will bring in required capital or the required amount will be transferred from their current accounts or capital accounts as the case may be and the partner who has surplus capital will withdraw excess amount of capital or the required amount will be transferred to their current accounts or capital accounts as the case may be For this, the following entries will be passed:

(i) If capital of remaining partner falls short, he brings in cash:

Cash / Bank A/c Dr.
 To Remaining Partners' Capital A/cs
(Being the deficient amount brought in by the remaining partners)

(ii) If capital of remaining partner has a surplus, he withdraws cash:

Remaining Partners' Capital A/cs Dr.
 To Cash /Bank A/c
(Being surplus amount withdrawn by the remaining partners)

(iii) If the surplus in capital account is transferred to current account:

Remaining Partners' Capital A/cs Dr.
 To Remaining Partners' Current A/cs
(Being the surplus amount transferred to the current accounts of the remaining partners)

Key Word

Profit and Loss Suspense A/c: The profit of the decreased partner from the beginning of the year till the date of death, is transferred to a special account which is called profit & Loss suspense Account.

(iv) If the deficit in capital account is adjusted by transferring to current account:

Remaining Partners' Current A/cs Dr.
To Remaining Partners' Capital A/cs
(Being the deficient amount reimbursed from the current accounts of the remaining partners)

- **Share of Profit of the Deceased Partner**
Generally, a partner retires on the date of preparation of final accounts but the date of death is not fixed as it can occur on any day. If a partner dies at any time during the year then his successor is entitled to get a share in profit from the beginning of the year till the date of death. It can be determined by either of the two following methods:
(1) **On the basis of time:** In this method, proportionate estimated profit of the firm will be determined for the period for which the deceased partner remained in the firm on the basis of profit of previous years and then, share of deceased partner in that profit will be calculated. In this, part of current year's profit will be computed on the basis of profit of the previous year or on the basis of average profits of previous years.
(2) **On the basis of Sales/Turnover:** In this method, ratio of profit to sales of past year (or average of past few years) is calculated, which is applied to the amount of sales from the beginning of the current year up to the date of death to determine profit of that period and share of deceased partner is calculated.

- **Interest on Capital of Deceased Partner**
As per partnership deed, interest on opening balance of capital of deceased partner may be given till the date of death as per predecided rate, which will be credited in the deceased partner's account.

- **Amount Payable to a Deceased Partner:** The share of the deceased partner can be ascertained by preparing his capital account.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Undistributed Losses A/c	—	By Balance b/d (Opening Balance)	—
To Revaluation A/c (Loss)	—	By Interest on Capital A/c	—
To Drawings A/c	—	By Salary/Commission A/c	—
To Interest on Drawings A/c	—	By Undistributed Profit and Reserves A/c	—
To Profit & Loss A/c	—	By Goodwill A/c	—
To Deceased Partner's Executor's A/c	—	By Revaluation A/c (Profit)	—
(Balancing Figure)	—	By Profit & Loss Suspense A/c	—
	—		—

Example 2

Q. Farhan, Hina and Dolly are partners in a firm sharing profits in the ratio of 5 : 3 : 2. On 1st April, 2016, the capitals of the partners were : ₹5,00,000; ₹3,00,000 and ₹2,00,000 respectively. The firm closes its books on 31st March every year. Dolly died on 5th April, 2016.

On that date:
(a) Goodwill of the firm was valued at ₹30,000; and
(b) Dolly's share of profit till the date of her death was calculated as ₹200.
Prepare Dolly's Capital Account to be rendered to her executors.

Ans. Dr. Dolly's Capital Account Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Dolly's Executor's A/c	2,06,200	By Balance b/d	2,00,000
(Bal. Figure)		By Profit and Loss Suspense A/c	200
		By Farhan's Capital A/c	3,750
		By Hina's Capital A/c	2,250
	2,06,200		**2,06,200**

Working Notes:

Share of Goodwill for Dolly $= \frac{2}{10} \times ₹30{,}000 = ₹6{,}000$

₹6,000 will be distributed between Farhan and Hina in their Gaining Ratio.

Farhan's Capital A/c $= \frac{5}{8} \times ₹6{,}000 = ₹3{,}750$

Hina's Capital A/c $= \frac{3}{8} \times ₹6{,}000 = ₹2{,}250$

Note: Their Gaining ratio will be 5 : 3.

CHAPTER-5

DISSOLUTION OF PARTNERSHIP FIRM

Revision Notes

- **Meaning of Dissolution of Partnership:** Dissolution of partnership means reconstitution of the firm due to change in the profit sharing ratio among existing partners, admission of a new partner, retirement of a partner, death of a partner, insolvency of a partner, completion on the venture(if partnership is formed for that), expiry of the period of partnership (if partnership is for a specific period of time) and the firm continues as before.
- **Meaning of Dissolution of Partnership Firm:** Dissolution of partnership firm means that the firm closes down its business and comes to an end. On the dissolution of partnership firm, assets of the firm are sold, liabilities are paid off and out of the remaining amount, the accounts of the partners are settled. It may be noted that dissolution of the firm necessarily brings in dissolution of the partnership. However,dissolution of partnership would not necessarily involve dissolution of firms.

Distinction Between Dissolution of Partnership and Dissolution of Firm

S. No.	Basis of Difference	Dissolution of Partnership	Dissolution of Firm
(i)	Change in economic relation	The economic relation of partnership among different partners is changed.	The economic relation among all the partners comes to an end.
(ii)	Termination of business	The business of the firm is not terminated.	The business of the firm is closed.
(iii)	Assets and Liabilities	Assets and liabilities are revalued and new balance sheet is drawn.	Assets are sold and realized and liabilities are paid off.
(iv)	Closure of books of accounts	It does not require the closing of books because the business is not terminated.	All books of accounts are closed.
(v)	Implication	It does not imply dissolution of firm.	It implies dissolution of the partnership and the firm.

- **Modes of Dissolution of a Partnership Firm:** Modes of dissolution of a firm have been described in Sections 40 to 44 of Indian Partnership Act, 1932, and they are as under:
  - **(1) Dissolution by Agreement (Section 40):** When all the partners agree to dissolve the firm or if there is any such agreement in partnership deed or amongst the partners regarding dissolution of firm.
  - **(2) Compulsory Dissolution or Dissolution by the Operation of Law (Section 41)**: In the following circumstances, the firm will be dissolved compulsorily:
    - **(a)** When any such event happens which makes the operation of business of the firm unlawful.
    - **(b)** When all partners or all partners except one are declared as insolvent by the court.
  - **(3) Dissolution on the Happening of an Unexpected Event (Section 42):** In this, a firm will be dissolved in the following conditions:
    - **(a)** When partnership is formed for a particular period, then on the expiry of that period.
    - **(b)** When formation of partnership was for some objectives, then on the fulfilment of those objectives.
    - **(c)** When any partner is declared as an insolvent.
    - **(d)** When any partner dies.
  - **(4) Dissolution by Notice of Partnership at will (Section 43)**: If partnership is at will, then any partner may notify other partners about his will in writing and then the firm may be dissolved.
  - **(5) Dissolution by Court (Section 44):** On filing of a suit by a partner, the court may pass orders for dissolution in the following conditions:
    - **(a)** When any partner becomes of unsound mind.
    - **(b)** When any partner becomes permanently incapable of executing his duties as a partner.
    - **(c)** When any partner is guilty of any such conduct which may bring loss to the business.
    - **(d)** When any partner knowingly violates the terms of agreement again and again.
    - **(e)** When any partner transfers or assigns all his interests to a third person.
    - **(f)** When it is not possible to run the business without loss.
    - **(g)** When dissolution of firm is just and equitable in the opinion of the court.
- **Settlement of Accounts:** Section 48 of the Indian Partnership Act, 1932, provides the following rules for the settlement of accounts between the partners:

(1) **Payment of Losses:** Losses shall be paid first out of profits, next out of capital and lastly, if necessary, by the partners individually in their profit sharing ratio.

(2) **Distribution of Assets:** Assets of the firm are first to be applied in paying the debts of the firm to the third parties; next in paying to each partner rateably what is due to him from the firm for advances as distinguished from capital; in paying to each partner proportionately rateably what is due to him on account of capital, and the residue to be divided among the partners in the proportion in which they were entitled to share profits.

Key Words

Contingency Reserve: An appropriation of surplus retained earnings that have been set aside to guard possible future losses.

Realisation Expenses: Those expenses which occurred during the time of dissolution of partnership firm.

(3) **Realisation Account:** Realisation Account is opened on dissolution of firm to close down the books of accounts of the firm. This account is a nominal account. The purpose of this account is to show the profit or loss on realisation of assets and payment of liabilities.

► **Format of Realisation Account**

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

Particulars	Amount (₹)	Particulars	Amount (₹)
To Land and Building	xxx	By Sundry creditors	xxx
To Plant and Machinery	xxx	By Bills payable	xxx
To Furniture and Fittings	xxx	By Bank overdraft	xxx
To Bills receivables	xxx	By Outstanding expenses	xxx
To Sundry debtors	xxx	By Provision for doubtful debts	xxx
To Cash/Bank A/c (Payment of liabilities)	xxx	By Cash/Bank A/c (sale of assets)	xxx
To Cash/Bank A/c (Payment of unrecorded liabilities)	xxx	By Partner's capital account (assets taken by the partner)	xxx
To Partner's capital account (liabilities assumed by the partner)	xxx	By Loss (transferred to partners' capital accounts)	xxx
To Profit (transferred to partners' capital accounts in their profit sharing ratio)	xxx		
Total	xxxxx	**Total**	xxxxx

► **Accounting Entries**

On dissolution of the firm, the accounting entries will be passed as under:

Journal Entries

Accounting of assets (Excluding cash & bank)	**Realisation A/c** Dr. To All Assets A/c (Individual)
Accounting of goodwill on dissolution **If goodwill account exists at the time of dissolution**	**Realisation A/c** Dr. To Goodwill A/c **Cash/Bank A/c** Dr. To Realisation A/c
Accounting of undisclosed assets: ● On selling in the market ● On taking over by any partner	**Cash/Bank A/c** Dr. To Realisation A/c **Partner's Capital/Current A/c** Dr. To Realisation A/c
Provisions relating to assets are opened	**Provision for Bad Debts A/c** Dr. **Provision for Discount on Debtors A/c** Dr. **Investment Fluctuation Reserve A/c** Dr. To Realisation A/c
Transfer of debit balance of Profit & Loss A/c	**Partners' Capital/Current A/cs** Dr. To Profit & Loss A/c
Closing the accounts of various liabilities	**Sundry Liabilities A/c** Dr. To Realisation A/c
Accounting of undisclosed liabilities: **(1)** If paid by the firm	**Realisation A/c** Dr. To Cash/Bank A/c

(2) Taking over the responsibility regarding payment of liability by any partner	**Realisation A/c** Dr. To Partner's Capital/Current A/c
Transfer of various reserve funds and credit balance of Profit & Loss A/c	**Contingencies Reserve A/c** Dr. **Reserve Fund A/c** Dr. **Profit & Loss A/c** Dr. To Partners' Capital/Current A/cs
Realising assets **(1)** On sale of asset in cash (with selling price)	**Cash/Bank A/c** Dr. To Realisation A/c
(2) Asset taken over by any partner (with agreed price)	**Partner's Capital/Current A/c** Dr. To Realisation A/c
(3) Asset taken over by any creditor (with agreed price)	**Realisation A/c (Claim Price—Agreed Price)** Dr. To Bank A/c (Claim Price—Agreed Price)
(i) If the amount due to creditors and value of assets taken by them from firm is equal	**No Entry needed**
(ii) If the amount due to creditors is more than the value of asset, and the difference amount is paid by the firm	**Realisation A/c** Dr. To Bank A/c
(iii) If the amount due to creditors is less than the value of asset taken over by creditors and the creditors pay-off the excess amount to the firm.	**Bank A/c** Dr. To Realisation A/c
Payment of liabilities **(1)** Liabilities paid by firm.	**Realisation A/c** Dr. To Cash/Bank A/c
(2) Liabilities taken over or paid by any partner.	**Realisation A/c** Dr. To Partner's Capital/Current A/c
Payment of realisation expenses: **(1)** If paid by firm.	**Realisation A/c** Dr. To Cash/Bank A/c
(2) Responsibility regarding payment of expenses taken over by any partner.	**Realisation A/c** Dr. To Partner's Capital/Current A/c
(3) If it is clearly mentioned in partnership deed that dissolution expenses will be borne by any partner, then this amount will not be recorded in Realisation A/c of the firm.	**No Entry needed**
(4) If it is clearly mentioned in partnership deed that in case of dissolution the winding up expenses will be borne by any partner but if such expense is incurred by the firm on behalf of that partner then the following entry will be recorded.	**Partner's Capital/Current A/c** Dr. To Cash/Bank A/c
Remuneration of dissolution work is to be paid to any partner	**Realisation A/c** Dr. To Partner's Capital/Current A/c
For closing realisation account **(1)** If debit balance of Realisation A/c (loss).	**Partners' Capital/Current A/cs** Dr. To Realisation A/c
(2) If credit balance of Realisation A/c (profit).	**Realisation A/c** Dr. To Partners' Capital/Current A/cs
For payment of partner's loan	**Partner's Loan A/c** Dr. To Cash/Bank A/c
For closing of current accounts: **(1)** If debit balance of partners' current A/cs.	**Partners' Capital A/cs** Dr. To Partners' Current A/cs
(2) If credit balance of partners' current A/cs.	**Partners' Current A/cs** Dr. To Partner's Capital A/cs

