

Senior Secondary Course

ACCOUNTANCY (320)

2

Course Coordinator
Dr. Piyush Prasad



NATIONAL INSTITUTE OF OPEN SCHOOLING

(An Autonomous Institution under MHRD, Govt. of India)

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Chairman's Message

*D*ear learners

As the needs of the society in general, and some groups in particular, keep on changing with time, the methods and techniques required for fulfilling those aspirations also have to be modified accordingly. Education is an instrument of change. The right type of education at right time can bring about positivity in the outlook of society, attitudinal changes to face the new/fresh challenges and the courage to face difficult situations.

This can be very effectively achieved by the curriculum renewal at regular intervals of time. A static curriculum does not serve any purpose, as it does not cater to the current needs and aspirations of the individual and society.

For this purpose only, educationists from all over the country come together at regular intervals to deliberate on the issues of changes needed and required. As an outcome of such deliberations, the National Curriculum Framework (NCF 2005) came out, which spells out in detail the type of education desirable/needed at various levels of education – primary, elementary, secondary or senior secondary.

Keeping this framework and other national and societal concerns in mind, we have currently revised the curricula of Accountancy course at Senior Secondary Level, as per the Common Core Curriculum developed by COBSE (Council of Boards of School Education) and NCERT (National Council for Educational Research and Training) making it current and need based. Textual material production is an integral and essential part of all NIOS programmes offered through open and distance learning system. Therefore, we have taken special care to make the learning material user friendly, interesting and attractive for you.

I would like to thank all the eminent persons involved in making this material interesting and relevant to your needs. I hope you find it appealing and absorbing.

On behalf of National Institute of Open Schooling, I wish you all a bright and successful future.

Prof. C.B. Sharma
Chairman
NIOS

A Note From the Director

Dear Learner,

The Academic Department at the National Institute of Open Schooling tries to bring you new programmes every now and then in accordance with your needs and requirements.

The Accountancy course at Senior secondary level has now been revised as per the Common Core Curriculum developed by COBSE (Council of Boards of School Education) and NCERT (National Council for Educational Research and Training) making it current and need based.

The National Curriculum Framework developed by the National Council for Educational Research and Training was kept as a reference point. Leading experts in the subject of the country were involved and with their active involvement, study materials based on the new curriculum have been updated. Old, outdated information has been removed and new, relevant things have been added.

I am happy to place this new revised study material in Accountancy in your hands. I hope you will find the new material that is now in your hands interesting and exciting. Any suggestions for further improvement are welcome.

Let me wish you all a happy and successful future.

*(Dr. Kuldeep Agarwal)
Director (Academic)
National Institute of Open Schooling*

A Word With You

Dear Learner,

I welcome you to this course in Accountancy for the Senior Secondary level.

We all know the importance of business in our everyday life. It not only fulfills our basic needs of recording transactions but also provides accounting information to users for career decision making. It is a dynamic process that keeps on changing as per the requirements and demands of the society. The procedure and practices of business in the past are completely different from modern days. It is more informative than what it was in past. The use of modern technology, government's policies and the awareness among common masses have made it user friendly. Therefore, a systematic effort is required to understand, analyse and respond to the changes that affect the functioning of accounting in the present day society.

Keeping in mind the above, the curriculum in the subject of Accountancy at Senior Secondary level has been designed. The whole learning material of the subject has been published in the form of three volumes for your convenience. The first book has two modules. Learning experiences considered essential for Accountancy are described in the first two modules. The module on Basic Accounting consists lessons on how to record transaction in books of Accounts while the second module of Trial Balance & Computers explain about the pre work done for perfect financial statement with the use of computers in Accounting, and these two modules are Tutor Marked Assignment Based modules.

The second volume which contains three modules are the core modules. The third module is Financial Statements of Profit & Not for Profit Organisations explains as how the financial statements are prepared by various organisations. The fourth module is Partnership Accounts explains how various types of accounts are maintained by Partnership firm under different situations. The fifth module is Accounting for Shares & Debentures, which contains lessons on different situations in raising capital by way of issue of Shares & Debentures by companies.

The third volume, which is an optional volume consists of two modules i.e., Analysis of Financial Statement and Application of Computer in Financial Accounting. Learners have to opt any one module out of the two. Analysis of Financial Statement consists four lessons as how to analyse the results of Business to take corrective measures & take future decisions while the other consists of four lessons as how to do accounting with help of computers.

For your practice, a sample question paper along with the question paper design and marking scheme is provided at the end of the second book.

To make your learning process interesting and useful we have changed the layout of the pages. You will also find some attractive icons in the lesson symbolising the content of different sections. The details are given separately under the heading 'How to study your lessons'.

I am sure that you will find the lessons and their approach interesting and would be able to apply your knowledge in the real life situations. So read and practice all the lessons of this course carefully and be prepared for the examination with confidence. If you face any difficulty in your studies, please feel free to write to me. Your suggestions are valuable for us.

Good luck and happy learning.

*Dr. Piyush Prasad
Academic Officer*

How To Study Your Lessons

Congratulation! You have accepted the challenge to be a self-learner. It means, you have to organise your study, learn regularly, keep up your motivation and achieve your goal. Here it is solely you, who is responsible for your learning. NIOS is with you at every step. It has developed the material in Accountancy. A format supporting independent learning has been followed. You can take the best out of this material if you follow the instructions given below.

Title: The title of the lesson will give a clear indication of the contents within. Do read it.

Introduction: This will introduce you to the lesson and also link it to previous one.



Objectives: These are statements of outcomes of learning expected from you after studying the lesson. You are expected to achieve them. Do read them and check if you have achieved the same.

Content: Total content has been divided into sections and sub-sections. A section leads you from one content element to another and sub-section helps you in comprehension of the concepts in the content element. The text in bold, Italics or boxes is important and must be given attention.



Intext Questions: Objective types, self-check questions are asked after every section, the answers to which are given at the end of the lesson. These will help you to check your progress. Do solve them. Successful completion will allow you to decide whether to proceed further or go back and learn the unit again.



Notes: Each page carries empty space on the outer margins for you to write important points or make notes.



What You Have Learnt : It is the summary of the main points of the lesson. It will help in recapitulation and revision. You are welcome to add your own points to it also.



Terminal Questions : These are very short, short and long answer type questions that provide you an opportunity to practice for better understanding of the whole topic.



Answers to Intext Questions: These will help you to know, how correctly you have answered the Intext questions.



Activity : Activities, if done by you, will help you to understand the concept clearly.

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Overview of the Learning Material

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Module-I : Basic Accounting

1. Accounting - An Introduction
2. Accounting Concepts
3. Accounting Conventions and Standards
4. Accounting for Business Transactions
5. Journal
6. Ledger
7. Cash Book

8. Special Purpose Books

Module-II : Trial Balance and Computers

9. Trial Balance
10. Bank Reconciliation Statement
11. Bills of Exchange
12. Errors and their Rectification
13. Computer and Computerised Accounting System

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Module-III : Financial Statements

14. Depreciation
15. Provision and Reserves
16. Financial Statements - An Introduction
17. Financial Statements - I
18. Financial Statements II
19. Not for Profit Organisations - An Introduction
20. Financial Statements (Not for Profit Organisations)
21. Accounts From Incomplete Records

Module-IV : Partnership Accounts

22. Partnership - An Introduction
23. Admission of a Partner
24. Retirement and Death of a Partner
25. Dissolution of a partnership firm

Module-V : Company Accounts

26. Company - An Introduction
27. Issue of Shares
28. Forfeiture of Shares
29. Reissue of Forfeited Shares
30. Issue of Debentures

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Module-VI : Analysis of Financial Statements

31. Financial Statements Analysis-An Introduction
32. Accounting Ratios-I
33. Accounting Ratios-II
34. Cash Flow Statement

Module-VII : Application of Computers in Financial Accounting

35. Electronic Spread Sheet
36. Use of Spread-sheet in Business Application
37. Graphs and Charts for Business
38. Database Management System for Accounting

Module - III

FINANCIAL STATEMENT

Marks 20

Hours 50

One of the basic functions of preparing accounts is to know the financial results of business for a particular period which is generally one year and ascertaining financial position on a particular date. For this financial statements are prepared called income statement and position statement. These are called Final accounts. Small business enterprises generally do not follow double entry system hence the method of accounting followed by them is called single entry system. Their method of preparing final accounts (financial statements) is different from business entities whose accounts are based on double entry system. They prepare trading and profit & loss account to know the performance results of business and Balance Sheet to know the net capital employed in business.

Not for profit organisations like clubs, hospitals, schools etc too prepare final accounts such as Income and Expenditure account to know the result of these activities in the form of surplus or deficit and Balance Sheet to ascertain the financial position. While preparing financial statements some adjustments are required to be made. Prominent among them are depreciation-position of the value of fixed asset to be appropriated to are accounting year and provision and reserves - position of profits to be appropriated to provisions for some expected expenses and losses and regime to meet contingencies.

Thus this module is so designed that it trains the learners how to prepare final accounts from incomplete records, of business entities following double entry system and of not for profit organisations. It exposes the learners to the concepts of depreciation, provisions and resources.

Lesson 14. Depreciation

Lesson 15. Provision and Reserves

Lesson 16. Financial Statement - An Introduction

Lesson 17. Financial Statement - I

Lesson 18. Financial Statement - II

Lesson 19. Not for Profit Organisations - An Introduction

Lesson 20. Financial Statements (Not for Profit Organisations)

Lesson 21. Accounts From Incomplete Records



Notes

14

DEPRECIATION

Expenditure on assets of the business like furniture, fixtures and fittings of the shop, motor vans, machines and equipments are neither goods nor expenses of a year. Expenditures of this nature give services to the business for many years and therefore called fixed assets. If the expenditure on the fixed assets is deducted from the profit of any one year, it would be wrong. Since their benefit is enjoyed by the business for more than one years. The correct thing will be to distribute their cost over the years of their useful life to the business. The portion of the cost of fixed assets charged each year as expense is named as depreciation.

In this lesson you will learn about the meaning and methods of charging depreciation and how depreciation is recorded in the books of accounts, together with the preparation of Fixed Assets account.



OBJECTIVES

After studying this lesson you will be able to:

- understand the meaning and concept of depreciation;
- explain the causes of depreciation;
- explain the objectives of depreciation;
- explain the factors affecting depreciation
- learn methods of charging depreciation and
- prepare fixed asset account showing the amount of depreciations charged for every year.



Notes

14.1 MEANING OF DEPRECIATION

You already know the meaning of terms assets and liabilities. Assets are broadly divided into two categories- current assets (cash, debtors or customers balances, stock of materials and goods) and fixed assets (buildings, furniture and fixtures, machinery and plant, motor vehicles).

Fixed assets are also called long term assets as they provide benefits to the business for more than one year. Most fixed assets lose their value over time as these are put in use and as the years pass by. The fixed assets lose their usefulness due to arrival of new technologies and change of fashions etc. These are then generally required to be replaced, as their useful life is over. Hence, the cost of a fixed asset is allocated over its useful life. Each year's allocation of the cost is charged as depreciation expense for that year.

For example an office chair is purchased for ₹ 2,500 and it is estimated that after ten years it will be scrapped. The useful life of the chair is ten years over which the cost of ₹ 2,500 will be distributed. Each year's allocation may be calculated as ₹ 250.

Thus, ₹ 250 is the depreciation expense for each year.

Depreciation, thus, is an expense charged during a year for the reduction in the value of fixed assets, arising due to:

- Normal wear and tear out of its use and passage of time
- Obsolescence due to change in technology, fashion, taste and other market conditions

14.2 CAUSES OF DEPRECIATION

Following are the causes for which depreciation is provided :

i) Normal wear and tear

- (a) Due to usage - Every asset has a life for which it can run, produce or give service. Thus, as we put the asset to use its worth decreases. Like decrease in the efficiency and functioning of a bicycle due to its running and usage.
- (b) Due to passage of Time – As the time goes by elements of nature, wind, sun, rain etc, cause physical deterioration in the worth of an asset. Like reduction in the worth of a piece of furniture due to passage of time even when it is not used.

ii) Obsolescence

- (a) Due to development of improved or superior equipment : Sometimes fixed assets are required to be discarded before they are actually worn out due to either of the above reasons. Arrival of superior equipments and machines etc.

allow production of goods at lower cost. This makes older equipments worthless as production of goods with their use will be costlier and non competitive. For example, Steam engines became obsolete with the arrival of diesel and electric locomotives.

- (b) Due to change in fashion, style, taste or market conditions : Obsolescence may also result due to decline in demand for certain goods and services with a change in fashion, style, taste or market conditions. The goods and services that are no longer in vogue lead to decrease in the value of the assets which were engaged in their production - like factories or machines meant for making old fashioned hats, shoes, furniture etc.

Loss in the value of fixed assets for such reasons is called obsolescence and also charged as depreciation.

14.3 OBJECTIVES OF CHARGING DEPRECIATION

Following are the objectives of charging depreciation of Assets:

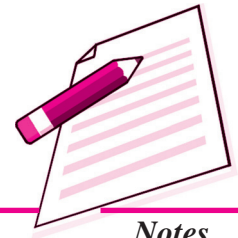
- i) **To show the True Financial Position of the Business :** Fixed Assets have some effective working life during which it can be economically operated. Depreciation is the gradual loss in the value of fixed assets. If depreciation is not provided, profit and loss A/c will not disclose the true profit made during the accounting period. At the same time, the Balance Sheet will not disclose the true Financial position as Fixed assets appearing in the Balance Sheet will be over valued. If depreciation is ignored year after year, ultimately when asset is worn out, the proprietor will not be in a position to continue the business smoothly.
- ii) **To retain funds in the business for replacement of the asset :** Net profit is the yield of the capital invested by proprietor and may be wholly withdrawn by him in the form of cash. If depreciation is provided, this figure of net profit will be reduced and the amount withdrawn by the proprietor will also be decreased. As such the cash equivalent to the charge for depreciation will be left over in the business. This accumulated amount will enable the proprietor to replace to a new asset.



INTEXT QUESTIONS 14.1

Fill in the blanks :

- i. Depreciation represents a _____ in the value of fixed assets.



Notes



Notes

- ii. Scrap value of an asset means the _____ that it will fetch on sale at the end of its _____.
- iii. Depreciation is calculated as cost of assets less scrap value divided by _____.
- iv. Obsolescence is one of the situations on fixed assets which arises due to change in _____, fashion, taste and other market conditions.

14.4 FACTORS AFFECTING THE DEPRECIATION

Following are the factors that affect the amount of depreciation to be charged on an asset.

- i) **Cost of Asset :** Cost of asset is the purchase price of the asset and includes all such expenses which are incurred before it is first put to use. For example expenses on loading, carriage, installation, transportation and unloading of the asset up to the point of its location, expense on its erection and assembly.
- ii) **Useful Life of the Asset :** Useful life is the expected number of years for which the asset will remain in use.
- iii) **Scrap Value :** Scrap value is the residual value at which the asset could be sold to scrap dealer (*Kabari*) after its useful life.
- iv) **Depreciable value of asset :** Depreciable value is the cost of asset minus the scrap value.

Illustration 1

A generator was purchased for ₹ 5,00,000. ₹ 1,500 was paid for the crane for its loading on the truck, ₹ 7,000 was paid for transporting the generator to the factory. ₹ 2,000 was spent on its unloading at the factory site. The generator was estimated to run for 10 years and thereafter would be saleable for ₹ 60,000. Calculate the depreciable value of the generator.

The cost of the asset is :

Purchase price	₹ 5,00,000
Expenses on Loading	₹ 1,500
Transportation	₹ 7,000
Expenses on unloading	₹ 2,000
Total	₹ 5,10,500

The useful life of the generator is 10 years

Depreciation

$$\begin{aligned}\text{Depreciable Value} &= \text{Cost of Asset} - \text{Scrap Value} \\ &= ₹ 5,10,500 - ₹ 60,000 = ₹ 4,50,500\end{aligned}$$

14.5 METHOD OF CHARGING DEPRECIATION

Most popularly used methods for charging depreciation are: i. Straight Line Method and ii. Diminishing Balance Method

Straight Line Method of Charging Depreciation

Under this method, the amount of depreciation is uniform from year to year. Suppose, if an asset costs ₹ 1,00,000 and depreciation is fixed @ 10%, then ₹ 10,000 would be written off every year. That is why this method is also called 'Fixed Installment Method' or 'Original Cost Method'. In this method, the amount to be written off every year is arrived at as under:

$$\text{Depreciation of Each Year} = \frac{\text{Cost of Assets} - \text{Estimated Scrap Value}}{\text{Number of years of expected life}}$$

Out of the cost of the asset, its scrap value is deducted and it is divided by the number of years of its estimated life.

For example: a machine is purchased for ₹ 1,20,000 and it is estimated that its useful life is 10 years. After its useful life its scrap value is ₹ 20,000. Depreciation of one year can be calculated as under:

$$\text{Depreciation of one Year} = \frac{₹ 1,20,000 - ₹ 20,000}{₹ 10} = ₹ 10,000$$

If its scrap can not be sold or no money can be realized from its scrap, then depreciation of one year is:

$$\text{Depreciation of one Year} = \frac{₹ 1,20,000}{₹ 10} = ₹ 12,000$$

In this method the amount of depreciation is same for each year. Therefore, this method is called Straight Line Method, Fixed Installment Method or Original Cost Method.

Illustration 2

A machine was purchased on January 1, 2011 for ₹ 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scraped and nothing will be realized from it. It is decided to charge depreciation on this machine @ 10% p. a. on Straight Line Method.

Calculate amount of depreciation for each year during the useful life of this machine.

MODULE - 3

Financial Statement



Notes

MODULE - 3

Financial Statement



Notes

Depreciation		
Year	Rate of Depreciation	Amount of Depreciation (₹)
2011	10%	10,000
2012	10%	10,000
2013	10%	10,000
2014	10%	10,000
2015	10%	10,000
2016	10%	10,000
2017	10%	10,000
2018	10%	10,000
2019	10%	10,000
2020	10%	10,000

Amount of depreciation is same every year, so this method is called 'Straight Line Method' or 'Fixed Instalment Method' or 'Original Cost Method'.

Merits of Straight Line Method

- i) **Simplicity** : Calculation of depreciation under this method is very simple and therefore, the method is widely popular. Once the amount of depreciation is calculated, the same amount is written off as depreciation each year. Hence, this method is simple and calculations are easier to understand.
- ii) **Asset is completely Written Off** : Under this method, the book value of an asset is reduced to net scrap value or zero value. In other words, in the books of accounts the value of the asset at the end of its useful life is equal to zero or its residual value.

Limitations of Straight Line Method

- i) **Difficulty in Computation** : When there are various machines having different life-spans, the computation of depreciation becomes complicated because the depreciation on each machine will have to be calculated separately for each asset.
- ii) **Illogical** : It is well known that the expense on its repairs and maintenance increases as the asset becomes older. Thus, the total burden on Profit and Loss Account,

Depreciation

depreciation plus repair expenses, is more in later years in comparison to earlier years. This is illogical because the efficiency and productivity of the asset is more in earlier years and less in later years.

Illustration 3

X limited purchased a machine on April 1, 2014 for ₹ 1,00,000 whose life was expected to be 10 years. Its estimated scrap value at the end of 10 years was ₹ 10,000. Find the amount of depreciation to be charged to Profit and Loss Account every year. Calculate the rate on which depreciation is to be charged every year.

Solution

In this question the information available is as under: The amount of depreciation that will be charged to Profit and Loss Account will be calculated as :

(i) Calculation of amount of depreciation

$$\begin{aligned}\text{Annual Depreciation} &= \frac{\text{Cost of Machine} - \text{Estimated Scrap Value}}{\text{Expected Life of the Asset}} \\ &= \frac{\text{₹ 1,00,000} - \text{₹ 10,000}}{10} = \text{₹ 9,000}\end{aligned}$$

(ii) Calculation of Rate of Depreciation

$$\begin{aligned}\text{Rate of Depreciation} &= \frac{\text{Annual Depreciation Amount} \times 100}{\text{Cost of Asset}} \\ &= \frac{\text{₹ 9,000} \times 100}{\text{₹ 1,00,000}} = 9\%\end{aligned}$$

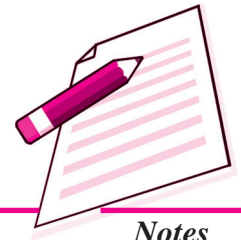
Illustration 4

Salman and Usman Bros. acquired a machine on July 1, 2014 at a cost of ₹ 70,000 and spent ₹ 5,000 on its installation. The firm writes off depreciation @ 10% on straight line method. The books are closed on December 31 every year. Show the machinery and depreciation account for three years.

Solution

Cost of Machine	₹ 70,000
Cost of Installation	₹ 5,000
Total	₹ 75,000
Rate of Depreciation	10%.

Then annual depreciation will be 10% of 75000 = ₹ 7,500.



Notes

MODULE - 3

Financial Statement



Notes

Depreciation

Dr. Depreciation Account Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2014				2014			
Dec. 31	To Machinery A/c		3,750	Dec. 31	By P & L A/c		3,750
2015				2015			
Dec. 31	To Machinery A/c		7,500	Dec. 31	By P & L A/c		7,500
2016				2016			
Dec. 31	To Machinery A/c		7,500	Dec. 31	By P & L A/c		7,500

Dr. Machinery Account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2014				2014			
July 01	To Bank A/c		70,000	Dec. 31	By Depreciation A/c $7000 \times \frac{10}{100} \times \frac{6}{12}$		3,750
July 01	To Bank A/c		5,000	Dec. 31	By Balance c/d		71,250
			75,000				75,000
2015				2015			
Jan. 01	To Balance b/d		71,250	Dec. 31	By Depreciation A/c $75000 \times \frac{10}{100}$		7,500
			71,250	Dec. 31	By Balance c/d		63,750
2016				2016			
Jan. 01	To Balance b/d		63,750	Dec. 31	By Depreciation A/c $75000 \times \frac{10}{100}$		7,500
			63,750	Dec. 31	By Balance c/d		56,250
			63,750				63,750

Illustration 5

On April 1, 2014, a company purchased machinery worth ₹ 1,00,000 . On October 1, 2016, it purchased additional machinery worth ₹ 20,000 and spent ₹ 2,000 on its erection. The accounts are closed each year on March 31. Assuming the annual depreciation to be 10%, show the Machinery Account for 5 years under the straight line method.

Depreciation

MODULE - 3

Financial Statement

Solution

Dr. **Machinery Account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2014 Apr. 01	To Bank A/c		1,00,000	2015 Mar. 31	By Depreciation A/c		10,000
					$1,00,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		90,000
			1,00,000				1,00,000
2015 Apr. 1	To Balance b/d		90,000	2016 Mar. 31	By Depreciation A/c		10,000
					$1,00,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		80,000
			90,000				90,000
2016 Apr. 1	To Balance b/d		80,000	2017 Mar. 31	By Depreciation A/c		11,100
Oct. 1	To Bank A/c		20,000		$1,00,000 \times \frac{10}{100}$		
	To Bank A/c		2,000	Mar. 31	By Balance c/d		90,900
					$22,000 \times \frac{10}{100} \times \frac{6}{12}$		
			1,02,000				1,02,000
2017 Apr. 1	To Balance b/d		90,900	2018 Mar. 31	By Depreciation A/c		12,200
					$1,00,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		78,700
			90,900		$22,000 \times \frac{10}{100}$		
2018 Apr. 1	To Balance b/d		78,700	2019 Mar. 31	By Depreciation A/c		12,200
					$1,00,000 \times \frac{10}{100}$		
				Mar. 31	By Balance c/d		66,500
					$22,000 \times \frac{10}{100}$		
			78,000				78,700
2019 Apr. 1	To Balance b/d		66,500				



Notes



Notes

Illustration 6

On 1st January, 2014 a Company purchased a plant for ₹ 20,000. On 1st July in the same year, it purchased additional plant worth ₹ 8,000 and spent ₹ 2,000 on its erection. On 1st July, 2015, the plant purchased on 1st jan., 2014 having become obsolete, was sold off for ₹ 12,500. On 1st October, 2016, fresh plant was purchased for ₹ 28,000 and on the same date, the plant purchased on 1st July, 2014 was sold at ₹ 6,000.

Depreciation is provided at 10% per annum on original cost on 31st December every year. Show the plant account for 2014 to 2016.

Solution

Dr.				Plant Account				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹				
2014				2014							
Jan. 01	To Cash A/c		20,000	Dec. 31	By Depreciation A/c						
July 01	To Cash A/c		8,000		(i) for a year 2,000						
	To Cash A/c				(ii) for six months 500		2,500				
	(expenses)		2,000		By Balance c/d						
					(i) 18,000						
					(ii) 9,500		27,500				
			30,000				30,000				
2015				2015							
Jan. 1	To Balanc b/d			July 1	By Cash A/c (sale)		12,500				
	(i) 18,000			Dec. 31	By Depreciation A/c (i)		1,000 ¹				
	(ii) 9,500		27,500		By Profit & Loss A/c		4,500 ¹				
				Dec. 31	By Depreciation A/c (ii)		1,000				
				Dec. 31	By Balance c/d						
					(₹ 9,500 - ₹ 1,000)		8,500				
			27,500				27,500				
2016				2016							
Jan. 1	To Balance b/d (ii)		8,500	Oct. 1	By Cash A/c (sale)		6,000				
Oct. 1	To Cash A/c (iii)		28,000	Oct. 1	By Depreciation A/c (ii)		750 ²				
				Oct. 1	By Profit & Loss A/c (loss)		1,750				
				Dec. 31	By Depreciation A/c (iii)						
					(28,000 x 10/100 x 3/12)		700				
				Dec. 31	By Balance c/d						
					(₹ 28,000 - ₹ 700)		27,300				
			36,500				36,500				

Note : Calculation of loss on sale of plant :

₹

(i)	On 1-1-2015 book value of the plant sold [Plant (i)]	18,000
	Less : Depreciation for 6 months i.e. 20,000 x 10/100 x 6/12	1,000



Depreciation

On 1-7-2015 book value of plant sold	17,000
Less : Sale price of plant	12,500
Loss on sale of plant	4,500
 (ii) On 1-1-2016 book value of plant sold [Plant (ii)]	 8,500
Less : Depreciation for 9 months is 10,000 x 10/100 x 9/12	750
On 1-10-2016 book value of plant sold	7,750
Less : Sale Price	6,000
Loss on Sale of Plant	1,750



INTEXT QUESTIONS 14.2

Fill in the blanks :

- i. The assumption underlying the fixed installment method of depreciation is that the amount of the fixed assets over different years of its useful life remains the _____.
- ii. Straight line method of charging depreciation is also known as _____ or _____.
- iii. Under straight line method the value of the assets at the end of its useful life is equal to _____ or its _____.
- iv. Under straight line method the total burden on Profit and Loss Account in comparison to earlier years is _____.

(2) Diminishing Balance Method

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year goes on declining. The amount of depreciation is calculated as a fixed percentage of the diminishing value of the asset shown in the books at the beginning of each year. Under this method the value of an asset never comes to zero.

Suppose, the cost of the asset is ₹ 40,000 and the percentage to be written off each year is 10%. In the first year the amount of the depreciation will be ₹ 4,000 i.e., 10% of ₹ 40,000. This will reduce the book value to ₹ 36,000 i.e. ₹ 40,000 – ₹ 4,000. Now, at the beginning of the next year the book value is ₹ 36,000. The amount of the depreciation for the next year will be ₹ 3,600, i.e., 10% of ₹ 36,000. Thus, every year the amount of the depreciation will go on reducing. This method of charging depreciation is also known as Reducing Balance Method or written down value method.



Notes

Illustration 7

A machine was purchased on January 1, 2014 for ₹ 1,00,000 and its useful life is 10 years. After completing its useful life the machine will be scrapped and ₹ 4,000 will be realized from it. It is decided to charge depreciation on this machine @ 10% p. a. on Diminishing Balance Method.

Calculate amount of depreciation for each year during the useful life of this machine.

Solution

Year	Rate of Depreciation	Amount of Depreciation
2014	10%	10,000
2015	10%	9,000
2016	10%	8,100
2017	10%	7,290
2018	10%	6,561
2019	10%	5,905
2020	10%	5,314
2021	10%	4,783
2022	10%	4,305
2023	10%	3,874

Amount of depreciation is decreased year after year in this method that is why this method is called ‘Diminishing Balance Method’ or ‘Reducing balance method’ or ‘written down value method’.

Merits of Diminishing Balance Method

Equal Burden on Profit & Loss Account

During the initial years the productivity of the asset is more hence its contribution to profit is also relatively greater. Therefore, the cost charged in terms of depreciation should also be greater.

In the initial year, the depreciation charges are more and repair expenses are less. In later years, depreciation charges are less and repair expenses are more. Hence the total burden of depreciation plus repair expenses, is some what equal on Profit & Loss Account for each year.

Demerits of Diminishing Balance Method

- i) **Asset cannot be completely written off :** Under this method, the value of an asset is not reduced to zero even when there is no scrap value.
- ii) **Complexity :** Under this method, the rate of depreciation cannot be determined easily.



Notes



INTEXT QUESTIONS 14.3

Fill in the blanks with suitable words

- i. Depreciation represents a _____ in the value of fixed assets.
- ii. The amount of depreciation on machinery is credited to _____ account.
- iii. Depreciation is calculated on _____ under the straight line method.
- iv. Depreciation is calculated on _____ under the diminishing balance method.
- v. The value of an asset is not reduced to _____ even when there is no scrap value in diminishing balance method of depreciation.

Illustration 8

Widson enterprise purchased Plant and Machinery for ₹ 1,00,000 on 1st October 2012. It decided to write off depreciation 20% per annum on Written Down Value Method. On 1st January, 2015 purchased additional Machinery for ₹ 40,000.

Show Machinery Account upto the year ending 31st March, 2016. The accounting year ends on 31st March.

Solution

Dr.		Plant and Machinery Account				Cr.	
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2012 Oct. 01	To Bank		1,00,000	2013 Mar. 31	By Depreciation (for six months)		10,000
					By Balance c/d		90,000
			1,00,000				1,00,000
2013 Apr. 01	To Balance b/d		90,000	2014 Mar. 31	By Depreciation (on ₹ 90,000 for one year)		18,000
					By Balance c/d		72,000
			90,000				90,000

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Depreciation

2014 Apr. 01	To Balance b/d		72,000	2015 Mar. 31	By Depreciation (On ₹ 72,000) for one year ₹ 14,400 On ₹ 40,000 for 3 months ₹ 2,000 By Balance c/d		
2015 Jan. 01	To Bank		40,000				16,400
							95,600
			1,12,000				1,12,000
2015 Apr. 01	To Balance b/d		95,600	2016 Mar. 31	By Depreciation (On ₹ 95,600) for one year By Balance c/d		19,120
							76,480
			95,600				95,600
2016 Apr. 01	To Balance b/d		76,480				

Illustration 9

On April 1, 2014 Ganga Bros. purchased two machines for ₹ 75,000 each. Depreciation at the rate of 10% on diminishing balance method was provided. On March 31, 2016, one machine was sold for ₹ 55,000. An improved model with a cost of ₹ 80,000 was purchased on the same day. You are required to show the Machinery Account for 2014-15 to 2015-16. The accounting year ends on 31st March.

Solution

Dr.				Machinery Account				Cr.			
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹				
2014 Apr. 01	To Bank		1,50,000	2015 Mar. 31	By Depreciation A/c		15,000				
				Mar. 31	By Balance c/d		1,35,000				
			1,50,000				1,50,000				
2015 Apr. 01	To Balance b/d		1,35,000	2016 Mar. 31	By Depreciation A/c		13,500				
2016 Mar. 31	To Bank A/c		80,000	Mar. 31	By Bank A/c		55,000				
					By P & L A/c		5,750				
					By Balance c/d		1,40,750				
			2,15,000				2,15,000				
2016 Apr. 01	To Balance b/d		1,40,750								

Depreciation

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Note : Calculation of loss on sale of machine :

Initial Cost	75,000
Dep. in 2015	- 7,500
Book Value in 2015	67,500
Dep. in 2016	- 6,750
Book Value in 2016	60,750
Sale Price	- 55,000
Loss on Sale	5,750



Notes

Illustration 10

On October 1, 2014, the Akash Transport Company purchased a Truck for ₹ 8,00,000. On April 1, 2016, this Truck was involved in an accident and was completely destroyed and ₹ 6,00,000 were received from Insurance Company in full settlement. On the same date another Truck was purchased by the company for ₹ 10,00,000. The company writes off 20% depreciation p. a. on written down value method. Give the Truck Account from 2014 to 2016. The accounting year ends on 31st December.

Solution

Dr. Truck Account Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2014				2014			
Oct. 01	To Bank A/c		8,00,000	Dec. 31	By Depreciation A/c		40,000
					$8,00,000 \times \frac{20}{100} \times \frac{3}{12}$		
				Dec. 31	By Balance c/d		7,60,000
			8,00,000				8,00,000
2015				2015			
Jan. 01	To Balance b/d		7,60,000	Dec. 31	By Depreciation A/c		1,52,000
					$7,60,000 \times \frac{20}{100}$		
				Dec. 31	By Balance c/d		6,08,000
			7,60,000				7,60,000

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Depreciation

2016			2016		
Jan. 01	Balance b/d	6,08,000	Apr. 01	By Bank A/c	6,00,000
Apr. 01	To P & L A/c	22,400	Apr. 01	By Depreciation A/c	30,400
				$6,08,000 \times \frac{20}{100} \times \frac{3}{12}$	
Apr. 01	To Bank A/c	10,00,000	Dec. 31	By Depreciation A/c	1,50,000
				$10,00,000 \times \frac{20}{100} \times \frac{9}{12}$	
			Dec. 31	By Balance c/d	8,50,000
		16,30,400			16,30,400

Distinction between Straight Line Method and Diminishing Balance Method

Basis	Straight Line Method	Diminishing Balance Method
Basis of Calculation	Depreciation is calculated on original cost of the asset.	Depreciation is calculated on original cost in first year and on written down value of the asset in subsequent years.
Amount of Depreciation	The amount of depreciation remains the same for all years.	The amount of depreciation goes on reducing year after year.
Value of Asset	The book value of the asset can be reduced to zero.	The book value of the asset can never be reduced to zero.
Depreciation and Repairs	The combined cost on account of depreciation and repairs is lower in the initial years and higher in the later years.	The combined cost on account of depreciation and repairs remains, more or less, equal throughout the period.



INTEXT QUESTIONS 14.4

I. State which of the following statements are true and which are false:

- Amount of depreciation goes on reducing year after year in Straight Line Method.
- The amount of depreciation remains the same for all years in Diminishing Balance Method.

- iii. The book value of the asset can be reduced to zero in Straight Line Method.
- iv. The book value of the asset can never be reduced to zero in Diminishing Balance Method.

II. Multiple Choice Questions

- i. Depreciation is charged on :
 - a) Stock of Goods b) Current Assets
 - c) Fixed Assets d) Liquid Assets
- ii. Obsolescence term is due to :
 - a) Tear and wear of the Assets
 - b) Decrease in the value of the assets which are engaged in production
 - c) Development of improved or superior quality of equipment.
 - d) Due to usage and age of assets
- iii. While charging depreciation on Fixed Assets by Straight line method, the value of the asset is taken into consideration is :
 - a) Original value b) Diminished value
 - c) Market value d) Book value
- iv. While charging depreciation on Fixed assets by Reducing balance method, the value of the asset is taken into consideration is :
 - a) Original cost b) Diminished value
 - c) Market value d) Book value
- v. The amount calculated for charging depreciation :
 - a) Includes the amount of scrap value of the Asset
 - b) Do not include the amount of scrap value of the asset
 - c) Cost of assets less scrap value
 - d) None of the above.
- vi. Out of the following which is the cause of depreciation:
 - a) Normal wear and tear b) Scrap value
 - c) Cost of asset. d) Decrease or increase in market price



Notes



Notes

- vii. Out of the following what will be the amount of annual depreciation :
 - a) Total Depreciation + installation charges cost
 - b) Total cost – Scrap value ÷ Expected life
 - c) Total cost + Scrap value ÷ Expected life
 - d) None of the above.
- viii. Which one of the following is not a factor affecting annual depreciation on an asset.
 - a) Cost of the Asset
 - b) Scrap Value of the asset
 - c) Useful life of the asset
 - d) Annual maintenance on the asset.
- ix. Out of the following on which asset depreciation will be charged :
 - a) Stock
 - b) Debtors
 - c) Machinery
 - d) Land
- x. Out of the following assets on which depreciation will not be charged:
 - a) Machinery
 - b) Plant
 - c) Photo Copier
 - d) Stock

14.6 ASSET DISPOSAL ACCOUNT

If part of the asset is sold, it is appropriate to open a new account called as ‘Assets Disposal Account’. In this case, method of recording the entries will depend on the fact whether :

- i. Provision for Depreciation A/c is not maintained.
- ii. Provision for Depreciation A/c is maintained.

I. When Provision for Depreciation A/c is not maintained, Journal Entries will be : Under this method depreciation is directly charged to the assets account. Thus, normally only the assets account is prepared.

(i) For Transfer of Book Value of Asset to Asset Disposal A/c

Assets Disposal A/c :	Dr.
To Assets A/c	

(ii) For Sale of Asset :

Bank A/c	
To Assets Disposal A/c	

(iii) For profit on Sale of Asset

Assets Disposal A/c	
To Profit & Loss A/c	

(iv) For loss on Sale of asset
 Profit & Loss A/c
 To Assets Disposal A/c

II. When Provision for Depreciation Account is maintained : (Accumulated Depreciation Account) Under this method, depreciation is not directly charged to the asset account. The amount of depreciation to be provided for the period is debited to depreciation account and credited to 'Provision for Depreciation Account' or 'Accumulated Depreciation Account'. Thus, entry will be as follows :



Notes

- (i) For asset purchased :
- | | |
|------------------|-----|
| Asset A/c | Dr. |
| To Cash/Bank A/c | |
- (ii) For depreciation charged :
- | | |
|-----------------------------------|-----|
| Depreciation A/c | Dr. |
| To provision for Depreciation A/c | |
- (iii) For transfer of depreciation to Profit and Loss Account
- | | |
|---------------------|-----|
| Profit & Loss A/c | Dr. |
| To Depreciation A/c | |

In the balance sheet, the asset appears at its original cost and provision for depreciation (or accumulated depreciation) appears on the liabilities side.

As the year passes, the balance of the accumulated depreciation goes on increasing since constant credit is given to this account in each accounting year. After the expiry of useful life, these two accounts are closed by debiting Accumulated Depreciation Account and crediting Asset Account and balance in asset account is transferred to Profit & Loss Account. Entry will be :

Provision for Depreciation A/c	Dr.
To Asset A/c	
(Balance of Prov. for depreciation to Asset A/c)	

Profit & Loss A/c	Dr.
To Asset A/c	
(For loss on asset)	

OR

Asset A/c	Dr.
To Profit & Loss A/c	
(For profit on asset)	



Notes

Illustration 11

On January 1, 2012 X Ltd. purchased a machinery by cheque for ₹ 12,00,000. On July 1, 2014 a part of the machinery purchased on January 1, 2012 for ₹ 80,000 was sold for ₹ 45,000 and new machinery at a cost of ₹ 1,58,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the original cost of the machinery.

Give journal entries and show the necessary ledger accounts assuming that (i) Provision for Depreciation A/c is not maintained. (ii) Provision for Depreciation Account is maintained. The accounting year ends on 31st December.

Solution

(i) When Provision for Depreciation A/c is not maintained :

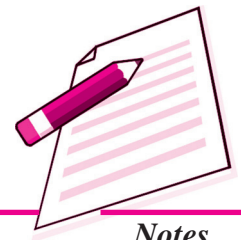
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
2012				
Jan. 1	Machinery A/c Dr. To Bank A/c (For purchase of machinery)		12,00,000	12,00,000
Dec. 31	Depreciation A/c Dr. To Machinery A/c (For depreciation charged)		1,20,000	1,20,000
Dec. 31	Profit & Loss A/c Dr. To Depreciation A/c (For depreciation transferred to P/L A/c)		1,20,000	1,20,000
2013				
Dec. 31	Depreciation A/c Dr. To Machinery A/c (For depreciation charged)		1,20,000	1,20,000
Dec. 31	Profit & Loss A/c Dr. To Depreciation A/c (For depreciation transferred to P/L A/c)		1,20,000	1,20,000
2014				
July 1	Depreciation A/c Dr. To Machinery A/c (For current half yearly depreciation charged on machinery disposed)		4,000	4,000

Depreciation

July 1	Machinery Disposal A/c To Machinery A/c (For transfer to machinery disposal A/c at its book value)	Dr.	60,000	60,000
July 1	Bank A/c To Machinery Disposal A/c (For sale of machine)	Dr.	45,000	45,000
July 1	Machinery A/c To Bank A/c (For purchase of machinery)	Dr.	1,58,000	1,58,000
Dec. 31	Depreciation A/c To Machinery A/c (For depreciation charged on remaining machinery)	Dr.	1,19,900	1,19,900
Dec. 31	Profit & Loss A/c To Depreciation A/c (For depreciation transferred P/L A/c)	Dr.	1,23,900	1,23,900
Dec. 31	Profit & Loss A/c To Machinery Disposal A/c (For Loss on sale of machinery transferred to P/L A/c)	Dr.	15,000	15,000

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Machinery Account

		₹		₹
2012			2012	
Jan. 1	To Bank A/c	12,00,000	Dec. 31 By Depreciation A/c	1,20,000
			Dec. 31 By Balance c/d	10,80,000
		12,00,000		12,00,000
2013			2013	
Jan. 1	To Balanced b/d	10,80,000	Dec. 31 By Depreciation A/c	1,20,000
			Dec. 31 By Balance c/d	9,60,000
		10,80,000		10,80,000
2014			2014	
Jan. 1	To Balance b/d	9,60,000	July 1 By Depreciation A/c (on 80,000 for 6 months @ 10%)	4,000

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Depreciation

July 1	To Bank A/c	1,58,000	July 1	By Machinery Disposal A/c (Rs. 80,000-Rs. 20,000)	60,000
			Dec. 31	By Depreciation A/c	1,19,900 ⁽¹⁾
				By Balance c/d	9,34,100
		11,18,000			11,18,000

Machinery Disposal Account

		₹		₹	
2013			2014		
July 1	To Machinery A/c	60,000	July 1	By Bank (sale)	45,000
			Dec. 1	By Profit & Loss A/c (loss)	15,000
		60,000			60,000

(ii) Provision for Depreciation A/c is Maintained :

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2012				
Jan. 1	Machinery A/c Dr. To Bank A/c (For purchase of machinery)		12,00,000	12,00,000
Dec. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (For depreciation charged)		1,20,000	1,20,000
Dec. 31	Profit & Loss A/c Dr. To Depreciation A/c (For depreciation transferred to Profit & Loss A/c)		1,20,000	1,20,000
2013				
Dec. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (For depreciation charged)		1,20,000	1,20,000

Depreciation

Dec. 31	Profit & Loss A/c To Depreciation A/c (For depreciation transferred to Profit & Loss A/c)	Dr.	1,20,000	1,20,000
2014				
July 1	Machinery Disposal A/c To Machinery A/c (For transfer to machinery disposal A/c)	Dr.	80,000	80,000
July 1	Bank A/c To Machinery Disposal A/c (For sale of machine)	Dr.	45,000	45,000
July 1	Depreciation A/c To Provision for Depreciation A/c (for current half yearly depreciation charged on machinery disposed)	Dr.	4,000	4,000
July 1	Provision for Depreciation A/c To Machinery Disposal A/c (For transfer accumulated depreciation on machinery sold)	Dr.	20,000	20,000
July 1	Machinery A/c To Bank A/c (For purchase of machinery)	Dr.	1,58,000	1,58,000
Dec. 31	Depreciation A/c To Provision for Depreciation A/c (For depreciation charged on remaining machinery)	Dr.	1,19,900	1,19,900
Dec. 31	Profit & Loss A/c To Depreciation A/c (For depreciation transferred P/LA/c)	Dr.	1,23,900	1,23,900
Dec. 31	Profit & Loss A/c To Machinery Disposal A/c (For Loss on sale of machinery transferred to P/LA/c)	Dr.	15,000	15,000

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Depreciation

Machinery Account

		₹			₹
2012			2012		
Jan. 1	To Bank A/c	12,00,000	Dec. 31	By Balance c/d	12,00,000
2013			2013		
Jan. 1	To Balance b/d	12,00,000	Dec. 31	By Balance c/d	12,00,000
2014			2014		
Jan. 1	To Balance b/d	12,00,000	July 1	By Machinery Disposal A/c	80,000
July 1	To Bank A/c	1,58,000	Dec. 31	By Balance c/d	12,78,000
		13,58,000			13,58,000

Depreciation Account

		₹			₹
2012			2012		
Dec. 31	To Provision for Depreciation A/c	1,20,000	Dec. 31	By Profit & Loss A/c	1,20,000
2013			2013		
Dec. 31	To Provision for Depreciation A/c	1,20,000	Dec. 31	By Profit & Loss A/c	1,20,000
2014			2014		
July 1	To Provision for Depreciation A/c	4,000	Dec. 31	By Profit & Loss A/c	1,23,900
Dec. 31	To Provision for Depreciation A/c	1,19,900			
		1,23,900			1,23,900

Provision for Depreciation Account

		₹			₹
2012			2012		
Dec. 31	To Balance c/d	1,20,000	Dec. 31	Depreciation A/c	1,20,000

Depreciation

2013			2013		
Dec. 31	To Balance c/d	2,40,000	Jan. 1	By Balance b/d	1,20,000
			Dec. 31	By Depreciation A/c	1,20,000
		2,40,000			2,40,000
2014			2014		
Dec. 31	To Machinery		Jan. 1	By Balance b/d	2,40,000
	Disposal A/c	20,000 ¹			
Dec. 31	To Balance c/d	3,43,900	July 1	By Depreciation A/c (80,000 x 10/100 x 6/12)	4,000
			Dec. 31	By Depreciation A/c	1,19,900 ²
		3,63,900			3,63,900

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Notes

Machinery Disposal Account

		₹			₹
2014			2014		
July 1	To Machinery A/c	80,000	July 1	By Bank A/c (Sale)	45,000
			July 1	By Provision on Depreciation A/c (8,000 + 8,000 + 4,000)	20,000
			Dec.31	By Profit & Loss A/c (loss)	15,000
		80,000			80,000

Note : (1) Calculation of Depreciation on machinery disposed off update :

Depreciation @ 10% on ₹ 80,000 for $2\frac{1}{2}$ year = 20,000.

(2) Calculation of Depreciation on machinery (other than sold)

(i) On old machine (11,20,000 x 10/100) 1,12,000

(ii) On new machine (1,58,000 x 10/100 x 6/12) 7,900

1,19,900



Notes

Illustration 12

On 1st April 2011, X Ltd. purchased a plant for ₹ 5,00,000. On 1st July 2013, a part of plant purchased for ₹ 70,000 on 1st April 2011 was sold for ₹ 40,000 and a fresh plant was purchased for ₹ 1,00,000. Depreciation is provided @20% p.a. on reducing balance method and books of accounts are closed on 31st December each year.

Prepare Plant A/c., Provision for Depreciation A/c and Plant Disposal A/c.

Solution :

Plant Account

		₹			₹
2011			2011		
April 1	To Bank A/c	5,00,000	Dec. 31	By Balance c/d	5,00,000
2012			2012		
Jan. 1	To Balance b/d	5,00,000	Dec. 31	By Balance c/d	5,00,000
2013			2013		
Jan. 1	To Balance b/d	5,00,000	July 1	By Plant Disposal A/c	70,000
July 1	To Bank A/c	1,00,000	Dec. 31	By Balance c/d	5,30,000
		6,00,000			6,00,000

Provision for Depreciation Account

		₹			₹
2011			2011		
Dec. 31	To Balance c/d	75,000	Dec. 31	By Depreciation A/c	75,000
2012			2012		
Dec. 31	To Balance c/d	1,60,000	Jan. 1	By Balance b/d	75,000
		1,60,000	Dec. 31	By Depreciation A/c	85,000
					1,60,000
2013			2013		
July 1	To Plant Disposal A/c	27,160 ⁽¹⁾	Jan. 1	By Balance b/d	1,60,000
July 1	To Balance c/d	2,06,080	July 1	By Depreciation A/c (Rs. 47,600 for 1/2 year @ 20%)	4,760
		2,33,240	Dec. 31	By Depreciation A/c	68,480 ⁽²⁾
					2,33,240

Plant Disposal Account

		₹			₹
2011			2011		
July 1	To Plant A/c	70,000	July 1	By Bank A/c (sale)	40,000
			July 1	By Prov. for Dep. A/c	27,160 ⁽¹⁾
			July 1	By P & L A/c (loss)	2,480
		70,000			70,000



Notes

Note :

(1) Depreciation on Plant Sold :

Particulars	₹
In 2011 on ₹ 70,000 for 9 months @ 20%	10,500
In 2012 on ₹ 59,500 (₹ 70,000 - ₹ 10,500) for 1 year - @ 20%	11,900
In 2013 on ₹ 47,600 (₹ 59,500 - ₹ 11,900) for 1/2 year @ 20%	4,760
Total	27,160

(2) Depreciation on Plant Retained :

	₹
Total Plant	₹ 5,30,000
Less : Purchased on July, 2013 for ₹ 1,00,000 for 1/2 year @ 20% =	10,000
Old Plant purchased on	₹ 4,30,000
Plant retained ₹ 4,30,000 - 64,500 - 73,100 =	
₹ 2,92,400 for 1 year @ 20%	58,480
Total	68,480



WHAT YOU HAVE LEARNT

- Depreciation is the gradual and permanent decrease in the value of an asset due to efflux of time, wear and tear, obsolescence or any other reason.
- **Causes of Depreciation**
 - ▶▶ Physical Wear and Tear due to usage
 - ▶▶ Physical wear and tear due to passage of time



Notes

»» Obsolescence due to advancement in technology

● **Objective of Depreciation**

- »» To show the True Financial Position of the business.
- »» To retain funds in the business for replacement of the Asset.

● **Methods of Charging Depreciation**

- »» Straight Line Method
- »» Diminishing Balance Method

● **Merits of Straight Line Method**

- »» Simplicity
- »» Assets can be Completely Written Off

● **Demerits of Straight Line Method**

- »» Difficulty in Computation
- »» Illogical

● **Merits of Diminishing Balance Method**

- »» Equal burden on Profit & Loss Account.
- »» Balance of Asset is never written Off to Zero

● **Demerits of Diminishing Balance Method**

- »» Asset cannot be completely written off
- »» Complexity



TERMINAL EXERCISE

1. What is depreciation? Write the various objectives of providing depreciation.
2. What are the causes of providing depreciation?
3. What are the two methods of providing depreciation? Explain their merits and demerits.
4. What are the objectives of providing depreciation?
5. Distinguish between Straight Line Method and Diminishing Balance Method of Depreciation.

6. Krishnamohan Limited purchased a machinery on October 1, 2008 for ₹ 90,000 and spent ₹ 10,000 on its erection. The depreciation is to be charged @ 10% p. a. on original cost. Show the Machinery Account for three years if books are closed on March 31 every year.
7. On April 1, 2008 Aashi Limited purchased a machinery for ₹ 80,000 and spent ₹ 20,000 on its repairs and installation. On September 30, 2011, the machinery was sold for ₹ 60,000. Prepare Machinery Account for the year 2008 to 2011, if depreciation is charged @ 10% p. a. by Straight Line Method.
8. Ajay Kumar and Company purchased machinery for ₹ 20,000 on April 1, 2007. The Machinery is depreciated at 10% per annum on the straight line method. On October 1, 2010, the machinery was sold for ₹ 8,000.

Give the Machinery Account if books are closed on March 31 every year.

9. A Plant is purchased for ₹ 80,000 on January 1, 2008. It is estimated that the residual value of the plant at the end of its working life of 10 years will be ₹ 27,894. Depreciation is to be provided at 10% p.a. on diminishing balance method.

You are required to show the Plant Account for 4 years assuming that the books are closed on March 31 every year.

10. On January 1, 1987 Machinery Account showed a balance of ₹ 10,000. On 1st July, 1988, a new machine costing ₹. 6,000 was purchased. On 30th June, 1990, Machinery other than the machine bought on 1st July, 1988, was disposed off for ₹ 6,000.

Show the Machinery Account for four years. The accounting year ends on 31st December, and depreciation is to be provided at 10% p.a. on written down value.

11. On 1.1.2010 X Ltd. purchased a machinery of Rs. 2,00,000 and spent ₹ 50,000 on its erection. Depreciation on the machinery was to be charged @ 20% p.a. on straight line method. On 30.6.2012 a piece of machinery included in machinery purchased on 1.1.2010 costing ₹ 20,000 was sold for ₹ 12,000.

Prepare machinery account, machinery disposal account and provision for depreciation account.



Notes



ANSWERS TO INTEXT QUESTIONS

- 14.1** i) Diminution ii) Amount, life
 iii) Life of assets iv) Technology

14.2 i) Same ii) Fixed instalment method, Original cost method
iii) Zero, Net Scrap value iv) More

14.3 i) Fall ii) Machinery iii) Original cost
iv) Opening balance of the year v) Zero

14.4 I. i) False ii) False i ii) True iv) True
II. i) c ii) c iii) a iv) b v) c
vi) a vii) b viii) d ix) c x) d



ACTIVITY

- Ask your parents about the date of various fixed assets purchased by them like T.V., Fridge, Motorcycle, Car etc., with its useful life and then calculate the amount of depreciation to be charged on each asset.

PROVISIONS AND RESERVES

You know that businessmen prepare their accounts on the basis of going concern concept assuming that their business will continue for an indefinite period. Hence, in order to ascertain the net profit for each year, businessmen need to take into account not only the current contingencies but future contingencies also. In fact, provisions and reserves are such considerations which actually relate to the future needs for which a part of the current earnings has to be set aside.



OBJECTIVES

After studying this lesson you will be able to

- understand the meaning and need of provision;
- understand the meaning and objectives of reserves;
- explain types of reserves and
- know the difference between provisions and reserves.

15.1 PROVISION : MEANING AND NEED

As you know in our daily routine life we make various arrangements for the future expected needs. For example, if your father wants to give you higher education such as Engineering, Doctorate, or any other professional course, he will need a lot of money. Now question arises how would your father be able to arrange such an amount? Yes, you are thinking right, he will start saving money from today and every year he will do the same. The events which are about to happen in the future are planned in the present with the help of available resources. In the same way these things are followed in a business also. When there are certain expected losses/ expenses, these are planned to

**Notes**

be managed in advance from the current year's profits/ surplus. The amount which is kept separately to meet such expected losses/expenses is called a Provision.

If an amount is payable in the future and the amount is certain, it is a liability. For example, October month's rent, totalling ₹ 2,000. is payable on 31st October. The enterprise will debit Rent Account and Credit Rent Outstanding Account as it is a definite liability. However, if the amount in respect of a liability or expected loss is not certain, an estimated amount is set aside by debiting the Profit and Loss Account. The amount so set aside is known as a Provision. Thus, 'Provision' means an estimated amount to meet an uncertain loss or expense in future. Some of the examples of Provisions are: Provision for Doubtful Debts on Debtors, Provision for Discount on Debtors, Provision for Depreciation.

Needs of Provision

Provisions are provided for:

- i) Depreciation, renewal or reduction in the value of assets.
- ii) A known liability, the amount of which cannot be determined with substantial accuracy.
- iii) A disputed claim.
- iv) Specific loss on realization of an asset or on payment of taxes.
- v) Redeeming the liability.
- vi) Writing off bad-debts/doubtful debts.
- vii) Contingent liabilities.

General rules in creation of Provisions:

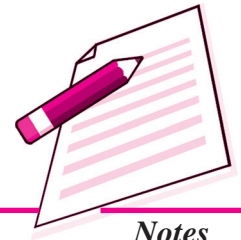
- i) It is created by debiting the profit and loss account.
- ii) It is created to meet a known liability or a specific contingency, e.g. 'Provision for bad and doubtful debts' and 'provision for depreciation' etc.
- iii) A provision is created irrespective of whether there is profit or loss in the business.
- iv) It is not available for distribution as dividend among shareholders.
- v) A provision is made for a definite amount and, therefore, a definite sum is set aside every year to meet the known contingency.
- vi) Making of a provision is must to meet known liability or contingency.
- vii) The provision is generally shown on the liability side of the balance sheet.



INTEXT QUESTIONS 15.1

Fill in the blanks with suitable words:

- i. Provision means an estimated amount to meet an uncertain _____ or _____ in future.
- ii. A provision may be provided for a _____ claim.
- iii. A provision is created by debiting _____ account.
- iv. A provision is not available for distributions as dividend among _____.
- v. A provision is generally shown on _____ side of the balance sheet.



Notes

15.2 MEANING OF RESERVE

Our future is uncertain. There are a lot of contingencies, various needs and requirements in the future. Sometime we estimate for some unexpected losses/ expenses we may have to bear in the future. For this, we save some money from our current earning. If the unexpected event happens, we can use this saved money. Suppose your father earns ₹ 20,000 in a month and he does not set some money aside for any type of unexpected happening. In the mid of the month you get ill then how will your father manage for the various medical expenses for your treatment. Definitely, he will have to ask for money from friends, relatives etc. If they do not help your father, then think what will happen?

If your father had kept some money for these kinds of unexpected happenings, he would not have to face such types of troubles. Thus, an amount which is kept aside from our current income to meet the unexpected happening in the future is the reserve.

Future is uncertain, in the business there are a lot of happenings which may happen unexpectedly. For this arrangement of funds in a well planned manner is necessary. Some amount of total earned fund in a year is needed to set aside as a reserve.

Reserves are the amounts set aside out of profits. It is an appropriation of profits or accumulated profits to strengthen the financial position of the business. It is not a charge against profits. Reserves are not meant to cover any liability or depreciation in the value of assets. Examples are General Reserves, Reserves for Expansion, Reserve for Equalization of Dividends, Reserve for Increased Costs of Replacement, etc.

15.3 TYPES OF RESERVES



Notes

Sometimes business, likely or certainly, has to anticipate some known or unknown future contingencies/emergencies. To meet this, business set aside a part of the profits and other surpluses which is called a reserve. Reserve is an appropriation of the profits and not a charge to it because it is not supposed to meet any known liability or diminution in the value of an asset. It is that part of profits that is kept aside to meet an unknown liability or for future emergency. It is created by debiting the P&L Appropriation A/c. It can be created only when there is profit in the business. It is usually shown on the liability side of the balance sheet. Reserves can be categorized into:

- | | | |
|---------------------|---------------------|---------------------|
| i. General Reserve | ii. Capital Reserve | iii. Secret Reserve |
| iv. Revenue Reserve | v. Specific Reserve | vi. Reserve Fund |
| vii. Sinking Fund | | |

i) General reserve: As the name suggests, the general reserve is not tied down to any specific purpose. It can be utilised to meet any future contingency or unknown liability. It is not legally mandatory to create a general reserve. It is created only when there is sufficient profit. It is shown on the debit side of P&L Appropriation A/c.

- It is created not for any specific purpose but for meeting future contingencies.
- It can be utilized for meeting any future loss.
- It is created only when there are sufficient profits.
- It is shown on the debit side of profit and loss appropriation account.
- Only distributable profits are reduced because of it.

This reserve is created by setting aside revenue profits. The object is to strengthen the general financial position of the business. It is not for a specific purpose. It is a free reserve. It acts as a safety cushion against all unforeseen contingencies in the future. It is immediately available for distribution as dividend profit.

General Reserves are retained profits. They are part of the surplus. They are the amount kept aside from profits. There can be no reserves if there are no profits. Reserves are undistributed profits. They are appropriations of profits. While provisions are a pre-profit matter, reserves are a post-profit matter. One cannot talk of creating reserves, without first finding out profits. It is a good business policy to create reserves. Reserve strengthen the financial position of the business. Reserves are created for different purposes. They may be for expansion of business; they may be for equalization of dividends or they may be for redemption of debentures

or loans. Again, reserves may be created out of capital profits or out of revenue profits. The reserves created out of capital profits are called capital reserves, whereas, others are called revenue reserves.

- ii) Capital Reserve :** A capital reserve is generally created out of profits which are of capital nature only, such as capital gains, premium on issue of shares and debentures, profits prior to incorporation, profits on revaluation of assets and liabilities etc. It should not be distributed as dividend among the shareholders. It is used to strengthen the financial position of business, to write off capital losses or losses of abnormal nature.



Notes

Thus, the Capital Reserves

- Are appropriations from profits which cannot be distributed by way of cash dividends.
- Arise mainly from (i) equity transactions between the enterprise and its shareholders; (ii) from adjustments arising in accounting for business combinations; (iii) from differences arising on transactions of foreign currency operations; (iv) from surpluses arising from asset revaluation; (iv) any unrealized gain which has not been included in income.
- Examples of capital reserves includes: security premium, capital redemption reserves, capital reserves arising on merger and acquisition of a business, statutory reserves, asset revaluation reserve and exchange fluctuation reserves.

Capital reserves are created out of capital profits. Capital profits are not regular trading profits. They are profits on rare transactions. Capital reserves are generally not available for distribution as dividend. They are set aside to strengthen the financial position of the business or to meet capital losses. The following are the examples of capital profits :

- a) Profit on sale of fixed' assets.
- b) Profit prior to incorporation.
- c) Profit on redemption of debentures.
- d) Premium on issue of shares or debentures.
- e) Profit on forfeiture of shares.
- f) Profit on acquisition of business.
- g) Profit which have not been earned in the regular course of business.



Notes

Capital reserves can be utilized in the following ways:

- a) Issue of bonus shares.
- b) Writing off goodwill.
- c) Writing off preliminary expenses.
- d) Writing off shares/debentures issue expenses.
- e) Writing off losses prior to incorporation.

iii) Secret Reserve : Sometimes, a firm creates a reserve which is not shown in the balance sheet; it is known as secret reserve or hidden reserve or internal reserve. The existence of this reserve is not disclosed in the financial statements. It strengthens the financial position of the business, promotes confidence and stability. It is not created by joint stock companies except banking, insurance and financing companies.

iv) Revenue Reserves : Revenue Reserves are appropriation from revenue profits which can be distributed by way of cash dividends although some may be set aside for other purposes.

v) Specific Reserve : As the name suggests, the Specific Reserve is created for a specific purpose. It is utilised for only that purpose for which it has been created and not for purpose other than that. Whether a firm earns profit or suffers losses, it is obligatory for it to create specific reserve. It is shown on the debit side of P&LA/c. Examples of such reserves are- dividend equalization reserves, investment fluctuation reserves, plant replacement reserves and reserves for redemptions of debentures.

- a) It is created for a specific purpose.
- b) It is utilized for that specific purpose, for which it was created.
- c) Whether profit or no profits, it must be created.
- d) It is necessary to create in order to ascertain profit.
- e) It is shown on the debit side of profit and loss account.
- f) Net profits are reduced because of it.

This too is created by setting aside revenue profits. But it is for a specific purpose. This is not immediately available for distribution. For example, reserve created for redemption of debentures. During the period of liability, this reserve is not available for distribution. It becomes a general reserve on the redemption of debentures. Similarly, a reserve may be created for equalization of dividend.

vi) Reserve Fund : When a part of the profit set aside and used in the business, it is a reserve. But when a part of profits and other surplus is set aside and invested outside the business then it is known as reserve fund. In this case, the retained amount is invested in safe securities which are readily and easily realisable. Investments are not being carried for definite period. The purpose is to strengthen the financial position of the business house. Thus, the use of the term 'fund' indicates investment of reserve outside the business. Reserve fund Investments are not made for definite period. It is created always out of divisible profits. Interest received on investments representing reserve fund may not be re-invested.



Notes

Profit set aside and used in the business is a reserve. But profit set aside and invested outside the business is a reserve fund.

- a) Investments are not for definite period.
- b) It is created always out of divisible profits.
- c) Interest received on investments representing reserve fund may not be re-invested.

vii) Sinking Fund : A sinking fund is established for the future redemption of the long-term debts or liabilities or for replacement of assets or to renew a lease. A sinking fund is a fund built up by annual contributions. The contributions are invested outside the business in readily realizable securities. Interest received on investments is reinvested in the same securities. Thus, a sinking fund may be (i) for replacement of fixed assets or (ii) for the redemption of debentures or repayment of loan. A sinking fund for the replacement of a fixed asset is a provision. But a sinking fund for redemption of debentures or repayment of loan is an appropriation of profits.

Reserves are appropriations of profit namely when profits have been ascertained after deducting all expenses which includes provision and others. Reserves are residual earnings after all expenses and taxation which belongs to the owners namely the shareholders.

- a) Sinking fund Investments are for a definite period.
- b) It is not always out of divisible profit e.g. sinking fund for replacement of asset is provision for depreciation, it must be created even if there are no profits.
- c) In case of sinking fund, interest is always re-invested.

A sinking fund is a fund built up by annual contributions. The contributions are invested outside the business in readily realizable securities. Interest received on investments is reinvested in the same securities.

*Notes*

A sinking fund may be (i) for replacement of fixed assets or (ii) for the redemption of debentures or repayment of loan. A sinking fund for the replacement of a fixed asset is a provision. But a sinking fund for redemption of debentures or repayment of loan is an appropriation of profits. A sinking fund represents amount invested outside the business.

General rules in creation of Reserves

- i) It is created by debiting the profit and loss appropriation account.
- ii) It is created to meet an unknown liability, or to strengthen the financial position of the company or for equalization of dividends etc.
- iii) A reserve is created only when there is profit in the business.
- iv) It can be distributed among shareholders as dividend.
- v) The reserve debentures is created without taking into consideration the actual amount required except in the case of redemption of when a definite sum is set aside.
- vi) Creation of reserve depends upon the financial policy of the business and discretion of its management.
- vii) It is usually shown on the liability side of the balance sheet as it is not a specific reserve.

**INTEXT QUESTIONS 15.2**

Fill in the blanks with suitable words :

- i. An amount kept aside from current income to meet unexpected happening in future is called _____.
- ii. It is not legally mandatory to create a _____.
- iii. _____ reserve is created out of _____ profit.
- iv. Profit on sale of fixed assets is _____ profit.
- v. _____ reserve is not shown in the financial statement.
- vi. Profit set aside and used in business is called a _____.
- vii. Profit set aside and invested outside the business is called _____.
- viii. Sinking Fund Investments are for a _____ period.

15.4 DIFFERENCES BETWEEN PROVISION AND RESERVE

S. No.	Provisions	Reserves
1.	It is created by debiting the Profit & Loss A/c.	It is created by debiting the Profit & Loss Appropriation A/c.
2.	It is a charge against the profits without which true profit or loss of the business can't be ascertained.	It is an appropriation of profits and doesn't require to be created to ascertain true profit or loss.
3.	It has to be provided even if there is loss or no profit in the business. It is created irrespective of whether there is profit or loss in the business.	It can be created only when there is profit in the business.
4.	It can't be available to be distributed as dividend among the shareholders.	It can be distributed as dividend among the shareholders.
5.	It is a sum for known liability or for specific contingency e.g. provision for bad and doubtful debts, or provision for depreciation etc.	It is a sum to meet an unknown future liability or contingency or to strengthen the financial position of the business or for equalization of dividends etc.
6.	Making of a provision is a legal necessity for the management.	It is not legally obligatory to create a reserve. It depends upon the financial policy of the business and discretion of its management.
7.	Amount can't be utilized for purposes other than that for which they are created.	Amount can be utilized for any purpose because they represent undistributed profits.



Notes



INTEXT QUESTIONS 15.3

I. State whether the following statements are True or False :

- i. Provisions are the charges against profits for all apprehended losses.
- ii. All reserves appear on the liability side of the balance sheet.
- iii. Capital reserves are freely distributed as profits.



Notes

- iv. The purpose of reserve is generally to strengthen the financial position of a business enterprise.
- v. A provision is made for a definite amount and therefore, a definite sum is set aside every year to meet the known contingency.

II. Multiple Choice Questions:

- i. Out of the following which is not a provision:
 - a) Provision for bad debts.
 - b) Provision for discount on debtors.
 - c) Dividend Equalization Reserve.
 - d) Provision for Depreciation.
- ii. Out of the following which is not a reserve:
 - a) Reserve for Expansion.
 - b) Dividend Equalization Reserve
 - c) Secret Reserve
 - d) Provision for bad debts.
- iii. Out of the following name the reserve which is created not for any specific purpose but for meeting future contingencies:
 - a) General Reserve b) Capital Reserve
 - c) Specific Reserve d) Secret Reserve
- iv. Out of the following name the reserve which can be utilised for issue of bonus shares:
 - a) General Reserve b) Capital Reserve
 - c) Secret Reserve d) Sinking Fund
- v. Out of the following identify the item which is created by debiting the profit and loss appropriations Account:
 - a) Provision for bad debts
 - b) Provision for discount on debtors
 - c) Provision for Income tax
 - d) General Reserve



WHAT YOU HAVE LEARNT

- Provision is an estimated amount to meet an uncertain loss or expense of future e.g., Provision for Doubtful Debts on Debtors, Provision for Discount on Debtors, Provision for Depreciation, etc. Provisions are created out of profits and are generally shown on the liability side of the balance sheet. Making a provision is must to meet a known liability in future.
- An amount which is kept aside from current income to meet the unexpected happening in the future is called a reserve e.g. General Reserve, reserve for expansion, reserve for equalization of dividend etc. General Reserve is undistributed or retained profits. No reserve can be created if there is no profit. Reserves strengthen the financial positions of the business. Capital reserves are created out of capital profits eg. Capital gains, premiums on issue of shares and debentures, profits prior to incorporation etc. These reserves are not available for distribution of dividend. Secret reserve is not shown in the balance sheet. Revenue reserves are appropriations of profits which can be distributed as dividends. Specific reserve is created for a specific purpose e.g. dividend equalization reserve, investment reserve, investment fluctuation reserve etc. When a part of the profit is set aside and invested outside the business then it is known as a reserve fund. A Sinking fund is established for the future redemption of long term debts or liability or replacement of assets etc.



Notes



TERMINAL EXERCISE

1. What is meant by Reserve Fund?
2. What is meant by a provision?
3. Give the meaning of reserves.
4. State the purposes for which provision are created?
5. Why an organisation creates reserves? Explain briefly.
6. State the purposes for which capital reserves can be utilized.
7. Distinguish between provision and reserve (any four points).
8. Describe briefly the following:

i. Secret Reserves	ii. Revenue Reserves
iii. Specific Reserves	iv. Sinking Fund



Notes



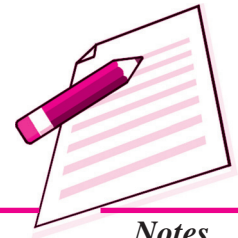
ANSWERS TO INTEXT QUESTIONS

- 15.1** i) Loss/expense ii) Disputed iii) Profit and Loss Account
 iv) Shareholders v) Liability
- 15.2** i) Reserve ii) General Reserve iii) Capital, Capital iv) Capital
 v) Secret vi) Reserve vii) Reserve Fund viii) Definite
- 15.3** I. i) True ii) True iii) False iv) True v) True
 II. i) c ii) d iii) a iv) b v) d



ACTIVITY

- Your parents from their regular income make some savings for the known or unknown expenses/liability to meet out in future. Prepare a list of past three months savings with reasons and differentiate them in reserves or provisions keeping in view the principles of the same, so that you may be clear about the term reserve & provisions.



Notes

16

FINANCIAL STATEMENTS : AN INTRODUCTION

In the previous lessons you have learnt to record the business transactions in various books of accounts and their posting into ledger. You have also learnt about balancing the account and preparing the trial balance. One of the most important purposes of accounting is to ascertain financial results, i.e., profit or loss of the business operations of a business enterprise after a certain period and financial position on a particular date. For this certain financial statements are prepared which are termed as income statement (i.e. Trading and Profit & Loss Account) to know what the business has earned during a particular period and the Position Statement (i.e. Balance Sheet) to know the financial position of the business enterprise on a particular date.

In this lesson you will learn about the financial statements that are prepared by a profit organisations.



OBJECTIVES

After studying this lesson you will be able to :

- explain the meaning and the objectives of preparing financial statements;
- classify the financial statements into Trading and Profit & Loss Account and Balance Sheet;
- distinguish between capital expenditure and revenue expenditure, capital receipts and revenue receipts;
- explain the purpose of preparing Trading Account and Profit and Loss Account;
- draw the format of Trading Account and Profit and Loss Account and
- prepare the Balance Sheet.

16.1 FINANCIAL STATEMENTS : MEANING AND OBJECTIVES



Notes

When a student has studied for a year, he/she wants to know how much he/she has learnt during that period. Similarly, every business enterprise wants to know the result of its activities of a particular period which is generally one year and what is its financial position on a particular date which is at the end of this period. For this, it prepares various statements which are called the financial statements.

Financial statements are the statements that are prepared at the end of the accounting period, which is generally one year. These include Income Statement i.e. Trading and Profit & Loss Account and Position statement i.e. Balance Sheet.

Objectives of preparing Financial Statements

Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that specified period.

Financial statements are generally of two types (a) Income Statement which comprises of Trading Account and Profit & Loss Account, and (b) Position Statement i.e., the Balance Sheet.

Following are the objectives of preparing financial statements: -

1. **Ascertaining the results of business operations :** Every businessman wants to know the results of the business operations of his enterprise during a particular period in terms of profits earned or losses incurred. Income statement serves this purpose.
2. **Ascertaining the financial position :** Financial statements show the financial position of the business concern on a particular date which is generally the last date of the accounting period. Position statement i.e. Balance Sheet is prepared for this purpose.
3. **Source of information :** Financial statements constitute an important source of information regarding finance of a business unit which helps the finance manager to plan the financial activities of the business and making proper utilisation of the funds.
4. **Helps in managerial decision making :** The Manager can make comparative study of the profitability of the concern by comparing the results of the current year with the results of the previous years and make his/her managerial decisions accordingly.

5. **An index of solvency of the concern :** Financial statements also show the short term as well as long term solvency of the concern. This helps the business enterprise in borrowing money from bank and other financial institutions and/or buying goods on credit.

Importance of Financial Statements

- i. **Pertaining to Finance :** The term “financial statement” doesn’t make sense at first. Numbers are for counting while statements need words, so how could these two mix together? But when seen as “money statements,” then suddenly it’s a crucially important matter.
- ii. **Facilitate in Decision Making :** Not only is it important for you, but for the management and stockholders as well. It’s important for the management because financial statements speak of the company’s success and competence, whereas stockholders refer to financial statements to know whether or not to invest in a company. In other words, financial statements tell whether the company made or lost money.
- iii. **Showing the Operational Performance :** Financial statement hold the secrets of a company. Aside from stating whether the company earns or loses money, they also provide clues on where the mangement might find more resources to boost its revenue. In addition, financial statements reveal a company’s past performance and potential.

Capital Expenditure and Revenue Expenditure, Capital Receipts and Revenue Receipts

The preparation of Trading Account and Profit and Loss Account requires the knowledge of revenue expenditure, revenue receipts and capital expenditure and capital receipts. The knowledge shall facilitate the classification of revenue items and put them in the Trading account and Profit and Loss Account on one hand and prepare Balance Sheet based on capital items (expenditure as well as receipts) on the other hand.

Capital Expenditure refers to the expenditure incurred for acquiring fixed assets or assets which increase the earning capacity of the business. The benefits of capital expenditure to the firm extend to number of years. Examples of capital expenditure are expenditure incurred for acquiring a fixed asset such as building, plant and machinery etc.

Revenue expenditure, on the other hand, is an expenditure incurred in the course of normal business transactions of a concern and its benefits are availed of during the same accounting year. Salaries, carriage etc. are examples of revenue expenditure.



Notes



Notes

There is another category of expenditure called **deferred revenue expenditure**. These are the expenses incurred during one accounting year but benefits from the same are available wholly or in part in future periods also. These expenditures are otherwise of a revenue nature. Example of deferred revenue expenditure are heavy expenditure on advertisement say for introducing a new product in the market, expenditure incurred on research and development, etc.

Difference between Capital Expenditure and Revenue Expenditure

<i>Basis of Difference</i>	<i>Capital Expenditure</i>	<i>Revenue Expenditure</i>
1. Purpose	It is incurred for acquiring fixed assets.	It is incurred for the maintenance of fixed assets.
2. Earning capacity	It increases the earning capacity of the business.	It helps in maintaining the earning capacity of the business intact.
3. Periodicity of benefit	Its benefits are spread over a number of years.	Its benefits accrue only in one accounting year.
4. Placement in financial statements	It is an item of Balance Sheet and is shown as an item of asset.	It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two.
5. Occurrence of expenditure	It is non-recurring in nature.	It is usually a recurring expenditure.

Capital and Revenue Receipts

Capital receipts are receipts which do not arise out of normal course of business. Examples of such receipts are sale of fixed assets, and raising of loans etc. Such receipts are not treated as income of the enterprise.

Revenue receipts are receipts which arise during the normal course of business, Sale of goods, rent from tenants, dividend received, etc. are some of the examples of revenue receipts. They are the items of incomes of the business entity.

Distinction between Capital Receipts and Revenue Receipts

<i>Basis of Difference</i>	<i>Capital Receipt</i>	<i>Revenue Receipt</i>
Source	Receipts that do not arise during the normal course of business.	Receipts that arise during the normal course of business.
Nature	These are of capital nature and hence are not treated as items of income of the business.	These are of revenue nature and hence are treated as items of income of the business.
Occurrence	These are of non-recurring in nature.	These are recurring in nature.



Notes



INTEXT QUESTIONS 16.1

I. Classify the following items of expenditure into capital expenditure revenue expenditure and deferred revenue expenditure

- (i) Amount spent on purchase of machine.
- (ii) Expenditure incurred on repairs of building.
- (iii) Heavy expenditure on advertisement to introduce a new product in the market.
- (iv) Purchase of motor vehicle for business use.

II. One important objective of financial statements is to ascertain the results of business operations. List the other objectives of the financial statements:

- (a)
- (b)
- (c)
- (d)

16.2 TRADING ACCOUNT

Income statement consists of Trading and Profit and Loss Account. Let us, first study the Trading Account. A business firm either purchases goods from others and sells them or manufactures and sells them to earn profit. These are known as trading activities. A statement is prepared to know the results in terms of profit or loss of these activities. This statement is called Trading Account.



Notes

Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit. Cost of goods sold is subtracted from the net sales of the business of that accounting year. In case the total sales value exceeds the cost of goods sold, the difference is called Gross Profit. On the other hand, if the cost of goods sold exceeds the total net sales, the difference is Gross Loss. All accounts related to cost of goods sold such as opening stock, net purchases i.e. purchase less returns outward, direct expenses such as wages, carriage inward etc. and closing stock with net sales (i.e. Sales minus Sales returns) are posted to the Trading Account. Then this account is balanced. Credit balance shows the gross profit and debit balance shows the gross loss.

It is necessary to understand the meaning of cost of goods sold before preparing Trading Account.

Cost of goods sold and gross profit

A business enterprise either purchases goods or manufactures goods to sell in the market. Cost of goods sold is computed to know the profit earned (Gross Profit) or loss incurred (Gross Loss) from the trading activities of a business unit for a particular period.

Cost of goods sold = the amount of goods purchased + expenses incurred in bringing the goods to the place of sale or expenses incurred on manufacturing the goods (called direct expenses).

In case there is a stock of goods to be sold in the beginning of the year or at the end of the year, the cost of goods is calculated as follows :

Cost of goods sold = Opening stock + Net purchases + All direct expenses – Closing stock

Gross Profit = Net sales – Cost of goods sold

Illustration 1

Calculate the cost of goods sold from the following information :

	₹
Opening stock	10000
Closing stock	8000
Purchases	80000
Carriage on purchases	2000
Wages	6600

Solution :

$$\begin{aligned}
 \text{Cost of Goods Sold} &= \text{Opening Stock} + \text{Purchases} + \text{Direct Expenses} \\
 &\quad (\text{Carriage on Purchases} + \text{Wages}) - \text{Closing Stock} \\
 &= ₹ [10,000 + 80,000 + 86,00 \\
 &\quad \quad \quad (\text{i.e. } 2,000 + 6,600) - 8,000] \\
 &= ₹ 90600
 \end{aligned}$$

Illustration 2

Calculate cost of goods sold and gross profit from the following information.

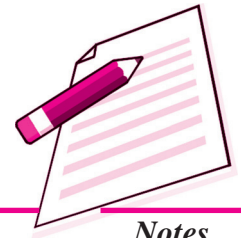
Sales	₹ 62500
Sales Returns	₹ 500
Opening Stock	₹ 6400
Purchases	₹ 32000
Direct Expenses	₹ 4200
Closing Stock	₹ 7200

Solution :

		₹
Net sales		
(Sales-Sales Returns i.e. 62500 – 500)		62000
Less : Cost of goods sold		
Opening Stock	6400	
Add Purchases	32000	
Add Direct Expenses	4200	
Less : Closing Stock	(7200)	35400
Gross Profit		26600
Or Gross profit = Net sales – cost of goods sold		
= 62000 – 35400 = 26600		

Illustration 3

From the following information for the year ending 31st March, 2014 furnished by Mr. Vikram, a trader, calculate cost of goods sold and also calculate Gross Profit/Gross Loss of business.

*Notes*



Notes

	₹
Sales	1,20,000
Purchases	80,000
Octroi	1,600
Carriage on purchases	4,500
Purchase Returns	2,400
Opening Stock	27,600
Closing Stock	32,400

Solution :

Cost of goods sold :

	₹
Opening stock	27,600
Add Net Purchases	
(₹ 80,000 – ₹ 2,400)	77,600
Add carriage on Purchases	4,500
Add Octroi	1,600
Cost of goods available for sale	1,11,300
Less closing stock	32,400
Cost of goods sold	78,900

Gross Profit :

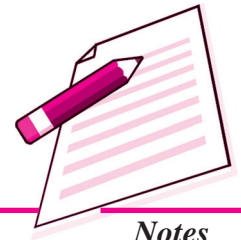
	₹
Sales	1,20,000
Less : Cost of goods Sold	78,900
Gross Profit	41,100

Need of Trading Account

Trading Account serves the following purposes :

- 1. Knowledge of Gross Profit :** Trading Account gives information about Gross Profit. It is the profit earned by a business enterprise from its trading activities. The percentage of gross profit on sales reflects the degree of success of business.

2. **Knowledge of All Direct Expenses :** All direct expenses are debited to trading Account. Direct expenses are the expenses that can be directly attributed to purchase or manufacturing of goods for sale. Percentage of Direct expenses on sales of current year when compared with the same of previous years, helps the manager to exercise control over direct expenses.
3. **Precaution against Future Losses :** Trading Account, if shows gross loss, reasons for this loss can be found out and necessary corrective steps can be taken.



Notes

FORMAT OF TRADING ACCOUNT

Trading Account of
for the year ending

Dr.	Amount ₹	Particulars	Amount ₹	Cr.
Opening Stock		Sales		
Purchases		Less: Sales Returns		
Less Purchase Returns		Closing stock		
Direct Expenses :		Gross loss transferred to		
Carriage Inward		Profit & Loss Account		
Freight				
Wages				
Fuel & Power				
Excise Duty				
Factory Rent				
Heating & Lighting				
Factory Rent & Insurance				
Work Managers Salary				
Gross Profit transferred to Profit & Loss Account				

Important Items of Trading Account

Important items of Trading account are :



Notes

1. **Stock :** Stock refers to the goods lying unsold on a particular date. It can be of two types : **(a) Opening stock and (b) Closing stock**
 - (a) Opening Stock :** Opening stock refers to the value of goods lying unsold at the beginning of the accounting year. It is shown on the debit side of the Trading Account. In the first year of business there is no opening stock.
 - (b) Closing Stock :** It is the value of goods lying unsold at the end of the accounting year. It is valued at the cost price or market price whichever is less. It is shown on the credit side of the Trading Account.
2. **Purchases :** Purchases mean total items purchased for resale during the year. It can be both in cash and on credit. Purchases are shown on the debit side of the Trading Account. These are always shown as net purchases i.e. amount of purchases returned (Purchase returns or return outwards) is deducted from the total amount of purchases made. Goods received on consignment basis are never treated as purchases. Similarly, goods received on 'sale or return' basis are never treated as purchases.
3. **Sales :** Sales refer to the total revenue from sale of goods of the business enterprise for which the Trading Account is being prepared. It includes both cash sales and credit sales. These are recorded on the credit side of the Trading Account. Sales are shown at their net value i.e. sales return or returns inward is deducted from the total sales. Cash sales plus credit sales minus sales returns constitute net sales. Goods sent on 'sale or approval' are not part of sales until approval is received.
4. **Direct Expenses :** Direct expenses are the expenses that can be attributed directly to the purchase of goods or goods manufactured. These are shown on the debit side of the Trading Account. These are shown at the amount as shown in the Trial Balance. For example, wages are recorded on the debit side of Trading Account at the amount shown in the Trial Balance.

Important Items of Direct Expenses

1. Wages i.e. wages relate to production. If amount under this head includes wages paid for construction of building or manufacturing of furniture for office it will be subtracted from the amount of wages.
2. Carriage, Cartage and Freight i.e. amount paid for carriage of goods purchased for sale or raw material purchased for manufacturing.
3. Other such direct expenses are customs and import duty, packing materials, gas, electricity water, fuel, oil, gas greese, heating and lighting, factory rent and insurance and many more such items.

5. **Gross Profit/Gross Loss :** It is the excess of net sales revenue over cost of goods sold. Gross Profit is equal to net sales minus cost of goods sold. If total of the credit side exceeds the total of debit side, the excess amount is termed as 'gross profit' and is shown on the debit side of Trading Account. On the other hand if debit side is more than the credit side, the difference in amount is called gross loss and is shown on the credit side of the Trading Account.

$$\text{Gross Profit} = \text{Net Sales} - \text{Cost of Goods Sold}$$

$$\text{Gross Loss} = \text{Cost of Goods Sold} - \text{Net Sales}$$



Notes



INTEXT QUESTIONS 16.1

I. Fill in the blanks with suitable word/words :

1. Financial statements are generally of Types.
2. Income statement comprises of A/c and A/c.
3. Trading Account is prepared to ascertain the profit of the business.
4. The percentage of gross profit on sales reflects the degree of of business.

