



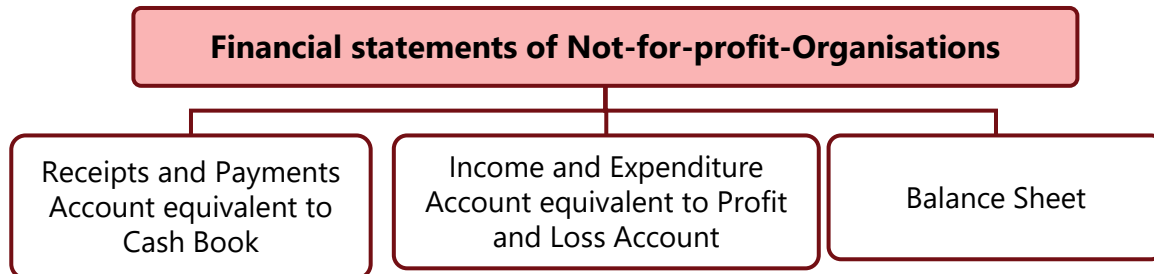
FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANISATIONS



LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the meaning of Not-for-profit-organisations and distinction between a profit-making organisation and a Not-for-profit-organisation.
- ◆ Accounting for Not-for-profit-organisations.
- ◆ Understand the meaning and technique of preparation of Receipts and Payments Account and Income and Expenditure Account and understand the distinction between the two Accounts.
- ◆ Learn the technique of preparing Balance Sheet of Not-for-profit-organisations.
- ◆ Understand the different adjustments and their accounting treatment in the books of Not for profit organisations.

CHAPTER OVERVIEW

Donations, Entrance and Admission Fees, Subscription, Life Membership Fee are some of the Sources of incomes for the non-profit organizations which have different treatments based on the nature of the receipts.

**1. INTRODUCTION**

A non-profit organization is a legal accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. The main motive behind the non-profitable organization is to render service to the society or the members of the organisation.

There is difference in the final accounts prepared between the profit making and the non-profitable organisations. The sources of receipts and payments also vary with the nature of the activity that is being carried on by the organisation. Non-profit making organisations such as public hospitals, public educational institutions, clubs, Temples, churches etc., as a part of their final accounts prepare Receipts and Payments Account and Income and Expenditure Account to show periodic performance (either surplus or deficit) and Balance Sheet to show financial position at the end of the period. In this Chapter, we shall discuss the technique of preparing Receipts and Payments Account, Income and Expenditure Accounts and Balance Sheet of not-for-profit organisations.

The Income and Expenditure Account (non- profitable organisation) is just similar to Profit and Loss Account prepared for the profit making organisations but there has been different terminology employed for the word Profit as SURPLUS – excess of income over expenditure or loss as DEFICIT – excess of expenditure over income. In non-profit making organisations, total cash receipts and total cash payments are highlighted through Receipts and Payments Account.



2. NATURE OF RECEIPTS AND PAYMENTS ACCOUNT

A Receipts and Payments Account is a summary of the cash book without date column. It is an elementary form of account commonly adopted by not for profit making concerns such as hospitals, clubs, societies, temples, churches etc., for presenting the receipts and payments periodically together with the cash balances at the beginning and close of the period. The receipts are entered on the left hand side, and payments on the right hand side i.e., the same way as they appear in Cash Book. "The main point to be noted here is that- receipts and payments account is not based on the accrual system of book keeping as it records all the receipts and payments whether capital or revenue, pertaining to the current, previous or future periods."

Features:

- ♦ It is the summary of the cash and bank transactions like cash book, all the receipts (**capital or revenue**) are debited, similarly, all the expenditures (**capital or revenue**) are credited.
- ♦ It starts with opening cash and bank balances and also ends with their closing balances. This account is usually not a part of the double entry system as it includes all cash and bank receipts and payments, whether they are related to present, past or future periods.
- ♦ Surplus or deficit for an accounting period cannot be ascertained from this account, since, it shows only the Cash/Bank position and excludes all non cash items.

ILLUSTRATION 1

The receipts and payments for the Swaraj Club for the year ended March 31, 2022 were: Entrance fees ₹ 300; Membership Fees ₹ 3,000; Donation for Club Pavilion ₹ 10,000, Foodstuff sales ₹ 1,200; Salaries and Wages ₹ 1,200 Purchase of Foodstuff ₹ 800; Construction of Club Pavilion ₹11,000; General Expenses ₹600; Rent and Taxes ₹400; Bank Charges ₹ 160.

Cash in hand–April. 1st ₹ 200, March. 31st ₹ 350

Cash in Bank–April. 1st ₹ 400; March. 31st ₹ 590

You are required to prepare Receipts and Payment Account.

SOLUTION

Swaraj Club
Receipts and Payments Accounts
for the year ended 31st March, 2022

Receipts	₹	Payments	₹
To Balance b/d(opening bal.)Cash in hand	200	By Salaries and Wages	1,200
To Cash with bank	400	By Purchase of Foodstuff	800
To Entrance Fees	300	By Club Pavilion (Expenditure on its construction)	11,000
To Membership Fees	3,000	By General Expenses	600
To Donation of Account of Club Pavilion	10,000	By Rent and Taxes	400
To Sales of foodstuff	1,200	By Bank Charges	160
		By Balance c/d (closing bal) Cash in hand	350
		Cash in bank	590
	15,100		15,100

2.1 Limitations of Receipts and Payments Account

From the study of the above account, it is apparent that the increase in the cash and bank balances at the end of the year, as compared to those in beginning, does not truly represent the surplus for the year since it does not take into account the other important transactions, such as cost of construction of the pavilion, which is in excess of the donation received, the outstanding subscription or those which were collected in advance, etc.

Another important drawback is that the Receipts and Payments Account includes items relating to all periods and of all types whether capital or revenue. In order to ascertain whether the organisation has made surplus or deficit, there is a need to construct an account which considers all the relevant revenue transactions for the current period. Since the Receipts and payments account does not consider the above, its preparation is not favoured except where the activities of the organization, the results of which are to be exhibited, are simple and modest, involve no carry over from one period to the next and it has no assets, apart from cash balance and no liabilities.



3. INCOME AND EXPENDITURE ACCOUNT

The income and expenditure account is **equivalent** to the Profit and Loss Account of a Profit making business enterprise. It is an account which is widely adopted by most of the Non-profit making concerns and is prepared by following **accrual principle**. Only items of revenue nature pertaining to the current period of account are included. The preparation of the account, therefore, requires adjustments in relevant accounts in respect of both outstanding and advance items of income and expenditure. The only difference is in the terms used to represent the profit and loss. Profit is termed as Surplus- Excess of income over expenditure and loss is termed as Deficit- Excess of expenditure over income.

Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.

Features:

- ♦ It is a revenue account prepared at the end of the accounting period for finding out the surplus or deficit of that period.
- ♦ It is prepared by matching expenses against the revenue of that period concerned.
- ♦ Both cash and non-cash items, such as depreciation, are taken into consideration.
- ♦ All capital expenditures and incomes are excluded.
- ♦ Only current years' income and expenses are considered. This Surplus/deficit is taken to the balance sheet and is added / deducted respectively with the capital fund (opening balance).

3.1 Main Sources of Income

For a not for profit organisation, the sources of income, largely depend on the nature of the activity carried on by them. The income for a charitable hospital is different from that of a income received by a sports club. Broadly for the purposes of solving the illustrations, we can classify the sources of income as subscriptions, ordinary donations, membership fees or entrances fees (if the amount is normal or provided according to bye-laws of the society), recurring grants from local authorities and income from investments, etc.

Any amount raised for a special activity, e.g. on sale of match tickets, is deducted from the expenditure of that activity and net amount is shown in the income and expenditure account. Any receipt of capital nature shall not be shown as income but will be credited to the Capital Fund or special purpose fund e.g. "Building Fund' or if the receipts is on account of sale of a

fixed asset, it shall be credited to the asset account. This system of showing the donation towards specific purposes separately is termed as fund accounting.

Examples:

Hospital - medicines and cost of tests and investigations.

Sports Club - sports materials, tournament expenses, etc.

Drama Club - expenses of staging plays, rent of the hall, payment to artists, etc.

Educational Societies - award of scholarships, organisation of seminars, etc.

Library Societies - newspapers and magazines.

Any expenditure for acquisition of a fixed asset will be capitalised, though the amount of annual depreciation shall be debited to revenue expenditure.

It may be noted that after various accounts have been adjusted as is considered necessary by transferring all the revenue accounts to the income and Expenditure account and all the capital items to the balance sheet. If a regular Trial Balance is available, the preparation of the Income and Expenditure Account and the Balance Sheet is on the lines of final accounts.

3.2 Distinction between Receipts and Payments Account and Income and Expenditure Account

Not for profit organizations such as public hospitals, public educational institutions, clubs, Temples, churches etc., conventionally prepare Receipt and Payment Account and Income and Expenditure Account to show periodic performance for a particular accounting period. The distinguishing features of both the accounts can be summarized as:

Receipt and Payment Account is an elementary form of account consisting of a classified summary of cash receipts and payments over a certain period together with cash balances at the beginning and close of the period. The receipts are entered on the left hand side and payments on the right hand side i.e. same sides as those on which they appear in cash book. All the receipts and payments whether of revenue or capital nature are included in this account. The receipts and payments pertaining to the current, previous or future periods are also considered here. The balance of the account at the end of a period represents the difference between the amount of cash received and paid up. It is always in debit since it is made up of cash in hand and at bank.

Income and expenditure account resembles and is drawn in the same form of a Profit and loss account in case of profit-making organisations. Expenditure of revenue nature is shown on the debit side, income and gains of revenue nature are shown on the credit side. Income and Expenditure Account contains all the items of income and expenditure relevant to the current

accounting period only, whether received or paid as well as that which have fallen due for recovery or payment. Capital Receipts, prepayments of income and capital expenditures, prepaid expenses are excluded. It does not start with any opening balance. The balancing figure represents the amount by which the income exceeds the expenditure or vice versa.

3.3 Preparation of Income and Expenditure Account from Receipts and Payments Account

Situations may require compilation of Income and Expenditure Account and the Balance Sheet from the Receipts and Payments Account after making adjustments in respect of Income accrued but not collected and expenses outstanding. The preparation of Balance Sheet in such a case is also necessary since an Income and Expenditure Account must always be accompanied by a Balance Sheet. The procedure which should be followed in this regard is briefly outlined below.

- (i) Compute the opening balance of the Accumulated Fund, or Capital Fund of the Institution with the help of making opening balance sheet. It will be excess of the total value of the assets over that of the liabilities at the commencement of the period.
- (ii) Open ledger accounts in respect of various items of income and expenditure (e.g. subscription, rents, printing, purchase of sports materials etc.) in which accruals or outstanding at the beginning or at the end of period have to be adjusted. Enter therein any accrual or outstanding at the end of the period as well as amounts which relate to an earlier period or the following period. The balance of the ledger accounts therefore will represent the amounts or income or expenditure pertaining to the period. These should be transferred to the Income and Expenditure Account.
- (iii) Post from the debit of the Receipts & Payments Account to the credit of the Income and Expenditure Account other items of income wherein accruals and outstanding amount have to be adjusted. Likewise, post item of expenses in which no adjustment is to be made directly to debit of income and Expenditure Account.
- (iv) Transfer the balance of Income and Expenditure Account to the Accumulated Fund/Capital Fund Account.
- (v) Post the receipts and payments of capital nature from the Receipts and Payments Account to the appropriate asset or liability account for incorporating in the Balance Sheet. If a part or whole of an asset has been sold, the capital profit/loss, if any, is credited / debited in the Income and Expenditure Account. The balance of Income and Expenditure Account should be transferred to the Accumulated Fund/Capital Fund Account.

- (vi) Prepare a Balance Sheet by including therein all the balances left over after transfers to the Income and Expenditure Account have been made.

ILLUSTRATION 2

During 2022, subscription received in cash is ₹42,000. It includes ₹1,600 for 2021 and ₹600 for 2023. Also ₹3,000 has still to be received for 2022.

Required

Calculate the amount to be credited to Income and Expenditure Account in respect of subscription.

SOLUTION

		₹
Amount received		42,000
Add : Outstanding on 31st Dec., 2022		3,000
		45,000
Less : Received on account of 2021	1,600	
2023	600	(2,200)
		42,800

The various accounts will appear as under:

Subscription Outstanding Account

2022		₹	2022		₹
Jan. 1	To Balance b/d (transfer)	1,600	Dec. 31	By Subscription A/c	1,600
Dec. 31	To Subscription A/c	3,000	Dec. 31	By Balance c/d	3,000
		4,600			4,600
2023					
Jan. 1	To Balance b/d	3,000			

Subscription Account

2022		₹	2022		₹
Dec. 31	To Subscription Outstanding A/c (transfer)	1,600	Dec. 31	By Cash A/c	42,000
Dec. 31	To Subscription received in advance A/c	600	Dec. 31	By Subscription Outstanding A/c	3,000
Dec. 31	To Income and Expenditure A/c	42,800			
		45,000			45,000

Subscription received in Advance Account

2022		₹	2022		₹
Dec. 31	To Balance c/d	600	Dec. 31	By Subscription A/c	600
			2023		
			Jan. 1	By Balance b/d	600

Subscription outstanding ₹ 3,000 and Subscription received in advance ₹ 600 will be shown in the balance sheet on the assets and liabilities side respectively.

ILLUSTRATION 3

Suppose salaries paid during 2022 were ₹23,000. The following further information is available:

	₹
Salaries unpaid on 31st March, 2021	1,400
" pre-paid on " " 2021	400
" un-paid on " " 2022	1,800
" pre-paid " " 2022	600

Required

Calculate the amount to be debited to Income and expenditure account in respect of salaries and also show necessary ledger accounts.

SOLUTION

Salaries Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
April, 1, 2021	To Prepaid Salaries A/c	400	April, 1, 2021	By Salaries Outstanding A/c	1,400
March, 31, 2022	To Cash	23,000	March, 31, 2022	By Salaries Prepaid A/c	600
	To Salaries Outstanding A/c	1,800		By Transfer to Income & Expenditure A/c	23,200
		25,200			25,200

Salaries Outstanding Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
April, 1, 2021	To Salaries A/c	1,400	April, 1, 2021	By Balance b/d	1,400
March, 31, 2022	To Balance c/d	1,800	March, 31, 2022	By Salaries A/c	1,800
		3,200			3,200
			April, 1, 2022	By Balance b/d	1,800

Salaries Prepaid Account

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
April, 2021	To Balance b/d	400	April, 1, 2021	By Salaries A/c (transfer)	400
March, 31, 2022	To Salaries A/c	600	March, 31, 2022	By Balance c/d	600
		1,000			1,000
April, 1, 2022	To Balance b/d	600			



4. BALANCE SHEET

A Balance Sheet is the statement of assets and liabilities of an accounting unit at a given date. It is generally prepared at the end of an accounting period after the Income and Expenditure Account has been prepared. It is classified summary of the ledger balances left over, after accounts of all the revenue items have been closed by transfer to the Income and Expenditure Account. In not for profit organizations, the excess of total assets over total outside liabilities is known as **Capital Fund**. The Capital fund represents the amount contributed by members, through legacies, special donations, entrance fees and accumulated surplus over the years. If

however, members have not contributed any amount, it shall be termed as "Accumulated fund" instead of "Capital fund". The surplus or deficit, if any, on the year's working as disclosed by the Income and Expenditure Account is shown either as an addition to or deduction from the Capital / Accumulated Fund brought forward from the previous period respectively.

4.1 Accounting Treatment of Some Special Items

4.1.1 Donations: These may have been raised either for meeting some revenue or capital expenditure; those intended for the first mentioned purpose are credited directly to the Income and Expenditure Account but others, if the donors have declared their specific intention, then they are credited to special fund account and in the absence thereof, to the Capital Fund Account. If any investments are purchased out of a special fund or an asset is acquired therefrom, these are disclosed separately. Any income received from such investments or any donations collected for a special purpose are credited to an account indicating the purpose and correspondingly the expenditure incurred in carrying out the purpose of the fund is debited to this account. On no account any such expense is charged to the Income and Expenditure Account. **The term "Fund" is strictly applicable to the amounts collected for a special purpose when these are invested, e.g. Scholarship Fund, Prize Fund etc.** In other cases, when the amounts collected are not invested in securities or assets distinguishable from those belonging to the institution, the word "Account" is more appropriate e.g. Building Account, Tournament Account etc.

Instead of paying cash, a donor may sometimes give away or transfer a security or some other readily realisable asset. In such a case, the value of asset on valuation, must be credited to the fund for which the amount has been donated.

4.1.2 Entrance and Admission Fees: Such fees which are payable by a member on admission to club or society are normally considered capital receipts and credited to Capital Fund. This is because these do not give rise to any special obligation towards the member who is entitled to the same privileges as others who have paid only their annual subscription. Nevertheless, where the amount is small, meant to cover expenses concerning admission, or the rules of the society provided that such fees could be treated as income of the society, these amounts may be included in the Income and Expenditure Account. The treatment depends upon the requirement of question. If the question is silent then always take it to be capital receipt.

4.1.3 Subscription: Subscriptions being an income should be allocated over the period of their accrual. For testing the knowledge of candidates of this important accounting principle, questions are often set in examinations wherein figures of subscription collected by a society during the year as well as those outstanding at the beginning of the year and at its close are given. If some subscriptions have been received in advance, their amount is also indicated. In such cases, it is always desirable to set up a Subscription Account for determining the amount

of subscription pertaining for the period for which accounts are being prepared. For example, if it is stated that subscriptions collected by a society during the year 2022 amounted to ₹ 1,850 out of which ₹ 200 represented subscription for the year 2021; ₹100 were subscriptions collected in advance for the year 2023, and subscriptions amounting to ₹ 500 were outstanding for recovery at the end of 2022, the adjusting journal entries and the Subscription Account should be set up as follows:

		₹	₹
Subscription Outstanding Account	Dr.	500	
To Subscriptions Account			500
(The amount outstanding for this year credited to Subscription Account)			
Subscription A/c	Dr.	300	
To Outstanding Subscription A/c			200
To Subscriptions Received in Advance A/c			100
(Subscription received ₹200 for the previous year and ₹100 for the next year, adjusted)			

Subscription Account

Dr.		₹	2022		Cr.
2022					₹
Jan 1	To Balance b/d	200	Dec.	By Cash A/c	1,850
	(Outstanding Subscriptions)				
Dec. 31	To Subscriptions received in advance	100		By Balance c/d	
	To Income and Expenditure Account	2,050		(Subscriptions Outstanding)	500
		2,350			2,350

The amount of outstanding subscription is adjusted in the Subscription Account by debit to Outstanding Subscription Account and that balance is shown as an asset in Balance Sheet. The Subscription Account is closed off by transferring its balance at the end of the year to the Income and Expenditure Account.

4.1.4 Life Membership Fee: Fees received for life membership is a **capital receipt** as it is of non-recurring nature. It is **directly added to capital fund** or general fund.

For adjusting lump sum subscription collected from the life members, one of the following methods can be adopted:

- (1) The entire amount may be carried forward in a special account until the member dies, after which the same may be transferred to the credit of the Accumulated Fund.
- (2) An amount equal to the normal annual subscription may be transferred every year to the Income and Expenditure Account and balance carried forward till it is exhausted. If, however, the life member dies before the whole of the amount paid by him has been transferred in this way, the balance should be transferred to the Accumulated Fund on the date of his death.
- (3) An amount, calculated according to the age and average life of the member, may annually be transferred to the credit of Income and Expenditure Account.

Other concepts

Treatment of Important Items in Not For Profit Organization

1. **Donation:** it is **gift in cash or kind** from some person. It may be of two types:
 - (a) **Specific Donation:** It is received for certain specific purpose like Building Donation, Library Books donation etc. It should be capitalized and shown on the liabilities side of the balance sheet.
 - (b) **General Donation:** It is not received for any specific purpose and shown on the credit side of Income and Expenditure Account.
2. **Entrance Fees:** It may also be known as admission fees. **Entrance Fees should be capitalized** and added to the capital fund for all organization. If the question gives any specific treatment of Entrance fees, then it should be followed accordingly.
3. **Legacy:** It is an amount received by an organization as per the will of the person after the death of the person. It should be capitalised and shown on the liabilities side of the balance sheet by adding to the Capital Fund.
4. **Life Membership Fees:** It should **be capitalized** and shown on the liabilities side of the balance sheet. If the question gives any specific treatment of Life membership Fees, then it should be followed accordingly.
5. **Endowment Fund Donation:** It is a donation received and **only income from that donation is to be used for certain specific purpose**. In such cases income relating to special funds should be added to these funds on the liabilities side of the Balance

Sheet. All the expenses should be deducted from that fund on the liabilities side of the Balance Sheet.

6. **Treatment of Sale of Old Newspaper and Periodicals:** The amount received on such sale is shown as Income on the credit side of income and expenditure account.
7. **Sale of old Fixed Assets:** The Sale proceeds of old Fixed Assets are treated as **capital receipts**. The profit or loss on sale of fixed asset is shown in the Income and Expenditure A/c
8. **Honorarium:** It is paid to someone for receiving any services from person who are **not the employees** of the Not for Profit Organisation.

4.2 Preparation of Balance Sheet

- ◆ **Preparation of opening balance sheet and calculation of surplus:** If capital fund or accumulated surplus in the beginning of the year is not given, it is calculated by deducting liabilities from assets in the beginning of year. While calculating opening capital fund, care should be taken to include prepaid expenses and accrued incomes as assets and outstanding expenses and advance incomes as liabilities. Any surplus earned during the year is added to the opening capital fund and deficit suffered during the year is deducted from the opening capital fund.
- ◆ **Cash and bank balance:** Closing cash and bank balance as disclosed in Receipt and Payment Account is shown in the assets side of Balance Sheet. If there is a bank overdraft, it is to be shown on the liabilities side of the balance sheet.
- ◆ **Fixed assets:** Opening balances of Fixed Assets (Furniture, building, equipment, etc.) are increased by the amount of purchases and reduced by sales of the same and depreciation on the same.
- ◆ **Liabilities:** Opening balances of liabilities should be adjusted for any increase or decrease in the same.

Note: The illustrations explained in this chapter comprise of clubs not registered under the Companies Act, 2013. Therefore, Income & Expenditure Account and Balance Sheet are not prepared as per Schedule III of the Companies Act, 2013.

ILLUSTRATION 4

Following is the Receipts and Payments Account of New bird Forty Club for the year ended 31st March, 2022:

Dr **Receipts and payments A/c for the year ended on 31st March 2022** Cr

Receipts	Amount (₹)	Payments	Amount (₹)
To balance b/d	2,50,000	By Salaries and wages	1,65,000
To Subscription- 2020-2021	65,000	By Office expenses	35,000
2021-2022	3,55,000	By Sports equipment	3,42,000
To Donations	55,000	By Telephone Charges	28,000
To Entrance fees	85,000	By Electricity charges	32,000
		By Travelling and conveyance	65,000
		By balance c/d	1,43,000
	8,10,000		8,10,000

Additional information :

- Outstanding subscriptions for the year ended 31st March, 2022 – ₹ 55,000.
- Outstanding salaries and wages – ₹ 40,000 for the year ended on 31st March 2022.
- Depreciate sports equipment by 25% for the year ended on 31st March 2022.
- Capitalize 50% of the entrance fees.

Prepare Income and Expenditure Account of the club from the above particulars for the year ended on 31st March 2022.

SOLUTION

In the books of New bird forty Club

Dr **Income and expenditure Account for the year ended on 31st March 2022** Cr

Expenditure	Amount (₹)	Income	Amount (₹)
Salaries and wages	1,65,000	By Subscriptions	4,20,000
Add: Outstanding Salaries for 2022	40,000	Add: Outstanding Subscriptions for 2022	55,000
	2,05,000		

To Office expenses	35,000	Less: Outstanding Subscriptions for 2021	<u>65,000</u>	4,10,000
To Depreciation (25% × 3,42,000)	85,500	By Donations		55,000
To Telephone Charges	28,000	By Entrance fees (50% × 85,000)		42,500
To Electricity charges	32,000			
To Travelling and conveyance	65,000			
Excess of income over expenditure	57,000			
	5,07,500			5,07,500

ILLUSTRATION 5

From the following information of a club show the amounts of match expenses and match fund in the appropriate Financial Statements of the club for the year ended on 31st March, 2022:

Details	Amount (₹)
Match expenses paid during the year ended 31 st March 2022	1,10,000
Match fund as on 01.04.2021	30,000
Donations for Match fund (received during the year)	55,000
Proceeds from the sale of the match tickets (during the year)	20,000

SOLUTION**Balance sheet as at March 31st 2022 (extract)**

Liabilities	Amt. (₹)	Assets	Amt (₹)
Match fund	30,000		
Add: Donation for match fund	55,000		
Add: Proceeds from sale of tickets	20,000		
Less: Match expenses (Note)	(1,05,000)		
	NIL		

Note: Since the expenses incurred are more than the Match fund available ₹ 1,05,000 we are limiting the expenses to ₹ 1,05,000. The remaining expenses of ₹ 5000 (1,10,000-1,05,000) will be debited to the Income and expenditure account.

ILLUSTRATION 6

During the year ended 31st March, 2022, the subscriptions received by the Jaipur Literary Society were ₹ 4,50,000. These subscriptions include ₹ 20,000 received for the year ended 31st March, 2021. On 31st March, 2022, subscriptions due but not received were ₹ 15,000. Advance subscription received for the year ending 31st March 2022 but pertaining to year 2023 amounted to ₹ 26,000. The Subscriptions received in advance for the year ending 31st March, 2021 includes ₹ 18,000 pertaining to year 2021-22. Show the subscription account in book of the society?

SOLUTION

In the books of Jaipur literary society

Subscription A/c (for the year ended on 31st March 2022)			
Dr		Cr	
Particulars	Amount (₹)	Particulars	Amount (₹)
To outstanding subscriptions (2021)	20,000	By Advance subscriptions (2021)	18,000
To Income from Subscriptions A/c	4,37,000	By Bank A/c	4,50,000
To Advance subscriptions (2023)	26,000	By Outstanding subscriptions (2022)	15,000
	4,83,000		4,83,000

ILLUSTRATION 7

From the following information, calculate amount of subscriptions outstanding for the year ended 31st March, 2022.

A club has 350 members each paying an annual subscription of ₹ 1,050. The Receipts and Payments Account for the year showed a sum of ₹ 4,10,000 received as subscriptions. The following additional information is provided:

Subscriptions Outstanding on 31st March, 2021 – ₹ 45,000

Subscriptions Received in Advance on 31st March, 2022 – ₹ 62,000

Subscriptions Received in Advance on 31st March, 2021 – ₹ 30,000

SOLUTION**Subscription Account**

Particulars	Amount (₹)	Particulars	Amount (₹)
To Outstanding subscriptions (2021)	45,000	By Advance subscriptions (2021)	30,000
To Income from subscriptions A/c (350*1050)	3,67,500	By Bank A/c	4,10,000
To Advance subscriptions (2023)	62,000	By Outstanding subscriptions (2021)	34,500
	4,74,500		4,74,500

ILLUSTRATION 8

The following was the Receipts and Payments Account of Exe Club for the year ended March 31, 2022

All the figures in thousands

Receipts	₹	Payments	₹
Cash in hand	100	Groundsman's Fee	750
Balance at Bank as per Pass Book:		Moving Machine	1,500
Deposit Account	2,230	Rent of Ground	250
Current Account	600	Cost of Teas	250
Bank Interest	30	Fares	400
Donations and Subscriptions	2,600	Printing & Office Expenses	280
Receipts from teas	300	Repairs to Equipment	500
Contribution to fares	100	Honorarium to Secretary and Treasurer of 2021	400
Sale of Equipment	80	Balance at Bank as per Pass Book:	
Net proceeds of Variety		Deposit Account	3,090
Entertainment	780	Current Account	150
Donation for forth coming		Cash in hand	250
Tournament	1,000		
	7,820		7,820

You are given the following additional information:

	April, 1, 2021	March, 31, 2022
	₹	₹
<i>Subscription due</i>	150	100
<i>Amount due for printing etc.</i>	100	80
<i>Cheques unpresented being payment for repairs</i>	300	260
<i>Estimated value of machinery and equipment</i>	800	1,750
<i>Interest not yet entered in the Pass book</i>		20
<i>Bonus to Groundsman outstanding</i>		300

For the year ended March 31, 2022, the honorarium to the Secretary and Treasurer are to be increased by a total of ₹ 200. Prepare the Income and Expenditure Account and Balance Sheet for period ending 31st March, 2022 .

SOLUTION

**Income and Expenditure Account of Exe Club
for the year ending 31st March, 2022**

(all figures in thousand)

Expenditure		₹	Income	₹
To Groundsman's fee		750	By Donations and Subscription	2,550
To Rent of Ground		250	By Receipts from teas	50
To Fares' Expenses	400		(Fares) less expenses	
Less : Contribution	(100)	300	(₹ 300 - ₹ 250)	
To Printing & Office Expenses		260	By Proceeds of Variety Entertainment	780
To Repairs		460	By Interest (₹ 30 + ₹ 20)	50
To Depreciation on Machinery				
Opening balance and Purchases	2,300			
Less: Closing Balance	(1,750)			
	550			
Less: Sale	(80)	470		
To Honorarium to Sect. &				

Treasurer		600		
To Bonus to Groundsman		300		
To Excess of Income over Expenditure		40		
		3,430		3,430

Balance Sheet of Exe Club as on 31st March, 2022

Liabilities		₹	Assets	₹
Outstanding Expenses:				
Groundsman Bonus		300	Cash in hand	250
Printing		80	Cash in Deposit A/c	3,090
Honorarium		600	Subscription Due	100
Bank Overdraft (₹260 – ₹150)		110	Interest Due	20
Capital Fund: Opening	3,080		Machinery & Equipments	1,750
Add: Surplus for the year	40	3,120		
Tournament Fund (Donation)		1,000		
		5,210		5,210

Balance Sheet as on 1st April, 2021

Liabilities	₹	Assets	₹
Outstanding Expenses and Honorarium (₹100 + ₹400)	500	Cash in hand	100
Capital Fund (Balancing Figure)	3,080	Cash in Deposit A/c	2,230
		Cash in Current A/c	300
		Subscription Due	150
		Machinery	800
	3,580		3,580

ILLUSTRATION 9

The Sportwriters Club gives the following Receipts and Payments Account for the year ended March 31, 2022:

Receipts and Payments Account

Receipts	₹	Payments	₹
To Balance b/d	4,820	By Salaries	12,000
To Subscriptions	28,600	By Rent and electricity	7,220
To Miscellaneous income	700	By Library books	1,000
To Interest on Fixed deposit	2,000	By Magazines and newspapers	2,172
		By Sundry expenses	10,278
		By Sports equipments	1,000
		By Balance c/d	2,450
	36,120		36,120

Figures of other assets and liabilities are furnished as follows:

	As at March 31	
	₹	₹
	2021	2022
Salaries outstanding	710	170
Outstanding rent & electricity	864	973
Outstanding for magazines and newspapers	226	340
Fixed Deposit (10%) with bank	20,000	20,000
Interest accrued thereon	500	500
Subscription receivable	1,263	1,575
Prepaid expenses	417	620
Furniture	9,600	
Sports equipments	7,200	
Library books	5,000	

The closing values of furniture and sports equipments are to be determined after charging depreciation at 10% and 20% p.a. respectively inclusive of the additions, if any, during the year. The Club's library books are revalued at the end of every year and the value at the end of March 31, 2022 was ₹ 5,250.

Required

From the above information you are required to prepare:

- The Club's Balance Sheet as at March 31, 2021;
- The Club's Income and Expenditure Account for the year ended March 31, 2022.
- The Club's Closing Balance Sheet as at March 31, 2022.

SOLUTION**(a)****Sportswriters Club****Balance Sheet as on 31st March, 2021**

Liabilities	₹	₹	Assets	₹
Outstanding expenses:			Furniture	9,600
Salaries	710		Library Books	5,000
Rent & Electricity	864		Sports Equipment	7,200
Magazines & Newspapers	226	1,800	Fixed Deposit	20,000
Capital Fund (Balancing figure)		47,000	Cash in hand & at Bank	4,820
			Prepaid Expenses	417
			Subscription receivable	1,263
			Interest accrued	500
		48,800		48,800

(b)**Income and Expenditure Account for the year ending 31st March, 2022**

Expenditure		₹	Income	₹
To Salaries		11,460	By Subscription	28,912
To Rent & Electricity		7,329	By Interest on Fixed Deposit	2,000
To Magazines & Newspapers		2,286	By Misc. Income	700
To Sundry Expenses		10,075	By Excess of expenditure over income	2,888
To Depreciation:				
Furniture	960			
Sports Equipment	1,640			
Library Books	750	3,350		
		34,500		34,500

**(c) Balance Sheet of Sports Writers Club
as on 31st March, 2022**

Liabilities	₹	₹	Assets	₹	₹
Outstanding Expenses:			Furniture		
Salaries	170		Cost	9,600	
Rent & Electricity	973		Less : Depreciation	(960)	8,640
Newspapers	340	1,483	Magazines & Sport		
Capital Fund:			Equipment:		
Opening balance	47,000		Opening balance	7,200	
Less : Excess of			Addition	1,000	
exp. over income	(2,888)	44,112		8,200	
			Less : Depreciation	(1,640)	6,560
			Library Books :		
			Opening Balance	5,000	
			Addition	1,000	
				6,000	
			Less : Depreciation	(750)	5,250
			Fixed Deposit		20,000
			Cash in hand & at bank		2,450
			Prepaid Expenses		620
			Subscription Receivable		1,575
			Interest accrued		500
		45,595			45,595

Working Notes:

(i)	Expenses	Salaries	Rent & Electricity	Magazines & News-Papers	Sundry Expenses
		₹	₹	₹	₹
	Paid during the year	12,000	7,220	2,172	10,278
	Add : Outstanding on 31.3.2022	170	973	340	—

	Add : Prepaid on 31.3.2021	–	–	–	417
		12,170	8,193	2,512	10,695
	Less : Outstanding on 31.3.2021	(710)	(864)	(226)	–
	Less : Prepaid on 31.3.2022	–	–	–	(620)
	Expenditure for the year	11,460	7,329	2,286	10,075
(ii)	Depreciation				₹
	(a) Furniture @10% on ₹ 9,600				960
	(b) Sports Equipment @ 20% on ₹ 8,200				1,640
	(c) Library books - book value			6,000	
	Revalued at			(5,250)	750
(iii)	Subscription				
	Received in cash				28,600
	Add : Receivable on 31.3.2022				1,575
					30,175
	Less: Receivable on 31.3.2021				(1,263)
					28,912

ILLUSTRATION 10

The Income and Expenditure Account of the Youth Club for the Year 2022 is as follows:

Expenditure	₹	Income	₹
To Salaries	4,750	By Subscription	7,500
To General Expenses	500	By Entrance Fees	250
To Audit Fee	250	By Contribution for	
To Secretary's Honorarium	1,000	annual dinner	1,000
To Stationery & Printing	450	By Annual Sport meet	
To Annual Dinner Expenses	1,500	receipts	750
To Interest & Bank Charges	150		
To Depreciation	300		
To Surplus	600		
	9,500		9,500

This account had been prepared after the following adjustments:

	₹
Subscription outstanding at the end of 2021	600
Subscription received in advance on 31st December, 2021	450
Subscription received in advance on 31st December, 2022	270
Subscription outstanding on 31st December, 2022	750

Salaries Outstanding at the beginning and the end of 2022 were respectively ₹ 400 and ₹ 450. General Expenses include insurance prepaid to the extent of ₹ 60. Audit fee for 2022 is as yet unpaid. During 2022 audit fee for 2021 was paid amounting to ₹ 200.

The Club owned a freehold lease of ground valued at ₹ 10,000. The club had sports equipment on 1st January, 2022 valued at ₹ 2,600. At the end of the year, after depreciation, this equipment amounted to ₹ 2,700. In 2021, the Club has raised a bank loan of ₹ 2,000. This was outstanding throughout 2022. On 31st December, 2022 cash in hand amounted to ₹ 1,600.

Required

Prepare the Receipts and Payments Account for 2022 and Balance Sheet as at the end of the year.

SOLUTION

The Youth Club

Receipts and Payments Account for the year ended 31st December, 2022

Receipts	₹	₹	Payments	₹	₹
To Balance b/d (balancing figure)		1,390	By Salaries	4,750	
To Subscriptions as per Income & Expenditure Account	7500		Add: Paid for 2021	400	
Add: 2021's Received	600		Less: Unpaid for 2022	(450)	4,700
2023's Received	270		By General Expenses	500	
	8,370		Add : Paid for 2023	60	560
Less: 2022's Received in 2021	(450)		By Audit fee (2022)		200
	7,920		By Secy. Honorarium		1,000
			By Stationery & Printing		450

Less: 2022's Outstanding	(750)	7,170	By Annual Dinner Expenses	1,500
To Entrance Fees		250	By Interest & Bank Charges	150
To Contribution for annual dinner		1,000	By Sports Equipments [2700 - (2600 - 300)]	400
To Annual sport meet receipt		750	By Balance c/d	1,600
		10,560		10,560
To Balance b/d		1,600		

Balance Sheet of Youth Club as on December 31, 2022

Liabilities	₹	₹	Assets	₹	₹
Subscription received in advance		270	Freehold Ground		10,000
Audit Fee Outstanding		250	Sport Equipment:		
Salaries Outstanding		450	As per last		
Bank Loan		2,000	Balance Sheet	2,600	
Capital Fund :			Additions	400	
Balance as per previous				3,000	
Balance Sheet	11,540		Less : Depreciation	(300)	2,700
Add : Surplus for 2022	600	12,140	Subscription Outstanding		750
			Insurance Prepaid		60
			Cash in hand		1,600
		15,110			15,110

Balance Sheet of Youth Club as on 31st December, 2021

Liabilities	₹	Assets	₹
Subscriptions received in advance	450	Freehold Ground	10,000
Salaries outstanding	400	Sports Equipment	2,600
Audit fees unpaid	200	Subscriptions Outstanding	600
Bank Loan	2,000	Cash in hand	1,390
Capital Fund (balancing figure)	11,540		
	14,590		14,590

ILLUSTRATION 11

Smith Library Society showed the following position on 31st March, 2021:

Balance Sheet as on 31st March, 2021

Liabilities	₹	Assets	₹
Capital fund	7,93,000	Electrical fittings	1,50,000
Expenses payable	7,000	Furniture	50,000
		Books	4,00,000
		Investment in securities	1,50,000
		Cash at bank	25,000
		Cash in hand	<u>25,000</u>
	<u>8,00,000</u>		<u>8,00,000</u>

The receipts and payment account for the year ended on 31st March, 2022 is given below:

	₹		₹
To Balance b/d		By Electric charges	7,200
Cash at bank 25,000		By Postage and stationary	5,000
Cash in hand <u>25,000</u>	50,000	By Telephone charges	5,000
To Entrance fee	30,000	By Books purchased	60,000
To Membership subscription	2,00,000	By Outstanding expenses paid	7,000
To Sale proceeds of old papers	1,500	By Rent	88,000
To Hire of lecture hall	20,000	By Investment in securities	40,000
To Interest on securities.	8,000	By Salaries	66,000
		By Balance c/d	
		Cash at bank	20,000
		Cash in hand	<u>11,300</u>
	<u>3,09,500</u>		<u>3,09,500</u>

You are required to prepare income and expenditure account for the year ended 31st March, 2022 and a balance sheet as at 31st, March, 2022 after making the following adjustments:

Membership subscription included ₹ 10,000 received in advance and 75% of the entrance fees is to be capitalized.

Rent for ₹ 4,000 and salaries for ₹ 3,000 are outstanding.

Books are to be depreciated @ 10% including additions. Electrical fittings and furniture are also to be depreciated at the same rate.

Interest on securities is to be calculated @ 5% p.a. including purchases made on 1.10.2021 for ₹ 40,000.

SOLUTION

Smith Library Society
Income and Expenditure Account
for the year ended 31st March, 2022

Dr.					Cr.
Expenditure	₹	₹	Income		₹
To Electric charges		7,200	By Entrance fee (25% of ₹ 30,000)		7,500
To Postage and stationary		5,000			
To Telephone charges		5,000	By Membership subscription	2,00,000	
To Rent	88,000		Less: Received in advance	<u>10,000</u>	1,90,000
Add: Outstanding	<u>4,000</u>	92,000	By Sale proceeds of old papers		1,500
To Salaries	66,000		By Hire of lecture hall		20,000
Add: Outstanding	<u>3,000</u>	69,000	By Interest on securities(W.N.2)	8,000	
To Depreciation (W.N.1)			Add: Receivable	<u>500</u>	8,500
Electrical fittings	15,000		By Deficit- excess of expenditure over income		16,700
Furniture	5,000				
Books	<u>46,000</u>	66,000			
		<u>2,44,200</u>			<u>2,44,200</u>

Balance Sheet of Smith Library Society
as on 31st March, 2022

Liabilities	₹	₹	Asset	₹	₹
Capital fund	7,93,000		Electrical fittings	1,50,000	
Add: Entrance fees	<u>22,500</u>		Less: Depreciation	<u>(15,000)</u>	1,35,000
	8,15,500		Furniture	50,000	

Less: Excess of expenditure over income	(16,700)	7,98,800	Less: Depreciation Books	(5,000)	45,000
				4,60,000	
Outstanding expenses:			Less Depreciation	(46,000)	4,14,000
Rent	4,000		Investment:		
Salaries	3,000	7,000	Securities	1,90,000	
Membership subscription in advance		10,000	Accrued interest	500	1,90,500
		8,15,800	Cash at bank		20,000
			Cash in hand		11,300
					8,15,800

Working Notes:

1. Depreciation

	₹
Electrical fittings 10% of ₹ 1,50,000	15,000
Furniture 10% of ₹ 50,000	5,000
Books 10% of ₹ 4,60,000	46,000

2. Interest on Securities

Interest @ 5% p.a. on ₹ 1,50,000 for full year	7,500
Interest @ 5% p.a. on ₹ 40,000 for half year	1,000
Less: Received	(8,000)
Receivable	500

5. EDUCATIONAL INSTITUTIONS

Registration

The educational institutions which are functioning in India are mostly registered as Societies under the Indian Societies Registration Act of 1860, in some of the States, where Public Trust Acts have been passed all the Societies registered under the Indian Societies Registration Act, 1860 are required to be simultaneously registered under the Trust Act. Accordingly, in the State of Maharashtra, all the Societies have simultaneously been registered under the Bombay Public Trust Act, 1950.

Organizational Pattern

The Trust Societies are autonomous bodies with office bearers consisting of President, Secretary, Treasurer and Executive Committee Members. The General Body consists of all the Members of the Society. In case of Societies/Trusts which run a number of colleges and schools etc., for managing the affairs of each individual school or college, there is a governing

body, wherein the head of the Unit, such as Principal of the college or Head Master of the school as, the case may be, are also members of the Governing Body.

The function of the Governing Body is to supervise the smooth functioning of the individual school or college.

Salient Features

The basic tenets pre-suppose, that part of the expenses of the educational institutions are met from the funds raised by the educational institutions themselves, either from donations, or from charities, collected from benevolent citizens in the country.

The State Governments through grant-in-aid-code have evolved different patterns of giving assistance to the educational institutions. There is, as such, no uniformity in the giving of assistance to the educational institutions in the form of grants.

All the educational institutions follow financial year as their accounting year.

5.1 Sources of Finance for Running the Educational Institution

There are three main sources through which amounts are collected by the educational institutions. These are:

- (1) Donation from Public;
- (2) Fees in the form of annual tuition fees, term fees, admission fees, laboratory fee etc., and
- (3) Grants received from the Government.

The Government grants are of four kinds namely Maintenance Grant, Equipment grant, Building Grant and such other grants as may be sanctioned by the Government from time to time.

5.2 Specific items

5.2.1 Donation from Public

These are received either for recurring or non-recurring purposes. Donations are received either in cash or in kind. The 'in kind' donations are in the form of land and building, shares and securities, utensils, furniture and fixtures and the like, generally with a desire to perpetuate the memory of a distinguished member of the family of the donor.

5.2.2 Capitation fees or admission fees

Amounts are collected from parents/guardians of the students who seek admission in the educational institution. These are either in the form of capitation fees or admission fees and are generally collected by the Parent Body which runs the institution. In recent times, such collections have been a matter of severe attack and ban.

5.2.3 Laboratory and Library deposit

These are generally collected by schools and colleges and they remain with the institution till the student finally leaves it.

The School Code prescribes the rates of tuition and other fees, to be charged from the students.

5.2.4 Use of Term Fees

A separate account of receipts and expenditures shall be maintained and surplus carried over to the next year. The following are main items on which term fee can be used:

- (1) Medical Inspection.
- (2) School Magazine-manuscript and/or printing.
- (3) Examination expenses i.e. printing, of question papers and supply of answer books if there is sufficient balance.
- (4) Contribution to athletic and cultural associations, connected with school activities.
- (5) School functions and festivals.
- (6) Inter-class and Inter-school tournaments.
- (7) Sports and Games-major and minor.
- (8) Newspapers and magazines.
- (9) Extra-curricular excursion and visits.
- (10) School competition such as elocution competition etc.
- (11) Scouting and Guiding.
- (12) School Band.
- (13) Social and Cultural activities and equipment required for the same.
- (14) Vocational Guidance in general.
- (15) Prizes for Co-curricular activities.
- (16) Any other extra-curricular or co-curricular activities.
- (17) Maintenance of playground.
- (18) Purchase of books for Pupils Library.
- (19) Drawing and Craft material.
- (20) Audio-Visual Education.

- (21) Curricular visits and excursions.
- (22) Equipment for Physical education.

5.2.5 Recurring grants

Recurring grants in the form of Maintenance Grants are received in instalments spread out throughout the year.

5.2.6 Use of grant-in-aid

The School Code provides a detailed list of items of expenditure which are admissible for grant-in-aid:

- (1) Staff salaries and allowances
- (2) Leave Allowance.
- (3) Bad Climate Allowance.
- (4) Water Allowance.
- (5) Leave Salary.
- (6) Expenditure on training of teachers.
- (7) Pension and Gratuity as may be applicable.
- (8) Expenditure on the appointment of Librarian.
- (9) Rent, Taxes and Insurance.
- (10) Other Contingencies: expenditure of printing and stationery, conveyance expenditure, expenditure on purchase of books and furniture equipment.
- (11) Current repairs.
- (12) Miscellaneous Expenses: e.g. School Garden, Physical Education.
- (13) Prizes.
- (14) Expenditure on co-operative stores.
- (15) Registration fee paid to the Board for recognition.
- (16) Maintenance of Tiffin Rooms.
- (17) Bonus to Teachers.
- (18) Electrical charges.
- (19) Telephone Charges.
- (20) Expenditure in connection with Conferences.

- (21) Subscription to educational Association etc.
- (22) Medical charges.
- (23) Audit fees of the auditors in accordance with prescribed scale.
- (24) Sales-tax and General tax on purchase of the school requirements.
- (25) Payments for merit scholarships.

ILLUSTRATION 12

From the following balances and particulars of Republic College, prepare Income & Expenditure Account for the year ended March, 2022 and a Balance Sheet as on the date :

	₹	₹
<i>Seminars & Conference Receipts</i>		4,80,000
<i>Consultancy Receipts</i>		1,28,000
<i>Security Deposit - Students</i>		1,50,000
<i>Capital Fund</i>		16,06,000
<i>Research Fund</i>		8,00,000
<i>Building Fund</i>		25,00,000
<i>Provident Fund</i>		5,10,000
<i>Tuition Fee Received</i>		8,00,000
<i>Government Grants</i>		5,00,000
<i>Donations</i>		50,000
<i>Interest & Dividends on Investments</i>		1,85,000
<i>Hostel Room Rent</i>		1,75,000
<i>Mess Receipts (Net)</i>		2,00,000
<i>College Stores-Sales</i>		7,50,000
<i>Outstanding expenses</i>		2,25,000
<i>Stock of-stores and Supplies (opening)</i>	3,00,000	
<i>Purchases - Stores & Supplies</i>	8,00,000	
<i>Salaries - Teaching</i>	8,50,000	
<i>Research</i>	1,20,000	
<i>Scholarships</i>	80,000	
<i>Students Welfare expenses</i>	38,000	

<i>Repairs & Maintenance</i>	1,12,000	
<i>Games & Sports Expenses</i>	50,000	
<i>Misc. Expenses</i>	65,000	
<i>Research Fund Investments</i>	8,00,000	
<i>Other Investments</i>	18,50,000	
<i>Provident Fund Investment</i>	5,10,000	
<i>Seminar & Conference Expenses</i>	4,50,000	
<i>Consultancy Expenses</i>	28,000	
<i>Land</i>	1,00,000	
<i>Building</i>	16,00,000	
<i>Plant and Machinery</i>	8,50,000	
<i>Furniture and Fittings</i>	6,00,000	
<i>Motor Vehicle</i>	1,80,000	
<i>Provision for Depreciation:</i>		
<i>Building</i>		4,80,000
<i>Plant & Equipment</i>		5,10,000
<i>Furniture & Fittings</i>		3,36,000
<i>Cash at Bank</i>	6,42,000	
<i>Library</i>	3,60,000	
	1,03,85,000	1,03,85,000

Adjustments:

	₹
(1) <i>Materials & Supplies consumed: (From college stores)</i>	
<i>Teaching</i>	50,000
<i>Research</i>	1,50,000
<i>Students Welfare</i>	75,000
<i>Games or Sports</i>	25,000
(2) <i>Tuition fee receivable from Government for backward class Scholars</i>	80,000
(3) <i>Stores selling prices are fixed to give a net profit of 10% on selling price</i>	
(4) <i>Depreciation is provided on straight line basis at the following rates:</i>	

**FINANCIAL STATEMENTS OF NOT FOR
PROFIT ORGANISATIONS**

8.35

(1) Building	5%
(2) Plant & Equipment	10%
(3) Furniture & Fixtures	10%
(4) Motor Vehicle	20%

SOLUTION

Republic College

Income and Expenditure Account for the year ending 31st March, 2022

Expenditure	₹	₹	Income	₹	₹
To Salaries:			By Tuitions & other fee		8,80,000
Teaching		8,50,000	By Govt. Grants		5,00,000
Research		1,20,000			
To Material & Supplies Consumed:			By Income from		1,85,000
Teaching		50,000	By Investments Hostel		1,75,000
Research		1,50,000	room Rent		
To Repairs & Maintenance		1,12,000	By Mess Receipts		2,00,000
To Sports & Games Expenses:			By Profit-Stores Sales		75,000
Cash	50,000		By Seminar and Conferences:		
Materials	25,000	75,000	Income	4,80,000	
To Students Welfare Expenses:			By Less : Expenses	(4,50,000)	30,000
Cash	38,000		By Consultancy		
Materials	75,000	1,13,000	charges: Income	1,28,000	
To Misc. Expenses		65,000	Less : Expenses	(28,000)	1,00,000
To Scholarships		80,000	By Donations		50,000
To Depreciation:					
Building		80,000			

Plant & Equipment		85,000		
Furniture		60,000		
Motor Vehicle		36,000		
To Excess of Income over Expenditure		3,19,000		
		21,95,000		21,95,000

Republic College

Balance Sheet as on 31st March, 2022

Liabilities	₹	₹	Assets	₹	₹
Capital Fund			Fixed Assets:		
Opening balance	16,06,000		Land		1,00,000
Add: Excess of Income over Expenditure	3,19,000	19,25,000	Building Cost	16,00,000	
Other Funds			Less: Depreciation	(5,60,000)	10,40,000
Research Fund		8,00,000	Equipment Cost	8,50,000	
Building Fund		25,00,000	Less: Depreciation	(5,95,000)	2,55,000
Current Liabilities :			Furniture & Fittings:		
Outstanding Expenses		2,25,000	Cost	6,00,000	
Provident Fund		5,10,000	Less: Depreciation	(3,96,000)	2,04,000
Security Deposit		1,50,000	Motor Vehicles		
			Cost	1,80,000	
			Less: Depreciation	(36,000)	1,44,000
			Library		3,60,000
			Investments:		
			Capital Fund		18,50,000
			Investments		
			Research Fund		8,00,000
			Investment		
			P.F. Investment		5,10,000
			Stock (stores)		
			Material & Supplies		1,25,000

			Tuition fees receivable		80,000
			Cash in hand & at Bank		6,42,000
		61,10,000			61,10,000

Working Notes:

			₹	₹
(1)	Material & Supplies - Closing Stock			
	Opening Stock			3,00,000
	Purchases			8,00,000
				11,00,000
	Less : Cost of Material & Supplies [7,50,000*90% (100-10)]		6,75,000	
	Consumed		3,00,000	(9,75,000)
	Balance			1,25,000
(2)	Provisions for Depreciation			
		Building	Plant & Equipment	Furniture & Fitting
		₹	₹	₹
	Opening Balance	4,80,000	5,10,000	3,36,000
	Addition	80,000	85,000	60,000
	Closing Balance	5,60,000	5,95,000	3,96,000
	Note: Expense related to income earned like consultancy charges, conference expenses are shown as net of income.			

SUMMARY

- ◆ A non profit organization is a legal accounting entity that is operated for the benefit of the society as a whole, rather than for the benefit of a sole proprietor or a group of partners or shareholders. Financial Statements of such organizations consists of:
 1. Receipts and Payments Account
 2. Income and Expenditure Account
 3. Balance Sheet
- ◆ A Receipts and Payments Account is a summary of the cash book.
- ◆ The income and expenditure account is equivalent to the Profit and Loss Account of a profit making enterprise and is based on the accrual principle of accounting. Only items of revenue nature pertaining to the current accounting period are recorded.
- ◆ Non-profit organizations registered under section 8 of the Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per the Schedule III to the Companies Act, 2013.
- ◆ It may be noted that after various accounts have been adjusted as is considered necessary - all the revenue accounts shall be closed by transfer to the Income and Expenditure Account, and the remaining balances of capital accounts will be closed by transferring the balances to the balance sheet. To ascertain the opening capital fund- the opening balance sheet will also be prepared. A balance sheet is thus a complement to such an account.
- ◆ Donations, Entrance and Admission Fees, Subscription, Life Membership Fee are some of the sources of incomes for the non-profit organizations. These sources of income are either taken to the Income and Expenditure account or the balance sheet, based on the nature, of the receipt.
- ◆ Educational institutions are quite different from other not-for-profit organisations in terms of sources of finance and items of expenditure.

TEST YOUR KNOWLEDGE

True and False

1. *The Receipts and payment account for a non-profit organization follows the accrual concept of accounting.*
2. *Both the revenue and capital nature transactions are recorded in the Income and expenditure account.*
3. *Sale of grass by a sports club is to be treated as sale of an asset.*
4. *Subscriptions outstanding for the current year are disclosed under the Fixed assets side of the Balance sheet.*
5. *Receipts and payments account gives the details about the expenses outstanding for the year.*
6. *Adjustments in the form of additional information shall be adjusted in the final accounts of a Non- profit organisation only in one place.*
7. *Tournament expenses incurred are more than the Tournament fund, then the excess to be shown as an asset in the closing Balance sheet.*
8. *For Non-profit organisation, Excess of income over expenditure in the Income and Expenditure account is termed as profit.*
9. *Surplus of non-profit organizations is distributed among its members.*
10. *Tournament fund, building fund, library fund is based on the fund based accounting.*
11. *Subscription fees refers to the one-time fees paid by the members to get admission for the benefits of the club.*
12. *Token payment made to a person, who voluntarily undertakes a service which would normally be paid in case of profitable organization is termed as Honorarium.*
13. *An Insurance company is an example of non-profit organization.*
14. *Part amount of entrance fees which is to be capitalized shall be disclosed in the income and expenditure account.*
15. *Both the income and expenditure of the current and the previous year are recorded in the Income and Expenditure account.*
16. *Amount received as donation by an Non-profit organisation under the will of a deceased person is termed as legacy.*

17. *Where a Non-profit organisation has a separate trading activity, the profit/loss from the trading account shall be transferred to Income and Expenditure Account at the time of consolidation.*
18. *Not for profit concerns concentrate their efforts to maximize the profit earning avenues.*
19. *All the receipts are of revenue nature in case of Non-profit organisation.*
20. *There is opening balance of Income and expenditure account.*

Multiple Choice Questions

1. *Scholarship granted to students out of specific funds provided by Government will be debited to*
 - (a) *Income and Expenditure Account.*
 - (b) *Receipts and payments Account.*
 - (c) *Funds granted for Scholarship account.*
2. *In case of NPO, excess of total assets over liabilities is known as*
 - (a) *Profits.*
 - (b) *Surplus.*
 - (c) *Capital Fund.*
3. *General donations and legacies are credited to*
 - (a) *Receipts and Payments Account.*
 - (b) *Income and Expenditure Account.*
 - (c) *Capital Fund.*
4. *Interest on prize funds is*
 - (a) *Credited to Income and Expenditure Account.*
 - (b) *Credited to Receipts and Payments Account.*
 - (c) *Added to prize fund.*
5. *Special aids are*
 - (a) *Treated as capital receipts.*
 - (b) *Treated as revenue receipts.*
 - (c) *Both (a) and (c).*

6. If there exist a specific sports fund, the expenses incurred in relation to sports activities will be taken to
- Income and Expenditure Account
 - Receipt and Payment Account
 - Sports fund

Theory Questions

- Distinguish between Receipt and Payment and Income and Expenditure Account.

Practical Questions

- The following is the Receipts and Payments Account of Lion Club for the year ended 31st March, 2022.

Receipts	₹	Payments	₹
Opening balance:		Salaries	1,20,000
Cash	10,000	Creditors	15,20,000
Bank	3,850	Printing and stationary	70,000
Subscription received	2,02,750	Postage	40,000
Entrance donation	1,00,000	Telephones and telex	52,000
Interest received	58,000	Repairs and maintenance	48,000
Sale of assets	8,000	Glass and table linen	12,000
Miscellaneous income	9,000	Crockery and cutlery	14,000
Receipts at		Garden upkeep	8,000
Coffee room	10,70,000	Membership fees	4,000
Soft drinks	5,10,000	Insurance	5,000
Swimming pool	80,000	Electricity	28,000
Tennis court	1,02,000	Closing balance:	
		Cash	8,000
		Bank	2,24,600
	21,53,600		21,53,600

The assets and liabilities as on 1.4.2021 were as follows:

	₹
Fixed assets (net)	5,00,000

Stock	3,80,000
Investment in 12% Government securities	5,00,000
Outstanding subscription	12,000
Prepaid insurance	1,000
Sundry creditors	1,12,000
Subscription received in advance	15,000
Entrance donation received pending membership	1,00,000
Gratuity fund	1,50,000

The following adjustments are to be made while drawing up the accounts:

- (i) Subscription received in advance as on 31st March, 2022 was ₹ 18,000.
- (ii) Outstanding subscription as on 31st March, 2022 was ₹ 7,000.
- (iii) Outstanding expenses are salaries ₹ 8,000 and electricity ₹ 15,000.
- (iv) 50% of the entrance donation was to be capitalized. There was no pending membership as on 31st March, 2022.
- (v) The cost of assets sold net as on 1.4.2021 was ₹ 10,000.
- (vi) Depreciation is to be provided at the rate of 10% on assets.
- (vii) A sum of ₹ 20,000 received in October 2021 as entrance donation from an applicant was to be refunded as he has not fulfilled the requisite membership qualifications. The refund was made on 3.6.2022.
- (viii) Purchases made during the year amounted ₹ 15,00,000.
- (ix) The value of closing stock was ₹ 2,10,000.
- (x) The club as a matter of policy, charges off to income and expenditure account all purchases made on account of crockery, cutlery, glass and linen in the year of purchase.

You are required to prepare an Income and Expenditure Account for the year ended 31st March, 2022 and the Balance Sheet as on 31st March, 2022 along with necessary workings.

2. During the year ended 31st March, 2022, Sachin Cricket Club received subscriptions as follows:

	₹
For year ending 31st March, 2021	12,000
For year ending 31st March, 2022	6,15,000

For year ending 31st March, 2023	18,000
Total	6,45,000

There are 500 members and annual subscription is ₹ 1,500 per member.

On 31st March, 2022, a sum of ₹ 15,000 was still in arrears for subscriptions for the year ended 31st March, 2021.

Ascertain the amount of subscriptions that will appear on the credit side of Income and Expenditure Account for the year ended 31st March, 2022. Also show how the items would appear in the Balance Sheet as on 31st March, 2021 and the Balance Sheet as on 31st March, 2022.

3. Summary of receipts and payments of Bombay Medical Aid society for the year ended 31.12.2022 are as follows:

Opening cash balance in hand ₹ 8,000, subscription ₹ 50,000, donation ₹ 15,000 (raised for meeting revenue expenditure), interest on investments @ 9% p.a. ₹ 9000, payments for medicine supply ₹ 30,000 Honorarium to doctor ₹ 10,000, salaries ₹ 28,000, sundry expenses ₹ 1,000, equipment purchase ₹ 15,000, charity show expenses ₹ 1,500, charity show collections ₹ 12,500.

Additional information:

	1.1.2022	31.12.2022
Subscription due	1,500	2,200
Subscription received in advance	1,200	700
Stock of medicine	10,000	15,000
Amount due for medicine supply	9,000	13,000
Value of equipment	21,000	30,000
Value of building	50,000	48,000

You are required to prepare receipts and payments account and income and expenditure account for the year ended 31.12.2022 and balance sheet as on 31.12.2022.

ANSWER / HINTS

True and False

- False: It depicts the cash system of accounting rather than the accrual system, as the cash receipts and payments pertaining to any year are entered in the Receipts and

payments account. The principle of accrual is not followed with regard to the receipts and payments account of a non-profit organization.

2. False: The income and expenditure account records only the revenue income and expenditure. The capital transactions are being recorded in the Balance sheet.
3. False: The grass for a sports club is not a capital item, hence the sale of such grass shall be treated as a revenue receipt.
4. False: They are disclosed under the current assets of the Balance sheet as they will be paid within the next year and not to be treated as non-current assets.
5. False: Receipts and payments account gives information about the expenses paid in cash for the current year, previous or the next year. It is only from the additional information we identify the outstanding expenses.
6. False: Additional information means that information which has been identified just before the preparation of the final accounts. As NPO follows the double entry system of book keeping, there shall be 2 effects for each of the additional information.
7. False: The excess of expenditure over the tournament fund shall be debited to the income and expenditure account and not taken to the closing balance sheet.
8. False: The excess of the income over the expenditure is called as Surplus and not profit for an Non-profit organisation.
9. False: The Non-profit organisation credits the surplus earned in a year to the general fund maintained by it.
10. True: It is Fund based accounting that records the fund balances in the balance sheet.
11. False: Subscription is a regular fees paid by the members to keep the membership alive.
12. True: Honorarium refers to the nominal amount paid for the services with a non-commercial intent.
13. False: Insurance Company has a profit motive, hence it is not a non-profit organization.
14. False: It shall be shown in the Balance sheet- where it is to be capitalized.
15. False: It is only the current year income and expenditure which is recorded in the Income and Expenditure account as per the accrual concept.
16. True: While on the death bed, if there is any will written that the assets of a person shall be donated to any NPO- then such a donation to the NPO, is termed as Legacy.
17. True: Where in case of the trading activities, the profit /loss from such activity to be transferred to the Income and expenditure account in case of consolidated accounts.

18. False: The Non-profit organisation has its very existence to serve the members and the society. Profit earning shall never be its motive.
19. False: Receipts can be both of revenue as well as capital nature. Receipts of both the nature are recorded in the receipts and payments account.
20. False: It represents a nominal account and is prepared in accordance with the accrual concept, hence there can be no opening balances.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(b)	4.	(c)	5.	(c)	6.	(c)

Theoretical Questions

1. Non-profit making organizations such as public hospitals, public educational institutions, clubs etc., conventionally prepare Receipt and Payment Account and Income and Expenditure Account to show periodic performance for a particular accounting period. For distinguishing features of both the accounts, Refer para 3.2.

Practical Questions

1. **Income and Expenditure Account of Lion Club**
for the year ended 31st March, 2022

Expenditure	₹	Income	₹
To Salaries	1,28,000	By Subscription	1,94,750
To Printing and stationary	70,000	By Entrance donation	90,000
To Postage	40,000	By Interest	60,000
To Telephone and telex	52,000	By Miscellaneous income	9,000
To Repairs and maintenance	48,000	By Profit from operations	92,000
To Glass and table linen	12,000	By Excess of expenditure over income	
To Crockery and cutlery	14,000	(deficit) transferred to capital fund	30,250
To Garden upkeep	8,000		
To Membership fees	4,000		
To Insurance	6,000		

To Electricity charges	43,000		
To Loss on sale of assets	2,000		
To Depreciation	49,000		
	4,76,000		4,76,000

Balance Sheet of Lion Club as on 31st March, 2022

Liabilities	₹	Assets	₹
Capital fund	10,89,600	Fixed assets	4,41,000
Gratuity fund	1,50,000	Stock	2,10,000
Sundry creditors	92,000	Investments	5,00,000
Subscription received in advance	18,000	Subscription outstanding	7,000
Entrance donation refundable	20,000	Interest accrued	2,000
Outstanding expenses	23,000	Bank	2,24,600
		Cash	8,000
	13,92,600		13,92,600

Working Notes:

1.

Opening Balance Sheet

Balance Sheet of Lion Club as on 1st April, 2021

Liabilities	₹	Assets	₹
Sundry creditors	1,12,000	Fixed assets	5,00,000
Subscription received in advance	15,000	Stock	3,80,000
Entrance donation received in advance	1,00,000	Investments	5,00,000
Gratuity fund	1,50,000	Subscription outstanding	12,000
Capital fund (balance figure)	10,29,850	Prepaid expenses	1,000
		Cash	10,000
		Bank	3,850
	14,06,850		14,06,850

2. **Subscription**

	₹
Subscription received during the year	2,02,750
<i>Add:</i> Outstanding subscription on 31.3.2022	7,000
	2,09,750
<i>Add:</i> Received in advance as on 1.4.2021	15,000
	2,24,750
<i>Less:</i> Outstanding subscription as on 1.4.2021	(12,000)
	2,12,750
<i>Less:</i> Received in advance as on 31.3.2022	(18,000)
	1,94,750

3. Entrance donation

	₹
Entrance donation received during the year	1,00,000
<i>Add:</i> Received in advance as on 1.4.2021	1,00,000
	2,00,000
<i>Less:</i> Entrance donation in respect of ineligible member	(20,000)
	1,80,000
<i>Less:</i> 50% capitalized	(90,000)
Taken to income and expenditure account	90,000

4. Loss on sale of asset

	₹
Cost of asset sold	10,000
<i>Less: Sale proceeds</i>	(8,000)
Loss on sale of asset	2,000

5. Depreciation

	₹
Fixed asset as per trial balance	5,00,000
<i>Less: Cost of asset sold</i>	(10,000)
	4,90,000
Depreciation on ₹ 4,90,000 @ 10%	49,000

6. Salaries

	₹
Salary paid during the year	1,20,000
<i>Add: Outstanding as on 31.3.2022</i>	8,000
	1,28,000

7. Electricity charges

	₹
Electricity charges paid during the year	28,000
<i>Add: Outstanding as on 31.3.2022</i>	15,000
	43,000

8. Interest

	₹
Interest on 12% Government securities investment (₹ 5,00,000 @ 12% p.a.)	60,000
<i>Less: Interest received during the year</i>	(58,000)
Interest accrued	2,000
Interest credited to Income and Expenditure Account	60,000

9. Profit from operations

	₹
Cost of goods sold:	
Opening stock	3,80,000
Add: Purchases	15,00,000
	18,80,000
Less: Closing stock	(2,10,000)
Cost of goods sold (A)	16,70,000
Receipts from operations:	
Receipts from coffee room	10,70,000
Receipts from soft drinks	5,10,000
Receipts from swimming pool	80,000
Receipts from tennis court	1,02,000
Total receipts (B)	17,62,000
Profits from operations (B-A)	92,000

10. Insurance

	₹
Insurance paid during the year	5,000
Add: Prepaid insurance as on 1.4.2021	1,000
	6,000

11. Sundry creditors

	₹
Opening balance as on 1.4.2021	1,12,000
Add: Purchases made during the year	15,00,000
	16,12,000
Less: Payments made during the year	(15,20,000)
Closing balance as on 31.3.2022	92,000

12. Outstanding expenses

	₹
Outstanding salaries	8,000
Outstanding electricity charges	15,000
Outstanding expenses	23,000

13. Fixed assets

	₹
Fixed assets as on 1.4.2021	5,00,000
Less: Cost of assets sold	(10,000)
	4,90,000
Less: Depreciation	(49,000)
Fixed assets as on 31.3.2022	4,41,000

14. Capital fund

	₹
Capital fund as on 1.4.2021	10,29,850
Add: Entrance donation capitalised	90,000
	11,19,850
Less: Excess of expenditure over income	(30,250)
Balance as on 31.3.2022	10,89,600

2. Income & Expenditure Account (An extract) of Sachin Cricket Club
for the year ended 31st March, 2022

	₹		₹
		By Subscription (500 members × ₹ 1,500 per member)	7,50,000

Balance Sheet of Sachin Cricket Club as on 31st March, 2021 (An extract)

Liabilities	₹	Assets	₹
		Subscription Receivable (₹15,000 + ₹12,000)	27,000

Balance Sheet of Sachin Cricket Club as on 31st March, 2022 (An extract)

Liabilities	₹	Assets	₹	₹
Unearned Subscription	18,000	Outstanding Subscription		
		of 2020-21	15,000	
		of 2021-22		
		₹ (7,50,000 – 6,15,000)	1,35,000	1,50,000

**3. Receipts and Payments Account of Bombay Medical Aid Society
for the year ended 31st December, 2022**

Receipts	₹	Payments	₹
To Cash in hand (opening)	8,000	By Medicine supply	30,000
To Subscription	50,000	By Honorarium to doctors	10,000
To Donation	15,000	By Salaries	28,000
To Interest on investment	9,000	By Sundry expenses	1,000
To Charity show collections	12,500	By Purchase of equipment	15,000
		By Charity show expenses	1,500
		By Cash in hand (closing)	9,000
	94,500		94,500

**Income and Expenditure Account of Bombay Medical Aid Society
for the year ended 31st December, 2022**

Expenditure		₹	Income		₹
To Medicine consumed		29,000	By Subscription		51,200
To Honorarium to doctors		10,000	By Donation		15,000
To Salaries		28,000	By Interest on investments		9,000
To Sundry expenses		1,000	By Profit on charity show:		
To Depreciation on			Show collections	12,500	
To Depreciation on			Less: Show expenses	(1,500)	11,000
Equipment	6,000				
Building	2,000	8,000			

To Surplus-excess of income over expenditure		10,200		
		86,200		86,200

**Balance Sheet of Bombay Medical Aid Society
as on 31st December, 2022**

Liabilities	₹	₹	Assets	₹	₹
Capital fund:			Building	50,000	
Opening balance	1,80,300		Less: Depreciation	(2,000)	48,000
Add: Surplus	10,200	1,90,500	Equipment	21,000	
Subscription received in advance		700	Add: Purchase	15,000	
Amount due for medicine supply		13,000		36,000	
			Less: Depreciation	(6,000)	30,000
			Stock of medicine		15,000
			Investments		1,00,000
			Subscription receivable		2,200
			Cash in hand		9,000
		2,04,200			2,04,200

Working Notes:

Subscription for the year ended 31st December, 2022:		₹
Subscription received during the year		50,000
Less: Subscription receivable on 1.1.2022	1,500	
Less: Subscription received in advance on 31.12.2022	700	(2,200)
		47,800
Add: Subscription receivable on 31.12.2022	2,200	
Add: Subscription received in advance on 1.1.2022	1,200	3,400
		51,200

Purchase of medicine:	
Payment for medicine supply	30,000
Less: Amounts due for medicine supply on 1.1.2022	(9,000)
	21,000
Add: Amounts due for medicine supply on 31.12.2022	13,000
	34,000
Medicine consumed:	
Stock of medicine on 1.1.2022	10,000
Add: Purchase of medicine during the year	34,000
	44,000
Less: Stock of medicine on 31.12.2022	(15,000)
	29,000
Depreciation on equipment:	
Value of equipment on 1.1.2022	21,000
Add: Purchase of equipment during the year	15,000
	36,000
Less: Value of equipment on 31.12.2022	(30,000)
Depreciation on equipment for the year	6,000

**Balance Sheet of Medical Aid Society
as on 1st January, 2022**

Liabilities	₹	Assets	₹
Capital fund (balancing figure)	1,80,300	Building	50,000
Subscription received in advance	1,200	Equipment	21,000
Amount due for medicine supply	9,000	Stock of medicine	10,000
		Investments (₹ 9,000 x 100/9)	1,00,000
		Subscription receivable	1,500
		Cash in hand	8,000
	1,90,500		1,90,500

NOTES

[illegible]



ACCOUNTS FROM INCOMPLETE RECORDS

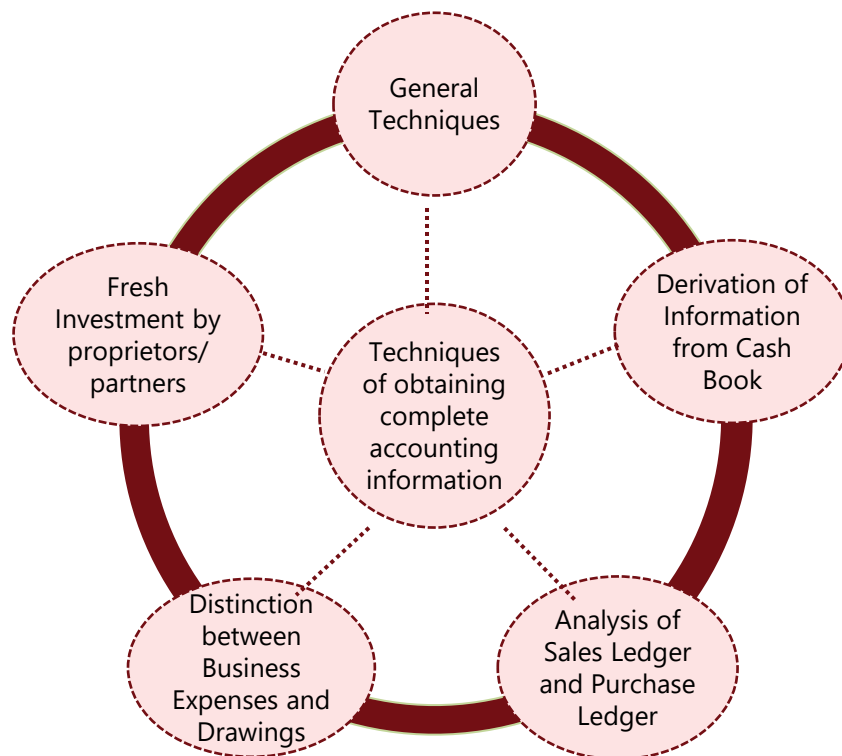
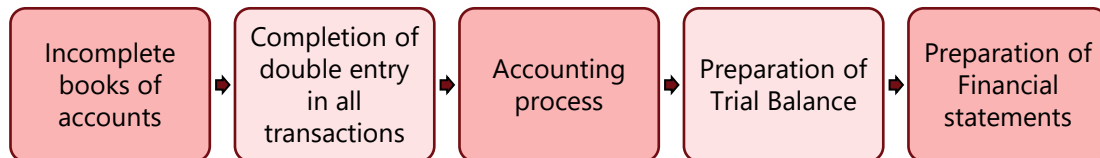
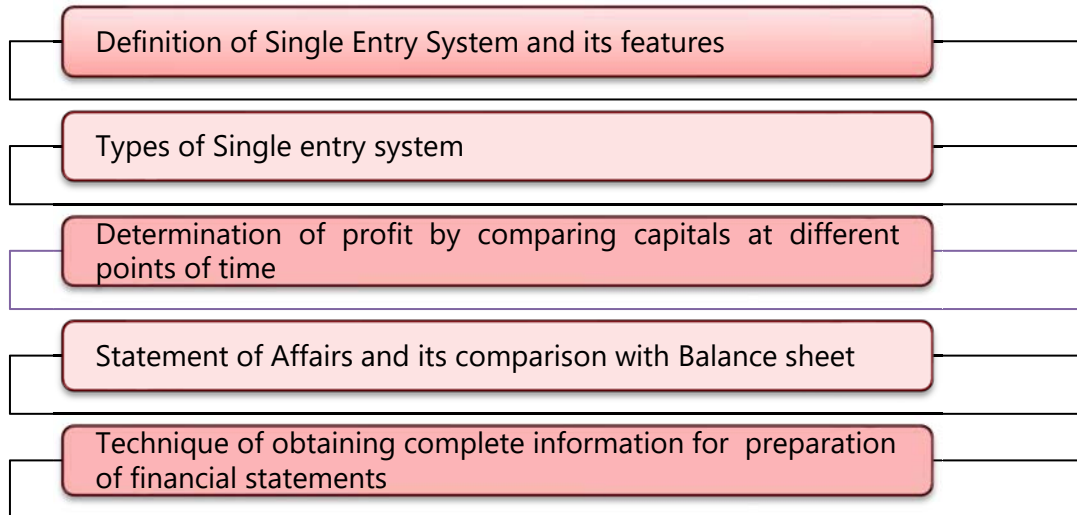


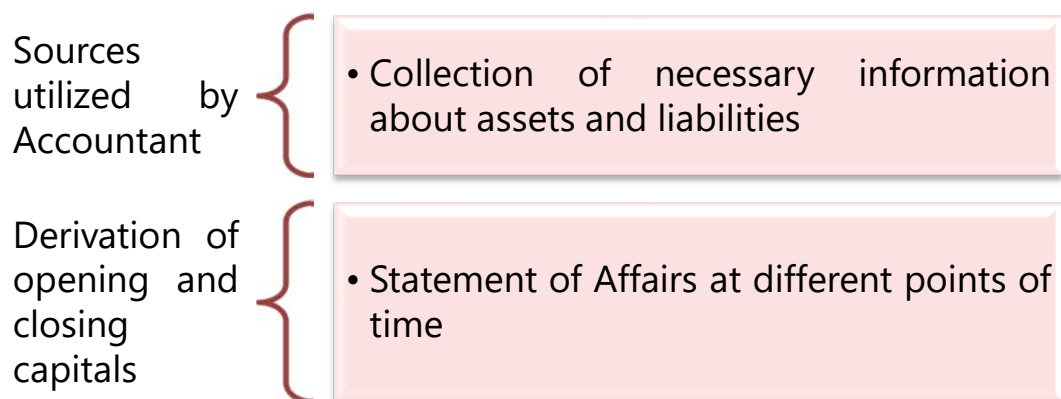
LEARNING OUTCOMES

After studying this Chapter, you would be able to:

- ◆ Learn how to derive capitals at two different points of time through statement of affairs.
- ◆ Learn the technique of determining profit by comparing capital at two different points of time.
- ◆ Prepare Trading and Profit and Loss Account and Balance Sheet from incomplete records.

CHAPTER OVERVIEW





1. INTRODUCTION

Very often small sole proprietorship and partnership businesses do not maintain double entry book keeping. There might be reasons like lack of knowledge of accounting, or the business is small and they do not wish to spend time or effort in maintaining the accounting records. As such, they might keep a record of the cash transactions and credit transactions only. But at the end of the accounting period, they will want to know the performance and financial position of their businesses. Think of a grocery-vendor who sells vegetables on a street or runs a small shop. Is he expected to learn accounting formally? No, he is only looking at keeping a record of a few items including:

- What amount is he supposed to pay for items purchased on credit from his supplier?
- What cash has he collected by selling those vegetables?
- In case he runs a shop, how much amount has he paid for rent or electricity expenses?
- In case he sells some items on credit, how much is he supposed to receive from that customer?

There might be other reasons for incomplete records such as:

- Accounting records are destroyed by accident, such as fire;
- Some essential figure is unknown and must be calculated as a balancing figure (for example, due to inventory being damaged or destroyed).

Every person would like to know the profit generated by the business. What we expect to learn is how to use those records to arrive at the profit or loss earned by the business or understand the financial position of that business.

This chapter discusses how to complete the accounts from available incomplete records and addresses the problems faced in a single-entry system.

There is no such formal system as Single-Entry System as the accounts can only be prepared using Double Entry System. It might be appropriate to mention that a single-entry system is truly a system of incomplete or improper records.

The way “**Single Entry System**” operates is that for some transactions the book-keepers complete entries and for some others they complete just one aspect of the transaction. In fact, for some other transactions, they even do not pass any entry. The task of the accountant is to establish link among the available information and to finalize these accounts.

Normally, the businessmen keep a record of cash receipts and cash payments and personal accounts (receivables, payables, capital etc.) Also, information from bank statement (withdrawals, deposits) is easily available as well.

Features of Single Entry System

- It is an inaccurate, unscientific and unsystematic method of recording business transactions.
- There is generally no record of real and nominal accounts and, in most of the cases; a record is kept for cash transactions and personal accounts.
- Cash book mixes up business and personal transactions of the owners.
- There is no uniformity in maintaining the records and the system may differ from firm to firm depending on the requirements and convenience of each firm.
- Profit under this system is only an estimate based on available information and therefore true and correct profits cannot be determined. The same is the case with the financial position in the absence of a proper balance sheet.



2. TYPES OF SINGLE ENTRY SYSTEM

A scrutiny of many procedures adopted in maintaining records under single entry system brings forth the existence of following three types:

- (i) **Pure single entry:** In this, only personal accounts are maintained with the result that no information is available in respect of cash and bank balances, sales and purchases, etc. In view of its failure to provide even the basic information regarding cash etc., this method exists only on paper and has no practical application.
- (ii) **Simple single entry:** In this, only: (a) personal accounts, and (b) cash book are maintained. Although these accounts are kept on the basis of double entry system, postings from cash book are made only to personal accounts with no other account to be found in the ledger. Cash received from debtors or cash paid to creditors is simply noted on the bills issued or received as the case may be.

For example, M/s Small shop runs a retail shop. It keeps a register of amount receivable from people for items sold (bread, butter, milk etc). as under:

Mr. A – ₹ 300

Mr. B – ₹ 450

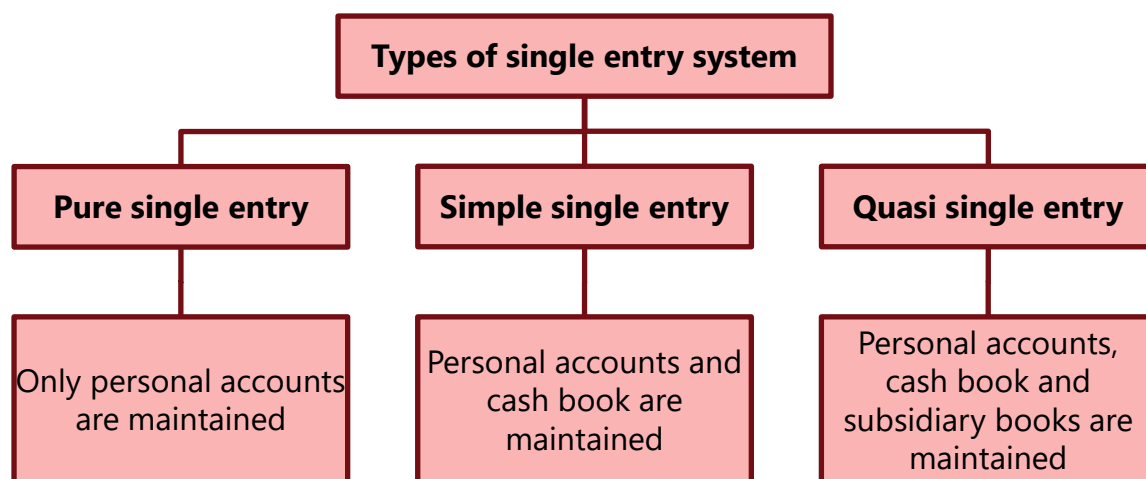
Mr. C – ₹ 260.

The business does not maintain a record of what item has been sold. It is only concerned about the amount receivable (personal account balance) from its customers.

- (iii) **Quasi single entry:** In this: (a) personal accounts, (b) cash book, and (c) some subsidiary books are maintained. The main subsidiary books kept under this system are Sales book, Purchases book and Bills book. No separate record is maintained for discounts, which are entered into the personal accounts. In addition, some scattered information is also available in respect of few important items of expenses like wages, rent, rates, etc. In fact, this is the method which is generally adopted as a substitute for double entry system.

Some businesses may also maintain additional records like Bills book or Sales book. This might be required for tax or other purposes. For example, a shop selling t-shirts may want to issue a bill to each customer for the sales made to them. This will help them validate any returns of goods within reasonable time. In addition, they may keep a purchase book to record all purchases.

Also, organisations employing workers keep records of cash wages paid and take acceptance from the workers for the amount paid to them.





3. ASCERTAINMENT OF PROFIT BY CAPITAL COMPARISON

This method is also known as **Net Worth method or Statement of Affairs Method**.

Net Worth method or Statement of Affairs Method.



If detailed information regarding revenue and expenses is not known, it becomes difficult to prepare profit and loss account. Instead by collecting information about assets and liabilities, it is easier to prepare balance sheet at two different points of time. So, while preparing accounts from incomplete records, if sufficient information is not available, it is better to follow the method of capital comparison to arrive at the profit/loss for the current year.

3.1 Methods of Capital Comparison

Closing capital increases if there is profit, while it reduces if there is loss incurred during the year. However, if the proprietor/partners make fresh investments in the business, capital increases; and any withdrawal made by them, decreases the capital.

The following points shall be considered while computing the profit/loss under capital comparison method-

Particulars	₹
Capital at the end (a)	XX
Add: Drawings	XX
Less: Fresh capital introduced	XX
Capital at the beginning (b)	<u>XX</u>
Profit (a-b)	<u>XX</u>

ILLUSTRATION 1

Raju does not maintain proper records of his business. However, he provides the following information:

	₹
Opening capital	10,000
Closing capital	12,500

Drawings during the year 3,000

Capital added during the year 3,750

You are required to calculate the profit or loss for the year.

SOLUTION

Computation of Profit or Loss during the year

	₹
Closing Capital	12,500
Add: Drawings during the year	<u>3,000</u>
	15,500
Less: Additional capital during the year	(3,750)
Less: opening capital	<u>(10,000)</u>
Net Profit for the year	<u>1,750</u>

ALTERNATIVELY

Profit/Loss can also be ascertained as balancing figure by preparing capital account as follows:

Particulars	₹	Particulars	₹
To drawings	3,000	By Balance b/d	10,000
To Balance c/d	12,500	By additional capital	3,750
		By Net Profit (Bal Fig)	1,750
	15,500		15,500

It is clear from the above discussion that to follow the capital comparison method, one should know the opening capital and closing capital. This should be determined by preparing statement of affairs at the two respective points of time.

Capital = Assets (-) liabilities.

Thus, the preparation of statement of affairs will require listing of assets and liabilities and their amount. The accountant utilizes the following sources for the purpose of finding out the assets and liabilities of a business enterprise:

- Cash book for cash balance
- Bank pass book for bank balance
- Personal ledger for debtors and creditors
- Inventory by actual counting and valuation.

- (v) As regards fixed assets, he prepares a list of them. The proprietor would help him by disclosing the original cost and date of purchase. After deducting reasonable amount of depreciation, the written down value would be included in the Statement of Affairs.

After obtaining all necessary information about assets and liabilities, the next task of the accountant is to prepare statement of affairs at two different points in time.

The design of the statement of affairs is just like balance sheet as given below:

Statement of affairs as on.....

Liabilities	₹	Assets	₹
Capital (Bal. Fig.)	xx	Building	xx
Loans, Bank overdraft	xx	Machinery	xx
Sundry creditors	xx	Furniture	xx
Bills payable	xx	Inventory	xx
Outstanding expenses		Sundry debtors	xx
		Bills receivable	xx
		Loans and advances	xx
		Cash and bank	xx
		Prepaid expenses	xx
	xx		xx

Now from the statement of affairs prepared at two different dates, the opening and closing capital balances can be obtained.

ILLUSTRATION 2

Rakesh started his business on 1st of April 2021. He invested a capital of Rs 1,00,000. On 31st March 2022, he has the following information available as per the Single-entry system maintained by him.

	₹
Cash balance (counted)	3,200
Inventory (physically verified)	34,800
Receivable from Ajay against credit sales	31,000
Machine	85,000
Payable to Vinod towards credit purchase	12,000

Loan taken from Bank 10,000

Drawings made during the year 24,000

You are required to calculate the profit or loss earned by Rakesh for the year ended 31st March 2022.

SOLUTION
Statement of Affairs as on 31st March, 2022

Liabilities	Amount	Assets	Amount
Sundry Creditors	12,000	Cash balance	3,200
Loan from bank	10,000	Inventory	34,800
Capital (Bal fig)	1,32,000	Sundry Debtors	31,000
		Machine	85,000
	1,54,000		1,54,000

Statement of profit or loss for the year ended 31st March, 2022

Capital as at 31st March 2022	1,32,000
Add: Drawings made during the year	<u>24,000</u>
Total	1,56,000
Less: Opening Capital as at 1st April 2021	<u>(1,00,000)</u>
Profit for the year ended 31st March 2022	<u>56,000</u>

3.2 Difference between Statement of Affairs and Balance Sheet

Basis	Statement of affairs	Balance sheet
Source	It is prepared on the basis of transactions partly recorded under the double entry book keeping and partly under the single entry. Most of the assets are recorded based on the estimates, assumptions, information gathered from memory rather from the records.	It is based on transactions recorded strictly on the basis of double entry book keeping; each item in the balance sheet can be verified from the relevant subsidiary books, ledger and documentary evidences.
Capital	In this statement, capital is merely a balancing figure	Capital is derived from the capital account in the ledger and therefore the total of

	being excess of assets over liabilities. Hence assets need not be equal to liabilities.	assets side will always be equal to the total of liabilities side.
Omission	Since this statement is prepared from incomplete records, it is very difficult, to identify and record those assets and liabilities, if omitted from the books.	There is no possibility of omission of any item of asset and liability since all items are properly recorded. Moreover, it is easy to locate the missing items since the balance sheet will not agree.
Basis of Valuation	The valuation of assets is generally done in an arbitrary manner; therefore, no method of valuation is disclosed.	The valuation of assets is done on scientific basis, fixed assets are shown at the original costs less depreciation till date. Any change in the method of valuation is properly disclosed.
Objective	The objective of preparing this statement is to identify the capital figures in the beginning and at the end of the accounting period respectively.	The objective of preparing the balance sheet is to ascertain the financial position on a particular date.

3.3 Preparation of Statement of Affairs and Determination of Profit

It has been discussed in Para 3.1 that figures of assets and liabilities should be collected for preparation of statement of affairs. Given below an example:

ILLUSTRATION 3

Assets and Liabilities of Mr. X as on 31-03-2021 and 31-03-2022 are as follows:

	31-03-2021	31-03-2022
	₹	₹
Assets		
Building	1,00,000	?
Furniture	50,000	?
Inventory	1,20,000	2,70,000
Sundry debtors	40,000	90,000
Cash at bank	70,000	85,000

Cash in hand	1,200	3,200
Liabilities		
Loans	1,00,000	80,000
Sundry creditors	40,000	70,000

Decided to depreciate building by 2.5%p.a. and furniture by 10% p.a. One Life Insurance Policy of the Proprietor was matured during the period and the amount ₹ 40,000 is retained in the business. Proprietor took @ ₹ 2,000 p.m. for meeting family expenses.

Prepare Statement of Affairs as on 31-03-2021 and 31-03-2022.

SOLUTION

Mr. X

Statement of Affairs as on 31-03-2021 & 31-03-2022

Liabilities	31-03-2021 ₹	31-03-2022 ₹	Assets	31-03-2021 ₹	31-03-2022 ₹
Capital	2,41,200	4,40,700	Building	1,00,000	97,500
Loans	1,00,000	80,000	Furniture	50,000	45,000
Sundry creditors	40,000	70,000	Inventory	1,20,000	2,70,000
			Sundry debtors	40,000	90,000
			Cash at bank	70,000	85,000
			Cash in hand	1,200	3,200
	3,81,200	5,90,700		3,81,200	5,90,700

ILLUSTRATION 4

Take figures given in Illustration 4. Find out profit of Mr. X for the year ended 31-03-2022.

SOLUTION

Determination of Profit by applying the method of the capital comparison

	₹
Capital Balance as on 31-03-2022	4,40,700
Less: Fresh capital introduced	(40,000)
	4,00,700

Add: Drawings (₹ 2000 × 12)	24,000
	4,24,700
Less: Capital Balance as on 31-03-2021	(2,41,200)
Profit	1,83,500

Note:

- Closing capital is increased due to fresh capital introduction, so it is deducted.
- Closing capital was reduced due to withdrawal by proprietor; so it is added back.

ALTERNATIVELY

Capital account can be prepared as follows:

Particulars	₹	Particulars	₹
To drawings	24,000	By Balance b/d	2,41,200
To Balance c/d	4,40,700	By additional capital	40,000
		By Net Profit (Bal Fig)	1,83,500
	4,64,700		4,64,700

ILLUSTRATION 5

The Income Tax Officer, on assessing the income of Shri Moti for the financial years 2020-2021 and 2021-2022 feels that Shri Moti has not disclosed the full income. He gives you the following particulars of assets and liabilities of Shri Moti as on 1st April, 2020 and 1st April, 2022.

₹			
1-4-2020	Assets	:	
		Cash in hand	25,500
		Inventory	56,000
		Sundry debtors	41,500
		Land and Building	1,90,000
		Wife's Jewellery	75,000
	Liabilities	:	
		Owing to Moti's Brother	40,000
		Sundry creditors	35,000
1-4-2022	Assets	:	
		Cash in hand	16,000
		Inventory	91,500
		Sundry debtors	52,500

	Land and Building	1,90,000
	Motor Car	1,25,000
	Wife's Jewellery	1,25,000
	Loan to Moti's Brother	20,000
Liabilities :	Sundry creditors	55,000

During the two years the domestic expenditure was ₹ 4,000 p.m. The declared incomes of the financial years were ₹ 1,05,000 for 2020-2021 and ₹ 1,23,000 for 2021-2022 respectively.

State whether the Income-tax Officer's contention is correct. Explain by giving your workings.

SOLUTION

Calculation of Capital of Shri Moti

	₹	1-4-2020₹	₹	1-4-2022₹
Assets				
Cash in hand		25,500		16,000
Inventory		56,000		91,500
Sundry debtors		41,500		52,500
Land & Building		1,90,000		1,90,000
Wife's Jewellery		75,000		1,25,000
Motor Car		—		1,25,000
Loan to Moti's Brother		—		20,000
		3,88,000		6,20,000
Liabilities:				
Owing to Moti's Brother	40,000		—	
Sundry creditors	35,000	75,000	55,000	55,000
Capital		3,13,000		5,65,000
Income during the two years:				
Capital as on 1-4-2022				5,65,000
Add: Drawings – Domestic Expenses for the two years (₹ 4,000 × 24 months)				96,000
				6,61,000

Less: Capital as on 1-4-2020	(3,13,000)
Income earned in 2020-2021 and 2021-2022	3,48,000
Income declared (₹ 1,05,000 + ₹ 1,23,000)	2,28,000
Suppressed Income	1,20,000

The Income-tax officer's contention that Shri Moti has not declared his true income is correct. Shri Moti's true income is in excess of the disclosed income by ₹ 1,20,000 based on the information available



4. TECHNIQUES OF OBTAINING COMPLETE ACCOUNTING INFORMATION

When books of accounts are incomplete, it is essential to complete double entry in respect of all transactions. The whole accounting process should be carefully followed and Trial Balance should be drawn up.

4.1 General Techniques

Where the accounts of a business are incomplete, it is advisable to convert them first to the double entry system and then to draw up the Profit and Loss Account and the Balance Sheet, instead of determining the amount of profit/loss by preparing the statement of affairs. As books of accounts of different firms being incomplete in varying degrees, it is not possible to suggest a formula which could uniformly be applied for preparing final accounts therefrom. As a general rule, it is essential to first start the ledger accounts with the opening balances of assets, liabilities and the capital. Afterwards, each book of original entry should be separately dealt with, so as to complete the double entry by posting into the ledger all entries which have not been posted. For example, If only personal accounts have been posted from the Cash Book, debits and credits pertaining to nominal accounts and real accounts that are not posted, should be posted into the ledger. If there are Discount Columns in the Cash Book, the totals of discounts paid and received should be posted to Discounts Allowed and Discounts Received Accounts respectively, for completing the double entry.

