UNIT-II : Accounting for Partnership Firms

CHAPTER-1
BASICS OF PARTNERSHIP

Concept of Partnership

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.

Partnership Deed

Revision Notes

- **Partnership Deed**

  According to Section 5 of the Indian Partnership Act, 1932, 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.

  The document which contains terms of the agreement is called 'Partnership deed'.
- **Contents of Partnership Deed**
  - **(i)** Name and Address of all Partners
  - **(ii)** Name and address of the Firm
  - **(iii)** Nature of the Business
  - **(iv)** Capital to be contributed by each Partner
  - **(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 evaluation 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

➢ **Different types of Partners in Partnership Firm are given below :**

(i) **Active Partner :** A person who provides his share in capital and also takes active part in the management of the business. The development of business depends upon the active partners.

(ii) **Sleeping or Dormant Partners :** These partners only provide capital and also share the profits and losses of the business. A sleeping partner does not take active part in the management of a firm. These are not known to public as partners.

(iii) **Silent Partner :** A silent partner is known to the public as a partner. He does not participate in the affairs of the management. But he is liable to pay debts of the firm.

(iv) **Secret Partner :** He takes active part in the business but public does not know him as a partner of the firm. He is liable to pay all the debts of the firm.

(v) **Nominal Partner :** These partners do not share the profits and losses of the firm. These partners do not participate in the management of a firm. A firm only uses the name and reputation of the partners. So these are called nominal partners.

(vi) **Minor Partner :** A minor may become a partner with the consent of all the partners. A minor is admitted in the profits of the business only. He has no liability for losses.

(vii) **Senior Partner :** A person who is playing an important role in the management according to his ability, experience and capital is called senior partner.

(viii) **Junior Partner :** A person who has small investment in the firm and has a limited experience of business is called junior partner.

(ix) **Limited Partner :** A partner whose liability is restricted to his share only is called limited partner. He cannot take part in the management of a firm.

(x) **Unlimited Partner :** When the liability of the partner is unlimited, he is called unlimited partner. The debts of firm can be paid even by using the personal property of that partner.

➢ **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 regarding interest on capital, no interest on capital is to be allowed.

(iii) If deed is silent regarding interest on drawings or charges on drawings by partners, no interest on drawings is to be charged.

(iv) If deed is silent regarding salary or remuneration or commission of partners for their services, no salary or remuneration or commission is to be allowed to any partner.

(v) If deed is silent regarding profit sharing ratio, profit will be distributed equally.

Capital Accounts of Partners

Revision Notes

➢ **Methods of Maintaining Capital Accounts of Partners**

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

1. **Fluctuating Capital :** When partners decide to maintain only Capital Accounts for each partner, all entries regarding Interest on Capital, Interest on Drawings, Salary, Share in Profit or Loss and Drawings will be made in the Capital Accounts. In this case, capital will be fluctuating from year to year. This is known as Fluctuating Capital.

2. **Fixed Capital :** When partners decide that their capitals will remain fixed and it will not change due to Interest on Capital, Interest on Drawings, Salary or Share of Profit or Loss and Drawings, it is termed as Fixed Capital. In

this case, there will be two accounts for each partner : Capital Account and Current Account. Entries for Interest on Capital, Interest on Drawings, Salary, Share of Profit or Loss and Drawings will be made through Current Account. However when there are frequent drawings, a separate Drawings Account may be opened for each partner. At the end of accounting year, balance of each Partner's Drawings Account will be transferred to their respective Current Accounts.

Proforma of Partner's Capital Account under Fluctuating Capital Method

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

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Balance b/d (in case of debit opening balance)	....		By Balance b/d (in case of credit opening balance)	....
	To Drawings A/c	....		By Cash/Bank A/c (Additional Capital)	....
	To Interest on drawings A/c	....		By Interest on Capital A/c	....
	To Profit & Loss A/c (Share in Loss)	....		By Commission A/c	....
	To Balance c/d (Closing Balance)	....		By Partner's Salary A/c	....
				By P&L Appropriation A/c (Share in Profit)	....
				By Balance c/d (Closing Balance)	....
		....			....