II. Show the result in the following cases

- (a) Sales – sales return =
- (b) Purchases – purchases return =
- (c) Total of the credit column of trading account – total of the debit column of trading account =
- (d) Cost of goods sold – total sales =
- (e) Total of the debt column of trading account - Total of the credit column of trading account =

16.3 TRANSFER ENTRIES

Before preparing Trading Account, closing or transfer journal entries are made in the journal proper of the business enterprise. These journal entries are:

- (a) For transferring debit balances

Trading A/c	Dr.
To Opening stock	
To Purchases	



Notes

To Direct expenses	
To Sales returns	
(Transfer of balances of opening Stock, Purchases, direct expenses & Sales Returns)	
(b) For transferring credit balances	
Sales A/c	Dr.
Closing stock A/c	Dr.
Purchase Returns A/c	Dr.
To Trading A/c	
(Transfer of credit balances of Sales, Closing Stock, Purchase return)	
(c) For transferring gross profit	
Trading A/c	Dr
To Profit & Loss A/c	
(Transferring of gross profit)	
(d) For transferring gross loss	
Profit & Loss A/c	Dr.
To Trading A/c	
(Transferring of gross loss)	

Illustration 4

The ledger balances extracted at the close of a trading year on 31st March, 2014 are given as follows

<i>Name of the Account</i>	<i>Amount (₹)</i>
Opening stock	12,000
Purchases	52,000
Sales	74,000
Purchase Returns	2,000
Carriage Inward	800
Wages	4,200
Closing stock	13,500

Pass necessary journal entries in the journal proper.

Solution :

Journal

Date 2014	Particulars	LF	Dr Amount ₹	Cr Amount ₹
March 31	Trading A/c Dr		69,000	
	To Opening stock A/c			12,000
	To Purchases A/c			52,000
	To Wages A/c			4,200
	To Carriage Inward A/c			800
	(Transfer of debit balances to trading Account)			
March 31	Sales A/c Dr		74,000	
	Purchase Returns A/c Dr		2,000	
	Closing stock A/c Dr		13,500	
	To Trading A/c			89,500
	(Transfer of credit items to trading account)			
March 31	Trading A/c Dr		20,500	
	To Profit & Loss A/c			20,500
	(Transfer of gross profit to Profit & Loss Account)			



Notes

Illustration 5

Following balances have been extracted from the ledger of Rohit & Sons at the close of the year 2014.

	₹
Stock (1.1.2014)	21,000
Purchases	1,40,000
Sales	2,24,000
Purchases Returns	8,000

MODULE - 3

Financial Statement



Notes

Financial Statements : An Introduction

Sales Returns	12,000
Wages	15,000
Factory Power	12,000
Stock (31.12.2014)	26,500

Make closing journal entries in the journal proper.

Solution :

Journal

<i>Date</i> 2014	<i>Particulars</i>	<i>LF</i>	<i>Dr</i> <i>Amount</i>	<i>Cr</i> <i>Amount</i>
Dec. 31	Trading A/c Dr		2,00,000	
	To Opening stock A/c			21,000
	To Purchases A/c			1,40,000
	To Sales Returns A/c			12,000
	To wages A/c			15,000
	To Factory power A/c			12,000
	(Closing entry of debit items transferred to Trading A/c)			
	Sales A/c Dr		2,24,000	
	Closing stock A/c Dr		26,500	
	Purchase Returns A/c Dr		8,000	
	To Trading A/c			2,58,500
	(Transfer of credit balances to Trading A/c)			
	Trading A/c Dr		58,500	
	To Profit & Loss A/c			5,8500
	(Transfer of Gross Profit)			

**INTEXT QUESTIONS 16.3**

Write the “debit” if the items given below are to be placed in debit side of the Trading A/c and “Credit” if they are placed in the credit side of the Trading Account.

- (i) Closing stock
- (ii) Carriage inward
- (iii) Sales
- (iv) Custom duty

*Notes***16.4 PROFIT & LOSS ACCOUNT**

As stated earlier, income statement consists of two accounts : Trading Account and Profit & Loss Account. You have seen that Trading account is prepared to ascertain the gross profit or gross loss of the trading activities of the business. But these are not the final results of business operations of an enterprise. Apart from direct expenses, there are indirect expenses also. These may be conveniently divided into office and administrative expenses, selling and distribution expenses, financial expenses, depreciation and maintenance charges etc.

Similarly, there can be income from sources other than sales revenue. These may be interest on investments, discount received from creditors, commission received, etc. Another account is prepared in which all indirect expenses and revenues from sources other than sales are presented. This account when balanced shows net profit (or net loss). This account is termed as Profit and Loss Account. The profit shown by this account is called ‘net profit’ and if it shows loss it is known as ‘net loss’.

FORMAT OF PROFIT AND LOSS ACCOUNT

Profit and Loss A/c of M/s

for the year ended

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Gross loss b/d; if any	—	Gross Profit b/d	—
Salaries	—	Discount Received	—
Rent, Rates & taxes	—	Commission Received	—
Insurance Premium	—	Dividend Received	—

MODULE - 3

Financial Statement



Notes

Financial Statements : An Introduction

Advertising	—	Interest on Investment	—
Commission paid	—	Rent Received	—
Discount Allowed	—	Net Loss transferred	
Repairs & Renewals	—	to capital account; if any	—
Bad Debts	—		
Establishment charges	—		
Travelling Expenses	—		
Bank Charges	—		
Sales Tax/Value added Tax	—		
Depreciation on fixed assets	—		
Net Profit transferred to Capital Account	—		

Some important items of Profit and Loss Account

As stated earlier indirect expense are shown on the debit side of Profit and Loss A/c. These can be classified under the following heads :

Debit Items

- 1. Selling and Distribution Expenses :** To materialise sales, the expenses incurred are called selling and distribution expenses. Examples are :

Carriage on sales/carriage outwards, advertisement, selling expenses, travelling expenses and salesman commission, depreciation of delivery van, salary of driver of the delivery van, etc.
- 2. Office and Administration Expenses :** These are the expenses incurred on establishment and maintenance of office. Some of the expenses that may be under this head are: rent, rates and taxes, postage, printing and stationery, insurance, legal charges, audit fees, office salaries, etc.
- 3. Financial Expenses :** Finances are to be arranged for carrying on business. Expenses that are incurred in this connection are called financial expenses. Some of the financial expenses are: interest on loan, interest on capital, discount on bills, etc.
- 4. Depreciation and Maintenance Charges :** The total value of a fixed asset like machinery, building, furniture, etc. is not charged to profit and loss account in the year in which it is purchased. Such assets help running business for a number of

years to come. Therefore, only a part of the value of such assets is treated as an expense and is charged to Profit and Loss A/c as depreciation. Depreciation means decline in the value of fixed asset due to wear and tear, lapse of time, obsolescence, etc. Expense incurred on repairs and renewals and maintenance of assets are expenses other than depreciation under this category.

- 5. Other Expenses :** These are the expenses which are not included under the above mentioned heads of expenses for example, losses and expenses due to fire, theft etc.

Credit Items

On the credit side of Profit and Loss Account, items of revenue and incomes are written. The first item on this side of Profit and Loss Account is the gross profit transferred from trading account. Other items of the credit side are : Interest on investment, interest on fixed deposits etc. rent received, commission received, discount received, dividend on shares received etc.

Need of preparing Profit and Loss Account

Need of preparing profit and loss account by a business concern may be stated as follows :

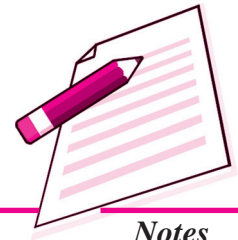
- (i) To know the net profit or net loss of a business for an accounting year.
- (ii) Net profit of one year can be compared with net profits of previous year or years. It helps in ascertaining whether the business is being conducted efficiently or not.
- (iii) Different expenses which are taken to Profit & Loss A/c in one year can be compared with the amounts incurred in previous year or years. This helps in ascertaining the need of applying control over such expenses.



INTEXT QUESTIONS 16.4

- I. Following are the items of expenditure and income to be taken to Profit and Loss Account. Write 'E' for expenses and 'I' for income against each item.**

- (i) Interest on Fixed Deposit
- (ii) Advertisement
- (iii) Insurance Premium
- (iv) Discount allowed by creditors
- (v) Carriage on sales



Notes



Notes

II. State whether the following statements are ‘true or false’. Write true for true statements and ‘false’ for false statements.

- (i) Profit and Loss Account is prepared to ascertain the Gross Profit of a business unit.
- (ii) Items of income are written on the credit side of Profit and Loss Account.
- (iii) Net Profit calculated by preparing Profit and Loss Account is transferred to Trading Account.
- (iv) Profit and Loss Account is prepared for an accounting year.

16.5 TRANSFERRING ENTRIES OF PROFIT AND LOSS ACCOUNT

Before preparing Profit and Loss Account as per the format given in the previous section, closing entries are made in the journal proper of the enterprise. Following journal entries are made :

- (i) For transferring the indirect expense accounts :

Profit & Loss A/c	Dr.
To Salaries A/c	
To Insurance Premium A/c	
To Bad Debts A/c	
To Discount Allowed A/c	
(Transfer of indirect expenses)	

- (ii) For transfer of items of incomes and gain

Interest on investment A/c	Dr.
Rent Received A/c	Dr.
Discount Received A/c	Dr.
To Profit & Loss A/c	
(Transfer of items of income)	

- (iii) For transferring Net Profit :

Profit & Loss A/c	Dr.
To Capital A/c	
(Transferring of Net Profit to Capital A/c)	

(iv) For transferring Net Loss

Capital A/c Dr.

 To Profit & Loss A/c

(Transfer of Net Loss to Capital Account)



Notes

Illustration 6

The following balances were extracted from the books of Maya Gupta & Sons at the end of March 31, 2014. Make necessary closing entries as on that date:

<i>Items</i>	<i>Dr. Balance (₹)</i>	<i>Cr. Balance (₹)</i>
Gross Profit	65,000	
Salaries	11,500	
Audit fees	400	
Insurance Premium	800	
Interest received		1,600
Discount (Cr)		460
Advertisement	1,200	
Bad Debts	150	
Discount Allowed	340	
Depreciation	460	
Rent from tenants	—	1,800

Solution :

Journal Entries

(i) Trading A/c	Dr.	65,000	
To P&LA/c			65,000
(Gross profit transfered to P&LA/c)			
(ii) Profit & Loss A/c	Dr.	14850	
To Salaries A/c			11500
To Audit Fees A/c			400

MODULE - 3

Financial Statement



Notes

Financial Statements : An Introduction

To Insurance Premium A/c			800
To Advertisement A/c			1200
To Bad Debts A/c			150
To Discount Allowed A/c			340
To Depreciation A/c			460
(Transfer of items of expenses to profit & Loss A/c)			
(iii) Interest A/c	Dr.	1600	
Discount Received A/c	Dr.	460	
Rent A/c	Dr.	1800	
To Profit & Loss A/c			3860
(Transfer of items of income to Profit & Loss A/c)			
(iv) Profit & Loss A/c	Dr.	54010	
To Capital A/c			54010
(Transfer of Net Profit to Capital Account)			

Illustration 7

The following ledger balances were extracted from the books of Rabina & Brothers at the end of accounting year 31st March, 2014. Make journal entries to transfer these balances to prepare Profit & Loss A/c for the year ending 31st March, 2014.

	₹
Gross Profit	65800
Salaries	8400
Rent paid	2400
Discount allowed	500
Interest on investments	3100
Advertisement	1800
Trading expenses	1600
Bad Debts	500
Depreciation	600
Insurance Premium	800
Commission received	2700

Solution :

Trading A/c	Dr.	65,800	
To P & L A/c			65,800
(Gross profit transferring to P&L A/c)			

Journal

<i>Date 2014</i>	<i>Particulars</i>	<i>LF</i>	<i>Dr Amount</i>	<i>Cr Amount</i>
March 31	Profit & Loss A/c Dr		16600	
	To Salaries A/c			8400
	To Rent A/c			2400
	To Discount allowed A/c			500
	To Advertisement A/c			1800
	To Trading expenses A/c			1600
	To Bad Debts A/c			500
	To Depreciation A/c			600
	To Insurance Premium A/c			800
	(Transfer of indirect expenses to profit & Loss A/c)			
March 31	Commision A/c Dr		2700	
	Interest A/c Dr		3100	
	To Profit & Loss A/c			5800
	(Transfer of incomes other than sales to Profit & Loss A/c)			
March 31	Profit & Loss A/c Dr		55000	
	To Capital A/c			55000
	(Transfer of net profit to capital A/c)			



Operating Profit

Operating profit is the excess of gross profit over operating expenses. Gross Profit is the excess of net sales revenue over cost of goods sold. Operating expenses includes office and administration expenses, selling and distribution expenses, cash discount allowed, interest on bills payable and other short term debt, bad debts and so on. Net sales means cash sales + credit sales - sales returns.

MODULE - 3

Financial Statement



Notes

Financial Statements : An Introduction

$$\begin{aligned} \text{Operating Profit} &= \text{Net Sales} - \text{Operating Cost} \\ &= \text{Net Sales} - (\text{Cost of goods sold} + \text{administration and office exp.} + \text{Selling and Distribution expenses}) \end{aligned}$$

$$\text{Operating Profit} = \text{Net Profit} + \text{Non-operating exp.} - \text{Non-Operating Income}$$

Illustration 8

Compute Operating profit from the following particular.

	₹		₹
Gross Profit	44,000	Interest on loan	2200
Carriage outward	480	Interest on investment	280
Advertising	1200	Printing and Stationery	360
Salaries	17,800	Loss on Sale of furniture	3,500
Rent & Taxes	6,200	General expenses	140
Lighting	1,500	Donation	510
Insurance charge	240	Rent Received	600
Bad Debts	150	Loss by fire	2,000
Audit fees	200	Gain on sale of machine	5,000

Solution

Computation of Operating Profit

	₹	₹
Gross Profit		44,000
Less : Selling and Distribution expenses :		
Carriage outward	480	
Advertising	1,200	
Bad Debts	150	
	1,830	
Less : Office and Administrative Expenses		
Salaries	17,800	
Rent & Taxes	6,200	
Lighting	1,500	
Insurance	240	
Audit fees	200	
Printing & Stationery	360	
General expense	140	
	26,440	(28,270)
Operating Profit		15,730

Position Statement/Balance Sheet

Position Statement or Balance Sheet is another financial statement that a business enterprise prepares. Balance Sheet is a statement prepared on a particular date, generally at the end of accounting year to ascertain the financial position of the business entity. It consists of assets on the one hand and liabilities on the other.

In the words of Francis R Steal, “Balance Sheet is a screen picture of the financial position of a going business at a certain moment.” In the words of Freeman, “A Balance Sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain date.”

Financial position of a business is the list of assets owned by the business and the claims of various parties against these assets. The statement prepared to show the financial position is termed as Balance Sheet.

In the next lesson we shall discuss Balance Sheet in detail.

*Notes***INTEXT QUESTIONS 16.5**

I. Write ‘debit’ if Profit and Loss Account is to be debited and ‘credit’ if profit and loss account is to be credited of the following items :

- (a) Legal charges (b) Net Loss (c) Rent Received
(d) Discount Allowed (e) Salaries

II. (a) Name the financial statement which is prepared in addition to income statement.

- (b) Why it is prepared?
(c) When it is prepared?
(d) Name its two elements.

III. (a) Operating Profit = Net Sales - _____

(b) Operating Profit = Net Profit + Non-Operating Expenses - _____

(c) If Net Sales = ₹ 2,00,000 and Operating cost = ₹ 1,50,000 than calculate Operating profit.

**WHAT YOU HAVE LEARNT**

- Financial statements are of two types :
 - (a) Income Statement i.e. Trading Account and Profit and Loss Account.



Notes

(b) Position Statement i.e. Balance Sheet.

- Trading Account is prepared to ascertain the results of the trading activities of the business.
- Trading Account may show profit (i.e. the excess of sales to cost of goods sold or excess of credit side over debit side), which is termed as Gross Profit.

Trading Account may show loss (i.e. Cost of goods sold exceeds sales or total of debit side exceeds total of credit side). This is called Gross Loss.

- Profit and Loss Account is prepared to find out Net Profit/Net Loss.

$\text{Net Profit} = \text{Gross Profit} + \text{other incomes} - \text{Indirect expenses.}$

It may also show a net loss.

All indirect expenses are shown on the debit side of Profit & Loss Account.

All incomes and gains are shown on the credit side of Profit & Loss Account.

- Balance Sheet is prepared to ascertain the financial position of a firm on a particular date.

**TERMINAL EXERCISE**

1. State the meaning of financial statements.
2. Explain in brief the various objectives of financial statements.
3. Explain in brief the following terms with two examples of each :
 - (a) Revenue expenditure.
 - (b) Revenue Receipts
 - (c) Capital expenditure
 - (d) Capital Receipts
4. Distinguish between capital expenditure and Revenue expenditure on the basis of:
 - (a) Earning capacity
 - (b) Placement in financial statements
 - (c) Occurrence of expenditure
5. Distinguish between capital receipts and revenue receipts.
6. How is cost of goods sold calculated?



Notes

7. What is Trading Account? Why is it prepared?
8. How is Gross Profit calculated?
9. What is meant by Profit and Loss Account? Why is it prepared?
10. When does Profit and Loss Account show Net Profit?
11. What are direct expenses? Give two examples of such expenses.
12. State the meaning of Balance Sheet.
13. From the following balances of Sabana calculate Gross Profit or Gross Loss by subtracting cost of goods sold from sales for the year ended 31st December, 2014

	₹
Stock (1.1.2014)	26500
Purchases	64600
Sales	86800
Purchases Returns	2600
Sales Returns	1800
Freight inward	750
Wages	1850
Closing Stock	31100

14. From the following balances extracted from the books of Seth Brothers. Pass journal entries to prepare a Trading Account and Profit and Loss Account for the year ended 31st March, 2014.

	₹		₹
Stock (1.4.2013)	20000	Electric Power	5000
Purchases	95000	Wages	14000
Return Inwards	2000	Selling Commission	5500
Carriage Inwards	1850	Repair & Renewals	2000
Carriage Outwards	1200	General Expenses	8000
Custom duty	3000	Insurance	2200
Return outwards	5000	Stock (31.3.2014)	45000
Sales	165000		
Discount Received	1500		

MODULE - 3

Financial Statement



Notes

Financial Statements : An Introduction

15. The balances from the books of Parimal Ghosh are given below. Pass journal entries to prepare Trading and Profit & Loss Account for the year ended 31st March, 2014

	₹		₹
Stock as on 1.4.2013	9480	Purchase Returns	1800
Purchases	50800	Advertising	1500
Wages	1200	Commission (Cr.)	3200
Salaries	3400	Rent from tenant	2800
Octroi	1320	Sales	72000
Rent & Taxes	850	Stock (31.3.2014)	10700
Bad Debts	250		
Discount (Dr.)	360		
Interest on capital	760		

16. From the following information calculate cost of goods sold for the year ending 31st March, 2014

	₹		₹
Opening Stock	14800	Factory expenses	7200
Purchases	65700	Closing stock	28400
Returns outward	1700		
Wages	12500		
Carriage Inward	2400		
Custom Duty	3200		
Rent paid	4500		
Establishment expenses	650		

17. From the following balances extracted from the books of Jai Bhagwan & Sons as on 31st March, 2014. Pass journal entries to prepare Trading A/c and Profits & Loss A/c

	₹		₹
Opening Stock	16000	Rent	3600
Purchases	76000	Office expenses	1600
Machinery	28000	Carriage Inward	1200

Debtors	21600	Sales Returns	5400
Drawings	7200	Credit Balance	
Wages	1500	Capital	70000
Bank	12000	Creditors	14000
Depreciaton	2800	Sales	108000
Closing stock	24000	Purchase Returns	2600



Notes



ANSWERS TO INTEXT QUESTIONS

- 16.1** I. (i) Capital (ii) Revenue
 (iii) Deferred Revenue (iv) Capital
- II. (a) Ascertaining the financial position
 (b) Source of information
 (c) Helps in managerial decision making
 (d) An index of the solvency of the concern.
- 16.2** I. 1. Two 2. Trading and Profit & Loss
 3. Gross Profit 4. Success
- II. (a) Net sales (b) Net purchases (c) Gross profit
 (d) Gross Loss (e) Gross Loss
- 16.3** (i) Credit (ii) Debit (iii) Credit (iv) Debit
- 16.4** I. (i) I (ii) E (iii) E (iv) I (v) E
 II. (i) F (ii) T (iii) F (iv) T
- 16.5** I. (a) debit (b) debit (c) Credit (d) debit (e) debit
- II. (a) Balance sheet
 (b) to show the financial position of the concern
 (c) At the end of an accounting year
 (d) assets; liabilities
- III. (a) Operating Cost (b) Non-operating income
 (c) ₹ 50,000



ANSWERS TO TERMINAL EXERCISE



Notes

- 13. Gross Profit : ₹ 25000
- 14. Gross Profit : ₹ 74150 Net Profit : ₹ 56750
- 15. Gross Profit : ₹ 21700 Net Profit : ₹ 20580
- 16. Cost of goods sold : ₹ 75700
- 17. Gross Profit : ₹ 21000 Net Profit : ₹ 13000

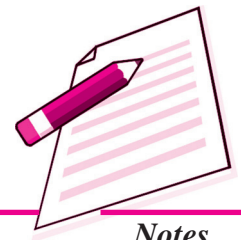


ACTIVITY

Procure trial balance of at least four business concerns and classify the items into :

- (a) Revenue expenditure (b) Revenue receipts
- (c) Capital expenditure (d) Capital Receipts

<i>Name of organisation</i>	<i>Item of expenditure</i>	<i>Revenue expenditure</i>	<i>Revenue receipts</i>	<i>Capital expenditure</i>	<i>Capital Receipts</i>



Notes

17

FINANCIAL STATEMENTS : I

You have learnt the meaning of the financial statements and the need to prepare these statements for the business organisations. You have also learnt the format of these statements and the important items that are recorded in these statements. You would now like to learn how to prepare these statements. You know Trial Balance is the basis of preparation of these statements. Every business organisation prepares two financial statements i.e. Trading and Profit and Loss A/c and the Balance sheet.

In this lesson you will learn the preparation of these statements.



OBJECTIVES

After studying this lesson you will be able to :

- prepare Trading Account and Profit and Loss Account;
- explain the Balance Sheet as per format;
- appreciate the marshalling of Balance Sheet;
- classify the assets and liabilities and
- prepare Balance Sheet.

17.1 PREPARATION OF TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

You have already learnt the meaning and format of Trading Account and Profit and Loss Account. You have also learnt how to make journal entries to transfer relevant ledger balances to Trading Account and Profit and Loss Account. Now, you will learn the various steps to be followed in preparing these statements.



Notes

Steps to be followed while preparing Trading Account

A. Debit side

- (i) We post the amount of opening stock (In case of a new firm there will not be any opening stock).
- (ii) We post the amount of purchases. Out of this, purchases returns or returns outward is deducted. Purchases may be cash or credit or both.
- (iii) Then we post the direct expenses such as carriage inward, wages, power, etc.

B. Credit side

- (i) We post sales. Sales return or returns inward is deducted from the sales to get the net sales figure. Sales may be cash or credit or both.
- (ii) Closing stock is the next item.

C. Ascertaining Gross Profit/Gross Loss

Finally, Trading Account is closed by calculating the difference of the two sides. If credit side exceeds the debit side, the difference is written as Gross Profit on the debit side of the Trading A/c. In case debit side is more than the credit side, the difference amount is termed as 'Gross Loss' and is shown on the credit side of the Trading A/c.

Total of Debit column < Total of credit column
 ⇒ Gross profit

Total of credit column < Total of debit column
 ⇒ Gross loss

Steps to be followed while preparing Profit and Loss Account

A. Debit side

- (i) Gross Loss, if any, transferred from Trading A/c is written as the first item.
- (ii) Next all items of revenue expenses and losses are written. These items may be salaries, rent paid, depreciation, etc.

B. Credit side

1. Gross Profit transferred from Trading A/c is the first item.
2. Next all items of revenue incomes and gains are written. These may be interest on investments, discount received, commission received, etc.

C. Ascertaining Net Profit/Net Loss

The next step is to get the balance. If credit side is more than the debit side the difference in amount is shown as Net Profit. If debit side exceeds the credit side, the difference is Net Loss. This amount is transferred to Capital Account.

Total of Debit side < Total of credit side

⇒ Net profit

Total of credit side < Total of debit side

⇒ Net loss



Notes

Illustration 1

From the following information of M/s Nand Lal & Bros. for the year ending 31st March, 2014 prepare Trading A/c and Profit and Loss A/c for the year ended 31st March, 2014.

	₹		₹
Stock 1.4.2013	5,800	Sales	72,000
Purchases - cash	42,000	Return Inward	2,000
Purchases - credit	18,000	Interest on Investment	1,500
Freight Inward	1,800	Discount Received	1,200
Wages	4,500	Closing stock (31.3.2014)	7,200
Carriage on Sales	800		
Telephone Charges	1,600		
Electricity Expenses	1,200		
Office Rent Paid	6,000		
Salaries	8,000		
Depreciation	1,400		

Solution :

Books of M/s Nand Lal & Bros.

Trading A/c

for the year ended 31st March, 2014

Dr.

Cr.

Particulars	Amount ₹	Particulars	Amount ₹
Stock (1.4.2013)	5,800	Sales	72,000
Purchases		<i>Less:</i> Return Inward	<u>2,000</u>
Cash	42,000	Closing stock (31.3.2014)	7,200
Credit	<u>18,000</u>		
	60,000		

MODULE - 3

Financial Statement



Notes

Financial Statements : I

Freight Inward	1,800		
Wages	4,500		
Gross profit transferred to Profit and Loss A/c	5,100		
	77,200		77,200

Profit and Loss A/c for the year ending 31st March, 2014

Particulars	Amount (₹)	Particulars	Amount (₹)
Carriage on sale	800	Gross Profit transferred from Trading A/c	5,100
Telephone charges	1,600	Interest on Investment	1,500
Electricity Expenses	1,200	Discount Received	1,200
Office Rent	6,000	Net Loss transferred to capital A/c	11,200
Salaries	8,000		
Depreciation	1,400		
	19,000		19,000

Illustration 2

Prepare Trading A/c and Profit and Loss A/c of Raman Irani from the following balances for the year ending 31st March, 2014.

	₹		₹
Opening Stock (1.4.2013)	14,600	Trading Expenses	1,450
Purchases	68,700	Discount allowed	1,250
Sales	85,300	Discount Received	800
Return outward	2,200	Bill Receivables	4,500
Carriage Inward	2,100	Debtors	16,800
Capital	50,000	Closing stock (31.3.2014)	28,700
Drawings	12,000		
Insurance	1,600		
Advertisement	2,400		
Salesmen's Salaries	5,200		

Solution :

Books of Raman Irani
Trading A/c
for the year ending 31st March, 2014

Dr.

Cr.

<i>Particulars</i>	<i>Amount ₹</i>	<i>Particulars</i>	<i>Amount ₹</i>
Opening Stock	14,600	Sales	85,300
Purchases 68,700		Closing stock	28,700
Less Return outward 2,200	66,500		
Carriage Inward	2,100		
Gross profit transferred to Profit and Loss A/c	30,800		
	1,14,000		1,14,000

Profit and Loss A/c

for the year ended 31st March, 2014

Dr.

Cr.

<i>Particulars</i>	<i>Amount (₹)</i>	<i>Particulars</i>	<i>Amount (₹)</i>
Insurance	1,600	Gross Profit transferred from Trading A/c	30,800
Advertisement	2,400	Discount Received	800
Salesmen's salaries	5,200		
Trading Expenses	1,450		
Discount allowed	1,250		
Net Profit transferred to capital A/c	19,700		
	31,600		31,600



INTEXT QUESTIONS 17.1

Write the name of the Account (Trading A/c, Profit & Loss A/c) and the side (debit/credit) against the items given below to which these are posted:

- (i) Closing stock
- (ii) Carriage outward



Notes



Notes

(iii) Interest on Investment	.....	.....
(iv) Custom duty	.....	.....
(v) Fuel & Power	.....	.....
(vi) Sales	.....	.....
(vii) Salaries	.....	.....
(viii) Rent from tenant	.....	.....

17.2 BALANCE SHEET

Apart from Trading Account and Profit and Loss Account, Balance Sheet is another financial statement that is prepared by every business firm. Balance sheet is a statement which shows the financial position of a business organisation on a particular date which is generally the last date of the accounting period. Financial position of a business unit is the amount of claims against the resources of business. These resources are cash, stock of goods, furniture, machinery, etc. The claims include the claims of the owner capital and the claims of outsiders such as creditors, bankers, etc. Therefore, it can be stated that Balance Sheet is the statement which shows assets owned by the business and liabilities owed by it on a particular date. Balance Sheet is not an account. It has two sides. (i) Assets side and (ii) the Liabilities side. The Asset side has a list of fixed as well current assets. The liabilities side has a list of items of capital, long term as well as short term liabilities.

Need

1. Balance Sheet is prepared to measure the true financial position of a business entity at a particular point of time.
2. It is a systematic presentation of what a business unit owns and what it owes.
3. Balance Sheet shows the financial position of the concern at a glance.
4. Creditors, financiers are particularly interested in the Balance Sheet of a concern so that they can decide whether to deal with the concern or not.

Grouping of Assets and Liabilities

All the assets can be categorised in following groups :

1. Current Assets
2. Liquid Assets
3. Non-current Assets
4. Tangible Assets
5. Intangible Assets

All the liabilities can be catagorised in two groups :

- 1. Current Liabilities
- 2. Non-current Liabilities

Marshalling of Assets and Liabilities

As stated above Balance sheet has two sides i.e. Assets side, which has various items of assets of the concern and liabilities side which has the liability or claim of the owner as well as of the outside parties.

Assets refer to the financial resources of the business and can broadly be divided into Current Assets and Fixed Assets, Liabilities denote claims against the assets of the business. Liabilities can be of two types owners liability or capital and outsiders liabilities such as creditors, bills payable, Bank Loan etc.

There is no prescribed form in which a Balance Sheet should be prepared by a sole proprietary business or a partnership firm. However, an order is generally maintained in which assets and liabilities are written. This is to maintain uniformity/consistency which facilitates comparative analysis for decision making. Balance sheet may be prepared in any of the following orders :

- (a) Liquidity order
- (b) Permanency order

(a) Liquidity Order

Liquidity means convertibility of assets into cash. Every asset cannot be converted into cash at the same degree of ease and convenience. Assets are written in the order of their liquidity, Assets of highest liquidity is written first and next highest follows and so on. Similarly, liabilities are also written in this very order. Short term liabilities are written first and then long term liabilities and lastly the capital.

A specimen of the balance sheet prepared in order of liquidity is given below:

**Balance Sheet of M/s
as at**

Liabilities	Amount ₹	Assets	Amount ₹
Bank overdraft	xxx	Cash in hand	xxx
Outstanding Expenses	xxx	Cash at bank	xxx
Bill payables	xxx	Prepaid expenses	xxx
Sundry creditors	xxx	Investments (short term)	xxx
Loans	xxx	Bill Receivables	xxx
Capital	xxx	Sundry Debtors	xxx
Add Net Profit	xxx	Closing stock	xxx



Notes

MODULE - 3

Financial Statement



Notes

Financial Statements : I

Less drawings	xxx	Investments	xxx
		Furniture	xxx
		Plant & Machinery	xxx
		Land & Building	xxx
		Goodwill	xxx
	xxx		xxx

(Investments on short term basis are marketable securities; they form part of current assets.)

(b) Permanency order

While following the order of permanency, assets, which are to be used permanently i.e. for a long time and not meant for resale are presented first. For example, Land and Building, Plant and Machinery, furniture etc. are written first. Assets which are most liquid such as cash in hand is written in the last. Order of liabilities is similarly changed. Capital is written first, then the long term liabilities and lastly the short term liabilities and provisions. Specimen of a Balance Sheet that can be prepared in the order of permanency is as follows :

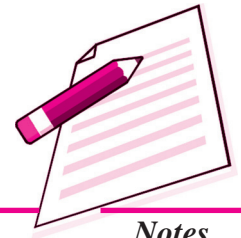
Balance sheet of M/s as at

<i>Liabilities</i>		<i>Amount</i> ₹	<i>Asset</i>	<i>Amount</i> ₹
Capital	xxx		Goodwill	xxx
Add : Net profit	xxx		Land & Building	xxx
Less : Drawings	xxx	xxx	Plant & Machinery	xxx
Loans		xxx	Furniture	xxx
Sundry creditors		xxx	Investments	xxx
Bills payable		xxx	Closing stock	xxx
Outstanding expenses		xxx	Sundry Debtors	xxx
Bank overdraft		xxx	Bills Receivables	xxx
			Investments (short term)	xxx
			Prepaid expenses	xxx
			Cash at bank	xxx
			Cash in hand	xxx
		xxx		xxx

[In case of joint stock companies balance sheet is prepared as per schedule VI of the Companies Act 1956]

Illustration 3

From the balances given below prepare Balance sheet of M/s Bharat & Bros as on 31st December, 2014. In (a) liquidity order and, (b) in permanency order.



<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Capital	50,000	Sundry Debtors	24,000
Loan from Bank	20,000	Bills Payable	8,000
Cash in hand	2,500	Drawings	6,000
Cash at Bank	12,800	Building	25,000
Closing stock	24,700	Furniture	4,500
Sundry creditor	15,000	Investments	15,000
		Net Profit	21,500

Solution :

A. Liquidity order

**Balance sheet of M/s Bharat & Bros
as on 31st Dec., 2014**

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Bills Payable	8,000	Cash in hand	2,500
Sundry creditors	15,000	Cash at Bank	12,800
Loan from Bank	20,000	Sundry Debtors	24,000
Capital	50,000	Closing stock	24,700
<i>Add : Net Profit</i>	<u>21,500</u>	Investments	15,000
	71,500	Furniture	4,500
<i>Less : drawings</i>	<u>6,000</u>	Building	25,000
	65,500		
	1,08,500		1,08,500

B. In permanency Order

**Balance sheet of M/s Bharat & Bros
as on 31st Dec., 2014**

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Capital	50,000	Building	25,000
Add Net Profit	21,500	Furniture	4,500
Less drawings	<u>6,000</u>	Investments	15,000
	65,500		

MODULE - 3

Financial Statement



Notes

Financial Statements : I

Loan from Bank	20,000	Closing stock	24,700
Sundry creditors	15,000	Sundry Debtors	240,00
Bills payable	8,000	Cash at Bank	12,800
		Cash in hand	2,500
	1,08,500		1,08,500



INTEXT QUESTIONS 17.2

I. Arrange the following Assets in (i) Liquidity order (ii) Permanency order.

- | | |
|----------------------|------------------|
| (i) Closing stock | (ii) Furniture |
| (iii) Cash in hand | (iv) Investments |
| (v) Bills Receivable | (vi) Goodwill |
| (vii) Building | (viii) Debtors |

II. Arrange the following items of liabilities in (i) Liquidity order and (ii) in permanency order

- | | |
|------------------------|---------------------------|
| (i) Bills Payable | (ii) Sundry Creditors |
| (iii) Loan on Mortgage | (iv) Outstanding Expenses |
| (v) Capital | |

17.3 CLASSIFICATION OF ASSETS AND LIABILITIES

Assets and Liabilities are of various types. These can be classified as under:

Assets

Assets can be classified as follows :

- Fixed Assets :** These are the assets that are purchased on permanent basis i.e. for long term use and help the business to earn revenue. Examples of such assets are Building, Machinery, Motor Vehicle, etc. These assets are not for sale in ordinary course of business but can be disposed off, if no more needed for business use.
- Current Assets :** These are the assets which are acquired by the business either for resale or for converting them into cash. These are normally realised within a period of one year. Examples of such assets are : cash in hand, cash at bank, bill receivable, debtors, stock etc.
- Tangible Assets :** These are the assets that can be seen, touched and have certain volume. Building, Machinery, goods etc. are tangible assets.

- (d) **Intangible Assets :** Assets which can neither be seen nor touched and have no volume are called intangible assets. Patents, trademark, goodwill etc are the examples of such assets.
- (e) **Liquid Assets :** These are the assets which are either in cash or can be easily converted into cash. For example cash, stock, marketable securities etc.
- (f) **Wasting Assets :** These are the assets which exhaust or reduce in value by their use. Mines, quarries etc come under this category.
- (g) **Fictitious Assets :** These are not the real assets. These are the items of such expenses and losses which have not been written off in full. For example, preliminary expenses, underwriting commission, etc.



Notes

Liabilities

Liabilities can be classified as follows :

- (a) **Long term Liabilities :** These are the liabilities which are not payable during the current accounting year. Generally, the funds raised through such means are used for purchase of fixed assets. Examples of such liabilities are loan on mortgage, loan from financial institutions.
- (b) **Current Liabilities :** These are the liabilities which are payable during the current year. These include Bank overdraft, trade creditors, bill payable etc.
- (c) **Owners' Funds :** The amount owing to the proprietor or proprietors is called owners' funds. As per business entity concept this is a liability of the business. Apart from capital it also includes undistributed profits and reserves. Amount of drawings by the proprietor is deducted from it.



INTEXT QUESTIONS 17.3

- I. Write the type of assets against the items given below :
- | | |
|----------------------------|-----------------------|
| (i) Goodwill | (ii) Bills Receivable |
| (iii) Preliminary Expenses | (iv) Mines |
| (v) Furniture | |
- II. Write the type of liabilities against the items given below :
- | | |
|----------------------------|----------------|
| (i) Loan on mortgage | (ii) Creditors |
| (iii) Outstanding expenses | (iv) Capital |

17.4 PREPARATION OF BALANCE SHEET



Notes

Balance sheet has two sides : Assets and Liabilities. On the assets side we present all types of assets such as Cash, Bills Receivable, Stock, Building etc.

On the liabilities side all liabilities, both long term liabilities and current liabilities are presented, such as Bills Payable, trade creditors, bank loan etc. Next we write owners' capital. Net profit is added to it. If there is net loss it is deducted from the capital. Amount of drawings is also deducted from the capital. Finally the two sides are totalled and the totals should agree.

Illustration 4

From the following Trial Balance of M/s Vikram Brothers prepare Trading and Profit and Loss Account for the year ended 31st March 2014 and Balance Sheet as on that date.

<i>Particulars</i>	<i>Dr. Balances ₹</i>	<i>Particulars</i>	<i>Cr. Balance ₹</i>
Cash in hand	500	Capital	70,000
Motor car	25,000	Discount Received	2,000
Drawings	48,000	Sales	2,30,000
Legal charges	1,500	Creditors	46,000
Plant & Machinery	60,000	Interest on investment	5,200
Investments	40,000	Purchases Return	3,800
Opening stock	35,000	Bills payable	34,000
Sales Returns	2,500		
Salaries	12,000		
Discount allowed	600		
Carriage Inward	1,800		
Wages	21,000		
Postage	400		
Debtors	60,000		
Interest	1,500		
Insurance Premium	1,200		
Purchases	80,000		
	3,91,000		3,91,000

Financial Statements : I

Closing stock as on 31.3.2014 ₹28,000

Solution :

Trading A/c for the year ended 31st March, 2014

Dr.		Cr.	
Particulars	Amount ₹	Particulars	Amount ₹
Opening stock	35,000	Sales	2,30,000
Purchases	80,000	Less sales Returns	2,500
Less purchase return	3,800		
	76,200	Closing stock	28,000
Wages	21,000		
Carriage Inward	1,800		
Gross Profit transferred to Profit & Loss A/c	1,21,500		
	2,55,500		2,55,500

Profit & Loss A/c for the year ended 31st March, 2014

Particulars	Amount ₹	Particulars	Amount ₹
Salaries	12,000	Gross Profit transferred from Trading A/c	1,21,500
Insurance Premium	1,200	Discount Received	2,000
Discount allowed	600	Interest on Investments	5,200
Postage	400		
Interest	1,500		
Legal charges	1,500		
Net Profit Transferred to Capital A/c	1,11,500		
	1,28,700		1,28,700

Balance Sheet As on 31st March, 2014

Liabilities	Amount ₹	Assets	Amount ₹
Bills Payable	34,000	Cash in hand	500
Creditors	46,000	Debtors	60,000

MODULE - 3 Financial Statement



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Financial Statements : I

Capital	70,000		Closing stock	28,000
Add : Net Profit	<u>1,11,500</u>		Investments	40,000
	1,81,500		Motor car	25,000
Less : Drawings	<u>48,000</u>	1,33,500	Plant & Machinery	60,000
		2,13,500		2,13,500

Illustration 5

Following is the Trial Balance extracted from the books of Jasmine Enterprises as on 31st March, 2014. Prepare Trading and Profit & Loss A/c from the information given in Trial Balance for the year ending 31st March, 2014. Also prepare the Balance Sheet as on that date.

<i>Particulars</i>	<i>Dr. Amount (₹)</i>	<i>Cr. Amount (₹)</i>
Stock (1.4.2013)	18,500	
Purchases & Sales	78,500	1,54,200
Return Inwards & Return Outwards	2,200	2,500
Debtors & Creditors	16,500	18,000
Bills Receivable & Bills Payable	14,000	21,000
Commission paid	2,000	
Audit fees	1,800	
Building	65,000	
Furniture	12,000	
Salaries	14,000	
Telephone charges	4,200	
Insurance	2,100	
Discount allowed	1,000	
Octroi	1,200	
Wages	16,000	
Freight Inward	2,400	
Bad debts	600	
Depreciation	4,200	
Bank loan		32,000
Cash in hand and at Bank	25,000	

Financial Statements : I

Capital		1,00,000
Drawing	16,500	
Machinery	30,000	
	3,277,00	3,27,700

Stock as on 31.3.2014 ₹ 19,600

Solution :

Trading A/c For the year ended 31st March, 2014

Dr.

Cr.

Particulars	Amount ₹	Particulars	Amount ₹
Stock (1.4.2013)	18,500	Sales	1,54,200
Purchases	78,500	Less Return Inward	2,200
Less return outward	2,500	Closing stock	19,600
Wages	16,000		
Freight Inward	2,400		
Octroi	1,200		
Gross Profit transferred to Profit & Loss A/c	57,500		
	1,71,600		1,71,600

Profit & Loss A/c for the year ended 31st March, 2014

Particulars	Amount ₹	Particulars	Amount ₹
Salaries	14,000	Gross Profit transferred from Trading A/c	57,500
Telephone Charge	4,200		
Insurance Premium	2,100		
Bad debts	600		
Depreciation	4,200		
Audit fees	1,800		
Discount allowed	1,000		
Commission paid	2,000		
Net Profit Transferred to Capital A/c	27,600		
	57,500		57,500

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Financial Statement



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Financial Statements : I

Balance Sheet as at 31st March, 2014

Liabilities		Amount ₹	Assets		Amount ₹
Bills Payable		21,000	Cash in hand & at Bank		25,000
Sundry creditors		18,000	Bill receivable		14,000
Bank Loan		32,000	Sundry Debtors		16,500
Capital	1,00,000		Closing stock		19,600
Add : Net Profit	<u>27,600</u>		Furniture		12,000
	1,27,600		Machinery		30,000
Less : Drawings	<u>16,500</u>	1,11,100	Building		65,000
		1,82,100			1,82,100

Illustration : 6

From the following balances extracted from the books of Hari on 31st March, 2014, prepare his Trading and Profit and Loss Accounts and Balance Sheet :

Trial Balance

	₹		₹
Opening Stock	9,600	Repairs to Plant	160
Wages and Salaries	3,200	Cash in Hand and at Bank	200
Commission on Purchases	200	Debtors	4,000
Freight	300	Income-Tax	550
Purchases <i>less</i> Returns	11,850	Drawings	650
Sales <i>less</i> Returns	24,900	Capital	5,000
Trade Expenses	20	Bills Payable	500
Bills Receivable	600	Loan	900
Rent	200	Discount on Purchases	400
Plant	2,000	Creditors	2,330
Bad Debts	500		

Information : Stock at the end was ₹ 3,500

Solution :

Trading and Profit & Loss Account for the year ending 31st March, 2014

Dr.

Cr.

Particulars	₹	Particulars	₹
To Opening Stock	9,600	By Sales <i>less</i> Returns	24,900
To Purchases <i>less</i> Returns	11,850	By Closing Stock	3,500

Financial Statements : I

To Wages and Salaries	3,200		
To Commission on Purchases	200		
To Freight	300		
To Gross Profit <i>c/d</i>	3,250		
	28,400		28,400
To Trade Expenses	20	By Gross Profit <i>b/d</i>	3,250
To Rent	200	By Discount on Purchases	400
To Bad Debts	500		
To Repairs to Plant	160		
To Net Profit transferred to Capital A/c	2,770		
	3,650		3,650

MODULE - 3

Financial Statement



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Balance Sheet of Hari as at March 31, 2014

<i>Liabilities</i>		₹	<i>Assets</i>	₹
Capital			Plant	2,000
Opening Balance	5,000		Stock at the end	3,500
Add : Net Profit	<u>2,770</u>		Debtors	4,000
	7,770		Bills Receivable	600
Less: Income Tax	550		Cash-in-Hand and at Bank	200
Drawing	<u>650</u>	1,200		
Loan		900		
Bills Payable		500		
Creditors		2,330		
		10,300		10,300



INTEXT QUESTIONS 17.4

Fill in the blanks with appropriate word/words :

- The amount by which credit side of Trading A/c exceeds the debit side is known as
- The amount by which debit side exceeds the credit side of Profit & Loss A/c is shown as
- The totals of the two sides of the Balance sheet should always be
- Bank loan is shown on the side of the Balance sheet.



Notes



WHAT YOU HAVE LEARNT

- To prepare Trading Account, on the debit side we present opening stock, net purchases and direct expenses on the credit we present net sales and closing stock. The difference of the two sides is found out which may be Gross Profit or Gross Loss. The same is transferred to Profit & Loss Account.
- All items of revenue expenditure and losses are shown on the debit side of Profit and Loss Account and on the credit are shown items of revenue receipts and gains. The difference of the two sides is calculated which may be either Net Profit or Net Loss.
- Balance sheet is a statement showing the financial position of a business unit on the last date of the accounting year.
- Balance sheet is a systematic presentation of what a business unit owns and what it owes.
- Balance sheet has two sides Assets and Liabilities.
- Assets and Liabilities may be written in (i) Liquidity order or (ii) Permanency order.
- Assets may be classified as : fixed assets, current assets, tangible assets, intangible assets, liquid assets, wasting assets and fictitious assets.
- Liabilities can be long term liabilities, current liabilities and owners funds.



TERMINAL EXERCISE

1. State the steps for preparing Trading Account.
2. Explain the term Balance Sheet. Also explain the objectives of preparing a Balance sheet.
3. List assets in ‘liquidity order’ and ‘permanency order’ in a Balance Sheet.
4. Explain the following types of assets with two examples each :
 - (a) Intangible Assets (b) Fictitious Assets
 - (c) Fixed Assets (d) Current Assets
5. What are owners’ funds ?
6. From the following information extracted from the books of P. Mukherjee, prepare Trading Account for the year ending 31st March, 2014.



Notes

	₹		₹
Opening stock	6,500	Cash	4,500
Purchases	45,000	Office expenses	3,200
Sales	72,000	Office Rent	6,800
Return Inward	1,500		
Return Outward	500		
Carriage on Purchases	1,200		
Wages	4,800		
Fuel & Power	3,200		

Closing stock on 31st March, 2014 was ₹ 8,600

7. From the following information of Rashmi prepare Profit & Loss Account for the year ending 31st March, 2014.

	₹		₹
Gross Profit	64,800	Discount Received	600
Bad debts	1,500	Commission Received	2,100
Depreciation	2,500	Freight outward	1,600
Office rent	4,800	Prepaid Insurance	600
Insurance	3,200	Salary	6,400
Telephone charges	1,700	Stationery	700
Interest on loan	2,400	Furniture	6,000
Building	50,000		

Closing stock as on 31st March, 2014 ₹ 20,000

8. From the following Trial Balance of M/s Krishna Murthi Garments as on 31st March, 2014, you are required to prepare Trading Account, Profit and Loss A/c for the year ended 31st March, 2014 and a Balance sheet as on that date.

**Trial Balance of M/s Krishna Murthi Garments
as at 31st March, 2014**

<i>Particulars</i>	<i>Dr. Balances ₹</i>	<i>Cr. Balances ₹</i>
Cash in hand	2,000	
Bank overdraft		35,000

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Financial Statement



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Financial Statements : I

Stock (1.4.2013)	32,000	
Purchases	80,000	
Freight Inward	4,000	
Custom duty	5,500	
Power	6,500	
Machines	40,000	
Furniture	20,000	
Sales		1,65,000
Bills Payable		18,000
Sundry Debtors	28,000	
Sundry creditors		22,000
Salaries	6,500	
Salesmen's commission	7,800	
Rent of Godown	7,200	
Insurance	2,400	
Land & Building	75,000	
Carriage on sales	3,600	
Advertisement	4,500	
Capital		1,00,000
Drawings	15,000	
	3,40,000	3,40,000

Closing stock as on 31st March, 2014 ₹ 38,000

9. Rakesh carries on business as a furniture manufacturer. Prepare his Trading and Profit & Loss Account and Balance Sheet from the following balances as on 31st March, 2014 :

	₹		₹
Capital	6,000	Polishing	500
Withdrawals (Drawings)	1,000	Rates and Taxes	40
Sales	10,000	Bills Receivable	300
Raw material (Purchased)	2,000	Insurance	150

Financial Statements : I

Loan or Mortgage (Cr.)	1,000	Carriage	10
Machinery	1,500	Incidental Expenses	200
Land and Building	2,000	Stock, 1st April, 2013	2,000
Creditors	500	Cash at Bank	1,250
Wages	5,000	Cash in Hand	50
Debtors	1,500		

Stock on 31st March, 2014, ₹ 1,500.

10. The following balances were extracted from the books of Harish Jalal on 31st March, 2014 :

	₹		₹
Capital	24,500	Loan	7,880
Drawings	2,000	Sales	65,360
General Expenses	2,500	Purchases	47,000
Buildings	11,000	Motor Car	2,000
Machinery	9,340	Reserve Fund (Cr.)	900
Stock	16,200	Commission (Cr.)	1,320
Power	2,240	Car Expenses	1,800
Taxes and Insurance	1,315	Bills Payable	3,850
Wages	7,200	Cash	80
Debtors	6,280	Bank Overdraft	3,300
Creditors	2,500	Charity	105
Bad Debts	550		

Stock on 31st March, 2014 was valued at ₹ 23,500.

**ANSWERS TO INTEXT QUESTIONS**

- 17.1**
- (i) Trading A/c credit
 - (ii) Profit & Loss A/c debit
 - (iii) Profit & Loss A/c credit
 - (iv) Trading A/c debit

MODULE - 3*Financial Statement**Notes*



Notes

- (v) Trading A/c debit
- (vi) Trading A/c credit
- (vii) Profit & Loss A/c debit
- (viii) Profit & Loss A/c credit

17.2

I. *Liquidity order*

- Cash in hand
- Bills Receivable
- Sundry Debtors
- Closing stocks
- Investments
- Furniture
- Building
- Goodwill

II. *Liquidity order*

- Outstanding expenses
- Bills payable
- Sundry Creditors
- Loan on Mortgage
- Capital

Permanency order

- Goodwill
- Furniture
- Building
- Investments
- Closing stock
- Sundry Debtors
- Bills Receivable
- Cash in hand

Permanency order

- Capital
- Loan on Mortgage
- Sundry Creditors
- Bill payable
- Outstanding expenses

17.3

- I. (i) Intangible Asset (ii) Current Asset (iii) Fictitious Asset
- (iv) Wasting Asset (v) Fixed Asset
- II. (i) Long term liability (ii) Current liability
- (iii) Current liability (iv) Owner fund

17.4

- (i) Gross Profit (ii) Net Loss (iii) Equal (iv) Liabilities



ANSWERS TO TERMINAL EXERCISE

- 6. Gross profit ₹ 10,300
- 7. Net Profit ₹ 42,700
- 8. Gross Profit ₹ 75,000

Financial Statements : I

Net Profit ₹ 44,000

Total of Balance Sheet ₹ 2,03,000

9. Gross Profit ₹ 1,790

Net Profit ₹ 1,600

Total of Balance Sheet ₹ 8,100

10. Gross Profit ₹ 16,220

Net Profit ₹ 11,270

Total of Balance Sheet ₹ 52,200



ACTIVITIES

1. Visit some business firms of your locality, parents of your friends and of your relatives and collect the information about assets which are not common because of the nature of their business and classify them into relevant categories.

<i>Name of the firm</i>	<i>Nature of business</i>	<i>Name of the asset</i>	<i>Category of the asset</i>
1.			
2.			
3.			
4.			
5.			

2. Analyse the Balance Sheet of a business enterprise being run by your father/father of your friend or by a relative and check the marshalling of Assets and Liabilities. If these are not in order place them in liquidity order or permanency order. If these are already in liquidity order place them in permanency order and vice-versa.

MODULE - 3

Financial Statement



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*Notes***18****FINANCIAL STATEMENTS - II**

You have learnt that Income Statement i.e. Trading & Profit and Loss Account and Position Statement i.e., Balance Sheet are two financial statements, which are prepared by every business concern at the end of a period. Income statement shows the Net Profit or Net loss as the case may be for that period and Position Statement presents the financial position of the business on the specific date. These statements are prepared on the basis of Trial Balance and other information. It is possible that there are certain items of income or expenses which do not pertain to the accounting period for which Trial Balance is prepared or other such items which have accrued but have not been accounted for and hence are not reflected in Trial Balance. Both these types of incomes and expenses are to be fully accounted for, only then the above stated two statements will show the true and fair position of the business. These are called 'adjustments'. In this lesson we shall learn about accounting treatment of some of the adjustments and incorporation of these adjustments in financial statements.

**OBJECTIVES**

After studying this lesson you will be able to:

- recognise the need for accounting adjustments;
- explain the adjustments as to closing stock, outstanding and pre-paid expenses, accrued income and income received in advance;
- interest on capital and drawings, depreciation, provision for bad and doubtful debts; and
- incorporate the adjustments in Trading Account, Profit & Loss Account and Balance Sheet.

18.1 NEED FOR ACCOUNTING ADJUSTMENTS

You have already learnt that every business entity prepares Trading and Profit & Loss Account and Balance Sheet, the two financial statements, at the end of an accounting period which is generally one year. It needs to be ensured that such items of income and expenditure which do not pertain to the said accounting period, should not to be included. If some of these items have been included in the trial balance these must be excluded by making necessary adjusting entry. Similarly, there can be items which are left out and are needed to be accounted for. Adjustment entry will also be made for them. This is necessary in order to calculate the correct profit or loss and to show true and fair financial position of the business. For example, a firm closes its books on March 31, every year, Suppose it has not paid rent of the shop for the month of March. This will not be reflected in Trial Balance and hence it needs to be accounted for as it relates to the year for which accounts are being prepared. Similarly, suppose annual insurance premium has been paid up to June, 30. It means premium for three months has been paid in advance. This is included in the item of insurance appearing in the Trial Balance. This amount paid in advance needs to be excluded. This process of exclusion or inclusion of items into books of accounts at the time of preparing financial statements is called adjustments. These are to be incorporated to arrive at the true and fair position of the business.

*Notes***INTEXT QUESTIONS 18.1**

Fill in the blanks with suitable word/words :

- (i) Trading and Profit & Loss Account shows the or
- (ii) Adjustments are necessary to show the correct and of a business concern.
- (iii) Items of income and expenditure which do not pertain to the accounting period should be
- (iv) Items of income & expenditure which relate to the accounting period but are left out should be

18.2 ADJUSTMENTS AND THEIR INCORPORATION

The number and nature of adjustments differ from organisation to organisation. It depends upon the volume and nature of activities in the organisation, However, certain adjustments are common in all types of organisations. Moreover, while making adjustments you will have to follow the general principle of double entry i.e. the amount is to be debited to one account and credited to another account. Thus in the financial statements the item to be adjusted should appear at two places one representing the debit and the other representing the credit.



Notes

Let us, now discuss some of the items of adjustment and their accounting treatment in financial statements. These are as under :

1. Closing Stock
2. Outstanding Expenses.
3. Prepaid Expenses
4. Accrued Income.
5. Income received in advance
6. Interest on Capital
7. Interests on Drawings
8. Depreciation.
9. Further Bad Debts.
10. Provision for Bad and Doubtful Debts.
11. Provision for discount on debtors.
12. Managers Commission
13. Abnormal losses.
14. Drawing of Goods by the Proprietor.
15. Goods Distributed as free Sample.

Let us take up these adjustments one by one:

1. Closing Stock

Closing Stock is the stock of goods remaining unsold at the end of the accounting year. Ordinarily this does not appear in the Trial Balance. Hence, this needs to be incorporated in financial statements. This appears on the credit side of the Trading Account as well as Assets side of the Balance Sheet.

The adjustment entry will be:

Closing Stock A/c Dr
To Trading A/c

(Closing stock transferred to trading A/c)

The effect of the adjustment entry on financial statements is as under :

Trading A/c

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
		Closing stock	.....

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Closing stock	.....

In case closing stock has already been accounted for it will form part of the Trial Balance and hence there is no need of making any adjustments in the Trading A/c. Then the adjusted closing stock will be on the asset side of the Balance Sheet only.

2. Outstanding Expenses

Expense which is related to the current accounting period but not yet paid is known as Outstanding Expense. Suppose the accounts are closed on 31st December every year. Salary for the month of December is due but not paid. It is an example of salary outstanding. Similarly, there are some other items like Rent outstanding, Wages outstanding etc. In case of Salaries Outstanding following adjustment entry will be made :

Salary A/c	Dr.
To Salary Outstanding A/c	
(Salary outstanding for the month of December)	

In financial statements it will be recorded as :

Profit & Loss A/c

Dr. Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Salaries			
Add : Salary outstanding			

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Salary Outstanding			

Amount of expense outstanding will be added to its paid amount which is shown in the Trading A/c or Profit & Loss A/c as the case may be. It is also shown on the liabilities side of the Balance Sheet because it is an item of liabilities.



Notes



Notes

3. Prepaid Expenses

Sometimes a part of a certain expense paid may relate to the next accounting period. Such expenses is called prepaid expense or expenses paid in advance. For example, insurance premium paid in the current year may be for the year ending, the date of which falls in the next year. The part of insurance premium which relates to next accounting year is the insurance premium paid in advance. It is deducted from the amount paid and is shown as an item of asset. Similarly, such items may be rent prepaid, tax prepaid etc.

Adjustment entry for prepaid Insurance Premium

Prepaid Insurance Premium A/c Dr.
 To Insurance Premium A/c
 (Insurance premium paid in advance)

In financial statements, it is recorded as :

Profit & Loss A/c

Dr. Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Insurance Premium			
<i>Less</i> : Prepaid Insurance premium			

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Prepaid insurance	

4. Accrued income (Due but not received)

Accrued income means income earned but not received till the end of the accounting year. For example, interest on securities or dividends on shares, which has become due but may be received on a date falling in the next year. Such income does not appear in the trial balance but should be duly accounted for in the year, because such income has accrued.

Adjustment entry for the transaction : suppose Rent receivable as it has become due but is not yet received



Notes

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Rent received in advance			



INTEXT QUESTIONS 18.2

Fill in the blanks with suitable terms :

- (i) Expenses related to the current accounting period but have not been paid are known as
- (ii) Part of expenses paid if relates to the next accounting year, it is called
- (iii) Income earned but not received till the end of the accounting year is termed as
- (iv) Income if received before it becomes due is called

18.3 OTHER ADJUSTMENTS

6. Interest on Capital

As per business entity concept capital of the proprietor is a liability for the business. Like other loans, interest can be allowed on capital also. In case it is decided to allow interest on capital, adjustment entry will be as follows :

Interest on Capital A/c Dr
 To Capital A/c
 (Interest allowed on capital)

In financial statements it is shown as under:

Profit & Loss A/c

Dr. Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Interest on capital			

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Capital			
<i>Add : Interest on Capital</i>			

7. Interest on Drawings

Interest may also be charged on money withdrawn by the proprietor for personal use. Following journal entry is made.

Capital A/c	Dr.
To Interest on Drawings A/c	
(Interest on Drawings charged)	

In financial statements, it will be shown as :

Profit & Loss A/c

Dr.	Cr.		
Particulars	Amount	Particulars	Amount
	₹		₹
		Interest on Drawings	

Balance Sheet

Liabilities	Amount	Assets	Amount
	₹		₹
Capital			
Less : Interest on drawings			

8. Depreciation

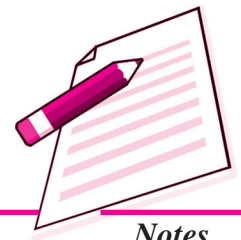
The value of fixed assets such as Plant and Machinery, Furniture and Fixtures, Land & Building, Motor Vehicles etc. goes on reducing year after year due to wear and tear, obsolescence or for any other reason.

As the fixed assets are used for earning revenue the amount by which the value of a fixed asset decreases is an item of expense, similar to other expenses. This is called depreciation. It should be charged to the Profit and loss Account. The value of such assets should also be shown in the Balance Sheet at the reduced value by the amount of depreciation:

The adjustment entry for depreciation will be

Depreciation A/c	Dr.
To Asset (by name) Account	

It will be shown in the Profit and Loss A/c and Balance sheet as under :

*Notes*

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Financial Statement



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Financial Statements : II

Profit & Loss A/c

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Depreciation on Plant & Machinery Motor Vehicle (etc)			

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Plant & Machinery	
		<i>Less</i> : Depreciation .....	.....
		Motor Vehicle	
		<i>Less</i> : Depreciation .....	.....

Note : In case amount of depreciation has been calculated before closing of accounts, it will appear in the debit column of the Trial Balance. It will be shown only on the debit of profit & Loss A/c and further adjustment is not required in the Balance Sheet.

9. Further Bad Debts

When the goods are sold on credit basis some of the debtors partly pay the due amount or do not pay at all. If this amount cannot be recovered it is called bad debts and is a loss to the firm. This is entered on the debit side of the Profit & loss A/c. But then there may be amount of bad debt which was not recorded in the books of accounts and hence did not appear in the Trial Balance. But the same was discovered before preparing the financial statements. It is called further bad-debts. Following adjustment entry is made for the same :

Bad Debts A/c	Dr.
To Debtors A/c	
(Further bad debts recorded)	

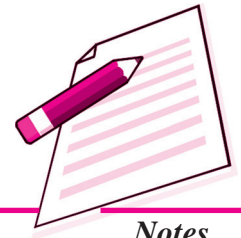
In Profit and Loss A/c and Balance sheet it is shown as under :

Profit & Loss A/c

Dr

Cr

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Bad Debts			
Add Further			
Bad debts			



Notes

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Sundry Debtors	
		Less: Further	
		Bad debts	

10. Provision for Bad and Doubtful debts

Some Debts of a particular year may become bad debts in the next year. It means the loss due to bad debts will be written off in the year it takes place instead of the year it belongs to. It will be a sound accounting practice that a suitable amount is kept aside in the current year to meet the possible loss of bad debts in the next year. Decision regarding maintenance for provision for Bad and Doubtful Debts is taken at the end of the year so it is an item of adjustment. It is called a provision for Bad and Doubtful Debt.

The adjustment entry will be as under :

Profit & loss A/c	Dr.
To Provision for Doubtful Debts A/c	
(Provision for doubtful debts created)	

In the Profit and Loss A/c and Balance sheet it will be shown as under:

Profit & Loss A/c

Dr

Cr

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Bad Debts			
Add : Provision for Doubtful debts			

Balance Sheet

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
		Debtors	
		<i>Less</i> : Provision for bad Debts	



Notes

Such Provision is created on Debtors at a given rate say 5%. In case there is further bad debts, provision for bad and doubtful Debts will be calculated on the amount of debtors after deducting from it the amount of further Bad Debts.

Over the years businessman might have experienced that a certain percentage of the debts created due to credit sales go bad every year. So a provision for bad and doubtful debt is made on the debtors of a year at a fixed percentage say 5%. This percentage may change if the circumstances have changed. For example, it may be reduced if the businessman has become selective in selling goods on credit.

Provision for bad and doubtful debt is maintained at every year at a fixed percentage of the debtors. Last year balance is carried forward in the current year. This may be called old provision for bad and doubtful debts. Current years bad debts or/and further bad debts is adjusted towards this provision and more provision is created, which may be called new provision for bad debts.

Arithmatically it is shown in the Profit and Loss A/c as follows :

Profit and Loss A/c

Dr

Cr

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Bad Debts			
<i>Add</i> : Further Bad Debts			
Add new provision for Bad and Doubtful Debts			
<i>Less</i> : Old provision for Bad and Doubtful Debts			

In case the balance amount of provision for bad and doubtful debts carried forward from last year is more than the amount of bad debts, amount of further Bad Debts and the amount of new provision for bad debts combined together, the excess balance will be credited to Profit and Loss A/c.

Financial Statements : II

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Financial Statement

The amount of provision for Bad and Doubtful Debts is an item of liability. But usual practice is to show it as deducted from the amount of book debts/sundry debtors on the assets side of the Balance Sheet.

The above can best be explained by the following example :

Items appearing in the Trial Balance of a sole trader on 31st Dec, 2013.

<i>Particulars</i>	<i>Dr Balance ₹</i>	<i>Cr Balance ₹</i>
Sundry Debtors	24600	
Provision for Bad and Doubtful Debts		1000
Bad Debts	700	



Notes

Additional Information

Further bad debts amounted to ₹ 600. Make a provision for Bad and Doubtful debts on Debtors @ 5%.

Show the above items and related adjustments in the financial statements as on that date.

Profit and Loss A/c for the year ended 31st Dec., 2013

Dr. Cr.

<i>Particulars</i>	<i>Amount ₹</i>	<i>Particulars</i>	<i>Amount ₹</i>
Bad Debts	700		
Further Bad Debts	600		
<i>Add</i> : New Provision for bad and Doubtful Debts	1200		
	2500		
<i>Less</i> : Old provision for bad and Doubtful Debts	(1000)		
	1500		

Balance Sheet as on 31st Dec., 2013

<i>Liabilities</i>	<i>Amount ₹</i>	<i>Assets</i>	<i>Amount ₹</i>
		Sundry Debtors	24600
		<i>Less</i> : Further Bad Debts	600
			24000
		<i>Less</i> : Provision for bad Debts @ 5%	1200
			22800

18.4 ADJUSTMENTS IN PREPARATIONS OF FINANCIAL STATEMENTS



Notes

11. Provision for Discount on Debtors

Debtors outstanding at the end of year make payment in the next year and they may be entitled to cash discount if they make the payment by the due date. Because, the debt has arisen during the year, the discount is to be taken as expense for the year. Thus a Provision for Discount on Debtors is made.

The process is same as for the provision for doubtful debt. The likely amount of the discount to be allowed is debited to the Profit and Loss Account and credited to the Provision for Discount Account. This amount is deducted from book debts (debtors) in the balance sheet and is carried forward to the next year. Discount allowed to the existing debtors in the next year are debited to the Provision for Discount Account and not to the Profit and Loss Account. The debit reduces the balance in the provision account, it is made up to the required figure by a debit to the Profit & Loss Account and credit to the provisions account just like the Provision for Doubtful Debts Account.

An important point to note is that discount is not allowed on debts that became bad. Therefore, the provision for discount is made for good debts only. In other words, the amount of the Provision for Discount is calculated after deducting bad debts and the provision for doubtful debts from sundry debtors. Suppose, sundry debtors total ₹ 1,00,000; provision for doubtful debts is required at 5% and provision for discounts at 2.5%. So first we have to calculate provision for doubtful debts i.e. ₹ 1,00,000 x 5% = ₹ 5,000; the remaining amount is ₹ 95,000. Now we calculate Provision for Discount on Debtors i.e. ₹ 95,000 x 2.5% it will be ₹ 2,375.

Accounting Treatment

(i) For Discount Allowed :

Discount Allowed A/c	Dr.
To Debtors A/c	

(Being discount allowed to debtors)

(ii) For transferring the amount of discount to profit & loss Account.

Profit & Loss A/c	Dr.
To Discount Allowed	

(Being discount allowed transferred to Profit & Loss A/c)



Notes

Provision for Discount on Debtors Account

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2012				2012			
Dec. 31	To Balance c/d		8,000	Dec. 31	By Profit and Loss A/c		8,000
2013				2013			
Dec. 31	To Discount Allowed A/c		4,000	Jan. 1	By Balance b/d		8,000
Dec. 31	To Balance c/d		6,000	Dec. 31	By Profit and Loss A/c		2,000
			10,000				10,000
2014				2014			
Jan. 1	By Balance c/d			Jan. 1	By Balance c/d		6,000

Discount Allowed Account

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2013				2013			
Dec. 31	To Sundry Debtors A/c		4000	Dec. 31	By Provision for Discount A/c		4000

12. Manager's Commission

Sometimes, the manager is entitled to a commission on profits which is usually calculated as a fixed percentage of the profits. Suppose, the profit earned by the firm is ₹ 80,000 without considering the commission which is at 5%. The commission will be then ₹ 4,000. The profit will be reduced to ₹ 76,000. As the amount of commission ₹ 4,000 is still to be paid, it should be treated as an outstanding expense. Accordingly, the entry is:

Profit and Loss A/c ...Dr.
 To Commission Payable or Outstanding Commission A/c

Commission Payable is a current liability and is shown in the Balance Sheet.

Sometimes, however, the commission is calculated on profits remaining finally after the commission. If the rate of the commission is 5%, and the profit remaining after the commission is ₹ 100; then the profit before the commission will be ₹ 105. That is in this case the commission of ₹ 5 should be out of every ₹ 105 of profit before the commission. The formula to calculate the commission in such a case is :

$$\frac{\text{Percentage of the commission}}{100 + \text{Percentage of the commission}} \times \text{Net Profit before charging the Commission}$$

If the profit before commission is ₹ 8,00,000 and the manager is entitled to a commission of 5% after deducting the commission, the amount will be ₹ 38,095, ₹ 8,00,000 of 5/105. This commission amount can be verified too. The profit after the commission is ₹ 7,61,905 and ₹ 38,095 is 5% of this figure. One can see that if we calculate it at 5% of ₹ 8,00,000 will be wrong since ₹ 40,000 is not 5% of ₹ 7,60,000.

Illustration : 2

The net profit of a firm amount to ₹ 1,05,000 before charging commission. The manager of the firm is entitled to a commission of Rs. 5% on the net profit. Calculate the commission payable to the manager under the following alternative cases :-

- I. If the manager is allowed commission on the net profit before charging such commission, and
- II. If the manager is allowed commission on the net profit after charging such commission. Also show the treatment in the final account ending on 31st March 2013.

Solution :

I Case

[Commission allowed on the net profit before charging such commission]

$$\begin{aligned} \text{Commission} &= \text{Net Profit before charging the Commission} \times \frac{\% \text{ of Commission}}{100} \\ &= ₹ 1,05,000 \times \frac{5}{100} = ₹ 5,250 \end{aligned}$$

Profit & Loss Account
for the year ended 31st March 2013

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Managers Commission	5,250		

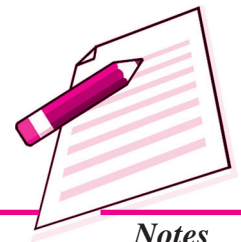
Balance Sheet
as at 31st March 2013

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Current Liabilities			
Manager's Com. Outstanding	5,250		

II Case

[Commission allowed on the net profit after charging such commission]

$$\text{Commission} = \text{Net Profit before charging the Commission} \times \frac{5}{105}$$



Notes



Notes

$$= ₹1,05,000 \times \frac{5}{105} = ₹5,000$$

Profit & Loss Account
for the year ended 31st March 2013

<i>Particulars</i>	<i>₹</i>	<i>Particulars</i>	<i>₹</i>
To Managers Commission	5,000		

Balance Sheet
as at 31st March 2013

<i>Liabilities</i>	<i>₹</i>	<i>Assets</i>	<i>₹</i>
Current Liabilities			
Manager's Com. Outstanding	5,000		



INTEXT QUESTIONS 18.3

I. Give exact term for the following:

- (i) Provision against amount due from debtors.
- (ii) Fall in the value of fixed assets due to wear and tear.
- (iii) Debts which can not be recovered.
- (iv) Stock of goods remaining unsold at the end of year.

II. Complete the journal entries for the following adjustments

- (i) Interest on capital allowed
Interest on capital A/c Dr
To
- (ii) Wages Outstanding
Wages A/c
To
- (iii) Insurance Premium paid for six months in advance
Unexpired Insurance A/c
To
- (iv) Commission received but not yet earned
Commission A/c
To

III. State whether the following statements are True or False :

- (i) Provision for discount on debtors is shown on the credit side of Profit & Loss A/c.
- (ii) The Amount of Provision for discount on debtors is deducted from debtors.
- (iii) Provision for discount on debtors is a income for a business.
- (iv) Provision for discount on debtors is an asset for a company.
- (v) If sundry debtors are of ₹ 10,000 and company creates provision for discount on debtors @ 10%. Then total provision is ₹ 1,000.

*Notes***IV. Fill in the blanks with appropriate words :**

- (i) Manager's commission is shown in the _____ side of Profit & Loss A/c
- (ii) Manager's commission is shown in the _____ of Balance Sheet.

Illustration : 3

From the following Trial Balance of M.B. Garments as on 31st December, 2013, prepare Trading A/c and Profit & Loss A/c for the year ended 31st December, 2013 and Balance Sheet as on that date :

<i>Name of the Account</i>	<i>Dr. Amount</i> ₹	<i>Cr. Amount</i> ₹
Capital		80,000
Cash in hand	570	
Cash at bank	5,600	
Purchases	43,200	
Sales		78,000
Wages	10,400	
Power	4,730	
Carriage inward	2,040	
Carriage outward	3,200	
Stock (1.1.2006)	5,660	
Land & Building	40,000	
Machinery	20,000	
Salaries	4,000	

MODULE - 3

Financial Statement



Notes

Financial Statements : II

Insurance	600	
Sundry Debtors	28,000	
Sundry Creditors		10,000
	1,68,000	1,68,000

Following adjustments are to be accounted for:

- Stock on 31.12.2013 ₹ 10000.
- Machinery to be depreciated @ 10% p.a. and Building to be depreciated @ 2% p.a.
- Salaries for the month of December outstanding were ₹ 1200.
- Insurance Premium was paid for one year ending 30th June, 2014.

Make journal entries for the adjustments and prepare Trading and Profit & loss A/c and the Balance Sheet.

Solution

Date	Particulars	Dr. Amount ₹	Cr. Amount ₹
2013			
Dec 31	Closing stock A/c ...Dr To Trading A/c (Closing stock taken to Trading A/c)	10,000	10,000
Dec 31	Depreciation A/c ...Dr. To Machinery A/c To Land & Building A/c (Depreciation on machinery @ 10% p.a. and on land & Building @ 2% p.a. charged)	2,800	2,000 800
Dec 31	Salaries A/c ...Dr. To Salary Outstanding A/c (Salary due but not paid for December 2013)	1,200	1,200
Dec 31	Prepaid Insurance A/c ...Dr. To Insurance A/c (Insurance paid in advance accounted for)	300	300

Trading A/c
for the year ended 31st Dec, 2013

<i>Particulars</i>	<i>Amount ₹</i>	<i>Particulars</i>	<i>Amount ₹</i>
Stock	5,660	Sales	78,000
Purchases	43,200	Closing stock	10,000
Wages	10,400		
Power	4,730		
Carriage Inward	2,040		
Gross Profit transferred to Profit & Loss A/c	21,970		
	88,000		88,000



Notes

Profit & Loss A/c
for the year ended 31st Dec. 2013

<i>Particulars</i>	<i>Amount ₹</i>	<i>Particulars</i>	<i>Amount ₹</i>
Carriage outward	3,200	Gross Profit transferred from Trading A/c	21,970
Salaries	4,000		
Add : Salary Outstanding	1,200		
Insurance	600		
Less : Prepaid insurance			
Depreciation on Machinery	300		
Land & building	2,000		
Net Profit transferred to capital A/c	2,800		
	10,470		
	21,970		21,970

Balance Sheet
as at 31st Dec. 2013

<i>Liabilities</i>	<i>Amount ₹</i>	<i>Assets</i>	<i>Amount ₹</i>
Salary Outstanding	1,200	Cash in hand	570
Sundry Creditors	10,000	Cash at Bank	5,600

MODULE - 3

Financial Statement



Notes

Financial Statements : II

Capital	80,000		Sundry debtors	28,000
Add: net profit	10,470	90,470	Closing stock	10,000
			Prepaid Insurance	300
			Land & Building	40,000
			Less depreciation	800
			Machinery	20,000
			Less depreciation	2,000
		1,01,670		18,000
				1,01,670

Illustration : 4

From the following Trial Balance of Mustafa & Co., prepare Trading and Profit and loss A/c for the year ending on 31st Dec. 2013 and Balance Sheet as on that date after making necessary journal entries for adjustments.

	<i>Dr.</i> <i>Balance</i> (₹)		<i>Cr.</i> <i>Balance</i> (₹)
Land and Building	60,000	Capital	1,50,000
Plant and Machinery	40,000	Sundry Creditors	30,000
Bill Receivables	8,000	Sales	1,20,000
Stock on 1.1.2013	40,000	Reserve for Bad and Doubtful Debts	4,500
Purchases	51,000	Loan (12% p.a.)	10,000
Wages	20,000	Commission Received	2,000
Coal, Gas & Coke	5,800		
Salaries	5,000		
Rent	2,800		
Cash at bank	25,000		
Sundry Debtors	45,000		
Repairs	1,800		
Bad Debts	5,500		
Sales Returns	2,000		
Furniture and Fixture	4,000		
Interest on Loan	600		
	3,16,500		3,16,500

Adjustments

1. Closing stock was valued at ₹ 30000.
2. Depreciate Plant & Machinery @ 5% and Furniture & Fixture @ 10%.
3. Provide for Bad and Doubtful Debts @ 5%.
4. Outstanding Wages ₹ 1000, Rent ₹ 500 and interest on loan outstanding ₹ 600.
5. Commission accrued ₹ 1000.

Solution.**Adjustment Entries**

<i>Date</i>	<i>Particulars</i>	<i>Amount ₹</i>	<i>Amount ₹</i>
2013 Dec 31	Closing Stock A/c Dr. To Trading A/c (Closing stock taken into account)	30,000	30,000
	Depreciation A/c Dr. To Plant & Machinery To Furniture & Fixture (Depreciation charged @ 5% on Plant & Machinery & @ 10% on Furniture)	2400	2000 400
	Profit & loss A/c Dr. To Reserve for Doubtful Debts (Reserve for Doubtful Debts created)	2250	2250
	Wages A/c Dr. Rent A/c Dr. To Outstanding Expenses A/c (Outstanding expenses provided for)	1000 500	1500
	Commission Accrued A/c Dr. To commission received (Commission accrued taken into consideration)	1000	1000
	Interest on loan A/c Dr. To Interest on loan Outstanding A/c (Interest on loan due but not paid)	600 600	

*Notes*



Notes

**Trading and Profit & Loss A/c of M/s Mustafa & Co.
for the year ended on 31.12.2013**

Dr.			Cr.	
<i>Particulars</i>		₹	<i>Particulars</i>	₹
Opening Stock		40,000	Sales	1,20,000
Purchases		51,000	<i>Less</i> : Sales Returns	2,000
Wages	20,000		Closing Stock	30,000
<i>Add</i> : Outstanding	<u>1,000</u>	21,000		
Coal, Gas & Coke		5,800		
Gross Profit c/d		30,200		
		<u>1,48,000</u>		<u>1,48,000</u>
Salaries		5,000	Gross Profit b/d	30,200
Rent	2,800		Commission Received	
<i>Add</i> : Outstanding	<u>500</u>	3,300	Received	2,000
Repairs		1,800	<i>Add</i> : Accrued	
Bad Debts	5,500		Commission	<u>1,000</u>
<i>Add</i> : New Reserve	<u>2,250</u>			3,000
	7,750			
<i>Less</i> : Old Reserve	<u>4,500</u>	3,250		
Interest on Loan	600			
<i>Add</i> : Interest Outstanding	<u>600</u>	1,200		
Depreciation				
Plant & Machinery	2,000			
Furniture & Fixture	<u>400</u>	2,400		
Net Profit Transferred to				
Capital A/c		16,250		
		<u>33,200</u>		<u>33,200</u>

**Balance sheet of M/s Mustafa & Co.
as at 31.12. 2013**

<i>Liabilities</i>		₹	<i>Assets</i>	₹
Sundry creditors		30,000	Cash in Bank	25,000
Loan		10,000	Bill Receivables	8,000
Interest outstanding		600	Sundry Debtors	45,000
Outstanding Expenses :			<i>Less</i> : Reserve for	
Wages	1,000		Doubtful Debts	<u>2,250</u>
Rent	<u>500</u>	1,500	Closing Stock	30,000

Financial Statements : II

Capital	1,50,000		Furniture & Fixture	4,000	
Add : Net Profit	<u>16,250</u>	1,66,250	Less : Dep.	<u>400</u>	3,600
			Plant & Machinery	40,000	
			Less : Dep.	<u>2,000</u>	38,000
			Land & Building		60,000
			Commission Accrued		1,000
		<u>2,08,350</u>			<u>2,08,350</u>

MODULE - 3

Financial Statement



Notes

Illustration : 5

From the following balances of the year ending 31st December, 2013 and additional information prepare the Trading and Profit and Loss Account and the Balance Sheet of M/s Kanohal and Sons.

	₹		₹
Capital	80,000	Insurance	600
Purchases	82,000	Salaries	12,500
Sales	1,10,000	Bad Debts	200
Return Outwards	1,000	Carriage on Purchase	200
Buildings	45,000	Commission (Cr.)	1,500
Opening Stock	15,000	Cash in Hand	5,000
Debtors	20,100	Cash at Bank	25,000
Creditors	28,000	Sales Tax Paid	5,000
Furniture	7,000	Sales Tax Collected	3,500
Wages	1,800	Interest on Investments	500
Rent	5,100		

Additional Information:

- Closing Stock was valued at ₹ 20,000.
- Provide Depreciation on building @5% and on furniture @10%.
- Outstanding salaries ₹ 1,000.
- Unexpired insurance ₹ 50.
- Accrued commission ₹ 300
- Provide for Manager's Commission at 5% on net profit after charging such commission.

Solution :

**Trading and Profit & Loss Account
for the ended 31st December, 2013**

Dr.

Cr.

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Opening Stock	15,000	By Sales	1,10,000
To Purchases	82,000	By Closing Stock	20,000
<i>Less</i> : Return Outward	1,000		
To Wages	1,800		
To Carriage on Purchases	200		
To Gross Profit c/d	32,000		
	<u>1,30,000</u>		<u>1,30,000</u>
To Rent	5,100	By Gross Profit b/d	32,000
To Insurance	600	By Interest on Investment	500
<i>Less</i> : Unexpired Insurance	50	By Commission	1,500
To Salaries	12,500	Add : Accrued	
Add : Outstanding		Commission	300
Salaries	1,000		1,800
To Bad Debts	200		
To Depreciation on :			
Building	2,250		
Furniture	700		
To Net Profit before			
Manager's Commission	12,000		
	34,300		34,300
To Manager's Commission		By Net Profit before	
(5/105 x 12,000)	571	Manager's Commission	12,000
To Net Profit after Manager			
Commission	11,429		
	<u>12,000</u>		<u>12,000</u>

**Balance Sheet
as at 31st December, 2013**

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Creditors	28,000	Cash in Hand	5,000
Outstanding Salary	1,000	Cash at Bank	25,000
Manager's Commission	571	Closing Stock	20,000



Notes

Capital	80,000		Debtors	20,100
Add : Net Profit	<u>11,429</u>	91,429	Advance Sales Tax Paid	
			(Sales Tax Paid - Sales Tax Collected)	1,500
			Accrued Commission	300
			Prepaid Insurance	50
			Building	45,000
			Less : Depreciation	<u>2,250</u>
			Furniture	7,000
			Less : Depreciation	<u>700</u>
				6,300
		<u>1,21,000</u>		<u>1,21,000</u>



Notes

13. Abnormal Losses

Such losses occur because of fire, earthquakes or accidents. These may destroy some fixed assets of the firm. In such case an Asset Account is credited and the Profit and Loss Account is debited. The debit may be spread over two or three years.

Stock of goods may also be destroyed or damaged by fire, or other causes. It is obvious that because of this, the value of the stock will be lower than otherwise. This will reduce the amount of gross and net profit. It is, however, better to ascertain the gross profit which would have been earned without the loss since this enables the firm to judge its trading operations properly. To nullify the effect of loss of stock, the Trading Account is credited with the cost of the goods destroyed. If the goods destroyed are not insured then the cost price of the goods destroyed is debited to Profit and Loss Account. If the goods are insured, then the claim admitted by the insurance company is deducted and the claim not admitted is debited to the Profit and Loss Account. The adjusting entries are as follows :

- (i) Accidental Loss of Stock A/c
 or Loss by Fire ...Dr. [Total Value of Abnormal Loss]
 To Trading A/c
- (ii) Insurance Claim or Insurance Co. ...Dr. [Amount of Insurance Claim]
 Profit and Loss A/c ...Dr. [Value of Irrecovered Loss]
 To Accidental Loss of Stock A/c [Total Value of Abnormal Loss]

Insurance Company's Account will be shown as an asset in Balance Sheet

Note : If stock is not insured, following entry will be passed.

- Profit and Loss A/c ...Dr. [Total Value of Abnormal Loss]
 To Trading A/c



Illustration : 6

On 31st Dec. 2013, stocks worth ₹ 4,00,000 were destroyed by fire. The stock was insured and the insurance company admitted the claim of ₹ 3,00,000 only. Give the necessary journal entries and show how it will be treated in the Final Accounts.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>LF.</i>	<i>Dr. (₹)</i>	<i>Cr. (₹)</i>
2013				
Dec. 31	Loss by Fire A/c Dr. To Trading A/c (Being loss of stock by fire)		4,00,000	4,00,000
Mar. 31	Insurance Co. Dr. P & LA/c Dr. To Loss by fire A/c (Being insurance co. admitted a partial claim only)		3,00,000 1,00,000	4,00,000

Trading Account
for the year ended 31st Dec. 2013

<i>Particulars</i>		<i>₹</i>	<i>Particulars</i>		<i>₹</i>
			By Loss by Fire A/c		4,00,000

Profit and Loss Account
for the year ended 31st Dec. 2013

<i>Particulars</i>		<i>₹</i>	<i>Particulars</i>		<i>₹</i>
To Loss by fire	4,00,000				
Less : Ins. Claim	3,00,000	1,00,000			

Balance Sheet
as at 31st Dec. 2013

<i>Liabilities</i>	<i>₹</i>	<i>Asset</i>	<i>₹</i>
		Current Assets	
		Claim due from Insurance Co.	3,00,000

Illustration : 7

From the following Ledger balances of Mr. Ghanshyam, prepare the Trading and Profit and Loss Account for the year ended 31st March 2013 and the Balance Sheet as on that date after making the necessary adjustments.