Afterwards, the other subsidiary books, i.e., Purchases Day Book, Sales Day Book, Purchase Return Book, Sales Return Book, Bills Receivable and Bills Payable, etc. should be totaled up and their totals posted into the ledger to the debit or credit of the appropriate nominal or real accounts, as the personal aspect of the transactions have been posted already.

When an Accountant is engaged in posting the unposted items from the Cash Book and other subsidiary books, he may be confronted with a number of problems. The manner in which some of them may be dealt with is described below:

- (1) In the Cash Book, there can be several receipt entries which have no connection with the business but which belong to the proprietor, e.g., interest collected on his private investment, legacies received by him, amount contributed by the proprietor from his private resources, etc. All those amounts should be credited to his capital account. Also the Cash Book may contain entries in respect of payments for proprietor's purchases and his personal expenses. All such items should be taken to his capital account on the debit side as drawings.
- (2) Amounts belonging to the business after collection may have been directly utilised for acquiring business assets or for meeting certain expenses instead of being recorded in the Cash Book. On the other hand, the proprietor may have met some of the business expenses from his private resources. In that case, the appropriate asset or expense account should be debited and the source of obtaining funds to be credited.
- (3) If cash is short, because the proprietor had withdrawn amount without any entry having been made in the cash book the proprietor's capital account should be debited. In fact, it will be necessary to debit or credit the proprietor's capital account in respect of all unidentified amounts which cannot be adjusted anywhere else.
- (4) Where the benefit of an item of an expense is received both by the proprietor and business, then it should be allocated between the two on some equitable basis e.g. rent of premises when the proprietor lives in the same premises, should be allocated on the basis of the area occupied by him for residence.

In the end, it will be possible to draw a Trial Balance. Students are advised to prepare a Trial balance as it will bring out any mistakes committed while making the above adjustments.

4.2 Derivation of Information from Cash Book

The analysis of cash as well as bank receipts and payments, should be extensive but under significant heads, so that various items of income and expenditure can be posted therefrom into the ledger. However before posting the information into the ledger the same should be collected in the form of an account, the specimen whereof is shown below:

Cash and Bank Summary Account for the year ended (assumed figures)

	Cash	Bank		Cash	Bank
	₹	₹		₹	₹
To Balance in hand	590	7,400	By Expenses	3,000	-

(opening)			(Sundry payments)		
To Sales	6,500	-	By Purchases	100	6,000
To Collection from Debtors	-	10,000	By Sundry creditors	-	5,000
			By Drawings	1,500	-
			By Petty expenses	800	-
			By Rent	-	1,000
			By Electricity and water	350	-
			By Repairs	350	-
			By Wages	-	1,000
			By Balance in Hand	990	4,400
	7,090	17,400		7,090	17,400

The important point about incomplete records is that much of the information may not be readily available and that the relevant information has to be ascertained. A good point is to prepare Cash and Bank Summary (if not available in proper form with both sides tallied). The cash and bank balance at the end should be reconciled with the cash and bank books. Having done so, the various items detailed on the Summary Statements, should be posted into the ledger.

It is quite likely that some of the missing information will then be available. Consider the following about a firm relating to 31st March 2022.

	₹
Cash Balance on 1st April, 2021	250
Bank overdraft on 1st April, 2021	5,400
Cash purchases	3,000
Collection from Sundry debtors	45,600
Sale of old furniture	750
Purchase of Machinery	12,000
Payment of Sundry creditors	26,370
Expenses	8,450
Fresh Capital brought in	5,000
Drawings	3,230
Cash Balance on 31st March, 2022	310
Bank balance on 31st March, 2022	1,180

Now prepare the cash and Bank Summary.

Cash and Bank Summary

Dr.	₹		₹ Cr.
Cash Balance on 1-4-2021	250	Bank overdraft on 1-4-2021	5,400
Collection from Sundry debtors	45,600	Cash purchases	3,000
Sale of old furniture	750	Purchase of Machinery	12,000
Fresh Capital brought in	5,000	Payment to Sundry creditors	26,370
Balancing figure- (Cash sales)	8,340	Expenses	8,450
		Drawings	3,230
		Cash balance on 31-03-2022	310
		Bank balance on 31-03-2022	1,180
	59,940		59,940

See that debit side is short by ₹ 8,340. What may be the possible source of cash inflow? It can be cash sales.

4.3 Analysis of Sales Ledger and Purchase Ledger

Sales Ledger: It would disclose information pertaining to the opening balances of debtors, transactions made with them during the year such as goods sold to them on credit, bills receivable drawn on them, bills dishonored, if any; cash received from them, sales returns, discount, rebate or any other concession allowed to them, receipts of bills receivable, bad debts written off and transfers. Journal entries must be made by debiting or crediting the impersonal accounts concerned with contra credit or debit given to total debtors account.

Analysis of Sales Ledger of the year

Op. Customer Balance	Sales	Bills Disho-nored	Total Debits	Cash Recd.	Dis-counts Allw.	Bills Recd.	Sales Returns	Bad Debts	Total Credit	Balance (cl.)

From the aforementioned, it will be possible to build up information about sales and other accounts which can then be posted in totals, if so desired. It would also be possible to prepare Total Debtors

Account in the following form:

Proforma of Total Debtors Account (assumed figures)

	₹		₹
To Opening balance	5,000	By Cash/Bank	10,000
To Sales	38,000	By Discount	500
To Bills dishonoured	280	By Bills receivable	20,000
To Interest	100	By Bad debts	280
		By Closing balance	12,600
	43,380		43,380

It can be seen from the above format that, if any one figure is not given it can be found out easily as the balancing figure. It can be opening balance, credit sales, cash collected or closing balance etc. For instance, if the information about sales is not available it could be ascertained as the balancing figure, *i.e.*, in the total Debtors Account given above, if all other figures are given, amount of sales on credit basis can be easily ascertained.

ILLUSTRATION 6

Calculate the bad debts from the below information:

Opening balance of Debtors	₹ 5,00,000
Closing balance of Debtors	₹ 7,00,000
Amount received in Cash	₹ 6,00,000
Discount allowed	₹ 10,000
Credit Sales	₹ 11,40,000
Bills Receivable	₹ 3,00,000
Bad Debts	???

SOLUTION

Debtors Account

Particulars	Amount	Particulars	Amount
Balance b/f	5,00,000	Cash A/c	6,00,000
Credit Sales	11,40,000	Discount allowed	10,000
		Bills Receivable	3,00,000

		Bad Debts (Bal fig)	30,000
		Balance c/f	7,00,000
	16,40,000		16,40,000

Purchases Ledger: Generally speaking, a Purchases Ledger is not as commonly maintained as the Debtors Ledger for it being convenient to make entries in respect of outstanding liabilities at the time they are paid rather than when they are incurred. The information is available in respect of opening balance of the creditors, goods purchased on credit, bills payable accepted, bills payable dishonored; cash paid to the creditors during the year, discount and other concessions obtained, returns outwards and transfers. Here also, journal entries must be made by debiting or crediting the respective impersonal accounts. Contra credit or debit being given to total creditor's account.

From the available information total creditors account can be prepared as follows

Proforma of Total Creditors Account (assumed figures)

	₹		₹
To Cash/bank	25,000	By Opening Balance	10,000
To Purchase Returns	400	By Purchases	30,400
To Bills Payable	8,700	By Bill payable dishonoured	450
To discount received	100		
To Closing Balance	6,650		
	40,850		40,850

If a proper record of return to creditors, discount allowed by them etc., has not been kept, it may not be possible to write up the Total Creditors A/c. In such a case, net credit purchase can be ascertained as follows:

Cash paid to Creditors including on account of bills payable during the period	XXX
Closing balance of Creditors and Bills Payable	<u>XXX</u>
Total	XXX
Less: Opening balance of Creditors and Bills Payable	<u>XXX</u>
Net credit purchase during the period	<u>XXX</u>

Alternatively

Cash paid to creditors during the period	XXX

Add: Bills Payable issued to them	XXX
Closing balance of Creditors	XXX
Less: Opening balance of creditors	<u>XXX</u>
Credit Purchases during the period	<u>XXX</u>

ILLUSTRATION 7

Calculate the credit purchases from the below information:

Opening balance of creditors	₹ 4,00,000
Closing balance of creditors	₹ 5,00,000
Payments made in Cash	₹ 8,50,000
Discount received	₹ 20,000

SOLUTION**Total Creditors Account**

Particulars	Amount	Particulars	Amount
Cash paid	8,50,000	Balance b/d	4,00,000
Discount received	20,000	Credit Purchases (Bal. fig)	
Balance c/d	<u>5,00,000</u>		<u>9,70,000</u>
	<u>13,70,000</u>		<u>13,70,000</u>

Nominal Accounts: It is quite likely that the total expenditure shown by balance of nominal account may contain items of expenditure which do not relate to the year for which accounts are being prepared and, also, there may exist certain items of expenditure incurred but not paid, which have not been included therein. On that account, each and every account should be adjusted in the manner shown below (figures assumed):

	Cash and Particulars	Amount Bank Payment	Paid out of Accrued	Total Private Fund	Pre Payment	Expenses for the period
1	2	3	4	5 (2+3+4)	6	7 (5-6)
	₹	₹	₹	₹	₹	₹
Rent & Rates	2,200	300	100	2,600	150	2,450
Salaries	4,500	500	1,000	6,000	250	5,750

Only the amount entered as "expenses for the period" should be posted to the respective nominal accounts. A similar adjustment of nominal accounts in respect of revenue receipt should be made.

Let us continue with the example given in para 4.2. Given some other information, how to compute credit purchase and credit sale is discussed below:

Opening balance (1-4-2021)	₹
Inventory	20,000
Sundry creditors	12,300
Sundry debtors	15,000
Closing Balance (31-03-2022)	
Inventory	15,000
Sundry creditors	13,800
Sundry debtors	25,600
Cash paid to creditors	26,370
Cash received from debtors	45,600
Cash sales	8,340
Cash purchases	3,000
Discount received during the year	1,130
Discount allowed	1,870

What are the purchases for 2021-2022? Let us prepare the Sundry Creditors Account.

Sundry Creditors Account

	₹		₹
To Cash	26,370	By Balance b/d	12,300
To Discount (received)	1,130	(opening)	
To Balance c/d (closing)	13,800	By Purchases (balancing figure)	29,000
	41,300		41,300

The credit purchases are ₹ 29,000; cash purchases are ₹ 3,000: hence total purchases are ₹ 32,000.

Likewise prepare the Sundry Debtors Account:

Sundry Debtors Account

	₹		₹
To Balance b/d	15,000	By Cash	45,600
To Credit sales (balancing figure)	58,070	By Discount (allowed)	1,870
		By Balance c/d	25,600
	73,070		73,070

So total sales = credit sales + cash sales

$$= ₹ 58,070 + ₹ 8,340 = ₹ 66,410$$

4.4 Distinction between Business Expenses and Drawings

It has been already stated that often the distinction is not made between business expenses and drawings. While completing accounts from incomplete records, it is necessary to scan the business transactions carefully to identify the existence of drawings.

The main items of drawings are (illustrative):

- Rent of premises commonly used for residential as well as business purposes.
- Common electricity and telephone bills.
- Life insurance premiums of proprietor/partners paid from business cash.
- Household expenses met from business cash.
- Private loan paid to friends and relatives out of business cash.
- Personal gifts made to any friends and relatives out of business cash.
- Goods or services taken from the business for personal consumption.
- Cash withdrawals to meet family expenses.
- Amount collected from debtors directly used for meeting personal expenses.

So it is necessary to scan the summary of cash transactions, business resources and their utilization to assess the nature of drawings and its amount.

4.5 Fresh Investment by proprietors / partners

Like drawings, often fresh investments made by proprietors' /partners are not readily identifiable. It becomes necessary to scan the business transactions carefully. Apart from direct cash investment, fresh investments may take the following shape:

- Money collected and put in the business on maturity of Life Insurance Policy of the proprietors.
- Interest and dividend of personal investment of the proprietors collected and put in the business.
- Income from non-business property collected and put in the business.
- Payments made to creditors out of personal cash.

Unless these items are properly identified and segregated, business income will be affected and proper statement of affairs cannot be prepared.

ILLUSTRATION 8

A. Adamjee keeps his books on single entry basis. The analysis of the cash book for the year ended on 31st March, 2022 is given below:

Receipts	₹	Payments	₹
Bank Balance as on 1st April, 2021	2,800	Payments to Sundry creditors	35,000
Received from Sundry Debtors	48,000	Salaries	6,500
Cash Sales	11,000	General expenses	2,500
Capital brought during the year	6,000	Rent and Taxes	1,500
Interest on Investments	200	Drawings	3,600
		Cash purchases	12,000
		Balance at Bank on 31st March, 2022	6,400
	—	Cash in hand on 31st March, 2022	<u>500</u>
	<u>68,000</u>		<u>68,000</u>

Particulars of other assets and liabilities are as follows:

	1st April, 2021	31st March, 2022
Sundry debtors	14,500	17,600
Sundry creditors	5,800	7,900
Machinery	7,500	7,500
Furniture	1,200	1,200
Inventory	3,900	5,700
Investments	5,000	5,000

Prepare final accounts for the year ending 31st March, 2022 after providing depreciation at 10 per cent on machinery and furniture and ₹ 800 against doubtful debts.

SOLUTION**A. Adamjee****Trading Account for the year ended 31st March 2022**

	₹	₹		₹
To Opening Inventory		3,900	By Sales	62,100
To Purchases		49,100	By Closing Inventory	5,700
To Gross profit c/d (b.f.)		14,800		
		67,800		67,800

Profit & Loss Account for the year ended 31st March 2022

	₹	₹		₹
To Salaries		6,500	By Gross Profit b/d	14,800
To Rent and Taxes		1,500	By Interest on investment	200
To General expenses		2,500		
To Dep:				
Machinery@ 10%	750			
Furniture @ 10%	120	870		
To Provision for doubtful debts		800		
To Net profit carried to Capital A/c (b.f.)		2,830		
		15,000		15,000

Balance Sheet as on 31st March 2022

Liabilities	₹	₹	Assets	₹	₹
A. Adamjee's Capital on 1 st April, 2021	29,100		Machinery	7,500	
Add: Fresh Capital	6,000		Less : Depreciation	(750)	6,750
Add: Profit for the year	2,830		Furniture	1,200	
	37,930		Less : Depreciation	(120)	1,080

Less: Drawings	(3,600)	34,330	Inventory-in-trade		5,700
Sundry creditors		7,900	Sundry debtors	17,600	
			Less : Provision for Doubtful debts	(800)	16,800
			Investment		5,000
			Cash at bank		6,400
			Cash in hand		500
		42,230			42,230

Working Notes:
1. Balance sheet of A. Adamjee as on 1st April 2021

Liabilities	₹	Assets	₹
Sundry creditors	5,800	Machinery	7,500
A. Adamjee's capital	29,100	Furniture	1,200
(balancing figure)		Inventory	3,900
		Sundry debtors	14,500
		Investments	5,000
		Bank balance (from Cash statement)	2,800
	34,900		34,900

2. Ledger Accounts
A. Adamjee's Capital Account

		₹			₹
31.03.22	To Drawings	3,600	01.04. 21	By Balance b/d	29,100
			31.03.22	By Net Profit	2,830
31.03.22	To Balance c/d (b.f.)	34,330	31.03.22	By Cash	6,000
		37,930			37,930

Sales Account

		₹			₹
31.03.22	To Trading A/c (b.f.)	62,100	31.03.22	By Cash	11,000
			31.03.22	By Total Debtors Account (Credit Sales)	51,100
		62,100			62,100

Total Debtors Account

		₹			₹
01.04.21	To Balance b/d	14,500	31.03.22	By Cash	48,000
31.03.22	To Credit sales (Balancing figure)	51,100	31.03.22	By Balance c/d	17,600
		65,600			65,600

Purchases Account

		₹			₹
31.03.22	To Cash A/c	12,000	31.03.22	By Trading Account (b.f.)	49,100
	To total Creditors A/c (credit Purchases)	37,100			49,100
		49,100			49,100

Total Creditors Account

		₹			₹
31.03.22	To Cash	35,000	01.04.21	By Balance b/d	5,800
31.03.22	To Balance b/d	7,900	31.03.22	By Credit Purchases (Balancing figure)	37,100
		42,900			42,900

ILLUSTRATION 9

From the following data furnished by Mr. Manoj, you are required to prepare a Trading and Profit and Loss Account for the year ended 31st March, 2022 and Balance Sheet as at that date. All workings should form part of your answer.

Assets and Liabilities	As on 1st April 2021	As on 31st March 2022
	₹	₹
<i>Creditors</i>	15,770	12,400
<i>Sundry expenses outstanding</i>	600	330
<i>Sundry Assets</i>	11,610	12,040
<i>Inventory in trade</i>	8,040	11,120
<i>Cash in hand and at bank</i>	6,960	8,080
<i>Trade debtors</i>	?	17,870
<i>Details relating to transactions in the year:</i>		
<i>Cash and discount credited to debtors</i>		64,000
<i>Sales return</i>		1,450
<i>Bad debts</i>		420
<i>Sales (cash and credit)</i>		71,810
<i>Discount allowed by trade creditors</i>		700
<i>Purchase returns</i>		400
<i>Additional capital-paid into Bank</i>		8,500
<i>Realisations from debtors-paid into Bank</i>		62,500
<i>Cash purchases</i>		1,030
<i>Cash expenses</i>		9,570
<i>Paid by cheque for machinery purchased</i>		430
<i>Household expenses drawn from Bank</i>		3,180
<i>Cash paid into Bank</i>		5,000
<i>Cash drawn from Bank</i>		9,240
<i>Cash in hand on 31-3-2022</i>		1,200
<i>Cheques issued to trade creditors</i>		60,270

SOLUTION

In the books of Mr. Manoj

Trading Account for the year ending 31st March, 2022

	₹	₹		₹	₹
To Opening Inventory		8,040	By Sales		
To Purchases	59,030		Cash	4,600	
(58,000 + 1,030)			Credit	67,210	
Less: Returns	(400)	58,630		71,810	
To Gross profit c/d		14,810	Less: Returns	(1,450)	70,360
			By Closing inventory		11,120
		81,480			81,480

Profit & Loss Account for the year ending 31st March, 2022

	₹		₹
To Sundry expenses (W.N.(v))	9,300	By Gross profit b/d	14,810
To Discount	1,500	By Discount	700
To Bad Debts	420		
To Net Profit transfer to Capital	4,290		
	15,510		15,510

Balance Sheet of Mr. Manoj as on 31st March, 2022

Liabilities	₹	₹	Assets	₹
<i>Capital</i>			Sundry assets	12,040
Opening balance	26,770		Inventory in trade	11,120
Add: Addition	8,500		Sundry debtors	17,870
Net Profit	4,290		Cash in hand & at bank	8,080
	39,560			
Less: Drawings	(3,180)	36,380		
Sundry creditors		12,400		
Outstanding expenses		330		
		49,110		49,110

Working Notes:**(i) Cash sales****Combined Cash & Bank Account**

	₹		₹
To Balance b/d	6,960	By Sundry creditors	60,270
To Sundries (Contra)	5,000	By Sundries (Contra)	5,000
To Sundries (Contra)	9,240	By Sundries (Contra)	9,240
To Sundry debtors	62,500	By Drawings	3,180
To Capital A/c	8,500	By Machinery	430
To Sales (Cash Sales-Balancing Figure)	4,600	By Sundry expenses	9,570
		By Purchases	1,030
		By Balance c/d	8,080
	96,800		96,800

(ii)**Total Debtors Account**

	₹		₹
To Balance b/d (bal. fig.)	16,530	By Bank	62,500
To Sales (71,810–4,600 ¹)	67,210	By Discount(64,000 – 62,500)	1,500
		By Return Inward	1,450
		By Bad Debts	420
		By Balance c/d	17,870
	83,740		83,740

(iii)**Total Creditors Account**

	₹		₹
To Bank	60,270	By Balance b/d (bal. fig.)	15,770
To Discount	700	By Purchases	58,000
To Return Outward	400		
To Balance c/d	12,400		
	73,770		73,770

¹ From combined cash and bank account

(iv)

Balance Sheet as on 1st April, 2021

Liabilities	₹	Assets	₹
Capital (bal. fig.)	26,770	Sundry Assets	11,610
Sundry Creditors	15,770	Inventory in Trade	8,040
Outstanding Expenses	600	Sundry Debtors (from total debtors A/c)	16,530
		Cash in hand & at bank	6,960
	43,140		43,140

(v)

Expenses paid in Cash	9,570
Add: Outstanding on 31-3-2022	330
	9,900
Less: Outstanding on 1-4-2021	(600)
	9,300

(vi) Due to lack of information, depreciation has not been provided on fixed assets.

ILLUSTRATION 10

Mr. Anup runs a wholesale business where in all purchases and sales are made on credit. He furnishes the following closing balances:

	31st March 2021	31st March 2022
<i>Sundry debtors</i>	70,000	92,000
<i>Bills receivable</i>	15,000	6,000
<i>Bills payable</i>	12,000	14,000
<i>Sundry creditors</i>	40,000	56,000
<i>Inventory</i>	1,10,000	1,90,000
<i>Bank</i>	90,000	87,000
<i>Cash</i>	5,200	5,300

Summary of cash transactions during the year 2021- 2022:

- (i) Deposited to bank after payment of shop expenses @ ₹ 600 p.m., salary @ ₹ 9,200 p.m. and personal expenses @ ₹ 1,400 p.m. ₹ 7,62,750.

- (ii) *Cash Withdrawn from bank ₹ 1,21,000.*
- (iii) *Cash payment to suppliers ₹ 77,200 for supplies and ₹ 25,000 for furniture.*
- (iv) *Cheques collected from customers but dishonoured ₹ 5,700.*
- (v) *Bills accepted by customers ₹ 40,000.*
- (vi) *Bills endorsed ₹ 10,000.*
- (vii) *Bills discounted ₹ 20,000, discount ₹ 750.*
- (viii) *Bills matured and duly collected ₹ 16,000.*
- (ix) *Bills accepted ₹ 24,000.*
- (x) *Paid suppliers by cheque ₹ 3,20,000.*
- (xi) *Received ₹ 20,000 on maturity of one LIC policy of the proprietor by cheque.*
- (xii) *Rent received ₹ 14,000 by cheque for the premises owned by proprietor.*
- (xiii) *A building was purchased on 30-11-2021 for opening a branch for ₹ 3,50,000 and some expenses were incurred on this building, details of which are not maintained.*
- (xiv) *Electricity and telephone bills paid by cash ₹ 18,700, due ₹ 2,200.*

Other transactions:

- (i) *Claim against the firm for damage ₹ 1,55,000 is under legal dispute. Legal expenses ₹ 17,000. The firm anticipates defeat in the suit.*
- (ii) *Goods returned to suppliers ₹ 4,200.*
- (iii) *Goods returned by customers ₹ 1,200.*
- (iv) *Discount offered by suppliers ₹ 2,700.*
- (v) *Discount offered to the customers ₹ 2,400.*
- (vi) *The business is carried on at the rented premises for an annual rent of ₹ 20,000 which is outstanding at the year end.*

Prepare Trading and Profit & Loss Account of Mr. Anup for the year ended 31st March 2022 and Balance Sheet as on that date.

SOLUTION**Trading Account of Mr. Anup for the year ended 31st March 2022**

	₹	₹		₹	₹
To Opening Inventory		1,10,000	By Sales	9,59,750	
To Purchases	4,54,100		Less: Sales Return	(1,200)	9,58,550
Less: Purchases Return	(4,200)	4,49,900	By Closing Inventory		1,90,000
To Gross Profit (b.f.)		5,88,650			
		11,48,550			11,48,550

Profit & Loss Account of Mr. Anup for the year ended 31st March 2022

	₹		₹
To salary (9,200 x 12)	1,10,400	By Gross Profit	5,88,650
To Electricity & Tel. Charges (18,700 + 2,200)	20,900	By Discount	2,700
To Legal expenses	17,000		
To Discount (2,400 + 750)	3,150		
To Shop exp. (600 x 12)	7,200		
To Provision for claims for damages	1,55,000		
To Shop Rent	20,000		
To Net Profit (b.f.)	2,57,700		
	5,91,350		5,91,350

Balance Sheet as on 31st March 2022

Liabilities	₹		Assets	₹
Capital A/c (W.N.vi)	2,38,200		Building (from summary cash and bank A/c)	3,72,000
Add : Fresh capital introduced			Furniture	25,000
Maturity value from LIC	20,000		Inventory	1,90,000
Rent	14,000		Sundry debtors	92,000
Add : Net Profit	2,57,700		Bills receivable	6,000
	5,29,900		Cash at Bank	87,000
Less : Drawing (14,00 x 12)	(16,800)	5,13,100	Cash in Hand	5,300
Rent outstanding		20,000		

Sundry creditors		56,000		
Bills Payable		14,000		
Outstanding expenses				
Legal Exp.	17,000			
Electricity &				
Telephone charges	2,200	19,200		
Provision for claims for damages		1,55,000		
		7,77,300		7,77,300

Working Notes :

(i)

Sundry Debtors Account

	₹		₹
To Balance b/d	70,000	By Bill Receivable A/c	
To Bill receivable A/c-Bills dishonoured	3,000	Bills accepted by customers	40,000
To Bank A/c-Cheque dishonoured	5,700	By Bank A/c - Cheque received	5,700
To Credit sales (Balancing Figure)	9,59,750	By Cash (from summary cash and bank account)	8,97,150
		By Return inward A/c	1,200
		By Discount A/c	2,400
		By Balance c/d	92,000
	10,38,450		10,38,450

(ii)

Bills Receivable Account

	₹		₹
To Balance b/d	15,000	By Sundry creditors A/c	
To Sundry Debtors A/c (Bills accepted)	40,000	(Bills endorsed)	10,000
		By Bank A/c (20,000 – 750)	19,250
		By Discount A/c (Bills discounted)	750

		By Bank	
		Bills collected on maturity	16,000
		By Sundry debtors	
		Bills dishonoured (Bal. Fig)	3,000
		By Balance c/d	6,000
	55,000		55,000

(iii)

Sundry Creditors Account

	₹		₹
To Bank	3,20,000	By Balance c/d	40,000
To Cash	77,200	By Credit purchase	
To Bill Payable A/c	24,000	(Balancing figure)	4,54,100
To Bill Receivable A/c	10,000		
To Return Outward A/c	4,200		
To Discount Received A/c	2,700		
To Balance b/d	56,000		
	4,94,100		4,94,100

(iv)

Bills Payable A/c

	₹		₹
To Bank A/c (Balance figure)	22,000	By Balance b/d	12,000
To Balance c/d	14,000	By Sundry creditors A/c	
		Bills accepted	24,000
	36,000		36,000

(v)

Summary Cash and Bank A/c

	Cash	Bank		Cash	Bank
	₹	₹		₹	₹
To Balance b/d	5,200	90,000	By Bank	7,62,750	
To Sundry debtors (Bal. Fig)	8,97,150		By Cash		1,21,000
To Cash		7,62,750	By Shop exp. (600 x 12)	7,200	
To Bank	1,21,000		By Salary (9,200 x 12)	1,10,400	

To Sundry Debtors		5,700	By Drawing A/c	16,800	
To Bills receivable		19,250	(1,400 x 12)		
To Bills receivable		16,000	By Bills Payable		22,000
To Capital (maturity value of LIC policy)		20,000	By Sundry creditors	77,200	3,20,000
To Capital (Rent received)		14,000	By Furniture	25,000	
			By Sundry Debtors		5,700
			By Electricity & Tel. Charges	18,700	
			By Building (Bal. fig)		3,72,000
			By Balance c/d	5,300	87,000
	10,23,350	9,27,700		10,23,350	9,27,700

(vi)

Statement of Affairs as on 31st March 2021

Liabilities	₹	Assets	₹
Sundry Creditors	40,000	Inventory	1,10,000
Bills Payable	12,000	Debtors	70,000
Capital (Balancing figure)	2,38,200	Bills receivable	15,000
		Cash at Bank	90,000
		Cash in Hand	5,200
	2,90,200		2,90,200

SUMMARY

- Single entry system is generally found in sole trading concerns or even in partnership firms to some extent but never in case of limited liability companies on account of legal requirements.
- There are basically 3 types of single entry systems:
 - Pure Single Entry
 - Simple Single Entry
 - Quasi Single Entry
- Single entry system ignores the concept of duality and therefore, transactions are not recorded in their two-fold aspects.

TEST YOUR KNOWLEDGE

True and false

1. *A Trial Balance cannot be drawn up from books kept under Single Entry.*
2. *Nominal Accounts are kept under Single Entry System.*
3. *Single Entry System can be adopted by small firms.*
4. *Profit under single entry system is always correct and accurate.*
5. *Profits computed under single entry system by different business entities are not comparable.*

Multiple Choice Questions

1. *In case of net worth method, profit is determined by*
 - (a) *Preparing a trading and profit and loss account.*
 - (b) *Comparing the capital in the beginning with the capital at the end of the accounting period.*
 - (c) *Comparing the net assets in the beginning with the net assets at the end of the accounting period.*
2. *Single entry system can be followed by*
 - (a) *Small firms.*
 - (b) *Joint stock companies.*
 - (c) *Co-operative societies.*
3. *Closing capital is calculated as*
 - (a) *Opening capital +Additional capital -Drawings.*
 - (b) *Opening capital +Additional capital –Drawings + Profit.*
 - (c) *Opening capital +Additional capital +Drawings - Profit.*
4. *Under single entry system, only personal accounts are kept and, in some cases,*
 - (a) *Cash book is maintained*
 - (b) *Fixed assets' accounts are maintained*
 - (c) *Liabilities' accounts are maintained.*

5. The closing capital of Mr. B as on 31.3.2022 was ₹4,00,000. On 1.4.2021 his capital was ₹ 3,50,000. His net profit for the year ended 31.3.2022 was ₹ 1,00,000. He introduced ₹30,000 as additional capital in February, 2022 Find out the amount drawn by Mr. B for his domestic expenses.
- (a) ₹ 1,00,000;
 (b) ₹ 80,000;
 (c) ₹ 1,20,000;
6. Given information:
- | | |
|---------------------------------------|--------|
| Opening capital: | 60,000 |
| Drawings: | 5,000 |
| Capital introduced during the period: | 10,000 |
| Closing capital: | 90,000 |
| Profit earned during the period | ? |
- (a) ₹ 20,000
 (b) ₹ 25,000
 (c) ₹ 30,000.

Theoretical Questions

- What is meant by Single entry System? What are the types of procedures adopted for this system?
- Differentiate between Statement of Affairs and Balance Sheet.

Practical Questions

- A Firm sold 20% of the goods on cash basis and the balance on credit basis. Debtors are allowed 1½ month's credit and their balance as on 31.03.2021 is ₹ 1,25,000. Assume that the sale is uniform throughout the year. Calculate the credit sales and total sales of the company for the year ended 31.03.2022.
- Mr. A runs a business of readymade garments. He closes the books of accounts on 31st March. The Balance Sheet as on 31st March, 2021 was as follows:

Liabilities	₹	Assets	₹
A's capital a/c	4,04,000	Furniture	40,000
Creditors	82,000	Stock	2,80,000

		Debtors	1,00,000
		Cash in hand	28,000
		Cash at bank	38,000
	4,86,000		4,86,000

You are furnished with the following information:

- (1) His sales, for the year ended 31st March, 2022 were 20% higher than the sales of previous year, out of which 20% sales was cash sales.
Total sales during the year 2020-21 were ₹5,00,000.
- (2) Payments for all the purchases were made by cheques only.
- (3) Goods were sold for cash and credit both. Credit customers pay by cheques only.
- (4) Depreciation on furniture is to be charged 10% p.a.
- (5) Mr. A sent to the bank the collection of the month at the last date of the each month after paying salary of ₹ 2,000 to the clerk, office expenses ₹ 1,200 and personal expenses ₹ 500.

Analysis of bank pass book for the year ending 31st March 2022 disclosed the following:

	₹
Payment to creditors	3,00,000
Payment of rent up to 31 st March, 2022	16,000
Cash deposited into the bank during the year	80,000

The following are the balances on 31st March, 2022:

	₹
Stock	1,60,000
Debtors	1,20,000
Creditors for goods	1,46,000

On the evening of 31st March 2022, the cashier absconded with the available cash in the cash book.

You are required to prepare Trading and Profit and Loss A/c for the year ended 31st March, 2022 and Balance Sheet as on that date. All the workings should form part of the answer.

3. Ram carried on business as retail merchant. He has not maintained regular account books. However, he always maintained ₹10,000 in cash and deposited the balance into the bank account. He informs you that he has sold goods at profit of 25% on sales.

Following information is given to you:

Assets and Liabilities	As on 1.4.2021	As on 31.3.2022
Cash in Hand	10,000	10,000
Sundry Creditors	40,000	90,000
Cash at Bank	50,000 (Cr.)	80,000 (Dr.)
Sundry Debtors	1,00,000	3,50,000
Stock in Trade	2,80,000	?
Ram's capital	3,00,000	?

Analysis of his bank pass book reveals the following information:

- Payment to creditors ₹7,00,000
- Payment for business expenses ₹1,20,000
- Receipts from debtors ₹7,50,000
- Loan ₹1,00,000 taken on 1.10.2021 at 10% per annum
- Cash deposited in the bank ₹1,00,000

He informs you that he paid creditors for goods ₹20,000 in cash and salaries ₹40,000 in cash. He has drawn ₹80,000 in cash for personal expenses. During the year Ram had not introduced any additional capital. Surplus cash if any, to be taken as cash sales. All purchases are on credit basis.

You are required to prepare Trading and Profit and Loss Account for the year ended 31.3.2022 and Balance Sheet as at 31st March, 2022.

ANSWERS/ SOLUTIONS

True and False

- True: Since incomplete records are maintained, trial balance cannot be prepared
- False: Under the single entry system of bookkeeping, generally cash book and personal accounts of creditors and debtors are maintained, and no other ledger is maintained.

3. True: A single entry system is the one where financial transactions are recorded as a single entry in a log and is usually used by new small businesses.
4. False: Profit under single entry system is only an estimate based on available information and correct profits cannot be determined.
5. True: Since entry system has no fixed set of principles for recording the financial transaction, different organisations maintain records as per their needs. Hence their accounts are not comparable.

Multiple Choice Questions

1.	(b)	2.	(a)	3.	(b)	4.	(a)	5.	(b)	6.	(b)

Theoretical Questions

1. Single entry system is an inaccurate and unsystematic method of recording business transactions. The procedures adopted are: Pure single entry; Simple entry and Queasy single entry. For details, Refer Para 1 and 2 of the chapter.
2. To understand the difference between Statement of Affairs and Balance Sheet, refer para 3.2 of the chapter.

Practical Questions

1. Calculation of Credit Sales and Total sales

$$\begin{aligned}
 \text{Credit Sales for the year ended 2021-22} &= \text{Debtors} \times \frac{12 \text{ months}}{1.5 \text{ months}} \\
 &= ₹1,25,000 \times \frac{12 \text{ months}}{1.5 \text{ months}} \\
 &= ₹ 10,00,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Total sales for the year ended 2021-22} &= \text{Credit sales} \times \frac{100\%}{80\%} \\
 &= ₹ 10,00,000 \times \frac{100\%}{80\%} \\
 &= ₹ 12,50,000
 \end{aligned}$$

2. **In the books of Mr. A**

Trading Account for the year ending 31st March, 2022

Particulars	₹	Particulars	₹
To Opening stock	2,80,000	By Sales (W.N. 3)	
To Purchases (W.N. 1)	3,64,000	Credit	4,80,000

To Gross profit (b.f.)	1,16,000	Cash <u>1,20,000</u>	6,00,000
		By Closing stock	1,60,000
	7,60,000		7,60,000

Profit and Loss Account for the year ending 31st March, 2022

Particulars	₹	Particulars	₹
To Salary (2,000 x 12)	24,000	By Gross profit	1,16,000
To Rent	16,000		
To Office expenses (1,200 x 12)	14,400		
To Loss of cash (W.N. 6)	23,600		
To Depreciation on furniture	4,000		
To Net Profit (b.f.)	34,000		
	1,16,000		1,16,000

Balance Sheet as on 31st March, 2022

Liabilities	₹	Assets	₹
A's Capital 4,04,000		Furniture 40,000	
Add: Net Profit 34,000		Less: Depreciation <u>(4,000)</u>	36,000
Less: Drawings		Stock	1,60,000
(500 x 12) <u>(6,000)</u>	4,32,000	Debtors	1,20,000
Creditors	1,46,000	Cash at bank	2,62,000
	5,78,000		5,78,000

Working Notes:**(1) Calculation of purchases****Creditors Account**

Particulars	₹	Particulars	₹
To Bank A/c	3,00,000	By Balance b/d	82,000
To Balance c/d	1,46,000	By Purchases (Bal. fig.)	3,64,000
	4,46,000		4,46,000

(2) Calculation of total sales

	₹
Sales for the year 2020-21	5,00,000
Add: 20% increase	1,00,000
Total sales for the year 2021-22	6,00,000

(3) Calculation of credit sales

	₹
Total sales	6,00,000
Less: Cash sales (20% of total sales)	(1,20,000)
	4,80,000

(4) Calculation of cash collected from debtors**Debtors Account**

Particulars	₹	Particulars	₹
To Balance b/d	1,00,000	By Bank A/c (Bal. fig.)	4,60,000
To Sales A/c	4,80,000	By Balance c/d	1,20,000
	5,80,000		5,80,000

(5) Calculation of closing balance of cash at bank**Bank Account**

Particulars	₹	Particulars	₹
To Balance b/d	38,000	By Creditors A/c	3,00,000
To Debtors A/c	4,60,000	By Rent A/c	16,000
To Cash A/c	80,000	By Balance c/d (b.f.)	2,62,000
	5,78,000		5,78,000

(6) Calculation of the amount of cash defalcated by the cashier

		₹
Cash balance as on 1 st April 2021		28,000
Add: Cash sales during the year		1,20,000
		1,48,000

Less: Salary (₹2,000x12)	24,000	
Office expenses (₹1,200 x 12)	14,400	
Drawings of A (₹500x12)	6,000	
Cash deposited into bank during the year	80,000	(1,24,400)
Cash balance as on 31 st March 2022 (defalcated by the cashier)		23,600

3.

**Trading Account of Ram
for the year ended 31st March, 2022**

	₹		₹
To Opening stock	2,80,000	By Sales	
To Purchases	7,70,000	Cash 2,40,000	
To Gross Profit @ 25%	3,10,000	Credit <u>10,00,000</u>	12,40,000
		By Closing Stock (bal. fig.)	1,20,000
	13,60,000		13,60,000

Profit and Loss Account of Ram for the year ended 31st March, 2022

	₹		₹
To Salaries	40,000	By Gross Profit	3,10,000
To Business expenses	1,20,000		
To Interest on loan (10% of 1,00,000 x 6/12)	5,000		
To Net Profit	1,45,000		
	3,10,000		3,10,000

Balance Sheet of Ram as at 31st March, 2022

Liabilities	₹	₹	Assets	₹
Ram's capital:			Cash in hand	10,000
Opening	3,00,000		Cash at Bank	80,000
Add: Net Profit	1,45,000		Sundry Debtors	3,50,000
	4,45,000		Stock in trade	1,20,000
Less: Drawings	(80,000)	3,65,000		

Loan (including interest due)		1,05,000		
Sundry Creditors		90,000		
		5,60,000		5,60,000

Working Notes:**1. Sundry Debtors Account**

	₹		₹
To Balance b/d	1,00,000	By Bank A/c	7,50,000
To Credit sales (Bal. fig)	10,00,000	By Balance c/d	3,50,000
	11,00,000		11,00,000

2. Sundry Creditors Account

	₹		₹
To Bank A/c	7,00,000	By Balance b/d	40,000
To Cash A/c	20,000	By Purchases (Bal. fig.)	7,70,000
To Balance c/d	90,000		
	8,10,000		8,10,000

3. Cash and Bank Account

	Cash ₹	Bank ₹		Cash ₹	Bank ₹
To Balance b/d	10,000		By Balance b/d		50,000
To Sales (bal. fig)	2,40,000		By Bank A/c (C)	1,00,000	
To Cash (C)		1,00,000	By Salaries	40,000	
To Debtors		7,50,000	By Creditors	20,000	7,00,000
To Loan		1,00,000	By Drawings	80,000	
			By Business expenses		1,20,000
			By Balance c/d	10,000	80,000
	2,50,000	9,50,000		2,50,000	9,50,000

NOTES

[illegible]



PARTNERSHIP AND LLP ACCOUNTS



UNIT – 1 INTRODUCTION TO PARTNERSHIP ACCOUNTS

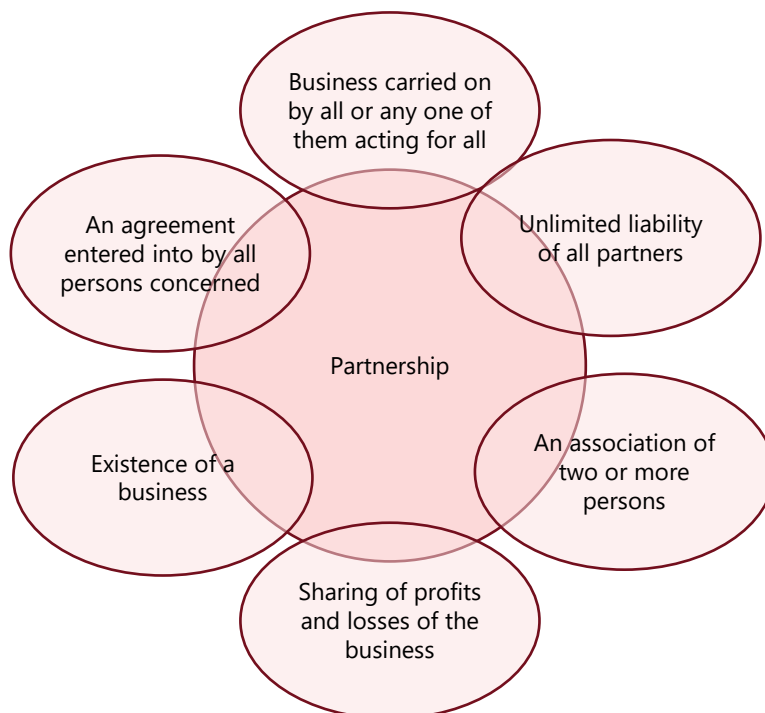
LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand the provisions of the Indian Partnership Act, 1932, Limited Liability Partnership Act, 2008 and Limited Liability Partnership Amendment Act, 2021
- ◆ Understand the features of a partnership firm and the need for a Partnership Deed.
- ◆ Understand the points to be covered in a Partnership Deed regarding accounts.
- ◆ Learn the technique of maintaining Profit and Loss Appropriation Account.
- ◆ Familiarize with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- ◆ Note that Capital Account balance as per Fluctuating Capital method is just equal to the sum of the balances of Capital Account and Current Account as per Fixed Capital Method.

- ◆ Learn how to arrive at the corrected net profit figure which is to be taken to be Profit and Loss Appropriation Account after rectification of errors. Rectification of errors may be necessary to arrive at the net profit of the partnership and preparing Profit and loss Appropriation Account.
- ◆ Learn that interest on capital and drawings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account and not in the Profit and Loss Account. Also learn that drawings by partners will not appear in the Appropriation Account.

UNIT OVERVIEW



Accounts of Partnership firm

Accounts of Partnership firm		
Trading and Profit and Loss Account and Balance Sheet	Profit and Loss Appropriation Account	Capital accounts of partners (fixed capital method or fluctuating capital method)

1.1 INTRODUCTION: WHY PARTNERSHIP?

An individual, i.e., a sole proprietor may not be in a position to cope with the financial and managerial demands of the present-day business world. As a result, two or more individuals may decide to pool their financial and non-financial resources to carry on a business. The preparation of final accounts of sole proprietors have already been discussed in chapter 6. The final accounts of partnership firms including basic concepts of accounting for admission of a partner, retirement and death of a partner have been discussed in succeeding units of this chapter.

1.2 DEFINITION AND FEATURES OF PARTNERSHIP

As per **Section 4** of the Partnership Act, 1932:

“Partnership is the relation between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.”

Features of a partnership,

- (i) **Existence of an agreement:** As per section 5 of the Indian Partnership Act, 1932, The relation of partnership arises from contract between parties and not from status as it happens in case of HUF (Hindu Undivided Family). **A formal or written agreement is not necessary to create a partnership.**
- (ii) **Business:** A partnership can exist only in business. Thus, it is not the agreement alone which creates a partnership. A partnership comes into existence only when partners begin to carry on business in accordance with their agreement. **Section 2 (b) of Indian Partnership Act, 1932 only states that business includes every trade, occupation and profession.**
- (iii) **Sharing of profit:** The persons concerned must agree to **share the profits of the business**. Because no person is a partner unless he or she has the right to share the profits of the business. **Section 4 of Indian Partnership Act, 1932** does not insist upon sharing of losses. Thus, a provision for sharing of loss is not necessary.
- (iv) **Mutual agency:** It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

- (v) **Minor as a partner:** A minor can be added in partnership firm. But the condition is that he can be admitted to share profit only. He cannot be made to share losses of the firm. If the partnership firm suffers loss then it will be borne by other major partners in their profit-sharing ratio.

Number of Partners: Minimum Partners: Two

Maximum Partners: As per Section 464 of the Companies Act, 2013, no association or partnership consisting of more than 100 number of persons as may be prescribed shall be formed for the purpose of carrying on any business. Rule 10 of Companies (incorporation) Rules 2014 specifies the limit as 50. Thus, maximum number of members in a partnership firm are 50.



1.3 LIMITED LIABILITY PARTNERSHIP

The Indian Partnership Act of 1932 provides for a general form of partnership which has inherent shortcoming of unlimited liability of all partners for business debts and legal consequences, regardless of their holding or profit-sharing ratio, as the firm is not a legal entity. General partners are also jointly and severally liable for tortuous acts of co-partners. In case of liquidation personal assets of partners can be liquidated to meet liabilities of the firm.

With the growth of the Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. Entrepreneurship, knowledge, risk and capital may be combined to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based governance structure of the limited liability company on the other. This would enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner.

The Government felt that with Indian professionals increasingly transacting with or representing multi-nationals in international transactions, the extent of the liability they could potentially be exposed to, is extremely high. Hence, in order to encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability, the need for having a legal structure like the LLP is encouraged. Thus, in convergence towards global scenario, Limited Liability Partnership Act, 2008 was introduced.

The Limited Liability Partnership (LLP) is viewed as an alternative corporate business proposal that provides the benefits of limited liability but allows its members, the flexibility of organizing their internal structure as a partnership, which is based on a mutually arrived agreement.

The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature. No partner would be liable on account of the independent or un-authorized actions of other partners or their misconduct. The liabilities of the LLP and partners who are found to have acted with intent to defraud Creditors or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.

The main benefit in an LLP is that it is taxed as a partnership, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability. An LLP has the special characteristic of being a separate legal personality distinct from its partners. The LLP is a body corporate in nature.

Summary of key advantages and challenges associated with formation of LLP could be presented as below:

Advantages:

- (i) LLP is organized and operates on the basis of an agreement.
- (ii) Enables professional/technical expertise and initiative to combine with financial risk taking capacity in an innovative and efficient manner.
- (iii) Limited liability of partners as in case of corporate entities along with flexibility of a partnership without imposing detailed legal and procedural requirements;
- (iv) Lower registration costs as compared to corporate entities;
- (v) Audit not mandatory (subject to turnover / capital contribution benchmark)

Challenges:

- (i) Public disclosure of financial statements;
- (ii) No option for Equity investments;
- (iii) Extensive penal provisions for non-compliance

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships. Later, the Ministry of Law and Justice made amendments to the Limited Liability Partnership Act, 2008 (LLP Act) through the LLP (Amendment) Act, 2021.

1.3.1 Definition of LLP

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines **limited liability partnership** as a partnership formed and registered under this Act; and **“limited liability partnership agreement”** means any written agreement between the partners of the limited

liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

“Small limited liability partnership” means a limited liability partnership—

- (i) the contribution of which, does not exceed twenty-five lakh rupees or such higher amount, not exceeding five crore rupees, as may be prescribed; and
- (ii) the turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees or such higher amount, not exceeding fifty crore rupees, as may be prescribed; or

1.3.2 Nature of Limited Liability Partnership

- (1) A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.
- (2) A limited liability partnership should have perpetual succession.
- (3) Any change in the partners of a limited liability partnership should not affect the existence, rights, or liabilities of the limited liability partnership.

1.3.3 Non-applicability of the Indian Partnership Act, 1932

Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.

1.3.4 Minimum number of partners in case of LLP

As per the LLP Act, any individual or body corporate may be a partner in a limited liability partnership; provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if-

- (a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;
- (b) he is an undischarged insolvent; or
- (c) he has applied to be adjudicated as an insolvent and his application is pending.

Every limited liability partnership shall have at least two partners.

If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge

of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

1.3.5 Designated partners

As per Section 7 of the LLP Act, every limited liability partnership should have at least two designated partners who are individuals and at least one of them should be a resident in India:

Provided that in case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such body corporate will act as designated partners.

Explanation. -For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less than 120¹ days during the immediately preceding one year.

Subject to the provisions of the Act,

- (1) if the incorporation document-
 - (a) specifies who are to be designated partners, such persons should be designated partners on incorporation; or
 - (b) states that each of the partners from time to time of limited liability partnership is to be designated partner, every such partner will be a designated partner;
- (2) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.
- (3) An individual will not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.
- (4) Every limited liability partnership should file with the registrar the particulars of every individual who has given his consent to act as a designated partner in such form and manner as may be prescribed within thirty days of his appointment.
- (5) An individual eligible to be a designated partner should satisfy such conditions and requirements as may be prescribed.

¹ Amended as per Limited Liability Partnership (Amendment) Act, 2021

1.3.6 Liabilities of designated partners

As per LLP Act, unless expressly provided otherwise in this Act, a designated partner should be-

- (a) responsible for the doing of all acts, matters, and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement, and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and.
- (b) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

1.3.7 Limitation of Liability of an LLP and its partners

- ◆ Under the LLP Act, 2008 an obligation of an LLP arising out of a contract or otherwise, will be solely the obligation of the LLP;
- ◆ The Liabilities of an LLP should be met out of the properties of the LLP;
- ◆ A partner is not personally liable, directly or indirectly, for an obligation referred to above, solely by reason of being a partner in the LLP;
- ◆ an LLP is not bound by anything done by a partner in dealing with a person, if:
 - The partner does not have the authority to act on behalf of the LLP in doing a particular act; and
 - The other person knows that the partner has no authority or does not know or believe him to be a partner in the LLP

The liability of the LLP and the partners perpetrating fraudulent dealings will be unlimited for all or any of the debts or other liabilities of the LLP. However, in case any such act is carried out by a partner, the LLP is liable to the same extent as the partner unless it is established by the LLP that such act was without the knowledge or the authority of the LLP.

- ◆ The LLP is liable if a partner of LLP is liable to any person as a result of wrongful or omission on his part in the course of business of the LLP or with his authority.

1.3.8 Financial Disclosures & Returns

- ◆ Every LLP should maintain such proper books of accounts as may be prescribed relating to its affairs for each year of its existence on cash basis or accrual basis and according to the double-entry system of accounting and should maintain the same at its registered office for such period as may be prescribed;
- ◆ Every LLP should within six months of the end of each financial year prepare a Statement of Account and Solvency for the said financial year as at the last day of the said financial year, in such form as may be prescribed, and such statement should be signed by the designated partners of the LLP;
- ◆ Every LLP should file within the prescribed time, the Statement of Account and Solvency with the Registrar every year in such form and manner and accompanied by such fee as may be prescribed;
- ◆ The accounts of an LLP must be audited in accordance with such rules as may be prescribed. Provided that the Central Government may, by notification in the Official Gazette, exempt any class or classes of limited liability partnerships from the requirements of this sub-section.



1.4 DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Basis	LLP	Partnership firm
1.	Regulating Act	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	Body corporate	It is a body corporate.	It is not a body corporate,
3.	Separate legal entity	It is a legal entity separate from its members.	It is a group of persons with no separate legal entity.
4.	Creation	It is created by a legal process called registration under the LLP Act, 2008.	It is created by an agreement between the partners.
5.	Registration	Registration is mandatory. LLP can sue and be sued in its own name.	Registration is voluntary. Only the registered partnership firm can sue the third parties.
6.	Perpetual succession	The death, insanity, retirement or insolvency of the partner(s) does not	The death, insanity, retirement or insolvency of the partner(s) may

		affect its existence of LLP. Members may join or leave but its existence continues forever.	affect its existence. It has no perpetual succession.
7.	Name	Name of the LLP to contain the word limited liability partners (LLP) as suffix.	No guidelines. The partners can have any name as per their choice.
8.	Liability	Liability of each partner limited to the extent to agreed contribution except in case of willful fraud.	Liability of each partner is unlimited. It can be extended upto the personal assets of the partners.
9.	Mutual agency	Each partner can bind the LLP by his own acts but not the other partners.	Each partner can bind the firm as well as other partners by his own acts.
10.	Designated partners	At least two designated partners and atleast one of them shall be resident in India.	There is no provision for such partners under the Partnership Act, 1932.
11.	Number of Partners	Minimum 2 but no maximum limit	Minimum 2 and maximum 50.
12.	Legal compliances	Only designated partners are responsible for all the compliances and penalties under this Act.	All partners are responsible for all the compliances and penalties under the Act.
13.	Foreign partnership	Foreign nationals can become a partner in a LLP.	Foreign nationals cannot become a partner in a partnership firm.
14.	Minor as partner	Minor cannot be admitted to the benefits of LLP.	Minor can be admitted to the benefits of the partnership with the prior consent of the existing partners.



1.5 MAIN CLAUSES IN A PARTNERSHIP DEED

The relation between the partners is governed by mutual agreement known as partnership deed. It should be comprehensive to avoid disputes later on. It is usual therefore, to find the following clauses in a Partnership Deed which may or may not be registered.

1. Name of the firm and the partners;

2. Commencement and duration of business;
3. Amount of capital to be contributed by each partner;
4. Amount to be allowed to each partner as drawings and the timings of such drawings;
5. Rate of interest to be allowed to each partner on his capital and on his loan to the firm, and to be charged on his drawings;
6. The ratio in which profits or losses are to be shared;
7. Whether a partner will be allowed to draw any salary;
8. Any variations in the mutual rights and duties of partners;
9. Method of valuing goodwill on the occasions of changes in the constitution of the firm;
10. Procedure by which a partner may retire and the method of payment of his dues;
11. Basis of the determination of the executors of a deceased partner and the method of payment;
12. Treatment of losses arising out of the insolvency of a partner;
13. Procedure to be allowed for settlement of disputes among partners;
14. Preparation of accounts and their audit.

Registration of the firm is not compulsory, but non-registration restricts the partners or the firm from taking any legal action. Often there is no written Partnership Deed or, if there is one, it may be silent on a particular point. In that case the relevant sections of the Partnership Act will apply. If on any point the Partnership Deed contains a clause, it will hold good; otherwise the provisions of the Act relating to the questions will apply.

Rules in the absence of Partnership Deed

In the absence of any agreement to the contrary;

-  No partner has the right to a salary,
-  No interest is to be allowed on capital,
-  No interest is to be charged on the drawings,
-  Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm, and
-  Profits and losses are to be shared equally.

Note: In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

Example

A and B commenced business in partnership on 1 January 2022. No partnership agreement was made either oral or written. They contributed ₹ 40,000 and ₹ 10,000 respectively as capital. In addition, A also advanced ₹ 20,000 on 1 July 2022. A met with an accident on 1 April 2022 and could not attend to the partnership business upto 30 June 2022. The profits for the year ended on 31 December 2022 amounted to ₹ 50,600. Disputes having been arisen between them for sharing the profits.

A claims: (i) He should be given interest at 10% p.a. on capital and loan (ii) Profit should be distributed in proportion of capital.

B claims: (i) Net profit should be shared equally. (ii) He should be allowed remuneration of ₹ 1,000 p.m. during the period of A's illness. (iii) Interest on capital and loan should be given @ 6% p.a. You are required to settle the dispute between them and distribute the profits according to law. State reasons for your answer.

Answer

Since there is no written or oral partnership agreement, allowing rules are applicable as per Indian partnership act 1932

- (a) No interest is allowed on capital.
- (b) 6% p.a. interest is allowed on the loan advanced.
- (c) Profits and losses shall be shared equally.
- (d) No remuneration is allowed to any partner for taking part in the conduct of the business.

Thus

- a) neither of A nor B will be allowed interest on capital
- b) 6% interest will be allowed to both A and B
- c) Profit and losses shall be shared equally between A and B
- d) No remuneration shall be allowed to B.

Net profit for the year	=	50,600
Less: Int. on A's loan $20,000 \times 6\% \times 6/12$	=	<u>600</u>
Net Profit	=	50,000
A's 50%		25,000
B's 50%		25,000

Example

A, B and C are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capitals were ₹ 15,00,000, ₹ 30,00,000 and ₹ 60,00,000 respectively. For the year 2022 interest on capital was credited to them @ 12% instead of 10%. Pass the necessary adjustment entry.

Particulars	A	B	C	Firm
Interest that should have been credited @ 10%	1,50,000	3,00,000	6,00,000	10,50,000
Interest already credited @ 12%	1,80,000	3,60,000	7,20,000	12,60,000
Excess credit in partners account	(30,000)	(60,000)	(1,20,000)	(2,10,000)
By recovering the extra amount paid, the share of profits will increase and it will be credited in the ratio of 2:3:5	42,000	63,000	105,000	2,10,000
Net effect	12,000	3,000	(15,000)	-

The necessary journal entry will be:

Particulars	Debit (₹)	Credit (₹)
C's Current A/c	15,000	
To A's Current A/c		12,000
To B's Current A/c		3,000
(Interest less charged now rectified)		

1.6 POWERS OF PARTNERS

The Partners are supposed to have the power to act in certain matters and not to have such powers in others. In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding on the firm and the provisions of the Act relating to the question will apply. In case of a trading firm, the implied powers of partners are the following:

- Buying and selling of goods;
- Receiving payments on behalf of the firm and giving valid receipt;
- Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

- (d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;
- (e) Engaging servants for the business of the firm.

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are:

- (a) Submitting a dispute relating to the firm arbitration;
- (b) Opening a bank account on behalf of the firm in the name of a partner;
- (c) Compromise or relinquishment of any claim or portion of claim by the firm;
- (d) Withdrawal of a suit or proceeding filed on behalf of the firm;
- (e) Admission of any liability in a suit or proceedings against the firm;
- (f) Acquisition of immovable property belonging to the firm;
- (g) Entering into partnership on behalf of the firm.

The rights, duties and powers of partners can be changed by mutual consent.



1.7 ACCOUNTS

Partnership Act doesn't specify any format for preparation of accounts of Partnership Firm and thus accounts are prepared as per Basic rules of accounts. There is not much difference between the accounts of a partnership firm and that of sole proprietorship (provided there is no change in the firm itself). The only difference to be noted is that instead of one Capital Account there will be as many Capital Accounts as there are partners. If, for instance, there are three partners; A, B, and C, then there will be a Capital Account for each one of the partners; A's Capital Account will be credited by the amount contributed by him as capital and similarly B's and C's Capital Accounts will be credited with the amounts brought in by them respectively as capital.

When a partner takes money out of the firms for his domestic purpose, either his Capital Account can be debited or a separate account, named as Drawings Account, can be opened in his name and the account may be debited. In a Trial Balance of a partnership firm, therefore, one may find Capital Accounts of partners as well as Drawings Accounts. Finally the Drawings Account of a partner may be transferred to his Capital Account so that a net figure is available. But, often the Drawings Account or Current Account (as it is usually called) remains separate.

 1.8 PROFIT AND LOSS APPROPRIATION

During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year. The final accounts of a sole proprietorship concern will not differ from the accounts of a partnership firm. The Profit and Loss Account will show the profit earned by the firm or loss suffered by it. This profit or loss has to be transferred to the Capital Accounts of partners according to the terms of the Partnership Deed or according to the provisions of the Indian Partnership Act (if there is no Partnership Deed or if the Deed is silent on a particular point). Suppose the Profit and Loss Account reveals a profit of ₹ 90,000. There are two partners, A and B. A devotes all his time to the firm; B does not. A's capital is ₹ 50,000 and B's is ₹ 20,000. There is no Partnership Deed. In such a case the profit will be distributed among A and B equally. This is irrespective of the fact that B does not work as much as A does and B's capital is much less than that of A. But if the Partnership Deed lays down that A is to get a salary and interest is to be allowed on the capital, then first of all, from the profit earned, A's salary must be deducted and interest on the Capital Accounts of both partners will be deducted. The remaining profit will be divided equally between A and B. Further if the Partnership Deed says that profits are to be divided in the ratio of, say, three-fourth to A and one-fourth to B, then this will be the ratio to be adopted.

In a partnership, profit has to be divided between the partners in a certain profit sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, drawings and loans; salaries or/and commission to partners etc. Accordingly, an additional account is prepared and net profit is transferred from the debit side of the profit and loss account to the credit side of this new account which is called Profit and Loss Appropriation Account and before the profit is divided between partners, it is necessary to record the above stated adjustments in this account.

The student can see for himself that if salary is to be allowed to a partner, the Profit and Loss Appropriation Account will be debited and the Partner's Capital Account will be credited. Similarly, if interest is to be allowed on capital, the Profit and Loss Appropriation Account will be debited and the respective Capital Accounts will be credited.

Let us take an illustration to understand how to divide profits among partners.

ILLUSTRATION 1

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Give journal entries relating to division of profit.

SOLUTION**Journal Entries**

2022	Particulars	Dr. (₹)	Cr. (₹)
Dec. 31	Profit and Loss Appropriation Account Dr. To B's Capital Account (Salary due to B @ ₹ 500 per month)	6,000	6,000
	Profit and Loss Appropriation Account Dr. To A's Capital Account To B's Capital Account (Interest due on Capital @ 6% per month)	3,000	1,800 1,200
	Profit and Loss Appropriation Account Dr. To A's Capital Account To B's Capital Account (Remaining profit of ₹ 16,000 divide between A and B in the ratio of 5:3)	16,000	10,000 6,000

Now, let us learn the preparation of profit and loss appropriation account with the help of same illustration of partnership firm consisting of partners A and B.

ILLUSTRATION 2

Ram, Rahim and Karim are partners in a firm. They have no agreement in respect of profit-sharing ratio, interest on capital, interest on loan advanced by partners and remuneration payable to partners. In the matter of distribution of profits they have put forward the following claims:

- (i) *Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim and Karim do not agree.*
- (ii) *Rahim has devoted full time for running the business and demands salary at the rate of ₹ 500 p.m. But Ram and Karim do not agree.*
- (iii) *Karim demands interest on loan of ₹ 2,000 advanced by him at the market rate of interest which is 12% p.a.*

How shall you settle the dispute and prepare Profit and Loss Appropriation Account after transferring 10% of the divisible profit to Reserve. Net profit before taking into account any of the above claims amounted to ₹ 45,000 at the end of the first year of their business

SOLUTION

There is no partnership deed. Therefore, the following provisions of the Indian Partnership Act are to be applied for settling the dispute.

- (i) No interest on capital is payable to any partner. Therefore, Ram is not entitled to interest on capital.
- (ii) No remuneration is payable to any partner. Therefore, Rahim is not entitled to any salary.
- (iii) Since interest on loan payable to partner is not an appropriation of profit. It will be charged to Profit and Loss Account.
- (iv) The profits should be distributed equally.

Profit and Loss Appropriation Account for the year ended...

	Particulars		₹	Particulars	₹
To	Reserve A/c – 10% of ₹ 44,880		4,488	By Profit and Loss A/c - ₹ (45,000-120)	44,880
To	Share of Profit A/c:			(Net profit)	
	Ram capital A/c	₹ 13,464			
	Rahim capital A/c	₹ 13, 464			
	Karim capital A/c	₹ 13, 464	40,392		
			44,880		44,880

ILLUSTRATION 3

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Profit and Loss Appropriation Account.

SOLUTION**Profit and Loss Appropriation Account for the year ended 31-Dec-22**

Particulars	₹	Particulars	₹
To B's Capital Account-Salary	6,000	By Net Profit	25,000
To A's Capital Account-interest	1,800		
To B's Capital Account-interest	1,200		
To Profit transferred to:			
A's Capital Account (5/8)	10,000		
B's Capital Account (3/8)	6,000		
	25,000		25,000

NOTE: Since date of drawing & rate of interest on drawing is not given, it is assumed drawings are made on last day of year.

Let us also learn the preparation of capital accounts of partners with the help of same illustration of partnership firm consisting of partners A and B.

ILLUSTRATION 4

A and B start business on 1st January, 2022, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2022, the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Capital Accounts of Partners A and B.

SOLUTION

Dr.			A's Capital Account			Cr.	
2022	Particulars	₹	2022	Particulars	₹		
Dec. 31	To Bank A/c- (Drawings)	8,000	Jan. 1	By Bank A/c	30,000		
	To Balance c/d	33,800	Dec. 31	By Profit and Loss appropriation A/c Interest	1,800		

				By Profit and Loss appropriation A/c-(5/8 Profit)	10,000
		41,800			41,800
			2023		
			Jan. 1	By Balance b/d	33,800

Dr.

B's Capital Account

Cr.

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Bank A/c (Drawings)	10,000	Jan. 1	By Bank A/c	20,000
Dec. 31	To Balance c/d	23,200	Dec. 31	By Profit and Loss appropriation A/c	
				- Salary	6,000
				-Interest	1,200
				By Profit and Loss appropriation A/c	6,000
				- (3/8 Profit)	
		33,200			33,200
			2023		
			Jan. 1	By Balance b/d	23,200

**1.9****FIXED AND FLUCTUATING CAPITAL**

You have seen in the above example that the Capital Account of A has changed from ₹ 30,000 at the beginning to ₹ 33,800 and B's Capital A/c from ₹ 20,000 to ₹ 23,200. This is because we have made entries in respect of interest, salary, profit earned during the year and money taken out by the partners in the Capital Account itself. If the Capital Accounts are prepared on this basis, capitals are said to be fluctuating. Some firms, however, prefer to continue to show the Capital Accounts of the partners at the same old figure. This means that no entry is to be made in the Capital Account in respect of interest, salary, profit and drawings etc. A separate account is to be opened for this purpose. This account is known as the Current Account or even as Drawings Account. Under this system interest on capital if allowed, should be calculated only on the amount of the fixed capital. If the capital Accounts are prepared on this basis, capitals are said to be fixed.

Thus, there are two methods of accounting –

- i) **Fixed capital method and**
- ii) **Fluctuating capital method.**

In Fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In Fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

1.9.1 Interest on Capital:

A partner is not entitled to interest on his capital as a matter of right. But if there is an agreement, that partner would receive interest on his capital it is paid at the agreed rate only out of profits. Interest on capital is generally calculated on the opening balance and allowance is made for any additions of capital or withdrawals there from during the accounting period.

- ♦ The amount of interest is debited to interest on capital accounts and credited to the capital accounts, if capitals are fluctuating and current accounts, if capitals are fixed. Interest on capital account is then closed by transfer to profit and loss appropriation account.
- ♦ Alternatively, credit the capital (or current) account of the partner concerned and debit the profit and loss appropriation account.

For interest on capital

Profit and Loss Appropriation Account

Dr.

To (Individual) Capital (or Current) Accounts of Partners

Interest is generally allowed on capitals of the partners. Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business. Normally, it is charged for full year on the balance of capital at the beginning of the year unless some fresh capital is introduced during the year. On the additional capital introduced, interest for the relevant period of utilization is calculated. For example, A has ₹30,000 capital in the beginning of the year and introduces ₹10,000 during the year. If rate of interest on capital is 20 % p.a., interest on A's capital is calculated as follows:

$$\left[30,000 \times \frac{20}{100} \right] + \left[10,000 \times \frac{20}{100} \times \frac{6}{12} \right] = ₹ 6,000 + ₹ 1,000 = ₹ 7,000$$

In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and no interest is payable / chargeable on the balance of current accounts.

Net loss and Interest on Capital: Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.

Example

Shilpa and Sanju are partners with a capital of ₹1,00,000 and ₹1,60,000 on January 1, 2022 respectively. Shilpa introduced additional capital of ₹30,000 on July 1, 2022 and another ₹20,000 on October 31, 2022. Calculate interest on capital for the year ending 2022. The rate of interest is 9% p.a.

Solution

Interest on Capital (Shilpa):

$$\begin{aligned} \text{On ₹1,00,000 for 12 month @ 9\%} &= 1,00,000 \times 9/100 \times 12/12 \\ &= ₹ 9,000 \end{aligned}$$

$$\begin{aligned} \text{On ₹30,000 for 6 month @ 9\%} &= 30,000 \times 9/100 \times 6/12 \\ &= ₹ 1,350 \end{aligned}$$

$$\begin{aligned} \text{On ₹20,000 for 2 month @ 9\%} &= 20,000 \times 9/100 \times 2/12 \\ &= ₹300 \end{aligned}$$

$$\begin{aligned} \text{Total interest on shilpa capital} &= ₹ 9,000 + ₹ 1,350 + ₹ 300 \\ &= ₹10,650 \end{aligned}$$

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

$$\text{Interest on capital } 14,20,000 \times 09/100 \times 1/12 = ₹ 10,650$$

Interest on Capital (Sanju):

On ₹1,60,000 for 12 month @ 9% = $1,60,000 \times 9/100 \times 12/12 = ₹14,400$

By product method: $= 1,60,000 \times 12 = 19,20,000 = 19,20,000 \times \frac{9}{100} \times \frac{1}{12} = 14,400$

1.9.2 Interest on Drawings

Sometimes interest is not only allowed on the capitals, but is also charged on drawings. In such a case, interest will be charged according to the time that elapses between the taking out of the money and the end of the year.

Method 1: Product Method: When Unequal amount is withdrawn at different time period.

Suppose X, a partner, has drawn the following sum of money –

	₹
On 29th February, 2022	500
On 31st March, 2022	400
On 30th June, 2022	600
On 31st October, 2022	800

Accounts are closed on 31st December every year. Interest is chargeable on drawings at 6% per annum. The interest on X's drawings will be calculated as shown below:

		₹
1.	On ₹ 500 for 10 months, i.e.	25
2.	On ₹ 400 for 9 months, i.e.	18
3.	On ₹ 600 for 6 months, i.e.	18
4.	On ₹ 800 for 2 months, i.e.	8
	Total	69

Alternatively, it can be calculated as follows:

Amount (₹)	Number of months	Product
500	10	5,000
400	9	3,600
600	6	3,600
800	2	1,600
2,300		13,800

Interest on ₹ 13,800 for one month at 6% per annum is ₹ 69.

If the dates on which amounts are drawn are not given, the student will do well to charge interest for six months on the whole of the amount on the assumption that the money was drawn evenly through out the year. In the above example, the total drawings come to ₹ 2,300; and at 6% for 6 months, the interest comes to ₹ 69. The entry to record interest on drawings is- debit the Capital Account of the partner concerned (or his Current Account if the capital is fixed) and credit the Profit and Loss Appropriation Account.

If withdrawals are made evenly in the beginning of each month, interest can be calculated easily for the whole of the amount of 6-1/2 months; if withdrawals are made at the end of each month, interest should be calculated for 5-1/2 months. If withdrawals are made at the beginning of each quarter, interest can be calculated by $\text{Total drawings} \times \text{Rate} \times 100 \times 7.5/12$.

However, if withdrawals are at end of each quarter, the formula : $\text{Total drawings} \times \text{Rate} \times 100 \times 4.5/12$ will apply.

1.9.3 Guarantee of Minimum Profit

Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- ◆ Excess is payable by one of the remaining partners.
- ◆ Excess is payable by at least two or all the partners in an agreed ratio.
- ◆ Excess is payable by remaining partners in their mutual profit sharing ratio.

If the question is silent about the nature of guarantee, the burden of guarantee is borne by the remaining partners in their mutual profit sharing ratio.

1.9.4 Capital ratio

Partners may agree to share profits and losses in the capital ratio. When capitals are fixed, profits will be shared in the ratio of given capitals. But if capitals are fluctuating and partners introduce or withdraw capitals during the year, the capitals for the purpose of ratio would be determined with reference to time on the basis of weighted average method.

Example

A and B formed a partnership with a capital contribution of ₹50,000 and ₹30,000 respectively on 1st January 2022. The profits were to be shared in the capital ratio. Calculate the capital ratio on the basis of following details:

	Capital Introduced		Capital Withdrawn	
	A (₹)	B (₹)	A (₹)	B (₹)
31 March	5,000	–	–	2,000
1 July	–	9,000	3,000	–
1 September	5,500	–	–	1,000
1 November	–	4,000	4,500	–

Answer**Total Capital Employed by A for one Month**

Capital (₹)	Months for which capital has been used in the business	Product (₹)
50,000	3	1,50,000
55,000	3	1,65,000
52,000	2	1,04,000
57,500	2	1,15,000
53,000	2	1,06,000
Total		6,40,000

Total Capital Employed by B for one Month

Capital	Months for which capital has been used in the business	Product
(₹)		(₹)
30,000	3	90,000
28,000	3	84,000
37,000	2	74,000
36,000	2	72,000
40,000	2	80,000
Total		4,00,000

On the basis of products of both the partners, the capital ratio between A and B is 64: 40 or 8 : 5.

ILLUSTRATION 5

A and B are partners sharing profits and losses in the ratio of their effective capital. They had ₹ 1,00,000 and ₹ 60,000 respectively in their Capital Accounts as on 1st January, 2022.

A introduced a further capital of ₹ 10,000 on 1st April, 2022 and another ₹ 5,000 on 1st July, 2022. On 30th September, 2022 A withdrew ₹ 40,000.

On 1st July, 2022, B introduced further capital of ₹ 30,000.

The partners drew the following amounts in anticipation of profit.

A drew ₹ 1,000 per month at the end of each month beginning from January, 2022. B drew ₹ 1,000 on 30th June, and ₹ 5,000 on 30th September, 2022.

12% p.a. interest on capital is allowable and 10% p.a. interest on drawings is chargeable. Date of closing 31.12.2022. Calculate: (a) Profit-sharing ratio; (b) Interest on capital; and (c) Interest on drawings.

SOLUTION**(a) Calculation of Effective Capital**

A		B	
₹ 1,00,000 invested for 3 months i.e.,		₹ 60,000 invested for 6 months i.e.,	
₹ 3,00,000 invested for 1 month	3,00,000	₹ 3,60,000 invested for 1 month	3,60,000
₹ 1,10,000 invested for 3 months i.e.,		₹ 90,000 invested for 6 months, i.e.,	
₹ 3,30,000 invested for 1 month.	3,30,000	₹ 5,40,000 invested for 1 month	5,40,000
			9,00,000
₹ 1,15,000 invested for 3 months i.e.,			
₹ 3,45,000 invested for 1 month.	3,45,000		
₹ 75,000 invested for 3 months, i.e.,			
₹ 2,25,000 invested for 1 month.	2,25,000		
	12,00,000		

(b) Calculation of Interest on Capital

$$A = ₹ 12,00,000 \times 12/100 \times 1/12 = ₹ 12,000$$

$$B = ₹ 9,00,000 \times 12/100 \times 1/12 = ₹ 9,000$$

(c) Calculation of Interest on Drawings

$$A = ₹ 12,000 \times 10/100 \times 5.5/12 = ₹ 550$$

$$B = ₹ 1,000 \times 10/100 \times 6/12 = ₹ 50$$

$$₹ 5,000 \times 10/100 \times 3/12 = ₹ 125$$

Effective capital is in the ratio 12 : 9 therefore profit sharing ratio is 12 : 9 i.e. 4 : 3.

ILLUSTRATION 6

Ram and Rahim start business with capital of ₹50,000 and ₹30,000 on 1st January, 2022. Rahim is entitled to a salary of ₹400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year, Ram withdrew ₹8,000 and Rahim withdrew ₹10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹30,000. Assuming the capitals to be fixed, prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

SOLUTION**Profit & Loss (Appropriation) Account**

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Rahim's Current A/c		Dec. 31	By Net Profit	30,000
	Salary	4,800		By Sundries-Interest on Drawings:	
	To Sundries-Interest on Capitals :			Ram's Current A/c	
	Ram's Current A/c	3,000		(6% on ₹ 8,000 for 6 months)	240
	Rahim's Current A/c	1,800		Rahim's Current A/c	
	To Profit transferred to			(6% on ₹ 10,000 for 6 months)	300
	Ram's Current A/c (1/2)	10,470			
	Rahim's Current A/c (1/2)	10,470			
		30,540			30,540

ILLUSTRATION 7

With the help of same information given in illustration 6, let us prepare the Capital and Current Accounts of Ram and Rahim.

SOLUTION

Ram's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Balance c/d	50,000	Jan. 1	By Bank A/c	50,000
			2023		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Balance c/d	30,000	Jan. 1	By Bank A/c	30,000
			2023		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2022	Particulars	₹	2022	Particulars	₹
Dec. 31	To Cash Bank A/C (Drawings)	8,000	Dec. 31	By Profit and Loss appropriation A/c - Interest	3,000
	To Profit and Loss appropriation A/c - Interest on Drawings	240		By Profit and Loss appropriation A/c - 1/2 profit	10,470
	To Balance c/d	5,230			
		13,470			13,470
			2023		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2022	Particulars	₹	2022	Particulars	₹
	To Cash Bank A/c (Drawings)	10,000	Dec. 31	By Profit and Loss A/c Salary	4,800
Dec. 31	To Profit and Loss appropriation A/c			Interest	1,800
	Interest on Drawings	300		By Profit and Loss A/c Profit	10,470
	To Balance c/d	<u>6,770</u>			<u>17,070</u>
		<u>17,070</u>	2023		
			Jan. 1	By Balance b/d	6,770

ILLUSTRATION 8

A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less than ₹250,00,000. Total profits of the firm for the year ended 31st March, 2022 were ₹900,00,000. Calculate share of profits for each partner when:

1. Guarantee is given by firm.
2. Guarantee is given by A
3. Guarantee is given by A and B equally.

SOLUTION

Case1. When Guarantee is given by firm.

Profit and Loss Appropriation Account

For the year ending on 31st March, 2022

Particulars	₹	Particulars	₹
To A's Capital A/c (3/5 of ₹ 650,00,000)	3,90,00,000	By Profit and Loss, A/c	9,00,00,000
To B's Capital A/c (2/5 of ₹ 650,00,000)	2,60,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000 or ₹ 25,00,00,000 which ever is more)	2,50,00,000		
	<u>9,00,00,000</u>		<u>9,00,00,000</u>

Case2. When Guarantee is given by A

Profit and Loss Appropriation Account
For the year ending on 31st March, 2022

Particulars	₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)		By Profit and Loss, A/c (net profits)	9,00,00,000
4,50,00,000			
Less: Deficiency borne for C (1,00,00,000)	3,50,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000) 1,50,00,000			
Add: Deficiency Recovery from A 1,00,00,000	2,50,00,000		
	9,00,00,000		9,00,00,000

Case3. When Guarantee is given by A and B equally.

Profit and Loss Appropriation Account
For the year ending on 31st March, 2022

Particulars		₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)	4,50,00,000		By Profit and Loss, A/c (net profits)	9,00,00,000
Less: Deficiency borne for C (1/2 of 1,00,00,000)	(50,00,000)	4,00,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000			
Less: Deficiency borne for C (1/2 of 1,00,00,000)	(50,00,000)	2,50,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000)	1,50,00,000			
Add: Deficiency Recovery from A 50,00,000				
Add: Deficiency Recovery from B 50,00,000	50,00,000	2,50,00,000		
		9,00,00,000		9,00,00,000

SUMMARY

- ◆ The Indian Partnership Act defines partnership as “the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.”
- ◆ The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature.
- ◆ In the partnership firm relations among the partners will be governed by mutual agreement. The agreement is known as Partnership Deed which is to be properly stamped.
- ◆ In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.
- ◆ During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year.
- ◆ There are two methods of accounting –
 - i. Fixed capital method and
 - ii. Fluctuating capital method.

In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

- ◆ Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business.
- ◆ Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.

- ◆ Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

TEST YOUR KNOWLEDGE

True and False

1. *In absence of any agreement partners share profits of the business in the ratio of their capital contribution.*
2. *Profit sharing ratio and capital contribution ratio need not be same.*
3. *Every partnership firm must register itself with Registrar of firms.*
4. *A partner can advance loan to the partnership firm in addition to capital contributed by him.*
5. *A partner can demand interest on capital even if it is not provided in the partnership deed.*
6. *If a partner does not take part in day to day business activities of the firm then he is not entitled to any share of profit.*
7. *Interest should be paid @ 6% p.a. on partners' loan even if it is not provided in the partnership deed.*
8. *Husband and wife cannot be partners in the same firm.*
9. *One senior partner is Principal and other partners are his agents.*
10. *Partners are the agents of the firm and each other.*

Multiple Choice Questions

1. *If a firm prefers Partners' Capital Accounts to be shown at the amount introduced by the partners as capital in firm then entries for salary, interest, drawings, interest on capital and drawings and profits are made in*
 - (a) *Trading Account*
 - (b) *Profit and Loss Account*
 - (c) *Partners' Current Account*

2. *In the absence of any agreement, partners are liable to receive interest on their Loans @*
 - (a) 12% p.a.
 - (b) 10% p.a.
 - (c) 6% p.a.
3. *The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as*
 - (a) Partnership.
 - (b) Joint Venture.
 - (c) Association of Persons.
4. *Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in*
 - (a) Profit sharing of the partners.
 - (b) Calculation of the goodwill.
 - (c) Both.
5. *In the absence of an agreement, partners are entitled to*
 - (a) Interest on Loan and Advances.
 - (b) Commission.
 - (c) Salary.
6. *Partners are supposed to pay interest on drawings only when by the*
 - (a) Provided, Agreement.
 - (b) Agreed, Partners
 - (c) Both (a) & (b) above.
7. *When a partner is given a guarantee by the other partner, loss on such guarantee will be borne by*
 - (a) Partner who gave the guarantee
 - (b) All the other partners.
 - (c) Partnership firm.

8. A, B and C had capitals of ₹ 50,000; ₹ 40,000 and ₹ 30,000 respectively for carrying on business in partnership. The firm's reported profit for the year was ₹ 80,000. As per provisions of the Indian Partnership Act, 1932, find out the share of each partner in the above amount after taking into account that no interest has been provided on an advance by A of ₹ 20,000, in addition to his capital contribution.
- (a) ₹ 26,267 for Partner B and C & ₹ 27,466 for partner A.
 - (b) ₹ 26,667 each partner.
 - (c) ₹ 33,333 for A, ₹ 26,667 for B and ₹ 20,000 for C.
9. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and X wanted interest on capital @ 20% as his capital contributions was ₹ 1,00,000 as compared to that of Y and Z which was ₹ 75,000 and ₹ 50,000 respectively.
- (a) Profits of ₹ 6,000 will be distributed equally with no interest on either Capital.
 - (b) X will get the interest of ₹ 20,000 and the loss of ₹ 14,000 will be shared equally.
 - (c) All the partners will get interest on capital and the loss of ₹ 39,000 will be shared equally.
10. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Y determined interest @ 24% p.a. on his loan of ₹ 80,000. There was no agreement on this point.
- Calculate the amount payable to X, Y and Z respectively.
- (a) ₹ 2,000 to each partner.
 - (b) Loss of ₹ 4,400 for X and Z & Y will take home ₹ 14,800.
 - (c) ₹ 400 for X, ₹ 5,200 for Y and ₹ 400 for Z.
11. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Z demanded minimum profit of ₹ 5,000 as his financial position was not good. However, there was no written agreement. Profits to be distributed to X, Y and Z will be
- (a) Other partners will pay Z the minimum profit and will suffer loss equally.
 - (b) Other partners will pay Z the minimum profit and will suffer loss in capital ratio.
 - (c) ₹ 2,000 to each of the partners.

Theory questions

- Write short notes on:
 - Features of Partnership
 - Powers of Partners
- Distinguish between fixed capital and fluctuating capital.
- What are the liabilities of designated partners in case of LLP.

Practical questions

- Weak, Able and Lazy are in partnership sharing profits and losses in the ratio of 2:1:1. It is agreed that interest on capital will be allowed @ 10% per annum and interest on drawings will be charged @ 8 % per annum. (No interest will be charged/allowed on Current Accounts).

The following are the particulars of the Capital and Drawings Accounts of the partners:

	Weak	Able	Lazy
	₹	₹	₹
Capital (1.1.2022)	75,000	40,000	30,000
Current Account (1.1.2022)	10,000	5,000	(Dr.) 5,000
Drawings	15,000	10,000	10,000

The draft accounts for 2022 showed a net profit of ₹ 60,000 before taking into account interest on capitals and drawings and subject to following rectification of errors:

- Life Insurance premium of Weak amounting to ₹ 750 paid by the firm on 30th June, 2022 has been charged to Miscellaneous Expenditure A/c.
- Repairs of Machinery amounting to ₹ 10,000 has been debited to Plant Account and depreciation thereon charged @ 20%.
- Travelling expenses of ₹ 3,000 of Able for a pleasure trip to U.K. paid by the firm on 30th June, 2022 has been debited to Travelling Expenses Account.

You are required to prepare the Profit and Loss Appropriation Account, Current Accounts of partners Weak, Able and Lazy for the year ended 31st December, 2022.

- Ram and Rahim are in partnership sharing profits and losses in the ratio of 3:2. As Ram, on account of his advancing years, feels he cannot work as hard as before, the chief clerk of the firm, Ratan, is admitted as a partner with effect from 1st January, 2022, and

becomes entitled to 1/10th of the net profits and nothing else, the mutual ratio between Ram and Rahim remaining unaltered.

Before becoming a partner, Ratan was getting a salary of ₹ 500 p.m. together with a commission of 4% on the net profits after deducting his salary and commission.

It is provided in the partnership deed that the share of Ratan's profits as a partner in excess of the amount to which he would have been entitled if he had continued as the chief clerk, should be taken out of Ram's share of profits.

The net profit for the year ended December 31, 2022 is ₹ 1,10,000. Show the distribution of net profit amongst the partners.

3. X and Y are partners. As per terms of agreement interest is allowed on capital at 8% p.a. and charged on drawings at 10% p.a. X withdrew ₹ 40,000 pm at the end of each month and Y withdrew ₹ 120,000 at the end of each quarter. You are required to fill the missing figures in following accounts:

Profit and Loss Appropriation Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To ...?		By Profit and Loss A/c (Net profit)	?
To Interest on Capital A/c		By Interest on Drawings A/c	?
X 160,000		X ?	
Y ?	288,000	Y ?	
To profit transferred to Capital A/c			
X (2/3) ?			
Y (1/3) 280,000	?		
	?		?

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To ...?	?	?	By ...?	?	?
To ...?	?	?	By Salary A/c	3,60,000	?
To ...?	?	?	By ...?	?	?
			By ...?	?	?
	?	?		?	?

ANSWERS/HINTS

True and False

1. False: In absence of any agreement partners share profits equally and not in capital contribution ratio.
2. True: Profit sharing can be different from the that of the capital introduced by each of the partner. Not necessary that partner contributing more capital should have a higher profit sharing ratio and vice versa.
3. False: Registration of firms is not compulsory under Indian Partnership Act, 1932.
4. True: Where the partnership deed is absent, then the interest shall be paid at 6% per annum. So the interest on the loan to be paid to the partner.
5. False: Interest on capital can be paid only if it is provided in the partnership deed.
6. False: Every partner need not take part in the business. Even if a partner does not take part in the business he is entitled for his share of profit.
7. True: In absence of Partnership deed, Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm.
8. False: Husband and wife can be partners in the same firm.
9. False: There is no senior or junior partner. Every partner is agent/principal of other partners.
10. True: Concept of agency applies to every partner and the firm as well. So each partner is a principal to and agent of every other partner and to the firm.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(a)	4.	(b)	5.	(a)	6.	(c)
7.	(a)	8.	(a)	9.	(a)	10.	(c)	11.	(c)		

Theoretical Questions

1. (a) The following four essential features of a partnership, namely:
 - (i) Partnership is the result of an agreement: It means that the relation of partnership arises from contract and not from status.
 - (ii) Business: A partnership can exist only in business.

- (iii) Sharing of profit: The persons concerned must agree to share the profits of the business.
 - (iv) Mutual agency: It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.
- (b)** Powers of partners are the following:
- (i) Buying and selling of goods;
 - (ii) Receiving payments on behalf of the firm and giving valid receipt;
 - (iii) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;
 - (iv) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;
 - (v) Engaging servants for the business of the firm.
2. **(a)** In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.
- In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.
3. Please refer para 1.3.6

Practical Problems

1.

Weak, Able & Lazy

Profit and Loss Appropriation Account for the year ended

31st December, 2022

	₹	₹		₹	₹
To Interest on Capital:			By Net Profit (Adjusted)		55,750
Weak	7,500		By Interest on Drawings:		

Able	4,000	14,500	Weak	630	1,550
Lazy	3,000		Able	520	
			Lazy	400	
To Partner's Current A/cs-					
Share of profit :					
Weak	21,400				
Able	10,700				
Lazy	10,700	42,800			
		57,300			57,300

Working Notes:**(i) Adjusted Profit**

	₹	₹
Net Profit as per Profit & Loss A/c	60,000	
Add : Drawings by Weak : Life Insurance Premium of Weak charged to Miscellaneous Expenditure A/c of the Firm	750	
Drawings by Able : Travelling expenses of Able in connection with pleasure trip to U.K. charged to travelling expenses A/c of the firm	3,000	63,750
Less: Repairs to Machinery wrongly capitalised	10,000	
Less : Depreciation charged @ 20%	(2,000)	(8,000)
		55,750

(ii) Interest on Drawings :

	Weak	Able	Lazy
	₹	₹	₹
Drawings	15,000	10,000	10,000
Add : Rectification adjustments	750	3,000	—
	15,750	13,000	10,000
Interest @ 8% p.a. for 6 months	630	520	400

Partners' Current Accounts

	Weak	Able	Lazy		Weak	Able	Lazy
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	5,000	By Balance b/d	10,000	5,000	–
To Drawings	15,000	10,000	10,000	By Profit & Loss App. A/c (Int. on capital)	7,500	4,000	3,000
To Life Insurance Premium	750	–	–	By Profit & Loss App. A/c (Share of profit)	21,400	10,700	10,700
To Travelling Expenses.	–	3,000	–				
To Profit & Loss App. A/c (Int. on drawings)	630	520	400				
To Balance c/d	22,520	6,180	–	By Balance c/d	–	–	1,700
	38,900	19,700	15,400		38,900	19,700	15,400

2. Amount due to Ratan as a Chief Clerk

	₹
Salary	6,000
Add: Commission 4/104 (₹ 1,10,000 - ₹ 6,000)	4,000
	10,000
Less: Share of Profit as a partner (1/10th of 1,10,000)	(11,000)
Excess chargeable to Ram	(1,000)

Profit and Loss Appropriation Account for the year ended December 31,2022

	Particulars	₹	Particulars	₹
To	Share of Profit A/c		By Profit and Loss A/c	
	Ram [3/5 of (₹ 1,10,000 - ₹ 10,000) – ₹ 1,000]	59,000	(Net profit)	1,10,000

Rahim [2/5 of (₹ 1,10,000 – ₹ 10,000)]	40,000		
Ratan [1/10 of ₹ 1,10,000]	11,000		
	1,10,000		1,10,000

3. Profit and Loss Appropriation Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Salary to X	3,60,000	By Profit and Loss A/c (Net profit)	14,48,000
To Interest on Capital A/c			40,000
X 1,60,000		By Interest on Drawings A/c	
Y <u>1,28,000</u>	2,88,000	X 22,000	
		Y <u>18,000</u>	
To profit transferred to Capital A/c			
X (2/3) 5,60,000			
Y (1/3) <u>2,80,000</u>	8,40,000		
	14,88,000		14,88,000

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To Drawing A/c	4,80,000	4,80,000	By Balance b/d	20,00,000	16,00,000
To Interest on Drawings A/c	22,000	18,000	By Salary A/c	3,60,000	1,28,000
To Balance c/d	25,78,000	15,10,000	By Interest on Capital A/c	1,60,000	
			By Profit and Loss App A/c	5,60,000	2,80,000
	30,80,000	20,08,000		30,80,000	2,008,000

Working Notes:

- X's Share of Profit $2,80,000 \times \frac{3}{1} \times \frac{2}{3} = 5,60,000$
- Interest on Drawings
 $X = 4,80,000 \times \frac{11}{2} \times \frac{1}{12} \times \frac{10}{100} = 22,000$
 $Y = 4,80,000 \times \frac{9}{2} \times \frac{1}{12} \times \frac{10}{100} = 18,000$
- Y's Interest on Capital $2,88,000 - 1,60,000 = 1,28,000$

UNIT – 2: TREATMENT OF GOODWILL IN PARTNERSHIP ACCOUNTS

LEARNING OUTCOMES

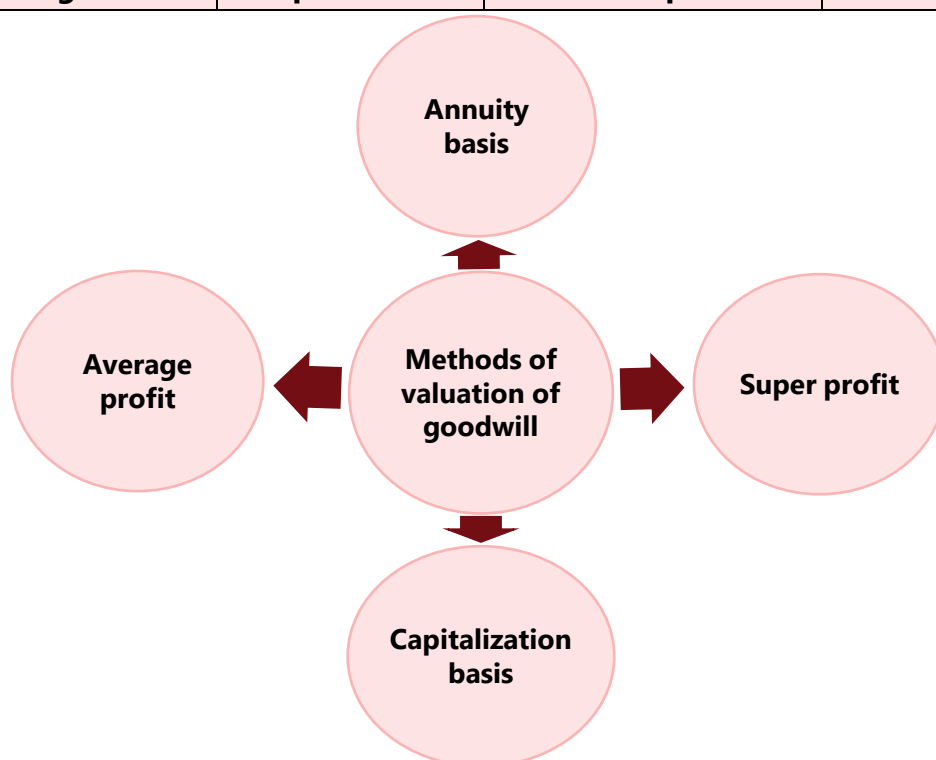
After studying this unit, you will be able to:

- ◆ Understand when does the need for valuation of goodwill arise.
- ◆ Learn the accounting of goodwill.

UNIT OVERVIEW



Necessity for valuation of goodwill			
Change in profit sharing ratio	Admission of partner	Retirement or death of partner	When business is dissolved or sold



 2.1 GOODWILL

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.

In simpler terms, Goodwill is nothing more than the probability that old customer will resort to old place again and again. The capacity of a business to earn super profits in the future is basically what is meant by term goodwill. **Goodwill is an intangible asset;** it cannot be seen; it cannot be felt; it cannot be transported physically. **Even then it is very real.** From accounting point of view, it is necessary that it has some monetary or saleable value. The implication of the term over and above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partner or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

- a) When the profit sharing ratio amongst the partners is changed;
- b) When a new partner is admitted;
- c) When a partner retires or dies; and
- d) When the business is dissolved or sold.

Let us take a simple example. There is a small Book business owned by a firm. Its net worth i.e. Asset–liabilities, is ₹ 140,000. Now if a purchaser is willing to pay ₹ 150,000 for it, the extra ₹ 10,000 is known in accounting as goodwill. The next question is: Why the purchaser is willing to pay ₹ 10,000 for goodwill.