Proforma of Partner's Capital Account under Fixed Capital Method :

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

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Cash/Bank A/c (Withdrawal of Capital)	....		By Balance b/d	....
	To Balance c/d	....		By Cash/Bank A/c (Additional Capital)	....
		....			....

Proforma of Partner's Current Account under Fixed Capital Method :

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

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Balance b/d (if there is old debit balance)	....		By Balance b/d (if there is old credit	....
	To Drawings A/c	....		balance)	....
	To Interest on Drawings A/c	....		By Interest on Capital A/c	....
	To Profit & Loss A/c			By Salary A/c	....
	(Share in Loss)	....		By Commission A/c	
	To Balance c/d			By P&L Appropriation A/c	....
	(if credit side total is more)	....		(Share of Profit)	
				By Balance c/d	....
				(if debit side total is more)	
		....			....

Profit and Loss Appropriation Account

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)

NET ENTRY :

Profit & Loss Appropriation A/c Dr.
To Partners' Capital /Current A/cs
(Being Interest on Capital allowed to partners)

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)

NET ENTRY :

Profit & Loss Appropriation A/c Dr.
To Partners' Capital /Current A/cs
(Being Salary/Commission allowed to partners)

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)

NET ENTRY :

Partners' Capital/Current A/cs Dr.

To Profit & Loss Appropriation A/c

(Being interest on drawings charged)

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 (Salaries)	....	By Net Profit (Profit shown by Profit & Loss A/c)	....
To Partner's Capital A/c (Commission)	....	By Partner's Capital/Current A/c (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.

Calculation of Appropriation Items and Charge Items

Revision Notes

- **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 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 total of interest is found which is calculated on different drawings. Thus, interest is calculated as following :

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

(2) Product Method : In this method, period of drawings is calculated in months from the date of drawings to the date of closing of account and thereafter product is found by multiplying number of months with the amount of drawings and the total of such product is then multiplied with the rate of interest and is divided by 100 × 12. The result obtained is the amount of interest. It is calculated as under :

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

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

Case (A). If the withdrawals are of equal amounts and are made at regular intervals on the monthly basis throughout the year :

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

Average period = (Longest outstanding period + Shortest outstanding period)/2

= (12+1)/2 = 6.5 months

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{6\frac{1}{2}}{12}$$

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

Average period = (Longest outstanding period + Shortest outstanding period)/2

= (11.5+0.5)/2 = 6 months

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

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

Average period = (Longest outstanding period + Shortest outstanding period)/2

= (11+0)/2 = 5.5 months

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{5\frac{1}{2}}{12}$$

Case (B). According to this formula, students will be able to calculate interest on drawings made in 9 months, 6 months and 3 months:

If rate of interest on drawings in 12 months = 6

Then rate of interest on drawings in 1 month = $\frac{6}{12}$

Then rate of interest on drawings in 9 months = $\frac{6}{12} \times 9$

Drawings made in middle of months = 4.5

If drawings made at the beginning of each month (+ 0.5 in given rate) = 4.5 + 0.5 = 5

If drawings made at the end of each month (– 0.5 in given rate) = 4.5 – 0.5 = 4

Just like that, student can calculate each and every rate month wise.

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 out 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

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

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.

➢ **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

Revision Notes

- **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 of correcting these omissions or mistakes, adjustment entries are passed through Profit and Loss Adjustment Account in which adjustments in respect of 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 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.

Guarantee of Profits

Revision Notes

- **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.

Treatment of Goodwill

Revision Notes

- **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

➢ **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 :

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

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 in business is calculated on the basis of average profit, as following :

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

Find out the actual capital employed or net assets and then deduct actual capital employed from capitalized value to find the value of goodwill.

(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 :

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

❑❑

CHAPTER-2

RECONSTITUTION OF PARTNERSHIP FIRMS : CHANGE IN PROFIT SHARING RATIO

Reconstitution of Partnership Firm

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 a partnership firm.

  A change in the profit sharing ratio among the existing partners results in a gain of additional share in the future profit for some partners while a loss of a part thereof for other partners.
- **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.