Particulars	₹	Particulars	₹
Trade Expenses	8,000	Purchases	8,20,000
Freight and Duty	20,000	Stock on (1.4.2012)	1,50,000
Carriage Outwards	5,000	Plant and Machinery (1.4.2012)	2,00,000
Sundry Debtors	2,06,000	Plant and Machinery (additions on 1.10.2012)	50,000
Furniture and Fixtures	50,000	Drawings	60,000
Return Inwards	20,000	Capital	8,00,000
Printing and Stationery	4,000	Reserve for Doubtful Debts	8,000
Rent, Rates and Taxes	46,000	Rent for Premises Sublet	16,000
Sundry Creditors	1,00,000	Insurance Charges	7,000
Sales	12,00,000	Salaries and wages	2,13,000
Return Outwards	10,000	Cash in Hand	62,000
Postage and Telegraphs	8,000	Cash at Bank	2,05,000



Notes

Adjustments :

- (i) Stock on 31st March 2013 was ₹ 1,40,000.
- (ii) Write off ₹ 6,000 as Bad Debts.
- (iii) Provision for Doubtful Debts is to be maintained @5%.
- (iv) Provide Depreciation on furniture and fixtures at 5% p.a. and on plant and machinery at 20% p.a.
- (v) Insurance prepaid was ₹ 1,000.
- (vi) A fire occurred in the godown and stock of the value of ₹ 50,000 was destroyed. It was insured and the insurance company admitted full claim.

Solution :

**Trading and Profit and Loss Account
for the year ended 31st March, 2013**

Dr.

Cr.

Particulars	₹	Particulars	₹
To Opening Stock	1,50,000	By Sales	12,00,000
To Purchases	8,20,000	Less : Return Inwards	20,000
Less : Return Outwards	10,000		11,80,000
To Freight and Duty	20,000	By Loss of Stock by Fire A/c	50,000
To Gross Profit c/d	3,90,000	By Closing Stock	1,40,000
	13,70,000		13,70,000

MODULE - 3

Financial Statement



Notes

Financial Statements : II				
To Trade Expenses		8,000	By Gross Profit b/d	3,90,000
To Carriage Outwards		5,000	By Rent for Premises	16,000
To Depreciation on Furniture and Fixtures		2,500		
To Dep. on Plant and Machinery				
2,00,000 x 20/100	40,000			
5,000 x 20/100 x 6/12	5,000	45,000		
To Printing & Stationery		4,000		
To Rent, Rates and Taxes		46,000		
To Insurance	7,000			
Less : Prepaid	1,000	6,000		
To Salaries and Wages		2,13,000		
To Postage and Telegraphs		8,000		
To Provision for Doubtful Debts (Closing)				
(₹2,00,000 x 5/100)	10,000			
Add : Bad Debts	6,000			
		16,000		
Less: Provison for Doubtful Debts (Opening)	8,000	8,000		
To Net Profit transferred to Capital A/c		60,500		
		4,06,000		4,06,000

Balance Sheet as at 31st March, 2013

Liabilities	₹	Assets	₹
Current Liabilities		Current Assets	
Sundry Creditors	1,00,000	Cash in Hand	62,000
Capital		Cash at Bank	2,05,000
Opening Balance	8,00,000	Sundry Debtors	2,06,000
Add: Net Profit	60,500	Less: Further Bad Debts	6,000
	8,60,500		2,00,000
Less: Drawings	60,000	8,00,500	
		Less: Provision for Doubtful Debts	10,000
			1,90,000
		Closing Stock	1,40,000
		Insurance Claim	50,000
		Prepaid Insurance	1,000
		Fixed Assets	
		Furniture and Fixture	50,000
		Less: Depreciation	2,500
			47,500

	Plant and Machinery	2,50,000	
	<i>Less:</i> Depreciation	45,000	2,05,000
9,00,500			9,00,500

14. Drawings of Goods by the Proprietor

When the proprietor draws some goods or cash from the business for his/her personal use, it is a drawing.

Now, if you find that this has not been recorded in the books, you have to make the necessary adjustments to take it into the Final Accounts. Then the treatment of such drawings of goods by the proprietor in the Final Account is as follows:

- i. Deduct it from purchases on the debit side of Trading A/c.
- ii. Deduct it either from the capital or add to drawings on the liability side of the Balance Sheet.

Accounting Treatment of Drawings

I. Drawing made in cash

(i) Drawings A/c Dr.

To Cash/Bank A/c

(Being cash withdrawn for personal use)

(ii) Capital A/c Dr.

To Drawings A/c

(Being drawings transferred)

II. Withdrawal of Goods by the Proprietor

(i) Drawings A/c Dr.

To Purchases A/c

(Being goods withdrawn for personal use)

(ii) Capital A/c Dr.

To Drawings A/c

(Being drawings transferred)

III. Income Tax Paid by sole proprietor out of the entity's (business) cash

(i) Income Tax A/c Dr.

To Cash/Bank A/c

(Being Income Tax Paid)



Notes



Notes

(ii) Drawings A/c Dr.

To Income Tax

(Being Income Tax Transferred)

(iii) Capital A/c Dr.

To Drawings

(Being drawings transferred)

15. Goods Distributed as Free Samples

For sales promotion, some of the goods may be distributed as free samples. For example, if goods worth ₹ 10,000 are distributed as free samples then it will be an advertisement for the concern but on the other hand the stocks will be less by goods of such value. In order to bring this into the books of accounts the following entry is passed :

Advertisement A/c Dr.

To Purchases A/c

(Being goods distributed as free samples)

The two-fold effect of this entry will be :

- i. It is shown on the credit side of Trading A/c, or deducted from the purchases.
- ii. It is shown on the debit side of the profit and loss A/c as advertisement expenses.

Illustration : 8

From the following Trail Balance, Prepare the Trading and Profit & Loss A/c for the year ended March 31, 2014 and the balance sheet as on that date :

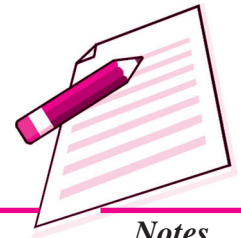
<i>Debit Balance</i>	<i>₹</i>	<i>Credit Balance</i>	<i>₹</i>
Salaries	10,600	Sales	66,420
Bills Receivable	6,000	Capital	50,000
Investments	40,000	Pro. for Doubtful Debts.	2,500
Furniture	12,000	10% Loan (1.10.2013)	10,000
Opening Stock	4,500	Discount Received	400
Purchases	30,000	Sundry Creditors	9,300
Sundry Debtors	20,000	Bills Payable	5,000
Interest on Loan	400	Outstanding Salaries	500
Insurance Premium	900	Bad Debts Recovered	200
Wages	4,600	Interest on Investments	2,000

Financial Statements : II

Rent	1,520	Trading Commission	7,000
Bad Debts	1,200		
Carriage Outwards	600		
Cash at Bank	10,000		
Depreciation on Furniture	2,500		
Accrued Commission	1,000		
Advertisement	7,500		
	<u>1,53,320</u>		<u>1,53,320</u>

MODULE - 3

Financial Statement



Notes

Adjustments :

- Closing Stock - ₹ 6,000.
- Goods costing ₹ 1,000 were distributed as free samples while goods costing ₹ 500 were taken by the proprietor for personal use.
- A credit sale of ₹ 2,000 was not recorded in the sales book.
- Closing Stock included goods costing ₹ 1,000 which were sold and recorded as sales but not delivered to the customer.
- Maintain provision for Doubtful Debts @5%.
- Only one-third advertising expenses are to be written off.

Solution

Trading and Profit & Loss Account for the year ending 31st March, 2014

Dr.

Cr.

Particulars	₹	Particulars	₹
To Opening Stock	4,500	By Sales	66,420
To Purchases	30,000	Add : Credit Sales	<u>2,000</u>
Less: Free Samples	<u>1,000</u>	By Closing Stock	6,000
	29,000	Less: Cost of Goods sold	
Less : Drawing of Goods	<u>500</u>	but not delivered	<u>1,000</u>
To Wages	4,600		5,000
To Gross Profit c/d	35,820		
	73,420		73,420
To Salaries	10,600	By Gross Profit b/d	35,820
To Interest on Loan	400	By Old Pro. for Bad Debts	2,500
Add: Outstanding Interest		Less: Bad Debts	<u>1,200</u>
on Loan	<u>100</u>		1,300
To Insurance Premium	900	Less : New Provision	<u>1,100</u>
			200

MODULE - 3

Financial Statement



Notes

Financial Statements : II

To Rent	1,520	By Discount Received	400
To Carriage Outwards	600	By Bad Debts Recovered	200
To Depreciation of Furniture	2,500	By Interest on Investment	2,000
To Advertisement	2,500	By Trading Commission	7,000
To Free Samples	1,000		
To Net Profit transferred to Capital A/c	25,500		
	45,620		45,620

Balance Sheet as at 31st March, 2013

Liabilities		₹	Assets		₹
Capital	50,000		Bill Receivable		6,000
Add: Net Profit	25,500		Investments		40,000
	<u>75,500</u>		Furniture		12,000
Less: Drawings	500	75,000	Debtors	20,000	
10% Loan		10,000	Add: Credit Sales Not Recorded	<u>2,000</u>	
Outstanding Interest on Loan		100		22,000	
Creditors		9,300	Less: New Provision	<u>1,100</u>	20,900
Bills Payable		5,000	Accrued Commission		1,000
Outstanding Salaries		500	Closing Stock		5,000
			Bank		10,000
			Unexpired Advertisement Exp.		5,000
		99,900			99,900

Summarised view of Adjustment Entries

Adjustment	Adjustment entry		Treatment in Trading and Profit & Loss A/c	Treatment in Balance Sheet
1. Closing stock	Closing stock A/c To Trading A/c	Dr	Shown on the credit side of Trading A/c	Shown on the Assets side
2. Outstanding expenses	Expenses A/c To Outstanding expenses A/c	Dr	Added to respective expenses on the debit side	Shown on the liabilities side
3. Prepaid expenses	Prepaid expenses A/c To Expenses A/c	Dr	Deducted from the respective expenses on the debit side	Shown on the Assets side
4. Accrued income	Accrued income A/c To Income A/c	Dr	Added to the respective income on the credit side	Shown on the Assets side

Financial Statements : II

5. Income received in advance	Income A/c To income received in advance A/c	Dr	Deducted from the respective income on the credit side	Shown on the liabilities side
6. Interest on capital	Interest on capital A/c To capital A/c	Dr	Shown on the debit side of P&L A/c	Shown as addition to capital on liabilities side
7. Interest on drawings	Capital A/c To interest on drawing A/c	Dr	Shown on the credit side P&L A/c	Shown as deduction to capital on liabilities side
8. Depreciation	Depreciation A/c To Assets A/c	Dr	Shown on the debit side P&L A/c	Deducted from the value of Assets
9. Further bad debts	Bad Debts A/c To Debtors A/c	Dr	Shown on the debit side P&L A/c	Deducted from debtors, shown on Assets side
10. Provision for bad and doubtful debts	Profit & Loss A/c To Provision for bad and doubtful debts	Dr	Shown on the debit side P&L A/c	Shown as deduction from debtors on Assets side.
11. Provision for Discount on Debtors	Profit & Loss A/c To Provision for Discount	Dr.	Shown on the debit side P&L A/c	Shown as deduction from debtors on Assets side.
12. Commission to Manager	Profit & Loss A/c To Manager's Commission	Dr.	Shown on the debit side P&L A/c	Shown in liability side
13. Extra Ordinary Loss	Profit & Loss A/c To Extra Ordinary Loss	Dr.	Shown on the debit side P&L A/c	Shown as deduction from concerned Asset on Assets side.
14. Drawings of goods by the Owner	Drawings A/c To Purchases A/c	Dr.	To be deducted from purchases.	Shown as deduction from Capital on Liabilities side.
15. Distribution of goods as free samples	Advertisement A/c To Purchases A/c	Dr.	To be deducted from purchases.	Shown on debit side of P & L A/c

MODULE - 3

Financial Statement



Notes



Notes



INTEXT QUESTIONS 18.4

State whether the following statements are True or False :

- i. Proprietor draws some goods or cash from the business is a drawing.
- ii. If proprietor draws goods then it will be deducted from purchases.
- iii. Drawing is an asset.
- iv. Good distributed as free samples is advertisement for the business.
- v. Goods distributed as free sample is shown on the debit side of trading A/c.



WHAT YOU HAVE LEARNT

- Adjustments are needed to be accounted for so that Income Statement and Position Statement show the correct profit or loss and financial position.
- There can be items of income and expenditure which do not pertain to the accounting year for which financial statements are being prepared. These are to be excluded. These are called prepaid items.
- There can be items of expenses and income which are left out and are to be accounted, which are called outstanding expenses or accrued incomes.
- Other important adjustments to be carried out are Closing Stock, Depreciation on fixed assets, interest on capital and interest on Drawings.
- There may be further bad debts and provision for bad and doubtful debts need to be made on debtors.
- Further bad debts are irrecoverable debts in addition to what has been shown in the Trial Balance as bad debts
- Provision for bad and doubtful debts is created for future payments due from debtors but seems to be irrecoverable. It is created on the basis of past experiences.
- The Process of creating provision for discount on debtors is same as provision for doubtful debts. The likely amount of the discount to be allowed is debited to the P&L A/c and the same will be deducted from debtors in the balance sheet.
- If the manager is allowed commission on the net profit before charging such commission then the following formula should be used :

$$\text{Net Profit} \times \frac{\% \text{ of commission}}{100}$$

and if the manager is entitled for commission. On the net profit after charging such commission then the following formula should be used :

$$\text{Net Profit} \times \frac{\% \text{ of commission}}{(100 + \% \text{ of commission})}$$

- Abnormal losses occur because of fire, earthquakes or accidents. These may destroy some fixed assets of the firm. In such case an Asset Account is credited to trading A/c and debited to profit and loss A/c debited.
- Drawings of goods by the proprietor is deducted from purchases on the debit side of Trading A/c., and deducted from capital in Balance Sheet.
- Goods distributed as free sample is deducted from purchases and shown in the debit side of P&L A/c as advertisement.



Notes



TERMINAL EXERCISE

1. Answer the following questions in brief.
 - (a) Why are adjustments needed?
 - (b) Why are outstanding expenses treated as liabilities?
 - (c) What is the difference between accrued income and unearned income?
2. Pass necessary journal entries for following adjustments :
 - i. Wages outstanding
 - ii. Depreciation on Furniture
 - iii. Interest on Investment accrued but not received
 - iv. Insurance Premium paid in advance
3. Why reserve is created for doubtful debts?
4. From the following trial balance of M/s V.B. Fertilizers prepare Trading & Profit and Loss Account for the year ending 31st December, 2013 and Balance Sheet as on that date. Also pass Journal entries for the adjustments:

<i>Particulars</i>	<i>Dr. (₹)</i>	<i>Particulars</i>	<i>Cr (₹)</i>
Stock (1.1.2013)	13,800	Capital	65,000
Purchases	52,000	Bills payable	18,000
Wages	4,000	Sales	74,400
Return inward	2,400	Return outward	1,500
Land & Building	40,000	Discount	450
Plant & machinery	24,500	Creditors	6,500
Bills receivable	12,000	Interest	600
Debtors	5,500	Bad debts Reserve	250

MODULE - 3

Financial Statement



Notes

Financial Statements : II

Cash in hand & at Bank	8,750	Loan	8,000
Rent (office)	2,200	Commission	700
Bad Debts	400		
Insurance	1,500		
Freight inward	1,400		
Fuel & Power	2,450		
Furniture	4,500		
	1,75,400		1,75,400

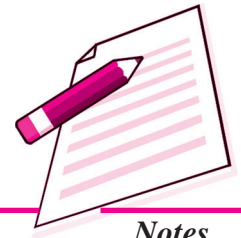
Adjustments

- Stock on 31.12.2013 ₹ 25,000.
 - Write off depreciation on furniture 10% and on plant & machinery 20%.
 - Provide for wages outstanding ₹ 650 and rent outstanding ₹ 200. Prepaid insurance amounted to ₹ 300.
 - Further bad debts amounted to ₹ 100. Make a provision for bad & doubtful debts @ 5% on debtors.
 - Interest on capital to be allowed @ 6%.
5. On 1st April, 2013 reserve for Bad Debts shows a balance of ₹ 3,200 Bad debts during the year as per ledger were ₹ 2,100. Debtors amounted to ₹ 7,000. After closing of the ledger, it was found that there were bad debts of ₹ 800. It was decided to create a reserve for doubtful debts on creditors @ 6%.
- Pass necessary journal entries and show the items in Profit & Loss account and Balance Sheet.
6. From the following trial balance of Pranaya as at 31st December, 2014, prepare Trading and Profit & loss account for the year ended 31st December, 2014 and a Balance Sheet as on that date after making necessary adjustments. Also Give journal entries for these adjustments

Trial Balance as at 31-12-2014

Name of Account	Dr. Balances (₹)	Dr. Balances (₹)
Pranaya's Capital Account		1,00,000
Drawings	24,000	—
Plant and Machinery	45,000	—
Stock (1 st Jan, 2014)	15,000	—
Purchases	85,000	—
Return inwards	5,000	—
Sundry Debtors	24,600	—

Freight and duty	2,000	–
Carriage outwards	1,600	–
Rent Rates & Taxes	3,800	–
Sundry Creditors	–	22,000
Postage & Courier Expenses	1,800	–
Sales	–	1,35,000
Provision for Bad Debts	–	600
Discount	–	800
Insurance Premium	900	–
Wages	23,000	–
Cash in Hand	6,200	–
Cash at Bank	20,500	–
	2,58,400	2,58,400



Notes

Adjustments

- i. Stock on 31st December, 2014 was valued at ₹ 24,000.
 - ii. Write off ₹ 600 as bad debts.
 - iii. Provision for doubtful debts is to be maintained at 5% on sundry debtors.
 - iv. Provide depreciation on plant and machinery at 20%. A machine costing ₹ 1,500 was purchased on 1st July, 2014.
 - v. Wages outstanding amounted to ₹ 1,500, and Insurance Prepaid was ₹ 250.
7. The following are the balances extracted from the books of Chinmay Aggarwal on 31st March 2014.

	₹		₹
Chinmay's Capital	60,000	Stock (1.4.2013)	44,200
Furniture & Fixtures	5,000	Debtors	36,000
Bank Overdraft	8,400	Rent received	2,000
Creditors	27,600	Purchases	2,20,000
Business Premises	50,000	Sales	3,00,000
Discount (Dr)	3,200	Sales Returns	4,000
Tax & Insurance	4,000	Bills Payable	10,000
Salaries	20,000		
Commission (Cr.)	2,000		
Carriage inward	3,600		
Bad Debts	1,600		
Motor Vehicle	14,400		
Investments	4,000		

Following adjustments are to be made :

- (i) Stock on 31 March, 2014 ₹ 35,000.



Notes

- (ii) Write off depreciation on :
 - Business Premises ₹ 800
 - Furniture & Fixture ₹ 500
 - Motor Vehicle 10% p.a.
 - (iii) Interest on bank overdraft ₹ 150.
 - (iv) Interest on capital was to be allowed @ 6% p.a.
 - (v) Make a provision of 5% on debtors for doubtful debts.
 - (vi) Carry forward ₹ 500 for unexpired insurance.
- Prepare Trading and Profit & loss A/c for the year ended 31st March, 2014 and Balance Sheet as on that date.
8. Pass necessary journal entries for the following adjustments :
- i. 1/3rd of the total commission received during the year of ₹12000 relates to the next year
 - ii. Insurance premium of Rs.8000 is paid for the year ending 30st June. Accounts are closed on 31st March every year.
 - iii. Interest on drawing is charged for the year amounting to ₹ 450.
9. Explain the following adjustments with examples :
- i. Provision for discount on debtors.
 - ii. Manager's Commission
10. What do you mean by Abnormal loss? Also explain its accounting treatment with the help of an example.
11. Explain the accounting treatment of drawing of goods by the proprietor and goods distributed as free samples.



ANSWERS TO INTEXT QUESTIONS

- 18.1** (i) profit, loss (ii) profit or loss, financial position
 (iii) excluded (iv) accounted for
- 18.2** (i) Outstanding expenses (ii) Prepaid expenses
 (iii) Accrued income (iv) Income received in advance
- 18.3** I. (i) provision for bad & doubtful debts
 (ii) depreciation (iii) bad debts (iv) closing stock

- II. (i) To capital account (ii) To wages outstanding A/c
 (iii) To insurance premium A/c
 (iv) To commission received in advance A/c
- III. (i) False (ii) True (iii) False (iv) False (v) True
- IV. (i) Debit (ii) Liability

18.4 (i) True (ii) True (iii) False (iv) True (v) False



Notes



ANSWERS TO TERMINAL EXERCISE

4. (G.P. ₹ 24200; N.P. ₹ 12580
 Total of Balance Sheet ₹ 114830
6. G.P. ₹ 27500; N.P. ₹ 10400
 Total Balance Sheet ₹ 109900
7. G.P. ₹ 63200; N.P. ₹ 30610
 Total balance Sheet : ₹ 140360



ACTIVITY

Analyse the financial statements of at least four business concerns and record the rate at which depreciation is charged on various fixed assets and provision is made for doubtful debts and find out the reasons of variation.

S.No.	Name of Business concern	Rate of Depreciation	Reasons of variation

*Notes***19****NOT FOR PROFIT ORGANISATION
- AN INTRODUCTION**

You buy goods of daily consumption from the general store of your locality, such as clothes from cloth shop or you see a movie in a cinema hall. These are all business organisations that deal in purchasing and selling goods and services. Their objective is to earn profit. You must have studied in a school, you go to a hospital for treatment. You may be a member of a sports club of your area. These are the organisations that are founded not to earn profits but to provide services to their members and to the public in general. You have learnt the preparation of financial statements of profit organisations. While performing the activities, these organisations also engage in financial transactions. They also want to know the results of their activities for a particular period. For this they also prepare financial statements. You will now study in this lesson the system of accounting of these organisations i.e. Not for Profit Organisations (NPOs) such as sports club literary society, etc.

**OBJECTIVES**

After studying this lesson, you will be able to :

- state the meaning and characteristics of Not-for-Profit Organisations;
- state the meaning and need for preparing Receipts and Payments account;
- identify the items of Receipts and Payments Account and prepare Receipts and Payments Account as per format; and
- distinguish between Receipts and Payments Account and Cash Book.

19.1 NOT-FOR-PROFIT ORGANISATIONS—MEANING AND CHARACTERISTICS

You must have come across organisations which are not engaged in business activities. Their objective is not to make profits but to provide service. Examples of such organisations are : schools, hospitals, charitable institutions, welfare societies, clubs, public libraries, resident welfare association, sports club etc. These are called Not-for-Profit Organisations (NPOs). These organisations provide services to their members and to the public in general. Their main source of income is membership fees, subscription, donation, grant-in-aid, etc. As the money is involved in the activities of these organisations, they also maintain accounts. These organisations prepare certain statements to ascertain the results in financial terms of their activities for a particular period say, one year.



Notes

Characteristics of Not-for-profit organisations (NPOs)

Following are the main characteristics or the salient features of Not for Profit organisations (NPOs) :

1. The objective of such organisations is not to make profit but to provide service to its members and to the society in general.
2. The main source of income of these organisations is not the profit earned from purchase and sale of goods and services but is admissions fees, subscriptions, donations, grant-in-aid, etc.
3. These organisations are managed by a group of persons elected by the members from among themselves. This group is called managing committee.
4. They also prepare their accounts following the same accounting principles and systems that are followed by business for profit organisations that are run with an objective to earn profits :

Financial statements that are generally prepared by Not-for-Profit Organisations (NPOs) are :

1. Receipts and Payments Account
2. Income and Expenditure Account
3. Balance Sheet

*Notes*

The receipts and payments account is the summary of cash and bank transactions which helps in the preparation of Income and expenditure Account and the Balance Sheet.

Income and Expenditure A/c is similar to Profit and Loss Account. NPOs usually prepares the Income and Expenditure Account and Balance Sheet with the help of Receipts and Payments Account.

**INTEXT QUESTIONS 19.1**

Following are the statements about Not-for-Profit organisation. Put (✓) mark against the statements which are the salient features of these organisations and (X) against the others :

- (i) The main objective of these organisations is to make profits.
- (ii) These organisations provide service to the society.
- (iii) The accounting principles and system followed by such organisations are the same that are followed by business organisations i.e. meant to earn profit.

19.2 RECEIPTS AND PAYMENTS ACCOUNT—MEANING AND NEED

Like any other organisation, Not-for-Profit Organizations (NPOs) also maintain cash book to record cash transactions on day to day basis. But at the end of the year they prepare a summary of cash transactions based on the cash-book. This summary is prepared in the form of an account. It is called Receipts and Payments account. All cash receipts and payments are recorded in this account whether these belong to current year or next year or previous year. All receipts and payments are recorded in this account whether these are of revenue nature or capital nature. As it is an account so it has the debit side and the credit side. All receipts are recorded on its debit side while all payments are shown on the credit side. This account begins with opening cash or/and bank balance. Closing balance of this account is cash in hand and or cash at bank/ overdraft. Items in this account are recorded under suitable heads.

Following are the main features of Receipts and Payments Account :

1. It is prepared at the end of the year taking items from the cash book.
2. It is the summary of all cash transactions of a year put under various heads.

3. It records all cash transactions which occurred during the year concerned irrespective of the period they relate to i.e. previous/current/next year.
4. It records cash transactions both of revenue nature and capital nature.
5. It begins with opening balance and ends with closing balance.

Need for preparing Receipts and Payments Account

As most of the transactions of Not-for-Profit Organisations are for cash, the Receipts and Payments Account shows most of the items at one place.

As it is in a summary form, it gives an idea of large number of transactions at a glance. It contains accounting information under various heads. So it gives information itemwise for the accounting year.

It shows the closing cash or/and bank balance, this cash/Bank balance is taken to the Balance Sheet.

The Receipts and Payments Account serves the purpose of trial balance and becomes the basis of preparing financial statements i.e. Income and Expenditure Account and Balance Sheet for the organisation.

Very small Not-for-Profit Organisations (NPOs) prepare only Receipts and Payments Account.

As the name itself suggests, Receipts and Payments Account is an account which has two sides, the debit side and the credit side. All cash receipts are shown on the debit side and all cash payments on the credit side. It has a definite format which is given below :

FORMAT OF RECEIPTS AND PAYMENTS ACCOUNT

Receipts and Payments Account of

For the year ended on

Dr.

Cr

<i>Receipts</i>	<i>Amount</i> ₹	<i>Payments</i> ₹	<i>Amount</i>
Balance b/d :		Purchase of Assets	
Cash		Printing and stationery	
Bank		Repairs and Renewal	



Notes

MODULE - 3

Financial Statement



Notes

Not for Profit Organisation : An Introduction

Donations	Newspapers/Magazines
Legacies	Rent and taxes
Membership fees	Postage
Entrance fees	Investments
Subscriptions	Conveyance
Donations	Honorarium
Lockers Rent	Charity
Sale of fixed assets	Insurance Premium
Interest on investments	Upkeep of Ground
Miscellaneous Receipts	Telephone Charges
Sale of old periodicals	Balance c/d :
	Cash
	Bank

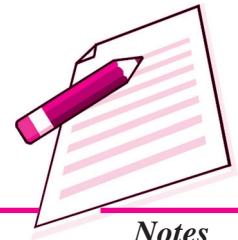


INTEXT QUESTIONS 19.2

- I. Following are the items of Not for Profit organisations. Classify them into Receipts and Payments.
- (i) Donations (ii) Charity (iii) Subscription
(iv) Purchase of Books (v) Legacies (vi) Honorarium
- II. Identify the following statements as characteristics or need of Receipts and Payments account
- (i) Closing cash or/and Bank Balance is used to prepare Balance Sheet.
(ii) It is prepared from the items taken from cash book.
(iii) It records cash transactions both of revenue nature and capital nature.
(iv) It is used to prepare financial statements of the Not for Profit organisations.

19.3 SPECIFIC ITEMS OF RECEIPTS AND PAYMENTS ACCOUNT

1. **Subscription :** It is a regular payment made by the members to the organisation. It is generally contributed annually. It is one of the main sources of income. Subscriptions received during the year are shown on the debit side i.e. Receipts side of the Receipts and Payments Account. Apart from amount for current year, it may include amount pertaining to previous year or advance payment for next years.
2. **Entrance fees or Admission fees :** Whenever a person is admitted as a member of the organisation, certain amount is charged from him/her to give him/her admission. This is called entrance fee or admission fee. Total amount of entrance fee received during a year is shown on the debit side of the Receipts and Payments Account.
3. **Life membership fees :** Membership, if granted to a person for the whole life, special fee is charged from him/her, this is called life membership fees. It is charged once in the life time of a member. It is a capital receipt for the organisation.
4. **Endowment fund :** It is a fund which provides permanent means of support for the organisation. Any contribution towards this fund is an item of capital receipt.
5. **Donation :** Donation is the amount received from some person, firm, company or any other body by way of gift. It is also an important item of receipt. It can be of two types :
 - (a) **Specific donation :** It is a donation received for a specific purpose. Examples of such donations are : donation for library, donation for building, etc.
 - (b) **General donation :** It is a donation which is received not for some specific purpose. It can be of two types :
 - (i) General donation of big amount
 - (ii) General donation of small amount
6. **Legacy :** It is the amount which is received by organisations as per the will of a deceased person. It is treated as a capital receipt.
7. **Sale of old newspapers/periodicals and sports material :** Old newspapers, used/condemned sports material are sold and may fetch some money. It is a source of revenue. Money realised from the sale of such items is shown on the debit (Receipts) side of Receipt and Payment Account.



Notes



Notes

8. **Purchase of fixed assets :** Assets such as building, machinery, furniture, books etc. are purchased for the organisation. These are items of capital expenditure. Payment made for the purchase of such assets is shown on the credit side i.e. the payment side of Receipts and Payments Account.
9. **Payment of honorarium :** This is another item of payment. This is an amount paid to persons who are not the employees of the organisation but take part in the activities of the organisation. Remuneration paid to them is called honorarium. For example, payment made to the secretary of the club as honorarium. This is a payment of revenue nature.
10. **Purchase of consumable items :** Items such as stationery, sports material, drugs and medicines etc. are called consumable items. Payments are regularly made by Not-for-Profit Organisation (NPO for the use of such items). These are shown on the payment side of Receipt & Payment Account.

Such payments may also be made for rent, salary, insurance, office expenses etc. which are payments made as revenue expenditure by both businesses for profit and not for Profit Organisations (NPOs).

Preparation of Receipts and Payments Account

Following are the steps followed to prepare Receipts and Payments A/c :

- At first, the cash and bank balance carried forward from the last year is shown on its debit side. In case there is bank overdraft at the beginning of the year, enter the same on the credit side of this account.
- The amounts are shown under relevant heads such as subscription, donations etc. on the receipts side and salary, rent, purchase of sports equipment, books etc. on the Payment side.
- The amounts comprise of only cash and all cash received or paid during the period for which Receipts and Payments Account is prepared. No distinction is made between the items of revenue nature or capital nature and whether these belong to current year, previous year or the coming year.

Finally, this account is balanced by deducting the total of the credit side i.e. the total payments from the total of the debit side i.e. total receipts and is put on the credit side as 'balance c/d'.

It shows the closing cash and Bank balance which is shown on the asset side of the Balance sheet of the concerned organisation.

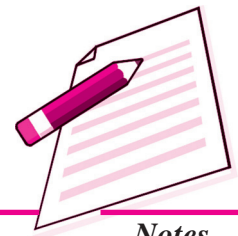


INTEXT QUESTIONS 19.3

A student has prepared the following Receipts and Payments A/c. Some of the items have been entered on wrong side. Correct the Account.

Receipts and Payments A/c
for the year ended 31st Dec. 2013

<i>Particulars</i>	<i>Amount</i> ₹	<i>Particulars</i>	<i>Amount</i> ₹
Opening balance	1,800	Entrance fees	400
Wages	800	Sale of Newspapers	200
Subscription	3,600	Purchase of Books	2,400
		Cash in hand	2,300
		Telephone charges	600
		Interest on Fixed deposit	300
	6,200		6,200



Notes

19.4 RECEIPTS AND PAYMENTS ACCOUNT AND CASH BOOK

You have learnt about Cash Book and Receipts and Payments Account. You have also learnt that Receipts and Payments Account is prepared with the items taken from the cash Book, still there are some differences between the two which are given as below:

Difference between Receipts and Payments Account and Cash Book

<i>Receipts and Payment Account</i>	<i>Cash Book</i>
1. It is prepared at the end of the accounting year.	It is prepared on day-to-day basis.
2. An item appears only once.	Items appear number of times on different dates depending upon their occurrence.

MODULE - 3

Financial Statement



Notes

Not for Profit Organisation : An Introduction

3. It serves the purpose of Trial Balance to prepare the financial statements.	It is a means of maintaining record of cash transactions.
4. It reflects the activities of the organisation.	It is only a systematic record of day to day cash transactions.
5. It is prepared only by Not-for-Profit Organisations (NPOs).	It is also prepared by business organisations meant to earn profit.

Illustration 1

From the information given below prepare Receipts and Payments Account for the year ending 31st December, 2013.

	₹		₹
Opening Balance :			
Cash in hand	1,650	Purchase of Books	10,000
Cash at Bank	18,250	Purchase of Sports Material	20,000
Subscription	15,000	Purchase of Bicycle	2,000
Entrance Fees	1,200	Sale of Investment	25,000
Donation	18,000	Life Membership Fees	4,000
Salaries	16,000	Rent paid	12,000
Stationery	500	Purchase of Government Bonds	10,000
Insurance Premium	800	Closing Balance :	
Sale of old Furniture	1,540	Cash in hand	1,510
Interest on Securities	3,670	Cash at Bank	20,000
Lockers Rent	4,500		

Solution :

Receipts & Payments A/c for the year ending 31st Dec. 2013

Receipts	Amount (₹)	Payments	Amount (₹)
Balance b/d			
Cash in hand	1,650	Salaries	16,000
Cash at Bank	18,250	Stationery	500

Entrance Fees	1,200	Insurance Premium	800
Donation	18,000	Purchase of Books	10,000
Sale of old furnitruce	1,540	Purchase of Sports Material	20,000
Interest on securities	3,670	Purchase of Bicycle	2,000
Lockers Rent	4,500	Rent paid	12,000
Sale of Investment	25,000	Purchase of Government bonds	10,000
Subscription	15,000	Balance c/d	
Life Membership fees	4,000	Cash in hand	1,510
		Cash at bank	20,000
	92,810		92,810



Notes

Illustration 2

From the information given below prepare Receipts and Payments Account of Rising Sun Club for the year ended on March 31, 2014.

<i>Details</i>	<i>Amounts (₹)</i>
Cash in hand as on 1.04.2013	9,800
Cash at bank as on 1.04.2013	17,600
Subscription :	
2012-13	7,500
2013-14	28,600
2014-15	6,400
Entrance Fees	4,000
Life membership Fees	8,000
Donations	35,000
Sale of old Bats and Balls	2,200
Printing and stationery	2,500
Electricity Charges	3,600
Telephone Charges	4,200
Wages and Salaries	14,000
Interest on Investments	2,000

MODULE - 3

Financial Statement



Notes

Not for Profit Organisation : An Introduction

Lockers Rent	2,800
Purchase of Sports Material	20,000
Purchase of Government Securities	40,000
Cash in hand as on 31.03.2014	7,200
Cash at bank as on 31.03.2014	32,400

Solution :

Receipts and Payments A/c for the year ended 31st March 2014

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i>	<i>Particulars</i>	<i>Amount</i>
	(₹)	(₹)	
Balance b/d		Printing & Stationery	2,500
Cash in hand	9,800	Electricity Charges	3,600
Cash at bank	17,600	Telephone Charges	4,200
Subscription		Wages and Salaries	14,000
2012-13 7,500		Purchases of Sports Material	20,000
2013-14 28,600		Purchase of Government	
2014-15 6,400	42,500	Securities	40,000
Entrance Fees	4,000	Balance c/d	
Life membership Fees	8,000	Cash in hand	7,200
Interest on Investments	2,000	Cash at bank	32,400
Locker Rent	2,800		
Donations	35,000		
Sales of old Bats and Balls	2,200		
	1,23,900		1,23,900



INTEXT QUESTIONS 19.4

- (i) In the cash Book, one type of item may appear for a number of times, how many times does an item appear in Receipts and Payments Account?



Notes

4. Distinguish between Receipts and Payments Account and Cash Book.
5. From the information given below prepare Receipts and Payments A/c of 'Friends in Need' a Non-Government organisation (NGO) for the year ended 31st December, 2013.

<i>Details</i>	<i>₹</i>
Cash in hand on 1st Jan, 2013	4,000
Entrance fees	1,400
Donations	15,000
Subscription	15,000
Electricity charges	1,500
Salaries 6,500	
Honorarium to Secretary	4,500
Petty Cash Payments	1,800
Paid into Bank as Fixed Deposits	15,000
Insurance Premium	2,100
Grant from the Government	40,000
Stationery	1,200

6. Following are the extracts taken from the Cash Book of HOPE of Kolkata, an organisation looking after the welfare of widows and AIDs patients. Prepare Receipts and Payments Account for the year ended 31st March, 2014.

	<i>₹</i>
Balance as on 1st April 2013	48,500
Subscription :	
2012-13 8,000	
2013-14 42,000	
2014-15 5,000	55,000
Donations	1,20,000
Grant in Aid	2,00,000
Legacy	80,000

Receipts from the sale of stitched clothes	32,000
Receipt from the sale of Bakery items	46,000
Wages and Salaries	12,000
Electricity Charges	8,600
Fuel	16,400
General Expenses	9,700
Maintenance of Building	6,000
Insurance Premium	4,000
Laundry Expenses	3,200
Construction of Rooms	1,25,000
Government Bonds	2,50,000
Food	1,20,000
Balance in the Bank A/c	1,00,000



Notes



ANSWERS TO INTEXT QUESTIONS

19.1 (i) X (ii) ✓ (iii) ✓

19.2 I. Receipts : Donation, subscription, Legancy
Payments : Charity, Purchase of Books, Honorarium

II. (i) Need (ii) Characteristics
(iii) Characteristics (iv) Need

19.3 Receipts & Payments A/c

<i>Receipts</i>	<i>Amount</i> ₹	<i>Payments</i>	<i>Amount</i> ₹
Opening Balance	1,800	Wages	800
Subscription	3,600	Purchase of Books	2,400
Entrance fees	400	Telephone Charges	600
Sale of Newspapers	200	Closing Balance	2,500
Interest on Fixed Deposit	300		
	6,300		6300

MODULE - 3

Financial Statement



Notes

Not for Profit Organisation : An Introduction

19.4 (i) Once (ii) ₹ 2,150 (iii) Yes, Receipt



ANSWERS TO TERMINAL EXERCISE

5. Closing cash balance ₹ 15,200
6. Closing cash balance ₹ 46,600



ACTIVITY

Visit at least five Not for Profit Organisations of your city/town/area engaged in the following activities

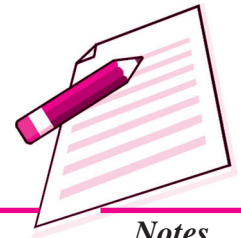
- (a) Conservation of forest and wild animals.
- (b) AIDS awareness
- (c) Girl child education
- (d) Sports club

and collect the following information :

<i>Name of the organisation</i>	<i>Nature of main activity engaged in</i>	<i>Main source of Revenue</i>

20

FINANCIAL STATEMENTS (NOT FOR PROFIT ORGANISATION)



Notes

You have learnt that Not for Profit Organisations (NPOs) such as Clubs, Hospitals, Blood Banks, Schools, Non-Governmental Organisations (NGOs) creating awareness among people about HIV/AIDs also involve in financial activities. They also maintain books of account to record them and also prepare financial statements at the close of the year. These statements are Receipts and Payments Account, Income and Expenditure Account and Balance Sheet. In the previous lesson, you have learnt the meaning and need for preparing Receipts and Payments Account, items to be taken and also its preparation. In this lesson you will learn about Income and Expenditure Account and Balance Sheet of Not for Profit Organisations (NPOs).



OBJECTIVES

After studying this lesson you will be able to :

- explain the meaning and need of Income and Expenditure Account;
- draw the format of Income and Expenditure Account;
- identify and explain the items exclusive to Income and Expenditure Account;
- prepare Income and Expenditure Account from the given information;
- explain the various adjustments and their incorporation while preparing Income and Expenditure Account;
- distinguish between Receipts and Payments Account and Income and Expenditure Account;
- prepare the Balance Sheet of a Not for Profit Organisation (NPOs).

20.1 INCOME AND EXPENDITURE ACCOUNT : MEANING, NEED AND ITEMS



Notes

Meaning

It is the summary of incomes and expenditures of the organisation of a particular year and is prepared at the end of the year. This account is similar to the Profit and Loss Account of the Business Organisations. In this account revenue expenditure and revenue income of the year for which Income and Expenditure A/c is prepared are taken. That means any amount of these items pertaining to either previous year or next year are not considered. The balance amount of this account is either surplus or deficit. If the income side of this account exceeds the expenditure side, the difference is ‘surplus’. In case the expenditure side exceeds the income side, the difference is ‘deficit’.

Need of preparing Income and Expenditure Account

Even the Not for Profit Organisations would like to know the net result of their activities of a particular period which generally is one year. Though such organisations do not engage in trading activities and their objective is not earning profits, yet they would like to know whether income exceeds expenditure or vice a versa. The amount of the such difference is not termed as Net Profit or Net Loss as it is so termed in case of business organisations. In case of Not for Profit organisations the net result is termed as ‘surplus’ or ‘deficit’ as the case may be. Moreover of a preparation of Income and Expenditure Account is a legal requirement. It helps the organisations to control their expenditure.

Format of Income & Expenditure with some important items

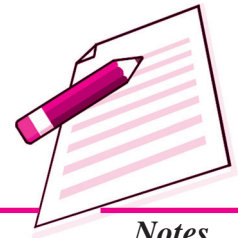
Income and Expenditure A/c of
for the year ended 31st March

Dr.

Cr.

<i>Expenditure</i>	<i>Amount</i> ₹	<i>Income</i>	<i>Amount</i> ₹
Rent		Subscriptions received during the year	
<i>Less :</i> paid for last years outstanding		<i>Less :</i> received on account of last year	
<i>Less :</i> paid for next year		<i>Less :</i> received on account of next year	
<i>Add :</i> current year outstanding		<i>Add :</i> subscription outstanding for current year	
<i>Add :</i> for current year paid in last year			
On account of current year salaries			
Newspaper expenses			

Loss on sale of furniture		Add : subscription received	
Depreciation		last year on account of	
Any other item of revenue expenses		current year	
Expenses on consumable material say stationery		Donations	
Surplus-excess of income or expenditure		Grant in aid	
		Sale of Grass	
		Interest on Investment	
		Miscellaneous Receipts	
		Sale of old newspapers	
		Revenue incomes	
		Deficit : excess of expenditure over income	



Notes

Relevant Items of Income and Expenditure

Following are the relevant items of income of a Not for Profit Organisations (NPO).

- 1. Subscription :** It is a periodic contribution by members of the organization
- 2. Entrance fees/Admission fees :** It is received from members at the time of their admission to the organisation.
- 3. Donations :** Donation is the amount received from person, firm, company etc. by way of gift. But only general donation that too of smaller amount and of recurring nature is treated an item of revenue income.
- 4. Sale of old newspapers, sports material, etc. :** Sale of old newspapers or condemned books, sports material etc. is treated as an item of revenue income.
- 5. Interest receipt :** The surplus funds may be kept in a fixed deposit account in a bank or invested elsewhere. Interest received thereon is an item of revenue income.
- 6. Grant-in-Aid :** Local, state and central government and some government agencies give money as grant-in-aid to Not-for-Profit Organisations (NPOs).

Apart from these, there are numerous other items like rent of hall, sale of grass, income from entertainment, etc.

Items of Revenue Expenses

Some important items are as follows :

- 1.** Salaries, wages, rent, stationery, postage, telephone charges, electricity charges are some items of revenue expenses which are common to all Not for Profit Organisations (NPOs).

MODULE - 3

Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

2. **Honorarium** : It is the amount paid to the person who looks after the functioning of the organisation but is not the employee of the company.
3. **Depreciation** : Depreciation is provided on the fixed assets such as furniture, building and books, etc.
4. Expenses on tournament, fair, etc.
5. Other items

There are numerous other items depending upon the nature of organisation. For example, upkeep of ground if it is a sports club, medicines, laundry if it is a hospital and so on.



INTEXT QUESTIONS 20.1

I. Classify the following items into income and expenditure :

- (a) Honorarium (b) Grant-in-aid (c) Sale of old newspapers
(d) Subscription (e) Lockers rent (f) Insurance Premium

II. Write 'R' if the statement is correct and 'W' if it is incorrect :

- (i) The excess of the income over expenditure is called Net Profit
- (ii) All items of receipts are entered on income side of Income and Expenditure Account and all items of payments are written on the expenditure side of Income and Expenditure Account.
- (iii) Income and expenditure account is prepared to know the net result of the activities of Not for Profit organisations involving finance.
- (iv) Entrance fees is an item of income.
- (v) Specific donation is an item of revenue income

20.2 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT

In the previous section the format of Income and Expenditure Account and the items that are usually entered in the account have been explained. Now you will learn how to prepare Income and Expenditure Account from the given items. This account is prepared from Receipts and Payments account and additional information if any. While preparing an Income and Expenditure account, the following important points have to be kept in mind:

A. Steps for Expenditure side : The payment column of Receipts and Payments Account contains both revenue items as well as capital items. Revenue items such as rent paid salary, telephone charges etc. will be entered on the expenditure side of Income and Expenditure Account.

If necessary, adjustments will be made in these items for expenses that are outstanding at the end of the current year and/or were outstanding at the end of the previous year. Adjustment will also be made for prepaid expenses at the end of previous year as well as those at the end of current year.

B. Steps for Income side : The receipt column contains items of revenue receipts as well as capital receipts. Revenue receipts are entered in the income column of the Income and Expenditure Account. Example of such items are subscription, interest on investment, entrance fees etc.

These items need to be adjusted for the amount received for the previous year or for the next year. Similarly, adjustment should be made for outstanding income both at the current year and at the end of the previous year.

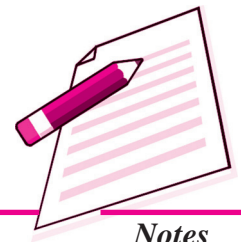
There may be other adjustments such as bad debts, depreciation, etc. will also be entered in the expenditure column.

C. Surplus or Deficit : Finally, this account is balanced i.e. difference of the totals of two amount columns is worked out. If credit side is more than the debit side the difference amount is written on its debit side as surplus and if debit side exceeds the credit side, the difference is deficit and is written on the credit side of the account.

Illustration 1

Prepare Income and Expenditure A/c from the following information of Promising Sportsmen's Club, Delhi for the year ending 31st December, 2013

	₹
Cash balance as on 1.1.2013	7,000
Subscriptions	30,000
Interest received	2,500
Sports material	24,000
Match fund	15,000
Donations	2,000



Notes

MODULE - 3

Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

Sale of grass	300
Newspaper expenses	600
Investments purchased	10,000
Salaries paid	16,000
Rent paid	5,400
Miscellaneous receipts	600
Telephone charges	1,200
Cash balance as on 31.12.2013	200

Solution :

Books of Promising Sportmen Club Income & Expenditure A/c for the year ending 31st Dec., 2013

Dr.

Cr.

<i>Expenditure</i>	<i>Amount</i> ₹	<i>Income</i>	<i>Amount</i> ₹
Salaries	16,000	Subscriptions	30,000
Rent	5,400	Interest Received	2,500
Newspaper Expense	600	Sale of grass	300
Telephone charges	1,200	Miscellaneous receipts	600
Surplus excess of income over expenditure	12,200	Donation	2,000
	35,400		35,400

Illustration 2

Prepare Income and Expenditure Account from the Receipts and Payments Account of Youngsters Health Club, Jhansi for the year ending 31st December, 2013.

Receipt & Payment A/c

<i>Receipts</i>	<i>Amount</i> ₹	<i>Payment</i>	<i>Amount</i> ₹
Opening balance	2,400	Rent	3,600
Subscriptions	16,000	Stationery	450

Financial Statements (Not for Profit Organisation)

Entrance fees	200	Salary	4,800
Sale of Investments	8,000	Purchase of Equipments	5,500
Sale of old Almirah (Book value Rs 1800)	800	Expenses on competitions	2,800
Donation	2,500	Miscellaneous Expenses	650
		Furniture Purchased	4,000
		Closing balance	8,100
	29,900		29,900

MODULE - 3

Financial Statement



Notes

Solution:

Books of Youngsters Health Club
Income & Expenditure A/c
for the year ending 31st Dec., 2013

<i>Expenditure</i>	<i>Amount</i> ₹	<i>Income</i>	<i>Amount</i> ₹
Rent	3,600	Subscription	16,000
Stationery	450	Entrance fees	200
Salary	4,800	Donations	2,500
Expenses on competitions	2,800		
Miscellaneous Expenditure	650		
Loss on sale of almirah	1,000		
Surplus (excess of Income over expenditure)	5,400		
	18,700		18,700



INTEXT QUESTIONS 20.2

Answer the following in one word :

- (i) To which side of the Income & Expenditure A/c items of revenue expenses are taken?
- (ii) What term is given to the amount by which credit side of Income and Expenditure Account exceeds its debit side?
- (iii) Which side of the Income and Expenditure A/c is the side of Income?
- (iv) From which side of Receipts and Payments A/c is taken the item of entrance fees to the credit of Income and Expenditure A/c?

20.3 ADJUSTMENT OF ITEMS IN INCOME AND EXPENDITURE ACCOUNT



Notes

Income and Expenditure A/c is prepared on the basis of Receipts and Payments A/c but there may be certain items which are not included in Receipts and Payments A/c. However these need to be incorporated in Income and Expenditure A/c. Following are some of the most common adjustments to be carried out :

1. Subscription Received

It is an item of income and is of recurring nature. It appears on the Receipts side of the Receipts and Payments account. It may include arrears of previous years which is received in the current year and may also include amount received for next year in advance. There may be an amount outstanding for the current year. Some members might have paid current year’s subscription during the previous year.

For the purpose of preparing Income and Expenditure Account, subscription for the current year only is to be taken into account. Hence, there is a need for adjustment to be made for the above reasons.

Various adjustments relating to subscription are made in the following manner :

i. Subscription outstanding for current year

Journal entry

Subscriptions outstanding A/c Dr
 To Subscriptions A/c
 (Subscription for current year due but not received)

Adjustment in Income and Expenditure A/c

Income and Expenditure A/c

Dr.		Cr.	
<i>Expenditure</i>	<i>Amount</i>	<i>Income</i>	<i>Amount</i>
		Subscription	
		<i>Add:</i> outstanding for current year	

This amount will be added to subscriptions received in Income and Expenditure Account and will be shown on the Asset side of the Balance Sheet.

ii. Subscription due in the previous year but received during the current year

Journal entry

Subscription A/c Dr
 To Subscription Outstanding A/c
 (Adjustment of subscription due in last year but received in the current year)



Illustration 3

	₹
Subscription received during the year 2013	15,000
Subscription outstanding as on 31st December 2013	1,500
Subscription received in the year 2012 on account of year 2013	800
Subscription received in the year 2013 for outstanding amount of the year 2012	400
Subscription received in the year 2013 for the year 2014	600
Calculate the amount of subscription received to be shown in the Income and Expenditure Account for the year adding 31st Dec, 2013.	

Solution :

Subscription received during 2013	15,000
Add : current years outstanding	1,500
Add : received in 2012 for 2013	800
Less : received for 2012	400
Less : advance for 2014	600
Subscription to be shown in Income & Expenditure Account for 2013	16,300

Subscription Account

Dr. Cr.

Particulars	₹	Particulars	₹
Subscription outstanding A/c 2012	400	Cash	15,000
Subscription received in Advance A/c 2014	600	Subscription out standing A/c	1,500
Income & Expenditure A/c	16,300	Subscription received in Advance A/c (2012)	800
	17,300		17,300



Notes

2. Rent Paid

Rent paid is an item of expenditure. It may also require some adjustments in rent. The adjustments required to made to be the amount of rent paid during the year may be as follows :

- (i) Rent outstanding for the current year
- (ii) Rent paid in the current year as advance for the next year
- (iii) Rent paid in the current year on account of the outstanding amount in the previous year
- (iv) Rent paid in the previous year on account of current year.

Journal entries in the books will be made as follows :

- (i) Rent A/c Dr.
 To Rent outstanding A/c
 (Rent due but not paid)
- (ii) Rent paid in advance A/c Dr.
 To Bank A/c
 (Rent paid in advance for for the year)
- (iii) Rent outstanding A/c Dr.
 To Bank A/c
 (Amount paid for outstanding rent of the previous year)
- (iv) Rent A/c Dr.
 To Rent paid in Advance
 (Rent paid in advance last year being transferred to Rent A/c)

Calculation of Rent Amount to be shown for current year in the Income and Expenditure Account.

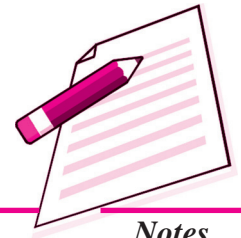
Rent paid in the current year	√
Add : Rent paid in advance in the previous year for current year	+ √
Add : Rent due in current year but not paid	+ √
Less : Outstanding Rent paid for previous year in current year	- √
Less : Advance rent paid for next year in current year	- √
Amount of rent to be debited to Income and Expenditure A/c	x x x x

Illustration 4

A club has paid rent of ₹ 20000 in the year 2013. Rent still to be paid amounts to ₹ 2,000. Amount of ₹ 1,500 was paid in 2012 on account of the year 2013. Calculate the amount to be taken to Income & expenditure A/c of 2013.

Solution :

	₹
Rent paid in 2013	20,000
Add Rent outstanding for 2013	2,000
Add Rent paid in advance in 2012 for the year 2013	1,500
Rent for 2013 to be charged to Income and Expenditure A/c	23,500

*Notes***Depreciation on Assets**

Depreciation is a non cash item. It is to be charged on every fixed asset such as Land & Building, Furniture, Books etc. every year as per predetermined method. The amount of depreciation is shown on the expenditure side of the Income & Expenditure Account and is deducted from the respective value of the asset while showing it on asset side of the Balance Sheet.

Journal Entry for the same will be

- | | |
|---------------------|-------------------------------|
| 1. Depreciation A/c | 2. Income and Expenditure A/c |
| To Asset A/c | To depreciation A/c |

Illustration 5

The following is the Receipts and Payments Account of Help AID Society of India for the year ended 31st December, 2013.

Receipts and Payments A/c

Dr.

Cr.

<i>Receipts</i>	<i>Amount</i>	<i>Payments</i>	<i>Amount</i>
	₹		₹
Balance b/d	8,400	Salaries	12,000
Subscriptions	7,800	Rent	6,000
Entrance fees	600	Purchase of Vans	28,000

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Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

Government Grant	30,000	Expenses of Motor Vans	6,400
Donation for Building Fund	25,000	Laundry charges	5,200
Interest Received	2,400	Drugs and incidental charges	9,600
		Publicity expenses	4,000
		Balance c/d	3,000
	74,200		74,200

Additional Information

1. Subscription outstanding amounted to ₹ 1,500
2. Interest accrued but not received ₹ 600
3. Salary outstanding is ₹ 1,200
4. Provide depreciation on Motor Van @ 20%

Prepare Income & Expenditure A/c.

Solution :

Books of Help AID Society of India
Income & Expenditure A/c
for the year ending December 31, 2013

Dr.

Cr.

<i>Expenditure</i>		<i>Amount</i>	<i>Income</i>		<i>Amount</i>
		₹			₹
Salaries	12,000		Subscription	7,800	
Add : Outstanding	<u>1,200</u>	13,200	Add : outstanding	<u>1,500</u>	9,300
Rent		6,000	Entrance fees		600
Expenses of Motor Van		6,400	Government Grant		30,000
Laundry charges		5,200	Interest	2400	
Drugs and incidental charges		9,600	Add : Interest Accrued	<u>600</u>	3000
Publicity Expenses		4,000	Deficit i.e. excess of expenditure		
Depreciation on Motor Van		5,600	over income		7100
		<u>50,000</u>			<u>50000</u>

After learning about Receipts and Payments A/c and Income Expenditure A/c in detail, we can now distinguish between the two. Following are the differences.

Difference between Receipts and Payments A/c and Income and Expenditure A/c

<i>Basis of Difference</i>	<i>Receipts and Payments A/c</i>	<i>Income and Expenditure A/c</i>
1. Nature	It is a summary of the Cash Book.	It is the summary of Revenue Income and Revenue Expenditure.
2. Side	Debit side of this account shows receipts and credit side shows payments.	Debit side of this account shows expenses and losses and credit side shows incomes and gains.
3. Opening Balance	It starts with the opening balance of Cash in hand or cash at bank.	There is no balance in the beginning.
4. Closing Balance	Closing balance of this account shows Cash in hand or cash at Bank.	Closing balance of this account shows Surplus or deficit.
5. Capital and Revenue Items	In Receipts and payments A/c, both capital and revenue nature of items are recorded.	In Income and expenditure A/c, only revenue nature items are recorded.
6. Adjustment	Adjustments are not considered while preparing it.	It is necessary to consider adjustments while preparing it.
7. Transfer of closing balance	Closing balance of this account is transferred to the Receipts and Payment A/c for the next period.	Closing balance of this account is transferred to the capital fund general fund in the Balance Sheet.



Notes



INTEXT QUESTIONS 20.3

I. A Clubs collects from its 500 members subscription @ ₹100 per member every year.

- (a) It has received ₹ 1,500 last year on account of current year. 20 members have not paid their due for the current year. Calculate the amount received on account of subscription.

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Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

- (b) Rent of ₹ 11,000 has been paid in the current year ₹ 20,000 is still to be paid. ₹ 9,000 was outstanding last year. Calculate the amount to be written as Rent paid in the current year.
- II. (a) Closing balance of Receipt and Payment account is transferred to the same account for the next year, where is the balance of Income and Expenditure transferred?
- (b) Income and Expenditure Account is the summary of Revenue Income and Revenue Expenditure then Receipt and Payment Account is the summary of what?
- (c) Closing Balance of receipts and Payments Account shows the cash in hand/ bank what does the closing balance of Income and Expenditure Account show?
- (d) Income and Expenditure Account does not start with any opening balance. What is the opening balance with which Receipt and Payment Accounts started?

20.4 PREPARATION OF BALANCE SHEET

Not for Profit Organisations (NPOs) also prepare Balance Sheet at the end of the year. The Balance Sheet prepared by a Not for Profit Organisation (NPOs) is not different from that which is prepared by for Profit Organisation. It has two sides (a) Assets side and (b) Liabilities side. It has only capital items i.e. Assets, liabilities and Capital fund.

The objective of preparing a balance sheet by a Non for Profit Organisation is to show the financial stability, strength and soundness on the last date of the accounting year.

The format of the balance Sheet is given below

Balance Sheet of

As at 31st Dec.

<i>Liabilities</i>	<i>Amount</i> ₹	<i>Assets</i>	<i>Amount</i> ₹
Rent outstanding		Cash in hand	
Salary outstanding		Cash at Bank	
Subscription Received in advance		Fixed Deposits	

Building fund		Subscription outstanding	
Capital fund/General fund		Sports material	
<i>Add</i> : Life membership fee		Books	
<i>Add</i> : Surplus or Less Deficit		Furniture	
		Building	



Notes

Income and Expenditure A/c and the Balance Sheet of NPOs is prepared from the Receipts and Payments Account and the additional information. While preparing Balance Sheet of a Not for Profit organisations (NPOs) certain points are to be kept in mind which are as follows :

1. Assets appearing in the preceding years balance sheet need to be adjusted for any sale or purchase of the asset made during the year and the depreciation provided on the particular asset. Only the adjusted amount will appear in the Balance Sheet of the current year.
2. If any new asset has been purchased during the year it will appear on the payment side of Receipts & Payments A/c, therefrom it is taken to the Balance Sheet.
3. If any loan has been raised it will appear on the receipt side of Receipts and Payments A/c and repayment on its payment side. Net amount will be shown on the liability side of the balance sheet. In the same manner if any advance has been made to a person and some repayment has been made by a person, it will be shown on the Asset side of the Balance sheet at the net amount.
4. Any adjustments made regarding expenses and/or regarding incomes such as outstanding or prepaid will be shown in the Balance Sheet.
5. Any item of liability appearing in the previous years Balance Sheet will be shown at its net value i.e. after deducting from it the amount paid against them.
6. Special receipts like donations for Building etc. will not be treated as income. It will be shown as a fund meant for a special purpose on the liability side of the Balance Sheet.
7. Capital General fund taken from the last balance sheet will be shown after adjusting for the current years 'surplus' or 'deficit'.

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Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

One important point regarding preparing balance sheet is that before preparing Income and Expenditure Account and Balance sheet of a Not for Profit organisation (NPOs) for the current year. Capital General fund carried forward from the last year should be considered. Besides this, other items of liabilities and assets carried from last year are also need to be adjusted. For this Balance Sheet of the previous year will be drawn with the help of given information. This is termed as opening Balance Sheet. An opening Balance Sheet will be prepared as per following illustration.

Illustration 6

Information as on 31st December, 2013 of 'All Green Ever Green' an NGO working for the preservation of forests is given as under :

<i>Details</i>	<i>₹</i>
Cash in hand	1,400
Cash at Bank	21,800
Books	78,000
Furniture	16,000
Computer	24,000
Subscription outstanding	2,600
Fixed deposit with Bank	1,00,000
Subscription Received for 2014	3,800
Rent outstanding	4,000
Publicity fund	35,000
Building fund	80,000

Solution :

Balance Sheet of 'All Green Ever Green' as at 31st December, 2013

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
	<i>₹</i>		<i>₹</i>
Subscription received in advance	3,800	Cash in hand	1,400
Rent outstanding	4,000	Cash at Bank	21,800
Publicity fund	35,000	Subscription outstanding	2,600
Building fund	8,0000	Books	78,000

Financial Statements (Not for Profit Organisation)

Capital General fund (Bal. Fig.)	1,21,000	Furniture	16,000
		Computer	24,000
		Fixed Deposit with Bank	1,00,000
	2,43,800		2,43,800



INTEXT QUESTIONS 20.4

Answer the following Questions

1. For what the assets need to be adjusted before showing them in the Balance Sheet?
2. On which side of the Balance Sheet loan item appearing on the Receipts side of Receipt and Payment Account will be shown?
3. For what items the capital fund for the years Balance Sheet will be adjusted?
4. At what value the liability of last years balance sheet will be shown in the current years balance Sheet?

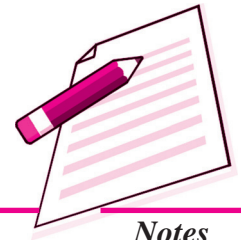


WHAT YOU HAVE LEARNT

- Income and Expenditure Account is similar to Profit and Loss Account. Income and Expenditure Account is the summary of Incomes and Expenditures of a Not for Profit Organization (NPO) of a particular year.
- Income and Expenditure Account is prepared to know the net result of the financial activities of Not for Profit Organisations (NPOs) which may be either surplus or Deficit.
- Important items of expenditure are revenue expenses such as salary, postage, stationery, honorarium, depreciation etc. Main items of incomes are subscription, entrance fees etc.
- All adjustments such as outstanding, prepaid etc. are incorporated before arriving at the surplus or deficit.
- Receipts and Payments Account and Income and Expenditure Account can be differentiated on the basis of nature, side, opening balance, closing balance, capital and Revenue items adjustments and transfer of closing balance.

MODULE - 3

Financial Statement



Notes

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Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

- Every Not for Profit Organization (NPO) prepares Balance Sheet at the end of the year. It also has the asset side and the liability side. Opening balance sheet is required to prepare Balance Sheet for the current year.



TERMINAL EXERCISE

1. What is an Income and Expenditure Account?
2. Explain the objectives of preparing Income and Expenditure Account.
3. List the various items of income and expenditure of a Not for Profit Organisations (NPOs).
4. Describe in brief the steps taken to prepare Income and Expenditure Account.
5. Differentiate between Receipt and payment Account and Income and Expenditure Account on the basis of
 - i. Nature
 - ii. Adjustment
 - iii. Side
 - iv. Transfer of closing balance.
6. Prepare Receipts and Payments Account from the information given below:

	₹
Cash in hand on 1.1.2013	3,600
Cash at bank on 1.1.2013	10,000
Subscription	6,000
Entrance Fees	1,000
Wages paid to labourers	800
Salaries paid to clerks	3,000
Electricity	1,500
Conveyance	600
Honorarium to Secretary	1,200
Printing and Stationery	500
Fixed Deposit made with bank	10,000

7. What amount will you post to Income and Expenditure Account from the information given below for the year 2013?

	₹
Subscription received during 2013	10,000
Subscription due in 2012	2,000
Subscription received in 2012 for 2013	400
Subscription received in 2013 for 2014	600
Subscription due for 2013	1,000



Notes

8. How will you show the followings in the Income and Expenditure Account?

- (i) Rent paid in the Current year ₹ 6,000
- (ii) Rent due in Current year ₹ 800
- (iii) Rent paid last year for this year ₹ 600
- (iv) Rent due of last year paid in this year ₹ 2,000
- (v) Advance rent paid for next year in this year ₹ 1,600

9. From the Receipts and Payments Account and the information given, prepare Income and Expenditure Account and Balance Sheet of Shrey Blue Star Club:

Receipts and Payment Account
for the year ended 31 st December, 2013

<i>Receipts</i>	<i>Amount</i> ₹	<i>Payments</i>	<i>Amount</i> ₹
Balance b/d	1,500	Electricity	1,500
Subscriptions:		General Expenses	1,250
2012	500	Honorarium to Secretary	1,250
2013	8,000	Books	2,250
2014	450	Newspapers	500
Sale of Newspapers	250	Furniture (Purchased)	1,000
Sale of old Furniture (Book value ₹ 300)	200	Fixed Deposit made with bank on 1.1.2013 @ 5%p.a.	4,000

MODULE - 3

Financial Statement



Notes

Financial Statements (Not for Profit Organisation)

Rent received for the use of Hall	1,750	Balance c/d	2,400
To Profit from Entertainment	1,500		
	14,150		14,150

Information

- (i) The club has 160 members each paying annual subscription of ₹100.
 - (ii) Subscription outstanding on 31.12.2012 ₹ 1350
 - (iii) On 31.12.2013 General Expenses outstanding amounted to ₹ 50.
 - (iv) On 1.1.2013 the club owned Building valued at ₹ 40,000, Furniture ₹ 2,000 and Books ₹ 6000.
10. How will you show the following in the Income and Expenditure Account?
- (i) Rent paid in the Current year ₹ 1,000
 - (ii) Rent due in Current year ₹ 200
 - (iii) Rent paid last year for this year ₹ 300
 - (iv) Rent due of last year paid in this year ₹ 500
 - (v) Advance rent paid for next year in this year ₹ 400
11. From the Receipts and Payments Account and the information given, prepare Income and Expenditure Account and Balance Sheet of Sports Club:

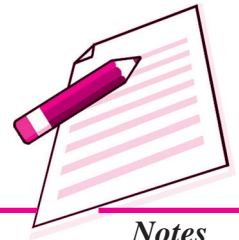
Receipts and Payment Account for the year ended 31st December, 2013

Receipts	Amount ₹	Payments	Amount ₹
Balance b/d	5,100	Purchase of sport equipment	5,000
Subscriptions:		Electricity	1,500
2012	800	General Expenses	2,250
2013	3,000	Honorarium to Secretary	3,250
2014	1,250	Books	4,250
Sale of newspapers	250	Newspapers	600
Life membership	6,000	Furniture (Purchased)	4,000
Sale of old Furniture (Book value ₹ 600)	400	Fixed Deposit made with bank on 30.6.2013 @ 8%	10,000
Rent received for the use of Hall	2,750	By Balance c/d	2,200

Govt. Grant	10,000		
Profit from Entertainment	3,500		
	32,450		32,450

Additional Information

- (i) The club has 100 members each paying annual subscription of ₹100.
- (ii) On 31.12.2013 General Expenses outstanding amounted to ₹250.
- (iii) On 1.1.2013, the club owned Building valued at Rs.10,000, Furniture ₹12,000 and Books ₹6,000
- (iv) Sports equipments ₹2,400 as on 1.1.2013. Depreciation was to be allowed on furniture @ 5%. Sports equipment at the end of the year were ₹3,600.



ANSWERS TO INTEXT QUESTIONS

- 20.1 I.** Income : Grant-in-aid, sale of old newspapers, subscription, locker rent
Expenditure : Honorarium, Insurance premium
- II.** (i) W (ii) W (iii) R (iv) R (v) W
- 20.2** (i) Expenditure (debit) (ii) Surplus (iii) Credit (iv) Receipts
- 20.3 I.** (a) ₹ 46,500 (b) ₹ 22,000
- II.** (a) Balance Sheet as Surplus / Deficit (b) Cash / Bank A/c
(c) Surplus / Deficit (d) Cash / Bank
- 20.4** 1. Sale/purchase in the current year and depreciation provided
2. Liability side 3. For surplus/deficit
4. At net value i.e. after deducting from it the amount paid against them.



ANSWERS TO TERMINAL EXERCISE

- 6. Closing cash in hand ₹ 3,000
- 7. Subscription ₹ 8,800 to posted
- 8. Rent to be ₹ 3,800 posted
- 9. Surplus ₹ 15,050, Capital fund (opening) ₹ 50,850
Total Balance Sheet ₹ 64,400
- 10. Rent : ₹ 600
- 11. Surplus ₹ 14,250 Capital fund (opening ₹ 36,300)
Total Balance Sheet ₹ 58,050

*Notes***21**

ACCOUNTS FROM INCOMPLETE RECORDS

We have studied so far the Double Entry System of accounting. According to this system, both the aspects of a transaction are recorded. Another system of recording transactions called Single Entry System also exists, under which both the aspects of a transaction may not be recorded. Unlike Double Entry System in Single Entry system, no set rules are followed. Even the books of account to be maintained are not certain. Usually, under this system the cash book and personal ledgers are maintained : real and nominal accounts are not. In this system because both the aspects of transactions are not recorded the system is known as 'Accounts from Incomplete records' or 'Single Entry System of Accounting'. Sometimes accounts that had been maintained, on double entry system may be rendered incomplete because of the happening of certain events like fire, floods, earthquakes etc. Accounting records that are not maintained according to Double Entry System are known as Accounts from Incomplete Records or Single Entry System of Accounting.



OBJECTIVES

After studying this lesson you will be able to:

- state the meaning of Single Entry System;
- explain uses and limitations of Single Entry System/Accounts from Incomplete Records;
- explain ascertainment of profit/loss by conversation method.
- ascertainment of profit /loss by statement of affairs method;
- ascertain the missing figures of total debtors, total creditors, B/R A/c and Cash Book;

- ascertain capital with beginning by preparing opening statement of affair and
- prepare final accounts.

21.1 DEFINATION

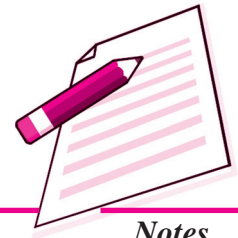
Kohler defines Single Entry System as, “A system of book keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances.”

Sometimes, the term Single Entry System is mistakenly understood that under this system only one aspect of a transaction is recorded in the books. This is not true. The fact remains that under this system, while for certain transactions both the aspects are recorded, for others only one aspect is recorded and some transactions are even ignored.

Features

The features of the Single Entry System are as follows :

- Suitability :** This system is suitable for small businesses such as sole trader or partnership firm. Limited companies due to legal provisions, cannot maintain accounting books on Single Entry System.
- Preparation of Cash Book :** Generally, a Cash Book is prepared in this system in which business as well as private transactions are mixed up.
- Preparation of Personal Accounts :** Normally under this system, only personal accounts are prepared and real and nominal accounts are avoided.
- No Uniformity :** This system may differ from firm to firm, because same principles are not followed by all the enterprises.
- Requirement of Original Vouchers :** Usually under this system, we have to depend on original vouchers for collecting the necessary informations.
- Preparation of Final Accounts :** In the absence of all nominal and real accounts the final accounts cannot be prepared easily. It is possible after converting the available information into double entry system and missing amounts are determined then Trading & Profit & Loss A/c can be prepared. The amount of all assets and all liabilities can also be computed from incomplete records, but they are based on estimates. That is the reason that the statement of assets and liabilities prepared under this system at the end of an accounting period is called a Statement of Affairs instead of Balance Sheet.



Notes

21.2 USES OF SINGLE ENTRY SYSTEM

Uses of Single Entry System are as follows :

- i. **Simple Method :** Single entry is a very simple method of recording business transactions.
- ii. **Less Expensive :** It is less expensive when it is compared to Double Entry System of book keeping.
- iii. **Suitable for Small Concerns :** It is mainly suited to small business concerns with limited number of transactions and very few assets and liabilities.
- iv. **No Need of Knowledge of Principles of Book Keeping :** Under Single Entry System, accounting records can be easily maintained as their maintenance does not require knowledge of the principles of book keeping.
- v. **Easy to Ascertain Profit or Loss :** Ascertainment of profit or loss is much easier. To ascertain profit or loss, the proprietor has to compare the financial position of business at the close of the accounting period with that at the beginning.

Limitations of Single Entry System

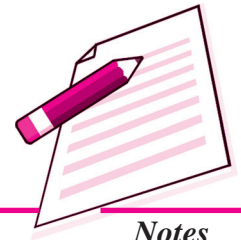
Single Entry System provides the incompleteness and insufficiency of information, hence it has the following limitations :

- i. **Arithmetical Accuracy Cannot be Proved :** Trial Balance can not be prepared and hence, arithmetical accuracy of books cannot be proved or tested. Chances of error, mischief of fraud remaining undetected are high.
- ii. **No Control on Assets :** Since asset accounts are not maintained, it may be difficult to keep full control, in order to avoid misappropriations of assets.
- iii. **True Profits cannot be Known :** Trading and Profit and Loss Account cannot be prepared and hence, the correct profit earned or loss suffered during the accounting period is not known.
- iv. **Financial Position of the Business cannot be Judged :** Balance Sheet, called Statement of Affairs under Single Entry System, is prepared in an unsatisfactory manner. The assets and liabilities are not provided from records but are put down by physical inspection and on estimated basis. Hence, Balance Sheet cannot be drawn up with a view to ascertaining the true financial position of the business on a particular date. Thus, exact position of total net assets cannot be known.



Notes

- v. **No Internal Check** : Since internal check is not possible, the method gives enough room for errors and frauds, besides their detection is very difficult.
- vi. **Difficult to Ascertain the Business Value** : The records being inadequate, it is difficult to value the business, especially goodwill.
- vii. **Inadequate for Planning and Control** : Accounting information supplied by the accounting records is inadequate for managerial planning and control.
- viii. **Incomplete and Unscientific System** : This system is incomplete and unscientific as both the aspects for a transactions are not recorded and no set rules are followed for recording them.
- ix. **Comparative Study is Difficult** : A major defect of this system is that the financial position of the current year cannot be compared with that of the previous year due to incomplete information of transactions of business.



Notes



INTEXT QUESTIONS 21.1

- I. Fill in the blanks with appropriate words :**
- i. The assets and liabilities are put down by physical and _____.
 - ii. Single Entry System is a very _____ method of recording business transactions.
 - iii. Single Entry System is _____ expensive as compared to Double Entry System of book keeping.
- II. State whether the following statements are true or false :**
- i. A statement of Affairs prepared from incomplete records provides satisfactory information.
 - ii. Preparation of incomplete records is scientific system.
 - iii. Comparative study is difficult in Single Entry System.

21.3 ASCERTAINING PROFIT FROM INCOMPLETE RECORDS

We know that the main purpose of any business is to earn profit. Every business owner, therefore, is desirous to know whether he has earned profit or incurred loss after a certain period of time generally at the end of a year. In fact, to ascertain profit



Notes

or loss becomes all the more essential if the business happens to be a partnership firm because the partners have to share the profits of the firm at the end of the each accounting period. Then, the question arises as to how to ascertain profits when the accounting records are incomplete. The reason is that Profit and Loss Account cannot be prepared in the absence of Trial Balance. In such a situation, there are two methods used for ascertaining profits of the business. They are :

- i. Net Worth Method or Statement of Affairs Method, and
- ii. Conversion Method

Net Worth Method or Statement of Affairs Method

To ascertain profit, from incomplete records, it is necessary to prepare a Statement of Affairs at the end of the year and also at the beginning of the year, if not already prepared.

A Statement of Affairs is a statement of all assets and liabilities. The difference between the amount of the two sides is taken as capital.

Like the Balance Sheet, the Statement of Affairs has two sides - the right-hand side for assets and the left-hand side for liabilities. To prepare the statement, information has to be collected from various sources. Information about assets will be available from the Cash Book, the Personal Ledger, etc. The value of the Closing Stock will be ascertained by preparing Stock Sheets and valuing the Stock in Hand, at lower of cost and market value. If the trader has any other assets also, like furniture, machinery, etc., the value will be ascertained and included among the assets. The business is likely to have full knowledge of the amounts owing to outsiders. The difference between the total of assets and liabilities will be capital.

$$\text{Capital} = \text{Total Assets} - \text{Total Liabilities}$$

For ascertaining profit the capital in the beginning of the year must also be ascertained, if necessary, by preparing a Statement of Affairs as at the beginning of the year. If the capital at the end of the year exceeds that at the beginning, we can say that there has been a profit. If, on the other hand, the capital in the beginning was more than that at the end, there must have been a loss. However, two adjustments must be borne in mind for ascertaining profit :

- i. **Adjustments for Capital Introduced :** If the proprietor brought in some additional capital during the year, it should be deducted from the capital at the end (since this increase is not due to profit but is due to fresh introduction of capital); and

- ii. **Adjustement for Drawings :** The drawings of the proprietor should be added to the capital at the end. Had the drawings not been made, the capital at the close of the year would have been higher.

Formula : Formula for determining the profit is put as follows :

$$\text{Profit} = (\text{Capital at the end} + \text{Drawing} - \text{Additional Capital Introduced} - \text{Capital at the beginning})$$

The above formula may be shown as follows in the form of Statement of Profit or Loss :

Statement of Profit or Loss
for the year ended

<i>Particulars</i>	₹
Capital at the end	.....
Add : Drawings during the year	.....
Less : Additional Capital introduced during the year	.....
Adjusted Capital at the end	.....
Less : Capital in the beginning	.....
Profit or Loss for the year	.....

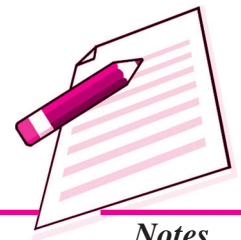
Now the procedure explained above can be simply summarised as follows :

- i. First, prepare Statement of Affairs at the beginning for calculating capital in the beginning.
- ii. Then, prepare Statement of Affairs at the end in order to calculate capital at the end.
- iii. Adjust the capital at the end by adding drawings, and deducting therefrom capital introduced during the year.
- iv. From the adjusted capital at the end deduct capital in the beginning. This difference is either a profit or a loss.

Look at the following illustration and study how opening and closing capital are determined by preparing Statement of Affairs and then how profit is ascertained after making the necessary adjustments for additional capital and drawings.

Illustration 1

Ram maintains books on Single Entry System. He gives you the following information:



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Accounts From Incomplete Records

	₹
Capital on April 1, 2013	60,800
Capital on April 1, 2014	67,600
Drawings made during the Period : April 2013 to March 2014	19,200
Capital introduced on August 1, 2013	8,000

You are required to calculate profit or loss made by Ram.

Solution :

Statement of Profit or Loss for the year ended March 31, 2014

Particulars	₹
Capital as on April 1, 2013	67,600
Add: Drawings made during the period : April 2013 to March 2014	19,200
	86,800
Less : Capital introduced on August 1, 2013	8,000
Adjusted Capital on April 1, 2014	78,800
Less: Capital on April 1, 2013	60,800
Profit made during the period	18,000

Illustration : 2

Rani who keeps her books on Single Entry System, tells you that her capital on 31st March, 2014 was ₹ 18,700 and her capital on 1st April, 2013 ₹ 19,200. She has withdrawn ₹ 8,420 for household purposes 8,420. She once sold her investment of ₹ 2,000 at 2% premium and brought that money into the business.

You are required to prepare a Statement of Profit or Loss.

Solution :

Statement of Profit or Loss for the year ended March 31, 2014

Particulars	₹
Capital at the end (as given)	18,700
Add: Drawings made during the year	8,420
	27,120

Accounts From Incomplete Records

Less: Capital introduced during the year : $102/100 \times ₹ 2,000$	2,040
Adjusted Capital at the end	25,080
Less: Capital in the beginning	19,200
Net Profit for the year	5,880

Illustration : 3

Following was the position of Arvind as on 31.3.2013 and 31.3.2014

	31.3.2013 ₹	31.3.2014 ₹
Cash	2,000	1,800
Sundry Debtors	78,000	90,000
Stock	68,000	64,000
Plant and Machinery	1,20,000	1,60,000
Sundry Creditors	30,000	29,800
Bills Payable	-----	10,000

During 2013-14 he introduced ₹ 20,000 as new capital. He withdrew ₹ 6,000 every month for his household expenses. Ascertain his Profit for the year ending March 31, 2014.

Solution :

Statement of Affairs as at 31st March, 2013

Liabilities	₹	Assets	₹
Sundry Creditors	30,000	Cash	2,000
Capital (Balancing Figure)	2,38,000	Sundry Debtors	78,000
		Stock	68,000
		Plant and Machinery	1,20,000
	2,68,000		2,68,000

Statement of Affairs as at 31st March, 2014

Liabilities	₹	Assets	₹
Sundry Creditors	29,800	Cash	1,800

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Accounts From Incomplete Records

Bills Payable	10,000	Sundry Debtors	90,000
Capital (Balancing Figure)	2,76,000	Stock	64,000
		Plant and Machinery	1,60,000
	3,15,800		3,15,800

Statement of Profit/Loss for the year ending March 31, 2014

Particulars	₹
Capital on March 31, 2014	2,76,000
Add : Drawings during 2013-14 (₹ 6,000 x 12)	72,000
	3,48,000
Less : Fresh Capital introduced	20,000
Adjusted Capital on March 31, 2014	3,28,000
Less : Capital on March 31, 2013	2,38,000
Profit earned during 2013-14	90,000

Illustration : 4

M.S. Dhoni, a trader, does not keep proper books of account. However, he furnishes you the following particulars :

	March 31, 2013 ₹	March 31, 2014 ₹
Cash at Bank	4,500	3,000
Cash in Hand	300	4,000
Stock-in Trade	40,000	45,000
Debtors	12,000	20,000
Office Equipment	5,000	5,000
Sundry Creditors	30,000	20,000
Furniture	4,000	4,000

During the year he introduced ₹ 6,000 as further capital and withdrew ₹ 4,000 as drawings. Write off Depreciation on furniture at 10% and on office equipment at 5%.

Prepare a statement showing the Profit or Loss made by him for the year ended 31st March, 2014.

Solution :

Statement of Affairs
as at 31.3.2013

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Sundry creditors	30,000	Cash in hand	4,500
Capital	35,800	Cash at Bank	300
		Stock in Trade	40,000
		Debtors	12,000
		Office Equipment	5,000
		Furnitures	4,000
	65,800		65,800



Notes

Statement of Affairs
as at 31.3.2014

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Sundry Creditors	20,000	Cash in Hand	3,000
Capital	61,000	Cash at Bank	4,000
		Stock in Trade	45,000
		Debtors	20,000
		Office Equipments	5,000
		Furniture	4,000
	81,000		81,000

Statement of Profit/Loss for the year ending March 31, 2014

<i>Particulars</i>	₹
Capital on March 31, 2014 before making adjustment of depreciation	61,000
Add : Drawings	4,000
	65,000
Less : Capital introduced during the year	6,000
Profit before adjustment	59,000
Less : Capital on 31 March 2013	35,800
Less : Depreciation on Office Furniture	400
Depreciation on Equipment	250
Net Profit	22,550



Notes

Statement of Affairs (Revised)
as at March 31, 2014

<i>Liabilities</i>		₹	<i>Assets</i>	₹
Sundry Creditors		20,000	Cash at Bank	3,000
Capital (Opening)	35,800		Cash in Hand	4,000
Add: Capital introduced	6,000		Stock-in-Trade	45,000
Profit	25,000		Debtors	20,000
			Office Equipment	5,000
			Less: Depreciation	250
Less: Drawings	4,000	60,350	Furniture	4,000
			Less: Depreciation	400
				3,600
		80,350		80,350



INTEXT QUESTIONS 21.2

State whether the following are True or False :

- i. Capital = Total Assets + Liabilities
- ii. Total Assets = Capital + Liabilities
- iii. Profit = (Capital at the end + Drawing - Additional Capital Introduced - Capital at the beginning)

21.4 CONVERSION METHOD

Preparation of Final Accounts from Incomplete Records

You have learnt Net Worth Method for ascertaining business results, *i.e.*, profits. But, under this method certain vital information (*e.g.*, sales, purchases and operating expenses) is not available from incomplete records, We can get such information by adopting Conversion Method. Conversion Method means converting the accounts from incomplete records to complete records.

The steps involved in conversion are :

- i. **Prepare Cash and Bank Summary** (if not available in proper form with both sides tallied) to ascertain the missing information (figures) (such as opening and closing balances of cash or bank, cash purchases/cash sales, drawings, etc.)

- ii. **Prepare Total Debtors Account** to ascertain the missing information (e.g., opening/closing balances, Bills Receivable received, Credit Sales, Payment Received from Debtors).
- iii. **Prepare Bills Receivable Account** to ascertain the missing information (such as opening/closing balances, Bills Receivable, Bills Receivable collected, Bills Receivable endorsed).
- iv. **Prepare Total Creditors Account** to ascertain the missing information (such as opening/closing creditors, credit purchases, Bills Payable accepted, Bills Receivable endorsed, payment made to creditors)
- v. **Prepare Bills Payable Account** to ascertain the missing information (such as opening/closing balances, Bills Payable accepted, Bills Payable discharged).
- vi. **Prepare Opening Statement of Affairs** to find out capital in the beginning.
- vii. Now, prepare **Trading Account, Profit and Loss Account and Balance Sheet** from the various information given in the question and from the computation made as above. Before preparing the Financial Statements, Trial Balance may also be prepared to check the arithmetical accuracy.



