PART - A : Accounting for Not-For-Profit Organisation Firms and Companies

UNIT - 1 : Financial Statements of Not-For-Profit Organisation

Chapter - 1 : Not-For-Profit Organisation

Quick Review

- **Meaning of Not-for-Profit Organizations :** The main purpose of any business organization is to earn profit. In other words, they work for self-Interest. However, there are some organizations whose basic aim is to serve the society *i.e.*, they work for the benefit of the society as a whole. These organisations are called Not-for-Profit Organizations.
- **Features of Not-for-Profit Organization :** The basic features of any non-profit organization are as under :
  (i) Service motive
  (ii) Profit is not the criterion.
  (iii) Surplus not distributed among its members.
  (iv) Separate entity.
  (v) Unique names connect their working.
  (vi) Managed by elected persons.
  (vii) Major funds in the form of contribution and donations, etc.
- **Difference between Trade Organization and Not-for-Profit Organization**

Basis	Trade Organization	Not-for-Profit Organization
(i) Primary Objective	The main purpose of trade organization is to earn profit.	The main purpose of NPO is to provide services to the public at large.
(ii) Ownership	The proprietors of the business are the owners.	In NPO subscribers are known as members.
(iii) Result	The result of trade organization is called profit or loss.	The result of the not-for-profit organization is called surplus or deficit.
(iv) Distribution of profit	Profit or loss is distributed among owners.	Surplus or deficit is not distributed among members, instead it is adjusted in capital fund.

- **The books of accounts generally maintained by every Not-for-Profit Organizations are :**
  (i) Cash book
  (ii) Ledger
  (iii) Member's Register
  (iv) Register of Assets
- **The final accounts of Not-for-Profit organization consists of :**
  (i) Receipts and Payments Account
  (ii) Income and Expenditure Account
  (iii) Balance Sheet.

Know the Terms

- **Endowment :** It is a donation with a condition by the donor to use only the income earned from investment of such fund for the specified purpose so that the original donated amount remain intact.
- **Loan fund :** It is a set up to quart loans for specific purpose say to pursue higher studies.
- **Legacy :** It is the amount received as donation by not for profit organisation under the will of a deceased person.
- **Subscription :** It is the amount paid by the members periodically so that their membership service alive.
- **Honorarium :** It is a payment made to a person who has voluntarily undertaken a service which would normally command a fee. It is an expression of gratitude rather than a payment for the receivers.

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Unit - 2 : Accounting for Partnership Firms

Chapter - 2 : Basics of Partnership

TOPIC-1
Concept of Partnership

Quick Review

- **Meaning of Partnership :** According to Indian Partnership Act, 1932 "Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all." The Act also explains that persons who have entered into partnership with one another are individually called "partners" and collectively "a firm."
- **Characteristics of Partnership :**
  - **Association of two or more than two persons :** It is essential for the Partnership that there must be atleast two persons who are competent for agreement because less than two persons does not establish partnership.
  - **Maximum numbers of Partners :** Rule 10 of Company (Miscellaneous) Rules, 2014 says that no association of partnership shall be formed, consisting of more than 50 persons for the purpose of carrying on any business.
  - **Existence of an Agreement :** Partnership is the outcome of an agreement between two or more persons to carry on business. This agreement may be oral or in writing. The Partnership Act, 1932 (Section 5) clearly states that " the relation of partnership arises from contract and not from status."
  - **Existence of Business :** Partnership Act, 1932 [Section 2 (6)] states that a " Business" includes every trade, occupation and profession. Business of course, must be lawful and its main object should be to earn profit.

Know the Terms

- **Fixed Capital Method :** Under this method, the partners are not allowed to change their capital during the life time of business except in extraordinary circumstances. However, the partners may decide to change their capital by agreement.
- **Fluctuating Capital Method :** Under this method, the balance of capital accounts is not fixed and fluctuates due to interest on drawing, interest on capital, salary, commission or share in Profit and Loss.
- **Partnership Deed :** A document which contains the terms of partnership as agreed upon by the partners is called 'Partnership Deed'.

TOPIC-2
Partnership Deed

Quick Review

- **Partnership Deed**

  According to Section (5) of the Indian Partnership Act, 1932, Partnership Deed is an agreement between two or more than two partners for determining their mutual contract relationship and its limitation for better and effective operation of business. It contains rules and conditions for operation of business. It can be registered or unregistered. It should be comprehensive to avoid disputes later on.

  The document which contains terms of the agreement is called 'Partnership deed.'
- **Content of Partnership Deed**
  1. Name and Address of all Partners
  2. Name of the Firm
  3. Nature of the Business
  4. Capital of the Partners
  5. Interest on Capital
  6. Drawing by the Partners
  7. Interest on Drawings

8. Profit and Loss Sharing Ratio
9. Partner's Salary and Commission
10. Method of Valuation of Goodwill
11. Settlement on dissolution of Firm
12. Duration of Partnership
13. Methods of evaluation of Assets and Liabilities
14. Lending and Borrowing by the Partner
15. Admission and Retirement of Partners
16. Duties of Partners
17. Death of a Partner & his legal representative
18. Insurance and its distribution
19. Relinquishment of Partnership
20. Arbitration Clause
21. Maintenance of Accounts and their Audit
22. Settlement of Disputes.

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

1. **Active Partner :** A person who provides his share in capital and also takes active part in the management. The development of business depends upon the active partners.
2. **Sleeping or Dormant Partners :** These partners only provide capital and also share the profits and losses of the business. A sleeping partner does not take part in the management of a firm. These are not known to public as partners.
3. **Silent Partner :** A silent partner is known to the public as a partner. He does not participate in the affairs of the management. But he is liable to pay debts of the firm.
4. **Secret Partner :** He takes active part in the business but public does not know him as a partner of the firm. He is liable to pay all the debts of the firm.
5. **Nominal Partner :** These partners do not share the profits and losses of the firm. These partners do not participate in the management of a firm. A firm only uses the name and reputation of the partners. So these are called nominal partners.
6. **Minor Partner :** A minor may become a partner with the consent of all the partners. A minor is only admitted in the profits of the business only. He has no liability of loss.
7. **Senior Partner :** A person who is playing important role in the management according to his ability, experience and capital is called senior partner.
8. **Junior Partner :** A person who has small investment in the firm and has a limited experience of business is called junior partner.
9. **Limited Partner :** A partner whose loss responsibility is restricted to his share only is called limited partner. He cannot take part in the management of a firm.
10. **Unlimited Partner :** When the liability of the partner is unlimited, he is called unlimited partner. The debts of firm can be paid even by the personal property of that partner.

➢ **Applicable provisions of the Indian Partnership Act, 1932 in the absence of Partnership deed :**

1. Interest on partner's loan will be paid @ 6% p.a.
2. If deed is silent or not given regarding charges of interest on capital, no interest on capital is to be allowed.
3. If deed is silent or not given regarding interest on drawings or charges on drawings by partners, no interest on drawings is to be charged.
4. If deed is silent or not given regarding salary or remuneration or commission of partners for their services, no salary or remuneration or commission is to be allowed to any partner.
5. If deed is silent or not given regarding Profit sharing ratio, Profit will be distributed equally.

TOPIC-3
Limited Liability Partnership

Quick Review

➢ **Limited Liability Partnership (LLP)**

Meaning : Limited Liability Partnership has been introduced in India by way of Limited Liability Partnership Act, 2008. A Limited Liability Partnership, popularly known as LLP combines the advantages of both the Company and Partnership into a single form of organization. In an LLP, one partner is not responsible or liable for another partner's misconduct or negligence. This is an important difference from that of an unlimited partnership. In an LLP, all partners have a form of limited liability for each individual's protection within the partnership, similar to that of the shareholders of a corporation. However, unlike corporate shareholders, the partners have the right to manage the business directly. An LLP also limits the personal liability of a partner for the errors, omissions, incompetence, or negligence of the LLP's employees or other agents.

Limited Liability Partnership is managed as per the LLP Agreement. However, in the absence of such an agreement the LLP would be governed by the framework provided in Schedule 1 of Limited Liability Partnership Act, 2008 which describes the matters related to mutual rights and duties of partners of the LLP and of the limited liability partnership and its partners.

LLP has a separate legal entity, liable to the full extent of its assets. The liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or un-authorized actions of other partners. Thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business' decisions or misconduct.

- **Advantages**
  1. Renowned and accepted form of business worldwide in comparison to Company.
  2. Low cost of Formation.
  3. Easy to establish.
  4. Easy to manage & run.
  5. No requirement of any minimum capital contribution.
  6. No restrictions to the maximum number of partners.
  7. LLP & its partners are distinct from each other.
  8. Partners are not liable for the acts of other partners.
  9. Less compliance level.
  10. No exposure to personal assets of the partners except in case of a fraud.
  11. Less requirement as to maintenance of statutory records.
  12. Less Government intervention.
  13. Easy to dissolve or wind-up.
  14. Professionals can form Multi-disciplinary Professional LLP, which was not allowed earlier.
  15. Audit requirement only in case of contributions exceeding ₹ 25 lakh or turnover exceeding ₹ 40 lakh.
- **Disadvantages**
  1. Any act of the partner without the other partner may bind the LLP.
  2. Under some cases, liability may extend to personal assets of partners.
  3. Cannot raise money from public.

TOPIC-4
Maintenance of Capital Accounts of Partners

Quick Review

- **Maintenance of Capital Accounts of Partners**

  In case of partnership firm, the transaction relating to partners are recorded in their respective capital accounts. There are two methods by which the capital accounts of partners can be maintained. These are:

1. **Fluctuating Capital :** When Partners decide to maintain only Capital Accounts for each partner, all entries regarding Interest on Capital, Interest on Drawings, Salary, Share in Profit or Loss and Drawings will be made in the Capital Accounts. In this case, Capital will be fluctuated from year to year. This is known as Fluctuating Capital.
2. **Fixed Capital :** When Partners decide that their capitals will remain fixed and it will not change due to Interest on Capital, Interest on Drawings, Salary or Share of Profit or Loss and Drawings, it is termed as Fixed Capital. In this case there will be two accounts for each partner : Capital Account and Current Account. Entries for Interest on Capital, Interest on Drawings, Salary, Share of Profit or Loss and Drawings will be made through Current Account. However when there are frequent drawings, a separate Drawing Accounts may be opened for each partner. At the end of accounting year, balance of each Partner's Drawing account will be transferred to their respective current accounts.

Proforma of Partner's Capital Account in Fluctuating Method

Partner's Capital Account

Date	Particulars	Journal Folio	Amount	Date	Particulars	Journal Folio	Amount
	To Drawings A/c		....		By Balance b/d		....
	To Interest on drawings A/c		....		By Cash/Bank A/c (Additional Capital)		....
	To Goodwill A/c (Written Off)		....		By Stock/Purchase A/c		....
	To Profit & Loss A/c		....		By Assets A/c		....
	(Share in Loss)		....		By Interest on Capital A/c		
	To Balance c/d (Closing Balance)				By Salary A/c		....
					By Commission A/c		....
					By Premium A/c		....
					By P&L appropriation A/c (Share in Profit)		
					By Balance c/d (Closing Balance)		....

Proforma of Partner's Capital Account in Fixed Capital Account Method

Partner's Capital Account

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

Proforma of Partner's Current Account in Fixed Capital Account Method

Partner's Current Account

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Balance b/d (if there is old debit balance)		....		By Balance b/d (if there is old Credit balance)		....
	To Drawings A/c		....		By Interest on Capital A/c		....
	To Interest on Drawings A/c		....		By Salary A/c		....
	To Goodwill A/c (Written off)		....		By Commission A/c		....
	To Profit & Loss A/c (Share in Loss)		....		By General Reserve A/c		....
	To Balance c/d (If credit side's total is more)		....		By Premium A/c (Goodwill)		....
					By P&L Appropriation A/c (Share of Profit)		....
					By Balance c/d (If debit side's total is more)		....

TOPIC-5
Division of Profits Among Partners

Quick Review

➢ **Division of Profits among Partners**

Partnership firm prepares its Trading, Profit and Loss Account and Balance Sheet at the end of every accounting year. The net profit as shown by the Profit and Loss account of a partnership firm requires certain adjustments with regard to interest on capitals, interest on drawings etc., if provided under the terms of agreement. Usually for this purpose, the net profit is arrived after preparing Profit & Loss Appropriation Account. In fact, it is an extension of the Profit and Loss Account and is credited with the net profits and interest on drawings and debited with interest on capital, salary to partners, etc. The balance (if any) will be distributed among the partners in their agreed ratio.

Journal Entries regarding Profit and Loss Appropriation Accounts are as follows :

1. **Transfer of balance of Profit and Loss Account**

If Profit & Loss Account shows a credit balance (Net Profit) :
Profit & Loss A/c Dr.
To Profit & Loss Appropriation A/c
(Being transfer of net profit to Profit & Loss Appropriation A/c)

2. **Interest on Capitals**

(a) For crediting interest on capital to Partners' Capital Accounts :
Interest on Capital A/c Dr.
To Partner's Capital/Current A/c
(Being interest on capital at ____% p.a. allowed to partners)

(b) For transferring interest on capital to Profit and Loss Appropriation Account :
Profit & Loss Appropriation A/c Dr.
To Interest on Capital/Current A/c
(Being interest on capital transferred to Profit & Loss Appropriation A/c)

NET ENTRY :
Profit & Loss Appropriation A/c Dr.
To Partner's Capital /Current A/c
(Being Interest on Capital allowed to Partners)

3. **Partners' Salary A/c**

(a) For crediting salary/commission to Partners' Capital Account
Salary/Commission A/c Dr.
To Partner's Capital/Current A/c
(Being ₹____Salary/Commission allowed to _____ partner for _____months)

(b) For transferring partners' salary/commission to Profit and Loss Appropriation Account :
Profit and Loss Appropriation A/c Dr.
To Salary/Commission A/c
(Being Salary/Commission transferred to Profit and Loss Appropriation Account)

NET ENTRY :
Profit & Loss Appropriation A/c Dr.
To Partner's Capital /Current A/c
(Being Salary/Commission allowed to Partners)

4. **Interest on Drawings**

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

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

NET ENTRY :

Partners' Capital/Current A/c Dr.
To Profit & Loss Appropriation A/c
(Being interest on drawings charged)

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

6. **Transfer of Profit to Reserve :**
Profit & Loss Appropriation A/c Dr.
To Reserve A/c
(Being profit transferred to Reserve account)

PROFORMA OF PROFIT & LOSS APPROPRIATION ACCOUNT
For the year ending ______________________________

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

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

TOPIC-6
Calculation of Appropriation Items and Charge Items

Quick Review

➢ **Interest on Capital**

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

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

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

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

Calculation of opening balance of Capital:

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

Note :

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

➢ **Interest on Drawings**

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

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

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

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

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

Rules for calculating Interest on Drawings :

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

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

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

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

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

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

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

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

(1) If rate of interest of drawings in 12 month = 6

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

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

$$\text{Drawings made in middle of months} = 4.5$$

$$\text{If Drawings made in the beginning of months (+ .5 in given rate)} = 4.5 + .5 = 5$$

$$\text{If Drawings made in the end of each months (– .5 in given rate)} = 4.5 - .5 = 4$$

Just like that, student can calculate each and every rate according to monthwise.

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

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

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

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

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

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

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

Note : Charges such as interest on partners' loans, manager's salary and commission must be deducted from profit before transferring it to the profit and loss appropriation account.

Rent Paid to a Partner : It is a charge against the profit and not an appropriation out of profits. It is therefore, debited to profit and loss account and credited to partner's current account in case of fixed capitals or to partner's capital account, when capitals are fluctuating.

➢ **Interest on Partner's Loan to Firm**

The firm pays interest on loan at the rate as mentioned in the deed. But, if the partnership deed is silent on this point, then the partner is entitled to get interest at the rate of 6 % per annum as per section 13 (d) of Indian Partnership Act.

➢ **Sharing of Profit & Loss**

Generally, profit or loss of the firm is divided among partners according to the ratio mentioned in partnership deed. Distribution of profits made by the firm in different methods are given below :

(1) **In a Fixed ratio :** The ratio may be in numbers, fractions or in percentage, like A, B and C are partners and share profit or loss in ratio of 2 : 3 : 5 or $\frac{1}{2}:\frac{3}{5}:\frac{5}{6}$, etc.

(2) **In ratio of Capital :** If, according to deed, profit & loss is to be divided in the ratio of capital then in such case, the deed should mention any one method of determining it out of the following methods :

(a) In the ratio of original capital,

(b) In the ratio of capital at the beginning of the year,

(c) In the ratio of capital at the end of each year,

(d) In the ratio of average capital for each year.