One reason may be the future capability of the business to earn more profit than the normal profit. It may be on account of favourable location.

The major factors which affect value of goodwill are as follows:

The list is in no way exhaustive but only provides the basic guidelines:

- (i) The quality of the goods sold.
- (ii) The personal reputation of the owners i.e., their ability to attract the customers.
- (iii) The location of the business premises e.g., a good position in a congested market.
- (iv) The possession of near monopoly right e.g. main agent for a particular vehicle like, Maruti car, Bajaj scooter, etc.
- (v) The possession of trademarks and patents.
- (vi) The presence of managerial skill.

- (vii) The cost of research and development which enables the production at low cost and of good quality.
- (viii) The possession of special contracts for the availability of materials

RECOMMENDATION OF ACCOUNTING STANDARD

Accounting Standards require an enterprise to recognize an intangible asset, only if and only if, certain conditions are satisfied, namely:

- (i) An intangible asset must have the **characteristics of an asset**. It means that it must have some value and must be clearly identifiable, so that it can be sold without disposing other assets or future benefits flowing from other assets.
- (ii) An intangible asset should be recognized only if the **future probable economic benefits** (i.e., increased revenue from sales) will flow to the business enterprise and not to others. It means that management can make reasonable estimates of future benefits.
- (iii) The cost of the intangible asset can **be measured reliably**, that is, the cost is objectively verifiable. If the cost cannot be measured reliably, then it cannot be recognized as an asset.

It is thus clear that none of the conditions is satisfied by internally generated goodwill or inherent goodwill. The reasons are simple to explain. First, it is not an identifiable resource like patent, trademark or copyright. Second, it is very difficult to assess its future benefits. Finally, the cost of internally generated goodwill cannot be reliably measured in the absence of any consideration in money or money' worth. There is no documentary evidence to support the value of goodwill as a resource.

Goodwill should be recorded in the books only when some consideration in money or money' worth has been paid for it. Accordingly, on admission or retirement/death of a partner or even when there is a change in profit sharing ratio amongst the existing partners, goodwill should not be raised in the books of account of the partnership firm because no consideration in money or money' worth has been paid for it. The conclusion is that only purchased goodwill should be recorded in the books of account whether the payment is made directly in cash or money' worth. For example, 'A' and 'B' purchase the net assets (assets minus liabilities) of 'C' amounting to ₹ 2,50,000 for ₹ 3,00,000 in cash, the additional payment of ₹ 50,000 is a payment for goodwill in cash. It is a case of purchased goodwill (an asset) and can be validly recorded in the books of A and B. When no payment is made for the purchase of goodwill and goodwill account is raised in the books, it is a case of internally generated goodwill or inherent goodwill and as per Accounting Standards, it is not permitted. For example, in the event of reconstitution of the firm due to admission, or retirement or death of a partner or even a change in the profit sharing ratio without reconstitution, goodwill of the firm is evaluated. In

such a situation, the value of goodwill should not be brought into books of account because it is inherent or self-generated goodwill since no money or money's worth has been paid for it. The only way out is that the value of goodwill as calculated with the help of different valuation methods should be adjusted through capital accounts of the partner(s) of the firm. In no case the goodwill account is to be raised in the books of account, either on the reconstitution of the firm or change in the profit sharing ratio.

The amount of goodwill is written off over a period of time. In case when the goodwill account exists at the time of reconstitution of firm, it should be written off immediately whether it is internally generated or goodwill has been bought for some consideration.

2.2 METHODS FOR GOODWILL VALUATION

There are three methods for valuation of goodwill

- 1) Average profit basis,-Simple and Weighted
- 2) Super profit basis,-Number of Year Purchase, Annuity basis, and Capitalization of Super Profit
- 3) Capitalization basis- Average Profits

(1) Average Profit Basis: In this case the average profits of past years are adjusted for any expected change in future. The number of year are decided on the basis of judgement and negotiation.

- ♦ For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.
- ♦ Let us suppose profits of a partnership firm for the last five years were ₹ 30,000, ₹ 40,000, ₹ 50,000, ₹ 60,000 and ₹ 70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weights as shown below :

1	2	3	4 = 2 × 3
Year	Profit	Weight	Weighted Profit
	₹		₹
1	30,000	1	30,000
2	40,000	2	80,000

3	50,000	3	1,50,000
4	60,000	4	2,40,000
5	70,000	5	3,50,000
		15	8,50,000

So, Weighted Average Profit = $\frac{8,50,000}{15} = ₹ 56,667$ (approx)

If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is ₹ 56,667 (approx) × 3 = ₹ 1,70,000.

However, if any such trend is not visible from the figures of past profits, then one should take simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were ₹ 30,000, ₹ 25,000, ₹ 20,000, ₹ 30,000 and ₹ 28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to ₹ 26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' of purchase of profit, the ninth is case, value of goodwill becomes ₹ 79,800.

Weighted average is used when profit has increasing or decreasing Trend. Highest weight is always given to current year, as it reflects the more realistic view of the future profitability

Example

The past profits of five years of a partnership firm are: ₹ 50,000; ₹ 40,000; ₹ 52,000; ₹ 48,000 and ₹ 56,000 respectively. Calculate the value of goodwill on the basis of 4 years' purchase of the average profits of the last five years.

Answer

Total profits for five years = ₹ (50,000 + 40,000 + 52,000 + 48,000 + 56,000) = ₹ 2,46,000

Average profit = Sum of profits/No. of years

Average Profit = ₹ 2,46,000 ÷ 5 = ₹ 49,200

Value of goodwill (being four years' purchase of the average profit of five years) = 4 × ₹ 49,200 = ₹ 1,96,800.

(2) Super Profit Basis: In case of super profit method, goodwill is valued on the basis of super profits earned by the firm.

Super Profit = Actual Profit - Normal Profit

Actual Profit is average maintainable profit

Normal Profit = Normal rate of Return (NRR) × Capital Employed

The rationale for using the super profit is the partner who gains excess earning owing to reconstitution of firm should compensate to partners sacrificing their share in the reconstitution. Super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because normal profit he can earn by joining any partnership firm. Under super profit method, what excess profit a partnership firm can earn is to be determined first.

Calculation of super profit:

- (i) Identify the capital employed by the partnership firm;
- (ii) Identify the average profit earned by the partnership firm based on past few years' figures;
- (iii) Determine normal rate of return prevailing in the locality of similar firms;
- (iv) Apply normal rate of return on capital employed to arrive at normal profit;
- (v) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose, total capital employed by a partnership firm was ₹ 1,00,000 and its average profit was ₹ 25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So, normal profit is ₹ 22,000 and average profit is ₹ 25,000. The partnership firm earns ₹ 3,000 super profit.

- (a) **Number of Years Purchase Method:** Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintenance of such profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as $₹ 3,000 \times 5 = ₹ 15,000$.

Example

A firm of A, B and C has a total capital investment of ₹ 4,50,000. The firm earned net profits during the last four years as: I-₹ 70,000; II-₹ 80,000; III-₹ 1,20,000 and IV-₹ 1,00,000. The reasonable expected return is 15 per cent having regard to the risk involved. The value of goodwill of the business, if it is based on 3 years' purchase of the average super profits of the past four years is as follows:

Average Profit = Sum of profits/no. of years

Normal Profit = NRR x Capital Employed

Super Profit = Average maintainable profit- Normal Profit

	₹
Total profits earned during four years :	3,70,000
Average annual profit ₹ 3,70,000 ÷ 4	92,500
Normal Profit (15% of ₹ 4,50,000)	67,500
Super Profit ₹ 92,500–₹ 67,500	25,000
Value of goodwill (being 3 years' purchase of the average super profit: ₹ 25,000 x 3 =	75,000

- (b) **Annuity Method:** The major drawback of number of number of years purchase method is that time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its value should be different depending upon the rate of interest. If 15% rate of interest is considered appropriate, then discounted value of super profit to be earned in different future years will be as follows:

Year	Super Profit ₹	Discount Factor @15%	Discounted value of Super Profit
1	3,000	.8696	2,608.80
2	3,000	.7561	2,268.30
3	3,000	.6575	1,972.50
4	3,000	.5718	1,715.40
5	3,000	.4972	1,491.60
		3.3522	10,056.60

So, under the annuity method, discounted value of total super profit becomes ₹ 10,056.60 and not ₹ 15,000 as was done under super profit method.

The word annuity is used to mean identical annual amount of super profit. So, for discounting it is possible to refer to annuity table. As per the annuity table, present value of ₹ 1 to be received at the end of each year for 5 years @15% interest p.a. is 3.3522. So value of goodwill under annuity method is ₹ 3,000×3.3522 = ₹ 10,056.60.

Example

Calculate the goodwill by annuity method of super profit from the following facts:

- (a) Annual maintainable profit after tax is ₹ 65,000.
- (b) Capital employed is ₹ 4,00,000.
- (c) Normal rate of return is expected at 12% p.a.
- (d) Present value of an annuity of ₹ 1 for five years @ 12% interest is 3.604776.

Answer

	₹
Annual maintainable profit	65,000
Less: Normal profit based on capital employed and normal rate of return i.e., 12% of ₹ 4,00,000	(48,000)
Super profit	17,000
The present value of an annuity of ₹ 1 for five years at 12% compound interest is	3.604776

The present value of annuity of ₹ 17,000 for five years at 12% compound interest = $17,000 \times 3.604776 = ₹ 61,281$ (Approx.)

Capitalization of Super Profit:

$$\text{Goodwill} = \frac{\text{Super Profit}}{\text{Normal Rate of Return (NRR)}} = \frac{17,000}{12\%} = ₹ 14,1667$$

3 Capitalization Basis: Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill. The steps to be followed under this method are given below:

- a. Determine the normal rate of return.
- b. Find out the average profit of the partnership firm for which goodwill is to be determined.
- c. Determine the capital employed by the partnership firm for which goodwill is to be determined.
- d. Find out normal value of the business by dividing average profit by normal rate of return.

- e. Deduct average capital employed from the normal value of the business to arrive at goodwill.

Goodwill = Normal Capital - Actual Capital

Normal capital = Average Profit/NRR

Let us suppose capital employed by a partnership firm is ₹ 1,00,000. Its average profit is ₹ 20,000. Normal rate of return is 15%.

Normal Value of business = $\frac{20,000}{15\%} = ₹ 1,33,333$ Value of goodwill = ₹ 1,33,333 – ₹ 1,00,000 = ₹ 33,333

Example

The net tangible assets of a firm are worth ₹ 4,10,000 and the average profit of last four years amounts to ₹ 60,000. Find out of the value of goodwill under capitalization method if the reasonable return on capital invested is 12%.

Answer

	₹
Capital invested in the business	4,10,000
Normal rate of return	12%
Average profit earned by the firm	60,000
Value of the firm (Capitalization of average profit): $60,000/12\% =$	5,00,000
Goodwill = Value of the firm – Net Assets = ₹ 5,00,000 – ₹ 4,10,000	90,000

Above methods are explained below with the help of following illustrations:

ILLUSTRATION 1

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s. Lee and Lawson earned profits during 2019-2022 as follows:

Year	Profits (₹)
2019	1,20,000
2020	1,25,000
2021	1,30,000
2022	1,50,000

On 31.12.2022 capital employed by M/s. Lee and Lawson was ₹5,00,000. Rate of normal profit is 20%.

Required

Find out the value of goodwill following various methods.

SOLUTION

Average Profit:

Year	Profit	Weight	Weighted Profit ₹
2019	1,20,000	1	1,20,000
2020	1,25,000	2	2,50,000
2021	1,30,000	3	3,90,000
2022	1,50,000	4	6,00,000
		10	13,60,000

Weighted Average Profit = ₹ 13,60,000 divided by 10 = ₹ 1,36,000

Method (1): Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Valuation of Goodwill: ₹ 1,36,000 × 3 = ₹ 4,08,000

Method (2): Super Profit Basis

	₹
Average Profit	1,36,000
Less: Normal Profit 20% on ₹ 5,00,000	(1,00,000)
	₹ 36,000

Assumption: Goodwill is valued at 3 years' purchase.

Value of Goodwill = ₹ 36,000 × 3 = ₹ 1,08,000

Method (3): Annuity Basis

Assumptions:

- (a) Interest rate is equivalent to normal profit rate i.e. 20%p.a.
- (b) Goodwill is valued at 3 years' purchases

Valuation of Goodwill: ₹ 36,000 × 2.1065 = ₹ 75,834

Method (4): Capitalisation Basis

Normal Value of business: $\frac{₹ 1,36,000}{20} \times 100$	=	₹ 6,80,000
Less: Capital Employed in M/s. Lee and Lawson	=	(₹ 5,00,000)
Goodwill	=	<u>₹ 1,80,000</u>

ILLUSTRATION 2

The following particulars are available in respect of the business carried on by Rathore

		₹
(1)	Capital Invested	1,50,000
(2)	Trading Results:	
	2019 Profit	40,000
	2020 Profit	36,000
	2021 Loss	6,000
	2022 Profit	50,000
(3)	Market Rate of interest on investment	10%
(4)	Rate of risk return on capital invested in business	2%
(5)	Remuneration from alternative employment of the proprietor (if not engaged in business).	₹ 6,000 per annum

You are required to compute the value of goodwill on the basis of 5years' purchase of super profit of the business calculated on the average profits of the last four years.

SOLUTION

Average maintainable profits:		₹
Trading profit during	2019	40,000
	2020	36,000
	2021	50,000
		<u>1,26,000</u>

Less: Loss during	2022	(6,000)
Total		1,20,000
Average Profits		30,000
Less: Remuneration for the proprietor		(6,000)
Average maintainable Profit		24,000
Less: Normal Profit (12% on capital employed of ₹ 1,50,000)		(18,000)
Super Profit		6,000
Goodwill at 5 year's purchase of super Profit		30,000

Hidden or Inferred or implied Goodwill

Sometimes the value of goodwill is not specifically given and has to be inferred or implied from the arrangement of capital or profit-sharing ratio. For example A's capital is ₹ 20,000 and B's Capital is ₹ 15,000 and they share profits equally. C is admitted as a partner with ₹ 18,000 as his capital for 1/4 share in the profits. The total capital of the firm now ought to be ₹ 72,000 for the simple reason that if C contributes ₹ 18,000 for 1/4 share, then for full or unit profit he ought to have contributed ₹ 72,000 (18,000 x 4). But the total capital of A, B and C becomes only ₹ 53,000. So the hidden value of the goodwill should be taken as ₹ 19,000 so that the total capital becomes ₹ 72,000

2.3 NEED FOR VALUATION OF GOODWILL

Whenever there is any change in the existing relationship of the partners in terse, some partners have to sacrifice their future profit and some others would gain. Those who are sacrificing future profit should be compensated by the others who are gaining. This adjustment of the partnership rights may arise due to admission of a new partner, change in the profit sharing ratio, retirement or death of a partner and a dissolution of the partnership. The partners, who gain in terms of profit sharing ratio, have to pay for such gain as a proportion to the value of goodwill. The partners, who lose in terms of profit sharing ratio, receive payments for the sacrifice as a proportion to the value of goodwill.

2.4 VALUATION OF GOODWILL IN CASE OF ADMISSION OF A PARTNER

When a new partner is admitted into a partnership, certain adjustments in accounts become necessary. Chiefly, this is because the new partner will acquire a share in the profits of the firm and because of this, the old partners will stand to lose. Suppose, A and B are partners sharing profits in the ratio of 3:2. If their profits are ₹ 20,000, A will get ₹ 12,000 and B will get ₹ 8,000. If C is admitted and given one fourth share in profits, then out of ₹ 20,000 he will get ₹ 5,000. The remaining ₹ 15,000 will be divided between A and B; A will get ₹ 9,000 and B will get ₹ 6,000. Thus on C's admission A loses ₹ 3,000 per year and B loses ₹ 2,000 per year. C will have to compensate A and B for this loss. It is no argument to say that on C's admission the profits will not remain at ₹ 20,000; extra profits will arise and therefore, A and B will both get more than what they previously got. But it should be noted that the additional profits will be earned by the combined efforts of all the partners A, B and C. Therefore, if A and B get a share of the extra profits they are not particularly obliged to C. Out of the present profits of ₹ 20,000 they have to give up a share in favour of C and, therefore, they are entitled to a compensation. The problem of compensation is the chief problem while dealing with admission of a partner. This is tackled through goodwill.

But one point should be made clear here. Goodwill is a compensation to old partners for their sacrifice in connection with admission of a new partner. So it is to be credited to the partners according to their profit sacrificing ratio. Whatever share the new partner is getting, it may be sacrificed by the old partners in proportion to their old profit sharing ratio or in different proportion.

For example, Nigam and Dhameja are in partnership sharing profits and losses equally. They agreed to take Ghosh as one-third partner. Now one-third share of Ghosh may come out of sacrifice made by Nigam and Dhameja equally (i.e. at their old profit sharing ratio). See the following profit sharing pattern:

Profit Sharing Pattern

Partners	Old Share	New Share	Sacrifice	Gain
Nigam	$\frac{1}{2}$	$\frac{1}{2} \left[1 - \frac{1}{3}\right] = \frac{2}{3} \times \frac{1}{2} = \frac{1}{3}$	$\frac{1}{2} - \frac{1}{3} = \frac{1}{6}$	—
Dhameja	$\frac{1}{2}$	$\frac{1}{2} \left[1 - \frac{1}{3}\right] = \frac{2}{3} \times \frac{1}{2} = \frac{1}{3}$	$\frac{1}{2} - \frac{1}{3} = \frac{1}{6}$	—
Ghosh	—		—	$\frac{1}{3}$

In other words, one-third share of Ghosh was borne by Nigam and Dhameja at their old profit sharing ratio. By this process Nigam sacrificed $\frac{1}{2} - \frac{1}{3} = \frac{1}{6}$ in share and Dhameja sacrificed

$1/2 - 1/3 = 1/6$ in share. So the profit sacrificing ratio becomes:

Nigam = Dhameja

$1/6 = 1/6$

1 : 1

Which is the same as old profit sharing ratio.

But if the new profit sharing ratio of Nigam, Dhameja and Ghosh becomes 4:2:3, then profit sacrificed by Nigam and Dhameja on Ghosh's admission is not at the old profit sharing ratio. In this case profit sacrificing ratio is as follows:

Nigam = $1/2 - 4/9 = 1/18$

Dhameja = $1/2 - 2/9 = 5/18$

i.e. 1 : 5

If Ghosh pays goodwill of ₹ 24,000, then in the first case, Nigam and Dhameja should share it equally; but in second case Nigam should get ₹ 4,000 and Dhameja should get ₹ 20,000.

Take another example: Nigam and Dhameja are equal partners. They agreed to take Ghosh as one-third partner. The new profit sharing ratio is 4:2:3. Nigam and Dhameja agreed ₹ 27,000 as value of goodwill.

Journal Entry

Ghosh's Capital Account	Dr.	9,000	
To Nigam's Capital Account			1,500
To Dhameja's Capital Account			7,500
(Goodwill adjustment in the profit sacrificing ratio)			

Nigam - ₹ 27,000 × $1/18$

Dhameja - ₹ 27,000 × $5/18$

As per the Accounting Standards, it is not recommended to raise goodwill account but to show the adjustment of goodwill through partners' capital accounts.



2.5 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF ADMISSION OF A NEW PARTNER

The goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Therefore, only purchased goodwill should be recorded in the books of the firm. In case of admission of a partner, goodwill cannot be raised in the books of the firm because no consideration in money or money's worth is paid for it. If the incoming partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed to other existing partners. When a new partner is admitted to a firm, the old partners generally sacrifice in favour of the new partner in terms of lower profit sharing ratio in the future. Therefore, the premium for goodwill brought in by the new partner shall be given to the existing partners on the basis of profit sacrificing ratio. The profit sacrificing ratio is computed by deducting the new profit sharing ratio from the old profit sharing ratio. If the difference is positive, then there is a profit sacrifice and in case the difference is negative, then there is a gain in terms of higher future profit sharing ratio. In case of admission of a partner, only those existing partners are entitled to a share for goodwill who have sacrificed a part of their profits in favour of the new partner. Sometimes, goodwill may be evaluated in case of admission of a partner when incoming partner is unable to bring in cash any premium for goodwill. In that situation also, the value of goodwill should not be raised in the books since it is inherent goodwill. Rather it is preferable that such value of goodwill should be adjusted through partners' capital accounts. It may also be noted that when the incoming partner pays any premium for goodwill privately to the existing partners, no entry is required in the books of the firm. In that case, the amount to be paid to each partner should be calculated as per the profit sacrificing ratio. If only new partner's profit sharing is given then profit sacrificing ratio of old partners would be same as old profit sharing ratio.

Example 1: A, B & C are in partnership sharing profits and losses in the ratio 2:2:1. They want to admit D into partnership with one-fifth share. D brings in ₹ 30,000 as capital and ₹ 10,000 as premium for goodwill.

The necessary journal entry will be:

Bank A/c	Dr.	₹ 40,000	
To A's Capital A/c			₹ 4,000
To B's Capital A/c			₹ 4,000
To C's Capital A/c			₹ 2,000

To D's Capital A/c (Amount brought in by D as Capital and premium for goodwill which is credited to the old partners' Capital accounts in profit sacrificing ratio which is same as old profit sharing ratio)		₹ 30,000

Example 2: A & B are equal partners. They wanted to take C as a third partner and for this purpose goodwill was valued at ₹ 1,20,000. The journal entry for adjustment of value of goodwill through partners' capital accounts will be:

C's Capital A/c	Dr.	₹ 40,000	
To A's Capital A/c			₹ 20,000
To B's Capital A/c			₹ 20,000
(Adjustment for goodwill)			

The net effect in partners' capital accounts is shown on the basis of profit sacrificing ratio:

$$A = 1/6 \times ₹ 1,20,000 = ₹ 20,000 \quad (\text{Cr.})$$

$$B = 1/6 \times ₹ 1,20,000 = ₹ 20,000 \quad (\text{Cr.})$$

$$C = 1/3 \times ₹ 1,20,000 = ₹ 40,000 \quad (\text{Dr.})$$

Example 3: A & B are equal partners. They wanted to admit C as 1/6th partner who brought ₹ 60,000 as goodwill. The new profit sharing ratio is 3:2:1. Profit sacrificing ratio is to be computed as follows:

Old Share – New Share = Share Sacrificed

$$A = 1/2 - 3/6 = 0$$

$$B = 1/2 - 2/6 = 1/6$$

So the entire goodwill should be credited to B's Capital A/c.

Cash A/c	Dr.	₹ 60,000	
To B's Capital A/c			₹ 60,000

(Goodwill brought in by C credited to B's Capital A/c)

Example 4: A, B & C are equal partners. They decided to take D who brought in ₹ 36,000 as goodwill. The new profit sharing ratio is 3:3:2:2.

Old Share – New Share = Share Sacrificed

$$A = 1/3 - 3/10 = 1/30$$

$$B = 1/3 - 3/10 = 1/30$$

$$C = 1/3 - 2/10 = 4/30$$

So goodwill should be shared in the ratio 1:1:4

Bank A/c	Dr.	₹ 36,000	
To A's Capital A/c			₹ 6,000
To B's Capital A/c			₹ 6,000
To C's Capital A/c			₹ 24,000
(Goodwill brought in by D credited to old partners' accounts in their profit sacrificing ratio 1:1:4)			

ILLUSTRATION 3

The following is the Balance Sheet of Yellow and Green as at 31st December, 2022:

Liabilities	₹	Assets	₹
Trade payables	20,000	Cash at Bank	10,000
Capital:		Sundry Assets	55,000
Yellow	25,000		
Green	20,000		
	65,000		65,000

The partners shared profits and losses in the ratio 3:2. On the above date, Black was admitted as partner on the condition that he would pay ₹ 20,000 as Capital. Goodwill was to be valued at 3 years' purchase of the average of four years' profits which were:

	₹		₹
2019	9,000	2021	12,000
2020	14,000	2022	13,000

The new profit sharing ratio is 6:5:5.

Give journal entries and Balance Sheet if goodwill is adjusted through partners' capital accounts.

SOLUTION

		₹	₹
(i)	Bank Account Dr. To Black's Capital Account (Amount brought in by Black as capital)	20,000	20,000
(ii)	Black's Capital Account Dr. To Yellow's Capital Account To Green's Capital Account (Black's share of goodwill adjusted through old partners' capital accounts in the profit sacrificing ratio 18:7)	11,250	8,100 3,150

Balance Sheet as on.31st December, 2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	8,750	65,000		
		85,000		85,000

Note: Calculation of Profit Sacrificing Ratio

Old Share – New Share = Share Sacrificed

$$\text{Yellow } \frac{3}{5} - \frac{6}{16} = \frac{18}{80}$$

$$\text{Green } \frac{2}{5} - \frac{5}{16} = \frac{7}{80}$$

Calculation of Goodwill

$$\text{Average profit} = \frac{9,000 + 14,000 + 12,000 + 13,000}{4} = 12,000$$

$$\text{Goodwill of the firm} = 3 \times 12,000 = 36,000$$

$$\text{Black share} = \left(\frac{36,000}{16} \right) \times 5 = 11,250$$

ILLUSTRATION 4

With the information given in illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash.

SOLUTION

Goodwill brought in cash

Bank Account	Dr.	31,250	
To Black's Capital Account			20,000
To Yellow's Capital Account			8,100
To Green's Capital Account			3,150
(Amount brought in by Black as capital and as goodwill; goodwill credited to Yellow and Green's Capital accounts in the profit sacrificing ratio)			

Balance Sheet as on 31st December, 2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	41,250
Capital:			Sundry Assets	55,000
Yellow	33,100			
Green	23,150			
Black	20,000	76,250		
		96,250		96,250

ILLUSTRATION 5

Continuing with the same illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is brought in cash, but withdrawn.

SOLUTION

Goodwill brought in cash, but withdrawn

In addition to the treatment under Illustration 3 the following additional entry will be made:

Yellow's Capital Account	Dr.	8,100	
Green's Capital Account	Dr.	3,150	
To Bank Account			11,250
(Amount withdrawn by Yellow and Green in respect of goodwill credited to them)			

Balance Sheet as on 31st December, 2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000

ILLUSTRATION 6

On the basis of information given in illustration 3, let us give journal entries and prepare balance sheet assuming that goodwill is paid privately.

SOLUTION

There will be no entry for goodwill but Black will pay ₹ 8,100 to Yellow and ₹ 3,150 to Green. For capital brought in by Black, the entry is:

Bank Account	Dr.	20,000	
To Black's Capital Account			20,000
(Amount brought in by Black as capital)			

Balance Sheet as on.....

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Cash at Bank	30,000
Capital:			Sundry Assets	55,000
Yellow	25,000			
Green	20,000			
Black	20,000	65,000		
		85,000		85,000



2.6 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF CHANGE IN PROFIT SHARING RATIO

In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio.

ILLUSTRATION 7

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. Make the necessary journal entries. Goodwill of the firm is valued at ₹ 90,000.

SOLUTION

Journal Entry

		₹	₹
A's Capital	Dr.	10,000	
To C's Capital A/c			10,000

In this case due to change in profit sharing ratio

A's gain is = $\frac{4}{9}$ less $\frac{1}{3} = \frac{1}{9}$

B's gain is = $\frac{1}{3}$ less $\frac{1}{3} = 0$

C's loss is = $\frac{1}{3}$ less $\frac{2}{9} = \frac{1}{9}$

So, A should compensate C to the extent of $\frac{1}{9}$ th of goodwill i.e. ₹ 90,000 × $\frac{1}{9} = ₹ 10,000$

ILLUSTRATION 8

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at ₹ 20,000. Calculate the sacrifice / gain by the partners and make the necessary journal entry.

SOLUTION

Partner	New Share		Old Share		Difference
A	$\frac{7}{20}$	—	$\frac{4}{10}$	=	$\left(\frac{1}{20}\right)$
B	$\frac{7}{20}$	—	$\frac{3}{10}$	=	$\frac{1}{20}$
C	$\frac{6}{20}$	—	$\frac{3}{10}$	=	0

Thus, B gained $\frac{1}{20}$ th share while A sacrificed $\frac{1}{20}$ th share i.e. ₹ 20,000 × $\frac{1}{20} = ₹ 1,000$. For C there was no loss no gain.

Journal Entry

		₹	₹
B's Capital A/c	Dr.	1,000	
To A's Capital A/c			1,000
(Being goodwill adjusted through partners' capital accounts in sacrificing/gaining ratio)			

ILLUSTRATION 9

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2. Goodwill of the firm is valued at ₹ 20,000. Give necessary journal entry.

SOLUTION

$$\text{A gains by } \frac{3}{10} - \frac{1}{4} = \frac{1}{20}$$

$$\text{B gains by } \frac{3}{10} - \frac{1}{4} = \frac{1}{20}$$

$$\text{C loses by } \frac{1}{4} - \frac{2}{10} = \frac{1}{20}$$

$$\text{D loses by } \frac{1}{4} - \frac{2}{10} = \frac{1}{20}$$

A and B should pay @₹ 1,000 each (i.e., ₹ 20,000 × 1/20) as compensation to C and D respectively for their sacrifice.

Journal Entry

A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
To C's Capital Account			1,000
To D's Capital Account			1,000
(Being goodwill adjusted through partners' capital A/cs at sacrificing/gaining ratio)			



2.7 ACCOUNTING TREATMENT OF GOODWILL IN CASE OF RETIREMENT OR DEATH OF A PARTNER

In case of retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. Therefore, they have to pay to retiring partner for his share of goodwill in the firm in the gaining ratio. Similarly, in case of death of the partner, the continuing partners should bear the share of goodwill due to the heirs of the deceased partner. For this purpose, the goodwill is valued on the date of the retirement or death and adjusted through the capital accounts of the partners.

Example: A, B & C are equal partners. C wanted to retire for which value of goodwill is considered as ₹ 90,000. The necessary journal entry will be:

A's Capital A/c	Dr.	₹ 15,000	
B's Capital A/c	Dr.	₹ 15,000	
To C's Capital A/c			₹ 30,000
(C's share of goodwill adjusted to existing partners' capital accounts in profit gaining ratio)			

ILLUSTRATION 10

Antoo, Bantoo and Chintoo were in partnership sharing profits and losses 3:4:3 respectively. The accounts of the firm are made up to 31st March every year. The partnership provided, inter alia, that: On the retirement of a partner the goodwill was to be valued at three years' purchase of average profits of the past four years up to the date of the retirement after deducting interest @ 12%p.a. on capital employed and remuneration of ₹ 2,000 p.m. to each partner. On 1st April 2022, Antoo retired and it was agreed on his retirement to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet. It was agreed that the capital employed would be ₹ 6,50,000. Bantoo and Chintoo were to continue the partnership, sharing profits and losses equally after the retirement of Antoo. The following were the amounts of profits of earlier years before charging salary to partners and interest on capital employed.

Year	Profit
2018-19	2,60,000
2019-20	2,75,000
2020-21	2,65,000
2021-22	2,80,000

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

SOLUTION**Valuation of Goodwill****Calculation of Average Profit**

2018-19	2,60,000
2019-20	2,75,000
2020-21	2,65,000
2021-22	<u>2,80,000</u>
Total	<u>10,80,000</u>

Average Profit (10,80,000/4)	2,70,000
Less: Interest on capital @ 12%p.a.	78,000
Less: Salaries of partners'(3 x 12 x 2,000)	<u>72,000</u>
Adjusted Average profit	1,20,000
Goodwill (3 years purchase = 3 x 1,20,000)	3,60,000
Antoo's Share of Goodwill (3/10) i.e.	1,08,000

Adjustment Journal entry for Goodwill

Particulars	Dr. ₹	Cr. ₹
Bantoo's Capital Account Dr.	36,000	
Chintoo's Capital Account Dr.	72,000	
To Antoo's Capital Account		1,08,000
(Adjusting entry passed for share of goodwill of Antoo through remaining partners' capital accounts in gaining ratio)		

Working Note:

Partner	New Share	Old Share	Difference
Antoo	0	3/10	= -3/10
Bantoo	1/2	4/10	= 1/10
Chintoo	1/2	3/10	= 2/10

ILLUSTRATION 11

Cu and Au were in partnership sharing profits and losses in the ratio 5:3. On 1st April 2022, they decided to admit Ag the partnership on the following terms:

1. *Ag will bring ₹ 2,00,000/- as capital for $\frac{1}{4}$ share.*
2. *New profit sharing ratio shall be 2:1:1 among Cu, Au and Ag.*
3. *Cu was entitled to salary of ₹ 2,000/- p.m., it was revised to ₹ 3,000 p.m. from 1st October 2020.*
4. *Interest on capital was paid at 8% p.a.*
5. *Capitals as on 31st March 2022 were Cu ₹ 4,00,000 Au ₹ 3,00,000, which had remained unchanged since last four years.*
6. *Goodwill was to be valued on the basis of 3 years purchase of average adjusted weighted average profits of past 4 years. The profits of previous four years, before charging interest on capital and salary to Cu were as follows:*

Year	Profit
2018-19	2,10,000
2019-20	2,60,000
2020-21	2,10,000
2021-22	3,05,000

These profits were subject to following rectification

- (a) *A machine costing ₹ 40,000 purchased on 1st October, 2020 was wrongly charged to revenue. The machinery was depreciated at 20% p.a. on written down value method*
 - (b) *Stock on 31st March 2020 was over valued by ₹ 20,000/-*
 - (c) *There was a loss by fire amounting to ₹ 10,000/- in the year 2018-19 which was not considered in trading account but correctly debited in the Profit & Loss a/c for that year.*
 - (d) *Debtors as on 31st March 2022 included bad debts of ₹ 5,800/-*
7. *Ag shall bring his share of goodwill in cash.*

You are required to calculate amount of goodwill Ag is supposed to bring and journal entry for the same.

SOLUTION

Valuation of goodwill

Particulars	2018-19	2019-20	2020-21	2021-22
Profits	2,10,000	2,60,000	2,10,000	3,05,000
Less: Salary to Cu	(24,000)	(24,000)	(30,000)	(36,000)
Less: Interest on Capital of Partners	(56,000)	(56,000)	(56,000)	(56,000)
Add: Machine to be capitalised			40,000	
Less: Depreciation on above			(4,000)	(7,200)
Less: Over valuation of closing stock		(20,000)		
Add: Over valuation of opening stock			20,000	
Add: Loss by fire	10,000			
Less: Bad debts to be written off				(5,800)
Adjusted profits	1,40,000	1,60,000	1,80,000	2,00,000
Weights	1	2	3	4
Product	1,40,000	3,20,000	5,40,000	8,00,000

Weighted Average profit = total product/ total weights

$$= 18,00,000/10 = 1,80,000$$

Goodwill (3 years purchase) = 3 x 1,80,000 = 5,40,000

Ag's share $\frac{1}{4}^{\text{th}}$ = 5,40,000/4 = 1,35,000

Adjustment Journal entry for Goodwill

Particulars	Dr. ₹	Cr. ₹
Bank A/c Dr.	1,35,000	
To Cu's Capital Account		67,500
To Au's Capital Account		67,500
(Adjusting amount brought in by Ag towards goodwill credited to remaining partners' capital accounts in sacrifice ratio)		

Working Note:

Partner	New Share	Old Share	Difference
Cu	$\frac{2}{4}$	$\frac{5}{8}$	$= \frac{1}{8}$
Au	$\frac{1}{4}$	$\frac{3}{8}$	$= \frac{1}{8}$
Ag	$\frac{1}{4}$		$= \frac{1}{4}$

SUMMARY

- ♦ **Goodwill** is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.
- ♦ **Necessity for valuation of goodwill in a firm arises in the following cases:**
 - When the profit sharing ratio amongst the partners is changed;
 - When a new partner is admitted;
 - When a partner retires or dies, or
 - When the business is dissolved or sold.
- ♦ **Methods for valuation of goodwill:-**
 - (1) **Average profit basis :**

Average Profit = Total profit/Number of years

Goodwill = Average Profit x No. of Years' purchased

The profits taken into consideration are adjusted with abnormal losses, abnormal gains, return on non-trade investments and errors. The average can be simple average or weighted average depending upon the circumstances.
 - (2) **Super profit basis:**

Calculate Capital Employed

Assets	
Less: Liability	
Capital Employed	

 - Find the normal Rate of Return (NRR)
 - Find Normal Profit=Capital Employed X Normal rate of Return
 - Find Average Actual Profit
 - Find Super Profit=Average Actual Profit-Normal Profit
 - Find Goodwill=Super Profit X Number of Years Purchased
 - (3) **Annuity basis:**

Goodwill=Super Profit x Annuity Number
 - (4) **Capitalization basis:**

Goodwill = Super Profit / Normal Rate of Return

TEST YOUR KNOWLEDGE

True and False

1. *Goodwill is intangible asset therefore it cannot be valued.*
2. *Goodwill is valued whenever there is change in the profit sharing ratio among the partners.*
3. *Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits.*
4. *At the time of admission or retirement of a partner, goodwill can be raised in the books of accounts and shown as an asset.*
5. *Only simple average method can be used for valuation of goodwill.*
6. *Super profit means excess of actual average profit over normal profit.*
7. *Normal profit means profit earned by similar companies in the same industry.*
8. *Normal profit depends upon Normal Rate of Return and past profits.*
9. *At the time of admission/retirement of a partner, since goodwill can not be raised in the books of accounts is recorded through capital accounts of the partners.*
10. *At the time of admission of a partner, goodwill brought in by the new partner is shared equally by old partners.*

Multiple Choice Questions

1. *Goodwill brought in by incoming partner in cash for joining in a partnership firm is taken away by the old partners in their.....ratio.*
 - (a) *Capital.*
 - (b) *New Profit Sharing.*
 - (c) *Sacrificing.*
2. *A & B are partners sharing profits and losses in the ratio 5:3. On admission, C brings ₹ 70,000 cash and ₹ 48,000 against goodwill. New profit sharing ratio between A, B and C are 7:5:4. Find the sacrificing ratio of A:B.*
 - (a) *3:1.*
 - (b) *4:7.*
 - (c) *5:4.*

3. *Following are the factors affecting goodwill except:*
- (a) *Nature of business.*
 - (b) *Efficiency of management.*
 - (c) *Location of the customers.*
4. *Weighted average method of calculating goodwill should be followed when:*
- (a) *Profits has increasing trend.*
 - (b) *Profits has decreasing trend.*
 - (c) *Either 'a' or 'b'.*
5. *In the absence of any provision in the partnership agreement, profits and losses are shared*
- (a) *In the ratio of capitals.*
 - (b) *Equally.*
 - (c) *In the ratio of loans given by them to the partnership firm.*
6. *The profits and losses for the last 4 years are 2018-19 Losses ₹ 10,000; 2019-20 Losses ₹ 2,500; 2020-21 Profits ₹ 98,000 & 2021-22 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%.*
- The remuneration of partners is estimated to be ₹ 1,000 per month not charged in the above losses/profits. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years.*
- (a) *₹ 9,000.*
 - (b) *₹ 8,750.*
 - (c) *₹ 8,250.*
7. *A, B and C are partners sharing profits and losses in the ratio 3:2:1. They decide to change their profit sharing ratio to 2:2:1. To give effect to this new profit sharing ratio they decide to value the goodwill at ₹ 30,000. Pass the necessary journal entry if Goodwill not appearing in the old balance sheet and should not appear in the new balance sheet.*
- (a) *B's Capital Account Dr. ₹ 2,000*
C's Capital Account Dr. ₹ 1,000
To A's Capital Account ₹ 3,000

- (b) *Goodwill Account Dr. ₹ 30,000*
 To A's Capital Account ₹ 15,000
 To B's Capital Account ₹ 10,000
 To C's Capital Account ₹ 5,000
- (c) *A's Capital Account Dr. ₹ 12,000*
 B's Capital Account Dr. ₹ 12,000
 C's Capital Account Dr. ₹ 6,000
 To Goodwill Account ₹ 30,000

Theory questions

1. *Write short note on methods for valuation of goodwill.*
2. *Explain Accounting treatment of goodwill in case of change in profit sharing ratio. Distinguish between Super profit basis and Capitalisation Basis.*

Practical questions

1. *Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made upto 31st December every year.*

The partnership provided, inter alia, that:

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto the date of the death after deducting interest @8 percent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2022, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be ₹ 15,000 per annum and that the capital employed would be ₹ 1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

The following were the amounts of profits of earlier years before charging interest on capital employed.

	₹
2019	67,200
2020	75,600
2021	72,000
2022	62,400

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

ANSWERS/HINTS

True and False

1. False: Even though Goodwill is intangible asset it can be valued in terms of money.
2. True: Goodwill has to be valued every time whenever there is a reconstitution.
3. True: Goodwill is the brand image the firm has in the market due to which it enjoys an advantageous position over the other players in the market.
4. False: At the time of admission or retirement of a partner, goodwill should not be raised in the books of account of partnership firm because no consideration in money or money worth has been paid for it.
5. False: Weighted average profit method, capitalisation method, super profits methods also can be used for valuation of Goodwill.
6. True: Super profit means excess profit that can be earned by the firm over and above the normal profit usually earned by similar firms under similar circumstances.
7. True: The rate of return is considered as an average for the industry, which is applied to the capital employed in the concerned firm.
8. False: Normal profit depends upon Normal rate of return only and not on past profits.
9. True: Generally, the goodwill at the time of admission is adjusted through the capital accounts and not shown in the books of the firm.
10. False: Goodwill brought in by new partner is shared by old partners in sacrificing ratio and not equally.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(c)	4.	(c)	5.	(b)	6.	(b)
7.	(a)										

Theoretical Questions

- There are three methods for valuation of goodwill
 - Average profit basis - Simple and Weighted
 - Super profit basis - Number of Year Purchase, Annuity basis, and Capitalization of Super Profit
 - Capitalization basis
- In case of change in profit sharing ratio, the value of goodwill should be determined and preferably adjusted through capital accounts of the partners on the basis of profit sacrificing ratio.

- Super Profit Basis:** In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years.

Super Profit = Actual Profit - Normal Profit

Actual Profit is average profit and Normal Profit = Normal rate of Return (NRR)

Capitalization Basis: Under this basis, value of whole business is determined applying normal rate of return. If such value (arrived at by applying normal rate of return) is higher than the capital employed in the business, then the difference is goodwill.

Practical Questions

- Computation of the value of goodwill:**

(i)	Average Profit for three years, ending 30th June; before death:		
	Year ending 30th June, 2020:	₹	₹
	1/2 of 2019 profits	33,600	
	1/2 of 2020 Profits	37,800	71,400

	Year ending 30th June, 2021:		
	1/2 of 2020	37,800	
	1/2 of 2021 Profits	36,000	73,800
	Year ending 30th June, 2022:		
	1/2 of 2021	36,000	
	1/2 of 2022 Profits	31,200	67,200
	Total		2,12,400
	Average Profits		
	Alternatively it can be calculated as below :		
	1/2 profit of 2019 + profit of 2020 + profit of 2021 + profit of 2022 = $\frac{33,600 + 75,600 + 72,000 + 31,200}{3}$ =		70,800
	70,800		
(ii)	Average future maintainable profit :		
	Average profits earned		70,800
	Less : Partner's remuneration	45,000	
	Less: 8% on capital employed	12,480	(57,480)
			13,320
(iii)	Goodwill of the firm @ three years' purchase		39,960
(iv)	Wise's share of Goodwill = 4/10 of 39,960 = 15,984		

Adjustment entry for Goodwill**Journal Entry**

		Dr. ₹	Cr. ₹
Clever's Capital Account	Dr.	7,992	
Dull's Capital Account	Dr.	7,992	
To Wise's Capital Account			15,984
(Adjusting entry passed for share of goodwill of Wise through remaining partners' capital accounts in gaining ratio)			

Working Note:

Partner	New Share	Old Share	Difference
Wise	-	4/10	4/10
Clever	1/2	3/10	2/10
Dull	1/2	3/10	2/10

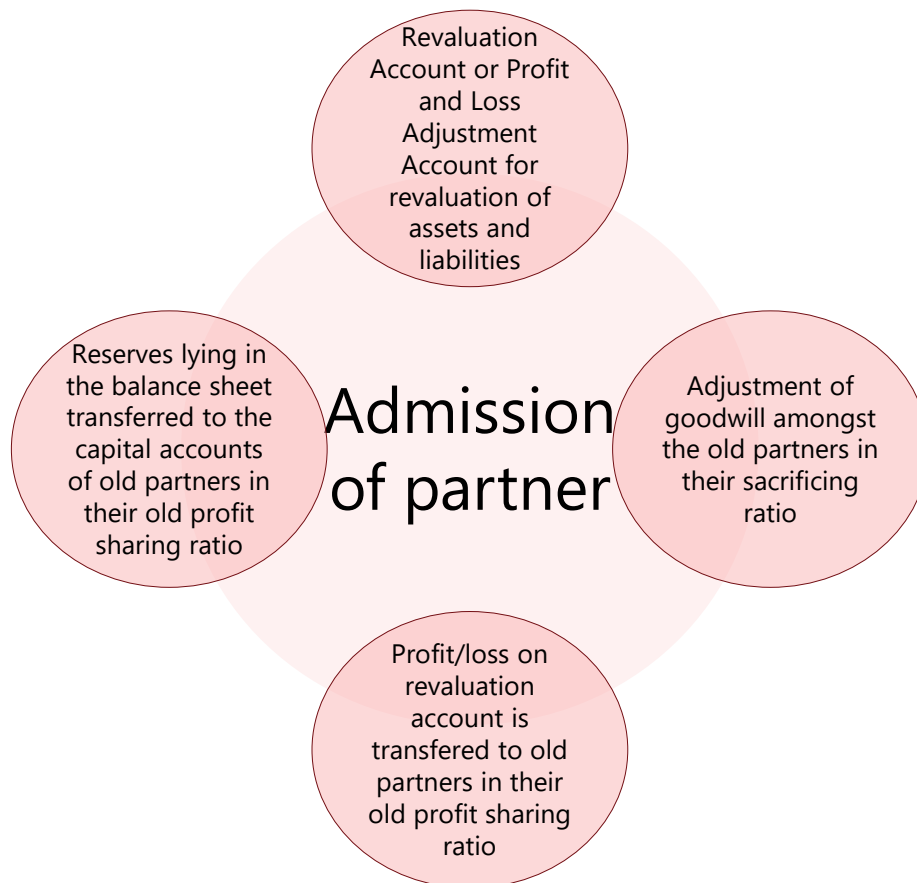
There is no change in profit sharing ratio of containing partners therefore gain ratio will be same as profit sharing ratio.

UNIT – 3: ADMISSION OF A NEW PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the reasons for which revaluation of assets and re computation of liabilities is required in case of admission of a new partner. Also understand the logic of revaluation of assets and re computation of liabilities at the time of admission of a partner.
- ◆ Learn the accounting treatments under two circumstances:
 - (a) When revalued assets and recomputed liabilities are shown in the Balance Sheet, and
 - (b) When revalued assets and recomputed liabilities are not shown in the Balance Sheet.
- ◆ Learn the technique of treating reserve balance on admission of a partner.
- ◆ See the technique of arriving at new profit-sharing ratio.
- ◆ Observe the technique of inferring goodwill although figure of goodwill is not mentioned clearly.

UNIT OVERVIEW

3.1 INTRODUCTION

New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm. When a new partner joins a firm, it is desirable to bring all appreciation or reduction in the value of assets into accounts as on the date of admission. Similarly, if the books contain any liability which has not been paid or if the books do not contain a liability which has to be paid, suitable entries should be passed. The purpose of such entries is to make an updated Balance Sheet on the date of admission. Also, all profits which have accrued but not yet brought into books and similarly, all losses which have occurred but not recorded, should now be brought into books so that the Capital Accounts of the old partners reflect the proper figure. As a

Also the value of goodwill is to be assessed and proper accounting treatment is required to bring the value of goodwill into books of accounts. Treatment for goodwill has already been discussed in unit 2 of this chapter.

3.2 REVALUATION ACCOUNT OR PROFIT AND LOSS ADJUSTMENT ACCOUNT

When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio. The entries to be passed are:

1.	Revaluation Account To Assets Account (individually which show a decrease) To the Liabilities Accounts (Individually which have to be increased)	Dr.	with the reduction in the value of the assets with the increase in the liabilities.
2.	Assets Account (Individually) Liabilities Accounts To Revaluation Account	Dr. Dr.	with the increase in the value of the of assets. with the reduction in the amount liabilities.
3.	Revaluation Account To Capital A/cs of the old partners or Capital A/cs of the old partners To Revaluation Account	Dr. Dr.	with the profit in the old profit sharing ratio. with the loss in old profit sharing ratio.

As a result of the above entries, the capital account balances of the old partners will change and the assets and liabilities will have to be adjusted to their proper values. They will now appear in the Balance Sheet at revised figures.

When the revised values are not to be Recognised in the books

Sometimes all the partners including the new partner may agree to keep the assets and liabilities at the old values even when they agree to revalue them. To record these, a Memorandum Revaluation Account is opened. This account is divided into two parts.

(a) In the first part the entries for the revaluation of assets and liabilities are made in the usual way as explained earlier. No record for the revaluation of assets and liabilities is made through the respective ledger accounts. The resultant profit or loss on revaluation in the first part of this account is transferred to the capital accounts of old partners only in the old profit and loss sharing ratio.

(b) In order to complete the double entry, entries made in the first part of Memorandum Revaluation Account are reversed in the second part so that the values of the assets and liabilities remain unchanged. The balance of the second part is transferred to the capital accounts of all the partners including new partner in their new profit and loss sharing ratio. Thus if there is a profit in the first part there will be a loss of the same amount in the second part. The only point to be remembered is that the result of the first part of Memorandum Revaluation Account is shared by old partners in the old profit sharing ratio, while the result of the second part is shared by all partners including the new one in the new profit sharing ratio.

Alternatively, the partners may agree that revalued figures will not be shown in the Balance Sheet and Assets and liabilities would appear in the Balance Sheet at their old values.

In this case, Memorandum Revaluation Account is opened. Any increase in the value of assets and/or decrease in the liabilities is credited to Memorandum Revaluation Account. The journal entry will be:

Assets Accounts	Dr.	(with increase in the value of individual assets)
Liabilities Accounts	Dr.	(With decrease in the value of individual liabilities)
To Memorandum Revaluation Account		

Similarly, any decrease in the value of assets and/or increase in the liabilities is debited to Memorandum Revaluation Account. The journal entry will be:

Memorandum Revaluation Account	Dr.	
To Assets Accounts		(with decrease in the value of individual assets)
To Liabilities Accounts		(with increase in the value of individual liabilities)

If the credit side of the Memorandum Revaluation Account is more than the debit side, there is a profit. This profit should be transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will be:

Memorandum Revaluation Account	Dr.

To Old Partners' Capital Accounts

If the debit side of the Memorandum Revaluation Account is more than the credit side, there is a loss which is transferred to old Partner's Capital Accounts in the old profit sharing ratio. The journal entry will:

Old Partners' Capital Accounts	Dr.

To Memorandum Revaluation Account

After completing the above procedure, reverse entries are made for increase in the values of assets and/or decrease in the liabilities, and decrease in the values of assets and/or increase in the liabilities) in the later portion of the Memorandum Revaluation Account. The profit on revaluation is to be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journey entry will be:

Memorandum Revolution Account	Dr.

To All Partners' Capital Accounts	(New profit and loss sharing ratio)

The loss on revaluation should be transferred to all Partners' Capital Accounts in the new profit sharing ratio. The journal entry will be:

All Partners' Capital Accounts	Dr.	(New profit and loss sharing ratio)

To Memorandum Revaluation Account

It should be noted that if there is a profit in the first half of the Memorandum Revaluation Account, the later half of the Memorandum Revaluation Account must show a loss. Conversely, if the first half of the Memorandum Revaluation Account shows a loss, the later half of the Memorandum Revaluation Account must show a profit.

When a Memorandum Revaluation Account is prepared, the book values of assets and liabilities do not change. In effect, the resultant profit or loss on revaluation is adjusted through the Partners' Capital Accounts. In this way, the amount invested as a capital by the incoming partner may be set at a level that reflects the current fair value of the partnership, even though the book values of assets and liabilities of the existing partnership remain unchanged in the books of accounts.

In case partners desire to disclose assets and liabilities in the balance sheet at old figures without opening Revaluation account then the change (i.e. increase or decrease) in the value of assets and liabilities may be adjusted through Partners' Capital Accounts directly.

Difference between Revaluation Account and Memorandum Revaluation Account

1. Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.
2. Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.
3. The net result of revaluation of assets and liabilities in the revaluation account is transferred to old partners' capital accounts in the old profit sharing ratio. In the case of memorandum revaluation account the first part is used to record the changes in the values of assets and liabilities due to revaluation and in the second part the effect of the first part is cancelled. The balance of the first part is transferred to old partner's capital accounts in the old profit sharing ratio while the balance of the second part is transferred to all partners including the new partner in the new profit sharing ratio.

ILLUSTRATION 1

The following is the Balance Sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January, 2022:

Liabilities	₹	Assets	₹
Trade payables	15,000	Buildings	18,000
Ram's Capital	20,000	Plant and Machinery	15,000
Mohan's Capital	25,000	Inventories	12,000
		Trade receivables	10,000
		Bank	5,000
	60,000		60,000

On this date Shyam was admitted on the following:

1. He is to pay ₹ 25,000 as his capital and ₹ 10,000 as his share of goodwill for one fifth share in profits.
2. The new profits sharing ratio will be 5:3:2.
3. The assets are to be revalued as under:

	₹
<i>Building</i>	25,000
<i>Plant and Machinery</i>	12,000
<i>Inventories</i>	12,000
<i>Trade receivables (because of doubtful debts)</i>	9,500

4. It was found that there was a liability for ₹ 1,500 for goods received but not recorded in books.

Give journal entries to record the above. Also, give the Balance Sheet of the partnership firm after Shyam's admission.

SOLUTION
Journal Entries

2022		Dr. (₹)	Cr. (₹)
Jan. 1	Bank Account Dr. To Shyam's Capital Account (Being amount brought in by Shyam for capital and goodwill)	35,000	35,000
	Shyam's Capital Account Dr. To Ram's Capital Account To Mohan's Capital Account (Being Shyam's share of goodwill adjusted to existing partners' capital accounts in the profit sacrificing ratio 1:1)	10,000	5,000 5,000
	Revaluation Account Dr. To Plant and Machinery Account To Provisions for Doubtful Debts Account To Trade payables Account (Being recording of the reduction in the value of assets and the liability which had been previously omitted)	5,000	3,000 500 1,500
	Building Account Dr. To Revaluation Account (Being increase in the value of building brought into account)	7,000	7,000

Revaluation Account	Dr.	2,000	
To Ram's Capital Account			1,200
To Mohan's Capital Account			800
(Being profit on revaluation credited to Ram and Mohan in the old profit sharing ratio)			

Working Note:

Profit sacrificing ratio:

$$\text{Ram} = 3/5 - 1/2 = 1/10$$

$$\text{Mohan} = 2/5 - 3/10 = 1/10$$

Balance Sheet of Ram, Mohan and Shyam as at January 1, 2022

Liabilities	₹	₹	Assets	₹	₹
Trade payables		16,500	Buildings		25,000
Capital Accounts :			Plant and Machinery		12,000
Ram	26,200		Inventories		12,000
Mohan	30,800		Trade receivables	10,000	
Shyam	25,000	82,000	Less : Provision for		
			Doubtful Debts	(500)	9,500
			Bank		40,000
		98,500			98,500

ILLUSTRATION 2

A and B are partners sharing profits and losses in the ratio of 3:2. Their Balance Sheet as on 31.3.2022 is given below:

Liabilities	₹	Assets	₹
Trade payables	50,000	Freehold premises	2,00,000
Capital Accounts:		Plant	40,000
A	2,00,000	Furniture	20,000
B	1,00,000	Office equipment	25,000
		Inventories	30,000
		Trade receivables	25,000
		Bank	10,000
	3,50,000		3,50,000

On 1.4.2022 they admit C on the following terms:

- (1) C will bring ₹ 50,000 as a capital and ₹ 10,000 for goodwill for 1/5 share;
- (2) Provision for doubtful debts is to be made on Trade receivables @ 2%
- (3) Inventory to be written down by 10%.
- (4) Freehold premises is to be revalued at ₹ 2,40,000, plant at ₹ 35,000, furniture ₹ 25,000 and office equipment ₹ 27,500.
- (5) Partners agreed that the values of the assets and liabilities remain the same and, as such, there should not be any change in their book values as a result of the above mentioned adjustments.

You are required to make necessary adjustment in the Capital Accounts of the partners and show the Balance Sheet of the New Firm.

SOLUTION

Memorandum Revaluation Account

	Particulars	₹		Particulars	₹
To	Provision for Bad Debts A/c	500	By	Freehold premises A/c	40,000
To	Inventory A/c	3,000	By	Furniture A/c	5,000
To	Plant A/c	5,000	By	Office equipment A/c	2,500
To	Profit on Revaluation A/c				
	A's Capital-3/5	23,400			
	B's Capital-2/5	15,600			
		47,500			47,500
To	Freehold premises A/c	40,000	By	Provision for Bad Debts A/c	500
To	Furniture A/c	5,000	By	Inventory A/c	3,000
To	Office equipment A/c	2,500	By	Plant A/c	5,000
				Loss on Revaluation A/c	
				A's Capital -12/25	18,720
				B's Capital-8/25	12,480
				C's Capital-5/25	7,800
		47,500			47,500

Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To A's Capital A/c			6,000	By Balance b/d	2,00,000	1,00,000	-
To B's Capital A/c			4,000				
To Loss on revaluation A/c	18,720	12,480	7,800	By Bank A/c			60,000
To Balance c/d	2,10,680	1,07,120	42,200	By C's Capital A/c	6,000	4,000	-
				By Profit on revaluation A/c	23,400	15,600	-
	2,29,400	1,19,600	60,000		2,29,400	1,19,600	60,000

Note: Amount brought in by new partner shall be distributed among the old partner's in their profit sacrificing ratio, which is same as old profit sharing ratio in this case.

Balance Sheet as at April 1, 2022

Liabilities	₹	Assets	₹
Trade payables	50,000	Freehold premises	2,00,000
Capital A/c:		Plant	40,000
A	2,10,680	Furniture	20,000
B	1,07,120	Office equipment	25,000
C	42,200	Inventories	30,000
		Trade receivables	25,000
		Bank	70,000
	4,10,000		4,10,000

ILLUSTRATION 3

A and B are partners in a firm, sharing profits and losses in the ratio of 3:2. The Balance Sheet of A and B as on 1.1.2022 was as follows:

Liabilities	₹	Amount ₹	Assets	₹	Amount ₹
Trade payables		17,000	Building		26,000
			Furniture		5,800
Bank overdraft		9,000	Inventories		21,400

Capital accounts:			Trade receivables	35,000	
A	44,000		Less: Provision	(200)	34,800
B	36,000	80,000	Investment		2,500
			Cash		15,500
		1,06,000			1,06,000

'C' was admitted to the firm on the above date on the following terms:

- C is admitted for 1/6 share in the future profits and to introduce a capital of ₹ 25,000.
- The new profit sharing ratio of A, B and C will be 3:2:1 respectively.
- 'C' is unable to bring in cash for his share of goodwill, they decide to calculate goodwill on the basis of C's share in the profits and the capital contribution made by him to the firm.
- Furniture is to be written down by ₹ 870 and Inventory to be depreciated by 5%. A provision is required for trade receivables @ 5% for bad debts. A provision would also be made for outstanding wages for ₹ 1,560. The value of buildings having appreciated be brought upto ₹ 29,200. The value of investments is increased by ₹ 450.
- It is found that the trade payables included a sum of ₹ 1,400, which is not to be paid off.

Prepare the following:

- Revaluation account.
- Partners' capital accounts.

SOLUTION

Revaluation Account

		₹			₹
To	Furniture	870	By	Building	3,200
To	Inventory	1,070	By	Trade payables	1,400
To	Provision for doubtful debts		By	Investment	450
	(₹ 1,750 – ₹ 200)	1,550			
To	Outstanding wages	1,560			
		5,050			5,050

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To A			4,500	By Balance b/d	44,000	36,000	–
To B			3,000	By Cash A/c	–	–	25,000
To Balance c/d	48,500	39,000	17,500	By C (working note 2)	4,500	3,000	–
	48,500	39,000	25,000		48,500	39,000	25,000

Working Notes:

1. Calculation of goodwill:

C's contribution of ₹ 25,000 consists of only 1/6th of capital.

Therefore, total capital of firm should be ₹ 25,000 x 6 = ₹ 1,50,000

But combined capital of A, B and C amounts ₹ 44,000 + 36,000 + 25,000 = ₹ 1,05,000

Thus, the hidden goodwill of the firm is ₹ 45,000 (₹ 1,50,000 - ₹ 1,05,000).

C's share 1/6th = 7,500

Goodwill will be shared by A & B in their sacrificing ratio.

2. Calculation of sacrificing ratio

Partners	New share	Old share	Sacrifice	Gain
A	$\frac{3}{6}$	$\frac{3}{5}$	$\frac{-3}{30}$	-
B	$\frac{2}{6}$	$\frac{2}{5}$	$\frac{-2}{30}$	-
C	$\frac{1}{6}$	-	-	$\frac{1}{6}$

Therefore, A will get = ₹ 45,000 × $\frac{3}{30}$ = ₹ 4,500;

B will get = ₹ 45,000 × $\frac{2}{30}$ = ₹ 3,000; and

C will be debited on account of goodwill = ₹ 45,000 × $\frac{1}{6}$ = ₹ 7,500



3.3 RESERVES IN THE BALANCE SHEET

Whenever a new partner is admitted, any reserve etc. appearing in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio.

The necessary journal entry would be:

Debit: Reserves or Profit and Loss Account

Credit: Old Partners' Capital Accounts (In the old profit sharing ratio)

ILLUSTRATION 4

Dalal, Banerji and Mallick are partners in a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2022 is as below:

Liabilities		₹	Assets	₹
Trade payables		12,850	Land and Buildings	25,000
Outstanding Liabilities		1,500	Furniture	6,500
General Reserve		6,500	Inventory of goods	11,750
Capital Account :			Trade receivables	5,500
Mr. Dalal	12,000		Cash in hand	140
Mr. Banerji	12,000		Cash at Bank	960
Mr. Mallick	5,000	29,000		
		49,850		49,850

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April, 2022 on the following terms:

- (1) Mr. Mistri shall bring ₹ 5,000 towards his capital.
- (2) The value of Inventory should be increased by ₹ 2,500 and Furniture should be depreciated by 10%.
- (3) Reserve for bad and doubtful debts should be provided at 10% of the Trade receivables.
- (4) The value of land and buildings should be enhanced by 20%.
- (5) The value of the goodwill be fixed at ₹ 15,000.
- (6) General Reserve will be transferred to the Partners' Capital Accounts.
- (7) The new profit sharing ratio shall be: Mr. Dalal 5/15, Mr. Banerji 5/15, Mr. Mallick 3/15 and Mr. Mistri 2/15.

The outstanding liabilities include ₹ 1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books.

Prepare (i) Revaluation Account, (ii) The Capital Accounts of the partners, (iii) Balance Sheet of the firm after admission of Mr. Mistri.

SOLUTION

Revaluation Account

2022		₹	2022		₹
April 1	To Provision for bad and doubtful debts	550	April 1	By Inventory in trade	2,500
	To Furniture and fittings	650		By Land and Building	5,000
	To Capital A/cs: (Profit on revaluation transferred)				
	Dalal	2,520			
	Banerji	2,520			
	Mallick	1,260			
		6,300			
		7,500			7,500

Partners' Capital Accounts

Particulars	Dalal	Banerji	Mallick	Mistri	Particulars	Dalal	Banerji	Mallick	Mistri
	₹	₹	₹	₹		₹	₹	₹	₹
To Dalal				1,000	By Balance b/d	12,000	12,000	5,000	–
To Banerji				1,000	By General Reserve	2,600	2,600	1,300	
To Balance c/d	19,120	18,120	7,560	3,000	By Cash	–	–	–	5,000
					By Mistri	1,000	1,000	–	–
					By Outstanding Liabilities	1,000	–	–	
					By Revaluation A/c	2,520	2,520	1,260	–
	19,120	18,120	7,560	5,000		19,120	18,120	7,560	5,000

Working Note:**Calculation of sacrificing ratio**

Partners	New share	Old share	Sacrifice	Gain
Dalal	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Banerji	$\frac{5}{15}$	$\frac{2}{5}$	$-\frac{1}{15}$	
Mallick	$\frac{3}{15}$	$\frac{1}{5}$	No gain No loss	—
Mistri	$\frac{2}{15}$			$\frac{2}{15}$

Sacrifice by Mr. Dalal and Mr. Banerji = ₹ 15,000 × $\frac{1}{15}$ = ₹ 1,000 each

Balance Sheet of M/s. Dalal, Banerji, Mallick and Mistri as on April 1, 2022

Liabilities	₹	Assets	₹
Trade payables	12,850	Land and Buildings	30,000
Outstanding Liabilities	500	Furniture	5,850
Capital Accounts of Partners :		Inventory of goods	14,250
Mr. Dalal 19,120		Trade receivables 5,500	
Mr. Banerji 18,120		Less : Provisions (550)	4,950
Mr. Mallick 7,560		Cash in hand	140
Mr. Mistri 3,000	47,800	Cash at Bank	5,960
	61,150		61,150

**3.4 COMPUTATION OF NEW PROFIT SHARING RATIO**

When a new partner is admitted and there is no agreement to the contrary, it is supposed that old partners will continue to have inter se at the old profit sharing ratio.

For example, A and B are in partnership sharing profits and losses at the ratio of 3:2. They admitted C as $\frac{1}{5}$ partner. For computation of new profit sharing ratio.

- (i) Firstly, deduct the share offered to new partner from 1.

$$1 - \frac{1}{5} = \frac{4}{5}$$

- (ii) Divide the balance of share between A and B in the ratio of 3:2.

$$A = 4/5 \times 3/5 = 12/25$$

$$B = 4/5 \times 2/5 = 8/25$$

- (iii) New profit sharing ratio is

A	:	B	:	C
12/25	:	8/25	:	1/5
or 12/25	:	8/25	:	5/25
i.e. 12:8				: 5

Computation of New profit sharing ratio- Cases

Case I: When new partner's share is given but the question is silent about the sacrifice made by the old partners: In this case it is assumed that the old partner will share the remaining share in their old profit sharing ratio.

Example: A and B are partners sharing profits in the ratio 3:2. They admit C for 1/3 share in future profits. Calculate the new ratio.

Solution

Share in Firm = 1

C's Share = 1/3

Remaining Profit = 1 - 1/3 = 2/3

This remaining share of 2/3 is divided between A and B in the ratio 3:2

So A's share = $2/3 \times 3/5 = 6/15$

B's share = $2/3 \times 2/5 = 4/15$

C's share = $1/3 \times 5/5 = 5/15$

New ratio = 6/15: 4/15: 5/15 = 6:4:5

Case II: When new partner purchases his share from old partner's in a particular ratio: In this case the new ratio of the old partners will be calculated by deducted the proportion given to the new partner from the shares of old partner.

Example: A and B are partners sharing in the ratio 3:2. They admit C as a new partner for 1/3rd share in future profits which he gets 1/9 from A and 2/9 from B. Calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$; A sacrifice in favour of C = $\frac{1}{9}$

So A's new share = $\frac{3}{5} - \frac{1}{9} = \frac{22}{45}$

B's old share = $\frac{2}{5}$; B sacrifice in favour of C = $\frac{2}{9}$

So B's new share = $\frac{2}{5} - \frac{2}{9} = \frac{8}{45}$

C's new share = $\frac{3}{9} \times \frac{5}{15} = \frac{15}{45}$

New ratio = 22: 8: 15

Case III: When the old partners surrender a particular fraction of their share in favour of new partner: In this case following steps are followed:

1. Determine the share surrendered by the old partners.
2. Find the new share of the old partners by deducting share surrendered from their old share.
3. Calculate share of the new partner by taking the sum of surrendered share of old partners.
4. Calculate the new ratio.

Example

A and B are partners sharing in the ratio 3:2. They admit C as the new partner. A surrenders $\frac{1}{3}$ rd of his share and B surrenders $\frac{2}{3}$ rd of his share in favour of C. calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$; A surrender in favour of C = $\frac{3}{5} \times \frac{1}{3} = \frac{3}{15}$

A's new share = $\frac{3}{5} - \frac{3}{15} = \frac{6}{15}$

B's old share = $\frac{2}{5}$; B surrender in favour of C = $\frac{2}{5} \times \frac{2}{3} = \frac{4}{15}$

B's new share = $\frac{2}{5} - \frac{4}{15} = \frac{2}{15}$

C's share = $\frac{3}{15} + \frac{4}{15} = \frac{7}{15}$

New ratio = 6:2:7

Case IV: When the new partner acquires his share entirely from any one partner: In this case the sacrificing partner share is calculated by deducting his sacrifice from his old share.

Example: A and B are partners sharing in the ratio 3:2. They admit C for $\frac{1}{5}$ th share in profits which he acquires entirely from A. Calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$; Sacrifice in favour of C = $\frac{1}{5}$

A's new share = $\frac{3}{5} - \frac{1}{5} = \frac{2}{5}$

B's share = $\frac{2}{5}$

C's share = $\frac{1}{5}$

New ratio = 2:2:1

Case V: When the new partner acquires his share from the old partners in the certain ratio: In this the sacrifice of each partner is deducted from their old shares.

Example: A and B are partners sharing profits in the ratio 3:2. C is admitted for $\frac{1}{5}$ th share which he acquires from A and B in the ratio of 2:1. Calculate the new ratio.

Solution

A's old share = $\frac{3}{5}$, A's sacrifice = $\frac{1}{5} \times \frac{2}{3} = \frac{2}{15}$

A's new share = $\frac{3}{5} - \frac{2}{15} = \frac{7}{15}$

B's old share = $\frac{2}{5}$, B's sacrifice = $\frac{1}{5} \times \frac{1}{3} = \frac{1}{15}$

B's new share = $\frac{2}{5} - \frac{1}{15} = \frac{5}{15}$

C's share = $\frac{1}{5} \times \frac{3}{3} = \frac{3}{15}$

New ratio = 7:5:3

Sacrificing Partner:

The partners whose shares have decreased as a result of change are known as sacrificing partners.

Sacrificing Ratio:

Ratio in which the old partners sacrifice their share in favour of new partner is called sacrificing ratio. This ratio is calculated by taking out the difference between old profit shares and new profit shares

Sacrificing ratio = Old Profit sharing ratio – New Profit sharing ratio

Gaining Partners

The partners whose shares have increased as a result of change are known as gaining partners.

Gaining Ratio

The ratio in which the partners have agreed to gain their shares in profit from the other partner or partners, is known as gaining ratio. This ratio is calculated by taking out the difference between new profit shares and old profit shares

Example: X and Y are partners in a firm sharing profits and losses in the ratio 5:3. They admit Z into partnership. The new ratio 3:2:1. Calculate the Sacrificing Ratio.

Solution

X's sacrifice = X's old share - X's new ratio = $\frac{5}{8} - \frac{3}{6} = \frac{6}{48}$

Y's sacrifice = Y's old share - Y's new ratio = $\frac{3}{8} - \frac{2}{6} = \frac{2}{48}$

Thus, sacrificing ratio = 6:2 or 3:1

Example: A, B and C are sharing profits and losses in the ratio of 5:3:2. Calculate the new profit sharing ratio and the sacrificing ratio in each of the following alternative cases:

Case (a) If C acquires $\frac{1}{10}$ th share from B

Case (b) If C acquired $\frac{1}{10}$ th share equally from A and B

Case (c) If C's share is increased by $\frac{1}{10}$ th share by acquiring from A.

Case (d) If C's share is increased to $\frac{3}{10}$ th by acquiring from B.

Case (e) if A, B and C decide to share future profits and losses in the ratio of 5:2:3.

Case (f) if A, B and C decide to share future profits and losses in the ratio of 2:3:5.

Case (g) if A, B and C decide to share future profits and losses in the ratio of 2:1:2.

Case (h) if A, B and C decide to share future profits and losses equally.

Case(i) If A, B and C decide that the future profit sharing ratio between B and C shall be the same as existing between A and B

Solution

Case (a)	A	B	C
Their existing shares	$\frac{5}{10}$	$\frac{3}{10}$	$\frac{2}{10}$
Share acquired by C from B	-	$-\frac{1}{10}$	$+\frac{1}{10}$
Their new shares	$\frac{5}{10}$	$\frac{2}{10}$	$\frac{3}{10}$

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = $\frac{1}{10}$

Case (b)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from A and B	-1/20	-1/20	+1/10
Their new shares	9/20	5/20	3/10

New Profit sharing ratio of A, B and C = 9 : 5 : 6

Sacrificing ratio of A and B = 1 : 1

Case (c)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-1/10	-	+1/10
Their new shares	4/10	3/10	3/10

New Profit sharing ratio of A, B and C = 4 : 3 : 3

Share sacrificed by A = 1/10

Share acquired by C = New Share – Old share = 3/10 - 2/10 = 1/10

Case (d)	A	B	C
Their existing shares	5/10	3/10	2/10
Share acquired by C from B	-	-1/10	+1/10
Their new shares	5/10	2/10	3/10

New Profit sharing ratio of A, B and C = 5 : 2 : 3

Share sacrificed by B = 1/10

Case (e)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	5/10	2/10	3/10
	-	1/10	-1/10

C gains by 1/10th share and B sacrifice 1/10th Share

Case (f)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/10	3/10	5/10
	3/10	-	-3/10

C gains by 3/10th share and A sacrifice 3/10th Share

Case (g)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	2/5	1/5	2/5
	1/10	1/10	-2/10

C gains by 2/10th share and A sacrifices 1/10th Share & B sacrifices 1/10th share.

Case (h)	A	B	C
Their existing shares	5/10	3/10	2/10
Their new shares	1/3	1/3	1/3
	5/30	-1/30	-4/30

B gains by 1/30th share, C gains by 4/30th share and A sacrifices by 5/30th Share

Case (i)

Ratio of A and B = 5 : 3

Ratio of B and C should be 5 : 3

Since B's share in relation to A is $\frac{3}{5}$ or 60% of A's share, C's share should also be 60% of B's share

Thus C's share (60% of 3) = 1.8

New ratio of A, B and C = 5 : 3 : 1.8 or 25 : 15 : 9

	A	B	C
Their existing shares	5/10	3/10	2/10
Their new share	25/49	15/49	9/49
	-5/490	-3/490	8/490

C sacrifices by 8/490 and A gains by 5/490 and B gains by 3/490

ILLUSTRATION 5

A and B are in partnership sharing profits and losses at the ratio 3:2. They take C as a new partner. Calculate the new profit sharing ratio if -

- C purchases 1/10 share from A
- A and B agree to sacrifice 1/10th share to C in the ratio of 2: 3
- Simply gets 1/10th share of profit.

SOLUTION

- (i) New profit sharing ratio:

$$A = 3/5 - 1/10 = 5/10$$

$$B = 2/5 \text{ i.e. } 4/10$$

$$C = 1/10$$

$$\text{i.e. } 5:4:1$$

- (ii) A's sacrifice
- $1/10 \times 2/5 = 2/50$

$$B's \text{ sacrifice } 1/10 \times 3/5 = 3/50$$

New profit sharing ratio

$$A = 3/5 - 2/50 = 28/50$$

$$B = 2/5 - 3/50 = 17/50$$

$$C = 1/10 \text{ i.e. } 5/50$$

$$\text{i.e. } 28:17:5$$

- (iii) Let total share be 1

$$C's \text{ share} = 1/10$$

$$\text{Remaining share} = 1 - 1/10 = 9/10$$

Distribution:

$$A = 9/10 \times 3/5 = 27/50$$

$$B = 9/10 \times 2/5 = 18/50$$

$$C = 1/10 \text{ i.e. } = 5/50$$

$$\text{i.e. } 27:18:5$$

ILLUSTRATION 6

A and B are in the partnership sharing profits and losses in the proportion of three-fourth and one-fourth respectively. Their balance sheet as on 31st March, 2022 was as follows:

Cash ₹ 1,000; trade receivables ₹ 25,000; Inventory ₹ 22,000; plant and machinery ₹ 4,000; trade payables ₹ 12,000; bank overdraft ₹ 15,000; A's capital ₹ 15,000; B's capital ₹ 10,000.

On 1st April, 2022, they admitted C into partnership on the following terms:

- (i) *C to purchase one-third of the goodwill for ₹ 2,000 and provide ₹ 10,000 as capital. Goodwill not to appear in books.*

- (ii) Further profits and losses are to be shared by A, B and C equally.
- (iii) Plant and machinery is to be reduced by 10% and ₹ 500 is to be provided for estimated bad debts. Inventory is to be taken at a valuation of ₹ 24,940.
- (iv) By bringing in or withdrawing cash, the capitals of A and B are to be made proportionate to that of C on their profit-sharing basis.

Set out entries to the above arrangement in the firm's journal and give the partners' capital accounts in tabular form.

SOLUTION

Journal Entries
as on 1st April, 2022

		Dr. (₹)	Cr. (₹)
Revaluation Account	Dr.	900	
To Plant and machinery Account			400
To Provision for bad debts Account			500
(Plant & machinery reduced by 10% and ₹ 500 provided for bad debts)			
Inventory Account	Dr.	2,940	
To Revaluation Account			2,940
(Value of inventory increased by ₹ 2,940)			
Revaluation Account	Dr.	2,040	
To A's capital Account			1,530
To B's capital Account			510
(Profit on revaluation transferred)			
Cash Account	Dr.	12,000	
To C's capital Account			12,000
(Cash brought in by C as his capital)			
C's Capital Account	Dr.	2,000	
B's capital Account	Dr.	500	
To A's capital Account			2,500
(Entry for goodwill purchased by B and C)			

A's capital Account	Dr.	9,030	
B's capital Account	Dr.	10	
To Cash Account			9,040
(Excess amount of capital withdrawn)			

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To A's capital A/c	-	500	2,000	By Balance b/d	15,000	10,000	-
To Cash	9,030	10		By Revaluation A/c	1,530	510	-
To Balance c/d	10,000	10,000	10,000	By Cash		-	12,000
				By C's Capital A/c	2,000		
				By B's Capital A/c	500		
	19,030	10,510	12,000		19,030	10,510	12,000

Working Note:

Calculation of goodwill

C pays ₹ 2,000 on account of goodwill for 1/3rd share of profit/loss. Total goodwill is ₹ 2,000 x 3 = ₹ 6,000.

Gaining ratio:

B: $1/3 - 1/4 = 1/12$

C: $1/3$

Goodwill to be paid to A:

By B ₹ 6,000 x $1/12$ =	₹ 500
By C ₹ 6,000 x $1/3$ =	₹ 2,000
Total	₹ 2,500

ILLUSTRATION 7

A and B are partners of X llp. sharing profits and losses in 3:2 ratio between themselves. On 31st March, 2022, the balance sheet of the firm was as follows:

Balance Sheet of X llp as at 31.3.2022

Liabilities	₹	₹	Assets	₹
Capital accounts:			Plant and machinery	20,000
A	37,000		Furniture and fittings	5,000
B	28,000		Inventories	15,000
		65,000	Trade receivables	20,000
Trade payables		5,000	Cash in hand	10,000
		70,000		70,000

X agrees to join the business on the following conditions as and from 1.4.2022:

- He will introduce ₹ 25,000 as his capital and pay ₹ 15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.
- A revaluation of assets of the firm will be made by reducing the value of plant and machinery to ₹ 15,000, Inventory by 10%, furniture and fitting by ₹ 1,000 and by making a provision of bad and doubtful debts at ₹ 750 on trade receivables.

Prepare profit and loss adjustment account, capital accounts of partners including the incoming partner X assuming that the relative ratios of the old partners will be in equal proportion after admission.

SOLUTION**Profit and Loss Adjustment Account**

2022, April 1	₹	2022, April 1	₹
To Plant and machinery A/c	5,000	By Partners' capital accounts	
To Inventory A/c	1,500	- Loss on revaluation	
To Furniture and fitting A/c	1,000	(3/5) A	4,950
To Provision for bad and doubtful debts	750	(2/5) B	<u>3,300</u>
	8,250		8,250

Partners' Capital Accounts

	A	B	X		A	B	X
	₹	₹	₹		₹	₹	₹
To Profit & loss adjustment A/c	4,950	3,300	–	By Balance b/d	37,000	28,000	–
To A's & B's capital A/cs	–	–	15,000	By Cash A/c	–	–	40,000
To Balance c/d	44,050	27,700	25,000	By X's capital A/c [W. N. (ii)]	12,000	3,000	–
	49,000	31,000	40,000		49,000	31,000	40,000

Working Notes:

- (i) New profit sharing ratio:

On admission of X who will be entitled to 1/3rd share of the future profits of the firm. A and B would share the remaining 2/3rd share in equal proportion i.e. 1:1.

$$A: 2/3 \times 1/2 = 1/3$$

$$B: 2/3 \times 1/2 = 1/3$$

$$X: 1/3$$

A, B and X would share profits and losses in equal ratio.

- (ii) Adjustment of goodwill:

X pays ₹ 15,000 as premium for goodwill for 1/3rd share of the future profits.

Thus, total value of goodwill is ₹ 15,000 x 3 i.e. ₹ 45,000

Sacrificing ratio:

$$A: 3/5 - 1/3 = 4/15$$

$$A: 2/5 - 1/3 = 1/15$$

Hence, sacrificing ratio is 4:1

Adjustment of X's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

	₹
A: 15,000 x 4/5 =	12,000
B: 15,000 x 1/5 =	3,000
	15,000

3.5 HIDDEN GOODWILL

When the value of the goodwill of the firm is not specifically given, the value of goodwill has to be inferred as follows:

Particulars	₹
Incoming partner's capital x Reciprocal of share of incoming partner	xxx
Less: Total capital of old partners + Net Accumulated Profits and Reserves (if any) + capital brought in by incoming partner	xxx
Value of Goodwill	xxx

ILLUSTRATION 8

A and B are partners with capitals of ₹ 7,000 each. They admit C as a partner with 1/4th share in the profits of the firm. C brings ₹ 8,000 as his share of capital. Give the necessary journal entry to record goodwill.

SOLUTION

Journal Entry

Particulars	Dr. (₹)	Cr. (₹)
C's Capital A/c [₹ 10,000 x 1/4] Dr.	2,500	
To A's Capital A/c		1,250
To B's Capital A/c		1,250
(Being the share of C in the hidden goodwill adjusted through capital accounts by crediting sacrificing partners in their sacrificing ratio)		

Note: Hidden Goodwill = $8,000 \times \frac{4}{1} - (\text{₹ } 7,000 + \text{₹ } 7,000 + 8,000) = \text{₹ } 10,000$

ILLUSTRATION 9

A and B are in partnership sharing profits and losses equally. The Balance Sheet M/s. A and B as on 31.12.2022, was as follows:

Liabilities	₹	Assets	₹
Capital A/cs		Sundry Fixed Assets	60,000
A	45,000	Inventories	30,000
B	45,000	Bank	20,000
Trade payables	20,000		
	1,10,000		1,10,000

On 1.1.2023 they agreed to take C as 1/3rd partner to increase the capital base to ₹ 1,35,000. C agrees to pay ₹ 60,000. Show the necessary journal entries and prepare partners' capital accounts.

SOLUTION**In the Books of M/s. A, B and C****Journal Entries**

		₹	₹
Bank A/c To C's Capital A/c (Cash brought in by C for 1/3rd share)	Dr.	60,000	60,000
C's Capital A/c To A's Capital A/c To B's Capital A/c	Dr.	15,000	7,500 7,500
A's Capital A/c B's Capital A/c To Bank A/c (Amount of goodwill due to A and B withdrawn)	Dr. Dr.	7,500 7,500	15,000

Workings:

- (1) Old Profit Sharing Ratio: 1: 1
- (2) New Profit Sharing Ratio: 1:1:1
- (3) C's share of capital ₹ 1,35,000 × 1/3 = ₹ 45,000
- (4) Goodwill ₹ 60,000 – ₹ 45,000 = ₹ 15,000 for 1/3rd share.

Total Goodwill: ₹ 15,000 × 3 = ₹ 45,000

Partners' Capital A/cs

Particulars	A	B	C	Particulars	A	B	C
	₹	₹	₹		₹	₹	₹
To A			7,500	By Balance b/d	45,000	45,000	–
To B			7,500	By Bank	–	–	60,000
To Bank	7,500	7,500	–	By C	7,500	7,500	–
To Balance c/d	45,000	45,000	45,000				
	52,500	52,500	60,000		52,500	52,500	60,000

Note : In this problem it is mentioned that total capital should be at ₹ 1,35,000 hence excess capital is to be withdrawn by partners hence third entry is passed.

ILLUSTRATION 10

Leena and Meena were in business sharing profits and losses in the ratio of 2:3

Their Balance Sheet as on 31st March, 2022 was as follows:

Liabilities	₹	Assets	₹
<i>Capital Accounts:</i>		<i>Building</i>	<i>60,000</i>
<i>Leena</i>	<i>60,000</i>	<i>Plant</i>	<i>45,000</i>
<i>Meena</i>	<i>1,40,000</i>	<i>Furniture</i>	<i>23,500</i>
<i>General Reserve</i>	<i>40,000</i>	<i>Debtors</i>	<i>38,400</i>
<i>Creditors</i>	<i>42,600</i>	<i>Bills Receivable</i>	<i>12,500</i>
<i>Bills Payable</i>	<i>17,400</i>	<i>Stock</i>	<i>42,600</i>
		<i>Bank</i>	<i>78,000</i>
	<i>3,00,000</i>		<i>3,00,000</i>

On 1st April, 2022, they decided to admit Neena into the partnership giving her a 1/5th share in future profits. She brings in ₹80,000 as her share of capital. Goodwill was valued at ₹1,00,000 at the time of admission of Neena. The partners decided to revalue the Assets as follows:

Plant ₹ 40,000, Debtors ₹ 38,000, Stock ₹ 42,000, Building ₹ 90,000, Furniture ₹ 20,000, Bills Receivable ₹ 12,000.

You are required to show the following accounts in the books of the firm:-

- Profit & Loss Adjustment Account*
- Partners' Capital Accounts*
- The Balance Sheet of the new firm.*

SOLUTION

In the books of Leena, Meena and Neena

(a) Profit & Loss Adjustment Account

Particulars	₹	Particulars	₹
To Plant	5,000	By Building	30,000
To Debtors	400		
To Stock	600		

To Furniture	3,500		
To Bills receivable	500		
To Profit on revaluation			
Leena	8,000		
Meena	12,000		
	30,000		30,000

Partners' Capital A/c

Particulars	Leena	Meena	Neena	Particulars	Leena	Meena	Neena
To Leena, Meena Goodwil adjustment entry			20,000	By Balance b/d	60,000	1,40,000	
To Balance c/d	92,000	1,88,000	60,000	By Bank			80,000
				By Neena	8,000	12,000	
				By General Reserve	16,000	24,000	
				By Revaluation	8,000	12,000	
	92,000	1,88,000	80,000		92,000	1,88,000	80,000

Balance Sheet as on 1st April, 2022 (after admission)

Liabilities	₹	Assets	₹
Capital Accounts:		Building	90,000
Leena	92,000	Plant	40,000
Meena	188,000	Furniture	20,000
Neena	60,000	Debtors	38,000
Creditors	42,600	Bills Receivable	12,000
Bills Payable	17,400	Stock	42,000
		Bank	1,58,000
	4,00,000		4,00,000

ILLUSTRATION 11

Alpha and Beeta were partners in a LLP namely Meta-Chem LLP sharing profits and losses equally.

Balance Sheet of Meta-Chem LLP as on 31st March, 2022

Liabilities	₹	Assets	₹
Capital :		Factory Building	4,78,000
Alpha 3,00,000		Plant & Machinery	3,41,000
Beeta <u>2,00,000</u>	5,00,000	Office Furniture	55,850
General Reserve	1,80,000	Inventory	77,740
Workmen compensation fund	60,000	Trade Receivables	1,43,210
Term loan from IDFC bank	2,78,000	Bank	44,200
Trade payables	1,22,000		
	<u>11,40,000</u>		<u>11,40,000</u>

They agreed to admit Gyama as partner from 1st April 2022 on the following terms:

1. He shall have one-sixth share in future profits.
2. New profit sharing ratio would be 3:2:1
3. He shall bring ₹ 2,50,000 as his capital.
4. Goodwill of the firm is valued at ₹ 3,00,000
5. Factory Building is to be appreciated by 20% and inventory is revalued at ₹ 70,000.
6. Machinery to be appreciated by 20%.and Office furniture to be revalued at ₹ 50,000
7. Of the trade receivables ₹ 3,210 are bad and 5% be provided for bad & doubtful debts.
8. There is no actual liability towards workman.

You are required to prepare:

1. Revaluation account
2. Partners' capital accounts.
3. Bank account.
4. Balance Sheet after admission.

SOLUTION**In the books of Meta-Chem LLP****Revaluation A/c**

Liabilities	₹	Assets	₹
To Bad debts	3,210	By Factory Building	95,600
To Provision for Doubtful Debts	7,000	By Plant and Machinery	68,200

To Office Furniture	5,850		
To Inventory	7,740		
To Profit on revaluation			
Alpha 70,000			
Beeta <u>70,000</u>	1,40,000		
	1,63,800		1,63,800

Partners' Capital A/c

Particulars	Alpha	Beeta	Gyama	Particulars	Alpha	Beeta	Gyama
To Beeta			50,000	By balance b/d	3,00,000	2,00,000	
To Balance c/d	4,90,000	4,40,000	2,00,000	By Bank			2,50,000
				By Gyama		50,000	
				By General Reserve	90,000	90,000	
				By Workman comp. fund	30,000	30,000	
				By Revaluation A/c	70,000	70,000	
	4,90,000	4,40,000	2,50,000		4,90,000	4,40,000	2,50,000

Bank A/c

Particulars	₹	Particulars	₹
To balance b/d	44,200	By Balance c/d	2,94,200
To Gyama's capital	2,50,000		
	2,94,200		2,94,200

Balance Sheet of Meta-Chem LLP as on 1st April 2022 (after admission)

Liabilities	₹	Assets	₹
Capital Accounts:		Factory Building	5,73,600
Alpha 4,90,000		Plant & Machinery	4,09,200
Beeta 4,40,000		Office Furniture	50,000
Gyama <u>2,00,000</u>	11,30,000	Inventory	70,000
Term Loan from IDFC bank	2,78,000	Trade Receivables 1,40,000	

Trade Payables	1,22,000	Less: Provision for Doubtful Debts	1,33,000
		<u>7,000</u>	
		Bank	2,94,200
	15,30,000		15,30,000

Working Note:

Partner	New Share		Old Share		Difference
Alpha	1/2	–	3/6	=	0
Beeta	1/2	–	2/6	=	1/6
Gyama		–	1/6 (gain)	=	1/6 (gain)

SUMMARY

- ♦ New partners are admitted for the benefit of the partnership firm. New partner is admitted either for increasing the partnership capital or for strengthening the management of the firm.
- ♦ When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.
- ♦ Whenever a new partner is admitted, any reserve etc. appearing in the Balance Sheet should be transferred to the Capital Accounts of the old partners in the old profit sharing ratio.

TEST YOUR KNOWLEDGE**True or False**

1. A newly admitted partner does not have same rights as old partners.
2. When a new partner is admitted, old partners have to forego certain share in profits of the firm, this is called as sacrifice ratio.
3. Revaluation account is also called as Profit and Loss Adjustment Account.

4. Any appreciation in the value of an asset is credited to Revaluation account.
5. All the partners may decide not to change the values of assets and liabilities in the books of accounts.
6. New partner is entitled to have share in reserves appearing in the balance sheet prior to his admission.
7. If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners equally.
8. New partner brings necessary amount as his capital.
9. New partner is entitled to share in revaluation profit.

Multiple Choice Questions

1. A and B are partners sharing profits and losses in the ratio 5:3. They admitted C and agreed to give him $\frac{3}{10}$ th of the profit. What is the new ratio after C's admission?
 - (a) 35:42:17.
 - (b) 35:21:24.
 - (c) 49:22:29.
2. A and B are partners sharing profits in the ratio 5:3, they admitted C giving him $\frac{3}{10}$ th share of profit. If C acquires $\frac{1}{5}$ from A and $\frac{1}{10}$ from B, new profit sharing ratio will be:
 - (a) 5:6:3.
 - (b) 2:4:6.
 - (c) 17:11:12
3. C was admitted in a firm with $\frac{1}{4}$ th share of the profits of the firm. C contributes ₹ 15,000 as his capital, A and B are other partners with the profit sharing ratio as 3:2. Find the required capital of A and B, if capital should be in profit sharing ratio taking C's as base capital:
 - (a) ₹ 27,000 and ₹ 16,000 for A and B respectively.
 - (b) ₹ 27,000 and ₹ 18,000 for A and B respectively.
 - (c) ₹ 32,000 and ₹ 21,000 for A and B respectively.
4. A, B and C are partners sharing profits and losses in the ratio 6:3:3, they agreed to take D into partnership for $\frac{1}{8}$ th share of profits. Find the new profit sharing ratio.
 - (a) 12:27:36:42.

- (b) 14:7:7:4.
- (c) 1:2:3:4.
5. A and B are partners sharing profits and losses in the ratio of 3:2 (A's Capital is ₹ 30,000 and B's Capital is ₹ 15,000). They admitted C and agreed to give $\frac{1}{5}$ th share of profits to him. How much C should bring in towards his capital?
- (a) ₹ 9,000.
- (b) ₹ 12,000.
- (c) ₹ 11,250.
6. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who brings in ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. In what ratio will this amount will be shared among the old partners A & B.
- (a) ₹ 8,000: ₹ 2,000.
- (b) ₹ 5,000: ₹ 5,000.
- (c) Old partners will not get any share in the goodwill brought in by C.
7. A and B are partners sharing the profit in the ratio of 3:2. They take C as the new partner, who is supposed to bring ₹ 25,000 against capital and ₹ 10,000 against goodwill. New profit sharing ratio is 1:1:1. C brought cash for his share of Capital and agreed to compensate to A and B outside the firm. How this will be treated in the books of the firm.
- (a) Cash brought in by C will only be credited to his capital account.
- (b) Goodwill will be raised to full value in old ratio.
- (c) Goodwill will be raised to full value in new ratio.
8. X and Y are partners sharing profits in the ratio of 3: 1. They admit Z as a partner who pays ₹ 4,000 as Goodwill the new profit sharing ratio being 2:1: 1 among X, Y and Z respectively. The amount of goodwill will be credited to:
- (a) X and Y as ₹ 3,000 and ₹ 1,000 respectively.
- (b) X only
- (c) Y only.
9. P and Q are partners sharing Profits in the ratio of 2:1. R is admitted to the partnership with effect from 1st April on the term that he will bring ₹ 20,000 as his capital for $\frac{1}{4}$ th share and pays ₹ 9,000 for goodwill, half of which is to be withdrawn by P and Q. If profit

on revaluation is ₹ 6,000 and opening capital of P is ₹ 40,000 and of Q is ₹ 30,000, find the closing balance of each capital.

- (a) ₹ 47,000: ₹ 33,500: ₹ 20,000
- (b) ₹ 50,000: ₹ 35,000: ₹ 20,000.
- (c) ₹ 40,000: ₹ 30,000: ₹ 20,000
10. Adam, Brain and Chris were equal partners of a firm with goodwill ₹ 1,20,000 shown in the balance sheet and they agreed to take Daniel as an equal partner on the term that he should bring ₹ 1,60,000 as his capital and goodwill, his share of goodwill was evaluated at ₹ 60,000 and the goodwill account is to be written off before admission. What will be the treatment for goodwill?
- (a) Write off the goodwill of ₹ 1,20,000 in old ratio.
- (b) Cash brought in by Daniel for goodwill will be distributed among old partners in sacrificing ratio.
- (c) Both (a) & (b)

Theory Questions

- Write short note on Revaluation account.
- What is the difference between revaluation account and memorandum revaluation account?

Practical Questions

- The following was the balance sheet of A, B and C who were equal partners on January 1, 2022

Liabilities	₹	Assets	₹
Bills Payable	3,000	Cash	1,000
Creditors	6,000	Debtors	10,000
Capital Accounts :		Stock	12,000
A	20,000	Furniture	5,000
B	15,000	Buildings	25,000
C	10,000	Bills Receivable	1,000
	54,000		54,000

They agree to take D into partnership and give him a 1/4 share in the profits on the following terms:

- (1) D should bring in ₹ 6,000 for goodwill and ₹ 10,000 as capital;
- (2) one-half of the goodwill shall be withdrawn by old partners;
- (3) stock and furniture be depreciated by 10%.
- (4) a liability of ₹ 1,300 be created against bills discounted;
- (5) the building be valued at ₹ 40,000;
- (6) the values of liabilities and assets other than cash are not to be altered.