Notes

Hints for Tracing the Missing Figures

<i>Missing Figure</i>	<i>Hints</i>
1. Net Credit Sales	a) Prepare Total Debtors Account b) Total Sales - Cash Sales - Sales Returns
2. Cash Sales	a) Cash and Bank Account Summary b) Total Sales - Net Credit Sales
3. Net Sales	a) Cash Sales + Credit Sales - Sales Returns b) Cost of Goods Sold + Gross Profit
4. Cost of Goods Sold	a) Opening Stock + Net Purchases + Direct Expenses - Closing Stock b) Net Sales - Gross Profit
5. Gross Profit	a) Net Sales - Cost of Goods Sold b) Net Sales x Rate of Gross Profit/100
6. Cash Purchases	a) Prepare Cash and Bank Account Summary b) Total Purchases - Net Credit Purchases

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Accounts From Incomplete Records

7. Net Credit Purchases	a) Prepare Total Creditors Account b) Total Purchases - Cash Purchases - Purchases Return
8. Net Purchases	a) Cash Purchases + Credit Purchases - Purchases Returns b) Cost of Goods Sold + Closing Stock - Opening Stock
9. Payment to Creditors	a) Total Creditors Account b) Cash and Bank Account Summary
10. Collection from Debtors	a) Total Debtors Account b) Cash and Bank Summary



INTEXT QUESTIONS 21.3

State Whether the following statements are true or false :

- (i) Net Credit Sales = Total Sales + Cash Sales - Sales Return
- (ii) Net Sales = Cost of goods sold + Gross Profit
- (iii) Net Purchases = Cost of goods sold + Closing stock - Opening stock
- (iv) Gross Profit = Net sales - Cost of Goods Sold.

21.5 CALCULATION OF MISSING FIGURES

The information required for preparing the Final Accounts is not directly available from incomplete records. In other words, certain figures are missing from the accounts. Hence, we need to find out such missing figures by preparing relevant accounts. The important ones are discussed below :

- i. **Ascertaining Total Purchases :** Total purchases are calculated by combining cash and credit purchases. Cash purchases, if not given in the question, can be ascertained by balancing Cash Book. Credit purchases are calculated by preparing - (a) Total Creditors Account, or (b) Total Creditors Account and Bills Payable Account.

(a) **Total Creditors Account :** For ascertaining the amount of credit purchases, the Total Creditors Account should be prepared. The available information

should first be entered - opening balance on the credit side, cash paid on debit side, any discount received on debit side, and the closing balance on the debit side. Bills issued to them should also be shown on debit side. The difference between the totals of the two sides will be credit purchases.

The specimen of Total Creditors Account is given below :

Total Creditors Account

Dr.		Cr.	
<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cash/Bank A/c	.....	By Balance b/d	.....
To Discount Received	.....	By Bills Payable (Bills Payable dishonoured)	.....
To Bills Payable	.....	By Total Debtors A/c	.....
To Purchases Returns	.....	(Endorsed Bills Receivable dishonoured)	.....
To Balance c/d	.....	By Credit Purchase (Balancing Figure)	.....



Notes

Illustration : 5

From the following information, you are required to calculate total purchases:

	₹
Cash Purchases	1,700
Creditors as on January 1, 2013	800
Cash Paid to Creditors	3,100
Purchases Returns	100
Creditors as on December 31, 2013	1,340

Solution :

Total Creditors Account

Dr.		Cr.	
<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cash/Bank A/c	3,100	By Balance b/d	800
To Purchase Returns	100	By Purchases made during the year (Balancing Figure)	3,740
To Balance c/d	1,340		
	4,540		4,540

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Accounts From Incomplete Records

$$\begin{aligned}\text{Total Purchases} &= \text{Cash Purchases} + \text{Credit Purchases} \\ &= ₹ 1,700 + ₹ 3,740 \\ &= ₹ 5,440\end{aligned}$$

(b) Calculation of Bills Payable Accepted : Just like total Creditors Account, a Bills Payable Account is drawn-up. All known figures (such as opening and closing balances of bills payable, bills payable honoured during the year) are inserted in the account and the missing figure is derived.

A format of Bills Payable Account is given below :

Bills Payable Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Cash/Bank A/c (Bills Payable discharged)	.....	By Balance b/d	.....
To Creditors (Bills Payable dishonoured)	.....	By Total Creditors (Bills Payable accepted)	.....
To Balance c/d	.....	

Illustration : 6

From the following information calculate the total purchases :

	₹
Opening balance of Bills Payable	15,000
Opening balance of creditors	18,000
Closing balance of Bills Payable	21,000
Closing balance of creditors	12,000
Cash paid to creditors during the year	90,600
Bills Payable discharged during the year	26,700
Purchases Returns	3,600
Cash Purchases	77,400

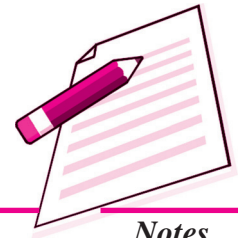
Solution :

Bills Payable Account

Dr.

Cr.

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cash/Bank A/c	26,700	By Balance b/d	15,000
To Balance c/d	21,000	By Creditors, being bills accepted during the year (Balancing Figure)	32,700
	47,700		47,700



Notes

Total Creditors Account

Dr.

Cr.

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cash/Bank A/c	90,600	By Balance b/d	18,000
To Purchases Returns	3,600	By Purchases (Bal. Fig.)	1,20,900
To Bills Payable (Fig. taken from Bills Payable A/c)	32,700		
To Balance c/d	12,000		
	1,38,900		1,38,900

$$\begin{aligned}
 \text{Total Purchases} &= \text{Cash Purchases} + \text{Credit Purchases} \\
 &= ₹ 77,400 + ₹ 1,20,900 \\
 &= ₹ 1,98,300
 \end{aligned}$$

ii. Ascertaining Total Sales : Total sales are calculated by combining cash and credit sales. Cash sales are given in the Cash Book. Credit sales are ascertained by preparing : (a) Total Debtors Account, or (b) Total Debtors Account and Bills Receivable Account.

(a) Total Debtors Account : The amount of credit sales is ascertained by preparing the Debtors Account. The available information is first entered - opening balance on the debit side, cash received on the credit side, any discount allowed or bad debt written off on the credit side and the closing balance on the credit side. Bills received from them is shown on the credit side, the amount of bills dishonoured is entered on the debit side. The difference between the totals of the two sides will be credit sales.

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Accounts From Incomplete Records

Total Debtors Account

Dr.		Cr.	
<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	.....	By Cash/Bank	.....
To Bills Receivable (Dishonoured)	.....	By Discount Allowed	.....
To Credit Sales (Balancing Figure)	.....	By Sales Returns	.....
		By Bad Debts	.....
		By Bills Receivable	.....
		By Balance c/d	.....

Illustration : 7

From the following information, calculate the total sales made during the period:

	₹
Debtors as on January 1, 2013	40,800
Cash received from Debtors	1,21,600
Sales Returns	10,800
Bad Debts	4,800
Debtors as on December 31, 2013	55,200
Cash Sales	1,13,600

Solution :

Total Debtors Account

Dr.		Cr.	
<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	40,800	By Cash/Bank	1,21,600
To Credit Sales	1,51,600	By Sales Returns	10,800
(Balancing Fig.)		By Bad Debts	4,800
		By Balance c/d	55,200
	1,92,400		1,92,400

Accounts From Incomplete Records

$$\begin{aligned}
 \text{Total Sales} &= \text{Cash Sales} + \text{Credit Sales} \\
 &= ₹ 1,13,600 + ₹ 1,51,600 \\
 &= ₹ 2,65,200
 \end{aligned}$$

(b) **Calculation of Bills Receivable Received from Customers :** Just like Total Debtors Account, a Bills Receivable Account is drawn-up. All known figures (such as opening and closing balances of bills receivable, bill honoured during the year, bill dishonoured, renewed during the year) are inserted in the account and the missing figure is derived as Balancing Figure.

A format of Bills Receivable Account is given below :

Bills Receivable Account

Dr.

Cr.

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	.....	By Cash/Bank (B/R Collected)	.....
To Total Debtors (Bill Receivable received)	.....	By Bank (B/R discounted)	.....
		By Banker's Discount (Discounting charges)	.....
		By Total Debtors (B/R dishonoured)	.....
		By Total Creditors (B/R endorsed)	.....
		By Balance c/d	.....

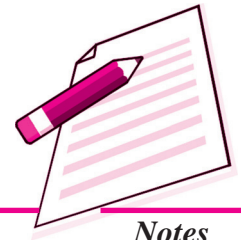
Illustration : 8

From the following information, calculate the total sales :

	₹
Bills Receivable in the beginning	1,560
Debtors in the beginning	6,160
Bills Receivable encashed during the year	4,180
Cash received from Debtors	14,000
Bad Debts written off	560

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Accounts From Incomplete Records

Sales Returns	1,740
Bills Receivable (Dishonoured)	360
Bills Receivable at the end	1,200
Debtors at the end	5,100
Cash Sales	8,180

Solution :

Bills Receivable Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Balance b/d	1,560	By Cash/Bank	4,180
To Debtors, being the bills received during the year		By Debtors (Bill Receivable dishonoured)	360
(Balancing Figure)	4,180	By Balance c/d	1,200
	5,740		5,740

Total Debtors Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Balance b/d	6,160	By Cash/Bank	14,000
To Bills Receivable (Dishonoured)	360	By Bad Debts	560
To Sales (Balancing Figure)	19,060	By Sales Returns	1,740
		By Bills Receivable	4,180
		By Balance c/d	5,100
	25,580		25,580

$$\begin{aligned}
 \text{Total Sales} &= \text{Cash Sales} + \text{Credit Sales} \\
 &= ₹ 8,180 + ₹ 19,060 \\
 &= ₹ 27,240
 \end{aligned}$$

iii. Ascertaining Balance of Sundry Debtors and Sundry Creditors : If credit sales and credit purchases are given, the opening or closing balances of debtors and/or creditors can be ascertained by preparing Total Debtors Account and Total Creditors Account.

Illustration : 9

From the following information, prepare the Total Debtors Account and Total Creditors Account and find out credit sales and credit purchases :

	₹
Debtors as on 1st January	5,000
Creditors as on 1st January	4,000
Debtors as on 31st December	4,000
Creditors as on 31st December	6,000
Bills receivable received during the year	10,000
Bills Payable issued during the year	8,000
Cash received from customers	30,000
Cash returned to customers	500
Cash paid to suppliers	20,700
Discount allowed by suppliers	270
Discount allowed by customers	150
Bad Debts written off	1,200
Bad Debts recovered	300
Bills Receivable endorsed to creditors	4,000
Bills Receivable dishonoured by customers	1,000
Endorsed Bills Receivable dishonoured	500
Discounted Bills Receivable dishonoured	700
Sales Returns	600
Purchases Returns	200



Notes

Solution :

Total Debtors Account

Dr.		Cr.	
<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	5,000	By Cash/Bank	30,000
To Credit Sales (Balancing Fig.)	38,250	By Discount	150
To Cash Returned	500	By Bad Debts	1,200
To Bills Receivable (Dishonoured)	1,000	By Sales Returns	600
To Creditors	500	By Bills Receivable	10,000

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Accounts From Incomplete Records

To Bank (Discounted B/R Dishonoured)	700	By Balance c/d	4,000
	45,950		45,950

Total Creditors Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Cash/Bank	20,700	By Balance b/d	4,000
To Discount	270	By Purchases (Credit)	
To Bills Receivable (Endorsed)	4,000	(Balancing Figure)	34,670
To Purchases Returns	200	By Debtors (Bills endorsed dishonoured)	500
To Bills Payable	8,000		
To Balance c/d	6,000		
	39,170		39,170

iv. Ascertaining Balancing of Bills receivable and Bills Payable : If the opening or closing balances of these items are not given, the missing figures can be ascertained by preparing Bills Receivable Account and Bills Payable Account.

Illustration : 10

From the following particulars, ascertain closing balance of Bills Receivable Account and opening balance of Bills Payable Account :

	₹
Opening balance of Bills Receivable	11,000
Closing balance of Bills Payable	8,000
Bills Payable issued	35,000
Bills Receivable encashed	46,000
Bills Receivable received	49,000
Bills Payable paid in cash	36,000
Bills Receivable dishonoured	1,000

Solution :

Bills Receivable Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Balance b/d	11,000	By Cash/Bank	46,000
To Sundry Debtors	49,000	By sundry Debtors	1,000
		By Balance c/d (Bal. Fig.)	13,000
	60,000		60,000



Notes

Bills Payable Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Cash/Bank	36,000	By Balance b/d (Bal. Fig.)	9,000
To Balance c/d	8,000	By Sundry Creditors	35,000
	44,000		44,000

Illustration : 11

Ashok does not maintain proper books of account. From the following particulars, prepare the Trading and Profit and Loss Account for the year ended December 31, 2014 and the Balance Sheet as on that date :

	December 31, 2013	December 31, 2014
	₹	₹
Debtors	9,000	12,500
Stock	4,900	6,600
Furniture	500	750
Creditors	3,000	2,250

Analysis of other transactions is as follows :

	₹
Cash collected from Debtors	30,400
Cash paid to Creditors	22,000
Salaries	6,000
Rent	750

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Notes

Accounts From Incomplete Records

Office Expense	900
Drawing	1,500
Additional Capital introduced	1,000
Cash Sales	750
Cash Purchases	2,500
Discount Received	350
Discount Allowed	150
Returns Inwards	500
Returns Outwards	400
Bad ebts	100

He had ₹ 2,500 as Cash Balance at the beginning of the year.

Solution :

Trading and Profit & Loss Account for the year ended December 31, 2014

Dr.	₹	Cr.	₹
<i>Particulars</i>		<i>Particulars</i>	
To Opening Stock	4,900	By Sales :	
To Purchases :		Cash	750
Cash	2,500	Credit (Note 3)	34,650
Credit (Note 4)	22,000		35,400
	24,500	<i>Less:</i> Returns	500
<i>Less:</i> Return	400	By Closing Stock	6,600
To Gross Profit c/d	12,500		
	41,500		41,500
To Salaries	6,000	By Gross Profit b/d	12,500
To Rent	750	By Discount Received	350
To Office Expenses	900		
To Discount Allowed	150		
To Bad Debts	100		
To Net Profit transferred to Capital A/c	4,950		
	12,850		12,850

Balance Sheet
as at December 31, 2014

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Creditors	2,250	Cash (Note 2)	1,000
Creditors for Furniture (Rs. 750 - Rs. 500) 13,900		Debtors	12,500
Add: Capital introduced 1,000		Stock	6,600
Net Profit 4,950		Furniture	750
	19,850		
Less: Drawings 1,500	18,350		
	20,850		20,850



Notes

Working Notes :

1. Balance Sheet as at December 31, 2013

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Creditors	3,000	Cash and Bank Balance	2,500
Capital (Balancing Fig.)	13,900	Debtors	9,000
		Stock	4,900
		Furniture	500
	16,900		16,900

2. Cash Book

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	2,500	By Sundry Creditors	22,000
To Sundry Debtors	30,400	By Salaries	6,000
To Capital	1,000	By Rent	750
To Cash Sales	750	By Office Expenses	900
		By Drawings	1,500
		By Purchases	2,500
		By Balance c/d	1,000
	34,650		34,650



Notes

3. Total Debtors Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	9,000	By Cash/Bank	30,400
To Credit Sales (Balancing Fig.)	150	34,650 By Discount	
		By Returns Inward	500
		By Bad Debts	100
		By Balance c/d	12,500
	43,650		43,650

4. Total Creditors Account

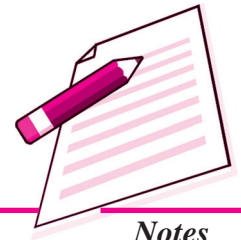
<i>Liabilities</i>	₹	<i>Assets</i>	₹
To Cash/Bank	22,000	By Balance b/d	3,000
To Discount	350	By Credit Purchase	
To Return Outward	400	(Balancing Figure)	22,000
To Balance c/d	2,250		
	25,000		25,000



WHAT YOU HAVE LEARNT

- Single entry system is a system in which accounting records are not according to double entry principle of book keeping.
- Usually under this system, only personal accounts are maintained and real and nominal accounts are avoided.
- A Statement of Affairs is a statement of all assets and liabilities. The difference between the amount of the two sides is taken as capital.
- There are two methods used for ascertaining profits of the business from incomplete records are :
 - i. Net Worth Method or Statement of Affairs Method
 - ii. Conversion Method

- Under Statement of Affairs Method, Statement of Affairs at close and at opening are prepared to determine opening and closing capital. The capital is adjusted with respect to capital introduced and drawings made, to determine profit earned during the year.
- Under Conversion method, in complete records are converted into Double Entry System and Profit is determined.



Notes



TERMINAL EXERCISE

1. Define Single Entry System and explain its features.
2. List any three circumstances under which records may be rendered as incomplete.
3. How is profit calculated under statement of Affairs Method?
4. What do you mean by Single Entry System? Also explain the uses of Single Entry System.
5. What steps are taken to convert a set of books not maintained under Double Entry System into the same?
6. Arvind does not keep proper records of his business, he gives you the following information :

	₹
Opening Capital	2,00,000
Closing Capital	2,50,000
Drawings during the year	60,000
Capital added during the year	75,000

Calculate profit or loss for the year.

7. The following information is supplied to you by a shopkeeper :

	<i>1 April 2013</i>	<i>31 March 2014</i>
	₹	₹
Cash	6,000	7,000
Sundry Debtors	68,000	64,000
Stock	59,000	87,000

MODULE - 3

Financial Statement



Notes

Accounts From Incomplete Records

Furniture	15,000	13,500
Sundry Creditors	20,000	18,000
B/p	15,000	11,000

During the year the shopkeeper withdrew ₹ 2,500 per month for domestic purposes. He also borrowed from a friend at 9% a sum of ₹ 20,000 on 1st October 2013. He has not yet paid the interest. A provision of 5% on debtors for doubtful debts was to be made.

Ascertain the profit or loss made by him during the period.



ANSWERS TO INTEXT QUESTIONS

- 21.1 I. (i) estimated (ii) simple (iii) less
II. (i) False (ii) False (iii) True
- 21.2 (i) False (ii) True (iii) True



ANSWERS TO TERMINAL EXERCISE

6. Profit = ₹ 35,000
7. Profit = ₹ 35,400

Module - IV

PARTNERSHIP ACCOUNTS

Marks 20

Hours 50

You are well aware that one important form of organisation which is widely practiced in our country is 'partnership'. While the learner should know the meaning, and features of partnership, they should also know about the partnership deed and its provisions affecting accounting a partnership firm such as calculating interest on drawings and capitals, preparing capital accounts of partners when their capitals are fixed and when these are fluctuating. When ever there is reconstitution of a partnership firm due to admission of a partners, retirement of a partner, death of a partner, the affect of this is to be reflected in accounts in the form of goodwill, revaluation of assets and liabilities and adjustment of partners capitals if a firm is dissolved that too requires special according treatment.

This module has been so designed that the learner will be able to understand the meaning of partnership and partnership deed accounting treatment of certain items if these is no provision is partnership deed about their such as partners salary, profit sharing ratio. The learner will know the according procedure regarding admission, retirement, and death of a partner and dissolution of the partnership firm.

Lesson 22. Partnership - An Introduction

Lesson 23. Admission of A Partner

Lesson 24. Retirement and Death of A Partner

Lesson 25. Dissolution of a Partnership Firm

*Notes***22**

PARTNERSHIP : AN INTRODUCTION

You have already learnt about preparation of accounts of sole proprietary form of business organisation. But, when a business expands, it goes beyond the capacity of one person to provide the capital and manage the affairs of the expanded business. A need is felt to combine his/her efforts and capital with those of another person/persons. This gives rise to the partnership form of organisation.

As far as recording of business transactions in the books of original entry, their posting to ledger and preparing financial statements are concerned there is no difference between a sole proprietor or a partnership firm. But there are certain issues which are specific to partnership firm and require separate accounting treatment. These issues are appropriation of profits of the firm, treatment of goodwill on various occasions and so on. This lesson focuses on such issues related to partnership firms.



OBJECTIVES

After going through this lesson, you will be able to :

- state the meaning and characteristics of partnership;
- explain the meaning of partnership deed and its contents;
- describe accounting treatment of specific issues related to partnership in the absence of partnership deed;
- state the meaning and preparation of capital account;
- distinguish between fluctuating and fixed capital account;



Notes

- calculate interest on capital and interest on drawings;
- state the meaning and purpose of Profit and Loss Appropriation account and its preparation;
- make adjustment for guarantee of profit and
- make adjustments for errors made after preparing Balance Sheet.

22.1 PARTNERSHIP AND PARTNERSHIP DEED

Partnership is a form of business organisation, where two or more persons join hands to run a business. They share the profits and losses according to the agreement amongst them.

According to the Indian Partnership Act 1932,

“Partnership is relation between persons who have agreed to share profits of a business carried on by all or any one of them acting for all”.

For example, one of your friends has passed class XII from National Institute of Open Schooling (NIOS) and wants to start a business. He/she approaches you to join in this venture. He/she wants you to contribute some money and participate in the business activities. Both of you if join hands, constitute a partnership.

Following are the characteristics of partnership :

- **Agreement :** A partnership is formed by an agreement. The agreement may be either oral or in writing. It defines the relationship between the persons, who agree to carry on business. It may contain the terms of sharing profit and the capital to be invested by each partner, etc. The written agreement is known as partnership deed.
- **Number of persons :** There must be at least two persons to form a partnership. The maximum number of partners in a partnership firm can be 50 according to Companies Act 2013.
- **Business :** The Partnership is formed to carry on business with a purpose of earning profits. The business should be lawful. Thus, if two or more persons agree to carry on unlawful activities, it will not be termed as partnership.
- **Sharing Profits :** The partners agree to share profits in the agreed ratio. In case of loss, all the partners have to bear it in the same agreed profit sharing ratio.

- **Mutual Agency :** Every partner is an agent of the other partners. Every partner can bind the firm and all other partners by his/her acts. Each partner will be responsible and liable for the acts of all other partners.
- **Unlimited liability :** The liability of each partner, except that of a minor, is unlimited. Their liability extends to their personal assets also. If the assets of the firm are insufficient to pay off its debts, the partners' personal property can be used to satisfy the claim of the creditors of the partnership firm.
- **Management :** All the partners have a right to manage the business. However, they may authorize one or more partners to manage the affairs of the business on their behalf.
- **Transferability of Share :** No partner can transfer his/her share to any one including his/her family member without the consent of all other partners.



Notes

Important Terms

- **Partner :** The persons who have agreed to carry on a business and share its profits and losses. They are the persons who have agreed upon the terms and conditions of partnership.
- **Firm :** Partners who carry on the business are collectively known as firm. The name under which the business is carried on is called firm name.
- **The Indian Partnership Act 1932 :** It is an Act that governs the partnership firms. In case, Partnership Deed is silent on an issue, provisions of the Indian Partnership Act, 1932 are applied.
- **Partnership deed :** Agreement forms the basis of partnership. The written form of the agreement is which is a document of partnership. It contains terms and conditions regarding the conduct of the business. It also explains relationship between the partners. This document is called partnership deed.

Every firm can frame its own partnership deed in which the rights, duties and liabilities of the partners are stated in detail. It helps in settling the disputes arising among the partners during the general conduct of business.
- **Contents of Partnership Deed :** The partnership deed generally contains the following :
 - (i) Name and address of the partnership firm;
 - (ii) Nature and objectives of the business;



Notes

- (iii) Name and address of each partner;
 - (iv) Ratio in which profits is to be shared;
 - (v) Capital contribution by each partner;
 - (vi) Rate of Interest on capital if allowed;
 - (vii) Salary or any other remuneration to partners, if allowed;
 - (viii) Rate of interest on loans and advances by a partner to the firm;
 - (ix) Drawings of partners and interest thereon, if any
 - (x) Method of valuation of goodwill and revaluation of assets and liabilities on the reconstitution of the partnership i.e. on the admission, retirement or death of a partner;
 - (xi) Settlement of disputes by arbitration;
 - (xii) Settlement of accounts at the time of retirement or death of a partner;
 - (xiii) Circumstances in which the firm can be dissolved;
 - (xiv) Settlement of accounts at the time of dissolution of a firm.
- **In the Absence of the Partnership Deed :** The partnership deed lays down the terms and conditions of partnership in regard to rights, duties and obligations of the partners. In the absence of partnership deed, there may arise a controversy on certain issues like profit sharing ratio, interest on capital, interest on drawings, interest on loan and salary of the partners. In such cases, the provisions of the Indian Partnership Act becomes applicable:

Some of the Issues are

- (i) **Distribution of Profit :** Partners are entitled to share profits equally.
- (ii) **Interest on Capital :** Interest on capital is not allowed.
- (iii) **Interest on Drawings :** No interest on drawing of the partners is to be charged.
- (iv) **Interest on Partner's Loan :** A Partner is allowed interest @ 6% per annum on the amount of loan given to the firm by him/her.
- (v) **Salary and Commission to Partner :** A partner is not entitled to any salary or commission or any other remuneration for managing the business.



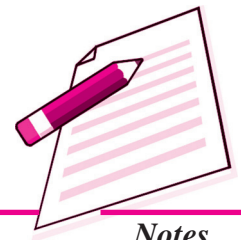
INTEXT QUESTIONS 22.1

I. Fill in the blanks with appropriate word/words :

- (i) There must be at least persons to form a partnership.
- (ii) A partnership is formed by
- (iii) Agreement of partnership can be or
- (iv) The written form of agreement of a partnership is called
- (v) The liability of each partner is

II. Asha and Rahul are partners in a firm . If there is no partnership deed, how will you deal with the following? Give your answer in yes or no.

- (i) Asha wants a salary of Rs.3000 per month to be paid to her. Can she claim the salary?
- (ii) Rahul has advanced a loan to the firm. He claims interest @ 6% p.a. is it permissible?
- (iii) Asha and Rahul contribute Rs. 50,000 each as capital. Rahul wants more profit than Asha. Is it permissible?
- (iv) Asha gets contracts for the firm. She wants 2% commission on the amount of contract. Is she entitled to such commission?
- (v) Rahul withdraws ₹ 500 p.m. for personal use. Asha wants interest to be charged on Rahul's drawings. Can it be charged?



Notes

22.2 CAPITAL ACCOUNT : MEANING AND PREPARATION

Partners contribute their share of capital in business. These are recorded in their respective accounts named as capital accounts. Suppose there are two partners A and B, there will be A's capital account and B's capital account. These accounts may be maintained in two ways :

(a) Fixed Capital Account

In fixed capital account, the closing balance of the capital account is same as that of opening balance except when additional capital is introduced or there is permanent withdrawal during the current accounting year. Items relating to capital account such as interest on capital, interest on drawings and share of profit etc, are recorded in



Notes

capital account. But in this case a separate account is opened for each partner to record these items. This account is known as ‘current account’. A current account may show a debit or a credit balance. Format of the fixed capital account and the current account is as under :

Partner’s Capital Account

Dr.				Cr.			
<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> (₹)	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> (₹)
	Bank (Permanent withdrawal of Capital)		xx		Balance b/d (Capital contribution opening balance)		xxx
	Balance c/d (Closing balance)		xx		Bank (Additional Capital introduced)		xxx
			xxx				xxx

Partner’s Current Account

Dr.				Cr.			
<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> (₹)	<i>Date</i>	<i>Particulars</i>	<i>J.F.</i>	<i>Amount</i> (₹)
	Balance b/d (in case of debit opening Balance)		xxx		Balance b/d (in case of credit Opening Balance)		xxx
	Drawings A/c		xx		Salary		xxx
	Interest on Drawings A/c		xx		Interest on capital		xxx
	Profit and Loss Appropriation (for share of loss)		xx		Profit and loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)				Balance c/d (in case of debit closing balance)		
			xxx				xxx

(b) Fluctuating Capital Account

When capital account for each partner is so maintained that in addition to the capital amount other items related to capital account such as interest on capital, drawings, net profit or net loss etc. are written in this account, it is termed as fluctuating capital. In this case there is no need to maintain a separate account for recording of these adjustments.

In the absence of any information, the capital account should be prepared by this method. The format of fluctuating capital account is as follows:

Partner's Capital Account

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i> (₹)	<i>Date</i>	<i>Particulars</i>	<i>JF</i>	<i>Amount</i> (₹)
	Balance b/d (in case of Debit opening balance)		xxx		Balance b/d (in case of Credit opening balance)		xxx
	Drawings		xxx		Bank (Additional Capital introduced) A/c		xxx
	Interest on Drawings		xxx		Salaries A/c		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Interest on Capital		xxx
	Balance c/d (in case of credit closing balance)		xxx		Profit and Loss Appropriation (for share of profit)		xxx
			xxx		Balance c/d (in case of debit closing balance)		xxx
			xxx				xxx

Illustration 1

Rohan and Monika are partners in a firm. Following information is provided as on 31 December, 2013:

	<i>Rohan</i> (₹)	<i>Monika</i> (₹)
Capital (as on 1.01.2013)	40,000	30,000
Drawings	3,000	2,000
Interest on Capital	2,000	1,500
Interest on Drawings	360	180
Share of Profit	5,000	4,000

*Notes*



Notes

Prepare capital account of each partner if capital is : (a) fixed, (b) fluctuating.

Solution :

(a) Fixed capital account

Capital Account

Dr.

Cr.

Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)	Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)
Dec.31	Balance c/d		40,000	30,000	Jan.1	Balance b/d		40,000	30,000
			40,000	30,000				40,000	30,000

Current Account

Dr.

Cr.

Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)	Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)
Dec.31	Drawings		3,000	2,000	Dec.31	Interest on capital		2,000	1,500
Dec.31	Interest on drawings		360	180	Dec.31	Profit and Loss Appropriation A/c		5,000	4,000
Dec.31	Balance c/d		3,640	3,320	Jan.1	Balance b/d		3,640	3,320
			7,000	5,500				7,000	5,500

(b) Fluctuating capital Account

Capital Account

Dr.

Cr.

Date	Particulars	JF	Rohan (₹)	Monika (₹)	Date	Particulars	JF	Rohan (₹)	Monika (₹)
	Drawings		3,000	2,000		Balance b/d		40,000	30,000
	Interest on drawings		360	180		Interest on capital		2,000	1,500
	Balance c/d		43,640	33,320		Profit & Loss Appropriation A/c		5,000	4,000
			47,000	35,500		Balance b/d		43,640	33,320

Distinction between Fixed and Fluctuating Capital Accounts

The main points of difference between the Fixed and Fluctuating capital accounts are as under:

S. No.	Basis of Distinction	Fixed Capital Account	Fluctuating Capital Account
1.	Number of accounts	Two separate accounts are prepared for each partner i.e. 'capital account' and 'current account'.	Only one account for each partner is prepared i.e. capital account.
2.	Adjustments	All adjustments are recorded in the current account and not in the capital account.	Adjustments are recorded directly in the capital accounts, as no current account is opened.
3.	Fixed balance	The capital account balance, normally remains, unchanged except under special circumstances.	The balance of the capital account fluctuates from period to period.
4.	Balance	Capital accounts always show a credit balance only.	The capital account can show a debit balance or a credit balance at the end of the period.

*Notes***INTEXT QUESTIONS 22.2**

Fill in the blanks with suitable word/words :

- (i) Fixed Capital account always show balance only.
- (ii) A capital account may show a debit or a credit balance.
- (iii) Two separate accounts are kept for each partner, if capital is
- (iv) Interest on capital is shown on the side of the current account.
- (v) Interest on drawings is shown on the side of the current account.

22.3 ACCOUNTING TREATMENT OF INTEREST ON CAPITAL AND INTEREST ON DRAWINGS

Interest on Capital

Let us now study about calculation of interest on capital. As you know that, interest on capital is allowed when it is provided in the Partnership Deed. If it is so provided, the



Notes

rate of interest will be as agreed upon by the partners. Interest is charged on the opening balance of the partner’s capital account. When additional capital is introduced and some capital is withdrawn permanently, the interest will be calculated on the amount of the capital used in the business during a particular period. Interest is treated as an expense as it is a charge on the profits of the firm. The following journal entry will be made :

For Interest on Capital

Interest on Capital A/c	Dr.
To Partner’s Capital A/c (Individually)	
(Crediting ‘Interest on Capital’ to Capital Account)	

Interest can be calculated directly i.e. simple interest is to be calculated by taking the principal amount, period and rate of interest. Alternately interest can be calculated by product method i.e. by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest. The following example will illustrate both the methods of calculating interest on capital.

Illustration 2

Shilpa and Sanju are partners with a capital of ₹ 1,00,000 and ₹ 1,60,000 on January 1,2013 respectively. Shilpa introduced additional capital of ₹ 30,000 on July 1, 2013 and another ₹ 20,000 on October 31,2013. Calculate interest on capital for the year ending 2013. The rate of interest is 9% p.a.

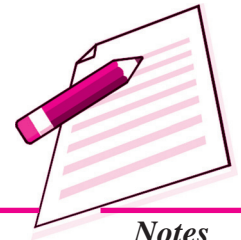
Solution:

Interest on Capital (Shilpa):

On ₹ 1,00,000 for 12 month @ 9%	=	1,00,000 × 9/100 × 12/12
	=	₹ 9,000
On ₹ 30,000 for 6 month @ 9%	=	30,000 × 9/100 × 6/12
	=	₹ 1,350
On ₹ 20,000 for 2 month @ 9%	=	20,000 × 9/100 × 2/12
	=	₹ 300
Total interest on shilpa capital	=	₹ 9,000 + ₹ 1350 + ₹ 300
	=	₹10,650

By product method

Amount ₹	Months	Product
1,00,000	12	12,00,000
30,000	6	1,80,000
20,000	2	40,000
Total product		14,20,000

*Notes*

$$\begin{aligned}\text{Interest on Capital} &= 14,20,000 \times \frac{9}{100} \times \frac{1}{12} \\ &= ₹ 10650\end{aligned}$$

Interest on Capital (Sanju):

$$\begin{aligned}\text{On ₹ 1,60,000 for 12 month @ 9\%} &= 1,60,000 \times \frac{9}{100} \times \frac{12}{12} \\ &= ₹ 14,400\end{aligned}$$

$$\begin{aligned}\text{By product method :} &= 1,60,000 \times 12 = 19,20,000 \\ &= 14,20,000 \times \frac{9}{100} \times \frac{1}{12} \\ &= ₹ 14,400\end{aligned}$$

22.4 INTEREST ON DRAWINGS

When a partner withdraws cash from the firm for domestic use, the withdrawal of cash is termed as drawings. If the partnership deed has a provision of charging interest on drawings, the firm may charge interest on drawings from partners. Interest on drawing is a gain for the firm. It is calculated at the agreed rate. The amount of interest on drawings will be credited to Profit and Loss Appropriation Account and will be debited to partner's capital account/current account (Individually). The journal entry will be:

Partners Capital/Current A/c	Dr.
To Interest on Drawings A/c	
(Charging interest on drawings to Partner's Capital account)	

Calculation of interest on Drawings :

There are two methods of calculating interest on drawings

- Simple Average method
- Product method



Notes

1. SIMPLE AVERAGE METHOD

A fixed amount may be withdrawn every month/ half yearly/ annually. The interest has to be calculated for the period for which the amount has been utilised for personal purposes by the partners. The calculation of amount of interest to be charged in different situations is shown as under :

I. When Fixed Amounts are Withdrawn at Equal Time Intervals

A fixed amount is withdrawn by the partners, at equal time interval, say each month or each quarter. The calculation of total time period, in such situations will depend upon whether the money was withdrawn at the beginning of the month, middle of the month or at the end of the month.

For example, Manisha withdrew ₹ 1,000 per month from the firm for her personal use during the year ending December 31, 2013. interest is charged at the rate of 12% per annum. The calculation of average period and the interest on drawings in different situations would be as follows:

(a) When money is withdrawn at the beginning of the period

<i>Date of Drawings</i>	<i>Amount Withdrawn (₹)</i>	<i>Period (in Month)</i>
1 January 2013	1,000	12
1 February 2013	1,000	11
1 March 2013	1,000	10
1 April 2013	1,000	9
1 May 2013	1,000	8
1 June 2013	1,000	7
1 July 2013	1,000	6
1 August 2013	1,000	5
1 September 2013	1,000	4
1 October 2013	1,000	3
1 November 2013	1,000	2
1 December 2013	1,000	1
Total	12,000	78

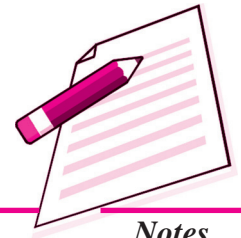
When money is withdrawn in the beginning of the month, the average period is calculated as under:

$$\begin{aligned}\text{Average Period} &= \text{Total of months}/12 \\ &= 78\text{months}/12 \\ &= 6\frac{1}{2}\text{ months}\end{aligned}$$

OR,

$$\begin{aligned}\text{Average Period} &= \frac{\text{Max. Period of Drawing} + \text{Min. Period of Drawing}}{2} \\ &= \frac{12 + 1}{2} = \frac{13}{2} = 6\frac{1}{2}\text{ months}\end{aligned}$$

$$\begin{aligned}\text{Interest on Drawings} &= 12,000 \times \frac{12}{100} \times \frac{6}{12} \\ &= ₹ 780\end{aligned}$$

*Notes***(b) When money is withdrawn at the end of the period**

<i>Date of drawings</i>	<i>Amount Withdrawn (₹)</i>	<i>Period (in Month)</i>
31 January 2013	1,000	11
28/29 February 2013	1,000	10
31 March 2013	1,000	9
30 April 2013	1,000	8
31 May 2013	1,000	7
30 June 2013	1,000	6
31 July 2013	1,000	5
31 August 2013	1,000	4
30 September 2013	1,000	3
31 October 2013	1,000	2
30 November 2013	1,000	1
31 December 2013	1,000	0
	12,000	66

When money is withdrawn at the end of the month, the average period is calculated as under:

$$\begin{aligned}\text{Average Period} &= \text{Total of months}/12 \\ &= 66\text{ months}/12 \\ &= 5\frac{1}{2}\text{ months}\end{aligned}$$



Notes

OR,

$$\begin{aligned} \text{Average Period} &= \frac{\text{Max. Period of Drawing} + \text{Min. Period of Drawing}}{2} \\ &= \frac{10 + 1}{2} = \frac{11}{2} = 5 \frac{1}{2} \text{ months} \end{aligned}$$

$$\begin{aligned} \text{Interest on Drawings} &= 12,000 \times \frac{12}{100} \times \frac{11}{2} \times \frac{1}{2} \\ &= ₹ 660 \end{aligned}$$

(c) When money is withdrawn in the middle of the month:

<i>Date of Drawings</i>	<i>Amount Withdrawn (₹)</i>	<i>Period (in Month)</i>
15 January 2013	1,000	11.5
14 February 2013	1,000	10.5
15 March 2013	1,000	9.5
15 April 2013	1,000	8.5
15 May 2013	1,000	7.5
15 June 2013	1,000	6.5
15 July 2013	1,000	5.5
15 August 2013	1,000	4.5
15 September 2013	1,000	3.5
15 October 2013	1,000	2.5
15 November 2013	1,000	1.5
15 December 2013	1,000	0.5
Total	12,000	72

When money is withdrawn in the middle of the month, the average period is calculated as under:

$$\begin{aligned} \text{Average Period} &= \text{Total of months}/12 \\ &= 72 \text{ months}/12 \\ &= 6 \text{ months} \end{aligned}$$

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing} + \text{Min. Period of Drawing}}{2}$$

$$= \frac{11.5 + 0.5}{2} = \frac{12}{2} = 6 \text{ months}$$

$$\begin{aligned} \text{Interest on Drawings} &= 12,000 \times \frac{12}{100} \times \frac{6}{12} \\ &= ₹ 720 \end{aligned}$$

(d) Withdrawal of Fixed amounts at equal time intervals (Beginning of each quarter)

If the money is withdrawn by the partners in the beginning of each quarter, the interest is calculated on total money withdrawn during the year for an average period of seven and half months.

Illustration 3

Sunny and Himanshu are partners in a firm sharing profits and losses equally. During financial year 2013, Sunny withdrew ₹ 20,000 quarterly at the beginning of each quarter. If interest is to be charged on drawings @ 8% per annum, calculate the amount of interest to be charged at the end of the year.

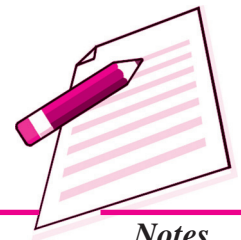
Solution :

Statement Showing Calculation of Interest on Drawings

<i>Date</i>	<i>Amount</i> (₹)	<i>Time Period</i>	<i>Interest</i> (₹)
Jan. 1, 2013	20,000	12 months	$20,000 \times \frac{8}{100} \times \frac{12}{12} = ₹ 1,600$
April 1, 2013	20,000	9 months	$20,000 \times \frac{8}{100} \times \frac{9}{12} = ₹ 1,200$
July 1, 2013	20,000	6 months	$20,000 \times \frac{8}{100} \times \frac{6}{12} = ₹ 800$
Oct. 1, 2013	20,000	3 months	$20,000 \times \frac{8}{100} \times \frac{3}{12} = ₹ 400$
Total	80,000		= ₹ 4,000

Alternatively, the interest can be calculated on the total sum withdrawn during the accounting year, which is ₹ 80,000 in this case, for a period of 7½ months

$$\frac{(12+9+6+3)}{4} = 7 \frac{1}{2} = \frac{15}{2}$$



Notes



Notes

Thus,

$$\begin{aligned} \text{Interest on Drawings} &= \text{Total sum Withdrawn} \times \text{Rate} \times 7\frac{1}{2} \times \frac{1}{12} \\ &= 80,000 \times \frac{8}{100} \times \frac{15}{2} \times \frac{1}{12} \\ &= ₹ 4,000. \end{aligned}$$

(e) When fixed amount is withdrawn at the end of each quarter

When the amounts are withdrawn at the end of each quarter the amount of interest is calculated on total drawings for a period of four and a half months.

In the previous illustration, if the money is withdrawn at the end of each quarter, the average period for calculation of interest will be taken as four and half months. The calculation of interest can be shown as follows:

Statement of Calculation of Interest on Drawings

<i>Date</i>	<i>Amount</i> (₹)	<i>Time Period</i>	<i>Interest</i> (₹)
March 31	20,000	9 months	$20,000 \times \frac{9}{12} \times \frac{8}{100} = ₹ 1,200$
June 30	20,000	6 months	$20,000 \times \frac{6}{12} \times \frac{8}{100} = ₹ 800$
September 30	20,000	3 months	$20,000 \times \frac{3}{12} \times \frac{8}{100} = ₹ 400$
December 31	20,000	0 months	₹ 0
Total	80,000	18 months	= ₹ 2,400

Alternatively, the interest on ₹ 80,000 for a period 4½ months is calculated as :

$$\frac{(9 + 6 + 3 + 0)}{4} = 4\frac{1}{2} = \frac{9}{2}$$

$$\begin{aligned} \text{Interest on Drawings} &= 80,000 \times \frac{8}{100} \times \frac{9}{12} \times \frac{1}{12} \\ &= ₹ 2,400 \end{aligned}$$

(f) When fixed amount is withdrawn at the middle of each quarter

When the amounts are withdrawn at the middle of each quarter the amount of interest is calculated on total drawings for a period of six months.

(g) When no specific period of drawing is given in the question

If no time period is mentioned in the question for which the drawings will be charged for a period of on an average of six months.

*Notes***PRODUCT METHOD****When different amounts are withdrawn at different intervals**

Under the product method, for each withdrawal, the money withdrawn is multiplied by the period for which it remained withdrawn during the financial year. The period is calculated from the date of the withdrawal to the last day of the accounting year. The products so calculated are totalled and interest for 1 month at the specified rate is found out on the total of the products. The calculation of interest can be explained with the help of the preceding illustration.

Statement showing calculation of interest on Drawings

<i>Date</i>	<i>Amount (₹)</i>	<i>Time Period</i>	<i>Product (₹)</i>
Jan. 1, 2013	20,000	12 months	2,40,000
April 1, 2013	20,000	9 months	1,80,000
July 1, 2013	20,000	6 months	1,20,000
Oct. 1, 2013	20,000	3 months	60,000
Total	80,000		6,00,000

$$\begin{aligned}
 \text{Interest on drawing} &= \text{Total of Product} \times \text{interest rate} \times 1/12 \\
 &= ₹6,00,000 \times 8/100 \times 1/12 \\
 &= ₹ 4,000
 \end{aligned}$$

**INTEXT QUESTIONS 22.3****I. Fill in the blanks with appropriate word/words :**

- (i) Interest on capital is in partner's capital account.



Notes

- (ii) Interest on drawings is in partner’s capital account.
- (iii) Interest is charged on the of the partner’s capital account.
- (iv) When money is withdrawn in the beginning of the each month, the average period is for charging interest.

II. Reema and Anish are partners with a capital of ₹50,000 and ₹80,000 on April 2013, respectively. Reema introduced additional capital of ₹50,000 on 1st Jan 2014. Calculate interest on capital @10 p.a. on March 31, 2014.

III. Ashu withdrew ₹2000 p.m. from business for personal use at the end of every month during the year. Calculate interest on Drawing @10 p.a.

22.5 PROFIT AND LOSS APPROPRIATION ACCOUNT: MEANING AND PREPARATION

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. The profit of the firm has to be distributed amongst the partners in their respective profit sharing ratio. But before its distribution it needs to be adjusted. All Adjustments like partner’s salary, partner’s commission, interest on capital, interest on drawings etc. are made in this account. These adjustments will reduce the amount of profit for distribution. This adjusted profit will be distributed amongst the partners in their profit sharing ratio. To prepare it, at first, the balance of Profit and Loss Account is transferred to this account. The journal entries for the preparation of Profit and Loss Appropriation Account are given below:

1. For transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account

- (a) In case of Net Profit :

Profit and Loss A/c	Dr.
To Profit and Loss Appropriation A/c	
(Net Profit transferred to Profit and Loss Appropriation A/c)	
- (b) In case of Net Loss :

Profit and Loss Appropriation A/c	Dr.
To Profit and Loss A/c	
(Net Loss transferred to Profit and Loss Appropriation A/c)	

2. *For Interest on Capital*

For transferring on Interest on Capital :

Profit and Loss Appropriation A/c	Dr.
To Interest on Capital A/c	

(Interest on capital transferred to Profit & Loss Appropriation A/c)

3. *For Interest on Drawings*

For transferring Interest on Drawings :

Interest on Drawings A/c	Dr.
To Profit and Loss Appropriation A/c	

(Interest on drawing transferred to Profit & Loss Appropriation A/c)

4. *For Partner's Salary*

For transfer of partner's Salary

Profit and Loss Appropriation A/c	Dr.
To Salary A/c	

(Salary transferred to profit & Loss Appropriation A/c)

5. *For Partner's Commission*

For transferring commission

Profit and Loss Appropriation A/c	Dr.
To Commission A/c	

(Commission transferred to Profit and Loss Appropriation A/c)

6. *For Transfer of agreed amount to General Reserve*

Profit and Loss Appropriation A/c	Dr.
-----------------------------------	-----

To General Reserve A/c

(Transfer to General Reserve)

7. *For share of Profit or Loss appropriation*

(a) If Profit

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

(Profit transferred to capital/current A/c)

(b) If Loss

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

(Loss transferred to capital/current A/c)

The format of Profit and Loss Appropriation Account is given as follows.

*Notes*

Profit and Loss Appropriation Account
for the year ended on



Notes

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Profit and Loss A/c (if there is loss)	xxx	Profit and Loss A/c (if there is profit)	xxx
Interest on Partners' Capital's A/c	xxx	Interest on Drawings	xxx
Partners' Salary A/c	xxx	Partner's capital A/c (distribution of loss)	xxx
Partners' Commission A/c	xxx		
Interest on Partners' Loan A/c	xxx		
General Reserve	xxx		
Partners' Capital A/c (distribution of profit)	xxx		
	xxx		xxx

Illustration 4

Monika and Krishan are partners with a capital of ₹ 80,000 and ₹ 1,00,000 respectively. They agree on the followings:

- (a) To share profit equally.
- (b) Interest allowed on capital @ 9% p.a.
- (c) Interest charged on drawing @ 6% p.a.
- (d) Salary to be paid to Krishan @ ₹ 600 per month.
- (e) Monika withdrew ₹ 8,000 and Krishan ₹ 6,000 during the year.

Profit for the year ending December 31, 2013 was ₹ 56,000. You are required to prepare Profit and Loss Appropriation account.

Solution :

Working Notes:

First you should calculate the interest on capital and the interest on drawings.

Interest on Capital

Monika	=	₹ 80,000 × 9/100
	=	₹ 7,200
Krishan	=	₹ 1,00,000 × 9/100
	=	₹ 9,000

Interest on Drawings

Monika's Drawings	=	₹ 8,000
Interest	=	₹ 8,000 × 6/100
	=	₹ 0.480
Krishan's Drawings	=	₹ 6,000
Interest	=	₹ 6,000 × 6/100
	=	₹ 360

Profit and Loss Appropriation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Interest on Capital's A/c :		Profit and Loss	56,000
Monika 7,200		Interest on Drawings :	
Krishan <u>9,000</u>	16,200	Monika 480	
Krishan Salary	7,200	Krishan <u>360</u>	840
Profit transferred to Partners' Capital A/c :			
Monika 16,720			
Krishan <u>16,720</u>	33,440		
	<u>56,840</u>		<u>56,840</u>

**INTEXT QUESTIONS 22.4**

- List the items which usually appear on the debit side of Profit and loss Appropriation Account.
- If, balance of Profit and Loss Account is debit, what entry will be recorded for transferring the amount to Profit and Loss Appropriation account?

*Notes*



Notes

- (iii) When interest on drawings is to be transferred to Profit and Loss Appropriation account, what journal entry is to be recorded in the books?

22.6 GUARANTEE OF PROFIT

Sometimes, a partner is admitted in the firm on guarantee in respect of his minimum share of profit from the business. Such a guarantee can be given even to an existing partner also. Such a guarantee to the incoming partner is given either by :

- (a) the firm *i.e.* by all the old partners in an agreed ratio, or
- (b) some of the old partners or any one of the old partners

When all the partners guarantee that one of the partners shall be given a minimum amount of profit, we should calculate the following two amounts separately:

- i. Share of profit of the guaranteed partner as per profit sharing ratio, and
- ii. Minimum guaranteed amount of profit of the guaranteed partner.

The higher of the above two is to be given to that partner. The balance of profit (total profit minus profit given to the guaranteed partner) is to be shared by the remaining partners in their respective profit -sharing ratio.

When the new partner’s share of profit is more than the guaranteed amount, his actual share of profit is given to him instead of the guaranteed amount of profit.

Illustration 5 (Guarantee given by the firm to a partner)

X and Y share profits & Losses in the ratio of 2 : 1 as from 1st April, 2013, they admitted Z as a partner who was to have one-tenth share of profit with a guaranteed amount of ₹1,60,000. X and Y continue to share profits as before. The profit for the year ended 31st March 2014 amounted to ₹ 10,00,000.

Prepare Profit & Loss Appropriation A/c for the year ended March 31, 2014.

Solution :

**Profit & Loss Appropriation Account
for the year ended 31st March, 2014**

Dr.		Cr.	
<i>Particulars</i>	<i>₹</i>	<i>Particulars</i>	<i>₹</i>
To Partner’s Capital A/cs (Note)		By Profit & Loss A/c	
X 5,60,000		- Profit for the year	10,00,000

Partnership : An Introduction

Y	2,80,000		
Z	<u>1,60,000</u>	10,00,000	
		10,00,000	10,00,000

Note : Z will get higher of the following:

- (i) Share of profit as per profit-sharing ratio,
i.e., of ₹ 10,00,000 = ₹ 1,00,000
- (ii) Minimum guaranteed profit, i.e., ₹ 1,60,000

Therefore, from ₹ 10,00,000; ₹ 1,60,000 is to be given (being higher) to Z first and balance of ₹ 8,40,000 (₹ 10,00,000 - ₹ 1,60,000) will be shared by X and Y in the ratio of 2 : 1.

In effect :

X will get ₹ 5,60,000 $\left(\frac{2}{3} \text{ of Rs. } 8,40,000\right)$; Y will get ₹ 2,80,000 $\left(\frac{1}{3} \text{ of Rs. } 8,40,000\right)$ and Z will get ₹ 1,60,000 (guaranteed profit).

When the guarantee is given not by all the partners or the firm but by any one of the partner or some of the partners then the difference between the guaranteed amount and his share of profit shall be borne by the partner or partners who have given the guarantee either in the old profit sharing ratio or in any other agreed ratio as the case may be.

Illustration : 6 (Guarantee of Profits by one partner)

A, B and C are partners in a firm. Their profit sharing ratio is 5 : 3 : 2. However, C is guaranteed a minimum amount of ₹ 50,000 as share of profit every year. Any deficiency arising on that amount shall be met by B. The profits for the two years ended 31st March, 2010 and 2011 were ₹ 2,00,000 and ₹ 3,00,000 respectively. Prepare the Profit & Loss Appropriation A/c for the two years.

Solution :

Profit and Loss Appropriation Account for the year ended 31st March 2010

Dr.

Cr.

Particulars	Amt. (₹)	Particulars	Amt. (₹)
To Profit transferred to : A's Capital A/c (5/10)	1,00,000	By Profit and Loss A/c (Net Profit)	2,00,000

MODULE - 4

Partnership Account



Notes

MODULE - 4

Partnership Account



Notes

Partnership : An Introduction

B's Capital A/c (3/10)	60,000			
Less: Transferred to C	10,000	50,000		
C's Capital A/c (2/10)	40,000			
Add: Transferred from B	10,000	50,000		
		2,00,000		2,00,000

Profit and Loss Appropriation Account for the year ended 31st March 2011

Dr.

Cr.

Particulars	Amt. (₹)	Particulars	Amt. (₹)
To Profit transferred to :		By Profit and Loss A/c	3,00,000
A's Capital A/c (5/10)	1,50,000	(Net Profit)	
B's Capital A/c (3/10)	90,000		
C's Capital A/c (2/10)	60,000		
	3,00,000		3,00,000

Note : C's share of profits is more than the guaranteed amount, so there is no need for any adjustment.

Illustration : 7 (Minimum Profit Guaranteed to a partner by another Partner of the Firm)

P, Q and R entered into partnership on 1st April 2010 to share profits and losses in the ratio of 5 : 3 : 2. P, guaranteed that R's share of profits, after charging interest on capital @ 5% p.a., would not be less than ₹ 30,000 in any year.

The capital was provided as follows : A- ₹ 3,20,000; B- ₹ 2,00,000 and C- ₹ 1,60,000. The profits for the year ended 31st March 2011 amounted to ₹ 1,59,000 before providing for interest on capital.

Prepare Profit and Loss Appropriation A/c for the year ended 31st March 2011.

Solution :

Profit and Loss Appropriation Account (for the year ended 31st March 2011)

Dr.

Cr.

Particulars	Amt. (₹)	Particulars	Amt. (₹)
To Interest on Capitals :		By Profit and Loss A/c	1,59,000
P	16,000	(Net Profit)	

Partnership : An Introduction

Q	10,000			
R	<u>8,000</u>	34,000		
To Share of Profit :			By Balance b/d	1,25,000
P : 5/10 of ₹ 1,25,000	62,500			
Less: Adjustment for guarantee	<u>5,000</u>	57,500		
Q 3/10 of ₹ 1,25,000		37,500		
R 2/10 of ₹ 1,25,000	25,000			
Add: Adjustment for guarantee	<u>5,000</u>	30,000		
		1,25,000		1,25,000

MODULE - 4

Partnership Account



Notes

Illustration 8

M and N were in partnership sharing profits and losses in the ratio of 3 : 2. In appreciation of the services of O, their manager who was in receipt of a salary of ₹ 24,000 and a commission of 5% of net profit after charging salary and commission. They took him into partnership from 1st April, 2010 giving him 1/8th share of profits. The agreement provided that any excess over his former remuneration to which O becomes entitled will be borne by M and N in the ratio of 2 : 3. The profits for the year ended 31st March, 2011 amounted to ₹ 4,44,000.

Prepare the Profit and Loss Appropriation Account, for the year ended on March 31, 2011.

Solution :

Profit and Loss Appropriation Account for the year ended 31st March, 2011

Dr.

Cr.

Particulars	Amt. (₹)	Particulars	Amt. (₹)
To Profit transferred to		By Profit as per Profit and Loss A/c	4,44,000
M's Capital A/c	2,40,000		
Less: Trfd. to C	<u>4,600</u>		
N's Capital A/c	1,60,000		
Less: Trfd. A/c	<u>6,900</u>		
O's Capital A/c	44,000		
Add: From A	4,600		
From B	<u>6,900</u>		
	4,44,000		4,44,000



Notes

Working Notes :

		₹
1. Profit for the year		
O's Share as partner (1/8 x ₹ 4,44,000)	=	55,500
<i>Less:</i> Amount payable to O as employee :		
Salary	=	24,000
Commission $\frac{5}{105}$ (₹ 4,44,000 - ₹ 24,000)	=	20,000
Deficiency		11,500
Deficiency chargeable to M and N in the ratio 2 : 3		
∴ A to bear	=	11,500 x 2/5 = 4,600
B to bear	=	11,500 x 3/5 = 6,900
2. Profit for the year available to M and N (₹ 4,44,000 - C's share as Manager ₹ 44,000) = ₹ 4,00,000		
A's Share = ₹ 4,00,000 x 3/5 = ₹ 2,40,000 - Share in deficiency		
B's Share = ₹ 4,00,000 x 2/5 = ₹ 1,60,000 - Share in deficiency		

Illustration 9 (Minimum earning Guaranteed by a Partner to the Firm and Minimum Profit Guaranteed by the Firm to a Partner)

Three Chartered Accountants A, B and C form a partnership, sharing profits and losses in the ratio of 3 : 2 : 1 subject to the following conditions:

- i. C's share of profits is guaranteed to be not less than ₹ 3,00,000 p.a.
- ii. B gives a guarantee to the effect that the gross fee earned by him for the firm shall not be less than the average gross fee earned by him during the preceding five years, when he was carrying on the profession alone (the average of which work out at ₹ 5,00,000)

The profits for the first year (year ended 31st March, 2011) of the partnership are ₹ 15,00,000. The gross fees earned by B for the firm are ₹ 3,20,000.

You are required to show the Profit and Loss Appropriation Account (after giving effect to the above).

Solution :

Profit and Loss Appropriation Account
for the year ended 31st March, 2011

Dr.

Cr.

Particulars	Amt. (₹)	Particulars	Amt. (₹)
To Profit transferred to :		By Profit and Loss A/c	
A's Capital A/c	8,40,000	-Net Profit	15,00,000
<i>Less:</i> Deficiency of		By B's Capital A/c	1,80,000
C transferred	12,000	(W.N. 1)	
(W.N. 2)			
B's Capital A/c	5,60,000		
<i>Less:</i> Deficiency of			
C transferred	8,000		
(W.N. 2)			
C's Capital A/c	2,80,000		
<i>Add:</i> From			
A	12,000		
B	8,000		
	16,80,000		16,80,000



Working Notes :

- ₹
- Profits for the first year of partnership 15,00,000
Add: Difference between the guaranteed fees to be earned by B
and actual fees earned (₹ 5,00,000 - ₹ 3,20,000) 1,80,000
Projected net profit of the firm 16,80,000
A's Share = ₹ 16,80,000 × 3/6 = ₹ 8,40,000
B's Share = ₹ 16,80,000 × 2/6 = ₹ 5,60,000
C's Share = ₹ 16,80,000 × 1/6 = ₹ 2,80,000
 - C was guaranteed a minimum sum of ₹ 3,00,000. Hence, the deficiency of ₹ 20,000 will be borne by A and B in the ratio of 3 : 2 as follows :
A - ₹ 20,000 × 3/5 = ₹ 12,000; B - ₹ 20,000 × 2/5 = ₹ 8,000
Thus, A's Share of Profit = ₹ 8,40,000 - ₹ 12,000 = ₹ 8,28,000
B's Share of Profit = ₹ 5,60,000 - ₹ 8,000 = ₹ 5,52,000
C's Share of Profit = ₹ 2,80,000 + ₹ 12,000 (A) + ₹ 8,000 (B)



Notes

In case, a partner has been guaranteed a minimum profit by the firm and also by a partner, first the guarantee given by a partner's shall be effected. This will be clear from the following illustration.

Illustration 10 (Guarantee by the Firm as well as by Partners)

P, Q, R and S are partners sharing profits and losses in the ratio of 4:3:2:1. Their capitals as on 1st April, 2012 were ₹ 3,00,000; ₹ 2,50,000; ₹ 1,50,000 and ₹ 1,00,000 respectively.

S's share of profits excluding interest on capital has been guaranteed by the firm to be not less than ₹ 2,50,000. R's share of profits including interest on capital and salary guaranteed by P is not less than ₹ 2,60,000.

The profits for the year ended 31st March, 2014 were ₹ 9,00,000 before interest on capital @ 10% and salary to R @ ₹ 10,000 per month.

Prepare the Profit and Loss Appropriation Account for the year ended on March 31, 2014.

Solution :

**Profit and Loss Appropriation Account
for the year ended 31st March, 2014**

Dr.		Cr.	
<i>Particulars</i>	<i>Amt. (₹)</i>	<i>Particulars</i>	<i>Amt. (₹)</i>
To Interest on Capitals :		By Profit and Loss A/c	
P (₹ 3,00,000 x 10/100) 30,000		- Profit	9,00,000
Q (₹ 2,50,000 x 10/100) 25,000			
R (₹ 1,50,000 x 10/100) 15,000			
S (₹ 1,00,000 x 10/100) 10,000	80,000		
To R's Salary (₹ 10,000 x 12)	1,20,000		
To Share of Profit :			
(₹ 9,00,000 - ₹ 80,000 -			
₹ 1,20,000) = ₹ 7,00,000			
P:4/10 of ₹ 7,00,000 = 2,80,000			
Less: Firms Deficiency			
borne (W.N.1)			
(₹ 1,80,000 x 4/9) 80,000			
Deficiency borne 25,000	1,75,000		
Q:3/10 of ₹ 7,00,000 = 2,10,000			

Less: Firm's Deficiency (₹1,80,000 x 3/9)	60,000	1,50,000	
R:2/10 of ₹ 7,00,000 =	1,40,000		
Less: Firm's Deficiency (₹ 1,80,000 x 2/9)	40,000		
	1,00,000		
Add: Deficiency recovered from P (W.N. 2)	25,000	1,25,000	
S:1/10 of ₹ 7,00,000 =	70,000		
Add: Deficiency recovered from P, Q and R	1,80,000	2,50,000	
		9,00,000	9,00,000



Notes

Working Notes :

1. Calculation of firm's deficiency :	₹
S's share of profit excluding interest on Capital has been guaranteed by firm	2,50,000
Less: S's share of profit (₹ 7,00,000 x 1/10)	70,000
Firm's deficiency borne by P, Q and R	1,80,000
2. Calculation of deficiency recovered by R from P :-	
R's share of profits (₹ 7,00,000 x 2/10)	1,40,000
Less: R's share in firm's deficiency (₹ 1,80,000 x 2/9)	40,000
	1,00,000
Add: Interest on Capital	15,000
Salary	1,20,000
	1,35,000
Deficiency recovered from P (Balancing Figure)	25,000
R's share of profits including interest on capital and salary is guaranteed by P	2,60,000

PAST ADJUSTMENT (Relating To Interest on Capital, Interest on Drawings, Salary and Change in Profit Sharing Ratio)

Sometimes, after closing the accounts of the partnership firm at the end of the financial year, it is discovered that there had been some errors or omissions in the accounts. In such cases, instead of altering the old accounts and the signed Balance Sheet an adjustment entry for such errors or omissions is made at the beginning of the next year. Usually the following types of adjustments are made:-



Notes

- i. Omission of Interest on Capital or on Drawings.
- ii. Distribution of Profit and Loss among the partners in the wrong proportion.
- iii. Altering of Profit sharing ratio with effect from some past data i.e. respectively partner.
- iv. Omission of salary or commission payable to a partner.

Illustration 11

P, Q and R are partners sharing profits and losses in the ratio of 3 : 2 : 1. After the final accounts have been prepared, it was discovered that interest on drawings had not been taken into consideration. The Interest on drawing of partners amounted to P - ₹ 500; Q - ₹ 360 and R - ₹ 200. Give the necessary adjusting journal entry.

Solution :

Interest charged on P's drawings	=	₹ 500
Interest charged on Q's drawings	=	₹ 360
Interest charged on R's drawings	=	₹ 200
Total interest to be charged from partners		₹ 1060

This amount of ₹ 1060 is an item of income for the firm but this has not been recorded on the credit side of P & L A/c of the previous year. As such the profit of the previous year will now be increased by this amount. Hence, this profit ₹ 1060 will be shared by the partners in their profit sharing ratio of 3:2:1 which amount to P ₹ 265, Q Rs. 177 and R ₹ 88.

Table Showing Adjustment

	<i>P</i>	<i>Q</i>	<i>R</i>	<i>Total</i>
	₹	₹	₹	₹
Interest on Drawing (Dr.)	500	360	200	1,060
Division of ₹ 530 in 3:2:1 (Cr.)	530	354	176	1,060
Difference	Cr. 30	Dr. 6	Dr. 24	----

Hence, the adjusting entry will be :

Journal Entry

<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Q's Capital A/c	Dr.	6

R's Capital A/c	Dr.	24	
To P's Capital A/c			30
(Adjustment in respect of interest on drawing omitted in previous year's accounts)			



Notes

Illustration 12

A, B and C are partners sharing profits and losses in the ratio of 3 : 2 : 1. After the final accounts have been prepared, it was discovered that interest on drawings @5% p.a. had not been taken into consideration. The drawings of the partners were : A - ₹ 75,000; B - ₹ 63,000; C - ₹ 60,000. Give the necessary adjusting journal entry.

Solutions :

Calculation of Interest on Drawings :

Since date of drawings are not given, interest will be charged for 6 months.

A : 5% on ₹ 75,000 for 6 months	=	1875
B : 5% on ₹ 63,000 for 6 months	=	1575
C : 5% on ₹ 60,000 for 6 months	=	1500
Total		<u>4,950</u>

Table Showing Adjustment

	A	B	C	Total
	₹	₹	₹	₹
Interest on Drawings (Dr.)	1,875	1,575	1,500	4,950
Division of Rs. 4,950 in 3:2:1 (Cr.)	2,475	1,650	825	4,950
	Cr. 600	Cr. 75	Dr. 675	-----

Journal Entry

Particulars	Dr. ₹	Cr. ₹
C's Capital A/c	Dr.	675
To A's Capital		600
To B's Capital		75
(Adjustment of omission of interest on drawings)		



Notes

Illustration 13

M and N were partners in a firm sharing profits in 3 : 2 ratio. Their respective fixed capitals were ₹ 2,00,000 and ₹ 3,00,000. The partnership deed provided the following:

- i. Interest on capital @ 10% p.a.
- ii. Interest on drawing @ 12% p.a.

During the year ended 31-3-2014, M’s drawings were ₹. 1,000 per month drawn at the end of every month and N’s drawings were ₹. 2,000 per month drawn in the beginning of the every month. After the preparation of final accounts for the year ended 31-3-2014 it was discovered that interest on M’s drawings was not taken into consideration.

Calculate interest on M’s drawings and give necessary adjusting entry for the same.

Solution :

Calculation of Interest on N’s Drawings :

Total drawings for the year = ₹ 1,000 x 12 = ₹ 12,000

When equal amount is withdrawn at the end of every month, interest is calculated for an average period of months :

$$\text{Interest on Drawings} = 12,000 \times \frac{12}{100} \times \frac{5.5}{12} = ₹ 660$$

Table Showing Adjustment

		<i>M</i>	<i>N</i>	<i>Total</i>
		₹	₹	₹
Interest on Drawings	(Dr.)	660		660
Division of Rs. 660 in 3 : 2	(Cr.)	396	264	660
	Difference	Dr. 264	Cr. 264	----

Adjustment Entry

	<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
	M’s Current A/c Dr.	264	
	To N’s Current A/c		264
	(Adjustment of omission of interest on drawings)		

Illustration : 14

X, Y and Z are partners sharing profits in the ratio of 5 : 4 : 3. Their capitals on 1st April 2013 were ₹ 5,00,000; ₹. 4,00,000 and ₹ 2,00,000 respectively. After closing the accounts on 31st March 2014 it was found out that according to the partnership agreement interest at 10% p.a. on partners' capital's a salary of ₹ 60,000 per year to B and a salary of ₹ 70,000 per year to C was not provided before distribution of profit. It was agreed among the partners to make the adjustment entry at the beginning of the next year rather than to alter the Balance Sheet. Pass the necessary journal entry assuming that capitals are not fixed.

*Notes***Solution :****Table Showing Adjustments**

	X ₹	Y ₹	Z ₹	Total ₹
Interest on Capital @ 10% p.a.	50,000	40,000	20,000	1,10,000
Salaries	---	60,000	70,000	1,30,000
Total Amt. Payable (Cr.)	50,000	1,00,000	90,000	2,40,000
Division of firm's loss of ₹ 2,40,000 in 5 : 4 : 3 (Dr.)	1,00,000	80,000	60,000	2,40,000
	(Dr.) 50,000	(Cr.) 20,000	(Cr.) 30,000	-----

Journal Entry

Date	Particulars	Dr. ₹	Cr. ₹
Mar. 31	X's Capital A/c	50,000	
	To Y's Capital A/c		20,000
	To Z's Capital A/c		30,000
	(The adjustment for the omission of interest on capital and salary)		

Illustration 15

Ram and Rahim were partners in a firm sharing profits in the ratio of 7 : 5. Their respective fixed capitals were Ram ₹ 10,00,000 and Rahim ₹ 7,00,000. The partnership deed provided for the following :

- i. Interest on Capital @ 12% p.a.
- ii. Ram's Salary ₹ 72,000 per year and Rahim's salary ₹ 5,000 per month.



Notes

The profit for the year ended 31-3-2014 was ₹ 5,04,000 which was distributed equally, without providing for the above. Pass the adjustment entry.

Solution :

Statement of Adjustments

		<i>Ram</i> ₹	<i>Rahim</i> ₹	<i>Total</i> ₹
Interest on Capital	(Cr.)	1,20,000	84,000	2,04,000
Salary	(Cr.)	72,000	60,000	1,32,000
Profit remaining after allowing interest on capital and salary will be ₹ 5,04,000 - ₹ 2,04,000 - ₹ 1,32,000 = ₹ 1,68,000. It will be divided in their profit sharing ratio, <i>i.e.</i> , 7 : 5		98,000	70,000	1,68,000
Net amount which should have been received	(Cr.)	2,90,000	2,14,000	5,04,000
<i>Less:</i> Profit already distributed equally	(Dr.)	2,52,000	2,52,000	5,04,000
Net Effect		(Cr.) 38,000	(Dr.) 38,000	

Adjustment Entry

<i>Date</i>	<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
2014	Rahim's Current A/c	38,000	
Apr. 1	Dr. To Ram's Current A/c		38,000
	(Adjustment for interest on capital, salary and wrongly distribution of profit)		

Illustration 16 (Cancellation of excessive interest)

P, Q and R are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capital were ₹ 5,00,000; ₹ 10,00,000 and ₹ 20,00,000 respectively. For the year 2013 interest on capital was credited to them @ 12% instead of 10%. Pass the necessary adjustment entry.

Solution :

Table Showing Adjustment

		<i>P</i>	<i>Q</i>	<i>R</i>	<i>Total</i>
Excess interest	(Dr.)	10,000	20,000	40,000	70,000
Division in 2:3:5 ratio	(Cr.)	14,000	21,000	35,000	70,000
Net Effect		(Cr.) 4,000	(Cr.) 1,000	(Dr.) 5,000	----

Adjustment Entry

Date			₹	₹
Jan. 1	R's Current A/c	Dr.	5,000	
	To P's Current A/c			4,000
	To Q's Current A/c			1,000
	(Interest excessive charged, now rectified)			



Notes

Illustration 17 (Rectification of Interest on Capital charged less)

Amar, Akbar and Anthony are partners in a firm sharing profits and losses in the ratio of 2 : 1 : 2. Their fixed capitals were ₹ 30,00,000; ₹ 10,00,000 and ₹ 20,00,000 respectively. Interest on capital for the year 2013 was credited to them @ 9% p.a. instead of 10% p.a. The profit for the year before charging interest was ₹ 25,00,000. Prepare necessary adjustment entry.

Solution :

Table Showing Adjustment

		Amar ₹	Akbar ₹	Anthony ₹	Total ₹
Less interest credited	(Cr.)	30,000	10,000	20,000	60,000
Division in 2:1:2 ratio	(Dr.)	24,000	12,000	24,000	60,000
	Net Effect	(Cr.) 6,000	(Dr.) 2,000	(Dr.) 4,000	

Adjustment

2014			₹	₹
Jan. 1	Akbar's Current A/c	Dr.	2,000	
	Anthony's Current A/c	Dr.	4,000	
	To Amar's Current A/c			6,000
	(Interest less charged on capital, now rectified)			

Illustration 18

A, B and C are partners in a firm on 1st April 2013 their capital accounts stood at ₹ 3,00,000 ₹ 1,50,000 and ₹ 1,50,000 respectively.

As per the provisions of the deed :

- C was to be allowed a remuneration of ₹ 30,000 p.a.



Notes

- ii. Interest at 5% p.a. was to be provided on capital.
- iii. Profits were to be divided in the ratio of 2 : 2 : 1.

Ignoring the above terms, net profit of ₹ 1,80,000 for the year ended 31st March 2014 was divided among the three partners equally.

Pass an adjustment entry to rectify the error. Show the workings clearly.

Solution :

Statement of Adjustment

	A ₹	B ₹	C ₹	Total ₹
Remuneration to C (Cr.)			30,000	30,000
Interest on Capital (Cr.)	15,000	7,500	7,500	30,000
Profit remaining after allowing remuneration and interest on capital will be ₹ 1,80,000 - ₹ 30,000 - ₹ 30,000 = ₹ 1,20,000. It will be divided in their profit sharing ratio, i.e., 2 : 2 : 1.				
	48,000	48,000	24,000	1,20,000
Net amount which should have been received (Cr.)	63,000	55,500	61,500	1,80,000
Less : Profit already distributed equally (Dr.)	60,000	60,000	60,000	1,80,000
Net effect	(Cr.) 3,000	(Dr.) 4,500	(Cr.) 1,500	-----

Adjustment Entry

	Dr. ₹	Cr. ₹
<i>Particulars</i>		
B's Capital A/c Dr.	4,500	
To A/s Capital A/c		3,000
To C's Capital A/c		1,500
(Adjustment for remuneration, interest on capital and wrong distribution of profit)		

Illustration 19

X, Y and Z have been sharing profits in the ratio of 2 : 2 : 1 respectively. Z wants that he should be given equal share in profits with X and Y and he further wants that the change in the profits sharing ratio should come into effect retrospectively for the last three years. X and Y have no objection to this. The profit for last three years were, ₹ 60,000; ₹ 40,000 and ₹ 50,000.

Show the adjustment of profit for the last three years by means of a Journal entry.

Solution :**Table Showing Adjustments**

		X ₹	Y ₹	Z ₹
Total Profits for the three years ₹60,000 + ₹40,000 + ₹50,000 = ₹1,50,000				
This Profit has already been divided in the ratio of 2 : 2 : 1	Dr.	60,000	60,000	30,000
If Profits are shared equally : $\frac{1,50,000}{3} = 50,000$	Cr.	50,000	50,000	50,000
Net Effect		Dr. 10,000	Dr. 10,000	Cr. 20,000

*Notes*

It is clear from the above table that X and Y, both have received ₹ 60,000 each, whereas each one of them should have received only ₹ 50,000 each. Therefore, X and Y will surrender ₹ 10,000 each in favour of Z.

Following adjustment entry will be passed for this purpose :

X's Capital A/c	Dr.	10,000	
Y's Capital A/c	Dr.	10,000	
To Z's Capital A/c			20,000

(Excess amount paid to X and Y now corrected)

Illustration : 20

Ram, Mohan & Sohan are partners in a firm. They have omitted interest on capital @ 10% p.a. for three years ended 31st March 2014. Their fixed capitals on which interest was to be calculated throughout were :

Ram : ₹ 10,00,000; Mohan : ₹ 8,00,000; Sohan : ₹ 7,00,000

Give the necessary adjusting journal entry with working.

Solution :

Calculation of Interest for 3 years :

	₹	
A : 10% on ₹ 10,00,000 for 3 years	=	3,00,000

MODULE - 4

Partnership Account



Notes

Partnership : An Introduction

B : 10% on ₹. 8,00,000 for 3 years	=	2,40,000
C : 10% on ₹ 7,00,000 for 3 years	=	2,10,000
Total		7,50,000

Table Showing Adjustment

	Ram ₹	Mohan ₹	Sohan ₹	Total ₹
Interest on Capital (Cr.)	3,00,000	2,40,000	2,10,000	7,50,000
Division of Rs. 7,50,000 in profit sharing ratio <i>i.e.</i> equally (Dr.)	2,50,000	2,50,000	2,50,000	7,50,000
Difference	Cr. 50,000	Dr. 10,000	Dr. 40,000	-----

Journal Entry

Date	Particulars	Dr. ₹	Cr. ₹
2014			
Apr. 1	Mohan's Current A/c Dr. Sohan's Current A/c Dr. To Ram's Current A/c (Omission of interest on capital for three years rectified)	10,000 40,000	50,000

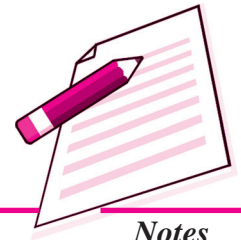
Note : Since the capitals are fixed, Current Account will be debited or credited.



WHAT YOU HAVE LEARNT

- Characteristics of partnership are : (i) Agreement; (ii) Number of persons; (iii) Business; (iv) Sharing of Profits; (v) Unlimited liability; (vi) Management; (vii) Mutual Agency; (viii) Transferability of share
- **Partnership Deed :** The written form of the agreement. It is a document in which the terms and conditions regarding the conduct of the business and the relationship between the partners are laid down. If there is no partnership deed or it is silent on certain issues, the Partnership Act becomes applicable. These issues are : (i) Distribution of Profit; (ii) Interest on capital; (iii) Interest on drawings; (iv) Interest on partner's loan; (v) Salary and commission to partners
- **Capital Account :** The contribution made by the partner's in a business is called capital. This capital may be fixed or fluctuating.

- (a) Fixed Capital Account- Two separate accounts are kept for each partner i.e. 'capital account' and 'current account'.
- (b) Fluctuating Capital Account – Only one account for each partner is kept i.e. capital account,
- **Profit and Loss Appropriation Account :** All adjustments such as partner's salary, partner's commission, interest on capital, interest on drawings etc. are made through this account.
- **Guarantee of Profit :** In this case a minimum amount of profit is guaranteed to a partner. This amount shall be given to him if his share of profit is lower than the guaranteed amount. The deficit shall be borne either by one of the old partners or by all the old partners in a particular agreed ratio. If nothing has been agreed, then in their old profit sharing ratio of the remaining partners. If his actual share of profit is more than the guaranteed amount, then, he will be given his actual share of profit.
- **Past Adjustments :** If after closing the accounts for the year it is discovered that some errors have been committed or some omissions have been made then these errors have to be rectified. An adjustment entry has to be passed to rectify the error. The entries are made without disturbing the signed balance sheet only through the capital account. These entries are to rectify the errors committed in past, therefore they are known as 'Past Adjustments'.



Notes



TERMINAL EXERCISE

1. Explain the characteristics of a partnership.
2. In the absence of any partnership deed, what are the provisions that become applicable?
3. Distinguish between fixed and fluctuating capital accounts.
4. Why the Profit and Loss Appropriation Account is prepared?
5. A and B are partners in a firm. On January 1, 2013 their capital is ₹ 3,00,000 and ₹ 2,00,000 respectively. Their drawings during the year were ₹ 3,000 per month each. They allowed 6% interest on capital. The profit for the year ₹ 4,00,000. Calculate interest on capital for the year 2013 when capitals are fixed.



Notes

7. X and Y are equal partners. They withdrew ₹ 4,000 each per month. Calculate interest 4% p.a. on drawing in the following cases:
- (i) if they withdrew in the beginning of each month:
 - (ii) if they withdrew at the end of each month:
 - (iii) if they withdrew in the middle of each month:

8. Naman and Asmeta started business with capital of ₹ 1,00,000 each on January 1, 2013. their drawings during the year were ₹ 1,000 and ₹ 500 per month respectively. The interest on drawing was ₹ 200 and ₹ 100 respectively. They are allowed interest on capital at 8% p.a. Naman is allowed a salary of ₹ 2,000 per month. They earned a profit of ₹ 94,000 before interest and salary. They share profit in the ratio of 2:1.

Prepare Profit and Loss Appropriation Account for the year ended March 31, 2013 and Capital accounts of partners.

9. Rohan and Bhanu were partners in a firm and their balances on March 1, 2013 are as under:

	<i>Rohan</i>	<i>Bhanu</i>
	(₹)	(₹)
Capital accounts	90,000	1,20,000
Current account	8,000 (Cr)	4,000 (Dr.)
Drawings	5,000	6,000

Net profit for the year 2013 before charging interest on capital and partners salary was ₹ 25,600. They agree on the following:

- (i) Profit and losses to be shared equally.
- (ii) 6% interest is to be allowed on capital.
- (iii) Bhanu will be paid a monthly salary ₹ 9,000.

Prepare Profit and Loss Appropriation Account for the year ended on March 31, 2013 and partners capital accounts.

10. The partnership agreement of M and R provides that:
- (i) Profit will be shared in the ratio of 3 : 2.

- (ii) M will be allowed a salary of ₹ 500 p.m.
- (iii) 8% interest will be allowed on partner's fixed capital accounts.
- (iv) 6% interest to be charged on partners drawings.
- (v) The fixed capital of M and R is ₹ 2,00,000 and ₹ 1,50,000 respectively. Their drawings were ₹ 10,000 and ₹ 12,000 respectively. The net profit for the year ending December 2013 amounted to ₹ 62,000.

Prepare Profit and Loss Appropriation Account.

11. What do you mean by guarantee of profits? Explain in brief.
12. Explain Past Adjustments.



Notes



ANSWERS TO INTEXT QUESTIONS

- 22.1** I. (i) Two (ii) agreement (iii) written, oral
(iv) partnership deed (v) unlimited
- II. (i) No (ii) Yes (iii) No (iv) No (v) No
- 22.2** (i) Credit (ii) Fluctuating (iii) fixed (iv) Credit (v) Debit
- 22.3** I. (i) credited (ii) Debited (iii) Opening balance (iv) 6½ months
- II. Interest on capital Reema ₹ 6250 and Anish ₹ 8,000
- III. Interest on Drawings ₹ 1100
- 22.4** (i) Partner's salary, partner's commission, interest on capital, interest on partner's loan.
- (ii) Profit and Loss Appropriation A/c Dr.
To Profit and Loss A/c
- (iii) Interest on Drawings A/c Dr.
To Profit and Loss Appropriation A/c



ANSWERS TO TERMINAL EXERCISE

5. Interest on Capital to 'A' ₹ 18,000 and 'B' ₹ 12,000.
6. (i) ₹ 1,040, (ii) ₹ 880, (iii) ₹ .960.

MODULE - 4

Partnership Account



Notes

Partnership : An Introduction

7. Profit distributed to Naman ₹ 36,200 and Asmeta ₹ 18,100
Balance in Capital A/c Naman ₹ 1,56,00 and Asmeta ₹ 1,20,000.
8. Profit distributed to Rohan ₹ 1,100 and Bhanu ₹ 1,100
Balance in current A/c Rohan ₹ 9,500 and Asmeta ₹ 9,100.
9. Profit distributed to M ₹ 17,592 and R ₹ 11,728



ACTIVITY

Make use of your communication skills to obtain Partnership Deed of five firms. Go through partnership deed of such firms. Identify the provisions which are not common. Also find out the important items that you would like to include in one of the partnership deeds.

	<i>Name of the firm</i>	<i>Items that are exclusive to the firm</i>	<i>Items to be included</i>
1.			
2.			
3.			
4.			
5.			

List of the items you suggest to be included in the partnership deeds

1.
2.
3.
4.
5.

23

ADMISSION OF A PARTNER

*Notes*

Kapil and Krish are running a partnership firm dealing in toys. They are one of the most successful businessmen in the locality. They now decide to start manufacturing toys that are electronically operated to diversify their business. For this they need more capital and also technical expertise. Mohit, their friend is an electronic engineer and has capital also. They have persuaded him to join their firm. In case, he joins the partnership firm, this will be a case of admission of a partner. As a result, he may need to bring in capital and share of goodwill. In this lesson, you will learn about goodwill and other adjustments at the time of admission of a partner. Mohit will bring in capital and share of goodwill. Some changes in the value of some assets and liabilities of the existing firm are needed to bring them at their realistic value, on his admission. There may be other issues involving finance on his admission. All this need accounting treatment. In this lesson you will learn accounting treatment and adjustments to be made on the admission of a partner.

**OBJECTIVES**

After studying this lesson, you will be able to :

- state the meaning of admission of a partner;
- calculate new profit sharing ratio and sacrificing ratio;
- state the meaning and factors affecting goodwill;
- explain the methods of valuation of goodwill;
- describe accounting treatment of goodwill;

**Notes**

- explain the need for revaluation of assets and reassessment of liabilities;
- illustrate the accounting treatment of changes arising from revaluation of assets and reassessment of liabilities;
- describe accounting treatment of undistributed profits and reserves;
- explain the treatment of various adjustments in partners' capitals; and
- prepare Revaluation Account, Partners' Capital Accounts and balance sheet of the reconstituted firm.

23.1 ADMISSION OF A PARTNER

Meaning, New Profit Sharing Ratio and Sacrificing Ratio

Meaning

An existing partnership firm may take up expansion/diversification of the business. In that case it may need managerial help or additional capital. An option before the partnership firm is to admit partner/partners. When a partner is admitted to the existing partnership firm, it is called admission of a partner.

According to the Partnership Act 1932, a person can be admitted into partnership only with the consent of all the existing partners unless otherwise agreed upon.

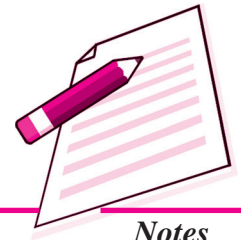
On admission of a new partner, the partnership firm is reconstituted with a new agreement. For example, Rekha and Nitesh are partners sharing profit in the ratio of 5:3. On April 1, 2014 they admitted Nitu as a new partner with 1/4th share in the profit of the firm. In this case, with the admission of Nitu as partner, the firm stands reconstituted.

On the admission of a new partner, the following adjustments become necessary:

- (i) Adjustment in profit sharing ratio;
- (ii) Adjustment of Goodwill;
- (iii) Adjustment for revaluation of assets and reassessment of liabilities;
- (iv) Distribution of accumulated profits and reserves; and
- (v) Adjustment of partners' capitals.