For closing of partners' capital accounts: **(1)** Debit balance of partners' capital A/c.	**Cash/Bank A/c** Dr. To Partners' Capital A/cs
(2) Credit balance of partner's capital A/c.	**Partners' Capital A/c** Dr. To Cash/Bank A/c

➢ **Distinction between Realisation Account and Revaluation Account**

S. No.	Basis of Difference	Realisation Account	Revaluation Account
(i)	Time of Preparation	This account is prepared at the time of dissolution of the firm.	This account is prepared when the firm is reconstituted due to change in the profit sharing ratio, admission, retirement or death of a partner.
(ii)	Objective of Preparation	This account is prepared to find out the profit or loss on the sale of assets and repayment of liabilities.	This account is prepared to make necessary adjustment regarding revaluation of assets and re-assessment of liabilities.
(iii)	Values of Assets and Liabilities recorded	Assets and Liabilities are shown in the Realisation Account on book values while the amount of actual payment and actual realisation is recorded in this account.	Only the difference between the book value and revised values of assets and liabilities is recorded in this account.
(iv)	Results	After preparation of Realisation Account, there will be no business afterwards.	After preparing Revaluation Account, firm continues its business.
(v)	Frequency of Preparation	Realisation Account is prepared only once during the life time of a firm.	Revaluation Account may be prepared at a number of occasions during the life time of a firm.
(vi)	Expenses	Usually realisation expenses are shown in the Realisation Account.	No expenses are shown in Revaluation Account.
(vii)	Memorandum	No such memorandum account is prepared.	Sometimes, when it is desired not to change the value of assets and liabilities in the reconstituted firm, Memorandum Revaluation Account is prepared.

➢ **Treatment of Reserves and Accumulated Profits:**
The undistributed profits and losses and reserves are always transferred to partners' capital accounts in their profit sharing ratio and not to the realisation account.

For distribution of reserves or accumulated profits:

General Reserve Dr.
Reserve Fund Dr.
Profit & Loss A/c Dr.
To Partners' Capital A/cs (in profit sharing ratio)
(Being undistributed profits and reserves transferred to partners' capital accounts)

For distribution of accumulated losses:

Partners' Capital A/cs Dr.
To Profit & Loss A/c
(Being undistributed losses transferred to partners' capital accounts)

➢ **Partner's Loan Account:** If a partner has given any loan to the firm, first of all, it will be shown on the credit side of partner's loan account. When all the outside liabilities are paid in full, afterwards this loan will be paid. Thus, partner's loan account is prepared separately and paid off by passing the following entry:

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

Note: Partner's loan account is prepared before partners' capital accounts because at the time of dissolution, capitals are paid off, only if, any balance is left after payment of partner's loan.

➢ **Treatment of Goodwill:** In case of dissolution of a firm, goodwill should be treated just like other assets if nothing is mentioned about the realisation of goodwill, it can be assumed that the goodwill is valueless and as such, nothing is received or realised from it.

➢ **Cash or Bank Account:** All the receipts are recorded on the debit side and all the payments are recorded on the credit side of cash account. At the time of dissolution, this account is closed at last and total of both the sides (Dr. and Cr.) must be equal. It means all accounts are closed. Thus, this account also helps in the verification of the arithmetical accuracy of all the accounts at the time of dissolution.

If both cash and bank balances are given in the balance sheet, only one account, either cash account or bank account is prepared. If cash account is prepared, an entry is made for withdrawing the bank balance and if a bank account is prepared, an entry is passed for depositing the cash balance into bank which are as follows:

(i) **For cash deposited into bank:**

Bank A/c Dr.

To Cash A/c

(ii) **For cash withdrawn from bank:**

Cash A/c Dr.

To Bank A/c

Example 1

Parth and Shivika were partners in a firm sharing profits in the ratio of 3 : 2. The Balance Sheet of the firm on 31st March, 2014 was as follows:

Liabilities		Amount (₹)	Assets	Amount(₹)
Sundry Creditors		80,000	Bank	1,72,000
Shivika's sister's loan		20,000	Debtors	27,000
Capitals:			Stock	50,000
Parth	1,75,000		Furniture	2,20,000
Shivika	1,94,000	3,69,000		
		4,69,000		**4,69,000**

On the above date, the firm was dissolved. The assets were realised and the liabilities were paid off as follows:

(a) 50% of the furniture was taken over by Parth at 20% less than book value. The remaining furniture was sold for ₹ 1,05,000.

(b) Debtors realised ₹ 26,000.

(c) Stock was taken over by Shivika for ₹ 29,000.

(d) Shivika's sister's loan was paid off along with an interest of ₹ 2,000.

(e) Expenses on realisation amounted to ₹ 5,000.

Prepare Realisation Account, Partners' Capital Accounts and Bank Account.

Ans. Step 1: Calculation of Profit or Loss earned in Dissolution process:

In the books of Parth and Shivika

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

Particulars	Amount (₹)	Particulars		Amount (₹)
To Stock A/c	50,000	By Shivika's Sister's Loan A/c		20,000
To Debtors A/c	27,000	By Sundry Creditors A/c		80,000
To Furniture A/c	2,20,000	By Bank A/c (Assets Realised):		
To Bank A/c	80,000	Furniture	1,05,000	
(Sundry Creditors)		Debtors	26,000	1,31,000
To Bank A/c (Sister's Loan + Interest)	22,000	By Parth's Capital A/c (Furniture)		88,000
To Bank A/c (Exp.)	5,000			
		By Shivika's Capital A/c (Stock)		29,000
		By Loss transferred to Partners' Capital A/c:		
		Parth	33,600	
		Shivika	22,400	56,000
	4,04,000			**4,04,000**

Step 2:Preparation of Partners' Capital Account

Dr. **Cr.**

Particulars	Parth (₹)	Shivika (₹)	Particulars	Parth (₹)	Shivika (₹)
To Realisation A/c	88,000		By Balance b/d	1,75,000	1,94,000
To Realisation A/c		29,000			
To Realisation A/c	33,600	22,400			
To Bank A/c	53,400	1,42,600			
	1,75,000	**1,94,000**		**1,75,000**	**1,94,000**

Step 3: Preparation of Bank Account in order to reflect the actual payments or receipts of money on the event of winding up of the partnership firm

Dr. **Cr.**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Bal. b/d	1,72,000	By Realisation A/c (Loan + Interest)	22,000
To Realisation A/c (Assets realised):		By Realisation A/c (Creditors)	80,000
Furniture 1,05,000		By Realisation A/c (Expenses)	5,000
Debtors 26,000	1,31,000	By Parth's Capital A/c	53,400
		By Shivika's Capital A/c	1,42,600
	3,03,000		**3,03,000**

UNIT 2 Accounting for Companies

CHAPTER-6

ACCOUNTING FOR SHARE CAPITAL

Topic-1 Introduction

Concepts Covered • *Concept of a company;* • *Concept of shares;* • *Concept of share capital*

Revision Notes

- **Company**

  A company may be viewed as an association of persons who contribute money or money's worth to a common inventory and use it for a common purpose. It is an artificial person having corporate legal entity distinct from its members (shareholders) and has a common seal used for its signature. Thus, it has certain special features which distinguish it from the other forms of organization. These are as follows:

  - **Body Corporate:** A company is formed according to the provisions of Law enforced from time to time. Generally, in India, the companies are formed and registered under Companies Law except in the case of Banking and Insurance companies for which a separate Law is provided for.
  - **Separate Legal Entity:** A company has a separate legal entity which is distinct and separate from its members. It can hold and deal with any type of property. It can enter into contracts and even open a bank account in its own name.
  - **Limited Liability:** The liability of the members of the company is limited to the extent of unpaid amount of the shares held by them. In the case of the companies limited by guarantee, the liability of its members is limited to the extent of the guarantee given by them in the event of the company being wound up.

- **Perpetual Succession:** The company being an artificial person created by law continues to exist irrespective of the changes in its membership. A company can be terminated only through law. The death or insanity or insolvency of any member of the company in no way affects the existence of the company. Members may come and go but the company continues its operation.
- **Common Seal:** The company being an artificial person, cannot sign its name by itself. Therefore, every company is required to have its own seal which acts as official signatures of the company. Any document which does not carry the common seal of the company is not binding on the company.
- **Transferability of Shares:** The shares of a public limited company are freely transferable. The permission of the company or the consent of any member of the company is not necessary for the transfer of shares. But the Articles of the company can prescribe the manner in which the transfer of shares will be made.
- **May Sue or be Sued:** A company being a legal person can enter into contracts and can enforce the contractual rights against others. It can sue and be sued in its name if there is a breach of contract by the company.
- **Kinds of Companies:** Companies can be classified either on the basis of the liability of its members or on the basis of the number of members. On the basis of liability of its members the companies can be classified into the following three categories:
  - **(i)** **Companies Limited by Shares:** In this case, the liability of its members is limited to the extent of the nominal value of shares held by them.
  - **(ii)** **Companies Limited by Guarantee:** In this case, the liability of its members is limited to the amount they undertake to contribute in the event of the company being wound up. Thus, the liability of the members will arise only in the event of its winding up.
  - **(iii)** **Unlimited Companies:** In other words, the creditors can claim their dues from its members. Such companies are not found in India even though permitted by the Companies Act, 1956. On the basis of the number of members, companies can be divided into two categories as follows:

(i) **Public Company:** A public company means a company which:
- **(a)** is not a private company,
- **(b)** has minimum paid up capital of ₹ 5 lakh rupees or such higher paid-up capital, as may be prescribed and
- **(c)** is a company which is not a subsidiary of a private company.

(ii) **Private Company:** A private company is one which has a minimum paid up capital of ₹ 1 Lakh rupees or such higher paid-up share capital as may be prescribed, and which by its articles:
- **(a)** restricts the right to transfer its shares;
- **(b)** limits the number of its members to fifty (excluding its employees);
- **(c)** prohibits any invitation to the public to subscribe for any shares in or debentures of the company.
- **(d)** prohibits any invitation or acceptance of deposits from person other than its members, directors, and relatives.

(iii) **One Person Company(OPC):** Sec.2(62) of the companies Act, 2013, defines OPC as a "company which has only one person as a member".

Rule 3 of the Companies(incorporation)Rules, 2014 provides that:
- **(a)** Only a natural person being an Indian citizen and resident in India can form one person,
- **(b)** It cannot carry out non-banking financial investment activities.
- **(c)** Its paid up share capital is not more than ₹ Lakhs
- **(d)** Its average annual turnover of three years does not exceed ₹ 2 crores.

► **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 company is divided into a number of equal units. Each unit is called a share. A company may divide its capital into share of ₹ 100, ₹ 50, ₹ 10, ₹ 5 or even ₹ 1 each.

► **Classes or Kinds of Shares**

1. **Preference Shares:** According to Section 43(b) of the Companies Act, 2013, preference shares are the shares which carry the following two preferential rights:
   - **(a)** Preferential right of highlight to be paid either as fixed amount or an amount calculated by a fixed rate, of the nominal value of each share before any dividend is paid to the equity shareholders.
   - **(b)** The preferential right to the repayment of capital, on the winding up of the company to the preference share holders before anything is paid to the equity share holders.

   Types of Preference Shares:

   (A) On the basis of Arrears of Dividend
   - **(i)** **Cumulative Preference Shares:** These are the preference shares which have the right to receive arrears of dividend in subsequent years and before the payment of dividend to equity shareholders is made.

(ii) **Non-Cumulative Preference Shares:** These are the preference shares which don't have the right to receive arrears of dividend in subsequent years.