Sacrificing Ratio = Old share – New share

Accounting Treatments at the time of change in Profit Sharing Ratio

Revision Notes

- **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)
- **Revaluation of Assets and Re-assessment of Liabilities**
  At the time of change in profit sharing ratio, the value of assets and reassessment of 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/cs.
  Following entry will be passed :
  (i) For transfer of Reserves and Accumulated Profits :
  Reserve/P & L A/c 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

❑❑

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

Admission of a Partner

Revision Notes

- **Admission of a Partner :** According to Section 31 of the Indian Partnership Act, 1932, a new partner shall not be introduced into a firm without the consent of all the existing partners, unless it is agreed otherwise by the partners in the partnership deed. Thus, a new partner can be admitted into a partnership firm with the consent of all the existing partners.
- **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.
- **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 his 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.

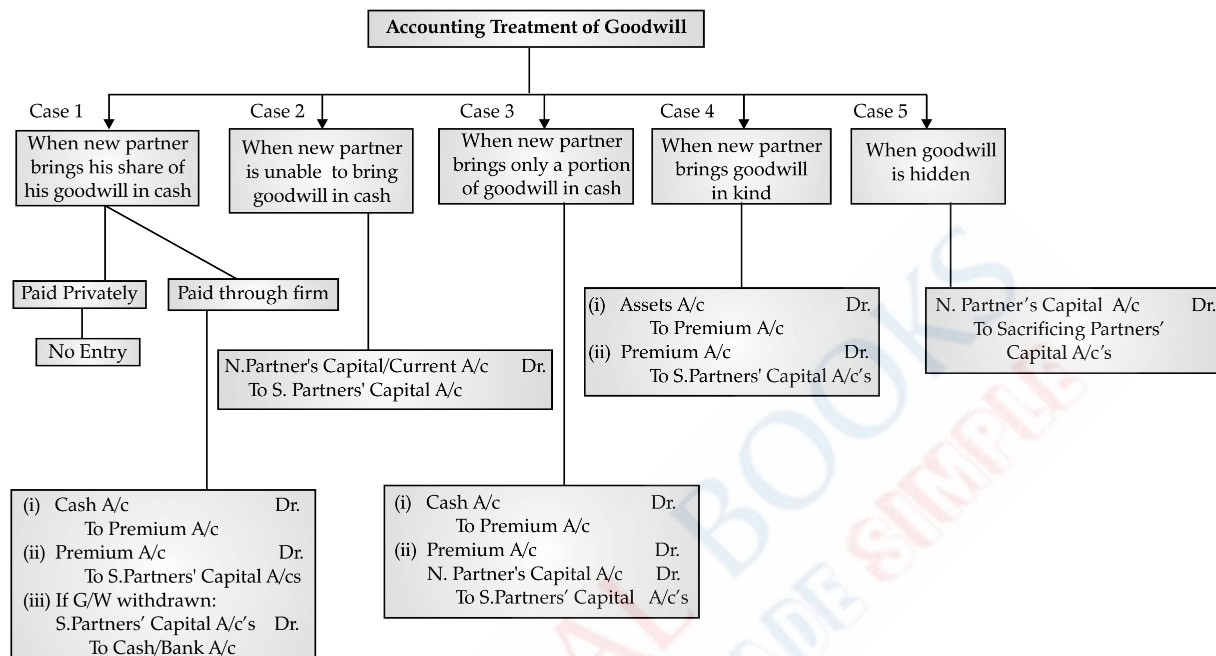
  Case 3 : If in the question, sacrificing ratio of old partners is given, then the ratio given will be the sacrificing ratio.

  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.

Accounting treatment of Goodwill

Revision Notes



- In the case of admission, old partners claim their share of goodwill of the firm because they have worked in the past to earn goodwill for the firm.
- As per Accounting Standard (AS-26), goodwill should be recorded in the books of accounts only when consideration in money or money's worth has been paid for it or for purchased goodwill. At the time of reconstitution of firm, *i.e.*, admission, death or retirement of a partner or change in profit sharing ratio among partners, valuation of goodwill is done so it should not be brought in books, because it is an intangible goodwill. The amount of goodwill should be adjusted through partners' capital/current accounts.