Adjustment in Profit sharing Ratio

When a new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner. The incoming partner acquires his/her share of future profits either from one or more existing partner. The existing partners sacrifice a share of their profit in the favour of new partner, hence the calculation of new profit sharing ratio becomes necessary.

*Notes***Sacrificing Ratio**

At the time of admission of a partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. Some amount is paid to the existing partners for their sacrifice. The amount of compensation is paid by the new partner to the existing partners for acquiring the share of profit which they have surrendered in favour of the new partner.

Sacrificing Ratio is calculated as follows:

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

Following cases may arise for the calculation of new profit sharing ratio and sacrificing ratio:

(i) Only the new partner's share is given

In this case, it is presumed that the existing partners continue to share the remaining profit in the same ratio in which they were sharing before the admission of the new partner. Then, existing partner's new ratio is calculated by dividing remaining share of the profit in their existing ratio. Sacrificing ratio is calculated by deducting new ratio from the existing ratio.

Illustration 1

Deepak and Vivek are partners sharing profit in the ratio of 3 : 2. They admit Ashu as a new partner for 1/5 share in profit. Calculate the new profit sharing ratio and sacrificing ratio.

Solution:**Calculation of new profit sharing ratio:**

Let total Profit = 1



Notes

New partner's share	=	1/5
Remaining share	=	1 - 1/5 = 4/5
Deepak's new share	=	3/5 of 4/5 i.e. 12/25
Vivek's new share	=	2/5 of 4/5 i.e. 8/25
Ashu's Share	=	1/5

The new profit sharing ratio of Deepak, Vivek and Ashu is :

	=	12/25 : 8/25 : 1/5 = 12 : 8 : 5/25 = 12 : 8 : 5
So Deepak Sacrificed	=	3/5 - 12/25 = 15 - 12/25 = 3/25
Vivek Sacrificed	=	2/5 - 8/25 = 10 - 8/25 = 2/25
Sacrificing Ratio	=	3 : 2

Sacrificing ratio of the existing partners is same as their existing ratio.

(ii) The new partner purchases his/her share of the profit from the Existing partner in a particular ratio.

In this case : the new profit sharing ratio of the existing partners is to be ascertained after deducting the sacrifice of share agreed from his share. It means the incoming partner has purchased some share of profit in a particular ratio from the existing partners.

Illustration 2

Neha and Parteek are partners, sharing profit in the ratio of 5 : 3. They admit Nisha as a new partner for 1/6 share in profit. She acquires this share as 1/8 from Neha and 1/24 share from Parteek. Calculate the new profit sharing ratio and sacrificing ratio.

Solution :

Neha's and Parteek's existing ratio is 5 : 3

Neha's new share	=	5/8 - 1/8 = 4/8 or 12/24
Parteek's new share	=	3/8 - 1/24 = 8/24
Nisha's share	=	1/8 + 1/24 = 4/24

The new profit sharing ratio of Neha, Parteek and Nisha is

		12/24 : 8/24 : 4/24
	=	12 : 8 : 4 = 3 : 2 : 1
(ii) Sacrificing ratio	=	1/8 : 1/24 or 3 : 1

(iii) Existing partners surrender a particular portion of their share in favour of a new partner.

In this case, sacrificed share of the each partner is to be ascertained. This is ascertained by multiplying the existing partner's share in the ratio of their sacrifice. The share sacrificed by the existing partners should be deducted from his existing share. Therefore, the new share of the existing partners is determined. The share of the incoming partner is the sum of sacrifice by the existing partners.



Notes

Illustration 3

Him and Raj shared profits in the ratio of 5:3. Jolly was admitted as a partner. Him surrendered $\frac{1}{5}$ of his share and Raj $\frac{1}{3}$ of his share in favour of Jolly. Calculate the new profit sharing ratio.

Solution :

Him surrenders $\frac{1}{5}$ of his share, i.e., = $\frac{1}{5}$ of $\frac{5}{8}$ = $\frac{1}{8}$

Raj surrenders $\frac{1}{3}$ of his share, i.e., = $\frac{1}{3}$ of $\frac{3}{8}$ = $\frac{1}{8}$

So, sacrificing ratio of Him and Raj is $\frac{1}{8} : \frac{1}{8}$ or equal.

Him's new share = $\frac{5}{8} - \frac{1}{8} = \frac{4}{8}$

and Raj's new share = $\frac{3}{8} - \frac{1}{8} = \frac{2}{8}$

Jolly's share = $\frac{1}{8} + \frac{1}{8} = \frac{2}{8}$

New profit sharing ratio of Him, Raj and Jolly is

= $\frac{4}{8} : \frac{2}{8} : \frac{2}{8}$ or 4 : 2 : 2 or 2 : 1 : 1.



INTEXT QUESTIONS 23.1

I. Fill in the blanks with appropriate word/words :

- (i) Sacrificing ratio is calculated by deducting share of profit from share of profit of the existing partners.
- (ii) On admission of a new partner, the partnership firm is
- (iii) The ratio in which partners surrender their profits is known as
- (iv) The new ratio of existing partners is calculated by dividing remaining share of the profit in their

II. If Tarun and Nisha are partners sharing profits in the ratio of 5:3. What will be their sacrificing ratio if Rahul is admitted for $\frac{1}{8}$ share of profit in the firm?



Notes

23.2 GOODWILL : MEANING, FACTORS AFFECTING GOODWILL AND VALUATION

Meaning of Goodwill

Over a period of time, a business firm develops a good name and reputation among the customers. This help the business earn some extra profits as compared to a newly set up business. In accounting, capitalised value of this extra profit is known as goodwill. For example, your firm earns say ₹1200 and the normal rate of profit expected to be earned by other similar firms in this industry is 10% say at this rate normal profit of your firm is ₹ 700 goodwill is ascertained as under :

Step 1 : Excess profit = Actual profit – Desired normal profit

$$1200 - 700 = 500$$

Step 2 : Goodwill = $500 \times \frac{100}{10} = ₹ 5000$

In other words, goodwill is the value of the reputation of a firm in respect of the profit earned in future over and above the normal profit. It may also be defined as the present value of the capacity to earn future profits. This means that a firm can be said to have goodwill only if it has capacity to earn profit in future. A firm earning only normal profits like similar firms cannot claim to have any goodwill.

Factors affecting the Goodwill

The factors affecting goodwill are as follows:

1. **Location :** If the firm is located at a central place, resulting in good sale, the goodwill tends to be high.
2. **Nature of Business :** A firm that produces high value products or having a stable demand is able to earn more profits and therefore has more goodwill.
3. **Efficient management :** A well managed firm earns higher profit and so the value of goodwill will also be high.
4. **Quality :** If a firm is known for the quality of its products the value of goodwill will be high.
5. **Market Situation :** The monopoly condition leads to earn high profits which leads to higher value of goodwill.
6. **Special Advantages :** The firms which have special advantages like importing licenses, long term contracts for supply of material, patents, trademarks, etc. enjoy higher value of goodwill.

Methods of Valuation of Goodwill

The methods of valuation of goodwill are generally decided by the partners among themselves while preparing partnership deed. The following are the important methods of valuing the goodwill of a firm :

- (i) Average Profit Method
- (ii) Super Profit Method
- (iii) Capitalisation Method

Let us learn about these methods.

- 1. Simple Average Profit Method :** Under this method, average of the profits of certain given years is calculated. The value of the goodwill is calculated at an agreed number of years purchase of the average profit. Thus the goodwill is calculated as follows :

Value of goodwill = Average Profit × Number of year of purchase

For example, the average profits of a firm of say 3 years is ₹ 25,000 and the goodwill is to be calculated at 2 years purchase of the average profit. The value of the goodwill will be ₹ 50,000 [₹ 25,000 × 2]. Thus goodwill = average profits × Number of years purchase.

Illustration : 4

The profit for the last five years of a firm were as follows Year 2001 ₹ 1,20,000: Year 2002 ₹ 1,50,000: Year 2003 ₹ 1,70,000: Year 2004 ₹ 1,90,000: Year 2005 ₹ 2,00,000. Calculate goodwill of the firm on the basis of 3 years purchases of 5 years average profits.

Solution :

<i>Year</i>	<i>Profit (₹)</i>
2001	1,20,000
2002	1,50,000
2003	1,70,000
2004	1,90,000
2005	2,00,000
Total	8,30,000



Notes



Notes

$$\begin{aligned} \text{Average Profit} &= \text{Total Profit/No. of Years} \\ &= ₹ 8,30,000/5 = ₹ 1,66,000 \\ \text{Goodwill} &= \text{Average Profits} \times \text{No. of years purchased} \\ &= ₹ 1,66,000 \times 3 = ₹ 4,98,000 \end{aligned}$$

2. Super Profit Method : Super profit is the excess of actual profit over the normal profit. If a new business earns certain percentage of the capital employed, it is called 'normal profit'. The value of the goodwill is calculated at an agreed number of years purchase of super profit by multiplying the Super Profit by the certain number of years. Normal profit is that profit which is, earned by other business unit of the same business. Normal profit will be calculated as follows:

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

Actual Profit : These are the profit earned during the year or it is also taken as the average of the last few years profit.

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

For example, A firm earns profit of ₹ 65,000 on a capital of ₹ 4,80,000 and the normal rate of return in similar business is 10%. Then the normal profit is ₹ 48,000[10% of the ₹ 4,80,000]. The actual profit is ₹ 65,000. Thus,

$$\begin{aligned} \text{Super profit} &= \text{Actual profit} - \text{Normal profit} \\ &= ₹ 65,000 - ₹ 48,000 \\ &= ₹ 17,000 \end{aligned}$$

If value of Goodwill is calculated by 3 years' purchase of super profit then goodwill is equal to ₹ 51,000[₹ 17,000 × 3].

Weighted average method : This method is a modified version of average profit method. In this method each year profit is assigned a weight i.e. 1, 2, 3, 4 etc. Thereafter each year profit is multiplied by the weight and find product. The total of products is divided by the total of weight. As a result we find the weighted average profit. After this the value of goodwill is calculated multiplying the weighted average profit by the agreed number of year's purchase. Thus the goodwill is calculated as follows :

$$\text{Weighted average profit} = \frac{\text{Total product of profit}}{\text{Total of weights}}$$

Value of goodwill = Weighted average profit × number of year of purchase

(Note : This method is used when we observe that there is a tendency to increase the annual profits. Latest year profit is assigned the highest weight.

Illustration : 5

The profit of firm for past years were as follow :

	<i>Profit ₹</i>
2002	80,000
2003	85,000
2004	90,000
2005	1,00,000
2006	1,10,000

The weight to be used are 1, 2, 3, 4, and 5 for the years from 2002 - 2006.

Calculate the value of goodwill on the basis of two year's purchase of weighted average profit.

Solution :

<i>Year</i>	<i>Profit</i>	<i>Weight</i>	<i>Products</i>
2002	80,000	1	80,000
2003	85,000	2	1,70,000
2004	90,000	3	2,70,000
2005	1,00,000	4	4,00,000
2006	1,10,000	5	5,50,000
		15	14,70,000

$$\text{Weighted Average Profit} = \frac{14,70,000}{15} = ₹ 98,000$$

$$\text{Goodwill} = ₹ 98000 \times 2 = ₹ 1,96,000$$

Illustration : 6

A firm earned the following net profits during the last 4 years

	₹
2003	90,000



Notes



Notes

2004	1,20,000
2005	1,60,000
2006	1,80,000

Capital employed in the firm is ₹10,00,000. The normal rate of profit is 10%. Calculate the value of the goodwill on the basis of 4 year purchase of super profit.

Solution :

$$\begin{aligned} \text{Total profit of 4 years} &= ₹ 90,000 + ₹ 1,20,000 + ₹ 1,60,000 + ₹ 1,80,000 \\ &= ₹ 5,50,000 \end{aligned}$$

$$\begin{aligned} \text{Average annual profit} &= ₹ 5,50,000/4 \\ &= ₹ 1,37,500 \end{aligned}$$

$$\begin{aligned} \text{Normal Profit} &= 10\% \text{ of } ₹ 10,00,000 = ₹ 10,00,000 \times 10/100 \\ &= ₹ 1,00,000 \end{aligned}$$

$$\begin{aligned} \text{Super profit} &= ₹ 1,37,500 - ₹ 1,00,000 \\ &= ₹ 37,500 \end{aligned}$$

$$\text{Value of goodwill at 4 years' purchase} = ₹ 37,500 \times 4 = ₹ 1,50,000$$

3. Capitalisation Method : In this method, goodwill is the amount of capital saved. Normally businessmen invest capital to operate business activities, and earn profit with the efficient utilisation of capital. If the business earns more profit by investing lesser amount of capital as compared to other business, who earned same amount of profit with more amount of capital, the saved amount is assumed to be goodwill.

Under this method, the Goodwill is calculated in two ways:

- i. Capitalisation of Average profit
- ii. Capitalisation of Super profit

i. Capitalisation of Average Profit : In this method, the value of goodwill is assumed to be excess of the capital value of average profit over the actual capital employed.

Following formula is applied for Calculation of capital employed:

$$\text{Capital employed} = \text{Total Assets} - \text{Outsider Liabilities}$$

Following formula is applied for calculation of capitalised value of profit :

$$\text{Capitalised Value of Profit} = \text{Average Profit} \times 100 / \text{Normal Rate of Profit}$$

$$\text{Goodwill} = \text{Capitalised Value of Profits} - \text{Capital Employed}$$

Illustration : 7

A firm earned average profit during the last few years is ₹ 40,000 and the normal rate of return in similar business is 10%. The total assets is ₹ 3,60,000 and outside liabilities is ₹ 50,000. Calculate the value of goodwill with the help of Capitalisation of Average profit method.

Solution :

$$\begin{aligned} \text{Capital employed} &= \text{Total assets} - \text{Outside liabilities} \\ &= ₹ 3,60,000 - ₹ 50,000 \\ &= ₹ 3,10,000 \end{aligned}$$

$$\begin{aligned} \text{Capitalised value of average profit} &= \text{Average Profit} \times 100 / \text{Normal rate of profit} \\ &= ₹ 40,000 \times 100 / 10 \\ &= ₹ 4,00,000 \end{aligned}$$

$$\begin{aligned} \text{Goodwill} &= \text{Capitalised value} - \text{Capital employed} \\ &= ₹ 4,00,000 - ₹ 3,10,000 \\ &= ₹ 90,000 \end{aligned}$$

Illustration : 8

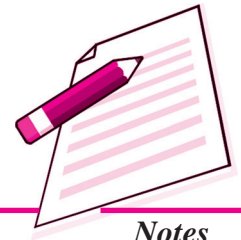
The capital invested in a firm is ₹ 4,60,000 and the rate of return in the similar business is 12%. The firm earns the following profit in the last 4 years:

2003	₹ 60,000	2005	₹ 80,000
2004	₹ 70,000	2006	₹ 90,000

Calculate the value of goodwill by Capitalisation method.

Solution :

$$\begin{aligned} \text{Total Profit} &= ₹ 60,000 + ₹ 70,000 + ₹ 80,000 + ₹ 90,000 / 4 \\ \text{Average Profit} &= ₹ 3,00,000 / 4 \\ &= ₹ 75,000 \end{aligned}$$



Notes



Notes

$$\begin{aligned} \text{Capitalised Value} &= \text{Average profit} \times 100/12 \\ &= ₹ 75,000 \times 100/12 \\ &= ₹ 6,25,000 \end{aligned}$$

$$\begin{aligned} \text{Goodwill} &= \text{Capitalised value} - \text{Capital employed} \\ &= ₹ 6,25,000 - ₹ 4,60,000 \\ &= ₹ 1,65,000 \end{aligned}$$

ii. Capitalisation of Super Profit : In this method, the value of goodwill is calculated on the basis of super profit method. Goodwill is the capitalised value of super profit. Following formula is applied for Calculation of capitalised value *i.e.*, goodwill.

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

Illustration : 9

A firm earns a profit of ₹ 26,000 and has invested capital amounting to ₹ 2,20,000. In the same business normal rate of earning profit is 10%. Calculate the value of goodwill with the help of Capitalisation of super profit method.

Solution :

$$\text{Actual profit} = ₹ 26,000$$

$$\text{Normal profit} = ₹ 2,20,000 \times 10/100 = ₹ 22,000$$

$$\begin{aligned} \text{Super Profit} &= \text{Actual Profit} - \text{Normal Profit} \\ &= ₹ 26,000 - ₹ 22,000 \\ &= ₹ 4,000 \end{aligned}$$

$$\begin{aligned} \text{Goodwill} &= \text{Super profit} \times 100/\text{normal rate of profit} \\ &= ₹ 4,000 \times 100/10 \\ &= ₹ 40,000 \end{aligned}$$



INTEXT QUESTIONS 23.2

I. Fill in the blanks with appropriate word/words :

- (i) Goodwill is an asset.
- (ii) The amount of goodwill is generally brought in by Partner.



Notes

Admission of a Partner

- (iii) Super Profit = Actual Profit –
- (iv) The methods of calculating goodwill are and
- (v) Capital employed = Total assets minus

II. (a) From the following information, Calculate average profit :

<i>Year</i>	<i>Profit (₹)</i>	<i>Loss (₹)</i>
2001	80,000	
2002	90,000	
2003	—	30,000
2004	1,10,000	

Average Profit = ₹

- (b) Calculate value of goodwill at two year’s purchase of average profit, ascertained in II(a) above.

23.3 TREATMENT OF GOODWILL

The new partner acquires his/her share of profit from the existing partners. This will result in the reduction of the share of existing partners. Therefore, he/she compensates the existing partners for the sacrifices. He/she compensates them by making payment in cash or in kind. The payment is equal to his/her share in the goodwill.

As per Accounting Standard 10(AS-10) that goodwill should be recorded in the books only when some consideration in money has been paid for it. Thus, if a new partner does not bring necessary cash for goodwill, no goodwill account can be raised in the books. He/she should pay for goodwill in addition to his/her contribution for capital.

If, he/she does not pay for goodwill, then amount equal to his/her share of goodwill will be deducted from the capital. The amount brought in by him/her as goodwill or amount of goodwill deducted from his/her capital is divided between the existing partners in their sacrificing ratio. At the time of admission of a new partner any goodwill appearing in the books, will be written off in existing ratio among the existing partners.

There are different situations relating to treatment of goodwill at the time of admission of a new partner. These are discussed as under:



Notes

1. When the amount of goodwill is paid privately by the new partner.
2. When the new partner brings his/her share of goodwill in cash.
3. When the new partner does not bring his/her share of goodwill in cash.

1. The amount of goodwill is paid privately by the new partner : If the amount of goodwill is paid by the new partner to the existing partner privately, no journal entries are made in the books of the firm.

2. The new partner brings his/her share of goodwill in cash and the amount of goodwill is retained in the Business : When, the new partner brings his/her share of goodwill in cash. The amount brought in by the new partner is transferred to the existing partners in the sacrificing ratio. If there is any goodwill account in the balance sheet of existing partners, it will be written off immediately in existing ratio among the partners. The journal entries are as follows:

(i) The existing goodwill in the books of the firm will be written off in existing profit ratio as;

Existing Partners Capital A/c	Dr. [individually]
To Goodwill A/c	
(Existing goodwill written off)	

(ii) For bringing cash for Capital and goodwill

Cash/Bank A/c	Dr.
To Goodwill Premium A/c	
To New partner's Capital A/c	
(Cash brought in for capital and goodwill)	

(iii) For amount of goodwill transferred to existing partner capital account:

Goodwill A/c	Dr.
To Existing Partner's Capital/current A/c	[individually]
(The amount of goodwill credited to existing partner's capitals in sacrificing ratio)	

Illustration : 10

Tanaya and Sumit are partners in a firm sharing profit in the ratio 5 : 3. They admitted Gauri as a new partner for 1/4th share in the profit. Gauri brings ₹ 30,000 for her share of goodwill and ₹ 1,20,000 for capital. Make journal entries in the books of the firm after the admission of Gauri. The new profit sharing ratio will be 2 : 1 : 1.

Solution :

Books of Tanaya, Sumit and Gauri

Date	Particulars	LF	Debit Amount (₹)	Credit Amount (₹)
1.	Bank A/c Dr. To Goodwill Premium A/c To Gauri's Capital A/c (cash brought by Gauri for her share of goodwill and capital)		1,50,000	30,000 1,20,000
	Goodwill Premium A/c Dr. To Tanaya's Capital A/c To Sumit's Capital A/c (Goodwill transferred to existing partners capital account in their sacrificing ratio)		30,000	15,000 15,000



Notes

Working Note:

Calculation of sacrificing ratio [existing ratio – new ratio]

Partners	Existing Ratio	New Ratio	Sacrifice	Sacrificing Ratio
Tanaya	5/8	2/4	$5/8 - 2/4 = 1/8$	Tanaya : Sumit
Sumit	3/8	1/4	$3/8 - 1/4 = 1/8$	1 : 1

The amount of goodwill is withdrawn by the existing partners:

- (iv) Existing Partners Capital/current A/c Dr. [individually]
 To Cash/Bank A/c
(The amount of goodwill withdrawn by the existing partners)

It is to be noted that sometimes partner's withdraw only 50% or 25% amount of goodwill. In such a case, entry will be made for the withdrawn amount only.

Illustration : 11

In previous illustration, it is assumed that the full amount of goodwill is withdrawn by Tanaya and Sumit . Make journal entry in the books of the firm.



Notes

Solution :

Books of Tanaya, Sumit and Gauri

<i>Date</i>	<i>Particulars</i>	<i>LF</i>	<i>Debit amount</i> ₹	<i>Credit amount</i> ₹
	Tanaya's Capital A/c Dr.		15,000	
	Sumit's Capital A/c Dr.		15,000	
	To Bank A/c			30,000
	(Amount of Goodwill is withdrawn by them)			

3. New partner does not bring his/her share of goodwill in cash : When the goodwill of the firm is calculated and the new partner is not able to bring his/her share of goodwill in cash, goodwill will be adjusted through new partner's capital accounts. In this case new partner's capital account is debited for his/her share of goodwill and the existing partner's capital accounts are credited in their sacrificing ratio. The journal entry is as under:

New Partner's Capital A/c Dr.
 To Existing Partner's Capital A/c [individually in sacrificing ratio]
 (New partner's share in goodwill credited to existing partner's in sacrificing ratio)

Goodwill appears in the books of the firm and new partner does not bring his/her share of goodwill in cash

If the goodwill account appears in the books of the firm, and the new partner is not able to bring goodwill in cash. In this case, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their existing profit sharing ratio.

Illustration 12

Ashmita and Sahil are partners sharing profit in the ratio of 3 : 2. They agree to admit Charu for 1/5 share in future profit. Charu brings ₹ 2,50,000 as capital and unable to bring her share of goodwill in cash, the goodwill of the firm to be valued at ₹ 1,80,000. At the time of admission goodwill existed in the books of the firm at ₹ 80,000. Make necessary journal entries in the books of the firm.

Solution :

Books of Ashmita, Sahil and Charu

Date	Particulars	LF	Debit amount ₹	Credit amount ₹
	Bank A/c Dr. To Charu's Capital A/c [Cash brought by Charu for her capital]		2,50,000	2,50,000
	Ashmita's Capital A/c Dr. Sahil's Capital A/c Dr. To Goodwill A/c [Goodwill written off before Charu's admission]		48,000 32,000	80,000
	Charu's Capital A/c Dr. To Ashmita's Capital A/c To Sahil's Capital A/c [Existing partners capital a/c credited for goodwill on Charu's admission in sacrificing ratio]		36,000	21,600 14,400



Notes

Working Note :

Ashmita and Sahil sacrifice their profit in favour of Charu in their existing profit sharing ratio i.e. 3 : 2. Therefore, the sacrificing ratio is 3 : 2.

Value of Goodwill = ₹ 1,80,000

Charu's share in Profit = 1/5

Charu's share of Goodwill = ₹ 1,80,000 × 1/5 = ₹ 36,000

New partner brings in only a part of his share of goodwill

When new partner is not able to bring the full amount of his/her share of goodwill in cash and brings only a part of cash. In this case, the amount of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him. The journal entries is as

MODULE - 4

Partnership Account



Notes

Admission of a Partner

Bank A/c	Dr.
To Goodwill Premium A/c	
[Part Amount of goodwill brought by new partner]	
Goodwill Premium A/c	Dr.
New Partner's Capital A/c	Dr.
To Existing Partner's Capital A/c	[individually in sacrificing ratio]
[Credit given to sacrificing partner by new partner's in full share of goodwill]	

Illustration 13

Tanu and Puneet are partners sharing profit in the ratio of 5 : 3. They admit Tarun into the firm for $\frac{1}{6}$ share in profit which he takes $\frac{1}{18}$ from Tanu and $\frac{2}{18}$ from Puneet. Tarun brings ₹ 9,000 as goodwill out of his share of ₹ 12,000. No goodwill account appears in the books of the firm. Make necessary journal entries in the books of the firm.

Solution :

Journal

Date	Particulars	LF	Debit Amount ₹	Credit Amount ₹
	Bank A/c Dr. To Goodwill Premium A/c [A part of his share of goodwill brought in by Tarun]		9,000	9,000
	Goodwill Premium A/c Dr. Tarun Capital A/c Dr. To Tanu's Capital A/c To Puneet's Capital A/c [Goodwill credited to Tanu and Puneet in their sacrificing ratio i.e 1 : 2]		9,000 3,000	4,000 8,000



INTEXT QUESTIONS 23.3

I. Fill in the blanks with appropriate word/words

- (a) When Goodwill is paid privately, will be made.

- (b) If the new partner brings amount of goodwill, the amount of goodwill brought by him is to goodwill account.
- (c) The amount brought in by the new partner is transferred to the existing partner in the ratio
- (d) Goodwill appearing in the books of the firm is at the time of admission of a new partner
- (e) If the new partner is not able to bring his share of goodwill, The new partner's capital account is for his share of goodwill



Notes

II. Match the appropriate entry of Column B with that of Column A. by writing the correct numbers of the column B in the space provided.

Column A

Column B

- | | |
|--|---|
| 1. Goodwill is paid privately | i. Existing Partners Capital A/c
To Goodwill A/c |
| 2. New partner is not able to bring cash for Goodwill. | ii. Goodwill Premium A/c Dr.
To Existing partner's Capital A/c |
| 3. At the time of admission the goodwill appearing in the books is written off. | iii. New Partner's Capital A/c Dr.
To Existing Partner's Capital A/c
To Existing Partner's Capital A/c |
| 4. At the time of admission the amount of goodwill brought by the new partner is transferred to sacrificing partners' capital A/c. | iv. No Entry |

ACCOUNTING TREATMENT OF RESERVES AND ACCUMULATED PROFITS/LOSSES

When There is Change in Profit Sharing Ratio of Existing Partner's

Case (i) When Reserves and Accumulated Profits/Losses are to be transferred to Capital Accounts :

If, at the time of change in the profit sharing ratio, there are Reserves or Accumulated profits/losses existing in the books of the firm, these should be transferred to the Partner's Capital Accounts (if capitals are fluctuating) or to partners Current Account



Notes

(if capitals are fixed) in their old profit sharing ratio. The reason for such transfer is that these reserves and accumulated profits/losses have come into existence before the change in profit sharing ratio and hence belong to the partners in their old profit sharing ratio. Following entries are passed for this purpose :

i. For Transfer of Reserves and Accumulated Profits :

Reserve A/c	Dr.	
Profit & Loss A/c	Dr.	
Workmen’s Compensation Reserve A/c	Dr.	(Excess of Reserve over Actual Liability)
Investment Fluctuation Reserve A/c	Dr.	(Excess of Reserve Over difference between Book value and Market value)
To Old Partner’s Capital or Current A/cs	Dr.	(in Old Profit Sharing Ratio)
(Being the undivided Profit/Reserves transferred to Partners Capital Current A/c)		

ii. For Transfer of Accumulated Losses :

Old Partner’s Capital or Current A/cs.	Dr.	(in Old Profit Sharing Ratio)
To Profit & Loss A/c		
To Deferred Revenue Expenditure A/c		(for example Advertisement Suspense A/c)
(Being the Losses/..... on assets transferred to partner capitals/.....)		

Illustration 14

Sita and Geeta are partners sharing profits and losses in the ratio of 2 : 1. From April 1, 2013, they decided to share the profits in the ratio of 3 : 2. On that date, profit and loss account showed a debit balance of ₹ 6,00,000. Record the necessary journal entry for the distribution of the balance in the Profit and Loss Account.

Solution :

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2013				
Apr. 1	Sita's Capital A/c (2/3) Dr.		4,00,000	
	Geeta's Capital A/c (1/3) Dr.		2,00,000	
	To Profit and Loss A/c			6,00,000
	(Transfer of undistributed loss on change in profit sharing ratio)			



Notes

Illustration 15

A, B and C are partners sharing profits in the ratio of 4 : 3 : 2. From April 1, 2014 they decided to share the profits equally. On that date their books showed a credit balance of ₹ 36,00,000 in the Profit and Loss Account and a balance of ₹ 9,00,000 in the General Reserve. Record the necessary journal entry for the distribution of profits and the general reserve.

Solution :

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2014				
April 1	Profit & Loss A/c Dr.		36,00,000	
	General Reserve A/c Dr.		9,00,000	
	To A's Capital A/c (4/9)			20,00,000
	To B's Capital A/c (3/9)			15,00,000
	To C's Capital A/c (2/9)			10,00,000
	(Transfer of undistributed profit and general reserve on change in profit sharing ratio)			

Illustration 16

X, Y and Z sharing profits and losses in the ratio of 3 : 2 : 1, decide to share future profits and losses in the ratio of 4 : 3 : 2 with effect from 1st April, 2014. Following an extract of their Balance Sheet as at 31st March, 2014 :

MODULE - 4

Partnership Account



Notes

Admission of a Partner

Liabilities	₹	Assets	₹
Workmen Compensation Reserve	3,00,000		

Show the accounting treatment under the following alternative case :

Case (i) If there is no other information.

Case (ii) If a claim on account of workmen's compensation is estimated at ₹ 1,20,000

Solution :

Journal

Date	Particulars	L.F	Dr. (₹)	Cr. (₹)
2014				
April 1	<i>Case (i)</i>			
	Workmen Compensation Reserve A/c	Dr.	3,00,000	
	To X's Capital A/c			1,50,000
	To Y's Capital A/c			1,00,000
	To Z's Capital A/c			50,000
	(Transfer of Workmen Compensation Reserve to partner's capital accounts in their old profit sharing ratio)			
	<i>Case (ii)</i>			
	Workmen Compensation Reserve A/c	Dr.	3,00,000	
	To Provision for Workmen Compensation Claim A/c			1,20,000
	To X's Capital A/c			90,000
	To Y's Capital A/c			60,000
	To Z's Capital A/c			30,000
	(Transfer of excess Compensation Reserve to partner's capital accounts in their old profit sharing ratio)			

Case (ii) When Reserves and Accumulated Profit/Loss are not to be transferred to Capital Accounts or to be continued in future Balance Sheet :

If, in case of change in profit sharing ratio, there are reserves and accumulated profits appearing in the old Balance Sheet and the partners decide to leave the reserves and accumulated profits undistributed, it will be necessary to pass an adjusting entry for the same. This is, because, at present the partners are entitled to share such reserves and profits in the old profit sharing ratio whereas in future they will be entitled to share such reserves and profits in the new profit sharing ratio. Hence, the gaining partner must compensate the sacrificing partner that share of reserves and profits which is proportionate to the share gained by him/her. For example, suppose P and Q sharing profits in the ratio of 2 : 1 decide to share future profits in equal proportion. Reserves appearing in the Balance Sheet amount to ₹ 6,00,000 and the partners do not want to distribute them. In such a case a present P is entitled to ₹ 4,00,000 and Q ₹ 2,00,000 of such reserves but in future, after the change in the profit sharing ratio, each would be entitled to ₹ 3,00,000. Hence, Q must compensate P to the extent of ₹ 1,00,000. This amount is proportionate to the $\frac{1}{2}$ th share (*i.e.* $\frac{1}{2} - \frac{1}{3}$) gained by him.

The adjustment for this amount is usually made by passing the following adjustment entry :

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr. (₹)</i>	<i>Cr. (₹)</i>
	Q's Capital A/c	Dr.	1,00,000	
	To P's Capital A/c			1,00,00
	(Being adjustment made in the capital A/cs of the partner for Reserves)			

Illustration 17

M and N are partners in a firm sharing profits in the ratio of 4 : 3. On March 31, 2014 their Balance Sheet showed a General Reserve of ₹ 7,00,000. On that date they decided to change their profit sharing ratio which will be 5 : 3. Record necessary journal entries in the books of the firm under the following circumstances :

- When they decided to transfer the general reserve to their capital accounts.



Notes

Illustration 18

X and Y were partners in a firm sharing profits in the ratio of 3 : 1. With effect from 1st January 2014 they agreed to share profits in the ratio of 2 : 1. For this purpose the goodwill of the firm was valued at ₹ 5,00,000. General reserves appear in the books at ₹ 4,00,000. Partners neither want to show goodwill in the books nor want to distribute the reserves. You are required to record the change by passing a single journal entry.

*Notes***Solution :**

	₹	
Value of goodwill	5,00,000	
General Reserve	4,00,000	
	9,00,000	
Old Ratio of X and Y	3 : 1	
New Ratio of X and Y	2 : 1	
Sacrifice or Gain :		

$$X = \frac{3}{4} - \frac{2}{3} = \frac{9-8}{12} = \frac{1}{12} \text{ (Sacrifice)}$$

$$Y = \frac{1}{4} - \frac{1}{3} = \frac{3-4}{12} = \frac{1}{12} \text{ (Gain)}$$

X will be compensated by Y to the extent of $\frac{1}{12}$ of ₹ 9,00,000 = ₹ 75,000

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014 Jan. 1	Y's Capital A/c To X's Capital A/c (Adjustment for goodwill and reserves on change in profit sharing ratio)	Dr. 75,000	 75,000

Illustration 19

P, Q and R are partner sharing profits and losses in the ratio of 2 : 3 : 4. They decided to share future profits and losses in the ratio of 4 : 3 : 2. They also decided to record the effect of the following without affecting their book values:

MODULE - 4

Partnership Account



Notes

Admission of a Partner

	₹
General Reserve	4,00,000
Profit & Loss A/c	2,00,000
Advertisement Suspense A/c	1,50,000

You are required to give the necessary single adjustment entry for the same.

Solution :

Calculation of Net Effect of Accumulated Profit/Losses :

	₹
General Reserve	4,00,000
(+) Profit & Loss A/c	2,00,000
(-) Advertisement Suspense A/c	1,50,000
Net Amount	4,50,000

Calculation of Sacrifice or Gain :

$$\text{Old Ratio of P, Q and R} \quad \frac{2}{9} : \frac{3}{9} : \frac{4}{9}$$

$$\text{New Ratio of P, Q and R} \quad \frac{4}{9} : \frac{3}{9} : \frac{2}{9}$$

Sacrifice or Gain :

$$P \quad \frac{2}{9} - \frac{4}{9} = \frac{2}{9} \text{ (Gain)}$$

$$Q \quad \frac{3}{9} - \frac{3}{9} = 0 \text{ (No Profit no loss)}$$

$$R \quad \frac{4}{9} - \frac{2}{9} = \frac{2}{9} \text{ (Sacrifice)}$$

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
	P's Capital A/c (2/9 of 4,50,000) Dr. To R's Capital A/c (2/9 of 4,50,000) (Adjustment for general reserve, profit & loss account balance and advertisement suspense account on change in profit sharing ratio)		1,00,000	1,00,000

Illustration 20

A, B and C sharing profits and losses in the ratio of 1 : 2 : 2, decided to share future profits equally with effect from 1st April, 2013. On that date, Profit & Loss Account showed a credit balance of ₹ 2,40,000. Partners do not want to distribute the profit but prefer to record the change in the profit sharing ratio by passing an adjustment entry. You are required to give the adjusting entry.

Solution :

$$\text{Old Ratio of A, B and C} \quad \frac{1}{5} : \frac{2}{5} : \frac{2}{5}$$

$$\text{New Ratio of A, B and C} \quad \frac{1}{3} : \frac{1}{3} : \frac{1}{3}$$

Sacrifice or Gain :

$$A = \frac{1}{5} - \frac{1}{3} = \frac{3-5}{15} = \text{(Gain)}$$

$$B = \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \text{(Sacrifice)}$$

$$C = \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \text{(Sacrifice)}$$

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
2014				
Apr. 1	A's Capital A/c (2/15 of 2,40,000) Dr.		32,000	
	To B's Capital A/c (1/15 of 2,40,000)			16,000
	To C's Capital A/c (1/15 of 2,40,000)			16,000
	(Adjustment for Profit and Loss Account balance on change in profit sharing ratio)			

23.4 ACCOUNTING TREATMENT OF GOODWILL WHEN THERE IS CHANGE IN THE PROFIT SHARING RATIO OF EXISTING PARTNERS

A change in profit sharing ratio basically implies that one partner is purchasing from another partner, a share of profits previously belonging to the latter. The purchasing



Notes



Notes

or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. In other words, the gaining partner should pay the sacrificing partner that share of goodwill which is equal to the share gained by him. For example,

suppose A and B are sharing profits in the proportion of $\frac{4}{5} : \frac{1}{5}$. If it is decided that

in future they will share profits in the proportion of $\frac{3}{5} : \frac{2}{5}$, it implies that A is selling

$\frac{1}{5}$ th $\left(\frac{4}{5} - \frac{3}{5}\right)$ of his share to B. If the profits of the firm are ₹ 1,00,000 p.a. A will

lose ₹ 20,000 and B will gain ₹ 20,000 annually. This must be compensated by B

by paying to A an amount equal to $\frac{1}{5}$ th of total present value of goodwill of the firm.

If the goodwill is valued at ₹ 5,00,000 B must pay to A $\frac{1}{5}$ th of ₹ 5,00,000 i.e., ₹ 1,00,000.

Such an adjustment is made by passing an adjustment entry wherein B's Capital Account will be debited and A's Capital Account will be Credited by ₹ 1,00,000.

Illustration 21

M and N were partners in a firm sharing profits in the ratio of 3 : 2. With effect from 31st March 2014 they agreed to share profits equally. For this purpose the goodwill of the firm was valued at ₹ 3,00,000. Pass the necessary adjustment entry :

Solution :

Old Ratio of M and N = 3 : 2

New Ratio of M and N = 1 : 1

Sacrifice or Gain :

$$M = \frac{3}{5} - \frac{1}{2} = \frac{6-5}{10} = \frac{1}{10} \text{ (Sacrifice)}$$

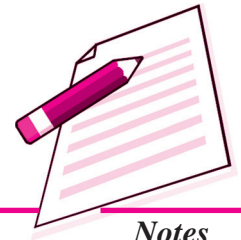
$$N = \frac{2}{5} - \frac{1}{2} = \frac{4-5}{10} = \frac{1}{10} \text{ (Gain)}$$

Since M has sacrificed, he will be credited by $\frac{1}{10}$ of ₹. 3,00,000 i.e. ₹ 30,000

Since N has gained, he will be debited by $\frac{1}{10}$ of ₹ 3,00,000 i.e. ₹ 30,000

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014 Mar.31	N's Capital A/c To M's Capital A/c (Adjustment for goodwill due to change in profit sharing ratio)	Dr. 30,000	30,000

*Notes***Illustration 22**

A, B and C are partners sharing profits equally. They decided that in future C will get $\frac{1}{5}$ th share in profits. On the day of change, firms's goodwill has been valued at ₹ 6,00,000. Make the necessary adjustment entry for the treatment of goodwill.

Solution :

$$\text{Old Ratio of A, B and C} = \frac{1}{3} : \frac{1}{3} : \frac{1}{3}$$

$$\text{New Ratio of A, B and C} = \frac{2}{5} : \frac{2}{5} : \frac{1}{5}$$

Sacrifice or Gain :

$$A = \frac{1}{3} - \frac{2}{5} = \frac{5-6}{15} = \frac{1}{15} \text{ (Gain)}$$

$$B = \frac{1}{3} - \frac{2}{5} = \frac{5-6}{15} = \frac{1}{15} \text{ (Gain)}$$

$$C = \frac{1}{3} - \frac{1}{5} = \frac{5-3}{15} = \frac{2}{15} \text{ (Sacrifice)}$$

Calculation of share of Loss or gain of Goodwill

Total Goodwill ₹ 6,00,000

$$\text{A's Share of loss} = \frac{1}{15} \text{ of ₹ 6,00,000} = ₹ 40,000$$



Notes

$$\text{B's Share of loss} = \frac{1}{15} \text{ of ₹ 6,00,000} = ₹ 40,000$$

$$\text{C's Share of Gain} = \frac{2}{15} \text{ of ₹ 6,00,000} = ₹ 80,000$$

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
	A's Capital A/c (1/15 of 6,00,000) Dr.	40,000	
	B's Capital A/c (1/15 of 6,00,000) Dr.	40,000	
	To C's Capital A/c (2/15 of 6,00,000)		80,000
	(C compensated by A and B for the sacrifice made by him)		

Illustration 23

P, Q and R are partners sharing profits and losses in the ratio of 5 : 4 : 1. It was decided that with effect from 1st January 2014 the profit sharing ratio will be 9 : 6 : 5. Goodwill is to be valued at 2 year's purchase of average of 3 year's profits. The profits for 2011, 2012 and 2013 were ₹ 96,000; ₹ 84,000 and ₹ 1,20,000 respectively.

Pass the necessary journal entry for the treatment of goodwill without opening Goodwill Account.

Solution :

$$\text{Average Profit} = ₹ \frac{96,000 + 84,000 + 1,20,000}{3} = ₹ 1,00,000$$

$$\text{Value of Goodwill at 2 year's purchase} = ₹ 1,00,000 \times 2 = ₹ 2,00,000$$

$$\text{Old Ratio of P, Q and R} = 5 : 4 : 1$$

$$\text{New Ratio of P, Q and R} = 9 : 6 : 5$$

Sacrifice or Gain :

$$\text{P} = \quad \quad \quad (\text{Sacrifice})$$

$$\text{Q} = \frac{4}{10} - \frac{6}{20} = \frac{8-6}{20} = \frac{2}{20} \text{ (Sacrifice)}$$

$$R = \frac{1}{10} - \frac{5}{20} = \frac{2-5}{20} = \frac{3}{20} \text{ (Gain)}$$

Since P has sacrificed, he will be credited by $\frac{1}{20}$ of ₹ 2,00,000 = ₹ 10,000

Since Q has sacrificed, he will be credited by $\frac{2}{20}$ of ₹ 2,00,000 = ₹ 20,000

Since R has gained, he will be debited by $\frac{3}{20}$ of ₹ 2,00,000 = ₹ 30,000



Notes

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014			
Jan. 1	R's Capital A/c To P's Capital A/c To Q's Capital A/c (Treatment for goodwill due to change in profit sharing ratio)	Dr. 30,000	10,000 20,000

Illustration 24

A, B and C are partners sharing profits in the ratio of 3 : 2 : 1. It is now agreed that they will share the future profits equally. Goodwill of the firm is valued at ₹ 3,00,000. The goodwill of the firm does not appear in the books. Pass necessary adjustment entry for the treatment goodwill.

Solution :

$$\text{Old Ratio of A, B and C} = 3 : 2 : 1$$

$$\text{New Ratio of A, B and C} = 1 : 1 : 1$$

Sacrifice or Gain :

$$A = \frac{3}{6} - \frac{1}{3} = \frac{3-2}{6} = \frac{1}{6} \text{ (Sacrifice)}$$

$$B = \frac{2}{6} - \frac{1}{3} = \frac{2-2}{6} = 0$$

$$C = \frac{1}{6} - \frac{1}{3} = \frac{1-2}{6} = \frac{1}{6} \text{ (Gain)}$$



Notes

Since A has sacrificed, he will be credited for $\frac{1}{6}$ of ₹ 3,00,000 = ₹ 50,000

Since C has gained, he will be debited for $\frac{1}{6}$ of ₹ 3,00,000 = ₹ 50,000

Journal

<i>Date</i>	<i>Particulars</i>	<i>Dr. (₹)</i>	<i>Cr. (₹)</i>
2014 Jan. 1	C's Capital A/c To A's Capital A/c (Adjustment for goodwill due to change in profit sharing ratio)	Dr. 50,000	50,000

Illustration 25

Ram and Ramesh were partners sharing profits and losses in the ratio of 3 : 1. They decided that with effect from 1st January 2013, they would share profits and losses in the ratio of 5 : 3. The partnership deed provides that in the event of any change in profit sharing ratio, the goodwill should be valued at the total of two year's profits preceding the date the decision became effective. The profits for 2010, 2011 and 2012 were ₹ 6,00,000; ₹ 7,00,000 and ₹ 9,00,000 respectively. Pass the necessary Journal entry to give effect to the above arrangement.

Solution :

$$\text{Value of goodwill} = ₹ 7,00,000 + ₹ 9,00,000 = ₹ 16,00,000$$

Calculation of Sacrifice or Gain :

$$\text{Old Ratio} = 3 : 1$$

$$\text{New Ratio} = 5 : 3$$

$$\text{Ram} = \frac{3}{4} - \frac{5}{8} = \frac{6-5}{8} = \frac{1}{8} \text{ (Sacrifice)}$$

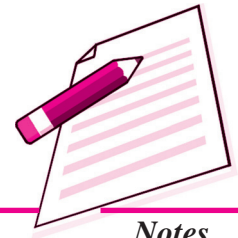
$$\text{Ramesh} = \frac{1}{4} - \frac{3}{8} = \frac{2-3}{8} = \frac{1}{8} \text{ (Gain)}$$

Since Ram has sacrificed, he will be credited by $\frac{1}{8}$ of ₹ 16,00,000 = ₹ 2,00,000

Since Ramesh has gained, he will be debited by $\frac{1}{8}$ of ₹ 16,00,000 = ₹ 2,00,000

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2013 Jan. 1	Ramesh's Capital A/c To Ram's Capital A/c (Adjustment for goodwill due to change in profit sharing ratio)	Dr. 2,00,000	2,00,000



Notes

23.5 REVALUATION OF ASSETS AND LIABILITIES

On admission of a new partner, the firm stands reconstituted and consequently the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner. If the values of the assets are raised, gain will increase the capital of the existing partners. Similarly, any decrease in the value of assets, i.e. loss will decrease the capital of the existing partners. For this purpose a 'Revaluation Account' is prepared. This account is credited with all increases in the value of assets and decrease in the value of liabilities. It is debited with decrease on account of value of assets and increase in the value of liabilities. The balance of this account shows a gain or loss on revaluation which is transferred to the existing partner's capital account in existing profit sharing ratio.

Accounting for Revaluation of Assets and Liabilities when there is a Change in the Profit Sharing Ratio of Existing Partners

Assets and liabilities of a firm must also be revalued at the time of change in profit sharing ratio of existing partners. The reason is that the realisable or actual value of assets and liabilities may be different from those shown in the Balance Sheet. It is possible that with the passage of time some of the assets might have appreciated in value while the value of certain other assets might have decreased and no record has been made of such changes in the books of accounts. Similarly there may be some unrecorded assets & liabilities that may have to be accounted for. Revaluation of assets and reassessments of liabilities becomes necessary because the change in the value of assets and liabilities belongs to the period to change in profit sharing ratio and hence must be shared by the partners in their old profit sharing ratio.

Revaluation of assets and reassessment of liabilities may be given effect to in two different ways :



Notes

- (a) When revised values are to be recorded in the books, and
- (b) When revised values are not to be recorded in the books.

When revised values are to be recorded in the books

In such a case revaluation of assets and reassessment of liabilities is done with the help of a new account called '**Revaluation Account**'. Sometimes this account is also called as '**Profit & Loss Adjustment A/c**'. If there is a loss due to revaluation, revaluation account is debited and if the revaluation results in a profit, the revaluation account is credited.

The following journal entries made for this purpose are:

- (i) For increase in the value of assets:

Asset A/c	Dr. (individually)
To Revaluation A/c	
- (ii) For decrease in the value of Asset

Revaluation A/c	Dr. (individually)
To Asset A/c	
[Decrease in the value of assets]	
- (iii) For increase in the value of Liabilities:

Revaluation A/c	Dr. (individually)
To Liabilities A/c	
[Increase in the value of Liabilities]	
- (iv) For decrease in the value of Liabilities:

Liabilities A/c	Dr.
To Revaluation A/c	
[Decrease in the value of Liabilities]	
- (v) For unrecorded Assets

Asset A/c [unrecorded]	Dr.
To Revaluation A/c	
[Unrecorded asset recorded at actual value]	
- (vi) For unrecorded Liability :

Revaluation A/c	Dr.
To Liability A/c [unrecorded]	
[Unrecorded Liability recorded at actual value]	

(vii) For transfer of gain on revaluation:

Revaluation A/c Dr.
 To Existing Partner's Capital/Current A/c
 [Profit on revaluation transferred to capital account in existing ratio]

(viii) For transfer of loss on revaluation:

Existing Partner's Capital/Current A/c Dr.
 To Revaluation A/c
 [Loss on revaluation transferred to capital account in existing ratio]

(a) When revaluation account shows gain :

Revaluation A/c Dr.
 To Partner's Capital A/c (Old Profit Sharing Ratio)
 (Profit on revaluation credited to Partner's Capital A/c)

(b) Above entry is reversed when revaluation account shows loss :

Partners Capital A/cs (Old Profit Sharing Ratio) Dr.
 To Revaluation A/c
 (Loss on revaluation debited to Partner's Capital A/cs)



Notes

Proforma of Revaluation Account is given as under:

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>₹</i>	<i>Particulars</i>	<i>₹</i>
To Decrease in value of assets	.....	By Increase in value of assets	.....
To Increase in value of liabilities	.....	By Decrease in value of liabilities	.....
To Unrecorded liabilities	.....	By Unrecorded assets	.....
To Gain on Revaluation transferred to partner's capital accounts (in old ratio)	.....	By Loss on Revaluation transferred to partner's capital accounts (in old ratio)	.....

Illustration 26

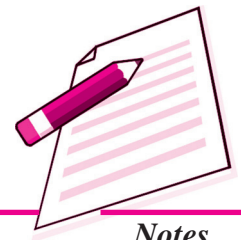
P, Q and R are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their balance sheet as on 31st March 2013 was as follows :

Admission of a Partner

Revaluation A/c	Dr. ⁽¹⁾	1,44,000	
To P's Capital A/c			54,000
To Q's Capital A/c			54,000
To R's Capital A/c			36,000
(The transfer of gain on revaluation to the capital accounts of partners in old ratio)			
P's Capital A/c	Dr. ⁽²⁾	25,000	
To Q's Capital A/c			15,000
To R's Capital A/c			10,000
(The adjustment for general reserve on change in profit sharing ratio)			

MODULE - 4

Partnership Account



Notes

Working Note :

(1) Revaluation Account

Particulars	₹	Particulars	₹
To Stock A/c	1,00,000	By Building A/c	4,00,000
To Machinery A/c	1,59,000	By Sundry Creditors A/c	25,000
To Provision for doubtful debts A/c	22,000		
To Gain on Revaluation transferred to :			
P's Capital A/c (3/8)	54,000		
Q's Capital A/c (3/8)	54,000		
R's Capital A/c (2/8)	36,000		
	4,25,000		4,25,000

(2) Adjustment for General Reserve :

Old Ratio of P, Q and R 3 : 3 : 2

New Ratio of P, Q and R 4 : 3 : 2

Sacrifice or Gain :

$$P = \frac{3}{8} - \frac{4}{9} = \frac{5}{72} \text{ (Gain)}$$

$$Q = \frac{3}{8} - \frac{3}{9} = \frac{3}{72} \text{ (Sacrifice)}$$



Notes

$$R = \frac{2}{8} - \frac{2}{9} = \frac{2}{72} \text{ (Sacrifice)}$$

Since P has gained, he will be debited for $\frac{5}{72}$ of General Reserve

$$\text{or } ₹ 3,60,000 = ₹ 25,000$$

Since Q has Sacrificed, he will be credited for $\frac{3}{72}$ of General Reserve

$$\text{or } ₹ 3,60,000 = ₹ 15,000$$

Since R has sacrificed, he will be credited for $\frac{2}{72}$ of General Reserve

$$\text{or } ₹ 3,60,000 = ₹ 10,000$$

Capital Accounts

Particulars	P ₹	Q ₹	R ₹	Particulars	P ₹	Q ₹	R ₹
To Q's Capital A/c	15,000			By Balance b/d	20,00,000	15,00,000	15,00,000
To R's Capital A/c	10,000			By Revaluation A/c	54,000	54,000	36,000
To Balance C/d	20,29,000	15,69,000	15,46,000	By P's Capital A/c		15,000	10,000
	<u>20,54,000</u>	<u>15,69,000</u>	<u>15,46,000</u>		<u>20,54,000</u>	<u>15,69,000</u>	<u>15,46,000</u>

Balance Sheet

as at 1st April 2013

Liabilities	₹	Assets	₹
Sundry Creditors	2,15,000	Cash at Bank	3,70,000
General Reserve	3,60,000	Sundry Debtors	4,40,000
Capital Accounts :		Less : Provision for doubtful debts	<u>22,000</u>
P	20,29,000	Stock	11,00,000
Q	15,69,000	Machinery	14,31,000
R	<u>15,46,600</u>	Building	24,00,000
			<u>57,19,000</u>
	<u>57,19,000</u>		<u>57,19,000</u>

Illustration 27

Ram, Mohan and Sohan are partners sharing profits and losses in the ratio of 3 : 2 : 1. Their balance sheet as at 31st December 2012 was as follows :

Admission of a Partner

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Creditors	8,700	Cash	3,000
Reserves	4,200	Debtors	6,200
Profit & Loss A/c (Profits)	2,100	<i>Less:</i> Provision for doubtful debts	200
Capital Accounts :		Stock	6,000
Ram	30,000	Furniture	18,000
Mohan	30,000	Plant	3,000
Sohan	5,000	Building	20,000
	65,000		30,000
	80,000		80,000

MODULE - 4

Partnership Account



Notes

The partners agreed that from 1st January 2013 they will share profits and losses in the ratio of 4 : 4 : 1. They agreed that :

- i. Stock is to be valued at 20% less.
- ii. Provision for doubtful debts to be increased by ₹ 150.
- iii. Furniture is to be depreciated by 20% and plant by 15%.
- iv. ₹ 350 are outstanding for salaries.
- v. Building is to be valued at ₹ 35,000.
- vi. Goodwill is valued at ₹ 4,500.

Partners do not want to record the altered values of assets and liabilities in the books and want to leave the reserves and profits undistributed. They also decided not to show goodwill in the books.

You are required to pass a single journal entry to give effect to the above. Also prepare the revised balance sheet.

Solution :

Workings :

Loss due to decrease in the value of Stock	3,600
Loss due to provision for doubtful debts	150
Loss due to decrease in the value of Furniture	600
Loss due to decrease in the value of Plant	3,000
Loss due to unrecorded liability (<i>i.e.</i> Outstanding salary)	350
	7,700

MODULE - 4

Partnership Account



Notes

Admission of a Partner

Gain due to increase in the value of Building	5,000
Loss on Revaluation	(-) 2,700
Adjustment for Reserves	(+) 4,200
Adjustment for Profit & Loss A/c (Profit)	(+) 2,100
Adjustment for Goodwill	(+) 4,500
Net Gain	(+) 8,100

Old Ratio of Ram, Mohan and Sohan 3 : 2 : 1

New Ratio of Ram, Mohan and Sohan 4 : 4 : 1

Sacrifice or Gain :

Ram	=	$\frac{3}{6} - \frac{4}{9} = \frac{1}{18}$ (Sacrifice)	$8,100 \times \frac{1}{18} = ₹ 450$ (Cr.)
Mohan	=	$\frac{2}{6} - \frac{4}{9} = \frac{2}{18}$ (Gain)	$8,100 \times \frac{2}{18} = ₹ 900$ (Dr.)
Sohan	=	$\frac{1}{6} - \frac{1}{9} = \frac{1}{18}$ (Sacrifice)	$8,100 \times \frac{1}{18} = ₹ 450$ (Cr.)

Journal

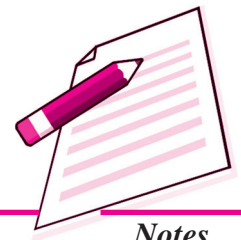
Date	Particulars	Dr. (₹)	Cr. (₹)
2013 Jan. 1	Mohan's Capital A/c To Ram's Capital A/c To Sohan Capital A/c (The adjustment for revaluation of assets and liabilities and for reserves, profits and goodwill on change in profit sharing ratio)	Dr. 900	450 450

Illustration 28

Saroj, Charu and Sangita are partners in a firm in the ratio of 5 : 4 : 2. On 1st April, 2014 they decided to share profits in future in the ratio of 4 : 3 : 2. On this date general reserve was ₹ 3,49,000 and loss on revaluation of assets and liabilities was ₹ 52,000. It was decided that adjustment should be made without altering the figures of assets and liabilities in the Balance Sheet. Make adjustment by a single journal entry.

Solution :

	₹
General Reserve	3,49,000
(-) Loss on Revaluation	52,000
Net amount of gain	2,97,000
Old Ratio of Saroj, Charu and Sangita 5 : 4 : 2	
New Ratio of Saroj, Charu and Sangita 4 : 3 : 2	



Sacrifice or Gain :

$$\begin{aligned} \text{Saroj} &= \frac{5}{11} - \frac{4}{9} = \frac{1}{99} \text{ (Sacrifice)} & 2,97,000 \times \frac{1}{99} &= ₹ 3,000 \text{ (Cr.)} \\ \text{Charu} &= \frac{4}{11} - \frac{3}{9} = \frac{3}{99} \text{ (Sacrifice)} & 2,97,000 \times \frac{3}{99} &= ₹ 9,000 \text{ (Cr.)} \\ \text{Sangita} &= \frac{2}{11} - \frac{2}{9} = \frac{4}{99} \text{ (Gain)} & 2,97,000 \times \frac{4}{99} &= ₹ 12,000 \text{ (Dr.)} \end{aligned}$$

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014 Apr. 1	Sangita's Capital A/c Dr. To Saroj's Capital A/c To Charu Capital A/c (The adjustment for general reserve and loss on revaluation of assets and liabilities on change in profit sharing ratio)	12,000	3,000 9,000

Illustration 29

A, B and C are partners sharing profits and losses in the ratio of 3 : 3 : 2. Their Balance Sheet as at 31st March, 2014 was as follows :

Liabilities	₹	Assets	₹
Sundry Creditors	2,400	Cash at Bank	3,700
General Reserve	3,600	Sundry Debtors	4,400
Capital Accounts :		Stock	12,000
A	20,000	Machinery	15,900

MODULE - 4

Partnership Account



Notes

Admission of a Partner

B	15,000		Building	20,000
C	15,000	50,000		
		56,000		56,000

Partners decided that with effect from 1st April, 2014 they would share profits and losses in the ratio of 4 : 3 : 2. It was agreed that :

- Stock be valued at Rs. 11,000.
- Machinery is to be depreciated by 10%.
- A provision for doubtful debts is to be made on Debtors @5%.
- Building to be appreciated by 20%.
- A liability for ₹ 250 included in Sundry Creditors is not likely to arise.

Partners agreed that the revised values are not to be recorded in the books. They also do not want to distribute the general reserve. You are required to pass Journal Entries, prepare Capital Account of the partners and the Balance Sheet.

Solution :

Journal

Date	Particulars	Dr. (₹)	Cr. (₹)
2014 April 1	A's Capital Ac/ Dr. To B's Capital A/c To C's Capital A/c (Being adjustment for revaluation of assets and liabilities and for general reserve made on change in profit-sharing ratio)	350	210 140

Partners' Capital Accounts

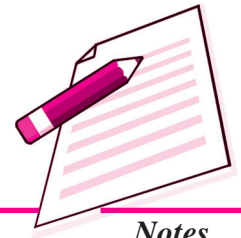
Dr.

Cr.

Particulars	A	B	C	Particulars	A	B	C
To B's Capital A/c	210	----	----	By Balance b/d	20,000	15,000	15,000
To C's Capital A/c	140	----	----	By A's Capital A/c	----	210	140
To Balance c/d	19,650	15,210	15,140				
	20,000	15,210	15,140		20,000	15,210	15,140

Balance Sheet
as at 1st April 2014

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Sundry Creditors	2,400	Cash at Bank	3,700
General Reserve	3,600	Sundry Debtors	4,400
Capital Accounts :		Stock	12,000
A 19,650		Machinery	15,900
B 15,210		Building	20,000
C <u>15,140</u>	50,000		
	56,000		56,000



Notes

Working Notes :

(1) <i>Particulars</i>	₹	₹
Loss due to decrease in the value of Stock	1,000	
Loss due to decrease in the value of Machinery	1,590	
Loss due to Provision for Doubtful Debts	<u>220</u>	2,810
Gain due to increase in the value of Building	4,000	
Gain due to decrease in Sundry Creditors	<u>250</u>	4,250
Gain on Revaluation	1,440	
+ General Reserve	<u>3,600</u>	5,040

(2) Old Ratio of A, B and C 3 : 3 : 2

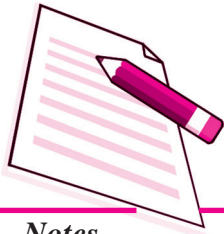
New Ratio of A, B and C 4 : 3 : 2

Sacrificing Ratio = Old Share - New Share

$$A = \frac{3}{8} - \frac{4}{9} = \frac{5}{72} \text{ (Gain)} \quad \text{₹ } 5,040 \times \frac{5}{72} = \text{₹ } 350 \text{ (Dr.)}$$

$$B = \frac{3}{8} - \frac{3}{9} = \frac{3}{72} \text{ (Sacrifice)} \quad \text{₹ } 5,040 \times \frac{3}{72} = \text{₹ } 210 \text{ (Cr.)}$$

$$C = \frac{2}{8} - \frac{2}{9} = \frac{2}{72} \text{ (Sacrifice)} \quad \text{₹ } 5,040 \times \frac{2}{72} = \text{₹ } 140 \text{ (Cr.)}$$



Notes

Illustration 30

Karan and Tarun are partners sharing profit and losses in the ratio of 2 : 1. Their Balance Sheet was as follows:

Balance Sheet of Karan and Tarun as at December 31,2014

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Creditors	10,000	Cash in hand	7,000
Bills payable	7,000	Debtors	26,000
Capitals:		Building	20,000
Karan	40,000	Investment	15,000
Tarun	<u>30,000</u>	Machinery	13,000
	70,000	Stock	6,000
	<u>87,000</u>		<u>87,000</u>

Nikhil is admitted as a partner and assets are revalued and liabilities reassessed as follows:

- (i) Create a Provision for doubtful debt on debtors at ₹ 800.
- (ii) Building and investment are appreciated by 10%.
- (iii) Machinery is depreciated at 5%
- (iv) Creditors were overestimated by ₹ 500.

Make journal entries and Prepare revaluation account before the admission of Nikhil.

Solution :

Journal

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Debit</i> (₹)	<i>Credit</i> (₹)
	Revaluation A/c Dr.		800	
	To Provision for Doubtful Debts			800
	[Provision made for doubtful debts]			
	Building A/c Dr.		2,000	
	Investment A/c Dr.		1,500	
	To Revaluation A/c			3,500
	[Increase in the value of Building & Investment]			

Admission of a Partner

Revaluation A/c	Dr.	650	
To Machinery A/c			650
[Decrease in the value of machinery]			
Creditors A/c	Dr.	500	
To Revaluation A/c			500
[Value of creditors reduced by ₹ 500]			

Revaluation account

Dr.		Cr.	
Particulars	₹	Particulars	₹
Provision for Doubtful Debts	800	Building	2,000
Machinery	650	Investment	1,500
Profit transferred to		Creditors	500
Karan's Capital	1,700		
Tarun's Capital	850		
	2,550		
	4,000		4,000

23.6 ADJUSTMENTS OF RESERVES AND ACCUMULATED PROFIT OR LOSSES

Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, is credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partner in the existing ratio. For this purpose the following journal entries are made:

(i) *For distribution of undistributed profit and reserve.*

Reserves A/c	Dr.	
Profit & Loss A/c (Profit)	Dr.	
To Partner's Capital A/c		[individually]
[Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio]		

(ii) *For distribution of loss*

Partner's Capital A/c	Dr.	[individually]
To Profit and Loss A/c [Loss]		
[Profit & Loss (loss) transferred to all partners capitals A/c in existing profit sharing ratio]		

MODULE - 4

Partnership Account



Notes



Notes

Illustration 31

Rohit and Soniya are partners sharing profit in the ratio of 4:3. On 1st April 2006 they admit Meena as a new partner for 1/4 share in profits. On that date the balance sheet of the firm shows a balance of ₹ 70,000 in general reserve and debit balance of Profit and Loss A/c of ₹ 21,000. make the necessary journal entries.

Solution :

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	General Reserve Dr To Rohit's Capital A/c To Soniya's Capital A/c [Transfer of general reserve to the existing partner's capital accounts]		70,000	40,000 30,000
	Rohit's Capital A/c Dr. Soniya's Capital A/c Dr. To Profit & Loss A/c [Transfer of accumulated Loss to existing partner's capital A/c]		12,000 9,000	21,000

Illustration : 32

Bhanu and Etika are partners sharing profit and losses in the ratio of 3:2 respectively. Their Balance Sheet as at March 31, 2014 was as under:

Balance Sheet of Bhanu and Etika as at December 31, 2014

Particulars	₹	Particulars	₹
Creditors	28,000	Cash in hand	3,000
Capitals :		Cash at Bank	23,000
Bhanu 70,000		Debtors	19,000
Etika 70,000	1,40,000	Buildings	65,000
		Furniture	15,000
		Machinery	13,000
		Stock	30,000
	1,68,000		1,68,000

Admission of a Partner

On that date, they admit Deepak into partnership for 1/3 share in future profit on the following terms:

- (i) Furniture and stock are to be depreciated by 10%.
- (ii) Building is appreciated by ₹ 20,000.
- (iii) 5% provision is to be created on Debtors for doubtful debts.
- (iv) Deepak is to bring in ₹ 50,000 as his capital and ₹ 30,000 as goodwill.

Make necessary ledger accounts and balance sheet of the new firm.

Solution :

Revaluation Account

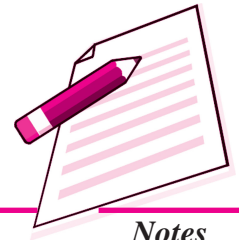
Dr.		Cr.	
Particulars	₹	Particulars	₹
Provision for Doubtful Debts	950	Building	20,000
Furniture	1,500		
Stock	3,000		
Profit transferred to Bhanu's Capital A/c 8,730			
Etika's Capital A/c <u>5,820</u>	14,550		
	20,000		20,000

Capital Account

Dr.				Cr.			
Particulars	Bhanu (₹)	Etika (₹)	Deepak (₹)	Particulars	Bhanu (₹)	Etika (₹)	Deepak (₹)
Balance c/d (closing)	96,730	87,820	50,000	Balance b/d (closing)	70,000	70,000	—
				Revaluation (Profit)	8,730	5,820	—
				Bank A/c	—	—	50,000
				Goodwill Premium A/C	18,000	12,000	—
	96,730	87,820	50,000		96,730	87,820	50,000

MODULE - 4

Partnership Account



Notes



Notes

**Balance Sheet of Bhanu , Etika and Deepak
as on December 31, 2014**

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Creditors	28,000	Cash in hand	3,000
Capitals :		Cash at Bank	1,03,000
Bhanu 96,730		Debtors 19,000	
Etika 87,820		Less: Provision 950	18,050
Deepak <u>50,000</u>	2,34,550	Stock	27,000
		Furniture	13,500
		Machinery	13,000
		Building	85,000
	<u>2,62,550</u>		<u>2,62,550</u>

Illustration 33

Ashu and Pankaj are partners sharing profit in the ratio of 3 : 2, their Balance sheet on March 31, 2014 was as follows:

**Balance Sheet of Ashu and Pankaj
as at March 31,2014**

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Creditors	38,000	Cash in hand	15,000
Bills Payable	40,000	Cash at Bank	62,000
Salaries outstanding	5,000	Debtors	58,000
Profit & Loss	40,000	Stock	85,000
Capitals:		Machinery	1,45,000
Ashu 1,50,000		Goodwill	38,000
Pankaj <u>1,30,000</u>	2,80,000		
	<u>4,03,000</u>		<u>4,03,000</u>

They admitted Gurdeep into partnership on the following terms on March 31, 2014.

- (a) New profit sharing ratio is agreed as 3 : 2 : 1.

Admission of a Partner

- (b) He will bring in ₹ 1,00,000 as his share of capital and ₹ 30,000 as his share of goodwill.
- (c) Machinery is appreciated by 10%
- (d) Stock is valued at ₹ 87,000.
- (e) Creditors are unrecorded to the extent of ₹ 6,000.
- (f) A provision for doubtful debts is to be created by 4% on debtors.

Prepare Revaluation account, Capital Accounts, Bank account and Balance Sheet of the new firm after admission of Gurdeep.

Solution :

Revaluation Account

<i>Particulars</i>	(₹)	<i>Particulars</i>	(₹)
Provision for Doubtful Debts	2,320	Machinery	14,500
Creditors	6,000	Stock	2,000
Profit transferred to			
Ashu's Capital A/c	4,908		
Pankaj's Capital A/c	3,272		
	8,180		
	16,500		16,500

Capital Account

<i>Particulars</i>	<i>Ashu</i> (₹)	<i>Pankaj</i> (₹)	<i>Gurdeep</i> (₹)	<i>Particulars</i>	<i>Ashu</i> (₹)	<i>Pankaj</i> (₹)	<i>Gurdeep</i> (₹)
Goodwill A/c	22,800	15,200	—	Balance b/d	1,50,000	1,30,000	—
Balance c/d	1,74,108	1,46,072	1,00,000	Profit & Loss A/c	24,000	16,000	—
				Revaluation A/c (Profit)	4,908	3,272	
				Bank A/c	—	—	1,00,000
				Goodwill Premium A/c	18,000	12,000	—
	1,96,908	1,61,272	1,00,000		1,96,908	1,61,272	1,00,000

MODULE - 4

Partnership Account



Notes



Notes

**Balance Sheet of Ashu Pankaj and Gurdeep
as at March 31,2014**

<i>Liabilities</i>	<i>Amount (₹)</i>	<i>Assets</i>	<i>Amount (₹)</i>
Creditors	44,000	Cash in hand	15,000
Bills Payable	40,000	Cash at Bank	1,92,000
Salaries outstanding	5,000	Debtors 58,000	
Capitals:		Less: Prov. of	
Ashu 1,74,108		doubtful debts (-) 2,320	55,680
Pankaj 1,46,072		Stock	87,000
Gurdeep 1,00,000	4,20,180	Machinery	1,59,500
	<u>5,09,180</u>		<u>5,09,180</u>

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (₹)</i>	<i>Particulars</i>	<i>Amount (₹)</i>
Balance b/d	62,000	Balance c/d	1,92,000
Gurdeep's Capital A/c	1,00,000		
Goodwill A/c	30,000		
	<u>1,92,000</u>		<u>1,92,000</u>

Working Note:

Sacrificing Ratio = Existing Ratio – New Ratio

<i>Partners</i>	<i>Existing Ratio</i>	<i>New Ratio</i>	<i>Sacrifice</i>	<i>Sacrificing Ratio</i>
Ashu	3/5	3/6	$\frac{18-15}{30} = \frac{3}{30}$	Ashu : Pankaj
Pankaj	2/5	2/6		3 : 2

Illustration 34

Himani and Harsha are partners in a firm. Their Balance Sheet on March 31, 2014 was as follows:

Balance Sheet of Himani and Harsha
as at March 31,2014

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Provision for Doubtful Debts	3,000	Cash	20,000
Creditors	36,000	Sundry Debtors	90,000
Bills Payable	15,000	Stock	45,000
Outstanding Expenses	2,000	Machinery	41,000
Capitals:		Building	1,10,000
Himani	1,70,000	Goodwill	40,000
Harsha	1,20,000		
	2,90,000		
	3,46,000		3,46,000



Notes

On April 1, 2014 they admitted Charu as a Partner on the following terms:

- (i) Charu brings ₹ 90,000 as her share of capital and she is unable to bring any amount for goodwill.
- (ii) Goodwill is valued at 2 Years purchase of the average profit of last 4 years. The Profit of last 4 years amounted to ₹ 20,000; ₹ 30,000; ₹ 30,000; ₹ 40,000 Respectively.
- (iii) New Profit sharing ratio between Himani's, Harsha's and Charu are 3 : 2 : 1.
- (iv) Outstanding Expenses to be brought down to ₹ 500.
- (v) The provision for doubtful debts is to be increased upto 5% on Debtors.
- (vi) Machinery is depreciated by 10% and Stock is valued at ₹ 47,000.

Prepare Revaluation Account, Partners Capital account and opening Balance sheet of the New firm.

Solution:**Revaluation Account**

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Provision for Doubtful Debts	1,500	Outstanding Expenses	1,500
Machinery	4,100	Stock	2,000

MODULE - 4

Partnership Account



Notes

Admission of a Partner

	Loss on revaluation transferred to :	
	Himani's Capital A/c	1,050
	Harsha's Capital A/c	1,050
		<u>2,100</u>
5,600		5,600

Capital Account

Dr.				Cr.			
Particulars	Himani (₹)	Harsha (₹)	Charu (₹)	Particulars	Himani (₹)	Harsha (₹)	Charu (₹)
Goodwill A/c	20,000	20,000	—	Balance b/d	1,70,000	1,20,000	—
Revaluation A/c (loss)	1,050	1,050	—	Charu's Capital A/c	—	10,000	—
Harsha's Capital	—	—	10,000	Bank A/c	—	—	90,000
Balance c/d	1,48,950	1,08,950	80,000				
	<u>1,70,000</u>	<u>1,30,000</u>	<u>90,000</u>		<u>1,70,000</u>	<u>1,30,000</u>	<u>90,000</u>

Balance Sheet of Himani, Harsha and Charu

as at March 31, 2014

Liabilities	Amount (₹)	Assets	Amount (₹)
Provision for Doubtful Debts	4,500	Cash	70,000
Creditors	36,000	Bank	90,000
Bills Payable	15,000	Sundry Debtors	90,000
Outstanding Expenses	500	Stock	47,000
Capitals:		Machinery	36,900
Himani	1,48,950	Building	1,10,000
Harsha	1,08,950		
Charu	<u>80,000</u>		
	2,90,000		
	<u>3,93,900</u>		<u>3,93,900</u>

Working Note:

(i) Valuation of Goodwill I:

Total Profit = ₹ 20,000 + ₹ 30,000 + ₹ 30,000 + ₹ 40,000

Average Profit = ₹ 1,20,000/4 = ₹ 30,000

Goodwill = ₹ 30,000 × 2 = ₹ 60,000

Charu's Share of Goodwill = ₹ 60,000 × 1/6 = ₹ 10,000

(ii) Sacrificing Ratio = Existing Ratio – New Ratio

Himani's sacrifice = = 0

Harsha's sacrifice =

Only Harsha sacrificed his share of profit.



Notes



INTEXT QUESTIONS 23.4

I. Fill in the blanks with suitable word/words :

- i. Revaluation account is debited for an increase in the value of
- ii. Revaluation account is credited for an increase in the value of
- iii. Revaluation account is credited for an decrease in the value of
- iv. Revaluation account is debited for an decrease in the value of
- v. Profit on revaluation is transferred to the of the partners' capital account.
- vi. Reserve should be distributed amongst the existing partners in
- vii. Accumulated Losses are in the existing partner's capital account in existing profit sharing ratio.

II. Choose the correct option :

- i. On change in the profit sharing ratio on the existing partners the accumulated profit will be transferred to the capital account/current accounts of the existing partners in
 - a) Old Profit Sharing Ratio
 - b) Equally
 - c) New Profit Sharing Ratio
 - d) Gaining/Sacrificing Ratio
- ii. On change in the profit sharing ratio of the existing partners the accumulated loss will be
 - a) debited to the capital accounts of the partners in old profit sharing ratio.

$$\frac{3-3}{6} = \frac{1}{6}$$

**Notes**

- b) credited to the capital accounts of the partners in old profit sharing ratio.
 - c) debited to the capital accounts of the partners in new profit sharing ratio.
 - d) credited to the capital accounts of the partners in new profit sharing ratio.
- iii. If profit sharing ratio of A & B is 3 : 2. They want to share profits equally. What is the sacrifice of A.
- a) 1/10 b) 1/20 c) 1/15 d) 1/5
- iv. If profit sharing ratio of A & B is 4 : 5. They agreed to share profit equally. What is the sacrifice of B.
- a) 1/18 b) 1/10 c) 5/18 d) 7/18
- v. If profit sharing ratio of A & B is 5 : 4. They agreed to share profit equally. What is the Gain of B.
- a) 2/9 b) 1/18 c) 1/8 d) 4/9

III. State whether the revaluation account will be debited or credited on the revaluation of the following assets at the time of change in profit sharing ratio of the existing partners :

- i. Increase in the value of land
- ii. Increase in the value of stock
- iii. Decrease in the value of machinery
- iv. Decrease in the value of furniture.

IV. State whether the following statements are true :

- i. Revaluation account is credited on depreciation in machinery.
- ii. Revaluation account is credited for depreciation in plant.
- iii. Revaluation account is debited for the amount of provision for bad and doubtful debts.
- iv. For recording the value of an unrecorded assets revaluation account is debited.

23.7 ADJUSTMENT OF PARTNER'S CAPITAL

Sometime, at the time of admission, the partners' agree that their capitals be adjusted in proportion to their profit sharing ratio. For this purpose, the capital accounts of

the existing partners are prepared, making all adjustments, on account of goodwill, general-reserve, revaluation of assets and resettlement of liabilities. The actual capital so adjusted will be compared with the amount of capital that should be kept in the business after the admission of the new partner. The excess if any, of adjusted actual capital over the proportionate capital will either be withdrawn or transferred to current account and vice versa.

The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner's Capital and his profit sharing ratio or on the basis of the existing partner's capital account balances.

1. Adjustment of existing partner's capital on the basis of the capital of the new partner :

If the capital of the new partner is given, the entire capital of the new firm will be determined on the basis of the new partner's capital and his profit sharing ratio. Therefore the capital of other partners is ascertained by dividing the total capital as per his profit sharing ratio.

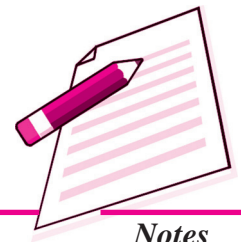
If the existing capital of the partner after adjustment is in excess of his new capital, the excess amount is withdrawn by partner or transferred to the credit of his current account. If the existing capital of the partner is less than his new capital, the partner brings the short amount or makes transfer to the debit of his current account. The journal entries are made as under:

(i) When excess amount is withdrawn by the partner or transferred to current account.

Existing Partner's Capital A/c	Dr.
To Bank A/c or Partner Current A/c	
(Excess amount is withdrawn by the partner or transferred to current account)	

(ii) For bringing in the Deficit amount or Balance transferred to current account.

Bank A/c or Partner Current A/c	Dr.
To Existing Partner's Capital A/c	
(Bringing the Deficit amount or Balance transferred to current account)	



Notes



Notes

Illustration 35

Asha and Bobby are partners sharing profit in the ratio of 5:3 with capital of ₹80,000 and ₹ 70,000 respectively. They admit a new partner Nitin. The new profit sharing ratio of Asha, Bobby and Nitin is 5:3:2 respectively. Nitin brings ₹40,000 as capital. The profit on revaluation of assets and reassessment of liabilities is ₹6,400. It is agreed that capitals of the partners should be in the new profit sharing ratio. Calculate new capital of each partner.

Solution :

Actual Capital of Asha and Bobby

	Asha	Bobby
	(₹)	(₹)
Balance in Capital A/c	80,000	70,000
Add Profit on Revaluation (5 : 3)	4,000	2,400
Capital after Adjustment	84,000	72,400

Calculation of new capital of the firm and existing partner's capital

Nitin's Share in the firm = 2/10

Nitin's brings ₹ 40,000 for 2/10 Share

$$\begin{aligned} \text{Total capital of the new firm in terms of Nitin's capital} &= ₹40,000 \times 10/2 \\ &= ₹ 2,00,000 \end{aligned}$$

$$\text{Asha's share in New Capital} = ₹ 2,00,000 \times 5/10 = ₹ 1,00,000$$

$$\text{Bobby's share in New Capital} = ₹ 2,00,000 \times 3/10 = ₹ 60,000$$

On comparing Asha's adjusted capital with the new capital we find that the Asha brings ₹ 16,000 [₹ 1,00,000 - ₹ 84,000] or the amount may be debited to her current account.

On comparing the Bobby's adjusted capital with the new capital, we find that the Bobby is to withdraw ₹ 12,400 [₹ 72,400 - ₹ 60,000] or the amount may be credited to his current account.

2. When the capital of the new partner is calculated in proportion to the total capital of the new firm.

Sometimes the capital of the new partner is not given. He/she is required to bring an amount proportionate to his/her share of profit. In such a case, new partner's capital will be calculated on the basis of adjusted capital of the existing partners.

For example, the capital accounts of Sumit and Anu show the balance after all adjustments and revaluation as ₹ 90,000 and ₹ 60,000 respectively. They admit Rohit as a new partner for 1/4 share in the profits. Rohit's capital is calculated as follows:

$$\begin{aligned} \text{Total share} &= 1 \\ \text{Rohit's share in the profit} &= 1/4 \\ \text{Remaining share} &= 1 - 1/4 = 3/4 \end{aligned}$$

$$\begin{aligned} 3/4 \text{ share of profit combined capital of Sumit and Anu} \\ &= ₹ 90,000 + ₹ 60,000 = ₹ 1,50,000 \end{aligned}$$

$$\begin{aligned} \text{Total Capital of the firm} &= ₹ 1,50,000 \times 4/3 \\ &= ₹ 2,00,000 \end{aligned}$$

$$\text{Rohit's capital for } 1/4 \text{ share of profits} = ₹ 2,00,000 \times 1/4 = ₹ 50,000$$

Rohit brings in ₹ 50,000 as his Capital

Illustration 36

Manoj and Hema are partner sharing profit and losses in the ratio of 7 : 3. On March 31, 2014, their Balance Sheet was as follows:

**Balance Sheet of Manoj and Hema
as at March 31, 2014**

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Capital :		Bank	12,000
Manoj 88,000		Sundry Debtors	45,000
Hema 64,000	1,52,000	Bills Receivable	30,000
Sundry creditors	32,000	Stock	35,000
Bills Payable	38,000	Investment	13,000
Reserve	18,000	Machinery	40,000
		Building	45,000
		Goodwill	20,000
	2,40,000		2,40,000





Notes

They admit Tarun into partnership on the following terms:

- (i) Stock is revalued at ₹ 40,000.
- (ii) Building, Machinery and Investment are depreciated by 12%.
- (iii) Prepaid Insurance is ₹ 1,000.
- (iv) Tarun brings ₹ 40,000 as his capital and ₹ 12,000 for goodwill for 1/6 share of profit of the firm.
- (v) Capital of the partners shall be proportionate to their profit sharing ratio. Adjustment of Capitals to be made by Cash.

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

Solution :

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Building	5,400	Stock	5,000
Machinery	4,800	Prepaid Insurance	1,000
Investment	1,560	Loss transferred to	
		Manoj's Capital	4,032
		Hema's Capital	<u>1,728</u>
	11,760		5,760
			11,760

Capital Account

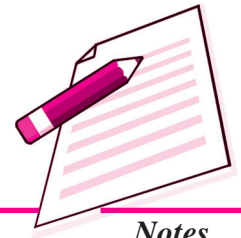
Dr.

Cr.

<i>Particulars</i>	<i>Manoj</i> (₹)	<i>Hema</i> (₹)	<i>Tarun</i> (₹)	<i>Particulars</i>	<i>Manoj</i> (₹)	<i>Hema</i> (₹)	<i>Tarun</i> (₹)
Goodwill	14,000	6,000		Balance b/d	88,000	64,000	
Revaluation A/c (loss)	4,032	1,728		Reserve	12,600	5,400	
Bank A/c		5,272		Goodwill A/c	8,400	3,600	
Balance c/d	1,40,000	60,000	40,000	Bank A/c	49,032		40,000
	<u>1,58,032</u>	<u>73,000</u>	<u>90,000</u>		<u>1,58,032</u>	<u>73,000</u>	<u>90,000</u>

**Balance Sheet of Manoj, Hema and Tarun
as at March 31, 2014**

<i>Liabilities</i>	<i>Amount (₹)</i>	<i>Assets</i>	<i>Amount (₹)</i>
Bills Payable	38,000	Bank	1,07,760
Sundry creditors	32,000	Bills Receivable	30,000
Capitals A/c:		Sundry Debtors	45,000
Manoj 1,40,000		Stock	40,000
Hema 60,000		Investment	11,440
Tarun 40,000	2,40,000	Prepaid Insurance	1,000
		Machinery	35,200
		Building	39,600
	3,10,000		3,10,000



Notes

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount (₹)</i>	<i>Particulars</i>	<i>Amount (₹)</i>
Balance b/d	12,000	Hema's Capital A/c	5,272
Manoj's Capital A/c	49,032	Balance c/d	1,07,760
Goodwill A/c	12,000		
Tarun's Capital A/c	40,000		
	1,13,032		1,13,032

Working Note:

(a) Calculation of New profit Sharing Ratio:

Total Profit = 1

Tarun gets = $1/6$

Remaining Profit = $1 - 1/6 = 5/6$ shared by Manoj and Hema in their existing profit sharing ratio.

Manoj's new share = $5/6 \times 7/10 = 7/12$



Notes

Hema's new shares = $\frac{5}{6} \times \frac{3}{10} = \frac{3}{12}$

New profit sharing ratio of Manoj, Hema and Tarun

= $\frac{7}{12} : \frac{3}{12} : \frac{1}{6}$ or 7 : 3 : 2.

(b) Adjustment of Capital:

Tarun brought capital for $\frac{1}{6}$ share = ₹ 40,000

Total Capital of the firm = ₹ 40,000 $\times \frac{6}{1}$ = ₹ 2,40,000

Manoj's Capital = ₹ 2,40,000 $\times \frac{7}{12}$ = ₹ 1,40,000

Hema's Capital = ₹ 2,40,000 $\times \frac{3}{12}$ = ₹ 60,000

Tarun's Capital = ₹ 2,40,000 $\times \frac{2}{12}$ = ₹ 40,000



INTEXT QUESTIONS 23.5

Tanu and Anu are partner's sharing profit in the ratio 3:2. They admit Sumit as a new partner for $\frac{1}{5}$ share in the profit and brings ₹ 50,000 for his capital. The Capital of Tanu and Anu after all the adjustments are ₹ 95,000 and ₹ 90,000 respectively. Calculate the total capital of the new firm and capital of each partner on the basis of the new partner's capital.