(B) On the basis of Share in Profits

(i) **Participating Preference Shares:** These are the shares which are entitled to share in the surplus profit of the company which remains after payment to equity shareholders.

(ii) **Non-participating Preference Shares:** These are the shares which do not have a share in surplus profits and on which only a fixed rate of dividend is paid.

(C) On the basis of Convertibility

(i) **Convertible Preference Shares:** Convertible preference shares are those shares which can be converted into equity shares.

(ii) **Non-convertible Preference Shares:** These are the preference shares which don't have the right to be converted into equity shares.

(D) On the basis of Redemption

(i) **Redeemable Preference Shares:** The preference shares which are repayable either after a fixed period or earlier at the option of the company (as per provisions of Sec. 80) are called redeemable preference shares.

(ii) **Irredeemable Preference Shares:** Preference shares which don't have any maturity date are called irredeemable preference shares. The Companies Act, 2013, does not permit issue of irredeemable preference shares.

2. **Equity Shares:** According to Section 43 (a) of The Companies Act, 2013, an equity share is a share which is not a preference share. Equity shares are the most commonly issued class of shares which carry the maximum 'risks and rewards' of the business. The risks being losing part or all of the value of shares if the business incurs losses, the rewards being payment of higher dividends and appreciation in the market value. The dividend on equity shares is not fixed and it may vary from year to year depending upon the amount of profits available for distribution.

- **Share Capital**

  Share capital means the capital raised by the company by the issue of shares.

  Types of Share Capital

  The term Share Capital has been used in many forms in the Companies Act, therefore, the share capital has been divided into the following types:

  (1) **Authorised or Registered or Nominal Capital:** It refers to the maximum capital that a company can raise from the market. It is stated in the capital clause of Memorandum of Association of the company. A company cannot raise more capital beyond the authorised capital.

  (2) **Issued Capital:** It refers to that portion of the authorised capital which is actually issued to the public for subscription.

  (3) **Unissued Capital:** It refers to that portion of the authorised capital which has not been issued to the public for subscription.

  (4) **Subscribed Capital:** It refers to that portion of the issued capital which has been subscribed by the public. Subscribed capital can be more or less than the issued capital.

  (5) **Allotted Capital:** Capital allotted to share applicants is called as allotted capital. It shall not exceed issued capital or applied capital (whichever is less.)

  (6) **Called-up Capital:** It refers to that portion of the allotted shares which has been called-up by the company for payment.

  (7) **Un-called Capital:** It refers to that portion of the allotted shares which has not been called up by the company for payment.

  (8) **Paid-up Capital:** It is that portion of the called-up capital which has actually been paid up by the shareholders.

  (9) **Reserve Capital:** Reserve capital refers to that portion of the subscribed capital which is not called-up for payment in its life time. Reserve capital is called up at the time of liquidation of a company by passing a special resolution.

- **Private placement:** A private placement is a sale of share or bonds to pre-selected investors and institution rather than the open market.
- **Employee Stock Option plan (ESOP):** An ESOP is a grant to an employee giving the right to buy a certain number of shares in the company's stock for a set price.
- **Sweat Equity:** Sweat equity is ownership interest or an increase in value that is created as a direct result of hard work by the owner. Sweat equity is a form of compensation by the owner. Sweat equity is a form of compensation by the business to their owners and employees.

Topic-2 Accounting Treatment

Concepts Covered • *Accounting treatment of issue, allotment, forfeiture and re- issue of equity and preference shares,* • *Disclosure of share capital in company's Balance sheet.*

Revision Notes

- **Issue of Shares:**
  The amount on shares issued can be gradually collected in easy instalments spread over a period of time depending upon its growing financial requirement. The instalments are termed as application, allotment, first call, second call and final call. However this is in no way which prevents a company from calling the full amont on shares right at the time of application.
  The important steps in the procedure of share issue are:
  (i) Issue of Prospectus
  (ii) Receipt of applications
  (iii) Allotment of Shares
- **Accounting treatment of Issue of shares for consideration of Cash:**
  a. Issue of Shares at Par: Issue of Shares at its actual price *i.e.*, face value is known as issue of shares at par.

At the time of Application:

i. For receipt of application money:
Bank A/c Dr.
To Share Application A/c
(Being application money received on …….. shares @............ per share)

ii. For transferring application money to share capital:
Share Application A/c Dr.
To Share Capital A/c
(Being application money transferred to share capital account)
Share Application A/c Dr.
To Bank A/c
(Being application money returned on rejected application for………shares)

At the time of Allotment:

(i) For making allotment due:
Share Allotment A/c Dr.
To Share Capital A/c
(Being allotment due on …..shares @ …………. per share)

(ii) For Adjustment of Excess Application Money:
Share Application A/c Dr.
To Share Allotment A/c
(Being Money on………shares @ ₹………per shares adjusted to the amount due on allotment)

(iii) For receipt of allotment money:
Bank A/c Dr.
To Share Allotment A/c
(Being allotment money received)

At the time of First Call:

(i) For making first call due:
Share First Call A/c Dr.
To Share Capital A/c
(Being first call money due on …. shares @ …….. per share)

(ii) For receipt of first call:
Bank A/c Dr.
To Share First Call A/c
(Being first call money received)

At the time of Second Call:

(i) For making second call due:
Share Second Call A/c Dr.
To Share Capital A/c
(Being second call money due on ...... shares @ ...... per share)

(ii) For receipt of second call:
Bank A/c Dr.
To Share Second Call A/c
(Being second call money received)

At the time of Third and Final Call:

(i) For making third and final call due:
Share Third and Final Call A/c Dr.
To Share Capital A/c
(Being third and final call money due on .... shares @ .... per share)

(ii) For receipt of Third and Final Call:
Bank A/c Dr.
To Share Third and Final Call A/c
(Being third and final call money received)

b. Issue of Shares at Premium: Issue of shares at a premium implies that shares are issued at a price which is more than their face value. *For example*, if a share of ₹ 100 is issued at ₹ 120, ₹ 20 will be the premium on share. As per the requirements of the Companies Act, 2013, the amount received on the securities premium shall be credited to Securities Premium Reserve Account. It is a capital receipt for the company.

According to Section 52(2) of the Companies Act, 2013, the amount of Securities Premium Reserve can be used only for the following purposes:

i. To issue fully paid-up bonus shares to the shareholders.
ii. To write off preliminary expenses of the companies.
iii. To write off the commission paid or expenses on issue of shares/debentures.
iv. To pay premium on the redemption of preference shares or debentures of the company.
v. Buy-back of equity shares and other securities as per Section 68.

Key Words

Share Premium: The amount by which the amount received by a company for a stock issue exceeds its face value.

Securities Premium Reserve: It is the additional amount charged on value of any share when shares are issued, redeemed or forfeited.

Journal Entries

(1) For making Allotment due with Premium:
Share Allotment A/c Dr.
To Share Capital A/c
To Securities Premium Reserve A/c
(Being amount due on share allotment with premium)

(2) For receipt of Allotment Money:
Bank A/c Dr.
To Share Allotment A/c
(Being share allotment money received)

- **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.
- **Oversubscription of Shares:** When the number of shares applied for is more than the number of shares offered for issue, it is known as oversubscription.
  The options available with the company to deal with money received on oversubscription are:
  (i) Board of Directors can make full allotment to some applicants and totally reject the others.
  (ii) They can make a pro-rata allotment. It means the proportion is determined by the ratio which the number of shares to be allotted bear to the number of shares applied for.
  (iii) They can adopt a combination of the above two alternatives.
- **Calls-in-Advance**
  A company can accept advance payment from any shareholder in respect of the shares held by them although calls have not been made on them, if it is authorized by its articles, *i.e.*, a shareholder may pay the whole or a part of the unpaid amount as calls-in-advance although it has not been called up. This is called Calls-in-Advance and a separate account having this title is opened.
  Then the calls are made, *i.e.*, due, then it is adjusted against the respective 'Calls A/c'. The company may pay interest on such ad-

Fundamental Fact

Berkshire Hathaway is the world's costliest stock, costing you over Rs. 2 crore.

vance from the date of advance received up to the date when it is due, which shall not be exceeding 12% per annum. In this regard, the following entries are made:

(1) For receipt of Calls-in-Advance:

Bank A/c Dr.
To Calls-in-Advance A/c
(Being amount received in advance for the ___ call)

(2) For adjustment of Calls-in-Advance:

Calls-in-Advance A/c Dr.
To Share …. Call A/c
(Being the calls in advance transferred to the ___ call)

Calls-in-Arrears

When a shareholder defaults to pay the amount of call due within a specified period, then the unpaid amount is called Calls-in-Arrears. It is not necessary to pass separate entry for the calls-in-arrears. But if there is an instruction to open a calls-in-arrears account, then the following entries shall be passed:

(1) For Amount unpaid on allotment:

Calls-in-Arrears A/c Dr.
To …. Share Allotment A/c
(Being amount not paid accrued on share allotment)

(2) For amount unpaid on calls:

Calls-in-Arrears A/c Dr.
To …. Share… Calls A/c
(Being amount not paid accrued on share ____ call)

(3) For receipt of arrears of allotment or calls money:

Bank A/c Dr.
To Calls-in-Arrears A/c
(Being amount not received on call/allotment duly received)

Issue of shares for consideration other than cash

A company may issue shares for consideration other than cash by acquiring some assets for running business or to the promoters for rendering services to the company. Such issue of shares is termed as issue of shares for consideration other than cash as there is no receipt of cash for the issue of shares.

Such issue may be either at par or at premium. The number of shares to be issued is calculated as follows:

$$\text{No. of shares to be issued} = \frac{\text{Amount Payable}}{\text{Issued price of share}}$$

These can be issued as fully paid shares for consideration other than cash, in the following circumstances:

(A) Issue of Shares to Promoters: A company may issue shares without cash to its promoters for the services rendered by them. The entry in this case will be:

Incorporation Expenses A/c Dr.
To Share Capital A/c
(Being fully paid shares issued to the promoters)

Incorporation or Formation Expenses Account is debited on the assumption that promoter's activities have resulted in forming the company into a profitable unit.

(B) Issue of Shares to Vendors: When a company purchases certain assets from vendor/supplier on credit, or when it purchases a business instead of making payment to vendor in cash, the company issues fully paid shares to the vendor. Shares may be issued to vendor at par or at premium. Following entries are passed in this case:

> **Key Word**
>
> **Promoters:** He/she is one who decides an idea for setting up a particular business at a given place and carries out a range of formalities required for the setting up a business.

(i) (a) For Purchase of Assets from Vendor:

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

(b) For Purchase of Business:

Sundry Asset A/c Dr.
Goodwill A/c Dr.
To Liabilities A/c
To Vendor's A/c
To Capital Reserve A/c
(Being business purchased)

(ii) For Issuing Shares to Vendor:

(a) At Par:

Vendor's A/c Dr.

To Share Capital A/c

(Being fully paid shares issued to vendor)

(b) 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)

Example 1

K Ltd. took over the assets of ₹ 15,00,000 and liabilities of ₹ 5,00,000 of P Ltd. for a purchase consideration of ₹ 13,68,500. ₹ 25,500 were paid by issuing a promissory note in favour of P Ltd. payable after two months and the balance was paid by issue of equity shares of ₹ 100 each at a premium of 25%.

Pass necessary Journal Entries for the above transactions in the books Of K Ltd.

Ans. Step 1. Calculation of profit or loss on purchase of a business:

Purchase consideration = 13,68,500

Value of the business = 15,00,000 - 5,00,000 = 10,00,000

Purchase consideration > Value of the business

Hence, the excess of purchase consideration (13,68,500 - 10,00,0000 = 3,68,500) will be debited to goodwill account.

Step 2: Calculation of number of shares to be issued to P Ltd.:

Purchase consideration = 13,68,500

bills payable issued = 25,500

Remaining amount of which shares are to be issued = 13,68,500 - 25,500 = 13,43,000

face value of each share = 100

Premium = 25 % of 100 = 25

number of shares issued = 13,43,000/125 = 10,744 shares

Step 3.

In the Books of K Ltd.