Give the necessary entries to give effect to the above arrangement; prepare revaluation account and opening balance sheet of the firm as newly constituted.

2. Gopal and Govind are partners sharing profits and losses in the ratio 60:40. The firms' balance sheet as on 31.03.2022 was as follows:

Liabilities	₹	Assets	₹
Capital accounts:		Fixed assets	3,00,000
Gopal	1,20,000	Investments	50,000
Govind	80,000	Current assets	2,00,000
Long term loan	2,00,000	Loans and advances	1,00,000
Current liabilities	2,50,000		
	6,50,000		6,50,000

Due to financial difficulties, they have decided to admit Guru as partner in the firm from 01.04.2022 on the following terms:

Guru will be paid 40% of the profits.

Guru will bring in cash ₹ 1,00,000 as capital. It is agreed that goodwill of the firm will be valued at 2 years' purchase of 3 years' normal average profits of the firm and Guru will bring in cash his share of goodwill. It was also decided that the partners will not withdraw their share of goodwill nor will the goodwill appear in the books of account.

The profits of the previous three years were as follows:

For the year ended 31.3.2020: profit ₹ 20,000 (includes insurance claim received of ₹ 40,000).

For the year ended 31.3.2021: loss ₹ 80,000 (includes voluntary retirement compensation paid ₹ 1,10,000).

For the year ended 31.3.2022: profit of ₹ 1,05,000 (includes a profit of ₹ 25,000 on the sale of assets).

It was decided to revalue the assets on 31.03.2022 as follows:

	₹
Fixed assets (net)	4,00,000
Investments	Nil
Current assets	1,80,000
Loans and advances	1,00,000

The new profit sharing ratio after the admission of Guru was 35:25:40.

Pass journal entries on admission, show goodwill calculation and prepare revaluation account, partners' capital accounts and balance sheet as on 01.04.2022 after the admission of Guru.

ANSWERS/HINTS

True or False

1. False: All the partners have same rights at all times, unless contrary is provided in the partnership deed/or agreed by the partners.
2. True: With every new partner, remaining old partners have to foregone a proportion in their share which is called as sacrificing ratio.
3. True: Revaluation is also called as profit and loss adjustment account.
4. True: Increase in asset is an income hence credited to revaluation account.
5. True: This can be done by opening Memorandum Revaluation Account.
6. False: New partner is not entitled to have any share in the reserves of the firm prior to his admission. Such reserves are distributed to old partners in their old profit sharing ratio.
7. False: If revaluation account shows credit balance then it represents profit and therefore it is credited to all partners in their profit sharing ratio and not equally.
8. True: Every incoming partner shall bring in some amount of capital for the firm.
9. False: New partner is not entitled to profit on revaluation, it belongs to old partners in their old profit sharing ratio.

Multiple Choice Questions

1.	(b)	2.	(c)	3.	(b)	4.	(b)	5.	(c)	6.	(a)
7.	(a)	8.	(b)	9.	(a)	10.	(c)				

Theoretical Questions

- When a new partner is admitted into the partnership, assets are revalued and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for the purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with increase in the value of assets and decrease in the value of liabilities. The difference in two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit sharing ratio.
- Difference between revaluation account and memorandum revaluation account
 - Revaluation account is prepared to find out the profit or loss on revaluation of assets and liabilities which appear in the new balance sheet at the new or revalued figures. Memorandum revaluation account is also prepared to record the effect of revaluation of assets and liabilities which of course are recorded at their old figures in the new balance sheet.
 - Revaluation account is not divided into two parts. But the memorandum revaluation account has two parts: first part for old partners and second part for all partners including the new partner.

Practical Problems

1.

		₹	₹
Cash Account	Dr.	16,000	
To D's Capital Account			16,000
(Amount of goodwill and capital brought in by D)			
D's Capital Account	Dr.	6,000	
To A's Capital Account			2,000
To B's Capital Account			2,000

To C's Capital Account (Goodwill brought in by D credited to old partners in sacrifice ratio)			2,000
A's Capital Account	Dr.	1,000	
B's Capital Account	Dr.	1,000	
C's Capital Account	Dr.	1,000	
To Cash Account (Half the amount of goodwill withdrawn by existing partners)			3,000
Memorandum Revaluation Account	Dr.	12,000	
To A's Capital Account			4,000
To B's Capital Account			4,000
To C's Capital Account			4,000
(Profit on revaluation credited to old partners)			
A's Capital Account	Dr.	3,000	
B's Capital Account	Dr.	3,000	
C's Capital Account	Dr.	3,000	
D's Capital Account	Dr.	3,000	
To Memorandum Revaluation Account (The profit credited previously to old partners written off to all partners including D in the new profit-sharing ratio)			12,000

Memorandum Revaluation Account

Stock	1,200	Buildings	15,000
Furniture	500		
Liability for bills discounted	1,300		
Profit transferred to capital accounts:			
A	4,000		

B	4,000		
C	4,000		
	15,000		15,000
Buildings	15,000	Stock	1,200
		Furniture	500
		Liability for bills discounted	1,300
		Loss transferred to capital accounts:	
		A	3,000
		B	3,000
		C	3,000
		D	3,000
	15,000		15,000

Balance Sheet of M/s. A, B, C and D

As on 1st January, 2022

Liabilities		₹	Assets	₹
Bills Payable		3,000	Cash	14,000
Creditors		6,000	Debtors	10,000
Capital Accounts:			Stock	12,000
A	22,000		Furniture	5,000
B	17,000		Buildings	25,000
C	12,000		Bills Receivable	1,000
D	7,000	58,000		
		67,000		67,000

2. (i) Calculation of Profit/ Loss for the year ended

	31.3.2020	31.3.2021	31.3.2022
Profit/(loss) for the year	20,000	(80,000)	1,05,000
Add/(less): Abnormal items	(40,000)	1,10,000	(25,000)
Net Profit/(loss)	(20,000)	30,000	80,000

$$\text{Average profit} = \frac{(20,000) + 30,000 + 80,000}{3} = ₹ 30,000$$

Two years' purchase of average profits = $30,000 \times 2 = ₹ 60,000$

Goodwill to be brought in by Guru = $₹ 60,000 \times 40\% = ₹ 24,000$

Goodwill brought in by Guru shared (at the profit sacrificing ratio) by:

	₹
Gopal (₹ 24,000 x 5/8)	15,000
Govind (₹ 24,000 x 3/8)	9,000
	24,000

(ii) **Journal Entries**

Date	Particulars	Dr. ₹	Cr. ₹
1.4.2022	Bank A/c Dr. To Guru's capital A/c (Amount of capital and goodwill brought in by Guru)	1,24,000	1,24,000
1.4.2022	Guru's capital A/c Dr. To Gopal's capital A/c To Govind's capital A/c (Amount of goodwill brought in by Guru credited to capital accounts of the old partners in the profit sacrificing ratio 5:3)	24,000	15,000 9,000
1.4.2022	Revaluation A/c Dr. To Investment A/c To Current assets A/c (Writing down the value of investments to nil and current assets from ₹ 2,00,000 to ₹ 1,80,000 on the occasion of admission of Guru)	70,000	50,000 20,000
1.4.2022	Fixed assets A/c Dr. To Revaluation A/c (Writing up the value of fixed assets from ₹ 3,00,000 to ₹ 4,00,000 on the occasion of admission of Guru)	1,00,000	1,00,000

1.4.2022	Revaluation A/c	Dr.	30,000	
	To Guru's capital A/c			18,000
	To Govind's capital A/c			12,000
	(Net revaluation profit credited to the capital accounts of the old partner in the old profit sharing ratio of 60:40)			

(iii)

Revaluation Account

Particulars	₹	Particulars	₹
To Investments A/c	50,000	By Fixed assets A/c	1,00,000
To Current assets A/c	20,000		
To Partner's capital A/c: (Profit on revaluation)			
Gopal (60%)	18,000		
Govind (40%)	12,000		
	1,00,000		1,00,000

(iv) **Partner's Capital Accounts:****Gopal's Capital Account**

Particulars	₹	Particulars	₹
To Balance c/d	1,53,000	By Balance b/d	1,20,000
		By Bank A/c	15,000
		By Revaluation A/c	18,000
	1,53,000		1,53,000

Govind's Capital Account

Particulars	₹	Particulars	₹
To Balance c/d	1,01,000	By Balance b/d	80,000
		By Bank A/c	9,000
		By Revaluation A/c	12,000
	1,01,000		1,01,000

Guru's Capital Account

Particulars	₹	Particulars	₹
To Balance c/d	1,00,000	By Bank b/d	1,00,000
	1,00,000		1,00,000

**Balance Sheet (after admission of Guru)
as on 1st April, 2022**

Liabilities		₹	Assets	₹
Capital accounts:			Fixed assets	4,00,000
Gopal	1,53,000		Current assets	3,04,000
Govind	1,01,000		(including bank balance	
Guru	<u>1,00,000</u>	3,54,000	of ₹ 1,24,000)	
Long term loan		2,00,000	Loans & advances	1,00,000
Current liabilities		2,50,000		
		<u>8,04,000</u>		<u>8,04,000</u>

Working Notes:

1. Calculation of profit sacrificing ratio

Profit sacrificed by Gopal = $60\% - 35\% = 25\%$

Profit sacrificed by Govind = $40\% - 25\% = 15\%$

Sacrificing ratio = $25\% : 15\%$ or $5:3$

2. Bank balance after admission of Guru:

Bank Account

Particulars	₹	Particulars	₹
To Guru's capital A/c	1,24,000	By Balance c/d	1,24,000
	<u>1,24,000</u>		<u>1,24,000</u>

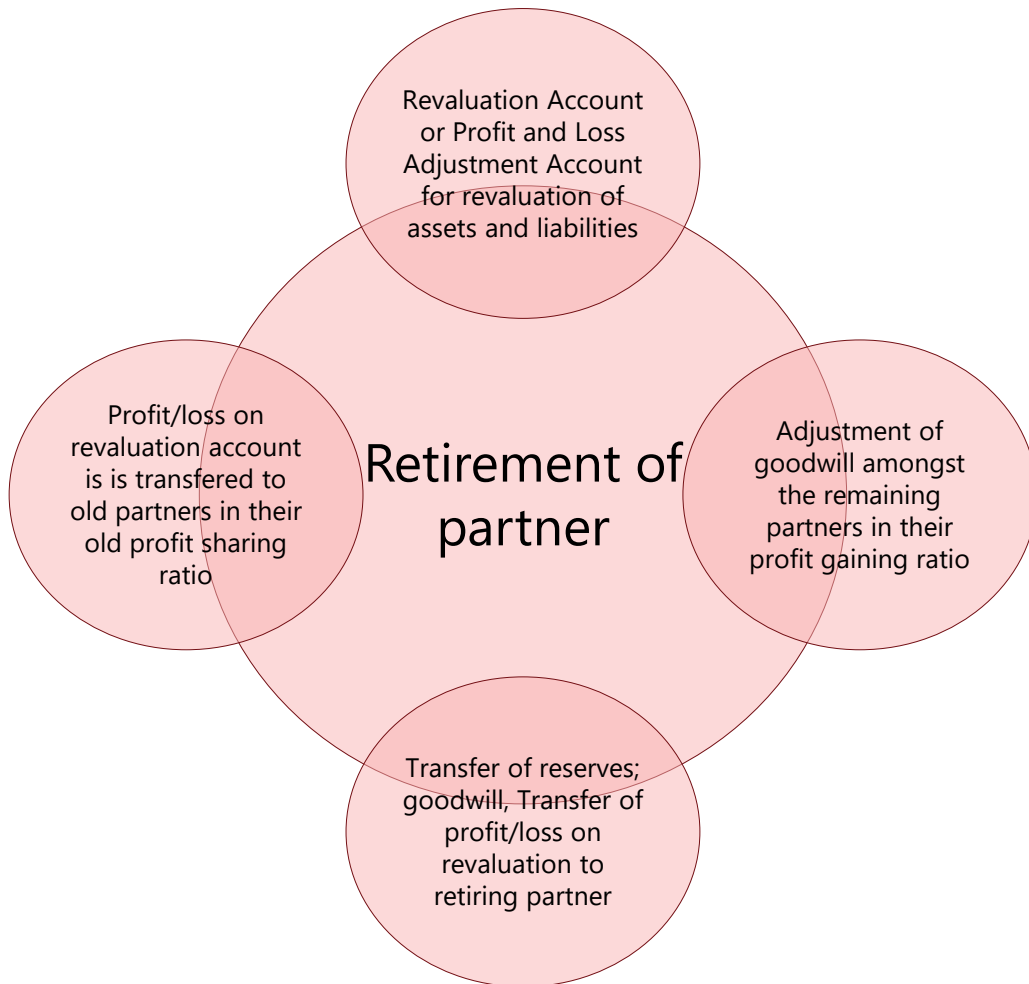
UNIT – 4: RETIREMENT OF A PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Learn how to compute the gaining ratio and observe the use of such gaining ratio.
- ◆ Be familiar with the accounting treatment in relation to revaluation of assets and liabilities.
- ◆ Learn the accounting entries to be passed for transfer of reserves standing in the balance sheet to partners' capital accounts in a manner already discussed for admission of a partner in unit 3 of the chapter.
- ◆ Learn the technique of keeping records if the balance due to the retiring partner is transferred to loan account.
- ◆ Familiarize with the term Joint Life Policy.
- ◆ Learn how to keep records for payment of premium in relation to Joint Life Policy. Also observe the accounting treatment in relation to such Joint Life Policy in case of retirement of a partner.

UNIT OVERVIEW



4.1 INTRODUCTION

A partner may retire from the partnership firm because of old age, illness, etc. Generally, the business of the partnership firm may not come to an end when one of the partners retires. Other partners may continue to run the business of the firm. Readjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. Therefore, the remaining partners arrange for the amount to be paid to discharge the claims of the retiring partners. Assets and liabilities are revalued, value of goodwill is raised and surrender value of joint life policy, if any, is taken into account. Revaluation profit and reserves are transferred to capital or current accounts of partners. Lastly, final amount due to the retiring partner is determined and discharged.



4.2 CALCULATION OF GAINING RATIO

On retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. For example, if A, B and C were sharing profits and losses in the ratio of 5:3:2 and B retires, then A and C have to decide at which ratio they will share profits and losses in future. If it is decided that the continuing partners will share profits and losses in future at the ratio of 3:2, then A gains $\frac{1}{10}$ th $[(\frac{3}{5}) - (\frac{5}{10})]$ and C gains $\frac{2}{10}$ $[(\frac{2}{5}) - (\frac{2}{10})]$. So the gaining ratio between A and C is 1:2. If A and C decide to continue at the ratio 5:2, this indicates that they are dividing the gained share in the previous profit sharing ratio.

Example: Amir, Jamir and Samir are in partnership sharing profits and losses at the ratio of 3:2:1. Now Amir wants to retire and Jamir and Samir want to continue at the ratio of 3:2. In this case, Jamir gains $\frac{8}{30}$ th of share of partnership ($\frac{3}{5}$ less $\frac{2}{6}$) whereas Samir gains $\frac{7}{30}$ th ($\frac{2}{5}$ less $\frac{1}{6}$) share of the partnership. So gaining ratio between Jamir and Samir is 8:7. On the other hand, if Jamir and Samir would decide to continue sharing profits and losses at the ratio of 2:1, then Jamir would gain $\frac{2}{6}$ th share of partnership i.e. $[(\frac{2}{3}) - (\frac{2}{6})]$, and Samir would gain $\frac{1}{6}$ th share of partnership i.e. $[(\frac{1}{3}) - (\frac{1}{6})]$. So it appears that in such a case gaining ratio of Jamir and Samir would be 2:1. i.e., the existing profit sharing ratio between them.

Thus, on the retirement or death of a partner, his share in the profit would be taken by the remaining partners. In other words, they get additional share which is obviously a gain or benefit. The calculation of gaining ratio or benefit ratio is done as follows:

- (i) When the new ratio is given, gaining ratio is calculated by deducting their new share of profits from the old share.
- (ii) When the new profit sharing ratio is not given and the remaining partners share the future profits in the same ratio as before, the gaining ratio would be the old profit sharing ratio.

Observe the following table:

Ratio between Remaining Partners

		New Ratio	Gaining or Benefit Ratio
1.	When new ratio is given	As given in the examination problem	New Ratio minus Old ratio
2.	When the new Ratio is not given	The same old ratios between them	The same old ratios between them
3.	When gaining or benefit ratio is given	Old ratio + Gaining ratio	As given in the question

Calculation of New Profit Sharing Ratio

Case 1 When nothing is given about the new profit sharing ratio of the remaining partners: Under this situation the calculation of new ratio is done by striking out the share of the retiring partner.

Example : Alok, Bhaskar and Chetan are partners sharing in the ratio 3:2:1. Calculate new ratio if:

- (a) If Alok retires.
- (b) If Bhaskar retires.
- (c) If Chetan retires.

Solution

Old Profit ratio = 3:2:1

- (a) If Alok retires new profit ratio will be 2:1
- (b) If Bhaskar retires new profit ratio will be 3:1
- (c) If Chetan retires new profit ratio will be 3:2

Case 2: When gains of the continuing partners are specifically given in the question: In such a case, the new shares of the continuing partners are calculated by adding their respective gain to their old share.

New share = Old share + Gain

Example

Aarav, Banta and Chunmun are partners sharing in the ratio 3:2:1. Aarav retires and his share is taken over by the remaining partners as follow

Banta takes $\frac{2}{6}$ th from Aarav.

Chunmun takes $\frac{1}{6}$ th from Aarav.

Calculate new ratio.

Solution

Banta's New Share = Banta's old share + Banta's gain = $\frac{2}{6} + \frac{2}{6} = \frac{4}{6}$

Chunmun's New Share = Chunmun's old share + Chunmun's gain = $\frac{1}{6} + \frac{1}{6} = \frac{2}{6}$

So the new share = $\frac{4}{6} : \frac{2}{6} = 2:1$

Case 3: When the ratio in which the remaining partners acquire the share of the outgoing partner is given:

Example

Deepu, Tasha and Honey are partners sharing profits in the ratio 3:2:1. Tasha retires and his share was acquired by Deepu and Honey in the ratio 2:1. Calculate new ratio.

Solution

Share acquired by Deepu = $\frac{2}{6} \times \frac{2}{3} = \frac{4}{18}$

Share acquired by Honey = $\frac{2}{6} \times \frac{1}{3} = \frac{2}{18}$

Deepu's new Share = Deepu's old share + Deepu's gain = $\frac{3}{6} + \frac{4}{18} = \frac{13}{18}$

Honey's new Share = Honey's old share + Honey's gain = $\frac{1}{6} + \frac{2}{18} = \frac{5}{18}$

New Ratio = 13:5

Calculation of Gaining Ratio**Case – 1**

A, B and C are partners sharing profits and losses in the ratio of $\frac{1}{2}$, $\frac{3}{10}$ and $\frac{1}{5}$ respectively. B retires from the firm and A&C decide to share future profits and losses in the ratio of 3:2.

		A	C
Their new shares	(a)	$\frac{3}{5}$	$\frac{2}{5}$
Their old shares	(b)	$\frac{1}{2}$	$\frac{1}{5}$
Difference being gain		(a – b)	$\frac{1}{10}$
			$\frac{2}{10}$

Gaining ratio of A and C = $\frac{1}{10} : \frac{2}{10} = 1 : 2$

Case – 2

W, A, B and C are partners sharing profits and losses in the ratio of $\frac{1}{3}$, $\frac{1}{6}$, $\frac{1}{3}$ and $\frac{1}{6}$ respectively. B retires and W, A and C decide to share future profits and losses equally.

		W	A	C
Their new shares	(a)	$\frac{1}{3}$	$\frac{1}{3}$	$\frac{1}{3}$
Their old shares	(b)	$\frac{1}{3}$	$\frac{1}{6}$	$\frac{1}{6}$
Difference being gain		(a – b)		-
		$\frac{1}{6}$		

Gaining ratio of A and C = $\frac{1}{6} : \frac{1}{6} = 1 : 1$

Case – 3

A, B and C are partners sharing profits and losses in the ratio of 25:15:9. B retires and it is decided that profit sharing ratio between A&C will be the same as existing between B and C.

Ratio of B and C = 15 : 9 = 5 : 3

Therefore new ratio of A and C should be 5 : 3

		A	C
Their new shares	(a)	5/8	3/8
Their old shares	(b)	25/49	9/49
Difference being gain	(a–b)	45/392	75/392

Gaining ratio of A and C = 45 : 75 = 3 : 5

Case – 4

A, B and C are partners sharing profits and losses in the ratio of 4/9, 1/3 and 2/9. B retires and surrenders 1/9th of his share in favour of A and remaining in favour of C.

		A	C
Their existing shares	(a)	4/9	2/9
Share surrendered by B	(b)	$1/9 \times 1/3 = 1/27$	$8/9 \times 1/3 = 8/27$
New share of remaining partner (a + b)		13/27	14/27

New ratio of A and C = 13 : 14

Gaining ratio = $1/27 : 8/27 = 1 : 8$

Case – 5

A, B & C are partners sharing profits and losses in the ratio of 1/2, 3/10 and 1/5 respectively. B retires and his share is taken by A and C in the ratio of 2:1. Then immediately W is admitted for 1/4th share of profit, half of which was gifted by A and remaining share was taken by W equally from A and C.

		A	C
Their existing shares	(a)	1/2	1/5
Share acquired by remaining partners	(b)	$2/3 \times 3/10 = 2/10$	$1/3 \times 3/10 = 1/10$
New shares of remaining partners	(c= a + b)	7/10	3/10
Share gifted by A	(d)	$1/2 \times 1/4 = 1/8$	-

Share acquired by W (other than gift) (e)	$1/2 \times 1/8 = 1/16$	$1/2 \times 1/8 = 1/16$
New Shares	(c – d – e)	41/80
New ratio of A , C and W =	41/80 : 19/80 : 20/80 =	41 : 19 : 20



4.3 REVALUATION OF ASSETS AND LIABILITIES ON RETIREMENT OF A PARTNER

On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio. On the other hand, if there is loss on revaluation that is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio. To arrive at, profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened. Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.

If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed with the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain. In the first instance, the journal entry for distribution of profit or loss on revaluation which will appear in the balance sheet also is as follows:

Revaluation A/c	Dr.
To Partners' Capital A/cs	
(For profit on revaluation)	
Or Partners' Capital A/c's	Dr.
To Revaluation A/c	
(For loss on revaluation)	

Now see how to deal with a situation where revalued figures will not appear in the Balance Sheet.

If A, B & C share profits and losses equally and there is a revaluation profit of ₹ 30,000 calculated on A's retirement, then ₹ 10,000 becomes due to A which is to be borne by B and C equally. So the journal entry will be as follows:

		₹	₹
B's Capital A/c	Dr.	5,000	
C's Capital A/c	Dr.	5,000	
To A's Capital A/c			10,000

Alternatively, it is possible to account for the increase in the value of assets or decrease in the value of liabilities by debiting the appropriate asset account or liability account and crediting partners' capital account at the existing profit sharing ratio. Simultaneously the partners capital accounts are to be debited for such gain at the new profit sharing ratio and the respective assets and liabilities account is to be credited again. So the following journal entries are necessary for ₹ 10,000 increase in sundry fixed assets and ₹ 2,000 decrease in trade payables:

			₹	₹
1)	Sundry Fixed Assets A/c	Dr.	10,000	
	Trade payables A/c	Dr.	2,000	
	To A's Capital A/c			4,000
	To B's Capital A/c			4,000
	To C's Capital A/c			4,000
	(Distribution of Revaluation Profit amongst the existing partners in the old profit sharing ratio)			
2)	B's Capital A/c	Dr.	6,000	
	C's Capital A/c	Dr.	6,000	
	To Sundry Fixed Assets A/c			10,000
	To Trade payables A/c			2,000
	(Being revalued assets and liabilities are not required to be shown in the Balance Sheet)			

In this case it is not necessary to open a separate Revaluation Account. However, the above effect can also be given through Memorandum Revaluation Account as discussed in the case of admission of a partner in unit 3.

4.4 RESERVE

On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

For example, A, B and C were in partnership sharing profits and losses at the ratio 5:3: 2. A retired and B and C agreed to share profits and losses at the ratio of 3:2. Reserve balance was ₹ 10,000. In this case either of the following journal entries can be passed:

		₹	₹
1)	Reserve A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Transfer of reserve to Partners' Capital A/cs in 5 : 3 : 2 on A's retirement)	10,000	5,000 3,000 2,000
2)	Reserve A/c Dr. To A's Capital A/c (Transfer of A's share of Reserve to the Capital Account on his retirement)	5,000	5,000

Note that alternative (2) has the same implications because B and C continued at the same ratio 3: 2 as they did before A's retirement.

Take another example: X, Y and Z were equal partners. Z decided to retire. X and Y decided to continue at the ratio of 3: 2. Reserve standing at the date of retirement of Z was ₹ 9,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

$$\text{X's gain: } \frac{3}{5} - \frac{1}{3} = \frac{9-5}{15} = \frac{4}{15}$$

$$\text{Y's gain: } \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \frac{1}{15}$$

Gaining Ratio: X: Y

4: 1

This is different from 1: 1. So alternative (1) is to be followed in this case.

		₹	₹
Reserve A/c	Dr.	9,000	
To X's Capital A/c			3,000
To Y's Capital A/c			3,000
To Z's Capital A/c			3,000
(Transfer of Reserve on Z's retirement)			

If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be:

		₹	₹
X's Capital A/c	Dr.	2,400	
Y's Capital A/c	Dr.	600	
To Z's Capital A/c			3,000
(Adjustment entry for Z's share in reserve)			

4.5 FINAL PAYMENT TO A RETIRING PARTNER

The following adjustments are necessary in the Capital A/c:

- (i) Transfer of reserve,
- (ii) Transfer of goodwill,
- (iii) Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will appear as follows:

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

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows:

Retiring partner's Capital A/c

Dr.

To Retiring Partner's Loan A/c

To Bank A/c

As a rule, the payment is made according to terms of partnership agreement which might provide one of the following alternatives:

- (a) Repayment may be made in instalments over a period of time and the interest is paid on outstanding balance which will be treated as a loan of the outgoing partner.
- (b) The amount due may be treated as a loan to the firm and in return the firm will either pay interest at a fixed rate or share of the profit of the firm.
- (c) An annuity may be paid to a retired partner for life or for an agreed number of years for the life of some dependent.

ILLUSTRATION 1

A and B are partners in a business sharing profit and losses as A-3/5th and B-2/5th. Their balance sheet as on 1st January, 2022 is given below:

Liabilities		₹	Assets	₹
Capital Accounts			Plant and Machinery	20,000
A	20,000		Inventories	16,000
B	15,000	35,000	Trade receivables	15,000
Reserve Account		15,000	Balance at Bank	6,000
Trade payables		7,500	Cash in hand	500
		57,500		57,500

B retires from the business owing to illness and A takes it over. The following revaluation was made:

- (1) *The goodwill of the firm is valued at ₹ 25,000.*
- (2) *Depreciate Plant & Machinery by 7.5% and Inventories by 15%.*
- (3) *Doubtful debts provision is raised against trade receivables at 5% and a discount reserve against trade payables at 2%.*

Required:

Journalize the above transactions in the books of the firm and close the Partners' Accounts as on 1st January 2022. Give also the opening Balance Sheet of A.

SOLUTION

Journal Entries

2022		Dr. (₹)	Cr. (₹)
Jan 1.	A's Capital Account Dr. To B's Capital Account (The amount of share of goodwill adjusted on B's retirement)	10,000	10,000
	Reserve Account Dr. To A's Capital Account To B's Capital Account (Transfer of reserve to A's Capital Account and B's Capital Account in the profit sharing ratio)	15,000	9,000 6,000
	Profit and Loss Adjustment Account Dr. To Plant and Machinery Account To Inventory Account To Provision for Doubtful Debts Account (Reduction in the values, assets and creation of provision for doubtful debts as per agreement with B)	4,650	1,500 2,400 750
	Reserve for Discount on Trade payables A/c Dr. To Profit and Loss Adjustment Account (Creation of reserve for discount on trade payables at 2%)	150	150
	A's Capital Account Dr. B's Capital Account Dr. To Profit and Loss Adjustment Account (Transfer of loss on revaluation of assets and liabilities to Capital Accounts of A and B in the profit sharing ratio)	2,700 1,800	4,500
	B's Capital Account Dr. To B's Loan Account (Transfer of B's Capital Account to his Loan A/c)	29,200	29,200

Note: Here it is assumed that amount payable to B is transferred to his loan a/c.

Balance Sheet of A as on 1st January, 2022

Liabilities	₹	₹	Assets	₹	₹
A's Capital Account		16,300	Plant and Machinery		18,500
B's Loan Account		29,200	Inventories		13,600
Trade payables	7,500		Trade receivables	15,000	
Less: Reserve for Discount	(150)	7,350	Less: Prov. for Bad Debts	(750)	14,250
			Balance at Bank		6,000
			Cash		500
		52,850			52,850

ILLUSTRATION 2

F, G and K were partners in LLP sharing profits and losses at the 2:2: 1. K wants to retire on 31.12.2022. Given below is the Balance Sheet of the partnership as well as other information:

Balance Sheet as on 31.12.2022

Liabilities	₹	Assets	₹
Capital A/cs		Sundry Fixed Assets	1,50,000
F	1,20,000	Inventories	50,000
G	80,000	Trade receivables	70,000
K	60,000	(Including Bills Receivable 20,000)	
Reserve	10,000	Bank	50,000
Trade payables	50,000		
	3,20,000		3,20,000

F and G agree to share profits and losses at the ratio of 3: 2 in future. Value of Goodwill is taken to be ₹ 50,000. Sundry Fixed Assets are revalued upward by ₹ 30,000 and Inventories by ₹ 10,000. Bills Receivable dishonoured ₹ 5,000 on 31.12.2022 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also they wanted to maintain ₹ 75,000 bank balance for working capital.

Required:

Pass necessary journal entries and draft the Balance Sheet of M/s F & G LLP. Also prepare capital accounts of partners and draft the Balance Sheet of Ms/ F & G after K's retirement.

SOLUTION

Journal Entries

		₹	₹
(1)	F's Capital A/c Dr. To K's Capital A/c (Being the adjustment for goodwill on K's retirement) - Refer W.N.	10,000	10,000
(2)	Reserve A/c Dr. To F's Capital A/c To G's Capital A/c To K's Capital A/c (Transfer of Reserve to Partners' Capital A/cs on K's retirement)	10,000	4,000 4,000 2,000
(3)	Sundry Fixed Assets A/c Dr. Inventory A/c Dr. To Profit and Loss Adjustment A/c (Increase in the value of Sundry Fixed Assets and inventory recorded)	30,000 10,000	40,000
(4)	Profit and Loss Adjustment A/c Dr. To Trade Receivable A/c (Loss arising out of dishonoured bill recorded)	5,000	5,000
(5)	Profit and Loss Adjustment A/c Dr. To F's Capital A/c To G's Capital A/c To K's Capital A/c (Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)	35,000	14,000 14,000 7,000
(6)	Bank A/c Dr. To F's Capital A/c To G's Capital A/c (Cash brought in by F and G as per agreement)	1,04,000	70,000 34,000
(7)	K's Capital A/c Dr. To Bank A/c (Payment made to K on retirement)	79,000	79,000

Working Note:

Adjusting entry for goodwill

Partner	Old Share	New Share	Gain	Sacrifice
F	$\frac{2}{5}$	$\frac{3}{5}$	$\frac{1}{5}$	—
G	$\frac{2}{5}$	$\frac{2}{5}$	—	—
K	$\frac{1}{5}$	—	—	$\frac{1}{5}$

Adjusting entry:

	₹	₹
F's Capital A/c (50,000 x 1/5) Dr.	10,000	
To K's Capital A/c		10,000

Balance Sheet (after K's retirement)

Liabilities	₹	Assets	₹
Capital A/cs:		Sundry Fixed Assets	1,80,000
F	1,98,000	Inventories	60,000
G	1,32,000	Trade receivables	65,000
Trade payables	50,000	Bank	75,000
	3,80,000		3,80,000

Partners' Capital Accounts

	F	G	K		F	G	K
	₹	₹	₹		₹	₹	₹
To K's Capital A/c	10,000	—	—	By Balance b/d	1,20,000	80,000	60,000
To Balance c/d	1,28,000	98,000	79,000	By F's Capital A/c			10,000
				By P & L Adj. A/c	14,000	14,000	7,000
				By Reserve	4,000	4,000	2,000
	1,38,000	98,000	79,000		1,38,000	98,000	79,000
To Bank	—	—	79,000	By Balance b/d	1,28,000	98,000	79,000
To Balance c/d	1,98,000	1,32,000	—	By Bank	70,000	34,000	—
	1,98,000	1,32,000	79,000		1,98,000	1,32,000	79,000

Working Notes:

1.	Total Capital	₹
	Sundry Fixed Assets (₹ 1,50,000 + ₹ 30,000)	1,80,000
	Inventory (₹ 50,000 + ₹ 10,000)	60,000
	Trade receivables (Including Bill Receivable of ₹ 15,000)	65,000
	Bank	75,000
		3,80,000
	Less: Sundry Creditors	(50,000)
		3,30,000
	F's share (3,30,000 × 3/5)	1,98,000
	G's share (3,30,000 × 2/5)	1,32,000

2. Bank Account

	₹		₹
To Balance b/d	50,000	By K's Capital A/c	79,000
To F's Capital A/c	70,000	By Balance c/d	75,000
To G's Capital A/c	34,000		
	1,54,000		1,54,000

ILLUSTRATION 3

A, B & C were in partnership sharing profits in the proportions of 5:4:3. The balance sheet of the firm as on 31st March, 2022 was as under:

Liabilities	₹	Assets	₹
Capital accounts:		Fixtures	8,200
A	1,35,930	Inventories	1,57,300
B	95,120	Trade receivables	93,500
C	61,170	Cash	74,910
Trade payables	41,690		
	3,33,910		3,33,910

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore, entered into as on 31st March, 2022, the terms of which were as follows:

- (i) The profit and loss account for the year ended 31st March, 2022 which showed a net profit of ₹ 48,000 was to be re-opened. B was to be credited with ₹ 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing was to be revised from 1st April, 2021, as 3:4:4.
- (ii) Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The fixtures were to be valued by an independent valuer. The valuations arising out of the above agreement were goodwill ₹ 56,800 and fixtures ₹ 10,980. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3:2 and decided to retain the fixtures on the books at the revised value, and to increase the provision for doubtful debts to 6%.

Required:

Submit the journal entries necessary to give effect to the above arrangements and to draw up the capital account of the partners after carrying out all adjusting entries as stated above.

SOLUTION

Journal Entries

Particulars		Dr. (₹)	Cr. (₹)
A's Capital Account	Dr.	20,000	
B's Capital Account	Dr.	16,000	
C's Capital Account	Dr.	12,000	
To Profit and Loss Adjustment Account (Profit written back for making adjustments)			48,000
Profit and Loss Adjustment Account	Dr.	4,000	
To B's Capital account (Bonus Credited to B's Capital Account)			4,000
Profit and Loss Adjustment Account	Dr.	44,000	
To A's Capital Account			12,000
To B's Capital Account			16,000
To C's Capital Account (Distribution of profits in the new ratio)			16,000
Fixtures Account	Dr.	2,780	
To Provision for Doubtful debts Account @ 2%			1,870

To A's Capital Account			248
To B's Capital Account			331
To C's Capital Account			331
(Revaluation of assets on A's retirement)			
A's Capital Account Dr.	1,43,669		
To A's Loan Account		1,43,669	
(Transfer of A's Capital Account to his Loan Account)			
B's Capital Account Dr.	2,244		
C's Capital Account Dr.	1,496		
To Provision for Doubtful Debts Account		3,740	
(Raising provision for bad debts)			
B's Capital Account Dr.	13,425		
C's Capital Account Dr.	2,066		
To A's Capital Account		15,491	
(Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)			

Partners' Capital Accounts

	A	B	C		A	B	C
	₹	₹	₹		₹	₹	₹
To Profit and Loss Adjustment A/c	20,000	16,000	12,000	By Balance b/d	1,35,930	95,120	61,170
				By Profit and Loss Adjustment A/c	–	4,000	–
To A's Loan A/c	1,43,669	–	–	By Profit and loss Adjustment A/c	12,000	16,000	16,000
To Provision for Doubtful Debts A/c	–	2,244	1,496	By Fixtures Less provision for Doubtful Debts A/c	248	331	331
To A	–	13,425	2,066	By B	13,425		
To Balance c/d	–	83,782	61,939	By C	2,066		
	1,63,669	1,15,451	77,501		1,63,669	1,15,451	77,501

Note: The balance of A's Capital Account has been transferred to A's Loan Account.

Working Note:

Calculation for adjustment of Amount of Goodwill

Partner	Old Share	New Share	Gain	Sacrifice
A	$\frac{3}{11}$	—	—	$\frac{3}{11}$
B	$\frac{4}{11}$	$\frac{3}{5}$	$\frac{13}{55}$	—
C	$\frac{4}{11}$	$\frac{2}{5}$	$\frac{2}{55}$	—

ILLUSTRATION 4

K, L & M are partners sharing profits and losses in the ratio 5:3:2. Due to illness, L wanted to retire from the firm on 31.3.2022 and admit his son N in his place.

Balance Sheet of K, L and M as on 31.3.2022

Liabilities	₹	₹	Assets	₹
Capital:			Furniture	20,000
K	40,000		Trade receivables	50,000
L	60,000		Inventory in Trade	50,000
M	30,000	1,30,000	Cash and Bank balances	80,000
Reserve		50,000		
Trade payables		20,000		
		2,00,000		2,00,000

On retirement of L assets were revalued: Furniture ₹ 10,000 and Inventory in trade ₹ 30,000. 50% of the amount due to L was paid off in cash and the balance was retained in the firm as capital of N. On admission of the new partner, goodwill was valued at ₹ 50,000. Partners are being paid off their extra balances to make capital proportionate by keeping N's capital as base.

You are required to give:

(i) Necessary journal entries; (ii) balance sheet of M/s K, M and N as on 1.4.2022; (iii) capital accounts of partners.

SOLUTION

Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
31.3.2022	Profit and Loss Adjustment A/c Dr. To Furniture A/c To Inventory in Trade A/c (Being revaluation of Furniture and inventory in trade recorded)	30,000	10,000 20,000
	K's Capital A/c Dr. L's Capital A/c Dr. M's Capital A/c Dr. To Profit and Loss Adjustment A/c (Being net revaluation loss debited to capital accounts of K, L and M in the ratio 5 : 3 : 2)	15,000 9,000 6,000	30,000
	Reserve A/c Dr. To K's Capital A/c To L's Capital A/c To M's Capital A/c (Being reserve transferred to capital accounts, K, L and M)	50,000	25,000 15,000 10,000
	N's Capital A/c Dr. To L's Capital A/c (Being adjusting entry for goodwill passed in gaining/ sacrificing ratio)	15,000	15,000
	L's Capital A/c Dr. To Cash and Bank A/c To N's Capital A/c (Being 50% of the amount due to L was paid off in cash and balance was retained in the firm as capital of N)	81,000	40,500 40,500

(Balancing figure)	7,500	-	17,000	-					
To Balance c/d	42,500	-	17,000	25,500					
	65,000	90,000	40,000	40,500		65,000	90,000	40,000	40,500
					By Balance b/d	35,000	-	14,000	25,500

Balance Sheet of M/s K, M & N

as on 1st April, 2022

Liabilities	₹	₹	Assets	₹
Capital Accounts:			Furniture	10,000
K	42,500		Trade receivables	50,000
M	17,000		Inventory in Trade	30,000
N	25,500	85,000	Cash and Bank balance	15,000
Trade payables		20,000		
		1,05,000		1,05,000

ILLUSTRATION 5

Dowell llp. with partners Mr. A, Mr. B and Mr., C, are sharing profits and losses in the ratio of 10:6:4. The balance sheet of the firm as at 31st March, 2022 is as under:

Liabilities		₹	Assets	₹
Capitals :			Land	10,000
Mr. A	80,000		Buildings	2,00,000
Mr. B	20,000		Plant and Machinery	1,30,000
Mr. C	30,000	1,30,000	Furniture	43,000
Reserves			Investments	12,000
(un-appropriated profit)		20,000	Inventories	1,30,000
Long Term Debt		3,00,000	Trade receivables	1,39,000
Bank Overdraft		44,000		
Trade payables		1,70,000		
		6,64,000		6,64,000

It was mutually agreed that Mr. B will retire from partnership and in his place Mr. D will be admitted as a partner with effect from 1st April, 2022. For this purpose, the following adjustments are to be made:

- (a) Goodwill is to be valued at ₹ 1 lakh but the same will not appear as an asset in the books of the reconstituted firm.
- (b) Buildings and plant and machinery are to be depreciated by 5% and 20% respectively. Investments are to be taken over by the retiring partner at ₹ 15,000. Provision of 20% is to be made on Trade receivables to cover doubtful debts.
- (c) In the reconstituted firm, the total capital will be ₹ 2 lakhs which will be contributed by Mr. A, Mr. C and Mr. D in their new profit sharing ratio, which is 2:2:1.
- (i) The surplus funds, if any, will be used for repaying bank overdraft.
- (ii) The amount due to retiring partner shall be transferred to his loan account.

Required:

Prepare

- (a) Revaluation account;
- (b) Partners' capital accounts;
- (c) Bank account; and
- (d) Balance sheet of the reconstituted firm as on 1st April, 2022.

SOLUTION**Revaluation Account**

	₹		₹
To Buildings A/c	10,000	By Investments A/c	3,000
To Plant and Machinery A/c	26,000	By Loss to Partners:	
To Provision for Doubtful Debts A/c	27,800	A 30,400	
		B 18,240	
		C 12,160	60,800
	63,800		63,800

A's Capital Account

	₹		₹
To Revaluation A/c	30,400	By Balance b/d	80,000
To Balance c/d	80,000	By Reserves A/c	10,000
		By C and D's Capital A/c	10,000
		By Bank A/c (balancing figure)	10,400
	1,10,400		1,10,400

B's Capital Account

	₹		₹
To Revaluation A/c	18,240	By Balance b/d	20,000
To Investments A/c	15,000	By Reserves A/c	6,000
To B's Loan A/c	22,760	By C and D's Capital A/c	30,000
	56,000		56,000

C's Capital Account

	₹		₹
To Revaluation A/c	12,160	By Balance b/d	30,000
To A and B's Capital A/c	20,000	By Reserves A/c	4,000
To Balance c/d	80,000	By Bank A/c (balancing figure)	78,160
	1,12,160		1,12,160

D's Capital Account

	₹		₹
To A and B's Capital A/cs	20,000	By Bank A/c	60,000
To Balance c/d	40,000		
	60,000		60,000

Bank Account

	₹		₹
To A's Capital A/c	10,400	By Bank Overdraft A/c	44,000
To C's Capital A/c	78,160	By Balance c/d	1,04,560
To D's Capital A/c	60,000		
	1,48,560		1,48,560

Balance Sheet of Dowell Iip.**as at 1st April, 2022**

Liabilities		₹	Assets		₹
Capital Accounts:			Land		10,000
A	80,000		Buildings		1,90,000
C	80,000		Plant and Machinery		1,04,000
D	40,000	2,00,000	Furniture		43,000
Long Term Debts		3,00,000	Inventories		1,30,000
Trade payables		1,70,000	Trade receivables	1,39,000	

B's Loan Account		22,760	Less: Provision for Doubtful Debts)	(27,800)	1,11,200
			Balance at Bank		1,04,560
		6,92,760			6,92,760

Note: Even though the problem says goodwill ₹ 1,00,000 to appear in new Balance Sheet, it is written off so as to comply with Accounting Standard. Net entry for goodwill is:

C's capital	Dr.	20,000	
D's capital	Dr.	20,000	
To A's capital			10,000
To B's capital			30,000



4.6 PAYING A PARTNER'S LOAN IN INSTALMENT

Strictly speaking, paying a partner's loan is only a matter of arranging finance. However, sometimes it is stated that the loan is to be paid off in so many equal instalments and that the balance is to carry interest. In such case, what should be done is that the loan should be divided into equal parts. The interest for the period should be calculated and the payment should consist of the instalment on account of the loan plus interest for the period. Suppose a partner's loan stands at ₹ 30,000 and that it has to be paid in four annual equal instalments and that the loan is to carry interest at 6% per annum. The annual instalment on account of loan comes to ₹ 7,500. For the first year the first interest is ₹ 1,800 i.e. 6% on ₹ 30,000. In the first year the amount to be paid will be ₹ 9,300. Balance of ₹ 22,500 will now be left. Next year the interest will be ₹ 1,350. The amount to be paid therefore will be ₹ 7,500 plus interest viz., ₹ 8,850. The loan account will appear in the books as under.

Retiring Partner's Loan Account

		₹			₹
I Year	To Cash (7,500 + 1,800)	9,300	I Year	By Capital A/c	30,000
	To Balance c/d	22,500		By Interest A/c	1,800
		31,800			31,800
II Year	To Cash (7,500 + 1,350)	8,850	II Year	By Balance b/d	22,500
	To Balance c/d	15,000		By Interest A/c	1,350

III Year	To Cash		III Year	(6% on ₹ 22,500)	
		23,850			23,850
		8,400			15,000
IV Year	To Balance c/d	7,500	IV Year	By Interest Account	900
		15,900			15,900
		7,950			7,500
IV Year	To Cash	7,950	IV Year	By Balance b/d	450
					7,950

ILLUSTRATION 6

M/s X is a partnership firm with the partners A, B and C sharing profits and losses in the ratio of 3:2:5. The balance sheet of the firm as on 30th June 2022, was as under:

Balance Sheet of M/s. X as on 30.06.2022

Liabilities	₹	Assets	₹
A's Capital A/c	1,04,000	Land	1,00,000
B's Capital A/c	76,000	Building	2,00,000
C's Capital A/c	1,40,000	Plant and Machinery	3,80,000
Long Term Loan	4,00,000	Investments	22,000
Bank Overdraft	44,000	Inventories	1,16,000
Trade payables	1,93,000	Trade receivables	1,39,000
	9,57,000		9,57,000

It was mutually agreed that B will retire from partnership and in his place D will be admitted as a partner with effect from 1st July, 2022. For this purpose, the following adjustments are to be made:

- Goodwill of the firm is to be valued at ₹ 2 lakhs due to the firm's locational advantage but the same will not appear as an asset in the books of the reconstituted firm.
- Buildings and plant and machinery are to be valued at 90% and 85% of the respective balance sheet values. Investments are to be taken over by the retiring partner at ₹ 25,000. Trade receivables are considered good only upto 90% of balance sheet figure. Balance be considered bad.

- (c) In the reconstituted firm, the total capital will be ₹ 3 lakhs, which will be contributed by A, C and D in their new profit sharing ratio, which is 3:4:3.
- (d) The amount due to retiring partner shall be transferred to his loan account.

Required:

Prepare Revaluation Account and Partners' Capital Accounts.

SOLUTION**Revaluation Account**

2022		₹	2022			₹
July 1	To Building	20,000	July 1	By Investments		3,000
	To Plant and Machinery	57,000		(25,000 - 22,000)		
	To Bad Debts	13,900		By Partners' Capital A/cs		
				(Loss on revaluation)		
				A (3/10)	26,370	
				B (2/10)	17,580	
				C (5/10)	43,950	87,900
		90,900				90,900

Partners' Capital Accounts

	A	B	C	D		A	B	C	D
	₹	₹	₹	₹		₹	₹	₹	₹
To Revaluation A/c	26,370	17,580	43,950	–	By Balance b/d	1,04,000	76,000	1,40,000	–
To B's and C's Capital A/cs	–	–	–	60,000	By D's Capital A/c (W.N.1)	–	40,000	20,000	–
To Investments A/c	–	25,000	–	–	By Bank A/c	12,370	–	3,950	1,50,000
To B's Loan A/c	–	73,420	–	–					
To Balance c/d (W.N. 2)	90,000	–	1,20,000	90,000					
	1,16,370	1,16,000	1,63,950	1,50,000		1,16,370	1,16,000	1,63,950	1,50,000

Working Notes:**1. Adjustment of goodwill**

Goodwill of the firm is valued at ₹ 2 lakhs

Sacrificing ratio:

A	$3/10 - 3/10$	$= 0$
B	$2/10 - 0$	$= 2/10$
C	$5/10 - 4/10$	$= 1/10$

Hence, sacrificing ratio of B and C is 2:1. A has not sacrificed any share in profits after retirement of B and admission of D in his place.

Adjustment of D's share of goodwill through existing partners' capital accounts in the profit sacrificing ratio:

			₹
B :	₹ 60,000 × 2/3	=	40,000
C :	₹ 60,000 × 1/3	=	20,000
			60,000

2. Capital of partners in the reconstituted firm :

	₹
Total capital of the reconstituted firm (given)	3,00,000
A (3/10)	90,000
B (4/10)	1,20,000
C (3/10)	90,000



4.7 JOINT LIFE POLICY

A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimize the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

The accounting treatment for the premium paid and the Joint Life Policy may be on any of the following ways:

- 1. When premium paid is treated as an expense:** When premium is treated as an expense then it is closed every year by transferring to profit and loss account. In this case complete amount received from the insurance company either on a surrender of policy or on the death of the partner becomes a gain.

Accounting entries are:

- (a) On payment of premium

Joint Life Policy Insurance Premium A/c

Dr.

To Bank A/c

- (b) On charging to Profit and Loss Account

Profit and Loss Account Dr.

To Joint Life Policy Insurance Premium A/c

- (c) On maturity of the Policy

Insurance Company/ Bank Account Dr.

To Partners' Capital A/cs (individually)

(Including the account of the representative of a deceased partner)

2. **When premium paid is treated as an asset:** In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.
3. **Creation of Joint Policy Reserve Account:** Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realized. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

On the death of a partner Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and then the balance is transferred to Partners' Capital Accounts.

ILLUSTRATION 7

Red, White and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2018 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2018 nil; 2019 ₹ 900; 2020 ₹ 2,000; 2021 ₹ 3,600. Black retires on 15th April, 2022.

Required

Prepare ledger accounts assuming no Joint Life Policy Account is maintained.

SOLUTION**Joint Life Policy Premium Account**

		₹			₹
10th June, 2018	To Bank A/c	3,000	31st Dec., 2018	By Profit and Loss A/c	3,000
10th June, 2019	To Bank A/c	3,000	31st Dec., 2019	By Profit and Loss A/c	3,000
10th June, 2020	To Bank A/c	3,000	31st Dec., 2020	By Profit and Loss A/c	3,000
10th June, 2021	To Bank A/c	3,000	31st Dec., 2021	By Profit and Loss A/c	3,000

Profit and Loss Account

		₹		₹
31st Dec., 2018	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2019	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2020	To Joint Life Policy Premium A/c	3,000		
31st Dec., 2021	To Joint Life Policy Premium A/c	3,000		

Joint Life Policy Account

		₹			₹
15th April, 2022	To Capital A/cs: (Transfer)		15th April, 2022	By Bank A/c	3,600
	Red 5/10	1,800			
	White 3/10	1,080			
	Black 2/10	720			
		3,600			3,600

ILLUSTRATION 8

Red, White and Black shared profits and losses in the ratio of 5: 3: 2. They took out a Joint Life Policy in 2018 for ₹ 50,000, a premium of ₹ 3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2018 nil; 2019 ₹ 900; 2020 ₹ 2,000; 2021 ₹ 3,600.

Black retires on 15th April, 2022.

Required:

Prepare ledger accounts assuming Joint Life Policy Account is maintained on surrender value basis.

SOLUTION**Joint Life Policy Account**

		₹			₹
10th June, 2018	To Bank A/c	3,000	31st Dec., 2018	By Profit and Loss A/c	3,000
10th June, 2019	To Bank A/c	3,000	31st Dec., 2019	By Profit and Loss A/c	2,100
				By Balance c/d	900
		3,000			3,000
1st January, 2020	To Balance b/d	900	31st Dec., 2020	By Profit and Loss A/c	1,900
10th June, 2020	To Bank A/c	3,000		By Balance c/d	2,000
		3,900			3,900
1st January, 2021	To Balance b/d	2,000	31st Dec., 2021	By Profit and Loss A/c	1,400
10th June, 2021	To Bank A/c	3,000		By Balance c/d	3,600
		5,000			5,000
1st January, 2022	To Balance b/d	3,600	15th April, 2022	By Bank	3,600
		3,600			3,600

Profit and Loss Account

		₹			₹
31st Dec., 2018	To Joint Life Policy A/c	3,000			
31st Dec., 2019	To Joint Life Policy A/c	2,100			
31st Dec., 2020	To Joint Life Policy A/c	1,900			
31st Dec., 2021	To Joint Life Policy A/c	1,400			

ILLUSTRATION 9

A, B and C are in partnership sharing profits and losses at the ratio of 5:3: 2. The balance sheet of the firm on 31.12.2021 was as follows:

Balance Sheet

Liabilities	₹	Assets	₹
Capital A/cs:		Sundry Fixed Assets	80,000
A	50,000	Inventories	50,000
B	40,000	Trade receivables	30,000
C	30,000	Joint Life Policy	20,000
Bank Loan	40,000	Bank	10,000
Trade payables	30,000		
	1,90,000		1,90,000

On 1.1.2022, A wants to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2017 for ₹ 1,00,000 and its surrender value as on 31.12.2021 was ₹ 25,000. For the purpose of A's retirement goodwill was raised for ₹ 1,00,000. Sundry Fixed Assets was revalued for ₹ 1,10,000. But B and C did not prefer to show such an increase in assets in the balance sheet. Also they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹ 25,000 and to make their capital proportionate.

Required:

Prepare necessary journal entries to give the effect in capital accounts of partners.

SOLUTION**Journal Entries**

			₹	₹
1.	B's Capital A/c	Dr.	49,500	
	C's Capital A/c	Dr.	18,000	
	To A's Capital A/c			67,500
	(Share of memorandum revaluation profit ₹ 67,500 including good will due to A borne by B and C at the gaining ratio 11 : 4)			
2.	A's Capital A/c	Dr.	1,17,500	
	To A's Loan A/c			58,750
	To Bank A/c			58,750
	(Settlement of A's claim on his retirement by payment of 50% in case and transferring the balance to his Loan A/c).			

3.	Bank A/c	Dr.	73,750	
	To B's Capital A/c			60,333
	To C's Capital A/c			13,417
	(Cash brought in by the continuing partners).			

Working Notes:

1. Memorandum Revaluation Profit	₹
Goodwill	1,00,000
Sundry Fixed Assets	30,000
Joint Life Policy	5,000
	<u>1,35,000</u>

A's Share ₹ 1,35,000 × 5/10 = ₹ 67,500.

2. Gaining Ratio

B : $2/3 - 3/10 = 11/30$

C : $1/3 - 2/10 = 4/30$

Gaining Ratio : B : C
 11 : 4

3. Total Capital

	₹
Assets as per Balance Sheet	1,90,000
Additional Bank Balance	<u>15,000</u>
	2,05,000
Less : Bank Loan	40,000
Sundry Creditors	30,000
A's Loan	<u>58,750</u>
	(1,28,750)
	<u>76,250</u>
B's Share	50,833
C's Share	25,417

4.8 SEPARATE LIFE POLICY

Instead of life policy taken jointly on the name of all the partners, all the partners may take individual life policies for each of them by paying the premium from the firm. In the event of retirement, the retired partner is entitled for the proportionate amount of the life policies of all the partners.

Example: Sona, Gabbu and Amit are partners Profit sharing ratio is 3:1:1

	SONA	GABBU	AMIT
Policy	1,00,000	2,00,000	3,00,000
Surrender Value	10,000	20,000	30,000

If Amit retires, then, Amit will get ₹ $60,000 \times 1/5 = 12,000$

ILLUSTRATION 10

Aarav, Nirav and Purav are partners in LLP sharing profits and losses in the ratio of 3:2:1. Their Balance Sheet as on 31st March, 2022 was as follows:

Balance Sheet as on 31st March, 2022

Liabilities	₹	Assets	₹
Capital : Aarav	80,000	Building	50,000
Nirav	50,000	Machinery	67,500
Purav	35,000	Debtors	65,000
General Reserve	60,000	Stock	80,000
Trade Creditors	50,000	Bank	12,500
	2,75,000		2,75,000

Purav retired from the business on 1st April 2022 on the following terms:

- Goodwill was to be valued at 2 years purchase of average profit of past 3 years.
 31st March, 2020 ₹ 41,000
 31st March, 2021 ₹ 50,000
 31st March, 2022 ₹ 55,000
- Goodwill was not to be raised in the books of accounts.
- Provision for Doubtful Debts was to be created on debtors at 5%. Machinery is to be depreciated by 10% and stock is revalued at ₹ 71,000.

5. Building to be appreciated by 20%.
6. Aarav and Nirav to bring in additional capital of ₹ 35,000 and ₹ 25,000 respectively.
7. Balance payable to Purav must be paid immediately.

You are required to prepare:

1. Revaluation account
2. Partners capital accounts.
3. Bank account.
4. Balance Sheet after retirement.

SOLUTION

In The Books of Aarav Nirav and Purav Revaluation A/c

Particulars	₹	Particulars	₹
To Provision for Doubtful Debts	3,250	By Building	10,000
To Machinery	6,750	By Loss on revaluation	
To Stock	9,000	Aarav	4,500
		Nirav	3,000
		Purav	<u>1,500</u>
			9,000
	<u>19,000</u>		<u>19,000</u>

Partners Capital A/c

Particulars	Aarav	Nirav	Purav	Particulars	Aarav	Nirav	Purav
To Loss on Revaluation	4,500	3,000	1,500	By Balance b/d	80,000	50,000	35,000
To Bank			60,500	By General Reserve	30,000	20,000	10,000
To Purav capital	10,200	6,800		By Aarav, Nirav capital			17,000
To Balance c/d	1,30,300	85,200		By Bank	35,000	25,000	
	<u>1,45,000</u>	<u>95,000</u>	<u>62,000</u>		<u>1,45,000</u>	<u>95,000</u>	<u>62,000</u>

Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	12,500	By Purav's Capital	60,500
To Aarav's Capital	35,000	By Balance c/d	12,000

To Nirav's Capital	25,000		
	72,500		72,500

Balance Sheet as on April 1st, 2022

Liabilities			₹	Assets			₹
Capital :	Aarav	1,30,300		Building			60,000
	Nirav	85,200	2,15,500	Machinery			60,750
Trade Creditors			50,000	Debtors	65,000		
				Less: Provision for doubtful Debts	3,250		61,750
				Stock			71,000
				Bank			12,000
			2,65,500				2,65,500

Working note :**Valuation of Goodwill (as per weight average method)**

31st March 2020 ₹ 41,000 X 1 = 41,000

31st March 2021 ₹ 50,000 X 2 = 1,00,000

31st March 2022 ₹ 55,000 X 3 = 1,65,000

Total ₹ 3,06,000

Weighted average profit (3,06,000/6) = 51,000

Goodwill (2 years purchase) = 2 x 51,000 = ₹ 1,02,000

Purav's share = 1/6th = 1,02,000/6 = 17,000

Journal entry for adjustment of goodwill

Aarav capital A/c Dr. 10,200

Nirav capital Dr. 6,800

To Purav capital 17,000

ILLUSTRATION 11

Satyam, Shivam & Sundaram are partners of M/s. Great Stationers sharing profits and losses in the ratio of 1:1:2.

On 31st March, 2022 their Balance Sheet was as under :

Liabilities	₹	Assets	₹
<i>Capitals :</i>		<i>Building</i>	2,50,000
Satyam 1,95,000		<i>Plant</i>	1,60,000
Shivam 1,48,000		<i>Investments</i>	85,000
Sunderam <u>1,12,000</u>	4,55,000	<i>Stock</i>	45,280
<i>General Reserve</i>	80,000	<i>Trade Receivable</i>	68,000
<i>Loan from Satyam</i>	94,000	<i>Bank</i>	95,720
<i>Sundry Creditors</i>	75,000		
	<u>7,04,000</u>		<u>7,04,000</u>

On 1st April 2022 Shivam retired on the following terms:

1. Goodwill is to be valued at ₹ 1,20,000 but the same will not appear as an asset in the books of the reconstituted firm.
2. Buildings is to be appreciated by 20% and Plant is to be depreciated by 10 %.
3. Investments are to be taken over by the Satyam in full settlement of his loan.
4. Provision of 5% is to be made on trade receivables to cover doubtful debts.
5. In the reconstituted firm, the total capital will be ₹ 3,00,000/- which will be contributed by Satyam and Sunderam in their new profit sharing ratio, which is 2:3.
6. The amount due to retiring partner shall be transferred to his loan account.

You are required to give journal entries to record above adjustments and also prepare Balance Sheet thereafter.

SOLUTION

In the books of Satyam Shivam & Sundaram

Journal entries

Sr No	Particulars	Dr. ₹	Cr. ₹
1	General Reserve A/c Dr.	80,000	
	To Satyam Capital A/c		20,000
	To Shivam Capital A/c		20,000
	To Sunderam Capital A/c		40,000
	(Being General reserve distributed among old partners)		
2.	Satyam Capital A/c Dr.	18,000	

	Sunderam Capital A/c	Dr.	12,000	
	To Shivam Capital A/c			30,000
	(Being adjustment entry for goodwill passed)			
3.	Building A/c	Dr.	50,000	
	To Revaluation A/c			50,000
	(Being Building appreciated)			
4.	Satyam loan A/c	Dr.	94,000	
	To Revaluation A/c			9,000
	To Investments A/c			85,000
	(Being investments taken over by Satyam)			
5.	Revaluation A/c	Dr.	19,400	
	To Plant			16,000
	To Provision for Doubtful Debts			3,400
	(Being Assets revalued)			
6.	Revaluation A/c	Dr.	39,600	
	To Satyam Capital A/c			9,900
	To Shivam capital A/c			9,900
	To Sundaram Capital A/c			19,800
	(Being profit on Revaluation distributed)			
7	Shivam Capital A/c	Dr.	2,07,900	
	To Shivam loan a/c			2,07,900
	(Being amount payable to Shivam transferred to his Loan A/c)			
8.	Satyam Capital A/c	Dr.	86,900	
	To Bank A/c			86,900
	(Being Capital accounts adjusted in Profit sharing ratio)			
9.	Bank A/c		20,200	
	To Sunderam Capital A/c			20,200
	(Being Capital accounts adjusted in Profit sharing ratio)			

Balance Sheet as on April 1st, 2022

Liabilities	₹	Assets	₹
Capitals :		Building	3,00,000
Satyam 1,20,000		Plant	1,44,000
Sunderam <u>1,80,000</u>	3,00,000	Stock	45,280
Shivam loan A/c	2,07,900	Trade Receivable 68,000	
Sundry Creditors	75,000	Less: Provision for Doubtful Debts <u>3,400</u>	64,600
		Bank	29,020
	5,82,900		5,82,900

Working Note:

Revaluation A/c

Particulars	₹	Particulars	₹
To Provision for Doubtful Debts	3,400	By building	50,000
To Plant	16,000	By Investments	9,000
To Revaluation profit			
Satyam 9,900			
Shivam 9,900			
Sunderam <u>19,800</u>	39,600		
	59,000		59,000

Bank A/c

Particulars	₹	Particulars	₹
To Balance b/d	95,720	By Satyam Capital	86,900
To Sundaram Capital	20,200	By Balance c/d	29,020
	1,15,920		1,15,920

Partners Capital A/c

Particulars	Satyam	Shivam	Sundaram	Particulars	Satyam	Shivam	Sundaram
				By Balance b/d	1,95,000	1,48,000	1,12,000
To Shivam 18,000			12,000	By Satyam and Sunderam		30,000	
To Shivam loan A/c		2,07,900		By General Reserve	20,000	20,000	40,000

To bank	86,900			By Revaluation	9,900	9,900	19,800
To balance c/d	1,20,000		1,80,000	By bank			20,200
	2,24,900	2,07,900	1,92,000		2,24,900	2,07,900	1,92,000

Partner	Old Share		New share		Gain Share
Satyam	1/4	-	2/5	=	3/20
Shivam	1/4	-	-	=	(5/20)
Sunderam	2/4	-	3/5	=	2/20

SUMMARY

- ◆ Re-adjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gain in terms of profit sharing ratio. So they arrange for the amount to be paid to discharge the claims of the retiring partners.
- ◆ On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner. If there is revaluation profit/loss, then such profit/loss should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio.
- ◆ On the retirement of a partner any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio.
- ◆ Following adjustments are necessary in the Capital A/c of a retiring partner at the time of final payment:
 - (i) Transfer of reserve,
 - (ii) Transfer of goodwill,
 - (iii) Transfer of profit/loss on revaluation.
- ◆ There are three methods for treating premium paid on Joint Life Policy: firstly, it can be shown as an expense; alternatively it can be shown as an asset to the extent of surrender value and the balance as an expense; Thirdly, a joint Life Policy reserve can be created; On retirement of a partner, the surrender value of the Joint Life Policy is to be raised in the books of accounts if it is not shown already as an asset. If the surrender value is more than the value of joint Life Policy shown in the Balance Sheet, only the excess amount should be transferred to revaluation account.

TEST YOUR KNOWLEDGE

True and False

1. *Business of a partnership has to be closed if any one of the partners retires.*
2. *At the time of retirement of a partner no special treatment is required for any reserves appearing in the Balance Sheet.*
3. *After retirement of a partner, profit sharing ratio of continuing partners remains the same.*
4. *If any partner wants to retire from the business, he must retire on 1st day of the accounting year.*
5. *Retiring partner has to forego his share of goodwill in the firm.*
6. *If a partner retires in between the accounting year then he is not entitled to any profit from the date of beginning of the year till his date of retirement.*
7. *If the firm has taken any joint life policy then it is to be surrendered at the time of retirement of a partner.*
8. *Any joint life policy reserve appearing in the Balance Sheet is credited to all the partners in their old profit sharing ratio.*
9. *No revaluation account is necessary on retirement of a partner.*
10. *Profit on revaluation is credited to continuing partners, retiring partner is not entitled to any profit on revaluation.*

Multiple Choice Questions

1. *C, D and E are partners sharing profits and losses in the proportion of $\frac{1}{2}$, $\frac{1}{3}$ and $\frac{1}{6}$. D retired and the new profit sharing ratio between C and E is 3:2 and the Reserve of ₹ 12,000 is divided among the partners in the ratio:*
 - (a) ₹ 2,000: ₹ 4,000: ₹ 6,000.
 - (b) ₹ 5,000: ₹ 5,000: ₹ 2,000.
 - (c) ₹ 6,000: ₹ 4,000: ₹ 2,000.
2. *A, B and C takes a Joint Life Policy, after five years B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement, A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy premium is fully charged to revenue as and when paid?*

- (a) ₹ 50,000 credited to all the partners in old ratio.
 - (b) ₹ 2,50,000 credited to all the partners in old ratio.
 - (c) ₹ 2,00,000 credited to all the partners in old ratio.
3. A, B and C take a Joint Life Policy, after five years, B retires from the firm. Old profit sharing ratio is 2:2:1. After retirement A and C decides to share profits equally. They had taken a Joint Life Policy of ₹ 2,50,000 with the surrender value ₹ 50,000. What will be the treatment in the partner's capital account on receiving the JLP amount if joint life policy is maintained at the surrender value?
- (a) ₹ 50,000 credited to all the partners in old ratio.
 - (b) ₹ 2,50,000 credited to all the partners in old ratio.
 - (c) No treatment is required.
4. A, B and C are partners sharing profits in the ratio 2:2:1. On retirement of B, goodwill was valued as ₹ 30,000. Find the contribution of A and C to compensate B.
- (a) ₹ 20,000 and ₹ 10,000.
 - (b) ₹ 8,000 and ₹ 4,000.
 - (c) They will not contribute anything.
5. A, B and C were partners in a firm sharing profits and losses in the ratio of 2:2:1 respectively with the capital balance of ₹ 50,000 for A and B, for C ₹ 25,000. B declared to retire from the firm and balance in reserve on the date was ₹ 15,000. If goodwill of the firm was valued as ₹ 30,000 and profit on revaluation was ₹ 7,050 then what amount will be transferred to the loan account of B.
- (a) ₹ 70,820.
 - (b) ₹ 50,820.
 - (c) ₹ 25,820.
6. A, B and C are partners sharing profits and losses in the ratio of 3:2:1. C retires on a decided date and Goodwill of the firm is to be valued at ₹ 60,000. Find the amount payable to retiring partner on account of goodwill.
- (a) ₹ 30,000.
 - (b) ₹ 20,000.
 - (c) ₹ 10,000.

7. A, B and C were partners sharing profits and losses in the ratio of 3:2:1. A retired and Goodwill of the firm is to be valued at ₹ 24,000. What will be the treatment for goodwill?
- Credited to Revaluation Account at ₹ 24,000.
 - Adjusted through partners' capital accounts in gaining/sacrificing ratio.
 - Only A's capital account credited with ₹ 12,000.
8. Balances of A, B and C sharing profits and losses in proportionate to their capitals, stood as A - ₹ 2,00,000; B - ₹ 3,00,000 and C - ₹ 2,00,000. A desired to retire from the firm, B and C share the future profits equally, Goodwill of the entire firm be valued at ₹ 1,40,000 and no Goodwill account being raised.
- Credit Partner's Capital Account with old profit sharing ratio for ₹ 1,40,000.
 - Credit Partner's Capital Account with new profit sharing ratio for ₹ 1,40,000.
 - Credit A's Account with ₹ 40,000 and debit B's Capital Account with ₹ 10,000 and C's Capital Account with ₹ 30,000.

Theoretical questions

- Write short notes on:
 - Calculation of gaining ratio.
 - Final payment of a retiring partner.
- What is joint life policy? What is the objective of taking such a policy?

Practical questions

- On 31st March, 2022, the balance sheet of M/s Ram, Rahul and Rohit sharing profits and losses in proportion to their capital, stood as follows:

Liabilities	₹	₹	Asset	₹
Capital accounts:			Land & building	2,00,000
Ram	3,00,000		Machinery	2,00,000
Rahul	2,00,000		Closing stock	1,00,000
Rohit	<u>1,00,000</u>	6,00,000	Sundry debtors	2,00,000
Sundry creditors		2,00,000	Cash and bank balances	1,00,000
		<u>8,00,000</u>		<u>8,00,000</u>

On 31st March, 2022, Ram desired to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the assets and liabilities on that date on the following basis:-

1. Land and buildings be appreciated by 30%.
2. Machinery be depreciated by 20%.
3. Closing stock to be valued at ₹ 80,000.
4. Provision for bad debts be made at 5%.
5. Old credit balances of sundry creditors ₹ 10,000 be written off.
6. Joint life policy of the partners surrendered and cash obtained ₹ 60,000.
7. Goodwill of the entire firm be valued at ₹ 1,80,000 and Ram's share of the goodwill be adjusted in the accounts of Rahul and Rohit who share the future profits equally. No goodwill account being raised.
8. The total capital of the firm is to be the same as before retirement. Individual capital be in their profit sharing ratio.
9. Amount due to Ram is to be settled as 50% on retirement and the balance 50% within one year.

Prepare revaluation account, capital account of partners: Rahul & Rohit, loan account of Ram, cash account and balance sheet as on 1.4.2022 of M/s Rahul and Rohit.

2. A, B, C were in partnership sharing profits and losses in the ratio of 3:2:1. The balance sheet of the firm as on 31.2.2022 was as under:

Liabilities		₹	Assets		₹
Capital accounts:					
A	1,50,000		Fixtures		30,000
B	1,00,000		Stock		1,70,000
C	50,000	3,00,000	Sundry debtors		90,000
Sundry creditors		40,000	Cash		50,000
		3,40,000			3,40,000

A, on account of ill-health, gave notice that he wished to retire from the firm. A retirement agreement was, therefore, entered as on 31.3.2022, the terms of which were as follows:

- (a) The profit and loss account for the year ended 31.3.2022, which showed a net profit of ₹ 42,000 was to be re-opened. B was to be credited with ₹ 6,000 as bonus, in consideration of the extra work, which had devolved upon him during the year. The profit sharing basis was to be revised and the revised ratio is to be 2:3:1 as and from 1st April 2021.

- (b) Goodwill was to be valued at two years' purchase of the simple average profits of five years. Profits for these five years ending on 31st March were as under:

	₹
31.3.2018	15,000
31.3.2019	23,000
31.3.2020	25,000
31.3.2021	35,000
31.3.2022	42,000

- (c) Fixtures are to be valued at ₹ 39,800 and a provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book value.

- (d) That the amount payable to A shall be paid by B.

B and C agreed, as between themselves, to continue the business, sharing profits and losses in the ratio of 3:1 and decided to retain fixtures in the books at the revised value and increase the provision for doubtful debts to 6 %. Total capital of the firm will be ₹ 3 lakhs as before to be maintained in the new ratio as between B and C.

You are required to give the necessary entries to give effect to the above arrangements. Prepare capital accounts of partners, cash account and balance sheet of B and C after giving effect to the above arrangements on the retirement of A.

ANSWERS/HINTS

True and False

1. False: Business of a partnership is not closed if any one of the partners retires, remaining partners continue to carry on the business.
2. False: At the time of retirement of a partner all the reserves appearing in the balance sheet are transferred to all the partners in their old profit sharing ratio.
3. False: After retirement of a partner, profit sharing ratio of continuing partners does not remain the same.
4. False: A partner can retire on any day as per his own wish.
5. False: Retiring partner is entitled to his share of goodwill in the firm.
6. False: If a partner retires in between the accounting year then he is certainly entitled to the profit from the date of beginning of the year till his date of retirement.

7. True: The firm is eligible for the surrender value on the Joint Life Policy taken on the partners at the time of their retirement.
8. True: As per the surrender policy method, the JLP reserve is distributed to the partners in their profit sharing ratio through capital account.
9. False: Revaluation account is necessary on retirement of a partner.
10. False: Profit on revaluation is credited to all the partners in their profit sharing ratio.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(c)	4.	(b)	5.	(a)	6.	(c)
7.	(b)	8.	(c)								

Theoretical Questions

1. (a) On retirement of a partner, the continuing partners will gain in terms of profit sharing ratio. For example, if A, B and C were sharing profits and losses in the ratio of 5:3: 2 and B retires, then A and C have to decide at which ratio they will share profits and losses in future. If it is decided that the continuing partners will share profits and losses in future at the ratio of 3:2, then A gains $\frac{1}{10}$ th $[(\frac{3}{5})-(\frac{5}{10})]$ and C gains $\frac{2}{10}$ $[(\frac{2}{5})-(\frac{2}{10})]$. So the gaining ratio between A and C is 1:2. If A and C decide to continue at the ratio 5:2, this indicates that they are dividing the gained share in the previous profit sharing ratio.
- (b) The following adjustments are necessary in the Capital A/c: (i) Transfer of reserve, (ii) Transfer of goodwill, (iii) Transfer of profit/loss on revaluation. After adjustment of these items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him. The continuing partners may discharge the whole claim at the time of retirement.
2. A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimize the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

Practical Questions

1. Revaluation Account

	₹		₹
To Machinery A/c	40,000	By Land and Buildings A/c	60,000
To Closing Stock A/c	20,000	By Sundry Creditors A/c	10,000
To Provision for Bad Debts A/c	10,000	By Cash and Bank A/c— Joint Life policy surrendered	60,000
To Partners' Capital A/cs:			
Ram	30,000		
Rahul	20,000		
Rohit	10,000		
	60,000		
	1,30,000		1,30,000

Partners' Capital Accounts

			Rahul	Rohit				Rahul	Rohit
			₹	₹				₹	₹
31.3.2022	To	Ram's Capital A/c	30,000	60,000	31-3-2022	By	Balance b/d	2,00,000	1,00,000
	To	Balance c/d	3,00,000	3,00,000		By	Revaluation A/c	20,000	10,000
						By	Cash & bank A/c — cash brought in by Rahul and Rohit	1,10,000	2,50,000
			3,30,000	3,60,000				3,30,000	3,60,000
					1-4-2022	By	Balance b/d	3,00,000	3,00,000

Ram's Loan Account

		₹			₹
31-3-2022	To Balance c/d	2,10,000	31-3-2022	By Ram's Capital A/c	2,10,000
		2,10,000			2,10,000
			1-4-2022	By Balance b/d	2,10,000

Cash and Bank Account

		₹			₹
31-3-2022	To Balance b/d	1,00,000	31-3-2022	By Ram's capital A/c	2,10,000
	To Revaluation A/c- joint life policy surrendered	60,000		By Balance c/d	3,10,000
	To Rahul's Capital A/c	1,10,000			
	To Rohit's Capital A/c	2,50,000			
		5,20,000			5,20,000
1-4-2022	To Balance b/d	3,10,000			

M/s Rahul & Rohit
Balance Sheet as on 1st April, 2022

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Land and buildings		2,60,000
Rahul	3,00,000		Machinery		1,60,000
Rohit	3,00,000	6,00,000	Closing stock		80,000
Ram's loan account		2,10,000	Sundry debtors	2,00,000	
Sundry creditors		1,90,000	Less: Provision for bad debts	(10,000)	1,90,000
			Cash and bank balances		3,10,000
		10,00,000			10,00,000

Working Notes:**1. Gaining ratio of existing partners:**

$$\text{Rahul } 1/2 - 1/3 = 1/6$$

$$\text{Rohit } 1/2 - 1/6 = 2/6$$

2. Total goodwill of firm is ₹ 1,80,000

$$\text{Ram's share } (1/2 \times ₹ 1,80,000) = ₹ 90,000$$

Ram's share of goodwill is to be borne by Rahul and Rohit in their gaining ratios i.e.

$$\text{Rahul} = 1/3 \times ₹ 90,000 = ₹ 30,000$$

$$\text{Rohit} = 2/3 \times ₹ 90,000 = ₹ 60,000$$

3. Ram's Capital Account

		₹			₹
31-3-2022	To Cash and Bank A/c	2,10,000	31-3-2022	By Balance b/d	3,00,000
	To Ram's Loan A/c -Transfer	2,10,000		By Revaluation A/c	30,000
				By Rahul's Capital A/c - Goodwill	30,000
				By Rohit's Capital A/c- Goodwill	60,000
		4,20,000			4,20,000

2. Journal Entries

			₹	₹
1.	A's Capital account Dr. B's Capital account Dr. C's Capital account Dr. To Profit and loss adjustment account (Profit written back for making adjustments)		21,000 14,000 7,000	42,000
2.	Profit and loss adjustment account Dr. To B's Capital account (Bonus credited to B's capital account)		6,000	6,000
3.	Profit and loss adjustment account Dr. To A's Capital account To B's Capital account To C's Capital account (Distribution of profits in the new ratio)		36,000	12,000 18,000 6,000
4.	Fixtures account Dr. To Provision for bad debts account To A's Capital account To B's Capital account To C's Capital account (Revaluation of assets on A's retirement)		9,800	1,800 2,667 4,000 1,333
5.	B's capital account Dr. C's capital account Dr. To Provision for bad debts account (Raising provision for bad debts)		2,700 900	3,600

6.	A's capital account To B's Capital account (Amount payable to A paid by B)	Dr.	1,62,334	1,62,334
7.	B's Capital account C's Capital account To A's Capital account (Adjusting entry of goodwill passed through partners' capital accounts in gaining/sacrificing ratio)	Dr. Dr.	14,000 4,667	18,667

Partners' Capital Accounts

	A ₹	B ₹	C ₹		A ₹	B ₹	C ₹
To P & L adjustment A/c	21,000	14,000	7,000	By Balance b/d	1,50,000	1,00,000	50,000
To Provision for bad debts A/c	-	2,700	900	By P & L adjustment account	-	6,000	-
To B's Capital A/c	1,62,334	-	-	By P & L adjustment account	12,000	18,000	6,000
To Cash A/c	-	34,634	-	By Fixtures A/c	2,667	4,000	1,333
To A's Capital A/c	-	14,000	4,667	By A's capital A/c	-	1,62,334	-
				By B and C's capital A/c	18,667		
To Balance c/d	-	2,25,000	75,000	By Cash A/c			30,234
	1,83,334	2,90,334	87,567		1,83,334	2,90,334	87,567

Cash Account

	₹		₹
To Balance b/d	50,000	By B's capital A/c	34,634
To C's capital A/c	30,234	By Balance b/d	45,600
	80,234		80,234

Balance Sheet of B and C**as on 31st March, 2022 (after retirement of A)**

Liabilities		₹	Assets	₹	₹
Capital accounts:			Fixtures		39,800
B	2,25,000		Stock		1,70,000

C	75,000	3,00,000	Sundry debtors	90,000	
Sundry creditors		40,000	Less: Provision for bad debts	(5,400)	84,600
			Cash		45,600
		3,40,000			3,40,000

Working Notes:
Calculation of goodwill:
1. Average of last five year's profit

Year ended on	Profit ₹
31.3.2018	15,000
31.3.2019	23,000
31.3.2020	25,000
31.3.2021	35,000
31.3.2022	42,000
	1,40,000

2. Goodwill at two years' purchase

₹ 28,000 x 2 = ₹ 56,000

3. Calculation for adjustment of Amount of Goodwill

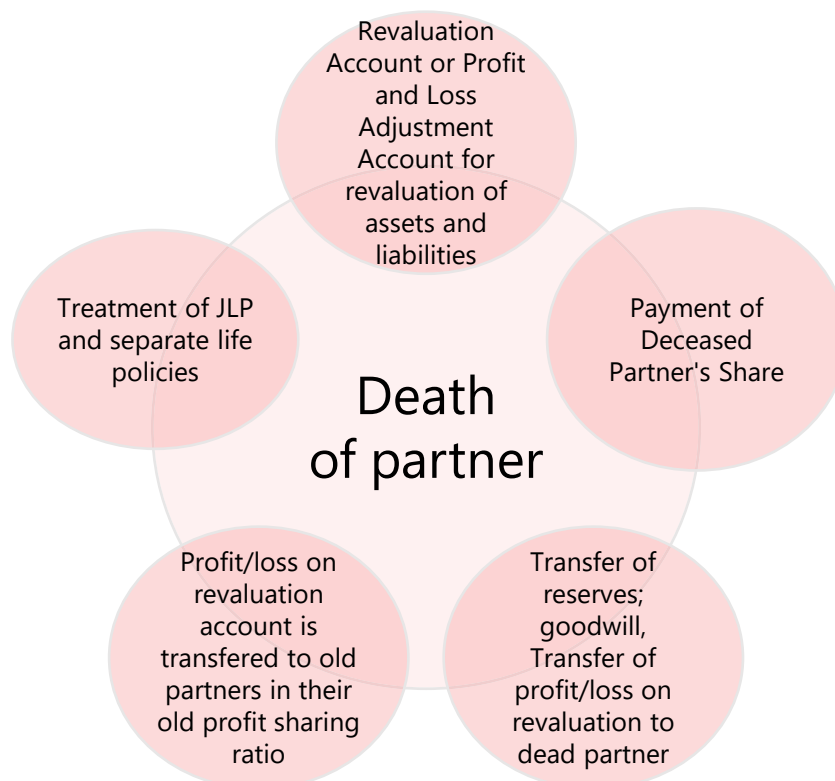
Partner	Old Share	New Share	Gain	Sacrifice
A	$\frac{2}{6}$	—	—	$\frac{2}{6}$
B	$\frac{3}{6}$	$\frac{3}{4}$	$\frac{3}{12}$	—
C	$\frac{1}{6}$	$\frac{1}{4}$	$\frac{1}{12}$	—

UNIT – 5 DEATH OF A PARTNER

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the implication of the excess money received on death of a partner from a joint life policy from the insurance company in the accounts of the partnership. Learn the journal entries required to record this transaction.
- ◆ Understand the accounting implications if death of a partner takes place at any date during the accounting period. Learn to record this transaction and how to record payment of profit to the Executor of the deceased partner for part of the accounting year.
- ◆ Be familiar with other accounting treatments in case of death of partner which are similar to the explained in case of retirement of a partner.

UNIT OVERVIEW **5.1 INTRODUCTION**

Business of a partnership firm may not come to an end due to death of a partner as it is known as Reconstitution of Partnership. Other partners shall continue to run the business of the firm. The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the capital accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement in the earlier unit. Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value.



5.2 RIGHT OF OUTGOING PARTNER IN CERTAIN CASES TO SHARE SUBSEQUENT PROFITS

As per provisions of Section 37 of the Indian Partnership Act., "Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm.

Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary".

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

For example, A, B and C are in a partnership business-sharing profits and losses equally. C died on 31st October, 2021. The capitals of the partners, after all necessary adjustments stood at ₹ 50,000, ₹75,000 and ₹ 1,20,000 respectively. A and B continued to carry on the business further without settling the accounts of C. Final payment to C is made on February 1, 2022. The profit made during the period of three months amounts to ₹ 28,000.

Under Section 37 of the Partnership Act, C can exercise any of the following two options.

- (i) Share in subsequent profits of firm:

Profit made—₹ 28,000

$$C's \text{ share} = 28,000 \times \frac{1,20,000}{2,45,000} = ₹ 13,714$$

- (ii) Interest at 6% p.a.

$$1,20,000 \times \frac{6}{100} \times \frac{3}{12} = ₹ 1,800$$

Since, (i) option is beneficial for C, he will necessarily go for his proportionate share in profits.

5.3 AMOUNT PAYABLE TO LEGAL REPRESENTATIVES OF DEAD PARTNER

When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings:

- (a) The amount standing to the credit to 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.

Legal representatives are liable for:

- (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.

Calculation of profit upto the date of death of a partner.

Such Profit is calculated through P&L Suspense account. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

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 throughout 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 up to 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.

Example

Arun, Tarun and Neha are partners sharing profits in the ratio of 3:2:1. Neha dies on 31st May 2022. Sales for the year 2021-2022 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 2022 to 31st May 2022 is ₹ 1,00,000. The deceased partner's share in the profit upto the date of death will be as follows.

Profit from 1st April 2022 to 31st May 2022 on the basis of sales:

If sales are ₹ 4,00,000, profit is ₹ 60,000

If the sales are ₹ 1,00,000 profit is: $60,000/4,00,000 \times 1,00,000 = ₹ 15,000$

Neha's share = $15,000 \times 1/6 = ₹ 2,500$

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

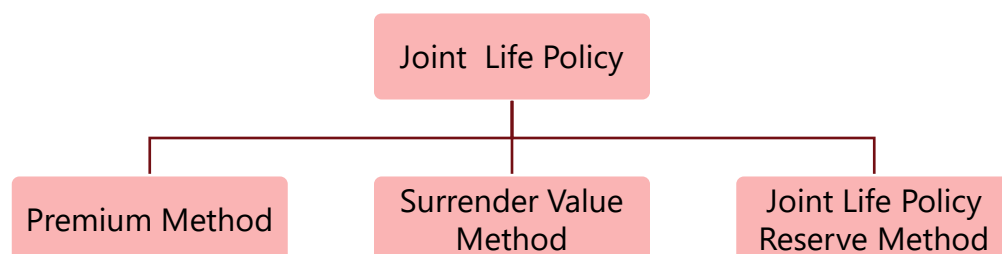
Profit = $1,00,000 \times 15/100 = ₹ 15,000$

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



5.4 SPECIAL TRANSACTIONS IN CASE OF DEATH: JOINT LIFE POLICY

In case of Partnership, Partners generally get Joint Life Policy(JLP) in name of all partners. If partner expires, then partners are entitled for share in JLP.



Method 1: If Joint Life Policy does not appear in the Balance Sheet, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

		₹	₹
(i) Bank A/c	Dr.	1,00,000	
To Joint Life Policy A/c			1,00,000
(Policy value received from the insurance company on A's death)			
(ii) Joint Life Policy A/c	Dr.	1,00,000	
To A's Capital A/c			50,000
To B's Capital A/c			30,000
To C's Capital A/c			20,000
(Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)			

Method 2: If Joint Life Policy appears in the Balance Sheet at surrender value, then the firm will gain on the death of a partner. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c Dr. To Joint Life Policy A/c (Policy value received from the insurance company on A's death)	1,00,000	1,00,000
(ii)	Joint Life Policy A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)	90,000	45,000 27,000 18,000

Method 3:

If Joint Life Policy appears in the Balance Sheet at surrender value along with Joint Life Policy Reserve, then the firm will gain on the death of a partner and reserve will be distributed among partners. For example, A, B and C are in partnership sharing profits and losses at the ratio of 5:3:2. They took a Joint Life Policy of ₹ 1,00,000 which is appearing in the Balance Sheet at the surrender value of ₹ 10,000, along with JLP reserve. Now, if A dies, the firm will receive ₹ 1,00,000 from the insurance company.

The journal entries will appear as follows:

		₹	₹
(i)	Bank A/c Dr. To Joint Life Policy A/c (Policy value received from the insurance company on A's death)	1,00,000	1,00,000
(ii)	Joint Life Policy A/c Dr. To A's Capital A/c To B's Capital A/c To C's Capital A/c (Joint Life Policy written off and credited to old partners in Profit Sharing Ratio)	90,000	45,000 27,000 18,000
(iii)	Joint Life Policy Reserve A/c Dr. To A's Capital A/c	10,000	5,000

To B's Capital A/c		3,000
To C's Capital A/c		2,000
(Joint Life Policy reserved written off and credited to old partners in Profit Sharing Ratio)		

5.5 SPECIAL TRANSACTIONS IN CASE OF DEATH: SEPARATE LIFE POLICY

Instead of taking one joint life policy in the names of all the partners, the partners may take individual policies on the lives of respective partners. The premium paid is charged to profit and loss account. On the death of a partner then only the amount for which the deceased partner was insured would be recovered from the insurance company. The policies of the surviving partners will continue to survive but the surrender value of the policies of the surviving partners would also be taken into account for the purpose of calculating the amount payable to the legal representatives of the deceased partner. In other words the legal representatives would be entitled to receive share in surrender value equivalent to the profit sharing ratio of the deceased.

Bank A/c	Dr.	(Assured value)
To Separate Life Policy of Deceased partner A/c		
(Policy value received on death of a partner)		

Separate Life Policy of Deceased Partner A/c	Dr.	(Assured value)
Separate Life Policy of Remaining Partners A/c	Dr.	(Surrender value)
To Executor's A/c	(Total value distributed in profit sharing ratio)	
To Remaining partners A/c	(Total value distributed in profit sharing ratio)	

(Being the total of assured value of deceased partner's life policy and surrender value of other partners' life policy(s) distributed in the profit and loss sharing ratio)

Example: Sona, Gabbu and Amit are partners sharing profits in the ratio of 3:1:1.

	SONA	GABBU	AMIT
Policy	1,00,000	2,00,000	3,00,000
Surrender Value	10,000	20,000	30,000

If Amit dies, then, Amit's executives will get $3,00,000 \times \frac{1}{5}$ and $\frac{1}{5}(10,000+20,000)$
 $= 60,000+6,000 = 66,000$



5.6 SPECIAL TRANSACTIONS IN CASE OF DEATH: PAYMENT OF DECEASED PARTNER'S SHARE

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although, revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2022. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off then profit for 2022 can be taken as base for calculating 3½ months profits in the year, 2022. If M/s. A, B & C earned ₹ 96,000 in year 2021, then 3½ months profit is ₹ 28,000. A's share comes to ₹ 28,000 × 2/5 i.e. ₹ 11,200.

Journal entry is:

Profit and Loss Suspense A/c *	Dr.	₹ 11,200
To A's Capital A/c		₹ 11,200
(Share of A 3½ months profit in 2022 is transferred to his Capital Account on death)		

*At the end of the year 2022, the Profit & Loss Suspense A/c will be transferred to Profit and Loss A/c.

ILLUSTRATION 1

The following was the Balance Sheet of Om & Co. in which X, Y, Z were partners sharing profits and losses in the ratio of 1:2:2 as on 31.3.2022. Mr. Z died on 31st December, 2022. His account has to be settled under the following terms.

Balance Sheet of Om & Co. as on 31.3.2022

Liabilities	₹	₹	Assets	₹
Trade payables		20,000	Building	1,20,000
Bank loan		50,000	Computers	80,000
General reserve		30,000	Inventories	20,000
Capital accounts:			Trade receivables	20,000
X	40,000		Cash at bank	50,000
Y	80,000		Investments	10,000
Z	80,000	2,00,000		
		3,00,000		3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three years' profits and losses. The profits and losses for the three years were detailed as below:

Year ending on	profit/loss
31.3.2022	30,000
31.3.2021	20,000
31.3.2020	(10,000) Loss

Profit for the period from 1.4.2022 to 31.12.2022 shall be ascertained proportionately on the basis of average profits and losses of the preceding three years.

During the year ending on 31.3.2022 a car costing ₹ 40,000 was purchased on 1.4.2021 and debited to traveling expenses account on which depreciation is to be calculated at 20% p.a. at written down value method. This asset is to be brought into account at the depreciated value.

Other values of assets were agreed as follows:

Inventory at ₹ 16,000, building at ₹ 1,40,000, computers at ₹ 50,000; investments at ₹ 6,000. Trade receivables were considered good.

Required:

- Calculate goodwill and Z's share in the profits of the firm for the period 1.4.2022 to 31.12.2022.
- Prepare revaluation account assuming that other items of assets and liabilities remained the same.
- Prepare partners' capital accounts and balance sheet of the firm Om & Co. as on 31.12.2022.

SOLUTION

(i) Calculation of goodwill and Z's share of profit

(a)	Adjusted profit for the year ended 31.3.2022:	₹	₹
	Profit (Given)		30,000
	Add: Cost of car wrongly written off	40,000	
	Less: Depreciation for the year 2021-22 (20% on 40,000)	(8,000)	32,000
			62,000
(b)	Average of last three year's profits and losses	Profit/ (loss)	
	Year ended on	₹	
	31.3.2020	(10,000)	

	31.3.2021	20,000	
	31.3.2022	62,000	
		72,000	
	Average profit (72,000/3)	24,000	
(c)	Goodwill at 2 years' purchase $\text{₹ } 24,000 \times 2 = \text{₹ } 48,000$		
(d)	Z's share of profits from the period 1.4.2022 to 31.12.2022 $\text{₹ } 24,000 \times 9/12 \times 2/5 = \text{₹ } 7,200$		

(ii)

Revaluation Account

	₹			₹
To Inventory account	4,000	By Building account		20,000
To Computers account	30,000	By Loss transferred to		
To Investments account	4,000	X	4,560	
To depreciation on car	4,800	Y	9,120	
		Z	9,120	22,800
	42,800			42,800

Partners' Capital Accounts

	X ₹	Y ₹	Z ₹		X ₹	Y ₹	Z ₹
To Revaluation A/c	4,560	9,120	9,120	By Balance b/d	40,000	80,000	80,000
To Z's Executor's A/c			1,22,080	By General reserve	6,000	12,000	12,000
To Z	6,400	12,800	–	By X and Y	–	–	19,200
To Balance c/d	41,440	82,880		By Car A/c	6,400	12,800	12,800
				By Profit and Loss suspense A/c	–	–	7,200
	52,400	1,04,800	1,31,200		52,400	1,04,800	1,31,200

Balance Sheet of Om & Co. as on 31st December, 2022

Liabilities	₹	Assets	₹
Trade payables	20,000	Building	1,40,000
Bank loan	50,000	Car	27,200
Capital accounts:		Inventories	16,000
X	41,440	Computers	50,000

Y	82,880	Investments	6,000
Z's Executor's account	1,22,080	Trade receivables	20,000
		Cash at bank	50,000
		Profit and Loss suspense Account	7,200
	3,16,400		3,16,400

Working Note:

Goodwill calculated at the time of death of partner Z ₹ 48,000

Partner	Old Share	New Share	Gain	Sacrifice
X	$\frac{1}{5}$	$\frac{1}{3}$	$\frac{2}{15}$	–
Y	$\frac{2}{5}$	$\frac{2}{3}$	$\frac{4}{15}$	–
Z	$\frac{2}{5}$	–	–	$\frac{2}{5}$

Adjusting entry:

X's Capital Account	Dr.	6,400	
Y's Capital Account	Dr.	12,800	
To Z's Capital Account			19,200

(Adjustment for goodwill on the death of Z on the basis of gaining ratio)

ILLUSTRATION 2

The partnership agreement of a firm consisting of three partners - A, B and C (who share profits in proportion of $\frac{1}{2}$, $\frac{1}{4}$ and $\frac{1}{4}$ and whose fixed capitals are ₹ 10,000; ₹ 6,000 and ₹ 4,000 respectively) provides as follows:

- That partners be allowed interest at 10 per cent per annum on their fixed capitals, but no interest be allowed on undrawn profits or charged on drawings.
- That upon the death of a partner, the goodwill of the firm be valued at two years' purchase of the average net profits (after charging interest on capital) for the three years to 31st December preceding the death of a partner.
- That an insurance policy of ₹ 10,000 each to be taken in individual names of each partner, the premium is to be charged against the profit of the firm.