  Treatment of goodwill in different cases :

1. **When the new partner brings his share of goodwill in cash and it is to be paid to the existing partners privately :**

   No entry is passed in the books because the intention of the partners is not to show any amount/transaction relating to goodwill for any of the reasons.

   Note : If goodwill is already appearing in the book, old goodwill should always be written off among old partners in the old ratio by way of the following entry :

   Old Partners' Capital/Current A/cs Dr.
   To Goodwill A/c
   (Being old goodwill written off)

2. **When the amount of goodwill is paid by the incoming partner through the firm :**

   Whenever new partner brings goodwill in cash, he should bring the amount of goodwill, only for his share. It is a common rule that the gaining partner should compensate the sacrificing partner to the extent of his gain. In the case of admission, new partner acquires some share of profit from the existing partners. So, the amount of goodwill brought in by the new partner is to be credited to the sacrificing partner(s) as per the sacrifice made by them.

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

Premium A/c (Goodwill) Dr.
To Sacrificing Partners' Capital/Current A/cs
(Being the amount of goodwill distributed among partners in their sacrificing ratio)
If the sacrificing partners withdraw their amount of goodwill in cash :
Sacrificing Partners' Capital/Current A/cs Dr.
To Cash / Bank A/c
(Being the amount withdrawn by sacrificing partners)

3. **When the new partner is not able to bring his share of goodwill in cash :**

When new partner could not bring his share of goodwill in cash then, for the same reason that gaining partner should compensate the sacrificing partners to the extent of his gain, new partner's capital/current account is to be debited and sacrificing partners' capital accounts are to be credited with the amount of new partner's share in total goodwill of the firm.

New Partner's Capital/Current A/c Dr. (With the amount of new partner's shares in goodwill)
To Sacrificing Partners' Capital A/c's (In sacrificing ratio)
(Being Capital accounts of sacrificing partners credited in their sacrificing ratio with the share of new partners' share of Goodwill/ Premium on his admission)

4. **When new partner is able to bring only a portion of share of goodwill in cash :**

When new partner could bring only a portion of his share of goodwill in cash then treatment should be made in the books of accounts in such a way so that sacrificing partners should be properly compensated for the share surrendered by them in favour of new partner. In this case treatment can be done by either of the following ways :

(a) By Opening Current Account
(b) Without Opening Current Account

(a) By Opening Current Account :

Cash A/c Dr. (With the amount of actual cash brought in by the new partner)
To Premium for Goodwill A/c
(Being new partner brought only a part of share of goodwill in cash)
Premium for Goodwill A/c Dr. (With the amount of actual cash brought in by new partner)
New Partner's Current A/c Dr. (With the unpaid amount)
To Sacrificing Partners' Capital/Current A/cs (In sacrificing ratio)
(Being share of goodwill distributed among sacrificing partners and unpaid amount of goodwill debited to the new partner's current account)

(b) Without Opening Current Account :

Cash A/c Dr. (With the amount of actual cash brought in by new partner)
To Premium for Goodwill A/c
(Being new partner brought only a part of share of goodwill in cash)
Premium for Goodwill A/c Dr. (With the amount of actual cash brought in by new partner)
New Partner's Capital A/c Dr. (With the unpaid amount)
To Sacrificing Partners' Capital/Current A/cs (In sacrificing ratio)
(Being share of goodwill distributed among sacrificing partners and unpaid amount of goodwill debited to the capital account of new partner)

5. **When new partner brings his share of goodwill in kind :**

Sometimes instead of bringing his share for premium (goodwill) in cash, new partner brings his share of goodwill in the form of assets, *i.e.,* he contributes some assets towards his share of goodwill. Generally, this happens when new partner had been running his own business.