Journal Entries

Date	Particulars		L.F.	Amount Dr. (₹)	Amount Cr. (₹)
(i)	Sundry Assets A/c	Dr.		15,00,000	
	Goodwill A/c	Dr.		3,68,500	
	To Sundry Liabilities A/c				5,00,000
	To P Ltd.				13,68,500
	(Being Assets and Liabilities acquired)				
(ii)	P Ltd.	Dr.		13,68,500	
	To Bills Payable A/c				25,500
	To Equity Share Capital A/c				10,74,400
	To Securities Premium Reserve A/c				2,68,600
	(Being promissory note accepted and equity shares issued at a premium of 25%)				

► **Forfeiture of Shares:**

When a member fails to pay allotment or calls of the issue price of his shares within a stipulated time then the company has a power to cease his membership and forfeit his shares. Statutory provisions regarding forfeiture of shares:

Accounting Treatment

Following entries are passed in three alternative circumstances:

(1) Forfeiture of Shares issued at Par:

Share Capital A/c Dr. (amount called up so far)

To Share Allotment A/c (amount not received on allotment)

To Share Calls A/c (amount not received on calls)

To Shares Forfeiture A/c		(amount received so far)
(Being shares issued at par forfeited)		

(2) Forfeiture of Shares issued at Premium:

(a) If Premium has not been received:

Share Capital A/c	Dr.	(amount called up so far *Less* premium)
Securities Premium Reserves A/c	Dr.	(premium amount called up)
To Share Allotment A/c		(amount not received on allotment)
To Share Calls A/c		(amount not received on calls)
To Shares Forfeiture A/c		(amount received so far)
(Being shares issued at premium forfeited)		

(b) If Premium has been received:

Share Capital A/c	Dr.	(amount called up so far *Less* premium)
To Share Allotment A/c		(amount not received on allotment)
To Share Calls A/c		(amount not received on calls)
To Shares Forfeiture A/c		(amount received so far *Less* premium)
(Being shares issued at premium forfeited)		

The balance of Share Forfeiture Account is added to the capital under 'Subscribed Share Capital' in the Notes to Accounts of Share Capital, being part of Shareholders' Funds shown under Equity and Liabilities part of the Balance Sheet.

Reissue of Forfeited Shares

Forfeited shares may be re-issued at par, premium or discount or cancelled as per the provisions of the Articles of Association of the company. Normally the total amount is collected on discount. The amount of discount on re-issue should not exceed the amount already credited to Shares Forfeiture Account. Such discount shall be debited to Shares Forfeiture Account in place of Discount on Shares Account. Any balance in Forfeiture Shares Account, after reissue shall be transferred to Capital Reserve Account. If all forfeited shares are not reissued, proportionate amount shall be left in Share Forfeiture Account and the balance shall be transferred to Capital Reserve A/c.

Following journal entries are passed for reissue of forfeited shares:

(1) For re-issue of Forfeited Shares:

(a) If re-issued at par:

Bank A/c	Dr.	(with the amount received)
To….Share Capital A/c		
(Being forfeited shares re-issued at par)		

(b) If re-issued at a discount:

Bank A/c	Dr.	(with the amount received)
Share Forfeiture A/c	Dr.	(with the discount on re-issue)
To ……. Share Capital A/c		(with the paid-up value of shares)
(Being forfeited share re-issued at a discount)		

(c) If re-issued at premium:

Bank A/c	Dr.	(with the total amount received)
To ….Share Capital Reserve A/c		(with the paid-up value of shares)
To Securities Premium Reserve A/c		(with the amount of premium)
(Being forfeited shares re-issued at a premium)		

(2) For transfer of balance of forfeited share account to capital reserve:

Share Forfeiture A/c	Dr.	
To Capital Reserve A/c		
(Being the balance of forfeited share transferred to the capital reserve account)		

Example 2

Rolga Ltd. is having an authorised capital of ` 50,00,000 divided into equity shares of ` 100 each. The company offered 40,000 shares to the public. The amount payable was as follows:

On Application	–	₹ 30 per share
On Allotment	–	₹ 40 per share (including premium)
On First and Final Call	–	₹ 50 per share

Applications were received for 40,000 shares.

All sums were duly received except the following:

Lal, a holder of 100 shares did not pay allotment and call money.

Pal, a holder of 200 shares did not pay call money.

The company forfeited the shares of Lal and Pal. Subsequently, the forfeited shares were reissued for ₹ 70 per share as fully paid-up. Show the entries for the above transactions in the Journal of the company.

Ans.

Books of Rolga Ltd.
Journal Entries

S. No.	Particulars	L.F.	Dr. Amount (₹)	Cr. Amount (₹)
(1)	Bank A/c Dr. To Equity Share Application A/c (Being application money received on 40,000 shares)		12,00,000	 12,00,000
(2)	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being application money transferred to share capital A/c)		12,00,000	 12,00,000
(3)	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium/Securities Premium Reserve A/c (Being equity share allotment made)		16,00,000	 8,00,000 8,00,000
(4)	Bank A/c Dr. Calls-in-Arrears A/c Dr. To Equity Share Allotment A/c (Being allotment money received except on 100 shares)		15,96,000 4,000	 16,00,000
(5)	Equity Share First Call A/c Dr. To Equity Share Capital A/c (Being first call money due on 40,000 shares)		20,00,000	 20,00,000
(6)	Bank A/c Dr. Calls-in-Arrears A/c Dr. To Equity Share First Call A/c (Being first call money received except on 300 shares)		19,85,000 15,000	 20,00,000
(7)	Equity Share Capital A/c Dr. Securities Premium/Securities Premium Reserve A/c Dr. To Share Forfeiture A/c To Equity Share Allotment A/c To Equity Share First Call A/c / Calls-in-Arrears A/c (Being 300 shares forfeited)		30,000 2,000	 13,000 4,000 15,000
(8)	Bank A/c Dr. Share Forfeiture A/c Dr. To Equity Share Capital A/c (Being forfeited shares reissued)		21,000 9,000	 30,000
(9)	Share Forfeiture A/c Dr. To Capital Reserve A/c (Being gain on forfeiture of reissued shares transferred)		4,000	 4,000

- **Private Placement of Shares:** Private placement means any offer of securities or invitation to subscribe securities to a selected group of persons through issue of a private placement offered by a company (other than public subscription). As per the provisions of Section 23 of Companies Act, 2013, both public and private company can issue shares through private placement.

Disclosure of Share Capital in the Company's Balance Sheet: As per Schedule III of the Companies Act, 2013, share capital is required to be disclosed in a Company's Balance Sheet in the following manner:

Balance Sheet

Particulars	Note No.	Figures as at the end of current year (₹)	Figures as at the end of previous year (₹)
I. Equity and Liabilities			
1. **Shareholders' Funds:**			
(a) Share Capital			
(b) Reserves and Surplus			
(c) Money Received Against Share Warrants			

Note: According to Schedule III of the Companies Act, 2013, disclosure requirements pertaining to share capital are to be provided in Notes to Accounts as given below:

Notes to Accounts

Particulars	Amount (₹)	Amount (₹)
(1) Share Capital		
Authorised Capital:		
.....Equity Shares of ₹...... each		
......Preference Shares of ₹ .... each		
Issued Capital:		
..... Equity Shares of ₹ .... each		
...... Preference Shares of ₹ .... each		
Subscribed Capital:		
Subscribed and Fully paid-up:		
...... Equity Shares of ₹ ..... each		
.... Preference Shares of ₹ .... each		
(Of the above shares .... shares are allotted as fully paid-up pursuant to a contract without payment in cash)		
Subscribed but not fully paid-up:		
...... Equity Shares of ₹ .... each, ₹ .... per share called-up		
Less: Calls- in-Arrears		
.... Preference Shares of ₹ .... each, ₹ .... called up		
Less: Calls- in-Arrears		
(i) By Directors ₹		
(ii) By others ₹		
Add: Forfeited Shares		
Amount to be shown in the Balance Sheet		

CHAPTER-7

ACCOUNTING FOR DEBENTURES

Revision Notes

- **Meaning of Debenture:**

  If a company needs funds for extension and development purpose without increasing its share capital, it can borrow from the general public by issuing certificates for a fixed period of time and at a fixed rate of interest. Such a loan certificate is called a debenture.

- **Features of Debentures:**

  (1) Debenture holders are the creditors of the company carrying a fixed rate of interest.

(2) Debenture is redeemed after a fixed period of time.
(3) Debentures may either be **secured** or **unsecured**.
(4) Interest payable on a debenture is a charge against profit and hence it is a tax deductible expenditure.
(5) Debenture holders do not enjoy any voting right.
(6) Interest on debenture is payable even if there is a loss.
(7) Debenture holders can apply for winding up of the company to safeguard their interests.

Key Words

Secured debentures: Debentures issued with collateral

Unsecured debentures: Debentures issued without any collateral.

Different Types of Debentures:

A company can issue different types of debentures for raising funds for long-term purposes. Some of them are as follows:

(1) **Ordinary Debentures:** Such debentures are issued without mortgaging any asset, *i.e.*, this is unsecured. It is very difficult to raise funds through ordinary debentures.
(2) **Mortgage Debentures:** This type of debenture is issued by mortgaging an asset and debenture holders can recover their dues by selling that particular asset in case the company fails to repay the claim of debenture holders.
(3) **Non-convertible Debentures:** A non-convertible debenture is a debenture, where there is no option for its conversion into equity shares. Thus, the debenture holders remain debenture holders till maturity.
(4) **Partly Convertible Debentures:** The holders of partly convertible debentures are given an option to convert part of their debentures. After conversion they will enjoy the benefit of both debenture holders as well as equity shareholders.
(5) **Fully Convertible Debentures:** Fully convertible debentures are those debentures which are fully converted into specified number of equity shares after predetermined period at the option of the debenture holders.
(6) **Redeemable Debentures:** Redeemable debenture is a debenture which is redeemed/repaid on a predetermined date and at a predetermined price.
(7) **Registered Debentures:** Registered debentures are those debentures, where names, address, etc. of the debenture holders are recorded in the register book of the company. Such debentures cannot be easily transferred to another person.
(8) **Unregistered Debentures:** Unregistered debentures may be referred to those debentures which are not recorded in the company's register book. Such a type of debenture is also known as bearer debenture and this can be easily transferred to any other person.
(9) **Specific Coupon Rate Debentures:** These debentures are issued with a specified rate of interest, which is called the coupon rate. The specified rate may either be fixed or floating. The floating interest rate is usually tagged with the bank rate.
(10) **Zero Coupon Rate Debentures:** These debentures do not carry a specific rate of interest. The difference between substantial discount and the nominal value and issue price is treated as amount of interest.

Over Subscription:

The company invites the investors to subscribe its debenture issue. However, it may happen that the applications received for the debentures may be more than the original number of debentures offered. This scenario is referred to as over-subscription. In case of over-subscription, a company cannot allot more debentures than it had originally planned to issue. So, the company refunds the money to the applicants to whom debentures are not allotted.

However, the excess money received from applicants who are allotted debentures is not refunded. The same money is used towards allotment adjustment and the subsequent calls to be made.

Issue of Debentures:

The procedure of issuing debentures by a company is similar to the one followed while issuing equity stocks. The company starts by releasing a prospectus declaring the debenture issuance. The interested investors, then, apply for the same. The company may need the entire amount while applying for the debentures or may ask for instalments to be paid while submitting the application, on allotment of debentures or on various calls by the company. The company can issue debentures at par, at premium or at discount as explained below:

Different Ways for Issuing of Debenture:

Once the company invites the applications and the investors apply for the debentures, the company can issue debentures in one of the following ways:

(1) **Issue of Debenture at Par:**

When the issue price of the debenture is equal to its face value, the debenture is said to be issued at par. When a debenture is issued at par, the long-term borrowings in the liabilities section of the balance sheet equals the cash in the assets side of the balance sheet.

(2) Issue of Debenture at Discount:

The debenture is said to be issued at a discount when the issued price is below its nominal value. Let us take an example – A ₹100 debenture is issued at ₹90, then ₹10 is the discount amount. The 'discount on debentures' issuance is noted as a capital loss and is charged to 'Securities Premium Account' and is reflected as an asset. The discount can be written off later.

► **Issue of Debenture at Premium:**

When the price of the debenture is more than its nominal value, it is said to be issued at a premium. For example, A ₹100 debenture is issued for ₹105 and ₹5 is the premium amount. The premium amount is credited to Securities Premium Reserve and is reflected under 'Reserves and Surplus' on the liabilities side of the balance sheet.