WHAT YOU HAVE LEARNT

- **Admission of a Partner – Meaning :** When a partner is admitted to the existing partnership firm, it is called admission of a partner.

On the admission of a new partner, the following adjustments become necessary:

- Adjustment in profit sharing ratio;
 - Adjustment of Goodwill;
 - Adjustment for revaluation of assets and reassessment of liabilities;
 - Distribution of accumulated profits and reserves; and
 - Adjustment of partners' capitals.
- **Adjustment in Profit sharing Ratio :** When new partner is admitted he/she acquires his/her share in profit from the existing partners. As a result, the profit sharing ratio in the new firm is decided mutually between the existing partners and the new partner.

- **Sacrificing Ratio :** At the time of admission of an incoming partner, existing partners have to surrender some of their share in favour of the new partner. The ratio in which they surrender their profits is known as sacrificing ratio.
- **Meaning of Goodwill :** Any established firm develops wide business connections. This helps the firm to earn more profits as compared to a new firm. The monetary value of such advantage is known as “Goodwill”.
- **Methods of valuation of Goodwill :** (i) Average Profit Method (ii) Super Profit Method (iii) Capitalisation Method
- **Revaluation of Assets and Liabilities :** On admission of a new partner, the firm is reconstituted and the assets are revalued and liabilities are reassessed. It is necessary to show the true position of the firm at the time of admission of a new partner.
- **Adjustments of Reserves and Accumulated Profit or Losses :** Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, are credited in the existing partner’s capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partners in the existing ratio.
- **Adjustment of Partner’s Capital :** Sometimes, at the time of admission, the partners’ agreed that their capitals are adjusted in proportionate to their profit sharing ratio. The partners may decide to calculate the capitals which are to be maintained in the new firm either on the basis of new Partner’s Capital and his profit sharing ratio or on the basis of the existing partner’s capital accounts.
- At the time of change in profit sharing ratio of the existing partners the Reserves and accumulated profits/losses existing in the books are transferred to the capital/current accounts of the partners in their old profit sharing ratio.
- In case the partners decide to leave the reserves and profits/losses undistributed then an adjustment entry passed to give effect to the change in the profit sharing ratio. This is done by debiting the capital accounts of the partner(s) who have gained and crediting the capital accounts of the partners who have sacrificed proportionately.
- A change in profit sharing ratio of the existing partners implies that one partner is purchasing from another partner, a share of profit previously belonging to the latter. Therefore, the purchasing or gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwill. The following journal entry is passed for treatment of goodwill on change in the profit sharing ratio of the existing partners.



Notes

**Notes**

Gaining Partners' Capital A/c Dr.
 To Sacrificing partner's Capital A/c
 (Treatment of goodwill on change in profit sharing ratio of existing partners)

- On change in profit sharing ratio of the existing partners it is desirable to revalue assets and reassess the liabilities. The reason is that the realisable value of assets may be different from the book value. Similarly the amount payable on account of third party liabilities may be different from the book value of the liabilities.
- Revaluation of assets and reassessment of liabilities may be given effect in two different ways : (a) When revised values are recorded in the books and; (b) When revised values are not recorded in the books.
- In the first case the revaluation is done by preparing Revaluation Account. Gain or Loss on revaluation is transferred to the capital accounts of the partners in their old profit sharing ratio.

**TERMINAL EXERCISE**

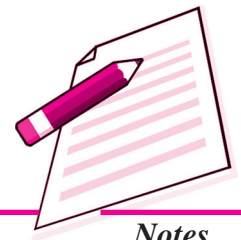
1. State the meaning of Sacrificing Ratio.
2. State the meaning of Goodwill.
3. Explain the methods of valuation of goodwill.
4. Explain 'Revaluation Account'. Why assets and liabilities are revalued at the time of admission of a new partner?
5. Explain the treatment of accumulated profit or losses and Reserves at the time of admission of a new partner.
6. Explain the calculation of the proportionate capital of the new partner in case of admission of a partner.
7. A and B are partners sharing profit in the ratio of 5 : 3 C is admitted to the partnership for 1/4 share of future profit . Calculate the new profit sharing ratio and sacrificing ratio.
8. Rohit and Meena are partners sharing profits and losses in the ratio of 7 : 3. Rohit surrenders 1/7 of his share and Meena surrenders 1/3 of her share in favour of Teena, a new partner. Calculate the new profit sharing ratio.

Admission of a Partner

MODULE - 4

Partnership Account

9. A firm has earned ₹3,00,000 as average profit for the last few years. Normal rate of return in the class of business is 15%. Find out goodwill according to Capitalisation of Super profit, if the value of net assets amounted to ₹16,00,000.
10. The following is the Balance Sheet of Tarun and Ashima sharing profit and losses in the ratio of 2 : 1.



<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
		(₹)			(₹)
Capitals :			Cash		12,000
Tarun	50,000		Sundry Debtors		60,000
Ashima	40,000	90,000	Stock		12,000
Sundry creditors		20,000	Furniture		6,000
			Building		20,000
		1,10,000			1,10,000

They agreed to admit Sunita into partnership on the following terms:

- Sunita to pay ₹ 9,000 as Goodwill.
- Sunita bring ₹ 11,000 as her Capital for 1/4 share of profit in the business.
- Building and furniture to be depreciated at 5%. Stock is reduced by ₹ 1,600 and Bad Debt Reserve ₹ 1,300 to be provided for.

Prepare necessary ledger accounts and balance sheet after admission.

11. A and B are partner in a firm sharing profit in the ratio 2 : 1. C is admitted into the firm with 1/4 share in profits. He will bring in ₹ 60,000 as capital and capital of A and B are to be adjusted in the profit sharing ratio. The Balance sheet of A and B as on March 31, 2014 was as under:

Balance Sheet of A and B as on March 31, 2014

<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
		(₹)			(₹)
Sundry creditors		16,000	Cash in Hand		4,000
Bills Payable		8,000	Cash at Bank		20,000
General Reserve		12,000	Sundry Debtors		16,000
Capitals:			Stock		20,000
A	1,00,000		Furniture		10,000

MODULE - 4

Partnership Account



Notes

Admission of a Partner

B	64,000	1,64,000	Machinery	50,000
			Building	80,000
		2,00,000		2,00,000

Other terms of agreement are as under:

- C will bring in ₹ 24,000 as his share of Goodwill.
- Building was valued at ₹ 90,000 and Machinery at ₹ 46,000
- A provision for bad debts is to be created @ 6% on Debtors.
- The capital account of A and B are to be adjusted through cash.

Prepare necessary accounts and Balance Sheet after C's admission.

- A and B were partners in a firm sharing profits in 3 : 2 ratio. From 1.4.2014 they decided to share profits equally. For this purpose the goodwill of the firm was valued at ₹ 50,000. Pass necessary adjustment entry for the treatment of goodwill due to change in profit sharing ratio between A and B.
- X and Y were partners sharing profits in 5 : 3 ratio. From 1.1.2013 they decided to change the profit sharing ratio. The new ratio will be 3 : 5. For this purpose the goodwill of the firm was valued at ₹ 1,60,000. Pass necessary adjustment entry for treatment of goodwill on change in profit sharing of X and Y.
- Alka, Jyoti and Sonam were partners sharing profits in 3 : 2 : 1 ratio. They decided to share the profits in future equally. For this purpose the goodwill of the firm was valued at ₹ 1,20,000.
Pass necessary adjustment entry in the books of Alka, Jyoti and Sonam for the treatment of goodwill due to change in profit sharing ratio.
- Akhil, Nikhil and Shakeel were partner in a firm sharing profits in 5:3:2 ratio. From 1.4.2014 they decided to share the profits in 3 : 5 : 2 ratio. For this purpose the goodwill of the firm was valued at ₹ 2,00,000.
Pass the necessary journal entry for the treatment of goodwill on change in profit sharing ratio of Akhil, Nikhil and Shakeel.
- Kumar and Janki were partners in a firm sharing profits in 3 : 2 ratio. On 31.3.2013 their balance sheet showed general reserve of ₹ 30,000. On that date they decided to share future profits equally.
Pass necessary journal entry for the treatment of general reserve on the occasion of change in profit sharing ratio.

17. Ravi and Kanta were partners sharing profits in 3 : 1 ratio. On 31.3.2013 their books showed a debit balance of ₹ 40,000 of profit and loss account. They decided to share the profits in 3 : 2 ratio.

Pass necessary journal entry for the treatment of the above balance.

18. Karan and Kartik were partners in a firm sharing profits in 3 : 2 ratio. Their balance sheet showed a general reserve of ₹ 15,000. They decided to share future profit in 3 : 1 ratio.

Pass necessary journal entries for the treatment of general reserve on change in profit sharing ratio of Karan and Kartik.

19. Mamta, Jyoti and Ruchi were partners in a firm sharing profits in 3 : 2 : 1 ratio. They decided to share the future profits equally. At the time of change in profit sharing ratio they had a debit balance of ₹ 60,000 in their profit and loss account. They decided not to distribute the loss among themselves and give effect to the same by passing an adjustment entry.

20. P and Q were partners in a firm sharing profits in 3 : 4 ratio. They decided to share the profits equally from 1.4.2013. The following revaluation of assets and reassessment of liabilities was agreed upon between the partners on this occasion :

- i. Building was depreciation by ₹ 2,000.
- ii. A provision of 5% on debtors which were ₹ 10,000 was created for bad and doubtful debts.
- iii. Land was appreciated by ₹ 70,000.
- iv. Stock was depreciated by ₹ 30,000.

Pass necessary journal entries for the above and prepare revaluation account.

21. Pass necessary journal entries and prepare revaluation account for the revaluation of the following items on change in profit sharing ratio of L and M from 2 : 3 to 4 : 5.

- i. There was an unrecorded Computer of ₹ 7,000 which was taken into account.
- ii. A creditor of ₹ 5,000 was not likely to be paid.
- iii. A piece of land purchased 5 years ago for ₹ 20,000 was valued at ₹ 2,00,000.



Notes



Notes



ANSWERS TO INTEXT QUESTIONS

- 23.1** I. (i) New, Existing (ii) Reconstituted
(iii) Sacrificing ratio (iv) Existing ratio
- II. Sacrificing ratio 5 : 3.
- 23.2** I. (i) intangible (ii) incoming (iii) Normal Profit
(iv) Average profit, super profit and Capitalisation
(v) Outsider liabilities
- II. (a) ₹ 62,500 (b) ₹ 1,25,000
- 23.3** I. (i) no entry (ii) credited (iii) sacrificing
(iv) debited (v) written off
- II. 1. IV 2. III 3. I 4. II.
- 23.4** I. (i) Liabilities, (ii) Assets, (iii) Liabilities,
(iv) Assets, (v) Credit side (vi) Existing ratio
(vi) debited
- II. (i) a (ii) a (iii) a (iv) a (v) b
- III. (i) Credit (ii) Credit (iii) Debit (iv) Debit
- IV. (i) False (ii) False (iii) True (iv) False
- 23.5** Total Capital of the new firm ₹ 2,50,000
Capital of Tanu's ₹ 1,20,000, capital of Anu's ₹ 80,000

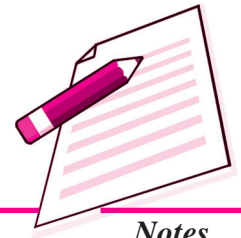


ANSWERS TO TERMINAL EXERCISE

7. New profit sharing ratio 15 : 9 : 8, Sacrificing ratio 5 : 3.
8. New profit sharing ratio 3 : 1 : 1
9. Goodwill ₹ 4,00,000
10. Loss on Revaluation ₹ 4,200, Total of Balance Sheet ₹ 1,25,800
11. Profit on Revaluation ₹ 5,040, Capital of A ₹ 1,20,000, B & C ₹ 60,000 each,
Balance sheet Total ₹ 2,64,000

**ACTIVITY**

Talk to the owners of five such business organisations which are doing good business and have built up good reputation in the market. Write against each firm the factor that have contributed to its goodwill

*Notes*

<i>Name of the firm</i>	<i>Nature of Business</i>	<i>Factors contributing to the goodwill of the firm</i>



Notes

24

RETIREMENT AND DEATH OF A PARTNER

If you look around, you must have noticed people in your relation and in your neighbourhood running business in partnership. You must have seen people quitting partnership firm or a person dies while in partnership. These are the events that take place during the lifetime of a partnership firm. Some issues arise on the happening of these events involving finance. Some assets and liabilities may need revaluation, goodwill is to be treated and amount of joint life policy is distributed and some accounting adjustment have to be made. Whenever such events take place, the firm has to calculate the dues of a partner leaving the firm or that of the deceased. In this lesson you will learn the accounting treatment in the books of the firm in these two cases i.e. retirement of a partner and death of a partner.

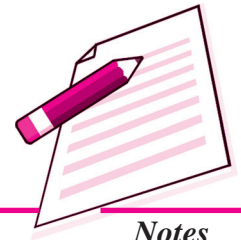


OBJECTIVES

After studying this lesson, you will be able to:

- state the meaning of retirement/death of a partner;
- calculate new profit sharing ratio and gaining ratio;
- make adjustments relating to goodwill;
- explain the need for revaluation of assets and reassessment of liabilities at the time of retirement/death;
- describe treatment of accumulated reserves and undistributed profits at the time of retirement/death of a partner;

- prepare revaluation account on retirement/death of a partner;
- illustrate the various methods of settling the claim of retiring partner and the related accounting treatment;
- illustrate the accounting treatment of partners' capital and its adjustment;
- ascertain profit up to the date of death of a partner and
- prepare the account of the deceased partner's executor.



Notes

24.1 RETIREMENT – MEANING, CALCULATION OF NEW PROFIT SHARING RATIO AND GAINING RATIO

When one or more partners leave the firm and the remaining partners continue to do the business of the firm, it is known as retirement of a partner. Amit, Sunil and Ashu are partners in a firm. Due to some family problems, Ashu wants to leave the firm. The other partners decide to allow him to withdraw from the partnership. Thus, due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions. At the time of retirement the retiring partner's claim is settled.

A partner retires either :

- (i) with the consent of all partners, or
- (ii) as per terms of the agreement; or
- (iii) at his or her own will.

The terms and conditions of retirement of a partner are normally provided in the partnership deed. If not, they are agreed upon by the partners at the time of retirement. The old partnership comes to an end and a new partnership is formed among the remaining partners. At the time of retirement the following accounting issues are dealt with :

- (a) New profit sharing ratio and gaining ratio.
- (b) Goodwill.
- (c) Adjustment of changes in the value of Assets and liabilities.
- (d) Treatment of reserve and accumulated profits.



Notes

- (e) Settlement of retiring partners dues.
- (f) New capital of the continuing partners.

New Profit Sharing Ratio and Gaining Ratio

As soon as a partner retires the profit sharing ratio of the continuing partners get changed. The share of the retiring partner is distributed amongst the continuing partners. In the absence of information, the continuing partners take the retiring partner’s share in their profit sharing ratio or in an agreed ratio. The ratio in which retiring partner’s share is distributed amongst continuing partners is known as gaining ratio. Gain of a partner is

$$\text{New Ratio} - \text{Existing Ratio}$$

Gain of an existing partner = His New Share - His Existing (old) Share

Various cases of new ratio and gaining ratio are illustrated as follows :

(i) Retiring Partner’s Share Distributed in Existing Ratio

In this case, retiring partner’s share is distributed in existing ratio amongst the remaining partners. The remaining partners continue to share profits and losses in the existing ratio. The following example illustrates this :

Tanu, Manu and Rena are partners sharing profits and losses in the ratio of 4 : 3 : 2. Tanu retires and remaining partners decide to take Tanu’s share in the existing ratio i.e. 3 : 2. Calculate the new ratio of Manu and Rena.

Existing Ratio between Manu and Rena = 3/9 and 2/9

Tanu’s Share (retiring partner) = 4/9

Tanu’s share taken by the Manu and Rena in the ratio of 3 : 2

Manu’s Gain = $4/9 \times 3/5 = 12/45$

Manu’s New Share = $3/9 + 12/45 = 27/45$

Rena’s Gain = $4/9 \times 2/5 = 8/45$

Rena’s New Share = $2/9 + 8/45 = 18/45$

New ratio of Manu and Rena is $27/45 : 18/45 = 27 : 18 = 3 : 2$.

Gain of a Partner = New Share – Existing Share

$$\text{Manu's Gain} = 27/45 - 3/9 = 12/45$$

$$\text{Rena's Gain} = 18/45 - 2/9 = 8/45$$

$$\text{Gaining Ratio} = 12/45 : 8/45 \text{ OR } 3 : 2$$

You may note that the new ratio is similar to existing ratio that existed between Manu and Rena before Tanu's retirement.

Note: In absence of any information in the question, it will be presumed that retiring partner's share has been distributed among the remaining partners in existing (old) ratio.



Notes

(ii) Retiring partner's share distributed in Specified proportion

Sometimes the remaining partners purchase the share of the retiring partner in specified ratio. The share purchased by them is added to their old share and the new ratio is arrived at. The following example illustrates this:

A, B and C are partners in the firm sharing profits in the ratio of 3 : 2 : 1. B retired and his share was divided equally between A and C. Calculate the new profit sharing ratio of A and C.

$$\text{B's Share} = 2/6$$

B's share is divided between A and C in the ratio of 1 : 1.

$$\text{A's Gain } 1/2 \text{ of } 2/6 = 2/6 \times 1/2 = 1/6$$

$$\text{A's New Share} = 3/6 + 1/6 = 4/6$$

$$\text{C's Gain } 1/2 \text{ of } 2/6 = 2/6 \times 1/2 = 1/6$$

$$\text{C's New share} = 1/6 + 1/6 = 2/6$$

Thus new, ratio of A and C will be 2 : 1

(iii) Retiring Partner's share is taken by one of the partners

The retiring partner's share is taken up by one of the remaining partners. In this case, the retiring partner's share is added to that of existing partner's share. Only his/her share changes. The other partners continue to share profit in the existing ratio. An example illustrating this point is given below:

Anuj, Babu and Rani share profit in the ratio of 5 : 4 : 2. Babu retires and his share is taken by Rani, So Rani's share is $2/11 + 4/11 = 6/11$, Anuj share will remain unchanged i.e, $5/11$. Thus, the new profit sharing ratio of Anuj and Rani is 5 : 6.



Notes

Illustration 1

Neru, Anu and Ashu are partners sharing profit in the ratio of 4 : 3 : 2. Ashu retires. Find the new ratio of Neru and Anu if terms for retirement provide the following :

- (i) Ratio is not given
- (ii) Equal distribution of Ashu's share
- (iii) Ashu's share is taken by Neru and Anu in the ratio of 2 : 1
- (iv) Anu takes over the share of Ashu.

Solution :

(i) New profit sharing ratio of Neru and Anu is 4 : 3.

(ii) Ashu's share = $\frac{2}{9}$

$$\text{Neru's Gain} = \frac{1}{2} \text{ of } \frac{2}{9} = \frac{2}{9} \times \frac{1}{2} = \frac{1}{9}$$

$$\text{Neru's New share} = \frac{4}{9} + \frac{1}{9} = \frac{5}{9}$$

$$\text{Anu's Gain} = \frac{1}{2} \text{ of } \frac{2}{9} = \frac{2}{9} \times \frac{1}{2} = \frac{1}{9}$$

$$\text{Anu's New Share} = \frac{3}{9} + \frac{1}{9} = \frac{4}{9}$$

New profit sharing ratio of Neru and Anu is $\frac{5}{9} : \frac{4}{9}$ or 5 : 4

Gaining ratio is equal $\frac{1}{9} : \frac{1}{9} = 1 : 1$

(iii) Ashu's Share = $\frac{2}{9}$

$$\text{Neru's Gain} = \frac{2}{3} \text{ of } \frac{2}{9} = \frac{2}{9} \times \frac{2}{3} = \frac{4}{27}$$

$$\text{Neru's new share} = \frac{4}{9} + \frac{4}{27} = \frac{16}{27}$$

$$\text{Anu's Gain} = \frac{1}{3} \text{ of } \frac{2}{9} = \frac{2}{9} \times \frac{1}{3} = \frac{2}{27}$$

$$\text{Anu's new share} = \frac{3}{9} + \frac{2}{27} = \frac{11}{27}$$

New profit sharing ratio of Neru and Anu is 16 : 11.

Gaining ratio is $\frac{4}{27} : \frac{2}{27} = 4 : 2 = 2 : 1$

$$\left[\text{i.e. } \frac{16}{27} - \frac{4}{9} = \frac{4}{27}; \frac{11}{27} - \frac{3}{9} = \frac{2}{27}; 4 : 2 = 2 : 1 \right]$$

(iv) Anu takes over Ashu share fully.

$$\text{Ashu's share} = \frac{2}{9}$$

Anu's Gain = $\frac{2}{9}$

Anu's new share = $\frac{3}{9} + \frac{2}{9} = \frac{5}{9}$

New profit sharing ratio of Neru and Anu is 4 : 5

Only Anu gains.

Illustration 2

Ashish, Barmon, and Chander are partners sharing profits and losses in the ratio of 2 : 1 : 2 respectively. Chander retires and Ashish and Barman decide to share the profits and losses equally in future. Calculate the gaining ratio.

Solution :

Gain of a Partner = New Share – Existing (old) Share

Hence, Ashish's Gain = $\frac{1}{2} - \frac{2}{5} = \frac{1}{10}$

Barman's Gain = $\frac{1}{2} - \frac{1}{5} = \frac{3}{10}$

Gaining ratio between Ashish and Barman is 1 : 3



INTEXT QUESTIONS 24.1

- I. Give any three circumstances under which a partner may retire from partnership.
- II. New share of remaining partner is
- III. Gain of a Partners Share = New Share –?
- IV. A B and C were sharing profit in the ratio of 3 : 2 : 1. A retires, his share is taken by B and C in the ratio of 2 : 1. Which of the following is the new ratio of B and C after A's retirement?
(a) 3 : 2 (b) 2 : 1 (c) 1 : 2

24.2 TREATMENT OF GOODWILL

The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of the efforts of all partners including the retiring one in the past. The retiring partner is compensated for his/her share of goodwill. As per Accounting Standard 10 (AS-10), goodwill is recorded in the books only when some consideration in money is paid for it. Therefore, goodwill is recorded in the books only when it is purchased and the goodwill account cannot be raised on its own.



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Partnership Account



Notes

Retirement and Death of a Partner

Therefore, in case of retirement of a partner, the goodwill is adjusted through partner's capital accounts. The retiring partner's capital account is credited with his/her share of goodwill and remaining partner's capital account is debited in their gaining ratio. The journal entry is made as under:

Remaining Partners' Capital A/c Dr. (individually)
 To Retiring Partner's Capital A/c
(Retiring partner's share of goodwill adjusted to remaining partners in the gaining ratio)

Illustration 3

Mitu, Udit and Sunny are partners sharing profit equally. Sunny retires and the goodwill of the firm is valued at ₹ 54,000. No goodwill account appears in the books of the firm. Mitu and Udit share future profit in the ratio of 3 : 2. Make necessary journal entry for goodwill.

Solution :

Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Mitu's Capital A/c Dr Udit's Capital A/c Dr. To Sunny's Capital A/c (Sunny's share of goodwill adjusted to remaining partners in their gaining ratio 4 : 1]		14,400 3,600	18,000

Note : Sunny's share of goodwill = ₹ 54,000 × 1/3 = ₹18,000

Gain of a Partner = New Share – Existing Share

Mitu Gains = $3/5 - 1/3 = 9/15 - 5/15 = 4/15$

Udit Gains = $2/5 - 1/3 = 6/15 - 5/15 = 1/15$

Gaining Ratio between Mitu and Udit = 4 : 1

When the Goodwill Account already appears in the Books

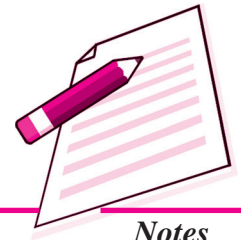
Retirement and Death of a Partner

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Partnership Account

Normally the goodwill is not shown in the books of the firm. If at the time of retirement/death of a partner, goodwill appears in the Balance Sheet of the firm, it will be written off by debiting all the partners' capital accounts in their existing profit sharing ratio and crediting the goodwill account. In such a case, the following journal entry is made:

Partners' Capital A/c Dr (including retiring partner's capital A/c)
 To Goodwill A/c
(Existing goodwill written-off)



Notes

Illustration 4

Tanu, Priya and Mayank are partners' sharing profit in the ratio of 3 : 2 : 1. Priya retires and on the date of Priya's retirement goodwill is valued at ₹ 90,000. Goodwill already appears in the books at a value of ₹ 48,000. New ratio of Tanu and Mayank is 3 : 2. Make the necessary journal entries.

Solution :

Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Tanu's Capital A/c Dr. Priya's Capital A/c Dr. Mayank's Capital A/c Dr. To Goodwill A/c (Existing goodwill written-off from the books)		24,000 16,000 8,000	48,000
	Tanu's Capital A/c Dr. Mayank's Capital A/c Dr. To Priya's Capital A/c (Priya's share of goodwill adjusted to remaining partners in their gaining ratio 3 : 2)		9,000 21,000	30,000

Note : Priya's share of goodwill = ₹90,000 × 2/6 = ₹30,000

Gaining of a Partner's = New Share – Existing Share,



Notes

$$\text{Tanu's Gain} = 3/5 - 3/6 = 18/30 - 15/30 = 3/30$$

$$\text{Mayank's Gain} = 2/5 - 1/6 = 12/30 - 5/30 = 7/30$$

$$\text{Gaining Ratio between Tanu and Mayank} = 3 : 7$$



INTEXT QUESTIONS 24.2

State whether the following statements are True or False :

- (i) Retiring partner's share of goodwill is debited to his/her capital account at the time of retirement.
- (ii) Goodwill is recorded in the books only when it is purchased.
- (iii) The retiring partner's capital account is debited with his/her share of goodwill and remaining partner's capital account is credited in their gaining ratio.
- (iv) In case goodwill account is written off the capital account of all partners is credited.

24.3 REVALUATION OF ASSETS AND REASSESSMENT OF LIABILITIES

At the time of retirement of a partner the assets of the firm are revalued and liabilities are reassessed. Revaluation Account is prepared in the same way as in case of admission of a partner. This is done to adjust the changes in value of assets and liabilities at the time of retirement/death of a partner. Any gain or loss due to revaluation is divided amongst all the partners including retiring/deceased in their existing profit sharing ratio. Following journal entries are made for this purpose:

- (i) For increase in value of assets:

Assets A/c	Dr.	(Individually)
To Revaluation A/c		
(Increase in the value of assets)		
- (ii) For decrease in value of assets:

Revaluation A/c	Dr.	
To Assets A/c		(Individually)
(Decrease in the value of asset)		

(iii) For increase in value of Liabilities:

Revaluation A/c	Dr.	
To Liabilities A/c		(Individually)
(Increase in the value of liabilities)		

(iv) For decrease in value of Liabilities:

Liabilities A/c	Dr.	(Individually)
To Revaluation A/c		
(Decrease in the value of liabilities)		



Notes

Revaluation account is prepared to record the change in the value of assets or liabilities. It will reveal profit or loss on revaluation. This profit or loss is divided amongst all partners including the retiring/deceased partner in existing profit sharing ratio.

(v) For Profit on Revaluation :

Revaluation A/c	Dr.	(Individually)
To Partner's Capital A/c		
(Profit on revaluation divided amongst all partners in their existing profit sharing ratio)		

(vi) For loss on Revaluation:

Partner's Capital A/c	Dr.	(Individually)
To Revaluation A/c		
(Loss on revaluation borne by all partners in their existing profit sharing ratio)		

Illustration 5

Mudit, Mohit and Sonu are partners sharing profit in the ratio 3 : 2 : 1. Mudit retires from the partnership. In order to settle his claim, the following revaluation of assets and liabilities was agreed upon:

- (i) The value of Machinery is increased by ₹ 25,000.
- (ii) The value of Investment is increased by ₹ 2,000.
- (iii) A provision for outstanding bill standing in the books at ₹ 1,000 is now not required.
- (iv) The value of Land and Building is decreased by ₹ 12,000.

Give journal entries and prepare Revaluation account.

Solution :

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Notes

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Machinery A/c Dr. Investments A/c Dr. Provision for Outstanding Bill Dr. To Revaluation A/c (Increase in value of Assets i.e. Machinery and investment and reduction in provision)		25,000 2,000 1,000	28,000
	Revaluation A/c Dr. To Land and Building A/c (Decrease in value of assets)		12,000	12,000
	Revaluation A/c Dr. To Mudit's Capital A/c To Mohit's Capital A/c To Sonu's Capital A/c (Gain on revaluation credited to all partners capital A/c in old profit sharing ratio i.e. 3 : 2 : 1)		16,000	8,000 5,333 2,667

Revaluation Account

Dr.

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
Land and Building	12,000	Machinery	25,000
Profit transferred to :		Investments	2,000
Mudit Capital 8,000		Provision for Outstanding Bill	1,000
Mohit Capital 5,333			
Sonu Capital 2,667	16,000		
	28,000		28,000

24.4 TREATMENT OF ACCUMULATED RESERVES AND UNDISTRIBUTED PROFIT

All the balances of Accumulated Reserves, funds and undistributed amount of Profit or Loss appearing in the balance sheet of the firm on the date of retirement/death is distributed amongst all partners including retiring/deceased partner in their old profit sharing ratio, The following entries are made:



Notes

(i) *For distribution of undistributed profit and reserve.*

Reserves A/c	Dr	
Profit & Loss A/c (Profit)	Dr.	
To Partners' Capital A/c		(individually)
(Reserves and Profit & Loss (Profit) transferred to all partners capitals A/c in existing profit sharing ratio)		

(ii) *For distribution of undistributed loss*

Partners' Capital A/c	Dr.	(individually)
To Profit & Loss A/c (Loss)		
(Profit & Loss (loss) transferred to all partners Capitals A/c in old profit sharing ratio)		



INTEXT QUESTIONS 24.3

I. *Fill in the blanks with suitable word or words :*

- The credit balance of Revaluation account shows
- Reserve shown in the Balance sheet are transferred to the side of at the time of retirement of a partner.
- The value of the assets has decreased at the time of retirement of a Partner Account will be debited and account will be credited with the decrease in amount.

II. *There was an increase in the value of a creditor at the time of retirement of a partner. What will be the journal entry for the above?*

24.5 SETTLEMENT OF RETIRING PARTNER'S CLAIM*Notes*

The amount due to the retiring partner is paid according to the terms of partnership agreement. The retiring partners' claim consists of

- (a) The credit balance of Capital Account;
- (b) His/her share in the Goodwill of the firm;
- (c) His/her share in the Gain/Profit on Revaluation;
- (d) His/her share in General Reserve and Accumulated Profit and
- (f) Interest on Capital

But, the following deductions are made from the balance in his/her Capital Account on account :

- (a) His/her share in the Loss on Revaluation;
- (b) His/her Drawings and Interest on Drawings up to the date of retirement;
- (c) His/her share of any accumulated losses and
- (d) Loan taken from the firm.

The total amount so calculated is the claim of the retiring partner. He/she is interested in receiving the amount at the earliest. Total payment may be made immediately after his/her retirement. However, the resources of the firm may not be adequate to make the payment to the retiring partner in lumpsum. The firm makes payment to retiring partner in instalments.

(i) Payment in Lump Sum

Retiring partners' claim is paid either out of the funds available with the firm or out of funds brought in by the remaining partners.

The following journal entry is made for disposal of-the amount payable to the retiring partner :

On payment of cash in lump sum.

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

Illustration 6

Om, Jai and Jagdish are partners sharing profit in the ratio of 3 : 2 : 1. Their balance sheet as at December 31st 2014 is as under :

Balance sheet as at December 31, 2014

<i>Liabilities</i>	<i>Amount (₹)</i>	<i>Assets</i>	<i>Amount (₹)</i>
Creditors	80,000	Building	1,80,000
Bills Payable	26,000	Plant	1,40,000
General reserve	24,000	Motor Car	40,000
Capital :		Stock	1,00,000
Om 1,60,000		Debtors 63,000	
Jai 1,20,000		<i>Less:</i> Provision	
Jagdish 1,20,000	4,00,000	for Bad debts 3,000	60,000
		Cash at Bank	10,000
	5,30,000		5,30,000



Jai retires on that date on the following terms:

- (a) The Goodwill of the firm is valued at ₹ 60,000.
- (b) Stock and Building to be appreciated by 10%.
- (c) Plant is depreciated by 10%
- (d) Provision for Bad debts is increased upto ₹ 5,000.
- (e) Jai's share of goodwill was adjusted through remaining partners capital account,

The amount due to Jai is paid out of the fund brought in by Om and Jagdish in their new profit sharing ratio. Jai is paid full amount.

Prepare Revaluation Account and Partner's Capital account.

Solution :

It is assumed that Om and Jagdish gaining ratio remains 3 : 1.

Jai' Share of goodwill

$$₹ 60,000 \times \frac{2}{6} = ₹ 20,000$$

Adjusted through the remaining partners capital account in 3 : 1 ratio

MODULE - 4

Partnership Account



Notes

Retirement and Death of a Partner

Revaluation Account

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
Provision for Bad debts	2,000	Stock	10,000
Plant	14,000	Building	18,000
Profit transferred to Capital Accounts :			
Om	6,000		
Jai	4,000		
Jagdish	<u>2,000</u>		
	28,000		28,000

Capital Account

Dr.				Cr.			
Particulars	Om (₹)	Jai (₹)	Jagdish (₹)	Particulars	Om (₹)	Jai (₹)	Jagdish (₹)
Capital	15,000	—	5,000	Balance b/d	1,60,000	1,20,000	1,20,000
Bank		1,52,000		General Reserve	12,000	8,000	4,000
Balance c/d	2,77,000	—	1,59,000	Revaluation (Profit)	6,000	4,000	2,000
				Om Capital	—	15,000	—
				Jagdish Capital	—	5,000	
				Bank	1,14,000		38,000
	2,92,000	1,52,000	1,64,000		2,92,000	1,52,000	1,64,000

(ii) Payment in Instalments

In this case the amount due to retiring partner is paid in instalments. Usually, some amount is paid immediately on retirement and the balance is transferred to his loan account. This loan is paid in one or more instalments. The loan amount carries some interest. In the absence of any agreement the rule under Section 37 of the Indian Partnership Act 1932 applies.

According to this rule, if the amount due to the retiring partner is not paid immediately on his retirement, he can claim interest @ 6% p.a. on the amount due.

An instalment consists of two parts :

- (i) Principal Amount of instalment due to retiring partner.
- (ii) Interest at an agreed rate,

Interest due on loan amount is credited to retiring partners' loan account. Instalment inclusive of interest then is paid to the retiring partner as per schedule agreed upon.



Notes

- (i) *On part payment in cash and balance transferred to his/her loan account.*

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

(Part payment made and balance transferred to loan A/c)

- (ii) *Total amount due transferred to loan A/c*

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

(Total amount due transferred to loan A/c)

- (iii) *For interest due*

Interest on loan A/c	Dr.
To Retiring Partners' Loan A/c	

(Interest due on loan)

- (iv) *For payment of instalment*

Retiring Partners' Loan A/c	
To Cash/Bank A/c	

(Instalment inclusive of interest paid)

Illustration 7

Taking the figures of the previous illustration, assuming that he is paid 40% of the amount due immediately and the balance in three equal yearly instalments. The interest payable is 12% p.a.

Solution:

The amount due to Jai	= ₹	1,52,000
Amount paid immediately	= ₹	1,52,000 × 40/100 = ₹ 60,800
Amount of three equal instalments	= ₹	1,52,000 – ₹ 60,800 × 3
	= ₹	91,200 ÷ 3 = ₹ 30,400

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Partnership Account



Notes

Retirement and Death of a Partner

1st Instalment at the end of 1st Year = ₹ 30,400 + ₹ 10,944 (interest)
= ₹ 41,344

Interest @ 12% pa. = ₹ 91,200 × 12/100 = ₹ 10,944

2nd Instalment at the end of 2nd Year = ₹ 30,400 + ₹ 7,296 (interest)
= ₹ 37,344

Interest @ 12% pa. = ₹ 60,800 × 12/100 = ₹ 7,296

3rd Instalment at the end of 3rd Year = ₹ 30,400 + ₹ 3,648
= ₹ 34,048

Interest @ 12% pa. = ₹ 30,400 × 12/100 = ₹ 3,648



INTEXT QUESTIONS 24.4

I. List the various claims of a retiring partner:

1. 2. 3. 4.

II. Mention the modes of settling the total claims of the retiring partner:

1. 2.

III. Find the total amount due to Munish, who is retiring as a partner:

1. Credit balance in Munish capital account ₹20,000.
2. Munish's share of goodwill ₹7,000
3. General reserve balance shown in Balance sheet ₹10,000
4. Profit on Revaluation of Assets /liabilities ₹ 3,000
5. Interest on drawings ₹ 1,500.
6. Munish share in the profit of the firm 1/2

24.6 ADJUSTMENT OF REMAINING PARTNER'S CAPITAL ACCOUNT AFTER RETIREMENT

After retirement of a partner the remaining partners may decide to adjust their capital. Often the remaining partners determine the total amount of capital of the reconstituted firm and decide to keep their respective capital accounts in proportion to the new profit sharing ratio. The total capital of the firm may be more or less than the total of their capital at the time of retirement. The new capitals of the partners are compared with the balance standing to the credit of respective partner's capital account. If there

is a surplus in the capital account, the amount is withdrawn by the concerned partner. The partner brings cash in case the balance in the capital account is less than the calculated amount.

Illustration 8

Roopa, Sunder and Shalu are partners sharing profit in the ratio of 5 : 3 : 2. Roopa retired, when their capitals were: ₹ 46,000, ₹ 42,000 and ₹ 38,000 respectively after making all adjustments on retirement. Sunder and Shalu decided to have a total capital of the firm at ₹ 84,000 in the proportion of 7 : 5. Calculate actual cash to be paid or brought in by each partner and make necessary journal entries.

Solution :

Total Capital of the New firm	= ₹ 84,000	
Sunder's share in the new capital	= ₹ 84,000 × 7/12	= ₹ 49,000
Shalu's share in the new capital	= ₹ 84,000 × 5/12	= ₹ 35,000

On comparing Sunder's share in the new capital of the firm with the amount standing to the credit of his capital, it is observed that he has to bring ₹ 7,000 the deficit amount (₹ 49,000 – ₹ 42,000) in Cash.

Similarly, Shalu's share in the new capital of the firm is ₹ 35,000 while ₹ 38,000 stand credited to her capital account. So she will withdraw ₹ 3,000, the surplus amount (₹ 38,000 – ₹ 35,000) from the firm so as to make her capital in proportion to their new profit share ratio.

Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr.		7,000	
	To Sunder's Capital A/c			7,000
	(The deficit amount brought in by the partner)			
	Shalu's Capital A/c Dr.		3,000	
	To Bank A/c			3,000
	(The surplus amount withdrawn by the partner)			



Notes



Notes

Adjustment of remaining partner’s capital in their profit sharing ratio, when the total capital of the new firm is not pre-determined.

In this case the total amount of adjusted capital of the remaining partners is rearranged as per agreed proportion in which they share profit of the reconstituted firm. The following steps may be adopted:

- (i) Add the balance standing to the credit of the remaining partners’ capital accounts.
- (ii) The total so obtained is the total capital of the firm.
- (iii) This capital is divided according to the new profit sharing ratio.

Illustration 9

Sumit, Amit and Neha are partners sharing profit in the ratio of 4 : 3 : 1. when Amit retired , their adjusted capitals were ₹ 76,000; ₹ 45,000 and ₹ 34,000 respectively. Sumit and Neha decided to have their total capital of the firm in the ratio of 3 : 2. The necessary adjustments were to be made in cash only. Calculate actual cash to be paid off or brought in by each partner.

Solution:

Total of the adjusted capitals of the remaining partners.

Sumit	= ₹ 76,000
Neha	= ₹ 34,000
Total	= ₹ 110,000

Total capital of the firm which is divided in the new ratio of 3 : 2.

New capital of Sumit	= ₹ 1,10,000 × 3/5 = ₹ 66,000
New Capital of Neha	= ₹ 1,10,000 × 2/5 = ₹ 44,000

Sumit’s share in the new capital of the firm is ₹ 66,000 while ₹ 76,000 stand credited to his capital account. So he will withdraw ₹ 10,000 (₹ 76,000 – ₹ 66,000) from the firm so as to make his capital in proportion to his new profit sharing ratio.

Similarly, Neha’s share in the new capital of the firm is ₹ 44,000 while ₹ 34,000 stands credited to her capital account, She has to bring ₹ 10,000 (₹ 44,000 – ₹34,000) in Cash to make up the deficit in the capital account.

Illustration 10

The Balance Sheet of Rohit, Nisha and Sunil who are partners in a firm sharing profits according to their capitals as on 31st March 2014 was as under:

Retirement and Death of a Partner

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Partnership Account

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Creditors	25,000	Machinery	40,000
Bills Payable	13,000	Building	90,000
General Reserve	22,000	Debtors	30,000
Capital :		Less Provision for	
Rohit	60,000	Bad debts	1,000
Nisha	40,000	Stocks	23,000
Sunil	<u>40,000</u>	Cash at Bank	18,000
	<u>2,00,000</u>		<u>2,00,000</u>



Notes

On the date of Balance Sheet, Nisha retired from the firm, and following adjustments were made:

- (i) Building is appreciated by 20%.
- (ii) Provision for bad debts is increased to 5% on Debtors.
- (iii) Machinery is depreciated by 10%.
- (iv) Goodwill of the firm is valued at ₹ 56,000 and the retiring partner's share is adjusted.
- (v) The capital of the new firm is fixed at ₹ 1,20,000.

Prepare Revaluation Account, Capital Accounts of the partner and Balance Sheet of the new firm after Nisha's retirement.

Solution :

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Provision for Bad debt A/c	500	Building A/c	18,000
Machinery A/c	4,000		
Profit transferred to Capital Accounts (3 : 2 : 2)			
Rohit	5,786		
Nisha	3,857		
Sunil	<u>3,857</u>		
	13,500		
	<u>18,000</u>		<u>18,000</u>

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Partnership Account



Notes

Retirement and Death of a Partner

Capital Account

Dr.

Cr.

Particulars	Rohit (₹)	Nisha (₹)	Sunil (₹)	Particulars	Rohit (₹)	Nisha (₹)	Sunil (₹)
Sunil's Capital a/c	9,600	—	6,400	Balance b/d	60,000	40,000	40,000
Bank		66,143		General Reserve	9,428	6,286	6,286
Balance c/d	72,000	—	48,000	Revaluation (Profit)	5,786	3,857	3,857
				Rohit's Capital A/c	—	9,600	—
				Sunil's Capital A/c		6,400	
				Bank	6,386		4,257
	81,600	66,143	54,400		81,600	66,143	54,400

Balance Sheet as at 31st March 2014

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	25,000	Building	1,08,000
Bank overdraft	37,500	Machinery	36,000
Bills Payable	13,000	Debtors	30,000
Capital:		Less: Provision for Bad debts	1,500
Rohit	72,000	Stock	23,000
Sunil	48,000		
	1,20,000		
	1,95,500		1,95,500

Working Notes :

(i) (a) Profit sharing ratio is 60,000 : 40,000 : 40,000 i.e. = 3 : 2 : 2

(b) Gaining Ratio: Rohit = $3/5 - 3/7 = 21/35 - 15/35 = 6/35$

Sunil = $2/5 - 2/7 = 14/35 - 10/35 = 4/35$

= $6/35 : 4/35$

= 6 : 4 = 3 : 2

(c) Nisha Share of Goodwill = ₹ 56,000 × 2/7 = ₹ 16,000.

Share of Goodwill in the gaining ratio by the existing partner, i.e.

Rohit = ₹ 16,000 × 3/5 = ₹ 9,600

Sunil = ₹ 16,000 × 2/5 = ₹ 6,400

Retirement and Death of a Partner

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Partnership Account

The journal entry is

		₹	₹
Rohit's Capital A/c	Dr.	9,600	
Sunil's Capital A/c	Dr.	6,400	
To Nisha's Capital A/c			16,000
(Share of Goodwill divided into gaining ratio)			



Notes

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Balance b/d	18,000	Nisha's Capital A/c	66,143
Rohit's Capital A/c	6,386		
Sunil's Capital A/c	4,257		
Balance c/d (Bank overdraft)	37,500		
	66,143		66,143

(ii) Bank overdraft is taken to pay the retiring partners amount.

(iii) New Capital of the firm is fixed at ₹ 1,20,000.

	<i>Rohit</i> (₹)	<i>Sunil</i> (₹)
New Capital (₹1,20,000 in the ratio of 3 : 2)	72,000	48,000
Existing Capital (After Adjustments) i.e. partner capitals	65,614	43,743
Cash to be brought by the remaining partners	6,386	4,257

Illustration 11

Chauhan Triphati and Gupta are partners in a firm sharing profit and losses in the ratio of 1/2, 1/6 and 1/3 respectively. The Balance Sheet on March 31, 2014 was as follows :

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry Creditors	36,000	Freehold Premises	80,000
Bills Payable	24,000	Machinery	60,000

MODULE - 4

Partnership Account



Notes

Retirement and Death of a Partner

General Reserve		24,000	Furniture		24,000
Capitals:			Debtors	40,000	
Chauhan	60,000		Less : Provision		
Triphati	60,000		for bad debts	2,000	38,000
Gupta	<u>56,000</u>	1,76,000	Stock		44,000
			Cash		14,000
		<u>2,60,000</u>			<u>2,60,000</u>

Gupta retires from the business and the partners agree to the following revaluation:

- Freehold premises and stock are to be appreciated by 20% and 15% respectively
- Machinery and furniture are to be depreciated by 10% and 7% respectively
- Bad debts reserve is to be increased to ₹ 3,000.
- On Gupta's retirement, the goodwill is valued at ₹ 42,000.
- The remaining partners have decided to adjust their capitals in their new profit sharing ratio after retirement of Gupta. Surplus/deficit, if any in their capital account will be adjusted through cash.

Prepare necessary ledger accounts and Balance Sheet of reconstituted firm.

Solution:

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Provision for Bad debts	1,000	Freehold Premises	16,000
Machinery	6,000	Stock	6,600
Furniture	1,680		
Profit transferred to Capital Accounts:			
Chauhan	6,960		
Triphati	2,320		
Gupta	<u>4,640</u>		
	13,920		
	<u>22,600</u>		<u>22,600</u>

Capital Account

Dr.

Cr.

Particulars	Chauhan (₹)	Triphati (₹)	Gupta (₹)	Particulars	Chauhan (₹)	Triphati (₹)	Gupta (₹)
Gupta Capital	10,500	3,500		Balance b/d	60,000	60,000	56,000
Gupta Loan			82,640	General Reserve	12,009	4,000	8,000
Cash		30,000		Revaluation (Profit)	6,960	2,320	4,640
Balance c/d	98,460	32,820		Chauhan Capital			10,500
				Tirphati Capital			3,500
				Cash	30,000		
	1,08,960	66,320	82,640		1,08,960	66,320	82,640



Notes

Balance Sheet as at March 31, 2014

Liabilities	Amount (₹)	Assets	Amount (₹)
Creditors	36,000	Freehold Premises	96,000
Bills Payable	24,000	Machinery	54,000
Gupta's Loan	82,640	Furniture	22,320
Capital:		Debtors 40,000	
Chauhan 98,460		Less : Provision	
Tirphati 32,820	1,31,280	for bad debts 3,000	37,000
		Stock	50,600
		Cash	14,000
	2,73,920		2,73,920

Working Note:

- In the absence of agreement, retiring partner's capital account is transferred to his loan account.
- In the absence of agreement, gaining ratio is equal to existing ratio (old ratio) of remaining partners is gaining ratio i.e. 3 : 1
- Calculation of Cash brought in (or paid off) by remaining partner.

	Chauhan ₹	Tirphati ₹
Total Capital of Chauhan and Tirphati (₹68,460 + ₹62,820 = ₹1,31,280 in the ratio of 3 : 1)	98,460	32,820
Adjusted existing Capital	68,460	62,820
Excess or Deficit	30,000 (Excess)	30,000 (Deficit)



Notes



INTEXT QUESTIONS 24.5

- i. Surinder, Mahinder and Tarun are partners in a firm. After Surinder’s retirement, the profit sharing ratio between Mahinder and Tarun is 5 : 3.

They decide to fix the firm’s capital at ₹ 80,000. Find the individual capitals of Mahinder and Tarun.

Mahinder’s Capital ₹ Tarun’s Capitals ₹

- ii. Sohan, Amisha and Neena are partners sharing profit in the ratio of 3 : 2 : 1. when Sohan retired, their adjusted capitals were ₹ 90,000, ₹ 60,000 and ₹ 70,000 respectively. Amisha and Neena decided to have their total capital of the firm in the ratio of 5 : 3. Find the capital of each partner and the total capital of firm.

Amisha Capital ₹ Neena Capital ₹

24.7 DEATH OF A PARTNER

On the death of a partner, the accounting treatment regarding goodwill, revaluation of assets and reassessment of liabilities, accumulated reserves and undistributed profit are similar to that of the retirement of a partner. On the death of partner the amount payable to him/her is paid to his/her legal representatives. The legal representatives are entitled to the followings :

- (a) The amount standing to the credit of the capital account of the deceased partner.
- (b) Interest on capital, if provided in the partnership deed upto the date of death.
- (c) Share of goodwill of the firm.
- (d) Share of undistributed profit or reserves.
- (e) Share of profit on the revaluation of assets and liabilities.
- (f) Share of profit upto the date of death.
- (g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner’s legal representatives:

- (i) Drawings
- (ii) Interest on drawings

- (iii) Share of loss on the revaluation of assets and liabilities;
- (iv) Share of loss that have occurred till the date of his/her death.

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor.

The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment.

*Notes*

Calculation of Profit upto the Date of Death of a Partner

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

- (i) Time Basis;
- (ii) Turnover or Sales Basis

(i) Time Basis

In this case, it is assumed that profit has been earned uniformly through out the year. For example:

The total profit of previous year is ₹ 2,25,000 and a partner dies three months after the close of previous year, the profit of three months is ₹ 31,250 i.e. ₹ 1,25,000 \times 3/12. If the deceased partner took 2/10 share of profit, his/her share of profit till the date of death is ₹ 6,250 i.e. ₹ 31,250 \times 2/10

(ii) Turnover or Sales Basis

In this method, we have to take into consideration the profit and the total sales of the last year. Thereafter the profit upto the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Illustration 12

Arun, Tarun and Neha are partners sharing profits in the ratio of 3 : 2 : 1 Neha dies on 31st May 2014. Sales for the year 2013-2014 amounted to ₹ 4,00,000 and the profit on sales is ₹ 60,000. Accounts are closed on 31 March every year. Sales from 1st April 2014 to 31st May 2014 is ₹ 1,00,000.



Notes

Calculate the deceased partner's share in the profit upto the date of death.

Solution :

Profit from 1st April 2014 to 31st May 2014 on the basis of sales:

If sales are ₹ 4,00,000, profit is ₹ 60,000

If the sales are ₹ 1,00,000 profit is : $\frac{₹ 60,000}{₹ 4,00,000} \times ₹ 1,00,000$
 = ₹15,000

Neha's share = ₹ 15,000 × 1/6 = ₹ 2,500

Alternatively profit is calculated as

$$\text{Rate of profit} = \frac{60,000}{4,00,000} \times 100 = 15\%$$

Sale upto date of death = 1,00,000

$$\text{Profit} = 1,00,000 \times \frac{15}{100} = ₹ 15,000$$

Illustration 13

Nutan, Sumit and Shiba are partners in a firm sharing profits in the ratio 5 : 3 : 2. On 31st December 2014 their Balance Sheet was as under:

<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
		(₹)			(₹)
Creditors		52,000	Building		60,000
Reserve Fund		15,000	Plant		50,000
Capitals :			Stock		27,000
Nutan	60,000		Debtors		25,000
Sumit	45,000		Cash		10,000
Shiba	<u>30,000</u>	1,35,000	Bank		30,000
		<u>2,02,000</u>			<u>2,02,000</u>

Nutan died on 1 July 2015. It was agreed between her executor and the remaining partners that:

- (i) Goodwill to be valued at 2½ years purchase of the average profits of the last Four years, which were: 2011 ₹ 25,000; 2012 ₹ 20,000; 2013 ₹40,000 and 2014 ₹35,000.

- (ii) Building is valued at ₹ 70,000; Plant at ₹46,000 and Stock at ₹ 32,000.
- (iii) Profit for the year 2015 be taken as having accrued at the same rate as that of the previous year.
- (iv) Interest on capital is provided at 9% p.a.
- (v) On 1 July 2015 her drawings account showed a balance of ₹.20,000.
- (vi) ₹ 25,950 are to be paid immediately to her executor and the balance is transferred to her Executors Loan Account.



Notes

Prepare Nutan's Capital Account and Nutan's Executor's Account as on 1st July 2015.

Solution :

- (i) Valuation of Goodwill:

$$\begin{aligned} \text{Total Profit} &= ₹ 25,000 + ₹ 20,000 + ₹ 40,000 + ₹ 35,000 \\ &= ₹ 1,20,000 \\ \text{Average Profit} &= ₹ 1,20,000/4 = ₹ 30,000 \end{aligned}$$

Hence, Goodwill at 2½ year's purchase = ₹ 30,000 × 2½ = ₹ 75,000

Nutan's share of goodwill = ₹ 75,000 × 5/10 = ₹ 37,500

It is adjusted into the Capital Accounts of Sumit and Shiba in the gaining ratio of 3 : 2 i.e. ₹ 22,500 and ₹ 15000 respectively.

- (ii) Share of Profit payable to Nutan [upto the date of death]
 - = ₹ 35,000 × 6/12 × 5/10
 - = ₹ 8,750
- (iii) Nutan's Share of Reserve Fund = ₹ 15,000 × 5/10
 - = ₹ 7,500
- (iv) Interest on Nutan's Capital = ₹ 60,000 × 9/100 × 6/12
 - = ₹ 2,700

Revaluation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Plant	4,000	Building	10,000

MODULE - 4

Partnership Account



Notes

Retirement and Death of a Partner

Profit transferred to		Stock	5,000
Nutan Capital	5,500		
Sumit Capital	3,300		
Shiba Capital	<u>2,200</u>		
	11,000		
	<u>15,000</u>		<u>15,000</u>

Nutan's Capital Account

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
Drawings	20,000	Balance b/d	60,000
Nutan's Executor's	1,01,950	Reserve fund	7,500
		Sumit's Capital (Goodwill)	15,000
		Shiba's Capital (Goodwill)	22,500
		Profit & Loss (Suspense)	8,750
		Revaluation A/c	5,500
		Interest on Capital	2,700
	<u>1,21,950</u>		<u>1,21,950</u>

Nutan's Executor's Accounts

Dr.		Cr.	
Particulars	Amount (₹)	Particulars	Amount (₹)
Bank	25,950	Nutan's Capital	1,01,950
Nutan's Executor's			
Loan A/c (Transfer)	76,000		
	<u>1,01,950</u>		<u>1,01,950</u>

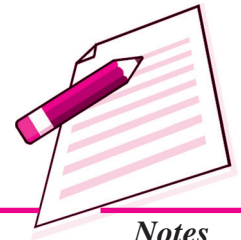


INTEXT QUESTIONS 24.6

Fill in the blanks with suitable words :

- The Executor is entitled to all the rights of a
- Share of goodwill of the deceased partner is to his capital account.

- iii. In case of death of a partner, the profit may be estimated on the basis of and
- iv. The balance in the capital account of the deceased partner is transferred to his account.
- v. Interest on drawing due from deceased partner till the date of the death is to his capital account.



Notes



WHAT YOU HAVE LEARNT

● Retirement

1. Due to some reasons like old age, poor health, strained relations etc., an existing partner may decide to retire from the partnership. Due to retirement, the existing partnership comes to an end and the remaining partners form a new agreement and the partnership firm is reconstituted with new terms and conditions.
2. At the time of retirement the following accounting issues are dealt:
 - (a) New profit sharing ratio and gaining ratio.
 - (b) Goodwill
 - (c) Adjustment of changes in the value of Assets and liabilities
 - (d) Treatment of reserve and accumulated profits.
 - (e) Settlement of retiring partner's dues,
 - (f) New capital of the continuing partners.

● Death

1. On the death of a partner, the amount payable to him is paid to his/her legal representatives.
2. The representatives of deceased partner is entitled to the followings:
 - (a) The amount standing to the credit of the capital account of the deceased partner.
 - (b) Interest on capital, if provided in the partnership deed, upto the date of death.
 - (c) Share of the value of goodwill of the firm.
 - (d) Share of undistributed profit or reserves.



Notes

- (e) Share of profit on the revaluation of assets and liabilities.
- (f) Share of profit upto the date of death.
- (g) Share of Joint Life Policy.

The following amounts are debited to the account of the deceased partner's legal representatives:

- (i) Drawings
 - (ii) Interest on drawings
 - (iii) Share of loss on the revaluation of assets and liabilities
 - (iv) Share of loss that have occurred till the date of his/her death
3. Calculation of Profit upto the date of death Two Methods
- (i) Time basis
 - (ii) Sales basis



TERMINAL EXERCISE

1. What is meant by retirement of a partner?
2. Explain the meaning of gaining Ratio.
3. Explain the accounting treatment of goodwill on retirement of a partner.
4. What problems involving finance arise when a partner dies? How would you deal with them as an accountant?
5. Seema, Mohit and Meenakshi were partners in a firm sharing profit in the ratio of 7 : 6 : 7. Mohit retired and his share was divided equally between Seema and Meenakshi. Calculate the new profit sharing ratio of Seema and Meenakshi.
6. Ashu, Ashmita and Meetu are partners sharing profits in the ratio of 4 : 3 : 2. Ashu retires, assuming Ashmita and Meetu will share profits in future in the ratio 5 : 3, determine the gaining ratio.
7. Anu, Beena and Chander are partners in a firm, sharing profit in the ratio of 3 : 2 : 1. Their Balance Sheet as on March 31, 2014 was as follows:

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry Creditors	3,200	Cash in hand	1,200
General Reserve	12,000	Cash at Bank	2,000

Retirement and Death of a Partner

Capitals:			Debtors	18,000
Anu	20,000		Stocks	14,000
Beena	20,000		Machinery	12,000
Chander	<u>20,000</u>	60,000	Building	28,000
		<u>75,200</u>		<u>75,200</u>

On the date of Balance Sheet Chander retires from firm. It is agreed to adjust the value of assets as follows:

- Provide a reserve of 5% on Sundry Debtors for Doubtful Debts.
- Building to be revalued at ₹ 30,200.
- Depreciate stock by 5% and Machinery by 10%.

Prepare Revaluation account, Partners Capital account and Balance Sheet of Anu and Beena.

8. Ashok, Babu and Chinu are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The firm's Balance Sheet on March 31, 2014 was as follows:

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry Creditors	38,000	Plant & Machinery	70,000
Bills Payable	10,000	Building	90,000
General Reserve	24,000	Motor Car	16,000
Capitals:		Debtors	32,000
Ashok	80,000	<i>Less:</i> Provision	
Babu	60,000	for bad debts	1,000
Chinu	<u>50,000</u>	Stock	50,000
	1,90,000	Cash	5,000
	<u>2,62,000</u>		<u>2,62,000</u>

Babu retires on that date, subject to the following adjustments:

- The Goodwill of the firm to be valued at ₹ 36,000.
- Plants and Machinery to be depreciated by 10% and Motor Car by 15%.
- Stock to be appreciated by 20% and Building by 10%.
- Provision for Doubtful debts to be increased by ₹ 3,900.

Prepare Revaluation Account and Babu's Capital account.

MODULE - 4

Partnership Account



Notes



Notes

9. Dhruv, Raja and Lela are partners sharing profit and losses in the ratio of 3 : 2 : 1 respectively. The Balance Sheet as on March 31, 2014 was as follows:

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry Creditors	31,200	Plant & Machinery	37,600
Dhruv Loan	10,000	Building	24,000
Capitals:		Debtors 24,800	
Dhruv 51,840		Less : Provision	
Raja 27,360		for bad debts 2,400	22,400
Lela 14 240	93,440	Stock	18,400
		Cash	32,240
	1,34,640		1,34,640

Dhruv retired on March 31, 2014 and Raja and Lela continued in partnership sharing profits and losses in the ratio of 2 : 1. Dhruv was paid ₹ 20000 on 1.4.2014 and it was agreed that the remaining balance due to him should be kept as his loan to the firm,

For the purpose of Dhruv’s retirement it was agreed that

- Building be revalued at ₹ 48,000 and Plant and Machinery at ₹31,600.
- The provision for bad debts was to be increased by ₹800.
- A provision of ₹1,000 included in creditor was no longer required.
- ₹ 2,400 was to be written off from the stock in respect of damaged items included therein.
- A provision of ₹ 8,480 made in respect of outstanding legal charges.
- The goodwill of the firm to be valued at ₹ 28,800.

Prepare Revaluation Account, Capital A/c of partners and Balance sheet of the reconstituted firm.

10. Sunny, Honey and Rupesh are partners in a firm. Their Balance sheet as on December 31,2013 is as under:

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Creditors	20,000	Plant & Machinery	40,000
General Reserve	20,000	Furniture & Fittings	5,000

Retirement and Death of a Partner

Capitals:			Debtors	30,000
Sunny	40,000		Stock	21,000
Honey	30,000		Investment	24,000
Rupesh	<u>10,000</u>	80,000		
		<u>1,20,000</u>		<u>1,20,000</u>

Honey died on 30.06.2014. The partnership deed provides that the representative of the deceased partner shall be entitled to:

- (i) Balance of the capital account of deceased partner.
- (ii) Interest on Capital at 8% p.a. upto date of death.
- (iii) His share of profit upto date of death on the average of last three years profit.
- (iv) His share of any undistributed profit and losses as per last balance sheet.
- (v) Profit for the last three years was ₹ 30,000, ₹ 40,000 and ₹ 50,000.

Ascertain the amount payable to the legal representatives of Honey.

MODULE - 4

Partnership Account



Notes



ANSWERS TO INTEXT QUESTIONS

- 24.1** I. (a) Old age (b) Poor health (c) Bad relations
II. Existing share + Gaining share
III. Existing share
IV. 2 : 1
- 24.2** (i) False, (ii) True, (iii) False, (iv) False.
- 24.3** I. (a) Gain/Profit, (b) Credit : Partners' Capital A/c,
(c) Revaluation, Assets
II. Revaluation A/c Dr.
 To Creditors A/c
(Increase in value of creditors)
- 24.4** I. i. The balance of his/her Capital Account;
 ii. His/her share in the Goodwill of the firm;
 iii. His/her share in the Revaluation Profit;
 iv. His/her share in General Reserve and Accumulated Profit;
 v. Interest on Capital OR any other

MODULE - 4

Partnership Account



Notes

Retirement and Death of a Partner

II. 1. Lumpsum 2. Instalments

III. ₹ 32,000.

- 24.5**
- i. Mahinder's Capital ₹ 50,000, Tarun's Capital ₹ 30,000
 - ii. Amisha Capital ₹ 1,37,500, Neena Capital ₹ 82,500 Total Capital ₹2,20,000.
- 24.6**
- (i) Deceased partner,
 - (ii) credited,
 - (iii) Time, Sales,
 - (iv) Executor's
 - (v) debited



ANSWERS TO TERMINAL EXERCISE

- 5. New Ratio 1 : 1
- 6. Gaining Ratio 21 : 11
- 7. Loss on Revaluation ₹ 600
Total of Balance Sheet ₹ 74,600
- 8. Profit on Revaluation ₹ 5,700,
Balance of Babu Capital Account ₹ 81,900.
- 9. Profit on Revaluation ₹ 7,320
Total of Balance Sheet ₹ 1,22,680.
- 10. Amount payable to Honney's Executor ₹ 44,534.

25

DISSOLUTION OF PARTNERSHIP FIRM



Notes

Rakesh and Mukesh were very good friends. They were running a business as a partnership firm. They were very successful. People were jealous of their relations. But one day people came to know that they have closed the business. Some dispute had arisen between the two on a trivial issue. Similarly, firm may come to an end because of dispute among the partners or firm running in losses for last few years or because of order of the court and so on. We can say that the partnership firm is dissolved. In this lesson, you will learn about the accounting treatment in case of dissolution of partnership firm.



OBJECTIVES

After going through this lesson, you will be able to:

- state the meaning of dissolution of partnership firm;
- distinguish between dissolution of partnership and dissolution of partnership firm;
- explain the Realisation account and disposal of assets and payment of liabilities;
- illustrate the treatment of unrecorded assets and liabilities; and
- prepare partners' capital accounts and bank and/or cash account.

25.1 DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF PARTNERSHIP FIRM

The term dissolution means coming to an end or discontinuation. The dissolution of the firm implies a complete breakdown of the partnership relation among all the



Notes

partners. Dissolution of the partnership (owing to retirement, death or insolvency of a partner), merely involves change in the relation of the partners but it does not end the firm; the partnership would certainly come to an end but the firm, the reconstituted one might continue under the same name. So the dissolution of the partnership may or may not include the dissolution of the firm but the dissolution of the firm necessarily means the dissolution of the partnership. On dissolution of the firm, the business of the firm ceases to exist since its affairs are wound up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

- (i) **Dissolution by Agreement :** A firm is dissolved in case
- all the partners give consent or
 - as per the terms partnership agreement .
- (ii) **Compulsory dissolution :** A firm is dissolved compulsorily in the following cases
- When all the partners or all excepting one partner becomes insolvent or of unsound mind.
 - When the business becomes unlawful.
 - When all the partners excepting one decide to retire from the firm.
 - When all the partners or all excepting one partner die.
 - A firm is also dissolved compulsorily if the partnership deed includes any provision regarding the happening of the following events
 - (a) expiry of the period for which the firm was formed,
 - (b) completion of the specific venture or project for which the firm was formed.
- (iii) **Dissolution by Notice :** In case of a partnership at will, the firm may be dissolved if any one of the partner gives a notice in writing to the other partners.
- (iv) **Dissolution by Court :** A court may order a partnership firm to be dissolved in the following cases:
- (a) When a partner becomes of unsound mind
 - (b) When a partner becomes permanently incapable of performing his/her duties as a partner,
 - (c) When partner deliberately and consistently commits breach of agreements relating to the management of the firm;
 - (d) When a partner's conduct is likely to adversely affect the business of the firm;

- (e) When a partner transfers his/her interest in the firm to a third party;
- (g) When the court regards dissolution to be just and equitable.

Distinction Between Dissolution of Partnership and Dissolution of Partnership Firm

You have already studied that on the occasion of admission, retirement and death existing partnership comes to an end, but the business of the firm continues under a new agreement. When a firm decides to wind up its business operations under any of the circumstances mentioned, it stands dissolved. Dissolution of a partnership firm is different from the dissolution of a partnership.

Dissolution of a firm means that the firm closes its business and comes to an end. While dissolution of a partnership means termination of old partnership agreement and a reconstitution of firm due to admission, retirement and death of a partner. In dissolution of a partnership the remaining partners may agree to carry on the business under a new agreement.



INTEXT QUESTIONS 25.1

Fill in the blanks with the appropriate word/words :

- i. A partnership firm comes to an end when the activities of the firm become
- ii. When a firm decides to close its business, it is said to be
- iii. Dissolution of a is different from dissolution of
- iv. The firm is compulsorily when all the partners or all excepting one partner die.
- v. The firm is dissolved by when a partner becomes of unsound mind.
- vi. The firm is dissolved by when all the partners give their consent.

25.2 TREATMENT OF ASSETS AND LIABILITIES

When the partners decide to discontinue the business of the firm, it becomes necessary to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it. For this purpose a separate account called 'Realisation Account' is opened. Realisation Account is an account in which assets excluding cash in hand and bank are transferred at their book value and all external liabilities are transferred at their book value.



Notes



Notes

It also shows what amount were realised on the sale of assets and which liabilities were discharged at what amount.

In order to record the disposal of assets and discharge of liabilities, the following journal entries are recorded:

1. For Transfer of Assets : Assets account is closed by transferring it to the Realisation Account at its Book Value.

Realisation A/c	Dr.
To Assets A/c (Individually)	
(Transfer of assets)	

It is to be noted that the following items on the assets side of the Balance Sheet are not transferred to the Realisation Account :

- (a) (i) Undistributed loss (i.e. Debit Balance of Profits and Loss account)
- (ii) Fictitious assets or deferred revenue expenditures such as preliminary expenses .

All the above items are closed by transferring them to the partners' Capital Account in their profit sharing ratio. The Journal entry is made:

Partner's capital A/c	Dr. (Individually)
To Profit & Loss A/c	
To Fictitious Assets A/c	
(Transfer of loss and fictitious Assets)	

- (b) Cash in hand, and Cash at Bank, will be the opening balance of the Cash/ Bank account;
- (c) Provisions and reserves against assets should be closed by crediting the Realisation Account.

The Journal entry is made :

Provision for Doubtful Debts A/c	Dr.
Provision for Depreciation A/c	Dr.
Any other Provision A/c	Dr.
To Realisation A/c	
(Transfer of provision on assets)	

- 2. For Transfer of Liabilities :** The accounts of various external liabilities are closed by transferring them to the Realisation Account. The loan given to the firm by a partner's wife is treated as an external liability and is transferred to the credit of Realisation Account. The relevant Journal entry is as under :

External Liabilities A/c	Dr. (Individually)
To Realisation A/c	
(Transfer of external liability)	

Capital and Loan account of the partners' are treated separately and so are not transferred to the Realisation Account.

- 3. Treatment of Accumulated Reserves and Profit/Loss :** Any balance of accumulated reserves (e.g. general reserves), Profit and Loss Account (Cr.), Reserve Fund and other reserves on the date of dissolution will be credited to the Partners' Capital accounts on the basis of profit sharing ratio. The following journal entry will be recorded :

Profit and Loss A/c	Dr.
General Reserve A/c	Dr.
Any Other Fund	Dr.
To Partners' Capital A/c (Individually)	
(Transfer of profit and reserve)	

- 4. For Sale of Assets (for cash)**

Bank/ Cash A/c	Dr. (Realised Value)
To Realisation A/c	
(Sale of assets)	

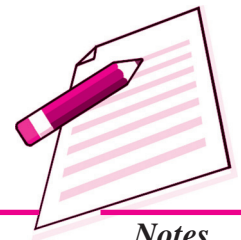
- 5. For Assets taken Over by the Partner**

Partners' Capital A/c	Dr.
To Realisation A/c (Agreed Price)	
(Assets taken over by partner)	

Bank/Cash/Partners capital A/c	Dr.
To Partner's Loan A/c	
(Settlement of loan to a partner)	

- 6. Settlement of loans given by the Partner**

Partners' Loan A/c	Dr.
To Bank/Cash/Partners' capital A/c	
(Settlement of loan given by the partner)	



Notes



Notes

7. Payment of Liabilities in Cash

Realisation A/c Dr.
 To Cash A/c
 (Payment of liabilities)

8. Payment of Liabilities by the Partner(s)

Realisation A/c Dr.
 To Partner Capital A/c
 (Liabilities taken over by partner)

Treatment of Unrecorded Assets and Liabilities

Sometimes, there may be some assets that have already been written off completely in previous years and thus, do not appear in the Balance Sheet but physically they still exist for operational purposes. For example, there is an old computer, which is still in working condition though its book value is zero. Similarly, there may be some liabilities, which do not appear in the Balance Sheet, but actually they are still there. For example, a bill discounted with bank, on dissolution it was dishonoured and had to be taken up by the firm for payment purposes.

It is to be kept in mind that an unrecorded asset would never be transferred to the debit of the Realisation Account, because the amount realised from its sale is in nature of a gain and the Realization Account is only credited accordingly. Similarly, an unrecorded liability need not be transferred to Realisation.

Reason being that its payment is a loss and Realisation Account is only debited with the actual payment. In such cases, the following journal entries are made:

(a) When the amount realised from the sale of an unrecorded asset.

Cash/Bank A/c Dr.
 To Realisation A/c
 (Sale of unrecorded assets)

(b) When an unrecorded asset is taken over by a partner at an agreed value.

Partner's Capital A/c Dr.
 To Realisation A/c
 (Unrecorded assets taken by partner)

(c) When unrecorded liability has been discharged by the firm.

Realisation A/c Dr.
 To Bank/Cash A/c
 (Payment of unrecorded liabilities)

- (d) When an unrecorded liability is discharged by a partner on behalf of the firm.

Realisation A/c	Dr.
To Partner's Capital A/c	
(Unrecorded Liabilities payment by partner)	

Payment of Realisation Expenses

- (a) When realisation expenses are paid by the firm (i.e. borne by the firm). The following journal entry will be recorded:

Realisation A/c	Dr.
To Bank/ Cash A/c	
(Payment of realisation expenses)	

- (b) When Realisation expenses are paid by the partner on behalf of the firm (i.e. realisation expenses paid by the partner but borne by the firm). The following journal entry is made:

Realisation A/c	Dr.
To Partners' Capital A/c	
(Payment of realisation expenses by partner on behalf of firm)	

- (c) Realisation expenses were agreed to be paid by the partner and were paid by the firm

Partner's Capital A/c	Dr.
To Cash/Bank A/c	
(Realisation expenses paid and borne by partner)	

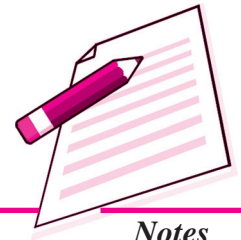
Closing of Realisation Account

The balance in the realisation account would show either profit or loss on dissolution. If the total of the credit side is more than the debit side, then there is a profit and following journal entry is made :

Realisation A/c	Dr.	
To Partner's Capital/ Current A/c		(Individually)
(Profit on realisation transferred to capital accounts)		

If, the debit side is more than credit side, then there is a loss on dissolution and following journal entry is made :

Partner's Capital/Current A/c	Dr.	
To Realisation A/c		(Individually)
(Loss on realisation transferred to capital account)		

*Notes*



Notes

Format of Realisation Account

Realisation Account

Dr.

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
All Assets A/c (Book Value) (Except Cash/Bank)		All External Liabilities A/c (Book Value)	
Cash/Bank A/c (Payment of external liabilities)		Cash/Bank A/c (Amount realised on sale of various assets)	
Partners Capital A/c (if any liability paid by partner)		Partners' capital A/c (If any asset is taken over)	
Cash/Bank A/c (Expenses on realisation)		Partners Capital A/c (For transferring loss on realisation)	
Partners Capital A/c (Expenses on realisation paid by a partner)			
Partners Capital A/c (For transferring profit on realisation)			



INTEXT QUESTIONS 25.2

Given below are certain statements. Some of these statement are true and some of these are false. Write 'T' against true statement and 'F' against false statements.

- (i) At the time of dissolution an account including cash and bank are transferred to realisation account.
- (ii) On dissolution of a firm, business operations of the firm are closed down.
- (iii) After the preparation of realisation account, Gain or loss of realisation is transferred to Partners capital account
- (iv) Amount realised from the sale of an unrecorded asset is recorded in Realisation Account.

- (v) Balance of general reserve is transferred to partners' capital accounts.
- (vi) Realisation expenses paid by the partners on behalf of the firm are recorded in realisation account and partners capital account.

25.3 PARTNERS' CAPITAL ACCOUNT AND CASH/BANK ACCOUNT

Settlement of Partners' Capital Accounts

After all the adjustments related to partners' capital accounts and transfer of profit or loss on realisation to the partners' capital accounts, the capital accounts are closed in the following manner:

- (a) If the Partner's Capital Account shows a debit balance, the partner has to bring the necessary amount of cash. The following journal entry is made :

Bank/Cash A/c	Dr.
To Partner's Capital A/c	
(Cash brought by the partner)	

- (b) If the Partner's Capital Account shows a credit balance, he/she is to be paid off the necessary amount of cash. The following journal entry will be made:

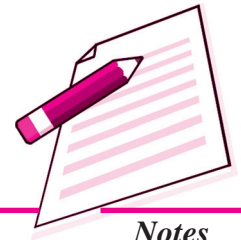
Partner's Capital A/c	Dr.
To Bank/Cash A/c	
(Cash paid to partner)	

Preparation of Cash/Bank account

After closing the partners' capital accounts, bank account is prepared and all entries pertaining to the bank/cash are posted in it including any cash brought in by the partner on the dissolution of firm. Partners' capital accounts are closed by making payment from the bank account and thereby bank account stands closed by making/receiving payment. In this way all the accounts stand closed. If cash/bank account does not show any balance, it implies that all the accounts of the dissolved firm have been closed properly.

Illustration 1

Arun and Seema are equal partners in a firm. They decided to dissolve the partnership on December 31, 2014 when the balance sheet stood as under:



Notes

MODULE - 4

Partnership Account



Notes

Dissolution of Partnership Firm

Balance Sheet as on December 31, 2014

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry creditors	54,000	Cash at Bank	22,000
Reserve fund	20,000	Sundry Debtors	24,000
Loan	80,000	Stock	84,000
Capital :		Furniture	50,000
Arun 1,20,000		Plant	94,000
Seema 1,20,000	2,40,000	Leasehold land	1,20,000
	3,94,000		3,94,000

Assets were realised as follows:

	₹
Leasehold land	1,44,000
Furniture	45,000
Stock	81,000
Plant	96,000
Sundry debtors	21,000

The creditors were paid ₹ 51,000 in full settlement. Expenses of realisation amounted to ₹ 6,000.

Prepare Realisation account, Bank account, partners' capital accounts to close the books of the firm.

Solution :

Books of Arun and Seema Realisation Account

Dr

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Assets transferred		Sundry Creditors	54,000
Sundry Debtors 24,000		Loan	80,000
Plants 94,000		Bank	
Stock 84,000		Sundry Debtors 21,000	



Notes

Dissolution of Partnership Firm					
Leasehold land	1,20,000		Plant	96,000	
Furniture	<u>50,000</u>	372000	Stock	81,000	
Bank			Lease hold land	1,44,000	
Creditors	51,000		Furniture	<u>45,000</u>	3,87,000
Loan	80,000				
Realisation Expense	<u>6,000</u>	1,37,000			
Profit transferred to					
Arun Capital	6,000				
Seema Capital	<u>6,000</u>	12,000			
		<u>5,21,000</u>			<u>5,21,000</u>

Capital Accounts

Dr.

Cr.

<i>Particulars</i>	<i>Arun</i> (₹)	<i>Seema</i> (₹)	<i>Particulars</i>	<i>Arun</i> (₹)	<i>Seema</i> (₹)
Bank	1,36,000	1,36,000	Balance b/d	1,20,000	1,20,000
			Reserve fund	10,000	10,000
			Realisation (Profit)	6,000	6,000
	<u>1,36,000</u>	<u>1,36,000</u>		<u>1,36,000</u>	<u>1,36,000</u>

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Balance b/d	22,000	Realisation A/c	1,37,000
Realisation A/c	3,87,000	Arun Capital	1,36,000
		Seema Capital	1,36,000
	<u>4,09,000</u>		<u>4,09,000</u>

Illustration 2

Sonya and Mayank are partners, who shared profit as 3:2. Following is the balance sheet as on December 31, 2014

MODULE - 4

Partnership Account



Notes

Dissolution of Partnership Firm

Balance Sheet as on December 31, 2014

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Creditors	28,000	Cash in hand	10,500
Bills payable	20,000	Cash at Bank	30,000
Profit & Loss A/c	13,500	Stock	7,500
Sonya's Capital	32,500	Sundry debtors	21,500
Mayank's Capital	11,500	Less : Provision for bad debt	500
		Land & Building	36,500
	1,05,500		1,05,500

The firm was dissolved on December 31, 2014. Close the books of the firm with the following information:

- Debtors realised at a discount of 5%.
- Stock realised at ₹ 7,000.
- Building realised at ₹ 42,000.
- Realisation expenses amounted to ₹ 1,500 .
- Creditors and bills payable are paid in full.

Prepare necessary ledger accounts.

Solution :

Books of Sonya and Mayank Realisation Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Assets transferred		Provision for bad debts	500
Stock	7,500	Creditors	28,000
Sundry assets	21,500	Bills payable	20,000
Land & Building	36,500	Bank	
Bank		Debtors	20,425
Creditors	28,000	Stock	7,000
	65500		



Notes

Dissolution of Partnership Firm					
Bills payable	20,000		Land & Building	42,000	69,425
Realisation [Expense]	1,500	49500			
Profit transferred to (3 : 2)					
Sonya's Capital	1,755				
Mayank's Capital	1,170	2,925			
		1,17,925			1,17,925

Capital Accounts

Dr.

Cr.

<i>Particulars</i>	<i>Sonya</i> (₹)	<i>Mayank</i> (₹)	<i>Particulars</i>	<i>Sonya</i> (₹)	<i>Mayank</i> (₹)
Bank	42,355	18,070	Balance b/d	32,500	11,500
			Profit & Loss A/c	8,100	5,400
			Realisation (Profit)	1,755	1,170
	42,355	18,070		42,355	18,070

Bank Account

Dr.

Cr.

<i>Particulars</i>	<i>Amount</i> (₹)	<i>Particulars</i>	<i>Amount</i> (₹)
Balance b/d	30,000	Realisation	49,500
Cash	10,500	Sonya's Capital	42,355
Realisation	69,425	Mayank's Capital	18,070
	1,09,925		1,09,925

Illustration 3

Tanu, Manu and Chetan are in partnership sharing profit in the proportion of 1/2, 1/3, 1/6 respectively. They dissolve the partnership firm on the December 31, 2014, when the balance sheet of the firm stood as under:

MODULE - 4

Partnership Account



Notes

Dissolution of Partnership Firm

Balance Sheet as on December 31, 2014

<i>Liabilities</i>		<i>Amount</i> (₹)	<i>Assets</i>		<i>Amount</i> (₹)
Sundry Creditors		30,000	Bank		37,500
Bills payable		25,000	Sundry debtors		58,000
Manu's loan		40,000	Stock		39,500
Capital			Investment		42,000
Tanu	90,000		Machinery		48,000
Manu	75,000		Freehold property		90,000
Chetan	<u>55,000</u>	2,20,000			
		<u>3,15,000</u>			<u>3,15,000</u>

The machinery was taken over by Manu for ₹ 45,000, Tanu took over the investment for ₹ 40,000 and freehold property was taken over by Chetan at ₹95,000. The remaining assets realised as follows: Sundry Debtors ₹ 56,500 and Stock ₹ 36,500. Sundry creditors were settled at discount of 5%. Bills payable is taken over by Chetan for ₹ 23,000. Their liabilities amounting to ₹3,000 not shown in books are also to be paid. An office computer, not shown in the books of accounts, realised ₹ 9,000. Realisation expenses amounted to ₹ 3,000.

Prepare Realisation Account, Partners Capital account and Bank Account.

Solution:

Books of Tanu Manu and Chetan Realisation Account

Dr.

Cr.

<i>Particulars</i>		<i>Amount</i> (₹)	<i>Particulars</i>		<i>Amount</i> (₹)
Assets transferred			Sundry Creditors		30,000
Sundry debtors	58,000		Bills payable		25,000
Stock	39,500		Tanu Capital (Investment)		40,000
Machinery	48,000		Manu Capital (Machinery)		45,000
Investment	42,000		Chetan Capital		95,000
Freehold property	<u>90,000</u>	277500	(freehold property)		

Dissolution of Partnership Firm

Chetan Capital (Bills payable)	23,000		Bank		
Bank			S. Debtors	56,500	
S. Creditors	28,500		Stock	36,500	
Liabilities (Unrecorded)	3,000		Computer	9,000	1,12,000
Realisation [Expense]	6,000	37,500			
Profit transferred to					
Tanu Capital	4,500				
Manu Capital	3,000				
Chetan Capital	1,500	9,000			
		3,47,000			3,47,000

MODULE - 4

Partnership Account



Notes

Capital Account

Dr.

Cr.

Particulars	Tanu	Manu	Chetan	Particulars	Tanu	Manu	Chetan
	(₹)	(₹)	(₹)		(₹)	(₹)	(₹)
Realisation (Assets)	40,000	45,000	95,000	Balance b/d	90,000	75,000	55,000
Bank	54,500	33,000	—	Realisation (Assets)	—	—	23,000
				Realisation (Profit)	4,500	3,000	1,500
				Bank	—	—	15,500
	94,500	78,000	95,000		94,500	78,000	79,500

Bank Account

Dr.

Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
Balance b/d	37,500	Realisation	37,500
Realisation	1,12,000	Manu's loan	40,000
Chetan Capital	15,500	Tanu Capital	54,500
		Manu Capital	33,000
	1,65,000		1,65,000



Notes

**INTEXT QUESTIONS 25.3****I. Which of the following is treated as unrecorded asset :**

- i. Sale of old Furniture.
- ii. Goodwill appearing in the balance sheet.
- iii. Bad debts recovered, written off in pervious year.
- iv. Sale of Investments.
- v. Sale of old computer, written off in pervious year.

II. Which of the following is treated as unrecorded liability :

- i. A Bill Discounted with bank dishonoured.
- ii. Repayment of Bank Loan.
- iii. Creditors for stock purchase of goods.
- iv. Settlement of a dispute against the firm.
- v. Payment of outstanding bills.

**WHAT YOU HAVE LEARNT**

- When a firm decides to close its business and no business activity is carried out by the firm, it is said to be dissolved.
- Dissolution of a firm is different from the dissolution of a partnership. Dissolution of a firm means that the firm closes its business and comes to an end. While dissolution of a partnership means termination of old partnership agreement and a reconstitution of firm due to admission, retirement and death of a partner.
- On dissolution of the firm the books of accounts are closed. All assets and liabilities are transferred to an account called “Realisation Account”. This account records the realisation of assets and the payment of liabilities.
- When the partners decide to discontinue the business of the firm, it becomes necessary for it to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it.
- An unrecorded asset would never be transferred to Realisation Account, because the amount realised from its sale is in the form of a gain and the Realization Account is only credited accordingly.
- After all the adjustments related to partners’ capital accounts and transfer of profit or loss on realisation to the partners capital accounts, the capital accounts are closed.

Dissolution of Partnership Firm

- Partners capital accounts are closed through making payment from the bank account and thereby bank account stands closed by making/ receiving payment.