Assets A/c Dr. (Various assets individually)
To New Partner's Capital A/c (With the share of capital)
To Premium for Goodwill A/c (With the share of goodwill)

(Being various assets contributed towards his share of capital and goodwill by the new partner)

Premium for Goodwill A/c Dr. (With the amount of goodwill in respect of new partner's share)

To Sacrificing Partners' Capital/Current A/cs (In sacrificing ratio)

(Being share of goodwill transferred to Sacrificing partners in their sacrificing ratio)

6. **When goodwill is hidden (Inferred Goodwill) :**

In case of admission of a partner 'Hidden Goodwill' is the excess of total capital as worked on the basis of new partner's capital over the adjusted capital of existing partners and capital of incoming partner.

Revaluation of Assets and Liabilities, Accounting Treatment of Reserves and Accumulated Profits

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 old profit sharing ratio.

Know the Terms

- **Sacrificing Ratio :** The ratio in which old partners sacrifice their share of profit in order to give share in profits to the new partner.
- **Hidden Goodwill :** When the value of goodwill is not specified at the time of admission of a partner is called Hidden Goodwill.
- **Goodwill in Kind :** When an incoming partner brings any asset in place of goodwill in cash is called goodwill in kind.
- **Revaluation Account :** The account which is opened to revalue and reassess the assets and the liabilities on admission of a partner is called Revaluation Account.
- **Workmen's Compensation Fund :** The fund which is created to replace Employer's liability and to give prompt protection against disease, disability, injury or death due to the Employment is called workmen's compensation fund.
- **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 is called Investment Fluctuation Fund.
- **Employees' Provident Fund :** It is a scheme for providing monetary benefits to all the salaried individuals after their retirement. It is a liability of the firm.

UNIT-III : Accounting for Companies

CHAPTER-4
ACCOUNTING FOR SHARE CAPITAL

Share and Share Capital

Revision Notes

- **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.

Shares, refer to the units into which the total share capital of company is divided. Thus, a share is a fractional part of the share capital and forms the basis of ownership interest in a company. The persons who contribute money through shares are called shareholders.

➢ **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 dividend to be paid as fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income tax.
   - **(b)** Return of capital on the winding up of the company before the equity shares to the holders of preference shares.

   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, equity share is that 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. As the share capital is received from shareholders and since number of shareholders in a company is authorized, therefore, separate capital account of each shareholder is not opened, instead one consolidated capital account is opened for all shareholders of similar types.

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. Normally, companies do not exhaust their authorised capital in the beginning but only a part of the authorised capital is issued for public subscription. Rest of the authorised capital is raised by the company in a phased manner depending on the need for funds.
- **(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.

Accounting Treatment

Revision Notes

➢ **Issue of shares for consideration of Cash :**

(1) 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)

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 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)

(2) 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.

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

(2) For receipt of Allotment Money :
Bank A/c Dr.
To Share Allotment A/c

➢ **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 advance from the date of advance received up to the date when it is due, which shall be 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

(2) For adjustment of Calls-in-Advance :
Calls-in-Advance A/c Dr.
To Share …. Call A/c

(3) For interest paid on Calls-in-Advance :
Interest on Calls-in-Advance A/c Dr.
To Bank A/c

Calls-in-Advance will be shown on the liabilities side of Balance Sheet under the head "Current Liabilities".

➢ **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

(2) For amount unpaid on calls :
Calls-in-Arrears A/c Dr.
To …. Share… Calls A/c

(3) For receipt of arrears of allotment or calls money :
Bank A/c Dr.
To Calls-in-Arrears A/c

(a) Interest on Calls-in-Arrears : The company may charge interest on Calls-in-Arrears from the due date upto the date of payment at a specified rate. (But not compulsorily)
The following entry shall be passed :
Bank A/c Dr.
To Interest on Calls-in-Arrears A/c
Calls-in-Arrears shall be shown on the liabilities side of the Balance Sheet as a deduction from called-up capital.

➢ **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 :

(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)

➢ **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 :

(i) Normally, shares are forfeited when allotment and call money are not paid by shareholders.
(ii) The Articles of Association of the company must expressly provide for forfeiture of shares.