► **Accounting Entries for Issue of Debentures for Cash:**

(i) When Debenture Amount is received in Lump-sum:

When Application Money is received	Bank A/c Dr. To Debenture Application and Allotment A/c	With the application money received
On Allotment of Debentures	Debenture Application and Allotment A/c Dr. To Debentures A/c	With the amount of application money on the allotted debentures
On Refund of Excess Application Money	Debenture Application and Allotment A/c Dr. To Bank A/c	With the application money refunded

(ii) When Debenture Amount is received in Instalments:

(a) When Applications are received	Bank A/c Dr. To Debenture Application A/c	With the application money received
(b) When Applications are accepted	Debenture Application A/c Dr. To ....% Debentures A/c	With the amount of application money on the allotted debentures
(c) When allotment money is due	**(i) When issued at Par:** Debenture Allotment A/c Dr. To .....% Debentures A/c **(ii) When issued at Premium:** Debenture Allotment A/c Dr. To ...% Debentures A/c To Securities Premium Reserve A/c **(iii) When issued at Discount:** Debenture Allotment A/c Dr. Discount on Issue of Debentures A/c Dr. To......% Debentures A/c	With the amount due on allotment of debentures
(d) When Excess Debenture Application money is adjusted	Debenture Application A/c Dr. To Debenture Allotment A/c	With the surplus application money adjusted on application
(e) When Excess Debenture Application money is refunded	Debenture Application A/c Dr. To Bank A/c	With the application money refunded on rejected applications
(f) When Allotment money is received	Bank A/c Dr. To Debenture Allotment A/c	With the amount actually received on allotment
(g) (i) When Calls are made	Debenture Call A/c Dr. To ....% Debentures A/c	With the money due on a particular call
(ii) When Call money is received	Bank A/c Dr. To Debenture Call A/c	With the amount received on a particular call

► **The Issue of Debenture as Collateral Security:**

Meaning: The term 'collateral security' implies additional security given for a loan. Where a company obtains a loan from a bank or insurance company and the security offered to the company is not sufficient, the company may issue its own debentures to the lender as collateral security against the loan. In such a case, the lender has the absolute right over the debentures until and unless the loan is repaid.

On repayment of the loan, however, the lender is legally bound to release the debentures forthwith. But in case, the loan is not repaid by the company on the due date or in the event of any other breach of agreement, the lender has the right to retain these debentures and to realize them. The lender is entitled to interest only on the amount of loan, but not on the debentures issued as collateral security.

When debentures are issued as a collateral security, there are options for treatment in the accounting books:

(i) First Option:

In this case, company does not record such issue of debentures. No journal entry is made in the books of accounts for issue of such debentures. A note is appended below the loan on the liabilities side of the balance sheet to the fact that they have been secured by the issue of debentures.

This will be shown in the balance sheet as follows:

Balance Sheet (Extract)

Particulars	Note No.	Current Year	Previous Year
I. EQUITY AND LIABILITIES			
Non-current Liabilities:			
Long-Term Borrowings			
Debentures			
(In addition, debentures for ₹... have been issued as collateral security)			
Loan			
(Secured by the issue of debentures of ₹............ as collateral security)			

(ii) Second Option:

In this case, company records such issue of debentures in the books and following journal entry is passed:

Debenture Suspense A/c Dr.

To Debentures A/c

(Being Debenture suspense Account created for the issue of debentures as collateral security)

(With nominal value of debentures)

The Debenture Suspense Account will appear on the assets side of the balance sheet and Debentures on the liabilities side. When the loan is re-paid the entry is reversed in order to cancel it.

► **Accounting Treatment of Interest on Debentures:**

Interest on Debentures:

Interest paid is the reward to the debenture holders for investing in the debentures of the company. Interest is paid periodically at a predetermined fixed rate on the face value of debentures and is treated as a charge against profits.

The Journal Entries are as follows:

For recording interest due:

Interest A/c Dr.

To Debenture holders' A/c

(Being the entry for interest due)

For making payment to debenture holders:

Debenture holders' A/c Dr.

To Bank A/c

(Being the entry for payment of interest)

For transferring interest to Statement of Profit & Loss:

Statement of Profit & Loss Dr.

To Interest A/c

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

No interest is payable on debentures issued as collateral securities:

- Interest accrued and due on debentures appear under the head 'Secured Loans'.
- Interest accrued but not due on debentures appear under the head 'Current Liabilities'.

Issue of Debentures with conditions Stipulated to their Redemption:

Journal Entry

1. **Issued at Par and redeemable at Par:**

(i) On receipt of application money:

Bank A/c Dr.

To Debentures Application and Allotment A/c

(Being application money received on ….. % Debentures at ₹ …. each)

(ii) On transfer of application money to Debentures Account:

Debenture Application and Allotment A/c Dr.
To .... % Debentures A/c
(Being debentures issued at par, redeemable at par)

2. Issued at Discount and redeemable at Par:

(i) On receipt of application money:

Bank A/c Dr.
To Debenture Application and Allotment A/c
(Being application money received on ..... % Debentures at ₹ .... each)

(ii) On transfer of application money to Debentures Account:

Debenture Application and Allotment A/c Dr.
Discount on Issue of Debentures A/c Dr.
To ..... % Debentures A/c
(Being debentures issued at discount, redeemable at par)

3. Issued at Premium and redeemable at Par:

(i) On receipt of application money:

Bank A/c Dr.
To Debenture Application and Allotment A/c
(Being application money received on ..... % Debentures at ₹ .... each)

(ii) On transfer of application money to Debentures Account:

Debenture Application and Allotment A/c Dr.
To ..... % Debentures A/c
To Securities Premium Reserve A/c
(Being debentures issued at premium, redeemable at par)

4. Issued at Par and redeemable at Premium:

(i) On receipt of application money:

Bank A/c Dr.
To Debenture Application and Allotment A/c
(Being application money received on ..... % Debentures at ₹ .... each)

(ii) On transfer of application money to Debentures Account:

Debenture Application and Allotment A/c Dr.
Loss on Issue of Debentures A/c Dr.
To ..... % Debentures A/c
To Premium on Redemption of Debentures A/c
(Being debentures issued at par, redeemable at premium)

5. Issued at Discount and redeemable at Premium:

(i) On receipt of Application money:

Bank A/c Dr.
To Debenture Application and Allotment A/c
(Being application money received on ..... % Debentures at ₹ .... each)

(ii) On transfer of Application money to Debentures Account:

Debenture Application and Allotment A/c Dr.
Discount of Issue of Debentures A/c Dr.
Loss on Issue of Debentures A/c Dr.
To ..... % Debentures A/c
To Premium on Redemption of Debentures A/c
(Being debentures issued at discount, redeemable at premium)

6. Issued at Premium and redeemable at Premium:

(i) On receipt of Application money:

Bank A/c Dr.
To Debenture Application and Allotment A/c
(Being application money received on ..... % Debentures at ₹ .... each)

(ii) On transfer of Application money to Debentures Account:

Debenture Application and Allotment A/c Dr.
Loss on Issue of Debentures A/c Dr.
To ..... % Debentures A/c
To Premium on Redemption of Debentures A/c
To Securities Premium Reserve A/c
(Being debentures issued at premium, redeemable at premium)

- **Issue of Debentures for Consideration other than cash:**

When debentures are issued to vendors against purchase of assets or against purchase of business, it is termed as issue of debentures for consideration other than cash. The debentures can be issued at a par, premium or discount and are accounted for in the similar fashion.

(1) Issue of Debentures to the Vendor for Purchase of Assets:

It may so happen that the company acquires some assets from the vendor and instead of paying the vendor in cash, the company may allot debentures in payment of purchase consideration. In such a case, the accounting entries will be as follows:

(i) For acquisition of assets:

Sundry Assets (Individually) A/c Dr. (with the value of assets)
To Vendor's A/c (with the purchase price)
(Being assets given to vendor)

Notes:

(a) If the value of debentures allotted is more than the agreed purchase price, the difference is debited to Goodwill Account.

(b) Similarly, if the value of debentures allotted is less than the agreed purchase price, credited to Capital Reserve Account.

Key Word

Vendor: A person or company offering something for sale.

(ii) On Allotment of Debentures:

(a) On allotment of debentures (at par):

Vendor's A/c Dr.
(with the value of debentures)
To Debentures A/c
(Being debenture allotted to the vendor)

(b) On allotment of debentures (at premium):

Vendor's A/c Dr. (with the purchase price)
To Debentures A/c (with the nominal value)
To Securities Premium Reserve A/c (with the amount of premium)
(Being debentures allotted to the vendor at premium)

(c) On allotment of debentures (at discount):

Vendor's A/c Dr. (with the amount of purchase)
Discount on Issue of Debentures A/c Dr. (with the amount of discount)
To Debentures A/c (with the nominal value)
(Being debentures allotted to the vendor on discount)

(2) Issue of Debentures to the Vendor for Purchase of Business:

Sometimes a company purchases a running business (its assets and liabilities both) and issues debentures to vendor as purchase consideration.

(i) When Purchase Consideration is equal to Net Assets:

Sundry Assets A/c Dr.
To Sundry Liabilities A/c
To Vendor's A/c
(Being purchase of business from the vendor company)

(ii) When Purchase Consideration is more than the Net Assets:

In this case, difference between purchase consideration and net assets is treated as Goodwill, which can be calculated as:

(a) Net Assets = Sundry Assets taken – Sundry Liabilities

(b) Goodwill = Purchase Consideration – Net Assets

Journal Entry:

Sundry Assets A/c Dr.
Goodwill A/c (Amount of difference) Dr.
To Sundry Liabilities A/c
To Vendor Company A/c
(Being purchase of business from vendor company)

(iii) When Purchase Consideration is less than Net Assets:

If purchase consideration is less than the net assets, the difference is treated as Capital Reserve, which can be calculated as:

(a) Net Assets = Sundry Assets taken – Sundry Liabilities

(b) Capital Reserve = Net Assets – Purchase Consideration

Journal Entry:

Sundry Assets A/c Dr.
To Sundry Liabilities A/c
To Capital Reserve A/c (Amount of difference)
To Vendor Company A/c
(Being business purchased from vendor company)

Example 1

C India Ltd. purchased machinery from B India Ltd. Payment to B India Ltd. was made as follows:

(i) By issuing 10,000 equity shares of ₹10 each at a premium of 20%.

(ii) By issuing 1000, 9% debentures of ₹100 each at a discount of 5%.

(iii) Balance by giving a bank draft of ₹37,000.

Pass the necessary journal entries in the books of C India Ltd. for the purchase of machinery and payment to B India Ltd.

Ans. **In the books of C India Ltd.**
Journal Entries

S. No.	Particulars	L.F.	Amount Dr. (₹)	Amount Cr. (₹)
(i)	Machinery A/c Dr. To B India Ltd. (Being machinery purchased from B India Ltd.)		2,52,000	 2,52,000
(ii)	B India Ltd. Dr. To Equity Share Capital A/c To Securities Premium Reserve A/c (Being 10,000 equity shares of ₹10 each issued at 20% premium)		1,20,000	 1,00,000 20,000
(iii)	B India Ltd. Dr. Discount on Issue of Debentures A/c To 9% Debentures A/c (Being 1000, 9% debentures of ₹100 each issued at 5% discount)		95,000 5,000	 1,00,000
(iv)	B India Ltd. Dr. To Bank A/c (Being balance payment made by giving a bank draft)		37,000	 37,000

Working Note:

Machinery purchased from B Ltd. of ₹2,52,000 (1,20,000 + 95,000 + 37,000)

Part-B Financial Statement Analysis
Unit 3 Analysis of Financial Statements
CHAPTER 8
FINANCIAL STATEMENT OF A COMPANY

Revision Notes

- **Financial Statements**: Financial statements are the end products of accounting process which reveal the financial results of a specified period and financial position as on a particular date. These statements include income statement and balance sheet. The basic objective of these statements is to provide information required for decision making by the management as well as other outsiders who are interested in the affairs of the undertaking, as per Section 129 Schedule III to the Companies Act, 2013 every year.

- **Nature of Financial Statements:**
  (1) First record facts in monetary form
  (2) Application of accounting conventions
  (3) Application of accounting postulates
  (4) Dependency on personal opinions and judgments

Fundamental Fact

As a management tool, financial statements are irrelevant without an explanation.

- **Uses of Financial Statements:**
  (1) As a report of **stewardship**;
  (2) As a basis for **fiscal policy**;
  (3) To determine the legality of **dividends**;
  (4) As guide to advise dividend action;
  (5) As a basis for the granting of credit;
  (6) As informative for prospective investors in an enterprise;
  (7) As a guide to the value of investment already made;
  (8) As an aid to government supervision;
  (9) As a basis for price or rate regulation;
  (10) As a basis for taxation.

- **Importance of Financial Statements:**

The utility of financial statements to different parties is discussed in detail as follows:

(1) **Management:** Financial statements are useful in evaluating the effectiveness of different cost centres. Managers can control costs through these statements. Efficient and inefficient areas are notified by management. Managers can decide which course of action to take next.