TERMINAL EXERCISE

- Answer the following questions in one sentence:
 - What is meant by dissolution of partnership firm ?
 - Why Realisation account is prepared ?
 - What journal entry is made in case of payment of unrecorded Liability?
 - What journal entry is made when expenses are agreed to be borne by the partners and paid by the firm.
- Distinguish between dissolution of partnership firm and dissolution of partnership.
- Under what circumstances can the court dissolve the partnership firm?
- Sumit and Anish are equal partners in a firm. They decided to dissolve the partnership on December 31,2014 when the balance sheet is as under:

Balance Sheet as on December 31, 2014

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry creditors	30,000	Cash at Bank	7,000
Reserve fund	7,000	Sundry Debtors	23,000
Bills Payable	30,000	Stock	42,000
Capital		Furniture	35,000
Sumit	70,000	Plant	40,000
Anish	60,000	Leasehold land	50,000
	<u>1,30,000</u>		
	1,97,000		<u>1,97,000</u>

Assets were realised as :

	₹
Leasehold land	62,000
Furniture	30,500
Stock	40,500
Plant	48,000
Sundry debtors	22,500

MODULE - 4

Partnership Account



Notes



Notes

Sundry creditors were paid ₹ 29,500 in full settlement. Bills payable paid 5% less. Expenses of realisation amounted to ₹ 2,500.

Prepare realisation account, Bank account and partners' capital accounts to close the books of the firm.

6. Ashu and Hemani are Partners sharing profit and losses in the ratio of 3 : 2. They decided to dissolve the firm on December 31 , 2014. Their balance sheet on the above date was :

Balance Sheet as on December 31, 2014

<i>Liabilities</i>		<i>Amount</i> (₹)	<i>Assets</i>		<i>Amount</i> (₹)
Capital			Building		90,000
Ashu	1,00,000		Machinery		60,000
Hemani	<u>92,000</u>	1,92,000	Furniture		10,000
Creditors		88,000	Stock		24,000
Bank overdraft		20,000	Investments		50,000
			Debtors		48,000
			Cash in hand		18,000
		<u>3,00,000</u>			<u>3,00,000</u>

Ashu is to take over the building at ₹ 98,000 and machinery and furniture is to be taken over by Hemani at value of ₹ 70,000. Ashu agreed to pay creditor and Hemani agreed to meet bank overdraft. Stock and investments are taken by both partners in their profit sharing ratio.

Debtors realised for ₹ 46,000, expenses of realisation amounted to ₹ 3,000.

Prepare necessary ledger accounts.

7. Tarun, Neeru and Vikas shared profit in the ratio of 3:2:1. On December 31, 2014 their balance sheet was as follows:

Balance Sheet as on December 31, 2014

<i>Liabilities</i>		<i>Amount</i> (₹)	<i>Assets</i>		<i>Amount</i> (₹)
Capital			Plant		80,000
Tarun	90,000		Debtors		70,000
Neeru	1,00,000		Furniture		22,000
Vikas	<u>80,000</u>	2,70,000	Stock		70,000
Creditors		60,000	Investments		60,000

Dissolution of Partnership Firm

Bills payable	30,000	Bills receivable	46,000
Reserve	20,000	Cash in hand	32,000
	<u>3,80,000</u>		<u>3,80,000</u>

On this date the firm was dissolved. The assets realised as follows: Plant ₹85,000, Debtors ₹69,000 Furniture ₹20,000, stock 95% of the book value, Investments ₹ 86,000 and Bills receivable ₹ 31,000. An office Electronic Typewriter, not shown in the books of accounts realised ₹ 9,000. Expenses of realisation amounted to ₹ 4,500. Creditor are taken over by Vikas at book value.

Prepare realisation account, Capital accounts and cash account

8. The following was the balance sheet of Anu and Hema as on December 31, 2014:

Balance Sheet as on December 31, 2014

<i>Liabilities</i>	<i>Amount</i> (₹)	<i>Assets</i>	<i>Amount</i> (₹)
Sundry Creditors	42,000	Cash at Bank	13,000
Bills payable	26,000	Sundry debtors	50,000
Hema's loan	20,000	Stock	40,000
Reserve fund	6,000	Bills receivable	28,000
Provision of Bad debts	2,000	Machinery	60,000
Capital		Investment	30,000
Anu	90,000	Fixtures	27,000
Hema	<u>62,000</u>		
	<u>2,48,000</u>		<u>2,48,000</u>

The firm was dissolved on December 31, 2014 and assets realised and settlements of liabilities was as follows :

- (a) The realisation of the assets were as follows:

	₹
Sundry debtors	48,000
Stock	38,000
Bills receivable	27,000
Machinery	62,000

- (b) Investment was taken over by Hema at agreed value of ₹ 36,000 and agreed to pay of creditors. Bills payable is paid 3% less.
 (c) Fixture are value less.
 (d) The expenses incurred on realisation were ₹ 2,200.

Journalise the entries to be made on the dissolution and prepare realisation account, bank account and partners capital accounts.

MODULE - 4

Partnership Account



Notes

MODULE - 4

Partnership Account



Notes

Dissolution of Partnership Firm

9. Rohit and Tina were partners in a firm and shared profit as 3 : 2. They decided to dissolve their firm on March 31, 2014 when their balance sheet was as follows:

Balance Sheet as on March 31, 2014

<i>Liabilities</i>		<i>Amount</i>	<i>Assets</i>		<i>Amount</i>
		(₹)			(₹)
Capital			Machinery	80,000	
Rohit	80,000		Investments	60,000	
Tina	<u>90,000</u>	1,70,000	Stock	22,000	
Sundry creditors		70,000	Sundry Debtors	80,000	
Reserve		10,000	Cash at bank	8,000	
		<u>2,50,000</u>			<u>2,50,000</u>

The assets and liabilities were disposed off as follows:

- Machinery were given to creditors in full settlement of their account and stock is taken over by Rohit at ₹ 19,000.
- Investment were taken over by Tina at book value. Sundry debtors of book value ₹ 50,000 taken over by Rohit at 10% less and remaining debtors realised for ₹ 28,000.
- Realisation expenses amounted to ₹ 2,000 paid by Rohit.

Prepare necessary ledger accounts to close the books of the firm.



ANSWERS TO INTEXT QUESTIONS

- 25.1** (i) Unlawful (ii) Dissolved (iii) Firm, partnership
(iv) Dissolved (v) Court (vi) Agreement
- 25.2** (i) F (ii) T (iii) T (iv) T (v) T (vi) T
- 25.3** I. (c) and (e) II. (i) and (iv)



ANSWERS TO TERMINAL EXERCISE

- Profit on Realisation ₹ 13,000 Total of Cash A/c ₹ 210500
- Profit on Realisation ₹ 2000 Total of Cash A/c ₹ 64000
- Profit on Realisation ₹ 14000 Total of Cash A/c ₹ 398500
- Loss on Realisation ₹ 23420 Total of Cash A/c ₹ 188000
- Loss on Realisation ₹ 92000 Total of Cash A/c ₹ 83800

Module - V

COMPANY ACCOUNTS

Marks 20

Hours 50

While sole proprietorship and partnership are the old forms of organisations. To meet the organisational needs of the modern day business run on large scale requiring huge amount of capital, joint stock company form of organisation was designed. The most important methods of raising finance by a company are issue of shares, and debentures. The present module of the Company Accounts explain about the company with its brief introduction and how the company issue shares to raise capital from capital market. In case the shareholders failed to pay calls on due its the company profit those shares & reissue them date. It also explains about the issue of debentures by company and its entries in the books of accounts.

Lesson 26. Company - An Introduction

Lesson 27. Issue of Shares

Lesson 28. Forfeiture of Shares

Lesson 29. Reissue of Forfeited Shares

Lesson 30. Issue of Debentures

26

COMPANY : AN INTRODUCTION



Notes

You may have come across the name of organisation with suffix limited (Ltd.), for example Hindustan Motors Ltd. or Hindustan Aeronautics Ltd. etc. Have you ever thought what does this indicate? Names of organisations with Ltd. indicate that these are forms of organisations which are different from sole proprietorship or partnership. These are called joint stock companies.

As you know that the sole proprietorship and partnership forms of business organisations could not meet the growing needs of huge capital and managerial skills required for increased scale of business and growing economic activities. The liability of owner/owners of these organisations is unlimited. In order to overcome these problems a new form of business organisation known as ‘company’ came into existence.

In this lesson, we shall study about company, its features and the methods of raising capital through issue of shares.



OBJECTIVES

After studying this lesson you will be able to :

- state the meaning of company as a form of business organisation;
- describe the characteristics of company;
- describe various types of companies;
- distinguish between public and private company;



Notes

- explain various types of shares;
- distinguish between equity shares and preference shares; and
- explain the types of share capital.

26.1 COMPANY-MEANING AND CHARACTERISTICS

A company is a voluntary association of individuals formed to carry on business to earn profits or for non profit purposes. These persons contribute towards the capital by buying its shares in which it is divided. A company is an association of individuals incorporated as a company possessing a common capital i.e. share capital contributed by the members comprising it for the purpose of employing it in some business to earn profit.

As per Companies Act 1956, a company is formed and registered under the Companies Act or an existing company registered under any other Act”.

Characteristics of a Company

Following are the main characteristics of a company:

- **Artificial Legal Person** : A company is an artificial person as it is created by law. It has almost all the rights and powers of a natural person. It can enter into contract. It can sue in its own name and can be sued.
- **Incorporated Body** : A company must be registered under Companies Act. By virtue of this, it is vested with corporate personality. It has an identity of its own. Although the capital is contributed by its members called shareholders yet the property purchased out of the capital belongs to the company and not to its shareholders.
- **Capital Divisible into Shares** : The capital of the company is divided into shares. A share is an indivisible unit of capital. The face value of a share is generally of a small denomination which may be of ₹ 1, ₹ 2, ₹ 5, ₹ 10, ₹ 25 or ₹ 100 etc.
- **Transferability of Shares** : The shares of the company are easily transferable. The shares can be bought and sold in the stock market.
- **Perpetual Existence** : A company has an independent and separate existence distinct from its shareholders. Changes in its membership due to death, insolvency etc. does not affect its existence and its continuity.

- **Limited Liability :** The liability of the shareholders of a company is limited to the extent of face value of shares held by them. No shareholder can be called upon to pay more than the face value of the shares held by them. At the time of winding up, if necessary, the shareholders may be asked to pay the unpaid value of shares.
- **Representative Management :** The number of shareholders is so large and scattered that they cannot manage the affairs of the company collectively. Therefore they elect some persons among themselves to manage and administer the company. These elected representatives of shareholders are individually called the 'directors' of the company and collectively the Board of Directors.
- **Common Seal :** A common seal is the official signature of the company. Any document bearing the common seal of the company is legally binding on the company.



Notes

Nature of Company

In the beginning, the size of business firms were very small. Sole proprietorship was therefore, the usual form of business organisation. Later on partnership become popular when the size of business firms increased. But sole proprietorship and partnership could not meet the growing demand of big size business because of their limitations such as limited capital, limited managerial ability, unlimited liability and other drawbacks. Therefore, in the present days of business world, it is only the Joint stock company form of business organisation which proved to be useful.

A company is a voluntary association of persons formed for some common purpose, with capital divisible into parts, known as shares and with a limited liability. It is created by law and is known as an artificial person with a perpetual succession and a common seal. It has a separate legal entity.



INTEXT QUESTIONS 26.1

- I. *Fill in the blanks with correct word/words relating to the characteristics of the company:*
- A company is created by law. Hence a company is
 - An indivisible unit of capital of a company is called a



Notes

- (iii) is the official signature of the company.
 - (iv) The shareholders elect some persons of their choice to manage the company's affairs. It explains the character of the company.
- II. Identify the correct statement by marking (✓) and incorrect one by marking (×):
- (i) The property of a company belongs to its shareholders.
 - (ii) The liability of every member of company is restricted to the face value of shares held by them.
 - (iii) The members of a company cannot transfer their shares freely.
 - (iv) A company can enter into contract in its own name.

26.2 TYPES OF COMPANIES

Companies can be classified under the following heads:

1. On the basis of formation.
2. On the basis of liability.
3. On the basis of ownership.

1. On the basis of Formation

On the basis of formation companies can be categorised as :

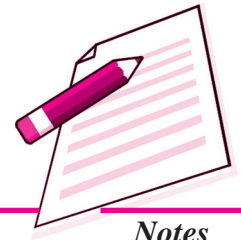
- (a) **Statutory Company** : A company formed by a Special Act of parliament or state legislature is called a Statutory Company. Reserve Bank of India, Industrial Financial Corporation of India, Life Insurance Corporation of India, Delhi State Finance Corporation are some of its examples.
- (b) **Registered Company** : A company formed and registered under the Companies Act, 1956 or earlier Companies Acts is called a Registered Company. The working of such companies is regulated by the provisions of the Companies Act.

2. On the basis of Liability

On the basis of liability, companies can be categorised as:

- (a) **Company Limited by Shares** : The liability of the member of such company is limited to the face value of shares held by him/her.
- (b) **Company Limited by Guarantee** : The liability of each member of such company is limited to the extent of guarantee undertaken by the member. It may arise in the event of it being wound up.

- (c) **Unlimited Company :** The company not having any limit on the liability of its members, is called an unlimited company. Liability in such a case extends to the personal property of its shareholders. Such companies do not use the word 'limited' at the end of their name.
- (d) **Company Under Section 25 :** A company created under section-25 is to promote art, culture and societal aims. Such companies need not use the term limited at the end of their name. Punjab, Haryana, Delhi chambers of commerce, etc. are the examples of such companies.

*Notes*

3. On the basis of Ownership

On the basis of ownership, companies can be categorised as :

- (a) **Private Company :** A private company is one which by its Articles of Association :
- (i) restricts the right of members to transfer its shares;
 - (ii) limits the number of its members to fifty (excluding its past and present employees);
 - (iii) prohibits any invitation to the public to subscribe to its shares, debentures.
 - (iv) The minimum paid up capital of the company is one lakh rupees (₹ 100000).

The minimum number of shareholders in such a company is two and the company has to add the words 'private limited' at the end of its name. Private companies do not involve participation of public in general.

- (b) **Public Company :** A company which is not a private company is a public company. Its Articles of association does not contain the above mentioned restrictions.

Main features of a public company are :

- (i) The minimum number of members is seven.
- (ii) There is no restriction on the maximum number of members.
- (iii) It can invite public for subscription to its shares.
- (iv) Its shares are freely transferable.
- (v) It has to add the word 'Limited' at the end of its name.
- (vi) Its minimum paid up capital is five lakhs rupees (₹ 500,000).



Notes

- (c) **Government Company :** A Government company is one in which not less than 51% of its paid up capital is held by (1) Central Government or (2) State Government, or (3) partly by Central Government and partly by State Government. Example of a Government company is Hindustan Machine Tools Limited, (HMT) State Trading Corporation (STC). Minerals and metals trading corporation (MMTC).
- (d) **Foreign Company :** A foreign company is one which is incorporated outside India but has a place of business in India, for example Philips, L.G, etc.
- (e) **Holding Company and Subsidiary Company :** A holding company is a company which controls another company (called subsidiary company) either by acquiring more than half of the equity shares of another company or by controlling the composition of Board of Directors of another company or by controlling a holding company which controls another company.
- (f) **Listed Company and Unlisted Company :** A company is required to file an application with stock exchange for listing of its securities on a stock exchange. When it qualifies for the admission and continuance of the said securities upon the list of the stock exchange, it is known as listed company. A company whose securities do not appear on the list of the stock exchange is called unlisted company.

Difference between public company and private company :

The major differences between public company and private company are as follows:

Difference between Public Company and Private Company

<i>Basis of Difference</i>	<i>Public Company</i>	<i>Private Company</i>
1. Minimum Number of Members	Minimum number of members required to form a public company is seven .	Minimum number of members required to form a private company is two .
2. Maximum number of Members	No limit on maximum number of members.	Maximum number of members is fifty .
3. Name	The word 'Limited' is used at the end of the company's name.	The word 'Private Limited' is used at the end of the company's name.

4. Commencement of Business	It can start its business only after getting a certificate of commencement of business.	It can commence its business as soon as it obtains certificate of Incorporation.
5. Invitation to Public	It invites public to subscribe to its shares.	It cannot invite public to subscribe to its shares.
6. Transfer of Shares	There is no restriction on transfer of its shares.	There is restriction on the transfer of its shares.
7. Number of Directors	It must have at least three directors.	It must have at least two directors.
8. Minimum Capital	It must have a minimum paid up capital of five lakh rupees (₹ 500000)	It must have a minimum paid up capital of one lakh rupees (₹ 100000).



Notes



INTEXT QUESTIONS 26.2

I. Fill in the blanks with correct words/figures given in brackets :

- (i) The minimum number of members in a public limited company is(two, five, seven)
- (ii) A Government company is one in which not less thanof its paid up capital is held by government. (50%, 51%, 75%)
- (iii) The minimum paid up capital of a private limited company is..... (rupees one lakh, rupees five lakh, rupees Ten lakh)
- (iv) A foreign company is one which is incorporated (In India, Outside India).

II. Name the type of company in the following cases :

- (i) A company that imposes restriction on transfer of its shares by its Articles of Association.
- (ii) A company with a liability of its members limited to the extent of the amount unpaid on its shares.
- (iii) A company formed by a Special Act enacted by parliament or state legislature.
- (iv) A company not having any limit on the liability of its members.
- (v) A company which controls another company.

26.3 SHARES-MEANING AND ITS KINDS



Notes

A joint stock company divides its capital into units of equal denomination. Each unit is called a share. These units i.e. shares are offered for sale to raise capital. This is termed as issuing shares. A person who buys share/shares of the company is called a shareholder and by acquiring share or shares in the company he/she becomes one of the members of the company.

Thus, a share is an indivisible unit of capital. It expresses the proprietary relationship between the company and the shareholder. The denominated value of a share is its face value. The total capital of a company is divided into number of shares.

Kinds of Shares

According to the Companies Act, a company can issue the following types of Shares:

- (i) Preference Shares (ii) Equity Shares

(i) Preference Shares : A preference share is one which carries following preferential rights over other type of shares called equity shares in regard to the following :

- Payment of dividend
- Repayment of capital at the time of winding up of the company.

Characteristics of Preference Shares

- i. Such type of shareholders have priority in the payment of dividend before any other class of shareholders get their payment of dividend.
- ii. The rate of dividend of such shares are pre-determined.

(ii) Equity Shares : All shares which are not preference shares are equity shares. Holders of these shares receive dividend out of the profits of the company after the payment of dividend has been made to the preference shareholders.

Characteristics of Equity Shares

- i. Its dividend rate can change from year to year.
- ii. Dividend on Equity shares is paid after the payment of dividend to preference shareholders.
- iii. In the event of winding up of company the repayment of capital to equity shareholder is made at last.
- iv. They are real owners of the company.

Equity shareholders have the right to elect directors of the company. Equity shares are the permanent source of capital.

Difference between Equity Shares and Preference Shares

<i>Basis of Difference</i>	<i>Equity Shares</i>	<i>Preference Shares</i>
1. Rate of Dividend	Rate of dividend on these shares is not fixed and depends upon the decision of the Board of directors.	Rate of dividend on these shares is fixed.
2. Payment of Dividend	Dividend on these shares is paid after payment of dividend to preference shareholders.	Dividend on these shares is paid before payment of dividend to equity shareholders.
3. Refund of Share Capital on Winding up of the Company	On winding up of the company equity share holders get refund of capital only after preference shareholders have been paid off.	Preference shareholders have a preference over equity shareholders in regard to refund of capital in case of winding up of the company.
4. Voting Rights	Shareholders have voting rights in all matters.	Shareholders can vote only in special circumstances.
5. Redemption	Shares cannot be redeemed during the life of the company.	Shares can be redeemed as per terms of issue.



Notes

Illustration 1

Alok Ltd. issued 12000 share of ₹ 10 each. The amount payable on shares was ₹ 2 on application, ₹ 4 on allotment and ₹ 4 on First & Final Call. All the shares were subscribed & all calls were received on due dates.

Pass the necessary Journal entries in the books of the company.

Solution :

Journal



Notes

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>₹ (Dr.)</i>	<i>₹ (Cr.)</i>
	Bank A/c Dr. To Share Application A/c (Being application money received)		24,000	24,000
	Share Application A/c Dr. To Share Capital A/c (Being application money transferred to share capital A/c)		24,000	24,000
	Share Allotment A/c Dr. To Share Capital A/c (Being allotment money due)		48,000	48,000
	Bank A/c Dr. To Share Allotment A/c (Being allotment money received)		48,000	48,000
	Share First & Final Call A/c Dr. To Share Capital A/c (Being First & Final Call money due)		48,000	48,000
	Bank A/c Dr. To Share First & Final Call A/c (Being First & Final Call money received)		48,000	48,000



INTEXT QUESTIONS 26.3

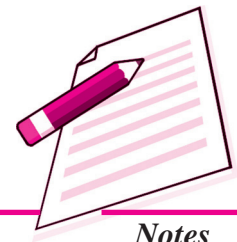
Fill in the blanks with suitable word/words.

- i. In a company, main source of finance is
- ii. A is an indivisible unit of capital
- iii. have the right to elect directors of the company
- iv. have the preferential right as the refund of capital in case of winding up of company over

26.4 SHARE CAPITAL—MEANING AND ITS TYPES

A joint stock company estimates its future capital requirements. The amount of the capital is mentioned in the capital clause of the Memorandum of Association registered with the Registrar of the Companies. Total capital is divided into a number of small indivisible units of fixed amount and each such unit is called a share. A share is nothing but a part in the share capital of the company. As the total capital of the company is divided into shares, the capital of the company is called share capital. Share capital of the company is divided into following categories:

- **Nominal/Authorised/Registered Capital :** It refers to the maximum amount of share capital which a company is authorised to issue as per its Memorandum of Association.
- **Issued Capital :** Issued capital is that part of the authorised capital which the company offers to public, that may include vendors, for subscription or purchase. A company may issue its entire authorised capital or may issue it in parts from time to time as per the needs of the company. It means and includes the nominal value of shares issued by the company for (a) cash, and (b) consideration other than cash to (i) promoters of a company, and (ii) others.
- **Subscribed Capital :** It is that part of issued capital which is taken up or subscribed by those who are offered for subscription. Company may receive application for equal to, more than or less than shares issued. This capital can be equal to or less than the issued capital. The portion of nominal value of the issued share capital which is actually paid (or subscribed) by the shareholders forms part of the subscribed capital.
- **Called up Capital :** It is that part of the issued/subscribed capital which is called up by company to pay on the allotted shares and is to be paid by the shareholders. The portion of the issue price of the shares which a company has demanded or called from shareholders is known as called up capital
- **Uncalled Capital :** Uncalled Capital is that portion of the issued/subscribed capital that is not called up by the company on the shares allotted.
- **Paid up Capital :** It is the portion of called up capital which has been paid by the shareholders, to calculate the paid up capital, the amount of instalments in arrears is deducted from the called up capital.



Notes



Notes

- **Unpaid Capital :** That part of the called up capital which has been called but has not been paid by the shareholders is called unpaid capital. *i.e.* calls-in-arrears.
- **Reserve Capital :** Company may keep some part of its share capital uncalled and keep in reserve to be called only in case of need at the time of its winding up. This is known as Reserve capital. For this, a special resolution will have to be passed by the company. Thus, it is that portion of the uncalled capital which a company has decided to call only in case of liquidation of the company.



INTEXT QUESTIONS 26.4

I. Fill in the blanks with suitable word/words :

- (i) Share capital is the amount of capital raised through
- (ii) Capital stated in the capital clause of the Memorandum of Association is called
- (iii) That part of the authorised capital which is offered to public for subscription is called
- (iv) That part of the uncalled capital which is kept in reserve to be called only on winding up of the company is termed as

II. Write ‘correct’ for correct statement and ‘wrong’ for incorrect statement for the following :

- (i) Subscribed capital is either equal to or less than issued capital
- (ii) Issued capital is stated in the capital clause of Memorandum of Association
- (iii) Liability of a shareholder is limited upto the face value of the share
- (iv) Reserve capital can be called by the company at any time.

26.5 PRIVATE PLACEMENT OF SHARES

According to **Section 81 (1A)** of Companies Act, 1956 private placement of shares implies issue and allotment of shares to a selected group of persons.

A private company limited by shares is prohibited by the Companies Act from issue of shares for public subscription. It also need not file a statement in lieu of prospectus. Its shares are issued privately to a small number of persons known as promoters or

related to them by family connections. This is an easy way of raising capital which involves less legal formalities. **However, a public company can also raise the capital by placing the shares privately and without inviting the public for subscription.** Such Private Placement requires special resolution to be passed by the company or consent of Central Government. An underwriter or broker finds clients who wish to buy shares. Since, no public offer is made, there is no need to issue prospectus. Statement in lieu of prospectus should be filed with registrar of companies in such a case.



Notes

Accounting treatment of private placement is similar to the public subscription.

Salient Features of Private Placement are as follows :

- i. The company needs to prepare a draft prospectus known as “Statement in lieu of Prospectus” and must file with the registrar atleast 3 days before the allotment of shares or debentures.
- ii. Private Placement of shares and debentures is carried only in the case where the company does not want to raise capital through public subscription.
- iii. In the case of private placement of shares the allottees will not sell their shares for a minimum period of 3 years from the date of allotment. This period is known as **lock-in period.**

Illustration 2 : (Under Subscription)

Sukriti Ltd. was registered with an authorised capital of ₹ 10,00,000 divided into shares of ₹ 10 each. Company issued 60,000 shares to public and amount was payable as follows : ₹ 3 on application; ₹ 2 on allotment & ₹ 5 on call

Application for 55000 shares were received, which were allotted. Full amount received on due dates. Pass Journal enteries in the Books of Sukriti Ltd.

Solution :

Journal

Date	Particulars	L.F.	₹ (Dr.)	₹ (Cr.)
	Bank A/c Dr.		1,65,000	
	To Share Application A/c			1,65,000
	(Being Application money received)			

MODULE - 5

Company Accounts



Notes

Company : An Introduction

Share Application A/c	Dr.	1,65,000	
To Share Capital A/c			1,65,000
(Being Application money transferred to share Capital A/c)			
Share Allotment A/c	Dr.	1,10,000	
To Share Capital A/c			1,10,000
(Being Allotment money due)			
Bank A/c	Dr.	1,10,000	
To Share Allotment A/c			1,10,000
(Allotment money received)			
Share Call A/c	Dr.	2,75,000	
To Share Capital A/c			2,75,000
(Share Call money due)			
Bank A/c	Dr.	2,75,000	
To Share Call A/c			2,75,000
(Being Call money received)			

Illustration 3 : (Over Subscription)

Bhiwani Ltd. issued a prospectus for inviting application from the public for 10,000 equity shares of ₹ 10 each. The amounts were payable as follows:

₹ 2 on Application, ₹ 3 on Allotment & the balance as and when called.

Applications were received for 12,000 shares & the allotment was made as follows: Full Allotment on applications for 8,000 shares; 2,000 shares on applications for 3,000 shares. No allotment was made on applications for 1,000 shares. Pass Journal entries in the books of the company assuming that all allotment money was received and the call was not made.

Journal

Date	Particulars	L.F.	₹ (Dr.)	₹ (Cr.)
	Bank A/c	Dr.	24,000	
	To Share Application A/c			24,000
	(Being application money received for 12000 @ ₹ 2)			

Share Application A/c	Dr.	24,000	
To Share Capital A/c			20,000
To Share Allotment A/c			2,000
To Bank A/c			2,000
(Being transfer of application Money to Capital A/c on 10000 shares allotted & refund on application money on 1000 shares received)			
Share Allotment A/c	Dr.	30,000	
To Share Capital A/c			30,000
(Being the amount on allotment due)			
Bank A/c	Dr.	28,000	
To Share Allotment A/c			28,000
(Being the receipts of allotment money due)			



Notes



INTEXT QUESTIONS 26.5

State whether the following statements are true or false :

- i. A joint stock company is an artificial person created by law.
- ii. The liability of the share holders of the company is unlimited.
- iii. Registration is not compulsory in the case of a Joint Stock Company.
- iv. Preference shareholders get dividend after the equity shareholders.

26.6 ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

The company purchases certain assets from vendors (sellers or suppliers) on credit. Instead of making payment to vendors in cash, the company issues them certain agreed number of shares at the agreed rate as a consideration (payment in exchange) of assets purchased. Shares may be issued to vendors at par, at premium or at discount. The requisite journal entry to be passed is as under:



Notes

On Purchasing the Assets

Particular Asset A/c	Dr.	
or Sundry Asset A/c	Dr.	(If name of assets is not given)
To Vendors A/c		
(Being purchase of assets on credit)		

Issue of Shares to Vendors

At Par

Vendor A/c	Dr.
To Share Capital A/c	
(Being issue of ___ number of shares to vendors @ ₹ - Per share)	

At Premium

Vendor A/c	Dr.
To Share Capital A/c	
To Securities Premium Reserve	

$$\text{No. of Shares} = \frac{\text{Amount Due}}{\text{Face Value} + \text{Premium}}$$

At Discount

Vendor A/c	Dr.
Discount on issue of Shares A/c	Dr.
To Share Capital A/c	

$$\text{No. of Shares} = \frac{\text{Amount Due}}{\text{Face Value} - \text{Discount}}$$

Illustration 4 : (Issue of Shares for Consideration other than Cash)

The Hindustan Limited was registered with a share capital of ₹ 5,00,000 in ₹100 shares. Pass Journal Entries in the following cases :

- i. The company purchased the business of Ram & Company for ₹ 1,50,000 payable ₹ 20,000 in cash and the balance in equity shares of ₹ 100.
- ii. The company purchased Building and issued 2,000 shares of ₹ 100 each as purchase consideration.

Solution :

Journal

Date	Particulars	L.F.	₹ (Dr.)	₹ (Cr.)
(i)	Sundry Assets A/c Dr. To Ram & Company A/c (Being purchase of the business of Ram & Company)		1,50,000	1,50,000
	Ram & Company A/c Dr. To Bank A/c To Equity Share Capital A/c (Being payment to Ram & Company by issue of 1,300 shares of ₹ 100 each and ₹ 20,000 in cash)		1,50,000	20,000 1,30,000
(ii)	Building A/c Dr. To Vendor's A/c (Being purchase of Building on credit)		2,00,000	2,00,000
	Vendor's A/c Dr. To Share Capital A/c (Being issue of 2000 shares of ₹ 100 each to vendors)		2,00,000	2,00,000



Notes

Illustration 5

Simran Ltd. purchased assets of Charu Ltd. for ₹ 99,000. The purchase consideration was agreed to be paid in terms of equity shares of Simran Ltd. You are required to pass necessary Journal Entries in the following cases :

- i. Shares issued at par of ₹ 10 each.
- ii. Shares issued at premium of 10%.
- iii. Shares issued at discount of 10%.

Solution :

Journal



Notes

Date	Particulars	L.F.	₹ (Dr.)	₹ (Cr.)
	Sundry Assets A/c Dr. To Charu Ltd. A/c (Being the purchase of assets from Charu Ltd.)		99,000	99,000
(i)	At Par Charu Ltd. A/c Dr. To Equity Share Capital A/c (Being purchase consideration paid by issue of 9,900 shares at ₹ 10 each)		99,000	99,000
(ii)	At Premium 10% Charu Ltd. A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being 9,000 shares issued at ₹ 10 to each at 10% premium to Charu Ltd.)		99,000	90,000 9,000
(iii)	At Discount 10% Charu Ltd. A/c Dr. Discount on issue of Equity Shares A/c Dr. To Equity Share Capital (Being 11000 Equity shares issued of ₹ 10 each at 10% discount to Charu Ltd.)		99,000 11,000	1,10,000

Working Notes

- i. No. of Shares = $\frac{99,000}{10} = 9,900$ shares
- ii. No. of shares = $\frac{99,000}{11} = 9,000$ shares
- iii. No. of shares = $\frac{99,000}{9} = 11,000$ shares

26.7 ISSUE OF SHARES TO PROMOTERS

Promoters are those persons, firms or companies, who promote the company. They are entrusted with the work of the formation of the company. Promoters are paid remuneration for their services. This remuneration can be paid in the form of shares also. In such cases companies issue shares to their promoters without payment. The journal entry to be passed is as under :

Goodwill A/c	Dr.	
To Share Capital A/c		

Goodwill A/c is debited on the assumption that promoter's function has resulted in forming the company into profitable unit.

Alternatively, conservative treatment is as under :

Preliminary Exp. / Incorporation Costs A/c	Dr.	
To Share Capital A/c		

Incorporation costs A/c should be written off against P/L Account as early as possible.

Illustration 6 : (Issue of Shares for consideration other than Cash)

ABC Ltd. was registered with a nominal capital of ₹ 10,00,000 divided into shares of ₹ 10 each. The company purchased Machinery for ₹ 27,000 from XYZ Co. Ltd and issued fully paid equity shares of ₹ 10 each in satisfaction of the claim. Shares of ₹ 10,000 were issued at par to the promoters for their services.

Give Journal entries of the above transactions if to XYZ shares were issued (i) at par (ii) at 20% premium & (iii) at 10% discount.

Solution :**Journal**

Date	Particulars	L.F.	₹ (Dr.)	₹ (Cr.)
A.	For Purchase of Machinery :			
	Machinery A/c Dr.		27,000	
	To XYZ Co. Ltd. A/c			27,000
	(Being Machinery purchased from XYZ Co. Ltd)			

*Notes*



Notes

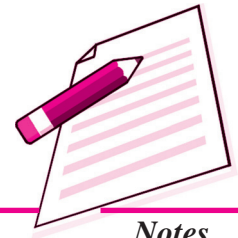
(i)	If Shares are issued at Par : XYZ Co. Ltd A/c Dr. 27,000 To Share Capital A/c 27,000 (Being 2700 shares of ₹ 10 each issued to XYZ Co. Ltd.)		
(ii)	If Shares are issued at Premium : XYZ Ltd. A/c (2250 x 12) Dr. 27,000 To Share Capital A/c (2250 x 10) 22,500 To Securities Premium Reserve(2250 x 2) 4,500 (Being 2250 shares of ₹ 10 each issues at 20% premium) No. of Shares = $27000 \div 12 = 2250$		
(iii)	If Shares are issued at Discount : XYZ Co. Ltd A/c (3000 x 9) Dr. 27,000 Discount on Issue of Shares A/c (3000 x 1) Dr. 3,000 To Share Capital A/c (3000 x 10) 30,000 (Being 3,000 Shares of ₹ 10 each issued at 10% Discount) Hint : No. of Shares = $27,000 \div 9 = 3,000$		
B.	For Issue of Shares to the Promoters : Goodwill A/c Dr. 10,000 To Share Capital A/c 10,000 (Being Shares issued at par to the promoters)		



INTEXT QUESTIONS 26.6

Choose the correct option :

- i. When shares are issued to the vendors at par as consideration of assets purchased, the total value of shares issued will be:
 - a) More than the purchase consideration.
 - b) Less than the purchase consideration.
 - c) Equal to the purchase considerations.
 - d) None of the above.



Notes

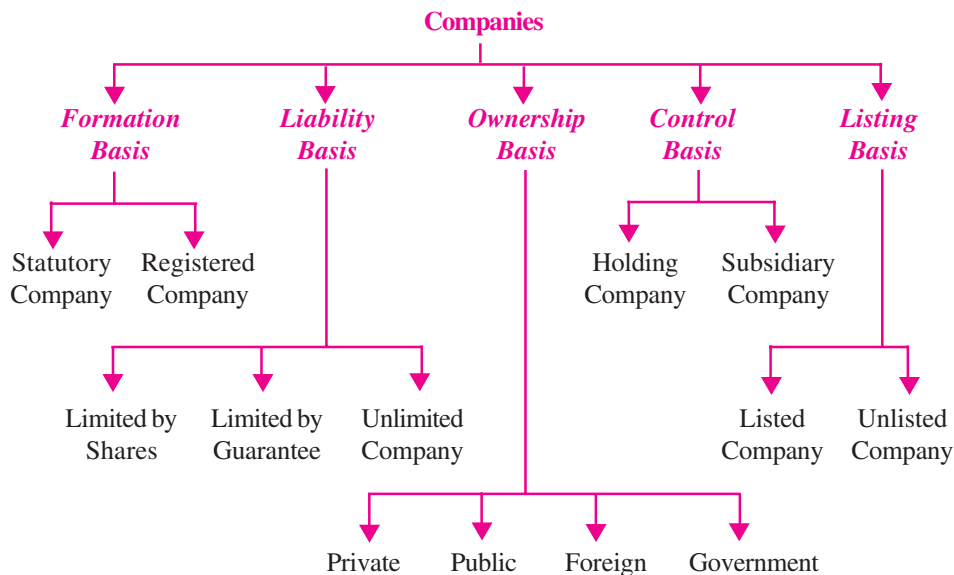
- ii. When shares are issued to the vendors at premiums as consideration of assets purchased, the total value of shares issued will be:
 - a) Equal to the purchase consideration.
 - b) More than the purchase considerations
 - c) Less than the purchase considerations.
 - d) None of the above

- iii. When shares are issued to the vendors at discount as consideration of assets purchased, the total value of shares issued will be:
 - a) Less than the purchase considerations.
 - b) More than purchase considerations.
 - c) Equal to purchase considerations.
 - d) None of the above



WHAT YOU HAVE LEARNT

- Company is an association of persons who contribute to its capital and is registered under Companies Act, 1956
- Characteristics of a company are : Seperate Legal Entity; Incorporated Body; Perpetual Existence; Limited Liability; Common Seal.
- Types of companies are:



**Notes**

- Private companies are companies which by their Articles of Association
 - (i) Restrict the maximum number of members to fifty
 - (ii) Restrict the transferability of shares
 - (iii) Put restriction on inviting public to buy its shares
 - (iv) Minimum paid up capital of such company is one Lakh rupees.
- Private company must add the words 'Private Limited' as a suffix to its name.
- Companies that are not private companies are public companies.
- Company raises its capital through issue of shares.
- Shares are of two types : Equity shares and preference shares. Preference shares carry preference over other shares with regard to payment of dividend and refund of capital in case of its winding up. Shares other than preference shares are called 'equity shares'.
- Share Capital : Authorised/Nominal; Issued; Subscribed; Called up; Uncalled Paid up; Unpaid; Reserve
- Share : Share means to possess a right on specific amount of Share Capital.
- Types of Shares : Equity Shares and Preference Shares shares may be issued to vendors as purchase considerations for purchase of assets. Such shares can be issued at par, at premium or at discount.
- When shares are issued to a selected lot of people without issuing of prospectus it is called private placement of shares.

**TERMINAL EXERCISE**

1. Define company. Explain in brief its characteristics.
2. What are preference shares? Distinguish between equity share and preference shares.
3. List the various restrictions on a private company. Distinguish between a public company and a private company.
4. What is share capital? Explain different types of share capital.

5. Explain different types of companies.
6. What is meant by a Joint Stock Company?
7. Explain the characteristics of a company.
8. State the characteristics of equity shares.
9. What is meant by private placement of shares?
10. Describe the features of private placement of shares.
11. Distinguish between equity shares and preference shares.
12. Give the meaning of issue of shares to vendors.
13. What is meant by issue of shares to promoters?



Notes



ANSWERS TO INTEXT QUESTIONS

- 26.1** I. (i) an artificial person (ii) share
(iii) common seal (iv) representative
- II. (i) × (ii) ✓ (iii) × (iv) ✓
- 26.2** I. (i) Seven (ii) 51% (iii) one Lakh (iv) outside India
- II. (i) private (ii) company limited by shares
(iii) Statutory company (iv) unlimited liability company
(v) Holding company
- 26.3** (i) share capital (ii) share (iii) Equity shareholders
(iv) Preference shareholders, Equity shareholders
- 26.4** I. (i) issue of shares (ii) Authorised capital
(iii) Issued capital (iv) Reserve capital
- II. (i) Correct (ii) Wrong (iii) Correct (iv) Wrong
- 26.5** (i) True (ii) False (iii) False (iv) False
- 26.6** (i) c (ii) c (iii) b



ACTIVITY



Notes

Your father is a shareholder of a company. Every year he receives report from the company. This report is called annual report of the company. After going through the report for a year, find out the following:

1. Name of the company with suffix Ltd. or Private Ltd.
2. Mention the amount of capital :
 - (a) Authorised
 - (b) Issued
 - (c) Called up
 - (d) Call in Arrears
 - (e) Reserve capital



Notes

27

ISSUE OF SHARES

In the preceding lesson you have studied about the company, its meaning, characteristics and its various types. You are also familiar with share capital, and its various kinds. Share capital is one of the main sources of finance for a company. In this lesson we shall study the procedure of issuing shares for raising capital and its accounting treatment in the books of the company.



OBJECTIVES

After going through this lesson you will be able to

- explain the procedure of issuing shares;
- explain that the share money may be called in lump sum or in two or more instalments;
- state that shares may be issued at par, at premium, or at discount;
- make journal entries to record the issue of shares and
- explain the terms calls in arrears and calls in advance.

27.1 PROCEDURE OF ISSUE OF SHARES

Face value of a share is the par value of the share. It is also known as the Nominal value or denomination of a share. To issue shares a company follows a definite procedure which is controlled and regulated by the Companies Act and Securities Exchange Board of India (SEBI). There are different ways of issue of shares which may be:



Notes

- (A) For consideration other than cash
- (B) For cash

(A) ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Sometimes shares are issued to the promoters of the company in lieu of the services provided by them during the incorporation of the company. The issue price of these shares is normally debited to ‘Goodwill A/c’ and journal entry is made as follows:

Goodwill A/c	Dr.
To Share Capital A/c	

In case a company does not have sufficient funds for the purchase of fixed assets or for payment to creditors it may offer and allot its shares to vendors/ creditors in lieu of cash. Any allotment of shares against which cash is not to be received is called ‘issue of shares for consideration other than cash’. For example building is purchased and payment is made by issuing shares.

In case of purchase of assets like building, machinery, stock of materials, etc. the following journal entry is made :

1. Assets A/c Dr.
 To Vendors/Creditors A/c
 (Assets purchased)
2. Vendors/Creditors A/c Dr.
 To Share Capital A/c
 (Issue of shares of ₹.....each fully paid up)

(B) ISSUE OF SHARES FOR CASH

In general, shares are issued for cash. The company may call the share money either in one instalment or in two or more instalments. But company always collects this money through its bankers.

(i) Receipt of Share Money in One Instalment : The company may receive the share money in one instalment along with application. In this case the following journal entries are made in the books of the company

1. On Receipt of Application Money
 Bank A/c Dr.
 To Share Application A/c
 (Application money received onshares of ₹...each)

2. On transferring the Application Money

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

- (ii) Share Money Received in Two or More Instalments :** Instead of receiving payment in one instalment i.e. at the time of application the company collects it in two or more instalments. The first, instalment which the applicants have to pay along with the applications for shares is known as application money. On the allotment of shares the allottees are required to pay the second instalment which is termed as allotment money. If the company decides to call the share money in more than two instalments the other instalment is/are termed as call money (i.e. first-call, second call or final call).

In the above case the transactions are recorded in journal as given below :

(a) On Receipt of Application Money

Bank A/c	Dr.
To Share Application A/c	
(Receipt of share application money for Shares @ ₹.. per share)	

- (b) On Allotment of Shares :** After receiving the application for shares within the prescribed time, the Board of Directors of the company proceed to allot shares. On allotment of shares the application money is transferred to Share Capital A/c. For this the following journal entry is made :

Share Application A/c	Dr.
To Share Capital A/c	
(Share application for Shares @ ₹... per share transferred to share capital A/c)	

Allotment Money Becoming Due and Received

On the allotment of shares the amount receivable on the next instalment i.e. on allotment becomes due. The following entry is made for recording the amount due:

(i) Allotment money becoming due

Share Allotment A/c	Dr.
To Share Capital A/c	
(Share allotment money due on shares @ ₹ ... per share)	



Notes



Notes

(ii) Receipt of allotment money

On the receipt of share allotment money the following journal entry is made:

Bank A/c	Dr.
To Share Allotment A/c	
(Receipt of the amount due on allotment of ... shares)	

Calls on Shares

After the receipt of application and allotment money the money that remains unpaid can be called up by the company as and when required. Thus a call is a demand made by the company asking the shareholders to remit the called up amount on shares allotted to them.

The company may demand the remaining money in more than two instalments. The amount called after the allotment is known as call money. There may be one or more calls, depending on the fund requirements of the company. When only **one** call is made and Call Money is Due :

Share First and Final Call A/c	Dr.
To Share Capital A/c.	
(Call money due on share @ ₹ ... per share).	

Receipt of Call Money

The following journal entry is made for receipt of call money:

Bank A/c	Dr.
To Share First & Final call A/c	
(call money due on ... shares @ ₹ ... per share received)	

Note : If the company makes more than one call the same accounting treatment is followed for recording the second call or third call money due and their receipt. The last call made is termed as final call.

Illustration 1

Fashion Fabrics Ltd. issued 100000 shares of ₹ 10 each on 1st April, 2014. The amount payable on these shares was as under:

- ₹ 2 per share on application.
- ₹ 3 per share on allotment.
- ₹ 5 per share on call.

Make journal entries and prepare relevant accounts in the books of company.

Solution :

Fashion Fabrics Ltd.
Journal Entries

S.No.	Particulars	L.F	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To Share Application A/c (Application money received @ ₹ 2 per share)		2,00,000	2,00,000
2.	Share Application A/c Dr. To Share Capital A/c (Share application money for 100000 shares transferred to share capital A/c)		2,00,000	2,00,000
3.	Share Allotment A/c Dr. To Share Capital A/c. (Allotment money made due on 100000 shares @ ₹ 3/- per share)		3,00,000	3,00,000
4.	Bank A/c Dr. To Share Allotment A/c. (Allotment money received on 100000 shares @ ₹ 3 per share.)		3,00,000	3,00,000
5.	Share First & Final call A/c. Dr. To Share Capital A/c (Call money on 1,00,000 share @ ₹ 5 per share made due)		5,00,000	5,00,000
6.	Bank A/c Dr To Share First & Final call A/c. (Call money received on 1,00,000 shares @ ₹ 5 per share)		5,00,000	5,00,000



Notes

Note : Although shares may be equity shares or preference shares but if the term shares is used it means equity shares)

MODULE - 5

Company Accounts



Notes

Issue of Shares

Relevant Accounts

Bank A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Application A/c		2,00,000		Balance c/d		10,00,000
	Share Allotment A/c		3,00,000				
	Share First and Final Call A/c		5,00,000				
			10,00,000				10,00,000
	Balance b/d		10,00,000				

Share Application A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		2,00,000		Bank A/c		2,00,000
			2,00,000				2,00,000

Share Capital A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Balance c/d		10,00,000		Share Application A/c		2,00,000
					Share Allotment A/c		3,00,000
					Share First and Final call A/c		5,00,000
			10,00,000				10,00,000
					Balance b/d		10,00,000

Share Allotment A/c

Dr.

Cr.

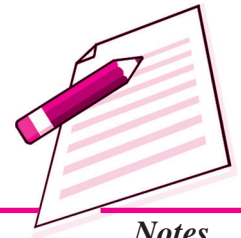
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		3,00,000		Bank A/c		3,00,000
			3,00,000				3,00,000

Share First and Final Call A/c

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		5,00,000		Bank A/c		5,00,000
			5,00,000				5,00,000



Notes



INTEXT QUESTIONS 27.1

Fill in the blanks with appropriate word/words :

- (i) Face value of share is value of the share.
- (ii) Shares in consideration other than cash are issued to
- (iii) Share money on issued shares can be demanded by the company in lump sum or in
- (iv) Share application money is received by the company from share

27.2 FULL, UNDER AND OVER SUBSCRIPTION

A company decides to issue number of shares to raise capital. It invites public to buy these shares. Now there may be three situations :

I. Full Subscription : Company may receive applications equal to the number of shares company has offered to people. It is called full subscription. In case of full subscription the journal entries will be made as follows :

- (a) On receipt of application money
Bank A/c Dr
 To Share Application A/c
(Application money received for shares)
- (b) On allotment of shares
Share Application A/c Dr
 To Share Capital A/c
(Application money of shares transferred to capital A/c on their allotment)

II. The company does not receive applications equal to the number of shares offered for subscription, there may be two situations : (i) under subscription;
(ii) over subscription



Notes

(i) **Under Subscription** : The issue is said to have been under subscribed when the company receives applications for less number of shares than offered to the public for subscription. In this case company is not to face any problem regarding allotment since every applicant will be allotted all the shares applied for. But the company can proceed with allotment provided the subscription for shares is at least equal to the minimum required number of shares termed as minimum subscription.

(ii) **Over Subscription** : When company receives applications for more number of shares than the number of shares offered to the public for subscription it is a case of over subscription. A company cannot allot more shares than what it has offered. In case of over subscription, company has the following options :

Option I

(i) **Rejection of Excess Applications and Money Returned** : The company may reject the applications for shares in excess of the shares offered for issue and a letter of rejection is sent to such applicants. In this case the application money received from these applicants is refunded to them in full. The journal entry made is as follows:

Share Application A/c	Dr.
To Bank A/c	
(Application money on ... shares refunded to the applicants)	

(ii) **Excess application money adjusted towards sums due on allotment.**
Journal entry made is :

Shares Application A/c	Dr.
To Share Allotment A/c	
(Excess application money adjusted towards sums due on allotment)	

If the application money received on partially accepted applications is more than the amount required for adjustment towards allotment money, the excess money is refunded. However, if the Articles of the company so authorise, the directors may retain the excess money as calls in advance to be adjusted against the call/calls falling due later on and the following entry is made :

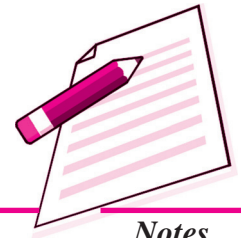
Share Application A/c	Dr.
To Call-in-advance A/c	
(The adjustment of excess share application money retained as call-in-advance in respect of ... shares)	

Option II

Partial Acceptance of Applications

In some cases the company accepts the applications for subscription partially. It means that the company does not allot the full number of shares applied for. For example if an applicant has applied for 5000 shares and is allotted only 2000 shares, then the applications is said to have been partially accepted. The company may evolve some formula of accepting applications partially or making proportionate allotment/ the Prorata allotment which means that the applicants are allotted shares proportionately. In such a case the company adjusts the excess share money received on application towards share allotment money due on partially accepted applications. The journal entry recording the adjustment of application money towards share allotment money, is as under :

Share Application A/c	Dr.
To Share Allotment A/c	
(Share application money transferred to Share Allotment Account in respect of ... shares)	

*Notes***Illustration 2**

The Full Health Care Ltd has offered to public for subscription 20000 shares of ₹ 100 each payable as ₹ 30 per share on application, ₹ 30 per share on allotment and the balance on call. Applications were received for 30000 shares. Applications for 5000 shares were rejected all together and application money was returned. Remaining applicants were allotted the offered shares. Their excess application money was adjusted towards some due on allotment. Calls were made and duly received. Make journal entries in the books of the company.

Solution :
Full Health Care Ltd.
Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To Share Application A/c (Application money received for 30000 shares @ ₹ 30 per share)		9,00,000	9,00,000

MODULE - 5

Company Accounts



Notes

		Issue of Shares	
2.	Share Application A/c Dr. To Share Capital A/c To Bank A/c To Share Allotment A/c (Application money of 20000 shares transferred to share capital A/c on their allotment. That of 5000 shares returned and of 5000 shares adjusted towards sum due on allotment)	9,00,000	
			6,00,000
			1,50,000
			1,50,000
3.	Share Allotment A/c Dr. To Share Capital A/c. (Allotment money due)	6,00,000	
			6,00,000
4.	Bank A/c Dr. To Share Allotment A/c. (Allotment money received)	4,50,000	
			4,50,000
5.	Share First and Final call A/c. Dr. To Share Capital A/c (Call money due)	8,00,000	
			8,00,000
6.	Bank A/c Dr. To Share First and Final call A/c. (Call money received)	8,00,000	
			8,00,000



INTEXT QUESTIONS 27.2

Fill in the blanks with appropriate word or words in the following sentences:

- (i) When company receives applications for more number of shares than offered for subscription it is a case of
- (ii) When share money is to be received in two or more instalments the first instalment is called
- (iii) Call is a demand made by the company asking the shareholders to pay the amount.
- (iv) A company allot more shares than it has issued.

27.3 ISSUE OF SHARES AT PREMIUM

A company can issue its shares at their face value. When company issues its shares at their face value, the shares are said to have been issued at par. Company can also issue its shares at more than or less than its face value i.e, at 'Premium' or at 'Discount' respectively. When shares are issued at premium or at discount an accounting treatment different from shares issued at par is required. Let us discuss issue of shares at premium.

*Notes***Issue of Shares at Premium**

If a company issues its shares at a price more than its face value, the shares are said to have been issued at Premium. The difference between the issue price and face value or nominal value is called 'Premium'. If a share of ₹ 10 is issued at ₹ 12, it is said to have been issued at a premium of ₹ 2 per share. The money received as premium is transferred to Securities Premium A/c. A company issues its shares at premium only when its financial position is very sound. It is a capital gain to the company. The Premium money may be demanded by the company with application, allotment or with calls.

The Companies Act has laid down certain restrictions on the utilisation of the amount of premium.

According to Section 78 of this Act, the amount of premium can be utilised for :

- (i) Issuing fully-paid bonus shares;
- (ii) Writing off preliminary expenses, discount on issue of shares and debentures, underwriting commission or expenses on issue;
- (iii) Paying premium on redemption of Preference shares or Debentures;
- (iv) By Back of Shares.

Further, the company may demand the total amount of premium in more than one instalment. In case the company doesn't specify the particular call with which Securities Premium is to be paid it is supposed to be called at the time of Allotment.

Accounting Treatment of Premium on Issue of Shares

Following is the accounting treatment of Premium on issue of shares :



Notes

(a) **Securities Premium Collected with Share Application Money :** If the Securities premium is collected on application and the company has taken decision about the allotment of shares, the following journal entry is made :

Share Application A/c	Dr.
To Securities Premium A/c	

(The amount of Securities premium received on application of the allotted shares is transferred to Securities Premium A/c)

(b) **Premium Collected with Allotment Money or Calls :** If the company decides to demand the premium with share Allotment or/and share call money, the journal entry made is :

Share Allotment A/c	Dr.
Or/and	
Share Call A/c	Dr.
To Securities Premium A/c	

(Adjustment of share premium due on.....shares @ ₹.....per share.)

Illustration 3

Luxury Cars Ltd. issued 100000 shares of ₹ 10 each at a premium of ₹ 5 per share, payable as:

On application	₹ 4 (including ₹ 2 premium) per share
On allotment	₹ 8 (including ₹ 3 premium) per share
On call	₹ 3 per share

Applications were received for 100000 shares and allotment was made to all. Make journal entries.

Solution :

Books of Luxury Cars Ltd.

Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To Share Application A/c (Amount received for 1,00,000 shares)		4,00,000	4,00,000

Issue of Shares

2.	Share Application A/c To Share Capital A/c To Securities Premium A/c (Share application money transferred to share capital A/c and securities Premium A/c)	Dr.	4,00,000	2,00,000 2,00,000
3.	Share Allotment A/c To Share Capital A/c To Securities Premium A/c (Share allotment money made Due)	Dr.	8,00,000	5,00,000 3,00,000
4.	Bank A/c To Share Allotment A/c (Share allotment money is received on 1,00,000 shares @ ₹ 8 per share)	Dr.	8,00,000	8,00,000
5.	Share First and Final Call A/c To Share Capital A/c (Share call money made due on 1,00,000 shares @ ₹ 3 per share.)	Dr.	3,00,000	3,00,000
6.	Bank A/c To Share First and Final Call A/c (Share call money received on 1,00,000 shares @ ₹ 3 per share.)	Dr.	3,00,000	3,00,000

MODULE - 5

Company Accounts



Notes



INTEXT QUESTIONS 27.3

Fill in the blanks with suitable word/words and figure/figures :

- (i) Securities premium is a to the company.
- (ii) If allotment money demanded is ₹ 5 per share including ₹ 2 for premium. the share capital account will be credited by ₹
- (iii) A company issues its shares of ₹ 50 each at ₹ 60 per share. The excess money of ₹ 10 each is
- (iv) If the premium per share is ₹ 20 on a share of ₹ 100 each, the share capital A/c will be credited with per share.



Notes

Illustration 4

Sunita Ltd. was registered with an authorised capital of ₹ 50,00,000 divided in 50,000 shares of ₹ 100 each. Company issued 20,000 shares at a premium of ₹ 20 per share. Amount receivables as ₹ 40 on application, ₹ 40 on allotment (including premium) ₹ 20 on first call & ₹ 20 on second & final call. All shares were subscribed & all money was duly received. Share issue expenses amounted to ₹ 20,000 which were fully written off against securities premium reserve A/c. Pass necessary Journal entries & Prepare Bank A/c, Security Premium A/c and Balance Sheet.

Solution :

Journal

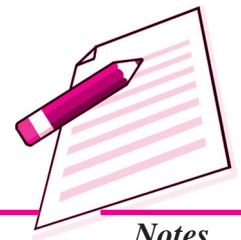
	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
	Bank A/c Dr. To Share Application A/c (Being application money received for 20000 shares @ ₹ 40 per share)		8,00,000	8,00,000
	Share Application A/c Dr. To Share Capital A/c (Being application money transferred to Share Capital A/c)		8,00,000	8,00,000
	Share Allotment A/c Dr. To Share Capital A/c To Securities Premium Reserve A/c (Being allotment money due with premium)		8,00,000	4,00,000 4,00,000
	Bank A/c Dr. To Share Allotment A/c (Being allotment money received with premium)		8,00,000	8,00,000
	Share First Call A/c Dr. To Share Capital A/c (Being First Call due @ ₹ 20 per share)		4,00,000	4,00,000

Issue of Shares

Bank A/c	Dr.	4,00,000	
To Share First Call A/c			4,00,000
(Being First call money received)			
Share Second & Final Call A/c	Dr.	4,00,000	
To Share Capital A/c			4,00,000
(Being Second Call due @ ₹ 20 per share)			
Bank A/c	Dr.	4,00,000	
To Share Second & Final Call A/c			4,00,000
(Being Second call money received)			
Share Issue Expenses/Preliminary Expenses A/c	Dr.	20,000	
To Bank A/c			20,000
(Being expenses incurred on issue of shares)			
Securities Premium Reserve A/c	Dr.	20,000	
To Share issue Expenses A/c			20,000
(Being share issue expenses written off against securities premium account)			

MODULE - 5

Company Accounts



Notes

Bank Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Application A/c	8,00,000	By Share Issue Exp. A/c	20,000
To Share Allotment A/c	8,00,000	By Balance c/d	23,80,000
To Share First Call A/c	4,00,000		
To Share Second Call A/c	4,00,000		
	24,00,000		24,00,000

Securities Premium Reserve Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Issue Exp. A/c	20,000	By Share Allotment A/c	4,00,000
To Balance c/d	3,80,000		
	4,00,000		4,00,000



Notes

Balance Sheet of Sunita Ltd.

as at

Particulars	Note	₹
I. Equity & Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	20,00,000
(b) Reserve and Surplus	2	3,80,000

Note 1

Share Capital

Authorised Capital

50000 shares of ₹ 100 each 50,00,000

Issued Capital

20000 shares of ₹ 100 each 20,00,000

Subscribed

Subscribed & Fully Paid up

20000 shares of ₹ 100 each 20,00,000

Note 2

Reserves & Surplus : Securities Premium Reserve 3,80,000

Disclosure of Share Capital in Company's Balance Sheet (Vertical form)

According to schedule V1, Part I of the companies Act 1956, the Share Capital of a company is shown in the Balance Sheet as given below.

Balance Sheet of a Company (an extract)

as at

Particulars	Note	₹
I. Equity and Liabilities		
(1) Shareholders Funds		
(a) Share Capital		
(b) Reserves and Surplus		
(c) Money received against share accounts		
(2) Share Application Money Pending Allotment		

Note : On the face of the Balance Sheet only so much information should be disclosed as is required and the remaining should be disclosed in the Notes to Accounts.

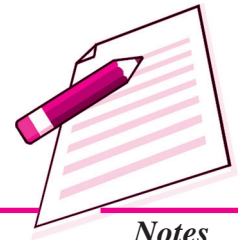
I. Equity and Liabilities

There are broadly two headings shown on the Equity and Liabilities side. First, being the equity, *i.e.*, liability of the company towards shareholders. It is termed as Shareholders' Funds. It includes Share Capital, Reserves and Surplus and Money received against share warrants. Second, being liability of the company towards the outsiders. It is termed as Liabilities.

1. Shareholders' Funds

(a) **Share Capital :** It is the first item under shareholders' funds. Details required to be shown are :

- i. ● **Authorised Share Capital :** Authorised Share Capital is stated in the Memorandum of Association and is divided into different categories such as **equity share capital and preference share capital**. It is the amount of share capital that a company is authorised to issue under each category. It is shown by way of information in the notes attached to the Balance Sheet. The above information is shown for information only, *i.e.*, it is not added to liability.
- **Issued Share Capital :** It is that part of the authorised share capital which the company has issued for subscription up to the authorised share capital which the company has issued for subscription up to the date of Balance Sheet. It includes a number and classes (Equity or Preference) of shares and their face value, etc.
- **Subscribed Share Capital :** It is that part of issued share capital which has been subscribed by the applicants.
- **Called-up Share Capital:** It is that part of the issued share capital that has been called-up to be paid by the company.
- **Paid-up Share Capital :** It refers to that part of subscribed share capital which has been paid-up by the subscriber towards share capital.



Notes



Notes

- (ii) If a company has issued different types of Equity and Preference shares, detail of each type of shares is given.
- (iii) Amount of Calls-in-Arrear is shown as deduction from called-up capital or 'subscribed capital' to ascertain the paid-up capital of the company and shown as liability in the Balance Sheet.
Calls-in Arrear from Directors and Officers of the company have to be disclosed.
- (iv) Forfeited shares amount, *i.e.*, amount originally paid up is shown by adding it to subscribed capital. But in case of profit on reissue of forfeited shares, it is transferred to Capital Reserves.

It is to be noted that details regarding share capital or in fact, any item of Balance Sheet and Statement of Profit and Loss is to be given in the notes.

(b) **Reserve and Surplus :** Reserve and Surplus include following items and are shown separately :

- (i) Capital Reserves
- (ii) Capital Redemption Reserve
- (iii) Securities Premium Reserve
- (iv) Debentures Redemption Reserve
- (v) Revaluation Reserves
- (vi) Share Options Outstanding Account
- (vii) Other Reserves (to specify the nature and purpose of each reserve)
- (viii) Balance in the statement of Profit and Loss after appropriations towards proposed dividend and transfer to reserves. In case, Reserves and Surplus has a balance under the head, profit (surplus) or loss (deficit) for the year is added to it. Thereafter, appropriation is made by transfer to reserves or for provision for dividend.

If the balance after transfer of profit to the existing balance results in negative figure, it is shown under Reserves and Surplus as a negative amount. It means it is deducted to arrive at the total reserves.

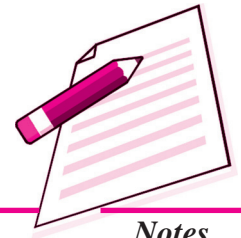
The balance of the reserve and surplus, whether positive or negative, is shown under shareholders funds.

Illustration 5

ABC Ltd invited applications for issuing 80,000 equity shares of ₹ 10 each. Money is payable as follows :

₹ 3 on Application, ₹ 3 on Allotment, ₹ 2 on First Call and ₹ 2 on Second & Final call.

All the shares were applied and all sums due on allotment and calls have been received. Share issue expenses amounted to ₹ 8,000. You are required to prepare Journal, Ledger Accounts and the Balance Sheet of ABC Ltd.



Notes

Solution :

Journal

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
	Bank A/c Dr. To Share Application A/c (Being application money received for 80000 shares @ ₹ 3 per share)		2,40,000	2,40,000
	Share Application A/c Dr. To Share Capital A/c (Being application money transferred to Share capital A/c)		2,40,000	2,40,000
	Share Allotment A/c Dr. To Share Capital A/c (Being allotment money due on 80,000 shares @ ₹ 3 per share)		2,40,000	2,40,000
	Bank A/c Dr. To Share Allotment A/c (Being allotment money received)		2,40,000	2,40,000
	Share First Call A/c Dr. To Share Capital A/c (Being First Call due on 80,000 shares @ ₹ 2 per share)		1,60,000	1,60,000

MODULE - 5

Company Accounts



Notes

Issue of Shares

Bank A/c	Dr.	1,60,000	1,60,000
To Share First Call A/c			
(Being amount received on first call)			
Share Second & Final Call A/c	Dr.	1,60,000	1,60,000
To Share Capital A/c			
(Being amount received on final call)			
Share Issue Expenses A/c	Dr.	8,000	8,000
To Bank A/c			
(Being expenses incurred on issue of shares)			

LEDGER

Bank Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Application A/c	2,40,000	By Share Issue Exp. A/c	8,000
To Share Allotment A/c	2,40,000	By Balance c/d	7,92,000
To Share First Call A/c	1,60,000		
To Share Final Call A/c	1,60,000		
	8,00,000		8,00,000

Share Application Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Capital A/c	2,40,000	By Bank A/c	2,40,000
	2,40,000		2,40,000

Share Allotment Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Capital A/c	2,40,000	By Bank A/c	2,40,000
	2,40,000		2,40,000

Share First Call Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Capital A/c	1,60,000	By Bank A/c	1,60,000
	1,60,000		1,60,000

Issue of Shares

MODULE - 5

Company Accounts

Share Final Call Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Share Capital A/c	1,60,000	By Bank A/c	1,60,000
	1,60,000		1,60,000

Share Capital Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Balance c/d	8,00,000	By Share Application A/c	2,40,000
		By Share Allotment A/c	2,40,000
		By Share First Call A/c	1,60,000
		By Share Final Call A/c	1,60,000
	8,00,000		8,00,000

Share Issue Expense Account

Dr.		Cr.	
Particulars	₹	Particulars	₹
To Bank A/c	8,000	By Balance c/d	8,000
	8,000		8,000

Balance Sheet of ABC Ltd (An Extract)

as at

Particulars	Note	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	8,00,000
II. Assets		
(1) Non Current Assets		
(a) Other non current assets	2	8,000

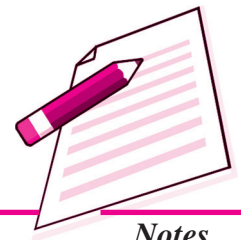
Note 1

Share Capital

Authorised Capital

.....Shares of ₹ 10 each

.....



Notes



Notes

Issued Capital

80000 shares of ₹ 10 each 8,00,000

Subscribed

Subscribed & Fully Paid up

80000 shares of ₹ 10 each 8,00,000

Note 2

Share Issue Expenses 8,000

27.4 ISSUE OF SHARES AT DISCOUNT

When the issue price of share is less than the face value, shares are said to have been issued at discount. For example if a company issues its shares of ₹ 100 each at ₹ 90 each, the shares are said to be issued at discount. The amount of discount is ₹ 10 per share (i.e. ₹ 100 – ₹ 90). Discount on issue of shares is a loss to the company.

Section 79 of Companies Act 1956 has laid down certain conditions subject to which a company can issue its shares at a discount. These conditions are as follows :

- (i) At least one year must have elapsed from the date of commencement of business;
- (ii) Such shares are of the same class which has had already been issued;
- (iii) The company has sanctioned such issue by passing a resolution in its General meeting and the approval of the court is obtained.
- (iv) Discount should not be more than 10% of the face value of the share and if the company wants to give discount more than 10%, it will have to obtain the sanction of the Central Government.

Accounting Treatment of Shares Issued at Discount

The amount of discount is generally adjusted towards share allotment money and the following journal entry is made:

Share Allotment A/c	Dr.
Discount on issue of shares A/c	Dr.
To Share Capital A/c	
(Allotment money due on....shares @ ₹per share after allowing discount @ ₹per share)	

Illustration 6

Sri Krishna Agro Chemical Ltd. was registered with a capital of ₹ 5000000 divided into 50,000 shares of ₹ 100 each. It issued 10000 shares at a discount of ₹ 10 per share, payable as :

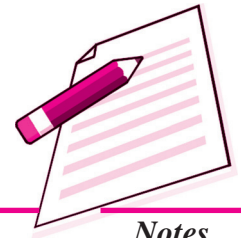
- ₹ 40 per share on application
- ₹ 30 per share on allotment
- ₹ 20 per share on call.

Company received applications for 15000 shares. Applicants for 12000 shares were allotted 10000 shares and applications for the remaining shares were sent letters of regret and their application money was returned. Call was made. Allotment and call money was duly received. Make journal entries in the books of the company.

Solution :

Sri Krishna Agro Chemicals Ltd
Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1	Bank A/c Dr. To Share Application A/c (Application money received for 15000 shares @ ₹ 40 per Share)		6,00,000	6,00,000
2.	Share Application A/c Dr. To Share Capital A/c (Application money for 10000 shares transferred to share Capital A/c on their allotment)		4,00,000	4,00,000
3.	Share Application A/c Dr. To Share Allotment A/c To Bank A/c (Application money of 3000 shares returned and for 2000 shares adjusted towards sum due on allotment)		2,00,000	80,000 1,20,000



Notes

MODULE - 5

Company Accounts



Notes

Issue of Shares				
4.	Share Allotment A/c	Dr.	3,00,000	4,00,000
	Discount on Issued of Shares A/c	Dr.	1,00,000	
	To Share Capital A/c. (Allotment money due)			
5.	Bank A/c	Dr.	2,20,000	2,20,000
	To Share Allotment A/c (Allotment money received)			
6.	Share First & Final Call A/c	Dr.	2,00,000	2,00,000
	To Share Capital A/c (Amount due on call)			
7.	Bank A/c	Dr.	2,00,000	2,00,000
	To Share First & Final Call A/c (Call money received)			



INTEXT QUESTIONS 27.4

Fill in the blanks with suitable word/words :

- Discount on issue of shares is a to the company.
- A company issues its shares of ₹ 100 each at a discount of 10%, money receivable on each share is
- If discount per share is ₹ 5 on shares of ₹ 100 each, the share capital A/c will be credited with ₹

27.5 CALLS IN ADVANCE AND CALLS IN ARREARS

If a shareholder pays any amount to company before it is demanded, it is called Call-in-Advance. This amount is put in a separate account known as Calls-in-Advance A/c. This amount is not shown as capital of the company, till such time the company makes a demand from all the shareholders. Call-in-Advance A/c is shown on the liabilities side of the Balance Sheet. For example if a company issued shares of ₹ 10 on which it has already called ₹ 5. Against the uncalled portion of ₹ 5 per share the company makes a call ₹ 3 per share, the entry for call money due will be made only for ₹ 3 per share. Now suppose a shareholder pays ₹ 5 per share including the uncalled amount of ₹ 2 per share along with the call money, it means he has paid ₹ 2 per share in advance, which will be credited to calls in Advance A/c. The company is required to pay interest on this amount @ 6% till the date of its appropriation.

Accounting Treatment

Following journal entry is made for calls-in-advance.

Bank A/c Dr.
 To Calls-in-Advance A/c
 (Calls in advance received on.....shares @ ₹per share)

Appropriation of calls-in-Advance A/c say in the final call

Journal entry will be :

Calls-in-Advance A/c Dr.
 To Share Final call A/c
 (Calls in advance amount adjusted)

For interest given on Calls-in-Advance

Journal entry will be :

Interest on calls-in-Advance A/c Dr.
 To Bank A/c
 (Interest paid on the amount of Call-in-Advance)

Illustration 7

India Software Ltd. offered 50000 shares of ₹ 10 each to the public payable as:
 ₹ 2 on application
 ₹ 3 on allotment
 ₹ 2 on First call and the balance as and when required.

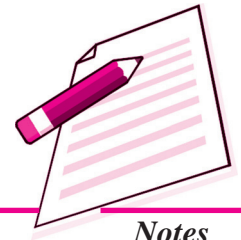
All the shares were applied for and duly allotted but Mukesh a shareholder holding 200 shares paid the entire balance on allotment.

Make necessary journal entries.

Solution :

India Software Ltd.
Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr. To Share Application A/c (Share application money received for 50000 shares @ ₹ 2 per share)		1,00,000	1,00,000



Notes

MODULE - 5

Company Accounts



Notes

		Issue of Shares	
Share Application A/c	Dr.	1,00,000	
To Share Capital A/c			1,00,000
(Share application money transferred to share capital A/c on allotment)			
Share Allotment A/c	Dr.	1,50,000	
To Share Capital A/c			1,50,000
(Share allotment money made due on 50000 shares @ ₹ 3 per share.)			
Bank A/c.	Dr.	1,51,000	
To Share Allotment A/c			1,50,000
To Call-in-Advance A/c			1,000
(Amount received on allotment @ ₹ 3 per share and advance for 200 shares @ ₹ 5 per share)			
Share First Call A/c	Dr.	1,00,000	
To Share Capital A/c			1,00,000
(Share first call money due on 50000 shares @ ₹ 2 per share.)			
Bank A/c	Dr.	99,600	
Call-in-Advance A/c	Dr.	400	
To Share First call A/c			1,00,000
(First call money received on 49800 shares and on 200 shares call in advance is adjusted.)			

Calls in Arrears

When the company sends notice to the shareholders to pay allotment and /or call money, it has to be paid by them within the specified time period. If it is not paid by any one or more of the shareholders, the unpaid amount becomes arrears due from them. Such arrears are transferred to an account termed as Calls-in-Arrears A/c. The company is authorised to charge interest on calls-in-Arrears @ 5% p.a. for the intervening period. (The period between date of non-receipt of the due amount and the date of actual receipt of the due amount).



Notes

Illustration 9

ABC Ltd issued 20000 shares of ₹ 10 each payable as ₹ 2 per share on application, ₹ 5 (including premium of ₹ 2 per share) on allotment, ₹ 3 per share on first call and the balance on Final Call.

All the money was received except the first call money on 400 shares; which was received later on with final call.

Make necessary journal entries.

Solution :

Journal Entries

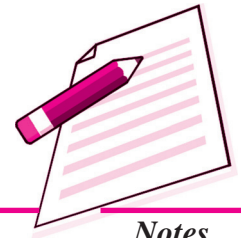
<i>S.No.</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
1	Bank A/c Dr. To Share Application A/c (Application money received for 20000 shares @ ₹ 2 per Share)		40,000	40,000
2.	Share Application A/c Dr. To Share Capital A/c (Application money of 20000 shares transferred to share Capital A/c on allotment)		40,000	40,000
3.	Share Allotment A/c Dr. To Share Capital A/c To Securities Premium A/c (Allotment money due with premium @ ₹ 5 (3+2) per share on 20000 shares)		1,00,000	60,000 40,000
4.	Bank A/c Dr. To Share Allotment A/c (Share allotment money received)		1,00,000	1,00,000
5.	Shares First Call A/c Dr. To Share Capital A/c (Share first call money due on 2000 shares @ ₹ 3 per share)		60,000	60,000

Issue of Shares

6	Bank A/c Calls-in-Arrears A/c To Share First Call A/c (First call money received on 19600 shares @ ₹ 3 per share.)	Dr. Dr.	58,800 1,200	60,000
7.	Share Final Call A/c To Share Capital A/c (Final Call money due on 20000 shares @ ₹ 2 per share.)	Dr.	40,000	40,000
8.	Bank A/c To Share Final Call A/c To Calls-in-Arrears A/c (Final Call money received on 20000 shares @ ₹ 2 per share along with arrears of first call on 400 shares)	Dr.	41,200	40,000 1,200

MODULE - 5

Company Accounts



Notes

Illustration 10

The Progressive Industries Limited was registered with a capital of ₹ 50,00,000. It issued 20000 equity shares of ₹ 100 each payable as ₹ 25 on application, ₹ 25 on allotment and balance on 1st and final call and 10000, 9% preference shares of ₹ 100 each payable as ₹ 50 on application and allotment and the balance on two calls of ₹ 25 each. All the shares were applied for and allotted. All money was duly received. Make necessary journal entries in the books of the company :

Solution :

Progressive Industries Ltd Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c To Equity Share Application A/c To 9% Preference Share Application and Allotment A/c (Application money received for 20000 equity shares @ ₹ 25 per Share and 10000 9% preference shares @ ₹ 50 per share)	Dr.	10,00,000	5,00,000 5,00,000

MODULE - 5

Company Accounts



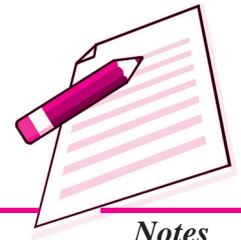
Notes

		Issue of Shares	
2.	Equity Share Application A/c Dr. 9% Preference Share Application & Allotment A/c Dr. To Equity Share Capital A/c To 9% Preference Share Capital A/c (Application money transferred to capital accounts)	5,00,000 5,00,000	5,00,000 5,00,000
3.	Equity Share Allotment A/c Dr. To Equity share Capital A/c (Allotment money due on 20000 equity shares at ₹ 25 per share)	5,00,000	5,00,000
4.	9% Preference share 1st call A/c Dr. To 9% Preference Share Capital A/c (1st call money due on 10000 9% preference shares at ₹ 25 per share)	2,50,000	2,50,000
5.	Bank A/c Dr. To Equity Share Allotment A/c To 9% Preference Share 1st call A/c (Equity share allotment money and 9% preference share 1st call money received)	7,50,000	5,00,000 2,50,000
6.	Equity Share First & Final Call A/c Dr. 9% Preference Share Final Call A/c Dr. To Equity Share Capital A/c To 9% Preference Share Capital A/c (First & Final call on equity shares and Final call on 9% preference shares due)	10,00,000 2,50,000	10,00,000 2,50,000
7.	Bank A/c Dr. To Equity Share First & Final Call A/c To 9% Preference Share Final Call A/c (Equity share 1st and final call and 9% Preference share final call money received)	1,25,000	10,00,000 2,50,000

**INTEXT QUESTIONS 27.5**

Fill in the blanks with suitable word/words and figure/figures:

- (i) The call money demanded by the company if not paid by a shareholder, will be debited toA/c.
- (ii) A shareholder pays ₹ 6 per share on allotment which includes ₹ 2 per share for the next call, extra amount paid is
- (iii) Interest charged by the company on the amount of calls-in-arrears will be credited to
- (iv) Interest allowed on the call paid in advance will be debited to



Notes

**WHAT YOU HAVE LEARNT**

- Face value of a share is its par value. Shares can be issued for considerations other than cash i.e., for purchase of assets or payment to creditors or promoters.
- Share money can be collected in lump sum or in instalment.
- The first instalment is termed as Share Application money and second instalment is known as Share Allotment money.
- In case share money is collected in more than two instalments this is call money.
- Applications for shares may be received equal to the number of shares offered, (full subscription) less than number of shares offered (under subscription) or for more than the number of shares offered (over subscription)
- When shares are issued at more than their face value these are said to be issued at premium. The premium amount can be utilised only for purposes as specified under section 78 of Companies Act.
- When issue price of a share is less than its nominal value, it is said to be issued at discount. Section 79 of Companies Act has laid down certain conditions to be fulfilled while issuing shares at discount.
- If a shareholder fails to pay Share Allotment money or share call money when demanded by the company, the unpaid amount is called calls in Arrears. If a shareholder pays the amount for calls not made, the amount paid is known as Call-in-Advance.



TERMINAL EXERCISE

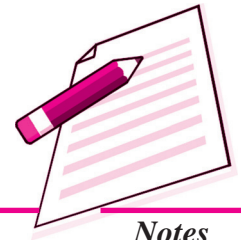


Notes

1. What is meant by over subscription of shares? What accounting treatment is given to the amount over subscribed?
2. What is meant by 'Shares Issued at Premium'? State the purposes for which Premium amount can be utilised.
3. What is meant by issue of shares at discount? State the conditions to be fulfilled for the issue of shares at discount under the Companies Act.
4. Explain in brief the terms:
 - (i) Calls-in Arrears.
 - (ii) Calls-in Advance
5. Make journal entries:
 - (a) XY Limited whose share capital is divided into 20,000 equity shares of ₹ 10 each, issued 6,000 shares to the public. The entire money is payable along with the application. All the shares were subscribed and application money was received.
 - (b) A Limited issued 10,000 equity shares of ₹ 100 each, payable ₹ 25 per share on application, ₹ 25 per share on allotment, and ₹ 25 on each of the two subsequent calls. All the money was duly received.
 - (c) X Ltd., issued 10,000 shares of ₹ 10 each at ₹ 15 payable ₹ 3 on application, Rs. 8 on allotment (including the premium of ₹ 5) and ₹ 4 on call. All the shares are subscribed, allotted and paid for at due dates.
 - (d) A limited issued 10,000 shares of ₹ 20 each at a discount of 10%. The shares were payable as ₹ 4 per share on application, ₹ 8 per share on allotment and the balance on first call. All the money was duly received.
6. (a) Akshay Ltd. made an issue of 20,000 shares of ₹ 10 each payable as follows :

₹ 2 on application, ₹ 2 on allotment, ₹ 3 on first call and the balance on second call. The first call is made and all members pay, including a member holding 800 shares, who pays for the balance due in full. Later the final call is made and is fully met.

Give journal entries.



Notes

- (b) Nirmal Ltd. with an authorised capital of ₹ 10,00,000, in shares of ₹10 each, issued 50,000 of such shares, payable ₹ 2 per share on application, ₹ 3 on allotment, ₹ 2.50 per share three months later, and duly received. But when the call of ₹ 2.50 was made a shareholder holding 200 share failed to pay the call money while another shareholder holding 400 shares paid the entire Balance. Give journal entries.
7. Goodluck Ltd. issued 50,000 shares of ₹ 10 each at a Premium of ₹4 per share payable as :
- On Application ₹ 2 per share
 On Allotment ₹ 6 per Share (including Premium ₹ 3)
 On first and final Call ₹ 6 per share (including Premium ₹ 1)
- Over payment on applications were to be applied towards sums due on allotment only. Applications were received for 75,000 shares. Applicants for 15,000 shares were sent letters of regret and money returned to them in full. Applicants for 15,000 shares were allotted only 5,000 shares. All money due on Allotment and call was duly received.
- Make journal entries
8. Super India Petro Chemicals Ltd. was registered with a capital of ₹ 1 crore divided into equity shares of ₹ 100 each. Company purchased plant of ₹ 2500000 and paid the amount by issuing shares at a premium of ₹ 25 per share. Company also issued shares of ₹ 5000000 to the general public at a premium of ₹ 25 per share. The amount payable was:
- ₹ 65 on application and allotment
 ₹ 30 on first call and the balance on final call.
- Company received applicaitons for 75000 shares Allotment was made as follows:
- Applicants for
- | | |
|--------------|-------|
| 10000 shares | nil |
| 40000 shares | Full |
| 25000 shares | 10000 |
- Allotment money was received in full but when calls were made all shareholders paid the amount in full except a shareholder holding 400 shares belonging to the



Notes



ANSWERS TO INTEXT QUESTIONS

category who were allotted full shares. A shareholder holding hundred shares failed to pay the 1st call money which he paid along with the amount of final call Company allows interest on call in advance @6% per annum and charges interest on call-in-arrears @ 12% p.a. After the allotment the calls are made at a interval of 2 months. Make necessary journal entries in the books of the company.

- 27.1 (i) Denominated (ii) Vendors
(iii) Instalments (iv) Applicants
- 27.2 (i) Over subscription (ii) Share 1st call
(iii) Called up (iv) Cannot
- 27.3 (i) gain (ii) ₹ 3
(iii) Securities premium (iv) ₹ 100 per share
- 27.4 (i) loss (ii) ₹ 90 (iii) ₹ 100 per shares
- 27.5 (i) Calls in arrears (ii) Calls in advance
(iii) Interest on calls in arrears A/c
(iv) Interest on call in advance A/c

28

FORFEITURE OF SHARES



Notes

In the previous lesson you have learnt about the shares and their issue by a Joint Stock Company. You have also learnt that generally the issue price of shares is payable in instalments i.e. on application, on allotment and on calls made from time to time by the Board of Directors of the Company. Sometimes some shareholders fail to pay the called up amount in full i.e., they do not pay on one or more instalments after the allotment of the shares to them. In such a case either the company can go to the court and file a suit against the defaulting shareholders for recovery of the due amount or can cancel the membership of the defaulting shareholders. In case the membership is cancelled, the amount paid by the defaulting members towards share capital stands forfeited. It is called 'Forfeiture of Shares.'

In this lesson you will learn about different situations in which shares can be forfeited and accounting treatment thereof.



OBJECTIVES

After studying this lesson you will be able to:

- explain the meaning of forfeiture of Shares:
- explain the situations in which shares can be forfeited;
- explain accounting treatment for forfeiture of shares issued at par, at discount and at premium and
- prepare relevant accounts.

28.1 MEANING AND PROCEDURE*Notes*

If a shareholder fails to pay the due amount of allotment or any call on shares issued by the company, the Board of directors may decide to cancel his/her membership of the company. With the cancellation, the defaulting shareholder also loses the amount paid by him/her on such shares. Thus, when a shareholder is deprived of his/her membership due to non payment of calls, it is known as forfeiture of shares. The result of forfeiture of shares is :

Cancellation of membership of the shareholder.

Reduction of issued share Capital of the company.

Let us take an example to make it more clear. S.K. Ltd. issued 100000 shares of ₹ 10 each payable as ₹ 2 on application, ₹ 2 on allotment, ₹ 3 on first call and ₹ 3 on second and final call. Mr. Harish, the allottee of 100 shares, fails to pay the second and final call money made by the company. In this case if the Board of Directors decide to forfeit his shares, his membership will be cancelled and the amount of ₹ 700 paid by him (on 100 shares ₹ 2 on application, ₹ 2 on allotment and ₹ 3 on first call per share) will be forfeited. Now Mr. Harish will no longer be the member of the company and the issued capital of the company will be reduced by ₹ 1000.

Procedure of forfeiture of shares

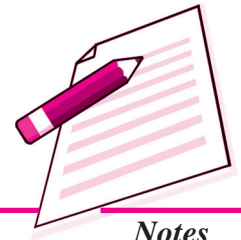
The authority to forfeit shares is given to the Board of Directors in Articles of Association of the company. The Board of Directors has to give at least fourteen days notice to the defaulting members calling upon them to pay outstanding amount with or without interest as the case may be before the specified date. The notice must also state that if the shareholders fail to remit the amount mentioned therein within the stipulated period, their shares will be forfeited. If they still fail to pay the amount within the specified period of time, the Board of Directors of the company may decide to forfeit such shares by passing a resolution. The decision regarding the forfeiture of shares should be communicated to the concerned allottees and should be asked to return the allotment letters and share certificates of the forfeited shares to the company.



INTEXT QUESTIONS 28.1

Fill in the blanks with an appropriate word/ words :

- (i) If a shareholder fails to pay the due amount on shares, the board of directors may decide to shares.
- (ii) Forfeiture of shares means
 - (a)
 - (b)
- (iii) The authority to forfeit shares is given by company's
- (iv) The Board of Directors has to give at least days notice to the defaulting members.