(3) **In equal share of Profit :** If nothing is mentioned in deed about profit sharing ratio then profit & loss will be divided equally among all partners, like the Profit & Loss sharing among 'A', 'B', 'C' is 1 : 1 : 1

(4) Some amount of Profit is divided in one ratio and remaining amount in another ratio.

(5) **Division of Profit and Loss in separate ratio :** In partnership deed, if profit ratio and loss ratio is agreed separately then in such case, profit will be divided in one ratio and loss will be divided in another agreed ratio.

TOPIC-7
Past Adjustments

Quick Review

➢ **Past Adjustments**

Sometimes after preparing the accounts of the firm, it is found that mistakes related to interest on capital, interest on drawing, salary to partner, etc. are committed or omitted or any amount is wrongly entered. Therefore, for the purpose of correcting these omissions or mistakes, adjustment entries are passed through Profit and Loss Adjustment Account in which adjustments in respect of each and every omission are to be made. However, an adjustment entry in journal can also be passed.

These entries are recorded for the errors made in past. Therefore, they are called Past Adjustments. Following are some types of omissions or errors given below :

1. Interest on Capital
2. Interest on Drawings
3. Salary to Partners
4. Commission to Partners
5. Interest on Capitals or Drawings provided at higher or lower rate, etc.

Adjustment through Profit & Loss Adjustment Account (Journal Entries for adjustment)

Following journal entries shall be passed through Profit & Loss Adjustment Account :

1. Adjusting entries for the items which were to be credited to the Partners' Capital or Current Account.

   Profit & Loss Adjustment A/c Dr.

   To Partner's Capital/Current A/c

   (Being adjustment made for __________ previously omitted now carried out)

2. Adjusting entries for the items which were to be debited to the partners' capital or current accounts.

   Partner's Capital A/c Dr.

   To Profit & Loss Adjustment A/c

   (Being adjustment made for _____________ previously omitted now carried out)

3. For the net profit/ loss on account of above adjustments.

   (a) In the case of profit

   Profit & Loss Adjustment A/c Dr.

   To Partner's Capital /Current A/c

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

(b) In the case of loss

Partner's Capital / Current A/c Dr.

To Profit & Loss Adjustment A/c

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

Adjustment Without Preparation of Profit & Loss Adjustment Account :

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

Adjustment Chart

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

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

TOPIC-8
Guarantee of Profits

Quick Review

- **Guarantee of Profits**

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

(I) When Guarantee is given by all the Partners in Old Ratio or Specific Ratio :

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

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

(II) When Guarantee is given by A Partner to Other Partner :

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

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

(III) When Guarantee is given by A Partner to the Firm :

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

(ii) His capital A/c is then, debited with the deficient amount and Profit & Loss A/c is credited with the deficient amount.

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

TOPIC-9
Treatment of Goodwill in Partnership Accounts

Quick Review

- **Meaning of Goodwill**

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

In Simple Words : Goodwill is the value of the reputation of a firm in respect of the profits expected in future, over and above the normal profits.

➢ **Methods of Valuation of Goodwill**

The following are methods of valuation of goodwill :

(1) Average Profit Method

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

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

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

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

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

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

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

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

(2) Super Profit Method

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

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

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

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

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

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

Computation of Average Capital Employed :

Average Capital Employed = [All Real Assets – External Liabilities – Preference Share Capital – ½ of Current year Profit]

(3) Capitalisation Method

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

(a) Capitalisation of Average Profit Method : In this method, Capitalised Value or Normal Capital employed in business is calculated on the basis of average profit, as following :

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

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

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

$$\text{Goodwill} = (\text{Super Profit} / \text{Normal Rate of Return}) \times 100$$

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Chapter - 3 : Reconstitution of Partnership Firm

TOPIC-1
Re-establishment of Partnership Firm

Quick Review

➢ **Meaning of Reconstitution of Partnership Firm**

In business, there may come a stage where the business requires more financial resources to meet the needs of expansion and the existing partners may not be able to supply requisite funds. For this purpose, the firm may admit additional partners. Also during the course of business, a partner may express his inability to continue as a partner and thus, he may leave the firm. Both of these situations lead to reconstitution of the partnership. The partnership can also be reconstituted by bringing in changes in the profit sharing ratio among the existing partners. In all these circumstances the existing partnership agreement stands dissolved and a new agreement comes into existence. All the assets and liabilities are to be revalued and the profit or loss is distributed among the old partners in the old ratio.

- **Admission of Partner**

  Accounting steps :

  Step 1 : Revaluation of Assets and Reassessment of Liabilities.

  Step 2 : Treatment of Accumulated Profits of Losses.

  ....After welcome of new partner

  Step 3 : New Profit sharing ratio and sacrificing ratio.

  Step 4 : Treatment of Goodwill

  Step 5 : Adjustment of capital and New Balance Sheet.

  Note : First two steps are calculated on the basis of old balance sheet, old partners' capital A/c's and old profit sharing ratio. If, firstly these steps are completed by students then, there will be no chance of mistake in accounting treatment.

1. New Partner's Capital

The Capital of new partner in the firm is determined by the mutual consent of all partners. A new partner can bring capital in the form of cash or goods or as assets or bring partially in cash and partially in goods or assets. But generally, he brings capital in cash.

The following journal entries are made for bringing capital :

(i) On bringing Capital in Cash :

Cash/ Bank A/c Dr.

    To New Partner's Capital A/c

(ii) On bringing Capital as Goods or Assets :

Assets A/c Dr.

    To New Partner's Capital A/c

(iii) On accepting liabilities of new Partner :

New Partner's Capital A/c Dr.

    To Liabilities A/c

Know the Terms

- **Reconstitution of a Partnership Firm :** It means change in the relationship among partners as a result of which the existing agreement comes to an end and a new agreement comes in its place.

TOPIC-2
Amendment-II Change in Ratio

Quick Review

- **New Profit Sharing Ratio**

  When new partner is admitted he acquires his share in profits from the old partners. In other words, on the admission of a new partner, the old partners sacrifice a share of their profit in favour of the new partner. But, what will be the share of new partner and how he will acquire it from the existing partners is decided mutually among the old partners and the new partner. However; if nothing is specified as to how does the new partner acquire his share from the old partner; it may be assumed that he gets it from them in their profit sharing ratio. In any case, on admission of a new partner, the profit sharing ratio among the old partners will change, keeping in view their respective contribution to the profit sharing ratio of the incoming partner. Hence, there is a need to ascertain the new profit sharing ratio among all the partners. This depends upon how does the new partner acquires his share from the old partners for which there are many possibilities.

➢ **Sacrificing Ratio**

The ratio in which one or more of the existing partners surrender some of their old share in favour of one or more partners.

Sacrificing Ratio = Old Ratio – New Ratio

➢ **Gaining Ratio**

The ratio in which one or more partners gain some portion of other partners' share of profit.

Gaining Ratio = New Ratio – Old Ratio

TOPIC-3
Accounting Treatment of Goodwilln

Quick Review

➢ **Treatment of Goodwill**

The amount of premium brought in by the new partner is shared by the sacrificing partners in their ratio of sacrifice. If this amount is paid to the old partners directly (privately) by the new partner, no entry is made in the books of the firm. But, when the amount is paid through the firm, which is generally the case, the following journal entries are passed :

(i)	Cash A/c Dr. To premium for Goodwill A/c (Amount brought by new partner as premium)			
(ii)	Premium for Goodwill A/c Dr. To Sacrificing Partners' Capital/Current A/c (Individually) (Goodwill distributed among the existing partners in their sacrificing ratio)			

➢ **Kinds of Goodwill :**

Goodwill can be classified as :

1. **Purchased Goodwill :** It is obtained by making a payment in money or money's worth. When a business is purchased, the difference between purchase consideration and net assets (assets-liabilities) is termed as 'Purchased Goodwill'. It is recorded in the books of accounts as an asset.
2. **Self-generated Goodwill :** It is the goodwill that is generated over the years by a number of internal factors that a running concern possesses, owing to which the business concern becomes able to earn higher profits. As per AS-26, goodwill should be recorded in the books of accounts only when consideration in money or money's worth is paid for it. Therefore, it should be adjusted through Partners' Capital Account at the time of 'Reconstitution of a partnership firm', *i.e.*, admission or retirement/death of a partner or change in the profit sharing ratio among partners.

TOPIC-4
Revaluation of Assets and Reassessment of Liabilities

Quick Review

➢ **Revaluation of Assets and Reassessment of Liabilities**

At the time of admission of a new partner, it is necessary to assess the proper value of various assets and liabilities of the firm shown in the balance sheet. In case, the assets are understated or overstated, these are revalued. Similarly, a reassessment of the liabilities is also done so that, these are brought in the balance sheet at their correct value. Unrecorded assets and unrecorded liabilities of the firm (if any) may also be brought into the balance sheet. For this purpose, the firm has to prepare the Revaluation Account or Profit & Loss Adjustment Account.

Need : Any profit or loss arising on account of such revaluation may be adjusted in the old partners' capital accounts in their old profit sharing ratio and the incoming partner may not be affected by the profit or loss on account of revaluation of assets and liabilities as new partner does not become liable for any act of the firm before he became a partner.

➢ **Format of Revaluation Account**

(1) When Revised Values are to be Recorded in the Books of Accounts : An account title 'Revaluation Account' or 'Profit and Loss Adjustment Account' is opened for revaluation of assets and reassessment of liabilities. This account is a nominal account. If the credit side of this account is in excess, it shows a profit and if the debit side is in excess, it shows a loss. Such profit or loss is transferred to the Capital Accounts of all the partners in their old profit sharing ratio.

Revaluation Account

Particulars	Amount (₹)	Particulars	Amount (₹)
To Decrease in Value of Assets (Loss)	---------	By Increase in Value of Assets (Profit)	---------
To Increase in Value of Liabilities (Loss)	---------	By Decrease in Value of Liabilities (Profit)	---------
To Unrecorded Liabilities (At an agreed Value)	---------	By Unrecorded Assets (At an agreed value)	---------
To Profit transferred to Old Partners' Capital/Current A/c (In old ratio)	---------	By Loss transferred to Old Partners' Capital /Current A/c (In old ratio)	---------
	---------		---------

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

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

(iii) For decrease in the value of Liabilities :
Liabilities A/c Dr.
    To Revaluation A/c
(Being value of liabilities decreased due to reassessment)

(iv) For increase in the value of Liabilities :
Revaluation A/c Dr.
    To Liabilities A/c
(Being value of liabilities increased due to reassessment)

(v) When revaluation account shows profit :
Revaluation A/c Dr.
    To Partners' Capital A/c (Old Partners)
(Being profit on revaluation credited to Partners' Capital A/c's in old ratio)

(vi) When revaluation account shows loss :
Partners' Capital A/c's (Old Partners) Dr.
    To Revaluation A/c
(Being loss on revaluation debited to Partners' Capital A/c's in old ratio)

(2) When Revised Values are not to be Recorded in the Books of Accounts
If partners decide to record the net effect of revaluation of assets and liabilities without affecting the old amount of assets and liabilities, a single adjusting entry involving the capital accounts of gaining partners and sacrificing partners is passed.

For profit on revaluation
Gaining Partner's Capital A/c
    To Sacrificing Partner's Capital A/c

For net loss on revaluation
Sacrificing Partner's Capital A/c
    To Gaining Partner's Capital A/c

➢ **Accounting Treatment of Reserves, Accumulated Profits or Losses**

(1) When these are not required to be shown in the books of the New Firm : At the time of change in profit sharing ratio, if any reserves or accumulated profits/ losses exist in the books of the firm, they are transferred to partners' capital/ current accounts in their old profit sharing ratio.

For Transfer of Reserves and Accumulated Profits :

Reserve/Profit & Loss A/c	Dr	
Workmen's Compensation Reserve A/c	Dr.	[Excess of reserve over actual liability]
Investment Fluctuation Reserve A/c	Dr.	[Excess of reserve over the differences between book value and market value]
To All Partners' Capital/Current A/c (Individually)		{In Old ratio}

For Transfer of Accumulated Losses :

All Partners' Capital / Current A/c's (Individually) Dr. {In Old ratio}
To Profit & Loss A/c
To Deferred Revenue Expenditure A/c

(2) When these are required to be shown in the books of the New Firm

A single adjusting entry involving the capital accounts of sacrificing and gaining partner is passed, when the partners decide to record net effect of reserves and accumulated profits/losses without affecting the old figures.

In Case of Profit : Gaining Partner's Capital A/c Dr.
To Sacrificing Partner's Capital A/c

In Case of Loss : Sacrificing Partner's Capital A/c Dr.
To Gaining Partner's Capital A/c

- **Workmen Compensation Reserve (WCR) :** A reserve created out of firm's profit to meet likely liability for payment of compensation to employees in case of accident is known as Workmen Compensation Reserve. At the time of change in profit sharing ratio/admission/retirement or death of a partner, its accounting treatment is as follows :

(1) When no Claim against WCR exists :

Workmen's Compensation Reserve A/c Dr.
To Partners' Capital/Current A/c's
(Being amount of WCR credited to partners in their old profit sharing ratio)

(2) When Claim against WCR exists :

(i) When Claim is lower than the amount of WCR :

Workmen's Compensation Reserve A/c Dr.
To Provision for Workmen Compensation Claim A/c
(Being provision for workmen compensation claim made)

(ii) When Claim is higher than the amount of WCR :

(a) Workmen's Compensation Reserve A/c Dr.
Revaluation A/c Dr.
To Provision for Workmen Compensation Claim A/c
(Being the amount of claim adjusted against WCR and revaluation A/c)

(b) Partners' Capital/Current A/c's Dr.
To Revaluation A/c
(Being revaluation loss debited to partners' capital or current accounts)

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Chapter - 4 : Admission of a Partner

TOPIC-1
Admission of a Partner

Quick Review

- **Meaning of Admission of a Partner :** According to Section 31 of the Indian Partnership Act, 1932, a new partner shall not be introduced into a firm without the consent of all the existing partners, unless it is agreed otherwise by the partners in the partnership deed. Thus, a new partner can be admitted into a partnership firm with the consent of all the partners.
- **Rights acquired by the new partner**
  1. **Right to Share in Firm's Assets :** It is the right of new partners on the firm's assets and liabilities in behalf of capital which is brought by him/her.
  2. **Right to Share the Future Profits of the Firm :** Old Partners of the firm sacrifice some profit according to the new sharing ratio in favour of incoming partner.
  3. Partner and for this purpose incoming partner has to contribute some amount of share or goodwill, which is called premium.
- **Modification in Profit Sharing Ratio :** When a new partner enters in the partnership firm, old partners sacrifice some ratio of their old share, so it is needed to modify or recalculate profit sharing ratio and the sacrificing ratio.
- **New Profit Sharing Ratio :** New Profit Sharing Ratio is the ratio in which old partners including new partner, share the profits or losses of the firm.