(2) **Creditors:** Commercial debt should be paid on a short-term basis. This liability is met out of current assets. The creditors will be interested in current solvency of the concern. Creditors can assess the current financial position of the concern by calculating current ratio and liquid ratio.

Key Words

Stewardship: The job of supervising is taking care of something, such as organisation or property.

Fiscal Policy: The use of government spending and taxation to influence the economy is known as fiscal policy.

Dividend: A distribution of cash or stock to a class of shareholders in a company in return of their investment is known as dividend.

(3) **Bankers:** The banker is interested in ensuring that the loan amount is secured and the customer is able to pay interest on a regular basis. The banker will analyse the balance sheet to determine the financial viability of the concern and the profit and loss account will also be analysed to determine earning status.

(4) **Investors:** Investors include both short-term and long-term investors. They are interested in the security of the principal amount of the loan and the interest rate payments with concern. Investors will learn the long-term solvency of concern with the help of financial statements. Investors will not only analyse the current financial situation but will also study future prospects and plans for expansion of the business. Opportunities to repay a loan when the concern is liquidated are also considered.

(5) **Government:** Financial statements are used to assess corporate tax liability. The government uses financial statements to study economic situation of the country. These statements enable the government to determine whether a business complies with various laws and regulations. These statements also form the basis for formulating and amending the various rules of business governance.

(6) **Trade Associations:** These associations provide assistance and protection to members. They may analyse financial statements in order to provide services to these members. They may develop standard ratios and design a similar account system.

(7) **Stock Exchange:** The stock exchanges deal in purchase and sale of securities of different companies. The financial statements enable the stock brokers to judge the financial position of different concerns. The fixation of prices for securities, etc., is also based on these statements.

PART-I: BALANCE SHEET

Balance Sheet as at 31st March, 20………

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of the 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) Long-term Provisions			
(d) Other Long-term Liabilities			
(4) Current Liabilities:			
(a) Short-term Borrowings			
(b) Trade Payables			
(c) Other Current Liabilities			
(d) Short-term Provisions			
Total			
II. ASSETS			
(1) Non-current Assets:			
(a) Fixed Assets:			
(i) Tangible Assets			
(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			

PART-II – STATEMENT OF PROFIT AND LOSS

Name of the Company……………………..

Profit & Loss Statement for the year ended 31st March, 20...................

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of the previous reporting period (₹)
I INCOME			
(i) **Revenue from Operations (Gross)**			
(ii) **Other Income**			
Total Revenue (i+ii)			

II. **Expenses**:			
(a) Cost of materials consumed			
(b) Purchases of stock-in-trade			
(c) Changes in inventories of finished goods, work-in progress and stock-in-trade			
(d) Employee benefits expenses			
(e) Finance costs			
(f) Depreciation and amortisation expenses			
(g) Other expenses			
Total Expenses			
III Profit before tax (I –II)			
(i) **Tax Expense**:			
(i) Current tax expense for current year			
(ii) Deferred tax			
IV Profit / Loss for the period (III –II)			
Earnings per equity share:			
(1) Basic			
(2) Diluted			

Explanation of Items:

Equity and Liabilities Side

Shareholders' Funds

(A) **Share Capital**: Shares issued by the company for subscription purposes and money received against the issued shares is called 'share capital'. As per Schedule III of Companies Act, 2013, the Balance Sheet must disclose authorized capital, issued capital and subscribed capital for each class of share capital (*i.e.* for both Equity and Preference Shares) besides the called-up amount made by the company and paid-up amount made by the shareholders. Share capital may be classified as:

(1) Authorised or Nominal Capital,

(2) Issued Capital,

(3) Subscribed Capital,

  (a) Subscribed and fully paid-up

  (b) Subscribed but not fully paid-up

(4) Called-up Share Capital

(5) Paid-up Share Capital

It is important that details required by the schedule should be given in the Notes to Accounts.

In the Balance Sheet, the Share Capital will be presented as under:

Balance Sheet

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			

Other information related to Share Capital will be disclosed in Notes to Accounts as follows:

Notes to Accounts

Particulars	Amount (₹)	Amount (₹)
(1) Share Capital		
Authorised Capital:		
…..Equity Shares of ₹…….. each		
…..Preference Shares of ₹……..each		
Issued Capital:		
…..Equity Shares of ₹……...each		
…..Preference Shares of ₹……..each		
Subscribed Capital:		
Subscribed and Fully paid-up:		
….Equity Shares of ₹……….each		
…..Preference Shares of ₹……..each		
(of the above shares ………… shares are allotted as fully paid-up pursuant to contract without payment in cash)		
Subscribed but not Fully paid-up:		
…….Equity Shares of ₹……...each, ₹…….per share called-up		
Less: Calls-in-Arrears		
…….Preference Shares of ₹…….. each, ₹……called up		
Less: Calls-in-Arrears		
(i) By Directors ₹………….		
(ii) By Others ₹………….		
Add: Forfeited Shares		
Amount to be shown in the Balance Sheet		

(B) Reserves and Surplus: Reserves are the amount set aside out of profits and surplus to meet prospective losses and future uncertainties strengthening the financial position of the company.

Surplus is the amount of accumulated profit (*i.e.*, balance in Statement of Profit & Loss) which may be appropriated towards reserves and for payment of dividend. Surplus may have a credit or debit balance. Current year's profit or loss is adjusted to the balance brought forward from which appropriation towards other reserves and dividend is made.

Reserves and Surplus shall be classified as:

(1) Capital Reserve
(2) Securities Premium Reserve
(3) Capital Redemption Reserve
(4) Debenture Redemption Reserve
(5) Revaluation Reserve
(6) Share Options Outstanding Account
(7) Other Reserves (specify the nature of each reserve and the amount in respect thereof)
(8) Surplus, *i.e.*, Balance in Statement of Profit & Loss.

A reserve specifically represented by earmarked investments must be termed as a 'fund'. Debit balance of Surplus, *i.e.*, Balance in Statement of Profit & Loss shall be shown as a negative figure under the head 'Reserves and Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

► **Non-current Liabilities**:

According to the Companies Act, 2013, Non-current liabilities to be classified into:

(1) Long-term Borrowings
(2) Deferred Tax Liabilities (Net)
(3) Other Long-term Liabilities
(4) Long-term Provisions.

(1) Long-term Borrowings: A company's long-term debt or liability, consists of items that expect to take longer than a year to pay off. Long-term liabilities differ from current liabilities, which a company expects to pay back within one year.

(2) Loans and Advances: A loan, or note, represents money a business owes to a lender, such as a bank. *For example*, a small business might have a ₹20,000, five-year loan that it pays down gradually with each payment. A business reports loans or notes as "loans payable" or "notes payable" in the balance sheet.

(i) **Bonds**: A bond is an instrument a company sells to investors to raise money. A company might sell multiple bonds at one time, with each bond carrying a certain denomination. A business reports its outstanding bonds as "bonds payable" on its balance sheet.

(ii) **Capital Leases**: A lease represents an agreement to use an asset, such as a machine, in exchange for making payments to the party who owns the asset. A capital lease is one in which the characteristics of the agreement are similar to a purchase. In a Capital Lease Agreement, the lessor agrees to transfer the ownership rights to the lessee after the completion of the lease period.

(iii) **Deferred Taxes**: The amount of deferred taxes, a company reports on its balance sheet, represents the money it owes for future income taxes. *For example*, your small business might use a different depreciation method on your financial statements than on your income taxes, which might create a future tax liability.

(3) **Other Long-term Liabilities**: These are of two types:

(i) **Trade Payable**: Trade payable have been defined in Schedule III of Companies Act, 2013 as follows: "Trade payable are the amounts payable for goods purchased and services taken in the normal course of business." It includes both sundry creditors and bills payable.

(ii) **Other Payable:** *Examples*—Purchase of fixed asset and interest, premium payable on redemption of debentures.

(4) **Long-term Provisions**: These are the provisions for which related claims are to be settled after 12 months of the date of Balance Sheet or after the period of operating cycle. *For example*: provision for employees benefits, provision for warranties, etc.

► **Current Liabilities**: Current liabilities are what a company currently owes to its suppliers and creditors. These are short-term debts, all due in less than a year. Paying them off normally requires the company to convert some of its current assets into cash.

There are five major categories of current liabilities:

(i) Accounts payable
(ii) Accrued expenses
(iii) Income tax payable
(iv) Short-term loans payable
(v) Portion of long-term debt payable

(i) **Accounts Payable**: This is the money the company currently owes to its suppliers, partners, and employees.

(ii) **Accrued Expenses and Payroll as a Current Liability**: The company has racked up these bills, but not yet paid them. These are normally marketing and distribution expenses that are billed on a set schedule and have not yet become due.

(iii) **Income tax payable**: This is a specific type of accrued expense — the income tax, a company accrues over the year, but does not have to pay yet, according to various federal, state and local tax schedules. Although they're subject to withholding. Some taxes simply are not accrued by the government over the course of the quarter or the year. Instead, they're paid in lump sum whenever they are due.

(iv) **Short-term loans payable**: The company has drawn off this amount from its line of credit from a bank or other financial institution. It needs to be repaid within the next 12 months.

(v) **Portion of long-term debt payable**: This represents a chunk of a company's longer-term obligations that may become due in a given year or quarter. That's why it's counted as a current liability, even though it's called "long-term".

Assets Side

Non-Current Assets: As per the Companies Act, 2013, "Non-current assets are those assets which are not current assets."

Long-term Assets are the ones the company will hold for more than one year. Typical examples of long-term assets are investments and property, plant and equipment currently in use by the company in day-to-day operations.

(i) **Fixed assets**: This category is the company's property, plant, and equipment. The account includes long-lived assets, such as a car, land, buildings, office equipment, and computers.

(ii) **Long-term Investments**: These investments are assets held by the company, such as bonds, stocks, or notes.

(iii) **Intangible Assets**: These assets lack of physical presence. Patents, trademarks, and goodwill are classified as intangible assets.

(iv) **Capital Work-in-progress**: Includes those fixed assets which are in the process of being constructed by the company.

Deferred Tax Assets (Net): Deferred tax assets arise when the tax amount has been paid or has been carried forward but has still not been recognised in the income statement. The value of deferred tax asset is created by taking the difference between the book income and the taxable income. *For example*, a case of deferred tax may arise if the tax authority recognizes revenue or expenses at different points of time than that set by an accounting standard. Any deferred tax asset is useful in plummeting the company's future tax liability.

Long-term Loans and Advances: A type of loan that has an extended time period for repayment usually lasting between 3 and 30 years. Car loans and home mortgages are examples of long-term loans. Whereas advances are the funds provided by the banks, which needs to be payable within one year.

These are classified into:

(i) Capital Advances

(ii) Security Deposits

(iii) Other Loans and Advances (nature to be specified).

Characteristics of Ideal Financial Statements:

The ideal financial statements should have the following characteristics:

(1) **True Financial Position**: All the information mentioned in the financial statement must be true and correct so that it is easy to know the financial position of the business. At the time of preparing these statements, no information should be withheld.

(2) **Effective Presentation**: Presentation plays a very important role to make the financial statement clear to everyone. It is very necessary to present the financial statements in a clear, simple and logical form so that it can be easily understood. It is better to avoid using difficult accounting terminology, so that a man with less knowledge of accounting can also understand it.

(3) **Brief**: The financial statements should be prepared in brief so that it is easy for the user to understand the facts and figures correctly.

(4) **Attractive**: It is good to underline and bold the important information in the financial statements to easily attract the user.

(5) **Comparability**: The financial statement should be prepared in such a way that the result can be compared to the previous year's statements. It is also in such a way so that it is easy to compare figures with the other businesses of same nature.

(6) **Analytical Representation**: Analytical representation of financial statements is very helpful in analysis and interpretation of data.