Notes

28.2 ACCOUNTING TREATMENT

You have learnt that shares can be issued at par, at discount and at premium. Accounting treatment for forfeiture of shares in these three situations can be explained as under :

1. Forfeiture of Shares Issued at Par

When shares issued at par are forfeited the accounting treatment will be as follows:

- (i) Debit Share Capital Account with amount called up (whether received or not) per share up to the time of forfeiture.
- (ii) Credit Share Forfeited A/c. with the amount received up to the time of forfeiture.
- (iii) Credit 'Unpaid Calls A/c' with the amount due on forfeited shares. This cancels the effect of debit to such calls which take place when the amount is made due.

The journal entry is :

Share capital A/c	Dr.
(Amount called up)	
To share forfeited A/c	
(Amount paid)	
To unpaid calls A/c	
(Amount called but not paid)	



Notes

- Note :**
- (i) Amount called up = No. of shares × called up per share
 - (ii) Amount paid = No. of shares × Amount paid per share
 - (iii) Amount called but not paid =
No. of shares × Amount called but not paid per share

Illustration 1

X, a shareholder, holding 100 shares of ₹ 10 each has paid application money of ₹ 2 per share and allotment money of ₹ 3 per share, but has failed to pay the first call of ₹ 2 per share and second call of ₹ 3 per share. His shares were forfeited. Make the journal entry to record the forfeiture of shares.

Solution :

Journal Entry

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
	Share Capital A/c (100 × ₹ 10) Dr.		1,000	
	To Share forfeited A/c (100 × ₹ 5)			500
	To Share First Call A/c (100 × ₹ 2)			200
	To Share Second and Final Call A/c (100 × ₹ 3) (forfeiture of 100 shares)			300

Illustration 2

Alpha Ltd. issued 10000 shares of ₹ 100 each payable as :

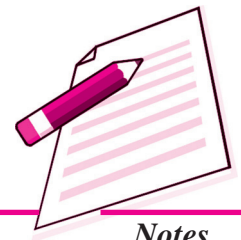
- ₹ 25 on application.
- ₹ 25 on allotment
- ₹ 20 on First call and
- ₹ 30 on second and final call.

9000 shares were applied for and allotted. All the payments were received with the exception of allotment money, first call and second and final call money on 300 shares allotted to Ganesh. The Board of Directors decided to forfeit these shares. Make journal entry to record transaction relating to forfeiture of shares.

Solution :

Journal Entry

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
	Share Capital A/c (300 × ₹ 100) Dr.		30,000	
	To Share forfeited A/c (300 × ₹ 25)			7,500
	To Share allotment A/c (300 × ₹ 25)			7,500
	To Share first call A/c (300 × ₹ 20)			6,000
	To Share second call A/c (300 × ₹ 30)			9,000
	(300 shares of ₹ 100 each forfeited due to non payment of allotment money and calls money)			



Notes

Forfeiture of Shares Allotted on Pro-rata Basis

In case the shares being over subscribed one of the scheme of allotment of shares to applicants is to allot in the ratio of shares for which applications are entertained by the company for allotment and the number of shares company has offered for subscription. This is called allotment of shares on pro-rata basis. In case of pro-rata allotment the excess money received on applications is transferred to Share Allotment A/c from Share Application A/c. In case a shareholder fails to make payment on allotment and call money of shares held by him/her, the unpaid amount will be calculated as under:

(i) Number of shares applied for allotment

$$= \frac{\text{Total No. of Shares Applied} \times \text{Shares Allotted to Defaulter}}{\text{Total Share Allotted}}$$

(ii) Excess Applications Received =

$$\text{Number of shares applied for (as per step) – number of shares allotted}$$

(iii) Excess application money received = Excess number of applied shares × money called per share on application.

(iv) Amount unpaid on allotment = Amount due on allotment – Excess application money adjusted towards allotment

Illustration 3

A company has offered for subscription to the public 10000 shares of ₹ 10 each. It has received applications for 15000 shares. Company has decided to allot shares



Notes

on prorata basis. Gunakshi holding 200 shares failed to pay allotment money and first call money. Her shares were forfeited :

Amount payable was as under :

₹ 2 per share on application.

₹ 3 per share on allotment.

₹ 5 per share on call.

Make journal entries and prepare relevant account in the books of the company.

Solution :

Working Notes

$$\text{Number of Shares Applied by Gunakshi} = \frac{15,000}{10,000} \times 200$$

$$= 300$$

$$\text{Excess Applications Received} = 300 - 200 = 100$$

$$\text{Excess Applications Amount Received} = 100 \times 2 = ₹ 200$$

$$\text{Amount Due on Allotment} = 200 \times 3 = ₹ 600$$

$$\text{Excess Application Money Adjusted} = ₹ 200$$

$$\text{Net Unpaid Amount on Allotment} = ₹ 600 - ₹ 200 = ₹ 400$$

Journal Entries

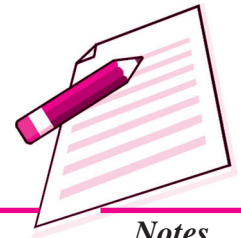
<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
1.	Bank A/c Dr. To Share Application A/c (Share application money received for 15000 shares @ ₹ 2 per share)		30,000	30,000
2.	Share Application A/c Dr. To Share capital A/c To Share Allotment A/c. (Share application money for 10000 shares transferred to share capital A/c on their allotment and application money for 500 shares transferred to share allotment A/c.)		30,000	20,000 10,000

Forfeiture of Shares

3.	Share Allotment A/c To Share Capital A/c (Allotment money due on 10000 Shares @ ₹ 3 per share)	Dr	30,000	30,000
4.	Bank A/c To Share Allotment A/c (Allotment money received on 9800 shares)	Dr	19,600	19,600
5.	Share First & Final call A/c To Share Capital A/c. (Call money made due on 10000 Shares @ ₹ 5 per share)	Dr	50,000	50,000
6.	Bank A/c To Share First & Final Call A/c (Call Money received on 9800 shares @ ₹ 5 per share)	Dr	49,000	49,000
7.	Share capital A/c To Share forfeited A/c To Share Allotment A/c To Share First & Final call A/c (200 shares forfeited for non payment of allotment & call money)	Dr	2,000	600 400 1,000

MODULE - 5

Company Accounts



Notes

Working Note

$$\frac{15,000}{10,000} \times 200 = 300 \text{ Shares were applied.}$$

300 x 2	=	₹ 600
200 x 2	=	- ₹ 400
Advance	=	<u>₹ 200</u>

Adjusted on Allotment

Total Requirement	₹ 30,000
(-) Advance	<u>₹ 10,000</u>
	₹ 20,000
(-) Arrear	<u>₹ 400</u>
	<u>₹ 19,600</u>

$$(200 \times 3 = 600 - 200 \text{ adv}) = ₹ 400$$

MODULE - 5

Company Accounts



Notes

Forfeiture of Shares

Ledger Bank A/c

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Application A/c		30,000		Balance c/d		98,600
	Share Allotment A/c		19,600				
	Share First and Final call A/c		49,000				
			98,600				98,600
	Balance b/d		98,600				

Share Application A/c

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		20,000		Bank A/c		30,000
	Share Allotment A/c		10,000				
			30,000				30,000

Share Capital A/c

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Forfeited A/c		600		Share Application A/c		20,000
	Share Allotment A/c		400		Share Allotment A/c		30,000
	Share First and Final call A/c		1,000		Share First and Final call A/c		50,000
	Balance c/d		98,000				
			1,00,000				1,00,000
					Balance b/d		98,000

Share Allotment A/c

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		30,000		Bank A/c		19,600
					Share Application Ac		10,000
					Share Capital A/c		400
			30,000				30,000

Forfeiture of Shares

MODULE - 5

Company Accounts



Notes

Share First and Final Call A/c

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Share Capital A/c		50,000		Bank A/c		49,000
					Share Capital A/c		1,000
			50,000				50,000

Share Forfeited A/c

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
	Balance cld		600		Share Capital A/c		600
			600				600
					Balance b/d		600

Balance Sheet of Co. Ltd.

As at

Particulars	Note No.	₹
I. Equity and Liabilities		
1. Shareholders' Funds		
(a) Share Capital	1	98,600

Note 1 :

Share Capital

Authorised Capital

..... Equity Share of ₹ 10 each

Issued Capital

10,000 Equity Shares of ₹ 10 each 1,00,000

Subscribed

Subscribed & Fully Paid up

9,800 Equity shares of ₹ 10 each 98,000

Add : Share Forfeiture A/c 600

98,600



Notes



INTEXT QUESTIONS 28.2

- i. 200 shares of ₹ 100 each were forfeited for non payment of first call of ₹20 per share and find call of ₹30 per share. Write the amount against each account in the journal entry for forfeiture of shares :

	₹	₹
Share Capital A/c	Dr. (a)	
To Share Forfeited A/c		(b)
To Share First Call A/c		(b)
To Share Final Call A/c		(d)

(Forfeitures of 200 shares of ₹ 100 each for non payment of first call and final call)

- ii. A Joint Stock Company has offered for subscription 50000 shares of ₹ 100 each on which it has demanded ₹ 30 on application, ₹ 40 on allotment and balance as and when required. Applications were received for 60000 shares. Allotment to the applicants was made on prorata basis. Rakesh who was allotted 200 shares did not pay the allotment money. Ascertain the following amounts of Rakesh’s shares.
- (a) Excess application amount received ₹
- (b) Amount due on allotment ₹
- (c) Net unpaid amount on allotment ₹

28.3 FORFEITURE OF SHARES ISSUED AT PREMIUM AND AT DISCOUNT

Forfeiture of Shares Issued at Premium

In case shares are issued at premium and thereafter forfeited there can be two situations :

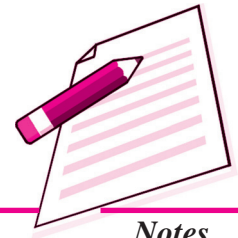
- Premium on shares has been received prior to the forfeiture.
- Amount of premium on shares has not been received and it still stands credited to the Securities Premium A/c.

1. Premium Money has been Received Prior to the Forfeiture : If the amount

of premium on shares forfeited has been received by the company prior to the forfeiture, securities Premium A/c will not get affected. In this case the journal entry of forfeiture of shares will be similar to the entry made as if the shares had been issued at par.

The journal entry will be :

Share Capital A/c	Dr.	
To Share forfeited A/c		
To Unpaid Calls A/c./Calls in arrears A/c		
(forfeiture of share issued at premium)		



Notes

Illustration 4

M.B. Software Ltd. issued ₹ 500000 capital divided into equity shares of ₹ 10 each. The shares were issued at a premium of ₹ 4 per share and were payable as : ₹ 3 per share on application, ₹ 7 (including premium) per share on allotment and the balance on call.

All the shares applied for and were duly allotted. All the money was duly received except on 500 shares on which the call money was not received. Company decided to forfeit these shares. Make journal entry to record the forfeiture of 500 shares.

Solution :

Journal Entry

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Share Capital A/c Dr.		5,000	
	To Share Forfeited A/c			3,000
	To Share First & Final Call A/c			2,000
	(Forfeiture of 500 shares of ₹ 10 each due to on non payment of call money of ₹ 4 per share)			

2. Premium on shares has not been received and stands credited to Securities Premium A/c as due but not paid : When a share is forfeited on which the amount of premium has been made due but has not been received, either wholly or partially, the Securities Premium A/c will be cancelled. At the time of making due, Securities Premium A/c will be credited. The journal entry will be as follows:



Notes

Share Capital A/c Dr
 Securities Premium A/c Dr
 To Share Forfeited A/c
 To Unpaid call A/c.
 (Forfeiture of shares originally issued at
 premium due to non payment of dues)

Illustration 5

The Latest Technology Company Ltd. offered to public for subscription of 50,000 shares of ₹ 20 each at a premium of ₹ 5 per share. The amount was payable as under :

On application ₹ 5 per share
 On allotment ₹ 12 per share (Including premium of ₹ 5 per share)
 On first call ₹ 4 per share
 On Second and Final call ₹ 4 per share

Applications were received for all the shares. Allotment was made to all the applicants in full. Ashima failed to pay allotment and call money on 200 shares held by her. Reshma was allotted 300 shares. She did not pay the call money. Their shares were forfeited. Make necessary journal entry for the forfeiture only.

Solution :

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	Share Capital A/c (₹200 × 20) Dr.		4,000	
	Securities Premium A/c (₹200 × 5) Dr.		1,000	
	To Share Forfeited A/c (₹200 × 5)			1,000
	To Share Allotment A/c (₹200 × 12)			2,400
	To Share First Call A/c (₹200 × 4)			800
	To Share Second and Final call A/c (₹200 × 4)			800
	(Forfeiture of 200 shares held by Ashima who did not pay allotment and call money)			



Forfeiture of Shares

(ii)	Share Capital A/c (₹300 × 20)	Dr.	6,000	
	To Shares forfeited A/c ₹(300 × 12)			3,600
	To Share First Call A/c (₹300 × 4)			1,200
	To Share Second Call A/c (₹300 × 4)		1,200	
	(Forfeiture of 300 shares held by Reshma)			

Combined entry of the above will be as :

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Share Capital A/c	Dr.	10,000	
	Securities premium A/c	Dr.	1,000	
	To Share forfeited A/c			4,600
	To Share Allotment A/c			2,400
	To Share First Call A/c			2,000
	To Share Second and Final Call A/c			2,000
	(Forfeiture of 200 shares held by Ashima, who did not pay allotment and call and 300 share of Reshma who did not pay call money)			

Forfeiture of Shares Issued at Discount

Discount on issue of shares is a loss to the company. When shares issued at a discount are forfeited for non payment of dues, the discount allowed on such shares is written back. At the time of issue of shares, Discount on issue of Shares A/c is debited and when forfeited, this account is credited to cancel the discount allowed on such shares. In this case the following journal entry is made :

Share Capital A/c	Dr.
To Share Forfeited A/c	
To Discount on Issue of Shares A/c	
To Unpaid call A/c	
(Forfeiture of shares originally issued at discount for non payment of dues).	

Illustration 6

The Evergrowing Ltd. invited applications for 20000 shares of ₹ 50 each at a discount of 10% payable as follows:

On application	₹ 10 per share
On allotment	₹ 20 per share
On call	₹ 15 per share



Notes

Whole of the issue was subscribed and paid for except the calls money on 200 shares which were forfeited by the company.

Make journal entry for forfeiture of shares.

Solution :

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Share Capital A/c (₹200 × 50) Dr.		10,000	
	To Share forfeited A/c (₹200 × 30)			6,000
	To Discount on Issue of Shares A/c (₹200 × 5)			1,000
	To Share First and Final call A/c (₹200 × 15)			3,000
	(Forfeiture of 200 shares of ₹ 50 each issued at discount of 10% on non payment of call money)			

Illustration 7

M/s Herbal Tea Plantations Ltd. was registered with a capital of ₹ 1 crore divided into equity shares of ₹ 100 each. The company offered to public 50000 shares at a premium of ₹ 20 per share. The amount on shares was payable as :

- ₹ 25 on application
- ₹ 50 (including ₹ 20 premium) on allotment
- ₹ 20 on first call and
- ₹ 25 on final call.

Applications were received for 75000 shares. Shares were allotted to the applicants on prorata basis. Kanti Bhai who was allotted 500 shares did not pay the allotment money. He also failed to pay the first call. His shares were forfeited. Sheetal was holding 200 shares did not pay the first call. Final call was not made.

Make journal entries in the books of the company.

Solution :

**M/s Herbal Tea Plantations Ltd
Journal Entries**

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To Share Application A/c (Application money received)		18,75,000	18,75,000

Forfeiture of Shares

2.	Share Application A/c	Dr.	18,75,000	
	To Equity Share Capital A/c			12,50,000
	To Share Allotment A/c			6,25,000
	(Application money of 50000 share transferred to share Capital A/c on their allotment and remaining adjusted towards shares allotment)			
3.	Share Allotment A/c	Dr.	25,00,000	
	To Equity Share Capital A/c			15,00,000
	To Securities Premium A/c			10,00,000
	(Allotment money due including premium)			
4.	Bank A/c	Dr.	18,56,250	
	To Share Allotment A/c			18,56,250
	(Allotment money received)			
5.	Share First Call A/c	Dr.	10,00,000	
	To Equity Share Capital A/c			10,00,000
	(First call money due)			
6.	Bank A/c	Dr.	9,86,000	
	Call-in-arrears A/c	Dr.	4000	
	To Share First Call A/c			9,90,000
	(First call money received of 49300 shares of 200 share debited to calls-in-arrears A/c)			
7.	Share Capital A/c	Dr.	37,500	
	Securities Premium A/c	Dr.	10,000	
	To Share Forfeited A/c			18,750
	To Share Allotment A/c			18,750
	To share First Call A/c			10,000
	(Forfeiture of 500 shares on non payment of allotment and call money)			

Working Notes :

Shares applied for 75,000

MODULE - 5

Company Accounts



Notes



Notes

Share Allotted 50000

Ratio = 3 : 2

Number of shares held by Kanti Bhai = 500

Number of shares applied $500 \times \frac{3}{2} = 750$

Excess application money received = $250 \times 25 = ₹ 6250$

Share allotment money due = $500 \times ₹ 50 = ₹ 25000$

Net Amount due after adjustment of excess applicaiton money

$$= ₹ 25000 - ₹ 6250 = ₹ 18750$$

Total allotment money due = ₹ 2500000

Less excess application money adjusted ₹ 625000

Less Kanti Bhai's amount due on allotment ₹ 18750

Net Amount Received ₹ 1856250



INTEXT QUESTIONS 28.3

In the following cases write whether the account given is to be debited or credited and the amount by which it is debited or credited.

- (i) Forfeiture of 100 shares of ₹ 10 each fully paid issued at par on which final call of ₹ 3 per share is not received.

Shares forfeited A/c.

- (ii) 250 shares of ₹ 10 each issued at a premium of ₹ 4 per share forfeited for non payment of call money, of ₹ 2 per share premium as called with allotment is paid.

Shares forfeited A/c

- (iii) 100 shares of ₹ 10 each issued as fully paid at a premium of ₹ 2 per share forfeited on which only application money @ ₹ 2 per share is received.

Securities Premium A/c

- (iv) 200 shares of ₹ 20 each issued at a discount of ₹ 2, ₹ 15 called are forfeited for non payment of final call of ₹ 5 per share.

Discount on issue of shares A/c



WHAT YOU HAVE LEARNT

- Forfeiture of shares means cancellation of membership of a shareholder due to non payment of calls made by the company. Forfeiture of shares amount to
 - ▶▶ Cancellation of the membership of the defaulting shareholder and
 - ▶▶ Reduction of share capital of the company.
- Power to forfeit shares is given in the Articles of Association of the company. The Board of Directors have to give a fourteen days notice to the defaulting shareholder
- There are three situations when shares can be forfeited:
 - (i) Shares issued at par
 - (ii) Shares issued at premium
 - (a) Premium received in full
 - (b) Premium due but not yet received
 - (iii) Shares issued at discount
- In all cases share capital is debited by the called up amount on forfeited shares
- Shares forfeited A/c is credited by the amount received (excluding the amount of premium) on forfeited shares.
- Securities premium A/c will not get affected if premium on forfeited shares has been received but it will be debited if it is due but not received.
- Shares issued at a discount when forfeited discount on issue of shares will always be credited by the amount of discount allowed on forfeited shares:



Notes



TERMINAL EXERCISE

1. State the meaning of forfeiture of shares. When can shares be forfeited?
2. What accounting treatment is given to Securities Premium A/c on forfeiture of shares when:
 - (i) Amount of premium has been received
 - (ii) Amount of premium has not been received on such forfeited shares.



Notes

3. X Ltd. forfeited 500 shares of ₹ 100 each on which final call of ₹ 30 per share has not been received. Other calls have been duly received. Make journal entry to record the forfeiture of shares.

5. All Time Entertainment Ltd. issued 50000 shares of ₹ 10 each at a premium of ₹ 4 per share payable as ₹. 3 per share on application ₹ 7 (including premium) on allotment and the balance on call. Akbar who was allotted 300 shares failed to pay the allotment amount and on his subsequent failure to pay the call money his shares were forfeited. Make the journal entry for the forfeiture of 300 shares.

6. Exe Ltd issued 10000 shares of ₹ 50 each at a discount of ₹ 5 per share payable as ₹10 per share on application, ₹ 20 per share on allotment and the balance on call. All money was duly received except of 400 shares on which allotment and call money was not received. These shares were forfeited. Make journal entries in the books of the company and prepare ledger accounts also.

7. The Multi Media Ltd. invited applications for issuing 50000 shares of ₹ 100 each at a premium of ₹ 20 per share. The amount was payable as follows:

On Application	₹ 30 per share
On Allotment	₹ 60 per share (including premium)
On First and Final call	₹ 30 per share

Applications were received for 1 lakh shares. Applications for 20000 shares were totally rejected and money was returned. Remaining applicants were allotted on prorata basis. Sukhbhinder who was allotted 400 shares did not pay the allotment money. On his subsequent failure to pay the call money, his shares were forfeited. Rajender who had applied for 400 shares failed to pay the call money. His shares were also forfeited after final call. Make journal entries in the books of the company and prepare necessary ledger accounts.

8. Aggarwal constructions Ltd. offered to public for subscription 40000 shares of ₹ 50 each at a premium of ₹ 10 per share. The amount of these shares is payable as :

₹ 20 per share on application
₹ 30 per share on allotment (including ₹ 10 of premium)
and the balance of First and Final call

Forfeiture of Shares

Applications were received for 75000 shares. Applicants of 15000 were sent letters of regret and their application money was returned. Remaining applicants were allotted shares on prorata basis. Sudhir holding 400 shares did not pay the allotment money. His shares were forfeited and call was made. Make journal entries.



ANSWERS TO INTEXT QUESTIONS

- 28.1**
- (i) forfeit
 - (ii) (a) cancellation of membership of the company
(b) reduction of issued capital
 - (iii) Articles of Association
 - (iv) Fourteen
- 28.2**
- i. (a) ₹ 20000 (b) ₹ 10000 (c) ₹ 4000 (d) ₹ 6000
 - ii. (a) $40 \times 30 = ₹ 120$ (b) $200 \times 40 = ₹ 800$
(c) $₹ 800 - ₹ 120 = ₹ 680$
- 28.3**
- (i) Credited by ₹ 700 (ii) Credited by ₹ 2000
 - (iii) Debited by ₹ 200 (iv) Credited by ₹ 400

MODULE - 5

Company Accounts



Notes



Notes

29

REISSUE OF FORFEITED SHARES

You have learnt that a company may call share money in instalments. You have also learnt that if a shareholder fails to pay the allotment and/or call money, the company may forfeit such shares. If shares are forfeited the membership of the shareholder stands cancelled and the shares become the property of the company. Thereafter, the company has an option of selling such forfeited shares. The sale of forfeited shares is called ‘reissue of shares’.

In this lesson you will learn the meaning of ‘reissue of shares’ and its accounting treatment in the books of the company.



OBJECTIVES

After studying this lesson you will be able to:

- state the meaning of reissue of shares;
- state the minimum price at which a company can reissue its forfeited shares and
- give accounting treatment of reissue of shares in different situations.

29.1 REISSUE OF SHARES : MEANING AND ISSUE PRICE

Shares are forfeited because only a part of the due amount of such shares is received and the balance remains unpaid. On forfeiture the membership of the original allottee is cancelled. He/she cannot be asked to make payment of the remaining amount. Such shares become the property of the company. Therefore company may sell these shares. Such sale of shares is called ‘reissue of shares’. Thus reissue of shares means issue of forfeited shares.

Once the Board of directors has forfeited the shares, the defaulting share holder is asked to return the share certificate which is cancelled thereafter. The board of directors passes a resolution allotting the forfeited shares to the new purchaser/purchasers of such shares.

In case of reissue of shares neither a prospectus is issued nor any offer is otherwise made to the general public. Though the amount of such shares may be called in more than one instalment but usually the entire amount is called in one instalment i.e. lumpsum.

The board of directors of the company while reissuing the shares decide the price of reissue. These shares can be reissued at par, at premium or at discount. Generally, these shares are reissued at a discount i.e. at a price which is less than its nominal value. The amount of discount allowed at the time of reissue in no case should be more than the amount forfeited on such shares.

Question arises at what price the forfeited shares can be reissued? There is no limit of the price at which it can be reissued if price charged is more than the price of issue at the time of their forfeiture. But then there is a limit below which price cannot be charged or we can say that there is a minimum price below which the company cannot reissue its forfeited shares. We can look at it from another angle i.e. the company cannot give discount more than a particular amount while reissuing the forfeited shares.

The maximum permissible discount at the time of reissue of forfeited shares is ascertained in different situations in the following manner:

- (i) **Shares Originally Issued at Par :** When the shares are originally issued at par, the maximum permissible discount for reissue of shares is equal to the amount forfeited on such shares
- (ii) **Shares Originally Issued at Premium :** In case of shares originally issued at premium, there can be two situations : (a) premium has not been received on the forfeited shares, and (b) premium has been received on such shares. The amount forfeited is the amount that has been received including the amount of premium if it has been received and the maximum discount that can be allowed on reissue of such shares is the amount so forfeited.
- (iii) **Shares Originally Issued at Discount :** In this case the actual amount received becomes the forfeited amount. But the maximum permissible discount on reissue of shares will be equal to the amount forfeited plus the amount of discount initially allowed on these shares at the time of their original issue.



Notes



Notes



INTEXT QUESTIONS 29.1

Fill in the blanks with suitable word/words :

- (i) On forfeiture of shares the membership of the allottee is cancelled.
- (ii) Forfeited shares are the property of the
- (iii) When the shares are originally issued at par, the maximum permissible discount for reissue of shares is equal to the amount on such shares.
- (iv) In case shares are originally issued at premium the amount forfeited is the amount that has been received including the amount of that has been received.
- (v) On reissue of forfeited shares which were originally issued at discount, the permissible discount will be the amount forfeited plus the amount of originally allowed.

29.2 RECORDING OF REISSUE OF SHARES

Reissue of Forfeited Shares at a Discount

When the shares forfeited are reissued at discount, Bank account is debited by the amount received and Share capital account is credited by the paid up amount. The amount of discount allowed is debited to Share Forfeited Account. This is for adjusting the amount of discount so allowed from the amount forfeited at the time of forfeiture.

The journal entry for the above will be as follows:

Bank A/c (the amount received on reissue)	Dr.
Share Forfeited A/c (the amount allowed as discount)	Dr.
To Share Capital A/c (paid up amount)	

As stated earlier the amount of discount allowed on reissue of shares at the most can be equal to the forfeited amount on such shares. In that case the share forfeited account after reissue will show a zero balance. But in case, this amount of discount is less than the amount forfeited, the remaining forfeited amount will be profit for the company. This profit is a capital gain to the company and is transferred to Capital Reserve account. Journal entry of the same will be as follows :

Share Forfeited A/c	Dr
To Capital Reserve A/c	
(Transfer of surplus share forfeited amount to capital reserve A/c)	

If all the forfeited shares are reissued, the Share Forfeited A/c will show a zero balance because whole of the amount of this account after adjusting the amount of discount allowed on reissue will be transferred to capital reserve account. But in case, only a part of the forfeited shares are reissued and others remain cancelled, the amount forfeited on forfeited shares not reissued will remain in the Shares Forfeited Account. For adjustment of forfeited amount on share reissued will be calculated as :

Amount to be Adjusted =

$$\frac{\text{Total Forfeited Amount}}{\text{Total No. of Shares Forfeited}} \times \text{Number of Shares Reissued}$$



Notes



INTEXT QUESTIONS 29.2

Given below are certain statements. Write (C) against the correct statements and (I) against the incorrect statements:

- (i) Share forfeited account can show a zero balance.
- (ii) Discount allowed on reissue of forfeited shares will be debited to discount on issue of shares account.
- (iii) Balance amount of share forfeited account after adjusting discount allowed on reissue of these share remains in the same account

29.3 ACCOUNTING TREATMENT OF REISSUE OF FORFEITED SHARES

There can be four situations of reissue of forfeited shares. These are:

- (i) Reissue of forfeited shares at discount originally issued at par
- (ii) Reissue of shares at par or at premium, originally issued at par
- (iii) Reissue of forfeited shares at par, at discount and at premium originally issued at premium.
- (iv) Reissue of forfeited shares at par, at discount and at premium, originally issued at discount.

Accounting treatment in each of the above cases is discussed hereafter :

1. Reissue of forfeited shares issued at discount, originally issued at par

In this case the maximum discount that can be given on reissue of forfeited shares is the amount that has been received on these shares and is debited to share forfeited account.



Notes

Illustration 1

X company Ltd. forfeited 200 shares of ₹ 10 each, fully called up on which ₹ 7 have been received and final call of ₹ 3 per share remains unpaid. These shares were later on reissued for ₹ 8 per share fully paid up. Make journal entry for recording the forfeiture and reissue of shares.

Solution

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	Share Capital A/c Dr. To Share Forfeited A/c To Share Final call A/c (Forfeiture of 200 shares of ₹ 10 each due to non payment of final call of ₹ 3 per share)		2,000	1,400 600
(ii)	Bank A/c Dr. Share Forfeited A/c Dr. To Share capital A/c (Reissue of 200 forfeited shares of ₹ 10 each for ₹ 8 per share as fully paid up)		1,600 400	2,000
(iii)	Share forfeited A/c Dr. To Capital Reserve A/c (The Balance amount in Share Forfeited A/c transferred to Capital Reserve A/c)		1,000	1000

2. Reissue of forfeited shares at premium and at par, originally issued at par

In this case the whole of the amount that has been credited to Shares Forfeited A/c is transferred to Capital Reserve A/c on the reissue of such shares.

Illustration 2

Y Ltd. forfeited 400 shares of ₹ 20 each, on which ₹ 15 per share have been received and balance remains due but not paid. These shares were reissued

- (a) at the rate of ₹ 20 per share i.e. at par
- (b) at the rate of ₹ 24 per share i.e. at premium

Make necessary journal entries for reissue of the shares

Solution :

Journal Entries

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
Case (a)				
(i)	Bank A/c Dr. To Share Capital A/c (Reissue of 400 share at the rate of ₹ 20 per share)		8,000	8,000
(ii)	Shares Forfeited A/c Dr. To Capital Reserve A/c (Balance amount of Share Forfeited A/c is transferred to Capital Reserve A/c)		6,000	6,000
Case (b)				
(i)	Bank A/c Dr. To Share Capital A/c To Securities Premium Reserve A/c (Reissue of forfeited shares at premium)		9,600	8,000 1,600
(ii)	Share Forfeited A/c Dr. To Capital Reserve A/c (Balance amount of Shares Forfeited A/c is transferred to Capital Reserve A/c)		6,000	6,000



Notes

In the above two illustrated cases, total amount forfeited on shares reissued is transferred to capital reserve because no discount has been given on reissue of these shares. Therefore, the whole of the amount forfeited is a gain for the company.

3. Reissue of forfeited shares at par, at discount and at premium, originally issued at premium :

If the shares were originally issued at premium, it is not necessary that their reissue after forfeiture is to be at premium. Such shares can be reissued at par, at discount or at premium.

If such shares are reissued at premium the premium received should be credited to Securities Premium A/c. Journal entry will be



Notes

Reissue of Forfeited Shares

Bank A/c Dr.
 (Number of shares × amount received per share)
 To Share Capital A/c
 (Number of shares × amount paid up per share)
 To Securities Premium Reserve A/c
 (Number of shares × amount of premium per share)

If such shares are reissued at par the amount that has been received and has been credited to share forfeited A/c will be credited to capital reserve A/c

If such shares are reissued at discount, the amount of discount allowed will be adjusted towards the amount credited to share forfeited A/c the balance amount of Share Forfeited A/c will be transferred to Capital Reserve A/c

Illustration 3

AZ Ltd. forfeited 200 shares of ₹ 10 each originally issued at a premium of ₹4 per share, the holder of which paid ₹ 3 per share on application but did not pay the allotment money of ₹ 7 per share (including premium) and call of ₹ 4 per share. Make necessary journal entries for the forfeiture and for reissue of these shares if :

- I. Reissued at ₹ 10 per share i.e. at par
- II. Reissued at ₹ 8 per share i.e. at discount
- III. Reissued at ₹ 12 per share i.e. at premium

Solution :

Journal Entries

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
(i)	Share Capital A/c (200 × ₹ 10) Dr. Securities Premium Reserve A/c (200 × ₹ 4) Dr. To Share Forfeited A/c (200 × ₹ 3) To Share Allotment A/c (200 × ₹ 7) To Share First & Final Call A/c (200 × ₹ 4) (Forfeiture of 200 shares for non-payment of dues)		2,000 800	600 1,400 800

Case I

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
(i)	Bank A/c Dr. To Share Capital A/c (Reissue of 200 forfeited shares reissued at par)		2,000	2,000
(ii)	Share Forfeited A/c Dr. To Capital Reserve A/c (Share Forfeited A/c balance is transferred to Capital Reserve A/c)		600	600



Notes

As the forfeited shares have been reissued at par therefore no discount is allowed on these shares at the time of their reissue. Therefore the full forfeited amount of ₹ 600 is a gain for the company which is transferred to Capital Reserve A/c

Case II

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
(i)	Bank A/c Dr. Share Forfeited A/c Dr. To Share Capital (Reissue of 200 forfeited shares reissued at discount)		1,600 400	2,000
(ii)	Share Forfeited A/c Dr. To Capital Reserve A/c (Balance amount of Shares Forfeited A/c is transferred to Capital Reserve A/c)		200	200

At the time of reissue of forfeited shares a discount of ₹ 2 per share is allowed so the total amount of discount of ₹ 400 is adjusted from the forfeited amount of ₹ 600 and the balance amount of ₹ 200 is transferred to Capital Reserve A/c being a capital gain.



Notes

Case III

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
(i)	Bank A/c To Share Capital A/c To Securities Premium Reserve A/c (200 forfeited shares reissued at premium)	Dr.	2,400	2,000 400
(ii)	Share Forfeited A/c To Capital Reserve A/c (Balance amount of Share Forfeited A/c transferred to Capital Reserve)	Dr.	600	600

As the forfeited shares have been issued at a premium so no amount of discount is there to be adjusted from the forfeited amount hence the total forfeited amount of ₹ 600 is transferred to capital Reserve A/c as capital gain of the company.

4. Reissue of forfeited shares at par, premium and discount, originally issued at discount

When the forfeited shares originally issued at discount are reissued, the discount allowed at the time of original issue of such shares which was written back at the time of their forfeiture is again allowed. Thus on forfeiture shares Discount A/c is credited by the amount of discount allowed at the time of issue because its effect is to be cancelled out when shares were forfeited. When the same shares are reissued, discount on issue of shares A/c is again debited by the original amount of discount.

Illustration 4

India infrastructure Ltd. has issued its shares of ₹ 20 each at a discount of ₹2 per share. Mahima holding 100 shares did not pay final call of ₹ 5 per share. Her shares were forfeited. Later on the company reissued these forfeited shares at (I) ₹ 15 per share (II) ₹ 20 per share, and (III) ₹ 25 per share

Make journal entries for the forfeiture and reissue of the shares in the books of company.

Solution :

Journal Entries

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
	Share Capital A/c Dr. To Share Forfeited A/c To Discount on Issue of Shares A/c To Share Final Call A/c (Forfeiture of 100 shares issued at discount for non payment of final call)		2,000	1,300 200 500



Notes

Reissue of shares: Reissued at ₹ 15 per share

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
I.	(i) Bank A/c Dr. Discount on Issue of Shares A/c Dr. Share Forfeited A/c Dr. To Share Capital A/c (100 shares reissued at ₹ 15 per share)		1500 200 300	2,000
	(ii) Share Forfeited A/c Dr. To Capital Reserve A/c (Balance in share Forfeited A/c of 100 shares reissued transferred to Capital Reserve A/c)		1,000	1,000
II.	Bank A/c Dr. To Share Capital A/c (100 shares reissued at ₹ 20 per share)		2,000	2,000
	Share Forfeited A/c Dr. To Capital Reserve A/c (Balance in shares forfeited A/c transferred to Capital Reserve A/c)		1,300	1,300

MODULE - 5

Company Accounts



Notes

Reissue of Forfeited Shares

III.	Reissued at ₹ 25 per share			
	Bank A/c	Dr.	2,500	
	To Share Capital A/c			2,000
	To Securities Premium Reserve A/c			500
	(Reissue of discounted shares at ₹ 25 per share)			
	Shares Forfeited A/c	Dr.	1,300	
	To Capital Reserve			1,300
	(Balance in shares forfeited A/c transferred to capital Reserve A/c)			

Reissue of a Part of the Forfeited Shares

Sometimes all the forfeited shares are not reissued but a part of them are reissued. The accounting treatment is explained by the following illustration.

Illustration 5

A company forfeited 40 shares of ₹ 50 each on which only application money of ₹ 10 per share and ₹ 20 on allotment were received. Final call of the ₹ 20 per share is not received 30 of these shares are reissued at ₹ 40 per share. Make journal entries for forfeiture and Reissue of forfeited shares.

Solution :

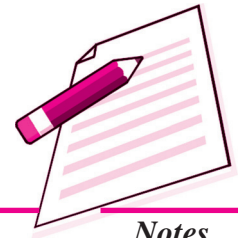
Journal Entries

	Particulars	L.F.	Dr. ₹	Cr. ₹
	Share Capital A/c	Dr.	2,000	
	To Share Forfeited A/c			1,200
	To Share First and Final Call A/c			800
	(40 shares forfeited for non payment of call)			
	Bank A/c	Dr.	1,200	
	Share Forfeited A/c	Dr.	300	
	To Share Capital A/c			1,500
	(30 of the forfeited shares are reissued)			
	Share forfeited A/c	Dr.	600	
	To Capital Reserve A/c			600
	(Balance of forfeited A/c of 30 shares transferred to capital Reserve A/c)			

**INTEXT QUESTIONS 29.3**

How much amount will be credited to Capital Reserve A/c in the following cases :

- (i) 100 shares of ₹ 10 each forfeited for non payment of call of ₹ 3 per share reissued at ₹ 7 per share.
- (ii) 200 shares of ₹ 10 each forfeited on which ₹ 8 per share have been called and only ₹ 2 per share have been paid are reissued at ₹ 9 per share fully paid up.
- (iii) 100 shares of ₹ 20 each issued at a discount of ₹ 2 per share have been forfeited for non payment of first call of ₹ 4 and final call of ₹ 5 per share. These shares are reissued at ₹ 15 per share fully paid up.

*Notes***WHAT YOU HAVE LEARNT**

- Reissue of shares means sale of shares which were issued earlier but had been forfeited for non payment of called up amount.
- Shares are reissued to realise at least the amount called but remained unpaid on forfeited shares
- The amount of shares reissued is generally called in one instalment
- Shares can be reissued at par, at discount and at premium
- The maximum permissible discount for reissue of shares is equal to the amount forfeited on these shares
- The forfeited amount is utilised to adjust the amount of discount allowed on reissue of shares
- The balance amount of share forfeited account is a capital gain of the company and is transferred to Capital Reserve A/c

**TERMINAL EXERCISE**

1. Give the meaning of 'reissue of shares'.
2. What is the maximum permissible discount at the time of reissue of forfeited shares when the forfeited shares originally issued are (a) at par (b) at premium (c) at discount?



Notes

3. What amount is transferred to Capital Reserve A/c after reissue of forfeited shares? Why is this account transferred to capital reserve A/c?
4. Make journal entries for forfeiture and reissue of shares in the following cases:
 - (a) The directors of X Ltd. forfeited 400 shares of ₹ 10 each fully called up on which ₹ 2400 have been received. 300 of these shares were reissued upon payment of ₹ 2500
 - (b) Real Estate Developers Ltd. forfeited 500 shares of ₹ 10 each held by Amarjeet Singh which were issued at a premium of ₹ 3 per share to be paid along with allotment money. He paid only application money of ₹ 3 per share. 200 of these shares were reissued at ₹ 10 per shares
 - (c) Royal Enterprises Ltd. forfeited 200 shares of ₹ 10 each issued at a discount of 10%, on which only ₹ 4 per share have been paid. Out of these 100 shares have been reissued at ₹ 7 per share.
5. Make journal entries
 - (a) P Ltd. issued 400 shares of ₹ 10 each to Suresh on which he has paid ₹ 3 per share on application but failed to pay allotment money of ₹ 3 per share and first call money of ₹ 2 per share. His shares were forfeited before making the final call. These shares were later on reissued at ₹ 8 per share fully paid up.
 - (b) A company issued 10000 shares of ₹ 100 each at a premium of ₹ 20 per share, payable as ₹ 20 on application, ₹ 60 including premium on allotment, ₹ 20 each on two calls. Final call was not made. Pinky holding 200 shares did not pay allotment money and on her non payment of first call, her shares were forfeited by the board of the directors of the company. 150 of these shares were reissued at ₹ 120 per share fully paid up.
6. Joy Entertain Ltd. issued 100000 shares of ₹ 10 each at a premium of ₹ 2 per share. The amount was payable as :
 - ₹ 3 per share on application
 - ₹ 5 (including premium) on allotment
 - ₹ 2 per share on first call and
 - ₹ 2 per share on final call

Applications were received for 150,000 shares. All applications were accepted and allotment was made on a prorata basis. Sushil who was allotted 1,000 shares failed to pay allotment money. On his subsequent failure of first call his shares were forfeited.

Gomang who had applied for 750 shares failed to pay the two calls. His shares were also forfeited. All the shares of Sushil and 200 shares of Gomang were reissued at a discount of ₹ 2 per share. Make journal entries in the books of the company and open necessary ledger accounts.

7. 21st Century Cotton Mills Ltd was registered with a capital of ₹ 10,00,000 divided into 1 lakh shares of ₹ 10 each. 50,000 shares were offered to public for subscription at a discount of ₹ 1 per share. The amount was payable as ₹ 5 per share on application and allotment and ₹ 4 per share on call.

Applications were received for 48,000 shares. Call was made and money was duly received except on 1,000 shares. These shares were forfeited.

800 of forfeited shares were reissued at ₹ 12 per share.

Make journal entries in the books of the company. Prepare the Balance sheet also.

*Notes***ANSWERS TO INTEXT QUESTIONS**

29.1 (i) original (ii) company (iii) forfeited (iv) premium (v) discount

29.2 (i) C (ii) C (iii) I

29.3 (i) 400 (ii) ₹ 200 (iii) 300

**ANSWERS TO TERMINAL EXERCISE**

4. (a) Capital Reserve ₹ 1,300 (b) Capital Reserve ₹ 600
(c) Capital Reserve ₹ 200

5. (a) Capital Reserve ₹ 400 (b) Capital Reserve ₹ 3,000

6. Capital Reserve ₹ 3,300

7. Capital Reserve ₹ 4,000

*Notes***30**

ISSUE OF DEBENTURES

You have learnt that share capital is the main source of finance of a joint stock company. Such capital is raised by issuing shares. Those who hold the shares of the company are called the shareholders and are owners of the company. Company may need additional amount of money for a long period. It cannot issue shares every time. It can raise loan from the public. The amount of loan can be divided into units of small denominations and the company can offer the same for subscription to the public. Each unit is called a 'debenture' and holder of such units is called Debenture holder. The amount so raised is loan for the company. In this lesson we shall learn about issue of debentures and its accounting treatment.



OBJECTIVES

After studying this lesson you will be able to :

- state the meaning and types of debentures;
- explain the procedure of issue of debentures and its accounting treatment;
- explain issue of debentures as collateral security;
- explain 'writing off 'discount' and 'loss' on issue debentures and their accounting treatment in the books of the company and
- calculate interest on debentures.

30.1 DEBENTURE AND ITS TYPES

A Debenture is a unit of loan amount. When a company intends to raise the loan amount from the public it issues debentures. A person holding debenture or debentures is called a debenture holder. A debenture is a document issued under the seal of the company. It is an acknowledgment of the loan received by the company equal to the nominal value of the debenture. It bears the date of redemption and rate and mode of payment of interest. A debenture holder is the creditor of the company.

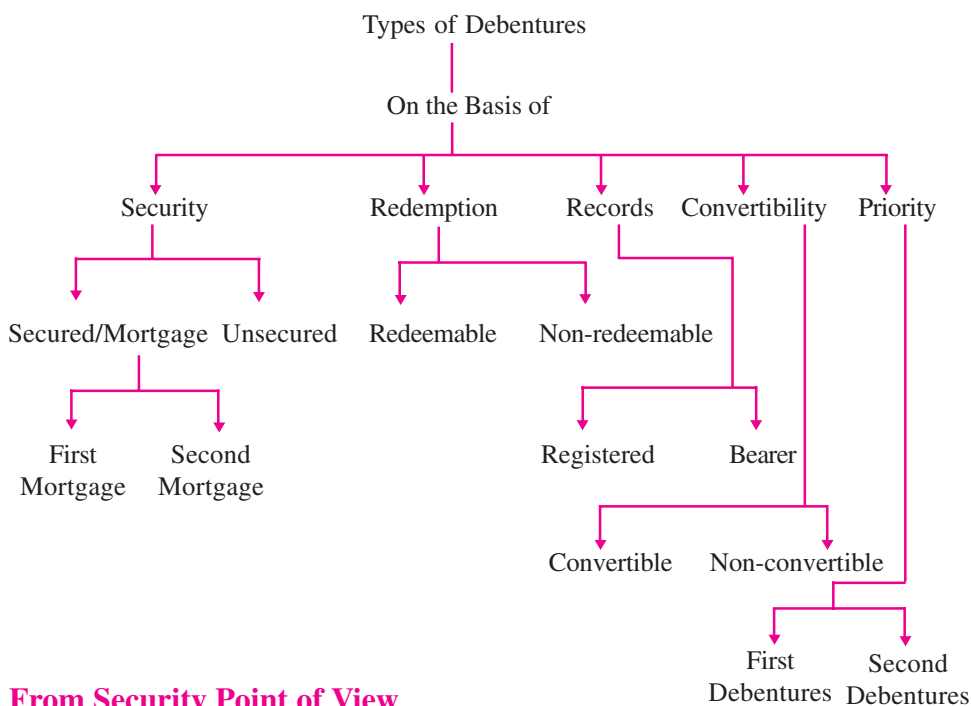


Notes

As per section 2(12) of Companies Act 1956, “Debenture includes debenture stock, bond and any other securities of the company whether constituting a charge on the company’s assets or not”.

Types of Debentures

Debenture can be classified as under :



1. From Security Point of View

- (i) **Secured or Mortgage Debentures :** These are the debentures that are secured by a charge on the assets of the company. These are also called mortgage debentures. The holders of secured debentures have the right to recover their principal amount with the unpaid amount of interest on such debentures out of the assets mortgaged by the company. In India, debentures must be secured. Secured debentures can be of two types :



Notes

- (a) **First Mortgage Debentures** : The holders of such debentures have a first claim on the assets charged.
- (b) **Second Mortgage Debentures** : The holders of such debentures have a second claim on the assets charged.
- (ii) **Unsecured Debentures** : Debentures which do not carry any security with regard to the principal amount or unpaid interest are called unsecured debentures. These are called simple debentures. Such debentures do not have any charge on the assets of the company.

2. On the Basis of Redemption

- (i) **Redeemable Debentures** : These are the debentures which are issued for a fixed period. The principal amount of such debentures is paid off to the debenture holders on the expiry of such period. These can be redeemed by annual drawings or by purchasing from the open market.
- (ii) **Non-redeemable Debentures** : These are the debentures which are not redeemed in the life time of the company. Such debentures are paid back only when the company goes into liquidation.

3. On the Basis of Records

- (i) **Registered Debentures** : These are the debentures that are registered with the company. The amount of such debentures is payable only to those debenture holders whose name appears in the register of the company.
- (ii) **Bearer Debentures** : These are the debentures which are not recorded in a register of the company. Such debentures are transferrable merely by delivery. Holder of these debentures is entitled to get the interest.

4. On the Basis of Convertibility

- (i) **Convertible Debentures** : These are the debentures that can be converted into shares of the company on the expiry of predecided period. The term and conditions of conversion are generally announced at the time of issue of debentures.
- (ii) **Non-convertible Debentures** : The debenture holders of such debentures cannot convert their debentures into shares of the company.

5. On the Basis of Priority

- (i) **First Debentures** : These debentures are redeemed before other debentures.
- (ii) **Second Debentures** : These debentures are redeemed after the redemption of first debentures.



INTEXT QUESTIONS 30.1

Name the type of debentures against each of the following :

- (i) Debentures that are redeemed before other debentures.
- (ii) Debentures the holders of which have a first claim on the assets charged.
- (iii) Debentures that are transferable merely by delivery.
- (iv) Debentures that are paid back only when the company goes into liquidation.



Notes

30.2 ISSUE OF DEBENTURES

By issuing debentures means issue of a certificate by the company under its seal which is an acknowledgment of debt taken by the company.

The procedure of issue of debentures by a company is similar to that of the issue of shares. A Prospectus is issued, applications are invited, and letters of allotment are issued. On rejection of applications, application money is refunded. In case of partial allotment, excess application money may be adjusted towards subsequent calls.

Issue of Debenture takes various forms which are as under :

1. Debentures issued for cash
2. Debentures issued for consideration other than cash
3. Debentures issued as collateral security.

Further, debentures may be issued

- (i) at par, (ii) at premium, and (iii) at discount

Accounting treatment of issue of debentures for cash

1. Debentures Issued for Cash at Par :

Following journal entries will be made :

(i) Application money is received

Bank A/c To Debentures Application A/c (Application money received for Debentures)	Dr.
--	-----

(ii) Transfer of debentures application money to debentures account on allotment of debentures

Solution :

Shining India Ltd.

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To 8% Debentures Application A/c (Application money received for 5000 debentures)		1,00,000	1,00,000
2.	8% Debentures Application A/c Dr. To 8% Debentures A/c (Application money transferred to Debentures A/c on allotment)		1,00,000	1,00,000
3.	8% Debentures Allotment a/c Dr. To 8% Debentures A/c (Allotment money due on 5000 debentures @ ₹ 30 per debenture)		1,50,000	1,50,000
4.	Bank A/c Dr. To 8% Debentures Allotment A/c (Allotment money received)		1,50,000	1,50,000
5.	8% Debentures First and Final call A/c Dr. To 8% Debentures A/c (Debentures first and final call money made due @ ₹ 50 per debenture)		2,50,000	2,50,000
6.	Bank A/c Dr. To Debentures First and Final call A/c (Receipt of 8% Debentures first and final call money)		2,50,000	2,50,000



Notes

Over Subscription

If the company receives applications for number of debentures that exceed the number of debentures offered for subscription, it is called over subscription. The excess application money received can be treated as follows :



Notes

- (a) The total amount of excess number of applications is refunded in case the applications are totally rejected.
- (b) The amount of excess application money is totally adjusted towards amount due on allotment and calls
 - in case partial allotment is made,
 - the excess amount is adjusted towards sums due on allotment and rest of the amount is refunded.

Journal entries in the above cases will be as follows :

For refund of money if the applications are rejected

Debentures Application A/c Dr.
 To Bank A/c
 (Refund of money on rejected applications)

For adjustment of excess application money adjusted towards sum due on allotment

Debentures Application A/c Dr.
 To Debentures Allotment A/c
 (Excess application money adjusted)

Illustration 2

ABC Ltd issued 5000 10% Debentures of ₹ 100 each payable as ₹ 40 on application and ₹ 60 on allotment. Applications were received for 6000 debentures. Applicants for 500 debentures were sent letter of regret and money was returned. Allotment was made proportionately to the remaining applicants. Over subscription was applied to the amount due on allotment. Remaining amount was duly received.

Make journal entries for the above transactions in the books of the company.

Solution :

Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr To 10% Debentures Application A/c (Application money received for 6000 10% debentures @ ₹ 40 per debenture)		2,40,000	2,40,000



Notes

Issue of Debentures					
2.	10% Debentures Application A/c	Dr	2,40,000		
	To 10% Debentures A/c			2,00,000	
	To Bank A/c			20,000	
	To 10% Debentures Allotment A/c			20,000	
	(Debenture application money of 5000 debentures transferred to debenture A/c on their allotment of 500 debentures returned and balance of 500 adjusted towards allotment)				
3.	10% Debentures Allotment A/c	Dr	3,00,000		
	To 10% Debentures A/c			3,00,000	
	(Allotment money due on 5000 debentures @ ₹ 60 per debenture)				
4.	Bank A/c	Dr	2,80,000		
	To 10% Debentures Allotment A/c			2,80,000	
	(Allotment money received)				



INTEXT QUESTIONS 30.2

- i. List the various forms in which debentures can be issued
 - a) _____
 - b) _____
- ii. A company issued 10000 10% debentures of ₹ 100 each. ₹ 30 per debenture was to be paid along with application. Applications were received for 12000 debentures. What can the company do with the excess application money i.e. ₹ 60000 (2000 × ₹ 30)

30.3 ISSUE OF DEBENTURES AT PREMIUM AND AT DISCOUNT

Debentures are said to be issued at premium when these are issued at a value which is more than their nominal value. For example, a debenture of ₹ 100 is issued at ₹ 110. This excess amount of ₹ 10 is the amount of premium. The premium on the issue of debentures is credited to the Securities Premium A/c as per section 78 of the Companies Act, 1956.



Notes

Journal entry will be as follows :

Debentures Allotment A/c	Dr.
To Debentures Account	
To Securities Premium A/c	
(Amount due on allotment alongwith premium of ₹)	

Illustration 3

A company issued 5000 10% Debentures of ₹ 100 each at a premium of 20% payable as ₹ 60 on application ₹ 60 on allotment (including premium).

All the debentures were subscribed for and money was duly received. Make journal entries.

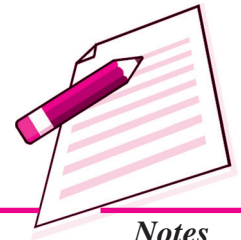
Solution :

Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To Debentures Application A/c (Application money received)		3,00,000	3,00,000
2.	10% Debentures Application A/c Dr. To 10% Debentures A/c (Application money transferred to Debenture A/c)		3,00,000	3,00,000
3.	Debentures Allotment A/c To 10% Debentures A/c To Securities Premium A/c (Amount due on allotment along with premium)		3,00,000	2,00,000 1,00,000
4.	Bank A/c Dr. To 10% Debentures Allotment A/c (Allotment money received)		3,00,000	3,00,000

Issue of Debentures at Discount

When debentures are issued at less than their nominal value they are said to be issued at discount. For example, debenture of ₹ 100 each is issued at ₹ 90 per debenture. Companies Act, 1956 has not laid down any conditions for the issue of debentures at a discount as have been laid down in case of issue of shares at discount. However, there should be provision for issue of such debentures in the Articles of Association of the Company.



Notes

Journal entry for issue of debentures at discount (at the time of allotment)

Debentures Allotment A/c	Dr.
Discount on issue of debentures A/c	Dr.
To Debentures A/c	
(Allotment money due. The amount of discount is @ ₹ per debenture)	

Illustration 4

A company has issued 2000 9% debentures of ₹ 100 each at a discount of 10% payable as

- ₹ 40 on application
- ₹ 50 on allotment

Make necessary journal entries.

Solution :

Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
1.	Bank A/c Dr. To 9% Debentures Application A/c (Application money received)		80,000	80,000
2.	9% Debentures Application A/c Dr. To 9% Debentures A/c (Application money transferred to debenture A/c)		80,000	80,000

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Company Accounts



Notes

Issue of Debentures

3.	9% Debentures Allotment A/c	Dr.	1,00,000	
	Debentures Discount A/c	Dr.	20,000	
	To 9% Debenture A/c			1,20,000
	(Amount due on allotment, along with discount amount ₹ 10 per debenture)			
4.	Bank A/c	Dr.	1,00,000	
	To 9% Debentures Allotment			1,00,000
	(Receipt of allotment money)			

Issue of Debentures for Consideration Other than Cash

When a company purchases some assets and issues debentures as a payment for the purchase, to the vendors it is known as issue of debentures for consideration other than cash. Debentures can be issued to vendors at par, at premium and at discount

Accounting Treatment :

1. Purchase of Assets

Sundry Assets A/c (Individually) Dr.
To Vendors A/c
(Purchase of assets)

2. Allotment of debentures

(i) At par

Vendors' A/c Dr.
To Debentures A/c
(issue of debentures at par to vendors)

(ii) At discount

Vendors' A/c Dr.
Debentures Discount A/c Dr.
To Debentures A/c
(Issue of debentures to vendors at a discount of ₹ ... per debenture)

(iii) At premium

Vendors' A/c Dr
To Debentures A/c
To Securities Premium Reserve A/c
(Issue of debentures to vendors at a premium of ₹ per debenture)

Illustration 5

M.B. Electronics Ltd. purchased machinery for ₹ 1,98,000 and issued 9% debentures of ₹ 100 each to the vendors. Make journal entries if the debentures were issued

- (a) at par
- (b) at a premium of ₹ 10
- (c) at a discount of ₹ 10



Notes

Solution :

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
	Machinery A/c Dr. To Vendors A/c (Machine purchased)		1,98,000	1,98,000
(a)	Vendors A/c Dr. To 9% Debentures A/c (1980 debentures of ₹ 100 each issued to vendors)		1,98,000	1,98,000
(b)	Vendors A/c Dr. To 9% Debentures A/c To Securities Premium Reserve A/c (1800 debentures issued at a premium of ₹ 10 per debenture)		1,98,000	1,80,000 18,000
(c)	Vendors A/c Dr. Discount on Issue of Debentures A/c Dr. To 9% Debentures A/c (Issue of 2200 9% debentures of ₹ 100 each at a discount of ₹ 10 per debenture)		1,98,000 22,000	2,20,000

Working Notes

Amount due = ₹ 198000

Value of debenture including ₹ 10 for premium = ₹ 110

No. of debentures to be issued = $\frac{₹1,98,000}{₹110} = ₹ 1,800$



Notes

∴ Debenture amount (Nominal value) = $1800 \times 100 = ₹ 1,80,000$

Securities Premium Amount = $1800 \times ₹ 10 = ₹ 18,000$

Working Notes

Amount due to vendor = ₹ 1,98,000

Value of one debenture at a discount of ₹ 10 = ₹ 90

No. of debentures to be issued = $₹ 1,98,000 \div ₹ 90 = ₹ 2,200$

Debentures amount (Nominal value) = $2200 \times ₹ 100 = ₹ 2,20,000$

Discount on issue of Debentures = $2200 \times ₹ 10 = ₹ 22,000$

Issue of Debentures with conditions Stipulated to their Redemption (Journal entry)

Issued at par redeemable at par

- (i) Bank A/c Dr.
 To Debentures Application Account
 (Issue of debentures of ₹ at par)
- (ii) Debentures Application Dr.
 To Debentures A/c
 (Debentures application amount transferred to debentures account)

Issued at discount and redeemable at par

- (i) Bank A/c Dr.
 To Debentures A/c
 (Issue of debentures of ₹ ... at a discount of ₹)
- (ii) Debentures A/c Dr.
 Discount on issue of Debentures A/c Dr.
 To Debentures Account
 (Debentures application amount transferred to debentures account)

Issued at premium redeemable at par

- (i) Bank A/c Dr.
 To Debentures Application A/c
 (Issue of ... debentures of ₹ at a premium of ₹)

Solution :

Journal



Notes

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
(i)	(a) Bank A/c Dr. To Debenture Application A/c (Received application for issue of 200, 9% debentures)		1,00,000	1,00,000
	(b) Debenture Application A/c To 9% Debentures A/c (9% debentures application amount transferred to 9% debentures a/c on allotment)		1,00,000	1,00,000
(ii)	(a) Bank A/c Dr. To Debenture application A/c (Received application for issue of 200 debentures of ₹ 50 each at ₹ 450)		90,000	1,00,000
	(b) Debentures Application A/c Dr. Discount on issue of 9% Debentures A/c Dr. To 9% Debentures A/c (Transferred 9% Debentures Application amount to 9% Debentures A/c on allotment of Debentures)		90,000 10,000	1,00,000
(iii)	(a) Bank A/c Dr. To Debentures Application A/c To Securities Premium Reserve A/c (Received application for 200 debentures of ₹ 500 each at ₹ 550)		1,10,000	1,00,000 10,000

Issue of Debentures

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Notes

	(b) Debentures Application A/c Dr. To 9% Debentures A/c To Securities Premium (9% Debentures Application amount transferred to 9% Debentures A/c & Securities Premium A/c on allotment of 9% Debentures)		1,10,000	1,00,000 10,000
(iv)	(a) Bank A/c Dr. To Debentures Application A/c (Issue of 200 debentures of ₹ 500 each at ₹ 500 repayable at ₹ 550)		1,00,000	1,00,000
	(b) Debentures Application A/c Dr. Loss on issue of debenture A/c Dr. To 9% debentures A/c To Premium on redemption of Debentures A/c (9% Debentures Application money transferred to 9% debentures a/c & accounted for loss on issue of debs.)		1,00,000 10,000	1,00,000 10,000
(v)	(a) Bank A/c Dr. To Debentures Application A/c (Issue of 200 Debentures of ₹ 500 each at ₹ 450 each)		90,000	90,000
	(b) Debentures Application A/c Dr. Loss on Issue of Debentures A/c Dr. To 9% Debentures A/c To Premium on Redemption A/c (9% Debentures Application money transferred to 9% debentures a/c & accounted for loss on issue of debs.)		90,000 20,000	1,00,000 10,000



Notes



INTEXT QUESTIONS 30.3

- I. A company purchased a building for ₹ 3,15,000 and issued 10% debentures of ₹ 100 each at a premium of 5%. Calculate**
- (i) the number of debentures issued to the vendors
 - (ii) make journal entry for the issue.
- II. Fill in the blanks with appropriate word/words, figure/figures**
- (i) A 10% debenture of nominal value of ₹ 100 has been issued at ₹ 90 is said to be issued at
 - (ii) A 9% debenture of a nominal value of ₹ 100 has been issued at ₹120 debentures are said to be issued at
 - (iii) 100 8% debentures of ₹ 100 each has been issued to vendors for plant purchased the debentures are said to be issued
 - (iv) A company can issue its debentures at a discount if a provision in this regard has been made in its

30.4 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Collateral security means security given in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as ‘issue of debentures as collateral security’. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise this right does not arise, debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on loan.

In the accounting books of the company issue of debentures as collateral security can be credited in two ways.

(i) No journal entry to be made in the books of accounts of the company

Journal entries are not passed in the books, however, debentures issued as collateral security are shown by way of information in Note to Accounts below Long-term Borrowings under Non-Current Liabilities if issued for obtaining Long-term Loans or below Short-term.

Borrowing under current liabilities if issued for obtaining short-term loans.

Illustration 7

On 30.9.2014 X Ltd. obtained a bank loan of ₹ 8,00,000 prepayable after 5 years. For this the company issued 9% debentures as collateral security. Show the loan in the balance sheet of the company and prepare 'note to accounts'.

Solution :

X Ltd.
Balance Sheet
as at 31.3.2014

<i>Particulars</i>	<i>Note No.</i>	<i>₹</i>
I. EQUITY AND LIABILITIES		
Non-Current Liabilities		
Long Term Borrowings	1	8,00,000

Note to Accounts

Long-Term Borrowing

Bank Loan 8,00,000
(Secured by issue of 9% debentures as collateral security)

Illustration 8

On 1.3.2014 Y Ltd. obtained a short term loan for ₹ 10,00,000. The company issued 12,000, 9% debentures of ₹ 100 each as collateral security for the same. Show loan in the balance sheet of Y Ltd and prepare 'note to account'.

Solution :

Y Ltd.
Balance Sheet
as at 31.3.2014

<i>Particulars</i>	<i>Note No.</i>	<i>₹</i>
I. EQUITY AND LIABILITIES		
Current Liabilities Shot-term Borrowings	1	10,00,000



Notes



Notes

Note to Accounts

Short-Term Borrowing

Bank Loan 10,00,000
 (Secured by issue of 12,000, 9% debentures
 of ₹ 100 each as collateral security)

(ii) Entry to be made in the books of account the company

A journal entry is made on the issue of debentures as a collateral security, Debentures suspense A/c is debited because no cash is received for such issue.

Following journal entry will be made

Debenture Suspense A/c	Dr.
To Debentures A/c	
(.....Debentures of ₹ each issued as collateral security to	

When the loan is paid this entry is cancelled by means of a reverse entry. In the Balance Sheet, debentures issued as collateral security are distinguished from other debentures.

Debentures issued as collateral security are related to the loan, therefore, they are shown in the same 'note to accounts' in which the loan secured by debentures is shown. For example if the loan is shown as Long-term Borrowings, debentures issued as collateral securities are also shown as long-term borrowings under Non-Current Liabilities in the Equity and Liabilities part of the Balance Sheet.

Illustration 9

XY Ltd obtained a term loan of ₹ 8,00,000 from bank on 1.1.1014 and issued ₹ 10,00,000, 9% debentures of ₹ 100 each as collateral security. Pass necessary journal entries, prepare Balance Sheet and Note to Account.

Solution :

Journal Entries

S.No.	Particulars	L.F.	Dr. ₹	Cr. ₹
	Bank A/c Dr.		8,00,000	
	To Bank Loan A/c			8,00,000
	(Obtained loan ₹ 8,00,000 from bank)			



Notes

Issue of Debentures

Debenture Suspense A/c To 9% Debentures A/c (Issued 9% Debentures as collateral security for obtaining loan)	Dr.		10,00,000		10,00,000
---	-----	--	-----------	--	-----------

XY Ltd.
Balance Sheet
as at 31.3.2014

<i>Particulars</i>	<i>Note No.</i>	<i>₹</i>
I. EQUITY AND LIABILITIES		
Long-Term Borrowings	1	8,00,000

Note to Accounts

Long-Term Borrowing

Loan from Bank		8,00,000
1,000, 9% Debentures of ₹ 100 each	10,00,000	
Issued as collateral Security		
(Less Debenture Suspense)	10,00,000	
		8,00,000



INTEXT QUESTIONS 30.4

Answer the following in one word/words :

- (i) Name the security which is issued in addition to the principal security.
- (ii) Which account is debited while making a journal entry in the books of the company on issue of debentures as collateral security.
- (iii) On which side of the balance sheet of a company issuing debentures as collateral security is written the Debentures Suspense A/c?
- (iv) When does a company issue debentures as collateral security ?

30.5 DISCOUNT ON ISSUE OF DEBENTURES AND LOSS ON ISSUE OF DEBENTURES



Notes

In case company issues debentures on discount the total amount of discount is not charged to profit and Loss Account of the company in the accounting year in which this discount is allowed. The amount of such discount is very heavy and to the company gets benefit from the loan by issuing debentures over a number of years. Hence some part of the amount of discount is written off every year. Generally it is written off prior to the redemption of these debentures.

As the amount of discount on issue of debentures is treated as a capital loss, it is shown on the asset side of the balance sheet of the company under the head “Miscellaneous Expenditure” until and by the amount it is not written off.

The amount of debenture discount can be written off in two ways :

1. All debentures are to be redeemed after a fixed period

When the debentures are to be redeemed after a fixed period, the amount of discount will be distributed equally within the number of years spreaded between the issue of debentures and their redemption. The amount of discount on issue of debentures to be written off each year is calculated as

Amount of discount to be written off annually =

$$\frac{\text{Amount of discount on issue of debentures}}{\text{No. of years after which debs. have to be redeemed}}$$

Illustration 10

A company issues 1000 debentures of ₹ 1000 each at a discount of 10% redeemed after 5 years. Calculate the amount of discount to be written off each year and prepare discount on issue of debentures account.

Solution :

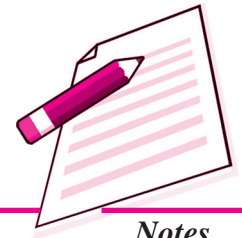
$$\text{Amount of discount} = \frac{(1,000 \times ₹1,000) \times 10}{100} = ₹ 1,00,000$$

$$\text{Amount to be written off each year} = \frac{₹1,00,000}{5} = ₹ 20,000$$

Accounting Treatment

Journal entry to write off discount on debentures will be.

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
	Profit and Loss A/c Dr.		20,000	
	To Discount on Issue of Debentures A/c			20,000
	(Amount of Discount on Issue of Debentures written off)			



Discount on Issue of Debentures Account till the amount of discount is written off, is shown as under :

Discount on Issue of Debentures A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>Amount</i> ₹
Jan 1	1st year Debenture A/c	1,00,000	Dec 31 Dec 31	1st year Profit & Loss A/c Balance cld	20,000 80,000
		1,00,000			1,00,000
		2nd year Jan 1 Balance b/d			80,000	Dec. 31 Dec.31	2nd year Profit & Loss A/c Balance cld	20,000 60,000
80,000	80,000				
3rd year Jan 1 Balance b/d	60,000	Dec 31 Dec 31	3rd year Profit & Loss A/c Balance cld	20,000 40,000	
60,000	60,000				
4th year Jan 1 Balance b/d	40,000			Dec 31 Dec 31	4th year Profit & Loss A/c Balance cld	20,000 20,000
40,000	40,000				

MODULE - 5

Company Accounts



Notes

Issue of Debentures

5th year			5th year		
Jan 1	Balance b/d	20,000	Dec 31	Profit & Loss A/c	20,000
		20,000			20,000

2. Debentures are redeemed in instalments

Debentures may also be redeemed in instalments but over a fixed period. In that case the amount of debenture discount will be written off each year in proportion to the amount of debentures outstanding at the end of each year.

Illustration 11

A company has issued 3000 9% debentures of ₹ 1,000 each at a discount of 10%. If the debentures are to be redeemed in five equal annual instalments, calculate the amount of Discount on Issue of Debentures to be written off each year and prepare Discount on Issue of Debentures A/c.

Solution :

Calculation of Amount of Discount on Issue of Debentures Account

Total amount of Discount on Issue of Debentures A/c

$$= \frac{10}{100} \times 3,000 \times 1,000 = ₹ 3,00,000$$

Year end	Outstanding amount of debenture ₹	Ratio	Amount of Discount written off ₹
1st	30,00,000	5	$3,00,000 \times \frac{5}{15} = 1,00,000$
2nd	24,00,000	4	$3,00,000 \times \frac{4}{15} = 80,000$
3rd	18,00,000	3	$3,00,000 \times \frac{3}{15} = 60,000$
4th	12,00,000	2	$3,00,000 \times \frac{2}{15} = 40,000$
5th	6,00,000	1	$3,00,000 \times \frac{1}{15} = 20,000$
		15	

Journal Entry

	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
1st year	Profit and Loss A/c Dr. To Debenture Discount A/c (Discount on issue of debenture written off)		1,00,000	1,00,000



Notes

Similarly entry will be made every year with the respective amount of discount.

Discount on issue of Debentures Account till the amount of discount is written off will be shown as under.

Discount on Issue of Debentures A/c

Dr.

Cr.

<i>Date</i>	<i>Particulars</i>	<i>Amount</i> ₹	<i>Date</i>	<i>Particulars</i>	<i>Amount</i> ₹
Jan 1	1st year Debentures A/c	3,00,000	Dec 31 Dec 31	1st year Profit & Loss A/c Balance cld	1,00,000
		3,00,000			2,00,000
					3,00,000
Jan 1	2nd year Balance b/d	2,00,000	Dec. 31 Dec.31	2nd year Profit & Loss A/c Balance cld	80,000
		2,00,000			1,20,000
					2,00,000
Jan 1	3rd year Balance b/d	1,20,000	Dec 31 Dec 31	3rd year Profit & Loss A/c Balance cld	60,000
		1,20,000			60,000
					1,20,000
Jan 1	4th year Balance b/d	60,000	Dec 31 Dec 31	4th year Profit & Loss A/c Balance cld	40,000
		60,000			20,000
					60,000



Notes

Jan 1	5th year Balance b/d	20,000	Dec 31	5th year Profit & Loss A/c	20,000
		20,000			20,000

Loss on Issue of Debentures

You have learnt that a company may issue debentures with the stipulation that the repayment of the debentures on maturity will be made at premium. The amount of the premium payable is debited to Loss on Issue of Debentures Account at the time of issue of debentures. This amount will also be written off in the same manner as is done in case of writing off Discount on Issue of Debentures. This is illustrated as under :

(i) All Debentures are redeemed after fixed period

Journal Entry

Amount of Loss on Issue of Debentures written off each year
 Profit and Loss A/c Dr.
 To Loss on Issue of Debentures A/c
 (Loss on Issue of Debentures written off)

Same journal entry will be made each year till the whole amount of the Loss on issue of Debentures is written off.

Calculation of the amount to be written off Total Amount of Loss on Issue of Debentures/No. of years.

Illustration 12

A company issues 1000 10% Debentures of ₹ 1,000 each on 1st Jan, 2014 payable at a premium of 10% after 5 years. Make journal entries and open Loss on Issue of Debentures A/c for the year ending 31st December 2014.

Solution :

$$\text{Amount of Loss on issue of Debentures} = \frac{1000 \times ₹1,000 \times 10}{100} = ₹ 1,00,000$$

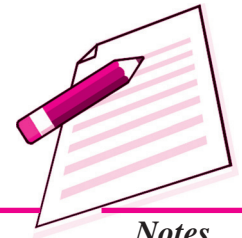
$$\text{Amount to be written off each year} = \frac{₹1,00,000}{5} = ₹ 20,000$$

Loss on Issue of Debentures A/c

Dr.

Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2014 Jan. 1	10% Debentures A/c	1,00,000	2014 Dec. 31	Profit & Loss A/c	20,000
			Dec. 31	Balance cld	80,000
		1,00,000			1,00,000
2015 Jan. 1	Balance b/d	80,000			



Journal Entry

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2014 Dec. 31	Profit and Loss A/c Dr. To Loss on Issue of Debentures A/c (Loss on Issue of Debentures transferred to Profit and Loss A/c)		20,000	20,000

(ii) Debentures are Redeemed in Instalments

The amount of Loss on Issue of Debentures to be written off each year is calculated in the manner it is calculated in case of Discount on Issue of Debentures and accounting treatment is also the same.

Illustration 13

Refer Illustration No. 10. A company decides to redeem its debentures in five equal instalments beginning from the end of first year. Make journal entry for the writing off and show Loss on Issue of Debentures A/c for first year.

Solution :

$$\text{Amount of Loss on Issue of Debentures} = \frac{1000 \times ₹1,000 \times 10}{100} = ₹ 1,00,000$$

MODULE - 5

Company Accounts



Notes

Issue of Debentures

Calculation of amount to be written off each year

Year end	Amount Outstanding ₹	Ratio	Amount of Loss to be written off each year (₹)
1st	10,00,000	5	$1,00,000 \times \frac{5}{15} = 33,333$
2nd	8,00,000	4	$1,00,000 \times \frac{4}{15} = 26,667$
3rd	6,00,000	3	$1,00,000 \times \frac{3}{15} = 20,000$
4th	4,00,000	2	$1,00,000 \times \frac{2}{15} = 13,333$
5th	2,00,000	1	$1,00,000 \times \frac{1}{15} = 6,667$
		15	

Journal Entry

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
2014 Dec 31	Profit and Loss A/c To Loss on Issue of Debentures A/c (Amount of Loss on Issue of Debentures written off for 2014)		33,333	33,333

Loss on Issue of Debentures A/c

Dr.

Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2014 Jan 1	10% Debentures A/c	1,00,000	2014 Dec 31	Profit & Loss A/c	33,333
			Dec 31	Balance cld	66,667
		1,00,000			1,00,000
2015 Jan 1	Balance b/d	66,667			

Interest on Debentures

If you have seen an advertisement in newspaper regarding issue of debentures by a company, you must have noticed that 'Debenture' is always prefixed by a certain percentage say 9% Debentures or 12% Debentures. Have you ever thought what meaning does this prefix carry. It is the rate of interest per annum that will be paid to the debenture holders. Companies generally pay interest on its debentures after every six months. Income Tax on such interest is deducted at source by the company. Journal entries that are made in the books of the company are as follows :

*Notes***(i) Interest due on Debentures**

Debenture Interest A/c	Dr.
To Debentures Holder's A/c	
To Income Tax Payable A/c	
(Interest on ...% Debentures due for six months ending ...@ ...% pa)	

(ii) For Payment of Interest

Debentures Holders A/c	Dr.
Income Tax Payable	Dr.
To Bank	

(iii) Transfer of Debenture Interest to Profit and Loss A/c

Profit and Loss A/c	Dr.
To Debenture Interest A/c	
(Debenture Interest transferred to Profit and Loss A/c)	

Illustration 14

X Ltd has issued 5000 9% Debentures of ₹ 1,000 each, on 1st April, 2013 Interest is payable after every six months. The ratio of TDS is 10%. Make journal entries for the interest paid for the first six months after the date of issue.

Solution :

Calculation of Interest payable at six monthly intervals :

$$\frac{\text{Amount of Debentures} \times 9}{100} \times \frac{6}{12}$$

Amount of Debentures = 5000 × ₹ 1,000 = ₹ 50,00,000

Interest on Debentures for six month ending 30th September, 2013

$$= \hspace{10em} = ₹ 2,25,000$$

Journal Entry



Notes

<i>Date</i>	<i>Particulars</i>	<i>L.F.</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
2013				
Sept. 30	Debentures Interest A/c Dr. To Debenture Holder's A/c To Tax Payable (Interest on 5000 9% Debentures @ ₹ 1000 per debenture paid for 6 months ending 30th Sept 2006)		2,25,000	2,02,500 22,500
Sept. 30	Debenture Holders A/c Dr. Tax Payable Dr. To Bank (Paid interest to debenture holder's tax to government)		2,02,500 22,500	2,25,000
2014				
Mar. 31	Profit and Loss A/c Dr. To Debentures Interest A/c (Debenture Interest transferred to profit and Loss A/c)		2,25,000	2,25,000



INTEXT QUESTIONS 30.5

Answer the following :

- (i) Why is the amount of Discount on Issue of Debentures written in the Balance sheet ?
- (ii) 1000 10% Debentures are issued at a discount of 10% to be redeemed after five years. Calculate the amount of Debenture Discount to be written off each year.

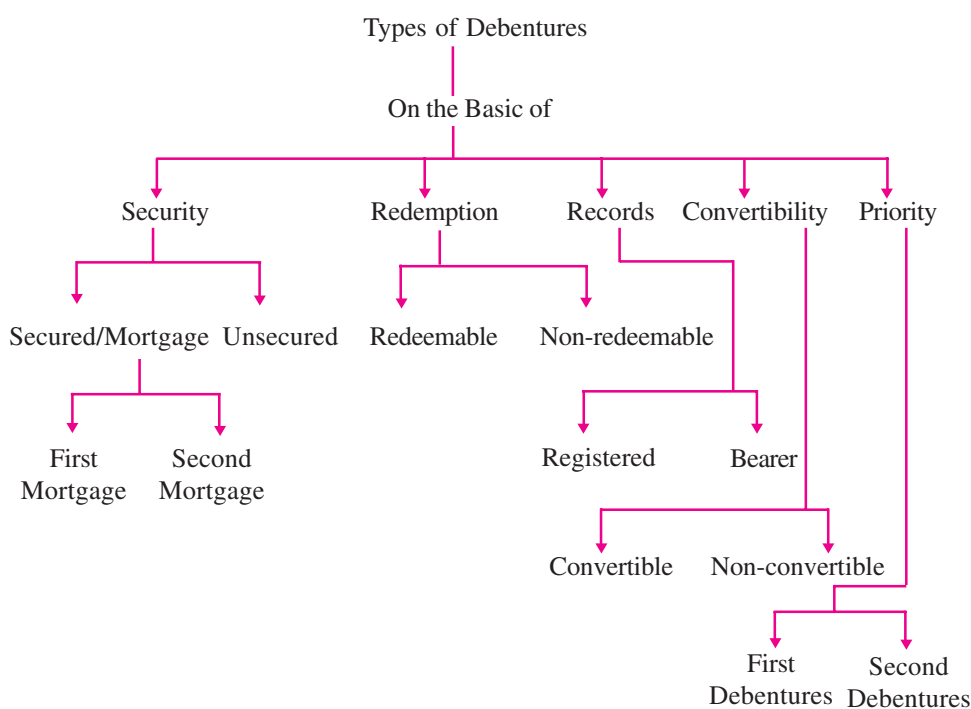
- (iii) 5000 10% Debentures of ₹ 100 each were issued by company on 1 Jan. 2014. Interest is payable on 30 June & 31 Decembers each year. Calculate the amount of interest paid to debenture holders during 2015.



WHAT YOU HAVE LEARNT

- A Debenture is a unit of loan amount issued to the lenders of the company. Debenture includes debenture stock, bond and any other security whether constituting a charge on the company's assets or not.

Debentures can be classified on the basis of :



- Issue of debentures : Debentures can be issued for cash at par, for consideration other than cash, as collateral security debentures are said to be oversubscribed when the company receives application for number of debentures than the company has offered for subscription.

Debenture can be issued at premium, at discount and in consideration other than cash.



Notes



Notes

- Debentures can be issued with conditions stipulated to their redemption as:
 - ▶▶ Issued at par redeemable at par
 - ▶▶ Issued at discount redeemable at par
 - ▶▶ Issued at premium redeemable at par
 - ▶▶ Issued at par redeemable at premium
 - ▶▶ Issued at discount redeemable at premium
- Issue of debentures as collateral security means issuing debentures to the lending agency that has given loan as additional/secondary security.



TERMINAL EXERCISE

1. What do you mean by debenture? State in brief the various types of debentures.
2. When are debentures said to be over subscribed? What accounting treatment is given in case debentures are oversubscribed?
3. What is the accounting treatment in the following cases :
 - (a) Debentures are issued at premium
 - (b) Debentures are issued at discount
 - (c) Debentures are issued in consideration other than cash
4. What is meant by debentures issued as collateral security? How is it treated in the books of accounts of the company?
5. Explain debentures issued at a discount. How is the amount of discount treated in the books of the company?
6. MBS Company Ltd has issued 5000 9% debentures of ₹ 100 each at a premium of ₹ 20 per debenture payable ₹ 60 (including premium) on application and allotment and the balance on call. Applications were received for 6500 debentures. Applications for 500 debentures were outrightly rejected and allotment was made on prorata basis to the remaining applicants.

All the money was duly called up. Make journal entries for the issue in the books of the company.

7. New Ventures Ltd. purchased plant of the book value of ₹ 4,95,000 from another firm. The purchase consideration was paid by issuing 10% debentures of ₹ 100 each. Assume debentures have been issued, (i) at par, (ii) at discount of 10%, (iii) at premium of 10%.
8. XYZ Co Ltd. has purchased the business of ABC Ltd. consisting assets of ₹ 4,50,000 and liabilities of ₹ 1,50,000 for a consideration of ₹ 4,00,000. It issued 10% debentures of ₹ 100 each fully paid in satisfaction of purchase consideration. Make journal entries.
9. Gaspig Furnishing and Decoration Ltd. raised a secured loan of ₹ 10,00,000 from State Bank of India and issued 1,500 10% debentures of ₹ 1,000 each as collateral security. Give the treatment of issue of such debentures in the books of the company.
10. Make journal entries for the issue of 10% debentures of ₹ 100 each in the following cases :
 - (a) 4,000 debentures issued at ₹ 100, redeemable at ₹ 120
 - (b) 2,000 debentures issued at ₹ 120, redeemable at ₹ 100
 - (c) 5,000 debentures issue at ₹ 90, redeemable at ₹ 100
 - (d) 6,000 debentures issued at ₹ 90, redeemable at ₹ 110
 - (e) 2,000 debentures issued at ₹ 100, redeemable at ₹ 100
11. On 1st January, 2014 a limited company issued its 1000000 debentures at a discount of 6%. The debenture were repayable by annual drawings of ₹ 2,00,000 made on 31st December each year. The discount was to be written off each year with an amount proportionate to debentures outstanding in the year.

Show the discount on issue of Debentures Account in the company ledger till it is written off.
12. High Rise Builders Ltd. issued 10% debentures of ₹ 100 each valued at ₹ 6,00,000 at discount of 6% repayable at par in equal proportions at the end of 2nd, 3rd and 5th year. Calculate the amount of discount to be written off at the end of each year and prepare discount on issue of debentures account.
13. AB Ltd issued 1000 12% debentures of ₹ 1,000 each on 1st January 2014. Make journal entries for the year ended 31st December 2014 assuming that interest was payable yearly on 31st December and tax deducted at source is @10%.

*Notes*



Notes



ANSWERS TO INTEXT QUESTIONS

- 30.1** (i) Redeemable; Non-redeemable (ii) Registered; Bearer
 (iii) Convertible; Non-convertible (iv) First; Second
- 30.2** I. (i) Issued for cash (ii) Issued in consideration other than cash
 (iii) Issued as collateral security
- II. (a) Application money is received
 (b) Application money is adjusted towards subsequent calls
- 30.3** I. 3,000
- | | | |
|---------------------------|-----|----------|
| Vendors A/c | Dr. | 3,15,000 |
| To 10% Debentures A/c | | 3,00,000 |
| To Securities Premium A/c | | 15,000 |
- II. (i) Discount (ii) Premium
 (iii) for considerations other than cash
 (iv) Articles of Association
- 30.4** (i) Collateral security (ii) Debenture suspense A/c
 (iii) Assets side (iv) When lender demands additional security
- 30.5** (i) It is treated as a capital loss (ii) ₹ 10000 ÷ 5 = ₹ 2000
 (iii) ₹ 25,000 on 30 June 2015 & ₹ 25,000 on 31 Dec. 2015



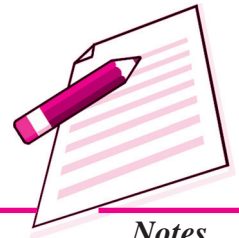
ANSWERS TO TERMINAL EXERCISE

7. Number of debentures to be issued (i) 4950, (ii) 5500 (iii) 4500
8. Amount of goodwill ₹ 1,00,000
11. Discount written of 1st year ₹ 20,000, 2nd year ₹ 16,000, 3rd year ₹12,000,
 4th year ₹ 8,000 and 5th year ₹ 4,000
12. Discount written of 1st year and 2nd year ₹ 10,800, 3rd year ₹ 7,200 4th and
 5th year ₹ 3,600.



ACTIVITY

Procure Balance Sheets of a number of companies which have raised funds by issuing debentures. Study them and collect information about the type of debentures issued by each company. Write the name of the company and put \checkmark mark in the appropriate column :



Notes

<i>Name of the Company</i>	<i>Convertible</i>	<i>Type of Debentures</i>			
		<i>Non-convertible</i>	<i>Secured</i>	<i>Unsecured</i>	<i>Collateral security</i>