- (d) Upon the death of a partner, he is to be credited with his share of the profits, interest on capitals etc. calculated upon 31st December following his death.
- (e) That the share of the partnership policy and goodwill be credited to the deceased partner as on 31st December following his death.
- (f) That the partnership books be closed annually on 31st December.

A died on 30th September 2022, the amount standing to the credit of his current account on 31st December, 2021 was ₹ 450 and from that date to the date of death he had withdrawn ₹ 3,000 from the business.

An unrecorded liability of ₹ 2,000 was discovered on 30th September, 2022. It was decided to record it and be immediately paid off.

The trading result of the firm (before charging interest on capital) had been as follows: 2019 Profit ₹ 9,640; 2020 Profit ₹ 6,720; 2021 Profit ₹ 7,640; 2022 Profit ₹ 3,670.

Assuming the surrender value of the policy to be 20 percent of the sum assured.

Required

Prepare an account showing the amount due to A's legal representative as on 31st December, 2022.

SOLUTION

A's Capital Account

2022		₹	2022		₹
Sep. 30	To Current A/c (3,000 - 450)	2,550	Jan. 1	By Balance b/d	10,000
			Dec. 31	By Profit and Loss A/c :	
Dec. 31	To Profit and Loss Adj. (Unrecorded Liability)	1,000		Interest on Capital	1,000
	To Balance Transferred to A's Executor's A/c	21,285		Share of Profit	835
		24,835		B & C (Goodwill)	6,000
				Insurance Policies A/c	7,000
					24,835

Working Notes:

(i) Valuation of Goodwill

Year	Profit before Interest on fixed capital	Interest	Profit after interest
	₹	₹	₹
2019	9,640	2,000	7,640
2020	6,720	2,000	4,720

2021	7,640	2,000	5,640
	21,000	6,000	18,000
			₹
Average			6,000
Goodwill at two years purchase of average net profits			12,000
Share of A in the goodwill			6,000
Profit on Separate Life Policy			
A's policy			10,000
B and C's policy @ 20%			4,000
			14,000
Share of A (1/2)			7,000
Share in profit for 2022			
Profit for the year			3,670
Less : Interest on capitals			(2,000)
			1,670
A's share in profit (1/2)			835

- (iv) As unrecorded liability of ₹ 2,000 has been charged to Capital Accounts through Profit and Loss Adjustment Account, no further adjustment in current year's profit is required.
- (v) Profits for 2019, 2020 and 2021 have not been adjusted (for valuing goodwill) for unrecorded liability for want of precise information.

ILLUSTRATION 3

The following is the Balance Sheet of M/s. ABC LLP as at 31st December, 2021.

Balance Sheet as at 31st December, 2021

Liabilities	₹	Assets		₹
Capital		Machinery		5,000
A	4,100	Furniture		2,800
B	4,100	Fixture		2,100
C	4,500	Cash		1,500
General Reserve	1,500	Inventories		950
Trade payables	2,350	Trade receivables	4,500	
		Less: Provision for Doubtful debts	300	4,200
	16,550			16,550

C died on 3rd January, 2022 and the following agreement was to be put into effect.

- Assets were to be revalued: Machinery to ₹ 5,850; Furniture to ₹ 2,300; Inventory to ₹ 750.
- Goodwill was valued at ₹ 3,000 and was to be credited with his share, without using a Goodwill Account
- ₹ 1,000 was to be paid away to the executors of the dead partner on 5th January, 2022.

Required

- The Journal Entry for Goodwill adjustment.
- The Revaluation Account and Capital Accounts of the partners.
- Which account would be debited and which account credited if the provision for doubtful debts in the Balance Sheet was to be found unnecessary to maintain at the death of C.

SOLUTION

(i) Journal Entry in the books of the firm

Date	Particulars		₹	₹
Jan 3, 2022	A's Capital A/c	Dr.	500	
	B's Capital A/c	Dr.	500	
	To C's Capital A/c			1,000
	(Being the required adjustment for goodwill through the partner's capital accounts)			

(ii) Revaluation Account

Particulars	₹	Particulars	₹
To Furniture A/c (₹ 2,800 – 2,300)	500	By Machinery A/c (₹ 5,850 – 5,000)	850
To Inventory A/c (₹ 950 – 750)	200		
To Partners' Capital A/cs (A – ₹ 50, B – ₹ 50, C – ₹ 50)	150		
	850		850

Partners' Capital Accounts

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To C (Goodwill)	500	500	–	By Balance b/d	4,100	4,100	4,500
To Cash A/c	–	–	1,000	By General Reserve A/c	500	500	500

To Executors A/c	–	–	5,050	By Revaluation A/c (Profit)	50	50	50
To Balance C/d	4,150	4,150	–	By A (Goodwill)	–	–	500
				By B (Goodwill)	–	–	500
	4,650	4,650	6,050		4,650	4,650	6,050

- (iii) Provision for Doubtful Debts Account is a credit balance. To close, this account is to be debited. It becomes a gain for the partners. Therefore, either Partners' Capital Accounts (including C) or Revaluation Account is to be credited.

Working Note:

Statement showing the Required Adjustment for Goodwill

Particulars	A	B	C
Right of goodwill before death	1/3	1/3	1/3
Right of goodwill after death	1/2	1/2	–
Gain/(Sacrifice)	(+) 1/6	(+) 1/6	(-) 1/3

Profit sharing ratio is equal before or after the death of C because nothing has been mentioned in respect of profit-sharing ratio.

ILLUSTRATION 4

B and N were partners. The partnership deed provides inter alia:

- (i) *That the accounts be balanced on 31st December each year.*
- (ii) *That the profits be divided as follows:*
B: One-half; N: One-third; and carried to Reserve Account: One-sixth
- (iii) *That in the event of death of a partner, his executor will be entitled to the following:*
 - (a) *the capital to his credit at the date of death; (b) his proportion of profit to date of death based on the average profits of the last three completed years; (c) his share of goodwill based on three years' purchases of the average profits for the three preceding completed years.*

Trial Balance on 31st December, 2021

Particulars	Dr. (₹)	Cr. (₹)
B's Capital		90,000
N's Capital		60,000
Reserve		30,000
Bills receivable	50,000	

Investments	40,000	
Cash	1,10,000	
Trade payables		20,000
Total	2,00,000	2,00,000

The profits for the three years were 2019: ₹ 42,000; 2020: ₹ 39,000 and 2021: ₹ 45,000. N died on 1st May, 2022. Show the calculation of N (i) Share of Profits; (ii) Share of Goodwill; (iii) Draw up N's Executors Account as would appear in the firms' ledger transferring the amount to the Loan Account.

SOLUTION

(i)	Ascertainment of N's Share of Profit		(ii)	Ascertainment of Value of Goodwill	
	2019	42,000		2019	42,000
	2020	39,000		2020	39,000
	2021	45,000		2021	45,000
	Total Profit	1,26,000		Total Profit for 3 years	1,26,000
	Average Profit	42,000		Average Profit	42,000
	4 months' Profit	14,000		Goodwill - 3 years	
	N's Share in Profit (2/5th* of ₹ 14,000)	5,600		Purchase of Average Profit	1,26,000
				N's Share of goodwill (2/5 of ₹ 1,26,000)	50,400

* Profit sharing ratio between B and N = 1/2; 1/3; = 3: 2, Therefore N's share of Profit = 2/5

N's Executors Account

Date	Particulars	₹	Date	Particulars	₹
2022 May 1,	To N's Loan A/c	1,28,000	2022 Jan. 1	By Capital A/c	60,000
			May 1	By Reserves (2/5th of ₹ 30,000)	12,000
			May 1	By B's Capital A/c (Share of goodwill)	50,400
			May 1	By P/L Suspense A/c (Share of Profit)	5,600
		1,28,000			1,28,000

ILLUSTRATION 5

Diya, Riya & Kiya are partners of M/s. DRK Fabrics sharing profits and losses in the ratio of 2:1:2. On 31st March 2022 their Balance Sheet was as under:

Liabilities	₹	Assets	₹
Capitals :		Land & Building	1,65,000
Diya	1,50,000	Furniture	75,000
Riya	1,80,000	Joint life Policy	60,000
Kiya	70,000	Inventory	88,740
General Reserve	1,40,000	Trade Receivable	96,750
Trade payables	60,000	Bank	1,14,510
	6,00,000		6,00,000

Kiya died on 30th September, 2022.

The partnership deed provides as follows:

- That partners be allowed interest at 12% p.a. on their capitals, but no interest be charged on drawings.
- Upon the death of a partner, the goodwill of the firm be valued at one years' purchase of the average net profits (after charging interest on capital) for the four years to 31st March preceding the death of a partner. The profits of the firm before charging interest on capitals were

2018-19 1,62,000

2019-20 1,99,000

2020-21 1,87,000

2021-22 1,96,000

Average capital during preceding four years may be assumed as ₹ 3,00,000

- Profits till the date of death to be ascertained on the basis of average profit of previous four years
- Upon the death of a partner, she is to be credited with her share of the profits, interest on capitals etc. calculated till the date of death

After the death of Kiya

- ₹ 2,00,000 was received from insurance company against Joint life Policy.
- Land & Building was appreciated by 20%, Furniture to be depreciated by 10%, inventory to be revalued at ₹ 80,000. Bad debts amounted ₹ 1760.

3. Amount payable to Kiya was paid in cash.

You are required to prepare

1. Revaluation A/c
2. Partners' Capital A/c
3. Balance Sheet as on 30th September 2022, assuming other Assets and liabilities remaining the same.

SOLUTION

Revaluation A/c

Particulars	₹	Particulars	₹
To Furniture	7,500	By Land & Building	33,000
To Inventory	8,740		
To Bad Debts	1,760		
To Profit on Revaluation			
Diya 6,000			
Riya 3,000			
Kiya <u>6,000</u>	15,000		
	33,000		33,000

Partners Capital A/c

Particulars	Diya ₹	Riya ₹	Kiya ₹	Particulars	Diya ₹	Riya ₹	Kiya ₹
To Kiya capital	40,000	20,000		By Balance b/d	1,50,000	1,80,000	70,000
To Bank			2,79,800	By General Reserve	56,000	28,000	56,000
To Balance c/d	2,28,000	2,19,000		By Joint life Policy	56,000	28,000	56,000
				By Interest on Capital			4,200
				By revaluation	6,000	3,000	6,000
				By Diya & Riya capital			60,000
				By Profit & loss suspense A/c			27,600
	2,68,000	2,39,000	2,79,800		2,68,000	2,39,000	2,79,800

Bank A/c

Particulars	₹	Particulars	₹
To Balance B/d	1,14,510	By Kiya's Capital	2,79,800
To Bank	2,00,000	By Balance c/d	34,710
	3,14,510		3,14,510

Balance Sheet as on 30th September, 2022

Liabilities	₹	Assets	₹
Capitals :		Land & Building	1,98,000
Diya	2,28,000	Furniture	67,500
Riya	2,19,000	Inventory	80,000
		Trade Receivable	94,990
Trade payables	60,000	Bank	34,710
		Profit and loss Suspense (27,600+4,200)	31,800
	5,07,000		5,07,000

Working Notes:

1. Goodwill valuation

2018-19 1,62,000

2019-20 1,99,000

2020-21 1,87,000

2021-22 1,96,000Total 7,44,000

Average = 7,44,000/4 = 1,86,000

Less: Interest on Capital 3,00,000 X 12% = 36,000

Adjusted Average Profit = 1,50,000

Goodwill (1 year's purchase) = 1,50,000

Kiya's share (2/5) = 60,000

2. Journal entry for adjustment of goodwill

Particulars		₹	₹
Diya's Capital A/c	Dr.	40,000	
Riya's Capital A/c	Dr.	20,000	
To Kiya's Capital A/c			60,000
(Share of goodwill adjusted)			

3. Kiya's share of profit till the date of death

Average profit for full year before interest on capital	=	1,86,000
6 month's profit	=	93,000
Less: interest on capital 4,00,000 X 12% X 6/12	=	<u>24,000</u>
Adjusted profit till the date of death	=	69,000
Kiya's share 2/5th	=	27,600

4. The Joint life policy in this question is based on the surrender value method- where in the amount shown in the balance sheet shall be deducted from the JLP proceeds received from insurance co, on the death of a partner.

₹ 2,00,000- 60,000 (Balance Sheet value) = ₹ 1,40,000 (divided in profit sharing ratio between the partners.)

NOTE: The ICAI through technical guide (issued in June, 2022) has recommended the formats of financial statements for Limited Liability Partnerships (LLPs). This would enable these entities to communicate their financial performance and financial position in standardised formats thereby enhancing their consistency and comparability. The said format of financial statements is being given as Annexure – II at the end of the chapter for awareness of students. It may be noted that this format does not form part of syllabus and has been given here for the knowledge of students only.

SUMMARY

- ♦ The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner. Goodwill is dealt with exactly in the way already discussed in the case of retirement.
- ♦ Treatment of joint life policy will also be same as in the case of retirement. However, in case of death of a partner, the firm would get the joint policy value. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of

the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

- ◆ If the death takes place during the accounting period, the Executor of the deceased partner is entitled to have a share of profit upto the date of death based on the profit earned in the immediately preceding year or some other agreed basis. For this purpose, the deceased partners' Capital Accounts is credited and Profit & Loss Suspense Account is debited.

TEST YOUR KNOWLEDGE

True and False

1. *Business of partnership comes to an end on death of a partner.*
2. *Legal heir of a deceased partner automatically becomes partner in the firm.*
3. *A revaluation account is opened in the books of accounts on death of a partner.*
4. *Any reserve appearing in the balance sheet on the date of death of a partner is transferred to all partners capital account in their profit sharing ratio.*
5. *Legal heirs of a deceased partner are entitled to his capital account balance only.*
6. *It is not necessary to adjust goodwill on death of a partner.*
7. *On death of a partner continuing partners can agree to change their capital contribution and profit sharing ratio.*
8. *On death of a partner, the firm gets surrender value of the joint life policy.*
9. *Only legal heirs of deceased partner are entitled to amount received from joint life policy.*

Multiple Choice Questions

1. *In the absence of proper agreement, representative of the deceased partner is entitled to the Dead partner's share in*
 - (a) *Profits till date, goodwill, joint life policy, share in revalued assets and liabilities.*
 - (b) *Capital, goodwill, joint life policy, interest on capital, share in revalued assets and liabilities.*
 - (c) *Capital, profits till date, goodwill, joint life policy, share in revalued assets and liabilities.*

2. A, B and C are the partners sharing profits and losses in the ratio 2:1:1. Firm has a joint life policy of ₹ 1,20,000 and in the balance sheet it is appearing at the surrender value i.e. ₹ 20,000. On the death of A, how this JLP will be shared among the partners.
- (a) ₹ 50,000: ₹ 25,000: ₹ 25,000.
(b) ₹ 60,000: ₹ 30,000: ₹ 30,000.
(c) ₹ 40,000: ₹ 35,000: ₹ 25,000.
3. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2022. It was decided to value the goodwill on the basis of three year's purchase of last five years average profits. If the profits are ₹ 29,600; ₹ 28,700; ₹ 28,900; ₹ 24,000 and ₹ 26,800. What will be D's share of goodwill?
- (a) ₹ 20,700.
(b) ₹ 27,600.
(c) ₹ 82,800.
4. R, J and D are the partners sharing profits in the ratio 7:5:4. D died on 30th June 2022 and profits for the accounting year 2021-2022 were ₹ 24,000. How much share in profits for the period 1st April 2022 to 30th June 2022 will be credited to D's Account.
- (a) ₹ 6,000.
(b) ₹ 1,500.
(c) ₹ 2,000.
5. Revaluation account is prepared at the time of
- (a) Admission and retirement of a partner
(b) Death of a partner
(c) All of the above
6. If three partners A, B & C are sharing profits as 5:3:2, then on the death of a partner A, how much B & C will pay to A's executer on account of goodwill. Goodwill is to be calculated on the basis of 2 years purchase of last 3 years average profits. Profits for last three years are: ₹ 3,29,000; ₹ 3,46,000 and ₹ 4,05,000.
- (a) ₹ 2,16,000 & ₹ 1,42,000.
(b) ₹ 2,44,000 & ₹ 2,16,000.
(c) ₹ 2,16,000 & ₹ 1,44,000.

Theory Questions

1. Explain distinction between retirement and death of a partner as relating to finalisation of amount payable.
2. What amount is payable to legal representatives of dead partner?

Practical Questions

1. The Balance Sheet of Seed, Plant and Flower as at 31st December, 2021 was as under :

Liabilities		₹	Assets	₹
Trade payables		20,000	Fixed Assets	40,000
General Reserve		5,000	Debtors	10,000
Capital:			Bills Receivable	4,000
Seed	25,000		Inventories	16,000
Plant	15,000		Cash at Bank	10,000
Flower	15,000	55,000		
		80,000		80,000

The profit sharing ratio was: Seed 5/10, Plant 3/10 and Flower 2/10. On 1st May, 2022 Plant died. It was agreed that:

- (a) Goodwill should be valued at 3 years purchase of the average profits for 4 years. The profits were:

2018	₹ 10,000	2020	₹ 12,000
2019	₹ 13,000	2021	₹ 15,000

- (b) The deceased partner to be given share of profits upto the date of death on the basis of the previous year.
- (c) Fixed Assets were to be depreciated by 10%. A bill for ₹ 1,000 was found to be worthless. These are not to affect goodwill.
- (d) A sum of ₹ 7,750 was to be paid immediately, the balance was to remain as a loan with the firm at 9% p.a. as interest.

Seed and Flower agreed to share profits and losses in future in the ratio of 3: 2.

Give necessary journal entries.

2. Peter, Paul and Prince were partners sharing profits and losses in the ratio 2:1:1. It was provided in the partnership deed that in the event of retirement /death of a partner he/his legal representatives would be paid:
 - (i) The balance in the capital Account

- (ii) His share of goodwill of the firm valued at two years purchase of normal average profits (after charging interest on fixed capital) for the last three years to 31st December preceding the retirement or death.
- (iii) His share of profits from the beginning of the accounting year to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%
- (iv) Interest on fixed capital at 10% p.a. though payable to the partners will not be payable in the year of death or retirement.
- (v) All the asset are to be revalued on the date of retirement or death and the profit and loss be debited/credited to the Capital Accounts in the profit sharing ratio.

Peter died on 30th September, 2022. The books of Account are closed on calendar year basis from 1st January to 31st December.

The balance in the Fixed Capital Accounts as on 1st January, 2022 were Peter ₹ 10,000, Paul ₹ 5,000 and Prince ₹ 5,000. The balance in the Current Account as on 1st January, 2022 were Peter ₹ 20,000, Paul ₹ 10,000 and Prince ₹ 7,000. Drawings of Peter till 30th September, 2022 were ₹ 10,000. The profits of the firm before charging interest on capital for the calendar years 2019, 2020 and 2021 were ₹ 1,00,000, ₹ 1,20,000 and ₹ 1,50,000 respectively. The profits include the following abnormal items of credit:

	2019	2020	2021
	₹	₹	₹
Profit on sale of assets	5,000	7,000	10,000
Insurance claim received	3,000	-	12,000

The firm has taken out a Joint Life Policy for ₹ 1,00,000. Besides the partners had severally insured their lives for ₹ 50,000 each, the premium in respect thereof being charged to the Profit and Loss account. The surrender value of the Policies were 30% of the face value. On 30th June, 2022 the firm received notice from the insurance company that the insurance premium in respect of fire policy had been undercharged to the extent of ₹ 6,000 in the year 2021 and the firm has to pay immediately. The revaluation of the assets indicates an upward revision in value of assets to the extent of ₹ 20,000. Prepare an account showing the amount due to Peter's Legal representatives as on 30th September, 2022 along with necessary workings.

ANSWERS/HINTS

True and False

1. False: Surviving partners continue to carry on the business.
2. False: Legal heirs of deceased partners are entitled to dues of the deceased partner.
3. True: To find out the actual values of the assets and liabilities, revaluation account is prepared.
4. True: reserves belong to the partners in the same manner the capital contributed by them. Hence it is distributed to them through the capital account.
5. False: Legal heirs of a deceased partner are entitled to all the dues of deceased partner.
6. False: It is very much necessary to adjust goodwill on death of a partner.
7. True: Yes, it can be continued in the earlier share or in new share- in either case it leads to computing a new profit sharing ratio
8. False: On death of a partner the firm gets full value of sum assured of the joint life policy.
9. False: All the partners are entitled to amount received from joint life policy.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(a)	4.	(b)	5.	(c)	6.	(c)

Theoretical Questions

1. The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although, revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death
2. When the partner dies the amount payable to him/her is paid to his/her legal representatives. The representatives are entitled to the followings :
 - (a) The amount standing to the credit to 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.

Practical Questions

1. Journal Entries

2022			₹	₹
May 1	General Reserve Account	Dr.	5,000	
	To Seed's Capital Account			2,500
	To Plant's Capital Account			1,500
	To Flower's Capital Account			1,000
	(General Reserve transferred to Capital Account on the death of Plant)			
	Seed's Capital Account	Dr.	3,750	
	Flower's Capital Account	Dr.	7,500	
	To Plant's Capital Account			11,250
	(Adjustment for goodwill on the death of Plant on the basis of gaining ratio) (Value = $3 \times (10,000 + 13,000 + 12,000 + 15,000)/4$)			
	Revaluation Account	Dr.	5,000	
	To Fixed Assets Account			4,000
	To Bills Receivable Account			1,000
	(Depreciation of fixed assets @ 10% and writing off of one bill for ₹1,000 on Plant's death)			
	Seed's Capital Account	Dr.	2,500	
	Plant's Capital Account	Dr.	1,500	
	Flower's Capital Account	Dr.	1,000	
	To Revaluation Account			5,000
	(Loss on Revaluation transferred to capital accounts)			
	Profit and Loss Suspense Account	Dr.	1,500	

To Plant's Capital Account (Plant's share of four month's profit based on the previous year)			1,500
Plant's Capital Account To Plant's Executor's Account (Amount standing to the credit of Plant's Capital Account transferred to the credit of his Executor's Account)	Dr.	27,750	27,750
Plant's Executor's Account To Bank Account (Amount paid to Plant's Executors)	Dr.	7,750	7,750

2. In the books of M/s Paul and Prince

Executors of Peter Account

	₹		₹
To Balance c/d	2,91,125	By Peter's capital A/c (W.N.6)	20,000
		By Peter's Current A/c (W.N.7)	2,71,125
	2,91,125		2,91,125

Working Notes:

		2019	2020	2021
		₹	₹	₹
1. Valuation of Goodwill:				
Profit as per Profit and loss A/c		1,00,000	1,20,000	1,50,000
Less: Interest on capital @ 10%		2,000	2,000	2,000
Abnormal Items:				
Profit on sale of asset		5,000	7,000	10,000
Insurance claim received		3,000	-	12,000
Insurance premium undercharged		-	-	6,000
		90,000	1,11,000	1,20,000
Total profit of three years			3,21,000	

Average profit	1,07,000
Goodwill (2 x Average profit)	2,14,000
Peter's share of goodwill (2/4)	1,07,000

2.	Peter's share of profit:	₹
	Profit for the year 2021	1,50,000
	Less: Insurance premium undercharged	6,000
		1,44,000
	Add: 25% increase thereof	36,000
	Estimated profit for 2022	1,80,000
	Less: Interest on capital *	1,000
	Estimated profit for 2022	1,79,000
	Estimated profit upto 30.9.22	1,34,250
	Peter's Share (2/4)	67,125

*Since Peter was not entitled to interest on capital in the year of death, interest is payable only to the remaining two partners.

3. Profit on revaluation of assets:

	₹
Upward revision in the value of assets	20,000
Peter's share (2/4)	10,000

4. Peter's share in insurance premium undercharged:

Insurance premium undercharged in 2021	6,000
Peter's share	3,000

5. Share of life policy:

Joint life policy	1,00,000
Maturity value of Peter's individual life policy	50,000
Surrender value of individual life policies of Paul & Prince	
(30 % of face value)	30,000
	1,80,000
Peter's share (2/4)	90,000

6.

Peter's Capital Account

		₹			₹
30.9.22	To Executors of Peter A/c (Transfer)	20,000	1.1.22	By Balance b/d	10,000
			30.9.22	By Profit on revaluation of assets	10,000*
		20,000			20,000

* This is generally transferred to Peter's current account. But as per the requirement of adjustment No. (v) of question, it is transferred to capital account.

7.

Peter's Current Account

		₹			₹
30.9.22	To Drawings	10,000	1.1.22	By Balance b/d	20,000
	To Insurance premium undercharged	3,000	30.9.22	By Share of goodwill	1,07,000
				By share of profit	67,125
	To Executor's of Peter's Account (balance transferred)	2,71,125		By Share of life policy	75,000
				By Paul & Prince	15,000
		2,84,125			2,84,125

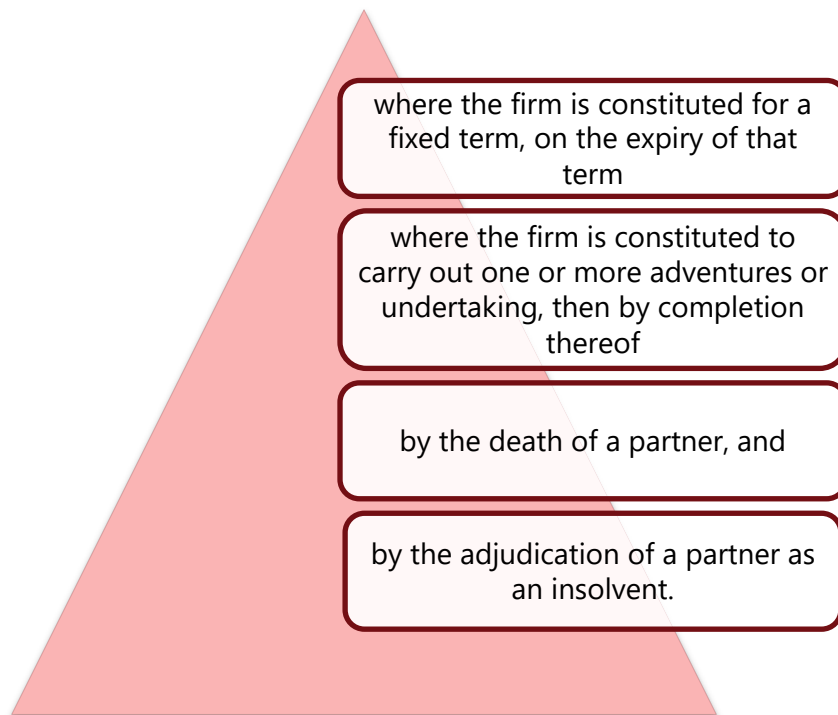
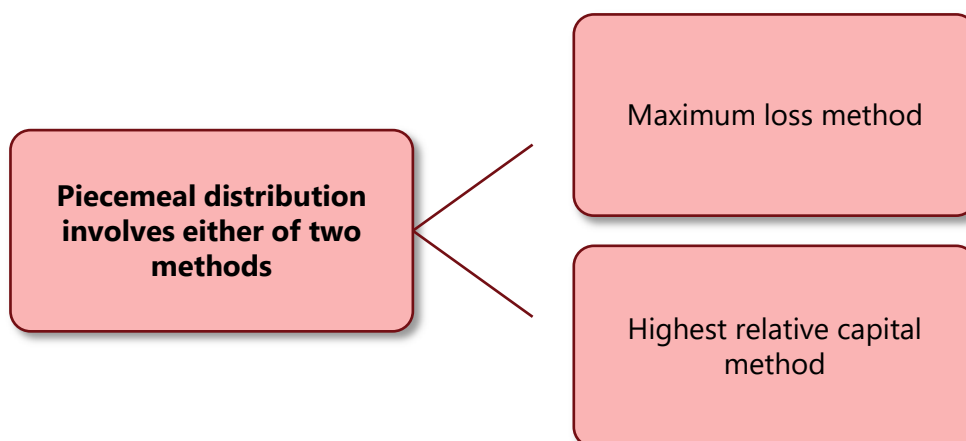
Note: The share of goodwill given to peter would be borne by remaining partners in their gaining ratio, so that goodwill account does not appear in the balance sheet.

UNIT - 6: DISSOLUTION OF PARTNERSHIP FIRMS AND LLP

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Go through the circumstances in which a partnership is dissolved.
- ◆ Understand that on the dissolution of a partnership all assets are sold out and all liabilities are discharged. Learn the accounting technique relating to the disposal of assets and payment of liabilities.
- ◆ Learn how to settle the partner's claims in case of surplus and how to raise money from partners in case of a deficit.
- ◆ Deal with piecemeal distribution to partners of the amount realized from assets net of liabilities.
- ◆ Winding up of a Limited Liability Partnership (LLP)

UNIT OVERVIEW**Circumstances leading to Dissolution of Partnership****Methods of piecemeal distribution**



6.1 INTRODUCTION

Apart from the readjustment of rights of partners in the share of profit by way of change in the profit-sharing ratio and admission of a new partner or for retirement/death of a partner, another important aspect of partnership accounts is how to close books of accounts in case of dissolution. In this Unit, we will discuss the circumstances leading to the dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also, we will discuss the special problems relating to the insolvency of partners and the settlement of the partnership's liabilities.



6.2 CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:



(a) the expiry of the term for which it was formed;



(b) completion of the venture for which it was entered into;



(c) death of a partner;



(d) insolvency of a partner.

However, the partners or remaining partners (in case of death or insolvency) may continue to do the business. In such a case there will be a new partnership but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

A firm stands dissolved in the following cases:

A firm stands dissolved in the following cases:

(i) The partners agree that the firm should be dissolved;

(ii) All partners except one become insolvent;

(iii) The business becomes illegal;

(iv) In case of partnership at will, a partner gives notice of dissolution; and

(v) The court orders dissolution.

The court has the option to order dissolution of a firm in the following circumstances :

- (a) Where a partner has become of unsound mind;
- (b) Where a partner suffers from permanent incapacity;
- (c) Where a partner is guilty of misconduct of the business;
- (d) Where a partner persistently disregards the partnership agreement;
- (e) Where a partner transfers his interest or share to a third party;
- (f) Where the business cannot be carried on except at a loss; and
- (g) Where it appears to be just and equitable.



6.3 CONSEQUENCES OF DISSOLUTION

On the dissolution of a partnership, firstly, the assets of the firm, including goodwill, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid and, if there is still a surplus, it is distributed among the partners in their profit-sharing ratio.

Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm leftover are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in section 48 of the Partnership Act, upon dissolution of the partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

- (a) Losses including deficiencies of capital are paid, first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.
- (b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order:
 - (i) in paying the debts of the firm to third parties;
 - (ii) in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital;
 - (iii) in paying to each partner what is due to him on account of capital; and

- (iv) the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

Distinction between Dissolution of Partnership and Dissolution of Partnership Firm

Dissolution of Partnership	Dissolution of Partnership Firm
Dissolution of a partnership refers to the discontinuance of the relation between the partners of the firm.	Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.
There can be change in profit sharing ratio or admission/death/retirement of a partner.	Dissolution of partnership firm occurs.
In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.	In event of the dissolution of the firm, the business ceases to end.
There is no intervention by the court.	Court has the inherent power to intervene. By its order, a firm can be dissolved.
Economic relationships among partners may remain same or change.	Economic relationship among partners comes to an end.
Assets and liabilities are revalued. New balance sheet is prepared.	Assets are sold and realized. Liabilities are paid off.
Revaluation account is prepared.	Realization account is prepared.
Assets and liabilities are revalued after winding up of the existing partnership.	Assets and liabilities are settled on winding up of a firm.
Books of accounts are not closed.	Books of accounts are closed.

6.3.1 Dissolution before the expiry of a fixed term

A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

No claim in this respect will arise if:

- (1) the firm is dissolved due to the death of a partner;
- (2) the dissolution is mainly due to the partner's (claiming refund) own misconduct; and
- (3) the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit-sharing ratio.

6.4 CLOSING OF PARTNERSHIP BOOKS ON DISSOLUTION

To close books of accounts of Partnership Firm. We need to transfer all the assets and liabilities to Realization Account. Given below is the specimen of the Realization Account.

Specimen of Realization Account

Particulars	₹	Particulars	₹
To Sundry Assets (Excluding Cash/Bank, Debit Balance of P&L A/c, Partners' Current, Capital, and Loan A/cs)		By Sundry Liabilities (Excluding Credit Balance of P&L A/c, Partners' Current, Capital, and Loan A/c)	
To Bank/Cash (expenses for realization)		By Provision on Assets	
To Bank/Cash A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from assets and unrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities paid by partners)		By Partners' Capital A/cs (Assets taken over by partners)	
To Partners' Capital A/cs (Profit on realization distributed among partners in profit sharing ratio)		By Partners' Capital A/cs (Loss on realization distributed among partners in profit sharing ratio)	

6.4.1 Treatment of Goodwill at the time of dissolution of Firm

Treatment of Goodwill

- If Goodwill appears in the Balance Sheet, it is considered as purchased Goodwill and is treated like any other asset and is transferred to realization account.
- If Goodwill does not appear in the balance sheet, no entry is required for this.
- If something is realized or Goodwill is purchased by any one of the partners, then either Cash Account is debited or Partner's Capital A/c is debited and Realization Account is credited.

We will understand how to close the books of accounts through illustration the required journal entries to be made for closing the books of a firm with the example given below:

Balance Sheet of Fast and Quick as at Dec. 31, 2021

Liabilities		₹	Assets		₹
Sundry Creditors		20,000	Plant and Machinery		40,000
Fast's Loan		10,000	Patents		6,000
General Reserve		10,000	Stock		25,000
Capitals:			Sundry Debtors	19,000	
Fast	30,000		Less: Prov. for doubtful debts	(1,000)	18,000
Quick	25,000	<u>55,000</u>	Cash		<u>6,000</u>
		95,000			95,000

Fast and Quick share profits in the ratio of 3:2. On 1st January, 2022 the firm was dissolved. Fast took over the patents at a valuation of ₹ 5,000. The other assets realized as under:

Particulars	₹
Plant and Machinery	45,000
Stock	22,000
Sundry Debtors	<u>18,500</u>
Total	<u>85,500</u>

The Sundry Creditors were paid off at a discount of 5%. The expense amounted to ₹ 3,500. The steps to close the books are given below:

- I. Open a **Realization Account** and **transfer all assets** except cash in hand or at a bank at book values. Realization Account is debited and the various assets are credited and thus closed. It should be remembered that Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be transferred. In the above example the entry will be:

Particulars		₹	₹
Realization Account	Dr.	90,000	
To Plant and Machinery Account			40,000
To Patents Account			6,000
To Stock Account			25,000
To Sundry Debtors			19,000
(Transfer of various assets to the debit side of Realization Account)			

- II. **Transfer of liabilities** to outsiders and provisions and reserves against assets (e.g., Provision for Doubtful Debts) to the credit side of Realization account. The accounts of the liabilities and provisions will be debited and thus closed. The entry should be at book figures. The entry will be:

Particulars		₹	₹
Sundry Creditors Account	Dr.	20,000	
Provision for Doubtful Debts Account	Dr.	1,000	
To Realization Account			21,000
(Transfer of liabilities to outsiders and provision against debtors to Realization Account)			

Note: Accounts denoting accumulated losses or profits should not be transferred to the Realization Account.

- III. (i) The Realization Account should be **credited with the actual amount realized by the sale of assets**. This should take no note of the book figures. of course, Cash (or Bank) Account will be debited. Thus:

Particulars		₹	₹
Cash Account	Dr.	85,500	
To Realization Account			85,500
(Amount realized by the sale of various assets)			

- (ii) If a **partner takes over an asset**, his Capital Account should be debited and Realization Account credited with the value agreed upon, Thus:

Particulars	₹	₹
Fast's Capital Account Dr.	5,000	
To Realization Account		5,000
(Patents taken over by Fast at ₹ 5,000)		

- IV. **Expenses of dissolution** or realization of assets are debited to the Realization Account and credited to Cash Account. Thus

Particulars	₹	₹
Realization Account Dr.	3,500	
To Cash Account		3,500
(Payment of Expenses)		

- V. (i) The actual amount **paid to creditors** should be debited to the Realization Account and Cash Account is credited:

Particulars	₹	₹
Realization Account Dr.	19,000	
To Cash Account		19,000
(Payment of Sundry Creditors ₹ 20,000 less 5%)		

- (ii) If any **liability is taken over by a partner**, his Capital Account should be credited and Realization Account debited with the amount agreed upon.

- VI. At this stage, the Realization Account will show **profit or loss**. If the debit side is bigger, there is a loss; if the credit side is bigger, there is a profit. Profit or loss is transferred to the Capital Accounts of partners in the profit-sharing ratio. In the case of profit, Realization Account is debited and Capital Accounts are credited. The entry for loss is, naturally, reverse of this entry. The Realization Account in the example given above shows a loss of ₹ 1,000 (see account below).

Particulars	₹	₹
Fast's Capital Account Dr.	600	
Quick's Capital Account Dr.	400	
To Realization Account		1,000
(Transfer of loss to Capital Account in the ratio of 3:2)		

- VII. **Partner's Loans** if any, should now be paid. The entry is to debit the Loan Account and credit Cash Account. Thus:

Particulars		₹	₹
Fast's Loan Account Dr.		10,000	
To Cash Account			10,000
(Repayment of Fast's Loan)			

- VIII. Any reserve of accumulated profit or loss lying in the books (as shown by the Balance Sheet) should be transferred to the Capital Account in the profit-sharing ratio. Thus:

Particulars		₹	₹
General Reserve Dr.		10,000	
To Fast's Capital Account			6,000
To Quick's Capital Account			4,000
(General Reserve transferred to Capital Account in the ratio of 3:2)			

- IX. At this stage the Capital Accounts of partners will show how much amount is due to them or from them. The partner owing money to the firm will pay; Cash Account will be debited and his Capital Account credited and thus closed. Money owing to a partner will be paid to him; his Capital Account will be debited and the Cash Account credited. This will close the Capital Accounts' as well as the Cash Account. The entry in the above example is seen in the Capital Accounts below:

Particulars		₹	₹
Fast's Capital Account Dr.		30,400	
Quick's Capital Account Dr.		28,600	
To Cash Account			59,000
(Amount paid to partners on Capital Account)			

Ledger Accounts
Plant and Machinery Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	40,000	Jan. 1	By Realization A/c – Transfer	40,000

Patents Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realization A/c – Transfer	6,000

Stock Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	25,000	Jan. 1	By Realization A/c – Transfer	25,000

Sundry Debtors Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	19,000	Jan. 1	By Realization A/c – Transfer	19,000

Provision for Doubtful Debts Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c Transfer	1,000	Jan. 1	By Balance b/d	1,000

Sundry Creditors Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c -Transfer	20,000	Jan. 1	By Balance b/d	20,000

Fast's Loan Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Cash Account	10,000	Jan. 1	By Balance b/d	10,000

General Reserve Account

2022	Particulars		₹	2022	Particulars	₹
Jan. 1	To Capital Accounts			Jan. 1	By Balance b/d	10,000
	Fast	6,000				
	Quick	4,000	10,000			
			10,000			10,000

Realization Account

2022	Particulars	₹	2022	Particulars		₹
Jan. 1	To Sundry Assets		Jan. 1	By Sundry Creditors		20,000
	Plant and Machinery	40,000		By Provision for Doubtful Debts		1,000
	Patents	6,000		By Cash Account-		85,500
	Stock	25,000		assets realized		

Sundry Debtors	19,000	By Fast's Capital Account- patents taken over	5,000
To Cash Account-Exp.	3,500		
To Cash Account- Creditors paid	19,000	By Loss to:	
		Fast	600
		Quick	400
	1,12,500		1,12,500

Cash Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realization A/c-Expenses	3,500
	To Realization b/d	85,500	Jan. 1	By Realization A/c-Creditors	19,000
			Jan. 1	By Fast's Loan Account	10,000
			Jan. 1	By Fast's Capital A/c	30,400
			Jan. 1	By Quick's Capital A/c	28,600
		91,500			91,500

Fast's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-Patents	5,000	Jan. 1	By Balance b/d	30,000
	To Realization A/c-Loss	600	Jan. 1	By General Reserve	6,000
	To Cash Account	30,400			
		36,000			36,000

Quick's Capital Account

2022	Particulars	₹	2022	Particulars	₹
Jan. 1	To Realization A/c-loss	400	Jan. 1	By Balance b/d	25,000
	To Cash Account	<u>28,600</u>		By General Reserve	<u>4,000</u>
		29,000			29,000

Note:

- (1) If any of the assets are taken over by a partner at a value mutually agreed to by the partners, debit the Partner's Capital Account and credit Realization Account with the price of asset taken over.

- (2) Pay off the liabilities, crediting cash, and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realization Account.
- (3) Liabilities to outsiders may also be transferred to the Realization Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realization Account, Cash Account being credited. If liability is taken over by a partner, Realization Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.
- (4) The balance of the Realization Account will represent either the profit or loss on realization. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realization Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.
- (5) Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.
- (6) The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash, and debit the partners' capital account with the amount payable to them to close their accounts.

ILLUSTRATION 1

X, Y, and Z are partners of the firm XYZ and Co., sharing Profits and Losses in the ratio of 4: 3: 2. Following is the Balance Sheet of the firm as on 31st March, 2022:

Balance Sheet as on 31st March, 2022

Liabilities	₹	Assets	₹
Partners' Capitals:		Fixed Assets	5,00,000
X	4,00,000	Stock in trade	3,00,000
Y	3,00,000	Sundry debtors	5,00,000
Z	2,00,000	Cash in hand	10,000
General Reserve	90,000		
Sundry Creditors	3,20,000		
	13,10,000		13,10,000

Partners of the firm decided to dissolve the firm on the above-said date.

Fixed assets realized ₹5,20,000 and book debts ₹4,40,000.

Stocks were valued at ₹2,50,000 and it was taken over by partner Y.

Creditors allowed discount of 5% and the expenses of realization amounted to ₹6,000.

You are required to prepare:

- (i) Realization account;
- (ii) Partners capital account; and
- (iii) Cash account.

SOLUTION

(i) Realization Account

Particulars	₹	Particulars	₹
To Fixed assets	5,00,000	By Creditors	3,20,000
To Stock in trade	3,00,000	By Cash (5,20,000+4,40,000)	9,60,000
To Debtors	5,00,000	By Y (Stock taken over)	2,50,000
To Cash – Expenses	6,000	By Loss transferred to partners' capital accounts	
To Cash -Creditors (3,20,000 x 95%)	3,04,000	X	35,555
		Y	26,667
		Z	17,778
	16,10,000		16,10,000

(ii) Partners' Capital Accounts

Particulars	X	Y	Z	Particulars	X	Y	Z
	₹	₹	₹		₹	₹	₹
To Realization Account	35,555	26,667	17,778	By Balance b/d	4,00,000	3,00,000	2,00,000
To Realization Account	-	2,50,000	-	By General reserve	40,000	30,000	20,000
To Cash	<u>4,04,445</u>	<u>53,333</u>	<u>2,02,222</u>				
	4,40,000	3,30,000	2,20,000		4,40,000	3,30,000	2,20,000

(iii) Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	10,000	By Realization A/c (Expenses)	6,000
To Realization A/c (Fixed assets and book debts realized)	9,60,000	By Realization A/c (Creditors)	3,04,000
		By X	4,04,445

		By Y	53,333
		By Z	<u>2,02,222</u>
	9,70,000		9,70,000



6.5 CONSEQUENCES OF INSOLVENCY OF A PARTNER

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realized. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well-known case of *Garner vs. Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

If a partner goes insolvent then the following are the consequences:

1. The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.	2. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.	3. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and	4. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.



6.6 LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of loss is to be borne by other solvent partners following the decision in the English case of *Garner vs. Murray*.

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to *Garner vs. Murray* rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per the deed should be applied.

Capital Ratio on Insolvency

- The partners are free to have either fixed or fluctuating capitals in the firm.
- If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.
- But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business should not exhibit Current Accounts of the partners and capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on Realization Account.
- If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear the loss on account of the insolvency of other partner.

Insolvency of all Partners

- When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account. The balance of the creditors' accounts is transferred to Deficiency Account.
- Creditors may be paid the amount available including the amount contributed by the partners.
- The unsatisfied portion of the creditor account is transferred to the Capital Accounts of the partners in the profit-sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

ILLUSTRATION 2

P, Q, and R were partners sharing profits and losses in the ratio of 3: 2: 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2022 is as follows:

Liabilities		₹	Assets		₹
<i>Fixed Capital</i>			<i>Fixed Assets:</i>		
P	20,000		Trademark		40,000
Q	20,000		Freehold Property		8,000

R	<u>10,000</u>	50,000	Plant and Equipment	12,800
Current Accounts:			Motor Vehicle	700
P	500		Current Assets	
Q	<u>9,000</u>	9,500	Stock	3,900
Loan from P		8,000	Trade Debtors	2,000
Trade Creditors		12,400	Less: Provision	(100)
			Cash at Bank	200
			Miscellaneous losses	
			R's Current Account	400
			Profit and Loss Account	<u>12,000</u>
		<u>79,900</u>		79,900

On 1st July, 2022 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of ₹ 500 but no cash passed specifically in respect of this transaction. Sale of other assets realized the following amounts:

	₹
Trademark	Nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid ₹ 11,700 in full settlement of their debts. The costs of dissolution amounted to ₹ 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 of the amount due.

Required

- Cash and Bank Account,
- Realization Account, and
- Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

SOLUTION

Cash / Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	200	By Realization A/c- Creditors	11,700
To Realization A/c-		By Realization A/c- Expenses	1,500
Freehold property	7,000	By P's Loan A/c	8,000

Plant and Equipment	5,000	By P's Capital A/c	14,200
Stock	3,000	By Q's Capital A/c	24,200
Trade Debtors	1,600		
To Capital Accounts:			
P	25,500		
Q	17,000		
R	300		
	<u>42,800</u>		
	59,600		59,600

Realization Account

Particulars	₹	Particulars	₹
To Trademark	40,000	By Trade Creditors	12,400
To Freehold Property	8,000	By Provision for Bad Debts	100
To Plant and Equipment	12,800	By Bank:	
To Motor Vehicle	700	Freehold Property	7,000
To Stock	3,900	Plant and Equip.	5,000
To Sundry Debtors	2,000	Stock	3,000
To Bank (Creditors)	11,700	Debtors	<u>1,600</u>
To Bank (Expenses)	1,500		16,600
		By Q (Car)	500
		By Capital Accounts: (Loss)	
		P	25,500
		Q	17,000
		R	8,500
	<u>80,600</u>		51,000
			<u>80,600</u>

Partners' Capital Accounts

Particulars	P	Q	R	Particulars	P	Q	R
	₹	₹	₹		₹	₹	₹
To Current A/c (Transfer) (WN)	5,500	—	2,400	By Balance b/d	20,000	20,000	10,000
To Realization A/c (Loss)	25,500	17,000	8,500	By Current A/c (Transfer) (WN)	—	5,000	—
To Realization A/c (Car)	—	500	—	By Bank	—	—	300
To R's Capital A/c	300	300	—	By Bank (realization)	25,500	17,000	—

To	(Deficiency)				loss)			
	Bank	14,200	24,200	—	By P & Q	—	—	600
					(Deficiency)			
		45,500	42,000	10,900		45,500	42,000	10,900

Working Note

Particulars	P	Q	R
Current Account Balance	500 (Cr)	9000 (Cr)	400 (Dr)
Less: share of Profit & Loss A/c (debit balance)	6000 (Dr)	4000 (Dr)	2000 (Dr)
Adjusted Current Account Balance	5500 (Dr)	5000 (Cr)	2400 (Dr)

Note:

1. P, Q, and R will bring cash to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.
2. On following Garner Vs. Murray rule, solvent partners P and Q have to bear the loss due to insolvency of a partner R in their fixed capital ratio.

ILLUSTRATION 3

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 2021 when the firm was dissolved:

Liabilities	₹	Assets	₹
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1,000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		5,550

The assets realized as under:

Particulars	₹
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realization amounted to ₹ 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of ₹ 200 only.

Show necessary ledger accounts to close the books of the firm.

SOLUTION

In the books of M/s Amal and Bimal

Realization Account

Particulars	₹	Particulars		₹
To Sundry Assets:		By Cash A/c:		
Plant & Machinery	2,500	Plant & Machinery	1,250	
Furniture	500	Furniture	150	
Debtors	1,000	Debtors	400	
Stock	800	Stock	<u>500</u>	2,300
Cash A/c-expenses	175	By Partners' Capital A/c		
		Loss on realization (Bal. fig.)		
		Amal	1,337	
		Bimal	1,338	2,675
	<u>4,975</u>			<u>4,975</u>

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	200	By Realization A/c- expenses	175
To Realization A/c		By Sundry Creditors A/c (Bal. fig.)	2,525
- Sale of sundry assets	2,300		
To Bimal's Capital A/c	200		
	<u>2,700</u>		<u>2,700</u>

Sundry Creditors Account

Particulars	₹	Particulars	₹
To Cash A/c	2,525	By Balance b/d	4,800
To Deficiency A/c-transfer (bal. fig.)	2,275		
	<u>4,800</u>		<u>4,800</u>

Partners' Capital Accounts

Particulars	Amal(₹)	Bimal (₹)	Particulars	Amal (₹)	Bimal (₹)
To Balance b/f	—	550	By Balance b/f	750	—
To Realization A/c			By Cash A/c	—	200
- loss	1,337	1,338	By Deficiency A/c- transfer (bal. fig.)	587	1,688
	1,337	1,888		1,337	1,888

Deficiency Account

Particulars	₹	Particulars	₹
To Partners' Capital A/c		By Sundry Creditors A/c	2,275
Amal	587		
Bimal	<u>1,688</u>		
	2,275		2,275

ILLUSTRATION 4

A, B, C, and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2022 when their balance sheet was as under:

Liabilities	₹	Assets	₹
Creditors	15,700	Bank	535
Employees Provident Fund	6,300	Debtors	15,850
Capital Accounts:		Stock	25,200
A 40,000		Prepaid Expenses	800
B <u>20,000</u>	60,000	Plant & Machinery	20,000
		Patents	8,000
		C's Capital A/c	3,200
		D's Capital A/c	8,415
	<u>82,000</u>		<u>82,000</u>

Following information is given to you: -

- One of the creditors took some of the patents whose book value was ₹ 5,000 at a valuation of ₹ 3,200. Balance of the creditors were paid at a discount of ₹ 400.
- There was a joint life policy of ₹ 20,000 (not mentioned in the balance sheet) and this was surrendered for ₹ 4,500.

- 3 The remaining assets were realized at the following values: - Debtors ₹ 10,800; Stock ₹ 15,600; Plant and Machinery ₹ 12,000; and Patents at 60% of their book-values. Expenses of realization amounted to ₹ 1,500.

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firm's claim against his estate. Prepare necessary ledger accounts.

SOLUTION**Realization Account**

Particulars		₹	Particulars		₹
To Sundry Assets: -			By Creditors		15,700
Debtors	15,850		By Employee's Provident Fund		6,300
Stock	25,200		By Bank A/c:		
Prepaid Expenses	800		Joint Life Policy	4,500	
Plant & Machinery	20,000		Debtors	10,800	
Patents	8,000	69,850	Stock	15,600	
To Bank-Creditors:		12,100	Plant and Machinery	12,000	
(₹ 15,700 - ₹ 3,200 - ₹ 400)			Patents 60% of		
To Bank A/c		6,300	(₹ 8,000 - ₹ 5,000)	1,800	44,700
Employee's (P.F)			By Loss transferred to:		
To Bank A/c (expenses)		1,500	A's Capital A/c	9,220	
			B's Capital A/c	6,915	
			C's Capital A/c	4,610	
			D's Capital A/c	2,305	23,050
		89,750			89,750

Capital Accounts

Particulars	A (₹)	B (₹)	C (₹)	D (₹)	Particulars	A (₹)	B (₹)	C (₹)	D (₹)
To Bal. b/d	—	—	3,200	8,415	By Bal. b/d	40,000	20,000	—	—
To Realization A/c	9,220	6,915	4,610	2,305	By Bank				
To D's Capital (Deficiency)	5,360	2,680	—	—	(Realization loss)	9,220	6,915	4,610	—
To Bank	34,640	17,320	—	—	By Bank				
					(Recovery)	—	—	—	2,680
					By A's Capital (2/3)	—	—	—	5,360

					By B's Capital (1/3)	—	—	—	2,680
					By Bank A/c		—	3,200	—
	49,220	26,915	7,810	10,720		49,220	26,915	7,810	10,720

Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	535	By Realization A/c	12,100
To Realization A/c	44,700	By Realization A/c	6,300
To A's Capital A/c	9,220	By Realization A/c	1,500
To B's Capital A/c	6,915	By A's Capital A/c	34,640
To D's Capital A/c	2,680	By B's Capital A/c	17,320
To C's Capital A/c (4,610 + 3,200)	7,810		
	71,860		71,860

Working Note

D's loss will be borne by A and B only because only solvent partners having credit balance has to bear the loss on account of insolvency. C will bring his share of loss in cash.

ILLUSTRATION 5

M/s X, Y, and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as on December 31, 2022:

Liabilities	₹	₹	Assets	₹	₹
Capital: X	29,200		Fixed Assets		40,000
Y	10,800		Stock		25,000
Z	10,000	50,000	Book Debts	25,000	
Z's Loan		5,000	Less: Provision	(5,000)	20,000
Loan from Mrs. X		10,000	Cash		1,000
Sundry Trade Creditors		25,000	Advance to Y		4,000
		90,000			90,000

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to ₹ 4,000 have been purchased in November, 2022 and had been received but the purchase was not recorded in books.

Fixed assets realized ₹ 20,000; Stock ₹ 21,000 and Book Debt ₹ 20,500. Similarly, the creditors allowed a discount of 2% on average. The expenses of realization come to ₹ 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in Garner vs. Murray.

SOLUTION**Realization Account**

Particulars	₹	Particulars		₹
To Sundry		By Provision for Doubtful Debts		5,000
Fixed Assets (transfer)	40,000	By Cash (20,000+21,000+20,500)		61,500
Stock	25,000	By Sundry Trade Creditors		
Book Debts	25,000	(Discount)		29,000
To Cash—Expenses	1,080	By Loss: X (2/5)	9,600	
- Creditors	28,420	Y (2/5)	9,600	
		Z (1/5)	4,800	24,000
	1,19,500			1,19,500

Sundry Trade Creditors

Particulars	₹	Particulars	₹
To Realization A/c	29,000	By Balance b/d	25,000
		By Partners Capital Accounts	
		(Purchase omitted)	4,000
	29,000		29,000

Z's Loan Account

Particulars	₹	Particulars	₹
To Cash Account	5,000	By Balance b/d	5,000

Mrs. X's Loan Account

Particulars	₹	Particulars	₹
To X's Capital A/c – transfer	10,000	By Balance b/d	10,000

Cash Account

Particulars	₹	Particulars	₹
To Balance b/d	1,000	By Sundry Trade Creditors (after deducting discount of 2%)	28,420
To Realization A/c- assets realized	61,500	By Realization A/c – expenses	1,080
To X's Capital A/c*	9,600	By Z's Loan	5,000
To Z's Capital A/c*	<u>4,800</u>	By X's Capital A/c	34,300
	76,900	By Z's Capital A/c	<u>8,100</u>
			76,900

*X and Z bring these amounts to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.

Capital Accounts

Particulars	X (₹)	Y (₹)	Z (₹)	Particulars	X (₹)	Y (₹)	Z (₹)
To Sundry Trade Creditors-omission	1,600	1,600	800	By Balance b/d	29,200	10,800	10,000
To Balance c/d	27,600	9,200	9,200				
	29,200	10,800	10,000		29,200	10,800	10,000
To Advance	-	4,000	-	By Balance b/d	27,600	9,200	9,200
To Realization A/c-loss	9,600	9,600	4,800	By Mrs. X's Loan	10,000	-	-
To Y's Capital A/c	3,300	-	1,100	By Cash (Realization loss)	9,600	-	4,800
				By X's Capital A/c		3,300	
To Cash	34,300	-	8,100	By Z's Capital A/c	-	1,100	-
	47,200	13,600	14,000		47,200	13,600	14,000

Note: Y's deficiency comes to ₹ 4,400 (difference in the two sides of his Capital Account); this has been debited to X and Z in the ratio of 27,600: 9,200 i.e., capital standing up just before dissolution but after correction of error committed while drawing up the accounts for 2022.

6.7 PIECEMEAL PAYMENTS

Generally, the assets sold upon dissolution of partnership are realized only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

6.7.1 Maximum Loss Method

Each installment realized is considered to be the final payment *i.e.*, outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either *Garner vs. Murray* Rule or the profit-sharing ratio rule.

ILLUSTRATION 6

A, B, and C are partners sharing profits and losses in the ratio of 5:3:2. Their capitals were ₹ 9,600, ₹ 6,000 and ₹ 8,400 respectively.

After paying creditors, the liabilities and assets of the firm were:

Liabilities	₹	Assets	₹
Liability for interest on loans from:		Investments	1,000
Spouses of partners	2,000	Furniture	2,000
Partners	1,000	Machinery	1,200
		Stock	4,000

The assets realized in full in the order in which they are listed above. B is insolvent.

You are required to prepare a statement showing the distribution of cash as and when available, applying the maximum possible loss procedure.

SOLUTION**Statement of Distribution of Cash**

Realization		Interest on loans from partner's spouses	Interest on loans from partners	Partners Capitals			Total
				A	B	C	
				₹	₹	₹	₹
Balances due	(1)	2,000	1,000	9,600	6,000	8,400	24,000
(i) Sale of Investments	1,000	(1,000)					
		1,000	1,000				
(ii) Sale of furniture	2,000	(1,000)	(1,000)				
(iii) Sale of machinery	1,200						
Maximum possible loss ₹ 22,800 (total of capitals ₹ 24,000 less Cash available ₹ 1,200) allocated to partners in the profit sharing ratio i.e. 5:3: 2				(11,400)	(6,840)	(4,560)	(22,800)
Amounts at credit				(1,800)	(840)	3,840	1,200
Deficiency of A and B written off against C				1,800	840	(2,640)	

Amount paid	(2)					-	-	1,200	<u>1,200</u>
Balances in capital accounts (1-2) = (3)						9,600	6,000	7,200	22,800
(iv) Sale of stock	4,000								
Max. possible loss 22,800-4,000=	18,800								
allocated to partner's in the ratio 5:3:2						(9,400)	(5,640)	(3,760)	(18,800)
Amounts at credit and cash paid (4)						200	360	3,440	<u>4,000</u>
Balances in capital accounts left unpaid - Loss (3-4) = (5)						9,400	5,640	3,760	18,800

ILLUSTRATION 7

The following is the Balance Sheet of A, B, C on 31st December, 2022 when they decided to dissolve the partnership:

Liabilities	₹	Assets	₹
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		
C	<u>9,000</u>		
	49,000		<u>49,000</u>

The assets realized the following sums in installments:

I	1,000
II	3,000
III	3,900
IV	6,000
V	<u>20,100¹</u>
	<u>34,000</u>

The expenses of realization were expected to be ₹ 500 but ultimately amounted to ₹ 400 only. Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

SOLUTION

First of all, the following table will be constructed to show the amounts available for distribution among the various interests:

Statement showing Realization and Distribution of Cash Payments

Particulars	Realization	Creditors	Partners' Loan	Partners' Capitals
	₹	₹	₹	₹
1. After taking into account cash balance and amount set aside for expenses	1,000	1,000	-	-

¹ includes saving in expenses i.e. ₹ 100 (₹ 500 - ₹ 400).

2.	3,000	1,000	2,000	-
3.	3,900	-	3,000	900
4.	6,000	-	-	6,000
Including saving in expenses	20,100	-	-	20,100
	34,000	2,000	5,000	27,000

To ascertain the amount distributable out of each installment realized among the partners, the following table will be constructed:

Statement of Distribution on Capital Accounts

(1) Calculation to determine the mode of distribution of ₹ 900

Particulars	Total (₹)	A (₹)	B (₹)	C (₹)
Balance	42,000	15,000	18,000	9,000
Less: Possible loss, should remaining assets prove to be worthless (in their profit-sharing ratio)	(41,100)	(16,440)	(16,440)	(8,220)
	+ 900	- 1,440	+ 1,560	+ 780
Deficiency of A's capital written off against those of B and C in the ratio of their capital, 18,000:9,000 (<i>Garner vs. Murray</i>)			(960)	(480)
Manner in which the first ₹ 900 should be distributed			+ 600	+ 300

(2) Distribution of ₹ 6,000

Balance after making payment of amount shown in step (1)	41,100	15,000	17,400	8,700
Less: Possible Loss assuming remaining asset to be valueless (in their profit sharing ratio)	(35,100)	(14,040)	(14,040)	(7,020)
Balance available and to be distributed	6,000	960	3,360	1,680

(3) Distribution of ₹ 20,100

Balance after making payment of amount shown in step (2)	35,100	14,040	14,040	7,020
Less: Possible loss, assuming remaining				

assets to be valueless (in their profit sharing ratio)	(15,000)	(6,000)	(6,000)	(3,000)
Manner of distribution of ₹ 20,100	20,100	8,040	8,040	4,020
<i>Summary:</i>				
Balance	42,000	15,000	18,000	9,000
Total amounts paid	27,000	9,000	12,000	6,000
Loss	15,000	6,000	6,000	3,000

6.7.2 Highest Relative Capital Method

According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

The illustration given above is now worked out according to this method.

Particulars	A	B	C
Capital	₹ 15,000	18,000	9,000
Profit-sharing ratio	2	2	1
Capital divided by the profit-sharing ratio	7,500	9,000	9,000
Proportionate Capital of B and C, taking A's capital as the base	₹ 15,000	15,000	7,500
Excess of actual over proportionate capital	₹ nil	3,000	1,500

This indicates that A should not get anything till ₹ 3,000 is paid to B and ₹ 1,500 is paid to C. Since capital of B and C are already according to their mutual profit-sharing ratio (2:1), they will share the available cash in this ratio.

After paying off creditors and A's loan, the available amount will be distributed as below in this method:

Particulars	Total	A	B	C
		₹	₹	₹
Third Installment	900	-	600	300
Fourth Installment (i)	3,600	-	2,400	1,200
(ii)	2,400	960	960	480
Fifth Installment	<u>20,100</u>	<u>8,040</u>	<u>8,040</u>	<u>4,020</u>
Total	27,000	9,000	12,000	6,000

Total payment made to each partner will, of course be same under both the methods.

ILLUSTRATION 8

A partnership firm was dissolved on 30th June, 2022. Its Balance Sheet on the date of dissolution was as follows:

Liabilities	₹	₹	Assets	₹
Capitals:			Cash	10,800
A	76,000		Sundry Assets	1,89,200
B	48,000			
C	36,000	1,60,000		
Loan A/c – B		10,000		
Sundry Creditors		30,000		
		<u>2,00,000</u>		<u>2,00,000</u>

The assets were realized in instalments and the payments were made on the proportionate capital basis. Creditors were paid ₹ 29,000 in full settlement of their account. Expenses of realization were estimated to be ₹ 5,400 but actual amount spent was ₹ 4,000. This amount was paid on 15th September. Draw up a statement showing distribution of cash, which was realized as follows:

	₹
On 5 th July, 2022	25,200
On 30 th August, 2022	60,000
On 15 th September, 2022	80,000

SOLUTION

	Creditors	B's Loan	A	B	C
2022	₹	₹	₹	₹	₹
June 30					
Balance b/d	30,000	10,000	76,000	48,000	36,000
Cash balance less Provision for expenses (₹ 10,800 – ₹ 5,400)	5,400	-	-	-	-
Balances unpaid	24,600	10,000	76,000	48,000	36,000
July 5					
1 st Instalment of ₹ 25,200	23,600	1,600	-	-	-
Discount received on full settlement	1,000	8,400	76,000	48,000	36,000
Less: Transferred to Realisation A/c	1,000				
	Nil				
August 30					
2 nd instalment of ₹ 60,000 (W.N. 2)		8,400	32,640	4,640	14,320
Balance unpaid		Nil	43,360	43,360	21,680
September 15					
Amount realised ₹ 80,000					
Add: Balance out of the Provision for Expenses A/c	1,400				
	81,400		32,560	32,560	16,280
Amount unpaid being loss on Realisation in the ratio of 2 : 2 : 1			10,800	10,800	5,400

Working Notes:**1. Highest relative capital basis**

		A	B	C
		₹	₹	₹
1.	Present Capitals	76,000	48,000	36,000
2.	Profit-sharing ratio	<u>2</u>	<u>2</u>	<u>1</u>
3.	Capital per unit of Profit share (1 ÷ 2)	<u>38,000</u>	<u>24,000</u>	<u>36,000</u>
4.	Proportionate capitals taking B, whose capital is the least, as the basis	48,000	48,000	24,000
5.	Excess capital (1-4)	28,000	Nil	12,000
6.	Profit-sharing ratio	<u>2</u>	<u>-</u>	<u>1</u>
7.	Excess capital per unit of Profit share (5 ÷ 6)	14,000		12,000
8.	Proportionate capitals as between A and C taking C capital as the basis	24,000	-	12,000
9.	Excess of A's Capital over C's Excess capital (5-8)	4,000	-	-
10.	Balance of Excess capital (5-9)	24,000		12,000
11.	Distribution sequence:			
	First ₹ 4,000 (2 : 0 : 0)	4,000	-	-
	Next ₹ 36,000 (2 : 0 : 1)	24,000	-	12,000
	Over ₹ 40,000 (2 : 2 : 1)			

2. Distribution of Second instalment

		Creditors	A	B	C
First	₹ 8,400	8,400	-	-	-
Next	₹ 4,000 (2 : 0 : 0)		4,000	-	-
Next	₹ 36,000 (2 : 0 : 1)		24,000	-	12,000
Balance	₹ 11,600 (2 : 2 : 1)		4,640	4,640	2,320
	60,000	8,400	32,640	4,640	14,320



6.8 WINDING UP OF A LIMITED LIABILITY PARTNERSHIP (LLP)

The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.

Winding up of a LLP may be initiated by Tribunal if:

- The LLP wishes to wind up;
- The LLP has less than 2 partners for more than 6 months;
- The LLP is unable to pay its debts;
- The LLP has not acted in the interest of the sovereignty and the integrity of India;
- The LLP has failed to submit with the statements of accounts and solvency or the LLP annual returns for more than five consecutive financial years with the Registrar;
- The Tribunal thinks that it is Just and Equitable that the LLP should be wound up.

The Central Government may make rules for the provisions in relation to winding up and dissolution of LLP.

ILLUSTRATION 9

P and Q were partners sharing profits equally in LLP. Their Balance Sheet as on March 31, 2022 was as follows:

Balance Sheet as on 31st March, 2022

Equity and Liabilities	₹	Assets	₹
Capitals:		Bank	30,000
P 1,00,000		Debtors	25,000
Q <u>50,000</u>	1,50,000	Stock	35,000
Creditors	20,000	Furniture	40,000
Q's current account	10,000	Machinery	60,000
Reserves	15,000	P's current account	10,000
Bank overdraft	5,000		
	<u>2,00,000</u>		<u>2,00,000</u>

The firm was dissolved on the above date:

P took over 50% of the stock at 10% less on its book value, and the remaining stock was sold at a gain of 15%. Furniture and Machinery realized for ₹ 30,000 and ₹ 50,000 respectively; There

was an unrecorded investment which was sold for ₹ 25,000; Debtors realized 90% only and ₹ 1,245 were recovered for bad debts written off last year. There was an outstanding bill for repairs which had to be paid for ₹ 2,000.

You are required to prepare Realization Account, Partners' capital accounts (including transfer of current account balances) and Bank Account in the books of the firm.

SOLUTION**Books of P & Q LLP.****Realization Account**

Particulars	₹	Particulars	₹
To Debtors 25,000		By Creditors 20,000	
To Stock 35,000		By Bank overdraft 5,000	
To Furniture 40,000		By Bank:	
To Machinery 60,000	1,60,000	Investment 25,000	
To Bank:		Furniture 30,000	
Creditors 20,000		Machinery 50,000	
Bank overdraft 5,000		Debtors (90%) 22,500	
Outstanding bill 2,000	27,000	Stock 20,125	
To Profit transferred to:		Bad debts Recovered 1,245	1,48,870
P's capital 1,310		By P's capital 15,750	
Q's capital 1,310	2,620	(stock taken over)	
	1,89,620		1,89,620

Partners' Capital Accounts

	P	Q		P	Q
To P's current Account	16,940		By Balance b/d	1,00,000	50,000
To Bank	83,060	68,810	By Q's current Account		18,810
	1,00,000	68,810		1,00,000	68,810

Bank Account

	₹		₹
To Balance b/d	30,000	By Realization	27,000
To Realization	1,48,870	By P's capital	83,060
		By Q's capital	68,810
	1,78,870		1,78,870

Working Note:**Partners' Current Accounts**

	P	Q		P	Q
To Balance b/d	10,000		By Balance b/d		10,000
To Realization	15,750		By Reserves	7,500	7,500
To Q's capital		18,810	By Realization (profit)	1,310	1,310
			By P's Capital	16,940	
	25,750	18,810		25,750	18,810

SUMMARY

- Reasons for which a partnership could be dissolved are
 - expiry of term for which it was formed
 - death of a partner
 - insolvency of a partner.
- Reasons when a firm stands dissolved
 - when partners mutually decide to dissolve
 - partners except one becomes insolvent
 - business becomes illegal
 - if partnership is at will any partner can give notice for dissolution
 - Court orders.
- The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.
- On dissolution assets are realized and all liabilities are paid off.
(if any liability remains unpaid then it is to be realized from partners in their profit-sharing ratio).
- Piecemeal distribution involves either of two methods:
 - Maximum loss method
 - Highest relative capital method.

TEST YOUR KNOWLEDGE

True and False

1. *Books of accounts are closed in dissolution of partnership.*
2. *On the dissolution of a partnership, firstly, the assets of the firm are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders.*
3. *In event of the dissolution of the firm, the business ceases to end. In event of dissolution of the partnership, the partnership is reconstituted and the business discontinues.*
4. *Expenses of dissolution on realization of assets are credited to the Realization Account.*
5. *Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm.*

Multiple Choice Questions

1. *Partnership could be dissolved because of*
 - (a) *Death of a partner.*
 - (b) *Insolvency of a partner.*
 - (c) *Either (a) or (b).*
2. *On the dissolution of partnership, profit or loss on realization of assets and liabilities should be divided among partners*
 - (a) *In the ratio of their capitals.*
 - (b) *In the same ratio in which they share profits.*
 - (c) *Equally.*
3. *An unrecorded asset realized at the time of dissolution is credited to*
 - (a) *Realization account.*
 - (b) *Revaluation account.*
 - (c) *Capital accounts.*
4. *A liability taken over by a partner at the time of dissolution is credited to*
 - (a) *Profit and loss account.*
 - (b) *Partners' capital accounts.*
 - (c) *Realization account.*

5. Realization account is a
- Nominal account.
 - Real account.
 - Personal account.
6. Which of the following method/methods is adopted to ensure that distribution of cash among partners is in proportion to their interest in partnership?
- Maximum loss method.
 - Highest relative capital method.
 - Either (a) or (b).

Theoretical Questions

- 1 State the circumstances when Garner V/S Murray rule not applicable.
- 2 W paid a premium to other partners of the firm at the time of his admission to the firm, with a condition that they will not be dissolved before the expiry of five years. The firm is dissolved after three years. W claims refund of premium.
- List the criteria for the calculation of the amount of refund.
 - Also list any two conditions when no claim in this respect will arise.

Practical Questions

1. P, Q, and R are partners sharing profits and losses as to 2:2:1. Their Balance Sheet as on 31st March, 2022 is as follows:

Liabilities	₹	Assets	₹
Capital accounts		Plant and Machinery	1,08,000
P 1,20,000		Fixtures	24,000
Q 48,000		Stock	60,000
R 24,000	1,92,000	Sundry debtors	48,000
Reserve Fund	60,000	Cash	60,000
Creditors	<u>48,000</u>		<u> </u>
	<u>3,00,000</u>		<u>3,00,000</u>

They decided to dissolve the business. The following are the amounts realized:

Particulars	₹
Plant and Machinery	1,02,000
Fixtures	18,000
Stock	84,000
Sundry debtors	44,400

Creditors allowed a discount of 5% and realization expenses amounted to ₹ 1,500. There was an unrecorded asset of ₹ 6,000 which was taken over by Q at ₹ 4,800. An amount of ₹ 4,200 due for GST had come to notice during the course of realization and this was also paid.

You are required to prepare:

- (i) Realization account.
 - (ii) Partners' capital accounts.
 - (iii) Cash account.
2. 'Thin', 'Short' and 'Fat' were in partnership sharing profits and losses in the ratio of 2:2:1.

On 30th September, 2022 their Balance Sheet was as follows:

Liabilities	₹	Assets	₹
Capital Accounts:		Premises	50,000
Thin 80,000		Fixtures	1,25,000
Short 50,000		Plant	32,500
Fat 20,000	1,50,000	Stock	43,200
Current Accounts:		Debtors	54,780
Thin 29,700			
Short 11,300			
Fat (Dr.) (14,500)	26,500		
Sundry Creditors	84,650		
Bank Overdraft	44,330		
	3,05,480		3,05,480

'Thin' decides to retire on 30th September, 2022 and as 'Fat' appears to be short of private assets, 'Short' decides that he does not wish to take over Thin's share of partnership, so

all three partners decide to dissolve the partnership with effect from 30th September, 2022. It then transpires that 'Fat' has no private assets whatsoever.

The premises are sold for ₹ 60,000 and the plant for ₹ 1,07,500. The fixtures realize ₹ 20,000 and the stock is acquired by another firm at a book value less 5%. Debtors realize ₹ 45,900. Realization expenses amount to ₹ 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership books following the rules in Garner vs. Murray:

- (i) Realization Account;
- (ii) Partners' Current Accounts;
- (iii) Partners' Capital Accounts showing the closing of the firm's books.

3. Amit, Sumit, and Kumar are partners sharing profit and losses in the ratio 2:2:1. The partners decided to dissolve the partnership on 31st March 2022 when their Balance Sheet was as under:

Liabilities	Amount	Assets	Amount
Capital Accounts:		Land & Building	1,35,000
Amit	55,200	Plant & Machinery	45,000
Sumit	55,200	Furniture	25,500
General Reserve	61,500	Investments	15,000
Kumar's Loan A/c	15,000	Book Debts	60,000
Loan from D	1,20,000	Less: Prov. for bad debts	(6,000)
Trade Creditors	30,000	Stock	36,000
Bills Payable	12,000	Bank	13,500
Outstanding Salary	7,500	Capital Withdrawn:	
		Kumar	32,400
	3,56,400		3,56,400

The following information is given to you:

- (i) Realization expenses amounted to ₹ 18,000 out of which ₹ 3,000 was borne by Amit.
- (ii) A creditor agreed to takeover furniture of book value ₹ 12,000 at ₹ 10,800. The rest of the creditors were paid off at a discount of 6.25%.

(iii) The other assets realized as follows:

Furniture	- Remaining taken over by Kumar at 90% of book value
Stock	- Realized 120% of book value
Book Debts	- ₹ 12,000 of debts proved bad, remaining were fully realized
Land & Building	- Realized ₹ 1,65,000
Investments	- Taken over by Amit at 15% discount

(iv) For half of his loan, D accepted Plant & Machinery and ₹ 7,500 cash. The remaining amount was paid at a discount of 10%.

(v) Bills payable were due on an average basis of one month after 31st March 2022, but they were paid immediately on 31st March @ 6% discount "per annum".

Prepare the Realization Account, Bank Account and Partners' Capital Accounts in the books of Partnership firm.

ANSWERS/HINTS

True and False

1. False. Books of accounts are not closed in dissolution of partnership but are closed in case of dissolution of partnership firm.
2. True. On the dissolution of a partnership, firstly, the assets of the firm, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid.
3. True. In event of the dissolution of the firm, the business ceases to end. However, in event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.
4. False. Expenses of dissolution on realization of assets are debited to the Realization Account.
5. True. Revaluation Account is prepared at the time of dissolution of partnership but Realization Account is prepared at the time of dissolution of partnership firm.

Multiple Choice Questions

1.	(c)	2.	(b)	3.	(a)	4.	(b)	5.	(a)	6.	(c)

Theoretical Questions

1. Non-Applicability of Garner vs Murray rule:

- (i) When the solvent partner has a debit balance in the capital account.

Only solvent partners will bear the loss of capital deficiency of insolvent partner in their capital ratio. If incidentally, a solvent partner has a debit balance in his capital account, he will escape the liability to bear the loss due to insolvency of another partner.

- (ii) When the firm has only two partners.

- (iii) When there is an agreement between the partners to share the deficiency in capital account of the insolvent partner.

- (iv) When all the partners of the firm are insolvent.

2. If the firm is dissolved before the term expires, as is the case, W being a partner who has paid a premium on admission will have to be repaid/refunded

The criteria for calculation of refund amount are:

- (i) Terms upon which admission was made,
 (ii) The time period for which it was agreed that the firm will not be dissolved,
 (iii) The time period for which the firm has already been in existence.

No claim for refund will arise if:

- (i) The firm is dissolved due to the death of a partner,
 (ii) If the dissolution of the firm is basically because of misconduct of W,
 (iii) If the dissolution is through an agreement and such an agreement does not have a stipulation for a refund of premium.

Practical Questions

1. Realization Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Debtors	48,000	By Creditors	48,000
To Stock	60,000	By Cash A/c (Assets realized):	
To Fixtures	24,000	Plant and Machinery	1,02,000

To Plant and machinery	1,08,000	Fixtures	18,000	
To Cash A/c (Creditors)	45,600	Stock	84,000	
To Cash A/c (GST)	4,200	Sundry Debtors	<u>44,400</u>	2,48,400
To Cash A/c (Realization expenses)	1,500	By Q (Unrecorded asset)*		4,800
To Profit on Realization				
P	3,960			
Q	3,960			
R	<u>1,980</u>			
	9,900			
	<u>3,01,200</u>			<u>3,01,200</u>

Partners' Capital Accounts

<i>Particulars</i>	<i>P</i>	<i>Q</i>	<i>R</i>	<i>Particulars</i>	<i>P</i>	<i>Q</i>	<i>R</i>
	₹	₹	₹		₹	₹	₹
To Realization A/c (unrecorded asset)		4,800		By Balance b/d	1,20,000	48,000	24,000
To Cash (Bal. Fig.)	1,47,960	71,160	37,980	By Reserve fund	24,000	24,000	12,000
				By Realization A/c (Profit)	3,960	3,960	1,980
	<u>1,47,960</u>	<u>75,960</u>	<u>37,980</u>		<u>1,47,960</u>	<u>75,960</u>	<u>37,980</u>

Cash Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	60,000	By Realization A/c (Creditors)	45,600
To Realization A/c (Assets)	2,48,400	By Realization A/c (Expenses)	1,500
		By Realization A/c (GST)	4,200
		By P's Capital A/c	1,47,960
		By Q's Capital A/c	71,160
		By R's Capital A/c	37,980
	<u>3,08,400</u>		<u>3,08,400</u>

* An unrecorded asset is in the nature of gain hence realization account is credited. Since this asset has been taken over by Q, therefore, his account has been debited.

2.

Realization Account

Particulars	₹	Particulars		₹
To Premises	50,000	By Sundry Creditors		84,650
To Plant	1,25,000	By Bank:		
To Fixtures	32,500	Premises	60,000	
To Stock	43,200	Plant	1,07,500	
To Debtors	54,780	Fixtures	20,000	
To Bank (Creditors)	84,650	Stock	41,040	
To Bank (Expenses)	4,500	Debtors	<u>45,900</u>	2,74,440
		By Loss on Realization transferred to Partners' Current A/cs		
		Thin	14,216	
		Short	14,216	
		Fat	<u>7,108</u>	35,540
	<u>3,94,630</u>			<u>3,94,630</u>

Partners' Current Accounts

Particulars	Thin	Short	Fat	Particulars	Thin	Short	Fat
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	14,500	By Balance b/d	29,700	11,300	–
To Realization	14,216	14,216	7,108	By Capital A/c			
To Capital A/c transfer	15,484	–	–	Transfer	–	2,916	21,608
	<u>29,700</u>	<u>14,216</u>	<u>21,608</u>		<u>29,700</u>	<u>14,216</u>	<u>21,608</u>

Partners' Capital Accounts

Particulars	Thin	Short	Fat	Particulars	Thin	Short	Fat
	₹	₹	₹		₹	₹	₹
To Current A/c	–	2,916	21,608	By Balance b/d	80,000	50,000	20,000
To Fat's Capital A/c				By Current A/c			
Deficiency in the				(transfer)	15,484	–	–
ratio of 8:5	990	618	–	By Bank	14,216	14,216	
				(Realization loss)			

To Bank	1,08,710	60,682	–	By Thin & Short Capital A/cs			1,608
	1,09,700	64,216	21,608		1,09,700	64,216	21,608

Working Notes:(i) **Bank Account**

Particulars	₹	Particulars	₹
To Realization A/c	2,74,440	By Balance b/d	44,330
To Thin's Capital A/c	14,216	By Realization A/c (Creditors)	84,650
To Short's Capital A/c	14,216	By Realization A/c (Expenses)	4,500
		By Thin's Capital A/c	1,08,710
		By Short's Capital A/c	60,682
	3,02,872		3,02,872

- (ii) Fat's deficiency has been borne Thin & Short in the ratio of their fixed capitals i.e., 8:5 following the rule in *Garner vs. Murray*.

3. Realization Account

	Particulars	₹		Particulars	₹
To	Land and Building	1,35,000	By	Provision for bad debts	6,000
To	Plant and Machinery	45,000	By	Loan from D	1,20,000
To	Furniture	25,500	By	Trade creditors	30,000
To	Investments	15,000	By	Bills payable	12,000
To	Book debts	60,000	By	Outstanding salary	7,500
To	Stock	36,000	By	Kumar - Furniture taken over (13,500 x .9)	12,150
To	Bank (Realization expenses)	15,000	By	Bank A/c -	
				Stock Realized	43,200
To	Amit- Realization expenses	3,000		Land & Building	1,65,000
				Debtors	<u>48,000</u>
					2,56,200
To	Bank A/c -		By	Amit (Investment taken over)	12,750
	Bill payable	11,940			
	D's Loan	61,500			
	Creditors	18,000			
	Salary	7,500			

To	Profit transferred to partners' capital Accounts				
	Amit	9,264			
	Sumit	9,264			
	Kumar	<u>4,632</u>	23,160		
			<u>4,56,600</u>		<u>4,56,600</u>

Bank Account

Particulars	₹	Particulars	₹
To Balance b/d	13,500	By Realization A/c (payment of liabilities: 11,940 + 7,500 + 54,000 + 15,000 + 18,000 + 7,500)	1,13,940
To Realization A/c (assets realized)	2,56,200	By Amit	79,314
To Kumar	12,618	By Sumit	89,064
	<u>2,82,318</u>		<u>2,82,318</u>

Partners' Capital Accounts

Particulars	Amit ₹	Sumit ₹	Kumar ₹	Particulars	Amit ₹	Sumit ₹	Kumar ₹
To Balance b/d			32,400	By Balance b/d	55,200	55,200	
To Realization A/c (Investment taken over)	12,750			By Kumar's Loan			15,000
To Realization A/c (Furniture taken over)			12,150	By General Reserve	24,600	24,600	12,300
To Bank A/c	79,314	89,064		By Realization A/c (expense)	3,000		
				By Realization A/c (profit)	9,264	9,264	4,632
				By Bank A/c			12,618
	<u>92,064</u>	<u>89,064</u>	<u>44,550</u>		<u>92,064</u>	<u>89,064</u>	<u>44,550</u>

Working Notes:**1. Payment for Bills Payable**

Particulars	Amount (₹)
Bills Payable as per Balance Sheet	12,000
Less: Discount for early payment {12,000 x 6% x (1/12)}	60
Amount Paid in Cash	<u>11,940</u>

2. Payment to D's Loan

Particulars	Amount (₹)
D's Loan as per Balance Sheet	120,000.00
50% of Loan adjusted as below:	
Plant & Machinery accepted at Book Value (₹ 45,000) and ₹ 7,500 in cash.	7,500
Balance 50% of Loan adjusted as below:	
In cash after allowing discount of 10% i.e. ₹ 60,000 – ₹ 6,000 = ₹ 54,000.	54,000

3. Payment to Trade Creditors

Particulars	Amount (₹)
Trade Creditors as per Balance Sheet	30,000
Less: Furniture of Book Value ₹ 12,000 accepted at value ₹ 10,800	10,800
	19,200
Less: Discount @ 6.25%	1,200
Amount paid in Cash	18,000

4. Furniture taken over by Kumar

Particulars	Amount (₹)
Furniture as per Balance Sheet	25,500
Less: Furniture of Book Value ₹ 12,000 accepted by trade creditors	12,000
	13,500
Less: 10% of Book Value	1,350
Value of Furniture taken over by Kumar	12,150

NOTES

[illegible]

ANNEXURE-II

FORMATS OF FINANCIAL STATEMENTS FOR LIMITED LIABILITY PARTNERSHIPS

PART I – Form of BALANCE SHEET

Name of the Limited Liability Partnership.....

Balance Sheet as at

(Rupees in.....)

	Particulars	Note No	Figures as at the end of (Current reporting period) (in ₹) _____ (DD/MM/YYYY)	Figures as at the end of (Previous reporting period) (in ₹) _____ (DD/MM/YYYY)
	1	2	3	4
I.	EQUITY AND LIABILITIES			
	(1) Partner's Fund			
	(a) Partners Capital Account (i) Partners' Contribution (ii) Partners' Current Account			
	(b) Reserves and surplus			
(2)	Non-current liabilities			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
(3)	Current liabilities			
	(a) Short-term borrowings			
	(b) Trade payables:- (A) total outstanding dues of micro, small and medium enterprises and			

	(B) total outstanding dues of creditors other than micro, small and medium enterprises .			
	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	ASSETS			
(1)	Non-Current Assets			
	(a) Property, Plant and Equipment and Intangible assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible assets			
	(iii) Capital work-in-progress			
	(iv) Intangible assets under development			
	(b) Non-current investment			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
(2)	Current assets			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and bank balances			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

See accompanying notes which form part of the financial statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realized within twelve months after the reporting date; or
 - (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be settled in the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within twelve months after the reporting date; or
 - (d) the Limited Liability Partnership does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A Limited Liability Partnership may disclose the following in the Notes to Accounts:

A. Partner Funds

For each partner's contribution account/current account following items for the year to be disclosed separately, as agreed in the LLP Agreement:

- (a) opening balance;

- (b) Introduced/Contributed during the year;
- (c) remuneration for the year;
- (d) interest for the year;
- (e) withdrawals during the year;
- (f) share of profit or loss for the year (share in % and amount);
- (g) closing balance.

For partners' contribution account, the agreed contribution shall also be disclosed.

B. Reserves and Surplus

- (i) Reserves and Surplus may be classified as:
 - (a) Capital Reserves;
 - (b) Revaluation Reserve;
 - (c) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (d) Undistributed Surplus i.e. balance in Statement of Profit and Loss.
- (ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Undistributed Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

- (i) Long-term borrowings may be classified as:
 - (a) Term loans
 - From banks
 - From other parties
 - (c) Deferred payment liabilities.
 - (d) Loans and advances from related parties.
 - (e) Long term maturities of finance lease obligations
 - (f) Other loans and advances (specify nature).

- (ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners/proprietor/owners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Terms of repayment of term loans and other loans may be stated.

D. Long-term provisions

The amounts may be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

E. Short-term borrowings

- (i) Short-term borrowings may be classified as:
 - (a) Loans repayable on demand
 - From banks
 - From other parties
 - (b) Loans and advances from related parties.
 - (b) Other loans and advances (specify nature).
- (ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) current maturities of Long term borrowings may be disclosed separately.

F. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
- (b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along

with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

- (c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
- (d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and
- (e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.-The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts may be classified as:

- (a) Current maturities of finance lease obligations;
- (b) Interest accrued but not due on borrowings;
- (c) Interest accrued and due on borrowings;
- (d) Income received in advance;
- (e) Other payables (specify nature);

H. Short-term provisions

The amounts may be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

I. Property, Plant and Equipment

- (i) Classification may be given as:
 - (a) Land.
 - (b) Buildings.

- (c) Plant and Equipment.
 - (d) Furniture and Fixtures.
 - (e) Vehicles.
 - (f) Office equipment.
 - (g) Others (specify nature).
- (ii) Assets under lease may be separately specified under each class of asset.
- (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible assets

- (i) Classification may be given as:
- (a) Goodwill.
 - (b) Brands /trademarks.
 - (c) Computer software.
 - (d) Mastheads and publishing titles.
 - (e) Mining rights.
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
 - (g) Recipes, formulae, models, designs and prototypes.
 - (h) Licenses and franchise.
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related amortisation and impairment losses or reversals shall be disclosed separately.

K. Non-current investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
 - (a) Investment property;
 - (b) Investments in Equity Instruments;
 - (c) Investments in preference shares;
 - (d) Investments in Government or trust securities;
 - (e) Investments in debentures or bonds;
 - (f) Investments in Mutual Funds;
 - (g) Investments in partnership firms;
 - (h) Other non-current investments (specify nature)

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

- (i) Long-term loans and advances may be classified as:
 - (a) Capital Advances;
 - (b) Loans and advances to related parties (giving details thereof);
 - (c) Other loans and advances (specify nature).

- (ii) The above may also be separately sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed separately.

M. Other non-current assets

Other non-current assets may be classified as:

- (i) Security Deposits;
- (ii) Bank deposits with more than 12 months maturity;
- (ii) Others (specify nature).

N. Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares;
 - (c) Investments in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms;
 - (g) Other investments (specify nature).

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments;

- (b) Aggregate amount of quoted investments and market value thereof;
- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

- (i) Inventories shall be classified as:
 - (a) Raw materials;
 - (b) Work-in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) Stores and spares;
 - (f) Loose tools;
 - (g) Others (specify nature).
- (ii) Goods-in-transit may be disclosed under the relevant sub-head of inventories.
- (iii) Mode of valuation may be stated.

P. Trade Receivables

- (i) Aggregate amount of trade receivables outstanding for a period exceeding six months from the date they are due for receipt may be stated separately.
- (ii) Trade receivables may be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed separately.

Q. Cash and bank balances

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;

- (c) Cash on hand;
- (d) Others (specify nature).
- (ii) Other bank balances shall be classified as
 - (a) Bank Deposits - Earmarked balances with banks.
 - (b) Margin money or deposits under lien shall be disclosed separately.
 - (c) Bank deposits with original maturity for more than 3 months but less than 12 months from reporting date.
 - (d) others (specify nature)

R. Short-term loans and advances

- (i) Short-term loans and advances may be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above may also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances may be disclosed under the relevant heads separately.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities (to the extent not provided for)

- (i) Contingent liabilities may be classified as:
 - (a) Claims against the limited liability partnership not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the limited liability partnership is contingently liable.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the LLP.....

Statement of Profit and loss for the year ended

(Rupees in.....)

	Particulars	Note	Figures for the current reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)	Figures for the previous reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)
	1	2	3	4
I.	Revenue from operations			
II.	Other income			
III.	Total Income (I + II)			
IV.	Expenses			
	(a) Cost of Goods Sold			
	(b) Employee benefits expense			
	(c) Depreciation and amortization expense			
	(d) Finance Cost			
	(e) Other expenses			
	Total expenses			
V	Profit before exceptional and extraordinary items, partners' remuneration and tax (III-IV)			
VI	Exceptional items			
VII	Profit before extraordinary items, partners' remuneration			

	and tax (V - VI)			
VIII	Extraordinary Items			
IX	Profit before partners' remuneration and tax (VII- VIII)			
X	Partners' remuneration			
XI	Profit before tax (IX- X)			
XII	Tax expense:			
	(i) Current tax			
	(ii) Deferred tax			
XIII	Profit (Loss) for the period from continuing operations (XI-XII)			
XIV	Profit/(loss) from discontinuing operations			
XV	Tax expense of discontinuing operations			
XVI	Profit/(loss) from Discontinuing operations (after tax) (XIV-XV)			
XVII	Profit/ (Loss) (XIII + XVI)			

See accompanying notes which form part of the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part may be applied to the income and expenditure account in like manner as they apply to a statement of profit and loss.
2. (A) Revenue from operations may disclose separately in the notes revenue from—
 - (a) Sale of products;
 - (b) Sale of services;
 - (c) Grants or donations received;
 - (d) Other operating revenues;
 - (e) Less: Excise duty(B) In respect of a finance Limited Liability Partnership, revenue from operations may include revenue from—
 - (a) Interest; and
 - (b) Other financial services.
3. Cost of Goods Sold
Costs of Goods Sold shall be classified as:
 - (a) Cost of materials consumed;
 - (b) Purchases of Stock-in-Trade;
 - (c) Changes in inventories of finished goods;
 - (d) Work-in-progress and Stock-in-Trade.
4. Finance Costs
Finance costs may be classified as:
 - (a) Interest expense;
 - (b) Other borrowing costs;
 - (c) Applicable net gain/loss on foreign currency transactions and translation.
5. Other income
Other income shall be classified as:
 - (a) Interest Income;
 - (b) Dividend Income;
 - (c) Net gain/loss on sale of investments;

- (d) Other non-operating income (net of expenses directly attributable to such income).
6. Following may be disclosed by way of notes regarding aggregate expenditure and income on the following items:—
- (i)
 - (a) Employee Benefits Expense showing separately (i) salaries and wages, (ii) Contribution to provident and other funds, (iii) staff welfare expenses;
 - (b) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000 whichever is higher;
 - (c) Adjustments to the carrying amount of investments;
 - (d) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
 - (e) Details of items of exceptional and extraordinary nature;
 - (f) Prior period items.
 - (ii) Expenditure incurred on each of the following items, separately for each item:—
 - (a) Consumption of stores and spare parts;
 - (b) Power and fuel;
 - (c) Rent;
 - (d) Repairs to buildings;
 - (e) Repairs to machinery;
 - (f) Insurance;
 - (g) Rates and taxes, excluding, taxes on income;
 - (h) Miscellaneous expenses.