(iii) If the Articles of Association do not expressly provide for forfeiture of shares, the company can forfeit shares by passing a special resolution.
(iv) The shareholders should be served a notice atleast 14 days before the forfeiture.
(v) A resolution to forfeit the shares must be passed by the Board of Directors.
(vi) Forfeiture of shares should take place in good faith and should be in the larger interest of the company.

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)		

- **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.
- **Conditions for Private Placement**

  Section 42 of the Companies Act, 2013, has specified certain conditions for 'Private Placement of Shares'. Among them, important ones are as follows :

  (1) A private placement offer cannot be made to more than 50 people in a financial year excluding "qualified institutional buyers" and employees of the company being offered securities under a scheme of Employees Stock Option Plan (ESOP).

  (2) No fresh offer or invitation under this section shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.

  (3) Any allottee under a private placement offer/invitation shall not transfer his/its securities to more than 20 persons during a quarter and the company shall not register any transfer which is not in conformity with this requirement.

  (4) The number of such offers or invitations shall not exceed 4 in a financial year and not more than once in a calendar quarter with a minimum gap of 60 days between any 2 such offers or invitations.

  (5) A company offering securities under this section shall not release any public advertisement informing the public at large about such an offer.

  (6) Offers covered under this section shall be made only to such persons whose names are recorded prior to the invitation by the company to subscribe.

  (7) The proposed offer of securities has to be approved by the shareholders of the Company through a Special Resolution, for each of such offers/invitations.

  (8) Application money under this section should be kept in a separate bank account in a scheduled bank and should not be utilized for any purpose other than :

  (a) For making adjustment against allotment of securities; or

  (b) For the repayment of application money when the company is unable to allot securities.

  (9) A company making such offer or invitation under this section should allot its securities within 60 days from the date of receipt of the application money.

  (10) The company should file a return of allotment under this section with the Registrar.

  Accounting treatment relating to private placement of shares is the same as in the case of equity shares. Following points must be remembered :

  (1) Broker or an underwriter may find persons to whom shares may be issued. There is no need to issue prospectus in such a case.

  (2) Such shares can be issued on conversion of debentures and also for a consideration other than cash, *i.e.*, they can be issued in exchange of some fixed assets to a select group of people.
- **ESOP (Employee Stock Option Plan) :** A scheme under which whole time directors, officers and employees of the company are given a right to purchase or subscribe the securities of the company at a future date and at a predetermined price.
- **Employees Compensation Expenses Account :** This account denotes proportionate expense or loss for the company which arises due to the difference between the market price and exercise price (issue price) of the shares granted under ESOP. At the year end, this account is transferred to Statement of Profit & Loss and is shown under head 'Employees Benefit Expenses'.

  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		

Know the Terms

- **ESOP (Employee Stock Option Plan) :** ESOP is an employee benefit scheme, that offers ownership interest to the employees of company.
- **Promotion :** It is the first stage in the formation of company when promoters conceive the idea of promoting a company.
- **Registration :** It is the second stage in the formation of company when promoters apply for the legislation of company before the concerned Registrar of Company.
- **Preliminary Expenses :** Expense incurred before the incorporation and commencement of business, e.g., legal charges, printing expense for MOA and AOA.
- **Bonus Shares :** Shares issued by a company to current shareholders free of charge. They must be fully paid.
- **Pro-rata allotment :** Shares are allotted proportionately to the shares applied for in case of over subscription.
- **Buy back of shares :** Company offers to purchase back the shares held by shareholders currently.
- **Capital Reserve :** A reserve created from accumulated capital surplus for long-term capital investment or to offset capital losses.

UNIT-IV : Analysis of Financial Statements

CHAPTER-5
FINANCIAL STATEMENTS 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.

PART-I : BALANCE SHEET

Balance Sheet as at ....

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 ....

Particulars	Note No.	Figures as at the end of current reporting period (₹)	Figures as at the end of the previous reporting period (₹)
CONTINUING OPERATIONS (1)			
(i) Revenue from Operations (Gross)			
(ii) Other Income			

(iii) **Total Revenue (i+ii)**			
(iv) **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**			
(v) Profit before tax (iii – iv)			
(vi) **Tax Expense :** **(i)** Current tax expense for current year **(ii)** Deferred tax			
(vii) Profit / Loss for the period (v – vi)			
(vii) **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 appropriations 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 'Reserve and Surplus'. Similarly, the balance of 'Reserve and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserve 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 Notes : 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 Payables : Trade payables have been defined in Schedule III of Companies Act, 2013 as follows :

"Trade payables 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 Payables : *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 reckons it will hold for at least 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 a physical presence. Patents, trademarks, and goodwill classify as non-current 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).

- **Nature of Financial Statements**

The financial statements are prepared on the basis of recorded facts. The recorded facts are those which can be expressed in monetary terms. The statements are prepared for the particular period generally one year. The nature of the financial statements is discussed below :

(1) Recorded Facts : The data which is taken out from the accounting records is known as recorded facts. Actual cost data are the source of maintaining the accounting records.

(2) Accounting Conventions : Various accounting conventions such as Historical Cost Convention, Monetary Measurement, Separate Entity, Materiality, Realization, etc., are adopted to prepare external and internal financial accounts. The accounting conventions help to make financial statements realistic, comparable and simple.

(3) Personal judgements : For preparing financial statements, standard accounting conventions are very important. One important thing plays a very important role in making financial statements, *i.e.*, Personal Judgements. *For example*, in applying the cost or market value whichever is less to inventory valuation the accountant will have to use his judgement in computing the cost in particular case. There are a number of methods of valuing stock, *i.e.*, First in First out, Last in First out, Average Cost Method, etc. The accountant will use one of these methods for valuing materials.

(4) Postulates : It is very important for an accountant to make certain assumptions at the time of preparing accounting records. These postulates are derived from accounting environment, so it does not require any proof. It is assumed that everyone can understand an accounting postulate so that it is recorded in financial statements.

Characteristics of Ideal Financial Statements :

The main purpose of preparing the financial statements is to depict financial position of the business concern. Therefore, the financial statements should be prepared in such a way that they are able to give a clear and orderly picture of concern. 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.

Know the Terms

- **Contingent Liability :** A contingent liability refers to the claim which is uncertain to arise/which may or may not arise/which is dependent on a happening in future. It is disclosed in the Notes to Accounts.

- **Fictitious Assets :** Fictitious Assets are the assets which do not have any physical existence. They are expected not to realise any value or render any service in future *e.g.*, preliminary expenses.
- **Capital Advances :** These are loans or advances take for procurement of fixed assets.

CHAPTER-6
ACCOUNTING RATIOS

Revision Notes

- **Ratio :** Ratio is a mathematical relationship between two related items or a group of items expressed in quantitative form.
- **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.
  7. **Aid in Budgeting and Forecasting :** Ratio analysis assumes much importance in financial forecasting and planning. These ratios provide meaningful conclusions that work as a guide for future decisions.
  8. **Simplify Accounting Figures :** A major objective of financial analysis is to shorten, summarise, organise and properly arrange the financial matters so that it may easily be absorbed by all.
- **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) $\text{Current Ratio} = \dfrac{\text{Current Assets}}{\text{Current Liabilities}}$

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

     Note : Liquid Assets= Current Assets – Inventories – Prepaid Expenses
  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 $= \frac{\text{Debt}}{\text{Equity}}$

(ii) Total Assets to Debt Ratio $= \frac{\text{Total Assets}}{\text{Debt}}$

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

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

3. **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 $= \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$

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

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

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

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 $= \frac{\text{Gross Profit}}{\text{Net Revenue from Operations}} \times 100$

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

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

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

Know the Terms

- **Acid Test Ratio :** A type of liquidity ratio which measures the ability of a firm to pay its current liability by using liquid assets. It is also known as Quick Ratio.
- **Liquid Asset :** An asset which can be converted into cash within a short period of time than the current asset.
- **Working Capital :** Capital used by firm to meet its day-to-day requirements.
- **Capital Employed :** Total amount of funds employed into a business for the acquisition of profits.