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

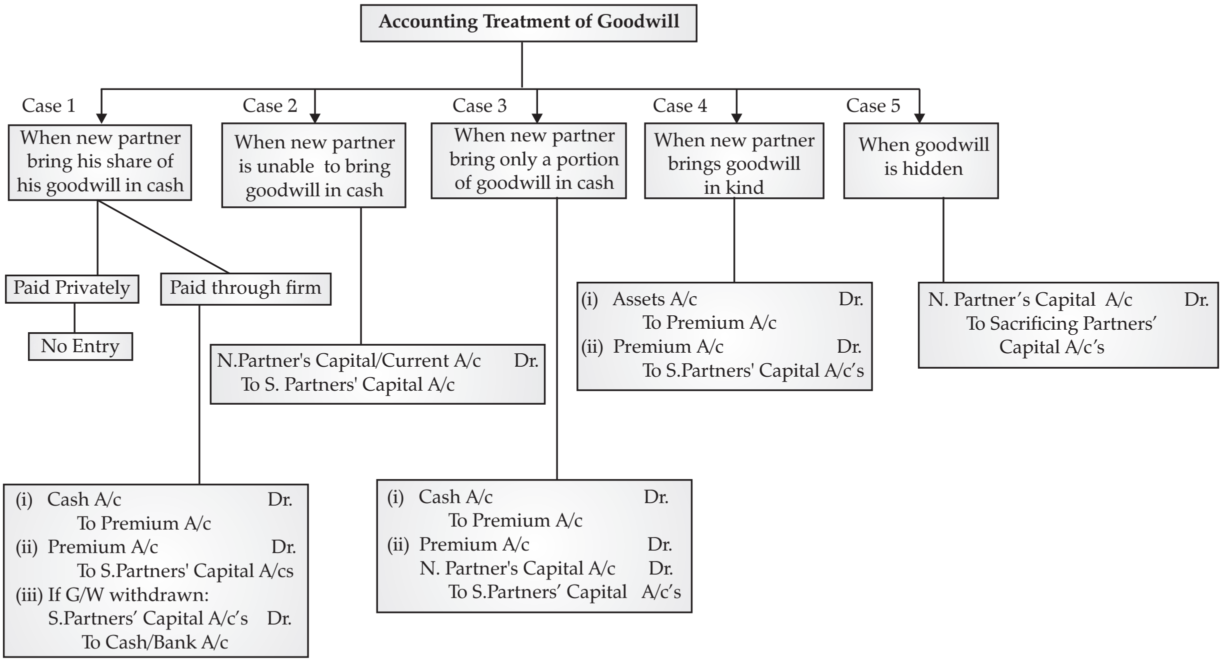
1. **Case 1 :** If in the question, only new partner's share is given, then it is presumed that the old partners will continue to share the remaining profits in the old profit sharing ratio. The new partner's share is deducted from the total share of the firm and the remaining share is divided amongst the old partners in their old profit sharing ratio.
2. **Case 2 :** If in the question, the old partners' sharing ratio and new partners sharing ratio is given, then the new share of old partners will be calculated by deducting the share given to the new partner from their original share.
3. **Case 3 :** If in the question, the old partners' sharing ratio is equal, then the new share of old partners will be calculating by deducting the equal share given to the new partner from their original share.
4. **Case 4 :** If in the question, surrender fraction value of old partners given, then in this case, shares surrendered by the old partners in favour of a new or incoming partner are added, it is the share of the new or incoming partner. The share surrendered by the old partners is deducted from their respective share to determine the old partners' share in the reconstituted firm.

- **Sacrificing Ratio :** It is the ratio in which old partners sacrifice their share of profit in favour of incoming partner. It is calculated in the ways given below :

1. **Case 1 :** If in the question, old and new profit sharing ratios are given then the new share of the old partner is deducted from his old share. The difference is known as sacrifice. The ratio in which the new partner is given the share by old partners is called the sacrificing ratio.
2. **Case 2 :** If in the question, old profit sharing ratio and new partner's share is given then the new partner's share is deducted from the total profit and the balance of profit left is divided among old partners in their old profit sharing ratio to get their new shares. New shares are deducted from the old shares respectively which gives us sacrifice made by each old partner. Ratio is established among these sacrificed shares which becomes the sacrificing ratio. In this case, it must be noted that the old profit sharing ratio is also the sacrificing ratio.
3. **Case 3 :** If in the question, sacrifice ratio of old Partner's given, then the ratio given will be the sacrificing ratio.
4. **Case 4 :** If in the question, receiving of share is predefined or prefix on the basis of sacrificing ratio, then sacrifice of old partners is deducted from their old share to calculate new share.
5. **Case 5 :** If in the question, old partners' agreed to share in different relative ratio in the new firm after the admission of the new partner, the combined share of the old partners in the new firm will be shared between them in new agreed relative ratio.

TOPIC-2
Accounting Treatment of Goodwill When New Partner Admitted in Firm

Quick Review



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

Treatment of goodwill in different cases:

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

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

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

Old Partners' Capital/Current A/c's Dr.
To Goodwill A/c
(Being old goodwill written off among old partners in old ratio)

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

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

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

Premium A/c (Goodwill) Dr.
To Sacrificing Partners' Capital/Current A/c's
(Being the amount of goodwill distributed among partners in their sacrificing ratio)

(i) If the sacrificing partners withdraw their amount of goodwill in cash.

Sacrificing Partners' Capital/Current A/c's Dr.
To Cash / Bank A/c
(Being the amount withdrawn by sacrificing partners)

(ii) If goodwill is already appearing in the books, old goodwill should always be written off among old partners in old ratio by way of the following entry:

Old Partners' Capital/Current A/c's Dr.
To Goodwill A/c
(Being old goodwill written off among old partners in old ratio)

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

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

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

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

Old Partners' Capital / Current A/c's Dr.
To Goodwill A/c
(Being old goodwill written off among old partners in old ratio)

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

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

(a) By Opening Current Account or

(b) Without Opening Current Account.

(a) By opening Current Account

Cash A/c Dr. (With the amount of actual cash brought in by new partner)

To Premium A/c (Goodwill)

(Being new partner brings only a part of share of goodwill in cash)

Premium A/c (Goodwill) Dr. (With the amount of actual cash brought in by new partner)

New Partner's Current A/c Dr. (With the unpaid amount)

To Sacrificing Partners' Current A/c's (In sacrificing ratio)

(Being share of goodwill distributed among sacrificing partners and unpaid amount of goodwill debited the new partner's current account)

(b) Without Opening Current Account

Cash A/c Dr. (With the amount of actual cash brought in by new partner)

To Premium A/c (Goodwill)

(Being new partner brings only a part of share of goodwill is cash)

Premium A/c (Goodwill) Dr. (With the amount of actual cash brought in by new partner)

New Partner's Capital A/c Dr. (With the unpaid amount)

To Sacrificing Partners' Capital A/c's (In sacrificing ratio)

(Being share of goodwill distributed among sacrificing partners and unpaid amount of goodwill debited to the capital account of new partner)

Notes : 1. If goodwill is already appearing in the book, old goodwill should always be written off among old partners in the old ratio by way of the following entry:

Old Partners' Capital/Current A/c's Dr.

To Goodwill A/c

(Being old goodwill written off among old partners in old ratio)

2. New Partner's Current A/c should be shown on the Assets side of the Balance sheet

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

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

Assets A/c Dr. (Various assets individually)

To New Partner's Capital A/c (With the share of capital)

To Premium A/c (Goodwill) (With the share of goodwill)

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

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

To Sacrificing Partners' Capital A/c's (In sacrificing ratio)

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

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

Old Partners' Capital /Current A/c's Dr.

To Goodwill A/c

(Being old goodwill written off among old partners in old ratio)

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

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

TOPIC-4
Adjustment of Capital

Quick Review

➢ **Adjustment of Capital**

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

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

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

Steps :

(i) Calculate the total capital of the firm on the basis of new partner's capital and his share in profits.

Total Capital/New Capital = New partner's capital × Reciprocal of the proportion of his share in profit.

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

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

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

(v) Surplus will be paid back to the old partners and if there is deficiency the same will be contributed in cash by the old partners.

(If it is specifically required under agreement, the surplus can be Cr. to their current a/c's and deficiency can be Dr. to their current a/c's)

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

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

Steps :

(i) Prepare old partners' capital a/c's (after all adjustments regarding Revaluation, General Reserve, Goodwill etc)

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

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

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

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

The following entries may be passed in different situations:

Cash/Bank A/c Dr.
    To Partners' Capital A/c's
(Being more capital brought in by partner(s) to meet capital requirement for their share in profits)

Partners' Capital A/c's Dr.
    To Cash/Bank A/c
(Being excess amount of capital withdrawn by partner(s) for proportionate share in profits)

In some cases, the surplus of deficit arising after capital accounts of partners have been adjusted , may also be transferred to newly opened partners' current accounts instead of undertaking actual cash transactions. Thus

If a partner's capital is more than his required proportionate share (surplus)

Partner's Capital A/c Dr.
    To Partner's Current A/c
(Being excess capital transferred to partners' current account on reconstitution)

If the partner's capital is less than his required proportionate share (deficit)

Partner's Current A/c Dr.
    To Partner's Capital A/c
(Being requirement of capital fulfilled by the partner at time of reconstitution of the firm)

It must be always remembered that in the absence of any agreement among the partners, the surplus or deficit of capital accounts of partners should be transferred to Cash Account and not to the Current Accounts.

Two examples of above given cases are :

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

For example, C and D are partners with capitals of ₹ 5,000 and ₹ 10,000. Their Profit sharing ratio is 3 : 2. E is admitted for 1/5th share for which he brings ₹ 10,000 as his capital but does not bring his share of goodwill in cash and firm's goodwill is determined at ₹ 20,000. So, E's share of goodwill is ₹ 4,000 (20,000 × 1/5). If we debit E's Capital A/c by 4,000, E's Capital will be ₹ 6,000 after this adjustment and firm's total capital will be ₹ 30,000 (6,000 × 5/1).

In this way, capitals of partners shown in Balance Sheet will not be based on E's actual capital. Therefore, we will have to adjust goodwill through E's current account.

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

For example, the combined capital of P and Q after all adjustments is ₹ 1,00,000. R is admitted for 1/5th share and brings proportionate capital but does not bring his share of goodwill in cash. Goodwill of the firm is valued at ₹ 50,000. R will bring in capital ₹ 25,000 (1,00,000 × 5/4 × 1/5) and his share of goodwill will be ₹ 10,000 (50,000 × 1/5). If we debit R's Capital Account by his share of goodwill, his capital will be less than his actual capital (*i.e.*, ₹ 15,000) after this adjustment. In this way, R's capital will not be based on partners' adjusted capitals. So, we should debit R's current account.

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Chapter - 5 : Retirement/Death of a Partner

TOPIC-1
Retirement of a Partner

Quick Review

➢ **Meaning of Retirement**

Retirement of a partner means a partner leaving or separating from a partnership firm due to certain reasons. On retirement, the old partnership comes to an end and a new partnership comes into existence between the remaining partners. According to Sec 32 (1) of the Indian Partnership Act,1932, "a partner may retire from the firm with the consent of all the partnership or at his will, by giving written notice to all the other partners of his intention to retire."

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

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

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

(3) Old age, illness or physical weakness;

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

(5) Other reason.

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

➢ **Gaining Ratio**

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

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

➢ **Calculation of Gaining Ratio**

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

Gaining Ratio = New Ratio – Old Ratio

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

➢ **Difference between Sacrificing Ratio and Gaining Ratio**

S. No.	Basis	Sacrificing Ratio	Gaining Ratio
1.	**Definition**	It is the proportion in which the old partners sacrifice their share in favour of a new partner.	It is the proportion in which the old partners acquire the outgoing (retired or deceased) partner's share.
2.	**Time of calculation**	Generally, it is calculated at the time of admission of a new partner.	Generally, it is calculated at the time of retirement or death of a partner.
3.	**Purpose**	It is calculated to know how the old partners shall share the goodwill brought in by the new partner.	It is calculated to know how the remaining partners shall contribute towards the share of goodwill of the retiring/deceased partner.
4.	**Formula**	Sacrificing Ratio = Old Share – New Share	Gaining Ratio = New Share – Old Share
5.	**Effect on Share of Profit of Old/ Remaining Partners**	The old partners' share decreases.	The remaining partners' share increases.
6.	**Effect on Capital Accounts**	Old partners' capital accounts are credited for the share of goodwill in the sacrificing ratio.	Remaining partners' capital accounts are debited for the share of goodwill in the gaining ratio.

Know the Terms

➢ **New Profit Sharing Ratio :** New profit sharing ratio is the ratio in which the remaining partner will share future profits after the retirement or death of any partner.

New Share = Old Share + Acquired Share from the Outgoing partner

➢ **Treatment of Goodwill :** The basic rule is that gaining partner (s) compensate the sacrificing partner to the extent of their gain for the respective share of goodwill.

If goodwill already appears in the books, it will be written off by debiting all partners' capital account in their old profit sharing ratio.

➢ **Revaluation of Assets and Liabilities :** At the time of retirement/death of a partner, there may be some assets which may not have been shown at their current values. Similarly, there may be certain liabilities which have been shown at a value different from the obligation to be met by the firm.

Besides this, there may be unrecorded assets and liabilities which have to be recorded.

➢ **Accumulated Profits or Losses :** The reserves (Accumulated profits) or losses belong to all the partners and should be transferred to capital account of all partners.

➢ Retiring partner / deceased partner may be paid in one lump sum or installments with interest.

➢ At the time of retirement / death of a partner, the remaining partner may decide to keep their capital contribution in their profit sharing ratio.

TOPIC-2
Accounting Treatment of Goodwill, Revaluation of Assets and Reassessment of Liabilities and Death of a Partner

Quick Review

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

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

Accounting Treatment

When goodwill is not appearing in the books | When goodwill is already appearing in the books

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

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

Gaining Partners' Capital A/c's Dr. (In gaining ratio)
To Retiring /Deceased Partners' Capital A/c's (Share of outgoing Partner)

(Being Retiring/Deceased Partners share of goodwill debited to gaining partners Capital Accounts in gaining ratio)

(2) When goodwill is already appearing in the books :

In this case, the old goodwill should always be written off among all partners in their old ratio by way of the following journal entries:

(i) All Partners' Capital /Current A/c's Dr. (In old ratio)
To Goodwill A/c (Value of old goodwill)

(Being old goodwill written off among all partners in their old ratio)

(ii) Gaining Partners' Capital A/c's Dr. (In gaining ratio)
To Retiring /Deceased Partners Capital A/c's
(Share of outgoing partner)

(Being retiring/deceased partner's share of goodwill adjusted in gaining partners' capital account)

Special Note : Goodwill cannot be shown in books unless and until it is purchased by paying some consideration. (AS-26)

- **Hidden Goodwill**

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

- **Revaluation of Assets and Re-assessment of Liabilities**

  At the time of retirement or death of a partner, there may be some assets which may not have been shown at their current values. Similarly, there may be certain liabilities which have been shown at a value different from the obligation to be met by the firm. Not only that, there may be some unrecorded assets and liabilities which need to be brought into books. As learnt in case of admission of a partner, a Revaluation Account is prepared in order to ascertain net gain (loss) on revaluation of assets or reassessment of liabilities and bringing unrecorded items into firm's books and the same is transferred to the capital account of all partners including retiring/deceased partners in their old profit sharing ratio.

  Note : (I) A Profit & Loss Adjustment A/c can be prepared instead of Revaluation a/c.

  (II)In case, it is desired that assets and liabilities should continue to appear at the old values, then a Memorandum Revaluation A/c is opened instead of Revaluation A/c as explained in case of admission of a partner.

- **Memorandum Revaluation Account :** When the partners decide to give effect to revaluation of assets and reassessment of liabilities without affecting existing amounts of assets and liabilities, Memorandum Revaluation Account is prepared in the same manner as in case of admission of a partner. It should be remembered that first part of Memorandum Revaluation Account is transferred to Capital Accounts of all the partners including outgoing partner in their old profit sharing ratio, while the second part of this account is transferred to the Capital Accounts of the continuing partners in their new profit sharing ratio.

- **Adjustment Of Accumulated Profits And Reserves**

  It is quite certain that some kind of Reserves, Accumulated Profits, Profit & Loss A/c appear in the balance sheet at the time of retirement/death of a partners. Since, these profits were earned with the contribution of the retiring or deceased partner also, so he is also entitled to share in such profits. In such a case, following journal entry will be passed :

General Reserve A/c Dr. (old profit sharing ratio).
Reserve Fund A/c Dr.
Profit & Loss A/c Dr.
To All Partners' Capital A/c's

(Being profits and reserves distributed)

All accumulated losses viz. Profit and Loss debit balance; Deferred Revenue Expenditure, etc. are also to be written off by passing the following journal entry :

All Partners' Capital A/c's Dr. (old profit sharing ratio)

To Accumulated Losses A/c

(Being loss distributed)

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

(1) Determination of payable amount : If a partner retires on the last day of the accounting year or first day of the next accounting year, then amount payable is determined by adjusting his capital and current account with the revaluation of assets and liabilities shown in the balance sheet of last year. But if a partner retires on any date during the accounting year, then the following is included in the determination of amount payable to him:

- Balance of capital and current account as shown in the date of last balance sheet.
- Interest, salary, bonus, commission, etc. payable from the date of last balance sheet till the date of retirement.
- Share in firm's goodwill.
- Share in undistributed profit, loss and reserves.
- Share in the profit or loss on revaluation of assets and Liabilities.
- Share of profit or loss from the date of last balance sheet to the date of retirement, which may be calculated according to the instructions given in question or on the basis of time or on the basis of sale.

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

➢ **Lump-sum payment system :** Amount payable to the retiring partner can be paid in cash or through bank, if the financial position of the firm is strong. The amount payable to the retiring partner in this method, will be as following :

The following journal entry will be passed :

- Out of firm's own resources :

If all the partners agree and the firm has sufficient cash available, then lump-sum amount may be paid in cash.

Retiring Partner's Capital A/c Dr.

To Cash /Bank A/c

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

The following entries will be passed in this respect :

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

Cash/Bank A/c Dr.

To Continuing Partners' Capital A/c's

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

Retiring Partner's Capital A/c Dr.

To Cash/Bank A/c

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

The following entries will be passed :

Retiring Partner's Capital A/c Dr.

To Bank Loan A/c

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

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

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

(ii) For making some payment immediately :

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

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

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

(iv) For making installment payment :

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

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

Profit & Loss A/c Dr.
To Interest A/c

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

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

Cash / Bank A/c Dr.
To Remaining Partners' Capital A/c's

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

Remaining Partners' Current A/c's Dr.
To Cash /Bank A/c

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

Remaining Partners' Capital A/c Dr.
To Remaining Partners' Current A/c

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

Remaining Partners' Current A/c's Dr.
To Remaining Partners' Capital A/c's

DEATH OF A PARTNER

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

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

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

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

  (1) Credit balance of capital and current account.
  (2) Salary, commission, interest, etc. upto the date of death.
  (3) Proportionate share in the profit of firm till the date of death.
  (4) Proportionate share in goodwill of the firm.
  (5) Proportionate share in undistributed profit/loss and reserves of the firm as shown in the balance sheet.
  (6) Proportionate share in the profit on revaluation of assets and liabilities till the date of death.
  (7) Share of deceased partner in Joint Life Insurance Policy.

After crediting the above items in the Executor's account of the deceased partner, the following items are debited in his account :

(1) Debit balance of deceased partner

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

(3) Share of reduction in value of goodwill.

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

(5) Share in undistributed profits/loss.

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

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

The amount due is paid to the executor as follows :

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

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

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

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

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

- **Share of Profit of the Deceased Partner**

Generally, a partner retires on the date of preparation of final accounts but the date of death is not fixed as it can occur on any day. If a partner dies at any time during the year then his successor is entitled to get a share in profit from the beginning of the year till the date of death. It can be determined by either of the two following methods :

(1) On the basis of time : In this method, proportionate estimated profit of the firm will be determined for the period for which the deceased partner remained in the firm on the basis of profit of previous years and then, share of deceased partner in that profit will be calculated. In this, part of current year's profit will be computed on the basis of profit of the previous year or on the basis of average profits of previous year.

(2) On the basis of Sales/Turnover : In this method, ratio of profit to sales of past year (or average of past few years) is calculated, which is applied to the amount of sales from the beginning of the current year upto the date of death to determine profit of that period and share of deceased partner is calculated.

- **Interest on Capital of Deceased Partner**

As per partnership deed, interest on opening balance of capital of deceased partner may be given for till the date of death as per pre-decided rate, which will be credited in the executor's account.

- **Share in Accumulated Profit**

When the balance sheet of previous year of the firm shows undistributed profit, general reserve, contingency reserve or fund then it will be credited in the partners capital account in the old profit sharing ratio. The entry will be :

Reserve or Profit & Loss A/c Dr.
 To All Partners' Capital A/c's

- **Share in Goodwill**

If deceased partner has right to receive share in the goodwill of the firm then the continuing partners capital accounts will be debited in the gaining ratio and Executor's account will be credited with the share of goodwill. Goodwill will be calculated on the basis of mutual agreement among the partners.

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

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

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Chapter - 6 : Dissolution of Partnership Firm

TOPIC-1
Dissolution of Partnership Firm

Quick Review

- **Meaning of Dissolution :** Dissolution means discontinuance of existing relationship among the partners.
- **Meaning of Dissolution of Partnership :** Dissolution of partnership means a reconstitution of the firm due to change in the profit sharing ratio among existing partners, admission of a new partner, retirement of a partner, death of a partner, insolvency of a partner and the firm continues as ever before. However, the dissolution of partnership does not lead to the dissolution of firm.
- **Meaning of dissolution of partnership firm**

  Dissolution of partnership firm means that the firm closes down its business and comes to an end. On the dissolution of partnership firm, assets of the firm are sold, liabilities are paid off and out of remaining amount, the accounts of partners are settled.

  Thus, in case of dissolution of partnership, the firm may continue, i.e., it does not mean the dissolution of firm. But in case of dissolution of the firm, the partnership is automatically dissolved.
- **Modes of Dissolution of Partnership Firm :** Modes of dissolution of a firm have been described in Sections 40 to 44 of Indian Partnership Act, 1932, and they are as under :

  (1) Dissolution by Agreement (Section 40) : When all the partners agree to dissolve the firm or if there is any such agreement in partnership deed or amongst the partners regarding dissolution firm.

  (2) Compulsory Dissolution or Dissolution by the Operation of Law (Section 41) : In the following circumstances the firm will be dissolved compulsorily :

  (a) When any such event happens which make the operation of business of the firm unlawful.

  (b) When all partners or all partners except one are declared as insolvent by the court.

  (3) Dissolution on the Happening of Unexpected Event (Section 42) : In this, a firm will be dissolved in the following conditions :

  (a) When partnership is formed for a particular period, then on the expiry of that period.

  (b) When formation of partnership was for few objectives, then on the fulfilment of those objectives.

  (c) When any partner is declared as insolvent.

  (d) When any partner dies.

  (4) Dissolution by Notice of Partnership at will (Section 43) : If partnership is at will, then any partner may notify other partners about his will in writing and then, the firm may be dissolved.

  (5) Dissolution by Court (Section 44) : On filing of a suit by a partner, the court may pass orders for dissolution in the following conditions :

  (i) When any partner becomes of unsound mind.

  (ii) When any partner becomes permanently incapable of executing his duties as a partner.

  (iii) When any partner is guilty of any such conduct which may bring loss to the business.

  (iv) When any partner knowingly violates the terms of agreement again and again.

  (v) When any partner transfers or assigns all his interests to a third person.

  (vi) When it is not possible to run the business without loss.

  (vii) When dissolution of firm is just and equitable in the opinion of the court.
- **Settlement of Accounts :** Section 48 of the Indian Partnership Act, 1932, provides the following rules for the settlement of accounts between the partners.
- **Payment of Losses :** Losses shall be paid first out of profits, next out of capital and lastly, if necessary, by the partners individually in their profit sharing ratio.
- **Distribution of Assets :** Assets of the firm are first to be applied in paying the debts of the firm to the third parties; next in paying to each partner rateably what is due to him from the firm for advances as distinguished from capital; in paying to each partner rateably what is due to him on account of capital, and the residue to be divided among the partners in the proportion in which they were entitled to share profits.

Distinction Between Dissolution of Partnership and Dissolution of Firm

S. No.	Basic Difference	Dissolution of Partnership	Dissolution of Firm
1.	Change in economic relation	The economic relation of partnership among different partners is changed.	The economic relations among all the partners come to end.
2.	Termination of business	The business of the firm is not terminated.	The business of the firm is closed.
3.	Assets and Liabilities	Assets and liabilities are revalued and new balance sheet is drawn.	Assets are sold and realized and liabilities are paid off.
4.	Closure of books of accounts	It does not require the closing of books because the business is not terminated.	All books of accounts are closed.
5.	Implication	It does not imply dissolution of firm.	It implies dissolution of the partnership and the firm.

- **Firm's Debts Vs Private Debts :** According to Partnership Act, each partner is jointly and individually liable for the debts of the firm and this liability is unlimited. (Except limited liability Partnership)

  When their is debt of the firm as well as of partners, then the debts will be settled as under :

  (i) Assets of the firm will be used in paying the debts of the firm. After which, if, any amount is left will be used to pay personal loans of partners proportionately.

  (ii) Personal asset of each partner will be used for payment of their personal loans first. Any balance, thereafter, remaining will be used for the payment of debts of the firm, provided the assets of the firm are not sufficient in discharging the debts of the firm.
- **Public Notice :** When the firm dissolves, it is compulsory to give a notice to public. The information of dissolution is to be given to each partner, otherwise after dissolution also each partner will be responsible for the work of other partners and the firm as he was responsible before dissolution of the firm for the partners.

TOPIC-2
Realisation Account

Quick Review

- **Realisation Account**

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

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

- **Accounting Entries**

  On dissolution of the firm,the accounting entries will be divided into two parts as under :

  (1) When all partners are solvent.

  (2) When all partners are not solvent.

I. When all the Partners are Solvent

Journal Entries

Accounting of assets (Excluding cash & bank)	Realisation A/c Dr. To All Assets A/c (Individual)
Accounting of goodwill on dissolution If goodwill account does not exist at the time of dissolution	Realisation A/c Dr. To Goodwill A/c Cash/Bank A/c Dr. To Realisation A/c
Accounting of undisclosed assets ● On selling in the market ● On taking over by any partner	Cash/Bank A/c Dr. To Realisation A/c Partner's Capital/Current A/c Dr. To Realisation A/c
The dissolution of firm is due to sale of firm's business	Realisation A/c Dr. To Cash A/c To Bank A/c
Provisions relating to assets are opened	Provision for Bad Debts A/c Dr. Provision for Discount on debtors A/c Dr. Life Insurance Policy Reserve A/c Dr. Investment Fluctuation Reserve A/c Dr. To Realisation A/c
Transfer of debit balance of profit & loss A/c	Partners' Capital/Current A/c's Dr. To Profit & Loss A/c
Closing the accounts of various liabilities	Sundry Creditors A/c Dr. Bills Payable A/c Dr. Partner's Wife's Loan A/c Dr. Bank Overdraft A/c Dr. Outstanding Expenses A/c Dr. Employees Provident Fund A/c Dr. Employees Saving A/c Dr. To Realisation A/c
Accounting of undisclosed liabilities **(1)** If paid by the firm	Realisation A/c Dr. To Cash/Bank A/c
(2) Taking over of responsibility regarding payment of liability by any partner	Realisation A/c Dr. To Partner's Capital/Current A/c
Transfer of various reserve funds and credit balance of profit & loss A/c	Contingencies Reserve A/c Dr. Reserve Fund A/c Dr. Profit & Loss A/c Dr. To Partners' Capital/Current A/c's
Realising assets **(1)** On sale of asset in cash (with selling price)	Cash/Bank A/c Dr. To Realisation A/c
(2) Asset taken over by any partner (with agreed price)	Partner's Capital/Current A/c Dr. To Realisation A/c
(3) Asset taken over by any creditor (with agreed price)	No Entry needed
(1) If the amount due to creditors and value of assets taken by them from firm is equal	No Entry needed
(2) If the amount due to creditors is more than the value of assets, and the asset is taken over by the creditors is full settlement	Realisation A/c Dr. To Cash/Bank A/c
(3) If the amount due to creditors is more than the value of asset, and the difference amount is paid by the firm	Cash/Bank A/c Dr. To Realisation A/c

(4) If the amount due to creditors is less than the value of asset taken over by creditors and the creditors pay-off the excess amount to the firm then the following entry will be passed with difference amount	Realisation A/c Dr. To Cash Bank A/c
Payment of liabilities **(1)** Liabilities paid by firm	Realisation A/c Dr. To Cash/Bank A/c
(2) Liabilities taken over or paid by any partner	Realisation A/c Dr. To Partner's Capital/Current A/c
Payment of realisation expenses **(1)** If paid by firm	Realisation A/c Dr. To Cash/Bank A/c
(2) Responsibility regarding payment of expenses, taken over by any partner	Realisation A/c Dr. To Partner's Capital/Current A/c
(3) If it is clearly mentioned in partnership deed that dissolution expenses will be borne by any partner, then this amount will not be recorded in Realisation A/c of the firm.	
(4) If it is clearly mentioned in partnership deed that in case of dissolution the winding up expenses will be borne by any partner but if such expense is incurred by the firm on behalf of that partner then the following entry will be recorded	Partner's Capital/Current A/c Dr. To Cash/Bank A/c
Remuneration of dissolution work is to be paid to any partner	Realisation A/c Dr. To Partners' Capital/Current A/c's
For closing realisation account **(1)** If debit balance of realisation (loss)	Partners' Capital/Current A/c's Dr. To Realisation A/c
(2) If credit balance of realisation A/c (profit)	Realisation A/c Dr. To Partners' Capital/Current A/c's
For payment of partners' loan	Partners' Loan A/c Dr. To Cash/Bank A/c
For closing of current accounts **(1)** If debit balance of partners' current A/c	Partners' Capital A/c's Dr. To Partners' Current A/c's
(2) If credit balance of partners' current A/c	Partners' Current A/c's Dr. To Partner's Capital A/c's
For closing of partners' capital accounts **(1)** Debit balance of partners' capital A/c	Cash/Bank A/c Dr. To Partners' Capital A/c's
(2) Credit balance of partner's capital A/c	Partners' Capital A/c Dr. To Cash/Bank A/c

➢ **When all the Partners are not Solvent**

If there is debit balance of capital account of any partner, then the said partner will pay the cash personally for meeting out that deficiency. If there is debit balance in capital account of any partner and if he makes partial payment of his liability or does not pay anything and is adjudicated as insolvent, then in the absence of any adverse contract, the firm becomes dissolved on account of insolvency of any partner.

Since, the liabilities of partners are unlimited, hence in case of any partner becoming insolvent, his deficiency will be covered by the remaining partners. The share of loss of any insolvent partner has to be borne by the solvent partners and in this connection, the solvent partners' capital account will be debited and insolvent partner's capital account will be credited with the amount of such deficiency. This deficiency is to be fulfilled by the solvent partners in their profit sharing ratio or in capital ratio of the partners.

Note :

(1) The loss of realisation will be distributed among all the partners in their profit and loss ratio.

(2) The loss of realisation will be brought in cash by the solvent partners in the firm.

(3) The total deficiency of capital of insolvent partner (debit balance and share in loss of realisation) will be borne by solvent partners in their capital ratio.

(4) The capital ratio of insolvent partners will be determined on the basis of capital shown in Balance Sheet on the date of dissolution.

Journal Entries

Amount of undivided Profit or Loss **(1)** Reserve Fund and Credit Balance of Profit and Loss A/c	Reserve Fund A/c Dr. Profit & Loss A/c Dr. To Partners' Current/Capital A/c's
(2) **Debit Balance of Profit & Loss A/c**	Partners' Current/Capital A/c's Dr. To Profit & Loss A/c
Loss on Realisation **(1)** Debit Balance of Realisation A/c (Loss)	Partners' Current/Capital A/c's Dr. To Realisation A/c
(2) Credit Balance of Realisation A/c (Profit)	Realisation A/c Dr. To Partners' Current/Capital A/c's
On Receipt of Cash Amount of Realisation Loss from Solvent Partners	Cash/Bank A/c Dr. To Solvent Partners' Current/Capital A/c's
Closing of Current A/c of Insolvent Partner	Insolvent Partner's Capital A/c Dr. To Insolvent Partner's Current A/c
If Some Amount is Received from Personal Assets of Insolvent Partner	Cash/Bank A/c Dr. To Insolvent Partner's Current A/c
Accounting of Deficiency of Insolvent Partners Capital A/c **(1)** If Capital are Fixed	Solvent Partners' Current A/c's Dr. To Insolvent Partner's Capital A/c
(2) If Capital are Fluctuating	Solvent Partners' Capital A/c's Dr. To Insolvent Partner's Capital A/c
Closing of Current A/c of Solvent Partners **(1)** Debit Balance of Current A/c	Solvent Partners' Capital A/c's Dr. To Insolvent Partner's Current A/c
(2) Credit Balance of Current A/c	Solvent Partners' Current A/c's Dr. To Insolvent Partner's Capital A/c
Closing of Capital A/c of Solvent Partners	Solvent Partners' Capital A/c's Dr. To Cash/Bank A/c

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

S. No.	Basic of Difference	Realisation Account	Revaluation Account
1.	Time of Preparation	This account is prepared at the time of dissolution of the firm.	This account is prepared when the firm is reconstituted due to change in their profit sharing ratio, admission, retirement or death of a partner.
2.	Objective of Preparation	This account is prepared to find out the profit or loss on the sale of assets and repayment of liabilities.	This account is prepared to make necessary adjustment regarding revaluation of assets and re-assessment of liabilities.
3.	Values of Assets and Liabilities recorded	Assets and Liabilities are shown in the Realisation Account on book values while the amount of actual payment and actual realisation is recorded in this account.	Only the difference between the book value and revised values of assets and liabilities is recorded in this account.
4.	Results	After preparation of Realisation Account, there will be no business afterwards.	After preparing Revaluation Account firm continues its business.

5.	Frequency of Preparation	Realisation Account is prepared only once during the life time of a firm.	Revaluation Account may be prepared at a number of occasion during the life time of a firm.
6.	Expenses	Usually realization expenses are shown in the Realisation Account.	No expenses are shown in Revaluation Account.
7.	Memorandum	No such memorandum account is prepared.	Sometimes, when it is desired not to change the value of assets and liabilities in the reconstituted firm, Memorandum Revaluation Account is prepared.

TOPIC-3
Reserves and Accumulated Profits

Quick Review

- **Treatment of Reserves and Accumulated Profits :**

  The undistributed profits and losses and reserves are always transferred to partners' capital accounts in their profit sharing ratio and not to the realisation account.

  For distribution of reserves or accumulated profits

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

  For distribution of accumulated losses

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

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

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

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

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

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

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

  (i) For cash deposited into bank:

  Bank A/c Dr.
  To Cash A/c

  (ii) For cash withdrawn from bank :

  Cash A/c Dr.
  To Bank A/c

❑❑

Unit - 3 : Accounting for Companies

Chapter - 7 : Accounting for Share capital

TOPIC-1
Introduction of Company & Shares

Quick Review

- **Meaning of Company :** A company is an incorporated association which is an artificial person, created by law, having separate entity distinct from its members with a perpetual succession and a common seal.
- A company is an organization formed by an association of persons through a process of law for undertaking (usually) a business venture.

  According to Section 2(20) of the Companies Act, 2013, 'Company means a company incorporated under this act or any previous company law.
- **Characteristics or Features of a Company**

  (1) Incorporated person
  (2) Voluntary association
  (2) Created by law
  (4) Capital divisible into transferable shares
  (5) Limited liability
  (6) Perpetual succession
  (7) Common Seal
  (8) Separate legal entity from its members
  (9) May sue or be sued
- **Kinds of Companies :** Companies can be categorised on the following basis :

  1. On the Basis of Participation

  (i) Private Company [Section 2(68) of the Companies Act,2013] : A private company is a company which
  - has a minimum paid-up share capital as may be prescribed;
  - by its Articles of Association :
    (1) restricts the right of transfer of its shares
    (2) limits the number of its member to 200 which will not include present employees or ex-employees
  - prohibits any invitation to the public to subscribe to any share or debenture of the company.

  Name of every private company must end with the words 'Private Limited'.

  (ii) Public Company : A public company is a company which :
  - is not a private company;
  - has a minimum paid-up capital as may be prescribed; and
  - is a company which is not a subsidiary of a private company.

  Name of every public company must end with the word 'Limited'.

  (iii) One Person Company : It is a company which has only one person as a member. It is a company incorporated as a private company which has only one member.
  - **Member of OPC :** Only natural person who is a citizen of India and resident of India can be a member of OPC.
  - **Minimum Paid-up Capital :** Its paid-up share capital is not more than ₹ 50 lakh.
  - **Purpose :** It can be established for business and for charitable purposes.
  - **Number of Directors :** Minimum number of director is one and maximum is fifteen.
  - **Conversion :** An OPC cannot convert itself into public or private company unless a period of 2 years has expired from the date of its incorporation and conversion is mandatory when its average annual turnover during the relevant period exceeds ₹ 2 Crore or paid-up share capital increases beyond ₹ 50 lakhs.

  Advantages of OPC
  - Cash Flow Statement is not required to be included in the financial statements of an OPC.
  - The provisions relating to calling of Annual General Meeting, Notice for General Meeting, Quorum for meetings, Proxies, etc., shall not be applicable to OPC.

2. **On the Basis of Liability :** Companies registered under Companies Act can be classified in the following two types :
   - **(i) Limited Liability Companies :** Such companies in which the liability of the shareholders is limited up to the extent of the face value of shares held or to the amount guaranteed as provided in Memorandum, are known as limited liability companies. Generally, companies with limited liability are divided into the following two kinds :
     - **(a)** Company limited by shares,
     - **(b)** Company limited by guarantee.

     In company, limited by shares, the liability of shareholders is limited to the face value of shares held in the company.

     In the company limited by guarantee, its members guarantee that they will be responsible to pay the guaranteed amount which is fixed and specified in the memorandum, in the event of its winding up during their membership or within one year of their membership.
   - **(ii) Unlimited Companies :** Such companies in which members have unlimited liabilities like the partners have unlimited liability in partnership firm, are known as unlimited liability companies.
3. **On the basis of Ownership :** Companies may be classified as following two types on the basis of ownership :
   - **(i) Government Company :** Government company means any company in which not less than 51 % of the paid-up capital is held jointly or separately by the Central Government or any State Government or partly by the Central Government and partly by one or more State government or any company of one or more Government or statutory corporations.
   - **(ii) Non-Government Company :** Non-government company means that company which is not a government company. Non-government companies are having dominance in India.
4. **On the basis of Control of Unit :** Companies are classified in the three types on the basis of control of unit which are as under :
   - **(i) Independent Company :** Independent company means that company which performs all operations of the company individually and independently and is not controlled by another company. Such companies are neither subsidiary nor holding company of any other companies.
   - **(ii) Holding Company :** A company is a holding company if it establishes control on management of other company. According to Companies Act, a company is holding company of another if the other is its subsidiary.
   - **(iii) Subsidiary Company :** According to the Companies Act, a company shall be a subsidiary of another, if :
     - That other company controls the composition of its board of directors; or
     - The other company enjoys more than half of the total voting power; or
     - The other company holds more than half in the face value of its equity share capital.
     - It is a subsidiary of a third company which itself is a subsidiary company.
5. **On the basis of Nationality :** On the basis of nationality, companies may be classified in the following two kinds :
   - **(i) Domestic or Indian Company :** All such companies which are formed in India under Companies Act or any other previous Company Laws, are known as Domestic or Indian Company.
   - **(ii) Foreign Company :** A foreign company means a company incorporated outside India but having business in India.

➢ **Share :** According to Section 2 (84) of the Companies Act, 2013, share means a share in the share capital of a company and includes stock. The capital of company is divided into a number of equal units. Each unit is called a share. A company may divide its capital into share of ₹ 100, ₹ 50, ₹ 10, ₹ 5 or even ₹ 1 each.

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

➢ **Classes or Kinds of Shares**

1. **Preference Shares :** According to Section 43 (b) of the Companies Act, 2013, preference shares are the shares which carry the following two preferential rights :
   - Preferential right of dividend to be paid as fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income tax.
   - Return of capital on the winding up of the company before the equity shares to the holders of preference shares are called preference shareholders.

   Types of Preference Shares :

   (A) On the Basis of Arrears of Dividend
   - **(i) Cumulative Preference Shares :** These are the preference shares which have the right to receive arrears of dividend before the payment of dividend to equity shareholders is made.
   - **(ii) Non-Cumulative Preference Shares :** These are the preference shares which don't have the right to receive arrears of dividend.

(B) On the Basis of Share in Profits

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

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

(C) On the Basis of Convertibility

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

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

(D) On the Basis of Redemption

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

(ii) Irredeemable Preference Shares : Preference shares which are not redeemable are called irredeemable preference shares. The Companies Act, 2013, does not permit issue of Irredeemable Preference Shares.

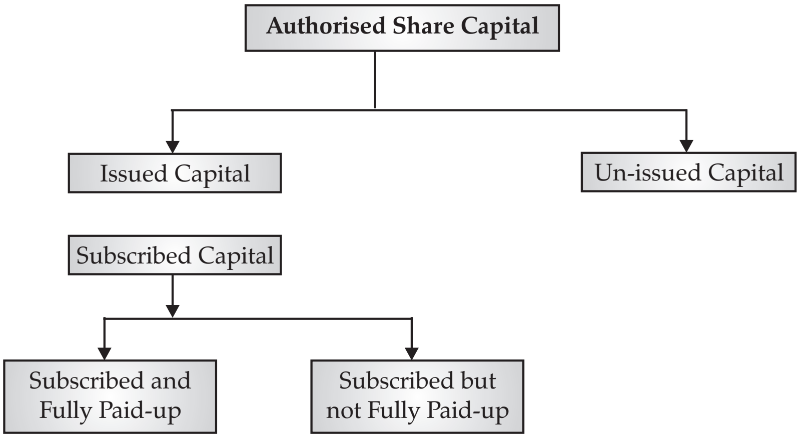
2. Equity Shares : According to Section 43 (a) of the Companies Act, 2013, equity share is that share which is not a preference share. Equity shares are the most commonly issued class of shares which carry the maximum 'risks and rewards' of the business. The risks being losing part or all of the value of shares if the business incurs losses, the rewards being payment of higher dividends and appreciation in the market value.

Equity shares : The dividend on equity shares is not fixed and it may vary from year to year depending upon the amount of profits available for distribution.

Difference between Equity Shares and Preference Shares

S. No.	Basis of Difference	Equity Shares	Preference Shares
1.	Dividend	The dividend on equity shares are paid only after the preference dividend has been paid.	Dividend on the preference shares is paid in preference to equity shares.
2.	Rate of Dividend	The rate of dividend on equity shares is not fixed.	The rate of dividend is fixed for preference shares.
3.	Arrears of Dividend	Arrears of dividend is not paid on equity shares in future years.	Arrears of dividend are accumulated and are paid in any future year, if it is cumulative preference shares.
4.	Redemption of Share Capital	Equity shares are not redeemed.	Preference shares are redeemed at the expiry of the stipulated period.
5.	Right in Management and operations	The Equity Shareholders have a right to take part in management and operation of the company.	The Preference Shareholders do not have such rights.
6.	Right to Vote	Equity shares carry right to vote because equity shareholders are real owners of the company.	Preference shares do not carry right to vote except in special circumstances.

➢ **Share Capital**



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

Types of Share Capital

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

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

(2) Issued Capital : It refers to that portion of the authorised capital which is actually issued to the public for subscription. Normally, companies do not exhaust their authorised capital in the beginning but only a part of the authorised capital is issued for public subscription. Rest of the authorised capital is raised by the company in a phased manner depending on the need for funds.

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

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

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

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

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

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

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

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

Balance Sheet

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

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

Notes to Accounts

Particulars	Amount (₹)	Amount (₹)
(1) Share Capital		
Authorised Capital :		
…..Equity Shares of ₹…... each		
……Preference Shares of ₹ …….. each		
Issued Capital :		
….. Equity Shares of ₹ ……. each		
…… Preference Shares of ₹ ……. each		
Subscribed Capital :		
Subscribed and Fully paid-up :		
…… Equity Shares of ₹ ….. each		
……. Preference Shares of ₹ …. each		
(of the above shares ……. Shares are allotted as fully paid-up pursuant to a contract without payment in cash)		

Subscribed but not fully paid-up : …… Equity Shares of ₹ …….. each, ₹ ……. per share called—up *Less :* Calls- in- Arrears ……. Preference Shares of ₹ ……… each, ₹ ……. called up *Less :* Calls- in- Arrears **(i)** By Directors ₹ ……….. **(ii)** By others ₹ ……….. *Add :* Forfeited Shares Amount to be shown in the Balance Sheet		

Procedure for Issue of Shares

A public company after its incorporation, has to adopt the following procedure to issue shares :

(1) Issue of Prospectus : First, the company issues a prospectus for issuing shares to the public. Prospectus is an invitation to the public to buy its shares. A Prospectus contains the history, objectives, business, names of directors, managers, secretary, banker, auditor of the company. It also points out the current status of the project. Possibilities, profitability and prospects of future growth of the company. The prospectus also contains the Application.

(2) Receive Application Forms : The company collects the duly filled-up application forms and the application money receipt to the applicants and deposits the application money in share application account. Bank sends the list of applicants and the application forms to the company daily or within a given time period. The application money which is directly received by the company are also deposited in the share application money account. According to the provisions of Companies Act, application money should not be less than 5% of the face value of the share.

(3) Prepare Application and Allotment List : The list of applicants sent by the bank is verified at the company headquarters and a list of share application and allotment shall be prepared either alphabetically in the names of the investors or on the basis of the number of shares applied for. A summary sheet of the applicants shall also be prepared for the Board of Directors on the basis of which allotment shall be made. Separate application and allotment books are prepared for different types of shares.

(4) Allotment of Shares : After the last date for subscription is over, the Board of Directors allots shares as per the provisions of the Companies Act. A public company has to comply with the following conditions in allotment of shares;

- Share should be allotted after five days of the issue of prospectus.
- The company should receive the minimum subscription before the allotment of share.
- The minimum application money should be collected within 120 days of the issue of the prospectus. Otherwise, the amount so collected should be refunded within 130 days of the issue of the prospectus.
- The company should receive minimum subscription of 90 % of whole issue before allotment of shares.
- Application money should be 5 % or more of the face value of the share.
- The application money should be deposited in scheduled bank till the certificate of commencement of business is received by the company.

(5) Allotment and Regret letter : On completion of the allotment process, the company sends allotment letters to all applicants to whom shares have been allotted. The allotment letter contains information about the number of shares allotted and the last date for the amount due on allotment of shares. Regret letters are sent to all applicants to whom no allotment has been made. In such case, their money shall be refunded. In case of Pro-rata allotment excess application money shall be used for adjustment in allotment money due.

SEBI Guidelines in Respect of Issue of Shares : Securities Exchange Board of India (SEBI) has issued various guidelines to protect and safeguard the interests of investors. A public company has to follow these guidelines concerned to the issue of shares. Main directives are as follows :

(1) A new company shall issue its shares at par value but a company existing since past five years having consistency in earning profit, shall be independent to decide issue price of its shares.

(2) A private company, having consistency to earn profits in last three years, shall be independent to determine its issue price after converting to a public company but in absence of consistency in profit, it shall issue its shares at par value.

(3) Existing listed company, company shall be allowed free pricing of its issue.

(4) Each company has to underwrite its whole issue.

(5) Minimum amount of subscription shall be 90 % of total issued capital. If the company fails to receive minimum subscription, *i.e.*, 90% of total issued capital within 120 days of opening of the issue, then the company has to refund the entire subscription, so received from the applicants.

(6) The application money on the issue of share shall be uniform for all the investors but in case of composite issues combining right issue and public issue, the company shall have different application prices for both the issues.

(7) Public issues less than 50 crore must be made fully paid-up on application.
(8) In case of a public issue exceeding capital of 500 crore then the amount due application or allotment or calls shall not be more than 25% of issue price.
(9) A company cannot make bonus issue within 12 months from the date of public issue or right issue.
(10) Subscription of public issue must be kept open for at least 3 working days.
(11) Failure to comply with the guidelines of SEBI shall be punishable accordingly.
(12) SEBI has full right to change its guidelines.

TOPIC-2
Accounting Treatment

Quick Review

Accounting related to issue of shares has been classified in the following two parts :

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

(1) Issues of Shares at Par : Issue of Shares at its actual price *i.e.*, face value is known as issue of shares at par.

At the time of Application :

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

(ii) For transferring application money to share capital :
Share Application A/c Dr.
  To Share Capital A/c
(Being application money transferred to share capital account)

At the time of Allotment :

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

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

At the time of First Call :

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

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

At the time of Second Call :

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

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

At the time of Third and Final Call :

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

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

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

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

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

Journal Entries

(1) For making Allotment due with Premium :
Share Allotment A/c Dr.
To Share Capital A/c
To Securities Premium Reserve A/c

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

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

➢ **Oversubscription of Shares :** When the number of shares applied for is more than the number of shares offered for issue, it is known as oversubscription.

The options available with the company to deal with money received on oversubscription are:

(i) Board of Directors can make full allotment to some applicants and totally reject the others.
(ii) They can make a pro-rata allotment. It means the proportion is determined by the ratio which the number of shares to be allotted bear to the number of shares applied for.
(iii) They can adopt a combination of the above two alternatives.

Difference between Undersubscription and Oversubscription

S. No.	Basis of Difference	Undersubscription	Oversubscription
1.	Meaning	In this case, the number of shares applied for is less than shares offered to the public for subscription.	In this case, the number of shares applied for is more than the shares offered to the public for subscription.
2.	Minimum subscription	The problem of minimum subscription may arise.	The problem of minimum subscription does not arise.
3.	Allotment of Shares	In case of undersubscription, all the applications for shares are allotted.	In case of oversubscription some applications are to be rejected.
4.	Refund	There is no question of refund of money.	Money is refunded to applicants whose applications are rejected.

➢ **Calls-in-Advance**

A company can accept advance payment from any shareholder in respect of the shares held by them although calls have not been made on them, if it is authorized by its articles, *i.e.*, a shareholder may pay the whole or a part of the unpaid amount of calls-in-advance although it has not been called up. This is called Calls-in-Advance and a separate account having this title is opened.

Then the calls are made, *i.e.*, due then it is adjusted against 'Calls A/c'. The company may pay interest on such advance from the date of advance received upto the date when it is due, which shall be 12% per annum.

In this regard, the following entries are made :

(1) For receipt of Calls-in-Advance :
Bank A/c Dr.
To Calls-in-Advance A/c

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

(3) For interest paid on Calls-in-Advance :

Interest on Calls-in-Advance A/c Dr.
To Bank A/c

- **Calls-in-Arrears**

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

(1) For Amount unpaid in allotment :

Calls-in-Arrears A/c Dr.
To …. Share Allotment A/c

(2) For amount unpaid on calls :

Calls-in- Arrears A/c Dr.
To …. Share… Calls A/c

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

Bank A/c Dr.
To Calls-in-Arrears A/c

- **Calls-in-Arrears shall be shown at the liabilities side of the Balance Sheet as a deduction from called-up capital.**

Interest on Calls-in-Arrears : The company may charge interest on Calls-in-Arrears from the due date upto the date of payment at a specified rate. (But not compulsorily)

The following entry shall be passed:

Bank A/c Dr.
To Interest on Calls-in-Arrears A/c

- **Issue of shares for consideration other than cash**

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

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

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

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

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

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

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

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

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

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

(b) For Purchase of Business :

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

(ii) For Issuing Shares to Vendor :

(a) At Par :

Vendor's A/c Dr.
To Share Capital A/c
(Being fully paid shares issued to vendor)

(b) At Premium :

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

➢ **Forfeiture of Shares :**

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

(i) Normally, shares are forfeited when allotment and call money are not paid by shareholders.
(ii) The Articles of Association of the company must expressly provide for forfeiture of shares.
(iii) If the Articles of Association do not expressly provide for forfeiture of shares, the company can forfeit shares by passing a special resolution.
(iv) The shareholders should be served a notice at least 14 days before the forfeiture.
(v) A resolution to forfeit the shares must be passed by the Board of Directors.
(vi) Forfeiture of share should take place in good faith and should be in the larger interest of the company.

Accounting Treatment

Following entries are passed in three alternative circumstances :

(1) Forfeiture of Shares issued at Par :

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

(2) Forfeiture of Shares issued at Premium :

(a) If Premium has not been received :

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

(b) If Premium has been received :

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

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

➢ **Reissue of Forfeited Shares**

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

Following journal entries are passed for reissue of forfeited shares :

(1) For re-issue of Forfeited Shares :

(a) If re-issued at par :

Bank A/c	Dr.	(with the amount received)
To….Share Capital A/c		

(b) If re-issued at a Discount :

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

(c) If re-issued at Premium :

Bank A/c	Dr.	(with the total amount received)
To ….Share Capital A/c		(with the paid-up value of shares)
To Securities Premium A/c		(with the amount of premium)

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

Shares Forfeiture A/c	Dr.	
To Capital Reserve A/c		

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

➢ **Conditions for Private Placement**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) Such shares can be issued on conversion of debentures and also for a consideration other than cash, *i.e.*, they can be issued in exchange of some fixed assets to a select group of people.

➢ **Sweat Equity Shares**

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.

➢ **Procedure for Issuing Sweat Equity Shares [Section 54]**

Where sweat equity shares are issued for a non-cash consideration on the basis of a valuation report in respect thereof obtained from the registered valuer, such non-cash consideration shall be treated in the following manner in the books of account of the company :

(a) where the non-cash consideration takes the form of a depreciable or amortizable asset, it shall be carried to the balance sheet of the company in accordance with the Accounting Standards; or

(b) Where clause (a) is not applicable, it shall be expensed off as provided in the Accounting Standards.

In respect of sweat equity shares issued during an accounting period, the accounting value of sweat equity shares shall be treated as a form of compensation to the employee or the director in the financial statements of the company.

Employees Compensation Expenses Account : This account denotes proportionate expense or loss for the company which arises due to the difference between the market price and exercise price (issue price) of the shares granted under ESOP. At the year end, this account is transferred to Statement of Profit & Loss and is shown under head 'Employees Benefit Expenses'.

Employees Stock Option Outstanding Account : This account represents the total expense or loss due to options granted under ESOP. It is shown in the Balance Sheet under head 'Shareholders Fund' and sub-head 'Reserve and Surplus'.

Journal Entries

- At the time of recording the Expense:

  Employees Compensation Expense A/c Dr.

  To Employees Stock Option Outstanding A/c

  (Being the proportionate expenses recognized in respect of ESOP)

  Note : This entry will be passed for each year of vesting period.

- At the time of exercising the options by the employees:

  (a) When the options are exercised by all the employees

  Bank A/c Dr. [Amount received *i.e.* Exercise Price × Number of Shares]

  Employees Stock Options Outstanding A/c Dr. [Amount Credited to Employees Stock Option Outstanding Account, *i.e.*, No, of Shares × Market Price – Exercise Price]

  To Share Capital A/c [Nominal Value of Shares]

  To Securities Premium Reserve A/c [Amount related to options that have been exercised, *i.e.*, No of Shares × (Market Price–Nominal Value)]

  To General Reserve A/c [Amount related to options that have not been exercised, *i.e.*, No. of Shares × (Market Price–Exercise Price)]

  (Being the options exercised by the employees)

- **Issue of Right Shares :** According to Section 62 of the Companies Act, 2013, the existing shareholders have a right to subscribe to the fresh issue of capital in their existing proportion or to reject the offer or sell their rights. It is known as 'Right Issue of Shares'. The right issue share price may be above the previous issue price, this difference will be known as value of right. In other words :

  Value of right = Market price of a share – Average price of a share.

- **Buy-Back of Shares :** Buy-back of shares is a method of financial engineering. It can be described as a procedure which enables a company to go back to the holders of its shares and offer to purchase the shares held by them. Buy-back helps a company by giving a better use for its funds than reinvesting these funds in the same business at below average rates or going in for unnecessary diversification or buying growth through costly acquisitions. When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value or what the company perceives to be its true value.

  This mode of purchase is also called 'Shares Repurchase'. A company can utilize its reserves to buy-back equity shares for the purpose of extinguishing these or treasure operations. The former option results in reduction of the paid-up capital, and consequently higher earnings and book value per share. The market price of equity goes up. The reduction in share capital strengthens the promoter's control and enhances the equity value for shareholders. In the later option, companies buy their shares from open market and keep these as 'treasury stock'. This enables the promoters to strengthen their control over the shares bought back, without any investment of their own. In case of treasure operations, there is a diversion of company's funds to buy shares and reduction in the value of equity for the shareholders. The main aim of shares repurchase might be to reduce the number of shares in circulation in order to improve the share price, or simply to return to the shareholders resources no longer needed by the company. The shares repurchased may be by way of purchase from the open market or by general tender offer to all shareholders made by the company to repurchase a fixed amount of its securities at pre-stated price.

- **Reasons for Buy-Back :**

  There are reasons why a company would opt for buy-back:

  1. To improve shareholder value, since buy-back provides a means for utilizing the companies surplus funds which have unattractive alternative investment options, and since a reduction in the capital base arising from buy-back would generally result in higher earnings per share (EPS).

  2. It is used as a defense mechanism, in an environment where the threat of corporate takeovers has become real. Buy-back provides a safeguard against hostile take-over by increasing promoter's holdings.

  3. It would enable corporate to shrink their equity base thereby injecting much needed flexibility.

  4. It improves the intrinsic value of the shares by virtue of the reduced level of floating stock.

5. It would enable corporate to make use of the buy-back shares for subsequent use in the process of mergers and acquisitions without enlarging their capital base.
6. Buy-back of shares is used as a method of financial engineering.
7. It is used for signaling the effects of buy-back on the share price.

➢ **Financing Aspects of Buy-Back :**

In order to buy-back of shares and securities in large numbers, the company needs huge amounts of capital and funds which may be mobilized through one or more of the sources, viz.

1. Internal sources
2. Sufficient cash position
3. Selling of temporary investment with the least possible loss
4. Raising of working capital needs
5. Raising cash by issuing fixed deposits
6. Raising by issue of debentures and loan bonds
7. Cash credit from commercial banks
8. Overdraft from commercial banks etc.

➢ **Benefits of Buy-Back :**

The benefits derived from share repurchase program are as follows :

1. Firms whose profitability was below their industry average enjoy greater share price growth after shares are repurchased than firms whose profitability was above their industry average.
2. Firms, whose sales growth was below their industry average, enjoy greater share price growth after shares are repurchased than firms, whose sales growth was above their industry average.
3. Profitable and growth firms that repurchase shares provide a clear indication to the investors about the strengths of the company.
4. Repurchasing firms with debt ratios below but sales growth rates above their industry average experience substantially higher share price growth after repurchasing than firms with debt ratios above but sales growth below their industry average.
5. Repurchasing firms with profitability and debt ratios below their industry average demonstrate higher share price growth after repurchasing than firms with profitability and debt ratios above their industry average.

Drawbacks of Buy-Back :

The shares repurchase is criticized for the following reasons :

1. This could enable unscrupulous promoters to use company's money to raise their personal stakes.
2. It opens up possibilities for share price manipulation.
3. It could divert away the company's funds from productive investments.

➢ **Profit or Loss Prior to Incorporation :**

A company may acquire another business from a date prior to its incorporation, normally from the beginning of the accounting year of the selling concern to avoid preparation of final accounts up to the date of acquisition.

For example, a company incorporated on May 1, 1984, may purchase a business with effect from January 1, 1984, the date on which the accounting year of the vendor starts.

Suppose, the company closes its accounts on December 31 and prepares the Profit & Loss Account for the year ended December 31, 1984, any Profit earned by the company from January 1, 1984, to April 30, 1984 (*i.e.*, Prior to incorporation) is known as profit prior to incorporation and treated as capital profit and transferred to the Capital Reserve Account.

In the same manner any loss incurred prior to incorporation is treated as capital loss and debited to the Goodwill Account. The profit earned by the company after the date of its incorporation is its revenue profit and is available for dividend.

A pertinent point to be noted is that even though a public company can earn revenue profits only after getting the Certificate of Commencement, for all practical purposes, the date of incorporation is taken as the basis for the calculation of profit prior to incorporation.

Ascertainment of Profit or Loss Prior to Incorporation:

The following steps are taken to ascertain the profit earned prior to incorporation and after incorporation :

(1) A Trading Account for the full accounting period is prepared and Gross Profit is arrived at.

(2) Gross profit is apportioned between the two periods on the basis of the sales in the two periods.

(3) All fixed expenses such as rent, rates, salaries, insurance, audit fees, etc., are allocated on a time basis as these expenses are related to the time factor.

(4) Expenses which are directly related to sales, like discount allowed, bad debts, commission on sales, advertising, etc., are allocated on the basis of the sales of each period.

(5) Certain expenses which are incurred by the company or incurred only in the post-incorporation period, e.g., preliminary expenses, debenture interest paid, directors' fees, etc., are charged as expenses of the post incorporation period only.

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Chapter - 8 : Accounting for Debentures

TOPIC-1
Debentures

Quick Review

➢ **Meaning of Debentures :**

The word debenture has been derived from the latin word 'debere' which means to borrow.

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

➢ **Features of Debentures :**

The important features of debentures are as follows :

(1) Debenture holders are the creditors of the company carrying a fixed rate of interest.
(2) Debenture is redeemed after a fixed period of time.
(3) Debentures may be either secured or unsecured.
(4) Interest payable on a debenture is a charge against profit and hence it is a tax deductible expenditure.
(5) Debenture holders do not enjoy any voting right.
(6) Interest on debenture is payable even if there is a loss.

➢ **Advantage of Debentures :**

Following are some of the advantages of debentures:

(1) Issue of debenture does not result in dilution of interest of equity shareholders as they do not have right either to vote or take part in the management of the company.
(2) Interest on debenture is a tax deductible expenditure and thus, it saves income tax.
(3) Cost of debenture is relatively lower than preference shares and equity shares.
(4) Issue of debentures is advantageous during times of inflation.
(5) Interest on debenture is payable even if there is a loss, so debenture holders bear no risk.

➢ **Disadvantages of Debentures :**

Following are the disadvantages of debentures :

(1) Payment of interest on debenture is obligatory and hence, it becomes burden if the company incurs loss.
(2) Debentures are issued to trade on equity but too much dependence on debentures increases the financial risk of the company.
(3) Redemption of debenture involves a larger amount of cash outflow.
(4) During depression, the profit of the company goes on declining and it becomes difficult for the company to pay interest.

➢ **Different Types of Debentures :**

A company can issue different types of debentures for raising funds for long-term purposes.

Different forms of Debentures are given and discussed below :

(1) **Ordinary Debenture :** Such debentures are issued without mortgaging any asset, *i.e.*, this is unsecured. It is very difficult to raise funds through ordinary debentures.
(2) **Mortgage Debenture :** This type of debenture is issued by mortgaging an asset and debenture holders can recover their dues by selling that particular asset in case, the company fails to repay the claim of debenture holders.
(3) **Non-convertible Debentures :** A non-convertible debenture is a debenture, where, there is no option for its conversion into equity shares. Thus, the debenture holders remain debenture holders till maturity.
(4) **Partly Convertible Debentures :** The holders of partly convertible debentures are given an option to convert part of their debentures. After conversion they will enjoy the benefit of both debenture holders as well as equity shareholders.
(5) **Fully Convertible Debenture :** Fully convertible debentures are those debentures which are fully converted into specified number of equity shares after predetermined period at the option of the debenture holders.
(6) **Redeemable Debentures :** Redeemable debenture is a debenture, which is redeemed/repaid on a predetermined date and at predetermined price.
(7) **Registered Debentures :** Registered debentures are those debentures, where names, address, serial number, etc., of the debenture holders are recorded in the register book of the company. Such debentures cannot be easily transferred to another person.

(i) Unregistered Debentures : Unregistered debentures may be referred to those debentures which are not recorded in the company's register book. Such a type of debenture is also known as bearer debenture and this can be easily transferred to any other person.

Difference Between A Debenture holder and A Share holder

Following are the important differences between a debentureholder and a shareholder of a company:

S. No.	Basis of Difference	Debentureholder	Shareholder
1.	Membership	Debenture holder is not a member of the company, but only a creditor.	Share holder is a member *i.e.*, the owner of the company.
2.	Dividend	Debenture holder do not receive dividend but they receive interest at fixed rate whether the company earns profit or not.	Receives dividend out of the profits of the company.
3.	Repayment	Has a right to receive repayment of the principal amount after definite period.	Capital amount is repaid only in case of redeemable preference shares.
4.	Status	Debenture holder is a creditor of the company.	Shareholders is the owner of the company.
5.	Voting Rights	Except few exceptional situations, debenture holder does not have a right to vote in the meetings of the company.	Being the owner of the company, share holder has a right to control and vote in the meetings of the company.
6.	Winding-up of the company	In case of winding-up of the company, debenture holders must be paid first, before anything is paid to the equity share holders.	In such a case, share holders are paid at last after making payments to external fund suppliers.

- **Over Subscription**

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

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

Know the Terms

- **Bearer Debentures :** Bearer Debentures are those which are payable to the bearer or holder of the debenture. These are transferable by mere delivery and the company does not keep any record of name and address of debenture holder.
- **Bond :** Bond is also an instrument of acknowledgement of debt. Traditionally, the Government issued bonds, but these days, bonds are also being issued by semi-government and non-government organisations. The terms 'debentures' and 'Bonds' are now being used inter-changeably.

TOPIC-2
Accounting Treatment of Issue of Debentures

Quick Review

- **Issue of Debentures**

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

➢ **Different Ways For Issuing of Debenture**

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

(1) Issue of Debenture At Par

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

(2) Issue of Debenture At Discount

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

(3) Issue of Debenture At Premium

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

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

(i) When Debenture Amount in Received in Lump Sum :

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

(ii)When Debentures Amount is Received in Installments :

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

(v) When Allotment Money is received	Bank A/c Dr. To Debenture Allotment A/c	With the amount actually received on allotment
(C) (i) When Calls are made	Debenture Call A/c Dr. To ….%Debentures A/c	With the money due on a particular call
(ii) When Call Money is received	Bank A/c Dr. To Debenture Call A/c	With the amount received on particular call

- **The Issue of Debenture As Collateral**

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

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

When debentures are issued as a collateral security there are two treatments in the accounting books :

(i) First Method :

No journal entry is made in the account books at the time of issue of such debentures. A note is appended below the loan on the liabilities side of the balance sheet to the fact that they have been secured by the issue of debentures.

This will be shown in the balance sheet as follows :

Balance Sheet (Extract)

Equity and Liabilities	Note No.	Current Year	Previous Year
Non-Current Liabilities			
Long-Term Borrowings			
Debentures			
(In addition, debentures for ₹ ... have been issued as collateral security)			
Loan			
(Secured by the issue of debentures of ₹ .... as collateral security)			

(ii) Second Method :

Sometimes issue of debentures as collateral security is recorded by making journal entry as follows :

Debentures Suspense A/c Dr.

To Debentures A/c

(With nominal value of debentures)

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

- **Accounting Treatment of Interest on Debentures**

Interest on Debentures

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

The company will pay an interest net of tax to the debenture holders as the company is under an obligation to deduct tax at source at the rates applicable as per the tax laws.

The tax deducted at source (TDS) will be remitted to the tax authorities.

The Journal Entries are as follows :

For recording interest due :

Interest A/c Dr.

To Debentureholders' A/c

(Being the entry for interest due)

For making payment to debentureholders :

Debentureholders' A/c Dr.

To TDS Payable A/c
To Bank A/c
(Being the entry for payment of interest and TDS)

For paying tax deducted at source :
TDS Payable A/c Dr.
To Bank A/c
(Being the entry for payment of TDS)

For transferring to profit and loss account
Profit and Loss A/c Dr.
To Interest A/c
(Being the entry for interest amount transferred to profit and loss account)

- No interest is payable on debentures issued as collateral security.
- Interest accrued and due on debentures appear under the head 'Secured Loans'.
- Interest accrued but not due on debentures appear under the head 'Current Liabilities'.

Issue of Debentures with conditions Stipulated to their Redemption

Journal Entry

(1) Issued at par redeemable at par :
Bank A/c Dr.
To Debentures A/c
(Issue of debentures of ₹ .... at par)

(2) Issued at discount and redeemable at par :
Bank A/c Dr.
Discount on Issue of Debentures A/c Dr.
To Debentures A/c
(Issue of.......debentures of ₹ .... at a discount of ₹ ....)

(3) Issued at premium and redeemable at par
Bank A/c Dr.
To Debentures A/c
To Securities Premium A/c
(Issue of ...... debentures of ₹ .... at a premium of ₹ ....)

(4) Issued at par and redeemable at premium :
Bank A/c Dr.
Loss on Issue of Debentures A/c Dr.
To Debentures A/c
To Premium on Redemption of Debenture A/c
(Issue of ..... debentures of ₹ .... a redeemable at a premium of ₹ ....)

(5) Issued at discount and redeemable at premium
Bank A/c Dr.
Discount on Issue of Debentures A/c Dr.
Loss on Issue of Debentures A/c Dr.
To Debentures A/c
To Premium on Redemption of Debenture A/c
(Issue of ..... debentures of ₹ .... at a discount of ₹ .... redeemable at a premium of ₹ ....)

Know the Terms

- **Debenture Suspense Account :** Debenture Suspense Account is an adjustment account which is prepared when debentures are issued as collateral. It is a temporary account. When loan is loan is repaid, reverse entry is passed to cancel it.
- **Oversubscription :** When the number of debentures applied for is more than those offered for subscription, it is known as oversubscription.
- **Tax Deducted at Source (TDS) :** TDS is a system introduced by Income Tax Department, where person responsible for making specified payments such as salary, rent, interest, commission, etc. is liable to deduct a certain parentage of tax before making payment in full to the receiver of the payment.

TOPIC-3
Accounting Treatment of Issue of Debentures for Consideration Other than Cash

Quick Review

➢ **Issue of Debenture For Consideration Other Than Cash**

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

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

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

(A) For acquisition of assets :

Sundry Assets (individually) A/c	Dr.	(with the value of assets)
To Vendor's A/c		(with the purchase price)

Notes :

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

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

(B) On Allotment of debentures :

(a) On allotment of debentures (at par)

Vendor's A/c	Dr.	(with the value of debentures)
To Debentures A/c		

(b) On allotment of debentures (at premium)

Vendors A/c	Dr.	(with the purchase price)
To Debentures A/c		(with the nominal value)
To Securities Premium A/c		(with the amount of premium)

(c) On allotment of debentures (at discount)

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

(2) Issue of Debentures To the Vendor For Purchase of Business

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

(A) When Purchase Consideration is Equal to Net Assets

Sundry Assets A/c	Dr.
To Sundry Liabilities A/c	
To Vendor’s A/c	

(Being purchase of business from the vendor company)

(B) When Purchase Consideration is more than Net Assets

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

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

(II) Goodwill = Purchase Consideration – Net Assets

Journal Entry :

Sundry Assets A/c	Dr.
Goodwill A/c (Amount of difference)	Dr.
To Sundry Liabilities A/c	
To Vendor Company A/c	

(Being purchase of business from vendor company)

(C) When Purchase Consideration is less than Net Assets

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

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

(ii) Capital Reserve = Net assets – Purchase Consideration

Journal Entry :

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

- **Redemption of Debentures : Sources and Methods**

Meaning of Redemption

Redemption of debentures means payment of the amount of debentures by the company.

Methods of Redemption of Debentures :

Debentures may be redeemed in a number of ways. Procedure for redemption of debentures is laid down at the time of issue of debentures and it is in accordance with the provisions of articles of association.

I. Redemption of Debentures in Lump sum at Maturity :

In this case, debentures are redeemed in one lump sum at the end of stipulated period.

The basic accounting entries for redemption of debentures are :

(i) Debentures A/c Dr.
　　To Debentureholders' A/c

(ii) Debentureholders' A/c Dr.
　　To Bank A/c

Debentures may be redeemed at par, at premium or at a discount. When debentures are redeemed at par, the above two entries are passed. When debentures are redeemed at premium, the following accounting entries are passed :

Debentures A/c Dr. (with the face value of debentures to be redeemed)
Premium on Redemption of Debentures A/c Dr. (with premium payable on redemption)
　　To Debentureholders' A/c (with the amount payable)

It may be noted here that 'premium on redemption of debentures A/c' may have opened and credited at the time of issue of debentures. If so, then premium payable on redemption of debentures has only to be transferred to debentureholders account as per first entry. If it has not been opened earlier, it will be debited now and later closed by transferring it to Securities Premium A/c or Profit & Loss Account.

Debentures may be redeemed at discount though it is an unreal situation and not found in practice.

However, in such a case the following entry is passed :

Debentures A/c Dr. (with the face value of debentures redeemed)
　　To Debentureholders A/c (with the amount payable)
　　To Profit on Redemption of Debentures (with discount on redemption)

Profit on redemption of debentures is a capital profit. It is used to write-off discount on issue of debentures/ shares; otherwise it will be transferred to capital reserve. Debentures may be redeemed out of capital or out of profits. Prudent companies make arrangements for the redemption of debentures from the very beginning. They set aside a certain sum of money out of profits every year and invest an equivalent amount in first class securities so that necessary funds are available for redemption of debentures at the appropriate time.

II. Redemption of Debentures by Draw of Lots : (or In Instalments)

Under this method, the company redeems debentures each year. The debentures to be redeemed are selected by draw of lots. Accounting entries for redemption of debentures are the same as passed in case debentures are redeemed out of profits.

They are as follows :

(i) Debentures A/c Dr.
　　To Debentureholders' A/c

(ii) Debentureholders' A/c Dr.
　　To Bank A/c

(iii) Profit & Loss Appropriation A/c Dr.
　　To Debenture Redemption Reserve A/c

When all the debentures are redeemed, the balance in DRR account will be transferred to General Reserve.

- **Debenture Redemption Reserve (DRR):** According to Section 71(4) of the Companies Act, 2013, along with the Rule 18 (7) of the Companies (Share Capital and Debentures) Rules, 2014, the companies are required to set aside an amount out of profit (Surplus, *i.e.*, Balance in Statement of Profit & Loss) for redemption of debentures to a separate account. This account is known as Debenture Redemption Reserve (DRR).

DRR is shown on the Equity and Liabilities part of the Balance Sheet under the head 'Shareholders' Funds' and Sub-head 'Reserves and Surplus'.

➢ **Sources of Redemption of Debentures :** Debentures can be redeemed by utilizing any of the followings sources.

I. Redemption out of Capital : When the debenture are redeemed without adequate profits being transferred from surplus, *i.e.,* Statement of profit and loss to debentures redemption reserve [DRR] at the time of redemption of debentures, such redemption is said to be out of capital.

1.	**For amount of debentures due to Debenture holders :**	
	(a) When debentures are redeemable at par :	
	% Debentures A/c	Dr.
	To Debentureholders' A/c	
	(b) When debentures are redeemable at premium :	
	% Debentures A/c	Dr.
	Premium on Redemption of Debentures A/c	Dr.
	To Debentureholders' A/c	
2.	**For payment to Debentureholders :**	
	Debenturesholders' A/c	Dr.
	To Bank A/c	

II. Redemption out of Profits : When debentures are redeemed only out of profit and amount equal to nominal [face] value of debenture is transferred from surplus, *i.e.,* Statement of profit and loss to debenture redemption reserve [DRR] before the redemption of debentures, such redemption is said to be out of profits.

1.	**For amount of debentures due to Debentureholders :**	
	(a) When debentures are redeemable at par :	
	% Debentures A/c	Dr.
	To Debentureholders' A/c	
	(b) **When debentures are redeemable at premium :**	
	% Debentures A/c	Dr.
	Premium on Redemption of Debentures' A/c	Dr.
	To Debentureholders A/c	
2.	**For payment to Debenture holders :**	
	Debenturesholders' A/c	Dr.
	To Bank A/c	
3.	**For profit transferred to General Reserve**	
	Profit & Loss Appropriation A/c	Dr.
	To General Reserve A/c	

III. Redemption partly out of profits and partly out of capital : It means that the company does not transfer 100 per cent nominal (face) value of the total redeemable debentures of a particular series to DRR out of surplus.

Debenture Redemption Reserve (DRR) : Is created out of profit of the company available for payment as divided for the purpose of redemption of debentures. As per the provision of section 71 (4) of the companies act, 2013 read with Rule 18(7) of the companies (share capital of debentures) Rules 2014, a company shall transfer at least 25% of total nominal (face) value of redeemable debentures of that class out of surplus available for payment of dividend to DRR. DRR is required to be created in only case of non-convertible Debentures (NCD) and non-convertible portion of Partly Convertible Debentures (PCD).

Debenture Redemption Investment : A company required to create/maintain DRR shall on or before 30th April of the current year, deposit or invest (as the case may be) at least 15% of the amount of its debentures maturing during the year ending on 31th March of the next year. Companies not required to create DRR are not requires to invest in specified securities.

The profit available for distribution of dividend are reduced because of transfer of profit to DRR. A company is also required to make Debenture Redemption Investment (DRI).

Journal Entries :

(1) For transfer of profit to Debenture Redemption Reserve :

Surplus, *i.e.*, Balance in Statement of Profit & Loss Dr.
To Debenture Redemption Reserve A/c
(Being profit equal to 25% of debentures transferred to DRR)

(2) For making investment or deposit in specified securities :

Debenture Redemption Investment (DRR) A/c Dr.
To Bank A/c
(Being investment made in specified securities)

(3) For amount payable on Redemption :

(a) When debentures are redeemable at par :

Debentures A/c Dr.
To Debentureholders' A/c
(Being amount due on redemption)

(b) For amount payable on Redemption :

When debentures are redeemable at premium :

Debentures A/c Dr.
Premium on Redemption of Debenture A/c Dr.
To Debentureholders' A/c
(Being amount due on redemption at premium)

(4) For Encashment of Investment

Bank A/c Dr.
To Debenture Redemption Investment (DRI)A/c
(Being investment encashed upon redemption of debentures)

(5) When all Debentures are Redeemed :

Debenture Redemption Reserve A/c Dr.
To General Reserve A/c
(Being DRR transferred to General Reserve Account)

Sometimes, Tax Deducted at Source (TDS) may be applied to the income earned from the Debenture Redemption Investment (DRI). Tax deducted on the income of the company is an asset for the company.

Following journal entry will be passed :

Bank A/c Dr.
TDS Collected A/c Dr.
To Interest Earned A/c

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Part - B : Financial Statement Analysis

Unit - 4 : Analysis of Financial Statements

Chapter - 9 : Financial Statements of a Company

TOPIC-1
Financial Statement of a Company

Quick Review

➢ **Meaning of Financial Statements**

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

Explanatory Notes to Accounts

PART-I – BALANCE SHEET

Balance Sheet as at ....

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
I. EQUITY AND LIABILITIES			
(1) Shareholders' Funds : (a) Share Capital (b) Reserve and Surplus (c) Money received against share warrants			
(2) Share application money pending allotment			
(3) Non-Current Liabilities : (a) Long-term Borrowings (b) Deferred Tax Liabilities (Net) (c) Other Long-term Liabilities (d) Long term Provisions			
(4) Current Liabilities : (a) Short-term Borrowings (b) Trade payables (c) Other current Liabilities (d) Short-term Provisions			
Total			
II. **Assets**			
(1) Non-current Assets (a) Fixed Assets : **(i)** Tangible Assets **(ii)** Intangible Assets **(iii)** Capital Work-in-progress **(iv)** Intangible Assets under development (b) Non-current Investments (c) Deferred Tax Assets (net) (d) Long-term Loans and Advances (e) Other Non-current Assets			
(2) Current Assets (a) Current Investments (b) Inventories			
(c) Trade Receivables (d) Cash and Cash Equivalents (e) Short-term Loans and Advances (f) Other Current Assets			
Total			

PART-II – PROFIT & LOSS STATEMENT

Name of the Company……………………..

Profit & Loss Statement for the year ended

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

(ii)	Other Income			
(iii)	**Total Revenue (i+ii)**			
(iv)	**Expenses :** **(a)** Cost of materials consumed **(b)** Purchases of stock-in-trade **(c)** Changes in inventories of finished goods, work-in progress and stock-in-trade **(d)** Employee benefits expense **(e)** Finance costs **(f)** Depreciation and amortisation expense **(g)** Other expenses			
	Total Expenses			
(v)	Profit before exceptional and extraordinary items and tax (III-IV)			
(vi)	Extraordinary items			
(vii)	Profit / Loss before extraordinary items and tax (V+VI)			
(viii)	Extraordinary items			
(ix)	Profit before tax (VII (–/+)VIII)			
(x)	**Tax Expense :** **(i)** Current tax expense for current year **(ii)** Deferred tax			
(xi)	Profit / Loss from continuing operations (IX+X)			
(xii)	Profit / Loss from discontinuing operations			
(xiii)	Tax expense of discontinuing operations			
(xiv)	Profit / Loss from Discontinuing operations (after tax) (XII-XIII)			
(xv)	Profit / Loss for the period (XI + XIV)			
(xvi)	**Earnings per equity share :** (1) Basic (2) Diluted			

Schedule III (See section 129) PREPARATION OF BALANCE SHEET AND STATEMENT OF PROFIT & LOSS OF A COMPANY

Explanation of Items :

Equity and Liabilities Side

Shareholders' Funds

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

(1) Authorised or Nominal Capital

(2) Issued Capital

(3) Subscribed Capital

(a) Subscribed and fully Paid-up

(b) Subscribed but not fully paid-up

(4) Called-up Share Capital

(5) Paid-up Share Capital

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

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

Balance Sheet

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of previous reporting period
I. EQUITY AND LIABILITIES			
(1) **Shareholders' Funds :** (a) Share Capital			

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

Notes to Accounts

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

(B) Reserve and Surplus :

Reserves are the amount set aside out of profits and surpluses to meet prospective losses and future uncertainties strengthening the financial position of the company.

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

Reserve and Surplus shall be classified as :

(1) Capital Reserve
(2) Securities Premium Reserve
(3) Capital Redemption Reserve
(4) Debenture Redemption Reserve
(5) Revaluation Reserve
(6) Share Options Outstanding Account

(7) Other Reserves (specify the nature of each reserve and the amount in respect thereof)

(8) Surplus, *i.e.*, Balance in Statement of Profit & Loss.

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

TOPIC-2
Money Received Against Share Warrants

Quick Review

- **Money received against Share Warrants :**

  Share warrant is an option issued by the company that gives the warrantholder a right to subscribe equity shares at a pre determined price on or after a pre determined time period.

  As per Section 2(h) of Securities Contract Regulation Act, 1956," securities" include—

  (1) Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;

  (2) Rights or interest in securities;

  Further since the underlying instrument in warrants is equity shares which in turn are marketable securities, therefore, warrants will also be marketable in nature.

  Further vide RBI vide Notification 2No. FEMA. 308/2014-RB2 dated June 30, 2014 RBI clarified that warrants shall be treated as security within the meaning of Section 2(za) of FEMA[3].

- **Share Application Money Pending Allotment**

  When any company makes a share issue to general public, investors subscribe to company for share and pay the initial application depending on the issue terms of the company. After the issue is closed and allotment is carried out, investors are allotted shares in following manner:

1. If Issue is fully subscribed, then investors are allotted the shares for which they have subscribed.

2. If Issue is not fully subscribed but subscribed more than 90%, then investors are allotted with shares for which they have subscribed.

3. If Issue of shares is over subscribed, then investors are allotted with shares either on pro rata basis or certain class or certain investors are not allotted, and others are allotted with full quantity of there respective subscription.

Hence, share application money means Company receives certain amount from shareholders for allotment of shares.

Now, companies are expected to allot shares or refund the amount of excess share application money received from investors. If companies do not either allot shares or refund the amount to investors, it give rise to share application money pending allotment.

The outstanding amount of Share application money pending allotment is to be disclosed on face of Balance Sheet as per Schedule-III to the Companies Act 2013.

- **Non-Current Liabilities** :

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

(1) Long-term Borrowings

(2) Deferred Tax Liabilities (Net)

(3) Other Long-term Liabilities

(4) Long-term Provisions.

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

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

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

(ii) Capital Leases : A lease represents an agreement to use an asset, such as a machine, in exchange for making payments to the party who owns the asset. A capital lease is one in which the characteristics of the agreement are similar to a purchase.

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

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

(i) Trade Payables : Trade payables have been defined in Schedule III of Companies Act, 2013 as follows:

"Trade payables are the amounts payable for goods purchased and services taken in the normal course of business". It includes both sundry creditors and bills payable.

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

➢ **Off-Balance-Sheet Items**

There are some components of a company's long-term debt that it is not required to report directly on the balance sheet, but that it typically reports in the footnotes to the balance sheet. Examples of these off-balance-sheet items include certain contractual agreements and operating leases, which are agreements to lease assets that you do not intend to own. Although these items are absent from the balance sheet, they still contribute to the overall long-term debt.

If goods purchased are to be paid after 12 months from the date of Balance sheet or after the period of operating cycle, it will be shown as 'Other Long-term liability.

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

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

There are five main categories of current liabilities :

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

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

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

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

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

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

Asset Side

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

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

- **Fixed assets :** This category is the company's property, plant, and equipment. The account includes long-lived assets, such as a car, land, buildings, office equipment, and computers.
- **Long-term Investments :** These investments are assets held by the company, such as bonds, stocks, or notes.
- **Intangible Assets :** These assets lack a physical presence. Patents, trademarks, and goodwill classify as non-current assets.
- **Capital Work-in-progress :** Includes those fixed assets which are in the process of being constructed by the company.

Non-current Investments : Investments which are held not for purpose of resale but to retain them. Non-current investments shall be classified as :

(i) Investment in Property
(ii) Investment in Equity Instruments
(iii) Investment in Preference Shares.
(iv) Investment in Government or Trust securities
(v) Investment in Debentures or Bonds

(vi) Investment in Mutual Funds

(vii) Investments in Partnership Firm

Other non-current investments (nature to be specified) :

The investments held-to-maturity shall be stated separately.

The following shall also be disclosed:

(i) Aggregate amount of quoted investments and market value

(ii) Aggregate amount of unquoted investments

(iii) Aggregate amount partly paid-up investments

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

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

These are classified into :

(i) Capital Advances

(ii) Security Deposits

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

Contents of Annual Report : As per law, the annual report of a company must disclose the prescribed information in the form of financial statements, Report by the Board of Directors and Auditors' Report. A company's set of annual report includes :

(i) A Report by the Board of Directors

(ii) Auditor's Report to the Shareholders

(iii) Financial Statement

(iv) Notes to Accounts.

➢ **Nature of Financial Statements**

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

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

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

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

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

Characteristics of Ideal Financial Statements

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

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

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

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

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

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

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

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Chapter - 10 : Tools for Financial Analysis

Quick Review

➢ **Analysis of Financial Statements :** An analysis of financial statements implies or means a thorough, estmatic, comprehensive and critical examination of the information contained in the financial statements in order to understand them better, base decision on them after drawing meaningful conclusions, take planned steps towards development and secure the future of the organisation.

➢ **Objectives of Financial Statements Analysis :**

1. Financial Statements Analysis presents financial data in a simplified and understandable form, so that meaningful conclusions can be drawn from it.
2. Financial analysis helps in assessing the profitability positions and operational efficiency of the firm as well as whole as its various departments so as to judge the financial health of the organisation.
3. Financial analysis helps in ascertaining the relative importance of different components of financial position (such as assets, liabilities, owners' equity etc.) of the firm.
4. It helps in making intra-firm and inter-firm comparisons.
5. It helps in identifying the causes of change in profitability of financial positions of the firm.
6. Financial Statements Analysis helps in assessing future trends and thus helps in forecasting and preparations of budgets.

➢ **Limitations of Financial Statements Analysis**

(1) The financial statements analysis suffers from such limitations as financial statements suffer. This ignores the qualitative informations like quality of management and labour force, public relation, etc.

(2) The analysis of financial statements do not disclose the current worth of the business. The financial statements of the company are prepared on cost principle.

(3) In many situations, accountant has to make a choice out of various alternatives available. He may choose that alternative which may be beneficial to the company. In such case, the financial statements are not free from bias.

(4) Different firms may follow different accounting policies. This may create difficulty in comparing the results of two companies.

➢ **Tools for Analysis of Financial Statements :** Analysis of Financial Statements can be carried out by using the following tools :

(1) Comparative Statements (Horizontal Analysis)

(2) Common Size Statements (Vertical Analysis)

(3) Ratio Analysis

(4) Cash Flow Statements.

➢ **Comparative Statements :** Comparative statements compare financial data at two points of time and help in deriving meaningful conclusions regarding the changes in financial position and operating results. Statements showing financial data for two or more than years, placed side by side to facilitate comparison are called Comparative Financial Statements.

(A) Comparative Balance Sheet

According to ***Faulke***, ''Comparative Balance Sheet analysis is the study of the trend of some items or group of some comprised items in balance sheets of the same business enterprise of different dates."

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

Format of comparative balance sheet

Comparative Balance Sheet of .... Ltd.

as at ....

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

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

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

➢ **Common-Size Statements :** According To *Kohler*. ''Common-Size Statements are accounting statements expressed in percentages of same base rather than rupees.

(A) Common-Size Balance Sheet : In a Common-Size Balance Sheet each item of assets is converted into percentages to total assets (*i.e.*, 100) and each item of equity and liabilities is converted into percentages to total equity and liabilities (*i.e.*, 100). Thus, the Balance Sheet is converted into percentage form and the converted Balance Sheet is called as 'common Size Balance Sheet'.

Format of Common-Size Balance Sheet

Common Size Balance Sheet

as at ....

Particulars	Note No.	Absolute Amounts		Percentage of Balance Sheet	
		Previous Year (₹)	Current Year (₹)	Previous Year (%)	Current Year (%)
(1)	(2)	(3)	(4)	(5)	(6)
I. EQUITY AND LIABILITIES					
1. Shareholders' Funds :					
(a) Share Capital :					
(i) Equity Share Capital		—	—	—	—
(ii) Preference Share Capital		—	—	—	—
(b) Reserve and Surplus		—	—	—	—
2. Non-Current Liabilities :					
(a) Long-term Borrowings		—	—	—	—
(b) Long-term Provisions		—	—	—	—
3. Current Liabilities :					
(a) Short-term Borrowings		—	—	—	—
(b) Trade Payables		—	—	—	—
(c) Other Current Liabilities		—	—	—	—
(d) Short-term Provisions		—	—	—	—
Total		—	—	100	100

2. ASSETS :					
1. Non-Current Assets :					
(a) Fixed Assets :		—	—	—	—
(i) Tangible Assets		—	—	—	—
(ii) Intangible Assets		—	—	—	—
(b) Non-current Investments		—	—	—	—
(c) Long-term Loans and Advances		—	—	—	—
2. Current Assets :					
(a) Current Investments		—	—	—	—
(b) Inventories		—	—	—	—
(c) Trade Receivables		—	—	—	—
(d) Cash and Cash Equivalents		—	—	—	—
(d) Short-terms Loans and Advances		—	—	—	—
(e) Other Current Assets		—	—	—	—
Total		—	—	100	100

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

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

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

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

- **Trend Analysis :** Trend percentages are very useful in making comparative study of the financial statements for a number of years. These indicate the direction of movement over a long time and help an analyst of financial statement to form an opinion as to whether favourable or unfavourable tendencies have developed. This helps in future forecasts of various items.

  For calculating trend percentages, any year may be taken as the 'base year'. Each item of base year is assumed to be equal to 100 and on that basis, the percentage of each item of each year is calculated.

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Chapter - 11 : Accounting Ratios

Quick Review

- **Ratio :** Ratio is a mathematical relationship between two related items of a group of items expressed in quantitative form.
- **Accounting Ratios :** Accounting ratios are those that are based on financial statements and express an arithmetical relation between various accounting variables.
- **Ratio Analysis :** According to ***Myres***, *''Ratio analysis of financial statements is a study of relationship among various financial factors in a business as disclosed by a single set of statements and a study of trends of these factors as shown in a series of statements.''*
- **Advantages of Accounting Ratios :**
  1. **Simplification of Accounting Data :** Accounting ratio simplifies and summarises a long array of accounting data and makes them understandable. It discloses the relationship between two such figures which have a cause and effect relationship with each other.
  2. **Helpful in Analysis of Financial Statements :** Ratio analysis is an extremely useful device of analysing the financial statements.
  3. **Effective Control :** Ratio analysis disclose the liquidity, solvency and profitability of the business enterprise, helps them in discharging their managerial functions, *e.g.*, planning, organising, directing, communicating and controlling more effectively.
  4. **Helpful in Comparative Study :** With the help of ratio analysis comparison of profitability and financial soundness can be made between one firm and another in the same industry. Similarly, comparison of current year figures can also be made with those of previous years with the help of ratio analysis.
  5. **Fixation of Ideal Standards :** Ratio helps us in establishing ideal standards of the different items of the business. By comparing the actual ratios calculated at the end of the year with the ideal ratios, the efficiency of the business can be easily measured.
  6. **Study of Financial Soundness :** Ratio analysis discloses the position of business with different view points. It discloses the position of business with the liquidity point of view, solvency point of view, profitability point of view, etc. With the help of such study, we can draw conclusions regarding the financial health of the business enterprise.
- **Objectives of Ratio Analysis :**
  1. **Identify Problem Areas :** Ratio analysis helps in locating those areas of business which are weak, not functioning properly and require immediate attention.
  2. **Measure Profitability :** Through an analysis of gross profit, net profit, expenses and other similar relative amounts, the ratio analysis helps in arriving at true figure of profitability and also highlights changes in it from time to time.
  3. **Ascertain Operational Efficiency :** Ratio analysis determines operational efficiency through operating activity ratio and also point out the areas where it may be improved and how.
  4. **Assess Business Solvency :** By highlighting relationships between assets and liabilities through solvency ratios, ratio analysis indicates the financial condition.
  5. **Gauge Financial Position :** Liquidity and solvency ratios together help in measuring short-term and long-term financial position of a concern. If the position is not satisfactory, corrective measures may instantly be initiated.
  6. **Facilitate Comparative Analysis :** A comparison between present and past performance and that between self and other firms of the same industry, constitutes the comparative analysis. This is especially useful to find out advantages and disadvantages of the firm itself.
  7. **Aid in Budgeting and Forecasting :** Ratio analysis assumes much importance in financial forecasting and planning. These ratios provide meaningful conclusions that work as a guide for future decisions.
  8. **Simplify Accounting Figures :** A major objective of financial analysis is to shorten, summarise, organise and properly arrange the financial matter so that it may easily be absorbed by all.
- **Type of Accounting Ratios :**
  1. **Liquidity Ratio :** Liquidity means ability of firm to pay its current liabilities in time. These ratios are used to assess the short-term financial position of the firm. Liquidity ratio include two ratios :

     (i) Current Ratio and **(ii)** Quick Ratio.
  2. **Solvency Ratio :** Solvency Ratio is one of the various ratios used to measure the ability of a company to meet its long, term debts. Important Solvency Ratios are :

     (i) Debt to Equity Ratio, **(ii)** Total Assets to Debt Ratio and **(iii)** Proprietary Ratio, **(iv)** Interest coverage Ratio.

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

   (i) Inventory Turnover Ratio, **(ii)** Trade Receivables Turnover Ratio, **(iii)** Trade Payables Turnover Ratio, **(iv)** Working Capital Turnover Ratio.

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

   (i) Gross Profit Ratio, **(ii)** Operating Ratio, **(iii)** Net Profit Ratio, **(iv)** Return on Investment.

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Unit - 5 : Cash Flow Statement

Chapter - 12 : Cash Flow Statement

Quick Review

- **Cash Flow Statement :** Cash flow statement is a statement that shows flow of cash and cash equivalents during a given period of time. Cash flow Statement shows the net increase or net decrease of cash and cash equivalents under each activity, *i.e.*, Operating, Investing, Financing and Collectively.
- **Objectives of Cash Flow Statement :** The basic objective of Cash Flow Statement is to highlight the changes in the cash position including the sources from which cash was obtained by the enterprise and specific uses to which cash was applied. A Cash Flow Statement has the following objectives :
  (1) To depict inflows and outflows of cash, *i.e.*, sources and uses of cash.
  (2) To facilitate formulation of financial policies such as dividend policy, etc.
  (3) To ascertain the liquidity of the enterprise.
  (4) To ascertain the net change in cash and cash equivalents.
  (5) To study the trend of cash receipts and cash payments.
  (6) To know the deviation of cash from earnings.
  (7) To enable a more realistic assessment of the financial condition of enterprise and to anticipate the cash position.
- **Operating Activities :** Operating Activities are the main revenue generating activities of a business firm. Operating activities are those transactions and events whose cash flows affect the net profit or loss of a business firm.
  Examples of Cash Flows from Operating Activities : AS–3 (Revised) gives the following examples of cash flows from operating activities :

Operating Activities

Cash Inflows	Cash Outflows
(i) Cash Sales	(i) Cash Purchase
(ii) Cash received from Debtors	(ii) Payment to Creditors
(iii) Cash received as Commission	(iii) Cash Operating Expenses
(iv) Cash received as Fees	(iv) Payment of Wages
(v) Cash received as Royalty	(v) Income Tax

The major inflows and outflows in case of financial companies :

Operating Activities

Cash Inflows	Cash Outflows
(i) Cash received for Interest	(i) Cash paid for Interest
(ii) Cash received form Dividends	(ii) Payment for Purchase of Securities
(iii) Proceeds from Sales of Securities	

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

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

Investing Activities

Cash Inflows

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

Cash Outflows

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

- **Financing Activities :** Financing Activities are those activities that result in the changes in size not composition of the owners' capital (including Preference Share Capital in the case of a company and borrowings of the business firm.

  Examples of Cash Flows from Financing Activities : AS–3 (Revised) gives the following examples of cash flows from Financing Activities :

Financing Activites

Cash Inflows

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

Cash Outflows

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

- **Format of Cash Flow Statement :**

Cash Flow Statement of ....
for the year ended ....
[As per Accounting Standard (AS-3) (Revised) (Indirect Method)]

Particulars	(₹)	(₹)
1. Cash Flows From Operating Activities		
(A) Net Profit before Taxation and (W.N. 1)		....
Assessment for Non-cash and Non-operating Items		
(B) Items to be added back :		
Depreciation	....	
Interest on Borrowings and Debentures	....	
Goodwill Patents / Trade Marks/Copyrights Amortised	....	
Loss on Sale of fixed assets	....	
Increase in Provision for Doubtful Debts	....	....

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

Working Notes :

1. Calculation of Net Profit before Tax and Extraordinary Items

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

2. Calculation of Cash and Cash Equivalents in the beginning

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

3. Calculation of Cash and Cash Equivalents at the end

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

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