CHAPTER-9
COMPARATIVE AND COMMON SIZE STATEMENTS

Revision Notes

- **Analysis of Financial Statements :** Analysis of financial statements implies or means a thorough, systematic, comprehensive and critical examination of the information contained in the financial statements in order to understand them better and take decision on them after drawing meaningful conclusions, take planned steps towards development and secure the future of the organization.
- **Objectives of Financial Statements Analysis :**
  1. Financial Statements Analysis presents financial data in a simplified and understandable form, so that meaningful conclusions can be drawn from it.
  2. Financial analysis helps in assessing the profitability positions and operational efficiency of the firm as a whole as well as of its various departments so as to judge the financial health of the organization.
  3. Financial analysis helps in ascertaining the relative importance of different components of financial position (such as assets, liabilities, owners' equity etc.) of the firm.
  4. It helps in making intra-firm and inter-firm comparisons.
  5. It helps in identifying the causes for change in profitability of financial positions of the firm.
  6. Financial Statements Analysis helps in assessing future trends and thus, helps in Forecasting and Preparation of budgets.
- **Limitations of Financial Statements Analysis :**
  (1) Financial statements analysis ignores the qualitative information like quality of management, labour force, public relation, etc.
  (2) The analysis of financial statements does not disclose the current worth of the business. The financial statements of the company are prepared on cost principle.
  (3) In many situations, accountant has to make a choice out of various alternatives available. He may choose that alternative which may be beneficial to the company. In such case, the financial statements are not free from bias.
  (4) Different firms may follow different accounting policies. This may create difficulty in comparing the results of two companies.

- **Tools for Analysis of Financial Statements :** Analysis of Financial Statements can be carried out by using the following tools :
  (1) Comparative Statements (Horizontal Analysis)
  (2) Common Size Statements (Vertical Analysis)
  (3) Ratio Analysis
  (4) Cash Flow Statements.
- **Comparative Statements :** Comparative statements compare financial data at two points of time and help in deriving meaningful conclusions regarding the changes in financial position and operating results. Statements showing financial data for two or more years, placed side by side to facilitate comparison are called Comparative Financial Statements.
  (A) 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 sheets of the same business enterprise on different dates."
  The Comparative Balance Sheet shows increase and decrease in absolute terms as well as in percentage in various assets, liabilities and capital and thus, provides information regarding progress of the business firm.
  Format of comparative balance sheet is given below :

Comparative Balance Sheet of .... Ltd.
as at ....

Particulars	Note No.	Previous Year (₹)	Current Year (₹)	Absolute Change (₹)	Percentage Change (%)
1		2	3	4	5
		A	B	(B – A) = C	C/A × 100 = D
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds :					
(a) Share Capital					
(b) Reserves and Surplus					
2. Non-current Liabilities :					
(a) Long-term Borrowings					
(b) Other Long-term Liabilities					
(c) Long-term Provisions					
3. Current Liabilities :					
(a) Short-term Borrowings					
(b) Trade Payables					
(c) Other Current Liabilities					
(d) Short-term provisions					
Total					
II. ASSETS					
1. Non-current Assets :					
(a) Fixed Assets :					
(i) Tangible Assets					
(ii) Intangible Assets					
(b) Non-current Investments					
(c) Long-term Loans and Advances					
(d) 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					

(B) 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 formulating effective planning. The generally accepted format of the Comparative Income Statement is given below:

Comparative Statement of Profit and Loss
for the years ended...

Particulars	Note No.	Previous Year (₹)	Current Year (₹)	Absolute change (₹)	Percentage change (%)
		A	B	(B – A) = C	C/A × 100 = D
I. Revenue from Operations					
II. Other Income					
III. Total Revenue (I + II)					
IV. Expenses :					
Cost of material consumed					
Purchases of Stock-in-Trade					
Changes in inventories of Finished Goods, Work-in-Progress and Stock-in-Trade					
Employees Benefit Expenses					
Finance Costs					
Depreciation and Amortization Expenses					
Other Expenses					
Total Expenses					
V. Profit before Tax (III–IV)					
VI. *Less* : Income Tax					
VII. Profit after Tax (V–VI)					

- **Common-Size Statements :** According to *Kohler*. ''Common-Size Statements are accounting statements expressed in percentages of same base rather than rupees.''
  (A) Common-Size Balance Sheet : In a Common-Size Balance Sheet, each item of assets is converted into the percentage to total assets (i.e., 100) and each item of equity and liabilities is converted into the 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 Common-Size Balance Sheet
Common Size Balance Sheet
as at ....

Particulars	Note No.	Absolute Amounts		Percentage of Balance Sheet	
		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) Other Long-term Liabilities		—	—	—	—
(c) Long-term Provisions		—	—	—	—
3. Current Liabilities :					
(A) Short-term Borrowings		—	—	—	—
(B) Trade Payables		—	—	—	—
(C) Other Current Liabilities		—	—	—	—
(D) Short-term Provisions		—	—	—	—

Particulars	Note No.	Previous Year (₹)	Current Year (₹)	Previous Year (%)	Current Year (%)
Total		—	—	**100**	**100**
2. ASSETS :					
1. Non-Current Assets :					
(A) Fixed Assets :					
(i) Tangible Assets		—	—	—	—
(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-terms Loans and Advances		—	—	—	—
(f) Other Current Assets		—	—	—	—
Total		—	—	**100**	**100**

- **Common-Size Income Statement :** A common-size income statement is a statement in which the figure of net sales is assumed to be equal to 100 and all other figures are expressed as percentage of net sales.

Format of a Common-Size Income Statement
for the years ended ....

Particulars	Note No.	Absolute Amounts		Percentage of Revenue from Operations	
		Previous Year (₹)	Current Year (₹)	Previous Year (%)	Current Year (%)
I. Revenue from Operations					
II. Other Income					
III. Total Revenue (I + II)					
IV. Expenses :					
(a) Cost of Materials Consumed					
(b) Purchase of Stock in-Trade					
(c) Changes in Inventories of Finished Goods, Work-in-Progress and Stock-in-Trade					
(d) Employees Benefit Expenses					
(e) Finance Costs					
(f) Depreciation and Amortisation Expenses					
(g) Other Expenses					
Total Expenses					
V. Profit before Tax (III–IV)					
VI. *Less* : Income Tax					
VII. Profit (Loss) for the period (V–VI)					

Key Words

Horizontal Analysis: Financial statements analysis through comparative statements is called horizontal analysis.

Vertical Analysis: Financial statements analysis through common-size statements is called vertical analysis.

Revenue from Operation: The net Sale (Total sales—Sales returns) is also called revenue from operation.

CHAPTER-10
FINANCIAL STATEMENT ANALYSIS: ACCOUNTING RATIOS

Revision Notes

- **Accounting Ratios:** Accounting ratios are those that are based on financial statements and express an arithmetical relation between various accounting variables.
- **Ratio Analysis:** According to ***Myres***, "Ratio analysis of financial statements is a study of relationship among various financial factors in a business as disclosed by a single set of statements and a study of trends of these factors as shown in a series of statements."
- **Objectives of Ratio Analysis:**
  - **(1) Identify Problem Areas:** Ratio analysis helps in locating those areas of business which are weak, not functioning properly and require immediate attention.
  - **(2) Measure Profitability:** Through an analysis of gross profit, net profit, expenses and other similar relative amounts, the ratio analysis helps in arriving at true figure of profitability and also highlights changes in it from time to time.
  - **(3) Ascertain Operational Efficiency:** Ratio analysis determines operational efficiency through operating activity ratio and also points out the areas where it may be improved and how.
  - **(4) Assess Business Solvency:** By highlighting relationships between assets and liabilities through solvency ratios, ratio analysis indicates the financial condition.
  - **(5) Gauge Financial Position:** Liquidity and solvency ratios together help in measuring short-term and long-term financial position of a business concern. If the position is not satisfactory, corrective measures may instantly be initiated.
  - **(6) Facilitate Comparative Analysis:** A comparison between present and past performance and that between self and other firms of the same industry, constitutes the comparative analysis. This is especially useful to find out advantages and disadvantages of the firm itself.

Key Words

Inter-firm Comparison: Comparison of two different firms.

Intra-Firm Comparison: Comparison of within the same firm.

Working capital: The difference of current Assets and current liabilities is termed as working capital.

Key Word

Capital Employed: Net Assets of the firm(Total of Real Assets-Outsiders Liability) is termed as Capital Employed.

- **Advantages of Ratio Analysis:**
  - **(1)** Helps in understand the efficacy of decisions
  - **(2)** Simplify complex figures and establish relationship
  - **(3)** Helpful in comparative analysis
  - **(4)** Identification of problem areas
  - **(5)** Enables SWOT analysis
- **Types of Accounting Ratios:**
  1. **Liquidity Ratio:** Liquidity means ability of firm to pay its current liabilities on time. These ratios are used to assess the short-term financial position of the firm. Liquidity ratios include two ratios:

     (i) $\text{Current Ratio} = \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$ or Current Assets: Current Liabilities

     (ii) $\text{Quick Ratio} = \dfrac{\text{Total Liquid / Quick Assets}}{\text{Total Current Liabilities}}$ or Quick Assets: Current Liabilities

     Note: Liquid Assets= Current Assets – Inventories – Prepaid Expenses
     Note: Quick Ratio is also known as Acid Test Ratio and Liquid Ratio.
  2. **Solvency Ratio:** Solvency Ratio is one of the various ratios used to measure the ability of a company to meet its long-term debts. Important Solvency Ratios are:

     (i) Debt to Equity Ratio $= \dfrac{\text{Long Term Debts}}{\text{Equity / Shareholder's Funds}}$

(ii) Total Assets to Debt Ratio $= \dfrac{\text{Total Assets}}{\text{Long Term Debts}}$

(iii) Proprietary Ratio $= \dfrac{\text{Shareholders' Funds}}{\text{Total Assets}}$

(iv) Interest Coverage Ratio $= \dfrac{\text{Net Profit before Interest and Tax}}{\text{Interest on Long-term Loans}}$

(iv) Debt to Capital Employed Ratio $= \dfrac{\text{Total Debts}}{\text{Capital Employed}}$

Note: Total Debts = Long Term Debts+Current Liabilities

Capital Employed = Total Assets i.e., total of non-current assets and current assets or shareholder's funds+long term debts+current liabilities

3. **Performance / Activity / Turnover Ratio:** A turnover ratio represents the amount of assets and liabilities that a company replaces in relation to its sales. Turnover ratios include:

(i) Inventory Turnover Ratio $= \dfrac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$

(ii) Trade Receivables Turnover Ratio $= \dfrac{\text{Net Credit Revenue from Operations}}{\text{Average Trade Receivables}}$

(iii) Trade Payables Turnover Ratio $= \dfrac{\text{Net Credit Purchases}}{\text{Average Trade Payables}}$

(iv) Working Capital Turnover Ratio $= \dfrac{\text{Net Revenue from Operations}}{\text{Working Capital}}$

(v) Net Assets or Capital Employed Turnover ratio $= \dfrac{\text{Revenue from Operations}}{\text{Capital Employed}}$

(vi) Fixed Assets Turnover Ratio $= \dfrac{\text{Net Revenue from operations}}{\text{Net Fixed Assets}}$

4. **Profitability Ratio:** A profitability ratio is a measure of profitability, which is a way to measure a company's performance. Profitability ratios are:

(i) Gross Profit Ratio $= \dfrac{\text{Gross Profit}}{\text{Net Revenue from Operations}} \times 100$

(ii) Net Profit Ratio $= \dfrac{\text{Net Profit}}{\text{Net Revenue from Operations}} \times 100$

(iii) Operating Ratio $= \dfrac{\text{Operating Cost } (i.e. \text{ Cost of Revenue from Operations} + \text{Operating Expenses})}{\text{Revenue from Operations}} \times 100$

(iv) Return on Capital Employed or Investment $= \dfrac{\text{Net Profit before Interest and Tax}}{\text{Capital Employed}} \times 100$

(v) Operating Profit Ratio $= \dfrac{\text{Operating Profit}}{\text{Revenue from Operations}} \times 100$

Note: Operating Profit = Revenue form Operations – Operating Cost

(vi) Return on Shareholder's Fund $= \dfrac{\text{Profit After Tax}}{\text{Shareholder's Funds}} \times 100$

(vii) Earnings per Share $= \dfrac{\text{Profit available for equity shareholders}}{\text{Number of Equity Shares}} \times 100$

(viii) Book Value per Share $= \dfrac{\text{Equity shareholder's Funds}}{\text{Number of Equity Shares}} \times 100$

(ix) Dividend Payout Ratio $= \dfrac{\text{Dividend per Share}}{\text{Earnings per Share}} \times 100$

(x) Price / Earning Ratio $= \dfrac{\text{Market Price of a Share}}{\text{Earnings per Share}} \times 100$

UNIT-4 Cash Flow Statement

CHAPTER-11
CASH FLOW STATEMENT

Revision Notes

- **Cash Flow Statement:** Cash flow statement is a statement that shows the flow of cash and cash equivalents during a given period of time. **Cash Flow Statement shows the net increase or net decrease of cash and cash equivalents under each activity, *i.e.*, Operating, Investing, Financing and Collectively as well.**
- **Objectives of Preparing Cash Flow Statement:** A Cash Flow Statement has the following objectives:
  (1) To depict inflows and outflows of cash, *i.e.*, sources and uses of cash.
  (2) To facilitate formulation of financial policies such as dividend policy, etc.
  (3) To ascertain the liquidity of the enterprise.
  (4) To ascertain the net change in cash and cash equivalents.
  (5) To study the trend of cash receipts and cash payments.
- **Benefits of Cash Flow Statement**
  - Cash Flow Statement is useful in knowing the exact figure of cash inflows and outflows from various operations of the business. It helps in assessing future requirements of the cash by comparing the cash budgets of past assessments with the present. It gives the accurate information about the cash-based transactions in the business.
  - Cash flow statement helps in knowing the periodical requirement of cash in the business as it is used in preparing the cash budget for future needs.
  - A cash flow statement when used along with other financial statements reveals the key changes required for the financial positioning of the business and priorities important activities to the management.
  - Cash flow statement also provides the information about various investing and financing cash transactions takes place during the year and helps in evaluating the financial structure of the business. Cash Flow statement helps in identifying the profitability of the business when it compared with the ratio analysis, keeping in response to changing condition.