NOTES

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COMPANY ACCOUNTS

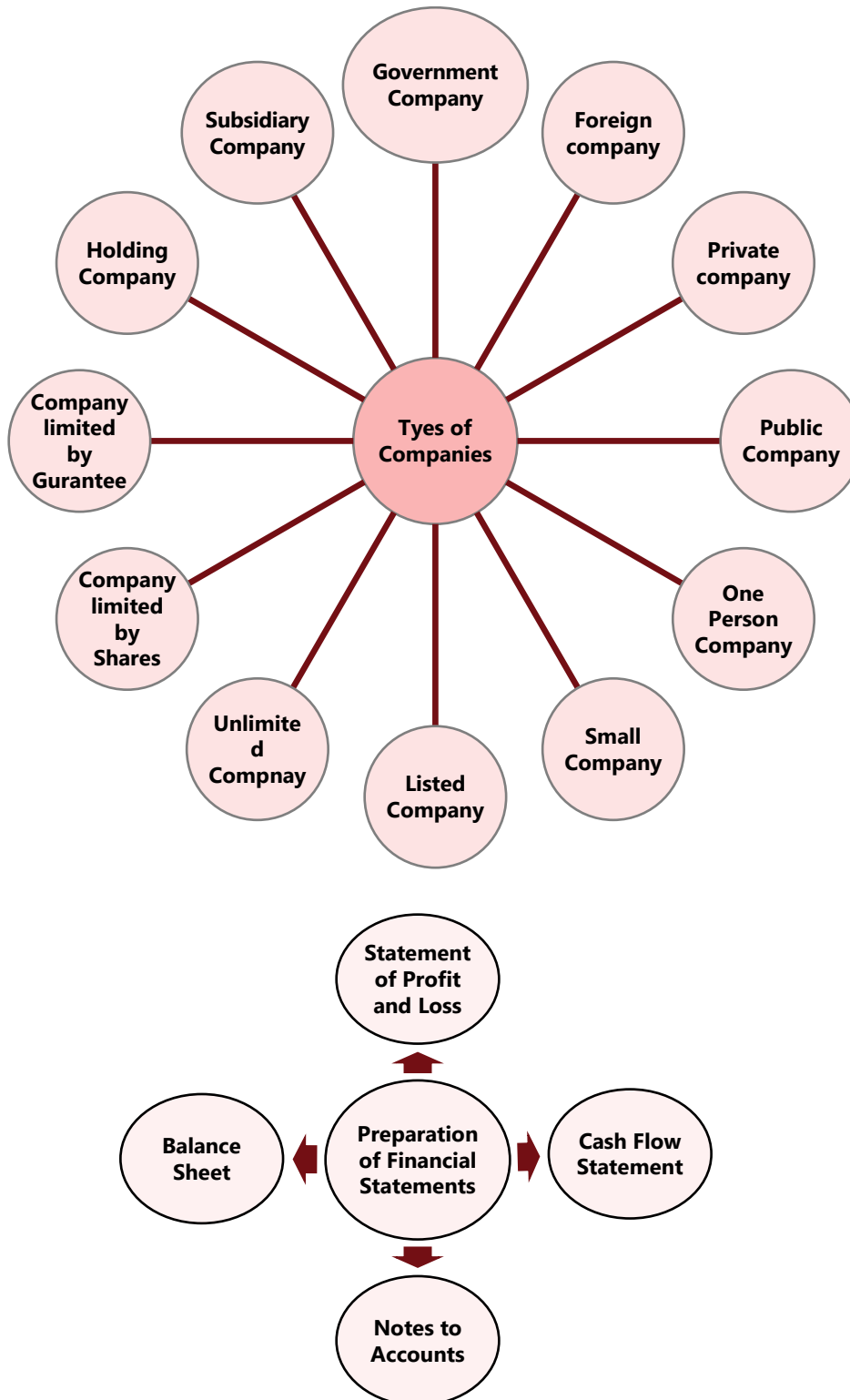


UNIT – 1 INTRODUCTION TO COMPANY ACCOUNTS

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the reason for the existence and survival of a company.
- ◆ Learn the nature and types of companies.
- ◆ Explain the salient features of a company.
- ◆ Understand the purpose of preparing the financial statements of the company.

UNIT OVERVIEW

 1.1 INTRODUCTION

The never-ending human desire to grow and grow further has given rise to the expansion of business activities, which in turn has necessitated the need to increase the scale of operations so as to provide goods and services to the ever-increasing needs of the growing population of consumers. Large amount of money, modern technology, large human contribution etc. is required for it, which is not possible to arrange under partnership or proprietorship. To overcome this difficulty, the concept of 'Company' or 'Corporation' came into existence.

While the invention of steam power ignited the human imagination to build big machines for the mass production of goods, the need to separate the management from ownership gave birth to a form of organisation today known as 'company'.

Company form of organisation is one of the ingenious creations of human mind, which has enabled the business to carry on its wealth creation activities through optimum utilisation of resources. In course of time, a company structure has become an important institutional form for business enterprise, which has carved out a key place for itself in the field of business operations as well as in the wealth-generating functions of society.

 1.2 MEANING OF COMPANY

The word 'Company', in everyday usage, implies an assemblage of persons for social purpose, companionship or fellowship. As a form of organisation, the word 'company' implies a group of people who voluntarily agree to form a company.

The word 'company' is derived from the Latin word 'com' i.e. with or together and 'panis' i.e. bread. Originally the word referred to an association of persons or merchant men discussing matters and taking food together. However, in law 'company' is termed as company which is formed and incorporated under the Companies Act, 2013 or an existing company formed and registered under any of the previous company laws. As per this definition of law, there must be group of persons who agree to form a company under the law and once so formed; it becomes a separate legal entity having perpetual succession with a distinct name of its own and a common seal. Its existence is not affected by the change of members.

Company begs its origin in law. It is an organisation consisting of individuals, called shareholders by virtue of holding the shares of a company, who are authorised by law to elect a board of directors and, through it, to act as a separate legal entity as regards its activities. Generally, the capital of the company consists of transferable shares, and members have limited liabilities.

To get to the heart of the nature of the company, let us examine the concept of company propounded under corporate jurisprudence.

According to Justice Marshal, "A corporation is an artificial being, invisible, intangible and existing only in the contemplation of law".

In the same manner, Lord Justice Hanay has defined a company as "an artificial person created by law with a perpetual succession and a common seal".

A common thread running through the various definitions of 'company' is that it is an association of persons created by law as a separate body for a special purpose. At the same time, definitions have laid down certain characteristics of a corporate organisation, which make it out as a separate and unique organisation which enables the people to contribute their wealth to the capital of the company by subscribing to its shares and appointing elected representatives to carry out the business.



1.3 SALIENT FEATURES OF A COMPANY

Following are the salient features of a company:

1. *Incorporated Association:* A company comes into existence through the operation of law. Therefore, incorporation of company under the Companies Act is must. Without such registration, no company can come into existence. Being created by law, it is regarded as an artificial legal person.
2. *Separate Legal Entity:* A company has a separate legal entity and is not affected by changes in its membership. Therefore, being a separate business entity, a company can contract, sue and be sued in its incorporated name and capacity.
3. *Perpetual Existence:* Since company has existence independent of its members, it continues to be in existence despite the death, insolvency or change of members.
4. *Common Seal:* Company is not a natural person; therefore, it cannot sign the documents in the manner as a natural person would do. In order to enable the company to sign its documents, it is provided with a legal tool called 'Common Seal'. The common seal is affixed on all documents by the person authorised to do so who in turn puts his signature for and on behalf of the company. Companies Act, 2013 required common seal to be affixed on certain documents (such as bill of exchange, share certificates, etc.) Now, the use of common seal has been made optional. All such documents which required affixing the common seal may now instead be signed by two directors or one director and a company secretary of the company. Further, every company registered in India are required to obtain unique Corporate Identification Number (CIN) that is assigned by Registrar of Companies.

5. *Limited Liability:* The liability of every shareholder of a company is limited to the amount he has agreed to pay to the company on the shares allotted to him. If such shares are fully paid-up, he is subject to no further liability.
6. *Distinction between Ownership and Management:* Since the number of shareholders is very large and may be distributed at different geographical locations, it becomes difficult for them to carry on the operational management of the company on a day-to-day basis. This gives rise to the need of separation of the management and ownership.
7. *Not a citizen:* A company is not a citizen in the same sense as a natural person is, though it is created by the process of law. It has a legal existence but does not enjoy the citizenship rights and duties as are enjoyed by the natural citizens.
8. *Transferability of Shares:* The capital is contributed by the shareholders through the subscription of shares. Such shares are transferable by its members except in case of a private limited company, which may have certain restrictions on such transferability.
9. *Maintenance of Books:* A limited company is required by law to keep a prescribed set of account books and any failure in this regard attracts penalties.
10. *Periodic Audit:* A company has to get its accounts periodically audited through the chartered accountants appointed for the purpose by the shareholders on the recommendation of board of directors.
11. *Right of Access to Information:* The right of the shareholders of a company to inspect its books of account, with the exception of books open for inspection under the Statute, is governed by the Articles of Association. The shareholders have a right to seek information from the directors by participating in the meetings of the company and through the periodic reports.

1.4 TYPES OF COMPANIES

1. Government Company

According to Section 2(45) of the Companies Act, 2013, "Government company" means any company in which not less than fifty-one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

2. Foreign Company

According to Section 2 (42) of the Companies Act, 2013, "Foreign company" means any company or body corporate incorporated outside India which –

- (a) Has a place of business in India whether by itself or through an agent physically or through electronic mode; and
- (b) Conducts any business activity in India in any other manner.

3. Private Company

Section 2(68) of the Companies Act, 2013 defines 'Private company' as a company which by its articles,

- i. Restrict the right to transfer its shares;
- ii. Except in case of One Person Company limits the number of its members to two hundred:

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this sub-clause, be treated as a single member:

Provided further that—

- (A) Persons who are in the employment of the company; and
 - (B) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased,
- shall not be included in the number of members; and
- (iii) Prohibits any invitation to the public to subscribe for any securities of the company. Shares of a Private Company are not listed on Stock Exchange.

4. Public Company

Section 2(71) of the Companies Act, 2013 defines Public Company as a company which—

- (a) is not a private company; and
- (b) has a minimum paid-up share capital as may be prescribed:

Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles;

A company which is a listed public company if it gets unlisted continues to be a public company.

No Minimum Paid-up Share Capital: The minimum paid-up share capital requirement of INR 1,00,000 (in case of a private company) and INR 5,00,000 (in case of a public company) has been done away with under Companies Act, 2013. Accordingly, no minimum paid-up

capital requirements will now apply for incorporating private as well as public companies in India.

5. One Person Company

Section 2 (62) of the Companies Act, 2013 defines "One Person Company" as a company which has only one person as a member.

6. Small Company

Section 2(85) of the Companies Act, 2013 defines "Small company" means a company, other than a public company

- (i) paid-up share capital of which does not exceed four crores rupees or such higher amount as may be prescribed which shall not be more than ten crore rupees; and
- (ii) turnover of which as per its last profit and loss account for the immediately preceding financial year does not exceed forty crore rupees or such higher amount as may be prescribed which shall not be more than hundred crore rupees:

Provided that nothing in this clause should apply to:

- (A) a holding company or a subsidiary company
- (B) a company registered under section 8
- (C) a company or body corporate governed by any special Act

7. Listed Company

As per Section 2 (52) of the Companies Act, 2013, "listed company" means a company which has any of its securities listed on any recognised stock exchange.

The company, whose shares are not listed on any recognised stock exchange, is called "Unlisted Company".

An unlisted company can be a public company or a private company.

8. Unlimited Company

Section 2 (92) of the Companies Act, 2013 defines "Unlimited company" means a company not having any limit on the liability of its members.

9. Company limited by Shares

As per Section 2(22) of the Companies Act, 2013, "Company limited by shares" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them.

10. Company limited by Guarantee

As per Section 2(21) of the Companies Act, 2013, "company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as

the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

11. Holding Company

According to Section 2 (46) of the Companies Act, 2013, "Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies.

12. Subsidiary Company

Section 2(87) of the Companies Act, 2013 defines "subsidiary company" as a company in which the holding company:

- (i) Controls the composition of the Board of Directors; or
- (ii) Exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.

A company shall be deemed to be a subsidiary company of the holding company even if there is indirect control through the subsidiary company (ies). The control over the composition of a subsidiary company's Board of Directors means exercise of some power to appoint or remove all or a majority of the directors of the subsidiary company.



1.5 MAINTENANCE OF BOOKS OF ACCOUNT

As per Section 128 of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting:

Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.



1.6 PREPARATION OF FINANCIAL STATEMENTS

Under Section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the notified accounting standards and shall be in the form or forms as may be provided for different class or classes of companies, as prescribed in Schedule III. The Board of Directors of the company shall lay financial statements at every annual general meeting of a company.

Financial Statements as per Section 2(40) of the Companies Act, 2013, inter-alia include -

- i. A balance sheet as at the end of the financial year;
- ii. A profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year;
- iii. cash flow statement for the financial year;
- iv. A statement of changes in equity, if applicable; and
- v. (any explanatory not annexed to, or forming part of, any document referred to in sub-clause (i) to sub-clause (iv):

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Requisites of Financial Statements

It shall give a true and fair view of the state of affairs of the company as at the end of the financial year.

Provisions Applicable

- (1) Specific Act is Applicable

For instance, any

- (a) Insurance company
- (b) Banking company or
- (c) Any company engaged in generation or supply of electricity* or
- (d) Any other class of company for which a Form of balance sheet or Profit and loss account has been prescribed under the Act governing such class of company.

- (2) In case of all other companies:

Balance Sheet as per Form set out in Part I of Schedule III and Statement of Profit and Loss as per Part II of Schedule III.

Compliance with Accounting Standards

As per Section 129 of the Companies Act, it is mandatory to comply with accounting standards notified by the Central Government from time to time.

Schedule III of the Companies Act, 2013

As per Section 129 of the Companies Act, 2013, Financial statements shall give a true and fair view of the state of affairs of the company or companies and comply with the accounting

standards notified under Section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Division I of Schedule III under the Act.

PART I – Form of BALANCE SHEET

Name of the Company.....

Balance Sheet as at.....

(₹ in.....)

Particulars		Notes No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
	EQUITY AND LIABILITIES			
1.	Shareholders' funds			
a.	Share capital (A)		xxx	xxx
b.	Reserves and Surplus (B)		xxx	xxx
c.	Money received against share warrants		xxx	xxx
2.	Share application money pending allotment		xxx	xxx
3.	Non-current liabilities			
a.	Long-term borrowings (C)		xxx	xxx
b.	Deferred tax liabilities (Net)		xxx	xxx
c.	Other long term liabilities		xxx	xxx
d.	Long-term provisions (D)		xxx	xxx
4.	Current liabilities			
a.	Short-term borrowings (E)		xxx	xxx
b.	Trade Payables (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises.]		xxx xxx	xxx xxx
c.	Other current liabilities (F)		xxx	xxx
d.	Short-term provisions		xxx	xxx
	Total		xxx	xxx

	ASSETS					
1.	Non-current assets					
	a.	i.	Property, Plant and Equipment		xxx	xxx
		ii.	Intangible assets (H)		xxx	xxx
		iii.	Capital Work-in-progress		xxx	xxx
		iv.	Intangible assets under development		xxx	xxx
	b.	Non-current investments (I)			xxx	xxx
	c.	Deferred tax assets (Net)			xxx	xxx
	d.	Long-term loans and advances (J)			xxx	xxx
	e.	Other non-current assets			xxx	xxx
2.	Current assets					
	a.	Current investments (K)			xxx	xxx
	b.	Inventories (L)			xxx	xxx
	c.	Trade receivables			xxx	xxx
	d.	Cash and cash equivalents (M)			xxx	xxx
	e.	Short-term loans and advances			xxx	xxx
	f.	Other current assets			xxx	xxx
	Total				xxx	xxx

Certain items are to be explained as follows (list not exhaustive):

A. SHARE CAPITAL

For each class of share capital following points is to be kept in mind:

- i. The number and amount of shares authorised.
- ii. The number of shares which are issued, subscribed and fully paid and which are issued, subscribed but not fully paid.
- iii. The par value per share.
- iv. Shares outstanding at the beginning and at the end of the reporting period should be reconciled.
- v. Calls unpaid.
- vi. Forfeited shares.

B. RESERVES AND SURPLUS

Reserves and surplus can be distributed among the following sub-heads:

- i. Capital reserves
- ii. Capital redemption reserves
- iii. Securities Premium
- iv. Debenture Redemption reserve
- v. Revaluation reserve
- vi. Surplus; the balance as per profit and loss statement
- vii. Other reserves (specify the nature and purpose)

C. LONG TERM BORROWINGS

Long term borrowings can be classified under the following sub-heads:

- i. Bonds/Debentures
- ii. Term loans
- iii. Deferred payment liabilities
- iv. Deposits
- v. Long term maturities of finance lease obligations
- vi. Loans and advances from related parties
- vii. Other loans and advances (specify nature)

D. LONG TERM PROVISIONS

This can be classified as follows:

- i. Employee benefits provision like gratuity, provident fund etc.
- ii. Other provisions (specify the nature)

E. SHORT TERM BORROWINGS

Short term borrowings can be classified among the following sub-heads:

- i. Loans repayable on demand
- ii. Loans and advances from related parties
- iii. Deposits
- iv. Other loans and advances (specify the nature)

F. OTHER CURRENT LIABILITIES

Some of the other current liabilities can be grouped as under:

- i. Interest accrued but not/and due on borrowings
- ii. Income received in advance
- iii. Unpaid dividends
- iv. Application money received for allotment of securities and due for refund and interest accrued thereon
- v. Other current liabilities (specify the nature)

G. PROPERTY, PLANT AND EQUIPMENT

Property, Plant and Equipment can be classified as follows:

- i. Land
- ii. Buildings
- iii. Plant and Equipment
- iv. Furniture and Fixtures
- v. Vehicles
- vi. Office equipment
- vii. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

H. INTANGIBLE ASSETS

Intangible assets can be classified as follows:

- i. Goodwill
- ii. Brands/trademarks
- iii. Computer software
- iv. Mining rights
- v. Publishing titles
- vi. Copyrights, patents and other intellectual property rights, services and operating rights.

- vii. Licence and franchise
- viii. Recipes, models, designs, formulae and prototypes
- ix. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

I. NON-CURRENT INVESTMENTS

Investments can be classified as under:

- i. Investments in property
- ii. Investments in equity instruments
- iii. Investments in preference shares
- iv. Investments in governments or trust securities
- v. Investments in debentures or bonds
- vi. Investments in mutual funds
- vii. Investments in partnership firms
- viii. Other non-current investments (specify the nature)

J. LONG TERM LOANS AND ADVANCES

It can be classified under the following sub-groups:

- i. Capital advances
- ii. Security deposits
- iii. Loans and advances to related parties
- iv. Other loans and advances (specify nature)

The above shall also be sub-classified as follows:

- i. Secured, considered goods
- ii. Unsecured, considered goods
- iii. Doubtful

K. CURRENT INVESTMENTS

It can be classified as follows:

- i. Investments in equity instruments
- ii. Investments in preference shares
- iii. Investments in government or trust securities
- iv. Investments in bonds or debentures
- v. Investments in mutual funds
- vi. Investments in partnership firms
- vii. Other investments (specify the nature)

L. INVENTORIES

Inventories can be classified as:

- i. Raw materials
- ii. Work-in-progress
- iii. Stores and spares
- iv. Finished goods
- v. Loose tools
- vi. Stock in trade
- vii. Goods in transit
- viii. Others (specify the nature)

M. CASH AND CASH EQUIVALENTS

The following head can be classified as follows:

- i. Balances with banks
- ii. Cheques, drafts in hand
- iii. Cash in hand
- iv. Others (specify the nature)

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Company.....

Profit and Loss Statement for the year ended

(` in.....)

Particulars		Note No.	Figures for the current reporting period		Figures for the previous reporting period	
I.	Revenue from operations			xxx		xxx
II.	Other income			xxx		xxx
III.	Total Revenue (I + II)			xxx		xxx
IV.	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of finished goods, Work-in-Progress and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and amortization expense			xxx		xxx
	Other expenses			xxx		xxx
Total expenses				xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)			xxx		xxx
VI.	Exceptional items			xxx		xxx
VII.	Profit before extraordinary items and tax (V-VI)			xxx		xxx
VIII.	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII-VIII)			xxx		xxx
X.	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI.	Profit (Loss) for the period from continuing operations (VII-VIII)			xxx		xxx
XII.	Profit/(Loss) from discontinuing operations			xxx		xxx
XIII.	Tax expense of discontinuing operations			xxx		xxx

XIV.	Profit/(Loss) from discontinuing operations (after tax) (XII-XIII)			xxx		xxx
XV.	Profit (Loss) for the period (XI + XIV)			xxx		xxx
XVI.	Earnings per equity share:					
	(1) Basic			xxx		xxx
	(2) Diluted			xxx		xxx

SUMMARY

1. 'Company' is termed as an entity which is formed and incorporated under the Companies Act, 2013 or an existing company formed and registered under any of the previous company laws.
2. Salient features of a company include: Incorporated Association; Separate Legal Entity; Perpetual Existence; Common Seal; Limited Liability; Distinction between Ownership and Management; Not a citizen; Transferability of Shares; Maintenance of Books; Periodic Audit; Right of Access to Information.
3. Types of companies: Government Company; Foreign Company; Private Company; Public Company; One Person Company; Small Company; Listed Company; Unlimited Company; Company limited by Shares; Company limited by Guarantee; Holding Company; Subsidiary Company.
4. The financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the notified accounting standards and shall be in the form or forms as may be provided for different class or classes of companies, as prescribed in Schedule III to the Companies Act, 2013. Financial Statements as per Section 2(40) of the Companies Act, 2013, include balance sheet as at the end of the financial year; profit and loss account, or in the case of a company carrying on any activity not for profit, an income and expenditure account for the financial year; cash flow statement for the financial year; statement of changes in equity, if applicable; and any explanatory note annexed to.

TEST YOUR KNOWLEDGE

True and False

1. Every public company is a listed company.
2. Shares of a private company are not listed on stock exchange.
3. It is not mandatory to incorporate a company under the companies act.

4. *Company is an artificial, legal person created by law.*
5. *Death, insolvency or change of members affects the existence of a company.*
6. *If the shares are fully paid-up by the shareholder, he is subject to no further liability.*
7. *Public limited company has restrictions on transferability of shares.*
8. *Financial statements of company show the financial position of the business.*
9. *Schedule I gives proforma of Balance Sheet.*
10. *Schedule III prescribes the format of Directors' Report*
11. *Financial statements need to be true and correct as per Companies Act.*

Multiple Choice Questions

1. *Which of the following statement is not a feature of a Company?*
 - (a) *Separate legal entity*
 - (b) *Perpetual Existence*
 - (c) *Members have unlimited liability*
2. *In a Government Company, the holding of the Central Government in paid-up capital should not be less than*
 - (a) *25%*
 - (b) *50 %*
 - (c) *51%*
3. *Which of the following statement is true in case of a Foreign Company?*
 - (a) *A Company incorporated in India and has place of business outside India.*
 - (b) *A Company incorporated outside India and has a place of business in India.*
 - (c) *A Company incorporated in India and has a place of business in India.*
4. *Which of the following statements is not a feature of a private company?*
 - (a) *Restricts the rights of members to transfer its shares.*
 - (b) *Does not restrict on the number of its members to any limit.*
 - (c) *Does not involve participation of public in general.*

5. *Under Schedule III of the Companies Act, assets and liabilities are to be disclosed based on:*
 - (a) *Current/ non-current.*
 - (b) *Financial /non-financial.*
 - (c) *Owned /not-owned.*
6. *Schedule III of the Companies Act prescribes the format and content of*
 - (a) *Balance sheet and statement of profit and loss*
 - (b) *Auditors' report.*
 - (c) *Directors' report.*
7. *A company is required to maintain its books of accounts at*
 - (a) *its registered office.*
 - (b) *its largest branch office.*
 - (c) *Managing Director's residence.*
8. *Cash flow statements are not required for*
 - (a) *Private company.*
 - (b) *One person company.*
 - (c) *Public company.*
9. *The presentation and disclosure requirements of a company are prescribed by*
 - (a) *Schedule III.*
 - (b) *Schedule II.*
 - (c) *Schedule I.*
10. *Following is an example of current assets*
 - (a) *Inventories.*
 - (b) *Property, Plant & Equipment.*
 - (c) *Intangible Assets.*
11. *Earnings per share (EPS) is to be disclosed in which of the following section of the financial statements*
 - (a) *Balance Sheet.*

- (b) *Statement of Profit and Loss.*
 - (c) *Cash Flow Statements.*
12. *Following is NOT an example of a company under Companies Act, 2013*
- (a) *Small company.*
 - (b) *Private company.*
 - (c) *Large company.*

Theory Questions

1. *Explain salient features of a company in brief.*
2. *Write short note on:*
 - (i) *Foreign company.*
 - (ii) *Small company.*
 - (iii) *Company limited by guarantee.*

ANSWER/HINTS

True and False

1. False: Listed companies are those which are listed on the stock exchange. Shares of listed companies are open to general public. Every listed company is a public company but every public company is not a listed company.
2. True: Only the shares of public company are listed on stock exchange. Every listed company is a public company.
3. False: It is mandatory to incorporate a company under the Companies Act. Without such incorporation, a company cannot come into existence.
4. True: Company comes into existence through the operation of law. It is a separate entity distinct from its members.
5. False: Company is a separate legal entity created by law. Death, insolvency or change of member does not affect its existence.
6. True: Liability of shareholders is limited to the extent of the unpaid share capital. So, if shares are fully paid-up, he is subject to no further liability.
7. False: Shares of public company are freely transferable. Transferability of shares is restricted in a private limited company.

8. True: Financial statements give a true & fair view of the state of affairs of the company. Financial statements include profit and loss account, balance sheet, etc.
9. False: Schedule III Part I explains proforma of Balance Sheet.
10. False: Schedule III Part I explains proforma of Balance Sheet and Profit and Loss.
11. False: As per Section 128, every company shall prepare financial statement for every financial year which give a true and fair view of the state of the affairs of the company.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(b)	4.	(b)	5.	(a)	6.	(a)
7.	(a)	8.	(b)	9.	(a)	10.	(a)	11.	(b)	12.	(c)

Theoretical Question

1. Refer para 1.3 of this unit for salient features of a company.

2. (i) **Foreign Company**

According to Section 2 (42) of the Companies Act, 2013, "Foreign company" means any company or body corporate incorporated outside India which –

- (a) Has a place of business in India whether by itself or through an agent physically or through electronic mode; and
- (b) Conducts any business activity in India in any other manner.

- (ii) **Small Company**

Section 2(85) of the Companies Act, 2013 defines "Small company" means a company, other than a public company.

- (i) paid-up share capital of which does not exceed four crores rupees or such higher amount as may be prescribed which shall not be more than ten crore rupees; or
- (ii) turnover of which as per its last profit and loss account for the immediately preceding financial year does not exceed forty crores rupees or such higher amount as may be prescribed which shall not be more than hundred crore rupees.

Provided that nothing in this clause should apply to:

- (A) a holding company or a subsidiary company

- (B) a company registered under section 8
- (C) a company or body corporate governed by any special Act

(iii) Company limited by Guarantee

As per Section 2(21) of the Companies Act, 2013, "company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

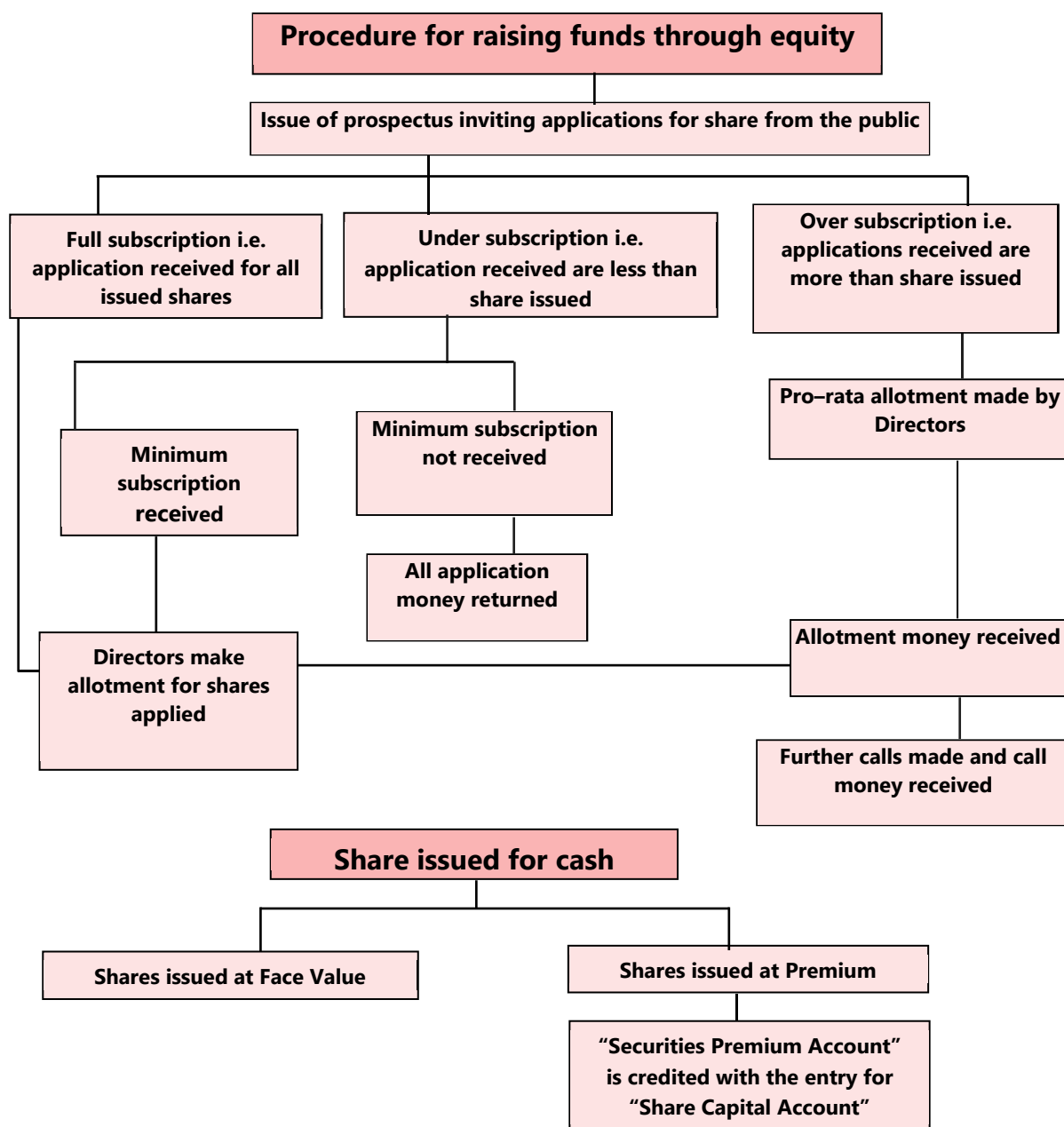
UNIT – 2 ISSUE, FORFEITURE AND RE-ISSUE OF SHARES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Appreciate various types of shares and share capital.
- ◆ Learn the accounting treatment if shares issued under different circumstances.
- ◆ Differentiate the accounting treatment for under-subscription and over-subscription of shares.
- ◆ Understand the concept and accounting treatment of call-in-arrears and call-in-advance.
- ◆ Deal with the forfeiture of shares issued with different conditions.
- ◆ Journalize the entry for re-issue of shares.
- ◆ Know the treatment of shares issued for consideration other than cash.

UNIT OVERVIEW



Note: As per Section 53 of Companies Act, 2013 a company cannot issue shares at discount except for in case of sweat equity shares and therefore any issue on discount by the company will be void with company being punishable with fine. Sweat equity shares means such equity shares as are issued by a company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

2.1 INTRODUCTION

Funds provided by the owner(s) into a business are recorded as capital. Capital of the business depends upon the form of business organisation. Proprietor provides capital in a sole-proprietorship business. In case of a partnership, there is more than one proprietor, called partners. Partners introduce capital in a partnership firm. As the maximum number of members in a partnership firm is restricted, therefore only limited capital can be provided in such form of businesses. Moreover, the liability of the proprietor(s) is unlimited in case of non-corporate business, namely, sole-proprietorship and partnership.

Capital funding process for different types of business forms can be summarised as follows:

Business Organisation	Ownership	Type of Capital	Liability of Owners
Sole - Proprietorship	Proprietor - He alone is the owner of business	Capital	Unlimited
Partnership	Partners	Partners' Capital	Unlimited
Company	Shareholders	Share Capital	Limited to issue price of shares held

With the onset of industrial revolution, requirement of capital investment soared to a new height and the attached risk of failure increased due to pace of technological developments. Non-corporate entities could not cope with the pressure of increased capital and degree of risk involved. This led to the emergence of corporate form of organisation.

2.2 SHARE CAPITAL

Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share. The fixed value of a share, printed on the share certificate, is called nominal/par/face value of a share. However, a company can issue shares at a price different from the face value of a share. The liability of holder of shares (called shareholders) is limited to the **issue price of shares** acquired by them.

Note: The issue price need not be equal to market price of the share. These days the shares are generally priced on the basis of book building process. (Book building is a process through which company determines its share prices. Under this method company determines a price band of its shares and on the basis of bids received from potential investors at various prices within the price band finally fixes its issue price.)

The total capital of the company is divided into shares, the capital of the company is called 'Share Capital'. At the time of issue of shares, every Company is required to follow SEBI Regulations.

Share capital of a company is divided into following categories:

- (i) *Authorised Share Capital or Nominal Capital:* A company estimates its maximum capital requirements. This amount of capital is mentioned in 'Capital Clause' of the 'Memorandum of Association' registered with the Registrar of Companies. It puts a limit on the amount of capital, which a company is authorised to raise during its lifetime and is called 'Authorised Capital'. It is shown in the Share Capital schedule in the financial statements as per the prescribed format at face value.
- (ii) *Issued Share Capital:* A company need not issue total authorised capital. Whatever portion of the share capital is issued by the company, it is called 'Issued Capital'. Issued capital means and includes the nominal value of shares issued by the company for:
 - 1. Cash, and
 - 2. Consideration other than cash to:
 - (i) Promoters of a company; and
 - (ii) Others.

It is also presented in the balance sheet at nominal value.

The remaining portion of the authorised capital which is not issued either in cash or consideration may be termed as '**Un-issued Capital**'. It is not shown in the balance sheet.

- (iii) *Subscribed Share Capital:* It is that part of the issued share capital, which is subscribed by the public i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.
- (iv) *Called-up Share Capital:* Companies generally receive the issue price of shares in instalments. The portion of the issue price of shares which a company has demanded or called from shareholders is known as 'Called-up Capital' and the balance, which the company has decided to demand in future may be referred to as **Uncalled Capital**.
- (v) *Paid-up Share Capital:* It is the portion of called up capital which is paid by the shareholders. Whenever a particular amount is called by the company and the shareholder(s) fails to pay the amount fully or partially, it is known as '**unpaid calls**' or '**instalments (or Calls) in Arrears**'. Thus, instalments in arrears mean the amount not paid although it has been demanded by the company as payment towards the issue price of shares. To calculate paid-up capital, the amount of instalments in arrears is deducted from called up capital.

Call-in-advance is that portion of capital which is yet to be called by the company but has already been paid by shareholder.

In the financial statements, called-up and paid-up capital are shown together.

- (vi) *Reserve Share Capital:* As per Section 65 of the Companies Act, 2013, a Company may decide by passing a resolution that a certain portion of its subscribed uncalled capital shall not be called up except in the event of winding up of the company. Portion of the uncalled capital which a company has decided to call only in case of liquidation of the company is called Reserve Capital.

Reserve Capital is different from Capital reserve, Capital reserves are part of 'Reserves and Surplus' and refer to those reserves which are not available for declaration of dividend. Thus, reserve capital which is portion of the uncalled capital to be called up in the event of winding up of the company is entirely different in nature from capital reserve which is created out of capital profits only.

1. Authorised Capital = Issued Capital + Unissued Capital.
2. Subscribed Capital can be equal to or greater than or less than Issued Capital resulting in 3 situations respectively: Fully Subscribed; Over Subscribed and Under Subscribed.
3. Called up Capital = Paid up Capital + Calls in arrears if any – Calls in advance if any.

ILLUSTRATION 1

A company had an authorised capital of ₹ 10,00,000 divided into 1,00,000 equity shares of ₹ 10 each. It decided to issue 60,000 shares for subscription and received applications for 70,000 shares. It allotted 60,000 shares and rejected remaining applications. Upto 31-3-2022, it has demanded or called ₹ 9 per share. All shareholders have duly paid the amount called, except one shareholder, holding 5,000 shares who has paid only ₹ 7 per share.

Prepare a balance sheet assuming there are no other details.

SOLUTION

Balance Sheet as at 31st March, 2022

Particulars	Notes No.	₹
EQUITY AND LIABILITIES		
Shareholders' funds		
Share capital	1	5,30,000
Total		5,30,000

ASSETS		
Current assets		
Cash and cash equivalents	2	5,30,000
Total		5,30,000

Notes to accounts

		₹	₹
1. Share Capital			
Equity share capital			
Authorised share capital			
1,00,000 Equity shares of ₹ 10 each	10,00,000		
Issued share capital			
60,000 Equity shares of ₹ 10 each	6,00,000		
Subscribed share capital			
60,000 Equity shares of ₹ 10 each	6,00,000		
Called up and Paid up share capital			
60,000 Equity shares of ₹ 10 each ₹ 9 called up	5,40,000		
Less: Calls unpaid on 5,000 shares @ ₹ 2 per share	(10,000)		5,30,000
2. Cash and cash equivalents			
Balances with banks			5,30,000

It is clear from above, that details of authorised, issued and subscribed capital are given in the Notes to Accounts but are not counted. It is only the paid-up capital i.e., the portion of the issued capital subscribed by shareholders which is taken into account while totalling the liabilities side of the balance sheet.

2.3 TYPES OF SHARES

Share issued by a company can be divided into following categories :

- (i) **Preference Shares:** According to Section 43 of the Companies Act, 2013 persons holding preference shares, called preference shareholders, are assured of a preferential dividend at a fixed rate during the life of the company. They also carry a preferential right over other shareholders to be paid first in case of winding up of the company. Thus, they enjoy preferential rights in the matter of:
- Payment of dividend, and
 - Repayment of capital

Generally, holders of these shares do not get voting rights. Companies use this mode of financing as it is cheaper than raising debt. Dividend is generally cumulative in nature and need not be paid every year in case of deficiency of profits. The Companies Act, 2013 prohibits the issue of any preference share which is irredeemable. Preference shares are cumulative and non-participating unless expressly stated otherwise.

Types of Preference Shares

Preference shares can be of various types, which are as follows :

- (a) **Cumulative Preference Shares:** A cumulative preference share is one that carries the right to a fixed amount of dividend or dividend at a fixed rate. Such a dividend is payable even out of future profit if current year's profits are insufficient for the purpose. This means that dividend on these shares accumulates unless it is paid in full and, therefore, the shares are called Cumulative Preference Shares. The companies are required to disclose the arrears of fixed cumulative dividends on preference shares separately in the financial statement. In case, the dividend remains in arrears for a period of not less than two years, holders of such shares will be entitled to take part and vote on every resolution on every matter in the general body meeting of the shareholders.
- (b) **Non-cumulative Preference Shares:** A non-cumulative preference share carries with it the right to a fixed amount of dividend. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires. It implies that holder of such a share is not entitled to arrears of dividend in future.
- (c) **Participating Preference Shares:** Notwithstanding the right to a fixed dividend, this category of preference share confers on the holder the right to participate in the surplus profits, if any, after the equity shareholders have been paid dividend at a stipulated rate. Similarly, in the event of winding up of the company, this type of share carries the right to receive a pre-determined proportion of surplus as well once the equity shareholders have been paid off.
- (d) **Non-participating Preference Shares:** A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares.' Unless otherwise specified, the preference shares are generally non-participating.

- (e) **Redeemable Preference Shares:** These are shares that a company may issue on the condition that the company will repay after the fixed period or even earlier at company's discretion. The repayment on these shares is called redemption and is governed by Section 55 of the Companies Act, 2013.
- (f) **Non-redeemable Preference Shares:** The preference shares, which do not carry with them the arrangement regarding redemption, are called Non-redeemable Preference Shares. According to Section 55, no company limited by shares shall issue irredeemable preference shares or preference shares redeemable after the expiry of 20 years from the date of issue. However, a Company may issue preference shares redeemable after 20 years for such infrastructure projects as may be specified, under the Companies Act, 2013.
- (g) **Convertible Preference Shares:** These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.
- (h) **Non-convertible Preference Shares:** When the holder of a preference share has not been conferred the right to get his holding converted into equity share, it is called Non-convertible Preference Shares. Preference shares are non-convertible unless otherwise stated.

Note: Unless mentioned otherwise Preference Shares are Non-Cumulative, Non Participating, Non-Convertible and Redeemable in nature.

- (ii) **Equity Shares:** Equity shares are those shares, which are not preference shares. It means that they do not enjoy any preferential rights in the matter of payment of dividend or repayment of capital. The rate of dividend on equity shares is recommended by the Board of Directors and may vary from year to year. Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders. These shares carry voting rights. Companies Act, 2013 permits issue of equity share capital with differential rights as to dividend, voting or otherwise in accordance with prescribed rules.

The shares can be issued by a company either

- (1) for cash or
- (2) for consideration other than cash.

2.4 ISSUE OF SHARES FOR CASH

To issue shares, private companies depend upon 'Private Placement' of shares. Public companies issue a 'Prospectus' and invite general public to subscribe for shares. To discuss accounting treatment, we shall concentrate on public companies who invite general public to subscribe for equity shares. Similar accounting treatment is applicable in other cases. However, for journal entries in case of issue of preference shares, the word 'Equity' is replaced with the word 'Preference'.

A public company issues a prospectus inviting general public to subscribe for its shares. On the basis of prospectus, applications are deposited in a scheduled bank by the interested parties along with the amount payable at the time of application, in cash. First instalment paid along with application is called 'Application Money'. **As per Section 39 of the Companies Act, 2013. Application money must be at least 5% of the nominal value of shares.** After the closing date of the issue (the last date for filing applications), company decides about allotment of shares in consultation with the SEBI and stock exchange concerned. According to the Companies Act, 2013, a company cannot proceed to allot shares unless minimum subscription is received by the company.

Minimum Subscription: A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company. The amount of minimum subscription to be disclosed in prospectus by the Board of Directors taking into account the following:

- (a) Preliminary expenses of the company,
- (b) Commission payable on issue of shares,
- (c) Cost of fixed assets purchased or to be purchased,
- (d) Working capital requirements of the company, and
- (e) Any other expenditure for the day to day operation of the business.

As per guidelines of the Securities Exchange Board of India (SEBI), the minimum subscription to be received in an issue shall not be less than ninety per cent of the offer through offer document [Provided that in the case of an initial public offer, the minimum subscription to be received shall be subject to allotment of minimum number of specified securities, as prescribed by Securities Contracts (Regulation) Rules, 1957]. If the Company does not receive the minimum subscription of 90% of the issue, all application moneys received shall be refunded to the applicants forthwith, but not later than:

- (a) fifteen days of the closure of the issue, in case of a non-underwritten issue; and

- (b) seventy days of the closure of the issue, in the case of an underwritten issue where minimum subscription including devolvement obligations paid by the underwriters is not received within sixty days of the closure of the issue.

The company reserves the right to reject or accept an application fully or partially. Successful applicants become shareholders of the company and are required to pay the second instalment which is known as 'Allotment Money' and unsuccessful applicants get back their money. However, in case of delay in refunding the money, the Company becomes liable to pay interest on the amount of refund. Subsequent instalments, if any, to be called by the company are known as 'Calls'.

As per Section 39 of the Companies Act, 2013, application money must be at least 5% of the face value of shares. However, as per SEBI Regulations, the minimum application moneys to be paid by an applicant along with the application money shall not be less than 25% of the issue price. According to Section 24 of the Companies Act, 2013 matters related to issue and transfer of securities will be administered by the SEBI and not by the Company Law Board.

The issue price of shares is generally received by the company in instalments and these instalments are known as under :

First instalment		Application Money
Second Instalment		Allotment Money
Third Instalment		First Call Money
Fourth Instalment		Second Call Money and so on.
Last Instalment		Final Call Money

2.4.1 Journal Entries for Issue of Shares for Cash

Upon the issue of share capital by a company, the undermentioned entries are made in the financial books:

- (1) On receipt of the application money

Bank Account Dr. (With the actual amount received.)

To Share Application Account

(Being application money received)

- (2) On allotment of share

Share Allotment Account Dr. (With the amount due on allotment.)

Share Application Account Dr. (With the application amount received on allotted shares.)

To Share Capital Account

(With the amount due on allotment and application.)

(Being the sum due on allotment and application money transferred to capital account)

- (3) On receipt of allotment money

Bank Account

Dr. (With the amount actually received on allotment.)

To Share Allotment A/c

(Being money received on allotment)

Sometimes separate Application and Allotment Accounts are not prepared and entries relating to application and allotment monies are passed through a combined Application and Allotment Account.

On receipt of Application Money:

Bank A/c

Dr

To Share Application and Allotment A/c

On allotment of shares:

Share Application & Allotment A/c

Dr (With total application and allotment amount)

To Share Capital A/c

On Allotment money being received:

Bank A/c

Dr

To Share Application & Allotment A/c

- (4) On a call being made

Share Call Account

Dr. (With the amount due on the call)

To Share Capital Account

(Being share call made due at ₹...)

- (5) On receipt of call money

Bank Account

Dr. (With the due amount actually received on call)

To Share Call Account

(Being share call money received)



2.5 SUBSCRIPTION OF SHARES

Accounting for issue of shares depends upon the type of subscription. Whenever a company decides to issue shares to public, it invites applications for subscription by issuing a prospectus. It is not necessary that company receives applications for the number of shares to be issued by it. There are three possibilities:

2.5.1 Full Subscription

Issue is fully subscribed if the number of shares offered for subscription and the number of shares actually subscribed by the public are same. To start discussion on accounting treatment for issue of shares, let us assume that the issue is fully subscribed.

ILLUSTRATION 2

A company invited applications for 10,000 equity shares of ₹ 50 each payable on application ₹ 15, on Allotment ₹ 20, on first and final call ₹ 15. Applications are received for 10,000 shares and all the applicants are allotted the number of shares they have applied for and instalment money was duly received by the company. Show Journal entries in the books of the company.

SOLUTION

Journal entries in the books of a company

For application money received: Amount received along with application is accounted as follows:

Bank A/c	Dr.	(Application money on allotted share i.e., $10,000 \times ₹ 15 = ₹ 1,50,000$)

To Equity Share Application A/c

At the time of allotment: Application money received from successful applicants become part of share capital and is transferred to share capital as under:

Equity Share Application A/c	Dr.	(Application money on allotted share i.e., $10,000 \times ₹ 15 = ₹ 1,50,000$)

To Equity Share Capital A/c

To record amount due on allotment: When the decision is taken to allot shares, allotment money on allotted shares falls due and is recorded as follows:

Equity Share Allotment A/c	Dr.	(Allotment money due at the allotted share i.e., $10,000 \times ₹ 20 = ₹ 2,00,000$)

To Equity Share Capital A/c

Bank A/c	Dr.	(Allotment money received from shareholders i.e. $10,000 \times ₹ 20 = ₹ 2,00,000$)

When decision to demand first call is made: After allotment of share, when the Board of Directors decide to demand the next instalment from shareholders, first call money falls due and is accounted for, as under:

To Equity Share Capital A/c

Bank A/c Dr. (Amount actually received on account of first call i.e., ₹ 10,000 × ₹ 15 = ₹ 1,50,000)

2.5.2 Under Subscription

ILLUSTRATION 3

₹ 20 on application;

₹ 30 on allotment;

₹ 25 on 1st October, 2021; and

₹ 25 on 1st February, 2022.

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SOLUTION

A Ltd.

Journal

2021		₹	₹
May 20	Bank Account Dr. To Share Application A/c (Application money on 40,000 shares at ₹ 20 per share received.)	8,00,000	8,00,000
June 1	Share Application A/c Dr. To Share Capital A/c (The amount transferred to Capital Account on 40,000 shares at - ₹ 20 on application. Directors' resolution no..... dated)	8,00,000	8,00,000
	Share Allotment A/c Dr. To Share Capital A/c (Being share allotment made due at ₹ 30 per share. Directors' resolution no..... dated)	12,00,000	12,00,000
July 15	Bank Account Dr. To Share Allotment A/c (The sums due on allotment received.)	12,00,000	12,00,000
Oct. 1	Share First Call Account Dr. To Share Capital Account (Amount due from members in respect of first call-on 40,000 shares at ₹ 25 as per Directors, resolution no... dated...)	10,00,000	10,00,000
Oct. 20	Bank Account Dr. To Share First Call Account (Receipt of the amounts due on first call.)	10,00,000	10,00,000
2022 Feb. 1	Share Second and Final Call A/c Dr. To Share Capital A/c (Amount due on 40,000 share at ₹ 25 per share on second and final call, as per Directors resolution no... dated...)	10,00,000	10,00,000

2.5.3 Over Subscription

(1) On refund of application money to applicants to whom shares have not been allotted:

To Bank Account

(2) When only a part of shares applied for are allotted.

To Share Allotment* A/c

To Share Calls-in-Advance* A/c

To Bank A/c

(Being application money adjusted)

*Credited to Share Capital A/c subsequently.

ILLUSTRATION 4

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SOLUTION**Pant Ltd.****Journal**

		₹	₹
Bank A/c	Dr.	12,00,000	
To Equity Share Application A/c			12,00,000
(Being the application money received for 60,000 shares at ₹ 20 per share)			
Equity Share Application A/c	Dr.	12,00,000	
To Equity Share Capital A/c			10,00,000
To Bank A/c			2,00,000
(Being share allotment made for 50,000 shares and excess refunded.)			
Equity Share Allotment A/c	Dr.	5,00,000	
To Equity Share Capital A/c			5,00,000
(Being allotment amount due on 50,000 equity shares at ₹ 10 per share as per Directors' resolution no... dated...)			
Bank A/c	Dr.	4,50,000	
Calls in Arrears A/c	Dr.	50,000	
To Equity Share Allotment A/c			5,00,000
(Being allotment money received for 45,000 shares at ₹ 10 per share.)			

ILLUSTRATION 5

The Delhi Artware Ltd. issued 50,000 equity shares of ₹ 100 each and 1,00,000 preference shares of ₹ 100 each. The Share Capital was to be collected as under:

	Equity Shares (₹)	Preference Shares (₹)
On Application	25	20
On Allotment	20	30
First Call	30	20
Final Call	25	30

All these shares were subscribed. Final call was received on 42,000 equity shares and 88,000 preference shares. Prepare the cash book and journalise the remaining transactions in the books of the company.

SOLUTION**Delhi Artware Ltd.****Cash Book**

Dr.		₹		Cr.
To	Equity Shares Applications Account (application money on 50,000 shares at ₹ 25)	12,50,000	By Balance c/d	14,440,000
To	Preference Share Application A/c (application money on 1,00,000 shares at ₹ 20)	20,00,000		
To	Equity Share Allotment A/c (allotment money on 50,000 shares at ₹ 20)	10,00,000		
To	Preference Share Allotment A/c (allotment money on 1,00,000 shares at ₹ 30)	30,00,000		
To	Equity Shares First Call A/c (₹ 30 on 50,000 shares)	15,00,000		
To	Preference Share First Call A/c (₹ 20 on 1,00,000 shares)	20,00,000		
To	Equity Shares Final Call A/c (₹ 25 on 42,000 shares)	10,50,000		
To	Preference Share Final A/c (₹ 30 on 88,000 shares)	26,40,000		
		14,440,000		14,440,000
To	Balance b/d	14,440,000		

Journal

		₹	₹
Equity Share Application A/c	Dr.	12,50,000	
Equity Share Allotment A/c	Dr.	10,00,000	
To Equity Share Capital A/c			22,50,000
[The Credit to share capital on allotment of 50,000 equity shares at ₹ 45 per share (₹ 25 on application and ₹ 20 on allotment) allotted as per Directors resolution no.... dated.....]			
Preference Share Application A/c	Dr.	20,00,000	
Preference Share Allotment A/c	Dr.	30,00,000	
To Preference Share Capital A/c			50,00,000
[The credit to Preference Share Capital on allotment of 1,00,000 preference shares at ₹ 50 per share (₹ 20 on application and ₹ 30 on allotment), allotted as per Directors' resolution no... dated...]			
Equity Share First Call A/c	Dr.	15,00,000	
To Equity Share Capital A/c			15,00,000
(Amount due on 50,000 equity shares at ₹ 30 per share as per Directors' resolution no... dated...)			
Preference Share First Call A/c	Dr.	20,00,000	
To Preference Share Capital A/c			20,00,000
(Amount due on 1,00,000 preference shares at ₹ 20 per share, as per Directors' resolution no...dated...)			
Equity Share Final Call A/c	Dr.	12,50,000	
To Equity Share Capital A/c			12,50,000
(Amount due on final call on 50,000 equity shares at ₹ 25 per share, as per Directors' resolution no... dated...)			
Preference Share Final Call A/c	Dr.	30,00,000	
To Preference Share Capital A/c			30,00,000
(Amount due on final call on 1,00,000 preference shares at ₹ 30 per share, as per Directors' resolution no... dated...)			

Note: Students may note that cash transactions have not been journalised as these have been entered in the Cash Book.

2.6 SHARES ISSUED AT DISCOUNT

Shares are regarded to be issued at a discount, if issue is at an amount less than the nominal or par value of shares. The excess of the nominal value over the issue price represents discount on the issue of shares. For example, when a share of the nominal value of ₹ 100 is issued at ₹ 98, it is said to have been issued at a discount of 2 per cent.

According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus, any issue of shares at discount shall be void.

2.7 SHARES ISSUED AT PREMIUM

When a company issues its securities at a price more than the face value, it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security. It is quite common for the financially strong, and well-managed companies to issue their shares at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, where a share of the nominal value of ₹ 100 is issued at ₹ 105, it is said to have been issued at a premium of 5 per cent.

When the issue is at a premium, the amount of premium may technically be called at any stage of share capital transactions. However, premium is generally called with the amount due on allotment, sometimes with the application of money and rarely with the call money.

2.7.1 Accounting Treatment

When shares are issued at a premium, the premium amount is credited to a separate account called "*Securities Premium Account*" because it is not a part of share capital. Rather, it represents a gain of a capital nature to the company.

Being a credit balance, Securities premium Account is shown under the heading, "Reserves and Surplus". However, 'Reserves and Surplus' is shown as 'shareholders' funds in the Balance Sheet as per Schedule III. According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company:

- (a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities.
- (b) To write off preliminary expenses of the company.
- (c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.

- (d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.
- (e) For the purchase of own shares or other securities.

Note : It may be noted that certain class of Companies as prescribed under Section 133 of the Companies Act, 2013, whose financial statements comply with the accounting standards prescribed for them (i.e. those companies to whom Indian Accounting Standards are applicable), can't apply the securities premium account for the purposes (b) and (d) mentioned above.

When shares are issued at a premium, the journal entries are as follows:

(a) Premium amount called with Application money

(i) Bank A/c To Share Application A/c (Money received on applications For Shares @ ₹_____ per share including premium)	Dr. [Total Application money + Premium Amount] [Amount received]
(ii) Share Application A/c To Securities Premium A/c To Share Capital A/c	Dr. [No. of Shares Applied for x Application Amount per share] [No. of Shares allotted x Premium Amount per share] [No. of Shares allotted x Nominal value per share for capital]

(b) Premium Amount called with Allotment Money

(i) Share Allotment A/c To Share Capital A/c To Securities Premium A/c (Amount due on allotment of shares @ ₹___ per share including premium)	Dr. [No. of Shares Allotted x Allotment and Premium Money per share] [No. of Shares Allotted x Allotment Amount per share] [No. of Share Allotted x Premium Amount per share]

- (ii) Bank A/c Dr.
 To Share Allotment A/c
 (Money received including premium
 consequent upon allotment).

ILLUSTRATION 6

On 1st October, 2022 Pioneer Equipment Limited received applications for 2,50,000 Equity Shares of ₹ 100 each to be issued at a premium of 25 per cent payable as :

On Application ₹ 25

On Allotment ₹ 75 (including premium)

Balance Amount on Shares As and when required

The shares were allotted by the Company on October 20, 2022 and the allotment money was duly received on October 31, 2022.

Record journal entries in the books of the company to record the transactions in connection with the issue of shares.

SOLUTION**Pioneer Equipment Limited****Journal**

Date	Particulars	L.F.	Debit Amount	Credit Amount
2022			(₹000)	(₹000)
Oct. 1	Bank A/c Dr. To Equity Share Application A/c (Money received on applications for 2,50,000 shares @ ₹ 25 per share)		6,250	6,250
Oct. 20	Equity Share Application A/c Dr. To Equity Share Capital A/c (Transfer of application money on allotment to share capital)		6,250	6,250
Oct. 20	Equity Share Allotment A/c Dr. To Equity Share Capital A/c		18,750	12,500

Oct. 31	To Securities Premium A/c (Amount due on allotment of 2,50,000 shares @ ₹ 75 per share including premium)			6,250
	Bank A/c	Dr.	18,750	
	To Equity Share Allotment A/c (Money received including premium consequent upon allotment)			18,750

Note: Bifurcation of Allotment amount

$$\begin{aligned}\text{Security premium per share} &= 25\% \times ₹100 \\ &= ₹ 25\end{aligned}$$

$$\text{Money received on allotment per share} = ₹ 75$$

	Premium	Capital
Per Share (75)	₹ 25	₹ 50
No. of Shares (in '000)	250	250
Total Amount (In '000)	₹ 6,250	₹12,500

2.8 OVER SUBSCRIPTION AND PRO-RATA ALLOTMENT

Over subscription is the application money received for more than the number of shares offered to the public by a company. It usually occurs in the case of good issues and depends on many other factors like investors' confidence in the company, general economic conditions, pricing of the issue etc. When the shares are oversubscribed, the company cannot satisfy all the applicants. It means that a decision is to be made on how the shares are going to be allotted. Shares can be allotted to the applicants by a company in any manner it thinks proper. The company may reject some applicants in full, i.e., no shares are allotted to some applicants and application money is refunded. Usually, multiple applications by the same persons are not considered. Allotment may be given to the rest of the applicants in full, i.e., for the number of shares they have applied for. A third alternative is that a company may allot shares to the applicants on **pro-rata** basis. 'Pro-rata allotment' means allotment in proportion of shares applied for.

For example, a company offers to the public 10,000 shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis,

applicants for 12,000 shares are to be allotted 10,000 shares, i.e., on the 12,000: 10,000 or 6:5 ratio. Any applicant who has applied for 6 shares will be allotted 5 shares.

Under pro-rata allotment, the excess application money received is adjusted against the amount due on allotment or calls. Surplus money after making adjustment against future calls is returned to the applicants. The applicants are informed about the allotment procedure through an advertisement in leading newspapers.

When there is a pro-rata allotment, the total application money paid by an applicant is more than the exact amount due on application. The excess amount is treated as an advance against allotment or any other future calls. The net amount due on allotment or any other calls is the difference between the amount due on allotment or any other calls and the excess amount received in application.

Accounting Entries

- (a) *For rejected applications:*

Share Application Account	Dr.
To Bank Account	

(Being application money refunded for rejected applications as per Board's Resolution No....dated....)

- (b) *For pro-rata allotment:*

Share Application Account	Dr.
To Share Allotment Account	

(Being excess application money adjusted against allotment money as per Board's Resolution No....dated....)

Illustration 7

JHP Limited is a company with an authorised share capital of ₹10,00,000 in equity shares of ₹10 each, of which 6,00,000 shares had been issued and fully paid on 30th June, 2021. The company proposed to make a further issue of 1,00,000 of these ₹10 shares at a price of ₹14 each, the arrangements for payment being:

- (a) *₹ 2 per share payable on application, to be received by 1st July, 2021;*
- (b) *Allotment to be made on 10th July, 2021 and a further ₹ 5 per share (including the premium) to be payable;*
- (c) *The final call for the balance to be made, and the money received by 30th April, 2022.*

Applications were received for 3,55,000 shares and were dealt with as follows:

- (i) Applicants for 5,000 shares received allotment in full;
- (ii) Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment;
- (iii) Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and
- (iv) the money due on final call was received on the due date.

You are required to record these transactions (including cash items) in the Journal of JHP Limited.

SOLUTION

Journal of JHP Limited

Date		₹	₹
2021	Particulars		
July 1	Bank A/c (Note 1 – Column 3) Dr. To Equity Share Application A/c (Being application money received on 3,55,000 shares @ ₹ 2 per share)	7,10,000	7,10,000
July 10	Equity Share Application A/c Dr. To Equity Share Capital A/c To Equity Share Allotment A/c (Note 1 Column 5) To Bank A/c (Note 1 – Column 6) (Being application money on 1,00,000 shares transferred to Equity Share Capital Account; on 2,15,000 shares adjusted with allotment and on 40,000 shares refunded as per Board's Resolution No.....dated...)	7,10,000	2,00,000 4,30,000 80,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c	5,00,000	1,00,000

2022	To Securities Premium a/c (Being allotment money due on 1,00,000 shares @ ₹ 5 each including premium at ₹4 each as per Board's Resolution No....dated....)		4,00,000
	Bank A/c (Note 1 – Column 8) Dr.	70,000	
	To Equity Share Allotment A/c (Being balance allotment money received)		70,000
	Equity Share Final Call A/c Dr.	7,00,000	
April 30	To Equity Share Capital A/c (Being final call money due on 1,00,000 shares @ ₹ 7 per share as per Board's Resolution No.....dated....)		7,00,000
	Bank A/c Dr.	7,00,000	
	To Equity Share Final Call A/c (Being final call money on 1,00,000 shares @ ₹ 7 each received)		7,00,000

Working Notes:**Calculation for Adjustment and Refund**

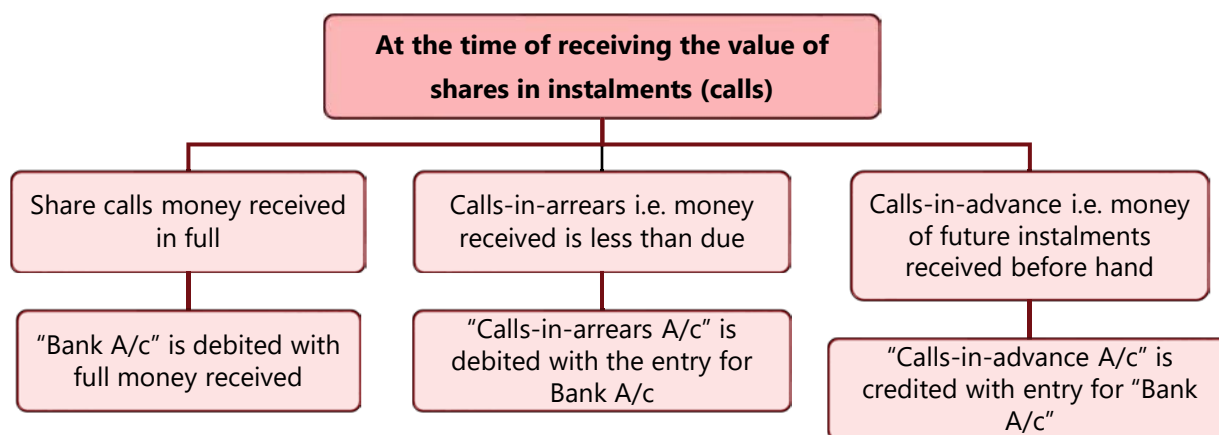
Category	No. of Shares Applied for	No. of Shares Allotted	Amount Received on Application	Amount Required on Application	Amount adjusted on Allotment	Refund [3 - 4 + 5]	Amount due on Allotment	Amount received on Allotment
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(i)	5,000	5,000	10,000	10,000	Nil	Nil	25,000	25,000
(ii)	30,000	15,000	60,000	30,000	30,000	Nil	75,000	45,000
(iii)	3,20,000	80,000	6,40,000	1,60,000	4,00,000	80,000	4,00,000	Nil
TOTAL	3,55,000	1,00,000	7,10,000	2,00,000	4,30,000	80,000	5,00,000	70,000

Also,

- (i) Amount Received on Application (3) = No. of shares applied for (1) x ₹ 2
- (ii) Amount Required on Application (4) = No. of shares allotted (2) x ₹ 2



2.9 CALLS-IN-ARREARS AND CALLS-IN-ADVANCE



Calls-in-Arrears

Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as *Calls-in-Arrears* or *Unpaid Calls*. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

For recording 'Calls-in-Arrears', the following journal entry is recorded :

Calls-in-Arrears A/c	Dr.	[Amount of Unpaid Calls]
Bank A/c	Dr.	[Amount received]
To Share Allotment A/c		[Total allotment money due]
To Share Calls A/c		[Total Call money due]

(Being call money/ allotment money received on shares at ₹.... per share.)

Calls-in-Advance

Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as Calls-in-advance. According to Table F, interest at a rate not exceeding 12 per cent p.a. is to be paid on such advance call money. This amount is credited in Calls-in-Advance Account. The following entry is recorded:

Bank A/c	Dr.	[Call amount received in advance]
To Call-in-Advance A/c		

When calls become actually due, calls-in-advance account is adjusted at the time of the call. For this the following journal entry is recorded:

Calls-in-Advance A/c	Dr.	[Call amount received in advance]

Bank A/c Dr. [Remaining call money received, if any]
 To Particular Call A/c [Call money due]
 (Being call in advance adjusted and call money due received)

ILLUSTRATION 8

Shreyas Ltd. did not receive the first call on 10,000 equity shares @ ₹ 3 per share which was due on 1.7.2021. This amount was received on 1.4.2022.

Open Calls in arrears account and journalise the entries in the books of the company on 1.7.2021 and 1.4.2022.

SOLUTION**Shreyas Ltd****Journal**

Date	Particulars	L.F.	Amount Dr.	Amount Cr.
1.7.2021	Calls in Arrears A/c Dr. To Equity Share First Call A/c (Being amount due on first call on 10,000 shares at ₹3 per share transferred to calls in arrears account)		30,000	30,000
1.4.2022	Bank A/c Dr. To Calls in Arrears A/c (Being calls in arrears received)		30,000	30,000

2.10 INTEREST ON CALLS-IN-ARREARS AND CALLS-IN-ADVANCE

Interest on calls in arrears is recoverable and that in respect of calls in advance is payable, according to provisions in this regard in the articles of the company, at the rates mentioned therein or those to be fixed by the directors, within the limits prescribed by the Articles. Table F prescribes 10% and 12% p.a. as the maximum rates respectively for calls in arrears and those in advance.

Interest on Calls in Arrears	Interest on Calls in Advance
It is payable by shareholders to company on the calls due but remaining unpaid.	It is payable by the Company to Shareholders on the call money received in advance but not yet due.

As per Table F maximum prescribed rate is 10%. Period considered : From the date call money was due to the date money is finally received. Directors have a right to waive off such interest in individual cases at their own discretion. It is a nominal account in nature and is credited to statement of profit and loss as an income.	As per Table F maximum prescribed rate is 12%. Period considered: From the date money was received to the day call was finally made due. Shareholders are not entitled for any dividend on calls in advance. It is a nominal account in nature with interest being an expense for the company.

The book entries to be passed for the adjustment of such interest are much the same as those in case of temporary borrowings or loans raised, the only difference being that debits are raised and credits are given to Sundry Members Account (and not the individual accounts of shareholders) in respect of interest recoverable on calls in arrear or that payable on call received in advance, the corresponding entries being made in the Interest Receivable on Calls in Arrears and Interest Payable on Calls in Advance, respectively.

The journal entries for calls-in-arrears are as follows :

- (i) For interest receivable on calls-in-arrears
- | | |
|-------------------------------------|-----|
| Shareholders' A/c | Dr. |
| To Interest on calls-in-arrears A/c | |
- (Being interest on calls in arrears at the rate of ...% made due)
- (ii) For receipt of interest
- | | |
|----------------------|-----|
| Bank A/c | Dr. |
| To Shareholders' A/c | |
- (Being interest money received)

The accounting treatment of interest on Calls-in-Advance is as follows:

- (i) Interest Due
- | | | |
|----------------------------------|-----|--------------------------------------|
| Interest on Calls-in-Advance A/c | Dr. | [Amount of interest due for payment] |
| To Shareholder's A/c | | |
- (Being interest on calls in advance made due)

(ii) Payment of Interest

Shareholder's A/c

Dr. [Amount of interest paid]

To Bank A/c

(Being interest paid on calls-in-advance)

ILLUSTRATION 9

Rashmi Limited issued at par 1,00,000 Equity shares of ₹10 each payable ₹2.50 on application; ₹3 on allotment; ₹2 on first call and balance on the final call. All the shares were fully subscribed. Mr. Nair who held 10,000 shares paid full remaining amount on first call itself. The final call which was made after 3 months from first call was fully paid except a shareholder having 1000 shares who paid his due amount after 2 months along with interest on calls in arrears. Company also paid interest on calls in advance to Mr. Nair. Give journal entries to record these transactions.

SOLUTION

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Equity Share Application A/c (Money received on applications for 1,00,000 shares @ ₹ 2.50 per share)		2,50,000	2,50,000
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Transfer of application money on 1,00,000 shares to share capital)		2,50,000	2,50,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Amount due on the allotment of 1,00,000 shares @ ₹ 3 per share)		3,00,000	3,00,000
	Bank A/c Dr. To Equity Share Allotment A/c (Allotment money received)		3,00,000	3,00,000

Equity Share First Call A/c	Dr.	2,00,000	
To Equity Share Capital A/c			2,00,000
(Being first call made due on 1,00,000 shares at ₹ 2 per share)			
Bank A/c	Dr.	2,25,000	
To Equity Share First Call A/c			2,00,000
To Calls in Advance A/c			25,000
(Being first call money received along with calls in advance on 10,000 shares at ₹ 2.50 per share)			
Equity Share Final Call A/c	Dr.	2,50,000	
To Equity Share Capital A/c			2,50,000
(Being final call made due on 1,00,000 shares at ₹ 2.50 each)			
Bank A/c	Dr.	2,22,500	
Calls in Advance A/c	Dr.	25,000	
Calls in Arrears A/c	Dr.	2,500	
To Equity Share Final Call A/c			2,50,000
(Being final call received for 89,000 shares and calls in advance for 10,000 shares adjusted)			
Interest on Calls in Advance A/c	Dr.	750	
To Shareholders A/c			750
(Being interest made due on calls in advance of ₹25,000 at the rate of 12% p.a.)			
Shareholders A/c	Dr.	750	
To Bank A/c			750
(Being payment of interest made to shareholder)			

Shareholders A/c	Dr.	41.67	
To Interest on Calls in Arrears A/c			41.67
(Being interest on calls in arrears made due at the rate of 10%)			
Bank A/c	Dr.	2,541.67	
To Calls in Arrears A/c			2,500
To Shareholders A/c			41.67
(Being money received from shareholder for calls in arrears and interest thereupon)			

2.11 FORFEITURE OF SHARES

The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money results in forfeiture of shares. Forfeiture of shares is the action taken by a company to cancel the shares. The directors are usually empowered by the Articles of Association to forfeit those shares by serving proper notice to the defaulting shareholder(s). When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him. The shareholder then has no further claim on the company. The power of forfeiture must be exercised strictly having regard to the rules and regulations provided in the Articles of Association and it should be bonafide in the interests of the company.

The Articles of a company usually authorise the Directors to forfeit shares of a member on account of non-payment of a call or interest thereon after serving him a prior notice as prescribed by the Articles. Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.

Accounting Entries

At the time of passing entry for forfeiture of shares, students must be careful about the following matters:

- (i) Amount called-up (i.e., amount credited to capital) in respect of forfeited shares.
- (ii) Amount already received in respect of those shares.
- (iii) Amount due but has not been received in respect of those shares.

We know that shares can be issued at par or at a premium. Accounting entries for forfeiture will vary according to situations.

2.11.1 Forfeiture of Shares which were issued at Par

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. Allotment or Calls Account will be credited with the amount due but not paid by the shareholder(s). (Alternatively, Calls-in-Arrears Account can be credited for all amount due, if it was transferred to Calls-in-Arrears Account). Forfeited Shares Account or Shares Forfeiture Account will be credited with the amount already received in respect of those shares.

Share Capital Account	Dr.	[No. of shares x called-up value per share]
To Forfeited Shares Account		[Amount already received on forfeited shares]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]

Where all amounts due on allotment, first call and final call have been transferred to Calls-in-Arrears Account, the entry will be :

Share Capital Account	Dr.	[No. of shares x called-up value per share]
To Calls-in-Arrears Account		[Total amount due, but not paid]
To Forfeited Shares Account		[Amount received]

ILLUSTRATION 10

A Ltd forfeited 30,000 equity shares of ₹ 10 fully called-up, held by Mr. X for non-payment of final call @ ₹ 4 each. However, he paid application money @ ₹ 2 per share and allotment money @ ₹ 4 per share. These shares were originally issued at par. Give Journal Entry for the forfeiture.

SOLUTION

In the books of A Ltd.

Journal

Date	Particulars	₹	₹
	Equity Share Capital A/c (30,000 x ₹ 10) Dr.	3,00,000	
	To Equity Share Final Call A/c (30,000 x ₹ 4)		1,20,000
	To Forfeited Shares A/c (30,000 x ₹ 6)		1,80,000
	(Being the forfeiture of 30,000 equity shares of ₹ 10 each fully called-up for non-payment of final call money @ ₹ 4 each as per Board's Resolution No.... dated....)		

ILLUSTRATION 11

X Ltd forfeited 20,000 equity shares of ₹ 10 each, ₹ 8 called-up, for non-payment of first call money @ ₹ 2 each. Application money @ ₹ 2 per share and allotment money @ ₹ 4 per share have already been received by the company. Give Journal Entry for the forfeiture (assume that all money due is transferred to Calls-in-Arrears Account).

SOLUTION

In the books of X Ltd

Journal

Date	Particulars	₹	₹
	Equity Share Capital A/c (20,000 x ₹ 8) Dr.	1,60,000	
	To Calls-in-Arrears A/c (20,000 x ₹ 2)		40,000
	To Forfeited Shares A/c (20,000 x ₹ 6)		1,20,000
	(Being the forfeiture of 20,000 equity shares of ₹ 10 each, ₹ 8 called-up for non-payment of first call money @ ₹ 2 each as per Board's Resolution No.....dated.....)		

2.11.2 Forfeiture of Shares which were issued at a Premium

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. If the premium on such shares has not been paid by the shareholder, the Securities Premium Account will be debited to cancel it (if it was credited earlier). Allotment, Calls and Forfeited Accounts will be credited in the usual manner.

If the premium has already received by the company, it cannot be cancelled even if the shares are forfeited in the future.

If premium not received

Share Capital A/c	Dr.	[Called-up value]
Securities Premium A/c	Dr.	[Amount of Security premium not received]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

If premium received

Share Capital A/c	Dr.	[Called-up value]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

ILLUSTRATION 12

X Ltd. forfeited 5,000 equity shares of ₹ 100 each fully called-up which were issued at a premium of 20%. Amount payable on shares were: on application ₹ 20; on allotment ₹ 50 (including premium); on First and Final call ₹ 50. Only application money was paid by the shareholders in respect of these shares. Pass Journal Entries for the forfeiture.

SOLUTION**In the books of X Ltd.****Journal**

Date	Particulars		₹	₹
	Equity Share Capital A/c (5,000 x ₹ 100)	Dr.	5,00,000	
	Securities Premium A/c (See Note)	Dr.	1,00,000	
	To Equity Share Allotment A/c (5,000 x ₹ 50)			2,50,000
	To Equity Share First and Final Call A/c (5000 x ₹ 50)			2,50,000
	To Forfeited Shares A/c (5000 x ₹ 20)			1,00,000
	(Being the forfeiture of 5,000 equity shares of ₹ 100 each fully called-up, issued at a premium of 20%, for non-payment of allotment and call money as per Board's Resolution No.....dated....)			

Tutorial Note: Share premium @ ₹ 20 on 5,000 shares has not been received by the company. Therefore, at the time of forfeiture, Securities Premium Account will be debited to cancel it (because Securities Premium Account was credited at the time of allotment).

Also, in case of pro-rata allotment where shares are issued at premium, the excess money received on application will be first adjusted to capital account and then for securities premium.

ILLUSTRATION 13

Mr. Shami has applied for 1,000 shares of Company XYZ Ltd. paying application money @ ₹ 2 per share but has been allotted only 600 shares. The shares have a face value of ₹ 10 and a premium of ₹ 2 per share, which are payable as: on Allotment- ₹ 5 (including premium) and on final call ₹ 5. Now in case Mr. Shami doesn't pay allotment money and final call and his shares are forfeited, then following entry will be passed on forfeiture:

SOLUTION

Share Capital A/c (600 x ₹ 10)	Dr.	6,000	
Securities Premium A/c (600 x ₹ 2)	Dr.	1,200	
To Share Forfeiture A/c			2,000
To Share Allotment A/c			2,200
To Share Final Call A/c (600 x 5)			3,000
(Being 600 shares forfeited due to non-payment of allotment money and call money as per Board Resolution no..... dated.....)			

Note:

Total Amount Received on application (1,000 x 2)	2,000
Less: Amount used for application money (600 x 2)	(1,200)
Excess money received on application	800
Amount due on Allotment (600 x 5)	3,000
For premium (600 x 2)	1,200
For Capital A/c (600 x 3)	1,800
Thus amount not received on allotment (3,000 - 800)	2,200

	For Premium A/c	For Capital A/c
Amount not received on allotment (2,200)	₹ 1,200	₹ 1,000

2.11.3 Forfeiture of Fully Paid-Up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specifically provide it.

A pie chart with a dashed outer circle. The chart is divided into two segments: a larger pink segment representing 67% and a smaller grey segment representing 33%.

A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale.

The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrear on those shares.

Accounting Entries :

(a) Bank Account Dr. [Actual amount received]
Forfeited Shares Account Dr. [Loss on re-issue]
To Share Capital Account
(Being the re-issue of....shares @ ₹ each as per Board's Resolution No.... dated.)

(b) Forfeited Shares Account Dr.
To Capital Reserve Account
(Being the profit on re-issue, transferred to capital reserve).

2.12.1 Points for Consideration

In connection with re-issue, the following points are important:

1. Loss on re-issue should not exceed the forfeited amount.
2. If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.
3. The forfeited amount on shares (amount originally paid-up) not yet reissued should be shown under the heading 'share capital.'
4. When only a portion of the forfeited shares are re-issued, then the profit made on re-issue of such portion of shares only must be transferred to Capital Reserve.
5. When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".
6. If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.

7. If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.

2.12.2 Calculation of Profit on Re-Issue of Forfeited Shares

Students will appreciate that the credit balance of forfeited shares account cannot be considered a surplus until the shares forfeited have been re-issued, because the company may, on re-issue, allow the discount to the new purchaser equivalent to the amount held in credit in this regard in the forfeited shares Account. Suppose 120 shares of a nominal value of ₹ 10 have been forfeited upon which ₹ 5 per share was paid up and transferred to Forfeited Share Account. Afterwards, 50 shares are re-issued, ₹ 6 per share being collected to make them fully paid up; ₹ 200 (50 shares x ₹ 10 - 50 shares x ₹ 6) out of shares forfeited will be credited to Share Capital Account to make up the deficiency on re-issued shares, and ₹ 50 (50 shares x ₹ 5 - ₹ 200) will be transferred to the Capital Reserve Account being the surplus on re-issue of the 50 shares. It would have in the Forfeited shares Account balance equivalent to the amount collected on the remaining 70 forfeited shares i.e. ₹ 350 which will be carried forward till these are re-issued.

In the above case, it has been assumed that the amount paid up on all the 120 forfeited shares was ₹ 5 per share. But in practice, shares may be forfeited on which varying amounts are outstanding. For instance, if in the above case 70 shares were forfeited with ₹ 5 paid up thereon and 50 shares with ₹ 7.50 was paid up thereon then:

$$\begin{aligned}\text{Share Forfeited Account Balance} &= (70 \times 5) + (50 \times 7.50) \\ &= ₹ 725\end{aligned}$$

Thus if 50 shares with ₹ 7.50 paid up are re-issued for ₹ 6 per share then Capital Reserve balance will be as follows:

$$₹ (7.50 + 6 - 10) \times 50 \text{ shares} = ₹ 175$$

ILLUSTRATION 14

Mr. Long who was the holder of 2,000 preference shares of ₹ 100 each, on which ₹ 75 per share has been called up could not pay his dues on Allotment and First call each at ₹ 25 per share. The Directors forfeited the above shares and reissued 1500 of such shares to Mr. Short at ₹ 65 per share paid-up as ₹ 75 per share.

Give Journal Entries to record the above forfeiture and re-issue in the books of the company.

SOLUTION

Particulars	₹	₹
Preference Share Capital A/c (2,000 x ₹ 75) Dr.	1,50,000	
To Preference Share Allotment A/c		50,000
To Preference Share First Call A/c		50,000
To Forfeited Share A/c		50,000
(Being the forfeiture of 2,000 preference shares ₹ 75 each being called up for non-payment of allotment and first call money as per Board's Resolution No.... dated.....)		
Bank A/c (1,500 x ₹ 65) Dr.	97,500	
Forfeited Shares A/c (1,500 x ₹ 10) Dr.	15,000	
To Preference Share Capital A/c		1,12,500
(Being re-issue of 1500 shares at ₹ 65 per share paid-up as ₹ 75 as per Board's Resolution No.....dated....)		
Forfeited Shares A/c Dr.	22,500	
To Capital Reserve A/c (Note 1)		22,500
(Being profit on re-issue transferred to Capital/Reserve)		

Working Note:**Calculation of amount to be transferred to Capital Reserve**

Forfeited amount per share = ₹ 50,000/2000 = ₹ 25

Loss on re-issue = ₹ 75 – ₹ 65 = ₹ 10

Surplus per share re-issued ₹ 15

Transferred to capital Reserve ₹ 15 x 1500 = ₹ 22,500

ILLUSTRATION 15

Beautiful Co. Ltd issued 30,000 equity shares of ₹ 10 each payable as ₹ 3 per share on application, ₹ 5 per share (including ₹ 2 as premium) on allotment and ₹ 4 per share on call. All the shares were subscribed. Money due on all shares was fully received except from Ram, holding 500 shares, who failed to pay the Allotment and Call money and Shyam, holding 1,000 shares, who failed to pay the Call Money. All those 1,500 shares were forfeited. Of the shares forfeited, 1,250 shares (including whole of Ram's shares) were subsequently re-issued to Jadu as fully paid up at a discount of ₹ 2 per share.

Pass the necessary entries in the Journal of the company to record the forfeiture and re-issue of the share. Also prepare the Balance Sheet of the company.

SOLUTION**In the books of Beautiful Co. Ltd.****Journal**

Date	Particulars		₹	₹
	Equity Share Capital A/c (1,500 x ₹ 10)	Dr.	15,000	
	Securities Premium A/c (500 x ₹ 2)	Dr.	1,000	
	To Equity Share Allotment A/c (500 x ₹ 5)			2,500
	To Equity Share Call A/c (1,500 x ₹ 4)			6,000
	To Forfeited Shares A/c			7,500
	(Being forfeiture of 1,500 equity shares for non payment of allotment and call money on 500 shares and for non-payment of call money on 1,000 shares as per Board's Resolution No.....dated)			
	Bank A/c	Dr.	10,000	
	Forfeited Shares A/c	Dr.	2,500	
	To Equity Share Capital A/c			12,500
	(Being re-issue of 1250 shares @ ₹ 8 each as per Board's Resolution No.....dated....)			
	Forfeited Shares A/c	Dr.	3,500	
	To Capital Reserve A/c			3,500
	(Being profit on re-issue transferred to Capital Reserve)			

Balance Sheet of Beautiful Limited as at.....

Particulars	Notes No.	₹
EQUITY AND LIABILITIES		
Shareholders' funds		
Share capital	1	2,99,000
Reserves and Surplus	2	62,500
Total		3,61,500
ASSETS		
Current assets		
Cash and cash equivalents (bank)		3,61,500
Total		3,61,500

Notes to accounts

		₹	₹
1.	Share Capital		
	Equity share capital		
	Issued share capital		
	30,000 Equity shares of ₹ 10 each	3,00,000	
	Subscribed, called up and paid up share capital		
	29,750 Equity shares of ₹ 10 each	2,97,500	
	Add: Forfeited shares	1,500	2,99,000
2.	Reserves and Surplus		
	Securities Premium	59,000	
	Capital Reserve	3,500	62,500

Working Note :

(1) Calculation of Amount to be Transferred to Capital Reserve

Amount forfeited per share of Ram	₹ 3	Amount forfeited per share of Shyam	₹ 6
Less: Loss on re-issue per share	(₹ 2)	Less: Loss on re-issue per share	(₹ 2)
Surplus	₹ 1	Surplus	₹ 4
Transferred to Capital Reserve:			
Ram share (500 x ₹ 1)		₹ 500	
Shyam's Share (750 x ₹ 4)		₹ 3,000	
Total		₹ 3,500	

(2) Balance of Security Premium

Total Premium amount receivable on allotment	=	60,000
Less: Amount reversed on forfeiture	=	(1,000)
Balance remaining	=	59,000

ILLUSTRATION 16

A holds 2,000 shares of ₹ 10 each on which he has paid ₹ 2 as application money. B holds 4,000 shares of ₹ 10 each on which he has paid ₹ 2 per share as application money and ₹ 3 per share as allotment money. C holds 3,000 shares of ₹ 10 each and has paid ₹ 2 on application, ₹ 3 on allotment and ₹ 3 for the first call. They all fail to pay their arrears on the second and final call and the directors, therefore, forfeited their shares. The shares are re-

issued subsequently for ₹ 12 per share fully paid-up. Journalise the transactions relating to the forfeiture and re-issue.

SOLUTION**Journal**

Date	Particulars	₹	₹
	Share Capital A/c (9,000 x ₹ 10) Dr.	90,000	
	To Share Allotment A/c (2,000 x ₹ 3)		6,000
	To Share First Call A/c (6,000 x ₹ 3)		18,000
	To Share Final Call A/c (9,000 x ₹ 2)		18,000
	To Forfeited Shares A/c		48,000
	(Being forfeiture of 9,000 shares of ₹ 10 each for non-payment of allotment, first and final call money as per Board's Resolution No.....dated....)		
	Bank A/c (9,000 x ₹ 12) Dr.	1,08,000	
	To Share Capital A/c		90,000
	To Securities Premium A/c		18,000
	(Being the re-issue of 9,000 shares of ₹ 10 each @ ₹ 12 as per Board's Resolution No.....dated...)		
	Forfeited Shares A/c Dr.	48,000	
	To Capital Reserve A/c		48,000
	(Being profit on re-issue transferred to Capital Reserve).		

Working Note:

Shareholders	Money Received				Money Not Received On		
	Application	Allotment	First Call	Final Call	Allotment	First Call	Final Call
A	2,000	-	-	-	2,000	2,000	2,000
B	4,000	4,000	-	-	-	4,000	4,000
C	3,000	3,000	3,000	-	-	-	3,000
TOTAL	9,000	7,000	3,000	-	2,000	6,000	9,000
Money	₹ 2	₹ 3	₹ 3	₹ 2	₹ 3	₹ 3	₹ 2
Receivable	₹ 18,000	₹ 21,000	₹ 9,000	-	₹ 6,000	₹ 18,000	₹ 18,000



2.13 ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. Shares may also be issued in payment for services rendered by promoters, lawyers in the formation of the company. These shares should be shown separately under the heading 'Share Capital'.

Within specified time of allotment, the company must produce before the Registrar a written contract of sale of service in respect of which shares have been allotted.

Under accounting standards, if an asset is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost is the fair value of the securities issued (which, in appropriate cases, may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued.

Accounting Entries

When assets are purchased in exchange of shares

Assets Account

Dr.

To Share Capital Account

ILLUSTRATION 17

X Co. Ltd. was incorporated with an authorized share capital of 90,000 equity shares of ₹ 10 each. The company purchased land and buildings from Y Co. Ltd for ₹ 4,00,000 payable in fully paid-up shares of the company. The balance of the shares were issued to the public, which were fully subscribed and paid for.

You are required to pass Journal Entries and to prepare the Balance Sheet.

SOLUTION

Journal

Date	Particulars	₹	₹
	Land and Buildings A/c Dr.	4,00,000	
	To Y Co. Ltd A/c		4,00,000
	(Being the land and buildings purchased from Y Co. Ltd as per agreement dated...).		

Y.Co. Ltd A/c	Dr.	4,00,000	
To Equity Share Capital A/c			4,00,000
(Being 40,000 shares of ₹ 10 each issued to Y Co. Ltd. on purchase of land and building)			
Bank A/c	Dr.	5,00,000	
To Equity Share Application and Allotment A/c			5,00,000
(Being the issue of 50,000 shares of ₹ 10 each as per Board's Resolution No.....dated...)			
Equity Share Application and Allotment A/c	Dr	5,00,000	
To Equity Share Capital A/c			5,00,000
(Being shares allotted for application money received.)			

Balance Sheet of X Company Limited as at....

	Particulars	Notes No.	₹
	EQUITY AND LIABILITIES		
	Shareholders' funds		
	Share capital	1	9,00,000
	Total		9,00,000
	ASSETS		
1.	Non-current assets		
	a Fixed assets		
	i. Plant Property and Equipment	2	4,00,000
2.	Current assets		
	Cash and cash equivalents	3	5,00,000
	Total		9,00,000

Notes to accounts

		₹
1.	Share Capital	
	Equity share capital	
	Authorised share capital	
	90,000 Equity shares of ₹ 10 each	9,00,000
	Issued share capital	
	90,000 Equity shares of ₹ 10 each	9,00,000
	Subscribed Share Capital	
	90,000 Equity Shares of ₹ 10 each	9,00,000
	Called up and Paid up Capital	
	90,000 Equity Shares of ₹ 10 each	9,00,000
	(Out of the above 40,000 shares have been allotted as fully paid up pursuant to contract(s) without payment being received in cash)	
2.	Plant Property and Equipment	
	Land and Building	4,00,000
3.	Cash and cash equivalents	
	Balances with banks	5,00,000

SUMMARY

- ◆ Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share.
- ◆ The total capital of the company is divided into shares, the capital of the company is called 'Share Capital'.
- ◆ Share capital of a company is divided into following categories:
 - (i) Authorised Share Capital or Nominal Capital; (ii) Issued Share Capital; (iii) Subscribed Share Capital (iv) Called-up Share Capital; (v) Paid-up Share Capital; (vi) Reserve Share Capital

- ◆ Types of shares are:
 - (i) Preference Shares. Preference shares can be of various types, e.g.: (a) Cumulative Preference Shares (b) Non-cumulative Preference Shares (c) Participating Preference Shares (d) Non-participating Preference Shares (e) Redeemable Preference Shares (f) Non-redeemable Preference Shares (g) Convertible Preference Shares (h) Non-convertible Preference Shares.
 - (ii) Equity Shares
- ◆ A company can issue shares either
 - (1) for cash or
 - (2) for consideration other than cash.
- ◆ A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company.
- ◆ When a company issues its securities at a price more than the face value, it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security.
- ◆ According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company:
 - (a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities.
 - (b) To write off preliminary expenses of the company.
 - (c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.
 - (d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.
 - (e) For the purchase of own shares or other securities.
- ◆ Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as *Calls-in-Arrears or Unpaid Calls*.
- ◆ Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as *Calls-in-advance*.

- ♦ Interest on calls in arrear is recoverable and that in respect of calls in advance is payable, according to provisions in this regard in the articles of the company, at the rates mentioned therein or those to be fixed by the directors, within the limits prescribed by the Articles. Table F prescribes 10% and 12% p.a. as the maximum rates respectively for calls in arrears and those in advance.
- ♦ The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money results in forfeiture of shares.
- ♦ A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale.
- ♦ Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. These shares should be shown separately under the heading 'Share Capital'.

TEST YOUR KNOWLEDGE

True and False

1. *Liability of a holder of shares is limited to the face value of shares acquired by them.*
2. *Authorised capital appears in the balance sheet at face value.*
3. *The rate of dividend on preference shares may vary From year to year.*
4. *A company may issue shares at a discount to the public in general.*
5. *Sweat equity shares are those which are issued to employees & directors at a discount.*
6. *As per table F, rate of interest on calls in arrears is 12%.*
7. *As per Table F, rate of interest on calls in advance is 10%.*
8. *Non-participating preference shareholders enjoy voting rights.*
9. *Forfeited shares are available to the company for the purpose of resale.*
10. *Loss on reissue should exceed the forfeited amount.*

Multiple Choice Questions

1. The excess price received over the par value of shares, should be credited to _____.
 - (a) Calls-in-advance account
 - (b) Share capital account
 - (c) Securities premium account
2. The Securities Premium amount may be utilized by a company for _____.
 - (a) Writing off any loss on sale of fixed asset
 - (b) Writing off any loss of revenue nature
 - (c) Writing off the expenses/discount on the issue of debentures
3. When shares are forfeited, the share capital account is debited with _____ and the share forfeiture account is credited with _____.
 - (a) Paid-up capital of shares forfeited; Called up capital of shares forfeited
 - (b) Called up capital of shares forfeited; Calls in arrear of shares forfeited
 - (c) Called up capital of shares forfeited; Amount received on shares forfeited
4. T Ltd. proposed to issue 6,000 equity shares of ₹ 100 each at a premium of 40%. The minimum amount of application money to be collected per share as per the Companies Act, 2013
 - (a) ₹ 5.00
 - (b) ₹ 6.00
 - (c) ₹ 7.00
5. Dividends are usually paid as a percentage of _____.
 - (a) Authorized share capital
 - (b) Net profit
 - (c) Paid-up capital
6. As per the SEBI guidelines, on issue of shares, the application money should not be less than
 - (a) 2.5% of the nominal value of shares
 - (b) 2.5% of the issue price of shares
 - (c) 25.0% of the issue price of shares

7. G Ltd. acquired assets worth ₹ 7,50,000 from H Ltd. by issue of shares of ₹ 100 at a premium of 25%. The number of shares to be issued by G Ltd. to settle the purchase consideration = ?
- (a) 6,000 shares
 - (b) 7,500 shares
 - (c) 9,375 shares
8. Securities Premium is presented as a part of
- (a) Reserves & Surplus
 - (b) Share Capital
 - (c) Liabilities
9. Schedule III of Companies Act 2013 prescribes the format for
- (a) Financial statements
 - (b) Directors' Report
 - (c) Auditors' Report
10. Dividend on _____ shares have to be paid before dividend on _____ shares.
- (a) Equity, Preference
 - (b) Preference, Equity
 - (c) Convertible, Non-Cumulative
11. Preference shares are _____ unless expressly stated otherwise.
- (a) Non-participating
 - (b) Convertible
 - (c) Interest-bearing

Theory Questions

1. Write short notes on:
- (i) Utilization of securities premium account
 - (ii) Re-issue of forfeited shares
2. Distinguish between:
- (i) Calls-in-Arrears and Calls-in-advance

(ii) *Issue of shares for cash and Issue of Shares for Consideration other than Cash*

3. *Can a company issue shares at discount?*

Practical Questions

1. *X Ltd. invited applications for 10 lakhs shares of ₹ 100 each payable as follows :*

	₹
On Application	20
On Allotment (on 1st May, 2022)	30
On First Call (on 1st Oct., 2022)	30
On Final Call (on 1st Feb., 2023)	20

All the shares were applied for and allotted. A shareholder holding 20,000 shares paid the whole of the amount due along with allotment. Journalise the transactions, assuming all sums due were received. Interest was paid to the shareholder concerned on 1st February, 2023.

2. *A limited Company, with an authorized capital of ₹ 20,00,000 divided into shares of ₹ 100 each, issued for subscription 10,000 shares payable at ₹ 25 per share on application, ₹ 30 per share on allotment, ₹ 20 per share on first call three months after allotment and the balance as and when required.*

The subscription list closed on January 31, 2022 when application money on 10,000 shares was duly received and allotment was made on March 1, 2022. All amounts due were received within one month of the date they were called.

The allotment amount was received in full but, when the first call was made, one shareholder failed to pay the amount on 1,000 shares held by him and another shareholder with 500 shares paid the entire amount on his shares.

Give journal entries in the books of the Company to record these share capital transactions.

3. *A Ltd. forfeits 100 shares of Rs. 10 each fully called upon. The shareholder failed to pay the first call money of Rs. 4 per share and the second and final Call Money of Rs. 4 per share. Give journal entry to show the effect of this transaction.*
4. *B Ltd. issued 20,000 equity shares of ₹ 100 each at a premium of ₹ 20 per share payable as follows: on application ₹ 50; on allotment ₹ 50 (including premium); on final call ₹ 20. Applications were received for 24,000 shares. Letters of regret were issued to applicants for 4,000 shares and shares were allotted to all the other applicants. Mr. A, the holder of 150 shares, failed to pay the allotment and call money, the shares were forfeited. Show the Journal Entries and Cash Book in the books of B Ltd.*

ANSWERS/ HINTS

True and False

1. False: Liability of the holder of shares is limited to the issue price of shares acquired by them.
2. True: Authorised capital is the amount of capital mentioned in 'capital clause' of the 'Memorandum of Association'. Authorised capital is considered only as presentation and not considered in total of balance sheet.
3. False: Rate of preference dividend is always fixed.
4. False: According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus any issue of shares at discount shall be void.
5. True: According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors).
6. False: As per table F, rate of interest on calls in arrears is 10%.
7. False: As per Table F, rate of interest on calls in advance is 12%.
8. False: A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares. Non-participating preference shareholders do not enjoy voting rights.
9. True: Reissue of forfeited shares is not allotment of shares but only a sale.
10. False: Loss on re-issue should not exceed the forfeited amount.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(c)	4.	(a)	5.	(c)	6.	(c)
7.	(a)	8.	(a)	9.	(a)	10.	(b)	11.	(a)		

Theoretical Questions

1. (i) Refer para 2.7.1 for utilization of securities premium account.
(ii) A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited

shares is not allotment of shares but only a sale. The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrears on those shares.

