



**THE TAMIL NADU
Dr. AMBEDKAR LAW UNIVERSITY**

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PRINCIPLES OF ACCOUNTING

FIRST YEAR – SECOND SEMESTER

STUDY MATERIAL

By

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MESSAGE

Knowledge is power. Legal Knowledge is a potential power. It can be exercised effectively everywhere. Of all the domains of reality, it is Legal Knowledge, which deals with rights and liabilities, commissions and omissions, etc , empower the holder of such knowledge to have prominence over the rest. Law Schools and Law Colleges that offer Legal Education vary in their stature on the basis of their ability in imparting the quality Legal Education to the students. Of all the Law Schools and Colleges, only those that educate their students to understand the nuances of law effectively and to facilitate them to think originally, excel. School of Excellence in Law aims to be in top of such institutions.

The revolution in Information and Communication Technology dump lot of information in the virtual world. Some of the information are mischievous and dangerous. Some others are spoiling the young minds and eating away their time. Students are in puzzle and in dilemma to find out the right information and data. They do not know how to select the right from the wrong, so as to understand, internalise and assimilate into knowledge. Hence in the present scenario, the role of teachers gains much more importance in guiding the students to select the reliable, valid, relevant and suitable information from the most complicated, perplexed and unreliable data.

The teachers of the School of Excellence in Law have made a maiden attempt select, compile and present a comprehensive course material to guide the students in various subjects of law. The students can use such materials as guidance and travel further in their pursuit of legal knowledge. Guidance cannot be a complete source of information. It is a source that facilitates the students to search further source of information and enrich their knowledge. Read the materials, refer relevant text books and case laws and widen the knowledge.

Dr. P. Vanangamudi
Vice-Chancellor

PREFACE

Accounting is the art of recording, classifying, and summarizing business transactions and events in proper books of accounts. In order to regulate the business various laws were enacted, accounting concepts and conventions also were formulated and enforced. These lead to the creation of awareness of adopting double-entry system of accounting. Besides, accounts show profit & loss made and the financial position of the concern clearly. Income tax authorities also rely on this to impose tax on the profit earned by the business concern, banks and financial institutions are also come forward to extend credit shareholders invest their funds. People show interest to take up job in such concern, Suppliers are prepared to given to credit. Financial accounting is not an end in itself, but is intended to provide information that is vital in making business decisions. Hence, now a days the importance of accounting is going on increasing.

When sole proprietorship and even partnership proved inadequate as a form of business organization to meet the growing needs of people, there began to be felt the need of an organization which could meet the needs of modern trade and industry and 'Joint stock company' came into existence as a result.

The accounting system which we find today is as old as money itself. Accounting has developed along with the development of trade, commerce and industry. Accounting is considered now as a tool of managerial decision-making and control.

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B.COM , LL B ,(HONS) DEGREE
FIRST YEAR – SECOND SEMESTER
SUBJECT · PRINCIPLES OF ACCOUNTING

UNIT – I

Introduction to accounts – Definition of accounting – Preparation of Final accounts

Computation of loss of stock by fire – ascertainment of claim as per the insurance policy

Hire purchase and Instalment system – Legal provision regarding hire purchase contract – Joint venture and Consignment accounts (only simple problems for understanding)

UNIT – II

Partnership Accounts Essential characteristics of Partnership – Partnership deed – Fixed and fluctuating capital

Admission of a partner – Retirement of a partner – Death of a partner

Dissolution of Partnership firm – Mode of dissolution of a firm – Insolvency of partners – Gradual realization of assets and piecemeal distribution

UNIT - III

Company Accounts – Meaning of a company – Maintenance of books of account – Profit or loss Prior to incorporation – Final accounts of company – Alteration of share capital – Final Accounts of Banking Companies including Balance Sheet

UNIT – IV

Amalgamation – Absorption and external reconstruction of a company - (Inter company investments excluded) - Liquidation - Statement of affairs and deficiency accounts - Liquidator's final statement of receipts and payments

UNIT –V

Analysis of financial statements – Financial ratio analysis, Cash flow and funds flow statement analysis

Books Recommended:

1. S P Jain and K L Narang – Financial Accounting
2. R L Gupta and V.K Gupta – Advanced Accounting
3. Shukla and Grewal – Advance Accounts
4. R L Gupta and M Radhaswamy – Advance Accountancy

Books Prescribed:

1. P C Tulsian – Financial Accounting
2. T S Reddy and A Murthy – Financial Accounting
3. Dr N Premavathy – Financial Accounting
4. Dr Radha – Financial Accounting

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UNIT – I

INTRODUCTION TO ACCOUNTS

Financial statements are to be prepared in accordance with generally accepted accounting principles. This is because if each organisation was to adopt its own principles in the maintenance of accounting records and the publishing of accounting information it will lead to a welter of confusion. Such financial statements will have low acceptability as it will be difficult to understand them without first knowing the principles underlying the preparation of such statements. Also financial statements prepared without the generally accepted accounting principles as their base will be unsuitable for inter-period and inter-firm comparison. It is for this reason that when accounts are audited by the auditors, they see to it that the financial statements are prepared in accordance with generally accepted accounting principles and they also certify that the statements have been prepared in accordance with generally accepted accounting principles.

NATURE AND MEANING OF ACCOUNTING PRINCIPLE:

There is ample confusion and controversy as to the meaning and nature of accounting principle. There is a school of thought which believes that the term "*principle*" connotes "fundamental belief" or a "general truth" and as such it is incorrect to use this term with reference to accounting because accounting, merely as an art, is only an adoption for the attainment of some useful and beneficial results. Adaptation, inherently, implies the changing nature and, hence, a sharp contradiction to the meaning of the term "principle" which stands for the "fundamental truth". There is another school of thought which feels that the term "principle" means only "rule of action or conduct" and as such can be very correctly used with reference to rules used in accounting. The American Institute of Certified Public Accountants (AICPA) has also supported the use of the word "principle" in the sense in which it means "rule of action". It has defined the principle as "a general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice". **Pato and Littleton**, in order to avoid the confusion as to the meaning of the term "principle", have purposely used a new term "*standards*" in place of "principle". 'Principles' would generally suggest a universality and a degree of permanence which cannot exist in a human service institution such as accounting."

ESSENTIAL FEATURES OF ACCOUNTING PRINCIPLES

Accounting principles are acceptable when they, in general, satisfy the following three basic norms

- (a) usefulness,
- (b) objectivity, and
- (c) feasibility

Accounting principles satisfy the first basic feature of usefulness as much as because of these, the accounting records become more meaningful and useful to the reader. In other words, an accounting rule, which does not increase the utility of the records to its readers, is not accepted as an accounting principle.

Accounting principles is that which is objective in nature. It is said to be objective when it is solidly supported by facts. It is objective when it cannot be influenced by the personal bias and whims. Accounting principles should be such as are practicable. It will be seen that assets in the accounts are recorded at cost less depreciation as against at market price. This accounting principle is

practicable and feasible because it does not entail the difficult work of ascertaining the market price of that asset. It does not make it obligatory for the accountant to record all fluctuation in the price of that asset.

KINDS OF ACCOUNTING PRINCIPLES:

To distinguish accounting principles, from the sense in which the term principles is used in physical science, various other terms like postulates, concepts, conventions, doctrines, tenets, axioms, assumptions, etc., have been used by writers of accounting theory. Instead of wasting our time to discuss the precise meaning of these generic terms, we should concern ourselves with the significance and importance of these ideas in the practical work of the accountants. However, a slight distinction is made between the two terms 'concepts' and 'conventions'. The term "Concept" is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. The term "Convention" is used to signify customs or traditions as a guide to the preparation of accounting statements.

The following are the important generally acceptable concepts:

- 1 Entity Concept
- 2 Going Concern Concept
- 3 Money Measurement Concept
- 4 Cost Concept
- 5 Accounting Period Concept
- 6 Dual Aspect Concept
- 7 Matching Concept
- 8 Realization Concept
- 9 Balance Sheet Equation Concept
- 10 Verification and Objective Evidence Concept
- 11 Accrual Concept

ACCOUNTING CONCEPTS:

Entity Concept:

It is very important to note that for accounting purposes the *business* is treated as a unit or entity apart from its owners, creditors and others. In other words, the *proprietor* of an enterprise is always considered to be separate and distinct from the business which he controls. All the transactions of the business are recorded in the *books of the business* (though they belong to the proprietor) from the point of view of the business as an entity and even the proprietor is treated as a creditor to the extent of his capital. Capital is thus a liability like any other liability although the amount is owing only to the proprietor. In the case of sole trading and partnership concerns the proprietors may even draw the amounts out, thus reducing the liability of the business. But in the case of corporate bodies, shareholders stand on a different footing. They cannot reclaim the amount they have invested. They can sell the shares to others if they desire to unload their investment. Therefore, in the case of corporate bodies capital is paid out only at the time of winding up, provided surplus assets are available after paying off the creditors. In the case of companies the entity concept is more apparent, as in the eyes of law it has separate legal entity independent of the persons who contribute its capital.

The concept of accounting entity for every business determines the scope of what is to be recorded or what is to be excluded from the business books. Therefore, whenever business receives cash from the proprietors cash account is debited as business receives cash and capital account is credited, capital account representing the personal account of the proprietor. In the case of corporate bodies since there are too many contributors the amount is shown under a single account called share capital account.

In the case of non-corporate bodies there is no separate legal entity. Still the principle of business entity is observed for accounting purposes. For example, although for legal and most practical purposes, we regard the sole trader and his business as one and the same thing, we nevertheless, for accounting purposes, regard them as different entities. Therefore in business, only the business assets and liabilities are recorded although legally there is no distinction between his business assets and liabilities and his private assets and liabilities. Thus, the concepts of legal and business entities are not compatible with each other. This is also clear from the fact that in the case of big companies each department may be the base for accounting although legal entity is much larger and covers all the departments. Likewise, in the case of consolidated statements accounting entity is much larger than the legal entity.

Going Concern Concept:

This concept assumes the enterprise will continue to exist in the foreseeable future. This is in contrast with another view that the enterprise will be liquidated. According to A S -1 relating to disclosure of accounting policies, going concern concept is a fundamental accounting assumption underlying the preparation of financial statements. Under this assumption, "the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations."

This assumption implies the following:

(i) Assets will be valued on the basis of going concern assumption. In other words, accountants do not record the values of goods and assets which will be fetched if a sale is forced. Certain assets which are specific to the particular enterprise may have a very low market value. However, the value of such machines to the business is very great because of its productive potential and contribution to profits. In spite of this accountants prefer to record assets at historical cost rather than adopt 'value-in-use' approach which is favored by economists. This is because historical cost approach satisfies the test of objectivity and verifiability.

(ii) Assets are depreciated on the basis of expected life rather than on the basis of market value. This facilitates the allocation of the cost of the asset over the expected period of the life of the asset and dispenses with the periodic consideration of market values. This concept strengthens and supports the view that 'depreciation' is a process of allocation, not of valuation.

Thus, the 'going concern' concept is the basis to the valuation of assets and the provision of depreciation thereon.

Money Measurement Concept:

The money measurement concept underlines the fact that in accounting every worth recording event happening or transaction is recorded in terms of money. In other words, a fact or a happening which cannot be expressed in terms of money is not recorded in the accounting books. General health condition of the chairman of the company, working condition in which a worker has to work, sales policy pursued by the enterprise, quality of products introduced by the enterprise, etc., cannot

be expressed in money terms and therefore are not recorded in the books. In view of the above condition this concept puts a serious handicap on the usefulness of accounting records for management decisions. This concept has another serious limitation and is currently attracting the attention of the accountants all over the world. As per this concept, a transaction is recorded at its money value on the date of occurrence and the subsequent changes in the money value are conveniently ignored.

Cost Concept (Historic):

The underlying idea of cost concept is that

(i) asset is *recorded* at the price paid to acquire it, that is, at cost, and

(ii) this cost is the *basis for all subsequent accounting* for the asset.

When asset is recorded at cost price as said under point (i) above, the change in the real worth of an asset (for variety of reasons) with the passage of time is not ordinarily recorded in the account books. For example, if a piece of land has been purchased for Rs 80,000, then its market price (whether Rs 1,70,000 or Rs 50,000) at the time of preparation of final statements will not be considered. Thus the balance sheet on a particular date, prepared on the basis of cost concept, does not ordinarily indicate what the assets could sold for. As an explanation of the point (ii) of the cost concept, it can be said that the cost concept does not mean that assets are always shown year after year for an indefinite period at the cost price. The assets recorded at cost price at the time of purchase are systematically reduced by the process called depreciation. These assets ultimately disappear from the balance sheet when their economic life is over and they have been fully depreciated and sold as scrap. Therefore, in the books assets figure at cost less depreciation written off and are called book values to distinguish from their market values which represent their true worth. However, in the case of liquid assets like cash and bank deposits there is no difference between the book values and current market values. But in the case of other current assets like stocks and investments there may be some difference between the two values but the margin will not be as wide as it will be in the case of fixed assets. In spite of the limitations of cost concept referred to above, accountants prefer this approach to other for the following reasons:

1. There is too much of subjectivity in 'current worth' or 'market value' or 'realisable value' approach.
2. Fixed assets are purchased for use in production and are not held for sale.
3. It is very difficult and time consuming for an enterprise to ascertain the market values.
4. There is objectivity and verifiability in cost approach which is lacking in the other approaches.

Accounting Period Concept:

Strictly speaking, the net income can be measured by comparing the assets of the business existing at the time of its commencement with those existing at the time of its liquidation. Since life of business is assumed to be indefinite (going concern concept), the measurement of income, according to the above concept, is not possible for a very, very long period. The proprietor of the business cannot wait for such a long period as the determination of income at the end of the life of business would render such a measurement of income useless in as much as it will be too late to take corrective steps at the time, if it is disclosed that the business had all the time been running at a loss on account of certain reasons or business had not been using its fully capacity to make more profits. Thus, he needs to know at frequent intervals "how things are going". Therefore, accountants choose

some shorter and convenient time for the measurement of income. Twelve-month period is normally adopted for this purpose. Under the Companies Act and Banking Regulation Act accounts are to be prepared for a 12-month period. This time interval is called *accounting period*.

Dual Aspect Concept:

Financial accounting is transaction based. Of course, we are only concerned with transactions and events involving financial element. In every type of business there are numerous transactions. If one takes a typical trading concern the main activity is purchase of goods and their subsequent sale at a profit. This involves several transactions like purchase of goods from several suppliers, sales to several customers on cash and credit, payment to suppliers, collection from customers, payment of salaries to salesmen, purchase assistants, payment of rent and taxes, electricity bills, etc. In each of the transactions listed above there are two aspects to be recorded from the point of view of entity. For example, if there is purchase of goods – it involves two aspects – one aspect is the receipt of goods and the other aspect is the immediate payment of cash (in the case of cash purchase) or the acknowledgement of debt to the supplier (in the case of credit purchase). The recognition of two aspects to every transaction is known as dual aspect analysis. Modern financial accounting is based on such recognition of the record of the two aspects of every transaction. The term 'double entry book-keeping' has come into vogue because of every transaction two entries are made. One entry consists of debit to one or more accounts and another entry consists of credit to one or more accounts. However, the total amount debited always equals the total amount credited. This balancing of debits and credits is the cornerstone of modern book-keeping. How this accounting principle operates is illustrated with a few examples.

For example, when Manish, the proprietor of the business, starts his business with Cash Rs 40,000 and Building Rs 50,000 then this fact is recorded at two places – Assets account and Capital account. The capital of the business is equal to the assets of the business. This expression can be shown in the form of equation as under

$$\text{Capital} = \text{Assets}$$

$$\text{Manish} = \text{Building} + \text{Cash}$$

$$\text{Rs } 90,000 = \text{Rs } 50,000 + \text{Rs } 40,000$$

If the business increases the assets by borrowing Rs 20,000, then the dual aspect of the transaction affects the equation as under

$$\text{Capital} + \text{Liabilities} = \text{Assets}$$

$$\text{Manish} + \text{Loan} = \text{Building} + \text{Cash}$$

$$\text{Rs } 90,000 + \text{Rs } 20,000 = \text{Rs } 50,000 + \text{Rs } 60,000$$

Matching Concept

This concept recognizes that the determination of profit or loss on a particular accounting period is a problem of matching the expired cost allocated to an activity period. In other words, the expenses which are actually incurred during a specific activity period, in order to earn the revenue for the said period must be matched against the revenue which are realized for that period. For this purposes, expenses which are specially incurred for earning the revenue of the related period are to be considered. In short, all expenses incurred during the activity period must not be taken. Only relevant cost should be deducted from the revenue of a period for periodic income statement, i.e., the expenses that are related to the accounting period shall be considered for the purpose of matching. This process of relating costs to revenue is called matching process. It should be remembered that cost of fixed asset is not taken but only the depreciation on such fixed asset related

to the accounting period is taken (For the purpose of matching, prepaid expenses are excluded from the total cost but outstanding expenses are added to the total cost for ascertaining the cost related to the period) Like costs all revenues earned during the period are not taken, but revenue which are related to the accounting period are considered

Application of matching concept creates some problems which are noted below

(a) Some special items of expenses e.g. preliminary expenses, expenses in connection with the issue of shares and debentures, advertisement expenses etc., cannot be easily identified and match against revenues of a particular period

(b) Another problem is that how much of the capital expenditure should be written off by way of depreciation for a particular period for matching against revenue creates the problems of finding out the expected life of the asset. As such, accurate matching is not possible

(c) In case of long term contracts usually, amount is not received in proportion to the work done. As a result, expenditures which are carried forward and not related to the income received, may create some problems

Realisation Concept:

According to this concept, revenue is considered as earned on the date when it is realised. In other words, revenue realised (either by sale of goods or by rendering services) during an accounting period should only be taken in the income statement (Profit and Loss Account). Unearned/Unrealised revenue is treated as earned on some specific matters or transactions. For example, when goods are sold to customers, they are legally liable to pay, i.e. as soon as the property of goods passes from the seller to the buyer. In short, when an order is simply received from a customer, it does not mean that the revenue is earned or realised. On the other hand, when an advance payment is made by a customer, the same cannot be treated as revenue realised or earned. In case of hire-purchase transactions, however, the title or ownership of the goods is not transferred from the seller to the buyer till the last instalment is paid. As such, the down payments and the instalment received or due should be treated as actual sale, i.e., revenue earned.

Balance Sheet Equation Concept:

The Historical Cost Concept needs support of two other concepts for practical purposes viz

(i) the Money Measurement Concept (ii) the Balance Sheet Equation Concepts. Accounting processes, however, conform to an algebraic equation which, in other words is involved in two laws of nature, i.e., the law of constancy of matter and the law that every effect originates from a cause. In relation to the former, it may be deduced that all that has been received by us must be equal to (=) all that has been given to us (In accounts, receipts are classified as debits and giving or sacrifices are classified as credits). Here, the equation comes *Debit = Credit*

(That is, in other words, every debit must have a corresponding equal credit or viceversa)

All receipts (referred to above) may again be classified into (i) benefits/services received and totally consumed (which are known as expenses), (ii) benefits or services received but not used properly or misused (which are known as losses) and (iii) benefits or services received but kept to be used in future (which are known as assets). Similarly, in the opposite case, all that have been given by others may also be classified into (i) What has been given to us but are not to be repaid (which are known as incomes or gains) and (ii) What has been given by others but has to be repaid at a later

date (which are known as liabilities) Therefore, the above equation may again be re-written as under

$$\text{Expenses} + \text{Loss} + \text{Assets} = \text{Income} + \text{Gains} + \text{Liabilities}$$

$$\text{Or, Asset} = \text{Net Profit (-) Net Loss} + \text{Liabilities}$$

Liabilities become due either to outsider or to the owner, viz The proprietors. in the case

$$\text{Assets} = \text{Net Profit or (-) Net Loss} + \text{External liabilities} + \text{Dues to Proprietors}$$

We know that proprietors due increases with the amount of net profit whereas decreases with the amount of net loss. The same is known as equity in the business. So, the above equation comes down to

$$\text{Assets} = \text{Equity} + \text{External Liabilities}$$

Again, from the proprietor's point of view, the equation can also be re-written as under

$$\text{Proprietor's Fund or Equity} = \text{Asset} - \text{Liabilities}$$

$$E = A - L$$

From the above, it may be said that the entire accounting process depends on the above accounting equation

Verifiable and Objective Evidence Concept:

It expresses that accounting data are subject to verification by independent experts i.e. there must be documentary evidences of transactions which are capable of verification. Otherwise, the same will neither be verifiable nor be realisable or dependable. In other words, accounting data must free from any bias. Because, verifiability and objectivity imply reliability, trustworthiness, dependability which are very useful for conveying the accounting data and information furnished in periodical accounting reports and statements. There should always be some documentary evidences in establishing the truth reflected in the said reports or statements. Entries which are recorded in accounting from the transactions and data which are reported in financial statements must be based on objectively determined evidence. The confidence of users of the financial statement cannot be maintained until there is a close adherence to this principle, invoices and vouchers for purchases, sales and expenses, physical checking of stock in hand.

Accrual Concept:

An associated concept to be discussed in the context of 'matching principle' is the accrual system of accounting which is favoured by the modern accountants as against cash system of accounting. Under this method revenue recognition depends on its realisation and not actual receipt. Likewise costs are recognised when they are incurred and not when paid. This necessitates certain adjustments in the preparation of income statement. In relation to revenue, the accounts should exclude amounts relating to subsequent period and provide for revenue recognised but not received in cash. Likewise, in relation to cost provide for costs incurred but not paid and exclude costs paid for subsequent period. Under the cash system of accounting revenue recognition does not take place until cash is received and costs are recorded only after they are paid. From the discussion it is clear that the matching principle is not followed in the case of cash system of accounting and the operating result prepared on this basis are not in conformity with generally accepted accounting principles. There are hybrid systems of accounting which combine the features of cash and accrual systems and are also recognised by taxation authorities. Under hybrid system certain revenues may be shown on cash basis while others are shown on accrual basis.

ACCOUNTING CONVENTIONS

Convention of Disclosure:

The convention of disclosure implies that accounts must be honestly prepared and all material information must be disclosed therein. The notion is so important (because of divorce between ownership and management) that the Companies Act makes ample provisions for the disclosure of essential information in company accounts. The contents of balance sheet and profit and loss account are prescribed by law. These are designed to make disclosure of all material facts compulsory.

The term *disclosure* does not imply that all information that anyone could conceivably desire is to be included in accounting statements. The term only implies that there is to be a sufficient disclosure of information which is of material interest to proprietors, present and potential creditors and investors. The practice of appending notes relative to various facts or items which do not find place in accounting statements is in pursuance to the convention of full disclosure of material facts. Examples are

- (a) Contingent liabilities appearing as a note,
- (b) Market value of investments appearing as a note

Business is now increasingly managed by stewards (managers) and they owe a duty to make a full disclosure to the persons who have contributed the capital. Financial accounting, while reporting on stewardship, has to make full disclosure. 'Openness in company affairs is the best way to secure responsible behavior. Because of the wide recognition of this principle now there is an "Accounting Standard" which requires the disclosure of all significant accounting policies adopted in the preparation of financial statements, due to the effect of such policies on the financial statements. The accounting principle of 'Going Concern', 'Consistency and 'Accrual' are considered fundamental in the preparation of financial statements and need not be disclosed. Only when the assumption is not followed the fact should be disclosed. Apart from disclosure of accounting policies, A S - 1 deals with information to be disclosed in financial statements.

The concept of disclosure also applies to events occurring after the balance sheet date and the date on which the financial statements are authorized for issue. Such events include bad debts, destruction of plant and equipment due to natural calamities, major acquisition of another enterprise and the like. Such events are likely to have a substantial influence on the earnings and financial position of the enterprise. Their non-disclosure would affect the ability of the users of such statements to make proper evaluations and decisions.

Convention of Materiality:

The role of this convention cannot be over-emphasized in as much as accounting will be unnecessarily overburdened with more details in case an accountant is not able to make an objective distinction between material and immaterial matters. American Accounting Association (AAA) defines the term materiality as under

"An item should be regarded as material if there is reason to believe that knowledge of its would influence the decision of informed investor"

Kohler has defined materiality as under

"The characteristic attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person"

Some of the examples of material financial information to be disclosed are likely fall in the value of stocks, loss of markets due to competition or Government regulation, increase in wage bill under

recently concluded agreement, etc. It is now agreed that information known after the date of balance sheet must also be disclosed. Another example of materiality is the question of allocation of costs. An item of small value may last for three years and technically its cost must be allocated to every one of the three years. Since its value is small, it can be treated as the expense in the year of purchase. Such a decision is in accordance with the principle of materiality. Likewise, unimportant items can be either left out or merged with other items. Sometimes items are shown as footnotes or in parentheses according to their relative importance.

It should be noted that an item material for one concern may be immaterial for another. And similarly, an item material in one year may not be material in the next year. As per A S - 1, materiality should govern the selection and application of accounting policies. According to the consideration of materiality financial statement should disclose all items which are material enough to affect evaluations or decisions.

Convention of Consistency:

In order to enable the management to draw important conclusions regarding the working of a company over a number of years, it is but essential that accounting practices and methods remain unchanged from one accounting period to another. The comparison for one accounting period with that in the past is possible only when the convention of consistency is adhered to. But the idea of consistency does not imply non-flexibility as not to permit the introduction of improved techniques of accounting. According to A S - 1 consistency is a fundamental assumption and it is assumed that accounting policies are consistent from one period to another. Where this assumption is not followed, the fact should be disclosed together with reasons. The principle of consistency plays its role particularly when alternative accounting method is equally acceptable. For example, in applying the principle that fixed asset is depreciated over its useful life a company may adopt any of the several methods of depreciation, viz., written-down-value method, straight-line method, sinking fund method, annuity method, sum-of-years-digit method, unit-of-production method or any other method. But in keeping with the convention of consistency it is expected that the company would consistently follow the same method of depreciation which is chosen. Any change from one method to another would result in inconsistency. In the following cases, however, there is no inconsistency although apparently they make look inconsistent.

(a) The application of principle for stock valuation 'at cost or market price whichever is lower' will result in the valuation of stock sometimes at cost price and sometimes at market price. But there is no inconsistency here because the shift from the cost to market is only the application of the principle.

(b) Similarly, if investments are valued at cost or market price whichever is lower, it is only an application of the principle. Kohler has talked about three types of consistencies.

(a) *Vertical consistency*. This consistency is maintained within the interrelated financial statement of the same date. Vertical inconsistency will occur when an asset has been depreciated on one basis for income statement and on another basis for balance sheet.

(b) *Horizontal consistency*. This enables the comparison of performance of an organization in one year with its performance in the next year.

(c) *Third dimensional consistency*. This enables the comparison of the performance of one organisation with the performance of other organisation in the same industry.

Convention of Conservatism:

This is the policy of 'playing safe'. It takes into consideration all prospective losses but leaves all prospective profits. This accounting principle is given recognition in A S - 1 which recommends the observance of prudence in the framing of accounting policies. "Uncertainties inevitably surround many transactions. This should be recognised by exercising prudence in financial statements. Prudence does not, however, justify the creation of secret or hidden reserves". Following are the examples of the application of the convention of conservatism.

- (a) Making the provision for doubtful debts and discount on debtors in anticipation of actual bad debts and discount,
- (b) Valuing the stock in trade at market price or cost price whichever is less,
- (c) Creating provision against fluctuation in the price of investments,
- (d) Charging of small capital items, like crockery, to revenue,
- (e) Adopting written-down-value method of depreciation as against straight-line method. The written-down-value method of depreciation is more conservative in a approach.
- (f) Amortization of intangible assets like goodwill which has indefinite life,
- (g) Showing joint life policy at surrender value as against the amount paid,
- (h) Not providing for discount on creditors,
- (i) Taking into consideration claims intimated but not accepted as a loss for calculating profit for a general insurance company,
- (j) Considering the loss relating to premium on the redemption of debentures when they are issued at par or at discount but redeemable at premium, at the time of their issue.

The principle of conservatism is applied :

- (a) When there is an uncertainty inherent in the activity, e.g., uncertainty as to the useful life of an asset, occurrence of loss, realization of income, remaining utility of an asset, estimated liability
- (b) When there are two equally acceptable methods then the one which is more conservative will be accepted
- (c) When there is judgment based on estimates and doubt exists as to which of the several estimates is correct, the most conservative would be selected
- (d) When there is possibility of the occurrence of a loss or profit, losses will be considered and profits will be overlooked

This principle has effect on :

- (a) Income statement. Here the principle results in lower net income than would otherwise be the case.
- (b) Balance sheet. When applied to the balance sheet, the conservative approach results in understatement of assets and capital and overstatement of liabilities and provisions. The principle of conservatism, however, should be applied cautiously. If the principle is stretched without reservations it results in the creation of secret reserves which is in direct conflict with the doctrine of full disclosure. Since the main aim of published accounts is to convey and not to conceal the information, the policy of secrecy is being abandoned in favour of the modern and more logical policy of disclosure.

DOUBLE ENTRY SYSTEM:

It was in 1494 that Luca Pacioli the Italian mathematician, first published his comprehensive treatise on the principles of Double Entry System. The use of principles of double entry system made it

possible to record not only cash but also all sorts of Mercantile transactions. It had created a profound impact on auditing too, because it enhanced the duties of an auditor to a considerable extent.

Features of Double Entry System

- (i) Every transaction has two fold aspects, i.e., one party giving the benefit and the other receiving the benefit.
- (ii) Every transaction is divided into two aspects, Debit and Credit. One account is to be debited and the other account is to be credited.
- (iii) Every debit must have its corresponding and equal credit.

Advantages of Double Entry System

- (i) Since personal and impersonal accounts are maintained under the double entry system, both the effects of the transactions are recorded.
- (ii) It ensures arithmetical accuracy of the books of accounts, for every debit, there is a corresponding and equal credit. This is ascertained by preparing a trial balance periodically or at the end of the financial year.
- (iii) It prevents and minimizes frauds. Moreover, frauds can be detected early.
- (iv) Errors can be checked and rectified easily.
- (v) The balances of receivables and payables are determined easily, since the personal accounts are maintained.
- (vi) The businessman can compare the financial position of the current year with that of the past year/s.
- (vii) The businessman can justify the standing of his business in comparison with the previous years' purchase, sales, stocks, incomes and expenses with that of the current year figures.
- (viii) Helps in decision making.
- (ix) The net operating results can be calculated by preparing the Trading and Profit and Loss A/C for the year ended and the financial position can be ascertained by the preparation of the Balance Sheet.
- (x) It becomes easy for the Government to decide the tax.
- (xi) It helps the Government to decide sickness of business units and extend help accordingly.
- (xii) The other stakeholders like suppliers, banks, etc. take a proper decision regarding grant of credit or loans.

Limitations of Double Entry System

- (i) The system does not disclose all the errors committed in the books of accounts.
- (ii) The trial balance prepared under this system does not disclose certain types of errors.
- (iii) It is costly as it involves maintenance of numbers of books of accounts.

Account

An account denotes a summarized record of transactions pertaining to one person, one kind of asset, or one class of income, expense or loss. It can also be explained as "TO COUNT".
→ the financial value of each event, which are termed as Transactions.

Classification of Accounts

Accounts are usually subdivided into the following classes

1 **Personal Accounts** : These accounts deal with transactions relating to persons or an organization. It can be classified as

(a) Natural Persons M. S. Sharma, Triveni & Sons, etc

(b) Artificial Persons State Bank of India, ITC Ltd, CC & FC, Royal Calcutta Golf Club, etc

(c) Representative Persons Outstanding Expenses (representing liability for expenses to supplies), Prepaid Salary (representing employees) etc

2 **Impersonal Accounts** : These accounts do not relate to any persons and are known as impersonal accounts

(a) Real Accounts It is an account relating to assets and properties

Eg Land, Building, Plant, Machinery, Cash, Bank, Stock, etc

(b) Nominal Accounts It is an account relating to expenses, losses, incomes and gains. They do not have any physical existence except names

Eg Sales, Purchases, Salary, Wages, Rent, Interest, Repairs, Travelling, etc

Debit and Credit

Debit is derived from the Latin word "debitum", which means 'what we will receive'. It is the destination, who enjoys the benefit.

Credit is derived from the Latin word "credere" which means 'what we will have to pay'. It is the source, who sacrifices for the benefit.

DOUBLE ENTRY

Assets + Expenses = Liabilities + Incomes

GOLDEN RULES

Traditional Version	Debit	Credit
Personal A/c	Receiver	Giver
Real A/c	What comes in	What goes out
Nominal A/c	Expenses and losses	Income and Gains

Modern Version : Any change in any variable of the equation must have another change in another variable either in the opposite direction in the same side, or in the same direction in the opposite side.

Events : Any or all activities which we are doing in our day-to-day life.

Example Reading, Sleeping, Eating, Thinking, Singing, Gossiping, Buying, Selling, Playing and etc.

Transactions : An event which has the following characteristics

(i) Which changes the financial position of a person

(ii) Which can be measured in terms of money

(iii) Which can be recorded in the Books of Accounts

Example Purchase, Sales, Travelling Expenses, Rent, Wages, Salaries, and etc. It is therefore concluded that "**All transactions are events but all events are not transactions**".

Classification of Transaction:

CASH & NON-CASH & CREDIT OTHERS

Cash Transactions : Those transactions which involve inflow ' outflow of cash

Example (i) Purchased goods for cash Rs 100

(ii) Paid Expenses Rs 20

(iii) Sold goods for cash Rs 300 and etc

Non-cash Transaction : Those transaction which is not involved with immediate inflow or outflow of cash. They are again sub-divided into

Credit Transactions : Those transactions which involve increase in assets & liabilities

Example (i) Goods sold to Mr Sen on credit

— increase in asset

(ii) Purchased goods from Sunny on credit

— increase in liability

Other Non - Cash Transactions : Those which involves losses and does not result in immediate outflow of cash

Example (i) Depreciation of Fixed assets

(ii) Bad Debts and etc

FINAL ACCOUNTS:

The transactions of a business enterprise for the accounting period are first recorded in the books of original entry, then posted there from into the ledger and lastly tested as to their arithmetical accuracy with the help of trial balance. After the preparation of the trial balance, every businessman is interested in knowing about two more facts. They are (i) Whether he

has earned a profit or suffered a loss during the period covered by the trial balance, and (ii) Where does he stand now? In other words, what is his financial position? For the above said purposes, the businessman prepares financial statements for his business i.e. he prepares the Trading and Profit and Loss Account and Balance Sheet at the end of the accounting period. These financial statements are popularly known as final accounts. The preparation

of financial statements depends upon whether the business concern is a trading concern or manufacturing concern. If the business concern is a trading concern, it has to prepare the following accounts along with the Balance Sheet

(i) Trading Account, and

(ii) Profit and Loss Account

But, if the business concern is a manufacturing concern, it has to prepare the following accounts along with the Balance Sheet

(i) Manufacturing Account,

(ii) Trading Account, and

(iii) Profit and Loss Account

Basically, two types of statements are prepared namely "Income Statement" and "Position Statement". The Income Statement is generally known as Profit and Loss Account. This Profit and Loss Account is further sub-divided either into three parts or two parts according to the nature of the business. As stated above, if the concern is a manufacturing one, the Profit and Loss Account is divided into three sub-sections viz, Manufacturing Account, Trading Account and Profit and Loss Account. On the other hand, if it is a trading concern, then this account is divided into two sub-sections, namely Trading Account and Profit and Loss Account. The second statement i.e. the "Position Statement" which is popularly known as the "Balance Sheet" is prepared by every type of business concern.

The Balance Sheet is a statement which shows the position of the assets, liabilities and capital in money terms, of an accounting entity as on a given date. A Balance Sheet is a formal representation of the accounting equation indicating that the assets are always equal, in value, to the liabilities plus capital. Trading Account is prepared to know the Gross Profit or Gross Loss.

Profit and Loss Account discloses net profit or net loss of the business. Balance sheet shows the financial position of the business on a given date. For preparing final accounts, certain accounts representing incomes or expenses are closed either by transferring to Trading Account or Profit and Loss Account. Any Account which cannot find a place in any of these two accounts goes to the Balance Sheet.

TRADING ACCOUNT:

After the preparation of trial balance, the next step is to prepare Trading Account. Trading Account is one of the financial statements which shows the result of buying and selling of goods and/or services during an accounting period. The main objective of preparing the Trading Account is to ascertain gross profit or gross loss during the accounting period. Gross Profit is said to have been made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of goods sold, gross loss is incurred. For the purpose of calculating cost of goods sold, we have to take into consideration opening stock, purchases, direct expenses on purchasing or manufacturing the goods and closing stock. The balance of this account i.e. gross profit or gross loss is transferred to the Profit and Loss Account.

Format of Trading Account

A Trading Account is prepared in "T" form just like every other account. Though it is an account, yet it is not exactly an ordinary ledger account. It is one of the accounts which are prepared only once in an accounting period to ascertain the gross profit or gross loss of the business. As it is prepared once in a year, columns for date and journal folio are not provided. While preparing a Trading Account, an important point that must be kept in mind is that a closing journal entry is to be recorded in the journal proper. At the end of every accounting period, items of revenue and direct expenses are closed by transferring their respective balances to the Trading Account. The format of a Trading Account and the usually appearing entries therein are shown below.

TRADING ACCOUNT

For the year ended 31st March, 2006

Particulars	Amount Rs.	Particulars	Amount Rs.
To Opening Stock		By Sales	
To Purchases		Less Sales Returns	
Less Purchases Returns		By Closing Stock	
To Direct Expenses		By Gross Loss	
Carriage Inward		transferred to	
Freight and Insurance		P & L A/c	
Wages			
Fuel, Power and Lighting			
expenses			
Manufacturing Expenses			
Coal, Water and Gas			
Motive Power			
Octroi			
Import Duty			
Custom Duty			
Consumable Stores			
Royalty on manufactured			
Goods			
Packing charges			
To Gross Profit transferred			
to P & L A/c			

Balancing of Trading Account

After recording the relevant items of various accounts in the respective sides of the Trading Account, the balance is calculated to ascertain Gross Profit or Gross Loss. If the total of the credit side is more than that of the debit side, the excess represents Gross Profit. Conversely, if the total the debit side is more than that of the credit side, the excess represents Gross Loss. Gross Profit is transferred to the credit side of the Profit and Loss Account and Gross loss to the debit side of the Profit and Loss Account.

Closing Entries for Trading Account

The journal entries necessary to transfer opening stock, purchases, sales and returns to the Trading Account are called closing entries, as they serve to close these accounts. These are as follows:

- For transfer of opening stock, purchases and direct expenses to Trading A/c
 Trading A/c Dr
 To Stock (Opening) A/c
 To Purchases A/c
 To Direct Expenses A/c

(Being opening stock, purchases and direct expenses transferred to Trading Account)

2 For transfer of sales and closing stock to Trading A/c

Sales A/c Dr

Stock (Closing) A/c Dr

To Trading A/c

(Being sales, closing stock transferred to Trading Account)

3 (a) For Gross Profit

Trading A/c Dr

To Profit & Loss A/c

(Being gross profit transferred to Profit and Loss Account)

(b) For Gross Loss

Profit & Loss A/c Dr

To Trading A/c

(Being gross loss transferred to Profit and Loss Account)

IMPORTANT POINTS REGARDING TRADING ACCOUNT

1 Stock:

The term 'stock' includes goods lying unsold on a particular date

The stock may be of two types

(a) Opening stock (b) Closing stock

Opening stock refers to the closing stock of unsold goods at the end of previous accounting period which has been brought forward in the current accounting period. This is shown on the debit side of the Trading Account.

Closing stock refers to the stock of unsold goods at the end of the current accounting period. Closing stock is valued either at cost price or at market price whichever is less. Such valuation of stock is based on the principle of conservatism which lays down that the expected profit should not be taken into account but all possible losses should be duly provided for. Closing stock is an item which is not generally available in the trial balance. If it is given in Trial Balance, it is not to be shown on the credit side of Trading Account but appears only in the Balance Sheet as an asset. But if it is given outside the trial balance, it is to be shown on the credit side of the Trading Account as well as on the asset side of the Balance Sheet.

2 Purchases

Purchases refer to those goods which have been bought for resale. It includes both cash and credit purchases of goods. The following items are shown by way of deduction from the amount of purchases.

(a) Purchases Returns or Return Outwards

(b) Goods withdrawn by proprietor for his personal use

(c) Goods received on consignment basis or on approval basis or on hire purchase

(d) Goods distributed by way of free samples

(e) Goods given as charity

3 Direct Expenses:

Direct expenses are those expenses which are directly attributable to the purchase of goods or to bring the goods in saleable condition. Some example of direct expenses are as under

(a) Carriage Inward

Carriage paid for bringing the goods to the godown is treated as carriage inward and it is debited to Trading Account

(b) Freight and insurance

Freight and insurance paid for acquiring goods or making them saleable is debited to Trading Account. If it is paid for the sale of goods, then it is to be charged (debited) to Profit and Loss Account

(c) Wages:

Wages incurred in a business are direct expenses, when they are incurred on manufacturing or merchandise or on making it saleable. Other wages are indirect wages. Only direct wages are debited to the Trading Account. Other wages are debited to the Profit and Loss Account. If it is not mentioned whether wages are direct or indirect, it should be assumed as direct and should appear in the Trading Account

(d) Fuel, Power and Lighting Expenses:

Fuel and power expenses are incurred for running the machines. Being directly related to production, these are considered as direct expenses and debited to Trading Account. Lighting expenses of factory are also charged to Trading Account, but lighting expenses of administrative office or sales office are charged to Profit and Loss Account

(e) Octroi:

When goods are purchased within municipality limits, generally octroi duty has to be paid on it. It is debited to Trading Account

(f) Packing Charges

There are certain types of goods which cannot be sold without a container or proper packing. These form a part of the finished product. One example is ink, which cannot be sold without a bottle. These type of packing charges are debited to Trading Account. But if the goods are packed for their safe dispatch to customers, i.e. packing meant for transportation or fancy packing meant for advertisement, will appear in the Profit and Loss Account

(g) Manufacturing Expenses

All expenses incurred in manufacturing the goods in the factory such as factory rent, factory insurance etc. are debited to Trading Account

(h) Royalties

These are the payments made to a patentee, author or landlord for the right to use his patent, copyright or land. If royalty is paid on the basis of production, it is debited to Trading Account and if it is paid on the basis of sales, it is debited to Profit and Loss Account

4 Sales:

Sales include both cash and credit sales of those goods which were purchased for resale purposes. Some customers might return the goods sold to them (called sales return) which are deducted from the sales in the inner column and net amount is shown in the outer column. While ascertaining the amount of sales, the following points need attention

- (a) If a fixed asset such as furniture, machinery etc. is sold, it should not be included in sales
- (b) Goods sold on consignment or on hire purchase or on sale or return basis should be recorded separately
- (c) If goods have been sold but not yet despatched, these should not be shown under sales but are to be included in closing stock

(d) Sales of goods on behalf of others and forward sales should also be excluded from sales

Illustration 1: From the following information, prepare the Trading Account for the year ending on 31 March 2002

Opening Stock Rs 1,50,000, Cash Sales Rs 60,000, Credit Sales Rs 12,00,000, Returns Outwards Rs 10,000, Wages Rs 4,000, Carriage Inward Rs 1,000, Freight Inward Rs 3,000, Octroi Rs 2,000, Cash Purchases Rs 50,000, Credit Purchases Rs 10,00,000, Returns Inward Rs 20,000, Closing Stock as on 31 3 2002 Rs 84,000

Solution :

Trading Account

Dr	for the year ending on 31 March, 2002		Cr
Particulars	Rs	Particulars	Rs
To Opening Stock	1 50,000	By Sales	
To Purchases		Cash Sales 60 000	
Cash Purchases 50,000		Credit Sales 12 00,000	
Credit Purchases 10,00,000		Total Sales 12 60 000	
Total Purchase 10,50,000		Less Return	
Less Return		Inward 20,000	12,40 000
Outwards 10 000	10 40,000	By Closing Stock	84 000
To Freight Inwards	3,000		
To Octroi	2,000		
To Carriage Inwards	1 000		
To Wages	4,000		
To Gross Profit tfd to P&L A/c	1,24,000		
	13,24 000		13,24 000

MANUFACTURING ACCOUNT

Manufacturing Account is prepared by an enterprise engaged in manufacturing activities. It is prepared to ascertain the cost of goods manufactured during an accounting period. This account is closed by transferring its balance to the debit of the Trading Account. A general format of a Manufacturing Account is shown below.

Dr. Manufacturing Account of for the period ending on.....

Cr

Particulars	Rs.	Particulars	Rs
To Opening Work-in-progress		By Sale of Scrap	
To Raw material consumed		By Closing Work-in-progress	
Opening Stock		By Trading Account	
<i>Add</i> Purchases		(Cost of goods produced transferred)	
<i>Add</i> Cartage Inwards			
<i>Add</i> Freight Inwards			
<i>Less</i> . Return Outwards			
<i>Less</i> . Closing Stock			
To Wages			
To Salary of Works Manager			
To Power, Electricity & Water			
To Fuel			
To Postage & Telephone			
To Depreciation on			
Plant & Machinery			
Factory Land & Buildings			
To Repairs to			
Plant & Machinery			
Factory Land & Building			
To Insurance			
Plant & Machinery			
Factory Land & Building			
To Rent and Taxes			
To General Expenses			
To Royalty based on production			

**DIFFERENCE BETWEEN TRADING ACCOUNT AND
MANUFACTURING ACCOUNT**

Trading Account	Manufacturing Account
1 Trading Account is prepared to find out the Gross Profit Gross Loss	Manufacturing account is prepared to find out the cost of goods produced
2 The balance of the Trading account is transferred to the Profit and Loss Account	The balance of the Manufacturing Account is transferred to the Trading Account
3 Sale of scrap is not shown in the Trading Account	Sale of scrap is shown in the Manufacturing Account
4 Stocks of finished goods are shown in the Trading Account	Stocks of raw materials and work-in-progress are shown in the Manufacturing Account
5 Trading Account is a part of the Profit and Loss Account	Manufacturing Account is a part of the Trading Account

Illustration 2 : From the following information, prepare a Manufacturing Account for the year ending on 31 March 2002 .

	Rs.		Rs
Work-in-progress (1.4.2001)	4,000	Wages	20,000
Raw Material (31.3.2002)	90,000	Salary of Works Manager	8,000
Carriage Inwards	3,000	Power, Electricity & Water	6,000
Freight Inwards	2,000	Fuel	4,000
Return Outwards	2,700	Depreciation .	
Sales of Scrap	1,000	Plant & Machinery	8,000
Work-in-progress (31.3.2002)	5,000	Factory Building	4,000
Raw Materials (1.4.2001)	74,000	Repairs & Insurance .	
Raw Material Purchased	45,000	Plant & Machinery	6,000
General Expenses	2,000	Factory Building	2,000
		Factory Rent & Taxes	10,000

Solution :

Manufacturing Account			
for the year ending on 31 March 2002			
Dr			Cr
Particulars	Rs	Particulars	Rs
To Opening WIP	4 000	By Sale of Scrap	1 000
To Raw Materials consumed		By Closing WIP	5 000
Opening Stock	74 000	By Trading Acc (Cost of goods	
Add Purchases	45 000	manufactured transferred)	99 800
Add Carriage Inwards	3 000		
Add Freight Inwards	2 000		
Less Returns Outwards	2 200		
Less Closing Stock	90 000		
	31 800		
To Wages	20 000		
To Salary of Works Managers	8 000		
To Power Electricity & Water	6 000		
To Fuel	4,000		
To Depreciation			
Plant & Machinery	8 000		
Factory Building	4,000		
To Repairs & Insurance			
Plant & Machinery	6 000		
Factory Building	2 000		
To Factory Rent & Taxes	10 000		
To General Expenses	2,000		
	1,05 800		
			1,05,800

PROFIT AND LOSS ACCOUNT

Trading Account results in the gross profit/loss made by a businessman on purchasing and selling of goods. It does not take into consideration the other operating expenses incurred by him during the course of running the business. Besides this, a businessman may have other sources of income. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or net loss suffered by a business during a particular period. All the indirect revenue expenses and losses are shown on the debit side of the Profit and Loss Account, whereas all indirect revenue incomes are shown on the credit side of the Profit and Loss Account. Profit and Loss Account measures net income by matching revenues and expenses according to the accounting principles. Net income is the difference between total revenues and total expenses. In this connection, we must remember that all the expenses, for the period are to be debited to this account - whether paid or not. If it is paid in advance or outstanding, proper adjustments are to be made (Discussed later). Likewise all revenues, whether received or not are to be credited. Revenue if received in advance or accrued but not received, proper adjustment is required. A proforma of the Profit and Loss Account showing probable items there in is as follows

PROFIT AND LOSS ACCOUNT

For the year ended

Particulars	Rs	Particulars	Rs
To Gross Loss b/d		By Gross Profit b/d	
To <i>Management Expenses</i>		By <i>Other Income</i>	
Rent, Rates and Taxes		Discount received	
Heating and Lighting		Commission received	
Office Salaries		By <i>Non-trading Interest</i>	
Printing & Stationary		Bank Interest	
Postage & Telegrams		Rent of property let-out	
Telephone Charges		Dividend from shares	
Legal Charges		By <i>Abnormal Gains</i>	
Audit Fees		Profit on sale of machinery	
Insurance		Profit on sale of investment	
General Expenses		By Net Loss transferred to	
To <i>Selling and Distribution</i>		Capital Account	
<i>Expenses</i>			
Advertisement			
Travellers' Salaries			
Expenses & Commission			
Godown Rent			
Export Expenses			
Carriage Outwards			
Bank Charges			
Agent's Commission			
Upkeep of Motor Lorries			
To <i>Depreciation and</i>			
<i>Maintenance</i>			
Depreciation			
Repairs & Maintenance			
To <i>Financial Expenses</i>			
Discount Allowed			
Interest on Loans			
Discount on Bills			
To <i>Abnormal Losses</i>			
Loss by fire (not			
covered by Insurance)			
Loss on Sale of Fixed			
Assets			
Loss on Sale of Investments			
To Net profit transferred to			
Capital A/c			

Important Points in Profit and Loss Account:

(i) **Salaries** These include salaries paid to office, godowns and warehouse staff and should be shown in Profit and Loss Account being indirect expenses. Salaries to partners must be debited separately. If salaries are paid after deduction of Income tax or Provident Fund then these should be added back to the salaries in order to have gross figure of salaries to be shown in Profit and Loss Account. If salaries are paid in kind by providing certain facilities to the employees such as house free of rent, meals or cloth or washing facility free of charge, then the value of such facilities should be regarded as salaries.

(ii) **Rent, Rates and Taxes** These include offices and warehouse rent, municipal rates and taxes. Factory rent, rates and taxes should be debited to Trading Account and others to Profit and Loss Account. If any rent is received on subletting of the building, the same should be shown separately on the credit side of the Profit and Loss Account. If rent is paid after deduction of some taxes then these should be added back to know the correct amount of rent payable.

(iii) **Interest** Interest paid on loans, overdrafts and bills overdue is an expense and is taken to the debit side of Profit and Loss Account. Interest received on loans advanced by the firm, on deposits and on securities is a gain and is shown on the credit side of Profit and Loss Account. Interest on capital should be shown separately on the debit side and interest on drawing on the credit side of Profit and Loss Account.

(iv) **Commission** Commission received for doing the work of other firms may be credited to Profit and Loss Account as a gain and commission payable to the agents employed to sell the firm's goods is debited to Profit and Loss Account as an expense.

(v) **Repairs** Repairs and small renewals or replacements relating to the plant and machinery, fixtures, fittings and utensils etc. are generally included under this heading and such expenditure, being an expense, is debited to Profit and Loss Account.

(vi) **Depreciation** It is an expense due to wear and tear, lapse of time and exhaustion of assets used in business. This is a loss sustained by fixed assets and should be charged to Profit and Loss Account.

(vii) **Advertising** All sums spent on advertising should be charged to Profit and Loss Account. If a large amount is paid under a contract covering two or three years, proportionate part should be charged to Profit and Loss Account and the balance appears as an asset in the Balance Sheet.

Expenses not to be shown in Profit and Loss Account

(i) **Domestic and Household Expenses** These expenses are not shown in Profit and Loss Account, as these are personal expenses of the proprietor and should be treated as drawings.

(ii) **Income tax** It should be treated as a personal expense of the proprietor and added to drawing. It should not be shown as an expense in Profit and Loss Account.

(iii) **Life Insurance Premium** Premium paid on the life policy of the proprietor should be charged to the Drawings Account.

Closing Entries for Profit and Loss Account

(i) For transfer of various expenses to Profit & Loss A/c

Profit and Loss A/c Dr

To Various Expenses A/c

(Being various indirect expenses transferred to Profit and Loss Account)

(ii) For transfer of various incomes and gains to Profit & Loss A/c

Various Incomes & Gains A/c Dr

To Profit & Loss A/c
 (Being various incomes & gains transferred to Profit and Loss Account)

(iii)(a) For Net Profit
 Profit & Loss A/c Dr

To Capital A/c
 (Being Net Profit transferred to capital)

(b) For Net Loss

Capital A/c Dr

To Profit & Loss A/c

(Being Net Loss transferred to Capital Account)

DISTINCTION BETWEEN TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

Trading Account	Profit and Loss Account
1 Trading Account is prepared as a part or section of the Profit and Loss Account	Profit and Loss Account is prepared as a main account
2 Direct Expenses are taken in Trading Account.	Indirect expenses are taken in Profit and Loss Account
3 Gross Profit or Gross Loss is ascertained from Trading Account	Net Profit or Net Loss is ascertained from the Profit and Loss Account
4 The Balance of the Trading Account i.e. Gross Profit or Gross Loss is transferred to the Profit and Loss Account	The balance of the Profit and Loss Account i.e. Net Profit or Net Loss is transferred to proprietor's Capital Account
5 Items of account written in the Trading Account are few as compared the Profit and Loss Account	Items of accounts written in the Profit and Loss Account are much more as compared to the Trading Account

BALANCE SHEET

A Balance Sheet is a statement of financial position of a business concern at a given date. It is called a Balance Sheet because it is a sheet of balances of those ledger accounts which have not been closed till the preparation of Trading and Profit and Loss Account. After the preparation of Trading and Profit and Loss Account the balances left in the trial balance represent either personal or real accounts. In other words, they either represent assets or liabilities existing on a particular date.

Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company

A Balance Sheet is also described as a "Statement showing the Sources and Applications of Capital" It is a statement and not an account and prepared from real and personal accounts The left hand side of the Balance Sheet may be viewed as description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date

Characteristics

The characteristics of a Balance Sheet are summarized as under

(a) A Balance Sheet is only a statement and not an account It has no debit side or credit side The headings of the two sides are 'Assets' and 'Liabilities'

(b) A Balance Sheet is prepared at a particular point of time and not for a particular period The information contained in the Balance Sheet is true only at that particular point of time at which it is prepared

(c) A Balance Sheet is a summary of balances of those ledger accounts which have not been closed by transfer to Trading and Profit and Loss Account

(d) A Balance Sheet shows the nature and value of assets and the nature and the amount of liabilities at a given date

Classification of Assets and Liabilities:

Assets

Assets are the properties possessed by a business and the amount due to it from others The various types of assets are

(a) Fixed Assets

All assets which are acquired for the purpose of using them in the conduct of business operations and not for reselling to earn profit are called fixed assets These assets are not readily convertible into cash in the normal course of business operations Examples are land and building, furniture, machinery, etc

(b) Current Assets

All assets which are acquired for reselling during the course of business are to be treated as current assets Examples are cash and bank balances, inventory, accounts receivables, etc

(c) Tangible Assets

These are definite assets which can be seen, touched and have volume such as machinery, cash, stock, etc

(d) Intangible Assets

Those assets which cannot be seen, touched and have no volume but have value are called intangible assets Goodwill, patents and trade marks are examples of such assets

(e) Fictitious Assets

Fictitious assets are not assets at all since they are not represented by any tangible possession They appear on the asset side simply because of a debit balance in a particular account not yet written off e.g provision for discount on creditors, discount on issue of shares etc

(f) Wasting Assets

Such assets as mines, quarries etc that become exhausted or reduce in value by their working are called wasting assets

Liabilities

A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of a business. The liabilities of a business concern may be classified as

(a) Fixed Liabilities

These are those liabilities which are payable only on the termination of the business such as capital contributed by the owner.

(b) Long Term Liabilities

The liabilities or obligations of a business which are not payable within the next accounting period but will be payable within next five to ten years are known as long term liabilities. Public deposits, debentures, bank loan are the examples of long term liabilities.

(c) Current Liabilities

All short term obligations generally due and payable within one year are current liabilities. This includes trade creditors, bills payable etc.

(d) Contingent Liabilities

A contingent liability is one which is not an actual liability but which may become an actual one on the happening of some event which is uncertain.

Thus such liabilities have two characteristics: (a) uncertainty as to whether the amount will be payable at all, and (b) uncertainty about the amount involved.

Examples of such liabilities are

- (a) Claims against the companies not acknowledged as debts
- (b) Uncalled liability on partly paid up shares
- (c) Arrears of fixed cumulative dividend
- (d) Estimated amount of contracts remaining to be executed on capital account and not provided for
- (e) Liability of a case pending in the court
- (f) Bills of exchange, guarantees given against a particular firm or person

Grouping and Marshalling of Assets and Liabilities:

The arrangement of assets and liabilities in certain groups and in a particular order is called Grouping and Marshalling of the Balance Sheet of a business. Assets and liabilities can be arranged in the Balance Sheet into two ways

(i) In order of liquidity

(ii) In order of permanence

(i) *In order of liquidity*: When assets and liabilities are arranged according to their reliability and payment preferences, such an order is called liquidity order. Such arrangement is given in the Balance Sheet (I)

Balance Sheet (I)

Liabilities	Rs	Assets	Rs
<i>Current Liabilities</i>		<i>Liquid Assets</i>	
Bills Payable		Cash in Hand	
Sundry Creditors		Cash at Bank	
Bank Overdraft		<i>Floating Assets</i>	
<i>Long Term Liabilities</i>		Sundry Debtors	
Loan from Bank		Investments	
Debentures		Bill Receivable	
<i>Fixed Liabilities</i>		Stock in Trade	
Capital		Prepaid Expenses	
		<i>Fixed Assets</i>	
		Machinery	
		Building	
		Furniture & Fixtures	
		Motor Car	
		<i>Fictitious Assets</i>	
		Advertisement	
		Misc Expenses	
		Profit & Loss A/c	
		<i>Intangible Assets</i>	
		Goodwill	
		Patents	
		Copyright	

(ii) *In order of permanence* When the order is reversed from that what is followed in case of liquidity, it is called order of permanence. This order is followed in case of joint stock companies compulsorily but can be followed in other forms of business organisations also. Fixed assets and liabilities are shown first on the assumption that these will be sold or paid only on the insolvency of a business. This order of Balance Sheet is given below in Balance Sheet (II)

Balance Sheet (II)

<i>Liabilities</i>	Rs	<i>Assets</i>	Rs
Fixed Liabilities		Intangible Assets	
Long Term Liabilities		Fictitious Assets	
Current Liabilities		Fixed Assets	
		Floating Assets	
		Liquid Assets	

Illustration 3: The following balances are extracted from the books of Nikhil & Co on 31st March, 2002. You are required to make the necessary closing entries and to prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date.

	Rs.		Rs
Opening Stock	500	Commission (Cr)	200
B/R	2,250	Returns Outwards	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inwards	400	Rent & Taxes	550
Commission (Dr)	400	Carriage Outwards	725
Interest on Capital	350	Sales	25,000
Stationary	225	Bills Payable	1,500
Returns Inwards	650	Creditors	9,825
		Capital	8,950

The Closing Stock was valued at Rs 12,500

Solution :

Closing Entries

Date	Particulars	Dr	Cr
		Amount	Amount
		Rs	Rs.
2002 March 31	Trading Account Dr.	22,450	
	To Stock A/c		500
	To Purchases A/c		19,500
	To Wages A/c		1,400
	To Returns Inwards A/c		650
	To Carriage Inwards A/c		400
	(Being balance transferred)		
"	Sales A/c Dr.	25,000	
	Returns Outwards A/c Dr.	250	
	To Trading Account		25,250
	(Being balances transferred)		
	Closing Stock A/c Dr.	12,500	
	To Trading A/c		12,500
	(Being value of closing stock)		
"	Trading Account Dr.	15,300	
	To Profit and Loss A/c		15,300
	(Being gross profit transferred)		
"	Profit and Loss Account Dr.	2,900	
	To Insurance A/c		550
	To Commission A/c		400
	To Interest on Capital A/c		350
	To Stationary A/c		225
	To Trade Expenses A/c		100
	To Rent and Taxes A/c		550
	To Carriage Outwards A/c		725
	(Being balances transferred)		
"	Commission A/c Dr.	200	
	To Profit & Loss A/c		200
	(Being balance transferred)		
"	Profit and Loss A/c Dr.	12,600	
	To Capital A/c		12,600
	(Being net profit transferred)		

Trading & Profit and Loss A/c of Messers Nikhil & Co
for the year ended 31st March, 2002

Particulars	Rs.	Particulars	Rs
To Opening Stock	500	By Sales	25,000
To Purchases	19,500	Less: Returns Inwards	650
Less: Returns Outwards	250	By Closing Stock	12,500
To Wages	1,400		
To Carriage Inwards	400		
To Gross Profit c/d	15,300		
	36,850		36,850
To Insurance	550	By Gross Profit b/d	15,300
To Commission	400	By Commission	200
To Interest on Capital	350		
To Stationary	225		
To Trade Expenses	100		
To Rent and Taxes	550		
To Carriage Outwards	725		
To Net Profit transferred to Capital A/c	12,600		
	15,500		15,500

Balance Sheet of Messers Nikhil & Co.
as on 31st March, 2002

Liabilities	Rs.	Assets	Rs
Creditors	9,825	Cash in Hand	250
Bills Payable	1,500	Cash at Bank	2,375
Capital		Bill Receivable	2,250
March 31, 2002	8,950	Stock	12,500
Add: Net Profit	12,600	Sundry Debtors	15,000
	21,550	Office Fixtures	500
	32,875		32,875

ADJUSTMENT ENTRIES:

While preparing Trading and Profit and Loss Account one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken into consideration. For example if an expense has been incurred but not paid during that period, liability for the unpaid amount should be created before the accounts can be said to show the profit or loss. All expenses and incomes should properly be adjusted through entries. These entries which are passed at the end of the accounting period are called adjusting entries. Some important adjustments which are to be made at the end of the accounting year are discussed in the following pages.

1 Closing Stock

This is the stock which remained unsold at the end of the accounting period. Unless it is considered while preparing the Trading Account, the gross profit shall not be correct. Adjusting entry for closing stock is as under:

Closing Stock Account Dr

To Trading Account

(Being closing stock brought in to books)

Treatment in final accounts

(i) Closing stock is shown on the credit side of Trading Account.

(ii) At same value it will be shown as an asset in the Balance Sheet.

2 Outstanding Expenses

Expenses which have become due and have not been paid by the end of financial year, are called outstanding expenses.

For example, when Profit and Loss Account is being prepared on 31st March 31, 2002, it may be found that salaries for the month of March have become due on March 31, 2002 but have not been paid till that date. This must be shown on the debit side of Profit and Loss Account being prepared on March 31, 2002. The entry will be as under:

Salary account Dr

To Outstanding salary account

(Being salary due but not paid)

Treatment in final accounts

(i) The amount of outstanding salary shall be added to particular expenses on the debit side of Profit and Loss Account.

(ii) In balance sheet the same amount will be shown as a liability.

3. Unexpired or Prepaid Expenses

Those expenses which have been paid in advance, i.e., whose benefit will be available in future are called unexpired or prepaid expenses. For example, if a fire insurance policy is taken for a year paying Rs. 1,000 as insurance premium on 1st July, 2000 and will expire on 30th June, 2001, the position on 31st March 2001, when accounts are closed, will be that Rs. 750, i.e., premium from 1st July, 2000 to 31st March, 2001 will be an expense but Rs. 250 i.e., premium from 1st April, 2001 to 30th June, 2001 will be unexpired expense. In order to bring this into account on 31st March, 2001, the following entry will be passed:

Prepaid Insurance Premium A/c Dr Rs. 250

To Insurance Premium A/c Rs. 250

The two-fold effect of prepaid expenses will be

(i) Prepaid expenses will be shown in the Profit and Loss Account by way of deduction from the expenses and

(ii) These will be shown on the assets side of the Balance Sheet as prepaid expenses. In the beginning of the next year, a reverse entry will be passed to nullify the effect of adjusting entry.

4. Accrued Income

That income which has been earned but not received during the accounting year is called accrued income. For example, if the business has invested Rs 10,000 in 5% gilt edged securities on 1st April, 2001 but during the year Rs 350 has been received as interest on securities. Then Rs 150 interest on securities earned and due for payment on 31st March, 2002 but not received, will be accrued interest for the year 2001-2002. In order to bring accrued interest into books of account, the following adjusting entry will be passed:

Accrued Interest A/c Dr Rs 150

To Interest A/c Rs 150

The two-fold effect of accrued income will be

(i) It will be shown on the credit side of Profit and Loss Account by way of addition to the income, and

(ii) It will be shown on the assets side of the Balance Sheet as Accrued Income. Next year, in the beginning, a reverse entry will be passed in order to eliminate the effect of adjusting entry and to bring the same to the correct position.

5. Income Received in Advance

Income received but not earned during the accounting year is called as income received in advance. For example, if building has been given to a tenant on Rs 2,400 per annum but during the year Rs 3,000 has been received, then Rs 600 will be income received in advance. In order to bring this into books of account, the following adjusting entry will be made at the end of the accounting year:

Rent A/c Dr Rs 600

To Rent Received in Advance Account Rs 600

The two-fold effect of this adjustment will be

(i) It is shown on the credit side of Profit and Loss Account by way of deduction from the income, and

(ii) It is shown on the liabilities side of the Balance sheet as income received in advance.

A reverse entry will be passed at the beginning of the next year to nullify the effect of adjusting entry.

6 Depreciation

Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence.

When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the Profit and Loss Account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet. There are various methods of charging depreciation on fixed assets. Suppose machinery for Rs 10,000 is purchased on 1.1.2001, 20% p.a. is the rate of depreciation. Then Rs 2,000 will be depreciation for the year 2001 and will be brought into account by passing the following adjusting entry:

Depreciation A/c Dr Rs 2,000

To Machinery A/c Rs 2,000

The two-fold effect of depreciation will be

- (i) Depreciation is shown on the debit side of Profit and Loss Account, and
- (ii) It is shown on the asset side of the Balance Sheet by way of deduction from the value of concerned asset

7 Interest on Capital

The amount of capital invested by the trader in his business is just like a loan by the firm. Charging interest on capital is based on the argument that if the same amount of capital were invested in some securities elsewhere, the businessman would have received interest thereon. Such interest on capital is not actually paid to the businessman. Interest on capital

is a gain to the businessman because it increases his capital, but it is a loss to the business concern. Interest is calculated on the opening balance of the capital at the given rate for the full accounting period. If some additional amount of capital has been brought in the business during the course of accounting period, interest on such additional amount of capital is calculated from the date of introduction to the end of the accounting period. The following adjustment entry is passed for allowing interest on capital.

Interest on Capital Account Dr

To Capital Account

Treatment in final accounts

(i) Interest allowed on capital is an expense for the business and is debited to Profit and Loss Account, i.e. it is shown on the debit side of the Profit and Loss Account.

(ii) Such interest is not actually paid in cash to the businessman but added to his capital account. Hence, it is shown as an addition to capital on the liabilities side of the Balance Sheet.

8 Interest on Drawings

If interest on capital is allowed, it is but natural that interest on drawings should be charged from the proprietor, as drawings reduce capital. Suppose during an accounting year, drawings are Rs 10,000 and interest on drawings is Rs 500. In order to bring this into account, the following entry will be passed.

Drawings A/c Dr Rs 500

To Interest on Drawings A/c Rs 500

The two-fold effect of interest on drawings will be :

- (i) Interest on drawings will be shown on the credit side of Profit and Loss Account, and
- (ii) Shown on the liabilities side of the Balance Sheet by way of addition to the drawings which are ultimately deducted from the capital.

9 Bad Debts

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss for the business. Such a loss is recorded in the books by making following adjustment entry.

Bad Debts A/c Dr

To Sundry Debtors A/c

The two-fold effect of bad debts will be that bad debts will be

- (i) Shown on the debit side of Profit and Loss Account, and
- (ii) Shown on the assets side of the Balance Sheet by way of deduction from sundry debtors.

10 Provisions for Doubtful Debts

In addition to the actual bad debts, a business unit may find on the last day of the accounting period that certain debts are doubtful, i.e., the amount to be received from debtors may or may not be received. The amount of doubtful debts is calculated either by carefully examining the

position of each debtor individually and summing up the amount of doubtful debts from various debtors or it may be computed (as is usually done) on the basis of some percentage (say 5%) of debtors at the end of the accounting period. The percentage to be adopted is usually based upon the past experience of the business. The reasons for making provision for doubtful debts are two as discussed below

(a) Loss caused by likely bad debts must be charged to the Profit and Loss Account of the period for which credit sales have been made to ascertain correct profit of the period

(b) For showing the true position of realizable amount of debtors in the Balance Sheet, i.e., provision for doubtful debts will be deducted from the amount of debtors to be shown in the Balance Sheet

For example, sundry debtors on 31/03/2002 are Rs 55,200. Further bad debts are Rs 200. Provision for doubtful debts @ 5% is to be made on debtors. In order to bring the provision for doubtful debts of Rs 2,750, i.e., 5% on Rs 55,000 (55,200-200), the following entry will be made

Profit and Loss A/c Dr Rs 2,750

To Provision for Doubtful Debts A/c Rs 2,750

It may be carefully noted that further bad debts (if any) will be first deducted from debtors and then a fixed percentage will be applied on the remaining debtors left after deducting further debts. It is so because percentage is for likely bad debts and not for bad debts which have been decided to be written off.

Treatment in final accounts

(i) The amount of provision for doubtful debts is a provision against a possible loss so it should be debited to Profit and Loss Account

(ii) The amount of provision for doubtful debts is deducted from sundry debtors on the assets side of the Balance Sheet

11 Provision for Discount on Debtors

It is a normal practice in business to allow discount to customers for prompt payment and it constitutes a substantial sum. Sometimes the goods are sold on credit to customers in one accounting period whereas the payment of the same is received in the next accounting period and discount is to be allowed. It is a prudent policy to charge this expenditure (discount allowed) to the period in which sales have been made, so a provision is created in the same manner, as in case of provision for doubtful debts i.e.

Profit and Loss Account Dr

To Provision for Discount on Debtors Account

Treatment in final accounts

(i) Provision for discount on debtors is a probable loss, so it should be shown on the debit side of Profit and Loss Account

(ii) Amount of provision for discount on debtors is deducted from sundry debtors on the assets side of the Balance Sheet

Note Such provision is made on debtors after deduction of further bad debts and provision for doubtful debts because discount is allowable to debtors who intend to make the payment

12 Reserve for Discount on Creditors

Prompt payments to creditors enables a businessman to earn discount from them. When a businessman receives cash discount regularly, he can make a provision for such discount since he is likely to receive the discount from his creditors in the following years also. The discount

received being a profit, the provision for discount on creditors amounts to an addition to the profit. Accounting treatment of Reserve for Discount on Creditors is just reverse of that in the case of Provision for Discount on Debtors. The adjustment entries for Reserve for Discount on Creditors is as follows

Reserve for Discount on Creditors Account Dr
To Profit and Loss Account

Treatment in final accounts

- i) Reserve for discount on creditors is shown on the credit side of Profit and Loss Account
- ii) In the liabilities side of the Balance Sheet, the reserve for discount on creditors is shown by way of deductions from Sundry Creditors

13. Deferred Revenue Expenditure

The expenditure done in the initial stage but the benefit of which will also be available in subsequent years is called deferred revenue expenditure. Part of such expenditure will be written off in each year and the rest will be capitalized. The entry for this expenditure (say advertisement Rs 2,000 which will be spread over 5 years) will be

Profit and Loss A/c Dr Rs 400
To Advertisement A/c Rs 400

The two-fold effect of such expenditure will be

- (i) It is shown on the debit side of Profit and Loss Account, and
- (ii) It is shown on the assets side by way of deduction from capitalized expense

14. Loss of Stock by Fire

In business, the loss of stock may occur due to fire. The position of the business may be

- (a) All the stock is fully insured
- (b) The stock is partly insured
- (c) The stock is not insured at all

If the stock is fully insured, the whole loss (say Rs 15,000) will be claimed from the insurance company. The following entry will be passed

Insurance Co A/c Dr Rs 15,000
To Trading A/c Rs 15,000

The double effect on this entry will be

- (i) It will be shown on the credit side of the Trading Account, and
- (ii) It is shown on the assets side of the Balance Sheet

If the stock is not fully insured, the loss of stock covered by insurance policy (say Rs 10,000) will be claimed from the insurance company and the rest of the amount (say Rs 5,000) will be loss for the business. The following entry will be passed

Insurance Co A/c Dr Rs 10,000
Profit & Loss A/c Dr Rs 5,000
To Trading A/c Rs 15,000

The two-fold effect of this entry will be

- (i) It will be shown on the credit side of the Trading Account with the value of stock and shown on the debit side of the Profit and Loss Account for that part of the stock which is not insured, and
- (ii) It is shown on the assets side of the Balance Sheet with the amount which is to be realized from the Insurance Co, i.e., that part of the loss which is insured. If the stock is not insured at all, whole of the loss (say Rs 15,000) will be borne by the firm. The entry for this will be

Profit and Loss A/c Dr Rs 15,000

To Trading A c Rs 15,000

The double effect of this entry will be

(i) It is shown on the credit side of the Trading Account, and

(ii) It is shown on the debit side of the Profit and Loss Accounts

16. Goods Distributed as Free Samples

Sometimes in order to promote the sale of goods, some of the produced goods are distributed as free samples. For example, if goods worth Rs 2,000 are distributed as free samples then it will be an advertisement for the concern and on other hand stock will be less by such goods. In order to bring this into books of account, the following entry is passed

Advertisement A/c Dr Rs 2,000

To Trading or Purchases A c Rs 2,000

The two-fold effect of this entry will be

(i) It is shown on the credit side of the Trading Account, or deducted from the purchases, and

(ii) It is also shown on the credit side of the Profit and Loss Account as advertisement expenses

Illustration 4 : From the following Trial Balance of Mr Nitin, prepare Trading and Profit and Loss Account for the year ending 31st March, 2002 and Balance Sheet on that date

Debit Balance	Rs.	Credit Balance	Rs.
Drawings	14,200	Capital	85,000
Plant and Machinery	19,000	Sales	2,38,120
Stock on 1st April, 2001	29,200	Discount Received	1,200
Purchases	2,07,240	Provision for Doubtful Debts	2,100
Bills Receivable	4,800	Returns outward	5,820
Returns Inwards	4,200	Apprenticeship premiums	2,400
Cash in hand	960	Bank Overdraft	4,000
Sundry Debtors	64,000	Sundry Creditors	20,000
Bad debts	3,440	Bills Payable	3,600
Sundry Expenses	8,800		
Rent	2,400		
Rates and Taxes	4,000		
	<u>3,62,240</u>		<u>3,62,240</u>

Adjustments :

- (i) Interest is charged on capital @ 5% per annum
- (ii) Provide for Doubtful Debts at 5% on sundry debtors
- (iii) Depreciation is charged on Plant and Machinery @ 10% p a
- (iv) Outstanding Rent was Rs 800
- (v) There were prepaid taxes for Rs 1,600
- (vi) Apprenticeship Premium Rs 400 was to be carried forward
- (vii) The value of stock on 31st March 2001 was Rs 34,000

Solution :**Trading and Profit and Loss Account**

Dr		for the year ending 31st March, 2002		Cr.	
Particulars	Rs	Particulars	Rs	Rs	Rs
To Opening Stock	29,300	By Sales	2,38,120		
To Purchases	2,07,240	Less Returns Inwards	4,200	2,33,920	
Less Returns Outwards	5,820	By Closing Stock			34,000
To Gross Profit c/d	37,300				
	2,67,920				2,67,920
To Sundry Expenses	8,800	By Gross Profit b/d			37,300
To Rent	2,400	By Apprenticeship Premium	2,400		
Add O/S rent	800	Less Carried forward	400	2,000	
To Rates and Taxes	4,000				
Less P/P rates and insurance	1,600	By Discount Received			1,200
To Depreciation on Plant & Machinery	1,900				
To Provision for Bad debts					
Bad debts	3,440				
Add New Provision required	3,200				
	6,640				
Less Old Provision	2,100				
To Interest on Capital	4,250				
To Net Profit (Transferred to capital account)	15,410				
	40,500				40,500

Balance Sheet
as on 31st March, 2002

Liabilities	Rs.	Assets	Rs.
Capital	85,000	Plant and Machinery	19,000
Add Interest on Capital	4,250	Less Depreciation @ 10%	1,900
Add Net Profit	15,410		17,100
	1,04,660	Closing Stock	34,000
Less drawings	14,200	Sundry Debtors	64,000
Bank overdraft	4,000	Less New Provision for	
Sundry Creditors	20,000	Doubtful debt @ 5%	3,200
Bills Payable	3,600	Bills Receivable	4,800
Outstanding Rent	800		
Apprenticeship Premium received in advance	400	Cash in hand	960
		Prepaid rates and insurance	1,600
	1,19,260		1,19,260

HIRE-PURCHASE AND INSTALLMENT PURCHASE SYSTEMS

HIRE-PURCHASE SYSTEM

INTRODUCTION:

It is not always possible by a purchaser to meet up the higher demand for goods due to immediate cash payment. To meet this demand the concept of Hire purchase is very popular in the market. Under this system the purchaser (**Hirer**) pays the entire amount in staggered way viz monthly, quarterly or yearly with some interest. Under this system the goods are sold with the following conditions. Possession of goods is delivered to a hirer but the title to the goods (Ownership) are transferred only when the agreed sum (Hire Purchase price) is paid by the hirer. Such hirer has a right to terminate the agreement at any time before the property so passes. That means he has the option to return the goods in which case he need not pay installments falling due thereafter. However, the hirer cannot recover the sums already paid as such sums legally represent hire charges of the goods in question.

The hire-purchaser, during that period of possession of goods, cannot damage, destroy, pledge or sell such goods. He is supposed to take all such care of goods as a prudent person does in his own goods. In case of Installment sale, it is not only the possession of goods but also the *ownership* in goods is transferred to the buyer immediately at the time of agreement. Further in installment system if the buyer stops the payment of dues, then He does not have the right of seizing his goods. The differences between installment sale and hire-purchase are as below

Particulars	Hire Purchase	Installment sale
Ownership	Stipulates the time at which the ownership passes to the buyer. It is usually on the payment of last installment.	Ownership passes at the time of sale.
Default in making payment	Seller can repossess the goods. In that case the installment so far paid is treated to be financing charges.	Seller does not have any other right except the right of suing the buyer for the non-payment of price.
Right of sale or otherwise	No right to sale or otherwise transfer the goods since the legal position of the hirer is bailee.	Right to sale or otherwise transfer the goods.
Loss or damages to the goods	Any loss occurring to goods has to be borne by the seller if the buyer takes reasonable care.	Any loss occurring to goods has to be borne by the buyer.

Accounting for hire purchase transactions:

In the books of hire purchaser:

There are two methods for making entries of the hire purchase transactions in the books of hire purchaser.

- 1) When asset is recorded at full cash price and
- 2) When asset is recorded at the cash price actually paid.

When asset is recorded at full cash price: Under this method the asset is recorded at the full price.

Thus this method treats the hire purchaser as owner of the asset.

Accounting entries in the books of hire purchaser are as follows:

- 1) When the asset is acquired on hire purchase:

Asset account Dr

To hire vendor a/c (cash price)

- 2) When down payment is made:

Hire vendor a/c Dr

To cash a/c

- 3) When interest becomes due:

Interest a/c Dr

To hire vendor a/c

- 4) When installment is paid:

Hire vendor a/c Dr

To cash

- 5) When depreciation is charged on asset:

Depreciation a/c Dr

To asset

- 6) For closing interest:

P & L a/c Dr

To interest

- 7) For closing depreciation:

P & L a/c Dr

To Depreciation a/c

In the books of hire vendor

Accounting entries are as follows

1) When the asset is sold

Hire purchase a/c Dr

To hire purchase sales a/c

2) When down payment received

Cash a/c Dr

To hire purchase a/c

3) When interest become due

Hire purchase a/c Dr

To interest

4) When installment received

Cash A/c Dr

To hire purchaser

5) For closing interest

Interest a/c Dr

To P & L a/c

Illustration 1

On 1st Jan 2008 A Ltd purchased from B Ltd five trucks under hire purchase system Rs 50000 being paid on delivery and the balance in five installments of Rs 75000 each payable annually on 31st Dec the vendor charges 5% p a interest on yearly balances. The cash price of five trucks was Rs 375000. Show how this transaction should be recorded in the books of A Ltd, if A Ltd writes off depreciation at 10% p a on the written down value.

In the books of A Ltd

Trucks account

2008	To B Ltd	375000	2008	By depreciation	37500
Jan 1			Dec 31	By balance c/d	337500
		<u>375000</u>			<u>375000</u>
	To balance b/d	337500			33750
2009			Dec 31	By depreciation	303750
Jan 1	balance b/d	337500		By balance c/d	<u>337500</u>
		<u>337500</u>			30380
2010			Dec 31	By depreciation	273370
Jan 1	balance b/d	303750		By balance c/d	<u>303750</u>
		<u>303750</u>			27340
2011			Dec 31	By depreciation	246030
Jan 1	balance b/d	273370		By balance c/d	<u>273370</u>
		<u>273370</u>			24600
2012			Dec 31	By depreciation	241430
Jan 1	balance b/d	246030		By balance c/d	<u>246030</u>
		<u>246030</u>			

B Ltd

2008 Jan 1			Jan 1	By trucks	375000
Dec 31	To cash	50000			
	To cash	75000	Dec 31	By interest	16250
	To balance b/d	266250			
					<u>391250</u>
		<u>391250</u>			266250
2009 Dec 31	To cash	75000	Jan 1	By balance b/d	13310
	To balance c/d	204560	31 st Dec	By interest	<u>279560</u>
					204560
2010 Dec 31	To cash	75000	Jan 1	By balance b/d	10230
	To balance c/d	139790	31 st Dec	By interest	
					<u>214790</u>
		<u>214790</u>			139790
2011 Dec 31	To cash	75000	Jan 1	By balance b/d	6990
	To balance c/d	71780	31 st Dec	By interest	
					<u>146780</u>
		<u>146780</u>			71780
2012 Dec 31	To cash	75000	Jan 1	By balance b/d	3220
			31 st Dec	By interest	
					<u>75000</u>
		<u>75000</u>			75000

Interest account

2000 Dec 31	To B Ltd	<u>16250</u>	31 st Dec	By P&L a/c	<u>16250</u>
2000 Dec 31	To B Ltd.	<u>13310</u>	31 st Dec	By P&L a/c	<u>13310</u>
2000 Dec 31	To B Ltd.	<u>10230</u>	31 st Dec	By P&L a/c	<u>10230</u>
2000 Dec 31	To B Ltd.	<u>6990</u>	31 st Dec	By P&L a/c	<u>6990</u>
2000 Dec 31	To B Ltd	<u>3220</u>	31 st Dec	By P&L a/c	<u>3220</u>

CALCULATION OF INTEREST

1 Calculation of interest when cash price and rate of interest and amount of installment are given – total interest is the difference between hire purchase price and cash price Interest for each year is calculated on the amount of outstanding cash price

2 Calculation of interest when cash price and amount of installment are given In the case , total interest apportioned to each year on the ratio of installment price outstanding

3 When rate of interest and installment are given but total cash price is not given In this method, interest is calculated from the last year firstly and then previous year and at last first year For this purpose Rate of interest must be converted on cash to on installment

Illustration 2

X purchased a radiogram on HP system He is required to pay Rs 800/- down, Rs 400 - at the end of first year and Rs 300/- at the end of second year and Rs 700/- at the end of third year Interest is charged at 5% p a calculate cash price and interest of each installment

year	installment	Interest paid	Cash price
1 st year down payment	800	No interest	800
First year end	400	$400 \times 254 + 667 \times 5 / 105 = 63$	337
Second year	300	$330 + 667 \times 5 / 105 = 46$	254
Third year end	700	$700 \times 5 / 105 = 33$	667 2054

Default and re possession

When hire purchaser is not able to make the payment in time, then default is committed by him and the owner takes back the possession of goods There are two possibilities

- 1) When seller takes back the possession of complete goods
- 2) When seller takes possession of only part of the total assets sold

When seller takes back the possession of complete goods In the case accounting treatment is as follows

In the books of purchaser:

- 1) All entries are passed as usual up to the date of default
- 2) Buyer closes the account of seller by passing the entry
Hire vendor account Dr
To assets account
- 3) Any balance left in asset account is closed by transferring to P & L account

In the books of seller

- 1) All entries are passed as usual up to the date of default
- 2) Seller closes the purchaser account by passing
Re possessed goods account Dr
To hire purchaser
- 3) Re possessed goods account or goods returned account is debited with all expenses incurred and re sale price is credited and if any balance, it is transferred to P & L account

When seller takes possession of the total assets sold

In the case accounting entries are similar to those of complete repossession The additional precautions to be taken are

- 1) Both the buyer and seller do not close seller's account and buyer's account in their respective books. The entry for repossession is passed with the agreed value of assets taken by the vendor.
- 2) The buyer finds out the value of asset still left with him using the normal rate of depreciation. This account shows the balance of asset, which is left, to him.
- 3) After crediting the asset account with the value of asset taken away by the seller and after keeping the balance of asset left, the difference by the asset account is transferred to P&L account.

Illustration 3

A Machinery is sold on hire purchase. The terms of payment is four annual installment of Rs 6000 at the end of each year commencing from the date of agreement. Interest is charged @ 20% and is included in the annual payment of Rs 6000. Show machinery account and hire vendors account in the books of the purchaser who defaulted in the payment of the third yearly payment where upon the vendors re-possessed the machinery. The purchaser provides depreciation on the machinery @ 10% p.a. on written down value method. All workings should form part of your answer.

Solution

CALCULATION OF CASH PRICE

No of installment	Amount due after payment of installment	Amount of installment	Total amount	Interest 20/120	Opening Balance
	Rs	Rs.	Rs.	Rs.	Rs
1	—	6000	6000	1000	5000
2	5000	6000	11000	1833	9167
3	9167	6000	15167	2528	12699
4	12699	6000	18699	3106	15533

Cash price of the machinery is Rs 15533

MACHINERY ACCOUNT

YEAR		Rs	YEAR		Rs
I	To hire vendors	15533	I	By depreciation a/c	1553
				By balance c/d	13980
		15533			15533
II	Balance b/d	13980	II	By depreciation a/c	1398
				By balance c/d	12582
		13980			13980
III	Balance b/d	12582	III	By depreciation a/c	1258
				By hire vendor a/c	11000
				By profit & loss a/c (loss in default)	324
		12582			12582

HIRE VENDOR A/C

YEAR		Rs	YEAR		Rs
I	To bank a/c	5000	I	By machinery a/c	15533
	To balance c/d	12639		By interest a/c	3106
		<u>18639</u>			<u>18639</u>
II	To bank a/c	5000	II	By balance b/d	12639
	To balance c/d	9167		By interest a/c	2528
		<u>15167</u>			<u>15167</u>
III	To Machinery a/c	11000	III	By balance b/d	9167
	(transfer)	11000		By interest a/c	1833
		<u>11000</u>			<u>11000</u>

Illustration 4

P purchased a truck on hire purchase system for Rs 56000 payment to be made, Rs15000 down and 3 installments of Rs 15000 each at the end of each year Rate of interest is charged at 5% per annum The buyer is depreciating the asset at 10% p a on written down value method

Because of financial difficulties, P after having paid down payment and first installment at the end of the first year could not pay second installment and sellers took possession of the truck sellers after expanding Rs 357 on repairs of the asset sold it away for 30110 Open ledger accounts in the books of both parties to record transactions

Solution

**IN THE BOOKS OF P
TRUCK ACCOUNT**

Year I		Rs	Year I		Rs.
Jan 1	To hire vendor	56000	Dec 31	By depreciation @10%	5600
				By balance c/d	
					50400
		<u>56000</u>			<u>56000</u>
II				By depreciation	
Jan 1	To balance b/d	50400	II	" hire vendor	5040
			Dec 31	" P & LA/c	29453
				(balancing figure)	15907
		<u>50400</u>			<u>50400</u>

HIRE VENDOR

Year I		Rs	Year I		Rs
JAN 1	To bank a/c	15000	Jan 1	By truck a/c	56000
Dec 31	To bank a/c	15000		By interest	2050
	" balance c/d	28050			
		<u>58050</u>			<u>58050</u>
II			II		
Dec 31	To truck a/c	29453	Jan 1	By balance b/d	28050
			Dec 31	By interest a/c	1403
		<u>29453</u>			<u>29453</u>

**IN THE BOOKS OF HIRE VENDOR
P's ACCOUNT**

Year I		Rs	Year I		Rs
Jan 1	To hire sales a/c	56000	Jan 1	By Bank a/c	15000
Dec 31	To interest a/c	2050	Dec 31	By Bank a/c	15000
			..	By balance c/d	28050
		58050			58050
II Jan 1	To balance b/d	28050	II		
Dec 31	By interest a/c	1403	Dec 31	By goods repossessed a/c	29453
		29453			29453

GOODS REPOSSESSED A/C

Year II		Rs	Year II		Rs
Dec 31	To P	29453	Dec 31	By sales	30110
..	To cash (expenses)	357			
..	P & L a/c	300			
		30110			30110

P & L ACCOUNT

				Rs
			Goods repossessed A/c	300

Illustration 5

Roman transport co purchased five trucks from Ramos Auto Ltd, on the January, 2011 on hire purchase system. The cash price of each truck is Rs 120000. The mode of payments was as follows:

- (i) 15% of cash price down
- (ii) 25% of cash price at the end of each year for 4 years

Roman transport co writes off 15% depreciation annually on diminishing balance. The payment due to 31st December 2011 could not be made. Ramos Auto Ltd agree to leave three Trucks with the buyer on the conditions that the value of the other two Trucks would be adjusted against the amount due, the trucks being valued at cost less 25% depreciation on diminishing balance.

Show the necessary accounts in the books of Roman Transport co.
Solution

IN THE BOOKS OF ROMAN TRANSPORT CO.

TRUCK ACCOUNT

2011			2011		
		Rs			Rs
Jan 1	To Ramons Auto Ltd	600000	Dec 31	By Depreciation A/c	90000
				By balance c/d	510000
		<u>600000</u>			<u>600000</u>
2012					
Jan 1	To balance b/d	510000	2012	By Depreciation A/c	76500
			Dec 31	, Ramos Auto Ltd	135000
				Profit & loss A/c	
				(loss on default)	
				(bal fig)	38400
				By balance c/d	260100
		<u>510000</u>			<u>510000</u>
2013					
Jan 1	To Balance b/d	260000			

RAMOS AUTO LTD ACCOUNT

2011			2011		
		Rs			Rs
Jan 1	To bank (15% of 600000)	90000	Jan 1	By Truck a/c	600000
	To bank a/c		Dec 31	By interest a/c	36000
Dec 31	To balance a/c	150000			
		396000			
		<u>636000</u>			<u>636000</u>
2012			2012		
Dec 31	To truck a/c	135000	Jan 1	By balance b/d	396000
" "	To balance c/d	288000		By interest	27000
		<u>423000</u>			<u>423000</u>

Working note.

Calculation of value of 2 Trucks taken up Ramos Auto Ltd

	Rs
Cost of 2 Trucks	240000
Less depreciation @ 25% for 2011	60000
	<hr/>
	180000
Less depreciation @ 25% for 2012	45000
	<hr/>
Value on 31-12-2012	135000

Calculation of value of 3 trucks retained by Roman Transport Co

Cost of 3 trucks	360000
Less depreciation @ 15% for 2011	54000
	<hr/>
	306000
Less depreciation @ 15% for 2012	45900
	<hr/>
	260100

Illustration 6

P purchased 4 cars of Rs 14000 each on hire purchase system the hire purchase price for all the 4 cars was Rs 60000 to be paid Rs 15000 down and 3 installment of Rs 15000 each at the end of each year interest is charged @ 5% p a, buyer depreciates cars @10% p a on straight line method After having paid down payment and first installment, buyer could not pay 2nd installment and seller took possession of three cars at an agreed value to be calculated after depreciating cars at 20% p a on written down value method one car was left with the buyer Seller after spending Rs 1200 on repairs sold away all the three cars to X for Rs 35000 open ledger accounts in the books of both parties

Solution

Calculation of value of asset taken by the seller	
Number of cars taken by the seller	= 3
Cost price 3 x 14000	= 42000
Less depreciation	
First year	8400
Second year	6720
	<hr/>
	15120
	<hr/>
Value of assets taken	26880
	<hr/>
	Value of car left with buyer
Number of car	= 1
Cost price	= 14000
Less depreciation	
First year	1400
Second year	1400
	<hr/>
	2800
	<hr/>
Value of asset left	11200
	<hr/>

In the books of P
Asset account

1 st year		By depreciation	5600
To hire vendor	56000	By balance c/d	50400
	<u>56000</u>		<u>56000</u>
Second year		By depreciation	5600
To balance b/d	50400	By hire vendor	26880
		By P&L account	6720
		By balance c/d	11200
	<u>50400</u>		<u>50400</u>

Hire vendor account

First year		By Assets account	56000
To cash account	15000	By interest account	2050
To cash	15000		
To balance c/d	28050		
	<u>58050</u>		<u>58050</u>
To asset	26880	By balance b/d	26880
To balance c/d	2573	By interest	1403
	<u>29453</u>		<u>29453</u>

In the books of seller
P's account

First year		By cash a/c	15000
To sales account	56000	By cash a/c	15000
To interest	2050	By balance c/d	28050
	<u>58050</u>		<u>58050</u>
Second year		By repossessed stock	26880
To balance c/d	28050	By balance c/d	2573
To interest	1403		
	<u>29453</u>		<u>29453</u>

Repossessed stock account

To P's account	26880	By cash	35000
To cash	1200		
To P&L account	6920		
	<u>35000</u>		<u>35000</u>

INSTALMENT SYSTEM

It is a system of a sale in which the price of the article is paid in installments along with interest on unpaid balances. Under this system the buyer gets the possession and ownership of the goods at the time of signing agreements.

Difference between hire purchase and installment system

- 1) Hire purchase is agreements of hiring where as an installment system is an agreement of sale
- 2) In the case of hire purchase system the ownership in the goods sold passes to the buyer only on payment of the last installment. But in the case of installment system ownership passes to the buyer immediately at the time of sale
- 3) If the buyer fails to pay any installment, the hire vendor can possess the goods. But in installment system, the seller cannot possess the goods
- 4) The buyer can return goods sold to the seller, in the case of hire purchase. But in the installment system, goods once sold cannot be returned
- 5) In the case of hire purchase system, the buyer cannot hire, sell, transfer or pledge the goods until the full amount is paid. In the installment system, the buyer can hire sell, transfer or pledge the goods before the payment of last installment
- 6) The risk of bad debt is relatively less in hire purchase transactions, but the risk of bad debt is relatively more in installment system

ACCOUNTING FOR CONSIGNMENTS AND JOINT VENTURES

ACCOUNTING FOR CONSIGNMENTS

1. MEANING OF CONSIGNMENT

Consignment is the process of sending of goods by one person to another person for the purpose of sale on commission basis at the sole risk of the sender. In other words, when goods are sent by one person to another to be sold by the latter on behalf and at the risk of the former, the transaction is known as consignment. The person who sends the goods to be sold on his behalf is called the 'consignor' whereas the person to whom the goods are sent to be sold is called 'consignee'. Consignment outward means that goods have been sent to some person on consignment basis while consignment inward implies that goods have been received to be sold on behalf of some other person on consignment basis. The goods consigned to the agent cannot be treated as sales at the time of consignment, they are treated as sales only when these goods are sold by the consignee.

The legal relationship between consignor and consignee is that of a principal and agent, consignor being the principal and consignee being the agent. Hence, when the consignor sends goods, the title to the goods does not pass from consignor to the consignee and the consignee does not become liable to pay for the goods so sent.

2. FEATURES OF CONSIGNMENT

On the basis of what has been stated above, the salient features of the consignment transaction may be summarized as follows:

- (i) Consignment of goods is not a sale. It is a mere transfer of possession of goods.
- (ii) The relationship between the consignor and consignee is that of principal and agent, not of seller and buyer, the goods never become the property of the consignee. The consignee is not responsible for any loss or destruction of goods.
- (iii) The consignee does not become the debtor of the consignor until he has sold the whole or portion of the consignment. When the goods have been sold he becomes liable for the payment of the proceeds.
- (iv) Bad debts in respect of goods consigned are borne by the consignor unless the consignee expressly assumes liability for such losses. In such case he is known as *del credere* agent and receives an extra rate of commission for the risk involved in credit sales effected by him.
- (v) The consignor has to pay all the expenses incurred by the consignee in taking the delivery of the goods when they reach the consignee's place and also the storage charges and other expenses until the goods are sold.
- (vi) The consignee is liable to account for the goods he receives from the consignor until they are sold.
- (vii) The consignee is paid by a commission which is generally based on the total value of sales affected by him.
- (viii) The unsold portion of the goods sent on consignment must appear in the assets side of the consignor's balance sheet as stock on consignment, because the unsold goods remain the property of the consignor until sold.
- (ix) Consignment transaction is distinguished from goods on sale or return. When goods are sent on consignment, the person receiving the goods is the agent of the sender, but in the case of goods sent on sale or return basis, the person to whom the goods are sent is only an optional purchaser.
- (x) Consignee is liable for payment on the sale proceeds after deducting, of course, his commission and the expenses incurred by him.
- (xi) It is customary for the consignee to give an advance to the consignor in the form of cash or bill of exchange. This advance is adjusted against the sale of goods.

3. DISTINCTION BETWEEN SALE AND CONSIGNMENT

<i>Sale</i>	<i>Consignment</i>
(i) In case of sale, property in goods is transferred to the buyer along with the transfer of goods.	(iii) When goods are sold on credit the buyer becomes the debtor of the seller. The relationship between the buyer and seller is that of debtor and creditor.
(ii) Goods once sold can not be returned to the seller except when they are defective or the seller agrees to take these back.	(iv) When goods are lost after the delivery to the buyer, it is the buyer who will bear the loss.

In case of consignment, goods remain the property of the consignor until the time they are sold by consignee

Unsold goods on consignment are the property of the consignor and can be returned to him

- (v) The expenses incurred by the buyer are to be borne by the buyer itself after the delivery of goods
- Expenses borne by the consignee to receive the goods and to store it safely is borne by the consignor

When goods are sold on credit, the buyer become debtor of the consignor. The relationship between the consignor and the consignee is that of a principal and agent

When goods are lost on consignment, it is the consignor who will bear the loss

4. PRO-FORMA INVOICE

Along with the goods, a statement is usually forwarded by the consignor to the consignee, giving description of the goods consigned, the weight, quantity, price and other relevant details. Such a statement is known as pro-forma invoice. Pro-forma invoice is like ordinary invoice which is used at the time of normal buying and selling transactions. Practically, it gives an idea to the consignee about the price at which the goods will be disposed of. Generally, pro-forma invoice includes a certain minimum amount of profit beyond which the consignee is not allowed to sell. Therefore, pro-forma invoice price is always higher than the actual cost price. Therefore, an adjustment is to be made at the end of the period in order to ascertain the correct amount of profit.

5. ACCOUNT SALES

This is a statement of accounts showing the gross and net proceeds of the consigned goods sold by the consignee for the account of the consignor. When the consignee has sold the goods at periodical intervals, the consignee submits to the consignor a statement showing

- The gross proceeds of the goods sold by him
- The charges or expenses incurred by him
- His commission
- The net amount due to the consignor and the mode of remittance i.e. cash, cheque, draft, bill receivable, etc

A specimen of the Account Sales is given below

Account Sales of 200 radio sets received from and sold on account on ~~Tena~~ Tena & Co Calcutta

	Rs	Rs
150 Radio sets @ Rs 750 each	1,12,500	
50 Radio sets @ Rs 1,000 each	<u>50,000</u>	1,62,500
Less Expenses		
	Rs	
Freight	750	
Insurance	300	
Rent	<u>550</u>	
Less Commission @ 10%	<u>16,250</u>	<u>17,850</u>
		1,44,650
Less Advance paid		<u>50,000</u>
Balance due remitted as per draft enclosed		<u>94,650</u>

6. CONSIGNEE'S COMMISSION

Generally, the consignee is remunerated by a commission which is usually calculated as an agreed percentage of the gross proceeds of sale. When goods are sold by the consignee on credit, there is a possibility that the amount may not be realizable by the consignee from the consignment debtors. Since the consignee sells goods as an agent of the consignor and not on his own account, it is the consignor who runs the risk of bad debts arising from credit sales. The consignor, not being in direct contact with customers may wish to have a guarantee from the consignee that he will pay if the customers fail to make the payment. The consignee gives such guarantee for covering the risk of bad debts in return for an extra commission which is known as *del*

credere commission This commission is paid by the consignor to the consignee for taking additional risk of recovery of debts on account of sales made on credit by the consignee on behalf of the consignor Sometimes, *del credere* commission is shown separately from and in addition to the ordinary commission, but very often the two commissions are merged into one percentage If the consignor allows *del credere* commission to the consignee then bad debts will be borne by the consignee Moreover, it will also make the consignee careful in choosing customers for credit sales

In order to give further incentives, sometimes an extra commission termed as overriding commission is allowed to consignee in case the sales exceed a specified amount Over-riding commission is allowed by the consignor to the consignee to promote sale at higher price than specified or to encourage consignee to put more work in introducing new product in the market Besides being entitled to commission, the consignee is also entitled to be reimbursed for expenses incurred by him on behalf of consignor

7. ACCOUNTING TREATMENT IN THE BOOKS OF CONSIGNOR

In order to ascertain profit or loss on consignment to a particular consignee, consignor maintains an account called Consignment Account If goods are consigned to several consignees, consignor maintains as many consignment accounts as there are consignees Then to distinguish different consignment accounts the names or places of consignees are added to consignment accounts For example, a consignment account may be styled as Consignment to Bombay Account or Consignment to Kochi Account

Consignment account is in the nature of Trading and Profit and Loss Account On the debit side of consignment account, cost of the goods sent, expenses incurred in respect of goods so sent including commission payable to consignee on sales made by him and expenses incurred by him are recorded on the credit side, sale proceeds and closing stock of goods consigned are recorded, the difference between the two sides represents profit earned or loss incurred and is transferred to Profit and Loss Account

Consignor also maintains, the account of the consignee which show the amount due from consignee after the various transactions with him have been recorded

Schemes of Entries

- (i) On dispatch of goods to Consignee
Consignment Account Dr
 To Goods Sent on Consignment Account
- (ii) For expenses incurred by consignor in respect of the goods consigned
Consignment Account Dr
 To Cash Account/Bank
- (iii) (a) For acceptance given by the Consignee
Bills Receivable Account Dr
 To Consignee

(b) If consignee pays cash as advance

Cash Account Bank Dr
 To Consignee

(iv) On consignee reporting Sale

Consignee Dr
 To Consignment Account

(v) For the expenses incurred by consignee and reported in the Account

Sales Consignment Account Dr
 To Consignee

(vi) For commission payable to the consignee

Consignment Account Dr
 To Consignee

(vii) For closing stock with the consignee

Stock on Consignment Account Dr
 To Consignment Account

At this stage if credit side of Consignment Account is heavier than the debit side, the difference is the profit and is credited to Profit and Loss Account and debited to Consignment Account. If the debit side of the Consignment Account is heavier than the credit side of the same account the difference represents loss and is debited to Profit and Loss Account and credited to Consignment Account. This closes the Consignment Account.

(viii) For transfer of Profit from Consignment Account to Profit and Loss Account

Consignment Account Dr
 To Profit and Loss Account

A reverse entry will be passed if Consignment Account reveals loss

In the next accounting period, Consignment Account starts with a debit for unsold and stock at the end of the previous accounting period

(ix) Goods Sent on Consignment Account must be transferred to Purchases Account in case of trading concern and to Trading Account in case of a manufacturing concern

For transfer of goods Sent on Consignment Account to Purchases Account

Goods Sent on Consignment Account Dr
 To Purchases Account

(x) For Cash received from consignee

Cash/Bank Account Dr
 To Consignee

8. ACCOUNTING TREATMENT IN THE BOOKS OF CONSIGNEE

Consignment is not equivalent to a sale with the result the consignee is not be debtor until the sales are made to him. Thus no entry is made when goods are received by him on consignment. He may however, record the details of the goods received in a separate book, called Consignment Inward Book. The scheme of journal entries in consignee's books is as under

- (i) For advance made to the consignor

Consignor	Dr
To Bank or Bills Payable Account	
 - (ii) For payment of expenses in respect of consignment

Consignor	Dr
To Cash or Bank Account	
 - (iii) For Cash sale of goods

Bank	Dr
To Consignor	
 - (iv) For credit sales

Consignment Debtors Account	Dr
To Consignor	
 - (v) For commission earned by him

Consignor	Dr
To Commission Account	
 - (vi) For bad debts when no del credere commission is paid

Consignor	Dr
To Consignment Debtors Account	
 - (vii) Bad debts arising when he is entitled to Del credere

Commission Bad Debts Account	Dr
To Consignment Debtors Account	
- Note* It is always appropriate to transfer bad debts to Commission Account
- | | |
|----------------------|----|
| Commission Account | Dr |
| To Bad Debts Account | |
- (viii) For payment to consignor

Consignor	Dr
To Cash or Bank Account	

On the last date of the accounting year, if there is any balance (debit/credit) in the Consignor's Account it should be shown in the Balance Sheet under Sundry Debtors or Sundry Creditors depending upon the nature of the balance. The student should note that the consignee will not make any entry in respect of stock on consignment. Similarly he will not ascertain any profit or loss in respect of goods sold by him on behalf of the consignor. However, the commission received should

be transferred to Profit and Loss Account at the year end

9. VALUATION OF STOCK

The unsold stock remained with the consignee has to be valued at cost (plus rateable share of non-recurring expenses) or market price whichever is lower. Non-recurring expenses are the expenses which are incurred to bring the goods to the godowns of the consignee. For example, packing and forwarding charges, railway freight, octroi duty, insurance in transit, cartage of goods from railway station to the godown of the consignee etc. But expenses incurred thereafter, for example godown rent, insurance charges to cover risks of loss while goods are in godown, salesmen's salary, advertising expenses, etc., are not considered for determining cost of goods remaining unsold. Cost of stock is not affected whether a particular expense is paid by the consignor or by the consignee. However, if the question does not give details of various expenses incurred, it should be assumed that expense paid by the consignor of non-recurring nature whereas those paid by the consignee are not so.

However, if it is assumed that the unsold stock will realize less than cost, the net realizable value (i.e. realizable value minus estimated expense including consignee's commission) is to be considered for the purpose. If the net realizable value is found to be less than cost, the stock must be written down accordingly since it is based on the principle of conservation i.e. anticipated losses must be provided for in the books.

Illustration 1

Peter sent to Qureshi 1,000 pieces of goods on consignment basis, one piece costing Rs 230. Peter sent Rs 2,200 on packing, Rs 450 on freight and Rs 1,400 on insurance in transit. Qureshi paid octroi duty amounting to Rs 1,200 and cartage Rs 1,100 to bring goods to his godowns. In course of time Qureshi also spent Rs 1,600 on insurance and rent of godown and paid Rs 4,000 as salaries to salesman. Just before close of accounting period, Qureshi reported that he had sold 800 pieces at Rs 305 per piece. Qureshi is entitled to a commission @ 5% of gross sales.

Show how the unsold stock will be valued and prepare Consignment Account in Peter's Ledger

Solution

Calculation of value of closing stock		
200 pieces @ Rs 230 per piece		Rs 46 000
200/1000 th. of non-recurring expenses		
Rs		
Packing	2 200	
Freight	450	
Insurance in transit	1 400	
Octroi duty	1,200	
Cartage	<u>1,100</u>	
	<u>6,350</u>	<u>1,270</u>
		<u>47,270</u>

<i>Dr</i>	Consignment Account		<i>Cr</i>
	<i>Rs</i>		<i>Rs</i>
To Goods Sent on Consignment	2 30,000	By Qureshi (Sales)	2 44 000
To Cash (Expenses)	4 050	By Consignment Stock	47 270
To Qureshi (Expenses)	7 900		
To Qureshi (Commission)	12 200		
To Profit and Loss A/c	<u>37,120</u>		
	<u>2,91,270</u>		<u>2,91,270</u>

10. LOSS OF GOODS ON CONSIGNMENT

A part of the goods sent on consignment may be lost or destroyed or damaged either in transit or in the consignee's godown. Such loss may be either normal loss or abnormal loss.

Normal Loss

Any loss which is unavoidable, inherent and due to natural causes, such as evaporation, leakage, drying etc. is known as normal loss. No effort either by the consignor or by the consignee can prevent this loss. Since normal loss is a part of the cost of goods, no additional adjustment is required for this purpose. While calculating the value of stock on consignment, the cost is inflated to cover the normal loss. This is done by appropriating the cost on the basis of actual quantity available for sale. Thus, value of stock on consignment

$$\frac{\text{Cost of goods consigned} \times \text{Unsold quantity available for sale}}{\text{Actual quantity}}$$

For example, suppose 1,000 tonnes of limestone is consigned @ ₹20 per tonne, freight thereon being Rs 4,000. If the quantity sold is 600 tonnes and that unsold is 350 tonnes, it means that there is a normal loss of 50 tonnes.

$$\begin{aligned} \text{Value of 350 tonnes will be} &= \text{Rs } \frac{20,000 + 4,000}{950} \times 350 \\ &= \text{Rs } \frac{24,000}{950} \times 350 \\ &= \text{Rs } 8,842.10 \end{aligned}$$

Abnormal Loss

Abnormal loss of stock in consignment is caused by theft, accident, fire, pilferage, abnormal breakage, carelessness etc. Abnormal loss is calculated just the same way as the valuation of stock on consignment after taking into consideration the proportionate expenses incurred on it and is credited to consignment account and debited to profit and loss account. In case the stock is insured, consignment account is credited with the full cost of the goods so lost and abnormal loss account is debited. Any amount realised on account of damaged goods should be credited to abnormal loss account. The amount of claim receivable from the insurance company is debited to insurance company account and credited to abnormal loss account and the balance of abnormal loss is debited to profit and loss account. Later, when the amount is received from the insurance company, cash account is debited and insurance company account is credited. The journal entries will be as follows:

(i) If not covered by Insurance Company
Profit and Loss A/c Dr
(Abnormal Loss A/c)
 To Consignment A/c

(ii) (a) If covered by Insurance Company
Abnormal Loss A/c Dr
 To Consignment A/c

(b) For amount received from the insurance
 company Insurance Company A/c Dr
 To Abnormal Loss A/c

(c) Balance of loss not covered by insurance
 company Profit and Loss A/c Dr
 To Abnormal Loss A/c

The amount of the loss is ascertained like the value of closing stock except that expenses incurred only after the loss had taken place have to be 'ignored' while calculating the cost of the loss because no part of such expenses can be said to have been incurred on the lost goods. For example, suppose 100 kgs of a commodity is sent, cost is being Rs 200 per kg and the consignor spending Rs 600 by way of freight. Further, suppose 5 kgs of the commodity is badly damaged due to poor packing and is disposed of at the railway station itself. The consignee brings the balance of the goods to his godown paying cartage of Rs 50. Now Consignment Account will be credited with Rs 1,030, i.e.,

$$5 \times \text{Rs } 200 + \frac{5}{100} \times 600$$

No part of cartage Rs 50 will be included

11. METHODS OF PREPARING CONSIGNMENT ACCOUNT

There are different methods of preparing Consignment Account. The methods differ due to the different basis on which goods consigned may be valued for records in the Consignment Account.

(a) Cost Price Method

Under this method, goods consigned are recorded at cost price in Consignment Account. Briefly, the various steps can be outlined as follows:

(i) Cost of goods sent is debited to Consignment Account and credited to Goods Sent on Consignment Account. Consignment Account is also debited with the amount of expenses incurred by the consignor in respect of the goods consigned, credit being to Cash or Bank as the case may be.

(ii) When account Sale is received, Consignment Account is credited and Consignee is debited, with the gross sale proceeds of goods sold by the

consignee Consignment Account is debited and consignee is credited for expenses incurred by consignee on behalf of the consignor and for the commission earned by consignee on sales. If some payments are received from Consignee the same is credited to Consignee.

- (iii) To determine profit or loss when only a part of the goods consigned has been sold, the unsold stock is valued at cost plus rateable expenses incurred till the goods reached the godown of consignee or the market price whichever is less. The amount is credited to Consignment Account and debited to Consignment Stock Account.

(b) Invoice Price Method

Sometimes, the consignor does not prefer to disclose the real profit that is earned on consignment for many reasons. For this purpose, the consignor sends goods at pro-forma invoice price to the consignee which is fixed after adding certain percentage on cost or on sale invoice price so that the consignee will not be able to know the profit which is earned by the consignor in the transaction. If there is any unsold stock or any abnormal loss they are to be valued at invoice price. Hence, in order to ascertain the true profit or loss on a consignment proper adjustments have to be made to eliminate such loading and bring down the items to cost level.

Under this method of dispatch of goods, Consignment Account is debited and Goods Sent on Consignment Account is credited with the 'Invoice' Price of goods sent.

But in order to ascertain Profit or Loss, sale proceeds have to be compared with cost of goods. Hence later, Goods Sent on Consignment Account is debited and Consignment Account is credited with the excess of 'invoice' price over cost (the excess is called 'loading') to adjust the two accounts.

Under this method, closing stock is also initially at 'Invoice' price plus rateable the share on non-recurring expenses. But again to adjust Consignment Account, the following entry is passed:

Consignment Account	Dr
To Consignment Stock Reserve A/c	

Loading included in the value of closing stock

In the next accounting period, Consignment Stock Reserve is transferred to Consignment Account. All other entries in the books of the Consignor are the same as in Cost Method.

For loading on abnormal loss the entry will be

Consignment A/c	Dr
To Abnormal Loss A/c	

Illustration 2

On 1st September, 2007 Atul of Assam sent on consignment to Daulat of Delhi 100

cases of tea costing Rs 500 each invoiced 'Pro-forma' at Rs 600 each Freight and other charges on the consignment amount to Rs 3,100

On 1st December, 2007 Daulat sent Account Sales Ledger with the necessary remittance showing that 40 cases had realised Rs 600 each and 30 cases Rs 700 each and 30 cases remained in stock unsold Rs 2,500 was spent by Daulat for the consignment Daulat was given a commission of 5% on sales On 27th December Daulat informed Atul that 20 cases were damaged due to bad packing that they would be sold at Rs 200 per case

Both the firms close their books of account on 31st December Prepare Ledger Account in the books on both the parties

Solutio

n

In Atul's Ledger		<i>Cr</i>
Consignment of Delhi Account		<i>Rs</i>
<i>Dr</i>	<i>Rs</i>	<i>Rs</i>
To Goods Sent on Consignment	60,000	By Daulat (Sales)
To Cash (Expenses)	3,100	40 x 600 = 24,000
To Daulat	2,500	30 x 700 = <u>21,000</u>
(Expenses)	2,250	45,000
To Daulat	1,000	By Goods Sent on Con-
(Commission)	10,000	signment (Loading)
Stock Reserve	6,620	3,080 By Abnormal Loss
To Profit and Loss		By Closing Stock
Account		Normal 10,000
		Damage 4,000
		<u>6,310</u>
	<u>71,930</u>	<u>71,930</u>

Daulat	
Rs	Rs
To Consignment to Delhi (Sales) <u>45,000</u>	By Consignment to Delhi A/c (expenses) 2,500
	By Consignment to Delhi A/c (commission) 2,250
	By Bank <u>40,250</u>
<u>45,000</u>	<u>45,000</u>

In Daulat's Ledger Atul	
Rs	Rs
To Cash (expenses) 2,500	By Cash (sales) 45,000
To Commission 2,250	
To Bank <u>40,250</u>	
<u>45,000</u>	<u>45,000</u>

(c) Memorandum Column Method

It is a modification of Cost Price Method. Under this system additional amount columns are provided in Consignment Account and Goods Sent on Consignment Account to make memorandum entries regarding 'Invoice' price of goods consigned sold and remaining unsold.

12. ADVANCE BY CONSIGNEE

Sometimes, the consignee may advance a sum of money or accept a bill of exchange against the value of the goods sent to him by the consignor. The amount so advanced or the amount of the bill so accepted is credited by consignor to the personal account of the consignee maintained by the consignor in his ledger. The consignee in turn debits the account of consignor for such an advance or acceptance.

If the consignor receives an acceptance and gets it discounted, the discount should be debited to Discount Account and not to Consignee's Account.

The advance money so received will automatically be adjusted against the local dues for ascertaining the net amount payable to the consignor. The entire amount of advance money may be adjusted even if a part of goods are sold provided that such advance is not treated as caution money or security money. However, if the advance is treated by way of security, that portion of advance which relates to the goods lying unsold with the consignee must not be adjusted but should be carried forward. For example, a consignee advances Rs 10,000 as security against goods consigned. Suppose, he sells 3/4th of the goods for Rs 12,000 and is entitled to a commission of Rs 480 and has incurred expenses amounting to Rs 120. Then the consignee will remit Rs 3,900 (and not Rs 1,400) so that a balance of Rs 2,500 still remains in his account as advance against 1/4th of the goods remaining unsold.

13. RETURN OF DAMAGED GOODS BY CONSIGNEE

Sometimes, the goods which are damaged on account of some reasons or other like floods, fire or negligence in handling while in the possession of the consignee or no longer saleable by the consignee are returned to the consignor. The loss due to the damaged goods is generally transferred to Profit and Loss Account like abnormal loss of goods. The damaged goods returned must be valued at the cost or market price whichever is less without taking into consideration the proportionate expenses paid either by consignor or consignee or both. Proportionate expenses are taken into consideration only for calculating the value of stock at the end and the amount of abnormal loss. The following journal entry is passed for the goods returned by the consignee in the books of the consignor.

Goods Sent on Consignment Account	Dr
To Consignment Account	

No entry is made by the consignee for this purpose. But when any expenses have been incurred by the consignee for return of such goods, the entry in the books of the consignor will be

Consignment Account	Dr
To Consignee	

In the books of consignee the entry will be

Consignor	Dr
To Bank	

14. FALL IN THE MARKET VALUE

When there is sudden fall in the market value of the goods consigned, the valuation of consignment stock should be done at the market price. Loss on valuation is not transferred to profit and loss account. It is automatically adjusted in the profit or loss on consignment itself. It must be noted that proportionate direct expenses have to be added to the market value of consignment stock.

Illustration 3

On 4th September, 2007 Dilip sent to Kuldeep on consignment basis goods costing Rs 80,000 invoiced proforma at Rs 1,00,000 and drew upon the latter a bill at 3 months for Rs 50,000 which was immediately accepted by the latter. Freight and other expenses incurred by Dilip on the goods consigned amounted to Rs 6,400.

On 21st December, 2007, Dilip received an Account Sales from Kuldeep along with a bank draft for the amount to settle the account up-to-date. According to Account Sales received,

Kuldeep had sold three-fourths of the goods for Rs 87,000 and had incurred selling expenses amounting to Rs 3,270 Kuldeep charge commission @5%

Both the parties closed their account on 31st December, 2007

Show journal entries to record the above mentioned transactions in the books of both the parties Also show important Ledger Accounts in Dilip's Ledger Dilip passed entries on the basis of invoice price of the goods consigned The advance money received may be treated by way of security

Solution

		Dilip's Book	
		Journal	
		Entries	
		<i>Dr</i>	<i>Cr</i>
		<i>Rs</i>	<i>Rs</i>
2007			
Sept 4	Consignment	1,06,400	
Account		Dr	
	To Goods Sent on Consignment A/c		1,00,000
	To Bank Account		6,400
	(Invoice price of goods sent to Kuldeep on consignment basis and expenses incurred on goods consigned)		
"	Bills Receivable Account	Dr	50,000
	To Kuldeep		50,000
	(Acceptance received from Kuldeep)		
Dec 7	Bank Account	Dr	50,000
	To Bills Receivable Account		50,000
	(Cash received on maturity of bill)		
Dec 21	Kuldeep	Dr	87,000
	To Consignment Account		87,000
	(Sale proceeds of three-fourth of Goods sold by Kuldeep)		
"	Consignment Account	Dr	3,270
	To Kuldeep		3,270
	(Expenses incurred by Kuldeep)		
2007		<i>Rs</i>	<i>Rs</i>
"	Consignment Account	Dr	4,350
	To Kuldeep		4,350
	(Commission payable to Kuldeep)		

"	Bank	Dr	41,880	
	To Kuldeep			41,880
	(Amount of bank draft received from Kuldeep in settlement of account up-to-date, 1/4 of the advance remaining unadjusted)			
Dec 31	Goods Sent on Consignment A/c	Dr	20,000	
	To Consignment Account			20,000
	(Loading in the invoice price of goods sent on consignment)			
"	Stock on Consignment Account	Dr	26,600	
	To Consignment Account			26,600
	(Invoice price of one-fourth of goods plus proportionate expenses incurred by consignor)			
"	Consignment Account	Dr	5,000	
	To Stock Reserve			5,000
	(Loading in the invoice price of one-fourth of the goods)			
"	Goods Sent on Consignment A/c	Dr	80,000	
	To Purchases Account/ Trading Account			80,000
	(Transfer of Goods Sent Consignment on Account)			
"	Consignment Account	Dr	14,580	
	To Profit and Loss Account			14,580
	(Transfer of profit on consignment to Profit and Loss Account)			

Ledger Accounts			
Consignment Account			
<i>Dr</i>		<i>Rs</i>	<i>Cr</i>
<i>2007</i>		<i>Rs</i>	<i>2007</i>
Sept 4	To Goods Sent on Consignment A/c	1 00 000	Dec 21 By Kulddeep (Sales)
	To Bank (Expenses)	6,400	Dec 31 By Goods Sent on Consignment A/c
Dec 21	To Kulddeep (expenses)	3 270	By Stock on Consignment
	To Kulddeep (commission)	4 350	
Dec 31	To Stock Reserve	5,000	
	To Profit and Loss Account (Profit)	<u>14,580</u>	
		<u>1,33,600</u>	<u>1,33,600</u>

Kulddeep's Account			
<i>Dr</i>		<i>Rs</i>	<i>Cr</i>
<i>2007</i>		<i>Rs</i>	<i>2007</i>
Dec 21	To Consignment A/c (sales)	87 000	Sept 4 By Bills Receivable A/c
Dec 31	To Balance c/d (1/4 of advance)	12 500	Dec 31 By Consignment A/c (expenses)
			By Consignment A/c (commission)
			By Bank A/c
		<u>99,500</u>	<u>41,880</u>
			<u>99,500</u>

ACCOUNTING FOR JOINT VENTURES

15. MEANING OF JOINT VENTURE

When two or more parties, normally carrying on business independently of one another, join together to exploit particular business opportunity where their individual capabilities can be profitably pooled and share profits resulting from that particular business opportunity in the agreed ratio, there comes into existence a joint venture. In other words, it is a very short duration business entered into by two or more persons jointly. Joint Venture may be limited to one transaction or may extend to a number of transactions. It may be even for a specified period of time. If there is no agreement to the contrary, the parties (called co-venturers) share profits and losses equally.

Joint Venture is in the nature of partnership but without a firm name and only relating to a specified field of activity. Suppose A and B are building contractors and they enter into a joint venture to construct a big Government building. In this case, A and B share profits and losses resulting from the particular contract with the Government. A and B may be having other separate contracts also but A will not share any profit or loss regarding other contracts entered into by B and similarly B will not be entitled to share the profits or liable to bear part of losses resulting from other contracts entered into by A.

16. FEATURES OF JOINT VENTURE

- (i) It is a short duration special purpose partnership.
- (ii) It does not entail a continuing partnership, since termination is certain.
- (iii) The business is dissolved after the venture is terminated.
- (iv) Ascertainment of income is relatively simple.
- (v) All the assets are ultimately received in cash and all liabilities are paid in cash.
- (vi) Application of many accounting concepts are dispensed with, such as the going concern concept.
- (vii) It does not use firm name.
- (viii) The co-venturers share profit or loss in the agreed ratio. In the absence of an agreement it is assumed to be equal.

17. DIFFERENCE BETWEEN JOINT VENTURE AND CONSIGNMENT

- (i) *Parties* the parties to a joint venture are called co-venturers whereas in consignment they are called consignor and consignee
- (ii) *Relationship* The relationship between co-venturers is that of partners whereas in consignment they are called consignor and consignee is that of principal and agent
- (iii) *Powers* Co-venturers enjoy full powers as to sale and purchase of goods and collection of dues etc. Consignee being an agent has to obey the instructions of the principal
- (iv) *Sharing Profits* The co-venturers are entitled to share in profits whereas consignee is usually given commission for his services by the principal
- (v) *Scope* Consignment is concerned only with the sale of movable goods. Joint venture may be undertaken for any type of legal business e.g. construction of roads, buildings, making films, underwriting shares and debentures etc. in addition to purchase and sale of goods
- (vi) *Capital Contribution* Generally all co-venturers contribute funds (capital) to carry out the activities of joint venture. In the case of consignment, consignee does not contribute funds
- (vii) *Number of Persons* In consignment there are normally two parties, namely the principal and agent. The number of co-venturers will be at least two though it may be more than two with equal status

18. ACCOUNTING TREATMENT OF JOINT VENTURES

Record of transaction in respect of a joint venture can be made in either of two ways. Either the parties to the joint venture may record the various transactions only in their respective books of account or they may also maintain a separate set of books to record the transactions relating to the joint venture. The second course is adopted when the joint venture is of a sufficiently large magnitude.

(i) *When No Separate Set of Books is Maintained*

Under this method accounts with respect of joint venture transactions are kept in the books of each co-venturer. Co-venturers are generally engaged in their own business. They have books of account of their respective business. Additional accounts with respect of joint venture transactions are opened in their respective books. When accounts are maintained in the books of each co-venturer, one of the two approaches may be adopted.

(a) *Record in Each Party's Books* Under this approach, each co-venturer maintains two accounts.

- (1) *Joint Venture Account* It is a nominal account prepared to find out profit

or loss of the venture. It contains all expenses, cost of goods sold, sales etc., balance being the profit or loss.

- (2) *Personal Account of the other Co-venturers* It contains his investments for joint venture, his receipts and sales effected by him. This account is prepared to find out the amount due from him or due to him. The accounting procedures are as under:

Each venturer records the transaction undertaken by him by debiting Joint Venture Account with all costs and expenses and crediting with all sales and gains. For all items of cost and expenses defrayed by the other venturer, Joint Venture Account is debited and his personal account is credited. For all revenue received by the other venturer, his personal account is debited and Joint Venture Account is credited. Advances by one venturer to the other are recorded in the recipient's books by debiting Bank Account and crediting the personal account of the venturer making the advance. In the books of the venturer making the advance, the personal account of the recipient is debited and Bank Account is credited.

The balance of Joint Venture Account then shows profit or loss on the venture. Each venturer transfers his own share of profit or loss to the profit and loss account and the other venturer's share to his personal account. The balance of the personal account of the other venturer shows the amount due to or due from him. On payment of such balance, the separate personal account is closed.

(b) *Memorandum Method* Under this method accounts are prepared in the books of each co-venturer. Each co-venturer prepares the following accounts:

- (1) Memorandum Joint Venture Account
- (2) Joint Venture with (Co-venturer) Account

The Memorandum Joint Venture Account is exactly the same in the books of the both the co-venturers. Hence, each venturer prepares this account in order to ascertain the profit or loss on the venture taking into consideration his own as well as the co-venturer's transactions. This account resembles a Trading and Profit and Loss Account but does not form part of double entry books. It is prepared as a memorandum i.e. transactions are directly entered without going through the process of journal.

Joint Venture with (Co-venturer) Account is treated as a personal account in which each venturer records only such transactions as he undertakes, all costs and expenses are debited to this account and all sales and gains are credited to it. No account is taken of goods used or cash spent on joint venture by the other party. If any cash or acceptance is received on account of joint venture, from the other party, the amount should be credited to this account. This account is also debited with own share of profit, the credit being given to profit and loss account. In case the Memorandum Joint Venture Account shows a loss, it is credited to this account by debiting profit and loss.

account. The balance of this account will show the amount due from or due to the co-venturer.

ii) When Separate Set of Books is Maintained:

Under this method, joint venture is treated as a separate business entity and separate account books and cash book, journal, ledger, etc. are maintained. Usually the following accounts are maintained under this method:

- (a) *Joint Venture Account* It is in fact a Trading and Profit and Loss Account for the venture showing purchase of goods, expenses, sale of goods etc. Balance of this account will show profit or loss of business and is distributed between co-venturers.
- (b) *Joint Bank Account* It is a separate bank account opened in the joint names showing receipts and payment of cash.
- (c) *Personal Accounts of Co-venturers* It is the capital accounts of the co-venturers showing, investment, entitlements, receipts and drawing by the co-venturers.

The accounting procedure is explained as follows:

A Joint Bank Account is opened by the contribution from the co-venturers, debit being given to Joint Bank Account and Co-venturers' (Capital) Accounts are credited. When expenses are incurred, Joint Venture Accounts is debited against Joint Bank Account if paid there from or against Venturers' (Capital) Accounts if paid by them personally. On goods being sold, Joint Bank Account is debited and Joint Venture Account is credited in case the proceeds are paid into the bank. If the sale proceeds are taken over by any venturer, his Capital Account is debited and Joint Venture Account is credited. At the close of the venture unsold goods may be taken over by a venturer at an agreed value for which the Venturer's Capital Account is debited and the Joint Venture Accounts is credited. If any commission or interest is payable to co-venturers, then Joint Venture Account is debited and Co-venturers' (Capital) Accounts are credited. If it is desired to make an interim settlement until all the goods are sold, the value of unsold stock may be shown by way of balance on the credit side of Joint Venture Account. The balance in Joint Venture Account will now represent profit or loss on the venture which is transferred to Venturers' (Capital) Accounts in the agreed profit sharing ratio. After closing the Joint Venture Account, the balance of the Joint Bank Account is paid out to the co-venturers, each receiving the balance of his Capital Account.

FIRE INSURANCE CLAIMS

INTRODUCTION:

Insurance contracts are contracts of indemnity whereby one party, called the insurer, undertakes to indemnify the loss suffered by the other party, called the insured, on the happening of some unforeseen event in consideration of a fixed sum of money, called the premium. The liability of the insurer to indemnify the loss suffered by the insured arises only on the happening of the event for which the policy is taken out. But the liability of the insurer is limited to the amount of loss actually suffered by the insured or the policy amount, whichever is less. In case of under-insurance, the liability of the insurer is limited to the extent of coverage only.

In the event of loss being sustained by the insured in respect of the subject matter insured, the insurance company should be notified of such loss and a claim for indemnity should be lodged in respect of the loss. The insurance company usually employs skilled persons, known as loss assessors or surveyors or inspectors, to investigate the circumstances leading to the loss suffered and to determine the extent of the damage or loss. The assessors or inspectors carry out their investigation by inspecting the spot where the damage has occurred and relevant books, papers and accounts of the claimants. They also seek information from employees and others who may be able to throw some light on the causes of the damage or loss. On completing their investigation, the assessors or inspectors submit a report to the insurance company giving their considered opinion as to whether the circumstances come within the scope of the policy. They also state their estimate of the extent and value of the damage or loss and the insurance company's corresponding liability.

The insured may agree to accept the amount of the claim estimated by the assessors or inspectors or he may refuse to accept the same. In case he refuses to accept the amount of the claim so estimated by the assessors or inspectors, he may seek to have the claim determined by -

- (a) arbitration, or
- (b) legal action on the policy

Now let us see how claims are determined under various types of policies

2. CLAIMS UNDER FIRE INSURANCE POLICIES

Fire insurance policies are generally taken to cover the following types of risks

- (i) Loss of stock in trade
- (ii) Loss of sundry fixed assets, such as, building, furniture, machinery etc
- (iii) Loss of profit that may arise due to dislocation caused by fire

3. SOME IMPORTANT TERMS IN CONNECTION WITH THE FIRE INSURANCE POLICIES

- (1) *Amount of Indemnity* - The policy always specifies the amount upto which the

insurers undertake to make good any damage. It should be noted that fire policies are essentially contracts of indemnity aiming to restore the insured to his original position and no further. In no case the insured can make a profit out of a fire. As such, the amount of claim will be limited to the actual loss sustained by the insured, even though the insured value of the property is higher.

- (2) *Period of Indemnity* - The contemplated period of dislocation of a business in consequence of a fire for which the insurance is effected is called the period of indemnity. The length of the period varies with the nature of the business and the delay anticipated in obtaining new machinery, equipment, etc. The longer the period of indemnity for which cover is required, the greater will be the amount of the premium charged. Generally, the period of indemnity does not exceed one year. The period of indemnity starts with the occurrence of fire and ends not later than twelve months thereafter.
- (3) *Insurable Interest* - In all contracts of insurance, it is necessary for the insured to have an insurable interest in the subject matter of insurance. In case of fire insurance, this interest must be continuous, i.e., it must be in existence at the time the policy is taken out and continued and be present when the loss occurs. The insured has an insurable interest in property where he benefits from its preservation and is prejudiced by its destruction. But only pecuniary interest is recognised.
- (4) *Average Clause* - This is a clause which is usually but not necessarily included in fire policies. Average clause is applicable only where the insured has underinsured, i.e., where he has not taken sufficient insurance to cover the value of the property insured. The effect of average clause is that if the actual value of the property is greater than the insured value of the property (i.e., the amount of policy), the insurer will be liable only for that proportion of the loss which the insured value bears to the actual value of the property insured.

For example, if, a property of Rs 3,00,000 is insured for Rs 2,00,000 and the loss amounts to Rs 1,50,000 the amount of claim will be determined as follows

$$\text{Rs } 1,50,000 \times \frac{\text{Rs } 2,00,000}{\text{Rs } 3,00,000} = \text{Rs } 1,00,000$$

If the property is totally destroyed, the average clause will not be applicable as the same will have no effect at all. In such a case, the amount of claim will be restricted to the sum insured, i.e., Rs 2,00,000.

4. CLAIMS FOR LOSS OF STOCK

While formulating a claim to loss of stock, the following principles should be borne in mind,

- (i) *Where proper stock records are maintained and such records are not destroyed by fire*. In such a case, no difficulty is faced in determining the value of the stock

as at the date of fire and the amount of claim. In the first instance, the amount of stock lost by fire has to be ascertained by deducting the value of stock saved or salvaged, if any, from the value of the stock as at the date of fire. Then the average clause, if applicable, has to be applied to determine the amount of claim.

(ii) *Where proper records are not maintained or such records are destroyed by fire*
In such a case, although it is difficult to determine the exact value of stock as at the date of fire, a fairly reasonable estimate of the same can be made. The usual method of ascertaining the estimated value of stock as at the date of fire is to prepare an estimated Trading Account for the period since the last accounts were drawn up till the date of fire. For this purpose the following factors should be taken into consideration:

(a) To determine the estimated value of stock as at the date of fire, the ratio or percentage of gross profit to turnover or sales is the most important guide. In the absence of any special circumstances, the Gross Profit Ratio or percentage of the last year may be taken to apply to the current period. If the gross profit percentage, so found, is calculated on the sales for the period, it will represent the estimated profit for the period. Now, the estimated Trading Account can be prepared on the basis of purchases and sales from the beginning of the period up to the date of fire together with the opening stock and the estimated gross profit. The balancing figure in the Trading Account will be taken as the estimated value of stock as at the date of fire.

(b) In arriving at the Gross Profit Percentage on the basis of last year's accounts, care should be taken about the mode of valuation of opening and closing stock. If the stock in the last year has not been valued at cost, the valuation should be adjusted first at cost to determine the appropriate gross profit percentage. The opening stock of the current period should also be taken at cost as the basis of valuation of stock is essentially the cost. For example, if the opening and closing stock of the last year were Rs 9,000 and Rs 18,000 respectively being valued at 10% below cost, the adjusted opening and closing stock

(c) When gross profit percentage figures for a number of years are available, an average of these percentages may be taken for finding out estimated gross profit percentage of the current period up to the date of fire. But, if the percentages show a clear upward or downward trend, weighted average or geometric average may be taken.

Note Sometimes, it may so happen that the percentage of gross profit may be given in the problem. If the given percentage of gross profit is based on cost, it is necessary to ascertain the percentage on sales. If, for example, the percentage of gross profit on cost is given as 25%, percentage

on sales has to be ascertained as follows

Let the cost price be 100 Therefore, profit = 25

$$\therefore \text{Selling price} = 100 + 25 = 125$$

- (d) Once the estimated value of stock as at the date of fire is ascertained the next step is to determine the amount of loss of stock by fire For this, the salvaged stock, if any, has to be deducted from the estimated value of stock as at the date of fire The remainder will represent the amount of stock lost by fire
- (e) Now, the average clause, if applicable, has to be applied to determine the amount of claim

(iii) *Where the books of accounts have also been destroyed by fire*

- (a) For such a case, it becomes more difficult to obtain the details necessary to prepare the estimated Trading Account In order to ascertain the approximate amount of sales and purchases all customers and suppliers should be contacted through circulars From the replies, received from the customers and suppliers and the knowledge of the proportion of cash sales and purchases, the approximate sales and purchases for the period can be estimated Copies of previous Profit and Loss Account and Balance Sheets are usually available in the hands of auditors or income tax authorities and as such there should be no difficulty in arriving at the value of opening stock and the usual percentage of gross profit on sales Now, it is possible to prepare the Trading Account and to ascertain the estimated value of stock as at the date of fire
- (b) The next step is to determine the amount of loss of stock by fire For this, the salvaged stock, if any, has to be deducted from the estimated value of stock as at the date of fire The remainder will represent the amount of stock lost by fire
- (c) Now, the average clause, if applicable, has to be applied to determine the amount of claim

Illustration 1 A trader took out a fire policy containing an average clause covering his stock for Rs 15,000 His practice was to base his selling price at cost plus 33 1/3% He closes his books on 30th June every year

On 31st March, 2007, a fire occurred at his premises and destroyed his stock The salvaged stock was Rs 6,000 During the period of 9 months preceding the fire his purchases amounted to Rs 61,000, and sales to Rs 84,000 His stock at 1st July, 2006 was valued at Rs 20,000

You are required to prepare a statement showing the amount of claim

Solution:

Trading Account for the period of 9 months, from 1.7.2006 to 31.3.2007

Dr	Rs	Cr	Rs
To Opening Stock	20,000	By Sales	84,000
" Purchases	61,000	" Closing Stock (Balancing figure)	18,000
" Gross Profit @ 25% on Sales*	21,000		
	<u>1,02,000</u>		<u>1,02,000</u>

Statement showing the Amount of Claim for the Loss of Stock

	Rs
Estimated value of stock as at the date of fire i.e. on 31.3.2007 as per Trading Account	18,000
Less Value of salvaged stock	<u>6,000</u>
Estimated value of stock lost by fire	<u>12,000</u>

* $33\frac{1}{3}\%$ on cost is the same as 25% on selling price

Illustration 2 The Trading Account of X Co for the year ended 31st December, 2006 is given Below

Dr	Rs	Cr	Rs
	34,240	By Sales less returns	98,000
To Opening Stock			
" Purchases less returns	78,470	" Closing Stock	29,410
" Gross Profit c/d	14,700		
	<u>1,27,410</u>		<u>1,27,410</u>

A fire occurred in the godown of the company on 30th June, 2007 and a considerable part of the stock was destroyed. The salvaged stock was worth Rs 1,750. The stock was fully insured against fire risks.

Considering the following further particulars prepare a statement showing the amount of claim to be lodged by X Co with the insurance company for the loss of stock.

Sales for the period ending 30th June, 2007 were Rs 54,600. The amount paid for purchases was Rs 44,000 including a cheque of Rs 360 which remains unrepresented to the bankers upto 30.6.2007. As shown by the books of accounts trade creditors on 31.12.2006 amount to Rs 12,300 and on 30.6.2007 they were Rs 11,050. Goods worth Rs 3,190 were returned to creditors during the period ending 30.6.2007.

Solution

**Trading Account for the period of 6 months,
i.e., from 1.1.2007 to 30.6.2007**

Dr		Rs		Cr
		<i>Rs</i>		<i>Rs</i>
To Opening Stock		29,410	By Sales	54,600
" Purchases	45,940		" Closing Stock	
Less Returns	<u>3,190</u>	42,750	(Balancing figure)	25,750
" Gross Profit				
@ 15% on Sales		8,190		
		<u>80,350</u>		<u>80,350</u>

Statement showing the amount of claim for loss of stock

	Rs
Estimated value of stock as at the date of fire i.e. on 30.6.2007 as per Trading Account	25,750
Less Value of salvaged stock	<u>1,750</u>
	<u>24,000</u>

2 Purchases during the period ending 30.6.2007 has been ascertained as follows

Trade Creditors Account

	Rs		Rs
To Returns	3 190	By Balance b/d	12,300
" Bank	44 000	" Purchases (Balancing Figure)	45 940
" Balance c/d	11 050		
	<u>58,240</u>		<u>58,240</u>

Illustration 3 Due to heavy fire in the godown of a company on 1st October, 2007, the entire stock was burnt except some costing Rs 35,000. The books were, however, saved.

From the information available it was found that

- 1 The company's average gross profit was 25% on sales
- 2 The stock on 31st March, 2007 valued at 10% above cost was Rs 1,10,000
- 3 The purchases and sales from 1st April, 2007, upto the date of fire were Rs 1,50,000 and Rs 3,40,000 respectively
- 4 The wages for the period amounted to Rs 72,000
- 5 The company insured the stock for Rs 60,000
- 6 The policy had an average clause

You are required to prepare a statement showing the amount of stock lost by fire and the amount of claim to be lodged with the Insurance Company

Solution

Trading Account for the period of 6 Months, from 1.4.2007 to 30.9.2007

	Rs		Rs
To Opening Stock		By Sales	3,40,000
110 000 - $\frac{100}{110}$	1,00,000	By Closing Stock	
To Purchases	1,50,000	(Balancing figure)	67,000
To Wages	72,000		
To Gross Profit @ 25% on Sales	85 000		
	<u>4,07,000</u>		<u>4,07,000</u>

**Statement showing the amount of stock lost by fire and
the amount of claim to be lodged**

	Rs
Estimated cost price of stock as on 1 10 2007	67 000
Less Value of salvaged stock	<u>35,000</u>
Amount of stock lost by fire	<u>32,000</u>
Applying Average Clause	

	Rs		Rs
To Opening Stock		By Sales	3,40 000
(110 000 - $\frac{100}{110}$)	1 00 000	By Closing Stock	
To Purchases	1 50 000	(Balancing figure)	67 000
To Wages	72 000		
To Gross Profit @ 25% on Sales	85 000		
	<u>4,07,000</u>		<u>4,07,000</u>

**Statement showing the amount of stock lost by fire and
the amount of claim to be lodged**

	Rs
Estimated cost price of stock as on 1 10 2007	67 000
Less Value of salvaged stock	<u>35,000</u>
Amount of stock lost by fire	<u>32,000</u>
Applying Average Clause	

$$=Rs\ 32\ 000 \times \frac{Rs\ 60,000}{Rs\ 67,000} =Rs\ 28\ 657$$

Illustration 4 Mahesh & Company prepares accounts on 31st March each year, but on 30th June 2007 a fire in the godown destroyed the greater parts of his stock. Following information was collected from his books:

	<i>Rs</i>
Stock as on 1 st April, 2007	59,400
Purchases from 1 st April 2007 to 30 th June 2007	1,50,000
Wages from 1 st April 2007 to 30 th June 2007	66,000
Sales from 1 st April 2007 to 30 th June 2007	2,80,000

The rate of gross profit is $33\frac{1}{3}$ % on cost. Stock to the value of Rs 6,000 was salvaged.

Insurance policy was taken for Rs 50,000 and claim was subject to average clause. The following additional information is available:

- (i) Stock in the beginning of the year was calculated at 10% less than cost.
- (ii) A plant was installed by firm's own workers. They were paid Rs 1,000, that was included in wages.
- (iii) Purchases include the purchase of the plant for Rs 10,000.

You are required to calculate the claim for the loss of stock.
Solution

Computation of claim for loss of stock :

	(Rs)
Stock on the date of fire i.e. 30.6.2007	61,000
Less Salvaged Stock	6,000
Loss of Stock	55,000

Amount of Claim $\frac{\text{Insured value of stock}}{\text{Total cost of stock on the date of fire}}$

$$= \frac{\text{Rs } 50,000}{\text{Rs } 61,000} \times 55,000 = \text{Rs } 45,082$$

working Note

Memorandum Trading Account is prepared for the period from 01.04.2007 to 30.6.2007 to compute the value of stock on 30.6.2007.

UNIT – II – PARTNERSHIP ACCOUNTS

INTRODUCTION

According to section 4 of the Partnership Act, 1932 a Partnership is “the relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all”

If we analyze the definition we find three basic element of a Partnership

- (1) It arises out of an agreement made by two or more persons,
- (2) The agreement is made regarding sharing profits of a business,
- (3) Such business is carried on by all or any one of them acting for all
 - (a) Partnership is the result of an agreement It does not arise from status
 - (b) The agreement may be either verbal or in writing There should be some terms and conditions binding the Partnership
 - (c) The existing law does not enforce that the terms of the Partnership must be in writing If written, the agreement is known as Deed or Articles of Partnership
 - (d) For the formation of a Partnership more then one person is requies For a banking business the maximum number of Partners is 10. in other businesses it is 20

Partnership Deed

Mode of Appropriation Among other details the deed contains the mode of appropriation of profits (or losses) specially regarding interest on partners capitals, salary or commission, etc payable to partners and the profit-sharing ratio

In the absence of deed the following guidelines should be followed

- 1 Every Partner should share profits equally [Section 13 (b)]
- 2 No interest is to be allowed on Partners' capitals [Section 13 (c)]
- 3 No interest should be charged on the drawings of the Partners
- 4 No salary is to be allowed to any partner
- 5 Interest on advances made by partners should be provided @ 6% per annum [Section 13(d)]
- 6 Every partner should be to have equal share in the property of the Partnership as per Section 14

Some Important Considerations

Partners' Capitals

(a) Where the Partners decide and the agreement provides, the Capitals Accounts of the Partners remain unchanged over years In that case the Capital Accounts show the original amounts invested by the Partners as capitals unless some change (like change in capital Ratio etc) takes place The Capitals are called Fixed Capitals Partners' Current Accounts are opened and used for recording subsequent trans actions between the Partner and the firm for salary/commission to Partners, Interest on Partners Capitals, their drawings and interests on drawings, share of profit/loss and interest on loans/advances given by Partners to the firm Where Capitals are Fixed, Current Accounts serve as the appendix

(b) Where there is no agreement to keep Capitals fixed over years, entries regarding Partners' drawings, Salary/Commission/Interest on Capital and share profit/loss are recorded through the Partners' Capital Accounts As a result, the Capitals undergo changes from period to period and are called Fluctuating Capitals

(c) If any Partner gives any amount as Loan or Advance to the firm separately, Partners Loan Accounts are opened and maintained Interest on Loan may be transferred to Loan Account or to Current Account (if any)

(d) A separate Drawings Account may be maintained to record withdrawals made by the partners from the firm On the closing date of a financial period, the balance of the Drawings Account is transferred to Capital Account or to Current Account (if capitals are fixed)

One must remember also that,

(i) A Capital represents a liability The balances of fixed capitals should always be credit balances The balances of Current Accounts may be credit balances or debit balances

(Where a partners' drawings exceed his share of profits/interests etc)

(ii) The balances of Fluctuating capital may be credit or debit balances

(iii) Capitals of partners may not be as per their profit sharing ratio

(iv) A partner may contribute his capitals in cash and also in the form of any other asset including goodwill If he brings in any liability his Capital = Assets brought in – Liabilities brought in = Net Assets brought in

Guaranteed Partnership

In a Partnership, there may be special agreement by virtue of which a Partner may get the guarantee of earning a minimum amount of profit This guarantee may be given by one partner in particular or by the firm It is given generally to encourage a junior partner or any sincere clerk of the business inducted to the benefits of Partnership

(a) Guarantee given by one Partner

(i) The appropriation of profit should be made in the general course by applying the existing profit sharing ratio

(ii) The minimum amount guaranteed is to be decided

(iii) In case the guaranteed amount (ii) is more, the excess should be deducted from the share of profit of the Partner given guarantee and calculated under (i) above

The same amount should be added with the original share of profit of the Partner to whom the guarantee has been given

Illustration 1 :

X and Y are Partners sharing profit as 5 : 3 Z is the clerk of their business getting a salary of Rs 500 p m and a commission of 5% of the net profit after deducting his salary and commission Now, X guarantee that Z be made a Partners with 1/10th share of profit and nothing else If the annual profits is Rs 1,32,000 Show the appropriation

Steps :

(i) General Application of Profit Z's Share as clerk Rs

Salary 500×12 6,000

Commission 5% of $[1,32,000 - 6,000]$ 6,000

12,000

Balance of profit 1,20,000 Shared as $X = 5/8 \times 1,20,000 = \text{Rs } 75,000$,

$Y = 3/8 \times 1,20,000 = \text{Rs } 45,000$

(ii) Minimum guaranteed share of Z = 1/10th of Rs 1,32,000 = Rs 13,200

(iii) Shortfall = Rs 13,200 – Rs 12,000 = Rs 1200 to be deducted from share and added with

Z's share

Final appropriation should be –

Rs

X Rs 75,000 – Rs 1200 73,800

Y 45,000

Z Rs 12,000 + Rs 1200 13,200

1,32,000

X's Capital / Current A/c Dr 1,200

To Z's Capital / Current A/c 1,200

(Being Guaranteed share of profits provided)

Guarantee given by firm :

(i) The share of profit of the guaranteed Partner is to be calculated according to the profit – sharing ratio

(ii) His minimum guaranteed amount is ascertained

(iii) The higher of (i) and (ii) is given or credited to him

(iv) The remaining profits are shared among the remaining Partners in their remaining ratio

If the minimum guaranteed amount is more, the shortfall may be agreed to be in a ratio specially agreed upon

Illustration 2 :

The profit sharing ratio among X, Y and Z is 3 : 2 : 1. Z is guaranteed a minimum profit of Rs 84,000 p a. Annual profit are Rs 4,20,000. Show the distribution.

Steps :

(i) Normal Distribution

X $\frac{3}{6}$ of Rs 4,20,000 2,10,000

Y $\frac{2}{6}$ of Rs 4,20,000 1,40,000

Z $\frac{1}{6}$ of Rs 4,20,000 70,000

(ii) Z's guaranteed share is Rs 84,000

(iii) Z's share should be Rs 84,000 (higher than Rs 70,000)

(iv) X's share $[4,20,000 - 84,000] \times \frac{3}{5}$ 2,01,600

Y's share $[4,20,000 - 84,000] \times \frac{2}{5}$ 1,34,400

Z's share 84,000

4,20,000

X's Capital / Current A/c Dr 8,400

Y's Capital / A/c Dr 5600

To Z's Capital / Current A. c 14,000

Prior Period Adjustments

Errors committed in making appropriations of profit or in measuring revenues or profits in any earlier year may be located by a partnership firm in a subsequent year. Such errors may result from wrong valuation of inventory, incorrect distribution of profit, errors of misposting or principles, etc. Their adjustments should be made with retrospective effect from the date of initiation of errors. The adjustment is usually made with the help of adjustment entries

made through the partner's Capital Accounts. A 'Prior Period Adjustment Account' or 'Profit & Loss Adjustment Account' may be used to accommodate the adjustments and the balance of this account may be transferred either to this Profit & Loss Account of the current year or

to the partners capital accounts

Also there may be situations involving personal payment of salary by one partner to another, omission to charge Interests, etc

Illustrations 3 :

A, B and C are partners sharing profits and loss as 2 : 2 : 1 They get interest on their Capitals at 5% p a and are charged @ 6% p a on their Drawings A and B are paid salary @ Rs 250 per month respectively A would be paid 6% interest on his loan A paid Rs 25,000 as loan on 1st July, 2007 A, B and C withdrew Rs 10,000, Rs 8,000 and Rs 6,000 respectively during 2007 C is entitled to a commission at 2% on total sales which amounted to Rs 3,46,000 during the year On 1st January, 2007 the capital balances of A, B and C were Rs 1,00,000, Rs 80,000 and Rs 60,000 respectively The net profit for the year is Rs 1,00,000 Prepare the Profit & Loss Appropriation Account and the Capital Accounts of partners

Solution

Profit & Loss Appropriation Account: for the year ended 31 12 2007

Dr			Cr		
Particulars	Amt Rs.	Amt Rs.	Particulars	Amt Rs	Amt Rs
To Salary			By Profit & Loss (Net Profit)		100,000
A [250 X 12]	3,000		Interest on Drawings :		
B [150 X 12]	<u>1,800</u>	4,800	• 6% p a. on an average		
• Commission C		6,926	of 6 months)		
[2% of Rs 3,46,000]			A	300	
• Interest on Capital			B	240	
A	5,000		C	<u>180</u>	720
B	4,000				
C	<u>3,000</u>	12,000			
• Interest on Loan - A		753			
• Share of profits					
A [2/5]	30,500				
B [2/5]	30,500				
C [1/5]	<u>15,250</u>	76,250			
		1,00,720			1,00,720

Capital Accounts

Dr.					Cr				
Date 2007	Particulars	A Rs	B Rs	C Rs.	Date 2007	Particulars	A Rs	B Rs	C Rs.
31.12	To Drawings	10,000	8,000	6,000	1.1	By balance b/d	1,00,000	80,000	60,000
-	* Interest on Drawings	300	240	180	31.12	* Salary	3,000	1,800	-
-	* Balance c/d	1,28,200	1,08,060	78,990	-	* Commission	-	-	6,920
					-	* Interest on Capital	5,000	4,000	3,000
					-	* Share of Profit	30,500	30,500	15,250
		1,38,500	1,16,300	85,170			1,38,500	1,16,300	85,170

Illustration 4 :

A and B are partners in a firm sharing profits and losses equally. On 1st April, 2007 the balance of their Capital Accounts were A-Rs 50,000 and B-Rs 40,000. On that date the balances of their Current Accounts were A-Rs 10,000 (credit) and B-Rs 3,000 (debit). Interest @ 5% p a is to be allowed on the balance of Capital Accounts as on 1.4.2007. B is to get annual salary of Rs 3,000 which had not been withdrawn. Drawings of A and B during the year were Rs 1,000 and Rs 2,000 respectively. The profit for the year ended 31st March, 2008 before charging interest on capital but after charging B's salary was Rs 70,000. It is decided to transfer 10% of divisible profit to a Reserve Account. Prepare Profit & Loss Appropriation Account for the year ended 31st March, 2008 and show Capital and Current Accounts of the Partners for the year.

Points to be noted

(i)	Profit before charging interest on Capital and Salary to B = Rs 70,000 - Rs. 3,000 = Rs. 73,000
(ii)	Transfer to Reserve = 10 % of Divisible Profits

Solution

Dr Profit & Loss Appropriation Account for the year ended 31.03.2008 Cr

Particulars	Amount	Amount	Particulars	Amount	Amount
To Salary - B		3,000	By Profit & Loss (Net Profit before Charging Salary and Interest)		73,000
- Interest on Capitals					
A	2,500				
B	2,000	4,500			
- Reserve (10% of 65,500)		6,550			
- Share of Profit					
A (1/2)	29,475				
B (1/2)	29,475	58,950			
		73,000			73,000

Capital Accounts

Dr

Cr

Date	Particulars	A Rs	B Rs	Date	Particulars	A Rs	B Rs
31.3.08	To balance c/d	50,000	40,000	1.4.07	By Balance b/d	50,000	40,000

Current Accounts

Dr

Cr

Date	Particulars	A Rs	B Rs	Date	Particulars	A Rs	B Rs
1.4.07	To balance b/d	-	3,000	1.4.07	By Balance c/f	10,000	-
31.3.08	- Drawings	1,000	2,000	31.3.08	- Interest on Capital	2,500	2,000
31.3.08	- Balance c/d	40,975	29,475	-	- Salary	-	3,000
		41,975	34,475	-	- Share of Profit	29,475	29,475
						41,975	34,475

Calculation of Interest on Drawings

1. If the date of drawings is mentioned, then calculate interest according to the time
2. If the date of drawings is not mentioned, then calculate interest on the average of the time period
3. If unequal amounts are drawn at irregular intervals

Illustration 5 : Accounting Period January – December Interest (@ 12% p a

Month	Amount Drawn (Rs)	Period (In Months)	Product (Amount × Period)
February	10,000	11	1,10,000
May	5,000	8	40,000
September	15,000	4	60,000
November	10,000	2	20,000
December	20,000	1	20,000
			2,50,000

$$\text{Interest} = \text{Product} \times \text{Rate of Interest} \times \frac{1}{12}$$

$$= 2,50,000 \times \frac{12}{100} \times \frac{1}{12} = 25000$$

4 If equal amounts are drawn at a fixed date every month, throughout the accounting period

(a) Drawn at the beginning of every month

(b) Drawn at the middle of every month

(c) Drawn at the end of every month

Interest = Amount Drawn p.m × Rate of Interest × Time

Again, the Accounting Period may be for 12 months, 6 months, 3 months or etc “How to calculate the time?”

If the Accounting Period is for 12 months (January – December)

	Beginning of the month			Middle of the month			End of the month		
	One-Year	6-months	3 months	One year	6 months	3 months	One-Year	6-months	3 months
January	12	6	3	11.5	5.5	2.5	11	5	2
February	11	5	2	10.5	4.5	1.5	10	4	1
March	10	4	1	9.5	3.5	0.5	9	3	0
April	9	3		8.5	2.5		8	2	
May	8	2		7.5	1.5		7	1	
June	7	1		6.5	0.5		6	0	
July	6		21	5.5		18	5		15
August	5			4.5			4		
September	4			3.5			3		
October	3			2.5			2		
November	2			1.5			1		
December	1			0.5			0		
	78			72			66		

Time Period

Accounting Period	At the Beginning	At the Middle	At the End
12 months	78/12	72/12	66/12
6 months	21/12	18/12	15/12
3 months	6/12	4.5/12	3/12

Note : It is a general tendency to learn the time period of 6.5, 6 & 5.5, irrespective of understanding the rationale behind on such

Refer to the 1st Row (where the amount is drawn at the beginning of every month and throughout the year), we find 78/12 = 6.5, 72/12 = 6 & 66/12 = 5.5

The rationale is Rate of interest being mentioned as per annum. But, if the rate of interest is mentioned per month basis, then interest shall be calculated by considering the time period for 78 months, 72 months & so on

Illustration 6 :

Amount Drawn p m Rs 1000 Rate of Interest @ 12% p a
 If drawn at the beginning of every month

A/c Period	Interest
12 months	$= 1000 \times \frac{12}{100} \times \frac{78}{12} = 780$
6 months	$= 1000 \times \frac{12}{100} \times \frac{72}{12} = 720$
3 months	$= 1000 \times \frac{12}{100} \times \frac{66}{12} = 660$

If drawn at the middle of every month

A/c Period	Interest
12 months	$= 1000 \times \frac{12}{100} \times \frac{71}{12} = 710$
6 months	$= 1000 \times \frac{12}{100} \times \frac{65}{12} = 650$
3 months	$= 1000 \times \frac{12}{100} \times \frac{59}{12} = 590$

If drawn at the end of every month

A/c Period	Interest
12 months	$= 1000 \times \frac{12}{100} \times \frac{60}{12} = 600$
6 months	$= 1000 \times \frac{12}{100} \times \frac{45}{12} = 450$
3 months	$= 1000 \times \frac{12}{100} \times \frac{30}{12} = 300$

Illustration 7 :

Rani, Rini and Rina are three partners in a firm. According to partnership deed, the partners are entitled to draw Rs 800 per month. On 1st day of every month Rani, Rini and Rina drew Rs 700, Rs 600 and Rs 500 respectively. Profit during the year 2008 was Rs 85,500 out of which Rs 30,000 was transferred to General Reserve. Rini and Rina are entitled to receive salary of Rs 3,000 and Rs 4,500 p.a. respectively and Rani is entitled to receive commission at 10% of net distributable profit after charging such commission. On 1st January, 2008 the balance of their Capital Accounts were Rs 50,000, Rs 40,000 and Rs 35,000 respectively. Interest on Capital provided at 8% p.a. You are required to show Profit & Loss Appropriation Account for the year ended 31st December, 2008 and Capital Accounts of Partners in the book of the firm.

Points to be noted

1. A partner was allowed to draw Rs 800 per deed in this case, none of the Partners draw more than that.

2. Interest on Drawings should be calculated as 1st month's drawings for 12 months, for second month's drawings for 11 months and so on. Alternatively, 6.5 month interest is to be calculated on total drawings of each partner. (See theoretical discussion regarding interest on drawings.)

Rani's total drawings = $700 \times 12 = \text{Rs } 8,400$, Int. on Drawings = $8,400 \times 10/100 \times 13/24 = \text{Rs } 455$

Rini's total drawings = $600 \times 12 = \text{Rs } 7,200$, Int. on Drawings = $7,200 \times 10/100 \times 13/24 = \text{Rs } 390$

Rina's total drawings = $500 \times 12 = \text{Rs } 6,000$, Int. on Drawings = $6,000 \times 10/100 \times 13/24 = \text{Rs } 325$

Solution

Dr Profit & Loss Appropriation Account for the year ended 31.12.2008 Cr

Particulars	Amount Rs	Amount Rs	Particulars	Amount Rs	Amount Rs
To General Reserve		30,000	By Profit & Loss		85,500
- Salary Rini	3,000		- Net Profit :		
Rina	4,500	7,500	Interest on Drawings		
- Interest on Capital (at 8%)			Rani	455	
Rani	4,000		Rini	390	
Rini	7,200		Rina	325	1,170
Rina	2,800	10,000			
- Commission Rani-(Note)		3,561			
- Share of Profit					
Rani (1/3)	11,870				
Rini (1/3)	11,870				
Rina (1/3)	11,865	35,605			
		85,670			85,670

Capital Accounts

Dr.

Cr

Date 2008	Particulars	Rani Rs	Rini Rs	Rina Rs	Date 2008	Particulars	Rani Rs	Rini Rs	Rina Rs
31.12	To Drawings	8,400	7,200	6,000	31.12	By Balance b/d	50,000	40,000	35,000
	* Interest on Drawings	455	390	325		* Interest on Capital	4,000	3,200	2,800
	* Balance c/d	60,576	50,400	47,844		* Salary	-	3,000	4,500
						* Commission	3,561	-	-
						* Share of Profit	11,870	11,870	11,869
		69,431	58,070	54,169			69,431	58,070	54,169

Working Notes

	Rs.
Net Profit before Commission (86,870 - 30,000 - 7,500 - 10,000)	39,370
Less Rina's Commission = 10/100 of 39,370 (approx)	3,561
Share of Profit	35,809

Illustration 8 :

Calculation of Interest on Drawings made uniformly at the end of each quarter On January 1, 2008, Amethyst and Emerald commenced business as partners introducing capitals of Rs 20,000 and Rs 30,000 to their respective accounts The partnership deed, provided inter alia that

- (i) Profit/Losses shall be shared in the ratio of 2 : 3 as between Amethyst and Emerald
- (ii) Partners shall be entitled to interest on Capital at the commencement of each year at 6 % p a , and
- (iii) Interest on Drawings shall be charged at 8 % p a

During the year ended 31.12.2008 the firm made a profit of Rs 19,280 before adjustment of interest on Capital and drawings The Partners withdrew during the year Rs 3,000 each at the end of every quarter commencing from 31.3.2008 You are required to prepare a Profit Loss Appropriation A/c and show the entries therein for distribution of Profit

Show also the Capital A/cs of the partners for the year

Points to be noted :

Each Partner drew Rs 3,000 at the end of each quarter or Rs 12,000 during the year But interest on drawings for each of them should be

- (a) On 3,000 draw at the end of 1st Quarter – Interest for 9 months = $3,000 \times \frac{8}{100} \times \frac{9}{12} = \text{Rs } 180$
- (b) On 3,000 draw at the end of 2nd Quarter – Interest for 6 months = $3,000 \times \frac{8}{100} \times \frac{6}{12} = \text{Rs } 120$
- (c) On 3,000 draw at the end of 3rd Quarter – Interest for 3 months = $3,000 \times \frac{8}{100} \times \frac{3}{12} = \text{Rs } 60$
- (d) On 3,000 draw at the end of 4th Quarter – No interest

* Total Interest on Drawings for each partner = Rs 180 + Rs 120 + Rs 60 = Rs 360

Solution

Dr Profit & Loss Appropriation Account for the year ended 31.12.1995 Cr

Particulars	Amount Rs	Amount Rs	Particulars	Amount Rs	Amount Rs
To Interest on Capital at 8% p.a.			By Profit & Loss (Net Profit)		19,200
Amethyst	1,200		- Interest on Drawings		
Emerald	1,800	3,000	Amethyst	260	
- Share of Profit			Emerald	460	720
- Amethyst (2/5)	6,800				
Emerald (3/5)	10,200	17,000			
		20,000			20,000

Capital Accounts

Dr Cr

Date	Particulars	Amethyst Rs	Emerald Rs	Date	Particulars	Amethyst Rs	Emerald Rs
31.12.08	To Drawings	12,000	12,000	1.1.08	By Bank	20,000	30,000
31.12.08	- Drawings	360	360		- (Capital Introduced)		
	- Balance b/d	15,640	29,640	31.12.06	- Interest on Capital	1,200	1,800
					- Share of Profit	6,800	10,200
		29,000	42,000			28,000	42,000

Illustration 9 :

Azu and Biju are partners firm contributing Rs 25,000 and Rs 20,000 respectively as capitals and sharing profit as Azu 3/5 th and Biju 2/5 th. Interest on Capitals is to be allowed at 10 % per annum. The net profit for year ended 31st March, 2008 amounts to Rs 3,600 before making any allowance for interest. Show the appropriation of profit.

Solution

	Azu (Rs)	Biju (Rs)	Total (Rs)
Interest on Capital @ 10% p.a.	2,500	2,000	4,500

The profit are Rs 3,600

Unless specifically agreed upon, interest on capitals should be allowed only up to Rs 3,600 and should be shared in Capital Ratio [25,000 : 20,000 or 5 : 4]

Azu's share = $5/9 \times \text{Rs } 3,600 = \text{Rs } 2,000$, Biju's share = $4/9 \times \text{Rs } 3,600 = \text{Rs } 1,600$

If the partners have agreed upon provision for interest on capital irrespective of profits, the distribution should be

Dr. Profit & Loss Appropriation Account for the year ended 31.12.2008 Cr.

Particulars	Amt Rs.	Amt Rs.	Particulars	Amt Rs.	Amt Rs.
To Interest on Capital			By profit & Loss (Net Profit)		3,600
Azi	2,500		Share of Loss		
Biju	2,000	4,500	Azi (3 : 5)	540	
			Biju (2 : 5)	360	900
		4,500			4,500

Illustration 10 :

Sharing of profit on Effective Capital Ratio Sachin, Sanat and Sohali Started a partnership firm on 1.1.2008 Sachin introduced Rs 10,000 on 1.1.2008 and further introduced Rs 5,000 on 1.7.08 Sanat introduced Rs 20,000 at first on 1.1.08 but withdrew Rs 8,000 from the business on 31.7.08 Sohali introduced Rs 12,000 at the beginning on 1.1.08, increased it by Rs 4,000 on 1.6.08 and reduced it to Rs 10,000 on 1.11.08 During the year 2008 they made a net profit of Rs 56,100 The partners decided to provide interest on their capitals at 12 % p a and to divide the balance of profit in their effective capital contribution ratio Prepare the Profit & Loss Appropriation Account for the year ended 31.12.08

Solution

(a) Calculation of effective capital contribution

		Product (Rs)
Sachin	Rs 10,000 for 6 months (1.1 to 1.7)	60,000
	Rs 15,000 for 6 months (1.7 to 31.12)	<u>90,000</u>
		<u>1,50,000</u>
Sanat	Rs 20,000 for 7 months (1.1 to 31.7)	1,40,000
	Rs (20,000 - 8,000) for 5 months (1.8 to 31.12)	<u>60,000</u>
		<u>2,00,000</u>
Sohali	Rs 12,000 for 5 months (1.1 to 1.6)	60,000
	Rs (12,000 + 4,000) for 5 months (1.6 to 1.11)	<u>80,000</u>
	Rs 10,000 for 2 months (1.11 to 31.12)	<u>20,000</u>
		<u>1,60,000</u>

Profit Sharing Ratio = Effective Capital Ratio = 15 : 20 : 16

(b) Interest on Capitals = Product x Interest on Capital x 1/12

Sachin = 1,50,000 x 12/100 x 1/12 = 1,500, Sanat = 2,00,000 x 12/100 x 1/12 = 2,000,

Sohali = 1,60,000 x 12/100 x 1/12 = 1,600

Dr Profit & Loss Appropriation Account for the year ended 31.12.1996

	Particulars	Amount Rs	Amount Rs	Particulars	Amount Rs	Amount Rs
To	To Interest on Capital			By Profit & Loss (Net Profit)		56,100
	- Sachin	1,500				
	- Sanat	2,000				
	- Sahal	1,600	5,100			
	- Share of Profit					
	- Sachin (15/51)	15,000				
	- Sanat (20/51)	20,000				
	- Sahal (16/51)	16,000				
			51,000			
			56,100			56,100

Interest on Capitals omitted to be charged.

Illustration 11 :

A, B, C and D are partners sharing profit and losses in the ratio of 4 : 3 : 3 : 2. Their respective capitals on 31st March, 2008 were Rs 3,000, Rs 4,500, Rs 6,000 and Rs 4,500. After closing and finalizing the accounts, it was found that interest on capital @ 6% per annum was omitted. Interest to altering the signed accounts, it was decided to pass a single adjusting entry on 1st April, 2008, crediting or debiting the respective partners' accounts. Show the Journal Entry.

Solution

Statement showing Rectification of Profits

Partner	Interest on Capital @ 6% p.a. not provided Rs.	Amount Wrongly distributed in PSR Rs.	(Excess) Deficit Rs.	Adjust Rs.
A	180	360	(180)	Debit
B	270	270	-	-
C	360	270	90	Credit
D	270	180	90	Credit
	1,080	1,080	-	

Date	Particulars	1 F	Dr	Cr
			Amount Rs	Amount Rs
1.4.08	A's Current A/c Dr		180	
	To C's Current Account			90
	To D's Current Account			90
	[Interest on Capital not provided @ 6% p.a. now rectified]			

Illustration 12 :

The Capital Accounts of Adhar and Bhudhar stood at Rs 40,000 and Rs 30,000 respectively after the necessary adjustment in respect of the drawings and the net profit for the year ended 31st December, 2008. It was subsequently ascertained that 5% p.a. interest on Capitals and drawings was not taken into account in arriving at the net profit. The drawings of the partners had been Adhar Rs 1,200 at the end of each quarter and Bhudhar Rs 1,800 at the end of each half year. The profit for the year as adjusted amounted to Rs 20,000. The partners share profit in the proportion of Adhar 3/5 and Bhudhar 2/5. You are required to pass journal entries and show the adjusted capital accounts of the partners.

Solution :

Working Notes

(i) Interest Drawings

	Adhar Rs	Bhudhar Rs
On 1,200 drawn at the end of 1 st quarter [$1,200 \times 5/100 \times 3/12$]	45	
On 1,200 drawn at the end of 2 nd quarter [$1,200 \times 5/100 \times 6/12$]	30	
On 1,200 drawn at the end of 3 rd quarter [$1,200 \times 5/100 \times 3/12$]	15	
On 1,200 drawn at the end of last quarter	Nil	
	90	
On 1,800 drawn at the end of 1 st half year [$1,800 \times 5/100 \times 6/12$]		45
On 1,800 drawn at the end of 2 nd half year		Nil
		45

(ii) Statement showing Rectification of Profits

	Adhar Rs	Bhudhar Rs
(A) Capital as on 31.12.08	40,000	30,000
Add Drawings	1,800	3,600
Less Share of Profits already Credited	12,000	8,000
Capital as on 1.1.08	32,800	25,600
Add Interest on Capital @ 5%	1,640	1,280
Less Interest on Drawings	90	45
Add Share of Profits = 17,215 [20,000 - 1,640 - 1,280 + 90 + 45]	18,325	6,886
Less : Drawings	4,800	3,600
(B) Adjusted Capital as on 31.12.08	39,875	30,121
Difference of Capital (A-B)	121 (Excess)	121 (Deficit)

Solution

Adjustment Entry

Journal		Dr	Cr.
Date	Particulars	l F	Amount Rs.
11/2009	Adhar's Capital Account - Cr To Bhudhar's Capital Account [Adjustment made for Interests on Capital and on Drawings not provided and the net amount wrongly shared as Profits]		121
			121

Capital Accounts

Dr				Cr			
Date	Particulars	Adhar Rs	Bhudhar Rs	Date	Particulars	Adhar Rs	Bhudhar Rs
11/09	To Bhudhar's Capital	121		11/09	By balance b/f	40,000	30,000
	Balance c/f	39,879	30,121		Adhar's Capital		121
		40,000	30,121			40,000	30,121

Illustration 13 :

Adjustments without alteration of book values

R, S and T are partners of a firm, sharing profits and losses as 5 : 3 : 2. Their Balance Sheet as on 31st March, 2007 stood as follows

Liabilities	Rs	Assets	Rs
Sundry Creditors	25,000	Cash at bank	10,000
General Reserve	20,000	Sundry Debtors	22,000
S Loan Account	15,000	Less: Reserve for Bad Debts	2,000
Capital Account		Furniture	10,000
R	25,000	Machinery	35,000
S	10,000	Stock	25,000
T	5,000		
	1,00,000		1,00,000

From 1st April, 2007 the partners decided to change their profit sharing ratio as 2 : 1 : 2 in place of their previous ratio 5 : 3 : 2 and the following adjustments were agreed upon (1) The Reserve for Bad Debts was to be raised to 10%, (2) Furniture was to be appreciated by Rs 5,200. They did not want to alter the book values of the assets and reserve but recorded the change by passing one single journal entry.

The profit for the year ended 31st March, 2008 showed a net profit of Rs 22,900.

You are required -

- To show the single journal entry adjusting the partners' capital on 1st April, 2007, and
- To prepare the Profits and Loss Account for the year ended 31st March, 2008 after taking into account the following: (i) Interest on Capital at 5% p.a., (ii) Interest on S's

loan and (iii) Transfer 25% of the divisible profit to Reserve Fund after charging interest on Capital & Loan

Solution :

Working Notes :

1. Calculation of Net Effect of the adjustments

	Rs
Profit due to increase of Value of Furniture	5,200
General Reserve	<u>20,000</u>
Less: Additional Reserve for Bad Debts (Provision)	25,200
(10% of (Rs 22,000 Rs 2000))	<u>200</u>
Profit	20,000

2 Adjustment of Capital as on 01/04/07

	R Rs	S Rs	T Rs
Profit Rs 25,000 shared in old ratio 5 : 3 : 2	12,500	7,500	5,000
Loss Rs 25,000 shared in new ratio 2 : 1 : 2	(10,000)	(5,000)	(10,000)
Net Effect	2,500	2,500	(5,000)
Capitals as on 31/03/07	25,000	10,000	5,000
Adjusted Capital on 1/4/07	27,500	12,500	

**Books of R, S & T
Journal Entry**

Date	Particulars	L.F.	Amount	Amount
1/4/07	T's Capital A/c Dr.		5,000	
	To, R's Capital			2,500
	To, S's Capital			2,500
	<i>(Adjustment made due to change in profit sharing ratio)</i>			

Particulars	Amount Rs	Amount Rs	Particulars	Amount Rs	Amount Rs
To Interest on Capital			By Profit & Loss A/c (Net Profit)		22,900
R - [5% of 27,500]	1,375				
S - [5% of 12,300]	625	2,000			
Interest on S's loan [6% of 15,000]		900			
Reserve fund [25 × 125 × (22,900 ÷ 2,900)]		4,000			
Shares of Profit					
R [2/5]	6,400				
S [1/5]	3,200				
T [2/5]	6,400	16,000			
		22,900			22,900

ADMISSION OF PARTNER:

Introduction

Partners of a continuing business may, by common consent, decide to admit a new partner for additional capital, technical skill or managerial efficiency. At the time of such admission, the usual adjustments required are (1) Adjustment regarding Profit Sharing Ratio, (2) Adjustment regarding Valuation of Assets and Liabilities, (3) Adjustment regarding Goodwill, (4) Adjustments regarding accumulated Profits or Losses and (5) Adjustment regarding Capital Contribution of New partner and Capitals of existing partners.

1. Adjustment regarding Profit Sharing Ratio : The new partner becomes entitled to a share of future profits which is sacrificed by the existing (old) partners in his favour. The sacrifice may be made by one or all of the existing partners. **The new profit sharing ratio has to be found out.**

It should be noted that

- (a) The new profit sharing ratio may be agreed upon by the partners [It may be given and we need not calculate it]
- (b) The mutual profit sharing ratio among the existing partners may remain unaltered after giving away the new partner's share

Example X and Y were partners sharing profit/losses as 3 : 2. They admit as a new partner giving him 1/5th share of future profits. What should be the new profit sharing ratio?

Solution Z's share = $\frac{1}{5}$ Balance = $1 - \frac{1}{5} = \frac{4}{5}$

X's share = $\frac{4}{5} \times \frac{3}{5} = \frac{12}{25}$, Y's share = $\frac{4}{5} \times \frac{2}{5} = \frac{8}{25}$, Z's share = $\frac{1}{5} = \frac{5}{25}$

The new profit sharing ratio = 12 : 8 : 5

- (c) The mutual profit sharing ratio among existing partners may be changed by agreement

Example P and Q were partners sharing profits/losses as 4 : 3. R is admitted as a new partner for 1/5th share. P and Q decide to share the balance of profits equally.

Solution R's share = $\frac{1}{5}$ Balance = $1 - \frac{1}{5} = \frac{4}{5}$

P's share = $\frac{4}{5} \times \frac{1}{2} = \frac{4}{10}$, Q's share = $\frac{4}{5} \times \frac{1}{2} = \frac{4}{10}$, R's share = $\frac{1}{5} = \frac{2}{10}$

New Ratio = $\frac{4}{4} \frac{2}{2}$ or $\frac{2}{2} \frac{1}{1}$

(d) If the sacrifice made individually by the existing partners is given then New Ratio should be calculated by deducting the sacrifice from the old ratio

Example A, B & C were partners sharing profits/losses as 3 : 2 : 1 They admitted D as a new partner giving him 1/6th share of future profits D acquired 3/24 th share from A and 1/24 share from B Calculate the new Profit Sharing Ratio

Solution New Ratio = Old Ratio – Sacrifice Ratio

$A = \frac{3}{6} - \frac{3}{24} = \frac{12}{24} - \frac{3}{24} = \frac{9}{24}$, $B = \frac{2}{6} - \frac{1}{24} = \frac{8}{24} - \frac{1}{24} = \frac{7}{24}$, $C = \frac{1}{6} - \text{Nil} = \frac{4}{24} - \text{Nil} = \frac{4}{24}$, $D = \frac{3}{24} + \frac{1}{24} = \frac{4}{24}$ The new ratio = 9 : 7 : 4 : 4

Thus regarding Profit Sharing Ratio we can sum up as follows :-

1 **Old Ratio** = Profit Sharing Ratio of existing Partners (before admission of new partner) = Given or Equal (If not mentioned)

2 **New Ratio** = Future Profit Sharing Ratio among all partners (including new partner, after his admission) = Given *or* = Old Ratio – Sacrificing Ratio made by each of existing partners

3. **Sacrificing ratio** = Share of an existing partner under Old Ratio – his Share under new ratio

But unless otherwise mentioned the mutual profit sharing Ratio between the existing partners will remain unaltered. In that case Sacrifice Ratio = Old Ratio.

It will be evident from subsequent discussions that proper use of the above ratios will be required for solving problems regarding Admission of a new partner

2. Adjustment Regarding Valuation of Assets and Liabilities The Book values of assets as shown in the Balance Sheet may not reflect their current realizable values Similarly the liabilities included in the Balance Sheet may not exhibit their actual position Whenever a change takes place in a partnership business in the form of admission or retirement or death of a partner or due to change in profit sharing ratio, revaluation of assets or liabilities become necessary The effect of Revaluation are given in two ways (a) **by incorporation the changes of the Balance Sheet Values** and (b) **without changing the Balance Sheet values.**

By Incorporating Changes in the Balance sheet values prepare : Revaluation Account

(i) For decrease in the value of assets, increase in the value of liabilities, provision for unrecorded liabilities Revaluation A/c Dr

To Assets A/c (with the decrease in value)

To Liabilities A/c (with the increase in value)

(ii) For increase in the value of assets, decrease in the value of liabilities, unrecorded assets

Assets A/c Dr (with the increase in value)

Liabilities A/c Dr (with the decrease in value)

To Revaluation A/c

(iii) For profit on revaluation

Revaluation A/c Dr

To old partners capital A/c (in their old profit sharing ratio)

[For loss on revaluation, the reverse entry should be made]

Proforma Revaluation Account

Rs	Rs
To Assets (Decrease) xx	By Assets (Increase) xx
To Liabilities (Increase) xx	By Liabilities (Decrease) xx
To Partners Capital A/c (Share of Revaluation Profit) xx	By Partners Capital A/c (Share of Revaluation loss) xx
xx	xx

Without changing the Balance sheet Values.

Prepare Memorandum Revaluation Account

- (i) Record increase/decrease in the value of assets and liabilities as discussed
- (ii) Share the profit or loss on Revaluation amongst the old partners in their old profit sharing Ratio
- (iii) Reverse the increase/decrease in the value of assets and liabilities
- (iv) After reversal, calculate profit or loss
- (v) Share the profit/loss, after reversal amongst all the partners (including the new partner) in their new profit sharing ratio

Memorandum Revaluation Account

Dr. Rs	Cr Rs.
To Assets (Decrease) xx	By Assets (Increase) xx
To Liabilities (Increase) xx	By Liabilities (Decrease) xx
To Partners Capital A/c (Share of Revaluation Profit) xx	By Partners Capital A/c (Share of Revaluation loss) xx
Old Partners in old Profit sharing Ratio xx	Old Partners in their Old profit sharing ratio xx
xxx	xxx
To Reversal of Items b/d xx	By Reversal of Items b/d xx
To Partners Capital A/c (Revaluation Profit amount all partners in new profit sharing Ratio) xx	By Partners capital A/c (Revaluation loss amount all partners in their new Profit sharing (Ratio) xx
xxx	xxx

3. Adjustment regarding Goodwill It is being separately discussed later.

4. Adjustment Regarding Accumulated Profits or Losses Usually accumulated Profits like Profit & Loss (Cr) or General Reserve and accumulated losses like Profit & Loss (Dr) should be apportioned among the Old Partners in Old Ratio. However, the partners may decide to maintain the Accumulated Profits at original figure even after the new partner's admission.

In that case the usual entries made are

(a) Accumulated Profits (P/L Reserve)	Dr
To Old Partners' Capitals (Old Ratio)	
(b) 'All Partners' Capitals	Dr
To Accumulated Profit (New Ratio)	

In most cases, the question remains silent regarding the treatment of accumulated profits or losses. In that case, these should be shared among old partners in old ratio.

5. Adjustment Regarding Capitals The new partner may have to introduce proportionate capital on the basis of the combined adjusted capitals of the existing (or old) partners. On the other hand, the old partners may agree to make their capitals proportionate to the new profit sharing ratio on the basis of the capital contribution of the new partner or on any other basis.

In that case additional capital may be withdrawn by them or transferred to Current Accounts. Similarly shortfall may be made good by introduction of further capital. But Capital contributions may not be in Profit Sharing Ratio, unless said otherwise.

Adjustment Regarding Goodwill

Goodwill is an invisible force that helps a business to earn more than the normal return on investment enjoyed by similar businesses. It is the sum total of the reputation and other favourable attributes built up by a business. Goodwill results into larger number of customers, higher turnover and more profits for a business. The additional profits earned by the business or its "super profits" indicate that it has goodwill. Thus goodwill is a real but intangible asset.

When the amount paid for the purchase of a business is in excess of its net assets, such excess payment is treated as "Goodwill at Cost" or "Purchased Goodwill". Where there is no purchase or sale but a change of constitution takes place like admission of a new partner etc., the value of goodwill may be recognized as "Inherent/Potential" Goodwill. Accounting Treatment of Goodwill as Read with the Relevant Accounting Standard issued by the ICAI.

(A) Accounting Standard 10 (AS—10) related is 'Accounting for Fixed Assets'

(B) Paragraph 16 of this standard stipulates that "Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is excess of the value of the net assets of the business taken over the excess is to be termed as 'goodwill'."

Illustration :

X and Y were partners sharing profits as 4 : 3. Z joined as a new partner. The new profit sharing ratio between X, Y and Z was agreed to be 7 : 5 : 3. The Goodwill of the firm was valued at Rs 84,000. But Z could not pay any premium for goodwill.

Solution

Step 1 Calculate Z's premium $\frac{3}{15}$ of Rs 84,000 = Rs 16,800

Step 2 Calculate sacrifices made by X and Y $X = \frac{4}{7} - \frac{7}{15} = \frac{11}{105}$

$Y = \frac{3}{7} - \frac{5}{15} = \frac{10}{105}$ Sacrifice Ratio 11 : 10

Z's Capital A/c Dr 16,800

Treatment of Goodwill (At the time of Admission of a New Partner)

Sl No	Case	Journal Entry	Ratio used	Remarks
1	New Partner pays Premium for Goodwill	Cash/ Bank Dr. To Old Partners Capital (Premium money)	Sacrifice Ratio	(1) If mutual ratio between old partners do not change sacrifice ratio = Old Ratio (2) If Goodwill stands at or is raised to full value, no premium should be paid
2	If the premium or its part is immediately withdrawn by old partners	Old Partners Capital. Dr To Bank (Amount withdrawn)	As withdrawn	
3	New Partner pays Premium although Goodwill appears in the Books at full value	Either Old Partners Capital Dr To Goodwill (written off) Cash/Bank Dr To New Partner's Capital (Premium Money treated as part of new partner's capital)	Old Ratio	Write off Goodwill if it is already existing in the Books
4.	New Partner pays privately for premium for Goodwill to old partners	No Entry		Not a transaction of the business
5.	New Partner cannot pay the Premium temporarily	Loan to New Partner Dr To Old Partners Capitals	Sacrifice Ratio	OR old ratio if the mutual ratio between old partners do not change
6	New Partner is unable to pay the Premium (a) A Goodwill Account is raised at its full value	Goodwill A/c Dr. To Old Partners Capital A/c (Full Value)	Old Ratio	*Full value may be given or may have to be calculated For example, the new partner for his 2/5th the share failed to pay premium Rs 5,000 Full value = $(5000 \times 5) / 2 = \text{Rs } 12,500$ As a result No GOODWILL ACCOUNT will appear in the Balance Sheet Goodwill Account will not appear in the Balance Sheet
	(b) A Goodwill Account is raised and written off	(i) Goodwill A/c Dr To Old Partners Capitals (Raised) (ii) All Partners Capital A/c Dr (Including new partner) To Goodwill (Written off)	Old Ratio New Ratio	

Illustration :

X and Y are partners having Capitals of Rs 80,000 and Rs 20,000 respectively and a profit sharing ratio of 4 : 1. Z is admitted for 1/5 th share in the profits of the firm and he pays

Rs 30,000 as Capital. Find out the value of the Goodwill

Total Capital of the firm $30,000 \times 5/1 = \text{Rs } 1,50,000$

{ Taking Z's Capital as base }

Less Combined Adjusted Capital

$80,000 + 20,000 + 30,000 = \text{Rs } 1,30,000$

Hidden Goodwill = Rs 20,000

7	New Partner is unable to pay the Premium and an adjustment is to be made through the Capital A/c	New Partner's Capital Dr To Old Partners Capitals {Premium Money}	Sacrifice Ratio	Or, old ratio if the mutual ratio between old Partners remain unchanged.
8	New partner pays only a portion of the Premium but cannot pay the remaining portion. (a) For Portion Paid (b) For unpaid Portion	(a) Cash / Bank Dr To Old Partners Capitals {Portion Paid} (b) Goodwill Dr To Old Partners Capital {Goodwill for unpaid portion}	Sacrifice Ratio Old Ratio	Or old ratio : Goodwill is valued on the basis of unpaid Premium For example, the new partner for his 2/5 th share paid Rs 12,000 out of Rs. 20,000 Premium Unpaid Premium for 2/5 th share = Rs. 8,000 Value of Goodwill = $(8,000 \times 5) / 2 = \text{Rs } 20,000$
9	If Goodwill Account already appears in the Books and Goodwill is to be raised at its full value (a) If Book value is lower than full value (b) If Book value is more than full value	(a) Goodwill Dr To Old Partners Capital A/c {Full value—Book Value} (b) Old Partners Capital Dr To Goodwill {Book value — Full Value}	Old Ratio Old Ratio	

Illustration Regarding Valuation of Goodwill

Valuation of Goodwill for a non corporate assessee

From the following information, calculate the value of goodwill by super profit method and Capitalization method

- (i) Average Capital employed in the business Rs 7,00,000
- (ii) Net trading profit of the firm for the past three years Rs 1,47,600, Rs 1,48,100 and Rs 1,52,500
- (iii) Rate of Interest expected from capital having regard to the risk involved —18%
- (iv) Fair remuneration to the partners for their services 12,000 per annum
- (v) Sundry Assets (excluding goodwill) of the firm Rs 7,54,762
- (vi) Sundry Liabilities Rs 31,329
- (vii) Goodwill valued at 2 years' purchase

Years	Profits Given Rs.	Adjusted Profits after considering Remunerations Rs.
1st	1,47,600	1,35,600
2nd	1,48,100	1,36,100
3rd	1,52,500	1,40,500
Total Profits	4,48,200	4,12,200
Average Adjusted Annual Profits		Rs. 4,12,200 ÷ 3
Less Normal Return on Capital @ 18% of Rs. 7,00,000		1,26,000
Super Profits		1,37,400
		11,400

Therefore Goodwill = Super profit x year of Purchase = 11,400 x 2 = 22,800

Illustration.

The new partner cannot pay premium and a Goodwill Account is raised

A and B are partners sharing profits and losses as 3 : 2. They admit C as a partner who is unable to bring Goodwill premium in cash but pays Rs 10,000 as capital. A Goodwill Account is raised in the books of the firm which is valued at two years' purchase of the last three years average profits. The profits for the last 3 years were Rs 5,000, Rs 4,000 and Rs 4,500. The Profit sharing ratio among the partners has been agreed to be 5 : 2 : 2. The partners decide to write-off Goodwill after C's admission.

Journal Entries, Points to be noted

1	Valuation of Goodwill Average Annual Profits of last 3 years = (Rs. 5,000 + 4,000 + 4,500) ÷ 3 = Rs. 4,500
2	Goodwill = Rs. 4,500 x 2 = Rs. 9,000
3	Goodwill to be raised = New Value — Book Value = Rs. 9,000 — Nil = Rs. 9,000 It is to be raised in Old Ratio and written off in new ratio. So sacrifice ratio is not required.

Date	Particulars	L F	Amount Rs.	Amount Rs.
	Goodwill A/c Dr To A's Capital A/c To B's Capital A/c (Goodwill Account raised and credited to old partners in old ratio 3 : 2)		9,000	5,400 3,600
	Bank A/c Dr To C's Capital A/c (Capital introduced by new partner on admission)		10,000	10,000
	A's Capital A/c Dr B's Capital A/c Dr C's Capital A/c Dr To Goodwill A/c		5,000 2,000 2,000	9,000

Illustration.

New partner pays premium for Goodwill but Goodwill Account is appearing at the Balance Sheet at full value. Gargi and Khana were partners sharing profits and losses as 5 : 3. They agreed to admit Lilabati as a new partner on payment of Rs. 9,000 as premium for Goodwill. The new profit sharing ratio was agreed as 3 : 2 : 1. The Goodwill Account appearing in the books amounted to Rs. 54,000. Pass the necessary Journal Entries.

Points to be noted

Lilabati brought in Rs. 9,000 as his share of premium for Goodwill for 1/6 in there

Therefore Full value of Goodwill = $9,000 \times 6/1 = 54,000$

There is neither overvaluation nor undervaluation

Khana had a gain of 2/48 in Profit Sharing Ratio

She shall have to pay proportionately for her share of Goodwill = $2/48 \times 54,000 = 2,250/-$

Calculation of Sacrifice	Gargi	Khana	Lilabati
Old Ratio	$\frac{5}{8}$	$\frac{3}{8}$	—
New Ratio	$\frac{3}{8}$	$\frac{2}{6}$	$\frac{1}{6}$
	$\frac{5}{8} - \frac{3}{8} = \frac{30-24}{48} = \frac{6}{48}$ (Sacrifice)	$\frac{3}{8} - \frac{2}{6} = \frac{18-16}{48} = \frac{2}{48}$ (Gain)	$\text{Nil} - \frac{1}{6} = \frac{0-8}{48} = \frac{8}{48}$ (Gain)

Journal Entries

Date	Particulars	L. F	Amount Rs	Amount Rs
	Gargi's Capital A/c Dr Khana's Capital A/c Dr To Goodwill A/c (Goodwill Account written back between the old partners in old ratio)			33,750 20,250 54,000
	Bank A/c Dr To Gargi's Capital A/c Khana's Capital A/c (Premium for Goodwill brought in by new partner and shared by old partners in their sacrifice ratio 3:1)			9,000 6,750 2,250
	Alternatively Bank A/c Dr To Lilabati's Capital A/c			9,000 9,000

Illustration

Premium for Goodwill paid privately

P and Q are partners sharing profits as 3:2. They admit R as a new partner for 1/4th share. The Goodwill Account appears in the books at its full value Rs 20,000. R is to pay proportionate amount as premium and he pays it privately to P and Q. Show the Journal Entries.

Points to be noted

1. For private payment of premium, no entry is required in the books of the partnership.
2. The new partner is paying premium although a Goodwill Account is appearing in the books at full value. So the Goodwill Account should be written back between the old partners in old ratio.

Solution

Date	Particulars	L.F.	Dr Amount Rs	Cr Amount Rs
	P's Capital A/c	Dr		12,000
	Q's Capital A/c	Dr		8,000
	To Goodwill A/c			20,000
	(Goodwill Account written back between the old partners in old ratio 3 : 2)			

Illustration :

Premium for Goodwill in "true sense"

Jatin and Lalit are partners sharing profit as 3 : 2, Anu Malik is admitted as a new partner for 1/5th share on payment of Rs 20,000 as capital and Rs 5,000 as premium for Goodwill. A Goodwill Account appearing in the books at Rs 20,000 is decided to be left undisturbed. Show the Journal Entries.

Points to be noted

1 Premium for 1/5th share = Rs 5,000 (It may be called premium in popular sense)

Goodwill should be taken as Rs 25,000

But Goodwill appearing in Books and to be maintained = Rs 20,000

Undervaluation of Goodwill = Rs 5,000

Premium in 'true sense' should be 1/5th of Rs 5,000 = Rs 1,000 (to be shared by old partners). The excess premium paid Rs 4,000 should be credited to Anu Malik himself.

2 Premium should be shared in old ratio which is the same as sacrifice ratio as mutual ratio between Jatin and Lalit has not changed.

Solution

Journal Entries

Date	Particulars	L.F.	Dr Amount Rs	Cr Amount Rs
	Bank A/c	Dr	25000	
	To Jatin's Capital (3/5 of 1000)			600
	Lalit's Capital (2/5 of 1000)			400
	Anu Malik's Capital (20,000 + 4,000)			24000
	(True Premium shared by Jatin and Lalit in sacrifice ratio 3:2 and the balance of contribution made by Anu Malik transferred to his capital)			

Illustration

Where the new partner pays premium for goodwill and also brings his own goodwill to the business Amal and Bimal are partners sharing profits in the ratio of 2 : 3 Charu is admitted as a partner on 1st January, 2008 and he pays into the firm cash Rs 9,000 out of which Rs 3,000 is to be premium on his admission to a quarter share, the ratio between Amal and Bimal to be 1 : 2 Charu also brings into the business his own Goodwill to be run as a separate unit and the Goodwill is agreed at Rs 4,800 Show the entries required to give effect to the above arrangements (for both the units separately)

Points to be noted

- 1 For the First unit, Rs 3,000 paid as premium should be shared by Amal and Bimal in their sacrifice ratio We should calculate the new ratio and the sacrifice ratio
- 2 For the 2nd unit, an adjustment should be made for Charu's own goodwill to be credited to his capital and debited to Amal and Bimal in remaining ratio 2 : 3, excluding Charu's share

Working Notes

1 Calculation of New Profit Sharing Ratio

Charu's share = $1/4$, Balance left = $1 - 1/4 = 3/4$ Amal's new share = $\frac{2}{3} \times \frac{3}{4} = 1/2$

Bimal's new share = $3/4 \times 2/3 = 1/2$ and Charu's new share = $1/4$

New Ratio = 1 : 2 : 1 Sacrifice Ratio = 3 : 2

solution

Journal Entries

Date	Particulars	L F	Dr Amount Rs	Cr Amount Rs
1.1.08	Bank A/c Dr To Charu's Capital A/c (Amount invested as capital contribution by Charu)		6,000	6,000
1.1.08	Bank A/c Dr To Amal's Capital A/c (3/5) To Bimal's Capital A/c (2/5) (Premium paid by Charu and credited to Amal and Bimal in their sacrifice ratio 3 : 2)		3,000	1,800 1,200
1.1.08	Amal's Capital A/c (2/10 of Rs. 4,800) Dr Bimal's Capital A/c (3/10 of Rs. 4,800) Dr To Charu's Capital A/c (Adjustment made for Charu's own Goodwill brought into the business)		960 1,440	2,400

Illustration

Special Points (a) Journal Entries, (b) Portion of Premium for Goodwill and Reserve withdrawn, (c) Discount received on payment of creditor

Brick, Sand and Cement were partners in a firm sharing profits and losses in the ratio of 3 2 1 respectively Following is their Balance Sheet as on 31st December, 2007

Liabilities	Rs.	Rs	Assets	Rs
Capital Accounts:				
Brick	30,000		Land & Buildings	50,000
Sand	20,000		Furniture	15,000
Cement	<u>10,000</u>	60,000	Stock	20,000
Reserve		29,800	Bill Receivable	5,000
Creditors		6,200	Debtors	7,500
Bills Payable		4,000	Cash in hand and at Bank	2,500
		<u>1,00,000</u>		<u>1,00,000</u>

Lime is to be admitted as a partner with effect from 1st January, 2008 on the following terms

(a) Lime will bring in Rs 15,000 as Capital and Rs 12,000 as premium for goodwill Half of the premium will be withdrawn by the partners

(b) Lime will be entitled to 1/6th share in the profits of the firm

(c) The assets will be revalued as follows Land and Building—Rs 56,000, Furniture—Rs 12 000, Stock—Rs 16,000, Debtors—Rs 7,000

(d) The claim of a creditor for Rs 2,300 is paid at Rs 2,000

(e) Half of the Reserve is to be withdrawn by the partners

Record the Journal entries (including cash transactions) in the books of the firm and show the opening Balance Sheet of the new firm

Solution .

**Books of Brick, Sand, Cement and Lime
Journal Entries**

			Rs.	Rs.
	Bank A/c Dr To Lime's Capital A/c [Being amount contributed by lime on admission as a new partner]		15 000	15,000
	Bank A/c Dr To Brick's Capital A/c [3/6] - Sand's Capital A/c [2/6] - Cement's Capital A/c [1/6] [Being premium for goodwill brought in by new partner and credited to old partners Capitals in their sacrifice ratio 3 : 2:1]		12,000	6 000 4 000 2,000
	Land and Buildings A/c Dr To Revaluation A/c [Being value of Land & Buildings appreciated on revaluation]		6,000	6,000
	Revaluation A/c Dr To Furniture A/c - Stock A/c - Provision for Bad Debts A/c [Being values of assets decreased on revaluation]		7 500	3,000 4,000 500

Creditors A/c	Dr	2,300	
To Bank A/c			2,000
- Revaluation A/c			300
[Being creditors claim discharged at a discount]			
Brick's Capital A/c	Dr	600	
Sand's Capital A/c	Dr	400	
Cement's Capital A/c	Dr	200	
To Revaluation A/c			1,200
[Loss on revaluation debited to old partners in old ratio 3 : 2 : 1]			
Reserve A/c	Dr	29,800	
To Brick's Capital A/c			14,900
- Sand's Capital A/c			9,933
- Cement's Capital A/c			4,967
[Reserve A/c closed and credited to old partners in old ratio 3 : 2 : 1]			
Brick's Capital A/c	Dr	7,450	
Sand's Capital A/c	Dr	4,967	
Cement's Capital A/c	Dr	2,483	
To Bank A/c			14,900
[Half of the Reserve withdrawn by old partners]			
Brick's Capital A/c	Dr	3,000	
Sand's Capital A/c	Dr	2,000	
Cement's Capital A/c	Dr	1,000	
To Bank A/c			6,000
[Half of the premium money withdrawn by old partners]			

Balance Sheet as on 1.1.2009

Liabilities	Amount Rs	Amount Rs	Assets Rs	Amount Rs	Amount Rs
Capital Accounts (Note 3)			Land & Buildings		56,000
Brick	39,850		Furniture		12,000
Sand	26,566		Stock		16,000
Cement	13,284		Debtors	7,500	
Lime	<u>15,000</u>	94,700	Less Provision for Bad Debts	<u>500</u>	7,000
Creditors 16,200 -2,300		3,900	Bill Receivable		5,000
Bills Payable		4,000	Cash in hand and at Bank (Note 2)		6,600
		<u>1,02,600</u>			<u>1,02,600</u>

Working Notes

1 It is assumed that after giving 1/6th share of profits to Lime, the balance will be shared by old partners in old ratio 3 : 2 : 1. So, Sacrifice Ratio = Old Ratio = 3 : 2 : 1

2 Cash and Bank			Rs	Rs
As per last Balance Sheet				2,500
+Lime's Capital Contribution and Premium (net)				<u>27,000</u>
-- Paid to creditors				2,000
-- Portion of Reserve withdrawn				14,900
-- Share of premium withdrawn				5,000
				<u>6,600</u>
3 Capital	Brick	Sand	Cement	Lime
Balances	30,000	20,000	10,000	15,000
+ Capital brought in	-	-	-	-
+ Share of Premium for Goodwill	6,000	4,000	2,000	-
+ Share of Reserves	14,900	9,933	4,967	-
- Share of Reserves withdrawn	7,450	4,967	2,483	-
- Share of Premium for goodwill withdrawn	3,000	2,000	1,000	-
- Loss on Revaluation	600	400	200	-
	<u>39,850</u>	<u>26,566</u>	<u>13,284</u>	<u>15,000</u>

Illustration

(a) Portion of Premium unpaid — Goodwill Account raised (b) General Reserve maintained
Arun and Anand were partners sharing profits in the ratio of 3 : 2. Their position as on 31st March, 2008 was as under

Particulars	Rs	Particulars	Rs
Arun's Capital	12,000	Land and Buildings	8,000
Anand's Capital	10,000	Plant and Machinery	10,000
General Reserve	12,000	Sundry Debtors	11,000
Workmen's Compensation Fund	4,000	Stock	12,000
Sundry Creditors	12,000	Cash at Bank	9,000
	50,000		50,000

They decided to admit Ashok for a 20% profit on the following terms (a) The liability on Workmen's Compensation Fund is to be determined at Rs 2,000, (b) Ashok to bring in Rs 3,000 as premium out of his share of Rs 3,600 He is also to bring in Rs 20,000 as his capital, (c) General Reserve is to be maintained at its original value, (d) Rs 2,000 out of creditors to be paid at 5% discount

Pass the necessary journal entries to give effect to the above arrangement, to show the capital accounts and prepare the Balance Sheet of the new firm

Points to be noted

1 Ashok pays premium Rs 3,000 This should be shared by Arun and Anand in their sacrifice ratio, which is eventually the old ratio 3 : 2 For the unpaid Premium [Rs 3,600 — Rs 3,000 = Rs 600] Goodwill Account to be raised at Rs 3,000 $\frac{5}{1} = 600$ This is to be credited to old partners in old ratio 3 : 2

2 For General Reserve to be maintained, the following adjustment will be required

Arun	Arun Rs.	Anand Rs.	Ashok Rs
Credited in Old Ratio between old partners (12,000 as 3 : 2)	7,200 (Cr)	4,800 (Cr)	
Debited in New Ratio (12:8:5)	5,760 (Dr)	3,840 (Dr)	2,400 (Dr)
Net Effect	1,440 (Cr)	960 (Cr)	2,400 (Dr)

**Arun, Anand and Ashok
Journal Entries**

Date	Particulars	L.F.	Dr. Amount Rs	Cr Amount Rs.
31.3.08	Workmen's Compensation Fund A/c Dr. [Rs. 4,000 — Rs. 2,000] To Revaluation A/c [Value of liability reduced]		2,000	2000
31.3.08	Bank A/c Dr. To Ashok's Capital A/c [Amount contributed as capital by incoming partner]		20,000	20,000
	Bank A/c Dr. To Arun's Capital A/c * Anand's Capital A/c (Premium for Goodwill paid by incoming partner and shared by existing partners in their sacrificing ratio 3 : 2)		3,000	1,800 1,200
	Goodwill A/c Dr. To Arun's Capital A/c * Anand's Capital A/c (Goodwill A/c raised and credited to existing partners in old ratio 3 : 2)		3,000	1,800 1,200
	Creditors A/c Dr. To Bank A/c (actual payment at 95%) * Revaluation A/c (A creditor paid off and the discount received credited to revaluation A/c)		2,000	1,900 100
	Revaluation A/c Dr. To Arun's Capital A/c To Anand's Capital A/c (Being Revaluation profit credited to old partners in the ratio 3 : 2)		2,100	1,260 840

Illustration*No alteration of book values of assets and liabilities*

Baisakhi and Srabani are partners sharing profits and losses in proportion to their capitals
 Their Balance Sheet as on 31st March, 2008 is given below

Liabilities	Rs.	Assets	Rs.
Creditors	15,000	Freehold Premises	10,000
General Reserve	2,100	Machinery	3,500
Capitals		Furniture	1,750
Baisakhi	20,000	Office Equipments	550
Srabani	15,000	Stock	14,100
		Bill Receivable	3,060
		Debtors	17,500
		Bank	1,500
		Cash	50
	52,100		52,100

On 1st April, 2008 they admit Poushali on the following conditions

(i) Poushali should bring in Rs 10,000 as capital and to pay Rs 3,500 for goodwill as she will get 1/4th share in profits

(ii) A provision of 2% to be raised against debtors, stock to be reduced by 5%, Freehold Premises to be revalued at Rs 12,650, Machinery at Rs 2,800, Furniture at Rs 1,540 and Office equipments at Rs 495

(iii) Partners agreed that the values of assets and liabilities should remain unaltered

Show the necessary accounts and prepare the opening Balance Sheet of the new firm

Points to be noted

1 The Partners have decided not to alter the book values of the assets and liabilities. The effects of revaluation may be ascertained by preparing a Memorandum Revaluation Account as follows

(a) Calculation of Profit/Loss on Revaluation

Memorandum Revaluation Account

Dr.	Rs		Cr. Rs
To Provision for bad debts (= 2% of 17,500)	350	By Freehold Premises	2,650
To Stock	705		
To Machinery	700		
To Furniture	210		
To Office Equipments	55		
To Partners Capital A/c's			
Balsakhi (4/7)	360		
Sarbanil (3/7)	270		
	2,650		2,650
To Reversal of Items b/d	2650	By Reversal of Items b/d	2,020
		By Partners Capital A/c (In New Ratio)	
		(Loss on Revaluation)	
		Balsakhi 270	
		Sarbanil 203	
		Parshant 157	630
	2,650		2,650

(b) As General Reserve is to remain unaltered, similar adjustment will be required to be shared among old partners in old ratio and then written back among all partner's in new ratio

2. Calculation of net effects on Capital Accounts

Solution: New Profit Sharing Ratio = 12 : 9 : 7

Capital Accounts

Date	Particulars	Rs.	Paise	Particulars	Rs.	Paise	Particulars	Rs.	Paise
1/1/08	To Capital Res.	400	00	By Balance b/d	2000	00			
	To M. Rev. A/c	270	00	By Profit & Loss	1000	00			
				By M. Rev. A/c	200	00			
				By Sundry Cr.	200	00			
	Balance c/d	2250	00						
		2250	00						22500

Balance Sheet as on 1/1/2008

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capitals			Freehold Premises		10,000
Balvakti	22,500		Machinery		3,500
Srabani	16,712		Furniture		1,750
Houshal	1,318	48,500	Office Equipments		550
General Reserve		2,100	Stock		14,100
Sundry Creditors		15,200	Bill Receivable		3,060
			Debtors		17,500
			Bank		15,000
			(2,500 + 10,000 + 3,500)		50
			Cash		65,600
		48,500			

RETIREMENT, DEATH AND DISSOLUTION

A. RETIREMENT

INTRODUCTION

A Partner may leave the firm by taking retirement. Normally the retirement takes place by consent of all the partners and or by other mode of communication by the intended partner to all other partners. In case of retirement, for paying off the retiring partner(s) some adjustments are required to be done in the books of accounts.

Steps for Adjustments / Books of Accounts :

Following steps to be taken and books of accounts to be prepared to calculate the due of retiring partner

1) Revaluation of Assets and liabilities

This is required for giving the share of net assets of the firm. Treatments are Profit or loss on revaluation to be transferred to all the partners in old Profit Sharing ratio. If the remaining partners decide not to alter the book value of assets or liabilities then the profit or loss on revaluation as distributed earlier should be reversed through remaining partner's capital account in new profit sharing ratio. We shall have to prepare Memorandum Revaluation Account.

2) Undistributed profit or loss

Any undistributed profit or loss including reserve is to be transferred in old profit sharing ratio

Journal entries:

In case of undistributed profit or reserves:

Profit and Loss A/c Dr

Reserve account A/c Dr

To Old Partners capital A/c (In old P S R)

In case of undistributed Loss

Old partners capital A/c Dr

To Profit and loss A/c

3) Adjustment regarding goodwill

At the time of retirement the retiring partner is also eligible for share of goodwill of the firm

This can be made in the following ways

a) Raising of goodwill (If goodwill is already existing in the Balance sheet the difference shall be raised)

Goodwill account Dr

(Value of goodwill – existing goodwill in the balance sheet)

To all partners capital account (Old P S R)

b) Goodwill raised and written off

i) Raise goodwill as discussed above

ii) Write off goodwill

Existing partners Capital A/c Dr

To Goodwill A/c

Settlement of Dues to the Retiring Partner :

The retiring partner becomes entitled to get back his dues from the firm which consists of the following

i) Balance of his capital and current account at the time of retirement

ii) Share of goodwill, undistributed profit or loss, reserves and profit or loss on revaluation of assets and liabilities

iii) Salary, commission, interest on capital, if any and all other dues till the date of retirement

iv) Any adjustment in drawings and interest thereon

Payment of dues.

i) Payment at a time Subject to availability of the fund, the payment may be made at a time Journal entry

Retiring Partner's Capital A/c Dr

To Bank A/c

ii) If part payment be made by giving assets

Retiring Partner's Capital A/c Dr

To Assets A/c

iii) If the dues are transferred to Loan account

Retiring Partner's Capital A/c Dr

To Retiring partners' Loan A/c

iv) If the existing partners bring in cash for making payment

Bank / Cash account Dr

To Existing Partners' Capital A/c
 v) For interest due on Retiring Partners Loan Account
 Interest on Retiring partner's loan account Dr
 To Retiring Partner's Loan account

Illustration

The Balance Sheet of Baichung, Taustif and Vijayan who shared profits and losses in the ratio 3:3:2 respectively was as follows on 31st December, 2007

<u>Capitals :</u>				
Baichung	24,000		Machinery	31,600
Taustif	10,000		Furniture	6,400
Vijayan	8,000	42,000	Stock	8,500
Reserve		4,800	Debtors	4,300
Creditors		8,700	Cash at Bank	4,700
		55,500		55,500

Baichung retired from the business on 1st January, 2008. Revaluation of assets were made as Machinery Rs 34,000, Furniture Rs 5,000, Stock Rs 9,600, Debtors Rs 4,000 and Goodwill Rs 10,000.

Baichung was paid Rs 4,225 immediately and the balance was transferred to a Loan Account for payment in 4 equal half-yearly installments together with interest @ 6% p.a.

Show the necessary accounts, the Balance Sheet of the firm immediately after Baichung's retirement and his Loan Account till finally paid off.

Solution :

**Books of Baichung, Taustif and Vijayan
 Revaluation Account**

Dr.

Cr.

Date	Particulars	Am't Rs.	Am't Rs.	Date	Particulars	Am't Rs.	Am't Rs.
1.1.08	To Furniture A/c		1,400	1.1.08	By Machinery A/c		2,400
	To Provision On Debtors A/c		300		By Stock A/c		1,100
	To Capital A/c. (Profit on Revaluation)						
	Baichung (3/8)	675					
	Taustif (3/8)	675					
	Vijayan (2/8)	450	1,700				
			3,500				3,500

Dr		Capital Account						Cr	
Dr	Particulars	Bal- hug Rs.	Tausif Rs.	Vijayan Rs.	Cr	Particulars	Lat. hug Rs.	Tausif Rs.	Vijayan Rs.
11	To Bank A/c	4,225	-	-	11	By Balance b/d	24,000	10,000	8,000
	To 10% Loan A/c (Balance Transferred)	26,000	-			By Reserve A/c [1:1:2]	1,800	1,800	1,200
	To balance b/d	-	16,225	12,150		By Revaluation A/c * Goodwill	675	675	450
							3,750	3,750	2,500
		30,225	16,225	12,150			30,225	16,225	12,150

Tausif and Vijayan
Balance Sheet as at 1.1.08

Liabilities	Amount Rs.	Amount Rs.	Assets	Amount Rs.	Amount Rs.
Capitals			Goodwill		10,000
Tausif	16,225		Machinery		34,000
Vijayan	12,150	28,375	Furniture		5,000
Balchung's 10% Loan		26,000	Stock		9,600
Sundry Creditors		8,700	Debtors	4,300	
			Less: Provision	300	4,000
			Cash at Bank [4,770 4,225]		475
		63,075			63,075

Banking's Loan 10% Account

Dr

Cr

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
30.6.08	To Bank A/c [1/4 of 26,000 + 785]	7,280	1.1.08	By Banking's Capital A/c	26,000
31.12.08	To Bank A/c [1/4 of 26,000 + 585]	7,365	30.6.08	By Interest [6% of 26,000 for 6 months]	780
	To Balance b/d	1,000	31.12.08	By Interest A/c of [6% of (26,000 - 6,500) for 6 months]	585
		<u>27,365</u>			<u>27,365</u>
30.6.09	To Bank A/c [6,500 + 350]	6,850	1.1.09	By Balance b/d	13,000
31.12.09	To Bank A/c [6,500 - 195]	6,695	31.06.09	By Interest A/c [6% of 13,000 for 6 months]	390
			31.12.09	By Interest A/c [6% of 6,500 for 6 months]	195
		<u>13,585</u>			<u>13,585</u>

Illustration 2

On 31st March, 2008 the Balance Sheet of S's Ram, Hari and Mohan sharing profits & losses as 2:3:2, stood as follows:

Liabilities	Rs	Assets	Rs
Capital Accounts		Land & Building	10,00,000
Ram	10,00,000	Machinery	17,00,000
Hari	15,00,000	Closing Stock	5,00,000
Mohan	10,00,000	Sundry Debtors	6,00,000
Sundry Creditors	5,00,000	Cash & Bank Balance	2,00,000
	<u>40,00,000</u>		<u>40,00,000</u>

On 31st March, 2008 Hari decided to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the Assets and Liabilities on that date on the following basis:

- (1) Land & Buildings be appreciated by 30%,
- (2) Machinery be depreciated by 20%,
- (3) Closing Stock to be revalued at Rs. 4,50,000,
- (4) Provision for bad debts be made at 5%,
- (5) Old

credit balances of Sundry Creditors Rs 50,000 be written back, (6) Joint Life Policy of the partners surrendered and cash obtained Rs 3,50,000 (7) Goodwill of the old firm be valued at Rs 6,30,000 and Hari's Share of the Goodwill adjusted in the accounts of Ram and Mohan who share the profits and losses as 3:2. No goodwill being raised. (8) The total capital of the firm is to be the same as before retirement, Individual capitals be in their profit sharing ratio, (9) Amount due to Hari is to be settled on the following basis - 50% on retirement and the balance 50% within one year. Prepare Revaluation Account, Capital Accounts of Partners, Cash Account and Balance Sheet as on 1/4/2008 of M/s Ram & Mohan.

Solution :

Books of M/s Ram, Hari & Mohan

Revaluation Account

Dr			Cr		
Particulars	Am't. Rs	Am't. ₹	Particulars	Am't. ₹	Am't. Rs
To Machinery A/c		3,40,000	By Land & Buildings A/c		1,00,000
To Stock A/c		50,000	By Sundry Creditors		50,000
To Provision for Bad Debts		10,000	By Partners' Contributions		
			Ram (2/7)	1,00,000	
			Hari (1/7)	1,50,000	
			Mohan (2/7)	1,00,000	
		4,20,000			4,20,000

[Treatment of Joint Life Policy - Surrender value

For proceeds from Joint Life Policy

Bank A/c Dr 3,50,000

To Joint Life Policy A/c 3,50,000

For sharing the proceeds of Joint Life Policy

Joint Life Policy A/c Dr 3,50,000

To Ram's Capital A/c 1,00,000

To Hari's Capital A/c 1,50,000

To Mohan's Capital A/c 1,00,000

Hari's share of goodwill = $\frac{3}{7} \times 6,30,000 = 2,70,000$

Ram's Capital A/c Dr 1,62,000

Mohan's Capital A/c Dr 1,08,000

To Hari's Capital A/c 2,70,000

(Being Hari's share of goodwill adjusted)

Partner's Capital Account

Dr

Cr

Date 2008	Particulars	Ram Rs	Hari Rs	Mohan Rs	Date 2008	Particulars	Ram Rs	Hari Rs	Mohan Rs
31.3	To Hari's Capital A/c	60,000		1,00,000	31.3	By Balance b/d	16,00,000	15,00,000	10,00,000
	To Revaluation A/c	20,000	10,000	70,000		By Bank A/c (Joint Life Policy as 2.3.2)	1,00,000	1,50,000	1,50,000
	To Cash/Bank A/c (50%)		3,45,000			By Ram's & Mohan's Capital (2/3 will share)		2,70,000	
	To Loan A/c		9,45,000			By Cash/Bank A/c (Paid figure)	11,82,000		4,23,000
	To Balance c/d (Note)	21,00,000		14,00,000					
		22,82,000	19,20,000	14,20,000			22,82,000	19,20,000	15,23,000

Total Capital of the new firm = Total capital of the old firm (given)
= Rs 35,00,00

Therefore Ram's Capital = $\frac{3}{5} \times 35,00,000 = 21,00,000$

Mohan's Capital = $\frac{2}{5} \times 35,00,000 = 14,00,000$

Cash/Bank

Dr

Cr

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
31.3.08	To Balance b/d	2,00,000	31.3.08	By Hari's Capital A/c	9,45,000
	To Joint Life Policy A/c	7,50,000		By Balance c/d	12,15,000
	To Ram's Capital A/c	11,82,000			
	To Mohan Capital A/c	4,28,000			
		21,60,000			21,60,000

Balance Sheet as on 1.4.2008

Liabilities	Amount Rs	Amount Rs	Assets	Amount Rs	Amount Rs
<u>Capital Accounts</u>			Land & Building		13,00,000
Ram		21,00,000	Machinery		13,60,000
Mohan		14,00,000	Stock		4,50,000
Sundry Creditors		4,50,000	Sundry Debtors		
Hari's Loan		9,45,000	Less Provision for Bad Debts	7,00,000	5,70,000
		48,95,000	Cash and Bank	33,360	12,15,000
					48,95,000

Working Notes :

1 Calculation of Gaining Ratio [New Ratio – Old Ratio]

Ram = $\frac{3}{5} - \frac{2}{7} = \frac{11}{35}$, Mohan = $\frac{2}{5} - \frac{2}{7} = \frac{4}{35}$ So, Gaining Ratio = 11 : 4

Illustration 3 :

A, B and C were in partnership sharing profits in the proportion of 5 : 4 : 3. The Balance Sheet of the firm as on 31st March, 2008 was as under

Liabilities	Rs	Assets	Rs
Capital Accounts		Goodwill	40,000
A	1,35,930	Fixtures	8,200
B	95,120	Stock	1,57,300
C	61,170	Sundry Debtors	93,500
Sundry Creditors	11,590	Cash	34,910
	3,33,910		3,33,910

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore entered into as on 31st March, 2008, the terms of which were as follows

(i) The Profit & Loss Account for the year ended 31st March, 2008, which showed a net profit of Rs 48,000 was to be reopened. B was to be credited with Rs 4,000 as bonus, in consideration of the extra work which had devolved upon him during the year. The profit sharing ratio was to be revised as from 1st April, 2007 to 3 : 4 : 4.

(ii) Goodwill was to be valued at two years' purchase of the average profits of the preceding five years. The Fixtures were to be revalued by an independent value. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

(iii) The valuations arising out of the above agreement were Goodwill Rs 56,800 and Fixture Rs 10,980.

(iv) B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3 : 2 and decided to eliminate Goodwill from the Balance Sheet, to retain the Fixtures on the books at revised value, and to increase the provision for doubtful debts to 6%.

You are required to submit the Journal Entries necessary to give effect to the above arrangement and to draw up the Capital Accounts of the partners after carrying out all adjustment entries as stated above.

Solution

Books of the Firm A, B & C

Journal Entries

Date	Particulars		Amount Rs	Amount Rs
31.3.06	A's Capital A/c (1/12 of Rs. 48,000)	Dr	20,000	
	B's Capital A/c (4/12 of Rs. 48,000)	Dr	16,000	
	C's Capital A/c (3/12 of Rs. 48,000)	Dr	12,000	
	To Profit & Loss Adjustment A/c (Profits of Rs. 48,000 already shared by A, B & C as 5:4:3 written back)			48,000
	Profit & Loss Adjustment A/c	Dr	4,000	
	To B's Capital A/c (B Credited with bonus of Rs. 4,000 for his extra work)			4,000

	Profit & Loss Adjustment A/c	Dr	44,000	
	To A's Capital A/c (3/11 of Rs. 44,000)			12,000
	To B's Capital A/c (4/11 of Rs. 44,000)			16,000
	To C's Capital A/c (4/11 of Rs. 44,000)			16,000
	(The remaining profits re distributed as 3:4:4)			
	Goodwill A/c	Dr	16,800	
	Fixtures A/c	Dr	2,780	
	To Profit & Loss Adjustment A/c (Values of assets increased on revaluation)			19,580
	Profit & Loss Adjustment A/c	Dr	1,870	
	To Provision for doubtful debts A/c (Provision created @ 2% on Debtors)			1,870
	Profit & Loss Adjustment A/c	Dr	17,710	
	To A's Capital A/c (3/11)			4,830
	To B's Capital A/c (4/11)			6,440
	To C's Capital A/c (4/11)			6,440
	(Profit on Revaluation shared among all partners as 3:4:4)			
	A's Capital A/c	Dr	1,32,760	
	To A's Loan A/c (Transfer of A's dues to his Loan A/c)			1,32,760
	B's Capital A/c (3/5)	Dr	36,324	
	C's Capital A/c (2/5)	Dr	24,216	
	To Goodwill A/c			56,800
	To Provision for doubtful debts A/c (Goodwill Account written off and provision on debtors increased by 4% further on Rs. 93,500)			3,740

Dr		Capital Accounts					Cr		
Date	Particulars	A	B	C	Date	Particulars	A	B	C
		Rs.	Rs.	Rs.	2008		Rs.	Rs.	Rs.
31.3	To Profit & Loss Adjustment A/c	30,000	16,000	12,000	31.3	By Balance b/d	1,35,900	85,120	61,170
	To Loan A/c (Balance Transferred)	1,32,760				By P&L Adjustment A/c (Bonus)		1,000	
	To Goodwill & Provision for Doubtful Debts		36,224	24,216		By Profit & Loss Adjustment A/c	12,000	16,000	19,600
	To Balance c/d		69,236	47,984		By Profit & Loss Adjustment A/c	1,800	6,440	6,440
		1,52,760	1,21,560	83,610			1,52,760	1,21,560	83,610

Illustration 4

Sona, Mona and Dona were partners sharing profits in the proportions of $\frac{1}{2}$, $\frac{1}{3}$ and $\frac{1}{6}$ respectively. Their Balance Sheet as on 31st March, 2008 was as under:

Liabilities	Rs	Assets		Rs
Sundry Creditors	24,000	Cash		2,500
Reserve	12,000	Debtors	16,000	
Capitals		Less Prov	<u>300</u>	15,500
Sona	35,000	Stock		25,000
Mona	30,000	Motor Vans		8,000
Dona	<u>20,000</u>	Plant		35,000
	95,000	Buildings		45,000
	<u>1,31,000</u>			<u>1,31,000</u>

Mona retired on that date subject to the following adjustments: (a) The Goodwill of the firm be valued at Rs 18,000, (b) Plant and Motor Vans be depreciated by 10% and 15% respectively, (c) Stock and Buildings be appreciated by 20% and 10% respectively, (d) Provision for Doubtful Debts be fixed at Rs 2,450, (e) Liability for damages be provided at Rs 450, (f) The new profit sharing ratio between Sona and Dona be $\frac{3}{5}$ and $\frac{2}{5}$ respectively. Pass the necessary Journal entries and prepare the Capital Accounts and the Balance Sheet assuming that no alteration of book values of assets and liabilities is to be made.

Solution :

Note :

- 1 As book values are not to be altered, there should be Memorandum Revaluation Account
- 2 The share of Reserve of the retiring partner should be credited to her account and debited to continuing partners in their gaining ratio
- 3 Calculation of Gaining Ratio
Gain by Sona = New Ratio – Old Ratio = $3/5 - 1/2 = 6-5/10 = 1/10$ or $3/30$,
Gain by Dona $2/5 - 1/6 = 12- 5/30 = 7/30$, So Gaining Ratio = 3 : 7
- 4 Effect of Revaluations

Solution .

Sona, Mona and Dona
Journal Entries

		Dr	Cr	
Date	Particulars	L.F	Amount	Amount
31.3.08	Sona's Capital A/c [3/10] Dr Dona's Capital A/c [7/10] Dr To Mona's Capital A/c [Mona's share of Reserve credited to her capital on her retirement and debited to continuing partners capitals in gaining ratio 3 : 7]		Rs. 1,200 2,800	Rs. 4,000
31.3.08	Sona's Capital A/c Dr Dona's Capital A/c Dr. Mona's Capital A/c [Retiring Partner's share of Goodwill borne by continuing partners]		1,800 4,200	 6,000
31.3.08	Mona's Capital A/c Dr To Mona's Loan A/c [Balance due to the retiring partner transferred to her loan account]		40,800	40,800

Dr

Memorandum Revaluation Account

Cr

Particulars	Amount Rs	Particulars	Amount Rs
To Liab. for Damages	450	By Stock	5,000
• Plant	3,500	• Building	4,500
• Motor Van	1,200		
• Prov. for D./Debts	1,950		
• Partners Capital A/c			
Sona - 1200			
Mona 800			
Dona 400	2,400		
	9,500		9,500
To Reversal of Items b/d		By Reversal of Items b/d	
Stock	5,000	Liab for Damage	450
Building	4,500	Plant	3,500
		Motorvan	1,200
		Prov. for D / Debts	1,950
		By P. Capital A/c	
		Sona - 1,440	
		Dona 960	2,400
	9,500		9,500

Dr

Capital Account

Cr

Date 2008	Particulars	Sona Rs	Mona Rs.	Dona Rs	Date 2008	Particulars	Sona Rs.	Mona Rs	Dona Rs
31.3	To Mona's Capital A/c	1,200		2,800	31.3	By Balance b/d	35,000	30,000	30,000
	To Mem. Rev. A/c	1,440	—	960		By Sona & Dona's Capital A/c	—	4,000	—
	To Mona's Capital A/c	1,800	—	4,200		By Mem. Rev. A/c	1,200	800	400
	To Mona's Loan A/c transfer		40,800	—		By Sona & Dona's Capital A/c	—	6,000	—
	To Balance c/d	31,760	—	22,440					
		36,200	40,800	30,400			36,200	40,800	30,400

Sona and Dona
Balance Sheet as on 31st March, 2008

Liabilities	Amount Rs	Amount Rs	Assets	Amount Rs	Amount Rs
Sundry Creditors		24,000	Cash		2,500
Reserve		12,000	Debtors	16,000	
Mona's Loan A/c		40,000	Less Prov.	500	15,500
Capital A/c			Stock		25,000
Sona	31,760		Motor Vans		8,000
Dona	22,440	54,200	Plant		35,000
			Buildings		45,000
		1,31,000			1,31,000

Illustration 5 :

P, Q & R were equal partners R retired on 31st March, 2008 The Balance Sheet of the firm as on 31st December, 2007 was as follows

Liabilities	Rs	Assets	Rs
Capitals .		Goodwill	18,900
P	30,000	Buildings	40,000
Q	20,000	Investments (at Cost)	5,000
R	20,000	Stock	10,000
Investment		Debtors	10,000
Fluctuation Fund	1,200	Cash at Bank	10,000
Bad Debts	800		
General Reserve	4,000		
Trade Creditors	17,900		
	93,900		93,900

On 31/3/08 the following adjustments were considered (a) Buildings were appreciated by Rs 18,000. Book Debts were considered good, Investments were considered worth Rs 4,700 and Stock was valued at Rs 9,400, (b) Goodwill was considered equivalent to the average annual profits of the last three years, (c) R's share of Profit up to the date of his retirement was calculated on the basis of the average annual profits of the preceding three years which were Rs 8,000, Rs 9,000 and Rs 10,000 Show the Journal Entries and prepare the Balance Sheet immediately after R's retirement

Working notes :

1. Valuation of Goodwill : Average Annual Profits = $8,000 + 9,000 + 10,000/3 = \text{Rs } 9,000$
Decrease in value of Goodwill = $\text{Rs } 18,900 - \text{Rs } 9,000 = \text{Rs } 9,900$

This shall be shared amongst all the Partners' in their old ratio

2. R retired on 31st March, 2008, that is, after 3 months from the date of the last year ending
Estimated Profits for 3 months = $3/12$ of $9,000 = \text{Rs } 2,250$ The retiring partner should be

credited with 1/3rd of 2,250 = Rs 750 Either the continuing Partners' Capital accounts should be debited in their Gaining Ratio OR Profit and Loss Suspense Account may be debited

3. Investment at cost was shown at Rs 5,000 Now It is valued at Rs 4,700 Loss on Revaluation is Rs 300 The fluctuation fund in excess of Rs 300 (that is Rs 1,200- Rs 300= 900) should be transferred to Revaluation Account

P, Q & R
(Journal Entries)

Date	Particulars	L. F.	Amount		
			Dr Rs	Cr Rs	
31.3.04	P's Capital A/c	Dr.	3,300		
	Q's Capital A/c	Dr	3,300		
	R's Capital A/c	Dr	3,300		
	To Goodwill A/c			9,900	
	[Value of Goodwill written down and partners capitals debited in old ratio 1 : 1 : 1]				
	Profit & Loss Suspense A/c	Dr	750		
	To R's Capital A/c			750	
	[Adjustment made for retiring partner's estimated share of profit]				
	Buildings A/c	Dr	10,000		
	Provision for Bad Debts A/c	Dr	300		
Investment Fluctuation Fund A/c [1,200 - 300]	Dr	900			
To Revaluation A/c			19,700		
[Adjustment made for revaluation of assets and liabilities]					
Revaluation A/c	Dr	600			
To Stock A/c			600		
[Value of stock reduced on revaluation]					
Revaluation A/c	Dr	19,100			
To P's Capital A/c			6,366		
To Q's Capital A/c			6,367		
To R's Capital A/c			6,367		
[Profit on Revaluation shared by all partners equally]					
General Reserve A/c	Dr	4,000			
To P's Capital A/c			1,334		
To Q's Capital A/c			1,333		
To R's Capital A/c			1,333		
[Undistributed Reserve shared equally by all partners]					
R's Capital A/c	Dr.		25,150		
To R's Loan A/c			25,150		
[Dues to the retiring partner transferred to Loan A/c]					

Partners Capital Accounts

Dr	P			Q			Cr
	Rs	Rs	Rs	Rs	Rs	Rs	
To Goodwill A/c							By Bal b/d
- Written off	3,300	3,300	3,300				" P & L Susp A/c
" R's Loan A/c							- Rev A/c Sh of Profit
(Transfer)			25,150				" Gen Reserve
To Balance c/d	34,400	24,400					
	37,700	27,700	28,450				
				37,700	27,700	28,450	

P and Q

Balance Sheet as on 31st March 2008

Liabilities	Amount		Assets	Amount	
	Rs	Rs		Rs	Rs
Capital			Goodwill		9,000
P	34,400		Buildings	40,000	
Q	24,400	58,800	Add Appreciation	18,000	58,000
R's Loan A/c		25,150	Investment at Cost		5,000
Investment			Stock		9,400
Fluctuation Fund		35.0	Debtors		10,000
Trade Creditors		17,900	Cash at Bank		10,000
			P & L Suspense A/c Dr		750
		1,02,150			1,02,150

B. DEATH OF A PARTNER

INTRODUCTION:

If a partner dies, the partnership is usually dissolved. But if the surviving partners desire so, they may purchase the share of the deceased partner and carry on the business. In that case they have to decide (1) the total amount payable to the legal representative or executor of the deceased partner and (2) the mode of such payment. Total Amount Payable includes

(i) The deceased partner's Capital and / Current Accounts last Balance

(ii) His share of undistributed profit/loss

(iii) His share of revaluation profit/loss (iv) his share of goodwill

(v) His share of Joint Life Policy, if any and

(vi) His share of profit/loss made by the firm between the last year ending and the date of his death

The accounting procedure involved is similar to that followed in case of retirement of a partner.

The mode of payment depends on the agreement between the partners. It may be

(i) Lump Sum Payment: If the firm has sufficient funds, the total amount payable on account of the deceased partner is transferred to his Representative's Account (or Executor). Such Representative's Account is debited and Bank Account is credited on payment of the dues.

(ii) Instalment Payment/Loan Payment: The firm may not have enough funds to make prompt payment. In such a case, the total amount payable is transferred to a loan account in the name of the legal representative or executor. The loan is paid off gradually by instalments after considering

interest on unpaid balance. The word "Loan" may or may not be appended with the Account. But its gradual payment will definitely resemble the payment of loan.

Joint Life Policy and its Treatment

The partners of a firm may have a Joint Life Policy covering the lives of all the partners. It helps to realize money from the Insurance company in case of death of a partner. The dues of the deceased partner can be paid off without affecting the working capital of the firm. The policy matures when a partner dies. The money realized from the Insurance Company is distributed among all the partners, including the deceased partner. The accounting entries made are stated below.

1. If Premium paid is treated as a revenue expense of the firm. The Premium is charged to Profit & loss Account which reduces the divisible profits. The amount paid by the Insurance Company in case of death of a partner or on surrender of the Policy is shared by all the partners (including the deceased partner) in their profit sharing ratio.

1. If premium paid is treated as an expense

Journal Entries

(a) Premium Paid

Joint Life Insurance Premium A/c	Dr,
To Bank A/c (amount of the Premium)	

(b) For charging premium as expense

P & L A/c	Dr
To J L P Premium A/c	

(c) Amount Realized from Insurance Company

Bank A/c	Dr
To Joint life Policies A/c (in profit sharing ratio)	

(d) For sharing the surplus of Joint Life Policy

Joint Life Policy A/c	Dr
To all partners Capital A/c	

2. If premium is treated as a capital expenditure (Joint Life Policy Method) :

Here the premium is debited to Life Policy Account. At the end of the accounting period, the book value of the Life Policy [Opening Balance of Joint Life Policy + Current year's premium] is adjusted to its surrender value [amount receivable in case the Policy is surrendered before maturity]. Under this method the Policy appears on the Asset side at its surrender value.

Journal Entries

(a) Premium Paid

Joint Life Policy A/c	Dr
To Bank A/c (amount of Premium)	

(b) At the end of the year

Profit & Loss A/c	Dr
To Joint Life Policy (Difference between Book value and surrender value)	

(c) Policy Money Realized

Bank A/c	Dr
To Joint Life Policy A/c (amount received)	

(d) Transfer of Credit Balance of Joint Life Policy A/c

Joint Life Policy A/c	Dr
To All Partners Capital A/c's (in their profit sharing ratio)	

3. Joint Life Policy Reserve Method

Journal Entries

(a) Premium Paid

Joint Life Policy A/c Dr

To Bank Ac/ (amount of premium)

(b) At the end of the year

Joint life Policy Reserve A/c Dr

To Joint Life Policy A/c

(Excess of surrender value over book value)

(c) Transferring from J L P Reserve to P&L A/c

Profit & Loss A/c Dr

To Joint Life Policy Reserve A/c

Adjusting the difference between premium paid and the increase in surrender value

(d) Recording the receipt of Policy money

Bank A/c Dr

To Joint Life Policy A/c

(e) Transferring the balance of the Reserve A/c

Joint Life Policy Reserve A/c Dr,

To Joint Life Policy A/c

(f) Distributing the Life Policy among partners

Joint Life Policy A/c Dr

To All Partners Capital A/cs (Old ratio)

Illustration 1 :

The following was the Balance Sheet of A, B and C who shared profits in the ratio of 1 : 2 : 2 as on 31st December, 2007

Sundry Creditors	10,000	Goodwill	15,000
Capital A/c		Debtors	10,000
A	10,000	Machinery	20,000
B	20,000	Buildings	30,000
C	20,000	Stock	10,000
General Reserve	5,000	Cash at Bank	5,000
Investment Fluctuation Fund	3,000	Investments	10,000
Bad Debts Reserve	2,000		
Bank Loan	30,000		
	1,00,000		1,00,000

C died on 31st March, 2008. His account is to be settled under the following terms:
 Goodwill is to be calculated at the rate of 2 years purchase on the basis of the average of 5 years profit or loss. Profit for January to March '08 is to be calculated proportionately on the average profit of 3 years. The profits were 2003 Rs 3,000, 2004 Rs 7,000, 2005 Rs 10,000, 2006 Rs 14,000, 2007 loss Rs 12,000. During 2007 a Moped costing Rs 4,000 was purchased and debited to

Travelling Expenses Account on which depreciation is to be calculated @ 25% Other values agreed on assets are Stock Rs 12,000, Building Rs. 35,000, Machinery Rs, 25,000 and Investments Rs 8,000 Debtors are considered good Prepare new Balance Sheet of the firm, necessary Journal entries and Ledger Accounts of the Partners

Solution

Working Notes

1 Adjusted profit for 2007

Profit (12,000)

Add Cost of Moped

roughly treated as Travelling Expense 4,000

Less Depreciation not charged on Moped @25%

on Rs 4,000 (1,000)

Adjusted Profit (9,000)

2 Valuation of Goodwill

Total Profit/Loss for the last 5 years = 3,000 + 7,000 + 10,000 + 14,000 – 9,000 = Rs 25,000

Average Profit = Rs 25,000/5 = Rs 5,000. Goodwill = 2 x Rs 5,000 = Rs 10,000 But Goodwill is appearing at Balance Sheet at Rs 15,000 Over valuation of Goodwill Rs 5,000 should be written off among A, B & C as 1 2 2 The balance of Goodwill between A & B in the ratio 1 2

3 Share of Profit of Deceased Partner till his date of death

Average Profit of the last 3 years [2005, 2006 & 2007] = (10,000 + 14,000 – 9,000)/3 = Rs.5,000

Estimated Profit for 3 months [Jan to March, '08] = Rs 5,000 x 3/12 = Rs 1,250

C's share of profit = Rs 1,250 x 2/5 = Rs 500

Solution

Books of A, B & C

Journal Entries

Date	Particulars		Amount (Rs)	Amount (Rs)
	Stock A/c	Dr	2 000	
	Buildings A/c	Dr	5 000	
	Machinery A/c	Dr	5 000	
	Moped A/c (4,000 Drpr 10%)	Dr	3 000	
	To Revaluation A/c			15,000
	[Values of assets increased on revaluation]			
	General Reserve A/c	Dr	5,000	
	Investment Fluctuation Fund A/c	Dr	3,000	
	Bad Debts Reserve A/c	Dr	2,000	
	To A's Capital A/c			2,000
	To B's Capital A/c			4 000
	To C's Capital A/c			4 000
	[Transfer of Reserves etc to Partners Capitals in 1 : 2 : 2]			
	Revaluation A/c	Dr	2,000	
	To Investment A/c			2 000
	[Value of Investments reduced]			
	Revaluation A/c	Dr	13 000	
	To A's Capital A/c			2,600
	To B's Capital A/c			5,200
	To C's Capital A/c			5,200
	[Being profit on revaluation shared in 1 : 2 : 2]			
	A's Capital A/c	Dr	1 000	
	B's Capital A/c	Dr	2,000	
	C's Capital A/c	Dr	2,000	
	To Goodwill A/c			5,000
	[Value of Goodwill reduced]			
	Profit & Loss Suspense A/c	Dr	500	
	To C's Capital A/c			500
	[Estimated share of Profit till his date of death transferred to the deceased partner's Capital]			
	C's Capital A/c	Dr	27,700	
	To C's Executors A/c			27 700
	[Total dues to the deceased partner transferred to his Executor's A/c]			

Capital Accounts

Date 2008	Particulars	A Rs	B Rs	C Rs	Date 2008	Particulars	A Rs	B Rs.	C Rs
31.3	To Goodwill A/c	1,000	2,000	2,000	1.1 31.3	By Balance b/d	10,000	20,000	20,000
	To Goodwill A/c	3,333	6,667	-		By Revaluation A/c	2,600	5,200	5,200
	To C's Executors A/c (Balance transferred)			27,700		By Sundry Reserves A/c	2,000	4,000	4,000
	To Balance c/d	10,267	20,533	-		By P & L Suspense A/c	-		500
		14,600	29,200	29,700			14,600	29,200	29,700

A and B

Balance Sheet as at 31.3.2008

Liabilities	Am't Rs	Am't Rs	Assets	Am't Rs	Am't Rs
Capital A/cs			Buildings		35,000
A	10,267		Machinery		25,000
B	20,533	30,800	Moped (cost less depreciation)		3,000
C's Executor's A/c		27,700	Investments		8,000
Bank Loan		30,000	Stock		12,000
Sundry Creditors		10,000	Debtors		10,000
			Bank		5,000
			Profit & Loss Suspense A/c (Dr)		500
		98,500			98,500

Illustration 2 :

A and B entered into partnership on 1.1.2005 agreeing to share profits and losses as 2 : 1. On that date they introduced capital A Rs 90,000 and B Rs 30,000. They effected a policy of Insurance for Rs 30,000 of their joint lives. The net profits before charging interests on capitals as at the beginning of each year at 6% per annum and on drawings averaged at 4% per annum were as follows

Year	Net Profits (Rs.)	A's Drawings (Rs.)	B's Drawings (Rs.)
2005	34,800	10,000	5,000
2006	37,600	12,000	7,000
2007	38,000	14,000	7,500

The annual insurance premium Rs 3,000 was being charged to Profit & Loss Account as a business expense. A died on 31st March, 2008. According to the terms of the Partnership Deed, the deceased partner's executors became entitled to receive his share of capital as it stood on 31st December, 2007 plus his share of profits for the three months calculated upon the previous year's rate of profit and share of goodwill which was calculated as 2/3rds of the previous three years profits

after adjusting for interest on capital and drawings but without deducting the premium paid on Joint Life Policy Show the amounts payable to the Executors of A

Solution :

Working Notes :

1 Adjustment of Profits

		2006 Rs	2006 Rs	2007 Rs.
Add	Profits before adjusting interests	34,800	37,600	38,000
	Interest on Drawings @ 4% p.a. (4% of total drawings of A & B for every year)	600	760	860
		35,400	38,360	38,860
Less	Interest on Capital (see working Note 2 below)	7,200	8,388	9,504
	Profits after adjustments	28,200	29,972	29,356
	A's Share (2/3)	18,800	19,981	19,571
	B's Share (1/3)	9,400	9,991	9,785

2 Adjustment of Capitals

	Total Rs	A Rs	B Rs
Capital on 1 1 2005	1,20,000	90,000	30,000
Add: Interest on Capital @ 6% p.a.	7,200	5,400	1,800
Add: Share of Profits (34,800 - 7,200 + 600)	28,200	18,800	9,400
Less: Drawings	15,000	10,000	5,000
Less: Interest on Drawings @ 4% Capital on 1 1.06	600	400	200
	1,30,800	1,03,800	36,000
Add: Interest on Capital @ 6% p.a.	8,388	6,228	2,160
Add: Share of Profits [Note 1]	25,972	19,981	5,991
Less: Drawings	19,000	12,000	7,000
Less: Interest on Drawings Capitals on 1 1.07	760	480	280
	1,58,400	1,17,529	40,871
Add: Interest on Capital @ 6% p.a.	9,504	7,052	2,452
Add: Share of Profits [Note 1]	29,356	19,571	9,785
Less: Drawings	21,500	14,000	7,500
Less: Interest on Drawings @ 4% Capital as on 1 1 08	860	560	300
	1,74,900	1,29,592	45,308

3 Valuation of Goodwill

Total Profits after adjustments for Interest [Note 1]

	Rs	Rs
2005	28,200	
2006	29,972	
2007	<u>29,356</u>	87,528
Add: Back - Insurance Premium for 3 years (3 x 3,000)		<u>9,000</u>
		96,528

Average Annual Profits before charging insurance premium = $96,528/3 = 32,176$

Goodwill = $32,176 \times 2 = 64,352$, A's share = $2/3 \times 64,352 = \text{Rs } 42,901$

4 Profits between 1 1 08 and 31 3 08

Profits for 2007 after interest = Rs 29,356

Average Profits for 3 months = $29,356 \times 3/12 = 7,339$, A's share = $2/3 \times 7,339 = \text{Rs } 4,893$

Dr		Executor of A's Account				Cr	
Date	Particulars	Am't Rs	Date	Particulars	Am't Rs		
31.3.08	To Balance b/d	1,99,330	31.3.08	By A's Capital A/c	1,29,592		
				By P & L Suspense A/c			
				Interest on Capital	1,944		
				Share of Profits	4,895		
				By Goodwill	42,901		
				By Joint Life Policy A/c	20,000		
		1,99,330			1,99,330		

Illustration 3 :

Peter, Paul and Prince were partners sharing profit and losses in the ratio 2 : 1 : 1. It was provided in the partnership deed that in the event of retirement/death of a partner he/his legal representatives would be paid

(i) The balance in the Capital Account

(ii) His share of Goodwill of the firm valued at two years purchase of normal average profits (after charging interest on fixed capital) for the last three years to 31st December preceding the retirement or death

(iii) His share of profits from the beginning of the accounting year to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%

(iv) Interest on Fixed Capital at 10% p a though payable to the partners, but not payable in the year of death or retirement

(v) All the assets are to be revalued on the date of retirement or death and the profit and loss be debited/credited to the Capital Accounts in the profit sharing ratio

Peter died on 30th September, 2008. The books of Account are closed on calendar year basis from 1st January to 31st December

The balance in the Fixed Capital Accounts as on 1st January, 2008 were Peter – Rs 1,00,000, Paul – Rs 50,000 and Prince – Rs 50,000. The balance in the Current Accounts as on 1st January, 2008 were Peter – Rs 20,000, Paul – Rs 10,000 and Prince – Rs 7,000. Drawings of Peter till 30th September, 2008 were Rs 10,000. The Profits of the firm before charging interest on capital for the calendar years 2005, 2006 and 2007 were Rs 1,00,000, Rs 1,20,000 and Rs 1,50,000 respectively. The profits include the following abnormal items of credit

2005 2006 2007
Profit on Sale of Assets Rs 5,000 Rs 7,000 Rs 10,000

Insurance claim received Rs 3,000 — Rs 12,000

The firm has taken out a Joint Life Policy for Rs 1,00,000. Besides the partners had severally insured their lives for Rs 50,000 each, the premium in respect thereof being charged to the Profit and Loss Account. The surrender value of the Policies were 30% of the face value. On 30th June, 2008 the firm received notice from the insurance company that the insurance premium in respect of a fire policy had been undercharged to the extent of Rs 6,000 in the year 2007 and the firm has to pay immediately. The revaluation of the assets indicate an upward revision in

value of assets to the extent of Rs 20,000 Prepare an account showing the amount due to Peter's legal representatives as on 30th September, 2008 along with necessary working

Working Notes:

1. Peter's Share of Profit on Revaluation

Profit on Revaluation = Upward revision in values of assets = Rs 20,000

Peter's share = 2/4 of 20,000 = Rs 10,000 (to be transferred to Capital A/c as said in the problem)

2. Valuation of Goodwill and Peter's share thereof

	2005 Rs	2006 Rs	2007 Rs
Reported Profits	1,00,000	1,20,000	1,50,000
Less. (a) Interest on Capital 10% of Rs 20,000	2,000	2,000	2,000
(b) Profit on Sale of assets	5,000	7,000	10,000
(c) Insurance claim received	3,000	-	12,000
(d) Undercharged Insurance			6,000
	90,000	1,11,000	1,20,000

Average Profits = 1/3 of (90,000 + 1,11,00 + 1,20,000) = Rs 1,07,000

Goodwill = 2 x Rs 1,07,000 = Rs 2,14,000

Therefore Peter's share of Goodwill = 2/4 x 2,14,000 = 1,07,000

3. Peter's Share of Profits between 1 1 2008 and 30 9 2008 (date of his death)

Profits (as reported) for 2007 1,50,000

Less Interest on Capital (@ 10% p a to the Surviving partners [not to Peter in the Year of his death] @ 10% 10,000

Add Undercharged insurance premium (Peter's share) 3,000 1,43,000

Add 25% increase on 1,43,000 35,750

Expected Annual Profits for 2008 1,78,750

Profits up to 30 9 08 = 9/12 of 1,78,750 = Rs 1,34,062 (approx) , Peter's Share = 2/4 of 1,34,062 = 67,031

(Undercharged Insurance Premium = Rs. 6,000; To be borne by Peter = 2/4 of 6,000 = Rs.3000).

Amount Payable to the Executor of Peter

	Rs
Capital (as on 1 1 08)	1,00,000
(+) Share of Revaluation Profit (Note - 1)	10,000
(+) Share of Goodwill (Note - 2)	1,07,000
(+) Proportionate share of Profits (Note - 3)	67,031
(-) Drawings upto 30. 09 '2008	(10,000)
	2,74,031

C. DISSOLUTION OF A FIRM

INTRODUCTION:

Whenever a reconstitution takes place within a Partnership in the form of admission, retirement or death of a Partner, the existing partnership is dissolved. The Partnership firm, may however, continue, if the remaining partners desire so. But if the partnership firm is discontinued for any reason, that is called Dissolution of the firm. Dissolution of Firm - when does it take place [in accordance with the Indian Partnership Act of 1932]

1 By Mutual consent of all the partners or in accordance with a contract made by them [Section 40]

2 By Notice - given in writing, by any partner to all other partners if the Partnership is at will [Section 43]

3 On the happening of any one of the following events [Section 42] (i) expiry of the term, where the Partnership was constituted for a fixed term, (ii) completion of the adventure for which the firm was constituted, (iii) Death of a partner, (iv) Adjudication of a Partner as insolvent

4 Compulsory Dissolution [Section 41]

(i) Where all the partners or all but one are adjudged insolvent

(ii) If any event occurs making it unlawful for the business of the firm to be carried on

5 Dissolution by Court According to Section 44 of the Indian Partnership Act the court, at the suit of a partner, may dissolve a firm on any one of the grounds namely -

(i) insanity of a partner ,

(ii) permanent incapability of a partner to do his duties ,

(iii) if a partner is guilty of misconduct that might affect prejudicially the carrying on of the business

(iv) If a partner willfully or persistently commits breach of agreement ,

(v) If a partner transfers all his shares to a third party or has allowed his share to be charged under the Provisions of Rule 49 of order XXI of the First Schedule to the Code of Civil Procedure, 1908 ,

(vi) If the court considers that the business cannot be carried on except at loss ,

(vii) On any other ground on which the court considers the dissolution as just and equitable

Settlement of Accounts on Dissolution

According to Section 48 of the Indian Partnership Act the following rules should be observed for settlement of Accounts after dissolution, subject to agreement by partners

(a) Regarding Losses "Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly if necessary, by the partners individually in the proportions in which they are entitled to share profits" [Section 48(1)]

(b) Regarding Assets "The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order

(i) in paying the debts of the firm to third parties ,

(ii) In paying each partner rateably what is due to him from the firm for advances as distinguished from capital ,

(iii) In paying to each partner rateably what is due to him as capital, and

(iv) The residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits " [Section 48(2)]

Accounting Entries Regarding Dissolution

The two separate aspects of Dissolution for which accounting entries have to be made are [A] Realization of Assets and Payment of liabilities and [B] Settlement of the dues of the Partners,

[A] Realization of Assets and Payment of liabilities

(i) Prepare Realization Account

(ii) Transfer all assets (except cash, bank & fictitious assets) and liabilities at book values to Realization Account

Journal Entries

Item/Purpose	Entry	Special Points to be noted
1 Transfer of book values of assets as recorded in the Balance Sheet	Realization A/c Dr To Sundry Assets (Book value) ¹ (including goodwill if any shown in the Balance Sheet) Realization A/c Dr To Debtors A/c Provision for Bad Debts A/c Dr To Realization A/c.	(a) Cash or Bank A/c are not to be credited unless the firm, as a whole, is sold out as a going concern. (b) Debit balance of any Cap A/c etc. or Debit balance of P. L. A/c not to be transferred to Realization A/c. (c) If there is any Provision for bad Debts debit Realization A/c and credit Debtors A/c with gross figure. Then debit Provision A/c and credit Realization A/c. Same treatment for Provision for Depreciation.
2 Realization 'Sale of above assets	Cash/Bank A/c (amt realized) Dr OR Partners Cap. A/c Dr (agreed value at which a partner takes over an asset, assets) To Realization A/c.	
3 Shares etc. received as purchase consideration in exchange of the firm's assets	Shares A/c Dr To Realization A/c. (agreed value)	

4 Closing the External liabilities	External Liabilities A/c Dr (such as creditors, outstanding expenses, Bank Loan etc , To Realization A/c (book value)	(a) Alternatively - this entry may be passed (combining 4,5 & 6) Liability A/c Dr. To Bank A/c (actual amt. paid) OR, To Partners Cap A/c (agreed value) To Realization A/c (Discount, if any received on payment /discharge)
5 External liabilities paid off	Realization A/c Dr To Cash /Bank A/c (actual amt. paid)	
6 External liabilities taken over by any partner	Realization A/c Dr To Partner's Cap. A/c (agreed value)	
7. Unrecorded asset sold or taken over by any partner	Cash / Bank A/c Dr Partners Capital A/c Dr To Realisation A/c	(b) Where assets and liabilities are taken over by another business on making some lump sum payment, separate entries for realization of assets and / payment of liabilities need not be made
8 If any unrecorded liability is paid	Realization A/c Dr To Cash /Bank A/c (actual amt. paid)	
9 If shares etc received and shown in (3) above are sold out or transferred to partners	Cash /Bank A/c Dr OR Partners Cap. A/c Dr (excluding insolvent partner) To shares A/c	For sale, there may be profit or loss on sale which is transferred to Realization A/c.
10 Payment of Expenses of Realization	Realization A/c Dr To Cash, Bank A/c (if paid by the firm) OR To Partners Cap. A/c (if paid by any partner)	If a partner bears such expenses personally in pursuance of a separate agreement NO ENTRY is required
11. Balance of Realization A/c representing Profit or Loss on Realization.	Realization A/c Dr To Partners Cap. A/c (Profit shared in Profit Sharing Ratio) OR, Partner's Cap. A/c Dr To Realization A/c (Loss shared in Profit Sharing Ratio)	

III Settlement of Partners Dues – through Capital Accounts

Item/Purpose	Entry	Special Points to be noted
1 Prepare Capital Accounts with balance as per Balance Sheet before the dissolution.		
2 Transfer of Current A/c s. if any	Partner's Current A/c Dr To Partner's Cap A/c (Credit Balance) OR Partner's Capital A/c Dr To Partner's Current A/c (Debit balance)	
3 Undistributed Profit, Reserve, Joint Life Policy Reserve, Investment Fluctuation Fund, Contingency Reserve etc transfer.	Profit & Loss (Cr) A/c Dr OR, Any Reserve A/c Dr To Partner's Capital A/c s (Profit sharing ratio)	
4 Undistributed Loss Fictitious 'Unrealizable Assets etc transfer	Partners Capital A/c Dr To Profit & Loss (Dr) A/c OR, To Fictitious Assets A/c (Profit Sharing Ratio)	Example of unrealizable Asset- Advertisement Suspense A/c
5 Any loan taken from any partner	Partner's Loan A/c Dr To Cash/Bank A/c	U/s 48 Repayment of loan should enjoy priority over repayment of capital.
6 Any loan given to any partner	Cash/Bank A/c Dr To Partner's Loan A/c OR, Partners Capital A/c Dr To Partners Loan A/c	If such amount is realized. Adjustment of loan against Capital
7 If any Partner's Capital A/c shows a debit balance (after balancing)	Cash/Bank A/c Dr To Particulars Partner's Capital A/c [Cash brought in to make up the shortfall]	If the deficient partner is insolvent, treatment will be different Vide Insolvency of Partner
8 Payment of credit balance (after final balancing)	Particulars Partner's Cap A/c Dr To Cash/Bank A/c	

Illustration 1 :

X, Y and Z sharing profits & Losses in the ratio of 2 : 2 : 1 agreed upon dissolution of their partnership on 31st December, 2007 on which date their Balance Sheet was as under

Liabilities	Rs	Assets	Rs
Capital		Fixed Assets	50,000
X	40,000	Joint Life Policy (at surrender Value)	10,000
Y	30,000	Debtors	13,000
Reserve Fund	10,000	Less Prov	500
Joint Life Policy Fund	10,000	Stock at Invoice Price	13,000
Creditors	19,000	Less Price loading	2,000
Less Prov	500	Investments	8,000
Salary Outstanding	2,000	Less Fluctuation Fund	500
		Capital Account Z	2,000
		Bank	23,500
	1,10,500		1,10,500

Investments were taken over by X at Rs 6,000, creditors of Rs 10,000 were taken over by Y who has agreed to settle account with them at Rs 9,900. Remaining creditors were paid Rs 7,500. Joint Life Policy was surrendered and Fixed Assets realized Rs 70,000, Stock and Debtors realized Rs 7,000 and Rs 9,000 respectively. One customer, whose account was written off as bad, now paid Rs 800 which is not included in Rs 9,000 mentioned above. There was an unrecorded asset estimated at Rs 3,000, half of which was handed over to an unrecorded liability of Rs 5,000 in settlement of claim of Rs 2,500 and the remaining half was sold in the market which realized Rs 1,300. Y took over the responsibility of completing the dissolution and he is granted a salary of Rs 400 per month. Actual expenses amounted to Rs 1,100. Dissolution was completed and final payments were made on 30th April, 2008.

You are required to prepare the Realization Account, Capital Account and Bank Account.

Solution

Dr Realization Account Cr

Particulars	Amnt. Rs	Amnt. Rs	Particulars	Amnt. Rs	Amnt. Rs
To Fixed Assets A/c		50,000	By Provision on Debtors A/c		500
To Joint Life Policy A/c		12,000	By Provision on Stock A/c		2,000
To Debtors A/c		10,000	By Investment Fluctuation Fund A/c		500
To Stock (at I.P.)		18,000	By Joint Life Policy Fund A/c		19,000
To Investments A/c		8,000	By Creditors A/c		19,000
To Pro. for Disc. on Creditors A/c		500	By Outstanding Salary A/c		2,000
To Y's Capital A/c (Creditors taken over - see Note)		10,000	By X's Capital A/c (Investments taken over)		5,000
<u>To Bank A/c:</u>			By Bank A/c		
Creditors paid off		7,500	Joint Life Policy		19,000
Unrecorded Liability paid (1/2 X 5,000)		2,500	Fixed Assets		70,000
Outstanding Salary		2,000	Stock		7,000
Outstanding Expense		1,100	Debtors (5,000 + 800)		5,800
To Y's Cap. A/c (Salary 400 x 4)		1,600	Unrecorded Assets (Sold)		1,300
To Partner's Capital A/c (Profit on Realization)					
X (2/5)	9,960				
Y (2/5)	9,960				
Z (2/5)	4,980	24,900			
		1,38,100			1,38,100

Dr Bank Account Cr

Particulars	Amount Rs	Particulars	Amount Rs
To Balance b/f	23,500	By Realization A/c	
To Realization A/c		Creditors	7,500
Joint Life Policy	10,000	Unrecorded Liability	2,500
Fixed Assets	70,000	Outstanding Salary	2,000
Stock	7,000	Expenses	1,100
Debtors	9,800	By X's Capital A/c	47,960
Unrecorded Asset	1,300	By Y's Capital A/c	55,560
		By Z's Capital A/c	4,980
	1,21,600		1,21,600

Dr		Partners Capital Account					Cr		
Date 2008	Particulars	X Rs	Y Rs	Z Rs	Date 2008	Particulars	X Rs	Y Rs	Z Rs
1.1	To Balance b/d	--	-	2,000	1.1	By Balance b/d	40,000	30,000	
30.4	To Realization A/c	6,000			30.4	By Reserve Fund (2:2:1)	4,000	4,000	2,000
	To Bank A/c (Balances withdrawn)	47,960	55,560	1,960		By Realization A/c (Profit)	9,960	9,960	1,960
						By Realization A/c (Creditors)		10,000	
						By Realization A/c (Salary)		1,600	
		53,960	55,560	6,960			53,960	55,560	6,960

NOTE

1 Unrecorded Asset and unrecorded liability were not recorded. Any part of such asset utilized to discharge any part of such liability and discount received there on have been ignored.

But unrecorded asset realized (debts previously written off now recovered) has been recorded. Similarly unrecorded asset sold has been recorded.

2 Y took over creditors of Rs 10,000. This has been recorded. How he settles such liability is his personal matter. The discount on payment does not benefit the firm.

Special considerations for a retiring partner and the estate of a deceased partner in relation to debts contracted by the partnership firm:

(a) debts due on the date of retirement/death: the retiring partner and the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death, to the extent of their share.

(b) debts incurred after retirement: where the notice of retirement is not published in accordance with law, the retiring partner is liable for debts contracted after retirement.

(c) deceased/ insolvent partner: the estate of a deceased or bankrupt partner will not be liable for debts contracted by the firm after the death or bankruptcy.

Applicability of Section 37 of the Partnership Act:

In case of retirement, the retiring partner or in case of death, the executor of the deceased partner, if the dues are not settled, then such retired partner or the executor is entitled to the following:

Maximum of Interest @ 6% p a on the amount due to them (i.e. if the amount is unsettled, like, rate of interest on loan to be allowed to the retired partner or the executor is not mentioned).

Or The share of profit earned for the amount due to the partner. Conditions

(a) The surviving partners/continuing partners continue to carry on the business of the firm.

(b) The business is carried on without any final settlement of accounts between the continuing partners and the outgoing partners or his estate

(c) There is no contract to the contrary of the options contained in Section 37 i.e. share in the profits or interest @ 6% p.a. on the unsettled capital

Example Unsettled capital of C Rs 52,000 (Date of retirement 30.9.08, financial year 2008-09)
Net Profit earned by the firm after C's retirement Rs 25,000 Capitals of A Rs 57,000 and B Rs 76,000)

C is entitled to the maximum of the following

(i) interest on unsettled capital = Rs 52,000 x 6% x 6 months = Rs 1,560

(ii) Profit earned out of unsettled capital = Profit x Retired or Deceased Partner's unsettled Dues / Total Capital of the firm (including the amount due to the retired or deceased partner)
= Rs (25,000 x 52,000) / (Rs 52,000 + 57,000 + 76,000) = Rs 7,027

For inclusion in Dissolution

In the case of insolvency, the deficiency of the insolvent partner shall be taken over by the solvent partners in their capital contribution ratio (fixed or fluctuating capitals)

Solvent Partners Capital A/cs Dr

To Insolvent Partners Capital A/cs

There are two methods followed to share the deficiency of the insolvent partner

(a) Garner Vs Murray Rule

(b) Indian Partnership Act, 1932

Garner Vs. Murray Rule : (The third partner who became insolvent was Mr. Wilkins)

The deficiency of the insolvent partner shall be taken over by the solvent partners. The following steps are taken

(a) The loss on realization shall be shared between all the partners (including the insolvent partner) in their profit-sharing ratio

(b) The solvent partners shall bring in cash equal to the amount of loss suffered by them
Cash A/c Dr

To Solvent Partners Capital A/cs

(c) The deficiency of the insolvent partner shall be taken over by the solvent partners in their capital contribution ratio (fixed or fluctuating capitals)

Solvent Partners Capital A/cs Dr

To Insolvent Partner's Capital A/c

Indian Partnership Act, 1932

As per the Indian Partnership Act, 1932, the deficiency of the insolvent partner is shared as follows

(a) The loss on realization shall be shared between all the partners (including the insolvent partner) in their profit-sharing ratio

(b) The deficiency of the insolvent partner shall be taken over by the solvent partners in their capital contribution ratio (fixed or fluctuating capitals)

Solvent Partners Capital A/cs Dr

To Insolvent Partner's Capital A/c

Note As per Indian Partnership Act, the solvent partners shall not bring in cash, their share of loss on realization

Illustration
Partners

Balance Sheet as at 31.10.08

A	25,000	Cash	15,000
B	15,000	C's Capital	10,000
		Realisation A/c(Dr)	15,000
	40,000		40,000

Profit sharing ratio 5:3:2 C is declared insolvent

Solution

Partners Capital Accounts

Dr

Cr.

Particulars	A	B	C	Particulars	A	B	C
To Balance b/d			10,000	By Balance b/d	25,000	15,000	—
To Realisation A/c	7,500	4,500	3,000	By Cash	7,500	4,500	—
To C's Capital A/c	8,125	4,875	—	By A & B's	—	—	13,000
To Cash A/c	16,875	10,125	—	Cap A/c			
				(final repayment)			
	32,500	19,500	13,000		32,500	19,500	13,000

Note The deficiency of the insolvent partner C= Rs 13,000 (= 10,000 + 3,000)

This will be shared by the solvent partners in their capital contribution ratio 5:3

A's Capital A/c Dr 8,125

B's Capital A/c Dr 4,875

To C's Capital A/c 13,000

If all the partners are insolvent

If all the partners are insolvent, the external liabilities shall have to take the share of deficiency of the insolvent partners, i.e. the firm. We shall have to prepare the following ledger accounts

(a) Realization A/c- the external liabilities shall not be transferred to realization account, as they will be paid off at the end, after they have taken the share of deficiency of the insolvent partners

Partners Capital A/cs Dr (in their profit sharing ratio)

To Realization A/c

(b) Partners Capital A/cs- the total deficiency of the insolvent partners shall have to be transferred to Deficiency A/c

Deficiency A/c Dr

To Partners Capital A/cs

(c) The total of the deficiency shall be shared between/amongst the external liabilities in the ratio of their amount outstanding as on the date of dissolution

External Liabilities A/c Dr

To Deficiency A/c

(d) The external liabilities shall be paid off

External Liabilities A/c Dr

To Cash A/c

Illustration.		Balance Sheet as at 30.10.08	
Capitals		Fixed Assets	1,00,000
P	5,000	Cash	10,000
Q	3,000		
R	2,000		
Bank Loan	60,000		
Sundry Creditors	40,000		
	1,10,000		1,10,000

All the partners were declared insolvent. Profit sharing ratio 5:3:2. Assets realized Rs 60,000. Prepare necessary ledger accounts to close the books of the firm.

Solution -

Dr		Realisation Account		Cr	
To Fixed Assets	1,00,000	By Cash A/c (realisation)	60,000		
		By Partners Capital A/cs (loss on realisation)	40,000		
		P 20,000			
		Q 12,000			
		R 8,000			
	1,00,000			1,00,000	

Dr		Partners Capital Accounts						Cr	
Particulars	P	Q	R	Particulars	P	Q	R		
To Realization A/c	20,000	12,000	8,000	By Balance b/d	5,000	3,000	2,000		
	20,000	12,000	8,000	By Deficiency A/c	15,000	9,000	6,000		
					20,000	12,000	8,000		

Dr		Deficiency Account		Cr	
To Partners Capital A/cs				By Bank Loan A/c	18,000
P		15,000		By Creditors	12,000
Q		9,000			
R		6,000			
		30,000			30,000

Dr		Bank Loan Account		Cr	
To Deficiency A/c	18,000	By Balance b/d	60,000		
To Cash A/c	42,000				
	60,000				60,000

Dr		Creditors Account		Cr	
To Deficiency A/c	12,000	By Balance b/d	40,000		
To Cash A/c	28,000				
	40,000				40,000

Dr		Cash Account		Cr	
To Balance b/d	10,000	By Bank Loan A/c	42,000		
To Realisation A/c	60,000	By Creditors A/c	28,000		
	70,000				70,000

Note. The total deficiency of the partners i.e. the firm is Rs 30,000. This is shared between the external liabilities in the ratio of their amount outstanding Rs 60,000 : Rs 40,000 = 3:2

Bank Loan A/c	Dr	18,000	
Creditors A/c	Dr	12,000	
	To Deficiency A/c		30,000

Return of Premium to a partner on dissolution before expiry of term:

Conditions

- (i) A partner was admitted in the partnership firm for a fixed term period,
- (ii) Such partner had paid a premium for goodwill at the time of admission
- (iii) The partnership firm has dissolved

Exceptions The partner will not be entitled to any claim under any of the following conditions

- (i) the firm is dissolved due to death of a partner
- (ii) the dissolution is due to the misconduct of the partner claiming refund
- (iii) dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it

Amount of Refund the amount to be repaid will be determined having regard to the terms upon which the admission was made and to the length of the period agreed upon and the period that has expired Liability of other partners the amount of refund payable shall be borne by the other partners in their profit sharing ratio

Illustration X was admitted into partnership for 5 years, for which he paid a premium of Rs 1,20,000 After 39 months, the partnership firm was dissolved due to misconduct of Mr Z , another partner of the firm Y ,being the third partner Profit Sharing Ratio Y Z X= 5 3 2

Solution X is entitled to claim the refund of premium paid at the time of admission, since the admission was for a fixed term period and the firm is getting dissolved due to a misconduct of Mr Z, another partner of the firm

The amount of refund is

$$= (\text{Total Premium Paid} \times \text{Unexpired term of the partnership}) / \text{Total term of the partnership}$$
$$= 1,20,000 \times 21/60 = 42,000$$

This shall be shared by the other partners Y and Z in their profit sharing ratio 3 2

Y's Capital A/c	Dr	25,200
Z's Capital A/c	Dr	16,800
To X's Capital A/c		42,000

PIECEMEAL DISTRIBUTION

On the event of dissolution of a partnership firm, the assets are realized and liabilities paid off The process of asset realization takes place gradually As a result of such the liabilities are also paid off as and when such realization takes place "Piece-meal Distribution" represents the process of "Pay as and when you realize" strategy

Methods followed under Piece-meal Distribution :

(1) Highest Relative Capital Method

OR

Proportionate Capital Method

OR

Absolute Surplus Capital Method

(2) Maximum Loss Method

Higher Relative Capital Method :

Under this method, the partner who had contributed highest capital in terms of their profitsharing ratio are paid off prior to the other partners

We have to prepare :

- (i) Statement showing Absolute Surplus
[to determine which partner has contributed maximum proportionate capital]
- (ii) Statement Showing Distribution of Cash

Illustration 1 :

Capitals (as on the date of dissolution)

P = Rs 35,000 , Q = Rs 37,500 , R = Rs 31,500 , Profit-Sharing Ratio = 5 : 3 : 2

Statement showing the Highest Relative Capital or Absolute Surplus :

	P	Q	R
1 Actual Capital	55,000	37,500	31,500
2 Profit Sharing Ratio (PSR)	5	3	2
3 Actual Capital \times PSR = Proportionate Capital	11,000	12,500	15,750
4 Consider the smallest of proportionate capital as per (3) as base capital \times PSR [i.e. 11,000 \times PSR]	55,000	33,000	22,000
5 Surplus Capital [(1) - (4)]	—	4,500	9,500
6 PSR		3	2
7 Surplus Capital (as per 5) \times PSR	—	1,500	4,750
8 Consider the smallest of Proportionate capital as per (7) \times PSR		4,500	3,000
9 Absolute Surplus [(5) - (8)]	—	—	6,500

This means that R will be paid Rs 6,500 to clear off his Absolute Surplus Capital

Illustration 2

Capitals X = Rs 15,000 - Y = Rs 18,000 , Z = Rs 9,000
Profit Sharing Ratio = 2 : 2 : 1

Statement showing the Highest Relative Capital

	X	Y	Z
1 Actual Capital	15,000	18,000	9,000
2 PSR	2	2	1
3 Actual Capital \times PSR = Prop Capital	7,500	9,000	9,000
4 Consider the smallest of Proportionate Capital as Base \times PSR [i.e. 7,500 \times PSR]	15,000	15,000	7,500
5 Surplus Capital [(1) - (4)]	NIL	3,000	1,500

Since the Surplus Capitals for Y & Z are in their profit-sharing ratio, no further steps are required

Illustration 3 : Partners M, N and P have called upon you to assist them in winding up the affairs of their partnership on 30th June, 2008. Their Balance Sheet as on that date is given below.

Liabilities	Rs	Assets	Rs
Sundry Creditors	17,000	Cash at Bank	6,500
Capital Accounts -		Sundry Debtors	22,000
M	67,000	Stock in trade	13,500
N	45,000	Plant and Equipment	90,000
P	31,500	Loan M	12,000
		Loan N	7,500
	1,60,500		1,60,500

- (a) The partners share profits and losses in the ratio of 5 : 3 : 2
 (b) Cash is distributed to the partners at the end of each month
 (c) A summary of liquidation transactions are as follows

July

- Rs 16,500 — collected from Debtors, balance is irrecoverable
 Rs 10,000 — received from sale of entire stock
 Rs 1,000 — liquidation expenses paid
 Rs 8,000 — cash retained in the business at the end of the month

August

- Rs 1,500 — liquidation expenses paid, as part of the payment of his capital, P accepted an equipment for Rs 10,000 (book value Rs 4,000)
 Rs 2,500 — cash retained in the business at the end of the month

September

- Rs 75,000 — received on sale of remaining plant and equipment
 Rs 1,000 — liquidation expenses paid. No cash is retained in the business.

Required Prepare a Schedule of cash payments as on 30th September, showing how the cash was distributed.

Solution

Statement showing the Distribution of Cash
(According to Proportionate Capital Method)

Particulars	Creditors			Capital
	Rs	M Rs	N Rs	P Rs
A Balance Due	17,000	55,000	37,500	31,500
B Amount distributed as on 31st July	17,000	—	—	6,500
C Balance Due (A - B)		55,000	37,500	25,000
D Cash paid to 'N' and Equipment given to P on 31st August		—	4,000	10,000
E Balance due (C - D)		55,000	33,500	15,000
F Amount paid to partners on 30th September		41,500	25,400	9,600
G Loss on Realisation (Unpaid Balance) [E - F]		13,500	8,100	5,400

Working Notes .

(i) Statement showing the Calculation of Highest Relative Capital

Particulars	M	N	P
A Balance of Capital Accounts	67,000	45,000	31,500
B Less Loan	12,000	7,500	—
C Actual Capital (A - B)	55,000	37,500	31,500
D Profit sharing ratio	5	3	2
E Actual Capital × Profit sharing ratio	11,000	12,500	15,750
F Proportionate Capitals taking M's Capital as Base Capital	55,000	33,000	22,000
G Excess of Actual Capitals over Proportionate Capitals (C - F)		4,500	9,300
H Profit Sharing Ratio	—	3	2
I Surplus Capital × Profit Sharing Ratio	—	1,500	4,750
J Revised Proportionate Capital taking N's Capital as Base Capital		4,500	3,000
K Excess of Surplus Capital over Revised Proportionate Capitals (C - J)		—	6,500

Scheme of distribution of available cash First instalment up to Rs 6,500 will be paid to P Next instalment up to Rs 7,500 will be distribution between N and P in the ratio of 3 : 2 Balance realization will be distributed among M, N and P in the ratio of 5 : 3 : 2

(ii) Statement showing the Calculation of Cash Available for Distribution

Particulars	July Rs	August Rs	September Rs
A Opening Balance	6,500	8,000	2,500
B Add Net amount realized (Gross amount - Expenses)	25,000	(1,500)	74,000
C Less Closing Balance	8,000	2,500	-
D Amount available for distribution (A+B-C)	23,500	4,000	76,500

(iii) Statement showing the Manner of Distribution of amount available in August and September

Particulars	M Rs	N Rs	P Rs
First Rs 7,500	-	4,500	3,000
Balance Rs 43,000 (Cash and Equipment)	41,500	24,900	16,600
	41,500	29,400	19,600
Less Actual Distribution in August	-	4,000	10,000
Manner of Distribution in September	41,500	25,400	9,600

Illustration 4 : The firm of Blue Collars presented you with the following Balance Sheet drawn as on 31st March 2008

Liabilities	Rs	Assets	Rs
Sundry Creditors	37,000	Cash in hand	3,000
Capital Accounts		Sundry Debtors	34,000
L 40,000		Stock in trade	39,000
K 30,000		Plant and Machinery	51,000
I 27,000	97,000	Current Accounts	
		K 4,000	
		I 3,000	7,000
	1,34,000		1,34,000

Partners shared profits and losses in the ratio of 4 : 3 : 3. Due to difference among the partners, it was decided to wind up the firm, realize the assets and distribute cash among the partners at the end of each month.

The following realizations were made:

(i) May: Rs 15,000 from debtors and Rs 20,000 by sale of stock. Expenses on realization were Rs 500.

(ii) June: Balance of debtors realized Rs 10,000. Balance of stock fetched Rs 24,000.

(iii) August: Part of machinery was sold for Rs 18,000. Expenses incidental to sale were Rs 600.

(iv) September: Part of machinery valued in the books at Rs 5,000 was taken by B, in part discharge at an agreed value of Rs 10,000. Balance of machinery was sold for Rs 30,000 (net).

Partners decided to keep a minimum cash balance of Rs 2,000 in the first 3 months and Rs 1,000 thereafter.

Required : Show how the amounts due to partners will be settled

Solution

(i) Statement showing the Distribution of Cash
(According to Proportionate Capital Method)

Particulars	Creditors		Capital	
	Rs	Rs	K	J
	Rs	Rs	Rs	Rs
A Amount due	37,000	40,000	26,000	24,000
B Amount distribution as on 31st May	35,500	-	-	-
C Balance Due (A - B)	1,500	40,000	26,000	24,000
D Amount Distributed as on 30th June				
First Rs 1,500	1,500			
Next Rs 5,333	-	5,333		
Next Rs 4,667	-	4,667	2,000	
Balance Rs 22,500	-	9,900	6,750	6,750
E Balance due (C - D)		23,000	17,250	17,250
F Amount Distributed as on 31st August		7,360	5,520	5,520
G Balance Due (E - F)		15,640	11,730	11,730
H Add Profit on realisation (Rs 41,000 Rs 39,100)		760	570	570
I Amount Distributed (including Machinery taken by J) as on 30th September * Includes value of Machinery Rs 10,000 and Cash Rs 2,300		16,400	12,300*	12,300

Working Notes :

(i) *Assumption* As the firm is dissolved due to difference among the partners, all partners are presumed to be solvent and the problem has been worked out on the basis of the highest relative capital

(ii) Statement showing the Calculation of Highest Relative Capitals

Particulars	L	K	J
	Rs	Rs	Rs
A Actual Capitals	10,000	26,000	24,000
B Profit sharing ratio	4	3	3
C Actual Capitals × Profit ratio	10,000	8,667	8,000
D Proportionate Capitals taking J's Capital as Base Capital	32,000	24,000	24,000
E Surplus Capital of L and K (A - D)	8,000	2,000	-
F Revised Proportionate Capital of L and J	2,667	2,000	-
G Revised Surplus Capital of L (E - F)	5,333	-	-

While distributing surplus among partners, 1st instalment up to Rs 5,333 will be paid to

L, next instalment up to Rs 4,667 will be distributed between *L* and *K* in the ratio of 4 : 3 and the Balance among *L*, *K* and *J* in the ratio of 4 : 3 : 3

(ii) Statement showing the Calculation of Cash available each month

(iii) Statement showing the Calculation of Cash available each month

Particulars	May Rs	June Rs	August Rs	September Rs
A Opening Balance	3,000	2,000	2,000	1,000
B Add : Amount realised Less Expenses	34,500	34,000	17,400	30,000
C Less : Closing balance	2,000	2,000	1,000	—
D Total Cash available for Distribution (A+B-C)	35,500	34,000	18,400	31,000

Dr.		(iv) Realisation Account		Cr	
Particulars	Rs	Particulars	Rs		
To Sundry Debtors	34,000	By Sundry Creditors	37,000		
To Stock in trade	30,000	By Cash/Bank	1,17,000		
To Plant and Machinery	31,000	By ! (Assets taken over)	19,000		
To Cash/Bank					
Creditors	37,000				
Expenses	1,100				
To Profit transferred to Capital A/c	1,800				
	<u>1,64,000</u>				<u>1,64,000</u>

Illustration 5 : A partnership firm was dissolved on 30th June, 2008. Its Balance Sheet on the date of dissolution was as follows

Liabilities	Rs	Assets	Rs
Capitals		Cash	5,400
Anilk	30,000	Sundry Assets	24,500
Mohit	24,000		
Rupa	15,000		
Loan A/c - Mohit	5,000		
Sundry Creditors	15,000		
	<u>1,00,000</u>		<u>1,00,000</u>

The assets were realized in instalments and the payments were made on the proportionate capital basis. Creditors were paid Rs 14,500 in full settlement of their account. Expenses of realization were estimated to be Rs 2,700 but actual amount spent on this account was Rs 2,000. This amount was paid on 15th September. Draw up a Memorandum of distribution of Cash, which was realized as follows

On 5th July Rs 12,600

On 30th August Rs 30,000

On 15th September Rs 40,000

The partners shared profits and losses in the ratio of 2 : 2 : 1. Give working notes

Solution -

Statement Showing the Distribution of Cash
(According to Proportionate Capital Method)

Particular	Creditors Rs.	Mohit's Loan Rs.	Atrik Rs.	Mohit Rs.	Rupa Rs.
A Balance Due	15,000	5,000	38,000	24,000	18,000
B Cash paid (Rs. 5,400 - Rs. 2,700)	2,700	—	—	—	—
C Balance unpaid (A - B)	12,300	5,000	38,000	24,000	18,000
D 1st Instalment of Rs. 12,600	11,800	800	—	—	—
E Balance unpaid (C - D)	500	4,200	38,000	24,000	18,000
F Less Written-off	500	—	—	—	—
G 2nd Instalment of Rs. 30,000	—	4,200	16,320	2,320	7,160
H Balance unpaid (E-F-G)	—	—	21,680	21,680	10,840
I 3rd Instalment (Rs. 40,000+Rs. 700)	—	—	16,280	16,280	8,140
J Unpaid Balance (H-I) = Loss on Realisation	—	—	5,400	5,400	2,700

Working Notes

(i) Statement showing the Calculation of Highest Relative Capitals

Particulars	Atrik Rs.	Mohit Rs.	Rupa Rs.
A Actual Capitals	38,000	24,000	18,000
B Profit-sharing ratio	2	2	1
C Actual Capitals + Profit Sharing Ratio	19,000	12,000	18,000
D Proportionate Capitals taking Mohit's Capital as Base Capital	24,000	24,000	12,000
E Surplus Capital (A-D)	14,000	Nil	6,000
F Surplus Capital + Profit Sharing Ratio	7,000	—	6,000
G Revised Proportionate capitals taking Rupa's Capital as the basis	12,000	—	6,000
H Revised Surplus Capital (E - G)	2,000	—	—

(ii) Distribution of Second Instalment of Rs. 30,000

	Mohit's Loan	Atrik	Mohit	Rupa
First Rs. 4,200	4,200	—	—	—
Next Rs. 2,000 (Absolute Surplus)	—	2,000	—	—
Next Rs. 18,000 (Balance of Surplus)	—	12,000	—	6,000
Balance Rs. 5,800 (2 2 1)	—	2,320	2,320	1,160
Total 30,000	4,200	16,320	2,320	7,160

Maximum Loss Method

Steps (1) Prepare a statement showing distribution of cash

(2) Pay off the external Liabilities

(3) After all the payment is made for the external liabilities, the partners will be paid off

Total Due of Partners xxx

Less Net/Balance of Realization (x)

Maximum Loss xxx

(4) The maximum loss shall be shared amongst the partners in their profit sharing ratio, as if, there will be no further realization

(5) If any of the partner capitals, after step (4) is negative, that partner shall be treated like an insolvent partner

(6) The deficiency of the insolvent partner as per step(5) shall be shared by the other solvent partners (i.e. those partners who has positive capital balances) in their capital contribution ratio as per Garner vs Murray Rule

(7) Repeat the steps (3) to (6) till final realization

PROBLEMS ON MAXIMUM LOSS METHOD

Illustration : The following is the Balance Sheet of X, Y and Z, who were sharing in the ratio 5 : 3 : 2, on 31st December, 2007 when they decided to dissolve the partnership

Liabilities	Rs.	Assets	Rs
X's Capital	55 000	Cash	20 000
Y's Capital	37 500	Other assets	13,34,000
Z's Capital	31,500		
Y's Loan	2,00 000		
Creditors	10,00 000		
	13,24 000		13,24,000

Note : There was a bill for Rs 4,000 due on 1/4/2008 under discount

Other assets realized as under

1st Jan Rs 8,85,000, 1st Feb. Rs 3,00,000 , 1st March Rs 8,000 , 1st April Rs 5,000 , 1st May Rs 10,000 The expenses of realization were expected to be Rs 5,000, but ultimately amounted to Rs 4,000 only and were paid on 1st May The acceptor of the bill under discount met the bill on the due date

Required : Prepare a statement showing the monthly distribution of cash according to Maximum Loss Method

Solution

Statement Showing the Distribution of Cash towards Firm's Outside Debts and Partner's loan

Particulars	Creditors Rs	Y's Loan Rs
A Amount Due	10,00,000	2,00,000
B Amount paid on 1st Jan (Rs 20,000 + Rs 8,85,000 - Rs 5,000)	9,00,000	—
C Balance Due (A - B)	1,00,000	2,00,000
D Amount paid on 1st February	1,00,000	2,00,000
E Balance Due (C - D)	—	—

Statement showing the Distribution of Cash
(According to Maximum Loss Method)

Particulars	Total Rs.	X Rs	Y Rs	Z Rs
(i) Distribution of Rs 4,000				
A Amount due as on 1st March	1,24,000	35,000	37,500	31,500
Less: Max. Possible Loss if the remaining nothing (Rs 1,24,000 - Rs 4,000) in the ratio of 5 : 3 : 2	1,20,000	60,000	36,000	24,000
Note: Cash available = Rs 5,000 - Rs 1,000 (Reserved for discounted B/R) = Rs 4,000				
Adjustment of X's Deficiency between B and Z in their Capital ratio i.e. 375 : 315		5,000	(2,717)	(2,283)
Adjustment of Y's Deficiency (charged to Z)		—	1,217	(1,217)
B Cash paid as on 1st March	4,000	—	—	4,000
(ii) Distribution of Rs 9,000 (including Amount kept reserved for B/R no longer required)				
C Balance due (A-B)	1,20,000	35,000	37,500	27,500
Less: Max. Possible Loss (Rs. 1,20,000 - Rs 9,000)	1,11,000	35,500	33,300	22,200
Note: Cash available = Rs 5,000 + Rs 4,000 = Rs 9,000		(5,000)	4,200	5,300
Adjustment of X's Deficiency between Y and Z in their Capital ratio i.e. 375 : 315		500	(272)	(228)
D Cash paid as on 1/4/96	9,000	—	3,928	5,072
(iii) Distribution of Rs 11,000				
E Balance due (C-D)	1,11,000	35,000	33,572	22,428
Less: Max. Possible Loss (Rs 1,11,000 - Rs 11,000)	1,00,000	50,000	30,000	20,000
F Cash paid as on 1st May	11,000	5,000	3,572	2,428
G Unpaid Balance (F - E)	1,00,000	50,000	30,000	20,000

Illustration 2 The following is the Balance Sheet of P, Q and R on 31st August, 2008 when they decided to dissolve the partnership. They share profits in the ratio of 2 : 2 : 1.

Liabilities	Rs	Assets	Rs
Creditors	2,000	Sundry Assets	41,500
P's Loan	5,000	Cash	500
P's Capital	15,000		
Q's Capital	18,000		
R's Capital	9,000		
	49,000		49,000

The assets realized the following sums in instalments

I—Rs 1,000, II—Rs 3,000, III—Rs 3,900, IV—Rs 6,000, V—Rs 20,000

The expenses of realization were expected to be Rs 500 but ultimately amounted to Rs 400 only.

Required : Show, how at each stage, the cash received should be distributed among partners according to Maximum Loss Method.

Solution :

Statement showing the Realization and Distribution of Cash

Instalments	Realisation	Creditors	Partners Loans	Partners Capital
	Rs	Rs	Rs	Rs
(I) (After taking into account cash and amount set aside for expenses)	1,000	1,000		
(II)	3,000	1,000	2,000	
(III)	3,900		3,000	900
(IV)	6,000			6,000
(V) (including saving in expenses)	20,100			20,100
	34,000	2,000	5,000	27,000

**Statement showing the Distribution of Cash among partners
(According to Maximum Loss Method)**

Particulars	Total Rs.	P Rs	Q Rs	R Rs
(i) Distribution of Rs 900				
A Balance Due	42,000	15,000	18,000	9,000
B Less Max. Possible loss, if the remaining assets prove to be worthless				
(Rs 42,000 - Rs. 900) in the ratio (2 : 2 : 1)	41,100	16,440	16,440	8,220

C Deficiency of P's Capital charged to Q and R in the ratio of their Capitals i.e., 18,000 : 9,000 (Garner vs Murray)				
	-	1,440	(960)	(480)
D Amount paid	900	-	600	300
(ii) Distribution of Rs. 6,000				
E Balance after payment (A - D)	41,100	15,000	17,400	8,700
F Less: Max. Possible loss (Rs. 41,100 - 6,000)	35,100	14,040	14,040	7,020
G Amount paid	6,000	960	3,360	1,680
(iii) Distribution of Rs. 20,100				
H Balance after payment (E - G)	35,100	14,040	14,040	7,020
I Less: Max. Possible loss (Rs. 35,100 - Rs. 20,100)	15,000	6,000	6,000	3,000
J Amount paid	20,100	8,040	8,040	4,020
K Unpaid balance (H - J)	15,000	6,000	6,000	3,000

Illustration 10 - Rahul, Roshan and Rohan were in partnership sharing profits and losses in the ratio of 3 : 2 : 1 respectively. The partnership was dissolved on 30th June, 2008 when the position was as follows:

Liabilities	Rs.	Assets	Rs.
Capitals		Cash in hand	28,000
Rahul	1,40,000	Sundry Debtors	2,94,000
Roshan	70,000	Stock in trade	1,12,000
Rohan	14,000		
Creditors	2,10,000		
	4,34,000		4,34,000

There was bill for Rs. 10,000, due on 30th November, 2008, under discount. It was agreed that the net realizations should be distributed in their due order (at end of each month) but as safely as possible. The realizations and expenses were as under:

Date	Stock and Debtors Rs	Expenses Rs
31st July	84,000	7,000
31st August	1,26,000	5,400
30th September	70,000	4,900
31st October	77,000	3,500
30th November	35,500	3,500

The Stock was completely disposed off and amounts due from debtors were realized, the balance being irrecoverable. The acceptor of the bill under discount met the bill on the due date. Prepare a Statement showing the piecemeal distribution of cash according to Maximum Loss Method.

Solution:

Statement showing the Distribution of Cash
(According to Maximum Loss Method)

Particulars	Creditors Rs	Rahul Rs	Roshan Rs	Rohan Rs
A Balance Due	2,10,000	1,40,000	70,000	14,000
B Cash on hand on 30th June paid to creditors	28,000			
C Balance outstanding (A - B)	1,82,000	1,40,000	70,000	14,000
D Cash paid on 31st July	77,000			
E Balance outstanding (C - D)	1,05,000	1,40,000	70,000	14,000
F Rs 1,05,000 paid to creditors on 31st August	1,05,000			
G Balance outstanding (E - F)		1,40,000	70,000	14,000
Balance available for distribution (Rs 1,20,600 - Rs 1,05,000 - Rs 10,000) = Rs 5,600				
Less Maximum loss (Rs 2,24,000 - Rs 5,600) in ratio of 3 : 2 : 1		(1,09,200)	(72,800)	(36,400)
Balance		30,800	(2,800)	(22,400)
Deficiency of Roshan and Rohan's capital charged to Rahul		(25,200)	2,800	22,400
H Cash paid on 31st August		5,600		
I Balance outstanding (G - H)		1,34,400	70,000	14,000
Less Maximum Loss (Rs 2,18,400 - Rs 65,000)		(76,650)	(51,100)	(25,550)
Balance		57,750	18,900	(11,550)
Deficiency of Rohan's capital charged to Rahul and Roshan (2 : 1)		(7,700)	(3,850)	11,550
J Cash paid on 30th September		50,050	15,050	
K Balance outstanding (I - J)		84,350	54,950	14,000
Less Maximum loss (Rs 1,53,300 - Rs 73,500)		(39,900)	(26,600)	(13,300)
L Cash paid on 31st October		44,450	28,350	700
M Balance outstanding (K - L)		39,900	26,600	(3,300)
Less Maximum loss (Rs 79,800 - Rs 42,000*)		(18,900)	(12,600)	(6,300)
N Cash paid on 30th November		21,000	14,000	7,000
O Unpaid Balance (M - N)		18,900	12,600	6,300
*Note: Cash available on 30th November = (Rs 35,500 - Rs 3,500) + Rs 10,000 (Reserved for Discounted B/R, now no longer required) = Rs 42,000				

UNIT – III - JOINT STOCK COMPANIES

INTRODUCTION:

Meaning of a Company:

A company is a voluntary and autonomous association of certain persons with capital divided into numerous transferable shares formed to carry out a particular purpose in common. It is an artificial person created by law to achieve the object for which it is formed. Section 3(1) (i) of the Companies Act, 1956 defines a company as "Company formed and registered under this Act or an existing company." An existing company means a company formed and registered under any of the former Companies Acts. Thus it is an abstract person, invisible, intangible and existing only in contemplation of law. It can hold, purchase or sell both movable and immovable property, incur and pay debts, open a bank account in its own name and sue and be sued in the same manner as an individual. Law creates it and law only can dissolve it. Its existence is altogether independent of the life of its members. Members may come and go but the company would go on for ever. Transferability of shares has given perpetual succession to a company. Death, insanity or insolvency of a member or any member will not affect the existence of the company at all. A company is a legal entity quite distinct and separate from the persons who are its members. A company cannot ordinarily buy its own shares. A shareholder is not the agent of the company. He cannot incur any debt so as to bind the company. They cannot bind the company by their acts. The same person can be a shareholder and a creditor of the company. The ownership is divorced from management because a joint stock company is managed by a Board of Directors elected by the shareholders (i.e. owners).

CHARACTERISTICS OF A COMPANY:

The main characteristics of a company are:

- (i) It is a distinct legal person existing independent of its members.
- (ii) Liability of the members is limited to the extent of the face value of shares held by them.
- (iii) It has a perpetual succession, i.e., the members of the company may keep on changing from time to time but this does not affect the company's continuity.
- (iv) The shares of a company are freely transferable except in case of a Private limited Company.
- (v) A company being a legal person is capable of owing, enjoying and disposing of the property in its own name.
- (vi) A company, being a separate body can sue and be sued in its own name.
- (vii) Though a company is an artificial person yet it acts through human beings who are called directors of the company. There is a divorce between ownership and the management.
- (viii) It is a voluntary association of persons usually for profit.

Statutory Books

Statutory books are those which a limited company is under statutory obligation to maintain at its registered office. The main statutory books are

- (i) Register of Investments held and their names
- (ii) Register of charges
- (iii) Register of Members

- (iv) Register of debenture holders
- (v) Annual returns
- (vi) Minutes books
- (vii) Register of contracts
- (viii) Register of Directors
- (ix) Register of shareholdings of the directors
- (x) Register of loans to companies under the same management
- (xi) Register of Investment in the shares of other companies

Books of Account

Every company is required to keep at its registered office books of account

These books are to be maintained in such a way so as to disclose

- (a) The sums of money received and expended by the company and the matter in respect of which the receipt and expenditure has taken place
- (b) All sales and purchases of goods of the company
- (c) All assets and liabilities of the company

SHARE CAPITAL

No trading concern can run without capital. The divisions of share capital are

(i) **Nominal or Registered or Authorized Capital** The amount of capital with which the company intends to be registered is called registered capital. It is the maximum amount which the company is authorized to raise by way of public subscription. There is no legal limit on the extent of the amount of authorized capital.

(ii) **Issued Capital** That part of the authorized capital which is offered to the public for subscription is called issued capital.

(iii) **Subscribed Capital.** That part of the issued capital for which applications are received from the public is called the subscribed capital.

(iv) **Called up Capital** The amount on the shares which is actually demanded by the company to be paid is known as called up capital.

(v) **Paid up Capital** The part of the called up capital which is offered and is actually paid by the members is known as paid up capital. The sum which is still to be paid is known as *calls in arrears*.

(vi) **Reserve Capital.** A company may determine by a special resolution that any portion of its share capital which has not been already called up shall not be capable of being called-up except in the event of winding up of the company. Such type of share capital is known as reserve capital.

Application for Shares

Whenever shares are to be issued by a company, an advertisement in a leading newspaper is given for the information of the general public along with some important extracts of the prospectus. Those who are interested to purchase the shares on the basis of that information may have the prospectus for detailed information and application form. If a person is satisfied with the profitability and other things he is required to fill up the application form and to deposit this along with the requisite amount (known as application money) with the prescribed scheduled bank. The application money should at least be 5 per cent of the face value of the share. The scheduled bank will send this application money along with a list of applicants to the company. The company will ultimately record these in the "Application and Allotment Book".

Allotment of Shares

After receiving the applications the directors take steps to allot the shares. Allotment of shares means acceptance of the offer of the applicant for the purchase of shares. Directors have discretionary power either to reject or to accept partially the applications. There are no restrictions on the rights of a private company to allot its shares. But the public company cannot allot its shares unless

i The minimum subscription stated in the prospectus has been subscribed by the public

ii A prospectus or a statement in lieu of prospectus has been filed with the Registrar before making the first allotment

iii The amount of application, *i.e.*, at least 5% of the face value has been received

The applicants, to whom shares are allotted, will be sent allotment letters. After allotment, they become the shareholders of the company. Those to whom shares could not be allotted will be sent a letter of regret along with refund of their application money. The shareholders will be required to pay the allotment money on allotment of shares which will also be recorded in the Application and Allotment Book.

Calls on Shares

Out of the face value of the shares, 5% is payable with application, some money will be paid on allotment and rest money will be paid as and when calls are made by the company.

Generally the prospectus gives the dates of different calls along with the amount of the calls by shareholders. In case it is not given in the prospectus, the directors have the discretion to call it in one call or more than one call. For this a resolution of the Board of Directors must be passed and a notice is sent to the shareholders with a request to pay the amount of the call.

As soon as a call notice is sent, its particulars are entered in a separate book known as Share Call Book, a specimen of which is given on the next page.

PROFIT PRIOR TO INCORPORATION

In many cases, a new company is formed exclusively to acquire an existing business unit and take it over as a going concern, from a date prior to its *own incorporation*. In such cases, the business unit is purchased first, and the registration of the acquiring company takes place later. For example, AB Pvt Ltd is incorporated on 1st October, 2009 to take over the running business of Das Bros from 1st January, 2009. The profit earned (or loss suffered) during the pre-incorporation period (in our example 1st January to 30th September 2009) is called

profit (loss) prior to incorporation. Legally, this profit is not available for distribution as dividend, since a company cannot earn profit before it comes into existence. However, profit earned after incorporation is available for distribution as dividend. Profit earned before

incorporation is a **capital profit** and profit earned after incorporation is a **revenue profit**.

It is a common practice that the **date of incorporation** should be taken as the basis for calculation of pre-acquisition profit.

Methods of Computing Profit Prior to Incorporation

They are different methods of computing profit prior to incorporation. They are

First Method

Step 1 Prepare a Profit and Loss Account for the pre-incorporation period

Step 2 Prepare a Profit and Loss Account for post-incorporation period

The entries are :

(1) Land & Building Account Dr

Plant & Machinery Account	Dr
Sundry Debtors Account	Dr At the value on the date of incorporation
Stock Account	Dr
Cash at Bank	Dr
Cash in Hand	Dr
To Liabilities Account	
To Vendors Account	
(ii) Vendors Account	Dr Purchase consideration
To Equity Share Capital Account	

Second Method

Under this method profit is calculated as follows

Step 1 Prepare a Trading Account for the entire period (pre- and post-incorporation periods combined)

Step 2 Allocate gross profit and expenses (indirect) between pre- and post-incorporation period on the basis of the following principles

- (i) Gross profit is allocated in the *ratio of sales* of each period
- (ii) Fixed portion of an expenses is allocated on *the basis of time*
- (iii) Expenses related to sales, e.g., traveler's commission, discount allowed, on *the basis of sales*
- (iv) Expenses related to time, e.g., rent, rates and taxes, insurance, depreciation, salaries of general staff, to that period's profit. Some examples are
 - (a) Preliminary expenses, director's fees, debenture interest, etc. are to be charged against post-incorporation profit
 - (b) Partner's salaries, interest on partners' capital, etc. are to be charged against the profit of pre-incorporation period

Appointment Basis may be :

	Allocated on Basis of Time		Allocated In Ratio of Sales
1	Rent, Rates and Taxes	1.	Gross Profit
2	Depreciation	2.	Bad Debts
3	Salaries of General Staff	3	Discount Allowed
4	Insurance	4	Carriage Outwards
5	Interest on Purchase Consideration	5	Selling Expenses
6	Audit Fees	6	Commission on Sales
7	General Expenses	7	Advertisement Expenses
8	Printing and Stationery	8	Delivery Expenses
9	Office Expenses	9	Free Samples
10	Fixed Expenses	10	After-sales service cost
11	Miscellaneous Expenses	11	Salaries to Salesmen
12	Fixed Distribution Expenses	12	Sales Promotion Expenses
13	Administrative Expenses	13	Variable Distribution Expenses
14	General Travelling Expenses		

Step 3 Net profit/loss of respective periods are calculated after deducting apportioned expenses and acquisition entries are passed at the *end of the accounting year*

Accounting Treatment of Pre-incorporation Profit/Loss :

Profit Prior to Incorporation

Any profit prior to incorporation may be

- (a) Credited to Capital Reserve Account
- (b) Credited to Goodwill Account to reduce the amount of goodwill arising from acquisition of business
- (c) Utilized to write down the value of fixed assets acquired

Loss Prior to Incorporation

Any loss prior to incorporation may be dealt with as follows

- (a) Debited to Goodwill Account
- (b) Debited to Capital Reserve Account arising from acquisition of business
- (c) Debited to a Suspense Account, which can be written-off later as fictitious asset

Accounting Treatment of Post-incorporation Profit/Loss

Any profit/loss after incorporation is transferred to Profit and Loss Appropriation Account

Post-incorporation profit can be distribution as dividend

Illustration 1.

Hansa Ltd was incorporated on 1st July, 2008 to acquire a running business with effect 1st April, 2008. The accounts for the year ended 31st March, 2009 disclosed the following

- (i) There was a gross profit of Rs 30,00,000
- (ii) The sales for the year amounted to Rs 1,20,00,000 of which Rs 24,00,000 were for the first six months
- (iii) The expenses debited to the Profit and Loss Account included—directors' fees Rs 1,50,000, bad debts Rs 36,000, advertising Rs 1,20,000 (under a contract amounting to Rs 10,000 per month), salaries and general expenses Rs 6,40,000, preliminary expenses written off Rs 50,000, and donation to a political party given by the company Rs 50,000

Prepare a statement showing the amount of profit made before and after incorporation

Solution :

Hansa Ltd.

Statement showing Apportionment of Profit between Pre- and Post-incorporation Period

Particular	Notes	Basis	Total Rs	Pre-incorporation 1.4.2008 to 30.6.2008 (3 months)	Post-incorporation 1.7.2008 to 31.3.2009 (9 months)
Gross Profit (A)	1	Sales (1.98)	29,00,000	3,00,000	27,00,000
Less: Expenses (B)					
Bad Debts		Sales (1.98)	36,000	3,600	32,400
Advertising		Direct	1,20,000	30,000	90,000
Salaries and General Expenses	2	Time (1.25)	6,40,000	1,60,000	4,80,000
Director's fees	3	Direct	1,50,000	-	1,50,000
			8,46,000	1,93,600	7,52,400
Net Profit (A - B)			20,54,000	1,06,400	19,47,600
Less: Appropriations					
Preliminary Expenses (Note 4)		50,000	50,000		
Donation (Note 5)		50,000	50,000		
			1,00,000		1,00,000
			19,54,000	1,06,400	18,47,600
				Capital Profit	Net Profit

Note : Capital profit is transferred to **Capital Reserve Account** and Net profit is transferred to **Profit and Loss Appropriation Account.**

Working Notes :

(1) Total sales for the year 2008-09 = Rs 12,00,000 Sales for the first 6 months (1 4 2008 to 30 9 2008) = Rs 24,00,000 Therefore, sales per month during first 6 months =
Rs 24,00,000/6 = Rs 4,00,000

In effect, sales of first three months (1 4 2008 to 30 6 2008) = Rs 4,00,000 × 3 =
Rs 12,00,000 Sales of next nine months (1 7 2008 to 31 3 2009) = Rs 1,20,00,000 —
Rs 12,00,000 = Rs 1,08,00,000

Ratio of Sales = 12,00,000 / 1,08,00,000 = 1 / 9 It is assumed that sales evenly occurred during first six months

(2) These expenses generally accrue evenly throughout the year and are, therefore, divided on the **time basis**, i.e. 3 / 9 or 1 / 3

(3) Directors' fees are paid in case of company only These must naturally be shown in the post-incorporation period

(4) Preliminary expenses and donation are not charges against profit These are treated as appropriations

Illustration 2.

The promoters of proposed Horizon Ltd purchased a running business on 1st January, 2009 from Mr Ultra Modern Horizon Ltd was incorporated on 1st May, 2009 The combined

Profit & Loss Account for the year ended on 31 12 2007

	Rs		Rs.
To Rent, rates, insurance, electricity & salaries	1,20,000	By Gross profit	15,00,000
To Directors' sitting fees	36,000	By Discount received from creditors	60,000
To Preliminary expenses	48,000		
To Carriage outwards and selling expenses	55,000		
To Interest paid to Vendors	1,00,000		
To Profit	12,00,000		
	<u>15,60,000</u>		<u>15,60,000</u>

Profit and loss prior and after the incorporation.

Following further information is available

(1) Sales up to 30 4 2009 were Rs 30,00,000 out of total sales of Rs 1,50,00,000 of the year

(2) Purchases up to 30 4 2009 were Rs 30,00,000 out of total purchases of Rs 90,00,000 of the year

(3) Interest paid to Vendors on 1 11 2009 @ 12% p a on Rs 10,00,000 being purchase consideration

From the above information, prepare Profit and Loss Account for the year ended 31st December, 2009, showing the profit earned prior to and after incorporation and also show

the transfer of the same to the appropriate accounts

Solution :

Horizon Ltd.

Dr. Profit and Loss Account for the year ended 31st December, 2009

Cr.

Particulars	Note	Total Rs	Pre incorporation	Post incorporation	Particulars	Note	Total Rs	Pre incorporation	Post incorporation
To Rent, Rates Insurance, Electricity & Salaries	2	1,20,000	40,000	80,000	By Gross Profit	1	15,00,000	3,00,000	12,00,000
To Directors sitting fees	3	36,000	-	36,000	By Discount received	7	60,000	20,000	40,000
To Preliminary Expenses	4	40,000	-	40,000					
To Carriage Outward	5	55,000	11,000	44,000					
To Interest on Vendor	6	1,00,000	40,000	60,000					
To Net Profit — Transferred to		12,00,000							
- Capital Reserve			2,20,000	-					
- P&L Appropriation			-	9,71,000					
		15,60,000	7,20,000	12,40,000			15,60,000	3,20,000	12,40,000

Working Notes :

- (1) For 4 months to 30th April sales amounted to Rs 30,00,000 and for the remaining 8 months, sales were (Rs 1,50,00,000 - Rs 30,00,000) = Rs 1,20,00,000. Gross profit is apportioned in the ratio of 3 : 12 or 1 : 4 assuming the gross rate was uniform throughout the year. Therefore, the gross profit is apportioned as

$$\text{Pre } \frac{15,00,000}{5} \times 1 = \text{Rs } 3,00,000 \quad \text{Post } \frac{15,00,000}{5} \times 4 = \text{Rs } 12,00,000$$

- (2) These expenses generally accrue evenly throughout the year and are therefore divided on the time basis, pre : post 4 months : 8 months or 1 : 2.

- (3) Directors' sitting fees and preliminary expenses are generally found in case companies. These must naturally be shown in post-incorporation period.

- (5) Carriage outward has been apportioned in the ratio of sales, i.e.

$$\text{Pre } \text{Rs } \frac{55,000}{5} \times 1 = \text{Rs } 11,000 \quad \text{Post } \text{Rs } \frac{55,000}{5} \times 4 = \text{Rs } 44,000$$

- (6) Interest accrues on the basis of time. Therefore it is divided on the time basis. Interest has been paid for a total of 10 months (January to October). 4 months related to pre-incorporation period and 6 months to post-incorporation period. Therefore it is split as

$$\text{Pre } \text{Rs } \frac{1,00,000}{10} \times 4 = \text{Rs } 40,000 \quad \text{Post } \text{Rs } \frac{1,00,000}{10} \times 6 = \text{Rs } 60,000$$

- (7) For 4 months to 30th April, purchases amounted to Rs 3,00,000 and for the remaining 8 months, purchases were (Rs 90,00,000 - 30,00,000) = Rs 60,00,000.

Discount received is apportioned in the ratio of 3 : 6 or 1 : 2. Therefore, discount received is apportioned as

$$\text{Pre } \frac{60,000}{3} \times 1 = \text{Rs } 20,000 \quad \text{Post } \frac{60,000}{3} \times 2 = \text{Rs } 40,000$$

Illustration 3.

From the following information, calculate the ratio of Sales in each case separately

(a) (i) Date of acquisition — 1st April, 2008, date of incorporation — 1st July, 2008 and date of closing the books of accounts — 31st March, every year

(ii) The sales for the year ending on 31st March, 2009 were Rs 1,20,000 of which Rs 24,000 were sold during the first six months of the accounting period

(b) (i) The accounts were made up to 31st December, 2008. The company was incorporated on 1st May, 2008 to take over a business from the preceding 1st January

(ii) Total sales for the year were Rs 24,00,000. It is ascertained that the sales for November and December are one and half times the average of those for the year, while those for February and April are twice the average

(c) (i) X Ltd was incorporated on 1st July, 2008 to take the existing business of X from 1st April, 2008. Date of closing the books of account — 31st March, 2009

(ii) Monthly sales in April 2008, January 2009 and March 2009 are double the average monthly sales for remaining months of the year. June & July half the average.

(d) (i) Z Ltd was incorporated on 1st August, 2008, to take over the running business of Kabir Bors with effect from 1st April, 2008. The company received the certificate of commencement of business on 1st October, 2008

(ii) Total sales for the year, which amounted to Rs 64,00,000 arose evenly upon the date of certificate of commencement, where after they recorded an increase of 2/3rd during the remaining period

Solution :

(a) Sales of first 6 months = Rs 24,000. Average sale of first 6 months = $\text{Rs } 24,000/6 = \text{Rs } 4,000$ per month

Pre-incorporation period consist of 3 months (i.e., April, May and June). The sales of those 3 months = $\text{Rs } 40,000 \times 3 = \text{Rs } 1,20,000$. Sales of remaining 9 months = $\text{Rs } 1,20,000 - \text{Rs } 12,000 = \text{Rs } 1,08,000$

Therefore, the ratio of sales = $\text{Rs } 12,000 : \text{Rs } 1,08,000 = 1 : 9$

(b) Let the average of monthly sales = x . The sales of different months can be shown as follows. Let the average of monthly sales = x . The sales of different months can be shown as follows

Month	Jan	Feb	March	April	May	June	July	Aug	Sept	Oct	Nov	Dec
Sales	$1x$	$2x$	$1x$	$2x$	$1x$	$1x$	$1x$	$1x$	$1x$	$1.5x$	$1.5x$	$1.5x$

The ratio of Sales = $7x : 6x = 7 : 6$

(c) Let the average monthly sales be x . The sales of different months can be shown as follows

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	$2x$	x	$0.5x$	$0.5x$	x	x	x	x	x	x	$2x$	$2x$

Date of Incorporation

The ratio of Sales = $3.5x : 10.5x = 1 : 3$

(d) Let the average monthly sales = x . The sales at different months can be shown as follows

Month	April	May	June	July	Aug	Sept	Oct	Nov	Dec	Jan	Feb	March
Sales	x	x	x	x	x	x	$1\frac{1}{2}x$	$1\frac{1}{4}x$	$1\frac{1}{2}x$	$1\frac{1}{4}x$	$1\frac{1}{4}x$	$1\frac{1}{4}x$

Date of Incorporation Date of commencement

The ratio of Sales = $5x : 12x = 5 : 12$

PREPARATION OF FINAL ACCOUNTS UNDER COMPANIES ACT, 1956

INTRODUCTION:

Preparation of company financial statements implies preparation of profit and loss account, balance sheet and notes to the accounts. Notes to the accounts includes relevant data and information which is needed by the users but which cannot be presented in the financial statements.

For example, they may contain additional information that is relevant to the needs of the users about items in the balance sheet and profit and loss account. They may include disclosures about risks and uncertainties affecting the enterprise and any resources and obligations not recognized in the balance sheet (such as mineral reserves). Information about geographical and industry segments and the effect on enterprise of changing prices may also be provided in the form of supplementary information. Notes also include significant accounting policies followed in the preparation of financial statements, physical data relating to production and sales, details regarding exports, foreign currency receipts, expenditure, etc. Financial statements also show the results of the efforts, accountability and performance of the management for the resources entrusted to it by the shareholders. The shareholders who assess the stewardship or accountability of management may do so in order to take a decision about their rights. They can also change the management if they are not satisfied with their performance. In addition to the shareholders there are several other interested parties like investors, creditors of both short and long-term, employees, researchers etc for whom the information provided by the financial statements is valuable for a wide range of economic decisions.

Objectives of Financial Statements

The main objectives in preparing the financial statements are as follows

- 1 To provide financial information that is useful in making rational investment, credit and similar decisions
- 2 To provide financial information to enable users to predict cash flows to the business
- 3 To provide financial information about business resources (assets), claims to these resources (liabilities and owner's equity) and changes in these resources and claims

FINANCIAL STATEMENTS REQUIREMENTS AND CONTENTS:

Need for Regulation

Financial statements, the main link between the management and the interested parties will not help much, if they are not drawn up properly and do not disclose the required information. Without a proper system and control, the managements may conceal more than reveal in attempting at window dressing to cover up their inefficiency. They would like to project a better image of the performance of the undertaking and its financial position than what it really is. Such manipulations are referred to sarcastically as 'Creative Accounting'. It may be worthwhile to recall the constitution of the now famous Cadbury Committee on Corporate Governance in U.K. The committee was set up due to the general lack of confidence in accounting and other statements published even by very prominent companies in U.K. which subsequently collapsed. The concern was not so much on account of the collapse of these companies but, more importantly, these companies were perceived as very stable and strong companies and did not give any prior indication of the true state of their financial affairs even before their sudden failure. If this can happen in a developed country one can easily imagine the scenario in a country like ours. It did happen in our country also. When some companies failed and the manipulations and frauds came to light, the audited accounts published immediately before such failures were seriously questioned. Due to the fact stated above, systematic and attempts on the part of regulatory authorities is coming out with more standards and compelling more disclosures in order to ensure transparency in financial statements resulting to improvement of the quality of information to many users. Corporates are also required to publish financial statements at more frequent intervals. While Companies Act requires annual reports, Securities Exchange Board of India (SEBI) requires corporate to publish quarterly results, although unaudited.

Legal framework

(1) The board of directors must present at every annual general meeting the following

- (a) a balance sheet at the end of the financial year, and
- (b) a profit and loss account for that period

A financial year may be more or less than a calendar year but it should not exceed 15 months.

With special permission from registrar it may extend to 18 months. Companies normally prepare their accounts for the financial year ending with 31st March every year (S. 210).

(2) The profit and loss account and the balance sheet are prepared with the help of books of account kept by the company. Such books are required to be kept on accrual basis and according to the double entry system of accounting (S. 209).

(3) Every balance sheet of a company must give a true and fair view of the state of affairs of the company and must conform to either the horizontal or vertical form specified in the part I of Schedule VI to the Act. It must also comply with the general instructions given at the end of the part I. Every profit and loss account must give a true and fair view of the profit and loss of the company for the financial year and must also comply with the requirements of part II of the Schedule VI.

Financial statements must be prepared in accordance with accounting standards. These standards are prepared by the Institute of Chartered Accountants of India (ICAI) and are prescribed by the Government in consultation with the National Advisory Committee on Accounting Standards constituted under S. 210 (A) of the Act. Until the standards are

prescribed by the Central Government the accounting standards specified by ICAI are applicable. Where the companies do not comply with the accounting standards such companies must disclose the following

(a) The deviation from the accounting standards,

(b) The reasons for such deviation, and

(c) The financial effect, if any, arising due to such deviation (S 211)

(4) As per standard ASI ('Disclosure of accounting policies') all significant accounting policies adopted in the preparation and presentation of financial statements must be given at one place and form part of financial statements. In the published accounts significant accounting policies constitute one of the schedules to the profit and loss account and the balance sheet. Some companies also give it under notes to accounts.

(5) A holding company must give a statement disclosing its interest in the subsidiaries besides enclosing the financial statements and the reports of board of directors of such subsidiaries (S 212)

(6) Every balance sheet and profit and loss account of a company must be authenticated by its manager or secretary and by not less than two directors one of whom must be managing director if there is one (S 215)

(7) The financial statements must be accompanied by the report of the statutory auditor to the shareholders. The audit report must also be accompanied by the annexure as required by the Manufacturing and Other Companies (Auditor's Report) Order 1988 issued by the Central Government in terms of S 227 (4A) of the companies Act, 1956 (S 216)

(8) Every balance sheet laid by the company at the annual general meeting must be accompanied by a report of the board of directors (S 217). The contents of this report are given later.

(9) All the above documents are known as published accounts/annual accounts and must be sent to every shareholder/trustees of debenture holders at least 21 days before the date of AGM (S 219)

(10) In addition to the above requirements annual accounts of listed companies will also include certain other statements in accordance with the requirements of listing agreement.

With a view to increase transparency, ensure good corporate governance and provide protection to investors SEBI has directed stock exchanges to introduce additional clauses in the listing agreement, which make the following statements mandatory.

Cash flow statement

A report on Corporate Governance

Management discussion and analysis

(11) Enlightened companies also include in the annual accounts much more information like 'financial highlights' for 5 to 10 years, important ratios, social responsibility statements etc. These aspects will be discussed in the next chapter.

(12) Annual accounts listed in stock exchanges outside the country must satisfy the requirements of those stock exchanges. For example those companies listed in U S A report income as per GAAP followed in USA.

Preparation of financial statements - Statutory and accounting standard requirements.

Under the heading Legal Framework we have seen that financial statements must be prepared in accordance with the provisions of company and also comply with the Accounting

Standards In the company law schedule VI deals with the preparation of both the balance sheet and profit and loss account Besides, there are number of Sections which have bearing on the ration of financial statements like 198,205, 349, 350 to mention a few These will be dealt with at the appropriate place With respect to accounting standards all accounting standards specified by ICAI have to be complied till the Government prescribe the standards It has been made mandatory for the directors to give a responsibility statement stating that applicable accounting standards have been followed They must also state that accounts are prepared on going concern basis We will discuss the relevant accounting standards on the preparation of statements at the appropriate place

Meaning of 'True and fair view'.

True and fair does not mean conforming to the forms prescribed by the Act True and fair view can be obtained only if annual accounts are prepared in a defined manner as laid down by various accounting standards and in conformity with the Generally Accepted Accounting Principles (GAAP) Although managers prepare the accounts to reflect a true and fair view according to their opinion, ultimately it must be to the satisfaction of the auditor, as he is the person concerned to give the certificate that the statements reflect a true and fair view of the state of affairs of the company If he is not satisfied he would give only a qualified report The term 'true and fair' has not been defined in law nor is defined by any accounting standard However, it may be presumed that the financial statements reflect a 'true and fair view' if the following requirements are met

- a) The statements are drawn in accordance with the requirements of Parts I and II of Schedule VI of the Companies Act
- b) Proper books of accounts are maintained on double entry principles and following accrual basis of accounting
- c) Accounts are drawn up conforming to GAAP and the requirements of accounting standards
- d) Financial statements reflect substance of transactions and events that took place during the year
- e) Accounts disclose all information as required by the statutory auditor although some information may not be strictly required by law

Accrual Basis

It is mandatory under the Companies Act for all companies to maintain their accounts on accrual basis and according to double entry system of accounting Accrual basis as distinguished from cash basis recognizes revenues in the period earned even if such revenues are not received in cash and similarly expenses are recognized in the period incurred in the process of generating revenues even if such expenses have not been paid AS-1 on 'Disclosure of Accounting Policies' requires disclosure if fundamental accounting assumptions, viz , Going Concern, Consistency and Accrual are not followed Implicit in this is that enterprises should follow these fundamental assumptions in the preparation of financial statements In the previous para, the meaning of accrual is explained The meaning of going concern is that the enterprise will continue operation for the foreseeable future On that basis assets are valued If there is a need or intention to liquidate the enterprise, the financial statements may have to be prepared on a different basis and, if so, the basis should be disclosed Consistency lies in following consistently the same accounting policies from one period to another However, accounting policies can be changed in exceptional circumstances such as legal compulsion

or due to the requirement by an accounting standard

(A) BALANCE SHEET

1 Balance sheet must be prepared in the prescribed form as set out in Part I of Schedule VI of the Companies' Act, (Sec 211) The Central Government may permit other forms either generally or in particular case Under Schedule VI a company has the choice to choose either the horizontal form or vertical form Almost all the companies prefer to report in vertical form as the horizontal form appears clumsy with all details stuffed under each heading Both the forms have a column indicating the figures of the immediately preceding financial year in respect of each of the items shown in the balance sheet

This form does not apply to banking, insurance, and electricity companies which are governed by special statutes and the formats for financial statements are prescribed therein

2 Companies while preparing the balance sheet must not only conform to the format but must also adhere to notes and general instructions given in the schedule For instance the Department of Company Affairs (DCA) has stated that it would not be desirable to use the general reserve for the purpose of redeeming the preference shares as long as there is a debit balance in the profit and loss account

3 Vertical balance sheet which is very simple is supported by a number of schedules which give details under each of the items The schedules giving such details, significant accounting policies and explanatory notes form an integral part of the balance sheet

4 A footnote is added to the balance sheet to show separately contingent liabilities

5 In addition to the balance sheet, companies are also required to give balance sheet abstract and company's general business profile in the prescribed format

6 A skeleton summary of the horizontal balance sheet is given below followed by details to be given under each item After that the two types of balance sheets, as prescribed in Part I of Schedule VI, are reproduced

Horizontal Balance Sheet (in skeleton form)

Liabilities

- (i) Share Capital
- (ii) Reserves and
- (iii) Secured Loans
- (iv) Unsecured Loans
- (v) Current Liabilities and Provisions

A Current Liabilities

B Provisions

Assets

- (i) Fixed Assets
- (ii) Investments
- (iii) Current Assets and Loans and Advances
 - A Current Assets
 - B Loans and Advances

(iv) Miscellaneous Expenditure

(v) Profit and Loss Account (debit balance)

Details in the Balance Sheet items

Share Capital

(i) Details of authorized, issued, subscribed and, called-up capital must be given separately with respect to preference and equity shares, the two types of shares, companies are permitted to issue

(ii) From the called-up capital 'calls in arrears' must be deducted to arrive at paid-up capital Calls in arrears must be separately shown for directors and others

(iii) Forfeited shares balance, if any, after transferring profit on reissue to capital reserve, should

be added to paid-up capital

(iv) Shares allotted for consideration other than cash such as shares allotted to vendor companies in mergers and acquisitions in pursuance of takeover agreements must be disclosed by way of information under this head

(v) Similarly particulars of bonus shares issued must be given. Sources from which bonus shares are issued, e.g., capitalization of profits or reserves or from share premium account, must also be stated

(vi) Terms and conditions of redemption/ conversion of preference shares along with the earliest date of redemption or conversion must be given. Particulars of any option on unissued share capital must be specified

(vii) When a public issue is made, any money received will become part of share capital only after the allotment is made. Therefore, share application moneys and calls-in-advance must be shown separately. The ICAI has suggested that such amounts should be shown separately between 'share capital' and 'reserves and surplus'. However, excess application moneys received must be shown under current liabilities as these have to be repaid within a short period

Reserves and Surplus

(i) Under this heading are shown the items reserves and surplus. Surplus refers to the credit balance in the profit and loss accounts after providing for appropriations such as dividends, reserves, etc. This item is available in future for distribution of dividends and any write-offs which the company may decide

Reserves are of two types, namely capital and revenue reserves. Capital reserves are built up by appropriating capital profits such as profits on sale of assets, investments, on reissue of forfeited shares etc. These are not available for distribution as dividends. On the other hand revenue reserves are built up by appropriating revenue receipts or profits. These may again be classified into free reserves and specific reserves. Specific reserves are created for a specific purpose and the examples are dividend equalization reserve, debenture redemption reserve, etc. Some of the specific reserves such as investment allowance reserve, development allowance reserve, export incentive reserve may be called tax reserves as these are created under the Income Tax Act. They are also referred to as statutory reserves

(ii) Details of reserves and surplus are to be shown under seven items provided under this heading. All additions and deductions since the last balance sheet must be shown under each of the specified heads

(iii) A reserve is to be distinguished from reserve fund. The last item under this heading is 'Sinking Fund'. The word fund in relation to any reserve is specifically represented by earmarked investments

(iv) If the profit and loss account is a credit balance it would be shown as surplus under this heading. On the other hand, if it is a debit balance the same should be deducted from the reserves. Although it is not specified, such deduction can only be from free reserves

(v) In the case of the item 'Security Premium account' all details of utilization in the manner provided under Sec. 78 of the Companies Act must be shown in the year of utilization

(vi) Debenture Redemption Reserve created as per SEBI guidelines is an example of specific revenue reserve

Secured Loans

(i) Under this heading fully secured loan are shown. A fully secured loan is one where the market value of the security is more than the amount of loan. If the value of the security is less than the loan amount, the loan becomes partly secured. Unsecured part of such loan has to be shown under the next heading unsecured loans.

(ii) Interest accrued on loans should be included under the appropriate item under this head. If it relates to debentures then under debentures and similarly for other items.

(iii) If the loans are guaranteed by the directors or managers, details must be disclosed. If loans are from directors it should be shown separately.

(iv) Nature of security in each case is to be specified.

(v) Terms of redemption or conversion of debentures and earliest date of redemption to be stated.

(vi) If the assets are mortgaged in favour of a third party who had guaranteed the loan, such loan should also be classified as secured loan. The fact of mortgaging the assets in favour of guarantor instead of the lender should be stated.

(vii) Future installments payable under hire-purchase agreements should be shown under secured loans as a separate item.

(viii) Debentures guaranteed by Government are not a secured loan as no asset has been mortgaged against such a loan.

(ix) Application moneys received against a debenture issue pending allotment should be shown as short-term deposits.

Unsecured Loans

(i) These are loans for which no security has been provided for. In the case of partly secured loans that portion of the loan which is not covered by the security will also appear under this heading. There are four items under this head, namely, (1) fixed deposits, (2) loans and advances, (3) short-term loans and advances, and (4) other loans and advances.

(ii) Short-term loans and advances are those which are due for payment within one year from the date of balance sheet. Normally such items are shown under current liabilities. However, current liabilities are expected to be repaid from out of current assets. Because of this other condition probably these items are not shown under current liabilities.

Current Liabilities

(i) The ICAI 'Guidance note on terms used in Financial Statements' defines current liability as liability including loans, deposits, bank overdraft which falls due for payment in a relatively short period, not more than twelve months. However, Schedule VI requires showing of short-term secured and unsecured loans under the appropriate heads and not under current liabilities. Again interest accrued and due with respect to secured and unsecured loans are also not shown under current liabilities but shown under the respective heads.

(ii) This heading provides for seven items. Acceptances are bills accepted by the enterprise and pending payment on the balance sheet date. The items sundry creditors include all liabilities arising out of the trading activities of the company and any other current liabilities fall under item (6) 'Other liabilities (if any)'.
(iii) The item 'Subsidiary Company' is to be used to reveal liabilities to a subsidiary for purchase of goods and services etc.

(iv) Advance payments include any payment received in advance against which goods are to be supplied or services are to be rendered in short run. Advances from customers, dealers etc. fall under this category.

(v) Unclaimed dividends. These are dividends in respect of which warrants have been issued to the shareholders but not yet encashed by the shareholders. These must be distinguished from unpaid dividends which mean dividends have been declared but not paid or the warrants and cheques in respect of that have not been issued. Both unclaimed dividends and unpaid dividends are to be shown as current liabilities.

(vi) Interest accrued on loans but not due should be shown under current liabilities. This happens when interest dates and balance sheet date do not coincide. For example, if interest is payable on a loan on June 30, and December 31, and the balance sheet is prepared on March 31. Interest Payable from December 31, the last date of interest payment to March 31, the date of balance sheet represents interest accrued but not due. It becomes due only on the next interest date, viz. June 30.

Provisions

(i) Part III of Schedule VI defines a provision as any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. For example, a tax on current profits is a known liability but the amount cannot be determined exactly as the income tax officer may compute taxable income differently. Therefore, a provision is made for taxation. Part III also states that reserves do not include any such provisions. If the directors feel any such provision already made is in excess of the requirement such excess can be treated as reserve.

(ii) There are six items under this heading. While some provisions have been mentioned like provisions for taxation, proposed dividends, provision for contingencies etc. there is a residuary item called "Other Provisions".

(iii) In the case of contingencies losses should be provided for if the two following conditions are satisfied:

(a) It is possible that future events will confirm, after taking into account any related recovery that an asset has been impaired or a liability has been incurred.

(b) A reasonable estimate of the resulting loss can be made.

All such amounts provided would appear under the heading provision for contingencies. Contingency

is a condition or situation at the balance sheet date, the ultimate outcome of which resulting in gain or loss is known only on occurrence or non-occurrence of one or more uncertain future events. Disputed tax liabilities such as excise duty, sales tax, income tax are all examples of contingencies. Where the amounts cannot be reasonably estimated, companies disclose them as contingent liabilities. Some of the contingencies can result in gains and such gains should not be recognized as per AS-4.

Contingent Liabilities

(1) According to Guidance note on Terms used in Financial Statements issued by ICAI, contingent liability means "an obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events". For example, there may be litigation against the company pending in

a court, say, for breach of contract. It becomes a liability if the decision is against the company and the company is called upon to pay damages to the other party. On the other hand if the court holds that no breach has occurred there will be no liability, as the company need not pay any damages. Similarly a company may contest the assessments made by tax authorities in relation to excise duty, sales tax, income tax etc. In all such cases the amounts involved in the appeal are shown as contingent liabilities. However, the correct procedure would be to assess the legal proceedings and after obtaining the opinion of the lawyers make adequate provision if such opinion expresses that there is no strength in the appeal and the appeal is likely to be lost.

(2) Schedule VI classifies contingent liabilities under the following heads:

(i) Claims against the company not acknowledged as debts,

(ii) Uncalled liability on shares partly paid,

(iii) Arrears of fixed cumulative dividend,

(iv) Estimated amount of contracts remaining to be executed on capital account not provided for, and

(v) Other money for which the company is contingently liable. Under this heading is to be shown the amount of any guarantees given by the company on behalf of directors or other officers of the company. Where practicable, the general nature and amount of each such contingent liability, if material, must also be specified.

With respect to contingencies, it is the accounting policy of many companies to provide for all known liabilities in the accounts, except liabilities of a contingent nature, which they disclose adequately at the foot of the balance sheet.

Fixed assets

(1) As per AS-10 'Accounting for Fixed Assets' a fixed asset is an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business." Even assets which are not legally owned but are held for the production of goods or services are shown under this heading. Examples are leasehold premises, and assets purchased under hire-purchase agreements. The latter are shown at cash price and the interest element is excluded from the value of assets.

(1a) With AS 19 coming into force, assets leased will appear in the books of lessee and not lesser as the case before. Lesser will show in his books lease payments due under financial lease.

(2) Under this heading there are different categories starting with goodwill and ending with vehicles etc. Under each head the original cost, and additions thereto and deductions therefrom during the year and the total depreciation written off or provided to the end of the year are to be stated. It would be clumsy to show all the details in the balance sheet itself and therefore a separate schedule will provide such details.

(3) In ascertaining the cost of an asset all expenditure incurred in bringing it to present location and put it to working condition should be included. Thus costs of transportation, expenditure on trial runs should be capitalized. In the case of land and buildings amounts spent on registration, stamp duty paid, architects fees etc. are all capitalized.

(4) In the case of assets purchased with a liability in foreign currency outstanding, such liability

may increase or decrease due to fluctuations in exchange rates. Such increase or decrease in liability is to be added or deducted from the assets concerned.

(5) Sometimes assets are written off due to a scheme of capital reduction or as a result of revaluation. In such cases every balance sheet (after the first balance sheet) subsequent to the reduction or revaluation must show the revised figures with the date of reduction in place of the original cost.

(6) Similarly, where sums have been added by writing up the assets, every balance sheet subsequent to such writing up must show the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of writing up must also show the amount of increase made.

(7) In every case where the original cost of the asset cannot be ascertained without unreasonable expense or delay, the valuation shown by the books can be given. For this purpose, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off by way of depreciation, and where such an asset is sold, the amount of sale proceeds shall be shown as a deduction.

Investments

(1) AS-13 defines investments as assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. Investments represent capital invested outside by an enterprise and they may be long-term or current investments. Current investments by its nature are readily realizable and are intended to be held for not more than one year. Investments other than current are considered to be long-term. This classification is very important as current investments are considered to be current in nature. Schedule VI does not require this classification. The schedule also leaves valuation to the company. A company can value the investments at cost or market value. The schedule was proposed to be amended in 1993 to make good the omissions but did not come through.

(2) The schedule requires investments to be shown under the following categories:

(i) Government or Trust securities,

(ii) Shares, debentures or bonds,

(iii) Immovable properties,

(iv) Capital of partnership firms.

(3) Shares, debentures and bonds held in subsidiary company must be separately shown.

(4) Company should disclose the nature of investment and the mode of valuation.

(5) The first two categories must be subdivided into quoted and unquoted and market value of quoted investments must be given.

(6) In the case of shares etc. details of fully-paid and partly-paid must be given.

(7) A statement of investments (whether shown under investment or under current assets as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance sheet, showing the names of body corporates in whose shares or debentures investments have been made and the nature and extent of investment so made.

In each such body corporate. Trade investment means an investment by a company in shares or debentures of another company, not being its subsidiary, for the purpose of promoting trade or business of the first company. Trade investments are considered to be fixed assets.

(8) In the case of investments in partnership firms, the names of the firms, the names of all the

partners, the total capital, and the shares of each partner must be given

Current Assets and Loans and Advances

(1) This is a common heading to

(A) Current Assets, and

(B) Loans and Advances

(2) Cash and other assets that are expected to be converted into cash or consumed in the production of goods or rendering of services in the normal course of business are defined as current assets (ICAI Guidance Note on terms used in Financial Statements). Current assets are usually valued at lower of cost and net realizable value. However, the schedule does not specify the mode of valuation but requires disclosure of mode of valuation with respect to stores and spare parts, raw material, stocks, and work-in-progress. If in the opinion of the board of directors, any of the current assets does not have a value on realization in the business at least equal to the amount at which it is stated, this fact must be disclosed.

(3) Sundry Debtors:

The following details must be shown

- a Age-wise classification showing debts outstanding for a period of more than six months and other debts
- b Classification based on security and recoverability (a) Debtors considered good in respect of which the company is fully secured, (b) Debts considered good for which the company holds no security other than the debtor's personal security, (c) Debts considered doubtful or bad
- c Related party debts and maximum outstanding (a) Debts due by directors or other officers of the company or any one of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member to be separately stated (b) Debts due from other companies under the same management to be disclosed with the names of the companies (c) The maximum amount due by directors or other officers of the company at any time during the year to be shown by way of a note
- d It is required to deduct provision for bad and doubtful debts from the sundry debtors. The provision should not exceed the amount considered doubtful or bad. Any surplus provision already created should be shown as 'Reserve for bad and doubtful debts' under the head 'Reserves and Surplus'

(4) Bank balances

These are primarily classified into (a) balances with scheduled banks, and other banks. With respect to balances with scheduled banks details of current accounts, call accounts and deposit accounts should be given. With respect to other banks, the name of the banks together with nature of accounts should be given. If the directors or their relatives have interest in the nonscheduled

bank wherein bank balances are maintained the same should be disclosed

(5) Loans and advances

These are also broken into:

- a Advances and loan to subsidiaries,
- b Advances and loans to partnership firms in which the company or its subsidiary is a

partner,

c Bills of Exchange,

d Advances recoverable in cash or kind or for value to be recovered, i.e., rates, taxes, insurance etc

e Balance with customers, port trusts, etc (where payable on demand)

f Disclosure requirements of loans and advances are similar to that of sundry debtors

Miscellaneous Expenditure

(1) The amounts are shown to the extent not written off or adjusted. The first item under this head is 'Preliminary Expenses'. These are also known as formation expenses and include legal costs in drafting the Memorandum and Articles, capital duty and other fees on registration, cost of printing memorandum, articles and the statutory books of the company and any other expenses associated with the formation of the company. These are normally written off against profits over a period of time. Until it is fully written off, the amount not written off appears under this head.

(2) Expenses associated with the issue of shares and debentures such as issue expenses, brokerage paid to brokers, underwriting commission paid to under-writers appears under this head. These can also be capitalized instead of showing as miscellaneous expenditure. When shares and debentures are issued at discount, the liability on account of share capital and debentures will appear at par value. However, cash received will be short of such liability and the difference being discount appears under this heading. Financial prudence requires such amount to be written off over a period.

(3) Interest paid out of capital during construction can either be capitalized or shown as miscellaneous

expenditure. Most of the items coming under miscellaneous expenditure are deferred revenue expenses and must be written off over the period for which benefit is available. For example, debenture discount and issue expenses can be written off over the maximum period for which the debentures would be outstanding. The fact that the amount spent is large does not make expenditure deferred revenue expenditure. Such expenditure should benefit future period.

Profit and Loss Account

This represents accumulated losses. To the extent free reserves are available, such losses must be adjusted. When the reserves are not sufficient, the balance appears under this heading.

B. VERTICAL FORM
Name of the Company
Balance Sheet as at .

1	2	Schedule No	Figures as at the end of current financial year 4	Figures as at the end of previous financial year 5
1	2	3	4	5
I Sources of Funds				
I1 Shareholders' funds				
Ia) Capital				
Ib) Reserve and surplus				
I2) Loan funds				
Ia) Secured loans				
Ib) Unsecured loans				
TOTAL				
II Application of Funds				
I1) Fixed assets				
Ia) Gross block				
Ib) Less Depreciation				
Ic) Net block				
Id) Capital work in progress				
I2) Investments				
I3) Current asset - loans and advances				
Ia) Inventories				
Ib) Sundry debtors				
Ic) Cash and bank balances				
Id) Other current assets				
Ie) Loans and advances				
Current Liabilities and provisions				
Ia) Liabilities				
Ib) Provisions				
Net current assets				
I4) (a) Miscellaneous expenditure to the extent not written off or adjusted				
Ib) Profit and loss account				
TOTAL				

Notes:

- (1) Details under each of the above items shall be given in separate schedules. The schedules shall incorporate all the information required to be given under Part 1A of the Schedule VI read with notes containing general instructions for preparation of Balance Sheet
- (2) The schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet
- (3) The fig in the balance sheet may be rounded off to the nearest '000 Or '00 as may be convenient or may be expressed in terms of decimals of thousand

PART II SCHEDULE VI REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT

1 The provision of this Part shall apply to the income and expenditure account referred to in sub-section (2) of Sec 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section

2 The profit and loss account

(a) Shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account, and

(b) Shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature

3 The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads, and in particular, shall disclose the following information in respect of the period covered by the account

(i) (a) The turnover, that is, the aggregate amount for which sales are affected by the company, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately

(b) Commission paid to sole selling agents within the meaning of Sec 294 of the Act

(c) Commission paid to other selling agents

(d) Brokerage and discount on sales, other than the usual trade discount

(ii) In the case of manufacturing companies,

(1) The value of the raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw materials shall be shown as separate items. The intermediates or components procured from other manufacturers may, if their list is too large to be included in the break-up, be grouped under suitable headings without mentioning the quantities, provided all those items which in value individually account for 10% or more of the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the breakup

(2) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof

a) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof

b) In the case of companies rendering or supplying services the gross income derived from services rendered or supplied

c) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative breakup and the gross income from services rendered is shown

d) In the case of other companies, the gross income derived under, different heads

Note 1 The quantities of raw materials, purchases, stocks and the turnover, shall be expressed in quantitative denominations in which these are normally purchased or sold in the market

Note 2 For the purpose of items (i) (a), (i)(b) and (ii)(d), the item for which the company is

holding separate industrial licenses, shall be treated as separate classes of goods, but where a company has more than one industrial license for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licenses shall be treated as one class. In the case of trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief Controller Imports and Exports in granting the import licenses.

Note 3 In giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of the purchases, stocks, or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.

(iii) In the case of all concerns having works in progress, the amounts for which such works have been completed at the commencement and at the end of the accounting period

(iv) The amount provided for depreciation, renewals or diminution in value of value of fixed assets. If such provision is not made by means of a depreciation charge, the method adopted for making such provision. If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with Sec 205(2) of the Act shall be disclosed by way of a note.

(v) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, paid or payable to the managing director and the manager, if any.

(vi) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable with Indian income-tax, any taxation imposed elsewhere to the extent to the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.

(vii) The amounts reserved for

(a) Repayment of share capital, and

(b) Repayment of loans

(viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist as the date as at which the balance sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(ix) (a) The aggregate, if material, of any amounts set aside to provisions made for meeting specific liabilities contingencies or commitments.

(b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.

(x) Expenditure incurred on each of the following items, separately for each item.

(a) Consumption of stores and spare parts

(b) Power and fuel

(c) Rent

(d) Repairs to buildings

(e) Repairs to machinery

(f) (1) Salaries, wages and bonus

- (2) Contribution to provident and other funds
- (3) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve

Note 1 Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account

- (g) Insurance
- (h) Rates and taxes, excluding taxes on income
- (i) Miscellaneous expenses

Provided that any item under which the expenses exceed 1 per cent of the total revenue of the company or Rs 5,000, whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account and shall not be combined with any other item to be shown under 'Miscellaneous expenses'

- (xi) (a) The amount of income from investments, distinguishing between trade investments and other investments
- (b) Other income by way of interest, specifying the nature of the income
- (c) The amount of income tax deducted if the gross income is stated under sub-paragraphs (a) and (b) above

(vii) (a) Profits or losses on investments showing distinctly the extent of the profits or losses earned or incurred on account of membership of a partnership firm to the extent not adjusted from any previous provision or reserve

Note Information in respect of this item should also be given in the balance sheet under the relevant provision reserve account

- (b) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount
- (c) Miscellaneous income

(xiii) (a) Dividends from subsidiary companies

(b) Provisions for losses of subsidiary companies

(xiv) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income-tax or not

(xv) Amount, if material by which any items shown in the profit and loss accounts are affected by any change in the basis of accounting

4 The profit and loss account shall also contain or given by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors including managing directors or manager, if any, by the company, the subsidiaries of the company and any other person,

(1) Managerial remuneration under Sec 198 of the Act paid or payable during the financial year to the directors (including managing directors, or manager, if any,

Clauses (ii) to (vi) relating to managing agents omitted by notification No GSR 78 dated 4-1-1963

(vii) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable),

(viii) pensions, etc ,

(a) pensions,

- (b) gratuities,
- (c) payments from provident funds, in excess of own subscriptions and interest thereon,
- (d) compensation for loss of office,
- (e) consideration in connection with retirement from office

4A The profit and loss account shall contain or give by way of a note a statement showing the computations of net profits in accordance with Sec 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors including managing director, or manager (if any)

4B The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered

- (a) as auditor,
- (b) as adviser, or in any other capacity, in respect of
 - (i) taxation matters,
 - (ii) company law matters,
 - (iii) management services, and
- (c) in any other manner

4C In the case of manufacturing companies, the profit and loss account shall also contain, by way of a note in respect of each class of goods manufactured, detailed quantitative information in regard to the following, namely

- (a) the licensed capacity (where license is in force),
- (b) the installed capacity, and
- (c) the actual production

Note 1 The licensed capacity and installed capacity of the company as on the last date of the year to which the profit and loss account relates, shall be mentioned against items (a) and (b) above, respectively

Note 2 Against item (c), the actual production in respect of the finished products meant for sale shall be mentioned. In cases where semi-processed products are also sold by the company, separate details thereof shall be given

Note 3 For the purposes of this paragraph, the items for which the company is holding separate industrial licenses shall be treated as separate classes of goods but where a company has more than one industrial license for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licenses shall be treated as one class

4D The profit and loss account shall also contain by way of a note the following information, namely

- (a) value of imports calculated on C I F basis by the company during the financial year in respect of
 - (i) Raw materials,
 - (ii) Components and spare parts,
 - (iii) Capital goods,
- (b) expenditure in foreign currency during the financial year on account of royalty, known how, professional and consultation fees, interest, and other matters,
- (c) value of all imported raw materials, spare parts and components consumed during the

financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.

(d) the amount remitted during the year in foreign currencies on account of dividends with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and year to which the dividends related.

(e) Earnings in foreign exchange classified under the following heads, namely

(i) Export of goods calculated on F O B basis,

(ii) Royalty, know-how, professional and consultation fees,

(iii) Interest and dividends,

(iv) Other income, indicating the nature thereof

5 The Central Government may direct that a company shall not be obliged to show the amount set aside the provisions other than those relating to depreciation renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact

6 (1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year

INCOME STATEMENT-REPORTING REQUIREMENTS

The Companies Act does not prescribe any format for the profit and loss account. It is left to the individual company to choose one, which is appropriate for its requirements. However, Part II of Schedule VI of Companies Act lays down certain requirements, which, every company should satisfy. In particular, every profit and loss statement should satisfy the following

(a) Disclose clearly the results of the working of the company during the period covered by the account, and

(b) Must disclose every material feature including revenue and expenses in respect of non-recurring transactions or transactions of an exceptional nature

Part II of Schedule VI is also very elaborate about the details to be given by profit and loss account which have been mentioned earlier and therefore are not repeated here

Besides Companies Act, the profit and loss statement should also comply with the accounting standards on the subject. In our country AS-5 in particular has a bearing on the preparation and presentation of the items in the statement. In brief the requirements of the standard are

(1) **Extraordinary Items** Profit and loss account should disclose net profit or loss separately for ordinary activities and extraordinary items. The nature and amount of each extraordinary activity should be disclosed separately, so that its impact on profit and loss can be perceived. However, these items although separately stated are part of the net profit or loss

An item to be called an extraordinary item must satisfy both the features listed below

(a) It should arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise, and

(b) The events are not expected to occur frequently or regularly. The standard gives the examples of attachment of property of an enterprise or an earthquake as extraordinary events.

Some of the events mentioned in the annual reports as extraordinary are given below

(i) Restructuring of business

(ii) Sale of segments of business

(iii) Write off of goodwill arising out of purchase of business

(iv) Compensation payments in accordance with non-competing agreements

Ordinary activities Profit or loss from some ordinary activities also warrant separate disclosure because of the size, nature or incidence of such activities. Examples of such activities are

(i) The write down of inventories to net realizable value as well as the reversal of such write downs,

(ii) Disposal of items of fixed assets,

(iii) Disposals of long-term investments,

(iv) Legislative changes having retrospective applications,

(v) Litigation settlements, and

(vi) Other reversals of provisions

Prior Period items These are items of income or expenses which arise in the current period as a result of errors or omissions in the presentation of financial statements of one or more prior periods. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. The standard requires separate disclosure of prior period items in the profit and loss account. So the people can perceive the impact of such items on current profit.

It would be better to show prior period items after the determination of current profit or loss although such items are normally included in the determination of current profit or loss. Examples of prior period items are tax adjustments relating to previous years, adjustments due to over or understatement of inventories of earlier years etc.

Changes in Accounting Estimates In the preparation of accounts many accounting estimates have to be made, such as bad debts, obsolescence of inventory, economic lives of the assets for determining depreciation etc. Such estimates may have to be revised subsequently because of the availability of more accurate information. The revision of the estimate, by its nature, does not bring the adjustment within the definition of an extraordinary item or a prior period item. The effect of a change in the accounting estimate should be included in the determination of the net profit or loss in

(a) the period of the change, if the change affects the period only, or

(b) the period of the change and future periods, if the change affects both

A change in the estimate of the bad debts if immediately made affects the current period only, whereas a revision in the estimate of the economic life of an asset affects both the current year as well as the future periods.

The nature and amount of a change in an accounting estimate which has material effect in the current period, or is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Change in Accounting Policies In order to ensure comparability of financial statements by users there should be consistency in the adoption of accounting policies. However, a change in the accounting policy should be made in the following cases

(a) a different accounting policy is required by statute,

(b) to comply with an accounting standard,

(c) change would result in more appropriate presentation of the financial statements of the enterprise

Any change in the accounting policy which has a material effect should be disclosed. The impact of and the adjustments resulting from such change, if material should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Format for Profit and Loss Account

In view of the above requirements of the accounting standards as well as the requirements of the Companies' Act the following summarized Profit and Loss Statement in vertical form is suggested for adoption. However, each item in the profit and loss account should be accompanied by supporting schedules which will give more details.

____ Limited
 Profit and Loss Account
 for the year ended _____

	Schedule Year	Current Year	Previous Year
Income			
Sales	1	XXXX	XXXX
Other Income	2	XXXX	XXXX
Increase/Decrease in Work-in progress			
Finished Stocks	3	XXXX	XXXX
Total		XXXX	XXXX
Expenditure			
Cost of Raw materials and Spares	4	XXXX	XXXX
Excise Duty		XXXX	XXXX
Employees' Remuneration & Benefits	5	XXXX	XXXX
Other Expenses	6	XXXX	XXXX
Interest	7	XXXX	XXXX
Depreciation	8	XXXX	XXXX
Total		XXXX	XXXX
Profit Before Taxation & Extraordinary Items		XXXX	XXXX
Extraordinary Item	9	XXXX	XXXX
Profit for the Current Year		XXXX	XXXX
Prior Period Adjustments	10	XXXX	XXXX
Profit before Taxation		XXXX	XXXX
Provision for Taxation		XXXX	XXXX
Profit After Tax		XXXX	XXXX
Balance B/F from the Previous Year		XXXX	XXXX
Total available for Appropriations		XXXX	XXXX
Appropriations		XXXX	XXXX
Proposed Dividend		XXXX	XXXX
Corporate Dividend on Taxes (C.D.T.)		XXXX	XXXX
Debiture Redemption Reserve		XXXX	XXXX
General Reserve		XXXX	XXXX
Any other Statutory Reserves			
Balance c/f to next year		XXXX	XXXX
Total of Appropriations & Balance c/f		XXXX	XXXX

NOTING POINTS AT THE TIME OF PREPARING FINAL STATEMENTS

(A) General Points

(1) Although there is no restriction, it is usually seen that a company does not split its income statement into three parts, i.e., trading account, profit and loss account and profit and loss appropriation account. The company prepares the profit and loss account only.

(2) The profit and loss account is usually divided into two parts—the first part for calculating

profit or loss of the company and the second (popularly known as 'below the line') for appropriating the profit

(3) In the case of a company it is essential to show the figures of the previous year on both sides of account

(4) It is neither essential nor useful to write 'To' on the debit side and 'By' on the credit side of the profit and loss account

(B) Some Adjustments

(1) **Calls in arrear** This item generally appears in the trial balance. It represents the amount not paid by the shareholders on the calls made on them by the company. This is shown in the balance sheet on the liability side by deducting the amount from the called-up amount. If this item appears in the adjustment then the trial balance shows paid-up capital (not called-up capital). The amount is first added to paid-up capital to make the paid-up capital as called-up capital and then deducted again.

(2) **Unclaimed dividend** This always appears on the credit side of trial balance. This represents dividend not collected by the shareholders. It is shown on the liability side of the balance sheet under the heading 'current liabilities'.

(3) **Interim dividend** This item always appears in the trial balance and it represents dividend paid by the company before the Annual General Meeting and mostly based on half yearly accounts. This is an appropriation of profit and is shown on the debit side of appropriation section of profit and loss account. The appropriation section of the profit and loss account is usually called 'profit and loss appropriation account'. We shall hereinafter use this term.

(4) **Final dividend** Like item (3) it is also shown on the debit side of profit and loss appropriation account.

(5) **Proposed dividend** This item is generally given under adjustments. This is shown on the debit side of profit and loss appropriation account and on the liability side of balance sheet under the heading 'Provisions'.

(6) **Dividends received** These are dividends received on investments made in shares of other companies, and represent income on investment.

(7) **Interest received** This is income being interest on monies lent on bank deposits. As per S 194A of the Income Tax Act, 1961, tax is to be deducted at source. Where interest is payable to a domestic company tax is to be deducted, if any.

Let X Ltd received a gross interest of Rs 12,000 and actually received net Rs 9,900 after deducting tax at source.

Then the entry will be

Bank	Dr 9,900	
Tax deducted at source	Dr 2,100	
To Interest received		12,000

(8) **Interest paid on money borrowed for construction** This is a capital expenditure and is capitalized by adding to the cost of asset. So long as this item is not adjusted, it is shown in the balance sheet on the assets side under the heading 'miscellaneous expenditure'.

(9) **Interest on debentures** The company disbursing interest on debentures has the responsibility of deducting tax at source. If a company is paying Rs 50,000 by way of debenture interest and deducted tax at 10% then the entry on payment will be

Interest on debentures	Dr 50,000	
To Bank		45,000
To Income tax payable		5,000
At the time of depositing the tax deducted from the payment the entry will be		
Income tax payable	Dr 5,000	
To Bank		5,000

(10) **Discount and cost of issue of debentures** This includes discount, commission and other expenses on the issue of debentures. This appears on the assets side of balance sheet under the heading 'miscellaneous expenditure'. This expense is written *off* as prudently as possible but in no case should it be allowed to stand in the books after the life of debentures. The amount written *off* is shown on the debit side of profit and loss account and the unwritten *off* portion is shown in the balance sheet under the heading 'Miscellaneous expenditure'.

(11) **Forfeited shares account** This appears on the credit side of trial balance and is shown on the liability side of the balance sheet by adding to the paidup capital under the heading subscribed capital.

(12) **Securities premium account** This is shown on the liability side of the balance sheet under the heading 'Reserves and surplus'.

(13) **Tax adjustments** In relation to corporate taxation, the following items to be considered

- (a) Tax deducted at source
- (b) Advance payment of tax
- (c) Income-tax (corporate tax)
- (d) Provision for taxation
- (e) Deferred tax

How these are to be dealt with

(a) **Tax deducted at source.** As per Section 194 of the Income-tax Act, 1961, tax is to be deducted at source from interest on securities before they are paid. Thus the item 'Tax deducted at source' will appear on the debit side of the trial balance. The amount so deducted can later be adjusted towards income tax payable after the assessment is over.

(b) **Advance payment of tax.** Under Section 207 of the Income-tax Act, 1961, an assessee is liable to pay advance tax when the income exceeds a certain limit and the limit is Rs 2,500 for companies. When the tax is so paid the following entry is made

Advance payment of tax A/c	Dr
To Bank account	

This amount also appears on the debit side of a trial balance and is in the nature of a prepaid item. Advance payment of tax can later be adjusted towards income-tax payable after the assessment is over.

(c) **Income-tax** Tax payable on the assessed income is debited to income tax account. As stated earlier a company adjusts any tax paid in advance or deducted at source towards tax due. For example, if the tax payable on assessed income is Rs 2,00,000 and it has already paid in advance Rs 1,40,000, the company now pays Rs 60,000 only. The entry will be

	Rs	Rs
Income-tax account	Dr 2,00,000	
To Advance payment of tax		140,000
To Bank		60,000

If the assessment is not completed both 'advance payment of tax' and 'tax deducted at source' remain unadjusted and would appear in the balance sheet under the heading 'Current Assets, Loan and Advances (B) Loan and Advances'

(d) Provision for taxation Since it would take quite some time for the company to get its income assessed, it is usual to provide some amount for income-tax on profits at current rates of taxation. Such provision is debited to the profit and loss account above the line and credited to 'provision for taxation account' which appears in the balance sheet under the head 'Current Liabilities and Provisions-B Provisions'. Just as provision is made this year, provision would have been made the previous year and such provision called 'old provision' would appear in the trial balance on the credit side. When such a provision exists income-tax paid must be debited to the provision account and not to the profit and loss account. If the old provision is in excess of the income tax paid, such surplus provision should be shown on the credit side of the profit and loss account below the line. Likewise, if the old provision is not sufficient, further debit is made to the profit and loss account below the line. These adjustments are shown below the line so that the current profits may not be affected due to these items.

Illustration

The trial balance of Karur Ltd as at 31st March 2007 shows the following items

Items

	<i>Debit (Rs)</i>	<i>Credit (Rs)</i>
Advance payment of income-tax	140000	
Provision for taxation for the year ended 31-3-2006		100000

The following further information is given

- (i) Advance payment of income tax includes Rs 1,20,000 for 2005-06
- (ii) Actual tax liability for 2005-06 amounts to Rs 1,32,000. No effect for the same has so far been given in the accounts
- (iii) Provisions for income tax has to be made for 2006-07 for Rs 1,80,000

You are required to pass the necessary journal entries and show the relevant accounts. Also show how these items will appear in the profit and loss account and balance sheet for the year 2007

Solution

Date	Particulars	Debit Rupees	Credit Rupees
31-3-07	Income tax account Dr To Advance payment of Income-Tax To Tax payable account (Bring the tax liability for 2005-06 and the tax Payable after adjusting advance payment of tax)	1,32,000	1,20,000 12,000
31-3-07	Provision for taxation (2005-06) a/c Dr Profit and loss appropriation A/c Dr To Income-Tax account (Tax for 2007 adjusted against the provision)	1,00,000 32,000	1,32,000
31-3-07	Profit and loss account Dr To provision for taxation account (31-07)	1,80,000	1,80,000

Ledger

Dr		Income-tax Account (2005-06)		Cr	
To Advance payment of Income-tax a/c	1,40,000	By Provision for taxation a/c	1,20,000		
To Liability for taxation a/c	12,000	By Profit and loss appropriation a/c (2006-07)	32,000		
	1,52,000		1,52,000		

Profit and Loss Account For the year ended 31-3-07 (extracts)

	Rs
Profit before taxation	xxxxx
Less Provision for taxation	1,80,000
Profit after taxation for the year	xxxxx
Less Appropriations	
Excess of income-tax over provision (2006-07)	32,000

Kartur Ltd

Balance sheet as at 31-3-07 (extracts)

Liabilities	Rs	Assets-	Rs
Current liabilities and provisions		- Current assets, loans and advances	
Current liabilities		Advance payment of Income-tax	1,20,000
Liability for taxation (2006-07)	12,000		
Provision for taxation (2006-07)	1,80,000		

DEFERRED TAXES

Taxable Income and Accounting Income

While preparing the profit and loss account, tax on profits is estimated and a provision is made for such tax. The current practice has been to make such a provision on the taxable income. AS 22 'Accounting for taxes on income' defines taxable income as the amount of income (loss) for a period determined in accordance with the tax laws based upon which income tax is payable (recoverable) is determined. Tax based on taxable income is known as the 'current tax'. The standard defines current tax 'as the amount of income tax determined to be payable (recoverable) in respect of taxable income (tax loss) for a period'.

Accounting income is different from taxable income. The standard defines 'accounting income' as the net profit or loss for a period, as reported in the statement of profit and loss before deducting income tax or adding income tax saving. Tax can also be calculated on the accounting income. The difference between tax on accounting income and taxable income is called 'deferred tax'. Deferred tax is the effect of timing differences (see below). What should be charged to the profit and loss account is tax expenses (tax saving). This is the aggregate of current tax and deferred tax charged or credited to the profit and loss account. This is in accordance with the matching principle. Taxes on income are considered to be an expense incurred by the enterprise in earning income and are accrued in the same period as the revenue and expenses to which they relate. Such matching may result into timing differences. The tax effect of timing differences are included in the tax expenses in the profit and loss statement as deferred tax and in the balance sheet as deferred tax assets or liabilities.

Deferred tax assets and liabilities

A **deferred tax asset** comes into existence when accounting income is more than taxable income and this is due to a timing difference. For example in accounts certain provisions are made for anticipated losses. Tax authorities allow such loss to be deducted only when it crystallizes. The common example is provision for bad debts. In accounts provision is made for anticipated bad debts whereas tax authorities allow only actual bad debts.

Illustration For the year ended 31/03/2007 accounting income of Picaso Ltd is Rs. 20 Lakh after a provision for bad debts to the extent of Rs. 5 Lakh. Tax authorities disallow this charge and this is the only timing difference. Discuss income tax treatment in the accounts for 2006-07, if the tax rate is 40%.

Solution

Taxable income would be Rs. 25 Lakh as the provision for bad debts has to be added back due to disallowance.

Tax on accounting income 40% of Rs. 25 Lakh = Rs. 10 Lakh

Tax on taxable income 40% on Rs. 20 Lakh = Rs. 8 Lakh

Hence, tax expense is Rs. 10 Lakh and current tax is Rs. 8 Lakh, deferred tax is the difference between the two, namely Rs. 2 Lakh. In this case it is a tax liability for future years & Journal entry is as below.

	Rs/Lakh	Rs/Lakh
Profit and loss A/c	Dr 8.00	
Deferred tax asset A/c	Dr 2.00	
To Provision for taxation A/c (Adjustment for differed tax liability)		10.00

MANAGERIAL REMUNERATION

The Act not defined the word managerial personnel. Considering S 197 A, S 309 (3) and section I of Part II of Schedule XXIII, it appears that managerial personnel refer to managing/ whole-time director and manager. From Sec-198 together with Sec- 309 it may conclude that directors also to be included under this category. Section 198 prescribes 11% as the overall limit for managerial personnel. The limit become 10%, if only whole-time/managing directors are considered.

Remuneration paid to managerial personnel, viz part-time and whole time directors, managing director or manager, is subject to overall limits as well as separate limits for each category of managerial personnel. Under S 197 A of the Act a company can have either managing director or manager and not both. (Amendment Act, 2000)

Overall Maximum

S 198 deals with overall maximum remuneration payable to managerial personnel. It also deals with the remuneration payable when profits are not adequate. As per this section the total managerial remuneration payable in a public limited company or a private limited company which is a subsidiary of a public company, to its directors and its manager in respect of any year should not exceed eleven percent of the profits of that company.

The profits must be calculated in accordance with the provisions in Sections 349 and 350 of the Act. This would be discussed later. Gross profit for the purpose of S 198 excludes remuneration to directors as expenditure. The percentage specified is exclusive of any fees payable to directors under S 309 of the Act. Within the maximum specified above a company may pay monthly remuneration to its whole time director or managing director or to its manager.

As per Schedule XIII of the companies act a company having profits in any financial year may pay remuneration by way of salary, dearness allowance, perquisites and other allowances.

Such remuneration should not exceed 5% of the net profits of the company for single managerial personnel and 10% for all of them together. Companies are not permitted to pay to any officer or employee remuneration free of tax or varying with any tax payable by him.

Remuneration when profits are inadequate

Schedule XIII provides for minimum remuneration if a company is making losses or the profits are inadequate. The remuneration to the managerial person may be by way of salary, dearness allowance, perquisites and any other allowances not exceeding a ceiling limit of Rs 24,00,000 per annum or Rs 2,00,000 per month.

The ceilings are exclusive of the following:

- (a) Contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income Tax Act, 1961,
- (b) Gratuity payable at a rate not exceeding half a month's salary for each completed year of service, and
- (c) Encashment of leave at the end of tenure.

In addition to the above an expatriate managerial person (including a nonresident Indian) is eligible to children's education allowance, holiday passage for children studying outside India and leave travel concession.

Prior approval of Government

Section 269 now dispenses with the requirement of prior approval of Central Government (requirement of S 198) for appointment of managerial personnel so long as appointment and remuneration are in accordance with Schedule XIII. Only in cases where appointment and

remuneration are not in accordance with Schedule XIII prior approval is required

Remuneration to directors

Directors can be classified into two categories. They are executive and non-executive directors. Non-executive directors are those who are not employed full time and they attend only board meetings convened to discuss matters included in the agenda. They are paid fees to attend the board or committee meetings at the rates prescribed in the articles [sec 309 (2)]. Maximum sitting fees is prescribed at Rs. 5000 per meeting, which can be increased with the prior approval of the central government. Executive directors are not entitled to sitting fees. In addition to the sitting fees they can also be paid remuneration if articles permit. This may be monthly or by way of commission. For paying commission company should pass a special resolution. The directors together can be paid up to 1% of the net profits, if the company has a managing director, whole-time director or manager. If the company has no managing director, whole time director or manager, the remuneration should not exceed 3% of the net profits. Directors should not be paid tax-free remuneration or remuneration indexed to tax rates (S. 200)

Remuneration to managing/whole-time director/manager

As stated earlier they are not entitled to sitting fees. Remuneration to them may be by way of salary, dearness allowance, perquisites, commission and other allowances. Remuneration to this category is restricted to 5% if there is only one person and if there is more than one 10% to all of them together. As in the case of directors profits must be computed in accordance with Sections 349 and 350.

If a person is employed by two companies, he can draw remuneration from both the companies but should not exceed the maximum admissible from any one of the companies of which he is a managerial person. As stated earlier a company can have either managing director or manager and not both. However while the company can have more than one managing director, it cannot have more than one manager.

Illustration. From the following particulars of Prakash Limited, you are required to calculate the managerial remuneration in the following situations

- (i) There is only one whole time director
- (ii) There are two whole time directors,
- (iii) There are two whole time directors, a part time director and Manager

Net profit before provision for income-tax and managerial remuneration, but after depreciation and provision for repairs 8,70,410

Depreciation provided in the books 3,10,000

Provision for repairs of machinery during the year 25,000

Depreciation allowable under Schedule XIV 2,60,000

Actual expenditure incurred on repairs during the year 15,000

Solution.

Sections 198 and 309 of the Companies Act, 1956 prescribe the maximum percentage of profit that can be paid as managerial remuneration. For this purpose, profit is to be calculated in the manner as specified in Section 349

Calculation of net profit u/s 349 of the Companies Act, 1956

	Rs	Rs
Net Profit before provision for income-tax and Managerial remuneration, but after depreciation and provision for repairs	8,70,410	
Add back Depreciation provided in the books	3,10,000	
Provision for repairs of machinery	<u>25,000</u>	
	3,35,000	12,05,410
Less: Depreciation allowable under Schedule XIV	2,60,000	
Actual expenditure incurred on repairs	<u>15,000</u>	2,75,000
Profit under section 349		9,30,410

Calculation of managerial remuneration

(i) There is only one whole time director

Managerial remuneration = 5 % of Rs 9,30,410 = Rs 46,520 50

(ii) There are two whole time directors

Managerial remuneration = 10% of Rs 9,30,410 = Rs 93,041

(iii) There are two whole time directors, a part time director and a manager

Managerial remuneration = 11% of Rs 9,30,410 = Rs 1,02,345 10

Illustration : The Steamship Company Limited has an Authorized Capital of 1,50,000 Equity Shares of Rs 100 each. The following balances have been extracted on 31st March, 2002 from the books of the company

	Rs.		Rs
Subscribed Capital	1,00,00,000	Dividend Equalisation Reserve	21,00,000
Steamers at cost	1,31,00,000	Provision for Doubtful Debts	2,62,000
Purchase of S S Jalaganga on 1.10.2001	40,75,000	Unclaimed Dividends	89,250
Furniture and Fittings less Depreciation Rs 36,000	1,42,500	Sundry Creditors	9,93,500
Unexpired Insurance	1,88,250	Final Call unpaid on 2,500 shares	62,500
General Reserve	26,00,000	Stock of Provision, Stores, Coal etc.	3,58,000
Steamer's Purchase Reserve	8,02,500	Investments (at cost in shares of Companies)	8,54,000
Provisions and Stores	26,03,000	Dividend accrued on the above	22,500
Coal	31,89,000	Voyage Receipts	1,11,89,450
Book Debts of which Rs. 2,87,500 are doubtful	16,59,000	Steamer's Depreciation Account	37,00,000
Loan to Directors	75,000	Dividend from Investments	78,900
Miscellaneous Voyage Expenses	31,51,000	Profit and Loss Account (Credit Balance)	1,29,000
Expenses of Management	16,04,000	Cash and Bank Balances	8,60,850

You are required to prepare the Profit and Loss Account and the Balance Sheet of the Company in a form which complies with the requirements of the Companies Act, after taking the following information into consideration and after necessary assumptions

- 1 The Articles of Association of the Company provide as under
 - (a) Depreciation at the rate of 6% should be charged to the Profit and Loss Account on the original cost of steamers owned by the Company,
 - (b) Surplus, if any, over the book value of a steamer on realization should be provided for,
 - (c) In the event of inadequacy of profits, Dividend Equalization Reserve should be made use of to the extent it is necessary to make good the deficiency in the proposed amount of dividend
- 2 S S Jalbharat was acquired at a cost of Rs 35,00,000 on 1 8 1999. It met with an accident on 1 12 2001 and proved a total loss. The underwriters have agreed to settle the claim for Rs 17,50,000
- 3 The Equity shares on which the final call was unpaid were forfeited by the Board during the year and have not been reissued
- 4 Furniture is to be depreciated a ten per cent on original cost
- 5 In the Profit and Loss Account of the year 1999-2000, a provision of Rs 1,25,000 was made in respect of a claim for damages. This claim was settled in December, 2001 for Rs 89,000 and the balance of the provision is included in the item "Sundry Creditors"
- 6 The directors propose to pay a dividend of Rs 5 per share, subject to deduction of tax

Solution :

Profit and Loss Account of the Steamship Company Ltd.

Dr	<i>for the year ending 31st March, 2002</i>		Cr.
	Rs		Rs
To Coal Consumed	31,89,000	By Voyage Receipts	1,11,89,450
To Provision and Stores	26,03,000	By Dividend from Investments	78,900
To Miscellaneous Voyage Expenses	31,51,000	By Net Loss c/d	14,47,000
To Expenses of Management	16,04,000		
To Depreciation			
Steamers 8,20,500			
Furniture and Fittings 17,850			
	8,38,350		
To Loss on S S Jalbharat destroyed in an accident (1)	13,30,000		
	<u>1,27,15,350</u>		<u>1,27,15,350</u>
To Net Loss b/d	14,47,000	By Balance b/d from previous year	1,29,000
To Proposed Dividend @ Rs 5 per share on 97,500 shares	4,87,500	By Provision for claim no longer required (1,25,000-89,000)	36,000
		By Transfer from Dividend Equalisation Reserve	3,22,500
		By Balance carried to the Balance Sheet	14,47,000
	<u>19,34,500</u>		<u>19,34,500</u>

Working Notes

(1) Loss on S S Jalbharat destroyed in an accident has been calculated as follows:

	Rs
Cost of S S Jalbharat purchased in 1999-2000	35,00,000
<i>Less</i> Depreciation for 2 years (1999-2000 & 2000-2001) @ 6% on original cost	<u>4,20,000</u>
Book value on 1-4-2001	30,80,000
<i>Less</i> Claim admitted by the underwriters	<u>17,50,000</u>
Loss	<u><u>13,30,000</u></u>

Balance Sheet of Steamship Company Limited

as on 31st March, 2001

	Rs		Rs
Share Capital— as per Schedule A	99,37,500	Fixed Assets— as per Schedule D	96,99,150
Reserve and Surplus— as per Schedule B	37,33,000	Investment—Share at Cost	8,54,000
Current Liabilities and Provisions— as per Schedule C	15,34,250	Current Asset: Loans and Advances as per Schedule E	46,51,600
	<u>1,52,04,750</u>		<u>1,52,04,750</u>

SCHEDULES FORMING PART OF THE BALANCE SHEET

Schedule A : Share Capital

Authorised 1,50,000 Equity Shares of Rs 100 each	1,50,00,000
Issued 1,00,000 Equity Shares of Rs 100 each	<u>1,00,00,000</u>
Subscribed 97,500 (1,00,000—2,500 shares forfeited) Equity Shares of Rs 100 each fully paid up	97,50,000
<i>Add</i> Forfeited Shares (Amount received on 2,500 shares forfeited)	1,87,500
	<u><u>99,37,500</u></u>

Schedule B : Reserves and Surplus

	Rs	Rs	
Steamers' Purchase Reserve		8,02,500	
General Reserve Balance on 1-4-2001	26,00,000		
<i>Less</i> Debit Balance of Profit and Loss Account	<u>14,47,000</u>	11,53,000	
Dividend Equalisation Reserve Balance on 1-4-2001	21,00,000		
<i>Less</i> Transfer Profit and Loss Account	<u>3,22,500</u>	17,77,500	
		<u><u>37,33,000</u></u>	

Schedule D : Fixed Assets

Assets	Cost				Depreciation				Net Book Value
	Cost upto 31.3.2011	Addition During 2011-2012	Cost of Assets written off during 2011-2012	Cost upto 31.3.2012	Depreciation upto 31.3.2011	On assets written off upto 31.3.2011	During the year 2011-12	Upto 31.3.2012	
	Rs	Rs	Rs	Rs	Rs	Po	Ra	Pa	Rd
Shed	1,31,00,000	40,75,000	35,00,000	1,36,75,000	57,00,000	4,20,000	3,20,500	41,00,500	95,74,500
House and fittings	1,79,500			1,79,500	76,000		17,850	59,850	1,24,650
	1,32,79,500	40,75,000	35,00,000	1,42,53,500	63,76,000	4,20,000	4,38,350	41,60,350	1,06,93,150

Schedule C - Current Liabilities and Provisions

	Rs	Rs
<i>Current Liabilities</i>		
Sundry Creditors (Less claim of Rs 36,000 no longer required)	9,57,500	
Unclaimed Dividends	<u>89,250</u>	10,46,750
<i>Provisions</i>		
Proposed Dividend		<u>4,87,500</u>
		<u>15,34,250</u>

Schedule E : Current Assets, Loans and Advances

	Rs	Rs
A Current Assets		
Accrued Dividends on Investments		22,500
Stock of Provisions, Stores, Coals etc		3,58,000
Book Debts (Unsecured-assumed)		
More than 6 months (assumed)	2,50,000	
Others (assumed)	14,09,000	
	<u>16,59,000</u>	
Less Provision for Bad Debts	2,62,000	13,97,000
Debits Considered Good	13,71,500	
Debits Considered Doubtful	2,87,500	
	<u>16,59,000</u>	
Cash and Bank Balance		8,60,850
		<u>26,38,350</u>
B Loans and Advances		
Claim Due from Underwriters	17,50,000	
Loans to Directors	75,000	
Prepaid Insurance	1,88,250	20,13,250
		<u>46,51,600</u>

ACCOUNTING OF BANKING COMPANIES

INTRODUCTION:

A bank is a commercial institution, licensed to accept deposits and acts as a safe custodian of the spendable funds of its customers. Banks are concerned mainly with the functions of banking, i.e., receiving, collecting, transferring, buying, lending, investing, dealing, exchanging and servicing (safe deposit, custodianship, agency, trusteeship) money and claims to money both

domestically and internationally. The principal activities of a bank are operating current accounts, receiving deposits, taking in and paying out notes and coins, and making loans.

Banking activities undertaken by banks include personal banking (non-business customers), commercial banking (small and medium-sized business customers) and corporate banking (large international and multinational corporations).

According to Charles J. Woelfel:

A complete banking service would comprehend a variety of functions, including any of the following

- (1) Receive demand deposits and pay customers' cheques drawn against them, and operate automated teller machines (ATM),
- (2) Receive time and savings deposits, issue negotiable orders of withdrawal, and pay interest thereon, as well as provide automatic transfer service (ATS) for funds from saving accounts to cover cheques,
- (3) Discount notes, acceptances and bills of exchange,
- (4) Supply credit to business firms with or without security, issue letters of credit and accept bills drawn there under,
- (5) Transfer money at home and abroad,
- (6) Make collections and facilitate exchanges,
- (7) Issue drafts, cashier's cheques, money orders, and certify cheques,
- (8) Furnish safe deposit vault service,
- (9) Provide custodianship for securities and other valuables,
- (10) Provide personal loans, credit and services to individuals, and lend or discount customer installment receivables of vendors,
- (11) Act in a fiduciary capacity for individuals, as well as establish common trust funds,
- (12) Provide corporate trust services (stock transfer agent, registrar, paying agent, escrow agent, and indenture trustee),
- (13) Act as factors and engage in equipment leasing,
- (14) Deal in Government securities and underwrite general obligations of state and municipal securities,
- (15) Invest in government and other debt securities,
- (16) Act as fiscal agent or depository for the Central Government, states and subdivisions of states,
- (17) Provide miscellaneous services such as place orders in securities for customers, act as insurance agent of incidental to banking transactions, serve as finder to bring buyers and sellers together, act as travel agent and issue letters of credit and traveler's cheques, provide club accounts and other special purpose accounts, act as agent for accepting service of legal process of incidental to normal banking or fiduciary transactions of the bank, act as pay role issuer, establish charitable foundations, invest in small business investment corporations and bank service corporations, deal in foreign exchange, buy and sell gold bullion under license from the Treasury Department, and foreign coin, provide domestic and international correspondent banking services, etc.

In India, banking activities are governed by The Banking Regulation Act, 1949. As per the provisional Section 5(b) of the said Act, "banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, drafts, order or otherwise.

Section 5(c) defines "Banking Companies" as any company which transacts the business of

banking in India. However, any company which is engaged in the manufacture of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as such manufacturer or trader shall not be deemed to transact the business of banking within the meaning of this clause.

Business of Banking Companies

As per the provision of Section 6 of the Banking Regulation Act, 1949, a banking company may engage in any one or more of the following forms of business, in addition to the business of banking. These are:

- (a) The borrowing, raising, or taking up of money, the lending or advancing of money either upon or without security, the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether transferable or negotiable or not, the granting and issuing of letters of credit, traveler's cheques and circular notes, the buying, selling and dealing in bullion and specie, the buying and selling of foreign exchange including foreign bank notes, the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds, the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others, the negotiating of loans and advances, the receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise, the providing of safe deposit vaults, the collecting and transmitting of money and securities,
- (b) Acting as agents for any Government or local authority or any other person or persons, the carrying on of agency business of any description, including the clearing and forwarding of goods, giving of receipts and discharges, and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent or secretary and treasurer of a company,
- (c) Contracting for public and private loans and negotiating and issuing the same,
- (d) The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association, and the lending of money for the purpose of any such issue,
- (e) Carrying on and transacting every kind of guarantee and indemnity business,
- (f) Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims,
- (g) Acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such security,
- (h) Undertaking and executing trusts,
- (i) Undertaking the administration of estates as executor, trustee or otherwise,
- (j) Establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependants or connections of such persons, granting pensions and allowances and making payments towards insurance, subscribing to or guaranteeing money for charitable or benevolent objects or for any exhibition or for any public, general or useful object,
- (k) The acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company,

(l) Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account, or otherwise dealing with all or any part of the property and rights of the company,

(m) Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in this sub-section,

(n) Doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company,

(o) Any other form of business which the Central Government may, by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage

Restriction on Business of Banking Company

Section 8 of the Banking Regulation Act, 1949, imposes certain restrictions on the business of a banking company. These are as follows:

(i) No banking company shall directly or indirectly deal in the buying, selling or bartering of goods, except in connection with the realization of security given to or held by it,

(ii) No banking company can engage in any trade, or buy, sell or barter goods for others otherwise than in connection with bills of exchange, received for collection or negotiation or with such of its business or is referred to in clause (i) of sub-section (1) of section 6

Some Important Provisions of the Banking Regulation Act, 1949 Disposal of Non-Banking Assets (Section 9)

Notwithstanding anything contained in Section 6, no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding seven years from the acquisition thereof or from the commencement of this Act, whichever is later or any extension of such period as in a section provided, and such property shall be disposed of within such period or extended period, as the case may be.

Provided that the banking company may, within the period of seven years as aforesaid, deal or trade in any such property for the purpose of facilitating the disposal thereof. Provided further that the Reserve Bank may in any particular case extend the aforesaid period of seven years by such period not exceeding five years, where it is satisfied that such extension would be in the interest of the depositors of the banking company.

Restrictions as to Payment of Dividend (Section 15)

No banking company shall pay any dividend on its shares until all its capitalized expenses (including preliminary expenses, organization expenses, share-selling commission, brokerage, amounts of losses incurred and any other item of expenditure not represented by tangible assets) have been completely written-off.

However, a banking company may pay dividends on its shares without writing-off

(i) The depreciation, if any, in the value of its investments in approved securities in any case where such depreciation has not actually been capitalized or otherwise accounted for as a loss,

(ii) The depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company,

(iii) The bad debts, if any, in any case where adequate provision for such debts has been made to the satisfaction of the auditor of the banking company.

Statutory Reserve (Section 17)

Every banking company incorporated in India shall create a reserve fund and transfer to it at least 20% of its annual profit as disclosed in the Profit and Loss Account prepared under Section 29 and before any dividend is declared

Where a banking company appropriates any sum or sums from the reserve fund or the Share Premium Account, it shall report the fact to the Reserve Bank, explaining the circumstances relating to such appropriations within 21 days from the date of such appropriation

Cash Reserve (Section 18)

Every banking company, not being a scheduled bank, has to maintain a cash reserve (CRR) of at least a percentage of the total of its demand and time liabilities in India, as on last Friday of the second preceding fortnight, as specified by RBI time to time. Cash reserve can be maintained with itself or by way of a balance in the Current Account with the Reserve Bank or by way of net balance in current accounts or in one or more of the aforesaid ways

Restrictions on Loans and Advances (Section 20)

No banking company shall

(a) grant any loans or advances on the security of its own shares, or

(b) enter into any commitment for granting any loan or advance to or on behalf of

(i) Any of its directors,

(ii) Any firm, in which any of its directors is interested as partner, manager, employee or guarantor, or

(iii) Any company (not being a subsidiary of the banking company or a company registered under Section 25 of the Companies Act, 1956 (1 of 1956) or a Government company) of which (or the subsidiary of holding company of which) any of the directors of the banking company is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or

(iv) Any individual, in respect of whom any of its directors is a partner or guarantor now a days, the daily transactions of a bank are numerous. All these transactions are to be recorded immediately to reflect the exact position of each customer's account. Therefore, a bank has to adopt specialized system of book-keeping, which will ensure immediate entry of numerous transactions and keep an internal check on the books of account. To achieve these objectives, banks generally maintain a large number of subsidiary and memorandum books in addition to Principal Books of Account. These are as below

Subsidiary Books

These include the following

(i) Personal Ledger The bank maintains separate ledgers for different types of accounts, such as,

(a) Current Accounts Ledger,

(b) Savings Bank Accounts Ledger,

(c) Fixed Deposit Accounts Ledger,

(d) Recurring Deposit Accounts Ledger, etc

Entries are made in these ledgers directly from the vouchers

(ii) Investments Ledger Accounts of all investments are kept in this ledger

(iii) Loan Ledger Accounts of all the parties to whom loans have been granted are kept in this ledger

(iv) Bills Discounted and Purchased Ledger Accounts of all the parties whose bills have been discounted and purchased are kept in this ledger

Memorandum Books

In addition to the subsidiary books, a bank maintains various other books to facilitate its works, which do not form a part of double entry system. Some of these are

- (i) Receiving Cashier's Counter Cash Book
- (ii) Paying Cashier's Counter Cash Book
- (iii) Cash Balance Book

Principal Books of Account

Cash Book and General Ledger are the principal Books of Account of any bank. Cash Book records all cash transactions and General Ledger contains Control Account of all subsidiary ledgers and different Assets and Liabilities Account. In the general ledger, accounts are arranged in such a manner that a Balance Sheet can be easily prepared.

Final Accounts

According to Section 29 of the Banking Regulation Act, 1949, every banking company is required to prepare with reference to that year a Balance Sheet and a Profit and Loss Account as on the last working day of the year in the 'Form A' and 'Form B' respectively set out in the 'Third Schedule' or as near thereto as circumstances admit.

Balance Sheet

With effect from 19th March, 1992, the Balance Sheet of a bank is to be prepared as per the new form. In the new form, assets and liabilities are shown vertically along with the figures of year. In the top section capital and liabilities are shown and in the bottom section, assets are shown.

THE THIRD SCHEDULE

(See Section 29)

Form 'A'

FORM OF BALANCE SHEET

Balance Sheet of

Balance Sheet as on 31st March

(000 omitted)

	Schedule No	As on 31.3 (Current Year)	As on 31.3 (Previous Year)
Capital and liabilities			
Capital	1		
Reserves & Surplus	2		
Deposits	3		
Borrowings	4		
Other Liabilities and Provisions	5		
Total			
Assets			
Cash and balances with RBI	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities	12		
Bills for collection			

SCHEDULES

Details of all schedules are in below :

A. Capital and Liabilities

1 Capital

2 **Reserve and Surplus** It includes Capital Reserve, Security Premium, Revenue and other Reserve and Profit and Loss Account balance

3 **Deposits** It includes Demand deposits, Savings bank deposits and term deposits

4 **Borrowings:** It includes Borrowings from Reserve Bank of India, other banks, institutions and agencies

5 **Other Liabilities and Provisions** It includes Bills payable, inter-office adjustments (net), interest accrued, provision for bad debts, provision for taxation

B. Assets

6 **Cash and Balances with Reserve Bank of India** Cash in hand (including foreign currency notes), and balances with Reserve Bank of India are shown under this item

7 **Balances with Banks and Money at Call and Short Notice** Balances with banks, money at call and short notice are shown under this item. Money at call is refundable at 24 hours' notice and money at short notice is refundable at 7 days' notice

8 **Investments:** Investment in Government securities, other approved securities, shares, debentures and bonds, subsidiaries, gold etc., are shown under this item

9 **Advances** Bills purchased and discounted, cash credit, overdrafts and loans payable on demand, and term loans are shown under this item

10 **Fixed Assets** Premises, other fixed assets (including furniture and fixtures) are shown under this item

11 **Other Assets** Inter-office adjustments, interest accrued, tax paid in advance, stationery and stamps, non-banking assets acquired in satisfaction of claims are shown under this

item

12 Contingent Liabilities It is shown by way of a footnote. It represents liabilities not provided in the balance sheet.

Profit and Loss Account
Profit and Loss Account of a banking company is also prepared in vertical form 'Form B' of the Third Schedule of the Banking Regulation Act, 1949 is to be used for preparing Profit and Loss Account. It is divided into four sections:

- I Income,
- II Expenditure,
- III Profit/Loss, and
- IV Appropriations

C. Income:

The schedules of Income are

13 Interest Earned It includes interest/discount on advances/bills, income on investments, interest on balances with RBI etc. It should be noted that according to the new form, bad debts and provision for bad debts, other provisions are not to be deducted from the interest earned. For greater transparency in accounts, these items are shown as separate items in the Profit and Loss Account.

14 Other income It includes commission, exchange and brokerage, profit on sale of investments, profit on revaluation of investments, profit on sale of land, building and other assets, profit on exchange transaction, and income earned by way of dividends from subsidiaries, etc.

D. Expenditure

15 Interest expended Interest paid on deposits, interest on RBI borrowings, interest on interbank borrowings, etc., are shown under this item.

16 Operating expenses Salaries and wages of staff, rent, rates and taxes, printing and stationery, advertisement, depreciation on banks' properties, director's fees, auditor's fees, law charges, postage, repairs, insurance, etc., are shown under this item. Third item of this section is provisions and contingencies. Provision for bad debts, provision for taxation and other provisions are shown under this item.

III. Profit/Loss

In this section, profit/loss for the current year (difference between income and expenditure explained above) and brought forward profit/loss are shown.

IV. Appropriations

In this section, amount transferred to statutory reserve as per Section 17, amount transferred to other reserve, proposed dividend, etc., are shown. The balance is transferred to the Balance sheet.

FORM OF SCHEDULES

SCHEDULE 1 - CAPITAL

	As on 31.3 (Current Year)	As on 31.3 (Previous Year)
For Nationalised Banks Capital Fully owned by Central Government)		
For Banks Incorporated Outside India		
Capital (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)		
Amount of deposit kept with the RBI under Section 11(2) of Banking Regulation Act, 1949		
Total		
For Other Banks		
Authorized Capital		
shares of Rs each		
Issued Capital		
shares of Rs each		
Subscribed Capital		
- shares of Rs each		
Called-up Capital		
shares of Rs each		
Less: Calls unpaid		
Add: Forfeited shares		

SCHEDULE 2 - RESERVES AND SURPLUS

	(Curr Year)	(Prev Year)
I. Statutory Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
II. Capital Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
III. Shares Premium		
Opening Balance		
Additions during the year		
Deductions during the year		
IV. Revenue and other Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
V. Balance in Profit and Loss Account		
Total (I + II + III + IV + V)		

SCHEDULE 3 - DEPOSITS

	As on 31.3. (Curr Year)	As on 31.3. (Prev Year)
I. Demand Deposits		
(1) From banks		
(2) From others		
II. Savings Bank Deposits		
III. Term Deposits		
(1) From banks		
(2) From others		
Total (I + II + III)		
(1) Deposits of branches in India		
(2) Deposits of branches outside India		
Total		

SCHEDULE 4 - BORROWINGS

	As on 31.3 (Curr. Year)	As on (Curr (Prev. Year)
I. Borrowings in India		
(i) Reserve Bank of India		
(ii) Other Banks		
(iii) Other Institution and agencies		
II. Borrowings Outside India		
Total (I + II)		
Secured borrowings included in I and II above Rs		

SCHEDULE 5 - OTHER LIABILITIES AND PROVISIONS

	As on 31.3 (Curr. Year)	As on 31.3 (Prev. Year)
Bills Payable		
Intra-Office adjustments/net)		
Interest accrued		
Others (including Provisions)		
Total		

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

	As on 31.3 (Curr. Year)	As on 31.3 (Prev. Year)
Cash in hand (including foreign currency notes)		
Balances with RBI		
(i) in Current Account		
(ii) in Other Accounts		
Total (I + II)		

SCHEDULE 7 - BALANCES WITH BANKS & MONEY AT CALL & SHORT NOTICE

	As on 31.3 (Curr. Year)	As on 31.3 (Prev. Year)
I. In India		
(i) Balances with banks		
(a) In Current Accounts		
(b) In Other Deposit Accounts		
(ii) Money at call and short notice		
(a) With banks		
(b) With other institutions		
Total		

	As on 31.3 (Curr. Year)	As on 31.3 (Prev. Year)
II. Outside India		
(i) in Current Accounts		
(ii) in Other Deposit Accounts		
(iii) Money at call and short notice		
Total		
Grand Total (I + II)		

SCHEDULE B - INVESTMENTS

	As on 31.3 (Curr. Year)	As on 31.3 (Prev. Year)
Investments in India in		
(i) Government securities		
(ii) Other approved securities		
(iii) Shares		
(iv) Debentures and Bonds		
(v) Subsidiaries and/or joint ventures		
(vi) Others (to be specified)		
Total		
Investments outside India in		
(i) Government securities (including local authorities)		
(ii) Subsidiaries and/or joint ventures abroad		
(iii) Other investments (to be specified)		
Total		
Grand Total (I + II)		

SCHEDULE 9 - ADVANCES

	As on 31.3 (Curr Year)	As on 31.3 (Prev Year)
(i) Bills purchased and discounted		
(ii) Cash credits, overdrafts and loans repayable on demand		
(iii) Term loans		
Total		
(i) Secured by tangible assets		
(ii) Covered by Bank/Government guarantees		
(iii) Unsecured		
Total		
I. Advances in India		
(i) Priority Sectors		
(ii) Public Sector		
(iii) Banks		
(iv) Others		
Total		
II. Advances outside India		
(i) Due from banks		
(ii) Due from others		
(a) Bills purchased and discounted		
(b) Syndicated loans		
(c) Others		
Total		
Grand Total (I + II)		

SCHEDULE 10 - FIXED ASSETS

	As on 31.3 (Curr Year)	As on 31.3 (Prev Year)
Premises		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Other Fixed Assets (including furniture and fixtures)		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Total (I + II)		

SCHEDULE 11 - OTHER ASSETS

	As on 31.3 (Curr Year)	As on 31.3 (Prev Year)
I Inter-office adjustments (net)		
II Interest accrued		
III Tax paid in advance, tax deducted at source		
IV Stationery and stamps		
V Non-banking assets acquired in satisfaction of claims		
VI Others		
Total		

SCHEDULE 12 - CONTINGENT LIABILITIES

	As on 31.3 (Curr Year)	As on 31.3 (Prev Year)
I Claims against the bank not acknowledged as debts		
II Liability for partly paid investments		
III Liability on account of outstanding forward exchange contracts		
IV Guarantees given on behalf of constituents		
(a) In India		
(b) Outside India		
V Acceptances, endorsements and other obligations		
VI Other items for which the bank is contingently liable		
Total		

SCHEDULE 13 - INTEREST EARNED

	As on 31.3 (Curr Year)	As on 31.3 (Prev Year)
I Interest discount on advances & bills		
II Income on investments		
III Interest on balances with Reserve Bank of India and other inter-bank funds		
IV Others		
Total		

SCHEDULE 14 - OTHER INCOME

	Year ended 31.3 Current Year	Year ended 31.3 Previous Year
I Commission, exchange and brokerage		
II Profit on sale of investments Less: Loss on sale of investments		
III Profit on revaluation of investments Less: Loss on revaluation of investments		
IV Profit on sale of land, buildings and other assets Less: Loss on sale of land, buildings and other assets		
V Profit on exchange transactions Less: Loss on exchange transactions		
VI Income earned by way of dividends etc. from subsidiaries / companies and /or joint ventures abroad / in India		
VII Miscellaneous Income		
Total		

SCHEDULE 15 - INTEREST EXPENDED

	Year ended 31.3 (Current Year)	Year ended 31.3 (Previous Year)
I Interest on deposits		
II Interest on Reserve Bank of India / inter-bank borrowing		
III Others		
Total		

SCHEDULE 16 - OPERATING EXPENSES

	Year ended 31.3 (Current Year)	Year ended 31.3 (Previous Year)
I Payments to and provisions for employees		
II Rent, taxes, and lighting		
III Printing and stationery		
IV Advertisement and publicity		
V Depreciation on bank's property		
VI Directors' fees, allowances and expenses		
VII Auditors' fees and expenses (including branch auditors' fees and expenses)		
VIII Law charges		
IX Postages, telegrams, telephones etc. Repairs and maintenance		
X Insurance		
Total		

(a) In case there is any unadjusted balance of loss, the same may be shown under this item with appropriate foot-note

Disclosure of Accounting Policies

In order that the financial position of banks represent a true and fair view, the Reserve Bank of India has directed the banks to disclose the accounting policies regarding the key areas of operations along with the notes of account in their financial statements for the accounting year ending 31.3.1991 and onwards, on a regular basis. The accounting policies disclosed may contain the following aspects subject to modification by individual banks

(1) General

The accompanying financial statements have been prepared on the historical cost and conform to the statutory provisions and practices prevailing in the country

(2) Transactions involving Foreign Exchange

(a) Monetary assets and liabilities have been translated at the exchange rates, prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost

(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates, ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year

(c) Profit or loss on pending forward contracts have been accounted for

(3) Investments

(a) Investments in Governments and other approved securities in India are valued at the lower of cost or market value

(b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 per cent of the share capital) have been accounted for on the historical cost basis

(c) All other investments are valued at the lower of cost or market value

(4) Advances

(a) Provisions for doubtful advances have been made to the satisfaction of the auditors

(i) In respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies

(ii) In respect of general advances, as a percentage of total advances taking into account the guidelines issued by the Government of India and the Reserve Bank of India

(b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have been included under "Other Liabilities and Provisions"

(c) Provisions have been made on a gross basis. Tax relief, which will be available when the advance is written-off, will be accounted for in the year of write-off

(5) Fixed Assets

(a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the value determined on the basis of such revaluation made by the professional valuers, profit arising on revaluation has been credited to Capital Reserve

(b) Depreciation has been provided for on the straight line/diminishing balance method

(c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent of revaluation is transferred annually from the Capital Reserve to the General Reserve Profit and Loss Account

(6) Staff Benefits

Provisions for gratuity/pension benefits to staff have been made on an accrual casual basis
Separate funds for gratuity/pension have been created

(7) Net Profit

- (a) The net profit disclosed in the Profit and Loss Account is after
- (i) Provisions for taxes on income, in accordance with the statutory requirements
 - (ii) Provisions for doubtful advances
 - (iii) Adjustments to the value of "current investments" in Government and other approved securities in India, valued at lower of cost or market value
 - (iv) Transfers to contingency funds
 - (v) Other usual or necessary provisions
- (b) Contingency funds have been grouped in the Balance Sheet under the head "Other Liabilities and Provisions"

Some Special Transactions

Interest on Doubtful Debts

When a debt is found to be doubtful at the end of the accounting year, a question may arise whether the interest on that should be credited to Interest Account or not. There is no doubt that interest has accrued, but it is equally clear that the realization of this interest is doubtful. Therefore, as a prudent accounting policy, such interest should be transferred to *Interest Suspense Account* by means of the following entry

Loan Account Dr

To Interest Suspense Account

In the Balance Sheet, it should be shown on the liability side

Next year, if a part of interest is realized and the balance becomes bad, the following entry should be passed

Interest Suspense Account Dr [Total interest]

To Interest Account [Interest realized]

To Loan Account [Interest unrealized]

It should be noted that if a debtor becomes insolvent, the bank should not take interest into account after the date of insolvency

Illustration 1

While closing the books of AB Bank Ltd on 31st March, 2007, you find in the loan ledger an unsecured balance of Rs 1 lakh in the account of Mr X, whose financial condition is reported to you as bad and doubtful. Interest accrued on that account is Rs 10,000. On 1st July, 2007 the bank accepted a dividend of Re 75 paise in rupee in full settlement of amount due upto 31st March, 2007. You are required to pass necessary Journal Entries and prepare necessary Ledger account

Date	Particulars	Rs	Rs
2007 March 31	By Loan A/c Dr To Interest Suspense A/c (Being accrued interest on doubtful debts)	10 000	10 000
July 1	Interest Suspense A/c Dr To Interest A/c To Loan A/c (Being the transfer of interest realised to Interest Account & the balance transferred to Loan Account)	10 000	7 500 2 500
	Bank A/c Dr Bad Debts A/c Dr To Loan A/c (Being the final dividend received from the estate of Mr. X. 75 paise in a rupee)	82 500 25 000	1 07 500

Rebate on Bills Discounted

When a bank discounts a bill, Bills Discounted and Purchased Account is debited with the full value of the bill and Current Account (customer's) is credited with the net proceeds and Interest and Discount Account is credited with the amount of total discount of the bill. Discount represents the interest on bill value for the unexpired period of the bill (difference between the date of maturity and date of discounting). It sometimes happens that on the closing day of the accounting year, the bill in question has not matured. At the time of preparing Final Accounts, the interest relating to next accounting period must be carried forward by means of the following entry:

Interest and Discount Account Dr
To Rebate on Bills Discounted Account

It appears in the Balance Sheet under 'Capital and Liabilities'. At the commencement of the next accounting year, it is transferred to Interest and Discount Account by means of a reverse entry.

Illustration 2

On 1st February, 2007 a bill of Rs 3 lakh is discounted @ 12% p a. The due date of the bill is 30th April, 2007. Pass necessary Journal Entries in the books of the bank assuming that the bill is collected on due date. Account year closing on 31st March, 2007.

Solution

In the books of Bank

Journal

Date	Particulars		Rs	Rs
2007	Bills Discounted and Purchased A/c	Dr	3,00,000	
Feb 1	To Current A/c			2,91,000
	To Interest and Discount A/c (Note 1)			9,000
	Discounting of a bill accepted by and due on @ 12% p a.)			
	At maturity on 30th April, 2007, the bank will collect the full amount of the bill and the entry will be			
	Cash A/c	Dr	3,00,000	
	To Bills Discounted and Purchased A/c			3,00,000
	(The bill collected at maturity)			
	Actually 2 months' interest is the income of 2006-07 and 1 month's interest is related to 2007-08			
	Therefore, on 31st March 2007, the adjusting entry will be			
	Interest and Discount A/c	Dr	3,000	
	To Rebate on Bills Discounted A/c (Note 2)			3,000
	(The proportionate discount not earned in 2006-07 carried forward through Rebate on Bills Discounted Account)			

Working Notes (1) Discount for 3 months = Rs 3,00,000 x 12/100 x 3/12 = Rs 9,000 (2) Rebate on Bills Discounted = Rs 9,000/3 x 1 = Rs 3,000

Illustration

Calculate rebate on bills discounted as on 21st March, 2007

Date of Bill	Amount (Rs)	Period	Rate of Discount
15.1.2007	25,000	5 Months	8%
10.2.2007	15,000	4 Months	7%
25.2.2007	20,000	4 Months	7%
20.3.2007	30,000	3 Months	9%

Solution

Calculation of Rebate on Bills Discounted

Date of Bill	Period	Due date (after days of grace)	Days beyond 31.3.07	Amount of the Bill	Rate of Discount	Amount Discount
15.1.2007	5 Months	14.6.2007	70	25,000	8%	432.86
10.2.2007	4 Months	13.6.2007	74	15,000	7%	212.86
25.2.2007	4 Months	28.6.2007	99	20,000	7%	341.37
20.3.2007	3 Months	25.6.2007	84	30,000	9%	621.37
				1,00,000		

Working Notes

(1) Calculation of Days beyond 31.3.2007

April	Mar	June	=	Total
30	+ 31	+ 14	=	70
30	+ 31	+ 13	=	74
30	+ 31	+ 28	=	89
30	+ 24	+ 24	=	84

(2) Journal Entry

Interest and Discount A/c Dr 1,608.50

To Rebate on Bills Discounted A/c 1,608.50

Illustration

Following is the Trial Balance of XYZ Bank Ltd. as on 31.03.2007

Particular	Dr. (Rs'000)	Cr. (Rs'000)
Share Capital		300 000
Cash in hand and with RBI	40 350	
Investments in Govt. of India Bonds	104 370	
Other Investments	155 030	
Gold Bullion	15 130	
Interest accrued on Investments	24 020	
Security Deposits of Employees		15 000
Savings Account Balance		7 420
Current Ledger Control Account		97 000
S. ed Deposit:		23 050
Security Premium Account		90 000
Statutory Reserve		140 000
Silver Bullion	1 000	
Constituents' Liability for acceptance and endorsements	50 500	
Buildings	05 000	
furniture	5 000	
Borrowings from Bank:		77 230
Money at Call and Short Notice	20,000	
Advances	200 000	

Particular	Dr (Rs 000)	Cr (Rs'000)
Profit and Loss Account Balance		6 500
Bills Discounted and Purchased	12,500	
Bills for Collection		43 500
Acceptances and Endorsement:		56,500
Interests	7,950	72,000
Commission and Brokerage		25 300
Discounts		42,000
Bills Receivable being bills for collection	43,500	
Audit fees	5 000	
Loss on sale of Furniture	1 000	
Directors' fees	1 200	
Salaries	21,200	
Postage	50	
Rents		600
Profit on Billion		1 200
Managing Director's Remuneration	12,000	
Miscellaneous income		2,700
Loss on sale of investments	30 000	
Deposit with other Banks	75 000	
Branch Adjustments	20 000	
Depreciation Reserve on Building		20,000
Total	1,020 000	1,020,000

You are required to prepare a Profit and Loss Account for the year ended on 31st March, 2007 and also the Balance sheet after considering the following

- (i) Provide rebate on bills discounted Rs 5,000,000
- (ii) A scrutiny of the Current Account Ledger reveals that there are accounts overdrawn to the extent of Rs 25,000,000 and the total of the credit balances is Rs 1,22,000,000
- (iii) Claims by employees for bonus amounting to Rs 15,000,000 is pending award of arbitration
- (iv) Depreciation on building for the year amounts to Rs 5,000,000
- (v) Out of profit for the year, 20 per cent thereof were transferred to statutory reserve, and the Directors proposed a dividend of 8 per cent, subject to deduction of tax

Solution

XYZ Bank Ltd
Balance Sheet as at 31st March, 1995

	Schedule No	As on 31.3.1995 (Current Year)	As on 31.3.1994 (Previous Year)
Capital and liabilities			
Capital	1	3,00,000	
Reserves & Surplus	2	2,67,900	
Deposits	3	1,52,470	
Borrowings	4	77,230	
Other Liabilities and Provisions	5	44,000	
Total		8,41,600	
Assets			
Cash and balances with RBI	6	46,350	

	Schedule No	As on 31.3.1995 (Current Year)	As on 31.3.1994 (Previous Year)
Balances with banks and money			
at call and short notice	7	1,01,000	
Investments	8	3,65,130	
Advances	9	2,37,500	
Fixed Assets	10	45,000	
Other Assets	11	46,620	
Total		8,41,600	
Contingent liabilities	12	71,500	
Bills for collection		43,500	

Bank Ltd.

Profit & Loss Account for the year ended 31st March, 1995

	Schedule No	Yr ended 31.3.07 (Current Year) Rs' 000	Yr ended 31.3.06 (Previous Year) Rs' 000
I. Income			
Interest earned	13	1,09,000	
Other Income	14	(1,200)	
Total		1,07,800	
II. Expenditure			
Interest Expended	15	7,950	
Operating Expenses	16	44,450	
Provision and contingencies			
Total		52,400	

	Schedule No	As on 31.3.2007 (Current Year) Rs' 000	As on 31.3.2007 (Previous Year) Rs' 000
III. Profit / Loss			
Net Profit/(Loss) for the year		55,400	
Profit/(Loss) brought forward		-	
Total		55,400	
Transfer to statutory reserve		11,000	
Transfer to other reserve		-	
Proposed Dividend		24,000	
Balance carried forward to			
Balance sheet		20,320	
Total		55,400	

SCHEDULE 1 - CAPITAL

	As on 31.3.07 (Curr Year) Rs' 000	As on 31.3.06 (Prev Year) Rs' 000
Authorized Capital		
... shares of Rs ... each		
Issued Capital		
... shares of Rs ... each		
Subscribed Capital		
... shares of Rs ... each		
Called-up Capital		
... shares of Rs ... each	3,00,000	-
Less: Calls unpaid	-	-
Add: Preferred shares	-	-
	3,00,000	-

SCHEDULE 2 - RESERVES AND SURPLUS

	As on 31.3.07 (Curr Year) Rs'000	As on 31.3.06 (Prev Year) Rs'000
Statutory Reserves		
Opening Balance	1,40,000	
Additions during the year	11,080	
Deductions during the year		
Total	1,51,080	
Capital Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
Security Premium		
Opening Balance	90,000	
Additions during the year		
Deductions during the year		
Total	90,000	
Revenue and other Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
Balance in Profit and Loss Account		
Total (I + II + III + IV + V)	2,41,080	

SCHEDULE 3 - DEPOSITS

	As on 31.3 07 (Curr Year) Rs 000	As on 31.3 06 (Prev Year) Rs 000
I. Demand Deposits		
(i) From banks	1 22,000	
(ii) From others		
II. Savings Bank Deposits	7 420	
III. Term Deposits		
(i) From banks	23 050	
(ii) From others		
Total (I + II + III)	1 52,470	
(i) Deposits of branches in India	1 52,470	
(ii) Deposits of branches outside India		
Total	1 52,470	

SCHEDULE 4 - BORROWINGS

	As on 31.3 07 (Curr. Year) Rs'000	As on 31.3 06 (Prev Year) Rs'000
Borrowings in India		
(i) Reserve Bank of India		
(ii) Other Banks	77,230	
(iii) Other Institution and agencies		
Borrowings Outside India		
Total (I + II)	77,230	
Secured borrowings included in I and II above. Rs	77,230	

SCHEDULE 5 - OTHER LIABILITIES AND PROVISIONS

	As on 31.3 07 (Curr Year) Rs'000	As on 31.3 06 (Prev Year) Rs'000
Bills Payable		
Inter -Office adjustments(net)		
Interest accrued		
Others(Including Provisions)		
Proposed Dividend	34,000	
Provision for Rebate	5,000	
Security Deposit of Employees	45,000	
Total	44,000	

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

	As on 31.3.07 (Curr. Year) Rs'000	As on 31.3.06 (Prev. Year) Rs'000
Cash in hand (including foreign currency notes)	45 350	
Balances with RBI		
(i) in Current Accounts		
(ii) in Other Accounts		
Total (I + II)	45 350	

SCHEDULE 7 - BALANCES WITH BANKS & MONEY AT CALL & SHORT NOTICE

	As on 31.3.07 (Curr. Year)	As on 31.3.06 (Prev. Year)
In India		
(i) Balances with banks		
(a) in Current Accounts	75 000	
(b) in Other Deposit Accounts		
(ii) Money at call and short notice		
(a) With banks	26,000	
(b) With other institutions		
Total	1,01,000	
Outside India		
(i) in Current Accounts		
(ii) in Other Deposit Accounts		
(iii) Money at call and short notice		
Total		
Grand Total (I + II)	1 01 000	

SCHEDULE 8 - INVESTMENTS

	As on 31.3.07 (Curr. Year) Rs'000	As on 31.3.06 (Prev. Year) Rs'000
Investments in India in		
(i) Government securities	1,44,370	
(ii) Other approved securities		
(iii) Shares		
(iv) Debentures and Bonds	1,55,630	
(v) Subsidiaries and/or joint ventures		
(vi) Others (to be specified) - Gold	15,130	
Total	3,65,130	
Investments outside India in		
(i) Government securities (including local authorities)		
(ii) Subsidiaries and/or joint ventures abroad		
(iii) Other investments (to be specified)		
Total		
Grand Total (I + II)	3,65,130	

SCHEDULE 9 - ADVANCES

	As on 31.3.07 (Curr. Year)	As on 31.3.06 (Prev. Year)
(i) Bills purchased and discounted	12,500	
(ii) Cash credits, overdrafts and loans repayable on demand	2,25,000	
(iii) Term loans		
Total	2,37,500	

SCHEDULE 10 - FIXED ASSETS

	As on 31.3.07 (Curr. Year) Rs'000	As on 31.3.06 (Prev. Year) Rs'000
Premises		
At cost as on 31st March of the preceding year	05,000	
Additions during the year		
Deductions during the year		
Depreciation to date	25,000	
	40,000	
Other Fixed Assets (including furniture and fixtures)		
At cost as on 31st March of the preceding year	5,000	
Additions during the year		
Deductions during the year		
Depreciation to date		
Total (I + II)	45,000	

SCHEDULE 11 - OTHER ASSETS

	As on 31.3.07 (Curr. Year)	As on 31.3.06 (Prev. Year)
I. Inter-office adjustments (net)	20,000	
II. Interest accrued on investments	24,020	
III. Tax paid in advance / tax deducted at source		
IV. Stationery and stamps		
V. Non-banking assets acquired in satisfaction of claims		
VI. Others (Silver)	2,000	
Total	46,020	

SCHEDULE 12 - CONTINGENT LIABILITIES

	As on 31.3.07 (Curr. Year)	As on 31.3.06 (Prev. Year)
I. Claims against the bank not acknowledged as debts	15,000*	
II. Liability for partly paid investments		
III. Liability on account of outstanding forward exchange contracts		
IV. Guarantees given on behalf of constituents		
(a) In India		
(b) Outside India		
V. Acceptances, endorsements and other obligations		
VI. Other items for which the bank is contingently liable	56,500	
Total	71,500	

* Claim for bonus by employee subject to Arbitration Award.

SCHEDULE 13 - INTEREST EARNED

	Year ended 31.3.07 (Curr Year) Rs'000	Year ended 31.3.06 (Prev Year) Rs'000
I Interest & discount on advances/ bills 1,14,500		
Less: CLBal on rebate of bills discounted 5,000	1,09,500	
II Income on investments		
III Interest on balances with Reserve Bank of India and other inter-bank funds		
IV Others		
Total	1,09,500	

SCHEDULE 14 - OTHER INCOME

	Year ended 31.3.07 (Curr Year) Rs'000	Year ended 31.3.06 (Prev Year) Rs'000
I Commission, exchange and brokerage	25,300	
II Rent	000	
III Profit on sale of investments	1,200	
Less: Loss on sale of investments	(30,000)	
IV Less: Loss on sale of Furniture	(1,000)	
V Miscellaneous Income	2,700	
Total	(1,200)	

SCHEDULE 15 - INTEREST EXPENDED

	Year ended 31.3.07 (Curr Year) Rs'000	Year ended 31.3.06 (Prev Year) Rs'000
I Interest on deposits	7,950	
II Interest on Reserve Bank of India / inter-bank borrowings		
III Others		
Total	7,950	

SCHEDULE 16 - OPERATING EXPENSES

	Year ended 31.3.07 (Curr Year) Rs'000	Year ended 31.3.06 (Prev Year) Rs'000
Payments to and provisions for employees	33,200	
Depreciation on bank's property	5,000	
Directors' fees, allowances and expenses	1,200	
Auditors' fees and expenses	5,000	
Postages, telegrams, telephones etc	50	
Total	44,450	

UNIT – IV – COMPANY ACCOUNTS

AMALGAMATION OF COMPANIES

INTRODUCTION:

There are many forms of business combinations to obtain the economies of large scale production or to avoid the cut throat competition. They are amalgamation, absorption, external reconstruction etc.

The term amalgamation is used when two or more existing companies go into liquidation and a new company is formed to take over the business of liquidated companies. The term absorption is used when an existing company takes over the business of one or more existing companies which go into liquidation. In external reconstruction, one existing company goes into liquidation and a new company is formed to take over the former company.

Definitions as per Accounting Standard 14 (AS-14)

- a Amalgamation – means an amalgamation pursuant to the provisions of the Companies Act 1956 or any other statute which may be applicable to companies
- b Transferor Company – means the company which is amalgamated into another company
- c Transferee Company – means the company to which a transferor company is amalgamated
- d Reserve – means the portion of earnings, receipts or other surpluses of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than provision for depreciation or diminution in the value of assets or for a known liability

Types of Amalgamation

As per AS-14 there are two types of amalgamation (1) Amalgamation in the nature of merger and (2) Amalgamation in the nature of purchase.

Amalgamation in the nature of Merger (Pooling Interest Method)

An amalgamation should be considered to be an amalgamation in the nature of merge when all the following conditions are satisfied:

- i All the assets and liabilities of the Transferor Company or companies before amalgamation should become the assets and liabilities of the transferee company.
- ii Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (excluding the proportion held by the transferee company) should become the shareholders of the transferee company.
- iii The consideration payable to the above mentioned shareholders should be discharged by the transferee company by the issue of the equity shares and cash can be payable in respect of fractional shares.
- iv The business of the Transferor Company/ companies is intended to be carried on by the transferee company.
- v No adjustment is intended to be made to the book values of the assets and liabilities of the Transferor Company/ companies when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the nature of purchase

An amalgamation should be considered to be an amalgamation in the nature of purchase, when any one or more of the conditions specified for amalgamation in the nature of merger is not satisfied.

Difference between Amalgamation in the nature of merger and Amalgamation in the nature of purchase

Merger	Purchase
<ol style="list-style-type: none"> 1. There is a genuine pooling of assets and liabilities of the transferor companies as well as the shareholders' interest. As such the shareholders of all the transferor companies continue to have substantial or proportionate share in the equity or management of Transferee Company. 2. Assets, liabilities and reserves of the transferor company are recorded by the transferee company at their book values. 3. The balance of P&L A/c of the transferor company aggregated with the balance of the P&L A/c of the transferee company. 4. All reserves whether capital or revenue of Transferor Company are merged into the reserves of Transferee Company. 5. It is always intended to continue the business of transferor company. 6. All the assets of Transferor Company become the assets of the transferee company. 7. Purchase consideration is usually valued at the par value of the shares issued. 	<ol style="list-style-type: none"> 1. One company acquires another. As a consequence, the shareholders of the transferor company normally do not continue to have a proportionate share in the equity management of the transferee company. 2. Assets, liabilities and reserves of the transferor company are recorded by the transferee company either at book value or at values revised on the basis of their fair values. 3. The balance of P&L A/c of the transferor company is not included in the books of the transferee company. 4. Only statutory reserves of Transferor Company are taken in the books of Transferee Company in order to preserve their identity. 5. It may not be intended to continue the business of Transferor Company. 6. All the assets of Transferor Company may or may not become the assets of the transferee company. 7. Purchase consideration is usually valued at the market price of the shares issued.

Purchase Consideration

Purchase consideration is the amount which is paid by the transferee company for the purchase the business of Transferor Company. As per AS-14, consideration for amalgamation means the aggregate of shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Purchase consideration does not include any payment to outsiders including debenture holders.

The purchase consideration may be calculated in the following ways

1 **Lump Sum Method** When the transferee company agrees to pay a fixed sum to the transferor company, it is called lump sum payment of purchase consideration. For example, X Ltd purchases the business of Y Ltd for a consideration of 1000000.

2 **Net Worth (Net Assets) Method** Under this method, the net worth of the assets taken over by the transferee company is taken as purchase consideration. Here, Purchase consideration = Assets taken over at agreed values – Liabilities taken over at agreed values

The following points are noted while calculating purchase consideration under this method
 a Cash balance is usually included in assets. But if it is not taken over, it will not be included

b Fictitious assets should never be added

c Accumulated profits and reserves should not be considered

d The term 'liabilities' include all liabilities to third parties. But 'trade liabilities' include only trade creditors and bills payable

e The term 'business' will always mean both the assets and liabilities

Illustration 1

The following is the Balance Sheet of Amrita Ltd

Liabilities	Rs	Assets	Rs
Share capital	60000	Goodwill	28000
Debentures	10000	Land & building	16000
Sundry creditors	6000	Plant & Machinery	24000
General reserve	4000	Stock	16000
Profit & Loss A/c	20000	Debtors	8000
		Cash	2000
		Preliminary expenses	2000
	100000		100000

Bangalore Ltd takes over the business of Amrita Ltd. The value agreed for various assets are Goodwill Rs 22000, Land & Building Rs 25000, Plant and Machinery Rs 24000, Stock Rs 13000

and Debtors Rs 8000. Bangalore Ltd does not take over cash but agrees to assume the liability of sundry creditors at Rs 5000. Calculate the purchase consideration.

Solution

Calculation of purchase consideration

Value of assets taken over-

Goodwill	22000
Land & Building	25000
Plant and Machinery	24000
Stock	13000
Debtors	8000
	<u>92000</u>

Less: Liabilities taken over

Sundry creditors	5000
Debentures	10000
	15000

Purchase consideration 77000

3 Net Payment method Under this method, purchase consideration is the aggregate of all payments in the form of cash, shares, securities etc. to the shareholders of the transferor company by the transferee company. The following points are considered while calculating purchase consideration under this method

a The assets and liabilities taken over by the transferee company are not considered

b Purchase consideration includes the payments to shareholders only

c Any payments made by the transferee company to some other party on behalf of the transferor company are to be ignored

Illustration 2

The balance sheet of Jay Ltd as on 31 March 2011 is as follows.

Liabilities	Rs	Assets	Rs.
Share capital	200000	Goodwill	40000
General reserve	35000	Land & building	90000
Profit & Loss A/c	20000	Plant & Machinery	75000
Debentures	50000	Stock	52000
Sundry creditors	25000	Debtors	58000
		Cash	15000
	330000		330000

Jay Ltd decides to amalgamate into a new company New Ltd which will take over the assets and liabilities of Jay Ltd in the term that holders of each share of Rs 10 in the company would receive one share of Rs 10 each, Rs 5 paid up and Rs 4 in cash. The liquidation expense of Rs 5000 is met by New Ltd. Calculate purchase consideration.

Solution-

Calculation of purchase consideration

Holder of each share of Rs 10 each will get one share of Rs 10 each Rs 5 paid up = 100000
 = 80000
 Holder of each equity share will get Rs 4 in cash (20000x4)
 Purchase consideration = 180000

{Note: Liquidation expense is not included in purchase consideration}

4 Share exchange or Intrinsic value Method Under this method purchase consideration is calculated on the basis of intrinsic value of shares. The intrinsic value of a share is calculated by dividing the net assets available for equity shareholders by the number of equity shares. This value determines the ratio of exchange of the shares between the transferee and transferor companies.

Steps in accounting procedure of amalgamation, absorption and external reconstruction

- Calculation of purchase consideration
- Ascertainment of discharge of purchase consideration
- Closing the books of transferor companies
- Passing opening entries in the books of purchasing or transferee company

Accounting entries in the books of transferor company

1. For transferring assets to Realization A/c.

Realization A/c
Dr
To Assets A/c (individually at book value)

(Note : (a) Fictitious assets should not be transferred to Realization A/c (b) If cash in hand and bank are not taken over by transferee company should not be transferred to Realization A/c. But it can be taken as opening balance of cash or bank A/c and (c) Other assets, even if they are not taken over, should be transferred to Realization A/c)

2. For transferring liabilities (outside liabilities only) to Realization A/c

Liabilities A/c
Dr (individually at book value)
To Realization A/c

(Note : (a) If any liability is not taken over by transferee company should not be transferred to Realization A/c, (b). Items in the nature of provisions are to be transferred to Realization A/c and (c). Any fund which denotes both liability and reserve, the portion of liability should be transferred to Realization A/c)

3. For purchase consideration due from transferee company

Transferee Company A/c
Dr
To Realization A/c

4. On receiving or discharging purchase consideration

Equity shares in Transferee company A/c Dr
Preference shares in Transferee company A/c Dr
Debentures in Transferee company A/c Dr
Cash/ Bank A/c Dr
To Transferee company A/c

5. For sale of assets not taken over by transferee company

Cash/ Bank A/c
Dr (Sale proceeds)
To Realization A/c

6. For discharging liabilities not taken over by transferee company

Liability A/c
Dr
Realization A/c
Dr (if excess amount paid)
To Cash/ Bank A/c
To Realization A/c
(if less payment is made)

7. For liquidation (realization) expenses

- a. If liquidation expenses are met by transferor company

Realization A/c
Dr
To Cash/ Bank A/c

- b. If liquidation expenses are met by transferee company

No entry is required.

8. For closing preference share capital

Preference share capital A/c
Dr
Realization A/c
Dr (if excess amount paid)
To Preference shareholders A/c
To Realization A/c
(if less amount paid)

9. For paying off Preference shareholders:

Preference shareholders A/c	Dr
To Preference shares in Transferee company A/c	
To Cash/ Bank A/c (if any)	
To Debentures A/c (if any)	

10. For transferring equity share capital, reserves etc.

Equity share capital A/c	Dr
General reserve A/c	Dr
P&L A/c	Dr
Dividend equalization reserve A/c	Dr
Security premium A/c	Dr
To equity shareholders A/c	

11. For transferring fictitious assets

Equity shareholders A/c	Dr
To P&L A/c	
To preliminary expenses	
To Discount/ expense on issue of shares/ debentures	

12. For closing Realization A/c

a. For loss on realization (if debit > credit)

Equity shareholders A/c	Dr
To Realization A/c	

b. For profit on realization (if credit > debit)

Realization A/c	Dr
To Equity shareholders A/c	

13. For payment to equity shareholders.

Equity shareholders A/c	Dr
To Equity shares in Transferee company A/c	
To Cash/ Bank A/c (if any)	

After payment to equity shareholders, all accounts in the book of transferor company will be closed

Accounting entries in the books of transferee company

(Amalgamation in the nature of purchase)

1. For purchase consideration due and assets and liabilities taken over

Assets A/c	Dr (At revised, otherwise at book value)
Goodwill A/c	Dr (if credit > debit)
To Liabilities A/c (At revised, otherwise at book value)	
To Liquidator of transferor company (purchase consideration)	
To Capital reserve (if debit > credit)	

2. For payment of purchase consideration:

Liquidator of transferor company A/c	Dr
To Share capital A/c	
To Debenture A/c	
To Bank A/c	

- (Note: If shares are issued at premium, security premium A/c is credited with premium. If shares are issued at discount, discount on issue of shares A/c is debited with discount)
3. For payment of liquidation expenses by transferee company
 - Goodwill/ Capital reserve/ P&L A/c Dr
 - To Cash/ Bank A/c
 4. For payment of formation expenses
 - Preliminary expenses A/c Dr
 - To Cash/ Bank A/c
 5. If there are both Goodwill and Capital reserve A/c, Goodwill may be set off against Capital reserve
 - Capital Reserve A/c Dr
 - To Goodwill A/c
 6. If any liability (including debenture) is discharged by transferee company
 - Liability A/c Dr (Amount payable)
 - To Share capital/ Debenture/ Bank A/c
 7. To record Statutory Reserves of transferor company
 - Amalgamation Adjustment A/c Dr
 - To Statutory Reserve A/c
- (Note: Amalgamation adjustment A/c is shown on the assets side of the company's Balance Sheet under the head "Miscellaneous Expenditure")

Illustration 3

X Ltd acquired the business of Y Ltd on 31 March 2011 for a purchase consideration of Rs 55000 to be paid by fully paid equity shares of Rs 10 each. The balance sheets of both the companies on the date of acquisition were as follows:

	X Ltd	Y Ltd		X Ltd	Y Ltd
Equity shares of Rs.10 each	55000	32500	Land & Building	21500	13500
10 % Preference shares of Rs.10 each	-	6000	Plant & Machinery	40000	25000
General Reserve	17000	11000	Furniture	7500	5000
Development Allowance Reserve	-	4000	Investment	12500	8000
P&L A/c	7000	5000	Inventories	25000	22500
Work men Compensation Fund	3000	1500	Sundry Debtors	8500	5000
10% Debentures	20000	10000	Cash & Bank	3000	1500
Fixed Deposit(unsecured)	7500	5000	Advance Tax	3500	3000
Sundry creditors	3000				
Bills Payable	4000	3000			
Provision for tax	121500	83500		121500	83500

Debenture holders of Y Ltd will be issued equity shares in X Ltd. Journalize the transactions in the books of X Ltd and the Balance sheet after amalgamation assuming that the amalgamation is in the nature of purchase. Also give journal entries in the books of the transferor company to close the books.

Solution:

In the books of Y Ltd (Transferor company)
Closing entries

Realization A/c Dr To Land & Building A/c To Plant & Machinery A/c To Furniture A/c To Investment A/c To Inventories A/c To Sundry Debtors A/c To Cash & Bank A/c To Advance Tax A/c (transfer of various assets to Realization A/c)		83500		
To Land & Building A/c To Plant & Machinery A/c To Furniture A/c To Investment A/c To Inventories A/c To Sundry Debtors A/c To Cash & Bank A/c To Advance Tax A/c				13500 25000 5000 8000 22500 5000 1500 3000
10% Debentures A/c Dr Fixed Deposit A/c Dr Sundry creditors A/c Dr Provision for tax A/c Dr To Realization A/c (transfer of various liabilities to Realization A/c)		10000 5000 5500 3000		23500
X Ltd A/c Dr To Realization A/c (purchase consideration due from X Ltd)		55000		55000
Equity Shares in X Ltd A/c Dr To X Ltd A/c (purchase consideration received)		55000		55000
10% Preference share capital A/c Dr To Preference shareholders A/c (amount payable to Preference shareholders)		6000		6000
Preference shareholders A/c Dr To Equity Shares in X Ltd A/c (distribution of equity shares received from X Ltd)		6000		6000
Equity share capital A/c Dr General reserve A/c Dr Development Allowance reserve A/c Dr P&L A/c Dr Workmen compensation Fund A/c Dr To equity shareholders A/c (transfer of equity shareholders funds)		11000 4000 5000 1500 5000		54000
Equity share capital A/c Dr General reserve A/c Dr Development Allowance reserve A/c Dr P&L A/c Dr Workmen compensation Fund A/c Dr To equity shareholders A/c (transfer of equity shareholders funds)		32500		
Equity share capital A/c Dr General reserve A/c Dr Development Allowance reserve A/c Dr P&L A/c Dr Workmen compensation Fund A/c Dr To equity shareholders A/c (transfer of equity shareholders funds)		11000 4000 5000 1500 5000		54000
Equity shareholders A/c Dr To Realization A/c (transfer of loss on realization)		5000		5000
Equity shareholders A/c Dr To Equity shares in X Ltd A/c (distribution of equity shares received from X Ltd)		49000		49000

Realization A/c			
To Land & Building A/c	13500	By 10% Debentures A/c	10000
To Plant & Machinery A/c	25000	By Fixed Deposit A/c	5000
To Furniture A/c	5000	By Sundry creditors A/c	5500
To Investment A/c	8000	By Provision for tax A/c	3000
To Inventories A/c	22500	By X Ltd (PC)A/c	55000
To Sundry Debtors A/c	5000	By Equity shareholders A/c	5000
To Cash & Bank A/c	1500	(realization loss)-Bal figure	
To Advance Tax A/c	3000		
	83500		83500

X Ltd A/c			
To Realisation A/c	55000	By Equity shares in X Ltd A/c	55000
	55000		55000

Preference shareholders A/c			
To Equity shares in X Ltd A/c	6000	By 10% Preference share capital	6000
	6000	A/c	6000

Equity shareholders A/c			
To Realisation A/c (loss)	5000	By Equity share capital A/c	32500
To Equity shares in X Ltd A/c	49000	By General reserve A/c	11000
		By Development Allowance reserve	4000
		By P&L A/c	5000
		By Workmen compensation Fund A/c	1500
	54000		54000

Opening Entries in the books of X Ltd (Transferee Company)			
Land & Building A/c	Dr		13500
Plant & Machinery A/c	Dr		25000
Furniture A/c	Dr		5000
Investment A/c	Dr		8000
Inventories A/c	Dr		22500
Sundry Debtors A/c	Dr		5000
Cash & Bank A/c	Dr		1500
Advance Tax A/c	Dr		3000

To 10% Debentures A/c			10000
To Fixed Deposit A/c			5000
To Sundry creditors A/c			5500
To Provision for tax A/c			3000
To Liquidators of Y Ltd A/c			55000
To Capital Reserve (Bal figure)			5000
(purchase consideration due and assets and liabilities taken over)			
Liquidators of Y Ltd A/c	Dr	55000	
To Equity share capital A/c			55000
(payment of purchase consideration in equity shares)			
10% Debentures A/c	Dr	10000	
To Equity Share capital A/c			10000
(discharge of debentures by issuing equity shares)			
Amalgamation Adjustment A/c	Dr	5500	
To Development Allowance reserve A/c			4000
To Workmen compensation Fund A/c			1500
(statutory reserves incorporated)			

Balance Sheet of X Ltd as on 1 April, 2011 (after amalgamation)

<i>Share Capital</i>		<i>Fixed Assets</i>	
12000 equity shares of		Land & Building	35000
Rs 10 Each	120000	Plant & Machinery	65000
<i>Reserves & Surplus</i>		Furniture	12500
Capital Reserve	5000	<i>Investments</i>	20500
General Reserve	17000	<i>Current Assets</i>	
Development Allowance		Inventories	47500
reserve	4000	Sundry Debtors	13500
Workmen compensation		Cash & Bank	4500
Fund	4500	Advance Tax	6500
P & L A/c	7000	<i>Miscellaneous Expenditure</i>	
<i>Secured Loan</i>		Amalgamation Adjustment A/c	5500
10% Debentures	20000		
<i>Unsecured loan</i>			
Fixed Deposit	12500		
<i>Current liabilities & Provisions</i>			
Sundry creditors	10500		
Bills Payable	3000		
Provision for tax	7000		
	210500		210500

**Accounting entries in the books of transferee company
(Amalgamation in the nature of merger)**

- For purchase consideration due and assets and liabilities taken over:

Assets A/c		Dr (Individually at book value)
	To Liabilities A/c (Individually at book value)	
	To Reserves of Transferor Company A/c	
	To P & L A/c	
	To Liquidator of transferor company A/c (purchase consideration)	

(Note: The difference between debit and credit is adjusted in the reserves of Transferee Company)

- For payment of purchase consideration

	Liquidator of transferor company A/c	Dr
	To Share capital A/c	
	To Debenture A/c	
	To Bank A/c	

(Note: if shares are issued at premium, security premium A/c is credited with premium. If shares are issued at discount, discount on issue of shares A/c is debited with discount)

- Payment of liquidation expense by transferee company

General Reserve/ P & L A/c		Dr
	To Cash/ Bank A/c	
- For the payment of formation expenses.

Preliminary expenses A/c		Dr
	To Cash/ Bank A/c	

Illustration 4

The following is the summarized Balance sheet of Moon Ltd as on 31 March 2012

Share Capital		Fixed Assets	
40000 equity shares of		Land & Building	200000
Rs 10 Each	400000	Plant & Machinery	100000
Reserves & Surplus		Furniture	80000
Capital Reserve A/c	180000	Investments	-----
P & L A/c	60000	Current Assets	
Secured Loan		Stock	40000
10% Debentures	200000	Sundry Debtors	60000
Current liabilities &		Bank	300000
Provisions		Cash	80000
Sundry creditors	20000		
	860000		860000

On 1 April 2012 Sun Ltd took over the business of Moon Ltd as per the following terms

- Debentures are to be discharged at a premium of 5% in Sun Ltd
- Creditors are to be paid off by Sun Ltd
- Sun Ltd will issue 5 equity shares of Rs 10 each at a market value of Rs 11 for every 4 equity shares of Moon Ltd
- Cost of liquidation Rs 10000 is to be paid by Sun Ltd

Close the books of Moon Ltd and pass opening entries in the books of Sun Ltd assuming that the amalgamation is in the nature of merger

Solution:

Purchase consideration (in Equity shares) = $40000 \times \frac{5}{4} \times 11 = \text{Rs } 550000$

Realisation A/c			
To Land & Building A/c	200000	By 10% Debentures A/c	200000
To Plant & Machinery A/c	100000	By Sundry creditors A/c	20000
To Furniture A/c	80000	By Sun Ltd (PC)	550000
To Stock A/c	40000	By Equity shareholders A/c	90000
To Sundry Debtors A/c	60000	(realisation loss)-Bal. figure	
To Bank A/c	300000		
To Cash A/c	80000		
	860000		860000

Sun Ltd A/c			
To Realisation A/c	550000	By Equity shares in Sun Ltd.	550000
	550000		550000

Equity Shares in Sun Ltd A/c			
To Sun Ltd A/c	550000	By Equity shareholders A/c	550000
	550000		550000

Equity shareholders A/c			
To Realisation A/c (loss)	90000	By Equity share capital A/c	400000
To Equity shares in Sun Ltd.	550000	By Capital Reserve A/c	180000
		By P&L A/c	60000
	640000		640000

Entries in the books of Sun Ltd				
Land & Building A/c	Dr		200000	
Plant & Machinery A/c	Dr		100000	
Furniture A/c	Dr		80000	
Stock A/c	Dr		40000	
Sundry Debtors A/c	Dr		60000	
Bank A/c	Dr		300000	
Cash A/c	Dr		80000	
		To 10% Debentures A/c		200000
		To Sundry creditors A/c		20000
		To Capital Reserve A/c (Bal Fig)		30000
		To P & L A/c		60000
		To Liquidators of Moon Ltd A/c		550000
(purchase consideration due and assets and liabilities taken over)				

Liquidators of Moon Ltd A/c	Dr	550000	
To Equity Share capital A/c			500000
To Security Premium A/c			50000
(payment of purchase consideration in 50000 equity shares of Rs 10 at Rs 11)			
10% Debentures A/c	Dr	200000	
Premium on Redemption of Debentures A/c	Dr	10000	
To Bank A/c			210000
(discharge of debentures at 5% premium)			
Capital Reserve A/c	Dr	10000	
To Premium on Redemption of Debentures A/c			10000
(Premium on Redemption of Debentures adjusted)			
Capital Reserve A/c	Dr	10000	
To Bank A/c			10000
(liquidation expenses paid)			

Working Note Calculation of Reserve

Purchase consideration	550000
Less Share capital of Moon Ltd	<u>400000</u>
Difference to be adjusted	<u>150000</u>
Capital Reserve in Moon Ltd	180000
Less Difference adjusted	<u>150000</u>
Balance of Capital Reserve	<u>30000</u>

Illustration 5

A Ltd acquired the business of B Ltd on 31 March 2012 for a purchase consideration of Rs 2,50,00,000 to be paid by fully paid equity shares of Rs 10 each. The balance sheets of two companies on the date of acquisition were as follows

	A Ltd	B Ltd		A Ltd	B Ltd
Equity shares of Rs 10 each fully paid	25000000	15000000	Land & Building	12000000	8000000
General Reserve	12000000	1000000	Plant & Machinery	20000000	18000000
Development Rebate Reserve	1000000	3700000	Furniture	1000000	3000000
P&L A/c	1000000	5300000	Stock	5500000	4000000
Workmen Compensation Fund	1500000	2400000	Sundry Debtors	4500000	4000000
Current Liabilities	4500000	9500000	Bank	2000000	1700000
	<u>45000000</u>	<u>37700000</u>		<u>45000000</u>	<u>37700000</u>

Pass the necessary journal entries in the books of A Ltd when amalgamation is in the nature of (i) merger and (ii) purchase

Also prepare the Balance sheet of A Ltd after amalgamation assuming that Development Rebate Reserve and Workmen Compensation Fund of B Ltd are required to be continued in the books of A Ltd

Solution:

- (i) When amalgamation is in the nature of merger

Entries in the books of A Ltd

2012	Land & Building A/c	Dr		8000000	
Mar	Plant & Machinery A/c	Dr		18000000	
31	Furniture A/c	Dr		2000000	
	Stock A/c	Dr		4000000	
	Sundry Debtors A/c	Dr		4000000	
	Bank A/c	Dr		1700000	
	General Reserve A/c (Bal Fig)	Dr		2900000	
	To Development Rebate Reserve A/c				3700000
	To Workmen Compensation Fund A/c				2400000
	To Current liabilities A/c				9500000
	To Liquidators of B Ltd A/c				25000000
	(purchase consideration due and assets and liabilities taken over)				
	Liquidators of B Ltd A/c	Dr		25000000	
	To Equity Share capital A/c				25000000
	(payment of purchase consideration in equity shares)				

Balance Sheet of A Ltd as on 1 April 2012 (after amalgamation)

Share Capital		Fixed Assets	
5000000 equity shares of Rs 10 Each, fully paid up	50000000	Land & Building	20000000
Reserves & Surplus		Plant & Machinery	38000000
General Reserve	9100000	Furniture	3000000
Development Rebate Reserve	4700000	Current Assets	
Reserve	3900000	Stock	9500000
Workmen Compensation Fund	1000000	Sundry Debtors	4000000
P & L A/c	14000000	Bank	3700000
Current liabilities	82700000		
			82700000

(ii) When amalgamation is in the nature of purchase

Entries in the books of A Ltd

2012	Land & Building A/c	Dr		8000000	
Mar	Plant & Machinery A/c	Dr		18000000	
31	Furniture A/c	Dr		2000000	
	Stock A/c	Dr		4000000	
	Sundry Debtors A/c	Dr		4000000	
	Bank A/c	Dr		1700000	
	To Current liabilities A/c				9500000
	To Liquidators of B Ltd A/c				25000000
	To Capital Reserve A/c (Bal. Fig)				3200000
	(purchase consideration due and assets and liabilities taken over)				
	Liquidators of B Ltd A/c	Dr		25000000	
	To Equity Share capital A/c				25000000
	(payment of purchase consideration in equity shares)				
	Amalgamation Adjustment A/c	Dr		6100000	
	To Development Rebate Reserve A/c				3700000
	To Workmen compensation Fund A/c				2400000
	(statutory reserves incorporated)				

Balance Sheet of A Ltd as on 1 Apr. 2012 (after amalgamation)			
<i>Share Capital</i>		<i>Fixed Assets</i>	
5000000 equity shares of		Land & Building	20000000
Rs 10 Each, fully paid up	50000000	Plant & Machinery	38000000
<i>Reserves & Surplus</i>		Furniture	3000000
Capital Reserve	3200000	<i>Current Assets</i>	
General Reserve	12000000	Stock	9500000
Development Rebate	4700000	Sundry Debtors	8500000
Reserve		Bank	3700000
Workmen Compensation		<i>Miscellaneous Expenditure</i>	
Fund	3900000	Amalgamation Adjustment A/c	6100000
P & L A/c	1000000		
Current liabilities	14000000		
	88900000		88800000

Illustration 6

A Ltd agrees to sell their undertaking to B Ltd on the following terms B Ltd will pay them Rs 600000 in cash and allot them two fully paid share of Rs 6 each (market value Rs 7.50 per share) in exchange of every three shares in their own company The Balance sheet of A Ltd on the date of amalgamation stood as follows

<i>Share Capital</i>		<i>Fixed Assets</i>	
120000 equity shares of		Land & Building	450000
Rs.6 Each, fully paid up	720000	Plant & Machinery	218700
<i>Reserves & Surplus</i>		<i>Current Assets</i>	
General Reserve	360000	Stock	273450
P & L A/c	34168	Sundry Debtors	229500
Creditors	132500	Bank	74280
		Cash	738
	1246668		1246668

A Ltd will pay their liquidation expenses themselves which amounted to Rs 9000 close the books of A Ltd and give opening entries in the books of B Ltd assuming that the amalgamation is in the nature of purchase

Solution

Calculation of purchase consideration

In cash	600000
In equity shares (120000 \times 2.3 \times 7.50)	600000
Purchase Consideration	1200000

Closing entries in the books of A Ltd

Realisation A/c Dr To Land & Building A/c To Plant & Machinery A/c To Stock A/c To Sundry Debtors A/c To Bank A/c To Cash A/c (transfer of various assets to Realisation A/c)		1246668	
			450000
			218700
			273450
			229500
			74280
			738
Sundry creditors A/c Dr To Realisation A/c (transfer of sundry creditors to Realisation A/c)		132500	
			132500
B Ltd A/c Dr To Realisation A/c (purchase consideration due from B Ltd)		1200000	
			1200000
Cash A/c Dr Equity Shares in B Ltd A/c Dr To B Ltd A/c (purchase consideration received)		600000	
		600000	
			1200000
Equity share capital A/c Dr General reserve A/c Dr P&L A/c Dr To equity shareholders A/c (transfer of equity shareholders funds)		720000	
		360000	
		34168	
			1114168
Realisation A/c Dr To Cash A/c (liquidation expenses paid)		9000	
			9000
Realisation A/c Dr To Equity shareholders A/c (transfer of profit on realisation)		76832	
			76832
Equity shareholders A/c Dr To Equity shares in B Ltd A/c To Cash A/c (distribution of equity shares and cash received)		1191000	
			600000
			591000

Opening entries in the books of B Ltd				
Land & Building A/c	Dr		450000	
Plant & Machinery A/c	Dr		218700	
Stock A/c	Dr		273450	
Sundry Debtors A/c	Dr		229500	
Bank A/c	Dr		74280	
Cash A/c	Dr		738	
Goodwill A/c (Bal Fig)	Dr		85832	
				132500
				1200000
(purchase consideration due and assets and liabilities taken over)				
Liquidators of A Ltd A/c	Dr	1200000		
				480000
				120000
				600000
(payment of purchase consideration)				

Illustration - 11

Divya Ltd agreed to take over the Swati Ltd as a going concern-both companies being engaged in the same trade. Divya Ltd was to pay the debentures and liabilities of Swati Ltd and take over the assets, the consideration being the issue by Divya Ltd of 4,00,000 fully paid shares of Rs 10 each and the payment of Rs 3,00,000 in cash to the Swati Ltd. Divya Ltd was to pay the liquidation expenses, which amounted to Rs 1,40,000. The Balances in the books of the respective companies, as on the date of absorption are given hereunder:

Particulars	Assets		Liabilities	
	Divya Ltd. Rs	Swati Ltd. Rs	Divya Ltd. Rs	Swati Ltd. Rs
Authorised Capital				
Divya Ltd 20,00,000 shares of Rs 10 each				
Swati Ltd 7,50,000 shares of Rs 10 each			2,00,00,000	75,00,000
Issued Capital				
Unpaid Calls	50,000	10,000	1,50,00,000	50,00,000
10% Debentures			50,00,000	10,00,000
Land and Buildings	1,03,33,000	45,62,200		
Goodwill	30,00,000	5,00,000		
Sundry Debtors and Creditors	1,24,000	3,98,400	854,200	4,30,200
Bank Balances				2,00,000
Stock	15,02,000	5,45,200		
Plant and Machinery	48,76,800	10,43,900		
Bills Receivable	5,62,000			
Profit and Loss				
Account balances			9,48,500	2,00,500
	2,18,22,700	69,05,700	2,18,22,700	69,05,700

Assume that the absorption was duly effected but that the unpaid calls and a book debt of Rs 40,000 due to Swati Ltd proved irrecoverable. Prepare the Realization Account and Members Account in the books of Swati Ltd and the Balance Sheet of Divya Ltd after the absorption. Your working should form part of the answer.

Solution :

Part I - Calculation of Purchase consideration - Payments Method

Divya Ltd to take over Swati Ltd by

	Rs
a Issuing 4,00,000 equity shares of Rs 20 each fully paid	40,00,000
b Cash	7,00,000
c Total Purchase consideration	47,00,000

Part II - In the books of transferor company Swati Ltd.

Realisation Account

Dr		Cr	
Particulars	Rs	Particulars	Rs
To Goodwill	5,00,000	By 10% Debenture-	10,00,000
To Land	35,00,000	By Sundry Creditors	4,50,000
To Sundry debtors	3,00,000	By Bank Cheque draft	2,00,000
To Stock	7,55,000	By Bad debt	40,000
To Plant and Machinery	16,43,000	By Shareholders A/c (Loss on Realisation (balancing figure))	9,19,000
To Cash (Realisation Exp)	1,40,000	By Divya Ltd	
		Purchase consideration	47,00,000
		Realisation Expenses	1,40,000
	70,35,000		70,35,000

Shareholders Account

Dr		Cr	
Particulars	Rs	Particulars	Rs
To Unpaid Capital	5,00,000	By Equity Share Capital	5,00,000
To Realisation A/c (Loss)	9,19,000	By Profit and Loss A/c	2,29,500
To Divya Ltd	47,00,000	(12,69,500 - 4,00,000)	
(purchase consideration)			
	52,29,500		52,29,500

Note :

- Realization loss includes the irrecoverable amount of debtors considered as bad debt in Realization amount
- For Realization expenses reimbursed by Divya Ltd

Particulars		Debit	Credit
Realisation A/c	Dr	1,40,000	
To Cash A/c			1,40,000
ii Divya Ltd A/c	Dr	1,40,000	
To Realisation A/c			1,40,000

Part III - In the Books of Divya Ltd :

- Nature of Amalgamation - Purchase
- Method of Accounting – Purchase

Particulars	Debit Rs.	Credit Rs.
a. For Business Purchase		
Business Purchase A/c To Liquidator of Swati Ltd	Dr 43,00,000	43,00,000
b. For takeover of Assets and Liabilities		
Goodwill A/c	Dr 5,00,000	
Land and Building A/c	Dr 35,68,200	
Sundry Debtors A/c (3,98,400 - 40,000)	Dr 3,58,400	
Stock A/c	Dr 7,85,200	
Plant and Machinery A/c	Dr 16,43,900	
To Capital Reserve A/c		9,19,800
To Creditors A/c		4,36,200
To Bank Overdraft A/c		2,00,000
To Business Purchase A/c		43,00,000
To Debentures A/c		10,00,000
c. Discharge of consideration		
Liquidator of Swati Ltd. A/c	Dr 43,00,000	
To Equity Share capital A/c		40,00,000
To Cash A/c		3,00,000
d. Reimbursement of realisation expenses		
Capital Reserve A/c	Dr 1,40,000	
To Cash A/c		1,40,000
[Being Reimbursement of realisation expenses adjusted against Capital reserve]		

Balance Sheet of Divya Ltd. (After Amalgamation)

Liabilities	Rs.	Assets	Rs.
Share capital :		Fixed Assets :	
Authorised capital 20 lakhs shares of Rs. 10 each	2,00,00,000	Goodwill	75,00,000
Issued capital 19 lakhs share of Rs. 10 each [of the above, 4 lakh shares were issued to Swati Ltd for consideration other than cash]	1,90,00,000	Land and Building	1,39,01,200
Less: Unpaid calls	(50,000)	Plant and Machinery	55,20,700
	1,89,50,000	Current Assets and Loans and Advances :	
		Sundry Debtors	10,82,400
		Stock	25,77,800
		Bills Receivable	3,62,100
		Bank Balance (16,84,200 - 3,00,000 - 1,40,000)	12,44,200

Liabilities	Rs.	Assets	Rs.
Reserves and Surplus			
Capital Reserve	7,79,500		
Profit & Loss	9,88,500		
Secured Loans :			
10 % Debentures (50+10)	60,00,000		
Current Liabilities and Provision :			
Creditors	12,70,000		
Bank Overdraft	2,00,000		
	2,81,88,400		2,81,88,400

ACCOUNTING FOR INTERNAL RECONSTRUCTION

There are two types of reconstruction, namely external reconstruction and internal reconstruction. In external reconstruction, a new company is formed to take over the assets and liabilities of an existing company which goes into liquidation. But in internal reconstruction, there will be neither liquidation of an existing company nor formation of a new company. Internal reconstruction means an internal rearrangement that gives a new look to the capital structure, adjusts the rights of shareholders, debenture holders and creditors along with some adjustments in the values of assets and writing off fictitious assets. Internal reconstruction may be done due to the accumulated losses, shortage of working capital, overvaluation of assets etc.

Difference between Internal reconstruction and External reconstruction

Internal reconstruction	External reconstruction
1. The company does not lose its identity.	1. The company loses its identity.
2. The overvalued assets are revalued at their net worth and the losses written off.	2. The newly formed company takes over the assets and liabilities of the liquidated company at agreed values.
3. No new company is formed nor is any existing company liquidated. It is the internal matter of a single company.	3. A new company is formed in place of the old company.
4. Debenture holders, creditors and bank overdraft may continue.	4. These parties will have to be settled.

Forms or Methods of Internal reconstruction

1. Alteration of share capital
2. Reduction of share capital
3. Variation of shareholders' rights
4. Scheme of compromise

Alteration of Share Capital

According to Sec 94 of the Companies Act, a limited company can, if authorized by its articles of association, alter the capital clause of its memorandum of association in any of the following ways

- a. By increasing its share capital by issue of new shares
- b. By consolidating existing shares of smaller amounts into shares of larger amounts

- c By subdividing the existing share into shares of smaller amounts
- d By converting fully paid shares into stock Or stock into fully paid shares

Accounting entries for alteration of capital

a For increasing its share capital

i Bank A/c ii Share Application & Allotment A/c	Dr To Share Application & Allotment A/c Dr To Share Capital A/c
--	--

b For consolidation of shares

Share Capital (old) A/c	Dr To Share Capital (New) A/c
-------------------------	----------------------------------

c For subdivision of shares

Share Capital (old) A/c	Dr To Share Capital (New) A/c
-------------------------	----------------------------------

d For conversion of shares into stock

Share Capital A/c	Dr To Stock A/c
-------------------	--------------------

e For conversion of stock into shares

Stock A/c	Dr To Share Capital A/c
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Illustration

A Ltd having a share capital of Rs 500000 divided into 5000 shares of Rs 100 each, resolves to subdivide the shares into 50000 shares of Rs 10 each. Pass the journal entry.

Solution

Share Capital (Rs 100) A/c Dr To Share Capital (Rs 10) A/c	500000 500000
---	------------------

Illustration

X Ltd resolves to convert its 50000 equity shares of Rs 10 each fully paid into Rs 500000 worth of equity stock. Journalize the transaction.

Solution:

Equity Share Capital A/c Dr To Equity Stock A/c	500000 500000
--	------------------

Illustration

B Ltd having an equity share capital of Rs 100000 divided into 10000 shares of Rs 10 each resolves to consolidate the shares into 1000 shares of Rs 100 each. Pass the journal entry.

Solution:

Equity Share Capital (Rs 10) A/c Dr To Equity Share Capital (Rs 100) A/c	100000 100000
---	------------------

Reduction of Share Capital

Reduction of capital is unlawful except when sanctioned by the court because conservation of capital is one of the main principles the Company Act. In order to reduce the share capital, the company must be authorized by its articles of association, a special resolution must be passed at general meeting, and confirmation of court etc. is required. A company can reduce its share capital by any of the following ways

- a By reducing the liability of the shareholders for uncalled capital

- b By paying off the surplus capital
- c By reducing paid up capital which is not represented by available assets

Accounting entries for reduction of share capital

b For reducing the liability in respect of uncalled capital

Share Capital (old) A/c Dr
To Share Capital (New) A/c

b For paying off surplus capital

i Share Capital A/c Dr
To Shareholders A/c

ii Shareholders A/c Dr
To Bank A/c

c For reducing or cancelling paid up capital which is not represented by available assets

i For reducing paid up capital by changing its face value
 Share Capital (old) A/c Dr
To Share Capital (New) A/c
To Capital Reduction A/c

ii For reducing paid up capital without changing its face value
 Share Capital A/c Dr (amount of reduced capital)
To Capital Reduction A/c

Capital Reduction Account

Capital Reduction Account is a new account opened for transferring that part of capital which is lost or not represented by the assets. It is a temporary account opened for carrying out internal reconstruction. This account will be closed as soon as the scheme is carried out. The balance in Capital Reduction A/c can be used to write off fictitious assets, past losses and excess value of assets. The entry is as follows:

Capital Reduction A/c Dr
To P&L A/c (Debit balance)
To Goodwill A/c
To Preliminary Expenses A/c
To discount on issue of shares/ debentures A/c
To Patents/ Trademarks A/c
To Plant & Machinery A/c
To other Assets A/c
To Capital Reserve A/c (Bal Fig)

Illustration 10

The following is the balance sheet of Brahma Ltd as on 31 March 2011

Liabilities	Amount	Assets	Amount
5000 Equity shares of Rs 100 each fully paid	500000	Plant & Machinery	173000
7500 10% Preference shares of Rs 100 each fully paid	750000	Patents	85000
Sundry creditors	50000	Stock in trade	55000
		Sundry debtors	77000
		Profit & Loss A/c	145000
	1300000		1300000

The company suffered losses and the following scheme was adopted

- i Equity shares are to be reduced to an equal number of shares of Rs 25 each
- ii The preference shares to be reduced to an equal number of shares of Rs 50 each
- iii The amount available to be used to write off Rs 39240 of plant and machinery and

Rs 15000 of stock in trade

iv Made a provision of Rs 15300 for doubtful debt

v The balance being used to write off patents

Journalize the transactions and prepare the balance sheet after reconstruction.

Solution

Journal			
2011 Mar 31	Equity Share Capital (Rs 100) A/c Dr To Equity Share Capital (Rs.25) A/c To Capital Reduction A/c (reduction of equity share capital to Rs 25 each)	500000	
			125000 375000
	10% Preference Share Capital (Rs.100) A/c Dr To Preference Share Capital (Rs.50) A/c To Capital Reduction A/c (reduction of preference share capital to Rs 50)	750000	
			375000 375000
	Capital Reduction A/c Dr To P&L A/c To Plant & Machinery A/c To Stock in trade A/c To Provision for doubtful debts A/c To Patents (Bal Fig) (utilization of capital reduction A/c)	750000	
			145000 39240 15000 15300 535460

Balance Sheet as on 1 April 2011 (after reconstruction)

Liabilities	Amount	Assets	Amount
5000 Equity shares of Rs.25 each fully paid	125000	Plant & Machinery(173000-39240)	133760
7500 10% Preference shares of Rs 50 each fully paid	375000	Patents (850000-535460)	314540
Sundry creditors	50000	Stock in trade (55000-15000)	40000
	550000	Sundry debtors (77000-15300)	61700
			550000

Illustration

The following is the balance sheet of Jay Ram Ltd as on 31 March 2011

Liabilities	Amount	Assets	Amount
10000 Equity shares of Rs 10 each fully paid	100000	Goodwill	25000
1000 7% Preference shares of Rs 100 each fully paid	100000	Other Fixed assets	104000
Sundry creditors	50000	Current assets	95000
	250000	Profit and loss A/c	26000
			250000

It was decided that equity shares of Rs 10 each be reduced to shares of Rs 7 each and 7% preference shares of Rs 100 each be reduced to 8% preference shares of Rs 75 each. The number of shares in each case is to remain the same. It was decided that the amount so available be used for writing of the debit balance in P&L A/c, goodwill A/c and with the balance for writing down the fixed assets. Journalize the transactions and prepare the balance sheet after reconstruction.

Solution

Journal

2011	Equity Share Capital (Rs.10) A/c	Dr	100000	
Mar	To Equity Share Capital (Rs 7) A/c			70000
31	To Capital Reduction A/c			30000
	(reduction of equity share capital to Rs 7 each)			
	7% Preference Share Capital (Rs 100) A/c	Dr	100000	
	To 8% Preference Share Capital (Rs 75) A/c			75000
	To Capital Reduction A/c			25000
	(reduction of preference share capital to Rs 75)			
	Capital Reduction A/c	Dr	55000	
	To P&L A/c			26000
	To Goodwill A/c			25000
	To Fixed assets A/c			4000
	(utilization of capital reduction A/c)			

Balance Sheet as on 1 April 2011 (after reconstruction)

Liabilities	Amount	Assets	Amount
10000 Equity shares of Rs 7 each fully paid	70000	Fixed assets (104000-4000)	100000
1000 8% Preference shares of Rs 75 each fully paid	75000	Current assets	95000
Sundry creditors	50000		
	195000		195000

Variation of Shareholders' rights

Under this, the shareholders rights are altered by changing the rate of dividend or changing the classes of shares. For example, it can be done by changing the cumulative preference shares to non-cumulative preference shares or from 10% preference shares into 7% preference shares etc.

Scheme of compromise or arrangement

Here a compromise or arrangement is made with creditors or debenture holders while settling their liabilities. This scheme involves the following

- a For sacrifice by debenture holders
 Debentures A/c Dr (with amount sacrificed)
 To Capital Reduction A/c
- b For exchange of debentures for new debentures or shares
 Debentures A/c (old) Dr
 To Debentures/ Share Capital A/c (New)
- c For sacrifice by creditors
 Creditors A/c Dr (with amount sacrificed)
 To Capital Reduction A/c
- d For agreement to receive shares or debentures in settlement of claims of creditors
 Creditors A/c Dr
 To Share Capital/ debentures A/c

Miscellaneous journals

- a For appreciation of fixed assets
 Fixed assets A/c Dr (with amount of appreciation)
 To Capital Reduction A/c
- b For expense incurred on reconstruction
 Capital Reduction A/c Dr
 To Bank A/c

Illustration

The balance sheet of Gloomy Ltd as on 31 March 2011 was as follows

Liabilities	Amount	Assets	Amount
4000 Equity shares of Rs 100 each fully paid	400000	Goodwill	15000
2000 5% Preference shares of Rs 100 each fully paid	200000	Freehold premises	200000
6% Debentures	100000	Plant & Machinery	300000
Bank overdraft	35000	Stock in trade	50000
Sundry creditors	100000	Sundry debtors	40000
		Cash in hand	5000
		Profit & Loss A/c	225000
	835000		835000

The company has got the following scheme of capital reduction approved by the court

- a Preference shares to be reduced to Rs 60 per share fully paid up and equity shares to Rs 40 per share fully paid up
- b The debenture holders to take over stock in trade and book debts in full satisfaction of the amount due to them
- c The value of freehold premises to be increased by 10%
- d The value of plant and machinery to be depreciated by 33 1/3%
- e The goodwill account to be eliminated
- f Expenses of reconstruction amounted to Rs 4000

Journalize the transactions and prepare the balance sheet after reconstruction

Solution

Journal

2011 Mar 31	Equity Share Capital (Rs 100) A/c Dr To Equity Share Capital (Rs 40) A/c To Capital Reduction A/c (reduction of equity share capital to Rs 40 each)	400000	160000 240000
	5% Preference Share Capita. (Rs 100) A/c Dr To 5%Preference Share Capital(Rs 60)A/c To Capital Reduction A/c (reduction of preference share capita' to Rs 60)	200000	120000 80000
	6% Debentures A/c Dr To Stock in trade A/c To Sundry debtors A/c To Capital Reduction A/c (Bal Fig) (stock and debtors taken over by debenture holders)	100000	50000 40000 10000
	Freehold premises A/c Dr To Capital Reduction A/c (Freehold premises appreciated by 10%)		

Capital Reduction A/c Dr To P&L A/c To Goodwill A/c To Plant and machinery A/c To Bank A/c (expenses) To Capital Reserve A/c (utilization of capital reduction A/c)	20000 350000	20000 15000 225000 100000 4000 6000
---	-----------------	--

Balance Sheet as on 1 April 2011 (after reconstruction)

Liabilities	Amount	Assets	Amount
4000 Equity shares of Rs.40each fully paid	160000	Freehold premises(200000+20000)	220000
2000 5% Preference shares of Rs 60 each fully paid	120000	Plant & Machinery(300000-100000)	200000
Capital Reserve	6000	Cash in hand(5000-4000)	1000
Bank overdraft	35000		
Sundry creditors	100000		
	421000		421000

Surrender of shares

Under reconstruction, the shareholders may be required to surrender a part of their share holdings. Such surrendered shares may be reissued to other parties (creditors, debenture holders etc.) in whole or in part satisfaction of their claims. The entries required are as follows:

- i. On surrender of shares

Share capital A/c	Dr
To Surrendered shares A/c	
- ii. On reissue of surrendered shares

Surrendered shares A/c	Dr
To Share capital A/c	
- iii. On cancellation of unissued surrendered shares

Surrendered shares A/c	Dr
To Capital Reduction A/c	

Illustration

A company has equity share capital of Rs 1000000 consisting 10000 shares of Rs 100 each. It is resolved:

- a. To subdivide the shares into shares of Rs 10 each
- b. To ask their shareholders to surrender 50% of their shares
- c. To issue 60% of the surrendered shares to 15% debenture holders of Rs 400000 in full settlement of their claims
- d. To cancel the unissued surrendered shares. Give entries in the books of the company.

Solution

Journal			
Equity Share Capital (Rs 100) A/c	Dr	1000000	
To Equity Share Capital (Rs 10) A/c			1000000
(subdivision of equity shares into Rs 10 each)			
Equity Share capital A/c	Dr	500000	
To Surrendered shares A/c			500000
(50% of shares surrendered)			
Surrendered shares A/c	Dr	300000	
15% Debentures A/c	Dr	400000	
To Equity Share capital A/c			300000
To Capital Reduction A/c			400000
(issue of 60% surrendered shares to debenture holders in full settlement of their claims)			
Surrendered Shares A/c	Dr	200000	
To Capital Reduction A/c			200000
(cancellation of unissued surrendered shares)			

LIQUIDATION:

The liquidator is required to prepare an account of winding up known as Liquidator's Final Statement of Account after the affairs of the company are fully wound up. This account takes the form of Cash Account. The main job of the liquidator is to collect the assets of the company and realize them and distribute the money realized among right claimants. For this purpose he maintains a Cash Book for recording the receipts and payments and is required to submit an abstract of the

Cash Book to the court in case of compulsory winding up and to the company in case of voluntary winding up. The following receipts are **shown on the debit side** of this account

- (1) Amount realized on sale of assets
- (2) Amount received from delinquent directors and other officers of the company
- (3) Contributions made by the contributors

On the credit side of the account, he records the payments made in the following order

- (1) Payment of secured creditors and dues to workmen up to their claim or up to the amount of securities held by secured creditors as per section 529. The balance of secured creditors left unsatisfied (i.e., when the claims of the secured creditors are more than the amount realized by sale of securities) will be added to unsecured creditors
- (2) Cost of winding up (i.e., legal charges)
- (3) Liquidator's remuneration
- (4) Payment of creditors (e.g., debentures) having a floating charge on the assets of the company. Interest on debentures should be paid upto the date of actual payment to the debenture holders and not only upto the date of liquidation provided the company is solvent. But if the company is insolvent, interest is payable upto the date of commencement of insolvency proceedings
- (5) Payment of preferential creditors
- (6) Payment of unsecured creditors. This may also include liability in respect of dividend declared but not paid but the payment of dividend due will be paid only after the amount due to outsiders is paid
- (7) Amount paid to preference shareholders
- (8) Amount paid to equity shareholders

The various claims will be satisfied by the liquidator in the order mentioned above. So, if the money available with the liquidator is exhausted after paying, say, debenture holders partly or fully, payments will not be possible to unsecured creditors, preference shareholders and equity shareholders.

STATEMENT OF AFFAIRS

DEFINITION AND EXPLANATION

Correct final accounts of a business can be prepared in the records are maintained under the double entry system. However, where the record is incomplete, and it is not all possible to complete it by double entry, in such cases the final accounts can be only approximately prepared by means of a statement of affairs. In appearance the **statement of affairs** is similar to a balance sheet. For this purpose, two comparative statements of affairs are prepared – one at the commencement of the year and other at the end of the year. The excess of the assets over the liabilities as shown by the statement will represent the capital of the firm. If capital at the end shows an increase as compared to the amount of capital at the start the difference will represent profit and if the capital at the end is less than the capital at the beginning the difference will be loss. In this calculation, however, two more factors should be taken into account:

1. Where fresh capital has been introduced into the business during the account period, the closing capital may be taken to have been increased to that extent. To arrive at the true profit or loss, therefore, the amount of fresh capital introduced is deducted from the closing assets as determined under such circumstances.
2. Where drawings have been made by the proprietor during the accounting period, such drawings reduce the amount of capital at the close. In order to calculate net profit, it is necessary, therefore, that amount withdrawal should be added to the capital at the close before deducting from it the capital at the beginning.

ILLUSTRATION

Rashid and Co keeps his book on single entry system. His position on 1st January, 1991 was as follows:

Cash in hand \$200, cash at bank \$3000, stock in trade \$20,000, sundry debtors \$8,500, furniture \$1,800, machinery \$15,000, sundry creditors \$22,000

On 31st December, 1991 the financial position was as follows:

Cash in hand \$300, cash at bank \$2,000, machinery \$27,000, furniture \$1,500, sundry debtors \$14,000, stock in trade \$19,000, sundry creditors \$29,000

During the year Rashid introduced a new capital of \$5,000 and withdrew for his personal expenditure \$9,000.

From the above figures, prepare a statement showing the profit or loss made by him during 1991.

SOLUTION

RASHID & CO
STATEMENT OF AFFAIRS AS AT 1ST JANUARY, 1991

Liabilities	\$	Assets	\$
			200
		Cash in hand	3,000
		Cash at bank	8,500
		Sundry debtors	20,000
	22,000	Stock in trade	1,800
Sundry creditors	26,500	Furniture	15,000
Capital (balancing figure*)	48,500	Machinery	48,500

* 48,500 – 22,000

RASHID & CO
STATEMENT OF AFFAIRS AS AT 1ST JANUARY, 1991

Liabilities	\$	Assets	\$
			300
		Cash in hand	2,000
		Cash at bank	14,000
		Sundry debtors	19,000
	29,000	Stock in trade	1,500
Sundry creditors	34,800	Furniture	27,000
Capital (balancing figure*)	63,800	Machinery	63,800

* 63,800 – 29,000

UNIT – V – MANAGEMENT ACCOUNTING

EMERGENCE OF MANAGEMENT ACCOUNTING:

With the advancement of science and technology more sophisticated equipments and gadgets have been put into operation in the realm of accounting as well. This has changed the accounting from a mere device of recording to a powerful tool of forecasting, budgeting and budgetary control. Thus, financial accounting has been supplemented with financial and cost control, budgeting and budgetary control and also production planning and control besides reporting on business performance. Precisely, it has led to the emergence of management accounting.

The term 'Management Accounting' is of recent origin even in the USA. This term was first coined and used by the British Team of Accountants that visited the United States in 1950 under the auspices of Anglo-American Productivity Council. Since then management accounting has grown into a full fledged subject and is looked upon as a subject distinct from accounting in recent years. It is also otherwise known as "Management-Oriented Accounting" or "Accounting for Management". In common parlance Management Accounting refers to the modern concept of accounts as an effective tool in the hands of the management as against the traditional package of accounts. The primary object is to furnish all the relevant financial and statistical information focusing on every phase of activity in the organization. This means that management accounting, in the words of W M Harper, is concerned with "(a) management need for information regarding the economic operation of the enterprise and (b) the actual direct management of cash."

The Institute of Chartered Accountants of England and Wales has defined Management Accounting as 'any form of accounting which enables a business to be conducted more efficiently be regarded as Management Accounting'. Management Accounting, according to J Batty "is the term used to describe the accounting methods, systems, and techniques which, coupled with special knowledge and ability, assist management in its task of maximizing profits or minimizing losses." Robert Anthony opined that "Management Accounting is

concerned with accounting information which is useful to management". Shillinglaw has stated that accounting, which serves management by providing information as to the cost or profit associated with some portion of firm's total operations, is called managerial accounting. But the most acceptable definition of Management Accounting has been furnished by the management accounting Team of Anglo-American Council on Productivity in its Report which reads

"Management Accounting is the presentation of accounting information in such a way as to assist management in the creation of policy and the day-to-day operation of an undertaking. The technique of accounting is of extreme importance as it works in the most nearly universal medium available for the expression of facts so that facts of great diversity can be presented in the same picture. It is not the presentation of these pictures that is the function of management but the use of them."

All these definitions of Management Accounting reveal the following salient features:

1. It is a merger of "management" and "accounting"
 2. It is concerned with accounting information which is useful to management in maximizing profits or minimizing losses.
 3. It is concerned with the improvement in the efficiency of the various phases of management.
- Briefly management accounting with all its paraphernalia, does not supplement financial accounting as is enormously misunderstood, but supplement the basic structure of traditional package of accounts to cater to the diversified requirements of modern

management

In the absence of an internationally accepted definition of management accounting, experts have used different terms to refer to managerial accounting such as business environment accounting, control accounting, decision accounting, responsibility accounting, etc. It is called responsibility accounting, since it provides accounting and statistical information to different levels of management to satisfy their needs.

FUNCTIONS OF MANAGEMENT ACCOUNTING:

Broadly speaking the functions of management accounting embrace all activities concerning collection of statistical data, processing, analyzing, interpreting and presentation of the same in a condensed capsule form, to satisfy the needs of different levels of management. The main functions of management accounting are discussed below.

1 Management accounting involves forecasts and planning of future operations of the business in the light of the past as well as present achievements. The formulation of business budgets will be immensely useful in guiding both short term and long-term operations of the business in a most effective manner.

2 Management accounting does not confine itself merely to financial data to assist the management in the decision making process but frequently draws upon various sources other than accounting for qualitative information which cannot be converted into monetary terms. For this purpose, engineering records, case studies, minutes of meetings, productivity reports, special surveys and other business documents are greatly relied upon.

3 Management accounting furnishes accounting data and statistical information required for the decision-making process in management which vitally affects the survival and the success of the business. This is affected through classification as well as combination of sales for different months and their break-up according to the class of products, types of customers, terms of credit, territory, etc.

4 Management accounting, though concerned with past records, maintenance of values, allocation and fixation of responsibilities and the evaluation of the future developments, is primarily concerned with the analysis and of data which provide a new vista to the management. Thus, the analysis and interpretation of data which are considered as the backbone of management accounting, provide the necessary basis or infrastructure for a focus on all the phases of management.

5 Management accounting establishes standards of performance in the different realms of activities in such way that any deviation there from can be easily measured leading to further investigation of the causes and institution of prompt remedial measures for rectifying the same. This is made possible through budgetary control and standard costing which are essential adjuncts of management accounting.

6 Management accounting furnishes statistical information according to the varying requirements of the different levels of management, at periodic intervals. The three-tier management which is in vogue in the recent times requires information of various types at different intervals, e.g., the top level management requires information in a capsule form covering all aspects of the business at relatively long intervals whilst detailed analysis relating to a particular aspect of the business at short intervals will suffice the persons in the lower rungs of the management ladder.

SCOPE OF MANAGEMENT ACCOUNTING: The scope of Management Accounting is very wide and broad based and it includes within its fold, a variety of aspects of business operations. The following are some of the areas of specialization included within the ambit of management accounting

- 1. Financial Accounting** This pertains to recording of all business transactions in the books of prime entry, posting them into respective ledger accounts, balancing them and preparing a trial balance, from and out of which a profit and loss account showing the results of the business and also a balance sheet depicting assets and liabilities of the business concern are prepared. This in turn forms the basis for analysis and interpretation for furnishing meaningful data to the management.
- 2. Cost Accounting** Costing refers to the classification, recording and allocation of expenditures for the determination of the cost of products or services, ensuring management control over the same. This includes the determination of cost of every order, job, contract, process, or unit as may be required. This helps in the sharpening of the internal aspects of financial accounting.
- 3. Forecasting and budgeting** This refers to the formulation of budgets and forecasts, using standard norms in co-operation with operating and other departments of a business concern. The ultimate success of any budgeting depends on the proper setting of target figures in the budgets and the actual realization of the same in practice, without even a slight deviation due to external reasons beyond the control of the management.
- 4. Cost control techniques** These serve as effective tools for comparing the actual results with the predetermined figures as laid down in budgets. They greatly help in translating the budgets into operating plans.
- 5. Statistical data** It is concerned with the supply of necessary statistical data and particulars needed by various departments of the business concern. This includes as stated earlier, statistical compilation of case studies, engineering records, minutes of meetings, special surveys and many other business documents.
- 6. Taxation** This necessitates the computation of profits in accordance with the provisions of the Income Tax Act and also prompt filing of returns periodically and payment of taxes.
- 7. Methods and procedures** They are concerned with standardization of methods and procedures in all fields of management for improving efficiency as well as for reducing the cost considerably. This also involves the preparation and issuance of accounting and other manuals which will provide the guidelines for others.
- 8. Office services** This mainly relates to the maintenance of data processing and other office management services, stencilling and duplicating, dealing of inward and outward mails, etc.
- 9. Internal audit** The effectiveness of the final audit depends in turn on the internal audit coverage in existence in any business concern. Management accounting represents a happy blending of the two older professions of 'Management' and 'Accounting'. The two important elements in the success of a business concern are accounting control and management efficiency. These two determinants are completely merged in management accounting through the harnessing of accounting for improving the efficiency of management. Management accounting greatly assists the management in achieving better results by making a clear shift in emphasis from mere recording of transactions to their analysis and interpretation to give a new vista to the management. It concerns with the tools and techniques of formulation of budgets and pre-setting of standards as well as evaluation of deviations in actual performance and also implementation.

of prompt remedial measures. In short, management accounting eliminates intuition from the field of business management and broadens the services of accounting to management.

LIMITATIONS OF MANAGEMENT ACCOUNTING:

Management accounting, as any other branch of knowledge, is not without limitations. Though the emergence of management accounting has greatly improved the managerial performance, yet the new discipline has to face certain challenges and constraints conditioned mostly by the external factors. These factors curtail the effectiveness of management accounting and they are discussed below.

1. Continuance of intuitive decision-making Management accounting eliminates the intuitive decision-making process of management and replaces it with scientific decision making. Unfortunately, much management is prone to take the easy and simple path of intuitive decision-making rather than the difficult but reliable scientific decision-making process in the day-to-day management.

2. Broad-based scope The scope of management accounting is wide and broad-based and this creates many difficulties in the implementation process. It is easy to record, analyze, and interpret an historical event converted into monetary terms in a most objective manner. But it will be difficult to perform the same functions in respect of future and unquantifiable situation in the light of the past records.

3. Comprehensive coverage The fusion of a number of subjects like financial accounting, statistics, engineering, economics, taxation, etc. has culminated in the emergence of management accounting. Under the circumstances, it should be remembered that lack of knowledge and understanding of any one or more of these subjects will have its impact on the fixation of standards as well as solutions to the problems connected with the management performance.

4. Evolutionary stage: Management accounting is a new discipline and growing subject too. It is still in the infancy stage and undergoing evolutionary process. Naturally, it faces certain obstacles and impediments before achieving perfection and finality. This necessitates sharpening of the analytical tools and improving of techniques for removing the air of doubt as regards uncertainty in their applications.

5. Psychological resistance The management accounting system spells a radical change in the management approach towards solving day-to-day problems confronted by it. This calls for a bound to attract opposition especially from the labour force misconstruing it as a tool meant for their exploitation. Constant education about the benefits of such a new technique alone will allay the fears of the labour force by and large. Management accounting, as a new discipline, is no exception to this rule and it encountered psychological resistance at least in the initial stage.

6. Costly installation For installation of a system of management accounting in a business concern, an elaborate organization and a large number of manuals are very essential. This in turn escalates the establishment charges such that only large scale organizations can afford to install it.

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS :

MEANING OF ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

An analysis of financial statements is the process of critically examining in detail accounting information given in the financial statements. For the purpose of analysis, individual items are studied, their interrelationships with other related figures are established, the data is sometimes rearranged to have better understanding of the information with the help of different techniques or

tools for the purpose Analyzing financial statements is a process of evaluating relationship between component parts of financial statements to obtain a better understanding of firm's position and performance. The analysis of financial statements thus refers to the treatment of the information contained in the financial statements in a way so as to afford a full diagnosis of the profitability and financial position of the firm concerned. For this purpose financial statements are classified methodically, analyzed and compared with the figures of previous years or other similar firms.

The term 'Analysis' and 'interpretation' though are closely related, but distinction can be made between the two. Analysis means evaluating relationship between components of financial statements to understand firm's performance in a better way. Various account balances appear in the financial statements. These account balances do not represent homogeneous data so it is difficult to interpret them and draw some conclusions. This requires an analysis of the data in the financial statements so as to bring some homogeneity to the figures shown in the financial statements. Interpretation is thus drawing of inference and stating what the figures in the financial statements really mean. Interpretation is dependent on interpreter himself. Interpreter must have experience, understanding and intelligence to draw correct conclusions from the analyzed data.

OBJECTIVES OF FINANCIAL ANALYSIS:

Analysis of financial statements is made to assess the financial position and profitability of a concern. Analysis can be made through accounting ratios, fitting trend line, common size statements, etc. Accounting ratios calculated for a number of years show the trend of the change of position, i.e., whether the trend is upward or downward or static. The ascertainment of trend helps us in making estimates for the future. Keeping in view the importance of accounting ratios the accountant should calculate the ratios in appropriate form, as early as possible, for presentation to management for managerial control. The main objectives of analysis of financial statements are

- (i) to assess the profitability of the concern,
- (ii) to examine the operational efficiency of the concern as a whole and of its various parts or departments,
- (iii) to measure the short-term and long-term solvency of the concern for the benefit of the debenture holders and trade creditors,
- (iv) to undertake a comparative study in regard to one firm with another firm or one department with another department, and
- (v) to assess the financial stability of a business concern.

TOOLS OF FINANCIAL ANALYSIS

Financial Analyst can use a variety of tools for the purposes of analysis and interpretation of financial statements particularly with a view to suit the requirements of the specific enterprise. The principal tools are as under

- 1 Comparative Financial Statements
- 2 Common-size Statements
- 3 Trend Analysis
- 4 Cash Flow Statement
- 5 Ratio Analysis
- 6 Funds Flow statements

1. Comparative Financial Statements : Comparative financial statements are those statements which have been designed in a way so as to provide time perspective to the consideration of various elements of financial position embodied in such

statements. In these statements figures for two or more periods are placed side by side to facilitate comparison.

Both the Income Statement and Balance Sheet can be prepared in the form of Comparative Financial Statements.

a) Comparative Income Statement: The comparative Income Statement is the study of the trend of the same items/group of items in two or more Income Statements of the firm for different periods. The changes in the Income Statement items over the period would help in forming opinion about the performance of the enterprise in its business operations. The Interpretation of Comparative Income Statement would be as follows:

- (i) The changes in sales should be compared with the changes in cost of goods sold. If increase in sales is more than the increase in the cost of goods sold, then the profitability will improve.
- (ii) An increase in operating expenses or decrease in sales would imply decrease in operating profit and a decrease in operating expenses or increase in sales would imply increase in operating profit.
- (iii) The increase or decrease in net profit will give an idea about the overall profitability of the concern.

Illustration 1 : The Income Statement of Sumit Ltd. are given for the years 2001 and 2002. Rearrange the figures in a comparative form and study the profitability position of the firm.

Items	2001 (Rs.)	2002 (Rs.)
Net Sales	17,00,000	22,00,000
<i>Less</i> Cost of Goods Sold	12,00,000	15,00,000
Gross Profit	5,00,000	7,00,000
<i>Less</i> Operating Expenses (Administration, Selling, Distribution Expenses)	75,000	1,00,000
Operating Profit	4,25,000	6,00,000
<i>Add</i> Other Incomes	25,000	40,000
Earnings before Interest & Tax	4,50,000	6,40,000
<i>Less</i> Interest	40,000	40,000
Earnings before Tax	4,10,000	6,00,000
<i>Less</i> Tax Payable	84,000	1,60,000
Profit after Tax	3,26,000	4,40,000

Solution :

Comparative Income Statement
For the year ended 31st March, 2001 and 2002

Items	31 03 01 Rs	31 03 02 Rs	Increase (Decrease) (Rs)	Percentage Increase (Decrease)
Net Sales	17 00 000	22,00 000	5,00 000	29 41
Less Cost of Goods Sold	12,00,000	15 00,000	3,00,000	25 0
Gross Profit	5,00,000	7,00 000	2,00,000	40 0
Less Operating Expenses (Administration Selling & Distribution Expenses)	75,0000	1,00,000	25,000	33 3
Operating Profit	4,25,000	6,00,000	1,75,000	41 17
Add Other Incomes	25,000	40 000	15,000	60 0
Earning before Interest & Tax	4,50,000	6,40 000	1 90,000	42 2
Less Interest	40,000	40,000	-	-
Earning before tax	4,10 000	6,00,000	1,90,000	46 34
Less Tax	84,000	1,60 000	76,000	90 5
Earnings after Tax	3,26 000	4,40,000	1,14,000	34 97

b) Comparative Balance Sheet

The comparative Balance Sheet analysis would highlight the trend of various items and groups of items appearing in two or more Balance Sheets of a firm on different dates. The changes in periodic balance sheet items would reflect the changes in the financial position at two or more periods. The Interpretation of Comparative Balance Sheets are as follows

- i) The increase in working capital would imply increase in the liquidity position of the firm over the period and the decrease in working capital would imply deterioration in the liquidity position of the firm
- (ii) An assessment about the long-term financial position can be made by studying the changes in fixed assets, capital and long-term liabilities. If the increase in capital and long-term liabilities is more than the increase in fixed assets, it implies that a part of capital and long-term liabilities has been used for financing a part of working capital as well. This will be a reflection of the good financial policy. The reverse situation will be a signal towards increasing degree of risk to which the long-term solvency of the concern would be exposed to
- iii) The changes in retained earnings, reserves and surpluses will give an indication about the trend in profitability of the concern. An increase in reserve and surplus and the Profit and Loss Account is an indication of improvement in profitability of the concern. The decrease in these accounts may imply payment of dividends, issue of bonus shares or deterioration in profitability of the concern

Illustration 2 From the following Balance Sheets of Ram Ltd as on 31st December, 2000 and 2001, prepare a comparative Balance Sheet for the concern

Balance Sheet of Ram Ltd. as on

Liabilities	2000 (Rs.)	2001(Rs.)	Assets	2000(Rs.)	2001Rs.)
Equity share capital	5,00,000	6,00,000	Land & Building	4,00,000	3,50,000
Reserves & surpluses	2,00,000	1,00,000	Plant & Machinery	2,40,000	2,90,000
Debentures	1,00,000	1,50,000	Furniture	25,000	30,000
Mortgage loan	80,000	1,00,000	Bills receivables	75,000	45,000
Bills Payable	30,000	25,000	S Debtors	1,00,000	1,25,000
S Creditors	50,000	60,000	Stock	1,13,000	1,72,000
Other current Liabilities	5,000	10,000	Prepaid Expenses	2,000	3,000
			Cash & Bank Balance	10,000	30,000
	9,65,000	10,45,000		9,65,000	10,45,000

Solution :

Comparative Balance Sheet of Ram Ltd.

Item	Year Ending		Increase (Decrease) (Rs)	Increase/ (Decrease) (Percentage)
	31 12 2000 (Rs)	31 12 2001 (Rs)		
Fixed Assets				
Land & Building	4,00,000	3,50,000	(50,000)	(12.5)
Plant & Machinery	2,40,000	2,90,000	50,000	20.83
Furniture	25,000	30,000	5,000	20.0
Total Fixed Assets	6,65,000	6,70,000	5,000	0.75
Current Assets				
Bills receivable	75,000	45,000	(30,000)	(40.0)
S Debtors	1,00,000	1,25,000	25,000	25.0
Stock	1,13,000	1,72,000	59,000	52.2
Prepaid Expenses	2,000	3,000	1,000	50.0
Cash & Bank Balance	10,000	30,000	20,000	200.0
Total Current Assets	3,00,000	3,75,000	75,000	25.0
Total Assets	9,65,000	10,45,000	80,000	8.29

Shareholders' Funds				
Equity Share Capital	5,00,000	6,00,000	1,00,000	20.0
Reserves & Surpluses	2,00,000	1,00,000	(1,00,000)	(50.0)
Total Shareholders Funds	7,00,000	7,00,000	00,000	0.0
Long-Term Loans				
Debentures	1,00,000	1,50,000	50,000	50.0
Mortgage Loan	80,000	1,00,000	20,000	25.0
Total Long-Term Loans	1,80,000	2,50,000	70,000	38.9
Current Liabilities				
Bills Payable	30,000	25,000	(5,000)	(16.7)
S Creditors	50,000	60,000	10,000	20.0
Other Current Liabilities	5,000	10,000	5,000	100.0
Total Current Liabilities	85,000	95,000	10,000	11.8
Total Liabilities	9,65,000	10,45,000	80,000	8.29

2. Common-size Financial Statements : Common-size Financial Statements are those in which figures reported are converted into percentages to some common base. In the Income Statement the sale figure is assumed to be 100 and all figures are expressed as a percentage of sales. Similarly in the Balance sheet the total of assets or liabilities is taken as 100 and all the figures are expressed as a percentage of this total.

a) Common Size Income Statement

In the case of Income Statement, the sales figure is assumed to be equal to 100 and all other figures are expressed as percentage of sales. The relationship between items of Income Statement and volume of sales is quite significant since it would be helpful in evaluating operational activities of the concern. The selling expenses will certainly go up with increase in sales. The administrative and financial expenses may go up or may remain at the same level. In case of decline in sale, selling expenses should definitely decrease.

Illustration 3 : From the following Profit and Loss Accounts and the Balance Sheets of Swadeshi Polytext Ltd for the year ended 31st December 2000 and 2001, you are required to prepare common size statements.

Profit and Loss Account

Particulars	2000	2001	Particulars	2000	2001
	Rs	Rs		Rs	Rs
To Cost of Goods sold	600	750	By Net Sales	800	1,000
To Operating Expenses					
Administration Expenses	20	20			
Selling Expenses	30	40			
To Net Profit	150	190			
	<u>800</u>	<u>1,000</u>		<u>800</u>	<u>1,000</u>

Balance Sheet
As on 31st December

(in lakhs of Rs.)

Liabilities	2000	2001	Assets	2000	2001
Bills Payable	50	75	Cash	100	140
Sundry Creditors	150	200	Debtors	200	300
Tax Payable	100	150	Stock	200	300
14% Debentures	100	150	Land	100	100
16% Preference Capital	300	300	Building	300	270
Equity Capital	400	400	Plant	300	270
Reserves	200	245	Furniture	100	140
	<u>1,300</u>	<u>1,520</u>		<u>1,300</u>	<u>1,520</u>

Solution :

Swadeshi Polytex Limited
COMMON-SIZE INCOME STATEMENT
For the years ended 31st December 2000 and 2001

(Figures in percentages)

Particulars	2000	2001
Net Sales	100	100
Cost of Goods Sold	75	75
Gross Profit	<u>25</u>	<u>25</u>
Operating Expenses		
Administration Expenses	2.50	2
Selling Expenses	3.75	4
Total Operating Expenses	<u>6.25</u>	<u>6</u>
Operating Profit	18.75	19

Interpretation : The above statement shows that though in absolute terms, the cost of goods sold has gone up, the percentage of its cost to sales remains consistent at 75%. This is the reason why the Gross Profit continues at 25% of sales. Similarly, in absolute terms the amount of administration expenses remains the same but as percentage to sales it has come down by 5%. Selling expenses have increased by 25%. This all leads to net increase in net profit by 25% (i.e., from 18.75% to 19%).

b) Common Size Balance Sheet

For the purpose of common size Balance Sheet, the total of assets or liabilities is taken as 100 and all the figures are expressed as percentage of the total. In other words, each asset is expressed as percentage to total assets, liabilities and each liability is expressed as percentage to total assets/liabilities. This statement will throw light on the solvency position of the concern by

providing an analysis of pattern of financing both long-term and working capital needs of the concern

Swadeshi Polytex Limited
COMMON-SIZE BALANCE SHEET
For the years ended 31st December 2000 and 2001

	(Figures in percentage)	
	2000	2001
Assets	100	100
Current Assets		
Cash	7.70	9.21
Debtors	15.38	19.74
Stock	15.38	19.74
Total Current Assets	38.46	48.69
Fixed Assets .		
Building	23.07	17.76
Plant	27.03	17.76
Furniture	7.70	9.21
Land	7.70	6.68
Total Fixed Assets	61.54	51.31
Total Assets	100	100

	2000 %	2001 %
Liabilities and Capital	100	100
Current Liabilities		
Bills Payable	3.84	4.93
Sundry Creditors	11.54	13.16
Taxes Payable	7.69	9.86
Total Current Liabilities	<u>23.07</u>	<u>27.95</u>
Long-term Liabilities		
14% Debentures	7.69	9.86
Capital & Reserves		
16% Preference Share Capital	23.10	19.72
Equity Share Capital	30.76	26.32
Reserves	15.38	16.15
Total Shareholder's Funds	<u>76.93</u>	<u>72.05</u>
Total Liabilities and Capital	100	100

Interpretation The percentage of current assets to total assets was 38.46 in 2000. It has gone up to 48.69 in 2001. Similarly the percentage of current liabilities to total liabilities (including capital) has also gone up from 23.07 to 27.95 in 2001. Thus, the proportion of current assets has increased by a higher percentage (about 10) as compared to increase in the proportion of current liabilities (about 5). This has improved the working capital position of the company. There has been a slight deterioration in the debt-equity ratio though it continues to be very sound. The proportion of shareholder's funds in the total liabilities has come down from 69.24% to 62.19%, while that of the debenture-holders has gone up from 7.69% to 9.86%.

3. Trend Analysis

The third tool of financial analysis is trend analysis. This is immensely helpful in making a comparative study of the financial statements of several years. Under this method trend percentages are calculated for each item of the financial statement taking the figure of base year as 100. The starting year is usually taken as the base year. The trend percentages show the relationship of each item with its preceding year's percentages. These percentages can also be presented in the form of index numbers showing relative change in the financial data of certain period. This will exhibit the direction, (i.e., upward or downward trend) to which the concern

is proceeding. These trend ratios may be compared with industry ratios in order to know the strong or weak points of a concern. These are calculated only for major items instead of calculating for all items in the financial statements.

While calculating trend percentages, the following precautions may be taken:

- The accounting principles and practices must be followed constantly over the period for which the analysis is made. This is necessary to maintain consistency and comparability.
- The base year selected should be normal and representative year.

(c) Trend percentages should be calculated only for those items which have logical relationship with one another

(d) Trend percentages should also be carefully studied after considering the absolute figures on which these are based. Otherwise, they may give misleading conclusions

(e) To make the comparison meaningful, trend percentages of the current year should be adjusted in the light of price level changes as compared to base year

Illustration 4 Interpret the results of operations of a trading concern using trend ratios, on the following information

(Amount in '000 Rupees)

For the year ended 31st March				
Items	2001	2000	1999	1998
Sales (net)	13,000	12,000	9,500	10,000
Cost of goods sold	7,280	6,960	5,890	6,000
Gross Profit	5,720	5,040	3,610	4,000
Selling Expenses	1,200	1,100	970	1,000
Net Operating Profit	4,520	3,940	2,640	3,000

Solution :

Trend Ratios
31st March, 1998=100

Items	1998	1999	2000	2001
Sales	100	95	120	130
Gross of Goods sold	100	98	116	121
Gross Profit	100	90	126	143
Selling Expenses	100	97	110	120
Net Operating Profit	100	88	131	150

Interpretation

From the above statement the following points are worth noting

(a) The sales volume, cost of goods sold and selling expenses all declined in 1999 as compared to 1998 but the decrease in cost of goods sold and selling expenses was lesser to the decrease in sales volume

(b) The sales volume, cost of goods sold and selling expenses in 2000 and 2001 have increased in comparison to 1998 but the increase in cost of goods sold and selling expenses is lesser to the increase in sales volume

In conclusion, it can be said that a large proportion of cost of goods sold and selling expenses is fixed and is not affected by changes in sales volume. This fact also becomes clear from this fact that in 1999 when sales fell down, the decrease in the company's net operating profit was faster to sales volume and in 2001 when the sales volume increased, the increase in company's net profit was faster to sales volume

MEANING OF RATIO ANALYSIS:

A ratio is a simple arithmetical expression of the relationship of one number to another. According to Accountant's Handbook by Wilson, Kelland and Bedford, "a ratio" is an expression of the quantitative relationship between two numbers." In simple language ratio is one number expressed in terms of the other and can be worked out by dividing one number into the other. This relationship can be expressed as (i) percentages, say, net profits are 20 per cent of sales (assuming net profits of Rs 20,000 and sales of Rs 1,00,000), (ii) fraction (net profit is one-fourth of sales) and (iii) proportion of numbers (the relationship between net profits and sales is

1:4). The rationale of ratio analysis lies in the fact that it makes related information comparable. A single figure by itself has no meaning but when expressed in terms of a related figure, it yields significant inferences. Ratio analysis helps in financial forecasting, making comparisons, evaluating solvency position of a firm, etc. For instance, the fact that the net profits of a firm amount to, say, Rs 20 lakhs throws no light on its adequacy or otherwise. The figure of net profit has to be considered in relation to other variables. How does it stand in relation to sales? What does it represent by way of return on total assets used or total capital employed? In case net profits are shown in terms of their relationship with items such as sales, assets, capital employed, equity capital and so on, meaningful conclusions can be drawn regarding their adequacy. Ratio analysis, thus, as a quantitative tool, enables analysts to draw quantitative answers to questions such as: Are the net profits adequate? Are the assets being used efficiently? Can the firm meet its current obligations and so on? However, ratio analysis is not an end in itself. Calculation of mere ratios does not serve any purpose, unless several appropriate ratios are analyzed and interpreted. The following are the four steps involved in the ratio analysis:

- (i) Selection of relevant data from the financial statements depending upon the objective of the analysis
- (ii) Calculation of appropriate ratios from the above data
- (iii) Comparison of the calculated ratios with the ratios of the same firm in the past, or the ratios developed from projected financial statements or the ratios of some other firms or the comparison with ratios of industry to which the firm belongs
- (iv) Interpretation of the ratio

13.3 INTERPRETATION OF RATIOS

The interpretation of ratios is an important factor. Though calculation is also important but it is only a clerical task whereas interpretation needs skills, intelligence and foresightedness. The interpretation of the ratios can be done in the following ways:

1. Single Absolute Ratio: Generally speaking one cannot draw meaningful conclusions when a single ratio is considered in isolation. But single ratios may be studied in relation to certain rules of thumb which are based upon well proven contentions as for example 2:1 is considered to be a good ratio for current assets to current liabilities.

2. Groups of Ratio : Ratios may be interpreted by calculating a group of related ratios. A single ratio supported by related additional ratios becomes more understandable and meaningful.

3. Historical Comparisons : One of the easiest and most popular ways of evaluating the performance of the firm is to compare its present ratios with the past ratios called comparison over time.

4 **Projected Ratios** : Ratios can also be calculated for future standard based upon the projected financial statements. Ratio calculation on actual financial statements can be used for comparison with the standard ratios to find out variance, if any. Such variance helps in interpreting and taking corrective action for improvement in future.

5 **Inter-firm Comparison** : Ratios of one firm can also be compared with the ratios of some other selected firms in the same industry at the same point of time.

MANAGERIAL USES OF RATIO ANALYSIS:

The following are the important managerial uses of ratio analysis –

1 *Helps in Financial Forecasting* : Ratio analysis is very helpful in financial forecasting. Ratios relating to past sales, profits and financial position form the basis for setting future trends.

2 *Helps in Comparison* : With the help of ratio analysis, ideal ratios can be composed and they can be used for comparing a firm's progress and performance. Inter-firm comparison or comparison with industry averages is made possible by the ratio analysis.

3 *Financial Solvency of the Firm* : Ratio analysis indicates the trends in financial solvency of the firm. Solvency has two dimensions—long-term solvency and short-term solvency. Long-term solvency refers to the financial viability of a firm and it is closely related with the existing financial structure. On the other hand, short-term solvency is the liquidity position of the firm. With the help of ratio analysis conclusions can be drawn regarding the firm's liquidity and long term solvency position.

4. *Evaluation of Operating Efficiency* : Ratio analysis throws light on the degree of efficiency in the management and utilisation of its assets and resources. Various activity ratios measure this kind of operational efficiency and indicate the guidelines for economy in costs, operations and time.

5 *Communication Value* : Different financial ratios communicate the strength and financial standing of the firm to the internal and external parties. They indicate the over-all profitability of the firm.

6 *Others Uses* : Financial ratios are very helpful in the diagnosis of financial health of a firm. They highlight the liquidity, solvency, profitability and capital gearing etc. of the firm.

DRAW BACKS OF RATIO ANALYSIS:

1. **Limited use of a single ratio** : Ratio can be useful only when they are computed in a sufficient large number. A single ratio would not be able to convey anything. At the same time, if too many ratios are calculated, they are likely to confuse instead of revealing any meaningful conclusion.

2. **Effect of inherent limitations of accounting** : Because ratios are computed from historical accounting records, so they also possess those limitations and weaknesses as accounting records possess.

4 **Lack of proper standards** : While making comparisons, it is always a challenging job to find out an adequate standard. It is not possible to calculate exact and well accepted absolute standard, so a quality range is used for this purpose. If actual performance is within this range, it may be regarded as satisfactory.

5 **Past is not indicator of future** : It is not always possible to make future estimates on the basis of the past as it always does not come true.

6 **No allowance for change in price level** : While making comparisons of ratios, no allowance for changes in general price level is made. A change in price level can seriously affect the validity of comparisons of ratios computed for different time periods.

7 **Difference in definitions** : Comparisons are also made difficult due to differences in definitions of various financial terms. The terms like gross profit, net profit, operating profit etc. have not precise definitions and an established procedure for their computation.

8. **Window Dressing** : Financial statements can easily be window dressed to present a better picture of its financial and profitability position to outsiders. Hence one has to be careful while making decision on the basis of ratios calculated from such window dressing made by a firm.

9 **Personal Bias** : Ratios are only means of financial analysis and is not an end in itself. Ratios have to be interpreted carefully because the same ratio can be looked at, in different ways.

CLASSIFICATION OF RATIOS:

Ratios can be classified into five broad groups (i) Liquidity ratios (ii) Activity ratios (iii) Leverage/Capital structure ratios (iv) Coverage ratios (v) Profitability ratios

Liquidity Ratios : Liquidity refers to the ability of a firm to meet its current obligations as and when they become due. The importance of adequate liquidity in the sense of the ability of a firm to meet current/short-term obligations when they become due for payment can hardly be overstressed. In fact, liquidity is a prerequisite for the very survival of a firm. The ratios which indicate the liquidity of a firm are (i) net working capital, (ii) current ratio, (iii) acid test/quick ratio, (iv) super quick ratio, (v) basic defensive interval.

1. Net Working Capital : The first measurement of liquidity of a firm is to compute its Net Working capital (NWC). NWC is really not a ratio, it is frequently employed as a measure of a company's liquidity position. NWC represents the excess of current assets over current liabilities. A firm should have sufficient NWC in order to be able to meet the claims of the creditors and the day-to-day needs of business. The greater the amount of NWC, the greater the liquidity of the firm. Inadequate working capital is the first sign of financial problems for a firm. It is useful for purposes of internal control also.

$NWC = \text{Total Current Assets} - \text{Total Current Liabilities}$

Illustration 1. : The following data has been given in respect of two general insurance firms. Calculate their NWC and comment upon the liquidity position.

	Company X	Company Y
Total Current Assets	Rs. 2.80.000	Rs. 1.30.000
Total Current Liabilities	Rs. 2.20.000	Rs. 1.10.000

Solution :

$$NWC = TCA - TCL$$

$$\text{Company X : Rs. } 2.80.000 - \text{Rs. } 2.20.000 = \text{Rs. } 60.000$$

$$\text{Company Y : Rs. } 1.30.000 - \text{Rs. } 1.10.000 = \text{Rs. } 20.000$$

X company has three times NWC in comparison to Y company, hence it is more liquid. However, the size of NWC alone is not an appropriate measure of the liquidity position of a firm. The composition of current assets is also important in this respect.

2. Current Ratio : Current ratio is the most common ratio for measuring liquidity. Being related to working capital analysis, it is also called the working capital ratio. The current ratio is the ratio of total current assets to total current liabilities.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

As a measure of short-term financial liquidity, it indicates the rupees of current assets available for each rupee of current liability. The higher the current ratio, the larger the amount of rupees available per rupee of current liability, the more the firm's ability to meet current obligations and the greater the safety of funds of short-term creditors. If the result is greater than 1, the firm presumably has sufficient current assets to meet its current liabilities. A ratio of 2:1 (two times current assets of current liabilities) is considered satisfactory as a rule of thumb. Thus, a good current ratio, in a way, provides a margin of safety to the creditors.

3. Acid-Test/Quick Ratio : One defect of the current ratio is that it fails to convey any information on the composition of the current assets of a firm. A rupee of cash is considered equivalent to a rupee of inventory or receivables. But it is not so. A rupee of cash is more readily available to meet current obligations than a rupee of, say, inventory. This impairs the usefulness of the current ratio. The acid test ratio is a measure of liquidity designed to overcome this defect of the current ratio. It is often referred to as quick ratio because it is a measurement of a firm's ability to convert its current assets quickly into cash in order to meet its current liabilities. Thus, it is a measure of quick or acid liquidity.

Acid-test ratio = The term quick assets refers to current assets which can be converted into cash immediately or at a short notice without diminution of value. Included in this category of current assets are (i) cash and bank balances, (ii) short-term marketable securities and (iii) debtors/receivables. Thus, the current assets which are excluded are prepaid expenses and inventory. The exclusion of inventory is based on the reasoning that it is not easily and readily convertible into cash. Prepaid expenses by their very nature are not available to pay off current debts. An acid-test ratio of 1:1 or greater is recommended.

4. Cash-Position Ratio or Super-Quick Ratio : It is a variant of Quick ratio. When liquidity is highly restricted in terms of cash and cash equivalents, this ratio should be calculated. It is calculated by dividing the super-quick current assets by the current liabilities of a firm. The super-quick current assets are cash and marketable securities. It can be calculated as below.

$$\text{Cash-Position Ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

$$\text{Cash} + \text{Marketable Securities} + \text{Current Liabilities}$$

Illustration 2 : From the following information regarding current assets and current liabilities of a firm, comment upon the liquidity of the concern.

Current Assets	Rs
Cash	50,000
Debtors	20,000
Bills Receivables	15,000
Stock	35,000
Investment in Govt. Securities	25,000
Prepaid Expenses	10,000
	<u>1,55,000</u>
Current Liabilities .	
Trade Creditors	27,000
Bills Payable	12,000
Outstanding Expenses	5,000
Provision for Taxation	18,000
Bank Overdraft	10,000
	<u>72,000</u>

Solution :

$$\begin{aligned}
 (1) \quad \text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{155000}{72.000} = 2.15 : 1 \\
 (2) \quad \text{Quick Ratio} &= \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{110.000}{72.000} = 1.53 : 1 \\
 (3) \quad \text{Cash Position Ratio} &= \frac{\text{Cash} + \text{Marketable Securities}}{\text{Current Liabilities}} \\
 &= \frac{75.000}{72.000} = 1.04 : 1
 \end{aligned}$$

Activity Ratios

Activity ratios which are also called efficiency ratio or asset utilization ratios are concerned with measuring the efficiency in asset management. The efficiency with which the assets are used would be reflected in the speed and rapidity with which assets are converted into sales. The greater is the rate of turnover or conversion, the more efficient is the utilization/management, other things being equal. For this reason, such ratios are also designated as turnover ratios.

1 **Inventory Turnover Ratio :** It is computed as follows

$$\text{Inventory turnover ratio} = \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

The cost of goods sold means sales minus gross profit. The average inventory refers to the simple average of the opening and closing inventory. The ratio indicates how fast inventory is sold. A high ratio is good from the view point of liquidity and vice versa. A low ratio would signify that inventory does not sell fast and stays on the shelf or in the warehouse for a long time.

2 Debtors Turnover Ratio : This ratio is determined by dividing the net credit sales by average debtors outstanding during the year. Thus,

$$\text{Debtors turnover ratio} = \frac{\text{Net credit sales}}{\text{Average debtors}}$$

Net credit sales consist of gross credit sales minus sales returns, if any, from customers. Average debtors is the simple average of debtors at the beginning and at the end of year. The ratio measures how rapidly debts are collected. A high ratio is indicative of shorter time-lag between credit sales and cash collection. A low ratio shows that debts are not being collected rapidly.

3 Creditors Turnover Ratio : It is a ratio between net credit purchases and the average amount of creditors outstanding during the year. It is calculated as follows

$$\text{Creditors turnover ratio} = \frac{\text{Net credit purchases}}{\text{Average creditors}}$$

Net credit purchases = Gross credit purchases less returns to suppliers

Average creditors = Average of creditors outstanding at the beginning and at the end of the year

A low turnover ratio reflects liberal credit terms granted by suppliers, while a high ratio shows that accounts are to be settled rapidly.

4. Average Age of Sundry Debtors : The average age of sundry debtors (or accounts receivable), or average collection period is more meaningful figure to use in evaluating the firm's credit and collection policies. The main objective of calculating average collection period is to find out cash inflow rate from realization from debtors. It is found by a simple transformation of the firm's accounts receivable turnover

$$\text{Average Age of Debtors} = \frac{365}{\text{Debtors Turnover}}$$

It can be calculated as follows also .

$$\text{Average Collection Period} = \frac{\text{Trade Debtors}}{\text{Net Credit Sales}} \times \text{No. of working days}$$

The average of collection period should not exceed the standard or stated credit period in sales terms plus 13 of such days. If it happens, it will indicate either liberal credit policy or slackness of management in realizing debts or accounts receivable.

Illustration 3 : A manufacturer of stoves sells to retailers on terms 2½% discount in 30 days, 60 days net. The debtors and receivables at the end of December of past two years and net sales for all these two years are as under

	2000	2001
	Rs.	Rs
Debtors	33,932	85,582
Bills Receivables	3,686	9,242
Net Sales	3,37,392	4,43,126

Determine the average collection period for both years and comment

Solution:

$$\text{Average Collection Period} = \frac{\text{Trade Receivables}}{\text{Net Credit Sales}} \times \text{No. of Working Days}$$

2000	$\frac{37,618}{3,37,392}$	$365 = 41$ days
2001	$\frac{94,824}{4,43,126}$	$365 = 78$ days

Comment : The average collection period in both years has been within standard period, i.e. 80 days (60+ 23 of 60 days), Hence it is good

Illustration 4 : The comparative statement of income and financial position of a company are given below

	1999	2000
	Rs	Rs.
Net Sales	75,000	92,000
Less Cost of Sales	50,000	69,000
Gross Profit	<u>25,000</u>	<u>23,000</u>
Less Operating Expenses (including Rs 3,000 p.a. for Depreciation)	22,000	21,000
Net Profit	<u>3,000</u>	<u>2,000</u>
Cash in hand	6,000	7,000
Debtors	30,000	18,000
Stock at cost	12,000	9,000
Fixed Assets (Net)	51,000	53,000
	<u>99,000</u>	<u>87,000</u>
Creditors and Bills Payable	19,000	10,000
Debentures	20,000	15,000
Share Capital	50,000	58,000
Surplus (earned)	10,000	4,000
	<u>99,000</u>	<u>87,000</u>

During the year 1979, 10% Stock Dividend was declared and paid. The factors for the change in earned surplus during 2000 are, inter-alia, profit and cash dividends. Compare the following

(i) Debtors turnover for two years

(ii) Liquidity Ratio for two years

(iii) Current Ratio for two years

(iv) Average collection period assuming all sales as credit sales

(v) If desirable current ratio is 3:1 what should be the amount of current liabilities at the end of 2000?

Solution :

(i) Debtors Turnover

$$\left(\frac{\text{Trade Receivables}}{\text{Net Credit Sales}} \times 100 \right) \quad \frac{30,000}{75,000} \times 100 = 40\% \quad \left| \quad \frac{18,000}{92,000} \times 100 = 19.56\%$$

(ii) Liquidity Ratio = Liquid Assets / Current Liabilities

$$1999 \quad 36,000 / 19,000 = 1.9:1$$

$$2000 \quad 25,000 / 10,000 = 2.5:1$$

(iii) Current Ratio = Current Assets / Current Liabilities

$$1999 \quad 48,000 / 19,000 = 2.5:1$$

$$2000 \quad 34,000 / 10,000 = 3.4:1$$

(iv) Average Collection Period = $\frac{\text{Trade Receivables}}{\text{Net Credit Sales}} \times \text{No. of Working Days}$

$$1999 \quad \frac{30,000}{75,000} \times 365 = 146 \text{ days}$$

$$2000 \quad \frac{18,000}{92,000} \times 365 = 71 \text{ days}$$

(v) As the current assets for 2000 are Rs. 34,000 and the desirable Current Ratio is 3:1, the current liability must be one-third of the current assets, i.e. Current Liabilities = $34,000 \times \frac{1}{3} = \text{Rs. } 11,333$

5. Assets Turnover Ratio : This ratio is also known as the investment turnover ratio. It is based on the relationship between the cost of goods sold and assets/investments of a firm. A reference to this was made while working out the overall profitability of a firm as reflected in its earning power. Depending upon the different concepts of assets employed, there are many variants of this ratio. Thus,

1	Total assets turnover	=	$\frac{\text{Cost of goods sold}}{\text{Average total assets}}$
2	Fixed assets turnover	=	$\frac{\text{Cost of goods sold}}{\text{Average fixed assets}}$
3	Capital turnover	=	$\frac{\text{Cost of goods sold}}{\text{Average capital employed}}$
4	Current assets turnover	=	$\frac{\text{Cost of goods sold}}{\text{Average current assets}}$

Here, the total assets and fixed assets are net of depreciation and the assets are exclusive of fictitious assets like debit balance of profit and loss account and deferred expenditures and so on

Leverage/Capital Structure Ratios : The second category of financial ratios is leverage ratios. The long-term creditors would judge the soundness of a firm on the basis of the long-term financial strength measured in terms of its ability to pay the interest regularly as well as repay the instalment of the principal on due dates or in lump sum at the time of maturity. The long-term solvency of a firm can be examined by using leverage or capital structure ratios. The leverage ratios may be defined as financial ratios which throw light on the long-term solvency of a firm as reflected in its ability to assure the long-term creditors with regard to (i) periodic payment of interest during the period of the loan and (ii) repayment of principal on maturity or in predetermined installments at due dates.

1 **The Debt-equity Ratio** – This ratio establishes the relationship between the long-term funds provided by creditors and those provided by the firm's owners. It is commonly used to measure the degree of financial leverage of the firm. It is calculated as follows:

Some experts use the following formula to calculate this ratio.

$$\text{Debt-equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}}$$

Generally, a ratio of 2.1 is considered satisfactory.

2. **Proprietary Ratio** : This ratio is also known as Shareholders' Equity to Total Equities Ratio or Net Worth to Total Assets Ratio. It indicates the relationship of Shareholders' equity to total assets or total equities. As per formula:

$$\text{Proprietary Ratio} = \frac{\text{Shareholders Funds}}{\text{Total tangible Asset or Total Equities}}$$

Higher the ratio better the financial position of the firm

3. **The Solvency Ratio** – It is also known as Debt Ratio. It is a difference of 100 and proprietary ratio. It measures the proportion of total assets provided by the firm's creditors. This ratio is calculated as follows:

$$\text{Solvency Ratio (or Debt Ratio)} = \frac{\text{Total Debt}}{\text{Total Tangible Assets}}$$

Interpretation :

Generally, lower the rate of total liabilities to total assets, more satisfactory or stable is the long-term solvency position of a firm

4. Fixed Assets to Net Worth Ratio – One of the important aspects of sound financial position of a firm is that its fixed assets are totally financed out of shareholders' funds. If aggregate of fixed assets exceeds the net worth (or proprietors' funds), it proves that fixed assets have been financed with outsiders' funds (or creditors' funds). It may create difficulty in the long-run. Thus ratio is calculated as follows

$$\text{Fixed Assets-Net Worth Ratio} = \frac{\text{Fixed Assets (after depreciation)}}{\text{Proprietors' Funds}}$$

This ratio should not exceed 1.1. On the contrary, lower the ratio, better the position. Usually, a ratio of 0.67-1 is considered satisfactory.

5. Proprietors' Liabilities Ratio : This ratio indicates the relationship of proprietors' funds to total liabilities. It is calculated as follows

$$\text{Proprietors' Liabilities Ratio} = \frac{\text{Proprietors' Funds}}{\text{Total Liabilities}}$$

Higher the ratio, better is the position of creditors

6. Fixed Assets Ratio

A variant to the ratio of fixed assets to net worth is the ratio of fixed assets to all long-term funds which is calculated as

$$\text{Fixed Assets Ratio} = \frac{\text{Fixed Assets (After depreciation)}}{\text{Total long-term funds}}$$

Interpretation :

This ratio indicates the extent to which the total of fixed assets are financed by long term funds of the firm. Generally, the total of the fixed assets should be equal to total of the long-term funds or say the ratio should be 100%. And if total long-term funds are more than total fixed assets, it means that part of working capital requirement is met out

7. Ratio of Current Assets to Proprietary's Funds

The ratio is calculated by dividing the total of current assets by the amount of shareholder's funds. For example, if current assets are Rs. 2,00,000 and shareholder's Funds are Rs. 4,00,000 the ratio of current assets to proprietors funds in terms of percentage would be

$$= \frac{\text{Current Assets}}{\text{Shareholders Funds}} \cdot 100$$

$$= \frac{2,00,000}{4,00,000} \cdot 100$$

Interpretation :

This ratio indicates the extent to which proprietors funds are invested in current assets. There is no rule of thumb for this ratio and depending upon the nature of the business there may be different ratios of different firms.

8. Debt-Service Ratio

Net income to debt service ratio or simply debt service ratio is used to test the debt-servicing capacity of a firm. The ratio is also known as interest coverage ratio or fixed charges cover or times interest earned. This ratio is calculated by dividing the net profit before interest and taxes by fixed interest charges.

$$\text{Debt Service or Interest Coverage Ratio} = \frac{\text{Net Profit (before interest and tax)}}{\text{Fixed Interest Charges}}$$

Interpretation

Interest coverage ratio indicates the number of times interest is covered by the profits available to pay the interest charges. Long-term creditors of a firm are interested in knowing the firm's ability to pay interest on their long-term borrowings. Generally, higher the ratio, more safe are long term creditors because even if earnings of the firm fall, the firm shall be able to meet its commitment of fixed interest charges. But a too high interest coverage ratio may not be good for the firm because it may imply that firm is not using debt as a source of finance so as to increase the earnings per share.

Illustration 5 : Extracts from financial account of X, Y, Z Ltd are given below

	Year I		Year II	
	Assets Rs.	Liabilities Rs	Assets Rs	Liabilities Rs
Stock	10,000		20,000	
Debtors	30,000		30,000	
Payment in advance	2,000		—	
Cash in hand	20,000		10,000	
Sundry Creditors		25,000		30,000
Acceptances		15,000		12,000
Bank Overdraft		—		5,000
	<u>62,000</u>	<u>40,000</u>	<u>65,000</u>	<u>47,000</u>

Sales amounted to Rs 3,50,000 in the first year and Rs 3,00,000 in the second year. You are required to comment on the solvency position of the concern with the help of accounting ratios.

Solution :

Short-term Solvency Analysis :

$$(1) \text{ Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Year I} = \frac{10,000 + 30,000 + 2,000 + 20,000}{25,000 + 15,000} = 1.55:1$$

$$\text{Year II} = \frac{20,000 + 30,000 + 15,000}{30,000 + 12,000 + 5,000} = 1.38:1$$

$$(2) \text{ Liquid or Quick Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Year I} = \frac{10,000 + 30,000 + 2,000}{25,000 + 15,000} = 1.30:1$$

$$\text{Year II} = \frac{30,000 + 15,000}{30,000 + 12,000} = 1.07:1$$

Note : Bank overdraft is not included in liquid liabilities, as it tends to become some sort of a permanent mode of financing

$$(3) \text{ Inventory Turnover Ratio} = \frac{\text{Net Sales}}{\text{Average Inventory}}$$

$$\text{Year I} = \frac{3,50,000}{10,000} = 35:1$$

$$\text{Year II} = \frac{3,00,000}{15,000} = 20:1$$

$$(4) \text{ Inventory Current Assets Ratio} = \frac{\text{Inventory}}{\text{Total Current Assets}} \times 100$$

$$\text{Year I} = \frac{10,000}{62,000} \times 100 = 16\%$$

$$\text{Year II} = \frac{20,000}{65,000} \times 100 = 31\%$$

$$(5) \text{ Average Collection Period} = \frac{\text{Trade Receivables}}{\text{Net Credit Sales}} \times \text{No. of Working Days}$$

$$\text{Year I} = \frac{30,000}{3,50,000} \times 365 = 31.3 \text{ days}$$

$$\text{Year II} = \frac{30,000}{3,00,000} \times 365 = 36.5 \text{ days}$$

The liquidity position (or short-term solvency) of the company is not sound. The current ratio in the first year, 1.55:1 does not appear to be good enough as it is below the norm of 2:1. In the second year, the position has further deteriorated to 1.38:1. The latter ratio shows a definite weakening in the solvency position of the company. As regards Acid Test Ratio, it is satisfactory in the first year and not alarming in the second year, as it is above the generally accepted standard of 1:1. However, the fall in the cash balance and appearance of bank overdraft in the second year show a definite deterioration in the financial position. Moreover, because of factors concerning sales, stock and debtors, the quick ratio is likely to soon deteriorate. The inventory turnover ratio, indicates a deterioration in the second year. The disproportionate rise in the percentage of stock of total current

assets from 16% in the first year to 31% in the second year is also a matter of concern. This shows over-purchase of materials which needs a thorough investigation. A comparison of debtors' turnover ratios of the two years indicates worsening of the company's liquid position. There will be much cause of worry, if the sales is only to a few customers.

Long-term Solvency Analysis

$$(1) \text{ Debt to Equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}}$$

$$\text{Year I} = \frac{25,000 + 15,000}{62,000 - 40,000} = \frac{40,000}{22,000} = 1.82:1$$

$$\text{Year II} = \frac{30,000 + 12,000 + 5,000}{65,000 - 47,000} = \frac{47,000}{18,000} = 2.61:1$$

$$(2) \text{ Proprietary Ratio} = \frac{\text{Shareholders' Equities}}{\text{Total Equities}}$$

$$\text{Year I} = \frac{22,000}{62,000} = 35\%$$

$$\text{Year II} = \frac{18,000}{65,000} = 28\%$$

To sum up, the financial position of the company is very unsatisfactory as the debt to equity ratio and proprietary ratio are far off the norm in both the years. The situation has worsened in the second year resulting in a serious decline in the shareholders' equity. The company seems to be heavily banking upon creditors' funds. The overall conclusion of the above analysis is that the solvency position of the company is not satisfactory and has deteriorated in the second year.

13.6.4 Coverage Ratios : The another category of leverage ratios are coverage ratios. These ratios are computed from information available in the profit and loss account. The coverage ratios measure the relationship between what is normally available from operations of the firms and the claims of the outsiders. The important coverage ratios are as follows:

1. Interest Coverage Ratio : This ratio measures the debt servicing capacity of a firm insofar as fixed interest on long-term loan is concerned. It is determined by dividing the operating profits or earnings before interest and taxes (EBIT) by the fixed interest charges on loans. Thus,

$$\text{Interest coverage} = \frac{\text{EBIT}}{\text{Interest}}$$

From the point of view of the creditors, the larger the coverage, the greater is the ability of the firm to handle fixed-charge capabilities and the more assured is the payment of interest to the creditors. However, too high a ratio may imply unused debt capacity.

2. Dividend Coverage Ratio : It measures the ability of a firm to pay dividend on preference shares which carry a stated rate of return. This ratio is computed as under

$$\text{Dividend coverage} = \frac{\text{EAT}}{\text{Preference dividend}}$$

The ratio, like the interest coverage ratio, reveals the safety margin available to the preference shareholders. As a rule, the higher the coverage, the better it is from their point of view.

3. Total Coverage Ratio : The total coverage ratio has a wider scope and takes into account all the fixed obligations of a firm, that is, (i) interest on loan, (ii) preference dividend, (iii) Lease payments, and (iv) repayment of principal

$$\text{Total coverage} = \frac{\text{EBIT} + \text{Lease payment}}{\text{Interest} + \text{Lease payments} + (\text{Preference dividend} + \text{Instalment of principal})(1-t)}$$

4. Debt-Services Coverage Ratio (DSCR) : This ratio is considered more comprehensive and apt measure to compute debt service capacity of a business firm. It provides the value in terms of the number of times the total debt service obligations consisting of interest and repayment of principal in installments are covered by the total operating funds, available after the payment of taxes

$$\text{DSCR} = \frac{\sum_{t=1}^n \text{EAT}_t + \text{Interest}_t + \text{Depreciation}_t + \text{OA}_t}{\sum_{t=1}^n \text{Instalment}_t}$$

The higher the ratio, the better it is. In general, lending financial institutions consider 2:1 as satisfactory ratio.

Profitability Ratios : Apart from the creditors, also interested in the financial soundness of a firm are the owners and management or the company itself. The management of the firm is naturally eager to measure its operating efficiency. Similarly, the owners invest their funds in the expectation of reasonable returns. Profitability ratios can be determined on the basis of either sales or investments.

1. Profitability Ratios Related to Sales : These ratios are based on the premise that a firm should earn sufficient profit on each rupee of sales. These ratios consist of (1) profit margin, and (2) expenses ratio.

(i) **Gross Profit Margin :**

Illustration 6 : Calculate the Gross Profit Ratio from the following figures :

Sales	Rs 1,00,000	Purchases	Rs 60,000
Sales Returns	10,000	Purchases Returns	15,000
Opening Stock	20,000	Closing Stock	5,000

Solution :

$$\begin{aligned} \text{Gross Profit Ratio} &= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 \\ &= \frac{\text{Net Sales} - \text{Cost of Goods sold}}{\text{Net Sales}} \times 100 \\ &= \frac{\text{Rs } 90,000 - \text{Rs } 60,000}{\text{Rs } 90,000} \times 100 \\ &= \frac{\text{Rs } 30,000}{\text{Rs } 90,000} \times 100 = 33.33\% \end{aligned}$$

A high ratio of gross profit to sales is a sign of good management as it implies that the cost of production of the firm is relatively low. It may also be indicative of a higher sales price without a corresponding increase in the cost of goods sold. A relatively low gross margin is definitely a danger signal, warranting a careful and detailed analysis of the factors responsible for it.

(ii) Net profit margin is also known as net margin. This measures the relationship between net profits and sales of a firm. Depending on the concept of net profit employed, this ratio can be computed in two ways

1. **Operating profit ratio** =
$$\frac{\text{Earnings before interest and taxes (EBIT)}}{\text{Sales}}$$
2. **Net profit ratio** =
$$\frac{\text{Earnings after interest and taxes (EAT)}}{\text{Sales}}$$

This ratio is indicative of management's ability to operate the business with sufficient success not only to recover from revenues of the period, the cost of merchandise or services, the expenses of operating the business (including depreciation) and the cost of the borrowed funds, but also to leave a margin of reasonable compensation to the owners for providing their capital at risk. The ratio of net profit (after interest and taxes) to sales essentially expresses the cost price effectiveness of the operation. A high net profit margin would ensure adequate return to the owners.

2. **Expenses Ratio** : Another profitability ratio related to sales is the expenses ratio. It is computed by dividing expenses by sales

1. **Cost of goods sold ratio** =
$$\frac{\text{Cost of goods sold}}{\text{Net sales}} \times 100$$
2. **Administrative expenses ratio** =
$$\frac{\text{Administrative expenses}}{\text{Net sales}} \times 100$$
3. **Selling expenses ratio** =
$$\frac{\text{Selling expenses}}{\text{Net sales}} \times 100$$
4. **Operating ratio** =
$$\frac{\text{Cost of goods sold} + \text{Operating expenses}}{\text{Net sales}} \times 100$$

The expenses ratio should be compared over a period of time with the industry average as well as firms of similar type. As a working proposition, a low ratio is favourable, while a high one is unfavourable.

3. **Rate of Return on Equity Share Capital** : This ratio is calculated by dividing the net profits (after deducting income-tax and dividend on preference share capital) by the paid up amount of equity share capital. It is usually expressed in percentage as below

$$\text{Rate of Return of Equity Share Capital} = \frac{\text{Net Profit (after tax and Pref Div.)}}{\text{Paid-up Equity Share Capital}} \times 100$$

This ratio examines the earning capacity of equity share capital.

4. **Return on Proprietors Funds on Return on Net Worth** : Some experts suggest to calculate return on net worth instead of calculating return on equity share capital. The proprietors funds or net

worth represents the total interest of shareholders which include share capital (whether equity or preference) and all accumulated profits. Alternatively, proprietors' funds may be taken equal to fixed assets plus current assets minus all outside liabilities both long-term and current. This ratio may be calculated as under

$$\text{Return on Proprietors' Funds} = \frac{\text{Net Profits (less taxes)}}{\text{Proprietors' Funds}}$$

This ratio helps the proprietors and potential investors to judge the earning of the company in relation to others and the adequacy of the return on proprietors' funds.

5. Return on Investment (ROI) Ratio : This is one of the key profitability ratios. It examines the overall operating efficiency or earning power of the company in relation to total investment in business. It indicates the percentage of return on the capital employed in the business. It is calculated on the basis of the following formula

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

The term capital employed has been given different meanings by different accountants. Some of the popular meanings are as follows

- (i) Sum-total of all assets whether fixed or current
- (ii) Sum-total of fixed assets
- (iii) Sum-total of long-term funds employed in the business, i.e.,
Share Capital + Reserves and Surplus + Long term Loans + Non-business Assets + Fictitious Assets

In management accounting the term capital employed is generally used in the meaning given in the point third above.

The term Operating Profit means Profit before Interest and Tax. The term Interest means Interest on long-term Borrowings. Interest on short-term borrowings will be deducted for computing operating profit. Non-trading incomes such as interest on Government securities or non-trading losses or expenses such as loss on account of fire, etc. will also be excluded.

The computation of ROI can be understood with the help of the following illustration

Illustration 7 : From the following figures extracted from the Income Statement and Balance Sheet of Anu Sales Pvt Ltd, calculate the Return on Total Capital employed (ROI)

Particulars	Amount Rs.	Particulars	Amount Rs.
Fixed Assets	4,50,000	Reserves	1,00,000
Current Assets	1,50,000	Debentures	1,00,000
Investment in Govt. Securities	1,00,000	Income from Investments	10,000
Sales	5,00,000	Interest on Debentures at 10%	
Cost of goods sold	3,00,000	Provision for tax at 50% of Net Profits	
Share Capital .			
10% Preference	1,00,000		
Equity	2,00,000		

Solution : It will be appropriate to prepare the Profit and Loss Account and the Balance Sheet of the company before computation of the returns on capital employed

Anu Sales Pvt. Limited
Profit and Loss Account

Particulars	Amount Rs.	Particulars	Amount Rs.
To Cost of goods sold	3,00,000	By Sales	5,00,000
To Interest on Debentures	10,000	By Income from Investments	10,000
To Provision for Taxation	1,00,000		
To Net profit after tax	1,00,000		
	5,10,000		5,10,000

Balance Sheet as on .

Liabilities	Rs	Assets	Rs.
Share Capital		Fixed Assets	1,50,000
10% Preference	1,00,000	Current Assets	1,50,000
Equity	2,00,000	Investment in govt. Securities	1,00,000
Reserves	1,00,000		
10% Debentures	1,00,000		
Profit and Loss Account	1,00,000		
Provision for Taxation	1,00,000		
	7,00,000		7,00,000

Return on total capital employed = $\frac{\text{Net operating profit before interest and tax}}{\text{Total capital employed}}$

$$= \frac{2,00,000}{5,00,000} \times 100$$

$$= 40\%$$

Net Operating Profit	=	Net Profit + Provision for Tax – Income from Investments + Interest on Debentures
	=	Rs.1,00,000 + Rs 1,00,000 – Rs 10,000 – Rs. 10,000
	=	Rs 2,00,000
Capital employed	=	Fixed Assets + Current Assets – Provision for Tax
	=	Rs 4,50,000 + Rs 1,50,000 – Rs 1,00,000
	=	Rs 5,00,000
Or	=	Share Capital + Reserves + Debentures + Profit & Loss Account Balance – Investment in Govt Securities
	=	Rs 3,00,000 + Rs. 1,00,000 + Rs. 1,00,000 + Rs 1,00,000 – Rs. 1,00,000
	=	Rs. 5,00,000

Significance of ROI : The Return on Capital invested is a concept that measures the profit which a firm earns on investing a unit of capital. Yield on capital is another term employed to express the idea. It is desirable to ascertain this periodically. The profit being the net result of all operations, the return on capital expresses all efficiencies or inefficiencies of a business collectively and thus is a dependable basis for judging its overall efficiency or inefficiency. On this basis, there can be comparison of the efficiency of one department with that of another or one plant with that of another, one company with that of another and one industry with that of another. For this purpose, the amount of profits considered is that before making deductions on account of interest, income-tax and dividends and capital is the aggregate of all the capital at the disposal of the company, viz, equity capital, preference capital, reserve, debentures, etc. The Return on Capital when calculated in this manner would also show whether the company's borrowing policy was wise economically and whether the capital had been employed fruitfully. Suppose, funds have been borrowed at 8% and the Return on Capital is 7½% it would have been better not to borrow (unless borrowing was vital for survival). It would also show that the firm had not been employing the funds efficiently.

Limitations of ROI : ROI is one of the very important measures for judging the overall financial performance of a firm. However, it suffers from certain important limitations. These limitations are

(i) **Manipulation is possible :** ROI is based on earnings and investments. Both these figures can be manipulated by management by adopting varying accounting policies regarding depreciation, inventory valuation, treatment of provisions, etc. The decision in respect of most of these matters is arbitrary and subject to whims of the management.

(ii) **Different bases for computation of Profit and Investments :** There are different bases for calculating both profit and investment as explained in the preceding pages. For example, fixed assets may be taken at gross or net values, earnings may be taken before or after tax, etc.

(iii) **Emphasis on short-term profit :** ROI emphasizes the generation of short term profits. The firm may achieve this objective by cutting down cost such as those on research and development or sales promotion. Cutting down of such costs without any justification may adversely affect the profitability of the firm in the long run, though ROI may indicate better performance in the short run.

(iv) **Poor Measure :** ROI is a poor measure of a firm's performance since it is also affected by many extraneous and non-controllable factors.

6. Return on Capital Employed (ROCE) : The ROCE is the second type of ROI. It is similar to the ROA except in one respect. Here the profits are related to the total capital employed. The term capital employed refers to long-term funds supplied by the creditors and owners of the firm. The higher the ratio, the more efficient is the use of capital employed. The ROCE can be computed in different ways as shown below.

$$1 \quad \text{ROCE} = \frac{\text{Net profit after taxes/EBIT}}{\text{Average total capital employed}} \times 100$$

$$2 \quad \text{ROCE} = \frac{\text{Net profit after taxes} + \text{Interest} + \text{Tax advantage on interest}}{\text{Average total capital employed}} \times 100$$

(7) Earnings Per Share (EPS) measures the profit available to the equity shareholders on a per share basis, that is, the amount that they can get on every share held. It is calculated by dividing the profits available to the shareholders by the number of the outstanding shares. The profits available to be the ordinary shareholders are represented by net profits after taxes and preference dividend. Thus,

$$\text{EPS} = \frac{\text{Net profit available to equity holders}}{\text{Number of ordinary shares outstanding}}$$

8. Dividend Per Share (DPS) is the dividends paid to shareholders on a per share basis. In other words, DPS is the net distributed profit belonging to the shareholders divided by the number of ordinary shares outstanding. That is,

$$\text{DPS} = \frac{\text{Dividend paid to ordinary shareholders}}{\text{Number of ordinary shares outstanding}}$$

The DPS would be a better indicator than EPS as the former shows what exactly is received by the owners.

9. Dividend-Pay Out (D/P) Ratio : This is also known as pay-out ratio. It measures the relationship between the earnings belonging to the ordinary shareholders and the dividend paid to them. In other words, the D/P ratio shows what percentage share of the net profits after taxes and preference dividend is paid out as dividend to the equity holders.

$$\text{D/P} = \frac{\text{Dividend per ordinary share (DPS)}}{\text{Earnings per share (EPS)}} \times 100$$

If the D/P ratio is subtracted from 100, it will give that percentage share of the net profits which are retained in the business.

10. Earnings and Dividend Yield : This ratio is closely related to the EPS and DPS. While the EPS and DPS are based on the book value per share, the yield is expressed in terms of the market value per share.

This ratio is calculated as follows

$$1 \quad \text{Earning yield} = \frac{\text{EPS}}{\text{Market value per share}} \cdot 100$$

$$2 \quad \text{Dividend yield} = \frac{\text{DPS}}{\text{Market value per share}} \cdot 100$$

The earning yield is also called the earning-price ratio

Price Earnings (P/E) Ratio is closely related to the earnings yield/earnings price ratio. It is actually the reciprocal of the latter. This ratio is computed by dividing the market price of the shares by the EPS. Thus,

$$\text{P/E ratio} = \frac{\text{Market price of share}}{\text{EPS}}$$

The P/E ratio reflects the price currently being paid by the market for each rupee of currently reported EPS. In other words, the P/E ratio measures investors' expectations and the market appraisal of the performance of a firm.

FUND FLOW STATEMENT

MEANING OF FLOW OF FUNDS:

The term 'flow' means movement and includes both 'inflow' and 'outflow'. The term 'flow of funds' means transfer of economic values from one asset or equity to another. Flow of funds is said to have taken place when any transaction makes changes in the amount of funds available before happening of the transaction. If the effect of transaction results in the increase of funds, it is called a source of funds and if it results in the decrease of funds, it is known as an application of funds. Further, in case the transaction does not change funds, it is said to have not resulted in the flow of funds. According to the working capital concept of funds, the term 'flow of funds' refers to the movement of funds in the working capital. If any transaction results in the increase in working capital, it is said to be a source or inflow of funds and if it results in the decrease of working capital, it is said to be an application or outflow of funds.

Rule of Flow of Funds

The flow of funds occurs when a transaction changes on the one hand a non-current account and on the other a current account and vice-versa. When a change in a non-current account e.g., fixed assets, long-term liabilities, reserves and surplus, fictitious assets, etc., is followed by a change in another non-current account, it does not amount to flow of funds. This is because of the fact that in such cases neither the working capital increases nor decreases. Similar, when a change in one current account results in a change in another current account, it does not affect funds. Funds move from non-current to current transactions or vice-versa only. In simple language funds move when a transaction affects (i) current asset and a fixed asset, or (ii) a fixed and a current liability, or (iii) a current asset and a fixed liability, or (iv) a fixed liability and current liability, and funds do not move when the transaction affects fixed assets and fixed liability or current assets and current liabilities.

Examples

(a) Transactions which involve only the current accounts and hence do not result in the flow of funds

- 1 Cash collected from debtors
- 2 Bills receivables realized
- 3 Cash paid to creditors
- 4 Payment or discharge of bills payable
- 5 Issued bills payable to trade creditors
- 6 Received acceptances from customers
- 7 Raising of short-term loans
- 8 Sale of purchased for cash or credit
- 9 Goods purchased for cash or credit

(b) Transactions which involve only non-current accounts and hence do not result in the flow of funds

- 1 Purchase of one new machine in exchange of two old machines
- 2 Purchase of building or furniture in exchange of land
- 3 Conversion of debentures into shares
- 4 Redemption of preference shares in exchange of debentures
- 5 Transfers to General Reserves, etc
- 6 Payment of bonus in the form of shares
- 7 Purchase of fixed assets in exchange of shares, debentures, bonds or long-term loans
- 8 Writing off of fictitious assets
- 9 Writing off a accumulated losses or discount on issue of shares, etc

(c) Transactions which involve both current and non-current accounts and hence result in the flow of funds

- 1 Issue of shares for cash
- 2 Issue of debentures for cash
- 3 Raising of long-term loans
- 4 Sale of fixed assets on cash or credit
- 5 Sale of trade investments
- 6 Redemption of Preference shares
- 7 Redemption of debentures
- 8 Purchase of fixed assets on cash or credit
- 9 Purchase of long-term/trade investments
- 10 Payment of bonus in cash
- 11 Repayment of long-term loans
- 12 Issue of shares against purchase of stock-in-trade

FUNDS FLOW STATEMENT

The Funds Flow Statement is a financial statement which reveals the methods by which the business has been financed and how it has used its funds between the opening and closing Balance Sheet dates. According to Anthony, "The Funds Flow Statement describe the sources from which additional funds were derived and the uses to which these funds were put". The analysis of such statements over periods of time clearly shows the sources from which past activities have been

financed and brings to highlight the uses to which such funds have been put. The statement is known by various titles, such as, Statement of Sources and Applications of Funds, Statement of Changes in Working Capital, Where Got and Gone Statement and Statement of Resources Provided and Applied

Objectives of Funds Flow Statement

Generally a business prepares two financial statements i.e., Balance Sheet and Profit and Loss Account. The former reflects the state of assets and liabilities of a company on a particular date whereas the latter tells about the result of operations of the company over a period of a year. These financial statements have great utility but they do not reveal the movement of funds during the year and their consequent effect on its financial position. For example, a company which has made substantial profits during the year, may discover to its surprise that there are not enough liquid funds to pay dividend and income tax because of profits tied up in other assets, and is always after the bank authorities to get the cash credit or bank overdraft facility. In order to remove this defect, another statement known as Funds Flow Statement is prepared.

The main purposes of such statement are

- (i) To help to understand the changes in assets and asset sources which are not readily evident in the Income Statement or the financial position statement
- (ii) To inform as to how the loans to the business have been used, and
- (iii) To point out the financial strengths and weaknesses of the business

USES OF FUNDS FLOW STATEMENT:

The various uses of Funds Flow Statement are summarized as under

- (a) As a tool of historical analysis, it provides an answer to some of the important financial questions such as
 - (i) How was it possible to distribute dividend in excess of current earnings or in the presence of a net loss for the period? (i.e. the firm might have raised funds from other sources also in addition to funds from operations)
 - (ii) Why has the net working capital decreased although the net income for the period has gone up? (i.e. the firm might have applied the funds more than the sources of funds)
 - (iii) Why has the net working capital increased even though there has been a net loss for the period? (i.e., the firm might have raised the funds more than the application of funds)
 - (iv) What happened to the proceeds of the sale of plant and equipment? (e.g., the firm might have purchased some fixed assets or it might have redeemed the redeemable debentures or preference shares)
 - (v) Why did the firm resort to long-term borrowings in spite of large profits?
 - (vi) Why did the firm issue new equity or preference shares?
 - (vii) How was the retirement of long-term debts or redemption of redeemable preference shares accomplished? (e.g. the firm might have issued new shares)
- (b) As a tool of planning, the Projected Fund Flow Statement enables the management to plan its future investments, operating and financial activities such as the repayment of long-term loans and interest thereon, modernization or expansion of plant, payment of cash dividend etc
- (c) Along with a Schedule of Changes in Working Capital, the Funds Flow Statement helps in managing and utilizing the working capital. The management can know the adequacy or otherwise

of the working capital and can plan for the effective use of surplus working capital or can make arrangement in case of inadequacy of working capital Besides this, the management can identify the magnitude and directions of changes in various components of working capital and if there is any undesired situation such as heavy inventory accumulations, heavy funds locked up in receivables than normally required, the necessary action may be taken so as to achieve the desired level thereof

LIMITATIONS OF FUNDS FLOW STATEMENT:

The major limitations of Funds Flow Statement are summarized below

- (a) It ignores the non-fund transactions In other words, it does not take into consideration those transactions which do not affect the working capital e g , issue of shares against the purchase of fixed assets, conversion of debentures into equity shares
- (b) It is a secondary data based statement It merely rearranges the primary data already appearing in other statements viz Income Statement and Balance Sheet
- (c) It is basically historical in nature, unless Projected Funds Flow Statements are prepared to plan for the future

PROCEDURE FOR PREPARING A FUNDS FLOW STATEMENT:

Funds flow statement is a method by which we study changes in the financial position of a business enterprise between beginning and ending financial statements dates Hence, the Funds Flow Statement is prepared by comparing two Balance Sheets and with the help of such other information derived from the accounts as may be needed Broadly speaking, the preparation of a Funds Flow Statement consists of following two parts

- 1 Statement or Schedule of Changes in Working Capital
- 2 Statement of Sources and Application of Funds

1. Statement or Schedule of Changes in Working Capital Working Capital means the excess of current assets over current liabilities Statement of changes in working capital is prepared to show the changes in the working capital between the two Balance Sheet dates This statement is prepared with the help of current assets and current liabilities derived from the two Balance Sheets The changes in the amount of any current asset or current liability in the current Balance Sheet as compared to that of the previous Balance Sheet either results in increase or decrease in working capital The difference is recorded for each individual current asset and current liability In case a current asset in the current period is more than in the previous period, the effect is an increase in working capital and it is recorded in the increase column But if a current liability in the current period is more than in the previous period, the effect is decrease in working capital and it is recorded in the decrease column or vice versa The total increase and the total decrease are compared and the difference shows the net increase or net decrease in working capital It is worth noting that schedule of changes in working capital is prepared only from current assets and current liabilities and the other information is not of any use for preparing this statement A typical form of statement or schedule of changes in working capital is as follows

Statement or Schedule of Changes in Working Capital

Particulars	Previous Year	Current Year	Effect on Working Capital	
			Increase	Decrease
<i>Current Assets</i>				
Cash in hand				
Cash at bank				
Bills Receivable				
Sundry Debtors				
Temporary Investments				
Stock Inventories				
Prepaid Expenses				
Accrued incomes				
Total Current Assets				
<i>Current Liabilities</i>				
Bills Payable				
Sundry Creditors				
Outstanding Expenses				
Bank Overdraft				
Short-term advances				
Dividends Payable				
Proposed dividends*				
Provision for taxation*				
Total Current Liabilities				
Working Capital (CA-CL)				
Net Increase or Decrease in Working Capital				

* May or may not be a current liability

Illustration 1. Prepare a Statement of changes in Working Capital from the following Balance Sheets of Manjit and Company Limited

BALANCE SHEETS

as on 31st March

Liabilities	2001	2002	Assets	2001	2002
	Rs.	Rs.		Rs.	Rs.
Equity Capital	5,00,000	5,00,000	Fixed Assets	6,00,000	7,00,000
Debentures	3,70,000	4,50,000	Long-term		
Tax Payable	77,000	43,000	Investments	2,00,000	1,00,000
Accounts Payable	96,000	1,92,000	Work-in-Progress	80,000	90,000
Interest Payable	37,000	45,000	Stock-in-trade	1,50,000	2,25,000
Dividend Payable	50,000	35,000	Accounts Receivable	70,000	1,40,000
			Cash	30,000	10,000
	11,30,000	12,65,000		11,30,000	12,65,000

Solution :

Statement of Changes in Working Capital

Particulars	2001 Rs.	2002 Rs.	Effect on Working Capital	
			Increase Rs.	Decrease Rs.
<i>Current Assets</i>				
Cash	30,000	10,000		20,000
Accounts Receivable	70,000	1,40,000	70,000	
Stock-in-trade	1,50,000	2,25,000	75,000	
Work-in-progress	80,000	90,000	10,000	
	3,30,000	4,65,000		
<i>Current Liabilities :</i>				
Tax Payable	77,000	43,000	34,000	
Accounts Payable	96,000	1,92,000		96,000
Interest Payable	37,000	45,000		8,000
Dividend Payable	50,000	35,000	15,000	
	2,60,000	3,15,000		
Working Capital (CA-CL)	70,000	1,50,000		80,000
Net Increase in Working Capital	80,000			80,000
	1,50,000	1,50,000	2,04,000	2,04,000

2. Statement of Sources and Application of Funds

Funds flow statement is statement which indicates various sources from which funds (working capital) have been obtained during certain period and the uses or applications to which these funds have been put during that period. Generally, this statement is prepared in two formats

(a) Report Form

(b) T Form or An Account Form or Self Balancing Type

Specimen of Report Form of Funds Flow Statement

<i>Sources of Funds</i>	Rs.
Funds from Operations	
Issue of Share Capital	
Raising of long-term loans	
Receipts from partly paid shares, called up	
Sales of non-current (fixed) assets	
Non-trading receipts, such as dividends received	
Sale of Investments (long-term)	
Decrease in working capital (as per Schedule of Changes in Working Capital)	
Total	
<hr/>	
<i>Applications or Uses of Funds</i>	
Funds Lost in Operations	
Redemption of Preference Share Capital	
Redemption of Debentures	
Repayment of long-term loans	
Purchase of non-current (fixed) assets	
Purchase of long-term Investments	
Non-trading payments	
Payments of dividends*	
Payment of tax*	
Increase in Working Capital (as per Schedule of Changes in Working Capital)	
Total	

T Form or An Account Form or Self Balancing Type

Funds Flow Statement

<i>Sources</i>	<i>Rs</i>	<i>Applications</i>	<i>Rs</i>
Funds from Operations		Funds lost in Operations	
Issue of Share Capital		Redemption of Preference Share Capital	
Issue of Debentures		Redemption of Debentures	
Raising of long-term loans		Repayment of long-term loans	
Receipts from partly paid shares, called up		Purchase of non-current investments	
Sale of non-current (fixed) assets		Non-trading payments	
Sale of long-term investments		Payment of Dividends	
Net Decrease in Working Capital		Net Increase in Working Capital	

* Note Payment of dividend and tax will appear as an application of funds only when these items are appropriations of profits and not current liabilities

Sources of Funds : The following are the sources from which funds generally flow (come), into the business

1 Funds from operation or Trading Profits

Trading profits or the profits from operations of the business are the most important and major source of funds. Sales are the main source of inflow of funds into the business as they increase current assets (cash, debtors or bills receivable) but at the same time funds flow out of business for expenses and cost of goods sold. Thus, the net effect of operations will be a source of funds if inflow from sales exceeds the outflow for expenses and cost of goods sold and vice-versa. But it must be remembered that funds from operations do not necessarily mean the profit as shown

by the Profit and Loss Account of a firm, because there are many non-fund or non-operating items which may have been either debited or credited to Profit and Loss Account. The examples of such items on the debit side of a Profit and Loss Accounts are amortization of fictitious and intangible assets such as goodwill, preliminary expenses and discount on issue of shares and debentures written off, appropriation of retained earnings, such as transfers to reserves, etc., depreciation and depletion, loss on sale of fixed assets, payment of dividend, etc. The non-fund items are those which may be operational expenses but they do not affect funds of the business, e.g., in case of depreciation charged to Profit and Loss Account, funds really do not move out of

business. Non-operating items are those which although may result in the outflow of funds but are not related to the trading operations of the business, such as loss on sale of machinery or payment of dividends. There are two methods of calculating funds from operations which are as follows

(a) *The first method* is to prepaid the Profit and Loss Account afresh by taking into consideration only fund and operational items which involve funds and are related to the normal operations of the business. The balancing figure in this case will be either funds generated from operations or funds lost in operations depending upon whether the income or credit side or Profit and Loss Account exceeds the expense or debit side of Profit and Loss Account or vice-versa

(b) *The second method* (which is generally used) is to proceed from the figure of net profit or net loss as arrived at from the Profit and Loss Account already prepared. Funds from operations by this method can be calculate as under

(a) Calculation of Funds from Operation

	Rs
Closing Balance of Profit and Loss Account (as given in the Balance Sheet)	
Add: Non-fund and Non-operating items which have been already debited to Profit and Loss Account	
(i) Depreciation and Depletion	
(ii) Amortization of fictitious and Intangible Assets such as Goodwill, Patents, Trade marks, Preliminary Expenses, Discount on Issue of Shares, etc.	
(iii) Appropriation of Retained Earnings, such as Transfer to General Reserve, Dividend Equalisation Fund, Transfer to Sinking Fund, Contingency Reserve etc.	
(iv) Loss on the Sale of any non-current (fixed) assets such as Loss on sale of land and building, Loss on sale of machinery, Loss on sale of furniture, Loss on sale of long-term investments etc.	
(v) Dividends including Interim Dividend, Proposed Dividend (if it is an appropriation of profits and not taken as current liability)	
(vi) Provision for Taxation (if it is not taken as Current Liability)	
(vii) Any other non-fund/non-operating items which have been debited to Profit and Loss Account	
Total (A)	
Less: Non-fund or Non-operating items which have already been credited to Profit and Loss Account	
(i) Profit or Gain from the sale of non-current (fixed) assets such as Sale of land and building, Sale of plant & machinery, Sale of long-term investments, etc.	
(ii) Appreciation in the value of fixed assets, such as increase in the value of land if it has been credited to Profit and Loss Account	
(iii) Dividends Received	
(iv) Excess Provision retransferred to Profit and Loss Account or written off	
(v) Any other non-operating item which has been credited to Profit and Loss Account	
(vi) Opening balance of Profit and Loss Account or Retained Earnings (as given in the Balance Sheet)	
Total (B)	
Total (A) – Total (B) = Funds generated by operations	

(b) Funds from operations can also be calculated by preparing Adjusted Profit and Loss Account as follows .

Adjusted Profit and Loss Account

	<i>Rs.</i>		<i>Rs.</i>
To Depreciation & Depletion or amortization of fictitious and intangible assets, such as . Goodwill, Patents, Trade Marks, Preliminary Expenses etc		By Opening Balance (of P&L A/c)	
To Appropriation of Retained Earnings, such as : Transfers to General Reserve, Dividend Equalisation Fund, Sinking Fund, etc		By Transfers from excess provisions	
To Loss on Sales of any non-current or fixed assets		By Appreciation in the value of fixed assets	
To Dividends (including interim dividend)		By Dividends received	
To Proposed Dividend (if not taken as a current liability)		By Profit on sale of fixed or non-current assets	
To Provision for taxation (if not taken as a current liability)		By Funds from Operations (balancing figure in case debit side exceeds credit side)	
To Closing balance (of P&L A/c)			
To Funds lost in Operations (balancing figure, in case credit side exceeds the debit side)			

Illustration 2 : Nikhil Company presents the following information and you are required to calculate funds from operations

Profit and Loss Account

Particulars	Rs	Particulars	Rs
To Expenses		By Gross Profit	2,00,000
Operation	1,00,000	By Gain on Sale of Plant	20,000
Depreciation	40,000		
To Loss on Sale of building	10,000		
To Advertisement written off	5,000		
To Discount allowed to customers	500		
To Discount on Issue of Shares written off	500		
To Goodwill	12,000		
To Net Profit	52,000		
	<u>2,20,000</u>		<u>2,20,000</u>

Solution :

Calculation of Funds From Operations

		Rs.
Net Profit (as given)		52,000
<i>Add</i> - Non-fund or non-operating items which have been debited to Profit and Loss Account		
Depreciation	40,000	
Loss on sale of Building	10,000	
Advertisement written off	5,000	
Discount on issue of shares written off	500	
Goodwill written off	12,000	67,500
		<u>1,19,500</u>
<i>Less</i> : Non-fund or non-operating items which have been credit to Profit and Loss Account		
Gain on sale of Plant	20,000	20,000
Funds from Operations		<u>99,500</u>

2. Issue of Share Capital and Debentures

If during the year there is any increase in the share capital, whether preference or equity, it means capital has been raised during the year. Issue of shares/ debentures is a source of funds as it constitutes inflow of funds. Even the calls received from partly paid shares/debentures constitutes an inflow of funds. It should also be remembered that it is the net proceeds from the issue of share capital which amounts to a source of funds and hence in case shares are issued at premium, even the amount of premium collected shall become a source of funds. The same is true when shares are

issued at discount, it will not be the nominal value of shares but the actual realization after deducting discount that shall amount to inflow of funds. But sometimes shares are issued otherwise than in cash, the following rules must be followed

- (i) Issue of shares or making of partly paid shares as fully paid out of accumulated profits in the form of bonus shares is not a source of funds
- (ii) Issues of shares for consideration other than current assets such as against purchase of land, machines, etc. does not amount to inflow of funds
- (iii) Conversion of debentures or loans into shares also does not amount to inflow of funds

In all the three cases mentioned above, both the accounts involved are non-current and do not involve any current assets or funds

3. Sale of Fixed (non-current assets) and Long-term or Trade investments

When any fixed or non-current asset like land, building, plant and machinery, furniture, long-term investments, etc. are sold it generates funds and becomes a source of funds. However, it must be remembered that if one fixed asset is exchanged for another fixed asset, it does not constitute an inflow of funds because no current assets are involved

4 Non-Trading Receipts

Any non-trading receipt like dividend received, refund of tax, rent received, etc. also increases funds and is treated as a source of funds because such an income is not included in the funds from operations

5 Decrease in Working Capital

If the working capital decreases during the current period as compared to the previous period, it means that there has been a release of funds from working capital and it constitutes a source of funds

Application or Uses of Funds

1 Funds lost in operations

Sometimes the result of trading in a certain year is a loss and some funds are lost during that period in trading operations. Such loss of funds in trading amounts to an outflow of funds and is treated as an application of funds

2 Purchase of fixed assets

Purchase of fixed assets such as land, building, plant, machinery, long-term investments, etc., results in decrease of current assets without any decrease in current liabilities. Hence, there will be a flow of fund. But in case shares or debentures are issued for acquisition of fixed assets, there will be no flow of funds

3 Payment of dividend

Payment of dividend results in decrease of a fixed liability and, therefore, it affects funds. Generally, recommendation of directors regarding declaration of dividend (i.e., proposed dividends) is simply taken as an appropriation of profits and not as an item affecting the working capital

4 Payment of fixed liabilities

Payment of a long-term liability, such as redemption of debentures or redemption of redeemable preference shares, results in reduction of working capital and hence it is taken as an application of funds

5 Payment of tax liability

Provision for taxation is generally taken as an appropriation of profits and not as application of funds. But if the tax has been paid, it will be taken as an application of funds

HIDDEN TRANSACTIONS

While preparing a Funds Flow Statement, one has to analyze the given balance sheets. Items relating to current accounts, i.e., current assets and current liabilities have to be shown in the Schedule of Changes in Working Capital. But the non-current assets and non-current liabilities have to be further analysed to find out the hidden information with regard to sale or purchase of non-current assets, issue or redemption of share capital, raising or repayment of long-term loans, transfer to reserve and provisions, etc. The following items require special care while preparing a Funds Flow Statement

1 Fixed Assets

Sometimes there are certain adjustments or transactions of sale and purchase of fixed assets which are given after two Balance Sheets. Under such circumstances, it is desirable to prepare accounts relating to such fixed assets and provisions or reserve for depreciation. The working of these accounts will be as follows

Fixed Asset Account

Particulars	Rs	Particulars	
Rs			
To Opening Balance b/d		By Adjusted Profit & Loss	
To Bank (Purchase of an Asset Balance)		(Dep't)	
To Adjusted Profit & Loss A/c (Profit on Sale)		By Bank (Sale of an Asset)	
		By Adjusted Profit & Loss A/c (Loss on Sale)	
		By Balance c/d	

Depreciation Account

Particulars	Rs	Particulars	Rs
To Fixed Asset A/c (Accumulated depreciation relating to asset transferred or sold)		By Opening Balance b/d	
To Closing Balance c/d		By Adjusted Profit & Loss A/c (New provision or reserve)	

Illustration 3 The following figures are available from the records of a Company

	2001	2002
	Rs	Rs
Plant and Machinery	80,000	1,20,000

Additional Information

(i) Depreciation charged during the year 50,000

(ii) A part of the plant whose written down value is Rs. 12,000 has been sold for Rs. 7,000

Prepare Plant and Machinery A/c

Solution

Plant and Machinery Account

	Rs		Rs
To Balance b/d	50,000	By Adjusted Profit & Loss A/c (Dep.)	50,000
To Bank A/c (Purchase of Plant & Machinery)		By Bank A/c (Sale)	7,000
(Bal. Fig.)	1,02,000	By Adjusted P.L.A.c (Loss on Sale of Machinery)	5,000
		By Balance c/d	1,20,000
	1,82,000		1,82,000

Thus depreciation of Rs 50,000 and loss on sale of machinery Rs 5,000 will be shown on the debit side of Adjusted Profit and Loss Account Rs 7,000 realized from the sale of plant will be shown as source and Rs 1,02,000 i.e. purchased of plant and machinery as application in the Funds Flow Statement

2 *Proposed Dividend* It can be treated as an item of current liability or noncurrent liability but preferably it should be treated as non-current liability For knowing hidden transactions relating to dividend, it is desirable to prepare proposed dividend account as follows (in case treated as non-current liability)

Proposed Dividend Account

	Rs		Rs
To Bank (Payment of dividend of last year)		By Opening Balance b/d	
To Closing Balance c/d		By Adjusted Profit & Loss A/c (Provision made for the current year)	
		(Bal. fig.)	

If dividend paid during the year is not given, then it is assumed that last year balance must have been paid during the year and provision made during the year must be equal to the closing balance Interim dividend has nothing to do with proposed dividend account If interim dividend is paid it will be shown on the debit side of Adjusted Profit and Loss Account and on the application side of Funds Flow Statement If treated as current liability it will be shown in Schedule of Changes in Working Capital and dividend paid will be shown on the debit side of Profit and Loss Account and as an application in the Funds Flow Statement

3 *Provision for Income tax* Like proposed dividend it can be treated as current liabilities or non-current Liability But preferably it should be treated as non-current liability If income tax paid during the year is not given, then it is assumed that last year balance must have been paid during the year and will be shown as an application in the Funds Flow Statement Provision made during the year must be the closing balance of such account and will be shown on the debit side of Adjusted Profit and Loss A/c Income Tax payable is a current liability The provision for income tax account is prepared as under (if treated as non-current liability)

Provision for Taxation Account

	Rs		Rs
To Bank (Tax paid)		By Opening Balance c/d	
To Closing Balance c/d		By Profit & Loss A/c	
		(Provision made) (Bal fig)	

If treated as a current liability, it will be shown in the Schedule of Changes in Working Capital and tax paid will be shown as an application in the Funds Flow Statement and on the debit side of Profit and Loss Account

4 *Fictitious Assets* If there are certain fictitious assets shown in the Balance Sheet such as discount on issue of shares or debentures, preliminary expenses, underwriting commission, etc., then the balance to be written off to the Adjusted Profit and Loss Account can be calculated by preparing the fictitious asset account. It will be prepared as follows

Fictitious Asset Account

	Rs		Rs
To Opening Balance c/d		By Adjusted Profit & Loss A/c	
		(Bal fig) (written off)	
		By Balance c/d	

5 *Undistributed Reserves and Funds* If there are any undistributed profits in the form of reserves and funds the difference of these reserves and funds will be shown on the debit or credit side of Adjusted Profit and Loss Account. If it increases, it will be shown on the debit side, if it decreases, will be shown on the credit side. The account is shown as under

Reserve Account

	Rs		Rs
To Adjusted Profit & Loss A/c		By Balance c/d	
(reserve utilised)		By Adjusted Profit and Loss A/c	
To Balance c/d		(new reserve)	

Illustration 4 : From the following balances extracted from XYZ Company Ltd. As on 31st March, 2001 and 2002, you are required to prepare a schedule of changes in Working Capital and a Funds Flow Statement

Liabilities	As on		Assets	As on	
	31st March			31st March	
	2001	2002		2001	2002
Share Capital	1,00,000	1,10,000	Building	40,000	38,000
General Reserve	14,000	15,000	Plant and Machinery	37,000	35,000
P & L A/c	16,000	13,000	Investment(L.T.)	10,000	21,000
Creditors	8,000	5,400	Stock	30,000	25,400
B/P	1,200	900	B/R	2,000	3,200
Provision for Tax	16,000	19,000	Debtors	18,000	19,000
Provision for Doubtful Debts	400	600	Cash at Bank	6,600	15,200
			Preliminary Expenses	12,000	10,000
	1,55,600	1,65,800		1,55,600	1,65,800

Additional Information

- (i) Depreciation charged on Plant was Rs 4,000
- (ii) Provision for taxation Rs 19,000 was made during the year 2001-02
- (iii) Interim dividend of Rs 8,000 was paid during the year
- (iv) A piece of machinery was sold for Rs 8,000 during the year 2001-02. It had costed Rs 12,000, depreciation of Rs 7,000 has been provided on it

Solution :

Schedule of Changes in Working Capital

	2001	2002	Increase	Decrease
	Rs	Rs	Rs	Rs
Current Assets -				
Stock	30,000	25,400		6,600
B/R	2,000	3,200	1,200	
Debtors	18,000	19,000	1,000	
Cash at Bank	6,600	15,200	8,600	
Current Liabilities -				
Creditors	8,000	5,400	2,600	
B/P	1,200	900	400	
Provision for Doubtful Debts	400	600		200
			13,800	6,800
				7,000
			13,800	13,800

Funds Flow Statement
for the year ended 31.03.2007

Sources	Rs	Uses	Rs.
Funds from Operations (a)	33,000	Purchase of Machinery (b)	8,000
Sale of Machinery	8,000	Payment of Interest Divided	8,000
Issue of Share Capital	10,000	Purchase of Investment	11,000
		Payment of Tax (c)	17,000
		Increase in Working Capital	7,000
	52,000		51,000

Working Notes :

(a) Adjusted Profit and Loss Account

	Rs		Rs.
To Interest Divided	8,000	By Net Profit b & d	16,000
To Depreciation of Building	2,000	By Profit on Sale of Machinery	3,000
To Preliminary Expenses	2,000	By Fund from Operations	33,000
To General Reserves	4,000		
To Depreciation on Plant and Machinery	4,000		
To Provision for Tax A/c	19,000		
To Net Profit c & d	13,000		
	52,000		52,000

(b) Plant and Machinery Account

	Rs		Rs
To Balance b & d	37,000	By Adjusted P & L A/c (Dep.)	4,000
To Adjusted P&L A/c (Profit)	3,000	By Bank A/c	8,000
To Bank (Purchase of Machinery)	8,000	By Balance c & d	35,000
(Bal. figure)			
	48,000		48,000

(c) Provision for Tax Account

	Rs		Rs
To Bank A/c (Bal. Fig.)	17,000	By Balance b & d	15,000
To Balance c & d	18,000	By Adjusted P&L A/c	19,000
	35,000		35,000

6 *Net Profit or Drawings* Sometimes in case of sole trader or partnership concerns, capital of the proprietor or partners is given but figures of drawings or net profit may be missing. In order to find out these figures, capital account may be prepared as follows:

Capital Account

	Rs		Rs
To Bank (Drawings, (Bal. fig.)		By Balance b & d	
		By Adjusted P & L A/c	
To Balance c & d		(Net Profit) (Bal. fig.)	

7 *Intangible Assets* Intangible assets as goodwill, patents, copyrights, licenses are also written off from the Adjusted Profit and Loss Account. Till these assets are completely written off their balances will be shown in the Balance Sheet. Sometimes additions are also made to these assets. Balance to be written off will be the balancing figure. Such assets accounts are prepared as follows:

Intangible Asset Account

	Rs		Rs
To Balance b/d		By Adjusted Profit & Loss A/c	
To Bank Share Capital A/c (purchase for cash or issue of share capital)		(written off)	
		By Balance c/d	

8 *Redemption of Debentures* When debentures are to be redeemed during a specified period, it must be seen whether the total payment to be made is more or less than the face value of debentures. If it is more than the face value, the excess will be charged to Adjusted Profit and Loss Account as loss on redemption and if less than the face value, the difference will be profit on redemption and will be shown on the credit side of Adjusted Profit and Loss Account. Actual amount paid will be shown an application in the Funds Flow Statement. The account will be prepared as under:

Debentures Account

	Rs		Rs
To Bank (Actual amount paid)		By Opening Balance	
To Adjusted Profit and Loss A/c (Bal. Fig.)		By Adjusted Profit and Loss A/c (loss on redemption)	
(Profit on redemption)		(Bal. Fig.)	

9 *Redemption of redeemable Share* Like redeemable debentures, the redeemable preference shares can be redeemed by the company either at premium or at discount. Excess amount of premium paid along with the face value of the shares will be a charge to Adjusted Profit and Loss Account while discount gained on redemption will be credited to Adjusted Profit and Loss Account. The account of redeemable shares will be prepared as under:

Redeemable Preference Share Capital Account

	Rs		Rs
To Bank		By Opening Balance b/d	
To Profit and Loss A/c (Gain on Redemption)		By Profit and Loss A/c (Premium on Redemption)	

10 *Bonus Shares* Bonus shares are those shares which are issued to the existing shareholders in certain proportion without receiving anything in cash from them. Such shares are issued from existing balances of various accounts such as capital redemption reserve, shares premium, general reserve or Profit and Loss Account. If indication to this respect is given, then that account is

prepared in order to see the net effect of the account to be taken to Adjusted Profit and Loss Account

Is depreciation a source of funds?

Depreciation means decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. Depreciation is taken as an operating expense while calculating funds from operations. The accounting entries are

(1)	Depreciation A/c	Dr
	To Fixed Asset A/c	
(11)	Profit and Loss A/c	Dr
	To Depreciation A/c	

Thus, effectively the Profit and Loss Account is debited while the Fixed Asset Account is credited with the amount of depreciation. Since, both Profit and Loss Account and the Fixed Asset Account are non-current accounts, depreciation is a non-fund item. It is neither a source nor an application of funds. It is added back to Operating Profit to find out funds from operations since it has already been charged to profit but it does not decrease funds from operations. Depreciation should not, therefore, be taken as a 'Source of Funds'. If depreciation were really a source of funds by itself, any enterprise could have improved its funds position at will by merely increasing the periodical depreciation charge.

However, depreciation can be taken as a source of funds in a limited sense because of three reasons:

(i) In case of manufacturing concern, when current assets include closing inventory is and the value of closing inventories includes the depreciation on fixed assets as an element of cost, depreciation acts as a source of funds in such a case.

(ii) Depreciation does not generate funds but it definitely saves funds. For example, if the business had taken the fixed assets on hire, it would have been required to pay rent for them. Since it owns fixed assets, it saves outflow of funds which would have otherwise gone out in the form of rent.

(iii) Depreciation reduces taxable income and therefore, income-tax liability for the period is reduced. This will be clear with the following example:

		Case I	Case II
Income before depreciation	Rs.	75,000	Rs. 75,000
Depreciation provided (A)		<u>Nil</u>	<u>15,000</u>
Taxable income		75,000	<u>60,000</u>
Income tax say at 50 per cent		<u>37,500</u>	<u>30,000</u>
Net Income after (B)		<u>37,500</u>	<u>30,000</u>
Net flow of funds after tax (A) + (B)		37,500	45,000

The above example shows that in case II, the net flow of funds is more by Rs. 7,500 as compared to case I. This is because on account of depreciation charge being claimed as an expense, tax liability has been reduced by Rs. 7,500 in case of case II. It may therefore be said that true funds flow from depreciation is the opportunity saving of cash outflow through taxation.

CASH FLOW STATEMENT

A cash flow statement shows an entity's cash receipts classified by major sources and its cash payments classified by major uses during a period. It provides useful information about an entity's activities in generating cash from operations to repay debt, distribute dividends or invest to maintain or expand its operating capacity, about its financing activities, both debt and equity, and about its investment in fixed assets or current assets other than cash. In other words, a cash flow statement lists down various items and their respective magnitude which bring about changes in the cash balance between two balance sheet dates. All the items whether current or non-current which increase or decrease the balance of cash are included in the cash flow statement. Therefore, the effect of changes in the current assets and current liabilities during an accounting period on cash position, which is not shown in a fund flow statement is depicted in a cash flow statement. The depiction of all possible sources and application of cash in the cash flow statement helps the financial manager in short term financial planning in a significant manner because the short term business obligations such as trade creditors, bank loans, interest on debentures and dividend to shareholders can be met out of cash only. The preparation of cash flow statement is also consistent with the basic objective of financial reporting which is to provide information to investors, creditors and others which would be useful in making rational decisions. The basic objective is to enable the users of information to make prediction about cash flows in an organization since the ultimate success or failure of the business depends upon the amount of cash generated. This objective is sought to be met by preparing a cash flow statement.

DISTINCTION BETWEEN FUND FLOW STATEMENT AND CASH FLOW STATEMENT

Some of the main difference between a fund flow statement and a cash flow statement are described below

1 **Concept of funds** : A fund flow statement is prepared on the basis of a wider concept of funds i.e., net working capital (excess of current assets over current liabilities) whereas cash flow statement is based upon narrower concept of funds i.e., cash only.

2 **Basis of accounting** : A fund flow statement can also be distinguished from a cash flow statement from the point of view of the basis of accounting used for preparing these statements. A fund flow statement is prepared on the basis of accrual basis of accounting, whereas a cash flow statement is based upon cash basis of accounting. Due to this reason, adjustments for incomes received in advance, incomes outstanding, prepaid expenses and outstanding expenses are made to compute cash earned from operations of the business (refer to computation of cash from operations). No such adjustments are made while computing funds from operations in the funds flow statement.

3 **Mode of preparation** : A fund flow statement depicts the sources and application of funds. If the total of sources is more than that of applications then it represents increase in net working capital. On the other hand if the total of applications of funds is more than that of sources then the difference represents decrease in net working capital. A cash flow statement depicts opening and closing balance of cash, and inflows and outflows of cash. In a cash flow statement, to the opening balance of cash all the inflows of cash are added and from the resultant total all the outflows of cash are deducted. The resultant balance is the closing

balance of cash. A cash flow statement is just like a cash account which starts with opening balance of cash on the debit side to which receipts of cash are added and from the resultant total, the total of all the payments of cash (shown on the credit side) is deducted to find out the closing balance of cash.

4 Treatment of current assets and current liabilities : While preparing a funds flow statement the changes in current assets and current liabilities are not disclosed in the funds flow statement rather these changes are shown in a separate statement known as schedule of changes in working capital. In a cash flow statement no distinction is made between current assets and fixed assets, and current liabilities and long-term liabilities. All changes are summarized in the cash flow statements.

5 Usefulness in planning : A cash flow statement aims at helping the management in the process of short term financial planning. A cash flow statement is useful to the management in assessing its ability to meet its short term obligations such as trade creditors, bank loans, interest on debentures, dividend to shareholders and so on. A fund flow statement on the other hand is very helpful in intermediate and long-term planning, because though it is difficult to plan cash resources for two, three or more years ahead yet one can plan adequate working capital for future periods.

Uses and Importance of Cash Flow Statements:

Cash flow statements are of great importance to a financial manager. The information contained in cash flow statement can help the management in the field of short-run financial planning and cash control. Some of the important advantages of cash flow statements are discussed below.

- 1) The projected cash flow statements if prepared in a business disclose surplus or shortage of cash well in advance. This helps in arranging utilization of surplus cash as bank deposits or investment in marketable securities for short periods. Should there be shortage of cash, arrangement can be made for raising the bank loan or sell marketable securities.
- 2) Cash flow statements are of extreme help in planning liquidation of debt, replacement of plant and fixed assets and similar other decisions requiring outflow of cash from the business as they provide information about the cash generating ability of the business.
- 3) The cash flow statement pertaining to a particular year compared with the budget for that year reveals the extent to which the actual sources and applications of cash were in consonance with the budget. This exercise helps in refining the planning process in future.
- 4) The inter-firm and temporal comparison of cash flow statements reveals the trend in the liquidity position of a firm in comparison to other firms in the industry. It can serve as a pointer to the need for taking corrective action if it is observed that the management of cash in the firm is not effective.
- 5) Cash flows statements are more useful in short term financial analysis as compared to fund flow statements since in the short run it is cash which is more important for executing plans rather than working capital.

Limitations of Cash flow Statements:

- 1) The possibility of window dressing in cash position is more than in the case of working capital position of a business. The cash balance can easily be maneuvered by deferring purchases and other payments, and speeding up collections from debtors before the balance sheet date. The possibility of such maneuvering is lesser in respect of working capital position. Therefore a fund flow statement which shows reasons responsible for the changes in the working capital presents a more realistic picture than cash flow statement.

2 The liquidity position of a business does not depend upon cash position only. In addition to cash it is also dependent upon those assets also, which can be converted into cash. Exclusion of these assets while assessing the liquidity of a business obscures the true reporting of the ability of the business in meeting its liabilities on becoming due for payment.

3 Equating of cash generated from the operations of the business with the net operating income of the business is not fair because while computing cash generated from business operations, depreciation on fixed assets is excluded. This treatment leads to mismatch between the expenses and revenue while determining the business results as no charge is made in the profit and Loss account for the use of fixed assets.

4 Relatively larger amount of cash generated from business operations vis-à-vis net profit earned may prompt the management to pay higher rate of dividend, which in turn may affect the financial health of the firm adversely.

PROCEDURE FOR PREPARING A CASH FLOW STATEMENT:

Cash flow statement shows the impact of various transactions on cash position of a firm. It is prepared with the help of financial statements, i.e., balance sheet and profit and loss account and some additional information. A cash flow statement starts with the opening balance of cash and balance at bank, all the inflows of cash are added to the opening balance and the outflows of cash are deducted from the total. The balance, i.e., opening balance of cash and bank balance plus inflows of cash minus outflows of cash is reconciled with the closing balance of cash. The preparation of cash flow statement involves the determining of

- (a) Inflows of cash
- (b) Outflows of cash

(a) Sources of Cash Inflows :

The main sources of cash inflows are

- (1) Cash flow from operations
- (2) Increase in existing liabilities or creation of new liabilities
- (3) Reduction in or Sale of Assets
- (4) Non-trading Receipts

(b) Application of Cash

- (1) Cash lost in operation
- (2) Decrease in or discharge of liabilities
- (3) Increase in or purchase of assets
- (4) Non-trading payments

Generally, cash flow statement is prepared in two forms

- (a) Report form
- (b) T Form or an Account Form or Self Balancing Type

SPECIMEN OF REPORT FORM OF CASH FLOW STATEMENT	
Cash balance in the beginning	
Rs	
<i>Add Cash inflows</i>	
Cash flow from operations	
Sale of assets	
Issue of shares	
Issue of debentures	
Raising of loans	
Collection from debtors	
Non trading receipts such as	
Dividend received	
Income tax refund	
<i>Less Applications or Outflows of cash</i>	
Redemption of Preference shares	
Redemption of debentures	
Repayment of loans	
Purchase of assets	
Payment of dividend	
Payment of taxes	
Cash lost in operations	
Cash Balance at the end	

SPECIMEN OF T FORM OR AN ACCOUNT OF CASH FLOW STATEMENT

	Rs		Rs
Cash balance in the beginning		<i>Outflow of Cash</i>	
<i>Add Cash inflows</i>		Redemption of Preference Shares	
Cash flow from operation		Redemption of Debentures	
Sale of Assets		Repayment of Loans	
Issue of Shares		Purchase of Assets	
Issue of Debentures		Payment of Dividends	
Raising of Loans		Payment of Tax	
Collection from Debtors		Cash lost in Operations	
Dividends Received		Cash Balance at the end	
Refund of tax			

SOURCE OF CASH INFLOWS

1 Cash from Operations or Cash Operating Profit

Cash from trading operations during the year is a very important source of cash inflows. The net effect of various transactions in a business during a particular period is either net profit or net loss. Usually, net profit results in inflow of cash and net loss in outflow of cash. But it does not mean that cash generated from trading operations in a year shall be equal to the net profit or that cash lost in operations shall be identical with net loss. It may either be more or less. Even,

there may be a net loss in a business, but yet there may be a cash inflow from operations. It is so because of certain non-operating (expenses or incomes) charged to the income statement, i.e., Profit and Loss Account

How to Calculate Cash from Operations or Cash Operating Profit ?

There are three methods of determining cash from operations

(a) **From Cash Sales :** Cash from operations can be calculated by deducting cash purchases and cash operating expenses from cash sales, i.e. $\text{Cash from Operations} = (\text{Cash Sales}) - (\text{Cash Purchases} + \text{Cash Operating Expenses})$

Cash sales are calculated by deducting credit sales or increase in receivables from the total sales. From the cash sales, the cash purchases and cash operating expenses are to be deducted. In the absence of any information, all expenses may be assumed to be cash expenses. In case outstanding and prepaid expenses are known given, any decrease in outstanding expenses or increase in prepaid expenses should be deducted from the corresponding figure

(b) **From Net Profit/Net Loss**

Cash from operations can also be calculated with the help of net profit or net loss. Under this method, net profit or net loss is adjusted for non-cash and non-operating expenses and incomes as follows

Calculation of Cash From Trading Operations

	Amount
Net Profit (as given)	
<i>Add</i> Non-cash and Non-operating items which have already been debited to P & L A/c.	
Depreciation	
Transfer to Reserves	
Transfer to Provisions	
Goodwill written off	
Preliminary expenses written off	
Other intangible assets written off	
Loss on sale or disposal of fixed assets	
Increase in Accounts Payable	
Increase in outstanding expenses	
Decrease in prepaid expenses	
<i>Less</i> Non-cash and Non-operating items which have already been credited to P & L A/c	
Increase in Accounts Receivables	
Decrease in Outstanding Expenses	
Increase in Prepaid Expenses	
Cash from Operations	

(C) Cash Operating Profit

Cash operating profit is also calculated with the help of net profit or net loss. The difference in this method as compared to the above discussed method is that increase or decrease in accounts payable and accounts receivable is not adjusted while finding cash from operations and it is directly shown

in the cash flow statement as an inflow or outflow of cash as the cash may be. The cash from operations so calculated is generally called operating profit.

Calculation of Cash Operating Profit	Amount
Net Profit (as given) or Closing Balance of Profit and Loss A/c	
<i>Add</i> Non-cash and non-operating items which have already been debited to P&L A/c	
Depreciation	
Transfers to Reserves and Provisions	
Writing off intangible a/c etc.	
Outstanding Expenses (current year)	
Prepaid Expenses (previous year)	
Loss on Sale of fixed Assets	
Dividend Paid, etc.	
<i>Less</i> Non-cash and non-operating items which have already been credited to P&L A/c	
Profit on Sale or disposal of fixed assets	
Non-trading receipts such as dividend received, rent received, etc.	
Re-transfers from provisions (excess provisions charged back)	
Outstanding income (current year)	
Pre-received income (in previous year)	
Opening balance of P&L A/c	
Cash Operating Profit	

Note: Generally the cash operating profit method has to be followed because of its similarity with calculating funds from operations. However, if this method is followed the following two points need particular care:

(1) **Outstanding/Accrued Expenses :** The outstanding/accrued expenses represent those expenses which are although charged to profit and loss account but no cash is paid during the year. For this reason, outstanding accrued expenses of the current year are added back while calculating cash operating profit. However, if some outstanding expenses of the previous year are also given, these may be assumed to have been paid during the year and hence shown as an outflow of cash in the cash flow statement.

(2) **Prepaid Expenses :** Prepaid expenses are those expenses which are paid in advance and hence result in the outflow of cash but are not charged to profit and loss account because they do not relate to the current period of profit and loss account. For this reason, prepaid expenses of the current year should be taken as an outflow of cash in the cash flow statement. But the expenses, if any, paid in the previous year do not involve outflow of cash in the current year but are charged to profit and loss account. Therefore, prepaid expenses of the previous year (related to the current year) should be added back while calculating cash operating profit. In the similar way, we can deal with outstanding and pre-received incomes.

Illustration 5. Calculate Cash from operations from the following informations

	Rs
Sales	70 000
Purchases	40 000
Expenses	8 000
Creditors at the end of the year	15 000
Creditors in the beginning of the year	12 000

Solution :

	Rs	Rs
Sales		70,000
Less: Purchases	40,000	
Expenses	<u>8,000</u>	<u>48,000</u>
Profit for the year		22,000
Add: Creditors at the end of the year		<u>15,000</u>
		37,000
Less: Creditors at the beginning of the year		<u>12,000</u>
Cash from operations		<u>25,000</u>

2 Increase in Existing Liabilities or Creation of new Liabilities

If there is an increase in existing liabilities or a new liability is created during the year, it results in the flow of cash into the business. The liability may be either a fixed long-term liability such as equity share capital, preference share capital, debentures, long-term loans, etc. or a current liability such as sundry creditors, bills payable, etc.

The inflow of cash may be either Actual or Notional

There is an actual inflow of cash when cash is actually received and generally long-term liabilities result into actual inflow of cash, e.g.

For issue of Shares, during the year, the journal entry shall be

Cash A/c	Dr
To Share Capital A/c	

So, actual cash flows into the business. In the same manner, issue of debentures, raising of loans for cash, etc. result into actual inflows of cash. But when the fixed liabilities are created in consideration of purchase of assets, i.e., other than cash, there is no inflow of actual cash. The journal entry for the issue of debentures in lieu of purchase of machinery is

Plant and Machinery A/c	Dr
To Debentures A/c	

For example, increase in sundry creditors implies purchase of goods on credit. In this case although no cash is actually received but we may say that creditors have given us loans which have been utilized in purchasing goods from them. Hence, increase in the current liabilities may be taken as a source of inflow of cash and decrease in current liabilities as an outflow of cash.

3. Reduction in or Sale of Assets

Whenever a reduction in or sale of any asset—fixed or current—takes place (otherwise than depreciation) it results into inflow of actual or notional cash. There is an actual inflow of cash when assets are sold for cash and notional cash flows in when assets are sold or disposed off on credit. Thus, sale of building, machinery or even reduction in current assets like stocks, debtors, etc. result in inflow of actual/notional cash.

4 Non-Trading Receipts

Sometimes, there may be non-trading receipts like dividend received, rent received, refund of tax, etc. Such receipts or incomes are although non-trading in nature but they result into inflow of cash and hence taken in the cash flow statement.

APPLICATIONS OF CASH OR CASH OUTFLOWS:

1 **Cash Lost in Operations** Sometimes the net result of trading in a particular period is a loss and some cash may be lost during that period in trading operations. Such loss of cash in trading is called cash lost in operations and is shown as an outflow of cash in Cash Flow Statement.

2 **Decrease in or Discharge of Liabilities** : Decrease in or discharge of any liability, fixed or current results in outflow of cash either actual or notional. For example, when redeemable preference shares are redeemed and loans are repaid, it will amount to an outflow of actual cash. But when a liability is converted into another, such as issue of shares for debentures, there will be a notional flow of cash into the business.

3 **Increase in or Purchase of Assets** Just like decrease in or sale of assets is a source or inflow of cash, increase or purchase of any assets is an outflow or application of cash.

4 **Non Trading Payments** : Payment of any non-trading expenses also constitute outflow of cash. For example, payment of dividends, payment of income tax, etc.

Illustration 6 : The following details are available from a company

Liabilities	31-12-98 Rs.	31-12-99 Rs.	Assets	31-12-98 Rs.	31-12-99 Rs.
Share Capital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,000	Debtors	14,900	17,700
Reserve for doubtful debts	700	800	Stock	49,200	42,700
Trade Creditors	10,360	11,440	Land	20,000	30,000
P & L A/c	10,040	10,560	Goodwill	10,000	5,000
	1,03,100	1,03,200		1,03,100	1,03,200

Additional Information: (i) Dividend paid total Rs. 3,500, (ii) Land was purchased for Rs. 10,000. Amount provided for amortization of goodwill Rs. 5,000 and (iii) Debentures paid off Rs. 6,000. Prepare Cash Flow Statement.

Solution :

Cash Flow Statement (for the year ended 31.12.1999)

	Rs.		Rs.
Opening balance of cash on 1.1.1999	9,000	<i>Cash Outflows:</i>	
<i>Add Cash Inflows:</i>		Purchase of Land	10,000
Issue of Share Capital	4,000	Increase in Debtors	2,800
Increase in trade creditors	1,480	Redemption of Debentures	6,000
Cash inflow from operations	9,120	Dividends Paid	3,500
Decrease in stock	6,500	Closing balance of cash on 31.12.1999	7,800
	30,100		30,100

Workings

1 Cash inflow from operations

Adjusted Profit And Loss A/c

	Rs.		Rs.
To Dividend (non-operating)	3 500	By Balance b/d	10,040
To Goodwill (non-fund cash)	5 000	By Cash inflow from operation	9 120
To Reserve for doubtful debts	100		
To Balance c/d	10,560		
	<u>19,160</u>		<u>19,160</u>

Alternatively

	Rs
Balance of P & L A/c on 31 12 1999	10 560
<i>Add</i> non-fund cash and non-operating items which have already been debited to P & L A/c	
Dividend paid	3,500
Goodwill written off	5 000
Reserve for doubtful debts	<u>100</u>
	19 160
<i>Less</i> Opening balance of P & L A/c and non-operating incomes	
Opening balance of P L A/c (on 31 12 1998)	<u>10,040</u>
Cash Inflow from operations	<u>9,120</u>

Register No.

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Subject Code

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SCHOOL OF EXCELLENCE IN LAW
B.Com., LL.B., (Hons.) – 2014-2015
Semester Examinations, March 2015

Sub: PRINCIPLES OF ACCOUNTING

Time : 2 ½ Hours

Maximum : 70 marks

PART – A (2 x 12 = 24 marks)

Answer any TWO of the following in about 500 words each:

- 1.Explain the characteristics of partnership accounts.**
- 2. From the following Trial Balance of Mr. Nitin, prepare Trading and Profit and Loss Account for the year ending 31st March, 2002 and Balance Sheet on that date :**

Debit Balance	Rs.	Credit Balance	Rs.
Drawings	14,200	Capital	85,000
Plant and Machinery	19,000	Sales	2,38,120
Stock on 1st April 2001	29,200	Discount Received	1,200
Purchases	2,07,240	Provision for Doubtful Debts	2,100
Bills Receivable	4,800	Returns outward	5,820
Returns Inwards	4,200	Apprenticeship premiums	2,400
Cash in hand	960	Bank Overdraft	4,000
Sundry Debtors	64,000	Sundry Creditors	20,000
Bad debts	3,440	Bills Payable	3,600
Sundry Expenses	8,800		
Rent	2,400		
Rates and Taxes	4,000		
	<u>3,62,240</u>		<u>3,62,240</u>

Adjustments :

- (i) Interest is charged on capital @ 5% per annum.
- (ii) Provide for Doubtful Debts at 5% on sundry debtors.
- (iii) Depreciation is charged on Plant and Machinery @ 10% p.a.
- (iv) Outstanding Rent was Rs. 800
- (v) There were prepaid taxes for Rs. 1,600.
- (vi) Apprenticeship Premium Rs. 400 was to be carried forward.
- (vii) The value of stock on 31st March 2001 was Rs. 34,000.

3. From the following balances extracted from XYZ Company Ltd. As on 31st March, 2001 and 2002, you are required to prepare a schedule of changes in Working Capital and a Funds Flow Statement.

Liabilities	As on 31st March		Assets	As on 31st March	
	2001	2002		2001	2002
Share Capital	1,00,000	1,10,000	Building	40,000	38,000
General Reserve	14,000	21,000	Plant and Machinery	37,000	36,000
P & L A/c	16,000	13,000	Investment (L.T.)	10,000	11,000
Creditors	8,000	5,400	Stock	30,000	23,400
B.P	1,200	800	B.R	2,000	3,200
Provision for Tax	16,000	18,000	Debtors	18,000	19,000
Provision for Doubtful Debts	400	600	Cash at Bank	6,600	15,200
			Preliminary Expenses	12,000	10,000
	1,55,600	1,65,800		1,55,600	1,65,800

Additional Information :

- (i) Depreciation charged on Plant was Rs. 4,000.
- (ii) Provision for taxation Rs. 19,000 was made during the year 2001-02.
- (iii) Interim dividend of Rs. 8,000 was paid during the year.
- (iv) A piece of machinery was sold for Rs. 8,000 during the year 2001-02. It had costed Rs. 12,000, depreciation of Rs. 7,000 has been provided on it.

PART – B (2 x 7 = 14 marks)

Answer any TWO of the following in about 200 words each:

4.

Particulars

The Balance Sheet of Bai Chung, Tanvir and Vijayan who shared profits and losses in the ratio 3:3:2 respectively was as follows on 31st December, 2007

Capital			Machinery	31,500
Bai Chung	21,000		Furniture	6,000
Tanvir	10,000		Stock	8,500
Vijayan	6,000	12,000	Debtors	4,500
Reserves		4,800	Cash at Bank	4,700
Goodwill		8,700		
		57,500		55,500

Bai Chung retired from the business on 1st January, 2008. Revaluation of assets were made as :

Machinery Rs. 34,000, Furniture Rs. 5,000, Stock Rs. 9,600, Debtors Rs. 4,000 and Goodwill Rs. 10,000.

Bai Chung was paid Rs. 4,225 immediately and the balance was transferred to a Loan Account

for payment in 4 equal half-yearly installments together with interest @ 6% p.a.

Show the necessary accounts, the Balance Sheet of the firm immediately after Bai Chung's retirement and his Loan Account till finally paid off.

5. Explain the limitations of ratio analysis.

6. On 1st Jan. 2008 A Ltd purchased from B Ltd five trucks under hire purchase system. Rs.50000 being paid on delivery and the balance in five installments of Rs 75000 each payable annually on 31st Dec. the vendor charges 5% p.a interest on yearly balances. The cash price of five trucks was Rs. 375000 Show how this transaction should be recorded in the books of A ltd, if A Ltd writes off depreciation at 10% p.a on the written down value.

PART – C (5 X 4 = 20 marks)

Answer any FIVE of the following:

7.a. Define Accounting.

b. Explain any two accounting concepts.

c. X and Y were partners sharing profits as 4 : 3. Z joined as a new partner. The new profit sharing ratio between X, Y and Z was agreed to be 7 : 5 : 3. The Goodwill of the firm was valued at Rs. 84,000. But Z could not pay any premium for goodwill.

d. X and Y are Partners sharing profit as 5:3. Z is the clerk of their business getting a

salary of Rs. 500 p.m. and a commission of 5% of the net profit after deducting his salary and commission. Now, X guarantee that Z be made a Partners with 1/10th share of profit and nothing else. If the annual profits is Rs. 1,32,000. Show the appropriation.

e. What do you mean by profit prior to incorporation?

f. What do you mean by statement of affairs?

g. A trader took out a fire policy containing an average clause covering his stock for Rs. 15,000. His practice was to base his selling price at cost plus 33 1/3%. He closes his books on 30th June every year.

On 31st March, 2007, a fire occurred at his premises and destroyed his stock. The salvaged stock was Rs. 6,000. During the period of 9 months preceding the fire his purchases amounted to Rs. 61,000, and sales to Rs. 84,000. His stock at 1st July, 2006 was valued at Rs. 20,000.

You are required to prepare a statement showing the amount of claim.

PART – D (2X 6 = 12 marks)
Answer any TWO of the following:

8.

Illustration 6 : The following details are available from a company

Liabilities	31-12-98 Rs.	31-12-99 Rs.	Assets	31-12-98 Rs.	31-12-99 Rs.
Share Capital	70,000	74,000	Cash	9,000	7,800
Debentures	12,000	6,900	Debtors	14,900	17,700
Reserve for doubtful debts	700	800	Stock	48,200	42,700
Trade Creditors	10,360	11,840	Land	20,000	30,000
P & L A/c	10,040	10,560	Goodwill	10,000	5,000
	1,03,100	1,03,200		1,03,100	1,03,200

Additional Information : (i) Dividend paid total Rs. 3,500, (ii) Land was purchased for Rs. 10,000. Amount provided for amortization of goodwill Rs. 5,000 and (iii) Debentures paid off

Rs. 6,000. Prepare Cash Flow Statement.

9. Hansa Ltd. was incorporated on 1st July, 2008 to acquire a running business with effect 1st

April, 2008. The accounts for the year ended 31st March, 2009 disclosed the following :

(i) There was a gross profit of Rs. 30,00,000.

(ii) The sales for the year amounted to Rs. 1,20,00,000 of which Rs. 24,00,000 were for the first six months.

**(ii) The expenses debited to the Profit and Loss Account included—directors' fees . Rs. 1,50,000; bad debts : Rs. 36,000; advertising : Rs. 1,20,000 (under a contract amounting to Rs. 10,000 per month); salaries and general expenses : Rs. 6,40,000; preliminary expenses written off Rs. 50,000; and donation to a political party given by the company Rs. 50,000.
Prepare a statement showing the amount of profit made before and after incorporation.**

10. Differentiate sale and consignment.

ANSWER SCHEME

PART – A

1 Characteristics of partnership firm

According to section 4 of the Partnership Act, 1932 a Partnership is “the relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all”

If we analyze the definition we find three basic element of a Partnership

- (1) It arises out of an agreement made by two or more persons.
 - (2) The agreement is made regarding sharing profits of a business.
 - (3) Such business is carried on by all or any one of them acting for all
- (a) Partnership is the result of an agreement It does not arise from status
 (b) The agreement may be either verbal or in writing There should be some terms and conditions binding the Partnership
 (c) The existing law does not enforce that the terms of the Partnership must be in writing If written the agreement is known as Deed or Articles of Partnership
 (d) For the formation of a Partnership more than one person is requires For a banking business the maximum number of Partners is 10, in other businesses it is 20

2

Solution :

Trading and Profit and Loss Account

Dr.	for the year ending 31st March, 2002		Cr
Particulars	Rs	Particulars	Rs
To Opening Stock	29,200	By Sales	2,38,120
To Purchases	2,07,240	Less Returns Inwards	4,200
Less Return. Outwards	5,820	By Closing Stock	34,000
To Gross Profit c/d	37,300		
	2,67,920		2,67,920
To Sundry Expenses	8,800	By Gross Profit b/d	37,300
To Rent	1,400	By Apprenticeship Premium	2,400
Add O/S rent	800	Less Carried forward	400
	3,200		2,000
To Rates and Taxes	4,000	By Discount Received	1,200
Less P/P rates and insurance	1,600		
To Depreciation on Plant & Machinery	1,900		
To Provision for Bad debts			
Bad debts	3,440		
Add New Provision required	3,200		
	6,640		
Less Old Provision	2,100		
To Interest on Capital	4,250		
To Net Profit (Transferred to capital account)	15,410		
	40,500		40,500

Balance Sheet
as on 31st March, 2002

Liabilities	Rs.	Assets	Rs.
Capital	85,000	Plant and Machinery	19,000
Add Interest on Capital	4,250	Less Depreciation @ 10%	1,900
Add Net Profit	15,410		17,100
	1,04,660	Closing Stock	34,000
Less drawings	14,200	Sundry Debtors	64,000
Bank overdraft	4,000	Less New Provision for	
Sundry Creditors	20,000	Doubtful debt @ 5%	3,200
Bills Payable	3,600	Bills Receivable	4,800
Outstanding Rent	800	Cash in hand	960
Apprenticeship Premium received in advance	400	Prepaid rates and insurance	1,600
	1,19,260		1,19,260

3. costed Rs 12,000, depreciation of Rs 7,000 has been provided on it

Solution

Schedule of Changes in Working Capital

	2001	2002	Increase	Decrease
	Rs	Rs	Rs	Rs
Current Assets				
Stock	30,000	23,400		6,600
B.B.	2,000	3,200	1,200	
Debtors	18,000	19,000	1,000	
Cash at Bank	6,600	15,200	8,600	
Current Liabilities				
Creditors	8,000	5,400	2,600	
B.P.	1,200	300	900	
Provision for Doubtful Debts	400	500		100
			13,500	7,000
			13,500	13,800

Funds Flow Statement
for the year ended 31.03.2002

Sources	Rs	Uses	Rs
Funds from Operations(a)	33,000	Purchase of Machinery (b)	8,000
Sale of Machinery	8,000	Payment of Interest Divided	8,000
Issue of Share Capital	10,000	Purchase of Investment	11,000
		Payment of Tax (c)	17,000
		Increase in Working Capital	7,000
	51,000		51,000

Working Notes :

(a) Adjusted Profit and Loss Account

	Rs		Rs
To Interest Divided	8,000	By Net Profit b/d	16,000
To Depreciation of Building	2,000	By Profit on Sale of Machinery	3,000
To Preliminary Expenses	2,000	By Fund from Operations	33,000
To General Reserves	4,000		
To Depreciation on Plant and Machinery	4,000		
To Provision for Tax A/c	19,000		
To Net Profit c/d	13,000		
	52,000		52,000

(b) Plant and Machinery Account

	Rs		Rs
To Balance b/d	37,000	By Adjusted P & L A/c (Dep.)	4,000
To Adjusted P&L A/c (Profit)	2,000	By Bank A/c	8,000
To Bank (Purchase of Machinery)	8,000	By Balance c/d	36,000
(Bal. Figure)			
	48,000		48,000

(c) Provision for Tax Account

	Rs		Rs
To Bank A/c (Bal. Fig.)	17,000	By Balance b/d	16,000
To Balance c/d	18,000	By Adjusted P&L A/c	19,000
	35,000		35,000

PART B

4 retirement and his Loan Account till finally paid off

Solution

**Books of batching, Tausif and Vijayan
Revaluation Account**

Dr				Cr			
Date	Particulars	Amnt Rs	Amnt Rs	Date	Particulars	Amnt Rs	Amnt Rs
11.08	To Furniture A/c		1,400	11.08	By Machinery A/c		2,400
	To Provision On Debtors A/c		300		By Stock A/c		1,100
	To Capital A/c (Profit on Revaluation)						
	Batchung (3.84)	575					
	Tausif (3.84)	575					
	Vijayan (7.74)	450					
			3,500				3,500

Dr					Cr				
Capital Account									
Dr	Particulars	Batchung Rs.	Tausif Rs.	Vijayan Rs.	Cr	Particulars	Batchung Rs.	Tausif Rs.	Vijayan Rs.
11	To Bank A/c	4,225			11	By Balance b/d	4,000	10,000	8,000
	To 10% Loan A/c (Balance Transferred To balance c/d)	26,000				By Reserve A/c [3.32]	1,800	2,400	1,200
			16,225	12,150		By Revaluation A/c	675	875	450
						By Goodwill	3,750	3,750	2,500
		30,225	16,225	12,150			30,225	16,225	12,150

**Tausif and Vijayan
Balance Sheet as at 11.08**

Liabilities	Amount Rs	Amount Rs	Assets	Amount Rs	Amount Rs
Capitals			Goodwill		10,000
Tausif	16,225		Machinery		34,000
Vijayan	12,150	28,375	Furniture		5,000
Batchung's 10% Loan		26,000	Stock		9,800
Sundry Creditors		8,700	Debtors	4,300	
			Less Provision	300	4,000
			Cash at Bank (4,774-4,225)		475
		83,075			83,075

Banking & Cash 100 Account

Dr

Cr

Date	Particulars	Amount Rs	Date	Particulars	Amount Rs
01/6/08	To Bank A/c [1/4 of 28,000 + 780]	7,280	11/6/08	To Banking & Capital A/c By Interest A/c	25,000
31/12/08	To Bank A/c [1/4 of 28,000 + 585]	7,585	31/12/08	[8% of 25,000 for 6 months]	780
	To Balance c/d	13,700		By Interest A/c of 1/6/08 (25,000 - 6,500) for 6 months]	585
		27,385			27,385
30/6/09	To Bank A/c [6,500 - 795]	5,705	1/1/09	By Balance b/d	13,000
31/12/09	To Bank A/c [6,500 - 195]	6,305	31/06/09	By Interest A/c [8% of 13,000 for 6 months]	300
		13,585	31/12/09	By Interest A/c [8% of 6,500 for 6 months]	195
					13,585

5 DRAW BACKS OF RATIO ANALYSIS:

1. **Limited use of a single ratio** : Ratio can be useful only when they are computed in a sufficient large number. A single ratio would not be able to convey anything. At the same time, if too many ratios are calculated, they are likely to confuse instead of revealing any meaningful conclusion.
2. **Effect of inherent limitations of accounting** . Because ratios are computed from historical accounting records, so they also possess those limitations and weaknesses as accounting records possess.
4. **Lack of proper standards** : While making comparisons, it is always a challenging job to find out an adequate standard. It is not possible to calculate exact and well accepted absolute standard, so a quality range is used for this purpose. If actual performance is within this range, it may be regarded as satisfactory.
5. **Past is not indicator of future** : It is not always possible to make future estimates on the basis of the past as it always does not come true.
6. **No allowance for change in price level** : While making comparisons of ratios, no allowance for changes in general price level is made. A change in price level can seriously affect the validity of comparisons of ratios computed for different time periods.
7. **Difference in definitions** : Comparisons are also made difficult due to differences in definitions of various financial terms. The terms like gross profit, net profit, operating profit etc. have not precise definitions and an established procedure for their computation.

8. Window Dressing : Financial statements can easily be window dressed to present a better picture of its financial and profitability position to outsiders. Hence one has to be careful while making decision on the basis of ratios calculated from such window dressing made by a firm.

9 Personal Bias . Ratios are only means of financial analysis and is not an end in itself. Ratios have to be interpreted carefully because the same ratio can be looked at, in different ways.

6 In the books of A Ltd

Trucks account

2008	To B Ltd	375000	2008	By depreciation	375000
Jan 1			Dec 31	By balance c/d	337500
		<u>375000</u>			<u>375000</u>
	To balance b/d	337500			33750
2009		<u>337500</u>	2009	By depreciation	303750
Jan 1	balance b/d		Dec 31	By balance c/d	337500
		<u>337500</u>			<u>337500</u>
2010				By depreciation	30380
Jan 1	balance b/d	303750	Dec 31	By balance c/d	273370
		<u>303750</u>			<u>303750</u>
2011				By depreciation	27340
Jan 1	balance b/d	273370	Dec 31	By balance c/d	246030
		<u>273370</u>			<u>273370</u>
				By depreciation	24500
2012			Dec 31	By balance c/d	241430
Jan 1	balance b/d	246030			<u>246030</u>
		<u>246030</u>			

B Ltd

2008 Jan 1			Jan 1	By trucks	375000
Dec 31	To cash	50000			
	To cash	75000	Dec 31	By interest	16250
	To balance b/d	266250			
					<u>391250</u>
		<u>391250</u>			266250
2009 Dec 31	To cash	75000	Jan 1	By balance b/d	13310
	To balance c/d	204560	31 st Dec	By interest	279560
		<u>279560</u>			204560
2010 Dec 31	To cash	75000	Jan 1	By balance b/d	10230
	To balance c/d	139790	31 st Dec	By interest	
		<u>214790</u>			214790
2011 Dec 31	To cash	75000	Jan 1	By balance b/d	139790
	To balance c/d	71780	31 st Dec	By interest	6990
		<u>146780</u>			146780
2012 Dec 31	To cash	75000	Jan 1	By balance b/d	71780
			31 st Dec	By interest	3220
		<u>75000</u>			75000

Interest account

2000 Dec 31	To B Ltd	16250	31 st Dec	By P&L a/c	16250
2000 Dec 31	To B Ltd	13310	31 st Dec	By P&L a/c	13310
2000 Dec 31	To B Ltd	10230	31 st Dec	By P&L a/c	10230
2000 Dec 31	To B Ltd	6990	31 st Dec	By P&L a/c	6990
2000 Dec 31	To B Ltd	3220	31 st Dec	By P&L a/c	3220

PART – C

7 a Accounting

Financial statements are to be prepared in accordance with generally accepted accounting principles. This is because if each organization was to adopt its own principles in the maintenance of accounting records and the publishing of accounting information it will lead to a welter of confusion. Such financial statements will have low acceptability as it will be difficult to understand them without first knowing the principles underlying the preparation of such statements.

b Money Measurement Concept:

The money measurement concept underlines the fact that in accounting every worth recording event happening or transaction is recorded in terms of money. In other words, a fact or a happening which cannot be expressed in terms of money is not recorded in the accounting books. General health condition of the chairman of the company, working condition in which a worker has to work, sales policy pursued by the enterprise, quality of products introduced by the enterprise, etc., cannot be expressed in money terms and therefore are not recorded in the books. In view of the above condition this concept puts a serious handicap on the usefulness of accounting records for management decisions. This concept has another serious limitation and is currently attracting the attention of the accountants all over the world. As per this concept, a transaction is recorded at its money value on the date of occurrence and the subsequent changes in the money value are conveniently ignored.

Cost Concept (Historic):

The underlying idea of cost concept is that

- (i) asset is recorded at the price paid to acquire it, that is, at cost, and
- (ii) this cost is the basis for all subsequent accounting for the asset.

When asset is recorded at cost price as said under point (i) above, the change in the real worth of an asset (for variety of reasons) with the passage of time is not ordinarily recorded in the account books. For example, if a piece of land has been purchased for Rs 80,000, then its market price (whether Rs 1,70,000 or Rs 50,000) at the time of preparation of final statements will not be considered. Thus the balance sheet on a particular date, prepared on the basis of cost concept, does not ordinarily indicate what the assets could be sold for. As an explanation of the point (ii) of the cost concept, it can be said that the cost concept does not mean that assets are always shown year after year for an indefinite period at the cost price. The assets recorded at cost price at the time of purchase are systematically reduced by the process called depreciation. These assets ultimately disappear from the balance sheet when their economic life is over and they have been fully depreciated and sold as scrap.

c Step 1 Calculate Z's premium $3/15$ of Rs 84,000 = Rs 16,800
Step 2 Calculate sacrifices made by X and Y $X = 4/7 - 7/15 = 11/105$
 $Y = 3/7 - 5/15 = 10/105$ Sacrifice Ratio 11 10
Z's Capital A/c Dr 16,800
To X's Capital A/c 8,800
To Y's Capital A/c 8,000

d (i) General Application of Profit Z's Share as clerk Rs
Salary $500 * 12$ 6,000
Commission $5/105$ of [1,32,000 – 6,000] 6,000

12,000

Balance of profit 1,20,000 Shared as $X = 5/8 \times 1,20,000 = \text{Rs } 75,000$,

$Y = 3/8 \times 1,20,000 = \text{Rs } 45,000$

(ii) Minimum guaranteed share of Z = 1/10th of Rs 1,32,000 = Rs 13,200

(iii) Shortfall = Rs 13,200 - Rs 12,000 = Rs 1,200 to be deducted from share and added with Z's share

Final appropriation should be –

Rs

X Rs 75,000 – Rs 1,200 73,800

Y 45,000

Z Rs 12,000 + Rs 1,200 13,200

1,32,000

X's Capital Current A/c Dr 1,200

To Z's Capital Current A/c 1,200

(Being Guaranteed share of profits provided)

c PROFIT PRIOR TO INCORPORATION

In many cases, a new company is formed exclusively to acquire an existing business unit and take it over as a going concern, from a date prior to its *own incorporation*. In such cases, the business unit is purchased first, and the registration of the acquiring company takes place later. For example, AB Pvt Ltd is incorporated on 1st October, 2009 to take over the running business of Das Bios from 1st January, 2009. The profit earned (or loss suffered) during the pre-incorporation period (in our example 1st January to 30th September 2009) is called

profit (loss) prior to incorporation. Legally, this profit is not available for distribution as dividend, since a company cannot earn profit before it comes into existence. However, profit earned after incorporation is available for distribution as dividend. Profit earned before

incorporation is a **capital profit** and profit earned after incorporation is a **revenue profit**.

It is a common practice that the **date of incorporation** should be taken as the basis for calculation of pre-acquisition profit.

F. STATEMENT OF AFFAIRS:

Correct final accounts of a business can be prepared in the records are maintained under the double entry system. However, where the record is incomplete, and it is not all possible to complete it by double entry, in such cases the final accounts can be only approximately prepared by means of a statement of affairs. In appearance the **statement of affairs** is similar to a balance sheet. For this purpose, two comparative statement of affairs are prepared – one at the commencement of the year and other at the end of the year. The excess of the assets over the liabilities as shown by the statement will represent the capital of the firm. If capital at the end shows an increase as compared to the amount of capital at the start the difference will represent profit and if the capital at the end is less than the capital at the beginning the difference will be loss.

g Trading Account for the period of 9 months, from 1.7.2006 to 31.3.2007

<i>Dr</i>	<i>Rs</i>	<i>Cr</i>	<i>Rs</i>
To Opening Stock	20 000	By Sales	84 000
Purchases	61 000	Closing Stock (Balancing figure)	18 000
Gross Profit @ 25% on Sales*	21 000		
	<u>1 02 000</u>		<u>1 02 000</u>

Statement showing the Amount of Claim for the Loss of Stock

	<i>Rs</i>
Estimated value of stock as at the date of fire i.e. on 31.3.2007 as per Trading Account	18 000
Less Value of salvaged stock	<u>6 000</u>
Estimated value of stock lost by fire	<u>12 000</u>

PART - D

8. Prepare Cash Flow Statement

Solution

Cash Flow Statement
(for the year ended 31.12.1999)

	<i>Rs</i>		<i>Rs</i>
Opening balance of cash on 1.1.1999	9 000	<i>Cash Outflows</i>	
<i>Add Cash Inflows</i>		Purchase of Land	10 000
Issue of Share Capital	4 000	Increase in Debtors	2 800
Increase in trade creditors	1 450	Redemption of Debentures	6 000
Cash inflow from operations	9 120	Dividends Paid	3 500
Decrease in stock	6 500	Closing balance of cash on 31.12.1999	<u>7 800</u>
	<u>30,100</u>		<u>30,100</u>

Workings

1 Cash inflow from operations

Adjusted Profit And Loss A/c

	Rs		Rs
To Dividend (non-operating)	3,500	By Balance b/d	10,040
To Goodwill (non-fund cash)	5,000	By Cash inflow from operation	9,120
To Reserve for doubtful debts	100		
To Balance c/d	10,560		
	<u>19,160</u>		<u>19,160</u>

Alternatively

	Rs
Balance of P & L A/c on 31.12.1999	10,560
Add non-fund cash and non-operating items which have already been debited to P & L A/c	
Dividend paid	3,500
Goodwill written off	5,000
Reserve for doubtful debts	100
	<u>19,160</u>
Less Opening balance of P & L A/c and non-operating incomes	
Opening balance of P/L A/c (on 31.12.1998)	10,040
Cash inflow from operations	<u>9,120</u>

9

Solution :

Hansa Ltd.

Statement showing Apportionment of Profit between Pre- and Post-incorporation Period

Particular	Notes	Base	Total Rs	Pre-incorporation 1.1.2008 to 30.6.2008 (3 months)	Post-incorporation 1.7.2008 to 31.3.2009 (9 months)
Gross Profit (A)	1	Sales (1.9)	30,00,000	3,00,000	27,00,000
Less: Expenses (B)					
Bad Debts		Sales (1.9)	36,000	3,600	32,400
Advertising		Direct	1,20,000	40,000	80,000
Salaries and General Expenses	2	Time (1.3)	6,00,000	1,00,000	4,00,000
Director's Fees	3	Direct	1,50,000		1,50,000
			<u>9,16,000</u>	<u>1,43,600</u>	<u>7,72,400</u>
Net Profit (A - B)			20,84,000	1,56,400	19,27,600
Less: Appropriations					
Preliminary Expenses (Note 4)		50,000			
Donation (Note 4)		50,000	1,00,000		1,00,000
			<u>17,54,000</u>	<u>1,56,400</u>	<u>18,10,400</u>
				Capital Profit	Net Profit

Note : Capital profit is transferred to **Capital Reserve Account** and Net profit is transferred to **Profit and Loss Appropriation Account.**

Working Notes :

(1) Total sales for the year 2008-09 = Rs 12,00,000 Sales for the first 6 months (1 4 2008 to 30 9 2008) = Rs 24,00,000 Therefore, sales per month during first 6 months = Rs 24,00,000/6 = Rs 4,00,000

In effect, sales of first three months (1 4 2008 to 30 6 2008) = Rs 4,00,000×3 = Rs 12,00,000 Sales of next nine months (1 7 2008 to 31 3 2009) = Rs 1,20,00,000 — Rs 12,00,000 = Rs 1,08,00,000

Ratio of Sales = 12,00,000 / 1,08,00,000 = 1 / 9 It is assumed that sales evenly occurred during first six months

(2) These expenses generally accrue evenly throughout the year and are, therefore, divided on the **time basis**, i.e. 3 / 9 or 1 / 3

(3) Directors' fees are paid in case of company only These must naturally be shown in the post-incorporation period.

(4) Preliminary expenses and donation are not charges against profit These are treated as appropriations

10 DISTINCTION BETWEEN SALE AND CONSIGNMENT

<i>Sale</i>	goods
(i) In case of sale, property in goods is transferred to the buyer along with the transfer of goods	
(ii) Goods once sold cannot be returned to the seller except when they are defective or the seller agrees to take these back	
(iii) When goods are sold on credit the buyer becomes the debtor of the seller The relationship between the buyer and seller is that of debtor and creditor	
(iv) When goods are lost after the delivery to the buyer, it is the buyer who will bear the loss	
(v) The expenses incurred by the buyer are to be borne by the buyer itself after the delivery of	

Consignment

In case of consignment, goods remain the property of the consignor until the time they are sold by consignee

Unsold goods on consignment are the property of the consignor and can be returned to him

When goods are sold on credit, the buyer becomes debtor of the consignor. The relationship between the consignor and the consignee is that of a principal and agent.

When goods are lost on consignment, it is the consignor who will bear the loss.

Expenses borne by the consignee to receive the goods and to store it safely is borne by the consignor.