> **Key Word**
>
> **Cash Equivalents:** The value of a company's assets that are cash or can be converted into cash – immediately.

- **Operating Activities:** Operating Activities are the main revenue generating activities of a business firm. Operating activities are those transactions and events whose cash flows affect the net profit or loss of a business firm.

  Examples of Cash Flow from Operating Activities: AS–3 (Revised) gives the following examples of Cash Flow from Operating Activities:

> **Key Word**
>
> **Marketable Securities:** These are short- term liquid securities which can be bought or sold on a public exchange.

Operating Activities

Cash Inflows	Cash Outflows
(i) Cash Sales	(i) Cash Purchase
(ii) Cash received from Trade Receivables	(ii) Payment to Trade Payables
(iii) Cash received as Commission	(iii) Cash Operating Expenses
(iv) Cash received as Fees	(iv) Payment of Wages, Salary, etc.
(v) Cash received as Royalty	(v) Income Tax Paid

The major inflows and outflows in case of financial companies: In case of Financial Companies, following will be cash flows from operating activities, as dealing in securities is their main business activity:

Operating Activities

Cash Inflows
(i) Cash received for Interest
(ii) Cash received from Dividends
(iii) Proceeds from Sale of Securities

Cash Outflows
(i) Cash paid for Interest
(ii) Payment for Purchase of Securities

- **Investing Activities:** Investing Activities are those activities which are related to acquisition and disposal of long-term assets and other investments not included in the cash equivalents.

  Examples of Cash Flow from Investing Activities: AS–3 (Revised) gives the following examples of Cash Flow from Investing Activities:

Investing Activities

Cash Inflows
(i) Sale of Fixed Assets
(ii) Sale of Investments (Non-current and current other than marketable securities)
(iii) Interest received on Investments
(iv) Dividend received

Cash Outflows
(i) Purchase of Fixed Assets
(ii) Purchase of Investments (Non-current and current other than marketable securities)

- **Financing Activities:** Financing Activities are those activities that result in the changes in size and composition of the owners' capital (including Preference Share Capital in case of a company and borrowings of the business firm).
  Examples of Cash Flow from Financing Activities: AS–3 (Revised) gives the following examples of Cash Flow from Financing Activities:

Financing Activites

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

Cash Outflows
(i) Payment of Loans
(ii) Payment of Interest
(iii) Payment of Dividend
(iv) Buy-back of Equity Shares
(v) Redemption of Preference Shares
(vi) Repayment of Long-term Loans
(vii) Repayment of Bank Overdraft or Cash Credit

- **Format of Cash Flow Statement:**

Cash Flow Statement of ....

for the year ended ....

[As per Accounting Standard (AS-3) (Revised) (Indirect Method)]

Particulars	₹	₹
1. Cash Flow From Operating Activities		
(A) Net Profit before Taxation and Extraordinary Items **(WN 1)**		....
Assessment for Non-cash and Non-operating Items		

(B) Items to be added back:		
Depreciation	....	
Interest on Borrowings and Debentures	....	
Goodwill Patents / Trade Marks/Copyrights Amortised	....	
Loss on Sale of Fixed Assets	....	
Increase in Provision for Doubtful Debts	....	....
(C) Items to be Deducted:		
Interest Income	....	
Dividend Income	....	
Rental Income	....	
Profit on Sale of Fixed Assets	....	
Liability / Provisions written back (Decrease in Provision for Doubtful Debts)	....	....
(D) Operating profit before working capital changes (A + B – C)	....	
(E) *Add:* Decrease in Current Assets	....	
Increase in Current Liabilities	....	
(F) *Less:* Increase in Current Assets	....	
Decrease in Current Liabilities	(...........)	
(G) Cash generated from Operations (D + E – F)	(...........)	
(H) *Less:* Income tax paid (Net of Refund of Tax)	(...........)	....
Net Cash Flow from (or used in) Operating Activities **(X)**		....
2. Cash Flow from Investing Activities		
Proceeds from Sale of Tangible Fixed Assets	....	
Proceeds from Sale of Intangible Fixed Assets	....	
Proceeds from Sale of Non-current Investments	....	
Interest and Dividend Received (for Non-financial Companies only)	....	
Rental Income	....	
Purchase of Tangible Fixed Assets	(...........)	
Purchase of Intangible Assets like Goodwill, Patents, etc.	(...........)	
Purchase of Non-Current Investments	(...........)	
Extraordinary Items (*e.g.* Insurance claim on machinery against fire)	(...........)	....
Net Cash Flow (or used in) from Investing Activities **(Y)**		
3. Cash Flow from Financing Activities		
Proceeds from Issue of Share Capital and Debentures	....	
Proceeds from Long-term Borrowings	....	
Increase/Decrease in Bank Overdraft and Cash Credit	....	
Final Dividend Paid	(...........)	
Interim Dividend Paid	(...........)	
Interest on Long-term Borrowings Paid	(...........)	
Redemption of Debentures/Preference Shares	(...........)	
Extraordinary items (*eg.* Buy-back of shares)	....	
Net Cash Flow from (or used in) Financing Activities **(Z)**		....
4. Net Increase/Decrease in Cash and Cash Equivalents (X + Y + Z)		....
5. ***Add:*** **Cash and Cash Equivalents in the beginning of the year (WN 2)**		....
6. Cash and Cash Equivalents at the end of the year (WN 3)		....

Working Notes:

1. Calculation of Net Profit before Tax and Extraordinary Items:

> **Key Word**
>
> **Proposed Dividend:** It is a provision created when the dividend is proposed by the directors but is to be paid to the shareholders.

Particulars	₹
Net Profit of the current year or Difference between Closing Balance and Opening Balance of Surplus *i.e.,* Balance in Statement of Profit & Loss	....
Add: Transfer to reserves (or transfer to reserves from Surplus *i.e.,* Balances in Statement of Profit & Loss)	....
Dividend Paid (Proposed dividend for Previous year)	....
Interim dividend paid during the year	....
Provisions for tax made during the current year	....
Extraordinary items if any debited to Statement of Profit & Loss	....
Less: Refund of tax credited to Statement of Profit & Loss	....
Extraordinary items, if any credited to Statement of Profit & Loss	....
	....

2. Calculation of Cash and Cash Equivalents in the beginning:

Particulars	₹
Cash in hand	....
Cash at Bank	....
Short-term Deposits	....
Marketable Securities	....
Cheques and drafts in hand	....
	....

3. Calculation of Cash and Cash Equivalents at the end:

Particulars	₹
Cash in hand	....
Cash at Bank	....
Short-term Deposits	....
Marketable Securities	....
Cheques and drafts in hand	....
	....

Example 1

Following is the Balance Sheet of J.M. Ltd. as at 31.3.2016:

J.M. Ltd.
Balance Sheet as at 31.3.2016

Particulars	Note No.	31.3.2016 (₹)	31.3.2015 (₹)
I. EQUITY AND LIABILITIES:			
1. Shareholders' Funds:			
(a) Share Capital		2,25,000	1,75,000
(b) Reserves and Surplus	1	1,12,500	56,250
2. Non-Current Liabilities:			
Long-term Borrowings	2	1,12,500	87,500
3. Current Liabilities:			
(a) Short-term Borrowings	3	37,500	18,750
Total		**4,87,500**	**3,37,500**
II. ASSETS:			
1. Non-Current Assets:			
(a) Fixed Assets			
(i) Tangible	4	3,66,250	2,28,750
(ii) Intangible	5	25,000	37,500
(b) Non-Current Investments		37,500	25,000
2. Current Assets:			
(a) Current Investments		10,000	17,500
(b) Inventories	6	30,500	18,000
(c) Cash and Cash Equivalents		18,250	10,750
Total		**4,87,500**	**3,37,500**

Notes to Accounts

S. No.	Particulars	31-3-2016 (₹)	31-3-2015 (₹)
1.	**Reserves and Surplus**		
	Surplus, i.e., Balance in Statement of Profit & Loss	1,12,500	56,250
		1,12,500	56,250
2.	**Long-term borrowings:**		
	12% Debentures	1,12,500	87,500
		1,12,500	87,500
3.	**Short-term Borrowings:**		
	Bank overdraft	37,500	18,750
		37,500	18,750
4.	**Tangible Assets:**		
	Machinery	4,18,750	2,63,750
	Less: Accumulated Depreciation	(52,500)	(35,000)
		3,66,250	2,28,750

5.	**Intangible Assets:**		
	Goodwill	25,000	37,500
		25,000	37,500
6.	**Inventories:**		
	Stock-in-trade	30,500	18,000
		30,500	18,000
7.	**Contingent liabilities:**		
	Proposed dividend	50,000	31,250
		50,000	31,250

Additional Information:

(i) ₹25,000, 12% debentures were issued on 31.3.2016.

(ii) During the year a piece of machinery costing ₹20,000, on which accumulated depreciation was ₹10,000 was sold at a loss of ₹2,500.

Prepare Cash Flow Statement.

Ans. Step 1: Calculation of Net Profit before Tax:

	₹
Net profit as per Statement of Profit & Loss	**56,250**
Add: **Dividend Paid**	**31,250**
Net Profit before Tax & Extraordinary Items	**87,500**

Step 2: Calculation of machinery purchased during the year

Dr. **Machinery Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	2,63,750	By Cash A/c	7,500
To Cash A/c	1,75,000	By Statement of P & L	
(Purchase (Bal. fig.)		(Loss on sale)	2,500
		By Accumulated Depreciation A/c	10,000
		By Balance c/d	4,18,750
	4,38,750		**4,38,750**

Step 3: Calculation of Accumulated Depreciation charged for the year 2016 to Profit and Loss Account

Dr. **Accumulated Depreciation Account** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Machinery A/c	10,000	By Balance b/d	35,000
To Balance c/d	52,500	By Statement of P/L (Balancing Figure)	27,500
	62,500		**62,500**

Step 4: Cash Flow Statement of J.M. Ltd.
for the year ended 31st March, 2016 as per AS-3 (Revised)

Particulars	Amount (₹)	Amount (₹)
I: Cash Flow from Operating Activities:		
Net Profit before tax & extraordinary items (Note 1)	**87,500**	
Add: Non cash and non-operating charges:		
Goodwill written off	**12,500**	
Depreciation on machinery	**27,500**	
Interest on debentures	**10,500**	
Loss on sale of machinery	**2,500**	
Operating profit before working capital changes	**1,40,500**	
Less: Increase in Current Assets:		
Increase in inventories	**(12,500)**	
Net Cash generated from Operating Activities		1,28,000

II: Cash Flow from Investing Activities:		
Purchase of machinery	**(1,75,000)**	
Sale of machinery	**7,500**	
Purchase of non current investments	**(12,500)**	
Net Cash used in Investing Activities		**(1,80,000)**
III: Cash Flow from Financing Activities:		
Issue of share capital	**50,000**	
Issue of 12% debentures	**25,000**	
Interest on debentures paid	**(10,500)**	
Dividend paid	**(31,250)**	
Bank overdraft raised	**18,750**	
Net Cash flow from Financing Activities		**52,000**
Net change in cash & cash equivalents (A + B + C)		**(Nil)**
Add: Opening balance of cash & cash equivalents:		
Current Investments	17,500	
Cash and Cash Equivalents	10,750	**28,250**
Closing Balance of cash & cash equivalents:		
Current Investments	10,000	
Cash and Cash Equivalents	18,250	**28,250**