2. (i) **Calls-in-Arrears:** Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as Calls-in-Arrears or Unpaid Calls. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

Calls-in-advance: Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as Calls-in-advance.

- (ii) The shares can be issued by a company either for cash or for consideration other than cash. Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets.
3. According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus any issue of shares at discount shall be void.

Practical Question

1. **Journal of X Ltd.**

2022			₹ in lakhs	₹ in lakhs
May 1	Bank A/c Dr. To Share Application A/c (Receipt of applications for 10 lakh shares along with application money of ₹ 20 per share.)		200	200
May 1	Share Application A/c Dr. Share Allotment A/c Dr.		200 300	

	To Share Capital A/c (The allotment of 10 lakh shares: payable on application ₹ 20 share and ₹ 30 on allotment as per Directors' resolution no... dated...)		500
May 1	Bank A/c Dr. To Shares Allotment A/c To Calls in Advance A/c [Receipt of money due on allotment @ ₹ 30, also the two calls (₹ 30 and ₹ 20) on 20,000 shares.]	310	300 10
Oct. 1	Share First Call A/c Dr. To Share Capital A/c (The amount due on 10 lakh shares @ ₹ 30 on first call, as per Directors, resolution no... dated...)	300	300
	Bank A/c Dr. Calls in Advance A/c Dr. To Share First Call A/c (Receipt of the first call on 9.80 lakh shares, the balance having been previously received and now debited to call in advance account.)	294 6	300
2023			
Feb. 1	Share Final Call A/c Dr. To Share Capital A/c (The amount due on Final Call on 10 lakh shares @ ₹ 20 per share, as per Directors' resolution no... dated...)	200	200
Feb. 1	Bank A/c Dr. Calls in Advance A/c Dr. To Share Final Call A/c (Receipt of the moneys due on final call on 9.80 lakhs shares, the balance having been previously received.)	196 4	200

Feb. 1	Interest on calls in Advance A/c Dr. To Shareholder A/c (Being interest on call in advance made due)	0.66	0.66
Feb 1	Shareholder A/c Dr. To Bank A/c (Being interest paid)	0.66	0.66

Working Note:

The interest on calls in advance paid @ 12% on :	₹
₹ 6,00,000 (first call) from 1st May to 1st Oct., 2022–5 months	30,000
₹ 4,00,000 (final call) from 1st May to 1st Feb., 2023–9 months	36,000
Total Interest Amount Due	66,000

2.

Journal Entries in the Books of the Company

Date	Particulars	L.F.	Debit	Credit
2022			Amount	Amount
			(₹)	(₹)
Jan. 31	Bank A/c Dr. To Equity Share Application A/c (Money received on applications for 10,000 shares @ ₹ 25 per share)		2,50,000	2,50,000
March 1	Equity Share Application A/c Dr. To Equity Share Capital A/c (Transfer of application money on 10,000 shares to share capital)		2,50,000	2,50,000
March 1	Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Amount due on the allotment of 10,000 shares @ ₹ 30 per share)		3,00,000	3,00,000
April 1	Bank A/c Dr.		3,00,000	

June 1	To Equity Share Allotment A/c (Allotment money received)			3,00,000
	Equity Share First Call A/c Dr. To Equity Share Capital A/c (First call money due on 10,000 shares @ ₹ 20 per share)		2,00,000	2,00,000
July 1	Bank A/c Dr.		1,92,500	
	Calls-in-Arrears A/c Dr.		20,000	
	To Equity Share First Call A/c			2,00,000
	To Calls-in-Advance A/c (First call money received on 9000 shares and calls-in-advance on 500 shares @ ₹ 25 per share)			12,500

3.

**In the Books of A Ltd.
Journal Entries**

Date	Journal Entries Particulars	₹	₹
	Equity Share Capital A/c (100X10) Dr. To Share First Call A/c (100X4) To Second and Final Call A/c (100X4) To Share Forfeiture A/c (100X2) (Being share forfeiture of 100 shares as per Board's Resolution No.....dated...)	1,000	400 400 200

4.

**In the Books of B Ltd.
Cash Book (Bank column only)**

Date	Particulars	₹	Date	Particulars	₹
	To Equity Share Application A/c (Being application money received on 24,000 shares @ ₹ 50 each)	12,00,000		By Equity Share Application A/c (Being excess money refunded on 4,000 shares @ ₹ 50 each as	2,00,000

	To Equity Share Allotment A/c (Being allotment money received on 19,850 shares @ ₹ 50 each)	9,92,500		per Board's Resolution No...dated....)	
	To Equity Share Final Call A/c (Being final call money received on 19,850 shares @ ₹ 20 each)	3,97,000		By Balance c/d	23,89,500
		25,89,500			25,89,500

Journal Entries

Date	Particulars	₹	₹
	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being application money on 20,000 shares @ ₹ 50 each transferred to Equity Share Capital Account as per Board's Resolution No.....dated...)	10,00,000	10,00,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Being allotment money @ ₹ 50 per share including premium of ₹ 20 per share being made due as per Board's Resolution No.....dated....)	10,00,000	6,00,000 4,00,000
	Equity Share Capital A/c (150 x ₹ 100) Dr. Securities Premium A/c (150 x ₹ 20) Dr. To Equity Share Allotment A/c To Equity Share Final Call A/c To Forfeited Shares A/c (Being forfeiture of 150 shares for non-payment of allotment money and final call money as per Board's Resolution No....dated...)	15,000 3,000	7,500 3,000 7,500

Equity Share Final Call A/c (19,850 x ₹ 20)	Dr.	3,97,000	
To Equity Share Capital A/c			3,97,000
(Being final call money received for ₹ 20 per share being made as per Board's resolution No.... dated)			

Note: Here, securities premium on forfeited shares has not been realised, so Securities Premium Account will be debited at the time of forfeiture of these shares.

Also, alternatively Calls in arrears A/c could have been used in which case following entries would have been passed in place of the entry (given above) for forfeiture:

On non- receipt of allotment money:			
Calls in Arrears A/c	Dr.	7,500	
To Equity Share Allotment A/c			7,500
(Being allotment money on 150 shares @ ₹ 50 not received transferred to calls in arrears.)			
On non - receipt of Call money:			
Calls in Arrears A/c	Dr.	3,000	
To Equity Share Final Call A/c			3,000
(Being final call on 150 shares @ ₹ 20 not received transferred to calls in arrears)			
On Forfeiture:			
Share Capital A/c (150 x ₹ 100)		15,000	
Securities Premium A/c (150 x ₹ 20)		3,000	
To Calls in Arrears A/c			10,500
To Share Forfeiture A/c			7,500
(Being forfeiture of 150 shares for non-payment of allotment money and final call money as per Board's Resolution No....dated...)			

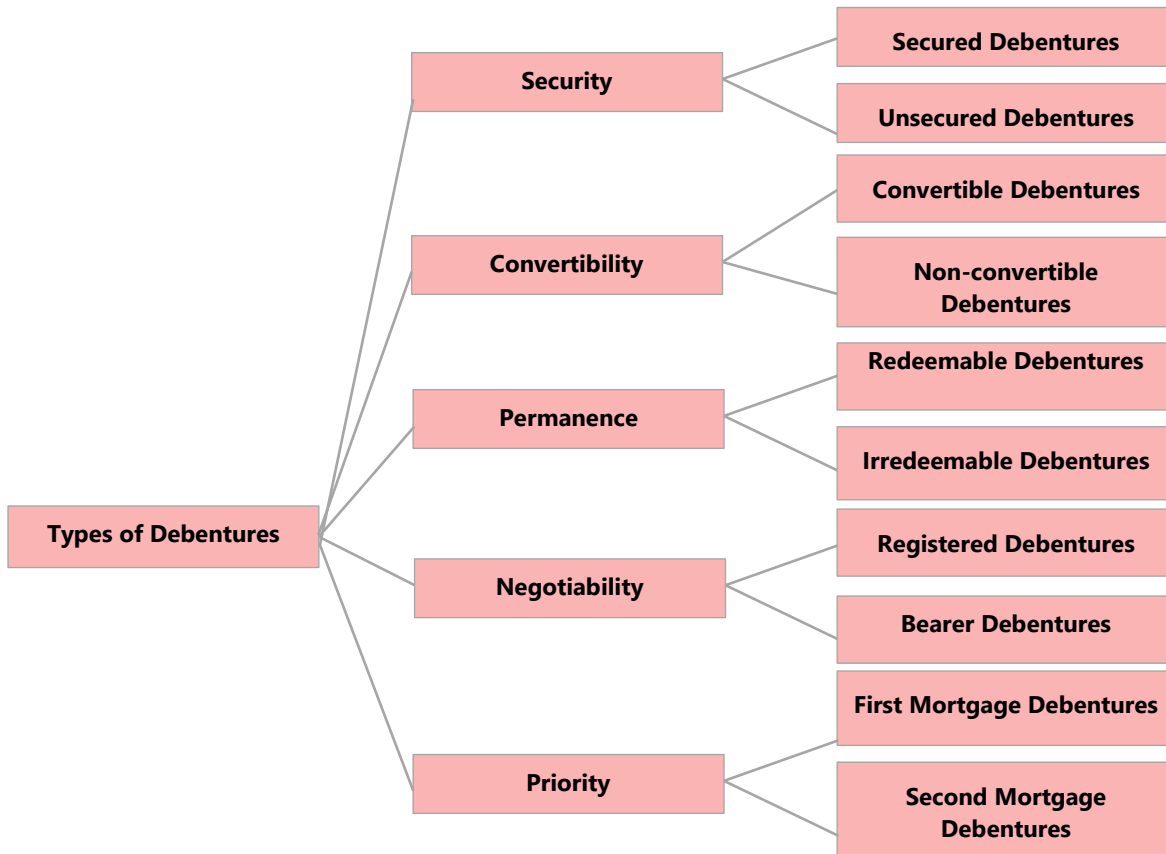
UNIT – 3 ISSUE OF DEBENTURES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the meaning and basic purpose for raising debentures by the company
- ◆ Differentiate between shares and debentures of a company
- ◆ Understand various types of debentures
- ◆ Pass entries for issue of debentures payable in instalments
- ◆ Make entries for issue of debentures considering the conditions of redemption
- ◆ Pass entries for issue of debentures as collateral security
- ◆ Pass entries for debentures issued for consideration other than for cash
- ◆ Write off discount on issue of debentures
- ◆ Calculate interest on debentures.

UNIT OVERVIEW



3.1 INTRODUCTION

In the earlier units of this chapter, we have studied the issue of share capital as a means of raising funds for financing the business activities. But with increasing and evergrowing needs of the corporate expansion and growth, equity source of financing is not sufficient. Hence corporates turn to debt financing through various means. Issuing debt instruments by offering the same for public subscription is one of the sources of financing the business activities. Debt financing does not only helps in reducing the cost of the capital but also helps in designing appropriate capital structure of the company. Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business.

3.2 MEANING

The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge* has been created on any or on the entire assets of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Section 2 (30) of the Companies Act, 2013 defines debentures as "Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

Thus, It is clear from definition that debenture may be Secured Debenture or Unsecured Debenture.

Note: No company shall issue any debentures carrying any voting rights.

3.3 FEATURES OF DEBENTURES

1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security where interest falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.
4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

*Charge is an incumbrance to meet the obligation under the Trust Deed, whereby the company agrees to mortgage specific portion either by way of a first or second charge. Such charge implies right of lenders to secure their payment from such asset(s) or from the liquidator in the event of winding up or from the company when the charge becomes void.

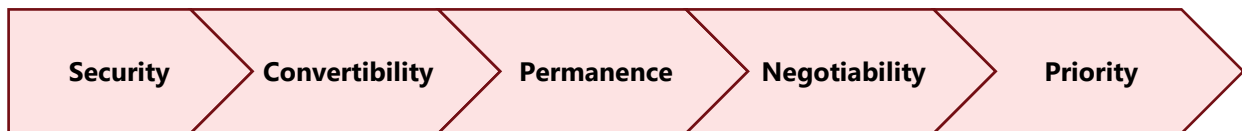


3.4 DISTINCTION BETWEEN DEBENTURES AND SHARES

Debentures	Shares
1. Debenture holders are the creditors of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company.	2. Shareholders have voting rights and consequently control the total affairs of the company.
3. Debenture interest is generally paid at a pre-determined fixed rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on equity shares is paid at a variable rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. Dividends are appropriation of profit and these are not deductible in determining taxable profit of the company.
5. There are different kinds of debentures, such as Secured/ Unsecured; Redeemable/ Irredeemable; Registered / Bearer; Convertible/ Non-convertible, etc.	5. There are only two kinds of shares—Equity Shares and Preference Shares.
6. In the Company's Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Company's Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.
7. Debentures can be converted into other debentures or shares as per the terms of issue of debentures.	7. Shares cannot be converted into other shares in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, debenture holders get back their money as per the terms and conditions of redemption.	9. Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of liquidation, debenture holders are paid-off before the shareholders.	10. At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.

3.5 TYPES OF DEBENTURES

The following are the types of debentures issued by a company. They can be classified on the basis of:



1. **Security**

- (a) *Secured Debentures:* These debentures are secured by a charge upon some or all assets of the company. There are two types of charges: (i) Fixed charge; and (ii) Floating charge. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders. A floating charge generally covers all the assets of the company including future one.
- (b) *Unsecured or "Naked" Debentures:* These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

2. **Convertibility**

- (a) *Convertible Debentures:* These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.
- (b) *Non-Convertible Debentures:* These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

3. **Permanence**

- (a) *Redeemable Debentures:* These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.
- (b) *Irredeemable Debentures:* These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation.

4. Negotiability

- (a) *Registered Debentures:* These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable. The provisions of the Companies Act, 2013 are to be complied with for effecting transfer of these debentures. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.
- (b) *Bearer Debentures:* These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. Priority

- (a) *First Mortgage Debentures:* These debentures are payable first out of the property charged.
- (b) *Second Mortgage Debentures:* These debentures are payable after satisfying the first mortgage debentures.



3.6 ISSUE OF DEBENTURES

3.6.1 Accounting entries for issue of redeemable debentures

The issue of redeemable debentures can be categorized into the following:

1. Debentures issued at a par and redeemable at par or at a discount;
2. Debentures issued at a discount and redeemable at par or at discount;
3. Debentures issued at premium and redeemable at par or at discount;
4. Debentures issued at par and redeemable at premium;
5. Debentures issued at a discount and redeemable at premium.
6. Debentures issued at premium and redeemable at premium.

Note: Redemption at a discount may be a rare circumstance in practical life.

Journal entries in each of the above cases are discussed below:

1. **Debentures issued at par redeemable at par:** When debenture are issued at par, the issue price is equal to par value, in this regard the following entries are recorded:

- (a) For receipt of application money :

Bank A/c	Dr.
To Debenture Application A/c	

- (b) For transfer of application money to debentures account :

Debenture Application A/c	Dr.
To ...% Debenture A/c	

ILLUSTRATION 1

Amol Ltd. issued 40,00,000, 9% debentures of ₹ 50 each, payable on application as per term mentioned in the prospectus and redeemable at par any time after 3 years from the date of issue. Record necessary entries for issue of debentures in the books of Amol Ltd.

SOLUTION

Books of Amol Ltd.

Journal

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr.		20,00,00,000	
	To Debenture Application A/c			20,00,00,000
	(Debenture application money received)			
	Debenture Application A/c Dr.		20,00,00,000	
	To 9% Debentures A/c			20,00,00,000
	(Application money transferred to 9% debentures account consequent upon allotment)			

2. **Debentures issued at Discount and Redeemable at par or at discount :** When debentures are issued at discount, issue price will be less than par value. The difference between the two is considered as loss on issue on debentures and is to be written-off over the life of debentures. The entries with regards to issue are given below :

- (a) For receipt of application money

Bank A/c	Dr.	
To Debenture Application A/c		

- (b) At the time of making allotment

(i) Debenture Application A/c	Dr.	
Discount on issue of debentures A/c	Dr.	
To ...% Debentures A/c		

ILLUSTRATION 2

Atul Ltd. issued 1,00,00,000, 8% debenture of ₹100 each at a discount of 10% redeemable at par at the end of 10th year. Money was payable as follows :

₹ 30 on application

₹ 60 on allotment

Record necessary journal entries regarding issue of debenture.

SOLUTION

Books of Atul Ltd.

Journal

Date	Particulars	L.F.	Debit	Credit
			(₹)	(₹)
	Bank A/c Dr.		30,00,00,000	
	To Debenture Application A/c			30,00,00,000
	(Debenture application money received)			
	Debenture Application A/c Dr.		30,00,00,000	
	To 8% Debentures A/c			30,00,00,000
	(Application money transferred to 8% debentures account consequent upon allotment)			
	Debenture allotment A/c Dr.		60,00,00,000	

Discount on issue of debentures A/c	Dr.	10,00,00,000	
To 8% Debentures A/c			70,00,00,000
(Amount due on allotment)			
Bank A/c	Dr.	60,00,00,000	
To Debenture Allotment A/c			60,00,00,000
(Money received consequent upon allotment)			

3. Debentures Issued at Premium and Redeemable at par or at discount

When debenture are issued at premium, the issue price is more than the par value. The premium is transferred to securities premium account. In this regard, the following journal entries are recorded:

When premium amount is received at the time of application;

- (a) For receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

- (b) For transfer of application of money at the time of allotment

Debenture application A/c	Dr.
To ...% Debentures A/c	
To Securities Premium A/c	

When debentures are issued at par or premium value but redeemed at discount, then it means that the company will gain by paying less. This gain will not be recognised in the books at the time of issue of debentures as per the conservatism concept. The utilisation of premium on debentures shall be based on the provisions of Section 52 of Companies Act, 2013,

ILLUSTRATION 3

Koinal Chemicals Ltd. issued 15,00,000, 10% debenture of ₹50 each at premium of 10%, payable as ₹20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in application money.

SOLUTION**Books of Koinal Chemicals Ltd.****Journal**

When premium money is received along with application money:

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr. To Debenture Application A/c (Debenture application money received)		3,00,00,000	3,00,00,000
	Debentures Application A/c Dr. To 10% Debentures A/c To Securities Premium A/c (Application money transferred to 10% debentures account and securities premium account consequent upon allotment)		3,00,00,000	2,25,00,000 75,00,000
	Debenture Allotment A/c Dr. To 10% Debentures A/c (Call made consequent upon allotment)		5,25,00,000	5,25,00,000
	Bank A/c Dr. To Debenture Allotment A/c (Call made consequent upon allotment money received)		5,25,00,000	5,25,00,000

4. Debentures issued at par and redeemable at a premium

Where debentures are to be redeemed at premium, an extra entry is to be made at the time of issue and allotment of debentures. This extra entry is to be passed for providing premium payable on redemption. Debenture Redemption Premium Account is a personal account which represents a liability of the company in respect of premium payable on redemption.

In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debentures at the time of allotment of debentures. Following journal entries are recorded in this regard:

- (a) For receipt of application money

Bank A/c	Dr.
To Debenture application A/c	

- (b) At the time of making allotment

- (i) Transfer of application money to debenture account

Debenture Application A/c	Dr.
To ...% Debenture A/c	

- (ii) Call made consequent upon allotment

Debenture Allotment A/c	Dr.
Loss on issue of debenture A/c	Dr. [Equal to Debenture Redemption Premium]
To ...% Debenture A/c	
To Debenture redemption premium A/c	

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Loss on issue of debenture A/c	Dr.
To ...% Debenture A/c	
To Debenture redemption premium A/c	

ILLUSTRATION 4

Modern Equipments Ltd. issued 4,00,000, 12% debentures of ₹ 100 payable as follows :

On application ₹ 30

On allotment ₹ 70

The debenture were fully subscribed and all the money was duly received. As per the terms of issue, debentures are redeemable at ₹110 per debenture. Record necessary entries regarding issue of debentures.

SOLUTION**Books of Modern Equipments Ltd.****Journal**

Date	Particulars	Debit Amount (₹ Lakhs)	Credit Amount (₹ Lakhs)
	Bank A/c Dr. To Debentures application A/c (Debenture application money received)	120	120
	Debentures Application A/c Dr. To 12% Debentures A/c (Application money transferred to 12% debentures account consequent to allotment)	120	120
	Debentures Allotment A/c Dr. Loss on issue of Debentures A/c Dr. To 12% Debentures A/c To Debenture redemption premium A/c (Call made on allotment of debentures at par and entry for debentures redeemable at premium)	280 40	280 40
	Bank A/c Dr. To Debentures allotment A/c (Call made consequent upon allotment money received)	280	280

5. Debentures Issued at discount and redeemable at premium

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price and the issue price is treated as discount/loss on issue of debentures. Suppose, a 10% debentures of ₹ 1,000 is issued at a discount of ₹ 100 and redeemable at a premium of ₹ 5 per debenture, the amount of loss will be equal to ₹ 1,005 – ₹ 900 = ₹ 105. This is to be treated as loss on issue. It is to be noted that premium on redemption of debentures is also credited by ₹ 5.

- (a) For the receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

- (b) At the time of making allotment

- (i) Transfer of application money to debenture account

Debenture Application A/c	Dr.
To % Debentures A/c	

- (ii) Call made consequent upon allotment of debentures at discount and redeemable at premium

Debenture Allotment A/c	Dr.	
Discount/Loss on issue of debenture A/c	Dr.	[Amount equal to the discount on issue of debenture plus Premium on redemption]
To ...% Debenture A/c		

- (c) For receipt of call made on allotment

Bank A/c	Dr.
To Debenture Allotment A/c	

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Discount/Loss on issue of debentures A/c	Dr.
To ...% Debentures A/c	
To Debenture redemption premium A/c	

ILLUSTRATION 5

Agrotech Ltd. issued 150 lakh 9% debentures of ₹ 100 each at a discount of 6%, redeemable at a premium of 5% after 3 years payable as: ₹ 50 on application and ₹ 44 on allotment. Record necessary journal entries for issue of debentures.

SOLUTION**Books of Agrotech Ltd.****Journal**

Date	Particulars	L.F.	Debit Amount (₹ Lakhs)	Credit Amount (₹ Lakhs)
	Bank A/c Dr. To Debenture Application A/c (Debentures application money received)		7,500	7,500
	Debenture Application A/c Dr. To 9% Debentures A/c (Application money transferred to 9% debentures account)		7,500	7,500
	Debenture Allotment A/c Dr. Loss on issue of debenture A/c Dr. To 9% Debentures A/c To Debenture redemption premium A/c (Call made consequent upon allotment of debentures issued at discount and redeemable at premium)		6,600 1,650	7,500 7,50
	Bank A/c Dr. To Debenture Allotment A/c (Allotment amount received)		6,600	6,600

Working Notes :

Loss on issue of debentures =

(Amount of discount on issue + Premium payable on redemption) x No. of Debentures

= (6% of ₹100 + 5% of ₹100) x 150 lakh

= (₹ 6 + ₹ 5) x 150 lakh

= ₹ 1,650 lakh

6. Debentures Issued at premium and redeemable at premium

In this situation, the issue price is more than par value and also redemption value is more than par value. The premium received at the time of issue of debentures is credited to Securities premium account and premium paid at the time of redemption

is a loss to be provided at the time of issue of debentures. Suppose, a 10% debenture of ₹1,000 is issued at a premium of ₹100 and redeemable at a premium of ₹50 per debenture. In the given case ₹100 is to be credited to Securities premium account and ₹50 will be the loss to be provided at the time of issue of debentures. It is to be noted that premium on redemption of debentures is also credited by ₹ 50.

- (a) For the receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

- (b) At the time of making allotment

- (i) Transfer of application money to debenture account

Debenture Application A/c	Dr.
To % Debentures A/c	

- (ii) Call made consequent upon allotment of debenture at premium and Redeemable at premium

Debenture Allotment A/c	Dr.	
Loss on issue of debenture A/c	Dr.	[Amount equal to the premium on redemption]
To ...% Debenture A/c		
To Securities Premium A/c		[Amount equal to premium on issue]
To Premium on Redemption of Debentures		[Amount equal to premium on Debentures A/c redemption]

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Loss on issue of Debentures A/c	Dr.
To ...% Debentures A/c	
To Securities Premium A/c	
To Premium on redemption of debentures A/c	

3.6.2 Accounting for issue of debentures payable in instalments

Just like shares, money payable on debentures may be paid either in full with application or by instalments. Accounting entries will differ to some extent in either case.

3.6.2.1 Debentures Payable in Full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures, such as 10% Debentures Application Account or 12% Debentures Application Account. These accounts record moneys received from the applicants of debentures. If an issue is over-subscribed, these accounts can be used to record the refund of moneys to the unsuccessful applicants. At the time of allotment of debentures, the amount in Debentures Application Account is transferred to the respective Debentures Account.

As discussed above, debentures may be issued at par, at a premium, or at a discount.

3.6.2.2 Debentures Issued at Par

The debentures which are issued at par are issued at the same price as their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at par, the company receives ₹ 100.

The accounting entries would be as follows:

- (a) When cash is received

Bank A/c	Dr.
To Debentures Application A/c	

(Being money received on.... debentures @ ₹ each)

- (b) When excess money is refunded or adjusted for future calls

Debentures Application A/c	Dr.
To Bank A/c (Amount refunded)	
To Debenture Allotment A/c (Amount adjusted for allotment)	

(Being excess money...debentures adjusted as per Board's Resolution
No....dated.....)

- (c) When the debentures are allotted

Debentures Application A/c	Dr.
To % Debentures A/c	

(Being the allotment of...debentures of ₹ each as per Board's Resolution
No....dated.....)

- (d) On Allotment money being called

Debenture Allotment A/c Dr.

To % Debentures A/c

(Being Allotment Money Called)

- (e) On Allotment money being received

Bank A/c Dr.

To Debenture Allotment A/c

(Being Allotment money received)

- (f) On Debenture Call money being called

Debenture Calls A/c Dr.

To % Debentures A/c

(Being Call money made due)

- (g) On Debenture Call money being called

Bank A/c Dr.

To Debenture Calls A/c

(Being Call money received)

ILLUSTRATION 6

Simmons Ltd. issued 1,00,000, 12% Debentures of ₹100 each at par payable in full on application by 1st April, Application were received for 1,10,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date.

You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

SOLUTION

In the books of Simmons Limited

Date	Particulars	₹ 000	₹ 000
April 1	Bank A/c Dr. To Debentures Application A/c (Being money received on 1,10,000 debentures)	11,000	11,000
April 7	Debentures Application A/c Dr.	1,000	

April 7	To Bank A/c (Being money on 10,000 debentures refunded as per Board's Resolution No.....dated...)		1,000
	Debentures Application A/c	Dr.	10,000
	To Debentures A/c (Being the allotment of 1,00,000 debentures of ₹ 100 each at par, as per Board's Resolution No....dated...)		10,000

3.6.2.3 Debentures Issued at a Premium

A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at 10% premium, the company receives at ₹110 where the investor gets slightly less interest than stated in the debenture. For example, 12% Debentures of ₹100 issued at a premium of 10%. The investor will get ₹12 p.a. for his investment of 110. Therefore, the effective rate of interest on investment is $(12/110 \times 100) = 10.91\%$.

The premium on debentures is credited to 'Securities Premium Account' as 'Debentures' are covered in the definition of 'securities' specified in the clause (h) of section 2 of the Securities Contracts (Regulation) Act. Therefore, restriction of utilization of debentures (securities) premium will also be governed by Section 52 of the Companies Act, 2013.

The accounting entries would be as follows:

- (a) When cash is received

Bank A/c Dr. [Nominal value plus premium]

To Debentures Application A/c

(Being money received on....debentures @ ₹

each including premium of ₹

- (b) When excess money is refunded

Debentures Application A/c Dr.

To Bank A/c

(Being refund of money on....debentures @ ₹

each, as per Board's Resolution No.....dated....)

- (c) When the debentures are allotted

Debentures Application A/c Dr.

To % Debentures A/c

To Securities Premium A/c
 (Being the allotment of....debentures, premium
 transferred to Securities Premium A/c,
 as per Board's Resolution No....dated....)

3.6.2.4 Debentures Issued at a Discount

The Companies Act does not impose any restriction on the price at which debentures can be issued. Unlike shares, there is no limit for discount on issue of debentures. This is why it is very common for debentures to be issued at a discount. The debentures which are issued at a discount are issued at a lower price than nominal value, that is, if a debenture with a nominal value of ₹100 is issued at 10% discount, the company receives ₹90 only. The issue of debentures at a discount slightly increases the true rate of interest payable. For example, 12% Debentures of ₹100 issued at a discount of 10%. The Company will have to pay ₹12 for a loan of ₹90. Therefore, the true rate of interest is $(12/90 \times 100) = 13.33\%$.

The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate. Like shares, Debentures Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "Discount on Issue of Debentures Account. In the subsequent years, Discount on Issue of Debentures is written-off proportionately by charging to the Statement of Profit and Loss. It is considered a normal practice to amortize discount on issue of debentures over the period of benefit, i.e., normally 3 to 5 years. However, this cannot go beyond tenure of debentures.

The accounting entries would be as follows :

- (a) When Cash is received

Bank A/c Dr. [Actual cash received]

To Debentures Application A/c

(Being money received on....debentures @₹ each)

- (b) When excess money is refunded

Debentures Application A/c Dr.

To Bank A/c

(Being excess money on...debentures refunded as per
 Board's Resolution No.....dated....)

- (c) When the debentures are allotted

Debentures Application A/c Dr. [Actual cash received]

In fact, the discount on issue of debentures is considered as incremental interest expense. The true expense (net borrowing cost) for a particular accounting period is, therefore, the total interest payment plus the discount amortised.

X Ltd. issued 1,00,000 12% Debentures of ₹100 each at a discount of 10% payable in full on application by 31st May, 2022. Applications were received for 1,20,000 debentures. Debentures were allotted on 9th June, 2022. Excess money was refunded on the same date. Pass necessary Journal Entries. Also show necessary ledger accounts.

In the books of X Limited

Journal Entries

Date			
2022	Particulars	₹ '000	₹ '000
May 31	Bank A/c Dr. To Debentures Application A/c (Being money received for 1,20,000 debentures @ ₹ 90 each)	10,800	10,800
June 9	Debentures Application A/c Dr. To Bank A/c (Being excess money on 20,000 debentures @ ₹ 90 refunded as per Board's Resolution No.....dated....)	1,800	1,800
June 9	Debentures Application A/c Dr. Discount on Issue of Debentures A/c Dr. To 12% Debentures A/c (Being the allotment of 1,00,000 debentures of ₹ 100 each at a discount of ₹ 10 per debenture as per Board's Resolution No.....dated...)	9,000 1,000	10,000

Bank Account

Date	Particulars	₹	Date	Particulars	₹
31.5.2022	To 12% Debentures Application A/c	10,800	9.6.2022	By 12% Debentures Application A/c	1,800
		10,800	9.6.2022	By Balance c/d	9,000
					10,800

12% Debentures Account

Date	Particulars	₹	Date	Particulars	₹
30.6.2022	To Balance c/d	10,000	9.6.2022	By 12% Debentures Application A/c	9,000
		10,000	9.6.2022	By Discount on Issue of Debentures A/c	1,000
					10,000

Debentures Application Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2022	To Bank A/c	1,800	31.5.2022	By Bank A/c	10,800
9.6.2022	To 12% Debentures A/c	9,000			
		10,800			10,800

Discount on Issue of Debentures Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2022	To 12% Debentures A/c	1,000	30.6.2022	By Balance c/d	1,000
		1,000			1,000



3.7 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.

In such cases, the holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

Accounting Entries

There are two methods of showing these types of debentures in the accounts of a company.

Method 1

Under this method, no entry is made in the books of account of the company at the time of making issue of such debentures. In the 'Notes to Accounts' of Balance Sheet, the fact of the debentures being issued and outstanding is shown by a note under the liability secured.

ILLUSTRATION 8

X Ltd. obtains a loan from IDBI of ₹1,00,00,000, giving as collateral security of ₹1,50,00,000 (of ₹ 10 each), 14%, First Mortgage Debentures.

SOLUTION

In the Notes to Accounts of Balance Sheet of X Ltd., it is shown as follows:

Notes to Accounts of X Limited as at...(includes)

<i>Long Term Borrowings</i>	₹
Secured Loan	
IDBI Loan	1,00,00,000

(Collaterally secured by issue of ₹ 1,50,00,000 14% First Mortgage Debentures)

Method 2

Under this method, the following entry is made to record the issue of such debentures:

Debentures Suspense Account	Dr.
To % Debentures Account	

(Being the issue of...debentures collaterally as per

Board's Resolution No.....dated.....)

The Debentures Suspense Account will appear on the assets side of the Balance Sheet under Other Non- Current Assets and Debentures on the liabilities side of the Balance Sheet. When the loan is repaid, the entry is reversed in order to cancel it.

ILLUSTRATION 9

Taking the same information of the illustration 8, the entry on issue will be as follows :

In the Books of X Ltd.**Journal**

Date	Particulars	₹	₹
	Debentures Suspense A/c Dr. To 14% First Mortgage Debentures A/c (Being the issue of ₹ 15,00,000 debentures @ ₹10 collaterally as per Board's Resolution No...dated...)	1,50,00,000	1,50,00,000

Balance Sheet of X Limited as at....(Extracts)

Particulars	Notes No.	₹	
EQUITY AND LIABILITIES			
1. Non-Current Liabilities			
Long Term Borrowings	1	2,50,00,000	
Total		2,50,00,000	
ASSETS			
2. Non-current Assets			
Other non-current asset	2	1,50,00,000	
3. Current Assets			
Cash and cash equivalent		1,00,00,000	
Total		2,50,00,000	
Notes to accounts			
1.	Long Term Borrowings		
	Secured Loan		
	IDBI Loan	1,00,00,000	
	14% First Mortgage Debentures	1,50,00,000	2,50,00,000

Students should note that the Method 1 is much more logical from the accounting point of view. Therefore, it is advised to follow Method 1.

Just like shares, debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc. In this case, the following entries are passed:

- Further it should be noted that these debentures can be issued at par, premium and at discount. In each case the second entry for issue of debentures would be done accordingly. Number of debentures to be issued is calculated as follows:-

1. When debentures are issued at par
$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value}}$$
2. When debentures are issued at premium
$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} + \text{Premium}}$$
3. When debentures are issued at discount
$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} - \text{Discount}}$$

ILLUSTRATION 10

X Company Limited issued 10,000 14% Debentures of the nominal value of ₹50,00,000 as follows:

- (a) *To sundry persons for cash at 90% of nominal value of ₹ 25,00,000.*
- (b) *To a vendor for purchase of fixed assets worth ₹10,00,000 – ₹ 12,50,000 nominal value.*
- (c) *To the banker as collateral security for a loan of ₹ 10,00,000 – ₹ 12,50,000 nominal value.*

Pass necessary Journal Entries.

SOLUTION

**In the books of X Company Ltd.
Journal Entries**

Date	Particulars	₹	₹
(a)	Bank A/c Dr. 22,50,000	22,50,000	
	To Debentures Application A/c		22,50,000
	(Being the application money received on 5,000 debentures @ ₹ 450 each)		
	Debentures Application A/c Dr. 22,50,000	22,50,000	
(b)	Discount on issue of Debentures A/c Dr. 2,50,000	2,50,000	
	To 14% Debentures A/c		25,00,000
	(Being the issue of 5,000 14% Debentures @ 90% as per Board's Resolution No....dated....)		
	Fixed Assets A/c Dr. 10,00,000	10,00,000	
(c)	To Vendor A/c		10,00,000
	(Being the purchase of fixed assets from vendor)		
	Vendor A/c Dr. 10,00,000	10,00,000	
	Discount on Issue of Debentures A/c Dr. 2,50,000	2,50,000	
	To 14% Debentures A/c		12,50,000
	(Being the issue of debentures of ₹ 12,50,000 to vendor to satisfy his claim)		
	Bank A/c Dr. 10,00,000	10,00,000	

To Bank Loan A/c (See Note) (Being a loan of ₹10,00,000 taken from bank by issuing debentures of ₹12,50,000 as collateral security)	10,00,000

Note : No entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet due to the fact that the debentures being issued as collateral security and outstanding are shown under the respective liability.



3.9 TREATMENT OF DISCOUNT/LOSS ON ISSUE OF DEBENTURES

The discount on issue of debentures is amortised¹ over a period between the issuance date and redemption date. It should be written-off in the following manner depending upon the terms of redemption:

- If the debentures are redeemable after a certain period of time, say at the end of 5 years, the total amount of discount should be written-off equally throughout the life of the debentures (applying the straight line method). The main advantage of this method is that it spreads the burden of discount equally over the years.
- If the debentures are redeemable at different dates, the total amount of discount should be written-off in the ratio of benefit derived from debenture loan in any particular year (applying the sum of the year's digit method). This method is suitable when debentures are redeemed by unequal instalments.

The accounting entries would be as follows :

Profit and Loss Account

Dr.

To Discount on Issue of Debentures Account

(Being the amount of discount on issue of debentures written-off)

Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.

ILLUSTRATION 11

HDC Ltd issues 1,00,000, 12% Debentures of ₹100 each at ₹94 on 1st January, 2022. Under the terms of issue, the debentures are redeemable at the end of 5 years from the date of the issue. Calculate the amount of discount to be written-off in each of the 5 years.

¹ Accounting Standard 16 Borrowing Costs states that ancillary borrowing costs and discounts or premiums related to borrowings can be amortized over the loan period. It also states that share issue expenses, discount on shares, and ancillary costs—such as discount premiums on borrowing—are excluded from the scope of Accounting Standard 26 Intangible Assets.

Keeping this in view, Guidance Note clarified that following the generally accepted accounting principle to amortize these expenses over the period of benefit, typically 3 to 5 years is acceptable.

SOLUTION

Total amount of discount comes to ₹ 6,00,000 (₹6 X 1,00,000). The amount of discount to be written-off in each year is calculated as under :

Year end	Debentures outstanding	Ratio in which discount to be written-off	Amount of discount to be written-off
1 st	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
2 nd	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
3 rd	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
4 th	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
5 th	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000

ILLUSTRATION 12

HDC Ltd. issues 2,00,000, 12% Debentures of ₹10 each at ₹9.40 on 1st January, 2022. Under the terms of issue, 1/5th of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 2022. Calculate the amount of discount to be written-off from 2022 to 2026.

SOLUTION**Calculation of amount of discount to be written-off**

At the Year end	Debentures Outstanding before redemption	Ratio of benefit Derived	Amount of discount to be written-off
2022	₹ 20,00,000	5	5/15th of ₹ 1,20,000 = ₹ 40,000
2023	₹ 16,00,000	4	4/15th of ₹ 1,20,000 = ₹ 32,000
2024	₹ 12,00,000	3	3/15th of ₹ 1,20,000 = ₹ 24,000
2025	₹ 8,00,000	2	2/15th of ₹ 1,20,000 = ₹ 16,000
2026	₹ 4,00,000	1	1/15th of ₹ 1,20,000 = ₹ 8,000
	TOTAL	15	₹ 1,20,000

3.10 INTEREST ON DEBENTURES

Interest payable on coupon debenture is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates

applicable under tax rules from time to time. The companies will deposit the tax so deducted with income tax authorities. Following accounting entries are to be recorded in this regard:

1. *For making interest due*

Interest A/c	Dr.
To Debenture holders' A/c	

2. *For making payment of interest and deduction of tax at source (TDS)*

Debenture holders A/c	Dr.
To TDS Payable A/c	
To Bank A/c	

3. *For making payment of tax deducted at source*

TDS payable A/c	Dr.
To Bank A/c	

4. *For transferring interest to profit and loss account*

Profit and Loss A/c	Dr.
To Interest A/c	

ILLUSTRATION 13

A company issued 12% debentures of the face value of ₹10,00,000 at 10% discount on 1-1-2022. Debenture interest after deducting tax at source @ 10% was payable on 30th June and 31st of December every year. All the debentures were to be redeemed after the expiry of five year period at 5% premium.

Pass journal entries for the accounting year 2022.

SOLUTION

Journal Entries

			(₹)	(₹)
1-1-2022	Bank A/c	Dr.	9,00,000	
	Discount/Loss on Issue of Debentures A/c	Dr.	1,50,000	
	To 12% Debentures A/c	Dr.		10,00,000
	To Premium on Redemption of Debentures A/c			50,000
	(For issue of debentures at discount redeemable at premium)			

30-6-2022	Debenture Interest A/c	Dr.	60,000	
	To Debenture holders A/c			54,000
	To Tax Deducted at Source A/c			6,000
	(For interest payable)			
31-12-2022	Debenture holders A/c	Dr.	54,000	
	Tax Deducted at Source A/c	Dr.	6,000	
	To Bank A/c			60,000
	(For payment of interest and TDS)			
	Debenture Interest A/c	Dr.	60,000	
	To Debenture holders A/c			54,000
31-12-2022	To Tax Deducted at Source A/c			6,000
	(For interest payable)			
	Debenture holders A/c	Dr.	54,000	
	Tax Deducted at Source A/c	Dr.	6,000	
	To Bank A/c			60,000
	(For payment of interest and tax)			
	Profit and Loss A/c	Dr.	1,20,000	
	To Debenture Interest A/c			1,20,000
31-12-2022	(For transfer of debenture interest to profit and loss account at the end of the year)			
	Profit and Loss A/c	Dr.	30,000	
	To Discount/Loss on issue of debenture A/c			30,000
	(For proportionate debenture discount and premium on redemption written off, i.e., 1,50,000 x 1/5)			

SUMMARY

- ◆ Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business. A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. Money payable on debentures may be paid either in full with application or in instalments.
 - ◆ Debenture holders are the creditors of the company whereas shareholders are the owners of the company. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company. Shareholders have voting rights and consequently control the total affairs of the company.
 - ◆ Debentures can be classified on the basis of: (1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.
 - ◆ Issue of redeemable debentures can be categorized into the following:
 1. Debenture issued at par and redeemable at par or at a discount;
 2. Debenture issued at a discount and redeemable at par or at discount;
 3. Debenture issued at premium and redeemable at par or at discount;
 4. Debenture issued at par and redeemable at premium;
 5. Debenture issued at a discount and redeemable at premium;
 6. Debenture issued at premium and redeemable at premium;
- Note:** In practical life, redemption of debentures at a discount is a rare situation.
- ◆ Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid. Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft.
 - ◆ Debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc.
 - ◆ The discount on issue of debentures is amortised over a period between the issuance date and redemption date. Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.
 - ◆ Interest payable on debentures is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures.

TEST YOUR KNOWLEDGE

True and False

1. *Debenture holder are the owners of the company.*
2. *Perpetual debentures are payable at the time of liquidation of the company.*
3. *Registered debentures are transferable by delivery.*
4. *When companies issue their own debentures as collateral security for a loan, the holder of such debenture is entitled to interest only on the amount of loan and not on the debentures*
5. *Debentures suspense account appears on liability side of balance sheet.*
6. *If a company incurs loss, then it does not pay interest to the debenture holders.*
7. *At the time of liquidation, debenture holders are paid off after the shareholders.*
8. *Convertible debentures can be converted into equity shares.*
9. *Redeemable debentures are not payable during the life time of the company.*
10. *Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc.*

Multiple Choice Questions

1. *Premium on redemption of debentures account appearing in the balance sheet is _____.
(a) A nominal account – expenditure
(b) A nominal account - income
(c) A personal account _____.*
2. *Debenture interest
(a) Is payable before the payment of any dividend on shares
(b) Accumulates in case of losses or inadequate profits
(c) Is payable after the payment of preference dividend but before the payment of equity dividend _____.*
3. *F Ltd. purchased Machinery from G Company for a book value of ₹ 4,00,000. The consideration was paid by issue of 10% debentures of ₹ 100 each at a premium of 25%. The debenture account was credited with _____.
(a) ₹ 4,00,000*

- (b) ₹ 5,00,000
 - (c) ₹ 3,20,000
4. Which of the following is not a characteristic of Bearer Debentures?
- (a) They are treated as negotiable instruments
 - (b) Their transfer requires a deed of transfer
 - (c) They are transferable by mere delivery
5. When debentures are issued as collateral security, the final entry for recording the collateral debentures in the books is _____.
- (a) Credit Debentures A/c and debit Cash A/c.
 - (b) Debit Debenture suspense A/c and credit Cash A/c.
 - (c) Debit Debenture suspense A/c and credit Debentures A/c.
6. When debentures are redeemable at different dates, the total amount of discount on issue of debentures should be written off
- (a) Every year by applying the sum of the year's digit method
 - (b) Every year by applying the straight line method
 - (c) To profit and loss account in full in the year of final or last redemption
7. Debentures are issued at discount when
- (a) Market interest rate is higher than debenture interest rate
 - (b) Market interest rate is lower than debenture interest rate
 - (c) Market interest rate is equal debenture interest rate
8. Interest payable on Debentures attract
- (a) Tax deducted at source
 - (b) Goods and Service tax
 - (c) Fringe benefit tax

Theoretical questions

1. Distinguish between debentures and shares.
2. Explain the purpose for raising of debenture by the company. Also give the main features of debentures.

Practical questions

1. Country Crafts Ltd. issued 1,00,000, 8% debentures of ₹ 100 each at premium of 5% payable fully on application and redeemable at premium of ₹ 10 Pass necessary journal entries at the time of issue.
2. Koinal Chemicals Ltd. issued 20,00,000, 10% debentures of ₹50 each at premium of 10%, payable as ₹ 20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in allotment money.
3. Kapil Ltd. issued 50,000, 12% Debentures of ₹100 each at a premium of 10% payable in full on application by 1st March, 2022. The issue was fully subscribed and debentures were allotted on 9th March, 2022.

Pass necessary Journal Entries (including cash transactions).

4. On 1st April 2022 Sheru Ltd. issued 1,00,000 12% debentures of ₹100 each at a discount of 5%, redeemable on 31st March, 2027. Issue was oversubscribed by 20,000 debentures, who were refunded their money. Interest is paid annually on 31st March. You are required to prepare:
 - (i) Journal Entries at the time of issue of debentures.
 - (ii) Discount on issue of Debenture Account
 - (iii) Interest account and Debenture holder Account assuming TDS is deducted @ 10%.
5. A Limited issued 14% Debentures of the nominal value of ₹ 10 each as follows:
 - (a) To sundry persons 1,00,000 Debentures for cash at 10% discount.
 - (b) To a vendor for purchase of Inventory worth ₹ 1,00,000, 8,000 debentures at 25% premium.
 - (c) To the banker as collateral security for a loan of ₹ 1,00,000 – ₹ 1,50,000 nominal value.

Pass necessary Journal Entries.

ANSWERS/HINTS

True and False

1. False: Debenture holder are the creditors of the company.
2. True: Perpetual debentures, also known as irredeemable debentures are not repayable during the life time of the company.
3. False: Registered debentures are not easily transferable by delivery. Bearer debentures are transferrable by delivery.
4. True: In case the company cannot repay its loan & the interest thereon on the due date, the lender becomes debenture holder & then only he is entitled to interest on debentures.
5. False: Debentures suspense account appears on asset side of balance sheet under non-current asset.
6. False: Even if the company incurs loss or earns profit, it has to pay the interest on debentures.
7. False: At the time of liquidation, debenture holders are paid off before shareholders on priority basis.
8. True: Convertible debentures can be converted into equity share after a certain period of time from the date of its issue.
9. False: These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.
10. True: Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(c)	4.	(b)	5.	(c)	6.	(a)
7.	(a)	8.	(a)								

Theoretical Questions

1. Refer para 3.4 for the distinction between Shares and Debentures.
2. Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business. The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or

naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

For features of debentures refer para 3.3.

Practical Questions

1. Journal Entries in the Books of Country Crafts Ltd.

Date	Particulars	L.F.	Debit	Credit
			Amount	Amount
			(₹'000)	(₹'000)
(a)	Bank A/c To Debenture Application A/c (Debenture application money received)	Dr.	10,500	10,500
(b)	Debenture Application A/c Loss on Issue of Debenture A/c To Securities Premium A/c To 8% Debentures A/c To Premium on Redemption A/c (Debenture application money transferred to debenture account)	Dr. Dr.	10,500 1,000	500 10,000 1,000

2. Journal Entries in the Books of Koinal Chemicals Ltd.

Particulars		Debit	Credit
		Amount (₹ lakhs)	Amount (₹ lakhs)
Bank A/c To Debenture Application A/c (Debenture application money received)	Dr.	400	400
Debentures Application A/c To 10% Debentures A/c (Debenture application money transferred to 10% debenture account consequent upon allotment)	Dr.	400	400

Debenture allotment A/c	Dr.	700	
To 10% Debentures A/c			600
To Securities Premium A/c			100
(Call made on allotment of debenture including premium)			
Bank A/c	Dr.	700	
To Debenture Allotment A/c			700
(Money received consequent upon allotment)			

3. **Journal Entries in the books of Kapil Limited**

Date	Particulars	₹	₹
2022			
March 1	Bank A/c Dr. To Debentures Application A/c (Being the money received on 50,000 debentures @ ₹ 110 each including premium of ₹ 10 each)	55,00,000	55,00,000
March 9	Debentures Application A/c Dr. To 12% Debentures A/c To Securities Premium A/c (Being the allotment of 50,000 debentures of ₹ 100 each, premium @ ₹ 10 each transferred to Securities Premium Account as per Board's Resolution No....dated....)	55,00,000	50,00,000 5,00,000

4. (i) **Journal in the Books of Sheru Ltd.**

Date	Particulars	LF	(₹ 00)	(₹ 00)
2022				
Apr 1	Bank A/c To Debenture Application A/c (Being debenture application money received for 1,20,000 debentures)		1,14,000	1,14,000
	Debenture Application A/c Dr.		1,14,000	
	Discount on Issue of Debenture A/c Dr.		5,000	

To 12% Debenture A/c	1,00,000
To Bank A/c	19,000
(Being application money transferred to debenture account and excess refunded)	

(ii)

Discount on Issue of Debenture A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
1.4.22	To 12% Debentures A/c	5,000	31.3.23	By Profit & Loss A/c	1,000
		_____	31.3.23	By Balance c/d	<u>4,000</u>
		<u>5,000</u>			<u>5,000</u>
1.4.23	To Balance b/d	4,000	31.3.24	By Profit & Loss A/c	1,000
		_____	31.3.24	By Balance c/d	<u>3,000</u>
		<u>4,000</u>			<u>4,000</u>
1.4.24	To Balance b/d	3,000	31.3.25	By Profit & Loss A/c	1,000
		_____	31.3.25	By Balance c/d	<u>2,000</u>
		<u>3,000</u>			<u>3,000</u>
1.4.25	To Balance b/d	2,000	31.3.26	By Profit & Loss A/c	1,000
		_____	31.3.26	By Balance c/d	<u>1,000</u>
		<u>2,000</u>			<u>2,000</u>
1.4.26	To Balance b/d	<u>1,000</u>	31.3.27	By Profit & Loss A/c	<u>1,000</u>
		1,000			1,000

(iii)

Interest A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
31.3.23	To Debentureholder A/c	<u>12,000</u>	31.3.23	By Profit & Loss A/c	<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>
31.3.24	To Debentureholder A/c	<u>12,000</u>	31.3.24	By Profit & Loss A/c	<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>
31.3.25	To Debentureholder A/c	<u>12,000</u>	31.3.25	By Profit & Loss A/c	<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>

31.3.26	To Debentureholder A/c	<u>12,000</u>	31.3.26	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000
31.3.27	To Debentureholder A/c	<u>12,000</u>	31.3.27	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000

Debentureholder A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
31.3.23	To Bank A/c	10,800	31.3.23	By Interest A/c	12,000
31.3.23	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			12,000
31.3.24	To Bank A/c	10,800	31.3.24	By Interest A/c	12,000
31.3.24	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			12,000
31.3.25	To Bank A/c	10,800	31.3.25	By Interest A/c	12,000
31.3.25	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			12,000
31.3.26	To Bank A/c	10,800	31.3.26	By Interest A/c	12,000
31.3.26	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			12,000
31.3.27	To Bank A/c	10,800	31.3.27	By Interest A/c	12,000
31.3.27	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			12,000

5.

In the books of A Ltd.**Journal Entries**

Date	Particulars	₹	₹
(a)	Bank A/c Dr. To Debentures Application A/c (Being the application money received on 100,000 debentures @ ₹ 9 each)	9,00,000	9,00,000
	Debentures Application A/c Dr. Discount on issue of Debentures A/c Dr. To 14% Debentures A/c (Being the issue of 100,000 14% Debentures @ 90% as per Board's Resolution No....dated....)	9,00,000 1,00,000	10,00,000

(b)	Inventories A/c Dr.	1,00,000	
	To Vendor A/c (Being the purchase of inventories from vendor)		1,00,000
	Vendor A/c Dr.	1,00,000	
	To 14% Debentures A/c		80,000
	To Securities Premium (Being the issue of 8,000 debentures of to vendor to satisfy his claim at premium of 25%)		20,000
(c)	Bank A/c Dr.	1,00,000	
	To Bank Loan A/c (See Note) (Being a loan of ₹1,00,000 taken from bank by issuing debentures of ₹1,50,000 as collateral security)		1,00,000

Note : No entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet due to the fact that the debentures being issued as collateral security and outstanding are shown under the respective liability.

UNIT – 4: ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ♦ Understand the provisions relating to issue of bonus shares and right shares;
- ♦ Account for bonus shares and rights issue in the books of issuing company;
- ♦ Understand the meaning of renunciation of right;
- ♦ Differentiate between cum-right and ex-right value of share;
- ♦ Calculate value of rights.

UNIT OVERVIEW

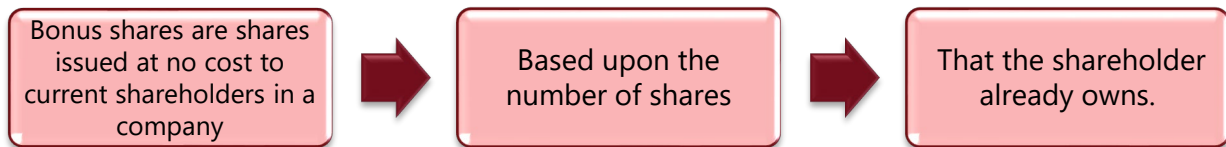
BONUS SHARES	Bonus issue means an issue of additional shares to existing shareholders free of cost in proportion to their existing holding. A company may issue fully paid-up bonus shares to its shareholders out of— (i) its free reserves; (ii) securities premium account; or (iii) capital redemption reserve account: Bonus shares should not be issued out of revaluation reserves (i.e., reserves created by the revaluation of assets).
RIGHT ISSUE	Rights issue is an issue of rights to a company's existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period. In a rights offering, the subscription price at which each share may be purchased is generally at a discount to the current market price. Rights are often transferable, allowing the holder to sell them in the open market. The difference between the cum-right and ex-right value of the share is the value of the right.

**4.1 ISSUE OF BONUS SHARES****4.1.1 Introduction**

A bonus share may be defined as issue of shares at no cost to current shareholders in a company, based upon the number of shares that the shareholder already owns. In other words, no new funds are raised with a bonus issue. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant.

Bonus issue is also known as 'capitalisation of profits'. Capitalisation of profits refers to the process of converting profits or reserves into paid up capital. A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to the members.

If the subscribed and paid-up capital exceeds the authorised share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution authorising the issue of bonus shares is also required to be filed with the Registrar of Companies.



Example 1

Alpha Company announced bonus issue to its shareholders in the ratio of 2:3 ie. 2 shares for every 3 shares held. Shareholder X has 6,000 shares before announcement of bonus issue. How much shares would he have after bonus issue?

Solution

Company announced bonus issue in ratio of 2:3

Shareholder X will be entitled to have 4,000 bonus shares $(6,000 \text{ shares} / 3 \times 2)$

Total number of shares X has after bonus issue 10,000 $(6,000 + 4,000)$

4.1.2 Provisions of the Companies Act, 2013

Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to Sub-section (1) of Section 63, a company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—

- (i) its free reserves*;
- (ii) the securities premium account; or
- (iii) the capital redemption reserve account:

Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Sub-section (2) of Section 63 provides that no company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless—

* As per Section 2(43) of the Companies Act, 2013, "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend. Provided that—

- (i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or
- (ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

- (a) it is authorised by its articles;
- (b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;
- (c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
- (d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
- (e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up.
- (f) it complies with such conditions as may be prescribed.

The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same.

Sub-section (3) of the Section also provides that the bonus shares shall not be issued in lieu of dividend.

As per Para 39 (i) of Table F under Schedule I to the Companies Act, 2013, a company in general meeting may, upon the recommendation of the Board, resolve—

- (i)
 - (a) that it is desirable to capitalise any part of the amount for the time being standing to the credit of any of the company's reserve accounts, or to the credit of the profit and loss account, or otherwise available for distribution; and
 - (b) that such sum be accordingly set free for distribution in the specified manner amongst the members who would have been entitled thereto, if distributed by way of dividend and in the same proportions.
- (ii) The sum aforesaid shall not be paid in cash but shall be applied, subject to the provision contained in clause (iii), either in or towards— (a) paying up any amounts for the time being unpaid on any shares held by such members respectively; (b) paying up in full, unissued shares of the company to be allotted and distributed, credited as fully paid-up, to and amongst such members in the proportions aforesaid; partly in the way specified in (a) and partly in that specified in (b) above;

A securities premium account and a capital redemption reserve account may only be applied in the paying up of unissued shares to be issued to members of the company as fully paid bonus shares. In other words, securities premium account and capital redemption reserve **cannot** be applied towards payment of unpaid amount on any shares held by existing shareholders.

As per Section 63(2) of the Companies Act, 2013, bonus shares cannot be issued unless partly paid-up shares are made fully paid-up. Para 39(ii) of Table F under Schedule I to the Companies Act, 2013 allows use of free reserves for paying up amounts unpaid on shares held by existing shareholders.

On a combined reading of both the provisions, it can be said that free reserves may be used for paying up amounts unpaid on shares held by existing shareholders (though securities premium account and capital redemption reserve cannot be used).

4.1.3 Journal Entries

(A) (1) Upon the sanction of an issue of bonus shares

Capital Redemption Reserve Account	Dr.
Securities Premium Account ¹	Dr.
General Reserve Account	Dr.
Profit & Loss Account	Dr.
To Bonus to Shareholders Account.	

(2) Upon issue of bonus shares

Bonus to Shareholders Account	Dr.
To Share Capital Account.	

(B) (1) Upon the sanction of bonus by converting partly paid shares into fully paid shares

General Reserve Account	Dr.
Profit & Loss Account	Dr.
To Bonus to Shareholders Account	

(2) On making the final call due

Share Final Call Account	Dr.
To Share Capital Account.	

¹ As per SEBI Regulations, such securities premium should be realized in cash, whereas under the Companies Act, 2013, there is no such requirement. In accordance with Section 52, securities premium may arise on account of issue of shares other than by way of cash. Thus, for unlisted companies, securities premium (not realized in cash) may be used for issue of bonus shares, whereas the same cannot be used in case of listed companies.

(3) On adjustment of final call

Bonus to Shareholders Account

Dr.

To Share Final Call Account

ILLUSTRATION 1

Following items appear in the trial balance of Bharat Ltd. (a listed company) as on 31st March, 2022:

	₹
40,000 Equity shares of ₹ 10 each	4,00,000
Capital Redemption Reserve	55,000
Securities Premium (collected in cash)	30,000
General Reserve	1,05,000
Surplus i.e. credit balance of Profit and Loss Account	50,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

SOLUTION**Journal Entries in the books of Bharat Ltd.**

		Dr.	Cr.
		₹	₹
Capital Redemption Reserve A/c	Dr.	55,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c (b.f.)	Dr.	15,000	
To Bonus to Shareholders A/c			1,00,000
(Bonus issue of one share for every four shares held, by utilising various reserves as per Board's resolution dated.....)			
Bonus to Shareholders A/c	Dr.	1,00,000	
To Equity Share Capital A/c			1,00,000
(Capitalisation of profit)			

Working Note-

Number of Bonus shares to be issued- $(40,000 \text{ shares} / 4) \times 1 = 10,000 \text{ shares}$

Value of Bonus shares- $10,000 \text{ shares of ₹ 10 each} = ₹ 1,00,000$

ILLUSTRATION 2

Pass Journal Entries in the following circumstances:

- (i) A Limited company with subscribed capital of ₹ 5,00,000 consisting of 50,000 Equity shares of ₹ 10 each; called up capital ₹ 7.50 per share. A bonus of ₹ 1,25,000 declared out of General Reserve to be applied in making the existing shares fully paid up.
- (ii) A Limited company having fully paid up capital of ₹ 50,00,000 consisting of Equity shares of ₹ 10 each, had General Reserve of ₹ 9,00,000. It was resolved to capitalize ₹ 5,00,000 out of General Reserve by issuing 50,000 fully paid bonus shares of ₹ 10 each, each shareholder to get one such share for every ten shares held by him in the company.

SOLUTION**Journal Entries**

		₹	₹
(i)	General Reserve A/c Dr. To Bonus to shareholders A/c (For making provision of bonus issue)	1,25,000	1,25,000
	Share Final Call A/c To Equity share capital A/c (For final calls of ₹ 2.5 per share on 50,000 equity shares due as per Board's Resolution dated....)	1,25,000	1,25,000
	Bonus to shareholders A/c Dr. To Share Final Call A/c (For bonus money applied for call)	1,25,000	1,25,000
(ii)	General Reserve A/c Dr. To Bonus to shareholders A/c (For making provision of bonus issue)	5,00,000	5,00,000
	Bonus to shareholders A/c Dr. To Equity share capital A/c (For issue of 50,000 bonus shares at ₹ 10)	5,00,000	5,00,000

ILLUSTRATION 3

Following notes pertain to the Balance Sheet of Solid Ltd. as at 31st March, 2022:

	₹
<i>Authorised capital :</i>	
10,000 12% Preference shares of ₹ 10 each	1,00,000
1,00,000 Equity shares of ₹ 10 each	<u>10,00,000</u>
	<u>11,00,000</u>
<i>Issued and Subscribed capital:</i>	
8,000 12% Preference shares of ₹ 10 each fully paid	80,000
90,000 Equity shares of ₹ 10 each, ₹ 8 paid up	7,20,000
<i>Reserves and Surplus :</i>	
General reserve	1,60,000
Revaluation reserve	35,000
Securities premium (collected in cash)	20,000
Profit and Loss Account	2,05,000
<i>Secured Loan:</i>	
12% Debentures @ ₹ 100 each	5,00,000

On 1st April, 2022 the Company has made final call @ ₹ 2 each on 90,000 equity shares. The call money was received by 20th April, 2022. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue assuming that the company has passed necessary resolution at its general body meeting for increasing the authorised capital.

SOLUTION**Journal Entries in books of Solid Ltd.**

			Dr.	Cr.
			₹	₹
2022				
April 1	Equity Share Final Call A/c	Dr.	1,80,000	
	To Equity Share Capital A/c			1,80,000
	(Final call of ₹ 2 per share on 90,000 equity shares due as per Board's Resolution dated....)			

April 20	Bank A/c	Dr.	1,80,000	1,80,000
	To Equity Share Final Call A/c (Final Call money on 90,000 equity shares received)			
	Securities Premium A/c	Dr.	20,000	
	General Reserve A/c	Dr.	1,60,000	
	Profit and Loss A/c (b.f.)	Dr.	45,000	
April 20	To Bonus to Shareholders A/c (Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated...)			2,25,000
	Bonus to Shareholders A/c	Dr.	2,25,000	
	To Equity Share Capital A/c (Capitalization of profit)			2,25,000

Balance Sheet (Extract) as at 30th April, 2022 (after bonus issue)

		Particulars	Notes	Amount (₹)
1		Equity and Liabilities		
		Shareholders' funds		
	a	Share capital	1	12,05,000
	b	Reserves and Surplus	2	1,95,000
2		Non-current liabilities		
	a	Long-term borrowings	3	<u>5,00,000</u>
		Total		<u>19,00,000</u>

Notes to Accounts

1	Share Capital	
	<u>Authorised share capital</u>	
	10,000 12% Preference shares of ₹ 10 each	1,00,000
	1,12,500 Equity shares of ₹ 10 each	<u>11,25,000</u>

<u>Issued, subscribed and fully paid share capital</u>		
8,000 12% Preference shares of ₹ 10 each		80,000
1,12,500 Equity shares of ₹ 10 each, fully paid (Out of above, 22,500 equity shares @ ₹ 10 each were issued by way of bonus)	(A)	<u>11,25,000</u>
Total		<u>12,05,000</u>
2 Reserves and Surplus		
Revaluation Reserve		35,000
Securities Premium	20,000	
Less: Utilised for bonus issue	<u>(20,000)</u>	Nil
General reserve	1,60,000	
Less: Utilised for bonus issue	<u>(1,60,000)</u>	Nil
Profit & Loss Account	2,05,000	
Less: Utilised for bonus issue	<u>(45,000)</u>	<u>1,60,000</u>
Total		<u>1,95,000</u>
3 Long-term borrowings		
Secured		
12% Debentures @ ₹ 100 each		5,00,000

The authorised capital has been increased by sufficient number of shares. (11,25,000 – 10,00,000)

Working Note-

Number of Bonus shares to be issued (90,000 shares / 4) X 1 = 22,500 shares

Note: It has to be ensured that the authorized capital after bonus issue should not be less than the issued share capital (including bonus issue) in all the practical problems. The authorized capital may either be increased by the amount of bonus issue or the value of additional shares [value of bonus shares issued less unused authorized capital (excess of authorized capital in comparison to the issued shares before bonus issue)].

ILLUSTRATION 4

Following notes pertain to the Balance Sheet of Preet Ltd. as at 31st March, 2022

	₹
Share capital:	
Authorised capital:	
15,000 12% Preference shares of ₹ 10 each	1,50,000
1,50,000 Equity shares of ₹ 10 each	<u>15,00,000</u>
	<u>16,50,000</u>
Issued and Subscribed capital:	
12,000 12% Preference shares of ₹ 10 each fully paid	1,20,000
1,35,000 Equity shares of ₹ 10 each, ₹ 8 paid up	10,80,000
Reserves and surplus:	
General Reserve	1,80,000
Capital Redemption Reserve	60,000
Securities premium (collected in cash)	37,500
Profit and Loss Account	3,00,000

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 1,35,000 equity shares. The call money was received by 20th April, 2022. Thereafter, the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2022 after bonus issue.

SOLUTION**Journal Entries in the books of Preet Ltd.**

		₹	₹
1-4-2022	Equity share final call A/c Dr.	2,70,000	
	To Equity share capital A/c		2,70,000
	(For final calls of ₹ 2 per share on 1,35,000 equity shares due as per Board's Resolution dated....)		
20-4-2022	Bank A/c Dr.	2,70,000	

To Equity share final call A/c (For final call money on 1,35,000 equity shares received)			2,70,000
Securities Premium A/c	Dr.	37,500	
Capital Redemption Reserve A/c	Dr.	60,000	
General Reserve A/c	Dr.	1,80,000	
Profit and Loss A/c (b.f.)	Dr.	60,000	
To Bonus to shareholders A/c (For making provision for bonus issue of one share for every four shares held)			3,37,500
Bonus to shareholders A/c	Dr.	3,37,500	
To Equity share capital A/c (For issue of bonus shares)			3,37,500

Extract of Balance Sheet as at 30th April, 2022 (after bonus issue)

		₹
Share Capital		
Authorised Capital		
15,000 12% Preference shares of ₹10 each		1,50,000
1,68,750 Equity shares of ₹10 each (refer working note below)		<u>16,87,500</u>
Issued and subscribed capital		
12,000 12% Preference shares of ₹10 each, fully paid		1,20,000
1,68,750 Equity shares of ₹10 each, fully paid		16,87,500
(Out of above, 33,750 equity shares @ ₹10 each were issued by way of bonus)		
Reserves and surplus		
Securities Premium	37,500	
Less: Utilised for bonus issue	<u>(37,500)</u>	NIL
Capital Redemption Reserve	60,000	
Less: Utilised for bonus issue	<u>(60,000)</u>	NIL
General Reserve	1,80,000	

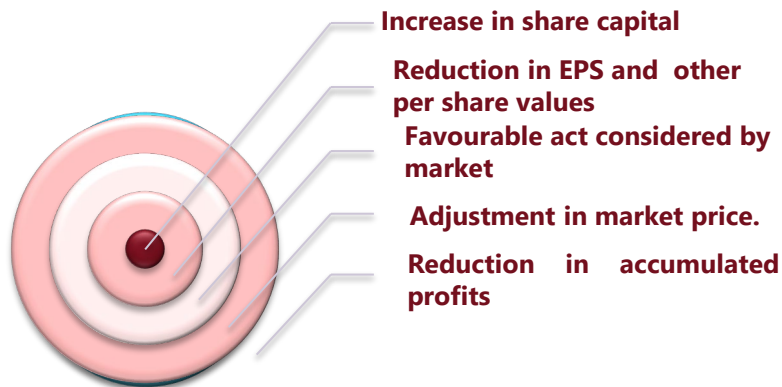
Less: Utilised for bonus issue	(1,80,000)	NIL
Profit and Loss Account	3,00,000	
Less: Utilised for bonus issue	(60,000)	2,40,000

Working Notes:

- Number of Bonus shares to be issued- ₹
 $(1,35,000 \text{ shares} / 4) \times 1 = 33,750 \text{ shares}$
 - The authorised capital should be increased as per details given below:
- | | |
|---|------------------|
| Existing issued Equity share capital | 13,50,000 |
| Add: Issue of bonus shares to equity shareholders | <u>3,37,500</u> |
| | <u>16,87,500</u> |

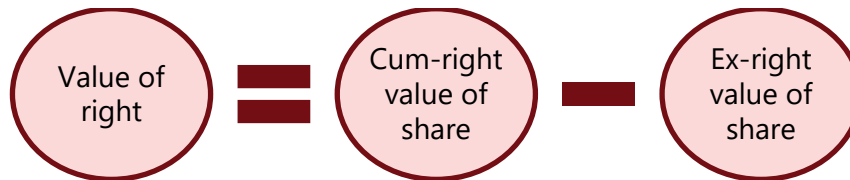
4.1.4 Effects of Bonus Issue

Bonus issue has following major effects:

**4.2 RIGHT ISSUE****4.2.1 Introduction**

Provisions of section 62(1)(a) of the Companies Act, 2013 govern any company, public or private, which is desirous of raising its subscribed share capital by issue of further shares. Whenever a company intends to issue new shares, the voting and governance rights of the existing shareholders may be diluted, if they are not allowed to preserve them. It may happen because new shareholders may subscribe to the issued share capital. Companies Act, 2013 allows existing shareholders to preserve their position by offering those newly issued shares at the first instance to them. The existing shareholders are given a right to subscribe these

shares, if they like. However, if they do not desire to subscribe these shares, they are even given the right to renounce it in favour of someone else (unless the articles of the company prohibits such a right to renounce).



In nutshell, the existing shareholders have a right to subscribe to any fresh issue of shares by the company in proportion to their existing holding for shares. They have an implicit right to renounce this right in favour of anyone else, or even reject it completely. In other words, the existing shareholders have right of first refusal, i.e., the existing shareholders enjoy a right to either subscribe for these shares or sell their rights or reject the offer.

Example 2

Assume a company makes a right issue of 10,000 shares when its existing issued and subscribed capital is 100,000 shares. This enables any shareholder having 10 shares to subscribe to 1 new share. Hence X, an existing shareholder holding 1,000 shares, may subscribe to 100 shares as a matter of right. The existing share percentage of X was 1% (1,000 / 100,000). If X subscribes these shares, his percentage holding in the company will be maintained at 1% (1,100 / 1,10,000). However, if X does not mind his share 0.91% diluting (1,000 / 1,10,000), he may renounce the right in favour of any one else, say Y. Hence, these 100 shares will be issued to Y, at the insistence of X. X may charge Y for this privilege, which is technically termed as the value of right.

A company desirous of issuing new shares has to offer, as per Section 62(1) (a) of Companies Act 2013, the shares to existing equity shareholders through a letter of offer subject to the following conditions, namely:

- The offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;
- Unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice (referred to in above bullet point) shall contain a statement of this right;
- After the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company.

Exceptions to the rights of existing equity shareholders

Section 62 recognises four situations under which the further shares are to be issued by a company, but they need not be offered to the existing shareholders.

The shares can be offered, without being offered to the existing shareholders, provided the company has passed a special resolution and shares are offered accordingly.

Situation 1

To employees under a scheme of employees' stock option subject to certain specified conditions

Situation 2

To any persons, either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer subject to certain specified conditions.

Situation 3

Sometimes companies borrow money through debentures / loans and give their creditor an option to buy equity shares of a company. An option is a right, but not an obligation, to buy equity shares on a future date (expiry date) at a price agreed in advance (exercise price).

According to Section 62(3), nothing in this section shall apply to the increase of the subscribed capital of a company caused by the exercise of an option as a term attached to the debentures issued or loan raised by the company to convert such debentures or loans into shares in the company.

Provided that the terms of issue of such debentures or loan containing such an option have been approved before the issue of such debentures or the raising of loan by a special resolution passed by the company in general meeting.

Situation 4

It is a special situation where the loan has been obtained from the government, and government in public interest, directs the debentures / loan to be converted into equity shares.

According to Section 62(4), notwithstanding anything contained in sub-section (3), where any debentures have been issued, or loan has been obtained from any Government by a company, and if that Government considers it necessary in the public interest so to do, it may, by order, direct that such debentures or loans or any part thereof shall be converted into shares in the company on such terms and conditions as appear to the Government to be reasonable in the circumstances of the case even if terms of the issue of such debentures or the raising of such loans do not include a term for providing for an option for such conversion.

Financial effects of a further issue

The financial position of a business is contained in the balance sheet. Further issue of shares increase the amount of equity (net worth)² as well as the liquid resources (Bank). *The amount of equity is the product of further number of shares issued multiplied by issue price.* The issue price may be higher than the face value (issue at a premium). Companies Act does not allow issue of shares at a discount, except issue of sweat equity shares under Section 53.

Book Value of a share

Book value of a share = Net worth (as per books)/ Number of shares

if there are 10,000 shares with net worth of 1,25,000. The book value of one share is (₹ 125,000/ 10,000 shares) ₹ 12.50 per share. However, the market value may differ from the book value of shares. The market value of a company's shares represents the present value of future cash flows expected to be earned from the share in the form of dividends and capital gains from expected future share price appreciation.

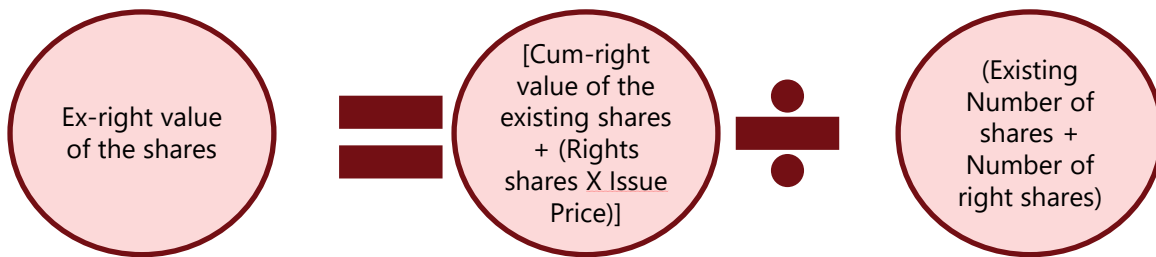
The market price, which exists before the rights issue, is termed as Cum-right Market Price of the share. If the company decides to issue further shares, it may affect the market value of the share. 'Theoretically', the value of a company's shares after a rights issue must equal the sum of market capitalisation immediately prior to rights issue and the cash inflows generated from the rights issue.

Normally, the further public issue to the existing shareholders are offered at a discounted price from the market value, to evoke positive response as well as to reward the existing shareholders.

Assume a company having a net worth of ₹ 250,000. 1,000 shares are issued (making it a right issue of 1:10; or 1 new share for 10 existing shares held) at a price of ₹ 14 per share. The existing worth of tangible assets held by the business shall become 264,000 (Existing net worth ₹ 250,000 + Fresh Issue ₹ 14,000). Equity shares shall correspondingly command a valuation of ₹ 264,000.

The market price of the shares after further issue of shares (right issue) is termed as Ex-right Market Price of the shares. Theoretical Ex-Rights Price is a deemed value, which is attributed to a company's share immediately after a rights issue transaction occurs. This price is going to prevail after the further issue of shares is executed.

² As per Section 2(57) of Companies Act 2013, "net worth" means the aggregate value of the paid-up share capital and all reserves created out of the profits and securities premium account, after deducting the aggregate value of the accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet, but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.



Right of Renunciation

Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person. Shareholders that have received right shares have three choices of what to do with the rights. They can act on the rights and buy more shares as per the particulars of the rights issue; they can sell them in the market; or they can pass on taking advantage of their rights (i.e., reject the right offer).

The renunciation of the right is valuable and can be monetised by the existing shareholders in well-functioning capital market. The monetised value available to the existing shareholders due to right issue is known as 'value of right'. If a shareholder decides to renounce all or any of the right shares in favour of his nominee, the value of right is restricted to the sale price of the renouncement of a right in favour of the nominee. In case the right issue offer is availed by an existing shareholder, the value of right is determined as given below:

Value of right = Cum-right value of share – Ex-right value of share

Ex-right value of the shares = $[\text{Cum-right value of the existing shares} + (\text{Rights shares} \times \text{Issue Price})] / (\text{Existing Number of shares} + \text{Number of right shares})$

In our previous example, Ex-right value of share = $[\text{₹ } 250,000 + (\text{₹ } 14 \times 1,000 \text{ shares})] / 10,000 + 1,000 \text{ shares} = \text{₹ } 24$

Value of right = $\text{₹ } 25 - \text{₹ } 24 = \text{₹ } 1$ per share.

Example 3

Continuing the previous case, consider an individual shareholder Mr. Narain holding 100 shares of Prosperous Company before rights issue.

Current worth of holding = No. of shares X Cum-right Market Price
 $= 100 \times 25 = \text{₹ } 2,500$

(a) If Narain exercises his right, he will pay $\text{₹ } 14 \times 10 \text{ shares} = \text{₹ } 140$.

His total investment in the company including right is $\text{₹ } 2,640$ ($\text{₹ } 2,500 + \text{₹ } 140$).

On a per share basis, it is $\text{₹ } 2,640 / 110 \text{ shares} = \text{₹ } 24$, which is the Ex-right Market value of the share.

- (b) If Narain does not exercise his right to further issue, his holding's worth will decline to ₹ 24 X 100 shares = ₹ 2400. The law allows him to compensate for this dilution of shareholding by renouncing this right in favour of, say, Mr. Murthy.

Narain can charge Murthy, in well-functioning capital markets, this dilution of ₹ 100 by renouncing his right to acquire 10 shares. Hence Murthy will be charged ₹ 10 per share (₹ 100 / 10 shares), in return for a confirmed allotment of 10 shares at ₹ 14 each.

For every share to be offered to Murthy, Narain must have ten shares at the back. Hence his holding of 10 shares fetches him right money of ₹ 10 or ₹ 1 per share held. This is exactly equal to the difference between Cum-right and Ex-right value of the share. It is termed as the Value of Right.

In a well-functioning capital market, this mechanism works in a fair manner to all the participants.

- Murthy's total investment will be ₹ 140 (payable to Company) + ₹ 100 (payable to Narain, by way of value of right), or ₹ 240. He will end up holding ten shares at an average cost of ₹ 24, which is the Ex-right Market Price of the share.
- Narain will have a final holding of ten shares worth ₹ 2400 + ₹ 100 by way of value of right received from Murthy. It matches with his cum-right holding valuation.

ILLUSTRATION 5

A company offers new shares of ₹ 100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is ₹ 150. Calculate the value of a right. What should be the ex-right market price of a share?

SOLUTION

Ex-right value of the shares = (Cum-right value of the existing shares + Rights shares Issue Price) / (Existing Number of shares + No. of right shares)

$$= (\text{₹ } 150 \times 4 \text{ Shares} + \text{₹ } 125 \times 1 \text{ Share}) / (4 + 1) \text{ Shares}$$

$$= \text{₹ } 725 / 5 \text{ shares} = \text{₹ } 145 \text{ per share.}$$

Value of right = Cum-right value of the share – Ex-right value of the share

$$= \text{₹ } 150 - \text{₹ } 145 = \text{₹ } 5 \text{ per share.}$$

Hence, any one desirous of having a confirmed allotment of one share from the company at ₹ 125 will have to pay ₹ 20 (4 shares X ₹ 5) to an existing shareholder holding 4 shares and willing to renounce his right of buying one share in favour of that person.

4.2.2 Accounting for Right issue

The accounting treatment of rights share is the same as that of issue of ordinary shares and the following journal entry will be made:

Bank A/c	Dr.
To Equity shares capital A/c	

In case rights shares are being offered at a premium, the premium amount is credited to the securities premium account.

The accounting entry is usual and is

Bank A/c	Dr.
To Equity Share Capital A/c	
To Securities Premium A/c	

Example 4

A Company having 70,000 shares of ₹10 each as its issued share capital and having market value of ₹21 issues rights shares in the ratio of 1:10 at an issue price of ₹10. Pass journal entry for issue of right shares.

The entry at the time of subscription of right shares by the existing shareholders will be:

Bank A/c	Dr.	70,000	
To Equity Share Capital A/c			70,000

(Being issue of 7,000 right shares at price of ₹ 10)

Working Note- Number of rights shares to be issued- $70,000/10 \times 1 = 7000$ shares.

Example 5

A company having 1,00,000 shares of ₹10 each as its issued share capital, and having a market value of ₹46, issues rights shares in the ratio of 1:10 at an issue price of ₹31. Pass journal entry for issue of right shares.

The entry at the time of subscription of right shares by the existing shareholders will be:

Bank A/c	Dr.	3,10,000	
To Equity Share Capital A/c			1,00,000
To Securities Premium A/c			2,10,000

(Being issue of 10,000 right shares @ ₹ 31 offered)

4.2.3 Advantages and Disadvantages of Right Issue

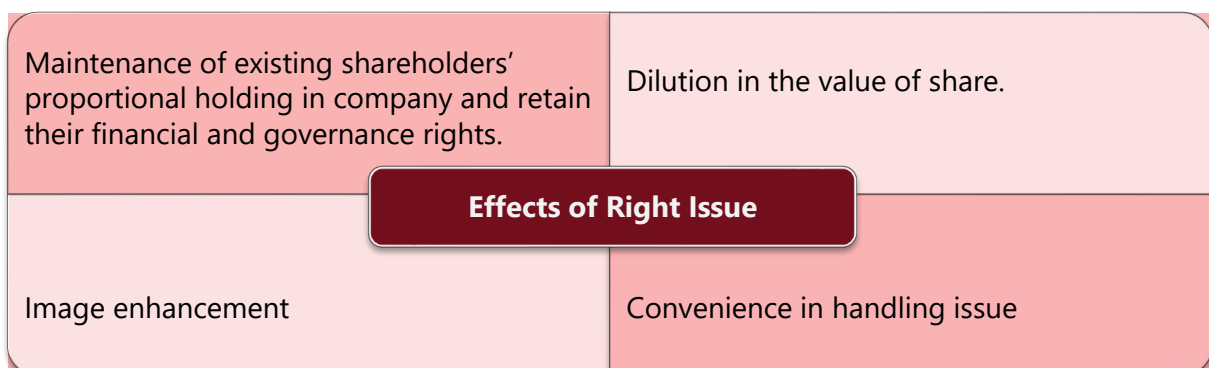
Advantages of Right Issue

1. Right issue enables the existing shareholders to maintain their proportional holding in the company and retain their financial and governance rights. It works as a deterrent to the management, which may like to issue shares to known persons with a view to have a better control over the company's affairs.
2. In well-functioning capital markets, the right issue necessarily leads to dilution in the value of share. However, the existing shareholders are not affected by it because getting new shares at a discounted value from their cum-right value will compensate decrease in the value of shares. The cum-right value is maintained otherwise also, if the existing shareholders renounce their right in favour of a third party.
3. Right issue is a natural hedge against the issue expenses normally incurred by the company in relation to public issue.
4. Right issue has an image enhancement effect, as public and shareholders view it positively.
5. The chance of success of a right issue is better than that of a general public issue and is logistically much easier to handle.

Disadvantages of Right Issue

1. The right issue invariably leads to dilution in the market value of the share of the company.
2. The attractive price of the right issue should be objectively assessed against its true worth to ensure that you get a bargained deal.

Effects of Right Issue



SUMMARY

- Bonus issue means an issue of additional shares free of cost to existing shareholders.
- Bonus Issue is also known as a "scrip issue" or "capitalization issue" or "capitalization of profits".
- Bonus issue has following major effects:
 - Share capital gets increased according to the bonus issue ratio
 - Effective Earnings per share, Book Value and other per share values stand reduced.
 - Markets take the action usually as a favourable act.
 - Market price gets adjusted on issue of bonus shares.
 - Accumulated profits get reduced.
- Bonus shares can be issued from following:
 - Free Reserves
 - Securities Premium collected in cash
 - Capital Redemption Reserve.
- Bonus issue cannot be made out of Revaluation Reserve created by revaluation of assets.
- A right issue is an offer of equity shares in a further issue of shares by a company to its existing shareholders, to enable them in maintaining their financial and governance interest in the company, if they so desire.
- The Right shares are normally offered at a price less than the cum-right value of the share, causing dilution in its value post-right issue. The value of share after right is termed as ex-right value (or average price) of the share. The difference between the cum-right and ex-right value (average price) of the share is called value of right.
- The accounting treatment of rights share is the same as that of issue of ordinary shares.
- The right issue offers considerable advantages to existing shareholders enabling them to maintain their rights in the company and is equally advantageous to the company for its relatively simple logistics and cost effectiveness as compared to a full blown public issue. However, the dilution in the value of the share is a dampener and a major limitation.

TEST YOUR KNOWLEDGE

True and false

1. *Earning per share gets increased after bonus issue.*
2. *Issued share capital including issue of rights shares and bonus shares may be more than the Authorised capital.*
3. *Rights issue of shares results in decrease of market value of per share in comparison to market price before rights issue.*
4. *Right shares are normally offered at a price more than the cum-right value of the share, causing dilution in its value post-right issue.*

Multiple Choice Questions

1. *Which of the following cannot be used for issue of bonus shares as per the Companies Act?*
 - (a) *Securities premium account*
 - (b) *Revaluation reserve*
 - (c) *Capital redemption reserve*
2. *Which of the following statements is true with regard to declaring and issuing of Bonus Shares?*
 - (a) *Assets are transferred from the company to the shareholders.*
 - (b) *A Bonus issue results in decrease in reserves and surplus.*
 - (c) *A Bonus issue is same as declaration of dividends.*
3. *Which of the following statement is true in case of bonus issue?*
 - (a) *Convertible debenture holders will get bonus shares in same proportion as to the existing shareholders.*
 - (b) *Bonus shares may be issued to convertible debenture holders at the time of conversion of such debentures into shares.*
 - (c) *Both (a) and (b).*
4. *Bonus issue is also known as*
 - (a) *Scrip issue.*
 - (b) *Capitalisation issue.*
 - (c) *Both (a) and (b).*

5. *The bonus issue is not made unless*
- (a) *Partly paid shares are made fully paid up.*
 - (b) *It is provided in its articles of association*
 - (c) *Both (a) and (b).*
6. *Bonus issue has the following effect*
- (a) *Market price gets adjusted on issue of bonus shares.*
 - (b) *Effective Earnings per share, Book Value and other per share values stand increased.*
 - (c) *Markets generally take the action as an unfavourable act.*
7. *ABC Co. Ltd resolved to issue bonus shares. Which of the following is not a pre-requisite for issuance of bonus shares?*
- (a) *Authorization in Articles of Association.*
 - (b) *Timely Payment of statutory dues of employees such as PF, Gratuity etc.*
 - (c) *Sufficient balance in bank account of company.*
8. *In case of further issue of shares, the right to renounce the shares in favour of a third party*
- (a) *Must include a right exercisable by the person concerned to renounce the shares;*
 - (b) *Should include a right exercisable by the person concerned to renounce the shares;*
 - (c) *Is deemed to include a right exercisable by the person concerned to renounce the shares (subject to the provisions under the articles of the company).*
9. *A company's share's face value is ₹ 10, book value is ₹ 20, Right issue price is ₹ 30 and Market price is ₹ 40, while recording the issue of right share, the securities premium will be credited with*
- (a) *₹ 10*
 - (b) *₹ 20*
 - (c) *₹ 30*
10. A. *Right shares enable existing shareholders to maintain their proportional holding in the company.*
- B. *Right share issue does not cause dilution in the market value of the share.*

Which of the option is correct?

- (a) A-Correct; B Correct
 - (b) A – Incorrect; B Correct
 - (c) A - Correct; B – Incorrect
11. Ex-Rights price can be calculated by which of these formulas?
- (a) $(\text{Cum rights value of the existing shares} + \text{Rights share issue proceeds}) / (\text{existing number of shares} + \text{No. of right shares})$.
 - (b) $(\text{Cum rights value of the existing shares} + \text{Rights share issue proceeds}) \times (\text{existing number of shares} + \text{No. of right shares})$.
 - (c) $(\text{Cum rights value of the existing shares} - \text{Rights share issue proceeds}) / (\text{existing number of shares} - \text{No. of right shares})$.

Theoretical Questions

- What is meant by Bonus issue? Explain its related provisions as per the Companies Act, 2013.
- Explain the financial effects of a further issue of equity shares on the market value of the share.
- What are the advantages and disadvantages of a rights issue?
- What is meant by renunciation of rights shares by existing shareholder?

Practical Questions

- Following items appear in the Trial Balance of Saral Ltd. as on 31st March, 2022:

Particulars	Amount
4,500 Equity Shares of ₹ 100 each	4,50,000
Securities Premium (collected in cash)	40,000
Capital Redemption Reserve	70,000
General Reserve	1,05,000
Profit and Loss Account (Cr. Balance)	65,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 3 shares held. Company decided that there should be the minimum reduction in free reserves. Pass necessary Journal Entries in the books Saral Ltd.

2. The following notes pertain to Brite Ltd.'s Balance Sheet as at 31st March, 2022:

Notes	₹ in Lakhs
(1) Share Capital	
Authorised :	
20 crore shares of ₹ 10 each	<u>20,000</u>
Issued and Subscribed :	
10 crore Equity Shares of ₹ 10 each	10,000
2 crore 11% Cumulative Preference Shares of ₹ 10 each	2,000
Total	12,000
Called and paid up:	
10 crore Equity Shares of ₹ 10 each, ₹ 8 per share called and paid up	8,000
2 crore 11% Cumulative Preference Shares of ₹ 10 each, fully called and paid up	2,000
Total	10,000
(2) Reserves and Surplus :	
Capital Redemption Reserve	1,485
Securities Premium (collected in cash)	2,000
General Reserve	1,040
Surplus i.e. credit balance of Profit & Loss Account	273
Total	4,798

On 2nd April 2022, the company made the final call on equity shares @ ₹ 2 per share. The entire money was received in the month of April, 2022.

On 1st June 2022, the company decided to issue to equity shareholders bonus shares at the rate of 2 shares for every 5 shares held . Pass journal entries for all the above mentioned transactions. Also prepare the notes on Share Capital and Reserves and Surplus relevant to the Balance Sheet of the company immediately after the issue of bonus shares.

3. Following notes pertain to the Balance Sheet of Manoj Ltd. as at 31st March, 2022

Authorised capital:	₹
30,000 12% Preference shares of ₹ 10 each	3,00,000
3,00,000 Equity shares of ₹ 10 each	30,00,000
	33,00,000

<i>Issued and Subscribed capital:</i>	
24,000 12% Preference shares of ₹ 10 each fully paid	2,40,000
2,70,000 Equity shares of ₹ 10 each, ₹ 8 paid up	21,60,000
<i>Reserves and surplus:</i>	
General Reserve	3,60,000
Capital Redemption Reserve	1,20,000
Securities premium (collected in cash)	75,000
Profit and Loss Account	6,00,000

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 2,70,000 equity shares. The call money was received by 20th April, 2022. Thereafter, the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2022 after bonus issue.

- A company has decided to increase its existing share capital by making rights issue to its existing shareholders. The company is offering one new share for every two shares held by the shareholder. The market value of the share is ₹ 240 and the company is offering one share of ₹ 120 each. Calculate the value of a right. What should be the ex-right market price of a share?
- A Ltd company having share capital of 25,000 equity shares of ₹10 each decides to issue rights share at the ratio of 1 for every 4 shares held at par value. Assuming all the share holders accepted the rights issue and all money was duly received, pass journal entries in the books of the company.
- Following notes pertain to the Balance Sheet of Mars Company Limited as at 31st March 2022:

	₹
<i>Authorised capital:</i>	
50,000 12% Preference shares of ₹ 10 each	5,00,000
5,00,000 Equity shares of ₹ 10 each	50,00,000
	55,00,000
<i>Issued and Subscribed capital:</i>	
50,000 12% Preference shares of ₹ 10 each fully paid	5,00,000

4,00,000 Equity shares of ₹ 10 each, ₹ 8 paid up	32,00,000
Reserves and surplus:	
General Reserve	1,60,000
Capital Redemption Reserve	2,40,000
Securities premium (collected in cash)	2,75,000
Revaluation Reserve	1,00,000
Profit and Loss Account	16,00,000

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 4,00,000 equity shares. The call money was received by 25th April, 2022. Thereafter, on 1st May 2022 the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held, it decided that there should be minimum reduction in free reserves.

On 1st June 2022, the Company issued Rights shares at the rate of two shares for every five shares held on that date at issue price of ₹ 12 per share. All the rights shares were accepted by the existing shareholders and the money was duly received by 20th June 2022.

Show necessary journal entries in the books of the company for bonus issue and rights issue.

ANSWERS/ HINTS

True and False

1. False. Earnings per share gets decreased after bonus issue.
2. False. Issued share capital including issue of rights shares and bonus shares is always less than or equal to Authorised capital.
3. True. Rights issue of shares results in decrease of market value of per share in comparison to market price before rights issue.
4. False. Right shares are normally offered at a price less than the cum-right value of the share, causing dilution in its value post-right issue.

Multiple Choice Questions

1.	(b)	2.	(b)	3.	(c)	4.	(c)	5.	(c)	6.	(a)
7.	(c)	8.	(c)	9.	(b)	10.	(c)	11.	(a)		

Theoretical Questions

1. Bonus Issue means an offer of free additional shares to existing shareholders. A company may decide to distribute further shares as an alternative to increase the dividend pay-out. For details, refer para 4.1.1 & 4.1.2.
2. The financial position of a business is contained in the balance sheet. Further issue of shares increases the amount of share capital as well as the liquid resources (Bank). The amount of share capital issued is the product of further number of shares issued multiplied by issue price. The issue price may be higher than the face value (issue at a premium).
3. Rights issue is an issue of rights to a company's existing shareholders that entitles them to buy additional shares directly from the company in proportion to their existing holdings, within a fixed time period. For advantages and disadvantages of right issue, refer para 4.2.3.
4. In a situation where existing shareholder does not intend to subscribe to the rights issue of a company, he may give up his right in favour of another person for a consideration. Such giving up of rights is called renunciation of rights.

Practical Questions

1. **Journal Entries in the books of Saral Ltd.**

2022		Dr.	Cr.
	Capital Redemption Reserve A/c Dr.	70,000	
	Securities Premium A/c Dr.	40,000	
	General Reserve A/c (b.f.) Dr.	40,000	
	To Bonus to Shareholders A/c (Bonus issue of one shares for every three shares held, by utilising various reserves as per Board's resolution dated.....)		1,50,000
	Bonus to Shareholders A/c Dr.	1,50,000	
	To Equity Share Capital A/c (Capitalisation of profit)		1,50,000

Working Note- Number of bonus shares to be issued- $4500 / 3 \times 1 = 1500$ shares

2.

Journal Entries in the books of Brite Ltd.

2022		Dr. ₹ in lakhs	Cr. ₹ in lakhs
April 2	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Final call of ₹ 2 per share on 10 crore equity shares made due)	2,000	2,000
	Bank A/c Dr. To Equity Share Final Call A/c (Final call money on 10 crore equity shares received)	2,000	2,000
June 1	Capital Redemption Reserve A/c Dr. Securities Premium A/c Dr. General Reserve A/c (b.f.) Dr. To Bonus to Shareholders A/c (Bonus issue of two shares for every five shares held, by utilising various reserves as per Board's resolution dated.....)	1,485 2,000 515	4,000
	Bonus to Shareholders A/c Dr. To Equity Share Capital A/c (Capitalisation of profit)	4,000	4,000

Notes to Accounts

		₹ in lakhs
1.	Share Capital Authorised share capital: 20 crore shares of ₹ 10 each Issued, subscribed and fully paid up share capital: 14 crore Equity shares of ₹ 10 each, fully paid up (Out of the above, 4 crore equity shares @ ₹ 10 each were issued by way of bonus) 2 crore, 11% Cumulative Preference share capital of ₹ 10 each, fully paid up	<u>20,000</u> 14,000 <u>2,000</u> <u>16,000</u>

2.	Reserves and Surplus:		
	Capital Redemption reserve	1,485	
	Less: Utilised for bonus issue	(1,485)	-
	Securities Premium	2,000	
	Less: Utilised for bonus issue	(2,000)	-
	General Reserve	1,040	
	Less: Utilised for bonus issue	(515)	525
	Surplus (Profit and Loss Account)		273
	Total		798

3. **Journal Entries in the books of Manoj Ltd.**

		₹	₹
1-4-2022	Equity share final call A/c Dr. To Equity share capital A/c (For final calls of ₹ 2 per share on 2,70,000 equity shares due as per Board's Resolution dated....)	5,40,000	5,40,000
20-4-2022	Bank A/c Dr. To Equity share final call A/c (For final call money on 2,70,000 equity shares received)	5,40,000	5,40,000
	Securities Premium A/c Dr. Capital redemption Reserve A/c Dr. General Reserve A/c Dr. Profit and Loss A/c (b.f.) Dr. To Bonus to shareholders A/c (For making provision for bonus issue of one share for every four shares held)	75,000 1,20,000 3,60,000 1,20,000	6,75,000
	Bonus to shareholders A/c Dr. To Equity share capital A/c (For issue of bonus shares)	6,75,000	6,75,000

Extract of Balance Sheet as at 30th April, 2022 (after bonus issue)

		₹
<i>Authorised Capital</i>		
30,000 12% Preference shares of ₹10 each		3,00,000
3,37,500 Equity shares of ₹10 each (refer W.N.)		<u>33,75,000</u>
<i>Issued and subscribed capital</i>		
24,000 12% Preference shares of ₹10 each, fully paid		2,40,000
3,37,500 Equity shares of ₹10 each, fully paid		33,75,000
(Out of the above, 67,500 equity shares @ ₹10 each were issued by way of bonus shares)		
<i>Reserves and surplus</i>		
Capital Redemption Reserve	1,20,000	
Less: Utilised for bonus issue	<u>(1,20,000)</u>	NIL
Securities premium	75,000	
Less: Utilised for bonus issue	<u>(75,000)</u>	NIL
General Reserve	3,60,000	
Less: Utilised for bonus issue	<u>(3,60,000)</u>	NIL
Profit and Loss Account	6,00,000	
Less: Utilised for bonus issue	<u>(1,20,000)</u>	4,80,000

Working Note:

- Number of bonus shares to be issued- $2,70,000/4 \times 1 = 67,500$ shares
 - The authorised capital should be increased as per details given below: ₹

Existing issued Equity share capital	27,00,000
Add: Issue of bonus shares to equity shareholders	<u>6,75,000</u>
	<u>33,75,000</u>
4. Ex-right value of the shares = (Cum-right value of the existing shares + Rights shares x Issue Price) / (Existing Number of shares + No. of right shares)
- = $(₹ 240 \times 2 \text{ Shares} + ₹ 120 \times 1 \text{ Share}) / (2 + 1) \text{ Shares}$
- = ₹ 600 / 3 shares = ₹ 200 per share.

Value of right = Cum-right value of the share – Ex-right value of the share
 = ₹ 240 – ₹ 200 = ₹ 40 per share.

Hence, any one desirous of having a confirmed allotment of one share from the company at ₹ 120 will have to pay ₹ 80 (2 shares x ₹ 40) to an existing shareholder holding 2 shares and willing to renounce his right of buying one share in favour of that person.

5. Journal Entry in the books of A Ltd.

		₹	₹
Bank A/c	Dr.	62,500	
To Equity share capital A/c			62,500
(For rights share issued at par value in the ratio of 1:4 equity shares due as per Board's Resolution dated....)			

Working Note:

Number of Rights shares to be issued- 25,000/4x1= 6,250 shares

6. Journal Entries in the books of Mars Ltd.

2022		Dr. ₹	Cr. ₹
April 1	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Final call of ₹ 2 per share on 4,00,000 equity shares made due)	8,00,000	8,00,000
April 25	Bank A/c Dr. To Equity Share Final Call A/c (Final call money on equity shares received)	8,00,000	8,00,000
May 1	Capital Redemption Reserve A/c Dr. Securities Premium A/c Dr. General Reserve A/c Dr. Profit and Loss A/c (b.f.) Dr.	2,40,000 2,75,000 1,60,000 3,25,000	

June 20	To Bonus to Shareholders A/c (Bonus issue of one shares for every four shares held, by utilising various reserves as per Board's resolution dated.....)		10,00,000
	Bonus to Shareholders A/c Dr.	10,00,000	
	To Equity Share Capital A/c (Capitalisation of profit)		10,00,000
	Bank A/c Dr.	24,00,000	
	To Securities Premium A/c		4,00,000
	To Equity Share Capital A/c (Being Rights issue of 2 shares for every 5 shares held as per board resolution dated)		20,00,000

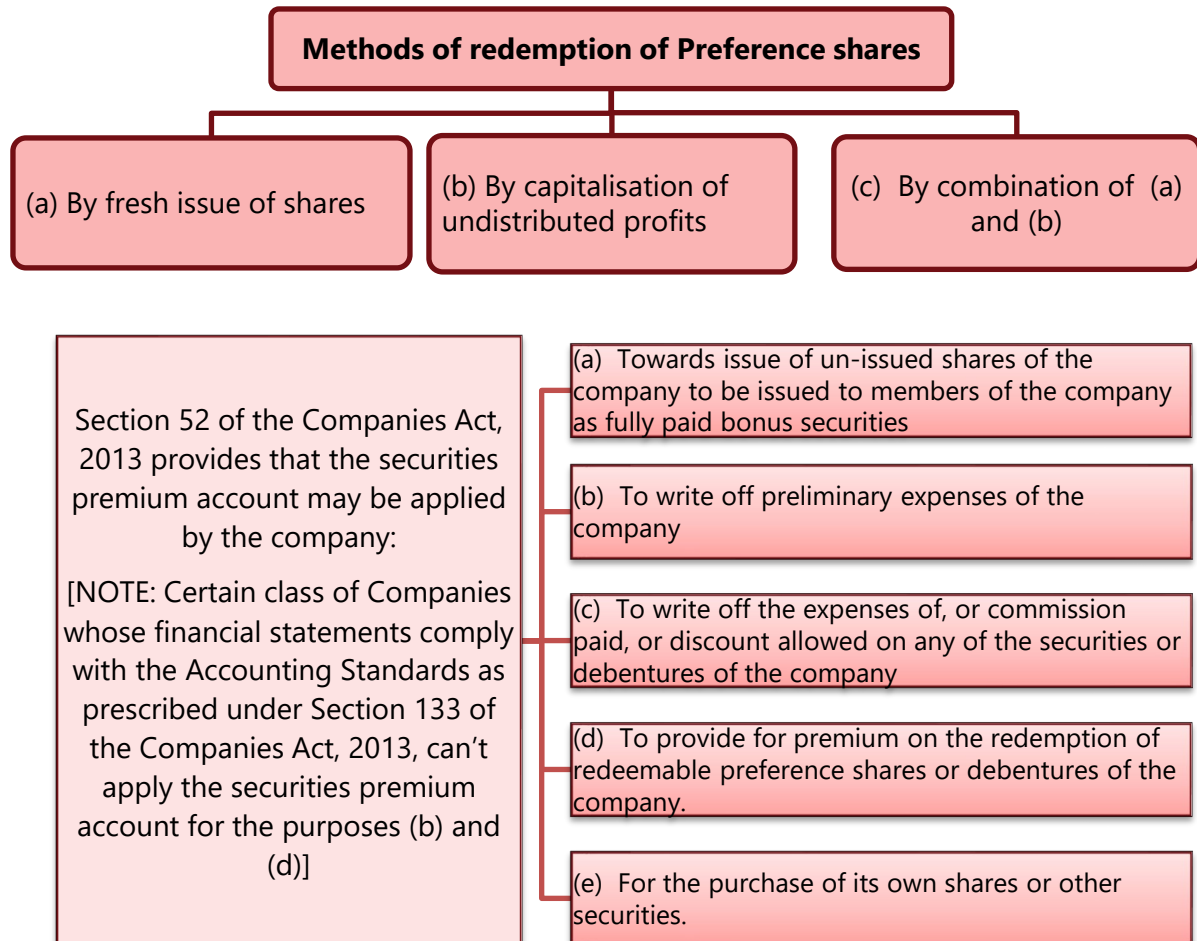
UNIT – 5: REDEMPTION OF PREFERENCE SHARES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ♦ understand the meaning of redemption and the purpose of issuing redeemable preference shares;
- ♦ learn various provisions of the Companies Act, 2013 regarding preference shares and their redemption;
- ♦ familiarise yourself with various methods of redemption of fully paid-up preference shares by:
 - (i) Fresh issue of shares; Or
 - (ii) Capitalisation of divisible or undistributed profits; Or
 - (iii) Combination of (i) and (ii) above;
- ♦ understand the logic behind the creation of Capital Redemption Reserve;
- ♦ learn the accounting treatment for redemption of:
 - (i) fully paid-up preference shares;
 - (ii) partly called-up preference shares; and
 - (iii) fully called-up but partly paid-up preference shares.

UNIT OVERVIEW



5.1 INTRODUCTION

Redemption is the process of repaying an obligation, at prearranged amounts and timings. It is a contract specifying the obligation to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (apart from the frequent payments of a specified amount of dividend as return on investment during the tenure of the preference shares). The redemption date is the maturity date, which specifies when repayment is scheduled to take place and is usually printed on the preference share certificate. Through the process of redemption, a company can also adjust its financial structure, for example, by eliminating preference shares and replacing those with other securities if future growth of the company makes such change advantageous.



5.2 PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

A company may issue redeemable preference shares because of the following:

1. It is a proper way of raising finance in a dull primary market.
2. A company may face difficulty in raising share capital, as its shares are not traded on the stock exchange. Potential investors who may, hesitate in putting money into shares that cannot easily be sold may be encouraged to invest if the shares are redeemable by the company.
3. The preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use.
4. No dividend is required to be paid, if there is loss or no profit, whereas interest is payable on debentures or loans even in case of loss. In other words, preference dividend declared / paid continues to be regarded as an appropriation of profits (similar treatment is given for equity shares), as against interest on debentures, which is a charge against profits.

In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.



5.3 PROVISIONS OF THE COMPANIES ACT (SECTION 55)

A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue. It should be noted that:

- (a) no shares can be redeemed except out of divisible or distributable profit, (i.e. out of the profit of the company which would otherwise be available for dividend) or out of proceeds of fresh issue of shares made for the purpose of redemption;
- (b) no such shares can be redeemed unless they are fully paid;
- (c) (i) in case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133, the premium, if any, payable on redemption shall be provided for out of the profits of the company, before the shares are redeemed;

Provided also that premium, if any, payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

- (ii) in case of other companies (not falling under (i) above), the premium, if any payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

(Refer to the Note given in para 5.4.1 for the basis applied in the Illustrations in this Chapter.)

- (d) where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of the divisible profits, i.e. the profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption Reserve Account, a sum equal to the nominal amount of the shares redeemed; and the provisions of the Act relating to the reduction of the share capital of a company shall, except as provided in the Section, apply as if the Capital Redemption Reserve (CRR) Account were the paid-up share capital of the company. The utilisation of CRR Account is further restricted to issuance of fully paid-up bonus shares only.

From the legal provision outlined above, it is apparent that on the redemption of redeemable preference shares out of accumulated divisible profits, it will be necessary to transfer to the Capital Redemption Reserve Account an amount equal to the amount repaid on the redemption of preference shares on account of face value less proceeds of a fresh issue of shares made for the purpose of redemption. The object is that with the repayment of redeemable preference shares, the security for creditors/ bankers, etc. should not be reduced. At times, a part of the preference share capital may be redeemed out of accumulated divisible profits and the balance out of a fresh issue.



5.4 METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

Redemption of preference shares means repayment by the company of the obligation on account of shares issued. According to the Companies Act, 2013, preference shares issued by a company must be redeemed within the maximum period (normally 20 years) allowed under the Act. Thus, a company cannot issue irredeemable preference shares.

Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to

redemption and, thus, the interest of outsiders is not affected. For this, it requires that either fresh issue of shares is made, or distributable profits are retained and transferred to 'Capital Redemption Reserve Account'.

The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital. The interest of outsiders is protected if the nominal value of capital redeemed is substituted, thus, ensuring the same amount of shareholders' fund.

- In case of redemption of preference shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious.
- If redemption is done out of distributable profits, replacement of capital is ensured in an indirect manner by retention of profit by transfer to Capital Redemption Reserve. In this case, the amount which would have otherwise gone to shareholders in the form of dividend is retained in the business and is used for settling the claim of preference shareholders. Thus, there is no additional drain from the net assets of the Company. The transfer of divisible profits to Capital Redemption Reserve makes them non-divisible profits. As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.

Security cover available to outside stakeholders depends upon called-up capital as well as uncalled capital to be demanded by the company as per its requirements. To ensure that the interests of outsiders are not reduced, Section 55 provides for redemption of only fully paid-up shares.

From the above paras, it can be concluded that the 'gap' created in the company's capital by the redemption of redeemable preference shares must be filled in by:

- (a) the proceeds of a fresh issue of shares; or
- (b) the capitalisation of undistributed profits (by creating Capital Redemption Reserve); or
- (c) a combination of (a) and (b) above.

5.4.1 Redemption of Preference Shares by Fresh Issue of Shares

One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity shares or preference shares) and the proceeds from such new shares can be used for redemption of preference shares.

The proceeds from issue of debentures cannot be utilised for the purpose.

A problem arises when a fresh issue is made for the purpose of redemption of preference shares, at a premium. The point to ponder is that whether the proceeds of a fresh issue of shares will include the amount of securities premium for the purpose of redemption of preference shares.

For securities premium account, Section 52 of the Companies Act, 2013 provides that the securities premium account may be applied by the company;

- (a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities
- (b) To write off preliminary expenses of the company
- (c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company
- (d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.
- (e) For the purchase of its own shares or other securities.

Note: It may be noted that certain class of Companies whose financial statements comply with the Accounting Standards as prescribed under Section 133 of the Companies Act, 2013, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

Note: All the questions in this chapter have been solved on the basis that the companies referred in the questions are governed by Section 133 of the Companies Act, 2013 and comply with the Accounting Standards prescribed for them. Accordingly the balance in securities premium account has not been utilized for the purpose of premium payable on redemption of preference shares.

Any other way, except the above prescribed ways, in which securities premium account is utilised will be in contravention of law.

Thus, the proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares.

Reasons for issue of New Equity Shares

A company may prefer issue of new equity shares for the following reasons:

- (a) When the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares as Preference Shares carry a fixed rate of dividend.

- (b) When the balance of profit, which would otherwise be available for dividend, is insufficient.
- (c) When the liquidity position of the company is not good enough.

Advantages of redemption of preference shares by issue of fresh equity shares

Following are the advantages of redemption of preference shares by the issue of fresh equity shares:

- (1) No cash outflow of money – now or later.
- (2) New equity shares may be valued at a premium.
- (3) Shareholders retain their equity interest.

Disadvantages of redemption of preference shares by issue of fresh equity shares

The disadvantages are:

- (1) There will be dilution of future earnings;
- (2) Share-holding in the company is changed if the fresh issue is made to outsiders. In case the fresh issue is made to existing shareholders in proportion to their shareholding (i.e., rights issue), the disadvantage of change in shareholding pattern can be mitigated.

5.4.2 Accounting Entries

- 1. When new shares are issued at par

Bank Account Dr.
 To Share Capital Account

(Being the issue of shares of ₹.....each for the purpose of redemption of preference shares, as per Board's Resolution No..... dated.....)

- 2. When new shares are issued at a premium

Bank Account Dr.
 To Share Capital Account

 To Securities Premium Account

(Being the issue of shares of ₹.....each at a premium of ₹.....each for the purpose of redemption of preference shares as per Board's Resolution No..... dated.....)

3. When preference shares are redeemed at par
 Redeemable Preference Share Capital Account Dr.
 To Preference Shareholders Account
4. When preference shares are redeemed at a premium
 Redeemable Preference Share Capital Account Dr.
 Premium on Redemption of Preference Shares Account Dr.
 To Preference Shareholders Account
5. When payment is made to preference shareholders
 Preference Shareholders Account Dr.
 To Bank Account
6. For adjustment of premium on redemption
 Profit and Loss Account Dr.
 To Premium on Redemption of Preference Shares Account

ILLUSTRATION 1

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION**In the books of Hinduja Company Ltd.****Journal Entries**

Date	Particulars	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To Equity Share Capital A/c (Being the issue of 50,000 Equity Shares of ₹10 each at par for the purpose of redemption of preference shares, as per Board Resolution No. dated.....)	5,00,000	5,00,000

	8% Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)	Dr.	5,00,000	5,00,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	5,00,000	5,00,000

ILLUSTRATION 2

C Ltd. had 10,000, 10% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of C Ltd.

Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c To Equity Share Capital A/c To Securities Premium A/c (Being the issue of 1,00,000 Equity Shares of ₹10 each at a premium of ₹2 per share as per Board's Resolution No..... dated.....)	Dr.	12,00,000	10,00,000 2,00,000
	10% Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)	Dr.	10,00,000	10,00,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	10,00,000	10,00,000

Note: Amount required for redemption is ₹ 10,00,000. Therefore, face value of equity shares to be issued for this purpose must be equal to ₹ 10,00,000. Premium received on new issue cannot be used to finance the redemption.

ILLUSTRATION 3

G India Ltd. had 9,000 10% redeemable Preference Shares of ₹ 10 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 9 each fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of G India Limited

Journal

Date	Particulars		Dr. (₹)	Cr. (₹)
	Bank A/c To Equity Share Capital A/c (Being the issue of 10,000 Equity Shares of ₹9 each at par, as per Board's Resolution No.....Dated.....)	Dr.	90,000	90,000
	10% Redeemable Preference Shares Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption of preference shares transferred to Preference Shareholders A/c)	Dr.	90,000	90,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	90,000	90,000

5.4.3 Calculation of Minimum Fresh Issue of Shares

Sometimes, examination problem does not specify the number of shares to be issued for the purpose of redemption of preference shares and requires that the minimum number of shares should be issued to ensure that provisions of Section 55 of the Companies Act, 2013, are not violated. This is done in four steps as given below:

- (1) In such cases, the maximum amount of reserves and surplus available for redemption is ascertained taking into account the balances appearing in the balance sheet before

redemption and the additional information provided in the problem. For example, if balance of general reserve in the balance sheet is ₹1,00,000 and additional information provides that the Board of Directors have decided that the balance of general reserve should not be less than ₹40,000 under any circumstances, then, the maximum amount of general reserve available for redemption is ₹ 60,000.

- (2) After ascertaining the maximum amount of reserves and surplus available for redemption, adjustment for premium on redemption payable out of profits is made and then it is compared with the nominal value of shares to be redeemed. By comparison, one gets the minimum proceeds of fresh issue as Section 55 permits redemption either out of proceeds of fresh issue or out of divisible profits. Thus,

Minimum Proceeds of Fresh Issue of shares :

Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

- (3) After computation of minimum proceeds, the minimum number of shares to be issued are determined by dividing minimum proceeds by the proceeds of one share. This is done as follows:

Minimum Number of Shares = Minimum proceeds to comply with Section 55/ face value of one share

Proceeds of one share mean the par value of a share issued, if it is issued at par or premium. However, in case of issue of share at a discount, it refers to the discounted value.

- (4) Minimum number of shares calculated as per (3) above, needs to be adjusted due to various reasons. Firstly, shares fractions cannot be issued. Thus, if minimum number of shares as per (3) above includes a fraction, it must be approximated to the next higher figure to ensure that provisions of Section 55 are not violated. Secondly, if the examination problem states that the proceeds/number of shares should be a multiple of say, 10 or 50 or 100, then again the next higher multiple should be considered.

ILLUSTRATION 4

The Board of Directors of a Company decided to issue minimum number of equity shares of ₹9 to redeem ₹5,00,000 preference shares. The maximum amount of divisible profits available for redemption is ₹3,00,000. Calculate the number of shares to be issued by the company to ensure that the provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of ₹50 only.

SOLUTION

Nominal value of preference shares	₹ 5,00,000
Maximum possible redemption out of profits	₹ 3,00,000
Minimum proceeds of fresh issue	₹ 5,00,000 – 3,00,000 = ₹ 2,00,000
Proceed of one share	= ₹ 9
Minimum number of shares	= $\frac{2,00,000}{9} = 22,222.22$ shares

As fractional shares are not permitted, the minimum number of shares to be issued is 22,223 shares.

If shares are to be issued in multiples of 50, then the next higher figure which is a multiple of 50 is 22,250. Hence, minimum number of shares to be issued in such a case is 22,250 shares.

5.4.4 Fresh Issue at a Premium and Minimum Fresh Issue

The calculation of minimum number of shares, when fresh issue is at a premium should be handled very carefully. Minimum fresh issue cannot be calculated unless one knows the profits available for replacement of preference shares and profit available for replacement cannot be determined unless one knows the portion of profit available for redemption which is required for paying premium on redemption. To tackle this, assume that profits available for redemption is not required for paying premium on redemption of preference shares. In other words, it means that securities premium including premium on fresh issue is comparatively more than premium on redemption.

If the above assumption holds good, minimum number of shares can be calculated in a simple manner without use of equation. But, if above condition does not hold good, then an equation is used to determine the minimum number of shares.

5.4.5 Minimum Fresh Issue to Provide Funds for Redemption

Besides, ensuring compliance with Section 55, the fresh issue of shares is made to provide funds for making payment to preference shareholders. To calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by fresh issue of shares are calculated. The amount to be raised is divided by the issue price of a share (amount payable by shareholder including premium, if any, on fresh issue) to compute the minimum number of shares to be issued.

ILLUSTRATION 5

X Ltd. gives you the following information as at 31st March, 2023:

	Particulars	₹
	EQUITY AND LIABILITIES	
1.	Shareholders' funds	
a	Share capital	2,90,000
b	Reserves and Surplus	48,000
2.	Current liabilities	
	Trade Payables	56,500
	ASSETS	
1.	Property, Plant and Equipment	3,45,000
2.	Non-current investments	18,500
3.	Current Assets	
	Cash and cash equivalents (bank)	31,000

The share capital of the company consists of ₹ 50 each equity shares of ₹ 2,25,000 and ₹ 100 each Preference shares of ₹ 65,000(issued on 1.4.2021). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

- to sell all the investments for ₹ 15,000.
- to finance part of redemption from company funds, subject to, leaving a bank balance of ₹ 12,000.
- to issue minimum equity share of ₹ 50 each share to raise the balance of funds required.

You are required to pass the necessary Journal Entries to record the above transactions.

SOLUTION**Journal**

Date	Particulars	Dr. (₹)	Cr. (₹)
	Bank A/c	Dr. 37,500	
	To Share Application A/c		37,500
	(For application money received on 750 shares @ ₹ 50 per share)		

Share Application A/c	Dr.	37,500	
To Equity Share Capital A/c			37,500
(For disposition of application money received)			
Preference Share Capital A/c	Dr.	65,000	
Premium on Redemption of			
Preference Shares A/c	Dr.	6,500	
To Preference Shareholders A/c			71,500
(For amount payable on redemption of preference shares)			
Bank A/c	Dr.	15,000	
Profit and Loss A/c (loss on sale) A/c	Dr.	3,500	
To Investment A/c			18,500
(For sale of investments at a loss of ₹ 3,500)			
Profit and Loss A/c	Dr.	27,500	
To Capital Redemption Reserve A/c			27,500
(For transfer to CRR out of divisible profits an amount equivalent to excess of nominal value of preference shares over proceeds (face value of equity shares) i.e., ₹ 65,000 - ₹ 37,500)			
Preference Shareholders A/c	Dr.	71,500	
To Bank A/c			71,500
(For payment of preference shareholders)			
Profit and Loss A/c	Dr.	6,500	
To Premium on Redemption of Preference Shares A/c			6,500
(For writing off premium on redemption out of profits)			

Working Note:**Calculation of Number of Shares:**

	₹
Amount payable on redemption (₹ 65,000 + 10% of ₹ 65,000)	71,500
Less: Sale price of investment	(15,000)
	56,500
Less: Available bank balance (31,000 - 12,000)	(19,000)
Funds from fresh issue	<u>37,500</u>

∴ No. of shares = 37,500/50=750 shares



5.5 REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED DIVISIBLE PROFITS

Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit. In other words, some of the distributable profits are kept aside to ensure that it can never be distributed to shareholders as dividend.

Profit or a portion of profit that can be otherwise legally distributed as dividend to the shareholders is known as Divisible or Distributable Profit.

In this connection, the provisions of the Companies Act state that 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend (i.e. out of divisible profits), be transferred to a reserve to be called the Capital Redemption Reserve Account sum equal to the nominal amount of the shares redeemed'.

Note: Only Divisible Profits can be used to create Capital Redemption Reserve, Non-Divisible Profits cannot be used for this purpose.

5.5.1 Advantages of redemption of preference shares by capitalisation of undistributed divisible profits

The advantages of redemption of preference shares by capitalisation of undistributed divisible profits are:

- (1) No change in the percentage of equity share-holding of the company;
- (2) Surplus funds can be used.

5.5.2 Disadvantages of redemption of preference shares by capitalisation of undistributed divisible profits

The disadvantage of redemption of preference shares by capitalisation of undistributed profits is that there will be a reduction in liquidity or assets may need to be sold such as investments.

Accounting Entries**1. For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account**

General Reserve Account Dr.

Profit and Loss Account Dr.

any other Divisible Profits Dr.

To Capital Redemption Reserve Account

(Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).

2. When shares are redeemed at par

Redeemable Preference Share Capital Account Dr.

To Preference Shareholders Account

(Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)

3. When shares are redeemed at a premium

Redeemable Preference Share Capital Account Dr.

Premium on Redemption of Preference Shares Account Dr.

To Preference Shareholders Account

(Being the amount payable on redemption transferred to Preference Shareholders Account)

4. When payment is made to preference shareholders

Preference Shareholders Account Dr.

To Bank Account

(Being the payment to preference shareholders as per terms)

5. For adjustment of premium of redemption

Divisible Profit Account Dr.

To Premium on Redemption of Preference Shares Account

(Being the premium on redemption adjusted against Profit and Loss Account)

ILLUSTRATION 6

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 2022.

Share capital: 40,000 Equity shares of ₹ 10 each fully paid – ₹ 4,00,000; 1,000 10% Redeemable preference shares of ₹ 100 each fully paid – ₹ 1,00,000.

Reserve & Surplus: Capital reserve – ₹ 50,000; Securities premium – ₹ 50,000; General reserve – ₹ 75,000; Profit and Loss Account – ₹ 35,000

On 1st January 2023, the Board of Directors decided to redeem the preference shares at par by utilisation of reserve.

You are required to pass necessary Journal Entries including cash transactions in the books of the company.

SOLUTION

In the books of ABC Limited
Journal Entries

Date	Particulars		Dr. (₹)	Cr. (₹)
2023				
Jan 1	10% Redeemable Preference Share Capital A/c To Preference Shareholders A/c (Being the amount payable on redemption transferred to Preference Shareholders Account)	Dr.	1,00,000	1,00,000
	Preference Shareholders A/c To Bank A/c (Being the amount paid on redemption of preference shares)	Dr.	1,00,000	1,00,000
	General Reserve A/c Profit & Loss A/c To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	Dr. Dr.	75,000 25,000	1,00,000

Note: Securities premium and capital reserve (not being distributable profits) cannot be utilised for transfer to Capital Redemption Reserve.

5.5.3 Redemption of Preference Shares by combination of Fresh Issue and Capitalisation of Undistributed divisible Profits

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer should be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.

Formula:

(i)	Amount to be Transferred to Capital Redemption Reserve	₹
	Face value of shares redeemed	***
	Less: Proceeds from new issue	***

(ii)	Proceeds to be collected from New Issue	₹
	Face value of shares redeemed	***
	Less: Profits available for distribution as dividend	***

The term 'proceeds from fresh/new issue' shall be interpreted as:

- Amount credited to Share Capital, in case of issue at par
- Amount credited to Share Capital, in case of issue at premium. Though premium is received which is credited to the Securities Premium A/c, the same shall not be regarded as 'proceeds', because if it were to be treated as such, the transfer of distributable profits to the Capital Redemption Reserve would be lower by the amount of the premium received.
- Amount received (i.e., debited to Cash/Bank), in case of issue at a discount.

Note: Section 53 of the Companies Act, 2013 prohibits issue of shares at a discount, except in case of issue of Sweat Equity Shares as outlined in Section 54.

ILLUSTRATION 7

C Limited had 3,000, 12% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company had to redeem these shares at a premium of 10%.

It was decided by the company to issue the following:

- 25,000 Equity Shares of ₹ 10 each at par,
- 1,000 14% Debentures of ₹ 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

SOLUTION

In the books of C Limited
Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To Equity Share Capital A/c (Being the issue of 25,000 equity shares of ₹ 10 each at par as per Board's resolution No.....dated.....)	2,50,000	2,50,000
	Bank A/c Dr. To 14% Debenture A/c (Being the issue of 1,000 Debentures of ₹ 100 each as per Board's Resolution No.....dated.....)	1,00,000	1,00,000
	Profit & Loss A/c Dr. To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	50,000	50,000
	12% Redeemable Preference Share Capital A/c Dr. Premium on Redemption of Preference Shares A/c Dr. To Preference Shareholders A/c (Being the amount payable on redemption transferred to Preference Shareholders Account)	3,00,000 30,000	3,30,000
	Preference Shareholders A/c Dr. To Bank A/c (Being the amount paid on redemption of preference shares)	3,30,000	3,30,000
	Profit & Loss A/c Dr. To Premium on Redemption of Preference Shares A/c (Being the adjustment of premium on redemption against Profits & Loss Account)	30,000	30,000

Working Note:**Amount to be transferred to Capital Redemption Reserve Account**

Face value of shares to be redeemed	3,00,000
Less: Proceeds from new issue	<u>(2,50,000)</u>
Total Balance	<u>50,000</u>

ILLUSTRATION 8

The capital structure of a company consists of 20,000 Equity Shares of ₹ 10 each fully paid up and 1,000 8% Redeemable Preference Shares of ₹ 100 each fully paid up (issued on 1.4.2021).

Undistributed reserve and surplus stood as: General Reserve ₹ 80,000; Profit and Loss Account ₹ 20,000; Investment Allowance Reserve out of which ₹ 5,000, (not free for distribution as dividend) ₹ 10,000; Securities Premium ₹ 2,000, Cash at bank amounted to ₹ 98,000. Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilising the undistributed reserve and surplus, subject to the conditions that a sum of ₹ 20,000 shall be retained in general reserve and which should not be utilised.

Pass Journal Entries to give effect to the above arrangements.

SOLUTION

In the books of
Journal Entries

Date	Particulars	Dr. (₹)	Cr. (₹)
	Bank A/c Dr. To Equity Share Capital A/c (Being the issue of 2,500 Equity Shares of ₹ 10 each at a premium of Re. 1 per share as per Board's Resolution No.....dated.....)	25,000	25,000
	General Reserve A/c Dr. Profit & Loss A/c Dr. Investment Allowance Reserve A/c Dr. To Capital Redemption Reserve A/c (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act)	60,000 10,000 5,000	75,000
	8% Redeemable Preference Share Capital A/c Dr.	1,00,000	

Premium on Redemption of Preference Shares A/c	Dr.	10,000	
To Preference Shareholders A/c			1,10,000
(Being the amount paid on redemption transferred to Preference Shareholders Account)			
Preference Shareholders A/c	Dr.	1,10,000	
To Bank A/c			1,10,000
(Being the amount paid on redemption of preference shares)			
Profit & Loss A/c	Dr.	10,000	
To Premium on Redemption of Preference Shares A/c			10,000
(Being the premium payable on redemption is adjusted against Profit & Loss Account)			

Working Note:

No of Shares to be issued for redemption of Preference Shares:

Face value of shares redeemed ₹ 1,00,000

Less: Profit available for distribution as dividend:

General Reserve : ₹(80,000-20,000) ₹ 60,000

Profit and Loss (20,000 – 10,000 set aside for
adjusting premium payable on redemption of
preference shares) ₹10,000

Investment Allowance Reserve: (₹ 10,000-5,000) ₹ 5,000 (₹ 75,000)

₹ 25,000

Therefore, No. of shares to be issued = ₹ 25,000/₹10 = 2,500 shares.

5.5.4 Sale of Investments to Provide Sufficient Funds for Redemption

Companies may have sufficient investments, which can be sold, in the market to arrange funds for redemption of preference shares.



5.6 REDEMPTION OF PARTLY CALLED-UP PREFERENCE SHARES

One of the conditions of redemption is that only fully paid up preference shares can be redeemed by a company. Hence:

- 1) If the problem states that it is decided to redeem preference shares which are partly called up, then it is assumed that the final call on these shares is demanded and received before proceeding with redemption of these shares.
- 2) If information about both fully paid and partly paid preference shares is provided, then, it is presumed that only fully paid shares are to be redeemed and partly paid shares are left intact.
- 3) The company can forfeit the shares, if the call money is not received by the company in spite of giving opportunity to pay the same via reminders.

ILLUSTRATION 9

The Balance Sheet of XYZ Ltd. as at 31st March, 2021 inter alia includes the following information:

	₹
50,000, 8% Preference Shares of ₹100 each, ₹70 paid up	35,00,000
1,00,000 Equity Shares of ₹100 each fully paid up	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000
Bank	15,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 2022 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹ 100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) on allotment and the balance on 1st January, 2023. The issue was fully subscribed and allotment made on 1st March, 2022. The money due on allotment were duly received by 31st March, 2022. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries. (Ignore date column)

SOLUTION**Journal Entries**

		₹	₹
8% Preference Share Final Call A/c	Dr.	15,00,000	
To 8% Preference Share Capital A/c			15,00,000
(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
Bank A/c	Dr.	15,00,000	
To 8% Preference Share Final Call A/c			15,00,000
(For receipt of final call money on preference shares)			
Bank A/c	Dr.	10,00,000	
To Equity Share Application A/c			10,00,000
(For receipt of application money on 50,000 equity shares @ ₹ 20 per share)			
Equity Share Application A/c	Dr.	10,00,000	
To Equity Share Capital A/c			10,00,000
(For capitalisation of application money received)			
Equity Share Allotment A/c	Dr.	17,50,000	
To Equity Share Capital A/c			12,50,000
To Securities Premium A/c			5,00,000
(For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)			
Bank A/c	Dr.	17,50,000	
To Equity Share Allotment A/c			17,50,000
(For receipt of allotment money on equity shares)			
General Reserve A/c	Dr.	27,50,000	
To Capital Redemption Reserve A/c			27,50,000
(For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 50,00,000 - 10,00,000 - 12,50,000)			
8% Preference Share Capital A/c	Dr.	50,00,000	

Premium on Redemption of Preference Shares A/c To Preference Shareholders A/c (For amount payable to preference shareholders on redemption at 5% premium)	Dr.	2,50,000	52,50,000
Preference Shareholders A/c To Bank A/c (For amount paid to preference shareholders)	Dr.	52,50,000	52,50,000
General Reserve A/c To Premium on Redemption A/c (For writing off premium on redemption of preference shares)	Dr.	2,50,000	2,50,000

Note: On the redemption of redeemable preference shares out of accumulated divisible profits, it will be necessary to transfer to the Capital Redemption Reserve Account an amount equal to the amount repaid on the redemption of preference shares on account of face value less proceeds of a fresh issue of shares made for the purpose of redemption.



5.6 REDEMPTION OF FULLY CALLED BUT PARTLY PAID-UP PREFERENCE SHARES

The problem of unpaid calls on fully called up shares may be studied under following categories:

5.6.1 When the amount of calls-in-arrears is received by the company

If the amount of unpaid calls is received by the Company before redemption, the entry passed is as under:

Bank A/c	Dr.
To Calls-in-Arrears A/c	

After receipt of calls in arrears, the shares become fully paid up and then, company can proceed with redemption in the normal course.

5.6.2 In case of Forfeited Shares

If in spite of receiving a proper notice from the company, the shareholders fail to pay the unpaid calls, the Board of Directors may decide to forfeit the shares and cancel these shares

instead of reissuing the forfeited shares because redemption of these shares is due immediately or in near future. In this case, the journal entry for forfeiture is passed as usual, which will be as follows:

Preference Share Capital A/c # Dr
 (#Called up share capital only relating to the shares to be forfeited)

To Calls In Arrears A/c

To Shares Forfeited A/c *

(*Amount actually collected on shares forfeited. This will be equal to the balancing amount)

NOTE: But it should be noted, in this case, that the number of shares to be redeemed will be reduced by the number of shares so forfeited. Further, since the preference shares are getting redeemed, the forfeited shares will not be reissued and hence the balance in the Shares Forfeited A/c should be transferred to Capital Reserve by passing the following journal entry:

Shares Forfeited A/c Dr.
 To Capital Reserve A/c

ILLUSTRATION 10

With the help of the details in Illustration 9 above and further assuming that the Preference Shareholders holding 2,000 shares fail to make the payment for the Final Call made under Section 55, you are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2022 with the corresponding figures as on 31st December, 2021 assuming that the shares in default are forfeited after giving proper notices. (Ignore date column)

SOLUTION

Journal Entries

		₹	₹
8% Preference Share Final Call A/c	Dr.	15,00,000	
To 8% Preference Share Capital A/c			15,00,000
(For final call made on preference shares @ ₹ 30 each to make them fully paid up)			
Bank A/c (48,000 x ₹30)	Dr.	14,40,000	
Calls in arrears A/c (2,000x ₹30)		60,000	
To 8% Preference Share Final Call A/c			15,00,000
(For receipt of final call money on preference shares)			

Preference Share Capital A/c (2000 X ₹100)	Dr.	2,00,000	
To Calls in Arrears A/c (2000 X ₹30)			60,000
To Shares Forefeited A/c (2000 X ₹70)			1,40,000
(For Shares Forefeited after shareholders fail to pay the Final Call)			
Bank A/c	Dr.	10,00,000	
To Equity Share Application A/c			10,00,000
(For receipt of application money on 50,000 equity shares @ ₹ 20 per share)			
Equity Share Application A/c	Dr.	10,00,000	
To Equity Share Capital A/c			10,00,000
(For capitalisation of application money received)			
Equity Share Allotment A/c	Dr.	17,50,000	
To Equity Share Capital A/c			12,50,000
To Securities Premium A/c			5,00,000
(For allotment money due on 50,000 equity shares @ ₹ 35 per share including a premium of ₹ 10 per share)			
Bank A/c	Dr.	17,50,000	
To Equity Share Allotment A/c			17,50,000
(For receipt of allotment money on equity shares)			
General Reserve A/c	Dr.	25,50,000	
To Capital Redemption Reserve A/c			25,50,000
(For transfer of CRR the amount not covered by the proceeds of fresh issue of equity shares i.e., 48,00,000 – 10,00,000 – 12,50,000)			
8% Preference Share Capital A/c	Dr.	48,00,000	
Premium on Redemption of Preference Shares A/c	Dr.	2,40,000	
To Preference Shareholders A/c			50,40,000
(For amount payable to preference shareholders on redemption at 5% premium)			
Preference Shareholders A/c	Dr.	50,40,000	
To Bank A/c			50,40,000
(For amount paid to preference shareholders)			

General Reserve A/c	Dr.	2,40,000	
To Premium on Redemption A/c			2,40,000
(For writing off premium on redemption of preference shares)			
Shares Forfeited A/c	Dr.	1,40,000	
To Capital Reserve A/c			1,40,000
(For transferring balance to Capital Reserve A/c after redemption of preference shares)			

Note: Amount received (excluding premium) on fresh issue of shares till the date of redemption should be considered for calculation of proceeds of fresh issue of shares. Thus, proceeds of fresh issue of shares ₹ 22,50,000 (₹10,00,000 application money plus ₹ 12,50,000 received on allotment towards share capital) will be considered.

SUMMARY

- Redemption is the process of repaying an obligation, at prearranged amount and timing.
- In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.
- A company limited by shares if so authorised by its Articles, may issue preference shares which at the option of the company*, are liable to be redeemed. It should be noted that:
 - (a) no shares can be redeemed except out of profit of the company which would otherwise be available for dividend or out of proceeds of fresh issue of shares made for the purpose of redemption;
 - (b) no such shares can be redeemed unless they are fully paid;
- * A company cannot issue irredeemable preference shares.
- Methods of redemption of fully paid-up preference shares: (i) by Fresh issue of shares; (ii) by Capitalisation of undistributed profits; (iii) Combination of (i) and (ii),

TEST YOUR KNOWLEDGE

True and False

1. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Reserve account by debiting the distributable profit.
2. A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing for premium on the redemption of Redeemable Preference shares of the Company.
3. The balance in forfeited shares account can be used for transfer to capital redemption reserve account.
4. Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses

Multiple Choice Questions

1. Securities premium cannot be used to _____.
(a) Issue bonus shares
(b) Redeem preference shares
(c) Write-off preliminary expenses
2. S Ltd. issued 2,000, 10% Preference shares of ₹ 100 each at par on 1.4.2021, which are redeemable at a premium of 10%. For the purpose of redemption, the company issued 1,500 Equity Shares of ₹ 100 each at a premium of 20% per share. At the time of redemption of Preference Shares, the amount to be transferred by the company to the Capital Redemption Reserve Account = ?
(a) ₹ 50,000
(b) ₹ 40,000
(c) ₹ 2,00,000
3. Which of the following cannot be used for the purpose of creation of capital redemption reserve account?
(a) Profit and loss account (credit balance)

- (b) General reserve account
 - (c) Unclaimed dividend account
4. According to Section 52 of the Companies Act, 2013, the amount in the Securities Premium A/c cannot be used for the purpose of
- (a) Issue of fully paid bonus shares
 - (b) Writing off losses of the company
 - (c) For purchase of own securities
5. Which of the following can be utilized for redemption of preference shares?
- (a) The proceeds of fresh issue of equity shares
 - (b) The proceeds of issue of debentures
 - (c) The proceeds of issue of fixed deposit
6. Preference shares amounting to ₹2,00,000 (already issued on 1.4.2021) are redeemed at a premium of 5%, by issue of shares amounting to ₹1,00,000 at a premium of 10%. The amount to be transferred to capital redemption reserve = ?
- (a) ₹1,05,000
 - (b) ₹1,00,000
 - (c) ₹2,00,000

Theoretical Questions

1. What is the purpose of issuing redeemable preference shares?
2. What are the provisions of the Companies Act, 2013 related with redemption of preference shares? Explain in brief.

Practical Questions

1. The books of B Ltd. showed the following balance on 31st December, 2023:
30,000 Equity Shares of ₹10 each fully paid; 18,000 12% Redeemable Preference Shares of ₹10 each fully paid; 4,000 10% Redeemable Preference Shares of ₹10 each, ₹8 paid up (all shares issued on 1st April, 2022).

Undistributed Reserve and Surplus stood as: Profit and Loss Account ₹80,000; General Reserve ₹1,20,000; Securities Premium Account ₹15,000 and Capital Reserve ₹21,000.

For redemption, 3,000 equity shares of ₹10 each are issued at 10% premium. At the same time, Preference shares are redeemed on 1st January, 2024 at a premium of ₹2 per share. The whereabouts of the holders of 100 shares of ₹10 each fully paid are not known.

A bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital Redemption Reserve Account. However, equity shares, issued for redemption are not eligible for bonus.

Show the necessary Journal Entries to record the transactions. (Ignore date column)

ANSWERS/ HINTS

True and false

1. False: When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve account by debiting the distributable profit.
2. True: A company who prepares financial statements in compliance with Accounting Standards under Section 133 of the Companies Act, 2013, it cannot utilize securities premium for the purpose of providing the premium on the redemption of redeemable preference shares.
3. False: The balance in Forfeited shares account cannot be used for transfer to capital redemption reserve account.
4. True: Capital redemption reserve cannot be used for writing off miscellaneous expenses and losses.

Multiple Choice Questions

1.	(b)	2.	(a) ¹	3.	(c)	4.	(b)	5.	(a)	6.	(b) ²

Theoretical Questions

1. A company may issue redeemable preference shares to raise finance in a dull primary market. Preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use. For details, refer para 5.2 of the chapter.

¹ 2,00,000 – 1,50,000

² 2,00,000 – 1,00,000

2. Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For details, refer para 5.3 of the chapter.

Practical Questions

1. **In the books of B Limited**

Journal Entries

Particulars		Dr. (₹)	Cr. (₹)
12% Redeemable Preference Share Capital A/c	Dr.	1,80,000	
Premium on Redemption of Preference Shares A/c	Dr.	36,000	
To Preference Shareholders A/c			2,16,000
(Being the amount payable on redemption of 18,000 12% Redeemable Preference Shares transferred to Shareholders Account)			
Preference Shareholders A/c	Dr.	2,14,800	
To Bank A/c			2,14,800
(Being the amount paid on redemption of 17,900 preference shares)			
Bank A/c	Dr.	33,000	
To Equity Shares Capital A/c			30,000
To Securities Premium A/c			3,000
(Being the issue of 3,000 Equity Shares of ₹ 10 each at a premium of 10% as per Board's Resolution No..... Dated.....)			
General Reserve A/c	Dr.	1,20,000	
Profit & Loss A/c	Dr.	30,000	
To Capital Redemption Reserve A/c			1,50,000
(Being the amount transferred to Capital Redemption Reserve A/c as per the requirement of the Act.)			
Capital Redemption Reserve A/c	Dr.	1,20,000	
To Bonus to Shareholders A/c			1,20,000
(Being the amount appropriated for issue of bonus share in the ratio of 5:2 as per shareholders Resolution No..... dated...)			

Bonus to Shareholders A/c To Equity Share Capital A/c (Being the utilisation of bonus dividend for issue of 12,000 equity shares of ₹ 10 each fully paid)	Dr.	1,20,000	1,20,000
Profit & Loss A/c To Premium on Redemption of Preference Shares A/c (Being premium on redemption of preference shares adjusted against to Profit & Loss Account)	Dr.	36,000	36,000

Working Note:

- (1) Partly paid-up preference shares cannot be redeemed.
- (2) Amount to be Transferred to Capital Redemption Reserve Account

Face value of share to be redeemed	₹ 1,80,000
Less: Proceeds from fresh issue (excluding premium)	<u>(₹ 30,000)</u>
	<u>₹ 1,50,000</u>
- (3) No bonus shares on 3,000 equity shares issued for redemption.

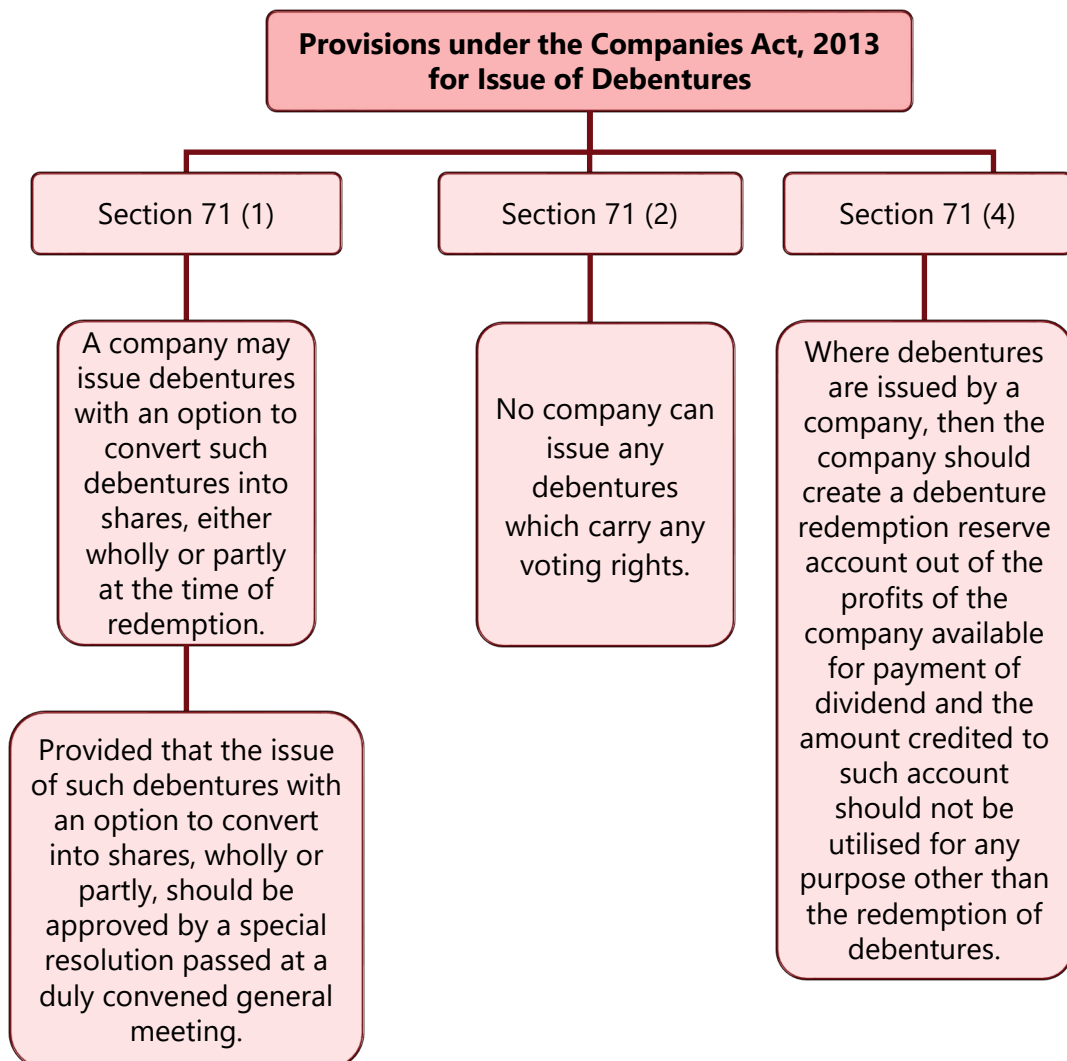
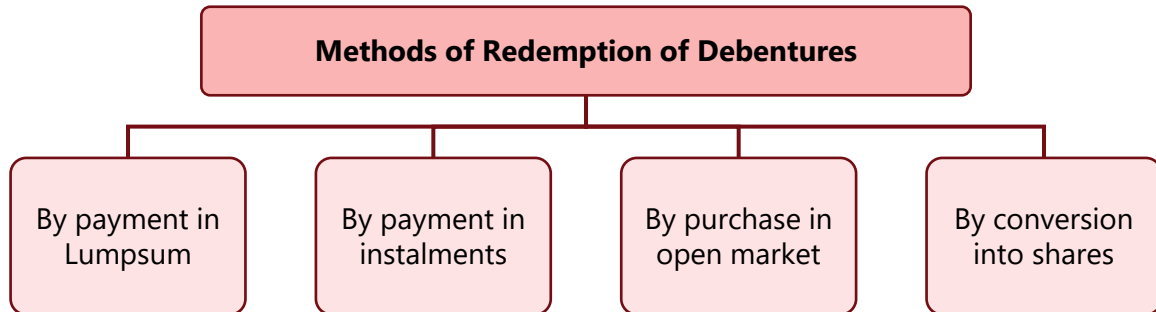
Note: Bonus shares does not result in receipt of cash, and hence the increase in share capital on account of bonus issue cannot be considered in determination of amount to be transferred to Capital Redemption Reserve.

UNIT – 6: REDEMPTION OF DEBENTURES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ♦ Understand about the redemption of debentures;
- ♦ Understand the requirement of creation of a Debenture Redemption Reserve and creation of Debenture Redemption Fund (i.e. making investments for purpose of redemption of debentures);
- ♦ Understand various methods of redemption of debentures;
- ♦ Understand the accounting treatment of redemption of debentures;
- ♦ Solve problems based on redemption of debentures.

UNIT OVERVIEW



6.1 INTRODUCTION

A debenture is an instrument issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest.

Under Section 71 (1) of the Companies Act, 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption.

Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, should be approved by a special resolution passed at a duly convened general meeting.

Section 71 (2) further provides that no company can issue any debentures which carry any voting rights.

Section 71 (4) provides that where debentures are issued by a company, the company should create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account should not be utilized by the company for any purpose other than the redemption of debentures.

Basic provisions

If a charge has been created on any asset or the entire assets of the company,

- the nature of the charge
- the asset(s) charged

are described therein.

- Since the charge is not valid unless registered with the Registrar, his certificate registering the charge is printed on the bond.
- It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever manner they think necessary to safeguard the interest of debenture holders.

Note: Issue of debentures has already been discussed in detail in unit 3 of Chapter 11.



6.2 REDEMPTION OF DEBENTURES

Debentures are usually redeemable i.e. either redeemed in cash or convertible to equity shares after a time period.

Redeemable debentures may be **redeemed**:

- after a **fixed number** of years; or
- any time after a **certain number of years** has elapsed since their issue; or
- on giving a **specified notice**; or
- by **annual drawing**.

A company may also purchase its debentures, as and when convenient, in the open market. When the debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them.



6.3 DEBENTURE REDEMPTION RESERVE

A company issuing debentures may be required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company for any other purpose except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they fall due for payment.

An appropriate amount is transferred from profits every year to Debenture Redemption Reserve and its investment is termed as Debenture Redemption Reserve Investment (or Debenture Redemption Fund). In the last year or at the time of redemption of debentures, Debenture Redemption Reserve Investments are encashed and the amount so obtained is used for the redemption of debentures.

6.3.1 Requirement to create Debenture Redemption Reserve

Section 71 of the Companies Act 2013 covers the requirement of creating a debenture redemption reserve account. Section 71 states as follows:

- (1) Where a company issues debentures under this section, it should create a debenture redemption reserve account out of its profits which are available for distribution of dividend every year until such debentures are redeemed.
- (2) The amounts credited to the debenture redemption reserve should not be utilised by the company for any purpose except for the purpose aforesaid.

- (3) The company should pay interest and redeem the debentures in accordance with the terms and conditions of their issue.
- (4) Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the Tribunal may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

6.3.2 Balance in Debenture Redemption Reserve (DRR)

When the company decides to establish the Debenture Redemption Reserve Account, the amount indicated by the Debenture Redemption Reserves tables is credited to the Debenture Redemption Reserve account and debited to profit and loss account. That shows the intention of the company to set aside sum of money to build up a fund for redeeming debentures. Immediately, the company should also purchase outside investments. The entry for the purpose naturally will be to debit Debenture Redemption Reserve Investments and credit Bank.

If the debentures are purchased within the interest period, the price would be inclusive of interest provided these are purchased "Cum-interest"; but if purchased "Ex-interest", the interest to the date of purchase would be payable to the seller additionally. In order to adjust the effect thereof the amount of interest accrued till the date of purchase, if paid, is debited to the Interest Account against which the interest for the whole period will be credited. As a result, the balance in the account would be left equal to the interest for the period for which the debentures were held by the company.

6.3.3 Adequacy of Debenture Redemption Reserve (DRR)

As per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, the company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year (*refer para 6.4 below*), in accordance with the conditions given below—

the Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend; the limits with respect to adequacy of DRR and investment or deposits, as the case may be, shall be as under:

S. No	Debentures issued by	Adequacy of Debenture Redemption Reserve (DRR)
1	All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking	No DRR is required

	Companies for both public as well as privately placed debentures	
2	Other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013	DRR will be as applicable to NBFCs registered with RBI (as per (3) below)
3	For listed companies (other than AIFs and Banking Companies as specified in Sr. No. 1 above):	
	a. All listed NBFCs (registered with RBI under section 45-IA of the RBI Act,) and listed HFCs (Housing Finance Companies registered with National Housing Bank) for both public as well as privately placed debentures	No DRR is required
	b. Other listed companies for both public as well as privately placed debentures	No DRR is required
4	For unlisted companies (other than AIFs and Banking Companies as specified in Sr. No. 1 above)	
	a. All unlisted NBFCs (registered with RBI under section 45-IA of the RBI (Amendment) Act, 1997) and unlisted HFCs (Housing Finance Companies registered with National Housing Bank) for privately placed debentures	No DRR is required
	b. Other unlisted companies	DRR shall be 10% of the value of the outstanding debentures issued

6.3.4 Investment of Debenture Redemption Reserve (DRR) Amount

Further, as per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, following companies

- (a) All listed NBFCs
- (b) All listed HFCs
- (c) All other listed companies (other than AIFs, Banking Companies and Other FIs); and
- (d) All unlisted companies which are not NBFCs and HFCs

shall on or before the 30th day of April in each year, in respect of debentures issued, deposit

or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March of next year, in any one or more of the following methods, namely:

- (a) in deposits with any scheduled bank, free from charge or lien;
- (b) in unencumbered securities of the Central Government or of any State Government;
- (c) in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
- (d) in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882.

The amount deposited or invested, as the case may be, above should not be utilised for any purpose other than for the redemption of debentures maturing during the year referred to above.

Provided that the amount remaining deposited or invested, as the case may be, shall not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.

In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issue.

The amount credited to DRR shall not be utilised by the company except for the purpose of redemption of debentures.

Note: It should be noted that appropriation to DRR can be made any time before redemption and Investments in specified securities as mentioned above can be done before 30th April for the debentures maturing that year, however, for the sake of simplicity and ease, it is advisable to make the appropriation and investment immediately after the debentures are allotted assuming that the company has sufficient amount of profits (issued if allotment date is not given in the question). Also, in some cases, the date of allotment could be missing, in such cases the appropriation and investments should be done on the first day of that year for which ledgers accounts are to be drafted.

6.3.5 Journal Entries

The necessary journal entries passed in the books of a company are given below:

1. After allotment of debentures

- (a) For setting aside the fixed amount of profit for redemption

Profit and Loss A/c

Dr.

To Debenture Redemption Reserve A/c

- (b) For investing the amount set aside for redemption

Debenture Redemption Reserve Investment A/c Dr.

To Bank A/c

- (c) For receipt of interest on Debenture Redemption Reserve Investments

Bank A/c Dr.

To Interest on Debenture Redemption Reserve Investment A/c

- (d) For transfer of interest on Debenture Redemption Reserve Investments (DRRI)

Interest on Debenture Redemption Reserve Investment A/c Dr.

To Profit and loss A/c*

** Considering the fact that interest is received each year through cash/bank account and it is not re-invested. In the illustrations given in the chapter, the same has been considered and hence interest on DRR investment is not credited to DRR A/c but taken to P&L A/c.*

2. At the time of redemption of debentures

- (a) For encashment of Debenture Redemption Reserve Investments

Bank A/c Dr.

To Debenture Redemption Reserve Investment A/c

- (b) For amount due to debentureholders on redemption

Debentures A/c Dr.

To Debentureholders A/c

- (c) For payment to debentureholders

Debentureholders A/c Dr.

To Bank A/c

- (d) After redemption of debentures, DRR should be transferred to general reserve

DRR A/c Dr.

To General Reserve



6.4 METHODS OF REDEMPTION OF DEBENTURES

Redemption of debentures must be done according to the terms of issue of debentures and any deviation therefrom will be treated as a default by the company.

Redemption by paying off the debt on account of debentures issued can be done in any one of the three methods viz:

6.4.1 By payment in lumpsum

Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period.

6.4.2 By payment in Instalments

Under payment in instalments method, the payment of specified portion of debenture is made in instalments at specified intervals.

6.4.3 Purchase of Debentures in Open Market

Debentures sometimes are purchased in open market. This is not covered in the chapter as it has been specifically excluded from the syllabus at Foundation level.

ILLUSTRATION 1

The following balances appeared in the books of a company (unlisted company other than AIFI, Banking company, NBFC and HFC) as on December 31, 2021: 6% Mortgage 10,000 debentures of ₹ 100 each; Debenture Redemption Reserve (for redemption of debentures) ₹ 50,000; Investments in deposits with a scheduled bank, free from any charge or lien ₹ 1,50,000 at interest 4% p.a. receivable on 31st December every year. Bank balance with the company is ₹ 9,00,000.

The Interest on debentures had been paid up to December 31, 2021.

On February 28, 2022, the investments were realised at par and the debentures were paid off at 101, together with accrued interest.

Write up the concerned ledger accounts (excluding bank transactions). Ignore taxation.

SOLUTION

6% Mortgage Debentures Account

2022			₹	2022			₹
Feb. 28	To	Debenture-holders A/c	10,00,000	Jan. 1	By	Balance b/d	10,00,000

Premium on Redemption of Debentures Account

2022			₹	2022			₹
Feb. 28	To	Debenture-holders A/c	10,000	Feb. 28	By	Profit and loss A/c	10,000

Debentures Redemption Reserve Investment Account

2022			₹	2022			₹
Jan. 1	To	Balance b/d	1,50,000	Feb. 28	By	Bank	1,50,000

Debenture Interest Account

2022			₹	2022			₹
Feb. 28	To	Bank (10,000 x 100 x 6% x 2/12)	10,000	Feb. 28	By	Profit & Loss A/c	10,000

Bank A/c

2022			₹	2022			₹
Jan 01	To	Balance b/d	9,00,000	Feb. 28	By	Debenture-holders (10,000 x 101)	10,10,000
Feb 28	To	Interest on Debentures Redemption Investments (1,50,000 x 4% x 2/12)	1,000				
	To	Debentures Redemption Reserve investment A/c	1,50,000		By	Debenture Interest A/c	10,000
			10,51,000		By	Balance c/d	31,000
							10,51,000

Debenture Redemption Reserve Account

2022			₹	2022			₹
Feb 28	To	General Reserve-note	1,00,000	Jan.1	By	Balance b/d	50,000
			1,00,000	Jan.1	By	Profit & Loss (b/f)	50,000
							1,00,000

Note

Amount to be transferred to DRR before the redemption = ₹ 1,00,000 [i.e. 10% of (10,000 X 100)].

ILLUSTRATION 2

The following balances appeared in the books of Paradise Ltd (unlisted company other than AIFI, Banking company, NBFC and HFC) as on 1-4-2021:

- (i) 12 % Debentures ₹ 7,50,000
- (ii) Balance of DRR ₹ 25,000
- (iii) DRR Investment 1,12,500 represented by 10% ₹ 1,125 Secured Bonds of the Government of India of ₹ 100 each.

Annual contribution to the DRR was made on 31st March every year. On 31-3-2022, balance at bank was ₹ 7,50,000 before receipt of interest. The investment were realised at par for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st March, 2022:

- (1) Debentures Account
- (2) DRR Account
- (3) DRR Investment Account
- (4) Bank Account
- (5) Debenture Holders Account.

SOLUTION**1. 12% Debentures Account**

Date	Particulars	₹	Date	Particulars	₹
31 st March, 2022	To Debenture holders A/c	7,50,000	1 st April, 2021	By Balance b/d	7,50,000
		7,50,000			7,50,000

2. DRR Account

Date	Particulars	₹	Date	Particulars	₹
31 st March, 2022	To General reserve A/c (Refer Note)	75,000	1 st April, 2021	By Balance b/d	25,000
		75,000	1 st April, 2021	By Profit and loss A/c (Refer Note)	50,000
					75,000

3. 10% Secured Bonds of Govt. (DRR Investment) A/c

		₹			₹
1 st April, 2021	To Balance b/d	1,12,500	31 st March, 2022	By Bank A/c	1,12,500
		1,12,500			1,12,500

4. Bank A/c

		₹			₹
31 st March, 2022	To Balance b/d	7,50,000	31 st March, 2022	By Debenture holders A/c	8,25,000
	To Interest on DRR Investment (1,12,500 x 10%)	11,250			
	To DRR Investment A/c	1,12,500		By Balance c/d	48,750
		8,73,750			8,73,750

5. Debenture holders A/c

		₹			₹
31 st March, 2022	To Bank A/c	8,25,000	31 st March, 2022	By 12% Debentures	7,50,000
				By Premium on redemption of debentures (7,50,000 X 10%)	75,000
		8,25,000			8,25,000

Note—

Calculation of DRR before redemption = 10% of ₹ 7,50,000 = 75,000

Available balance = ₹ 25,000

DRR required = 75,000 – 25,000 = ₹ 50,000.

ILLUSTRATION 3

XYZ Ltd. has issued 1,000, 12% convertible debentures ₹100 each redeemable after a period of five years. According to the terms & conditions of the issue, these debentures were redeemable at a premium of 5%. The debenture holders also had the option at the time of redemption to convert 20% of their holdings into equity shares of ₹ 10 each at a price of ₹ 20 per share and balance in cash. Debenture holders amounting ₹ 20,000 opted to get their debentures converted into equity shares as per terms of the issue. You are required to calculate the number of shares issued and cash paid for redemption of ₹ 20,000 debenture holders.

SOLUTION

	Number of debentures
Debenture holders opted for conversion (20,000 /100)	<u>200</u>
Option for conversion	20%
Number of debentures to be converted (20% of 200)	40
Redemption value of 40 debentures at a premium of 5% [40 x (100+5)]	₹ 4,200
Equity shares of ₹ 10 each issued on conversion [₹ 4,200/ ₹ 20]	210 shares

Calculation of cash to be paid :	₹
Number of debentures	200
Less: number of debentures to be converted into equity shares	<u>(40)</u>
	<u>160</u>

Redemption value of 160 debentures (160 × ₹ 105) ie. ₹ 16,800.

ILLUSTRATION 4

The Balance Sheet of BEE Co. Ltd. (unlisted company other than AIFI, Banking company, NBFC and HFC) as at 31st March, 2021 is as under:

Particulars	Note No	₹
I. Equity and liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	2,00,000
(b) Reserves and Surplus	2	1,20,000
(2) Non-current liabilities		
(a) Long term borrowings	3	1,20,000
(3) Current Liabilities		
(a) Trade payables		1,15,000
Total		<u>5,55,000</u>
II. Assets		
(1) Non-current assets		
(a) Property, Plant and Equipment	4	1,15,000

(2) Current assets		
(a) Inventories		1,35,000
(b) Trade receivables		75,000
(c) Cash and bank balances	5	2,30,000
Total		5,55,000

Notes to Accounts

			₹
1. Share Capital			
Authorised share capital			
30,000 shares of ₹ 10 each fully paid			<u>3,00,000</u>
Issued and subscribed share capital			
20,000 shares of ₹ 10 each fully paid			<u>2,00,000</u>
2. Reserve and Surplus			
Profit & Loss Account			1,20,000
3. Long term borrowings			
12% Debentures			1,20,000
4. Property, Plant and Equipment			
Freehold property			1,15,000
5. Cash and bank balances			
Cash at bank	2,00,000		
Cash in hand	<u>30,000</u>		2,30,000

At the Annual General Meeting, it was resolved:

- To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution). This option was taken up by all the shareholders.
- To issue one bonus share for every five shares held.
- To repay the debentures at a premium of 3%.

Give the necessary journal entries for these transactions.

SOLUTION**Journal of BEE Co. Ltd.**

		Dr. ₹	Cr. ₹
Bank A/c Dr.		75,000	
To Equity Share Application A/c			75,000
(Application money received on 5,000 shares @ ₹ 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Share Application A/c Dr.		75,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			25,000
(Share application money on 5,000 shares @ ₹ 10 per share transferred to Share Capital Account, and ₹ 5 per share to Securities Premium Account vide Board's Resolution dated...)			
Securities Premium A/c Dr.		25,000	
Profit & Loss A/c Dr.		25,000	
To Bonus to Shareholders A/c			50,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:5 vide General Body's resolution dated...)			
Bonus to Shareholders A/c Dr.		50,000	
To Equity Share Capital A/c			50,000
(Issue of bonus shares in the ratio of 1 for 5 vide Board's resolution dated....)			
Profit and Loss A/c Dr.		12,000	
To Debenture Redemption Reserve			12,000
(for DRR created 10% x 1,20,000)			
Debenture Redemption Reserve Investment A/c Dr.		18,000	
To Bank A/c			18,000
(for DRR Investment created 15% x 1,20,000)			
12% Debentures A/c Dr.		1,20,000	
Premium Payable on Redemption A/c @ 3% Dr.		3,600	

To Debenture holders A/c (Amount payable to debentures holders)		1,23,600
Profit and loss A/c Dr. To Premium Payable on Redemption A/c (Premium payable on redemption of debentures charged to Profit & Loss A/c)	3,600	3,600
Debenture Redemption Reserve A/c Dr. To General Reserve (for DRR transferred to general reserve)	12,000	12,000
Bank A/c Dr. To Debenture Redemption Reserve Investment (for DRR Investment realised)	18,000	18,000
Debenture holders A/c Dr. To Bank A/c (Amount paid to debenture holders on redemption)	1,23,600	1,23,600

SUMMARY

- Debentures may create a charge against some or all the assets of the company.
- Charge may be fixed or floating, depends upon the condition of issue.
- Debentures may be redeemed after a fixed number of years or after a certain period has elapsed.
- For redemption of debentures, certain companies are required to create Debenture Redemption Reserve.
- Methods of redemption: lumpsum payment and payment in instalments.

TEST YOUR KNOWLEDGE

True and False

1. Amounts credited to the debenture redemption reserve may be utilised by the company for any purpose.
2. All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures need not create any Debenture Redemption Reserve (DRR).

3. *Under payment in instalments method, the payment of entire debenture is made in one lot.*
4. *At redemption of debentures, DRR should be transferred to general reserve.*

Multiple Choice Questions

1. *Which of the following statements is true?*
 - (a) *A debenture holder is an owner of the company.*
 - (b) *A debenture holder can get his money back only on the liquidation of the company.*
 - (c) *A debenture issued at a discount can be redeemed at a premium.*
2. *Which of the following statements is false?*
 - (a) *Debentures can be redeemed by payment in lump sum at the end of a specified period.*
 - (b) *Debentures cannot be redeemed during the life time of the company.*
 - (c) *Debentures can be redeemed by payments in annual instalments.*
3. *For debentures issued by unlisted companies (other than AIFs, Banking companies, NBFCs and HFCs), Debentures Redemption reserve will be considered adequate if it is:*
 - (a) *25% of the value of debentures issued through public issue.*
 - (b) *10% of the value of debentures issued through public issue.*
 - (c) *5% of the value of debentures issued through public issue.*
4. *A company has issued 6% debentures for ₹ 10,00,000, interest being payable on 31st March and 30th September. The company redeems ₹ 10,000 debentures at ₹ 96 (ex-interest) on 1st August 2021. The amount of Profit/loss on cancellation of debentures will be*
 - (a) *Profit of ₹ 600.*
 - (b) *Profit of ₹ 400.*
 - (c) *Loss of ₹ 400*

Theoretical Questions

1. *What is meant by redemption of debentures? Explain.*
2. *Write short note on Debenture Redemption Reserve.*

Practical Questions

1. A company had issued 20,000, 13% debentures of ₹ 100 each on 1st April, 2021. The debentures are due for redemption on 1st July, 2022. The terms of issue of debentures provided that they were redeemable at a premium of 5% and also conferred option to the debenture holders to convert 20% of their holding into equity shares (Nominal value ₹ 10) at a price of ₹ 15 per share. Debenture holders holding 2,500 debentures did not exercise the option. Calculate the number of equity shares to be allotted to the debenture holders exercising the option to the maximum.
2. Libra Limited (a listed company) recently made a public issue in respect of which the following information is available:
 - (a) No. of partly convertible debentures issued- 2,00,000; face value and issue price- ₹ 100 per debenture.
 - (b) Convertible portion per debenture- 60%, date of conversion- on expiry of 6 months from the date of closing of issue.
 - (c) Date of closure of subscription lists- 1.5.2021, date of allotment- 1.6.2021, rate of interest on debenture- 15% payable from the date of allotment, value of equity share for the purpose of conversion- ₹ 60 (Face Value ₹ 10).
 - (d) No. of debentures applied for- 2,00,000.
 - (e) Interest payable on debentures half-yearly on 30th September and 31st March.

Write relevant journal entries for all transactions arising out of the above during the year ended 31st March, 2022 (including cash and bank entries).

3. Case Ltd. (unlisted company other than AIFI, Banking company, NBFC and HFC) provides the following information as at 31st March, 2022:

Particulars	₹
Shareholder's Funds	
(a) Share Capital	
Authorized share capital:	
45,000 equity shares of ₹ 10 each fully paid	4,50,000
Issued and subscribed share capital:	
30,000 equity shares of ₹ 10 each fully paid	3,00,000
(b) Reserves and Surplus	
Profit & Loss Account	1,62,000

Debenture Redemption Reserve	18,000
Non-current liabilities	
(a) Long term borrowings	
12% Debentures	1,80,000
Current Liabilities	
(a) Trade payables	1,72,500
Non-current assets	
(a) Property, Plant and Equipment (Freehold property)	1,72,500
(b) Non-current Investment: DRR Investment	27,000
Current assets	
(a) Inventories	2,02,500
(b) Trade receivables	1,12,500
(c) Cash and bank balances:	
Cash at bank	2,73,000
Cash in hand	45,000

At the Annual General Meeting on 1.4.2022, it was resolved:

- (a) To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution). This option was taken up by all the shareholders.
- (b) To issue one bonus share for every five shares held.
- (c) To repay the debentures at a premium of 3%.

Give the necessary journal entries for these transactions.

ANSWERS/ HINTS

True and False

1. False: Amounts credited to the debenture redemption reserve should not be utilised by the company for any purpose except for the purpose other than for redemption of debentures.
2. True: All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures need not create any DRR.

3. False: under payment in instalments method, the payment of specified portion of debentures are made in instalments at specified intervals.
4. True: DRR is transferred to general reserve at the time of redemption of debentures.

Multiple Choice Questions

1.	(c)	2.	(b)	3.	(b)	4.	(b)				

Theoretical Questions

1. Debentures are usually redeemable i.e. either redeemed in cash or convertible after a time period.

Redeemable debentures may be **redeemed**:

- after a **fixed number** of years; or
- any time after a **certain number of years** has elapsed since their issue; or
- on giving a **specified notice**; or
- by **annual drawing**.

For details, refer para 6.2 of the chapter.

2. A company issuing debentures may be required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they fall due for payment. For details, refer para 6.3.

Practical Questions

1. **Calculation of number of equity shares to be allotted**

	<i>Number of debentures</i>
Total number of debentures	20,000
Less: Debenture holders not opted for conversion	<u>(2,500)</u>
Debenture holders opted for conversion	<u>17,500</u>
Option for conversion	20%
Number of debentures to be converted (20% of 17,500)	3,500
Redemption value of 3,500 debentures at a premium of	

5% [3,500 x (100+5)]	₹ 3,67,500
Equity shares of ₹ 10 each issued on conversion	
[₹ 3,67,500/ ₹ 15]	24,500 shares

2.

Journal Entries in the books of Libra Ltd.**Journal Entries**

Date	Particulars	Amount ₹ Dr.	Amount ₹ Cr.
1.5.2021	Bank A/c Dr. To Debenture Application A/c (Application money received on 1,50,000 debentures @ ₹ 100 each)	2,00,00,000	2,00,00,000
1.6.2021	Debenture Application A/c Dr. To 15% Debentures A/c (Allotment of 1,50,000 debentures to applicants and 50,000 debentures to underwriters)	2,00,00,000	2,00,00,000
1.6.2021	Debenture Redemption Investment A/c Dr. To Bank A/c (2,00,000 X 100 x 15% X 40%) (Being Investments made for redemption purpose)	12,00,000	12,00,000
30.9.2021	Debenture Interest A/c Dr. To Bank A/c (Interest paid on debentures for 4 months @ 15% on ₹ 2,00,00,000)	10,00,000	10,00,000
31.10.2021	15% Debentures A/c Dr. To Equity Share Capital A/c To Securities Premium A/c (Conversion of 60% of debentures into shares of ₹ 60 each with a face value of ₹ 10)	1,20,00,000	20,00,000 1,00,00,000

31.3.2022	Debenture Interest A/c	Dr.	7,50,000	
	To Bank A/c			7,50,000
	(Interest paid on debentures for the half year) (Refer working note)			

Working Note:

Calculation of Debenture Interest for the half year ended 31st March, 2022

On ₹ 80,00,000 for 6 months @ 15% = ₹6,00,000

On ₹ 1,20,00,000 for 1 months @ 15% = ₹ 1,50,000

₹7,50,000

3.

Journal Entries in the Books of Case Ltd.

		Dr.₹	Cr.₹
Bank A/c	Dr.	1,12,500	
To Equity Shareholders A/c			1,12,500
(Application money received on 7,500 shares @ ₹ 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Shareholders A/c	Dr.	1,12,500	
To Equity Share Capital A/c			75,000
To Securities Premium A/c			37,500
(Share application money on 7,500 shares @ ₹ 10 per share transferred to Share Capital Account, and ₹ 5 per share to Securities Premium Account vide Board's Resolution dated...)			
Securities Premium A/c	Dr.	37,500	
Profit & Loss A/c	Dr.	37,500	
To Bonus to Shareholders A/c			75,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:5 vide General Body's resolution dated...)			
Bonus to Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			75,000
(Issue of bonus shares in the ratio of 1 for 5 vide Board's resolution dated....)			

12% Debentures A/c	Dr.	1,80,000	
Premium Payable on Redemption A/c (@ 3%)	Dr.	5,400	
To Debenture holders A/c			1,85,400
(Amount payable to debentures holders)			
Profit and loss A/c	Dr.	5,400	
To Premium Payable on Redemption A/c			5,400
(Premium payable on redemption of debentures charged to Profit & Loss A/c)			
Debenture Redemption Reserve A/c	Dr.	18,000	
To General Reserve			18,000
(For DRR transferred to general reserve)			
Bank A/c	Dr.	27,000	
To Debenture Redemption Reserve Investment			27,000
(for DRR Investment realised)			
Debenture holders A/c	Dr.	1,85,400	
To Bank A/c			1,85,400
(Amount paid to debenture holders on redemption)			

ACCOUNTING TERMINOLOGY GLOSSARY

Acceptance

The drawee's signed assent on bill of exchange, to the order of the drawer. This term is also used to describe a bill of exchange that has been accepted.

Accounting policies

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Accrual

Recognition of revenues and costs as they are earned or incurred (and not as money is received or paid). It includes recognition of transactions relating to assets and liabilities as they occur irrespective of the actual receipts or payments.

Accrual/Mercantile Basis of Accounting

The method of recording transactions by which *revenues, costs, assets and liabilities* are reflected in the accounts in the period in which they accrue. The 'accrual basis of accounting' includes considerations relating to *deferrals, allocations, depreciation and amortisation*. This basis is also referred to as *mercantile basis of accounting*.

Accrued Asset

A developing but not yet enforceable claim against another person which accumulates with the passage of time or the rendering of service or otherwise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accrued Expense

An expense which has been incurred in an accounting period but for which no enforceable claim has become due in that period against the enterprise. It may arise from the purchase of services (including the use of money) which at the date of accounting have been only partly performed, and are not yet billable.

Accrued Liability

A developing but not yet enforceable claim by another person which accumulates with the passage of time or the receipt of service or otherwise. It may arise from the purchase of services

(including the use of money) which at the date of accounting have.

Accrued Revenue

Revenue which has been earned in an accounting period but in respect of which no enforceable claim has become due in that period by the enterprise. It may arise from the rendering of services (including the use of money) which at the date of accounting have been partly performed, and are not yet billable.

Accumulated Depletion

The total to date of the periodic depletion charges on wasting assets.

Accumulated Depreciation

The total to date of the periodic depreciation charges on depreciable assets.

Advance

Payment made on account of, but before completion of, a contract, or before acquisition of goods or receipt of services.

Amortised Value

The *amortizable* amount less any portion already provided by way of *amortization*.

Annual Report

The information provided annually by the management of an enterprise to the owners and other interested persons concerning its operations and financial position. It includes the information statutorily required, e.g., in the case of a company, the *balance sheet*, *profit and loss statement* and notes on accounts, the *auditor's report* thereon, and the report of the Board of Directors. It also includes other information voluntarily provided e.g., *value added statement*, graphs, charts, etc.

Appropriation Account

An account sometimes included as a separate section of the *profit and loss statement* showing application of *profits* towards *dividends*, *reserves*, etc.

Assets

Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

Authorised Share Capital

The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as **nominal share capital**.

Average Cost

The cost of an item at a point of time as determined by applying an average of the cost of all items of the same nature over a period. When weightages are also applied in the computation, it is termed as **weighted average cost**.

Bad Debts

Debts owed to an enterprise which are considered to be irrecoverable.

Balance Sheet

A statement of the financial position of an enterprise as at a given date, which exhibits its *assets, liabilities, capital, reserves* and other account balances at their respective *book values*.

Bill of Exchange

An instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only, to or to the order of a certain person or to the bearer of the instrument.

Bonus Shares

Shares allotted by capitalization of the reserves or surplus of a corporate enterprise.

Book Value

The amount at which an item appears in the books of account or financial statements. It does not refer to any particular basis on which the amount is determined e.g., cost, replacement value, etc.

Borrowing costs

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Bond/Debenture

A formal document constituting acknowledgment of a debt by an enterprise usually given under its common seal and normally containing provisions regarding payment of interest, repayment of principal and security, if any. It is transferable in the appropriate manner.

Call

A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or *debentures* after allotment.

Called-up Share Capital

That part of the subscribed share capital which shareholders have been required to pay.

Capital

Generally refers to the amount invested in an enterprise by its owners e.g. *paid-up share capital* in a corporate enterprise. It is also used to refer to the interest of owners in the assets of an enterprise.

Capital Assets

Assets, including *investments* not held for sale, conversion or consumption in the ordinary course of business.

Capital Commitment

Future *liability* for capital expenditure in respect of which contracts have been made.

Capital Employed

The finances deployed by an enterprise in its *net fixed assets, investments* and *working capital*. Capital employed in an operation may, however, exclude *investments* made outside that operation.

Capital Profit/Capital Loss

Excess of the proceeds realised from the sale, transfer, or exchange of the whole or a part of a capital asset over its cost. When the result of this computation is negative, it is referred to as **capital loss**.

Capital Reserve

A *reserve* of a corporate enterprise which is not available for distribution as *dividend*.

Capital Work-in-progress

Expenditure on *capital assets* which are in the process of construction or completion.

Cash

Cash comprises cash on hand and demand deposits with banks

Cash equivalents

Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash Basis of Accounting

The method of recording transactions by which *revenues* and *costs* and *assets* and *liabilities* are reflected in the accounts in the period in which actual receipts or actual payments are made.

Cash Discount

A reduction granted by a supplier from the invoiced price in consideration of immediate payment or payment within a stipulated period.

Cash Profit

The *net profit* as increased by non-cash costs, such as *depreciation*, *amortization*, etc. When the result of the computation is negative, it is termed as **cash loss**.

Carrying amount

Carrying amount is the amount at which an asset is recognized in the balance sheet, net of any accumulated amortization and accumulated impairment losses thereon.

Charge

An encumbrance on an asset to secure an indebtedness or other obligations. It may be fixed or floating.

Cheque

A *bill* of exchange drawn upon a specified banker and not expressed to be payable otherwise than on demand.

Collateral Security

Security which is given in addition to the principal security against the same *liability* or obligation.

Costs of disposal

Costs of disposal are incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.

Contingency

A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

Contingent Asset

An *asset* the existence, ownership or value of which may be known or determined only on the occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability

An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

Contra Account

One or two or more accounts which partially or wholly off-set another or other accounts.

Cost

The amount of *expenditure* incurred on or attributable to a specified article, product or activity.

Cost of Purchase

The purchase price including duties and taxes, freight inwards and other *expenditure* directly attributable to acquisition, less *trade discounts*, rebates, duty drawbacks, and subsidies in respect of such purchase.

Cost of Goods Sold

The cost of goods sold during an accounting period. In manufacturing operations, it includes (i) cost of materials; (ii) labour and factory overheads; selling and administrative expenses are normally excluded.

Conversion Cost

Cost incurred to convert raw materials or components into finished or semi-finished products. This normally includes costs which are specifically attributable to units of production, i.e., direct labour, direct expenses and subcontracted work, and production overheads as applicable in accordance with either the *direct cost* or *absorption costing method*. Production overheads exclude expenses which relate to general administration, finance, selling and distribution.

Convertible Debenture

A *debenture* which gives the holder a right to its conversion, wholly or partly, in shares in accordance with the terms of issue.

Cumulative Dividend

A *dividend* payable on *cumulative preference shares* which, if unpaid, accumulates as a claim against the earnings of a corporate enterprise, before any distribution is made to the other shareholders.

Cumulative Preference Shares

A class of preference shares entitled to payment of *cumulative dividends*. Preference shares are always deemed to be cumulative, unless they are expressly made non-cumulative.

Current Assets

Cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business.

Current Liability

Liability including loans, deposits and bank overdraft which falls due for payment in a relatively short period, normally not more than twelve months.

Deferral

Postponement of recognition of a revenue or expense after its related receipt or payment (or incurrance of a *liability*) to a subsequent period to which it applies. Common examples of deferrals include prepaid rent and taxes, unearned subscriptions received in advance by newspapers and magazine selling companies, etc.

Deficiency

The excess of *liabilities* over *assets* of an enterprise at a given date. The debit balance in the *profit and loss statement*.

Deficit

The debit balance in the profit and loss statement.

Depletion

A measure of exhaustion of a wasting asset represented by periodic write off of cost or other substituted value.

Depreciation

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

Depreciable amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

Depreciable assets

Depreciable assets are assets which

- (i) are expected to be used during more than one accounting period; and
- (ii) have a limited useful life; and
- (iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Depreciation Method

Any method of calculating depreciation for an accounting period.

Depreciation Rate

A percentage applied to the historical cost or the substituted amount of a *depreciable asset* (or in case of *diminishing balance method*, the historical cost or the substituted amount less *accumulated depreciation*).

Diminishing Balance Method

A method under which the periodic charge for *depreciation* of an *asset* is computed by applying a fixed percentage to its historical cost or substituted amount less *accumulated depreciation* (net book value). This is also referred to as **written down value method**.

Discount

A reduction from a list price, quoted price or invoiced price. It also refers to the price for obtaining payment on a bill before its maturity.

Dividend

A distribution to shareholders out of profits or reserves available for this purpose.

Entity Concept

The view of the relationship between the accounting entity and its owners which regards the entity as a separate person, distinct and apart from its owners.

Equity Share

A share which is not a preference share. Also sometimes called **ordinary share**.

Exchange difference

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

Expenditure

Incurring a *liability*, disbursement of cash or transfer of property for the purpose of obtaining *assets*, goods or services.

Expense

A cost relating to the operations of an accounting period or to the *revenue* earned during the period or the benefits of which do not extend beyond that period.

Expired Cost

That portion of an *expenditure* from which no further benefit is expected. Also termed as **expense**.

Extraordinary items

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Fair value

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Fair Market Value

The price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

First Charge

A *charge* having priority over other charges.

First In, First Out (FIFO)

Computation of the cost of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

Fixed asset

Asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.

Fixed Cost

That cost of production which by its very nature remains relatively unaffected in a defined period of time by variations in the volume of production.

Fixed Deposit

Deposit for a specified period and at specified rate of interest.

Fixed or Specific Charge

A *charge* which attaches to a particular *asset* which is identified when the charge is created, and the identity of the *asset* does not change during the subsistence of the *charge*.

Floating Charge

A general *charge* on some or all *assets* of an enterprise which are not attached to specific *assets* and are given as security against a debt.

Financial Instrument

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

Foreign currency

Foreign currency is a currency other than the reporting currency of an enterprise.

Forfeited Share

A share to which title is lost by a member for non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

Free Reserve

A *reserve* the utilization of which is not restricted in any manner.

Functional Classification

A system of classification of *expenses* and *revenues* and the corresponding *assets* and *liabilities* to each function or activity, rather than by reference to their nature.

Fund

An account usually of the nature of a *reserve* or a *provision* which is represented by specifically earmarked *assets*.

Fundamental Accounting Assumptions

Basic accounting assumptions which underlie the preparation and presentation of financial statements. They are *going concern*, consistency and *accrual*. Usually, they are not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

Gain

A monetary benefit, *profit* or advantage resulting from a transaction or group of transactions.

General Reserve

A *revenue reserve* which is not earmarked for a specific purpose.

Going Concern Assumption

An accounting assumption according to which an enterprise is viewed as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations.

Goodwill

An *intangible asset* arising from business connections or trade name or reputation of an enterprise.

Gross Margin or Gross Profit

The excess of the proceeds of goods sold and services rendered during a period over their *cost*, before taking into account administration, selling, distribution and financing expenses. When the result of this computation is negative it is referred to as **gross loss**.

Government

Government refers to government, government agencies and similar bodies whether local, national or international.

Government grants

Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Gross book value

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Income and Expenditure Statement

A financial statement, often prepared by non-profit making enterprises like clubs, associations etc. to present their *revenues* and *expenses* for an accounting period and to show the excess of *revenues* over *expenses* (or vice versa) for that period. It is similar to profit and loss statement and is also called **revenue and expense statement**.

Intangible Asset

Asset which does not have a physical identity e.g. *goodwill*, patents, copyright etc.

Inventories are assets:

- (a) held for sale in the ordinary course of business;
- (b) in the process of production for such sale; or
- (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Investment

Expenditure on assets held to earn interest, income, profit or other benefits.

Investments

Assets held not for operational purposes or for rendering services i.e. assets other than *fixed assets* or *current assets* (e.g. securities, shares, *debentures*, immovable properties).

Issued Share Capital

That portion of the *authorized share capital* which has actually been offered for subscription. This includes any *bonus shares* allotted by the corporate enterprise.

Joint venture

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

Last In, First Out (LIFO)

Computation of the cost of items sold or consumed during a period on the basis that the items last acquired were sold or consumed first.

Liability

The financial obligation of an enterprise other than owners' funds.

Lien

Right of one person to satisfy a claim against another by holding or retaining possession of that other's *assets/property*.

Long-term Liability

Liability which does not fall due for payment in a relatively short period, i.e., normally a period not more than twelve months.

Lease

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Materiality

An accounting concept according to which all relatively important and relevant items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements are disclosed in the financial statements.

Mortgage

A transfer of interest in specific immovable property for the purpose of securing a loan advanced, or to be advanced, an existing or future debt or the performance of an engagement which may give rise to a pecuniary *liability*. The security is redeemed when the loan is repaid or the debt discharged or the obligations performed.

Net Assets/Shareholders' funds/Net Worth

The excess of the *book value* of *assets* (other than *fictitious assets*) of an enterprise over its *liabilities*. This is also referred to as **net worth** or **shareholders' funds**.

Net Fixed Assets

Fixed assets less accumulated depreciation thereon up-to-date.

Net Profit/Net loss

The excess of *revenue* over *expenses* during a particular accounting period. When the result of this computation is negative, it is referred to as **net loss**. The net profit may be shown before or after tax.

Net realizable value

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Obsolescence

Diminution in the value of an asset by reason of its becoming out-of date or less useful due to technological changes, improvement in production methods, change in market demand for the product or service output of the asset, or legal or other restrictions.

Operating Profit

The *net profit* arising from the normal operations and activities of an enterprise without taking account of extraneous transactions and expenses of a purely financial nature.

Paid-up Share Capital

That part of the *subscribed share capital* for which consideration in cash or otherwise has been received. This includes *bonus shares* allotted by the corporate enterprise.

Preference Share Capital

That part of the *share capital* of a corporate enterprise which enjoys preferential rights in respect of payments of fixed *dividend* and repayment of *capital*. Preference shares may also have full or partial participating rights in surplus profits or surplus capital.

Preliminary Expenses

Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

Prepaid Expense

Payment for expense in an accounting period, the benefit for which will accrue in the subsequent accounting period(s).

Prime Cost

The total cost of direct materials, direct wages and other direct production expenses.

Prior Period Item

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Profit/Loss

A general term for the excess of *revenue* over related *cost*. When the result of this computation is negative it is referred to as **loss**.

Profit and Loss Account

A financial statement which presents the *revenues* and *expenses* of an enterprise for an accounting period and shows the excess of *revenues* over *expenses* (or vice versa). It is also known as **profit and loss account**.

Promissory Note

An instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Provision

An amount written off or retained by way of providing for *depreciation* or diminution in value of assets or retained by way of providing for any known *liability* the amount of which cannot be determined with substantial accuracy.

Provision for Doubtful Debts

A *provision* made for debts considered doubtful of recovery.

Prudence

A concept of care and caution used in accounting according to which (in view of the uncertainty attached to future events) *profits* are not anticipated, but recognised only when realised, though not necessarily in cash. Under this concept, *provision* is made for all known *liabilities* and losses,

even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

Redeemable Preference Share

The preference share that is repayable either after a fixed or determinable period or at any time decided by the management (by giving due notice), under certain conditions prescribed by the instrument of incorporation or the terms of issue.

Redemption

Repayment as per given terms normally used in connection with preference shares and debentures.

Reserve

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a *provision* for *depreciation* or diminution in the value of assets or for a known *liability*. The reserves are primarily of two types: *capital reserves* and *revenue reserves*.

Revaluation Reserve

A *reserve* created on the revaluation of *assets* or *net assets* of an enterprise represented by the surplus of the estimated replacement cost or estimated market values over the *book values* thereof.

Residual value

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

Revenue/Income

Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

Revenue Reserve

Any reserve other than a capital reserve.

Right Share

An allotment of shares on the issue of fresh *capital* by a corporate enterprise to which a shareholder is entitled on payment, by virtue of his holding certain shares in the enterprise in proportion to the number of shares already held by him. (Shares allotted to certain categories of *debenture* holders pursuant to the rights enjoyed by them are sometimes called right shares)

Sales Turnover/Gross Turnover/Gross Sales

The aggregate amount for which sales are effected or services rendered by an enterprise. The terms **gross turnover** and **net turnover** (or **gross sales** and **net sales**) are sometimes used to distinguish the sales aggregate before and after deduction of returns and trade discounts.

Secured Loan

Loan secured wholly or partly against an asset.

Share Capital

Aggregate amount of money paid or credited as paid on the shares and/ or stocks of a corporate enterprise.

Share Discount

The excess of the face value of shares over their issue price.

Shareholders' Equity

The interest of the shareholders in the *net assets* of a corporate enterprise. However, in the case of liquidation it is represented by the residual assets after meeting prior claims.

Share Issue Expenses

Costs incurred in connection with the issue and allotment of shares. These include legal and professional fees, advertising expenses, printing costs, underwriting commission, brokerage, and also expenses in connection with the issue of prospectus and allotment of shares.

Share warrants

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

Securities Premium

The excess of the issue price of shares over their face value.

Sinking Fund

A *fund* created for the repayment of a *liability* or for the replacement of an asset.

Straight Line Method

The method under which the periodic charge for *depreciation* is computed by dividing the *depreciable amount* of a *depreciable asset* by the estimated number of years of its useful life.

Subscribed Share Capital

That portion of the *issued share capital* which has actually been subscribed and allotted. This includes any *bonus shares* allotted by the corporate enterprise.

Substance over Form

An accounting concept according to which the substance and not merely the legal form of transactions and events governs their accounting treatment and presentation in financial statements.

Sundry Creditors / Trade Creditors/Trade payables

Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. Also termed as **trade creditors** or **account payables** or **Trade payables**.

Sundry Debtors / Trade Debtors/ Trade Receivables

Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as **debtors**, **trade debtors**, **account receivables**, **trade receivables**.

Surplus

Credit balance in the *profit and loss statement* after providing for proposed appropriations, e.g., *dividend* or *reserves*.

Trade Discount

A reduction granted by a supplier from the list price of goods or services on business considerations other than for prompt payment.

Unexpired Cost

That portion of an *expenditure* whose benefit has not yet been exhausted.

Unissued Share Capital

That portion of the *authorised share capital* for which shares have not been offered for subscription.

Unpaid Dividend

Dividend which has been declared by a corporate enterprise but has not been paid, or the warrant or *cheque* in respect whereof has not been dispatched within the prescribed period.

Useful life

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise