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CA FOUNDATION ACCOUNTING

VOLUME -2

BY

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(B.COM , FCA , CS , LLB , DISA , DIRM)

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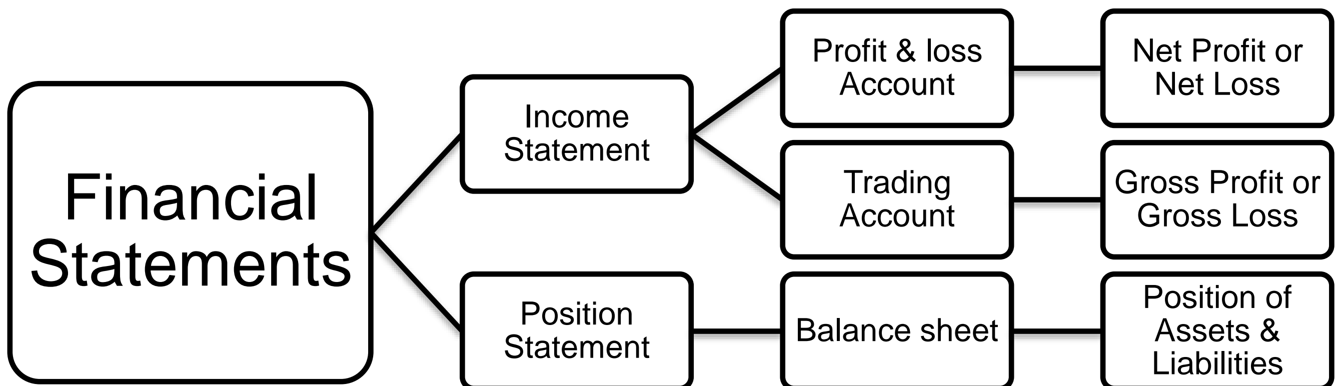
CHAPTER - 14
FINAL ACCOUNTS OF NON MANUFACTURING ENTITY

---------------------------- **Bird's Eye View**-------------------------

- ❑ Components of Final Accounts of Sole proprietors
- ❑ Basic Principles While Drawing Final Accounts
- ❑ Trading Account
- ❑ Profit & Loss Account
- ❑ Balance Sheet
- ❑ Adjustments

Components of Final Accounts of Sole proprietors



POINTS FOR CONSIDERATION WHILE PREPARING FINAL ACCOUNTS

a) **Distinction between personal and business income: -** Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditure should be separated from business income and expenditure.

b) **Distinction between capital and revenue expenditure: -** A distinction should be made between capital and revenue, both receipts and expenditure. Different types of income and expenditure should be classified under separate heads. Assets should be included in the Balance Sheet by following accounting principles and accounting standards. Likewise, a provision for income and expenses which have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.

c) **All material information to be disclosed: -** Every information, considered material for judging the profitability of the business or its financial position, should be disclosed. For example, when the labour charges have increased on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, if some of the items of inventory are not readily saleable, these should be valued at their approximate net realizable value and the basis of valuation and value of such inventory should be shown separately.

d) **Record only current period transactions: -** Though the record of transactions should be maintained continuously, at the end of each accounting period, the transactions of the closing accounting period should be cut off from those of the succeeding period.

e) **Only transactions completed before close of accounts should be given effect: -** It should be seen that only the effect of transactions, which were concluded before the close of period of account, has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

TRADING ACCOUNT

Trading Account of......for the year ended......

Particulars		₹	Particulars		₹
To Opening Stock		XXX	By Sales	XXX	XXX
To Purchases	XXX		Less: Returns Inwards	XXX	XXX
Less: Returns outwards	XXX	XXX			
To Direct expenses:		XXX	By Closing Stock		
Freight & Carriage		XXX	By Gross Loss c/d*		
Customs & Insurance	XXX				
Wages	XXX				
Gas, Water & Fuel	XXX				
Factory Expenses	XXX				
Royalty on production	XXX	XXX			
		XXX			XXX

Point to Remember: -

- The opening inventory and purchases are written on the debt side.
- Sales and the closing inventory are entered on the credit side.
- If there are any direct expenses then they should also be written on the debit side of the Trading account.

- If the balances of credit side is more, the difference is written on the debit side as gross profit. This amount will also be carried forward to the Profit and Loss Account on the credit side.
- In case of gross loss, i.e., when the debit side of the Trading Account exceeds the credit side, the amount will be written on the credit side of the Trading Account and transferred to the debit side of the Profit and Loss Account.

Illustration 1

Trial Balance for the financial year (FY) ended 31st March 2020 of M/s Deepakshi shows following details:

Particulars	Debit	Credit
Purchase & Sales	10,00,000	12,00,000
Debtors & Creditors	5,00,000	4,00,000
Opening Stock	2,00,000	
Closing Stock	3,00,000	
Other Expenses & Incomes	7,00,000	9,00,000
Fixed Assets & Long-Term Liabilities	25,00,000	6,00,000
Capital		21,00,000
	52,00,000	**52,00,000**

Additional Information: Creditors balance as on 1st April, 2019 is ₹ 3,00,000.
You are required to calculate cost of goods sold and amount paid to creditors during the year.

Illustration 2

Particulars	₹
Opening Inventory	1,00,000
Purchases	6,72,000
Carriage Inwards	30,000
Wages	50,000
Sales	11,00,000
Returns inward	1,00,000
Returns outward	72,000
Closing Inventory	2,00,000

Required

From the above information, prepare a Trading Account of M/s. ABC Traders for the year ended 31st March, 2020 and Pass necessary closing entries in the journal proper of M/s. ABC Traders

PROFIT & LOSS ACCOUNT

Particulars	₹	Particulars	₹
To Gross Loss b/d		**By Gross Profit b/d**	
Management expenses		**Other Income**	
To Salaries (administrative)		By Discount Received	
To Office rent, rates, and taxes		By Commission Received	
To Printing and stationery		**Non-trading Income**	

To Telephone charges To Postage To Insurance To Audit Fees To Legal Charges To Electricity Charges **Maintenance expenses** To Repairs & renewals To Depreciation on: Office Equipment Office Furniture Office Buildings **Selling and Distribution expenses** To Salaries (selling staff) To Advertisement To Godown rent To Carriage Outward To Bad Debts To Provision for bad debts To Selling commission **Financial expenses** To Bank charges To Interest on loans To Discount on bills To Discount allowed to customers **Abnormal Losses** To Loss on sale of machinery To Loss on sale of investment To Loss by fire **To Net Profit (transferred to Capital A/c)**		By Bank Interest By Rent of property let-out By Dividend from shares **Abnormal Gains** By Profit on sale of machinery By Profit on sale of investment **By Net Loss (transferred to capital A/c)**	

Illustration 3

Revenue, Expenses and Gross Profit Balances of M/s ABC Traders for the year ended on 31st March 2020 were as follows:

Gross Profit ₹ 4,20,000, Salaries ₹ 1,10,000, Discount (Cr.), ₹ 18,000, Discount (Dr.) ₹ 19,000, Bad Debts ₹ 17,000, Depreciation ₹ 65,000, Legal Charges ₹ 25,000, Consultancy Fees ₹ 32,000, Audit Fees ₹ 1,000, Electricity Charges ₹ 17,000, Telephone, Postage and Telegrams ₹ 12,000, Stationery ₹ 27,000, Interest paid on Loans ₹ 70,000.

Required

Prepare Profit and Loss Account of M/s ABC Traders for the year ended on 31st March, 2020.

Show necessary closing entries in the Journal Proper of M/s. ABC Traders also.

BALANCE SHEET

The balance sheet may be defined as "a statement which sets out the assets and liabilities of a firm or an institution as at a certain date." Since even a single transaction

will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."
The assets are shown on the right-hand side and liabilities and capital on the left-hand side.

ARRANGEMENT OF ASSETS & LIABILITIES

(1) **Assets:** Assets may be grouped in one of the following two ways:

i. **Liquidity:** Under this approach, the asset, which can be converted into cash first, is presented first. Those assets, which are most difficult in this respect, are presented at the bottom. As per Liquidity the balance sheet can be prepared as follow: -

Balance Sheet

Liabilities	Amount	Assets	Amount
	₹		₹
Bills Payable Trade Creditors Loans Outstanding Expenses Reserves & Surplus Capital		Cash in Hand Cash at Bank Government Securities Other Investments Bills Receivable Sundry Debtors Stock Furniture & Fixtures Plant & Machinery Land and Building	

ii. **Permanence:** Assets, which are to be used, for long term in the business and are not meant to be sold are presented first. Assets, which are most liquid, such as cash in hand, are presented at the bottom.

Balance Sheet

Liabilities	Amount	Assets	Amount
	₹		₹
Capital Reserves & Surplus Outstanding Expenses Loans Trade Creditors Bills Payable		Land and Building Plant & Machinery Furniture & Fixtures Stock Sundry Debtors Bills Receivable Other Investments Government Securities Cash at Bank Cash in Hand	

ADJUSTMENTS

Adjustments	If Given in Trial Balance	If Not Given in Trial Balance
1. Closing Stock	Balance Sheet – Asset Side	a. Trading A/c- Credit Side b. Balance Sheet- Assets Side

2. Outstanding Expenses	Balance Sheet- Liability Side	a. Trading/Profit & Loss A/c Debit Side. Add to the concerned expenses b. Balance Sheet - Liability Side
3. Prepaid Expenses	Balance Sheet- Assets Side	a. Trading/Profit & Loss A/c Debit Side. Deduct from the concerned expense. b. Balance Sheet- Assets
4. Income Outstanding	Balance Sheet- Assets Side	a. Profit & Loss A/c - Credit Side. Add to the concerned income. b. Balance Sheet - Asset Side.
5. Income Received in Advance	Balance Sheet- Liability Side	a. Profit & Loss A/c - Credit Side. Deduct from concerned income. b. Balance Sheet - Liability Side
6. Bad Debts	Profit & Loss A/c- Debit Side	a. Profit & Loss A/c - Debit Side. b. Balance Sheet - Asset Side. Deduct from debtors.
7. Provision for Bad or Doubtful debts	Profit & Loss A/c – Credit Side	a. Profit & Loss A/c - Debit Side. b. Balance Sheet - Asset Side. Deduct from Debtors after Additional bad debts, if any.
8. Provision for Discount on Debtors	Profit & Loss A/c – Credit Side	a. Profit & Loss A/c - Debit Side. b. Balance Sheet - Asset Side. Deduct from debtors after providing for provision for bad debts
9. Depreciation	Profit & Loss A/c – Credit Side	a. Profit & Loss A/c - Debit Side. b. Balance Sheet - Asset Side. Deduct from Respective Asset.
10. Interest on Capital	Profit & Loss A/c - Debit Side	a. Profit & Loss A/c - Debit Side. b. Balance Sheet - Liability Side Add to Capital.
11. Interest on Drawings	Profit & Loss A/c - Credit Side	a. Profit & Loss A/c - Credit Side. b. Balance Sheet - Liability Side.

		Deduct from Capital.
12. Loss by Fire	Profit & Loss A/c - Debit Side	a. Trading A/c - Credit Side (with full amount of loss) b. Profit & Loss A/c - Debit Side (Actual loss, if any) c. Balance Sheet - Asset Side (with insurance claim admitted by Insurance Co.)
13. Goods withdrawn for personal use	Trading A/c – Credit Side	a. Trading A/c - Credit Side or Deduct from Purchases. b. Balance Sheet - Liability Side (Deduct from Capital as Drawings)
14. Goods Distributed as free Samples	Profit & Loss A/c - Debit Side	a. Trading A/c - Credit Side or Deduct from Purchases b. Profit & Loss A/c - Debit Side
15. Sale of Goods on Approval Basis, approval not yet received	Usually, it is not given in Trial Balance	a. Trading A/c - Credit Side. Deduct from Sales the selling price of goods sold and add to stock at cost price. b. Balance Sheet - Asset Side. Deduct from Debtors the selling price of such sales and show the cost price of such sales along with closing stock.

Illustration 4

On 1st April 2020 provision for Doubtful Debts existed at ₹ 40,000. Trade receivables on 3.03.2020 were ₹ 15,00,000; bad debts totaled ₹ 1,00,000. It is required to write off the bad debts and create a provision equal to 5% of the Trade receivables' balances.

Required

Show how you would compute the amount debited to the Profit and Loss Account.

COMMISSION BASED ON PROFITS

Commission based on profit: Sometimes commission is payable to manager based on net profit; in such a case calculation is done as follows:

i. Commission on net profit before charging such commission=

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100}$$

ii. Commission on net profit after charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100 + \text{Rate of commission}}$$

Commission is recorded by following journal entry

Commission A/c Dr.
    To Commission Payable A/c

Illustration 5

The following is the Trial Balance of C. Wanchoo on 31st March, 20220.

Trial Balance on 31st March, 2020

Particulars	₹	₹
Capital Account		10,00,000
Inventory Account	2,00,000	
Cash in hand	1,44,000	
Machinery Account	7,36,000	
Purchases Account	18,20,000	
Wages Account	10,00,000	
Salaries Account	10,00,000	
Discount Allowed A/c	50,000	
Discount Received A/c		30,000
Sundry Office Expenses Account	6,00,000	
Sales Account		50,00,000
Sums owing by customer (Trade receivables)	8,50,000	
Trade payables (sums owing to suppliers)		3,70,000
Total	64,00,000	64,00,000

Value of Closing Inventory on 31st March, 2020 was ₹ 2,70,000

Prepare closing entries for the above items and Prepare Trading and Profit and Loss Account.

Illustration 6

Given below Trial Balance of M/s Dayal Bros. as on 31st March, 2020:

Particulars	Debit Balances ₹	Credit Balances ₹
Capital A/c		7,00,000
Land and Building	3,00,000	
14% Term Loan		4,00,000
Loan from M/s. D & Co.		4,60,000
Trade receivables	4,20,000	
Cash in hand	20,000	
Inventories in Trade	6,00,000	
Furniture	2,00,000	
Trade payables		40,000
Advance to suppliers	1,00,000	
Net Profit		1,00,000
Drawings	60,000	
	17,00,000	**17,00,000**

Required

Prepare Balance Sheet as on 31st March, 2020.

Illustration 7

The balance sheet of Thapar on the 1st April, 2019 was as follows:

Liabilities	Amount ₹	Assets	Amount ₹
Trade Payables Expenses Payable Capital	15,00,000 1,50,000 50,00,000	Plant & Machinery Furniture & Fixture Trade receivables Cash at Bank Inventories	30,00,000 3,00,000 14,00,000 6,50,000 13,00,000
	66,50,000		**66,50,000**

During 2019-20, his Profit and Loss Account revealed a net profit of ₹18,30,000. This was after allowing for the following:

a) Rent received from property let out ₹ 3,00,000.
b) Depreciation on Plant and Machinery @ 10% and on Furniture and Fixtures @ 5%.
c) A provision for Doubtful Debts @ 5% of the trade receivables as at 31st March, 2020.

But while preparing the Profit and Loss Account he had forgotten to provide for (1) outstanding expenses totaling ₹ 1,80,000 and (2) prepaid insurance to the extent of ₹ 20,000.

His current assets and liabilities on 31st March, 200 were: Inventories ₹ 14,50,000; Trade
Receivables ₹ 20,00,000; Cash at Bank ₹ 10,35,000 and Trade payables ₹ 11,40,000.
During the year he withdrew ₹ 6,00,000 for domestic use.

Required

Draw up his Balance Sheet at the end of the year.

OPENING ENTRY

We have seen that on commencing a new business one debits the cash account and credits the capital account with the amount introduced. A firm closes the books of account at the end of each year and starts new books in the beginning of each year. The first entry in the journal is to record the closing balances of various assets and liabilities at the end of the previous year as the opening balances in the beginning of the New Year. The balance sheet prepared at the end of the year records these balances and is the basis for this first entry. It is called the opening entry.

The assets shown in the balance sheet are debited and the liabilities and the capital account
Credited.

Illustration 8

Balance Sheet as at 31st March, 2020

Liabilities	Amount	Assets	Amount
Mahendra & Sons Capital	5,60,000 20,00,000	Cash in hand Cash at Bank Trade receivables Closing Inventory Machinery and Equipment	43,000 2,67,500 7,49,500 9,00,000 6,00,000
	25,60,000		**25,60,000**

From the above given balance sheet prepare the relevant opening entry

Illustration 9

Shri Mittal gives you the following Trial Balance and some other information:

Trial Balances as on 31st March, 2020

Particulars	Dr. ₹	Cr. ₹
Capital		8,70,000
Purchases and Sales	6,05,000	12,10,000
Opening Inventory	72,000	
Trade receivables and Trade payables	90,000	1,70,000
14% Bank Loan (loan taken at year end)		2,00,000
Overdrafts (overdraft taken at year end)		1,12,000
Salaries	2,70,000	
Advertisements	1,10,000	
Other expenses	60,000	
Returns	40,000	30,000
Furniture	4,50,000	
Building	8,90,000	
Cash in Hand	2,000	
Input CGST	9,000	
Input SGST	9,000	
Output IGST		15,000
	26,07,000	**26,07,000**

Closing Inventory on 31st March, 2020 was valued at ₹ 1,00,000.

Required

Prepare final accounts of Shri Mittal for the year ended 31st March, 2020.

Illustration 10

Mr. Mohan gives you the following trial balance and some other information:

Particulars	₹	₹
Capital		6,50,000
Sales		9,70,000
Purchases	4,30,000	
Opening Inventory	1,10,000	
Freights Inward	40,000	
Salaries	2,10,000	
Other Administration Expenses	1,50,000	
Furniture	3,50,000	
Trade receivables and Trade payables	2,10,000	1,90,000
Returns	20,000	12,000
Discounts	19,000	9,000
Bad Debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and Cash at Bank	1,89,000	
Input CGST	10,000	
Input SGST	10.000	
Output CGST		8,000
Output SGST		8,000
Output IGST		8,000
	18,53,000	**18,53,000**

Other Information:
(i) Closing Inventory was ₹ 1,80,000;
(ii) Depreciate Furniture @ 10% p.a.

Required
Prepare Trading and Profit and Loss Account for the year ended on 31.3.2020 and Balance Sheet of Mr. Mohan as on that date.

Illustration 11
The Balance Sheet of Mr. Popatlal, a merchant on 31st March, 2020 stood as below:

Liabilities	Amount ₹	Assets		Amount ₹
Capital	2,40,000	Fixed Assets		1,25,600
Trade payables	1,64,000	Inventories		2,06,400
Bank Overdraft	1,46,000	Trade receivables	1,88,000	
		Less: Provision	(6,200)	1,81,800
		Cash		36,200
	5,50,000			5,50,000

Required
Show opening journal entry on 1st April, 2020 in the books of Mr. Popatlal.

Illustration 12
The following is the schedule of balances as on 31.3.20 extracted from the books of Shri Gavaskar, who carries on business under the same name and style of Messer's Gavaskar Viswanath & Co., at Bombay:

Particulars	Dr. ₹	Cr. ₹
Cash in hand	14,000	
Cash at bank	26,000	
Sundry Debtors	8,60,000	
Stock on 1.4.2019	6,20,000	
Furniture & fixtures	2,14,000	
Office equipment	1,60,000	
Buildings	6,00,000	
Motor Car	2,00,000	
Sundry Creditors		4,30,000
Loan from Viswanath		3,00,000
Provision for bad debts		30,000
Purchases	14,00,000	
Purchase Returns		26,000
Sales		23,00,000
Sales Returns	42,000	
Salaries	1,10,000	
Rent for Godown	55,000	
Interest on loan from Viswanath	27,000	
Rates & Taxes	21,000	

Discount allowed to Debtors	24,000	
Discount received from Creditors		16,000
Freight on purchases	12,000	
Carriage Outward	20,000	
Drawings	1,20,000	
Printing and Stationery	18,000	
Electricity Charges	22,000	
Insurance Premium	55,000	
General office expenses	30,000	
Bad Debts	20,000	
Bank Charges	16,000	
Motor car expenses	36,000	
Capital A/c		16,20,000
TOTAL	**47,22,000**	**47,22,000**

Prepare Trading and Profit and Loss Account for the year ended 31st March, 2020 and the Balance Sheet as at that date after making provision for the following

1. Depreciate: (a) Building used for business by 5 percent; (b) Furniture and fixtures by 10 percent; One steel table purchased during the year for ₹ 14,000 was sold for same price but the sale proceeds were wrongly credited to Sales Account; (c) Office equipment by 15 percent; Purchase of a typewriter during the year for ₹ 40,000 has been wrongly debited to purchase; and (d) Motor car by 20%.
2. Value of stock at the close of the year was ₹ 4,40,000.
3. Two month's rent for godown is outstanding.
4. Interest on loan from Viswanath is payable at 12 percent per annum, this loan was taken on 1.5.2019.
5. Provision for bad debts is to be maintained at 5 percent of Sundry Debtors.
6. Insurance premium includes ₹ 40,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.2019 to 30.6.2020.

Illustration 13

From the following particulars extracted from the books of Ganguli, prepare trading and profit and loss account and balance sheet as at 31st March, 2020 after making the necessary adjustments:

Particulars	₹	Particulars	₹
Ganguli's capital account (Cr.)	5,40,500	Interest received	7,250
		Cash with Traders Bank Ltd.	40,000
Stock on 1.4.2019	2,34,000	Discounts received	14,950
Sales	14,48,000	Investments (at 5%) as on 1.4.2019	25,000
Sales return	43,000		
Purchases	12,15,500	Furniture as on 1-4-2019	9,000
Purchases return	29,000	Discounts allowed	37,700
Carriage inwards	93,000	General expenses	19,600
Rent	28,500	Audit fees	3,500
Salaries	46,500	Fire insurance premium	3,000
Sundry debtors	1,20,000	Travelling expenses	11,650
Sundry creditors	74,000	Postage and telegrams	4,350
Loan from Dena Bank Ltd. (at 12%)	1,00,000	Cash in hand	1,900
		Deposits at 10% as 1-4-2019 (Dr.)	1,50,000
Interest paid	4,500		
Printing and stationery	17,000	Drawings	50,000
Advertisement	56,000		

Adjustments:

1. Value of stock as on 31st March, 2020 is ₹ 3,93,000. This includes goods returned by customers on 31st March, 2020 to the value of ₹ 15,000 for which no entry has been passed in the books.
2. Purchases include furniture purchased on 1st January, 2020 for ₹ 10,000.
3. Depreciation should be provided on furniture at 10% per annum.
4. The loan account from Dena bank in the books of Ganguli appears as follows:

Date	Particulars	₹	Date	Particulars	₹
31.3.2020	To Balance c/d	1,00,000	1.4.2021	By Balance b/d	50,000
			31.3.2022	By Bank	50,000
		1,00,000			1,00,000

5. Sundry debtors include ₹ 20,000 due from Robert and sundry creditors include ₹ 10,000 due to him.
6. Interest paid include ₹ 3,000 paid to Dena bank.
7. Interest received represents ₹ 1,000 from the sundry debtors (due to delay on their part) and the balance on investments and deposits.
8. Provide for interest payable to Dena bank and for interest receivable on investments and deposits.
9. Make provision for doubtful debts at 5% on the balance under sundry debtors. No such provision need to be made for the deposits.

Illustration 14

Sengupta & Co. employs a team of eight workers who were paid ₹ 30,000 per month each in the year ending 31st March, 2019. At the start of financial year 2019-2020, the company raised salaries by 10% to ₹ 33,000 per month each.

On October 1, 2019 the company hired two trainees at salary of ₹ 21,000 per month each.

The work force are paid salary on the first working day of every month, one month in arrears, so that the employees receive their salary for January on the first working day of February etc.

You are required to calculate:

1) Amount of salaries which would be charged to the profit and loss for the year ended 31st March, 2020.
2) Amount actually paid as salaries during 2019-20
3) Outstanding Salaries as on 31st March, 2020.

Illustration 15

You are required, prepare a Trading and Profit and Loss Account for the year ending 31st
March, 2020 and a Balance Sheet as on that date from the Trial Balance given below:

Particulars	₹	Particulars	₹
Debit Balance:			
Trade receivables	3,50,000	Salaries	2,20,000
Inventory 1st April, 2019	5,00,000	Purchases	12,50,000
Cash in Hand	5,60,000	Plant and Machinery	15,70,000
Wages	3,00,000	Credit Balance:	
Bad Debts	50,000	Capital	25,00,000
Furniture and Fixtures	1,50,000	Trade payables	9,00,000
Depreciation	1,50,000	Sales	17,00,000

On 31st March, 2020 the Inventory was valued at ₹ 10,00,000.

Illustration 16

Mr. Kotriwal is engaged in business of selling magazines. Several of his customers pay money in advance for subscribing his magazines. Information related to year ended 31st March 2020 has been given below:

On 1.4.2019 he had a balance of ₹ 2,00,000 advance from customers of which ₹ 1,50,000 is related to year 2019-20 while remaining pertains to year 2020-21. During the year 2019-20 he made cash sales of ₹ 5,00,000.

You are required to compute:

1. Total income for the year 2019-20.
2. Total money received during the year if the closing balance in advance from customers account is ₹ 1,70,000.

Illustration 17

Mr. Birla is a proprietor engaged in business of trading electronics. An excerpt from his Trading & P&L account is as follows:

Trading and P&L A/c for the year ended 31st March, 2020

Particulars	₹	Particulars	₹
To Cost of Goods Sold	45,00,000	By Sales	C
To Gross Profit c/d	D		
	F		**F**
To Rent A/c	26,00,000	By Gross Profit b/d	D
To Office Expenses	13,00,000	By Miscellaneous Income	E
To Selling Expenses	B		
To Commission to Manager (on Net Profit before charging such commission)	2,00,000		
To Net Profit	A		
	G		**60,00,000**

Commission is charged at the rate of 10%.
Selling Expenses amount to 1% of total sales.
You are required to compute the missing figures.

PROVISION & RESERVES

Basis of Distinction	Provision	Reserve
Meaning	Provision means – (i) Any Amount written off. (ii) Any Amount retained by way of providing for depreciation, renewal, or diminution in value of Assets, (iii)Any Provision for known liability, of which amount cannot be determined with substantial Accuracy.	Profit retained in the business not having any of the attributes of a 'provision' is to be treated as a reserve. Also, provisions in excess of the amount considered necessary for the purposes these were originally made are to be considered as reserves.
Propose	It is created for a particular purpose and can only be used for that particular purpose	It need not necessarily be created for a particular purpose, e.g., General reserve is not for any particular purpose.
Charge Vs. Appropriation	It is a charge against the profit	It is an appropriation out of profit
Disclosure in Balance Sheet	Usually, a provision is shown by way of deduction from the amount of the items for which it is created. E.g., Provision for Doubtful Debts.	Reserve is known as a separate item under the head Reserves and Surplus' on the liabilities side of the Balance Sheet.
Investment outside the business	There is no question of investment of the amount of provisions.	The amount of a reserve can be invested outside the business. If it is invested outside business, it

		is called 'FUND'.
Utilisation for dividends	It cannot be utilised for distribution by way of dividends.	It can be utilised for distribution by way of dividends.
Examples	Provision for Tax Provision for Doubtful Debts	General Reserve Contingency Reserve Worker's Welfare Reserve

Illustration 18

Crimpson Ltd.'s profit and loss account for the year ended 31st March, 2020 includes the following information:

	₹
1. Depreciation	57,500
2. Bad debts written off	21,000
3. Increase in provision for doubtful debts	18,000
4. Proposed Dividend	15,000
5. Retained profit for the year	20,000
6. Liability for tax	4,000

Required

State which one of the items (i) to (vi) above are – (a) transfer to provisions; (b) transfer to reserves; and (c) neither related to provisions nor reserves.

Illustration 19

The following are the balances as at 31st March, 2021 extracted from the books of Mr. Satender.

	₹		₹
Plant and Machinery	78,200	Bad debts recovered	1800
Furniture and Fittings	41,000	Salaries	90,200
Bank Overdraft	3,20,000	Salaries payable	9,800
Capital Account	2,60,000	Prepaid rent	1,200
Drawings	32,000	Rent	17,200
Purchases	6,40,000	Carriage inward	4,500
Opening Stock	1,29,000	Carriage outward	5,400
Wages	48,660	Sales	8,61,200
Provision for doubtful debts	12,800	Advertisement Expenses	13,400
Provision for Discount on debtors	5,500	Printing and Stationery	5,000
		Cash in hand	5,800
Sundry Debtors	4,80,000	Cash at bank	12,500
Sundry Creditors	1,90,000	Office Expenses	40,640
Bad debts	4,400	Interest paid on loan	12,000

Additional Information:

1. Purchases include sales return of ₹ 10,300 and sales include purchases return of ₹ 6,900.

2. Goods withdrawn by Mr. Satender for own consumption ₹ 14,000 included in purchases.
3. Wages paid in the month of April for installation of plant and machinery amounting to ₹ 1,800 were included in wages account.
4. Free samples distributed out of purchases for publicity costing ₹ 3,300.
5. Create a provision for doubtful debts @ 5% and provision for discount on debtors @2.5%.
6. Depreciation is to be provided on plant and machinery @ 20% p.a. and on furniture and fittings @ 10% p.a.
7. Bank overdraft is secured against hypothecation of stock. Bank overdraft outstanding as on 31.3.2020 has been considered as 80% of real value of stock (deducting 20% as margin) and after adjusting the marginal value 80% of the same has been allowed to draw as an overdraft.

Prepare a Trading and Profit and Loss Account for the year ended 31st March, 2021, and a Balance Sheet as on that date. Also show the rectification entries.

Illustration 20

Karuna decided to start business of fashion garments under the name of M/s. Designer Wear on 1st April, 2020. She had a saving of about ₹ 10,00,000. She invested ₹ 3,00,000 out of her savings and borrowed equal amount from bank. She purchased a commercial space for ₹ 5,00,000 and further spent ₹ 1,00,000 on its renovation to make it ready for business.

Loan and interest repaid by her in the first year are as follows:

30th June, 2020 - ₹ 15,000 principal+ ₹ 9,000 interest
30th September, 2020 - ₹ 15,000 principal+ ₹ 8,550 interest
31st December, 2020 - ₹ 15,000 principal+ ₹ 8,100 interest
31st March, 2021 - ₹ 15,000 principal+ ₹ 7,650 interest.

In view of further capital requirement, she transferred ₹ 2,00,000 from her saving bank account to the bank account of the business. She paid security deposit of ₹ 7,000 for telephone connection. Furniture of ₹ 10,000 was purchased, all payments were made by cheque and all receipts in cash were deposited in the bank.

At the end of the year, her business showed the following results:

Particulars	Amount	Particulars	Amount
Total Sales	20,00,000	Total Purchases	17,00,000
Electricity Expenses paid	40,000	Telephone Charges	50,000
Cartage Outwards	60,000	Travelling Expenses	45,000
Entertainment Expenses	5,000	Maintenance Expenses	25,000
Misc. Expenses	15,000	Electricity Expenses Payable	20,000

Other Information:
1. She withdrew ₹ 5,000 by cheque each month for her personal expenses.
2. Depreciation on building @ 5% p.a. and oil furniture @ 10% p.a.
3. Closing stock in hand as on 31st March, 2021: ₹ 5,50,000

Prepare trading account, profit and loss account for the year ended 31-3-2021 and Balance Sheet as on that date.

Illustration 21

The following is the trial balance of Hari as at 31st December, 2017:

Particulars	Dr. ₹	Cr. ₹
Hari's capital account	-	76,690
Stock 1st January, 2017	46,800	-
Sales	-	3,89,600
Returns inward	8,600	-
Purchases	3,21,700	-
Returns outward	-	5,800
Carriage inwards	19,600	-
Rent & taxes	4,700	-
Salaries & wages	9,300	-
Sundry debtors	24,000	-
Sundry creditors	-	14,800
Bank loan@ 14% p.a.	-	20,000
Bank interest	1,100	-
Printing and stationary expenses	14,400	-
Bank balance	8,000	-
Discount earned	-	4,440
Furniture & fittings	5,000	-
Discount allowed	1,800	-
General expenses	11,450	-
Insurance	1,300	-
Postage & telegram expenses	2,330	-
Cash balance	380	-
Travelling expenses	870	-
Drawings	30,000	-
	5,11,330	**5,11,330**

The following adjustments are to be made:

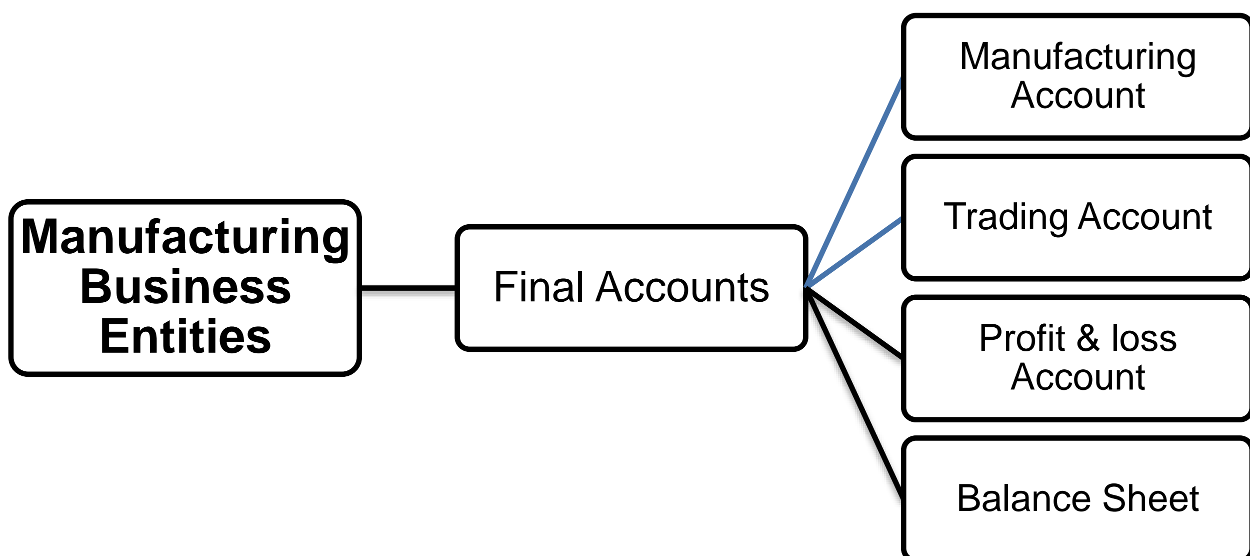
1. Included amongst the debtors is ₹ 3,000 due from Ram and included among the creditors ₹ 1,000 due to him.
2. Provision for bad and doubtful debts be created at 5% and for discount @2% on sundry debtors.
3. Depreciation on furniture & fittings @ 10% shall be written off.
4. Personal purchases of Hari amounting to ₹ 600 had been recorded in the purchases day book.
5. Interest on bank loan shall be provided for the whole year.
6. A quarter of the amount of printing and stationary expenses is to be carried forward to the next year.
7. Credit purchase invoice amounting to ₹ 400 had been omitted from the books.
8. Stock on 31.12.2017 was ₹ 78,600.

Prepare (i) Trading & profit and loss account for the year ended 31.12.2017 and (ii) Balance sheet as on 31st December, 2017.

CHAPTER - 15
FINAL ACCOUNTS OF MANUFACTURING ENTITY

---------------------------- **Bird's Eye View**-------------------------

- ❑ Components of Final Accounts of Manufacturing Entity
- ❑ Introduction
- ❑ Purpose of manufacturing Account
- ❑ Manufacturing Cost
- ❑ Direct Manufacturing Expenses
- ❑ Indirect Manufacturing Expenses (overheads)
- ❑ Treatment of By Products
- ❑ Format of Manufacturing Account
- ❑ Problems



INTRODUCTION

The manufacturing entities generally prepare a separate Manufacturing Account as a part of Final accounts in addition to Trading Account, Profit and Loss Account and Balance Sheet.

The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities. Manufacturing costs of finished goods are then transferred from the Manufacturing Accounts to Trading Account.

Trading account shows Gross Profit while Manufacturing Account shows Cost of goods sold/Cost of Production which includes direct expenses.

Manufacturing account deals with the raw material, and work in progress while the trading account would deal with finished goods only.

PURPOSE OF MANUFACTURING ACCOUNT

A manufacturing account serves the following functions:

1) It shows the total cost of manufacturing the finished products and sets out in detail, with appropriate classifications, the constituent elements of such cost. It is, therefore, debited with the cost of materials, manufacturing wages and expenses incurred directly or indirectly on manufacture.
2) It provides details of factory cost and facilitates reconciliation of financial books with cost records and also serves as a basis of comparison of manufacturing operation from year to year.
3) The Manufacturing Account may also be used for various other purposes. For example, if the output is carried to the Trading Account at market prices, it discloses the profit or loss on manufacture.

MANUFACTURING COST

Manufacturing costs are classified into:

+ Raw Material Consumed	....
+ Direct Manufacturing Wages	…...
+ Direct Manufacturing Expenses	…...
+ Indirect Manufacturing expenses (Overheads)	…...

Raw Material Consumed = Opening inventory of Raw Materials + Purchase – Closing inventory of Raw Materials

Opening inventory of Work-in-Process is posted the debit of the Manufacturing Account and closing inventory of Work-in-Process is posted to the credit of the Manufacturing Account.

DIRECT MANUFACTURING EXPENSES

1. Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.
2. Examples of direct manufacturing expenses are (i) Royalties for using license or technology if based on units produced, (ii) Hire charge of the plant and machinery used on hire, if based on units produced, etc.

INDIRECT MANUFACTURING EXPENSES (OVERHEADS)

These are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages, and indirect expenses.

Overhead= Indirect Material + Indirect Wages + Indirect Expenses

Indirect material means materials which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc.

Indirect wages are those which cannot be directly linked to the units produced, for example, wages for maintenance works, holding pay, etc.

Indirect expenses are those which cannot be directly linked to the units produced, for example, training expenses, depreciation of plant and machinery, depreciation of factory shed, insurance premium for plant and machinery, factory shed, etc.

Accordingly, indirect manufacturing expenses comprise indirect material, indirect wages and indirect expenses of the manufacturing division.

TREATMENT OF BY PRODUCTS

1. In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale.
2. Example - Molasses is the by-product in sugar manufacturing, Butter milk is the by-product of a dairy which produces butter and cheese, etc.
3. The subsidiary product is termed as a by-product because its production is not consciously undertaken but results out of the production of the main product. It is usually very difficult to ascertain the cost of the product. Moreover, its value usually forms a very small percentage of the main product.
4. By-product is a secondary product. This is produced from the same raw materials, which are used for producing the main product and without incurring any additional expenses form the same production process in which the main product is produced.
5. By-products generally have insignificant value as compared to the value of main product. They are generally valued at net realizable value, if their costs cannot be separately identified. It is often treated, as “Miscellaneous income” but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.

FORMAT OF MANUFACTURING ACCOUNT

Manufacturing Account

Particulars	**Units**	**Amount ₹**	**Particulars**	**Units**	**Amount ₹**
To Opening Work-in-process			By Closing Work-in-Process		
To Raw Material Consumed:			By By-products at net realizable value		
Opening inventory			By Trading A/c (Cost of production)		
Add: Purchases					
Less: Closing inventory					
To Direct Wages					
To Direct manufacturing Expenses					
Royalty					
Hire charges					
To Indirect Manufacturing expenses:					
Indirect Material					
Indirect Wages					
Indirect Expenses					

Illustration 1

Mr. Vimal runs a factory which produces soaps. Following details were available in respect of his manufacturing activities for the year ended on 31.3.2020:

	₹
Opening Work-in-Process (10,000 units)	16,000
Closing Work-in-Process (12,000 units)	20,000
Opening inventory of Raw Materials	1,70,000
Closing inventory of Raw Materials	1,90,000
Purchases	8,20,000
Hire charges of machine @ 0.60 per unit manufactured	
Hire charges of factory	2,20,000
Direct wages-Contracted @ 0.80 per unit manufactured and @ ₹0.40 per unit of Closing W.I.P.	
Repairs and Maintenance	1,80,000
Units produced – 5,00,000 units	

Required

Prepare a Manufacturing Account of Mr. Vimal for the year ended 31.3.2020.

Illustration 2

Mr. Pankaj runs a factory which produces motor spares of export quality. The following details were
Obtained about his manufacturing expenses for the year ended on 31.3.2020.

			₹
W.I.P.	- Opening		3,90,000
	-Closing		5,07,00
Raw Materials	- Purchase		12,10,000
	- Opening		3,02,000
	- Closing		3,10,000
	- Returned		18,000
	- Indirect Material		16,000
Wages	- Direct		2,10,000
	- Indirect		48,000
Direct expenses	- Royalty on production		1,30,000
		- Repairs and maintenance	2,30,000
		- Depreciation on factory shed	40,000
		- Depreciation on plant & machinery	60,000
By-product at selling price			20,000

You are required to prepare Manufacturing Account of Mr. Pankaj for the year ended on 31.3.2020.

Illustration 3

Following are the Manufacturing A/c, Creditors A/c and Trading A/c provided by Ms. Shivi related to 2019-20. There are certain figures missing from these accounts.

Raw Material A/c

Date	Particular	Amount ₹	Date	Particular	Amount ₹
	To Opening Stock A/c	1,00,000		By Raw Material Consumed	……..
	To Creditors A/c	……….		By Closing Stock A/c	……..

Creditors A/c

Date	Particular	Amount ₹	Date	Particular	Amount ₹
	To Bank A/c To Balance c/d	22,00,000 6,00,000		By Balance b/d	15,00,000

Manufacturing A/c

Particular	Amount ₹	Particular	Amount ₹
To Raw Material Consumed To Wages To Depreciation To Direct Expenses	………… 3,50,000 2,00,000 2,44,000	By Trading A/c	17,94,000

Additional Information:

1. Purchase of machinery worth ₹ 10,00,000 has been omitted. Machinery are chargeable at a depreciation rate of 10%.
2. Wages include the following
    - Paid to Factory Workers - ₹ 3,00,000
    - Paid to labour at office - ₹50,000
3. Direct Expenses include following:
    - Electricity charges of ₹ 80,000 of which 30% pertained to office.
    - Fuel Charges of ₹ 20,000
    - Freight Inwards of ₹ 35,000
    - Delivery charges to customers - ₹ 20,000.

You are required to prepare revised Manufacturing A/c, and Raw Material A/c.

Illustration 4

On 31st March, 2020 the Trial Balance of Mr. White were as follows:

Trial Balance as on 31st March, 2020

Particulars	Dr.₹	Particulars	Cr.₹
Stock on 1st April 2021			
Raw Materials	21,000	Sundry Creditors	15,000
Work in Progress	9,500	Bills Payable	7,500
Finished goods	15,500	Sale of Scrap	2,500
Sundry Debtors	24,000	Commission Received	450
Carriage on Purchases	1,500	Provision for doubtful debts	1,650
Bills Receivable	15,000	Capital Account	1,00,000
Wages	13,000	Sales	1,67,200
Salaries	10,000	Bank Overdraft	8,500
Telephone, Postage etc.	1,000		
Repairs to Office Furniture	350		
Cash at Bank	17,000		
Office Furniture	10,000		
Repairs to Plant	1,100		
Purchases	85,000		
Plant and Machinery	70,000		
Rent	6,000		
Lighting	1,350		
General Expenses	1,500		
	3,02,800		**3,02,800**

The following additional information is available:

Stocks on 31st March, 2020 were:

Raw Materials ₹ 16,200

Finished goods ₹ 18,100

Semi-finished goods ₹ 7,800
Salaries and wages unpaid for March 2020 were respectively, ₹ 900, and ₹ 2,000
Machinery is to be depreciated by 10% and office furniture by 71/2 %
Provision for doubtful debts is to be maintained @ 1% of sales
Office premises occupy 1/4 of total area.
Lighting is to be charged as to 2/3 to factory and 1/3 to office.
Prepare the Manufacturing Account Trading Account, Profit and Loss Account and the Balance Sheet
relating to 31st March 2020.

Illustration 5
The following is the trial balance of Mr. Pandit for the year ended 31st March, 2020:

Trial Balance as on 31st March, 2020

Particulars	Dr.₹	Particulars	Cr.₹
Opening Stock:			
Raw Materials	1,50,000	Sundry Creditors	50,000
Finished goods	75,000	Purchase Returns	5,000
Purchase of Raw Materials	5,00,000	Capital	1,00,000
Land & Building	1,00,000	Bills Payable	24,000
Loose tools	30,000	Long-Term Loan	2,00,000
Plant & Machinery	30,000	Provision for Bad and Doubtful	
Investments	25,000	Debts	2,000
Cash in Hand	20,000	Sales	8,50,000
Cash at Bank	5,000	Bank Overdraft	23,000
Furniture & Fixtures	15,000		
Bills Receivable	15,000		
Sundry Debtors	40,000		
Drawings	20,000		
Salaries	20,000		
Coal and Fuel	15,000		
Factory rent & rates	20,000		
General Expenses	4,000		
Advertisement	5,000		
Sales Return	10,000		
Bad Debts	4,000		
Direct Wages (Factory)	80,000		
Power	30,000		
Interest Paid	7,000		
Discount Allowed	3,000		
Carriage Inwards	15,000		
Carriage Outwards	7,000		
Commission Paid	9,000		
	12,54,000		**12,54,000**

Additional Information
Stock of finished goods at the end of the year ₹ 1,00,000.
A provision for doubtful debts at 5% on Sundry Debtors. Depreciation on building ₹ 1,000 and ₹ 3,000 on Machinery to be provided.
Accrued commission of ₹ 12,500. Interest has accrued on investment ₹ 15,000.
Salary Outstanding ₹ 2,000 and Prepaid Interest ₹ 1,500.
You are required to prepare Manufacturing, Trading and Profit and Loss Account for the year ended 31st March, 2020.

CHAPTER - 16
PARTNERSHIP - BASICS

---------------------------- **Bird's Eye View**-------------------------

- ❑ Meaning of Partnership
- ❑ Features of Partnership
- ❑ Partnership Deed – Meaning & Contents
- ❑ Limited Liability Partnership
- ❑ Distinction Between Partnership Firm & LLP
- ❑ Provisions of Partnership Act, 1932 Affecting Accounting Treatment
- ❑ P/L Appropriation A/c – Meaning & Purpose
- ❑ Methods of Maintaining Capital Accounts of Partners
- ❑ Interest on Capital to Partners
- ❑ Interest on Drawings
- ❑ Interest on Partner's Loan to the Firm
- ❑ Salary or Commission to partner
- ❑ Minimum or Guarantee profit
- ❑ Past Adjustments

MEANING OF PARTNERSHIP

Sec. 4 of the Indian partnership Act, 1932 defines Partnership as –
''The relationship between persons who have agreed to share the profits of a business carried on by all or by any of them acting for all ''.

FEATURES OF PARTNERSHIP

1. An association of two or more persons; (Min. - 2, Max. – 50)
2. An agreement entered into by all persons concerned;
3. Existence of a business;
4. The carrying on of such business by all or anyone of them acting for all; and
5. Sharing of profits of the business (including losses)
6. Unlimited liability of all partners.
7. Minor Can Be added as Partner but The Condition is that He can be admitted to Share Profits Only.

8. Registration of Firm is not Compulsory, but Non-Registration Restricts The partners or the firm from taking any Legal Action.

PARTNERSHIP DEED – MEANING & CONTENTS

'Partnership Deed' is a document which contains the terms of partnership as agreed among the partners. The deed is required to be duly stamped as per Indian Stamp Act, 1889 and duly signed by all the partners.

CONTENTS OF PARTNERSHIP DEED

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

LIMITED LIABILITY PARTNERSHIP – MEANING

Section 2 of the Limited Liability Partnerships (LLPs) Act, 2008 defines limited liabilities partnership" as a partnership formed and registered under this act; and "limited liability partnership agreement" means any written agreement between the partners of limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation of that limited liability partnership.

FEATURES OF LLP

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

4. The main benefit under the LLP is that it is taxed as a partnership, but has the benefit of being a corporate limited liability.
5. LLP has a special characteristic of being a separate legal personality distinct from its partners.
6. Save as otherwise provided, the provisions of India Partnership Act, 1932 shall not apply to a limited liability partnership.

DISTINCTION BETWEEN PARTNERSHIP FIRM AND LLP

Sr. No.	Key Elements	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
2	Registration	Optional	Compulsory with ROC
3	Creation	Created by an Agreement	Created by Law
4	Body Corporate	No	Yes
5	Separate Legal Entity	No	Yes
6	Perpetual Succession	Partnerships do not have perpetual succession	It has perpetual succession and individual partners may come and go
7	Number of Partners	Minimum 2 and Maximum 50	Minimum 2 but no maximum limit
8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	The LLP as an independent entity can own assets
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner
10	Principal Agent Relationship	Partners are the agents of the firm and of each other	Partners are agents of the firm only and not of other partners

PROVISION AFFECTING ACCOUNTING TREATMENT

Law does not make it obligatory for the partners to reduce in writing all the terms and conditions. In the absence of any such agreement, the Indian Partnership Act, 1932 provides following provisions –

1. Every partner is entitled to share profits equally.
2. No partner is entitled to interest on capital.
3. No interest on drawings is to be charged by the firm to a partner.
4. A partner is not entitled to any salary for taking part in carrying on the firm's business.
5. A partner is entitled to interest on advances (over and above the agreed capital contribution) at the rate of six per cent per annum.
6. Every partner being joint owner of partnership, is entitled to have equal share in the property.

PROFIT & LOSS APPROPRIATION A/C – MEANING & PURPOSE

Meaning

1. Profit & Loss Appropriation Account is merely an extension of the profit & Loss Account
2. It is credited with Net Profits and interest on drawings
3. It is debited with Interest on Capitals, salary, or commission to partners if provided under the terms of partnership agreement and
4. Its balance is transferred to the partners Capitals (or Current) Accounts in their agreed profit-sharing ratio (or equally if there is no agreed profit-sharing ratio)

Purpose

The purpose of Profit & Loss Appropriation Account is to show how net Profit is to be distributed among the partners. The balance in profits & Loss Appropriation Account may be used:

1. To provide for Interest on Capitals of partners (*if Partnership deed so provides)*
2. To provide for Salary or Commission to partners (*if partnership Deed so provides)*
3. To transfer the profits to General Reserve or Specific Reserve.
4. To distribute the profits among the partners in their profit-sharing ratio.
5. To retain the profits in the business by ploughing back of profits.

METHODS OF MAINTAINING PARTNERS CAPITAL ACCOUNTS

The Partners' Capital Accounts may be maintained according to Fluctuating Capital method or Fixed Capital method

Fluctuating Capital Method: Under Fluctuating Capital Method, only one account (viz. Capital Account) for each partner is maintained and all the transaction relating to a partner are recorded in his Capital Account. As a result, the balance in the Capital Account keeps on fluctuating.

Fixed Capital Method: Under fixed Capital Method, two accounts (viz. Capital Account and Current Account) for each partner are maintained. The transaction relating to introduction or withdrawal of Capital are recorded in Capital Account and other transaction like Interest on Capital Drawings, Salary, Commission, Share of Profit / Loss are recorded in Current Account. As a result of these, the Capital Account will continue to show the same balances from year to year unless some amount of Capital amount is introduced or withdrawn while the balances of Current Account keeps on fluctuating.

INTEREST ON CAPITAL

Interest is generally allowed on capitals of the partners. Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business. Normally, it is charged for full years on the balance of capital at the beginning of the year unless some fresh capital is introduced during the year. On the additional capital introduced interest for the relevant period of utilization is calculated**.** In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and no interest is payable/ chargeable on the balance of current accounts.

Important Points:

1. As studied earlier, If the partnership agreement is silent as to interest on capital, then no interest on capital will be allowed.
2. Subject to an agreement between partners in conformity with Partnership Deed, interest on capital is to be provided only out of profits of the firm. Therefore, if there is no profit, will be no interest on capital.
3. If profit before interest on capital is less than the interest amount (i.e. in case of insufficient or inadequate profit), then the available profit is shared by partners in their capital ratio as partners get profit by way of interest on capital only.
4. If the partnership agreement provides for interest on capital as a charge against profits, then the same will be provided even if it results in loss to the firm.

Journal Entries for Interest on Capital in Books of Firm

1. Interest on Capital A/c……Dr
   To Partner's Capital A/c / Partner's Current A/c

2. Profit & Loss Appropriation A/c……Dr
   To Interest on capital A/c

INTEREST ON DRAWINGS

1. Drawings mean the amount withdrawn in cash or in kind for personal purpose. Drawings may be against profits or against capital.
2. Interest on Drawings is to be charged from the partners only when the partnership agreement provides for the same.
3. Interest on drawings is to be calculated with reference to the time period for which the money was withdrawn. Depending upon the availability of information, the interest on drawings in various cases may be calculated as follows:

Case	Calculation of Interest on Drawings
Where dates of drawings and the amounts of drawings at various dates are clearly stated,	The Interest on drawings is calculated with the help of **Product Method**
Where dates of drawings made during the period of 12 months are not given	The Interest on drawings is calculated on the total amount of drawings for an average period of **6 months**
Where the fixed amount is withdrawn on the first day of every month or quarter, during the period of 12 months	The Interest on drawings is calculated on the total amount for an average period (for computation of average period in this case see below)
Where the fixed amount is withdrawn during the middle of every month or quarter, during the period of 12 months	The Interest on drawings is calculated on the total amount for an average period (for computation of average period in this case see below)
Where the fixed amount is withdrawn on the last day of every month or quarter, during the period of 12 months	The Interest on drawings is calculated on the total amount for an average period (for computation of average period in this case see below)

Average Period in above cases can be calculated with the help of following formula:

a) **If fixed amount is withdrawn in the beginning of every month/ quarter**
= [Total period of drawings (in Months) + Time interval between two consecutive drawings (in months)] / 2

b) **If fixed amount is withdrawn during the middle of every month / quarter**
= Total period of drawings (in months) / 2

c) **If fixed amount is withdrawn at the end of every month/ quarter**
= [Total period of drawings (in Months) - Time interval between two consecutive drawings (in months)] / 2

Journal Entries for Interest on Drawings in Books of Firm

1. Partner's Capital A/c / Partner's Current A/c ……Dr
   To Interest on Drawings

2. Interest on Drawings A/c……Dr
   To Profit & Loss Appropriation A/c

INTEREST ON PARTNER'S LOAN TO THE FIRM

1. If there is an agreement as to the rate of Interest then partner is entitled to an Interest on loan at an agreed rate of interest but if there is no agreement as to the rate of interest then as per section 13(d) of Indian Partnership Act, 1932 partner is entitled to Interest on loan @ 6% P.a.
2. It may be noted that Interest on Partner's loan is a charge against the profits and not an appropriation out of profits. In other words, Interest on partner's loan is to be allowed whether there are profits are not.

Journal Entries for Interest on Partner's Loan to the Firm

1. Interest on Partner's Loan A/c ………Dr
   To Partner's Loan A/c

2. Profit & Loss A/c …………. Dr
   To Interest on Partner's Loan A/c

SALARY OR COMMISSION TO A PARTNER

1. Salary or commission to a partner is to be allowed if the partnership agreement provides for the same.
2. Salary or commission to a partner is an appropriation of profits and not a charge against the profits. In other words, it is to be allowed only if there are profits.

Journal Entries for Salary or Commission in Books of Firm

1. Salary or Commission A/c ……Dr
   To Partner's Capital A/c / Partner's Current A/c

2. Profit & Loss Appropriation A/c……Dr
    To Salary or Commission A/c

GUARANTEE OF MINIMUM PROFIT TO PARTNER

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

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

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

Note - Unless otherwise stated, it is presumed that all the existing partners (other than the guaranteed partner) have given such guarantee in their existing profit-sharing ratio.

Journal Entry –
Guaranteeing Partner's capital Ac/………Dr
    To Guaranteed Partner's A/c

PAST ADJUSTMENTS

Sometimes, after the final accounts of a firm have been closed, certain matters come to light which were left out by mistake. For example, interest on partner's capitals or drawings or remuneration may have been omitted completely or allowed/charged at a high or low rate, profits or losses have been distributed in one year or in several years among the partners in a wrong proportion etc. in such cases, instead of altering the final accounts which have already been closed, an adjustment for such mistake may have to be made in the capital accounts at the beginning of new year.

Types of Adjustments

(i) When interest on capitals may have been omitted by mistake or have been wrongly treated.
(ii) When interest on drawings may have been omitted.
(iii) When salary or commission payable to a partner has been omitted.
(iv) When profit sharing ratio has been changed w.e.f. some past date (i.e., retrospectively).

Accounting Treatment

In order make adjustment, firstly an adjustment table is to be prepared to find out the net effect of errors and after that debit the capital/current account of the partner who had been credited in excess and credit the capital/current account of the partners who had been debited in excess. In such a case, single entry will be passed for adjustment.

Illustration 1

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

(i) Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim & Karim do not agree.

(ii) Rahim has devoted full time for running the business and demands salary at the rate of Rs 500 p.m. But Ram and Karim do not agree.

(iii) Karim demands interest on loan of Rs 2,000 advanced by him at the market rate of interest which is Rs 12% p.a.

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

Illustration 2

A and B start business on 1st January, 2019, with capitals of Rs.30,000 and Rs.20,000. According to the Partnership Deed, B is entitled to a salary of Rs.500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2019 the firm earned a profit, before charging salary to B and interest on capital amounting to Rs.25,000. During the year A withdrew Rs.8,000 and B withdrew Rs.10,000 for domestic purposes.

Give journal entries relating to division of profit

Illustration 3

A and B start business on 1st January, 2019, with capitals of Rs.30,000 and Rs.20,000. According to the Partnership Deed, B is entitled to a salary of Rs.500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2019 the firm earned a profit, before charging salary to B and interest on capital amounting to Rs.25,000. During the year A withdrew Rs.8,000 and B withdrew Rs.10,000 for domestic purposes.

Prepare Profit and Loss Appropriation Account.

Illustration 4

A and B start business on 1st January, 2019, with capitals of Rs.30,000 and Rs.20,000. According to the Partnership Deed, B is entitled to a salary of Rs.500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2019 the firm earned a profit, before charging salary to B and interest on capital amounting to Rs.25,000. During the year A withdrew Rs.8,000 and B withdrew Rs.10,000 for domestic purposes.

Prepare Capital Accounts of Partners A and B.

Illustration 5

Shilpa and Sanju are partners with a capital of ₹ 1,00,000 and ₹ 1,60,000 on January 1, 2019 respectively. Shilpa introduced additional capital of ₹ 30,000 on July 1, 2019 and another ₹ 20,000 on October 31, 2019. Calculate interest on capital for the year ending 2019. The rate of interest is 9% p.a.

Illustration 6

Calculate the Interest on Drawings of Ram @ 10% p.a. for the year ended 31st Dec. 2021 in each of the following alternative cases -

a) If his drawings during the year were Rs 24,000;
b) If he withdrew Rs 2,000 p.m. in the beginning of every month;
c) If he withdrew Rs 2,000 p.m. at the end of every month;
d) If he withdrew Rs 2,000 p.m.;
e) If he withdrew the following amounts as follows:
   Jan 31 Rs 6,000, Mar 31 Rs 4,000, Jul 1 Rs 8,000, Sept 30 Rs 3,000, Nov 1 Rs 5,000,
f) If he withdrew Rs 6,000 in the beginning of each quarter.
g) If he withdrew Rs 6,000 at the end of each quarter.
h) If he withdrew Rs 6,000 during the middle of each quarter.

Illustration 7

A and B are partners sharing profits and Losses in the ratio of their effective capital. They had Rs.1,00,000 and Rs.60,000 respectively in their Capital Accounts as on 1st January,2019.

A introduced a further capital of Rs.10,000 on 1st April, 2019 and another Rs.5,000 on 1st July, 2019. On 30th September, 2019 A withdrew Rs.40,000.

On 1st July, 2019, B introduced further capitals of Rs.30,000.

The partners drew the following amounts in anticipation of profit.

A drew Rs.1,000 per month at the end of each month beginning form January, 2016. B drew Rs.1,000 on 30th June, and Rs.5,000 on 30th September, 2019.

12% p.a. interest on capital is allowable and 10% p.a. interest on drawings is chargeable. Date of closing 31.12.2019. Calculate: (a) Profit-sharing ratio; (b) Interest on capital; and (c) Interest on drawings.

Illustration 8

Ram and Rahim start business with capital of Rs.50,000 and Rs.30,000 on 1st January, 2019. Rahim is entitled to a salary of Rs.400 per month. Interest is allowed on capitals and charged on drawings at 6% per annum. Profits are to distributed equally after the above noted adjustments. During the year, Ram withdrew Rs.8,000 and Rahim withdrew Rs.10,000. The profit for the next year before allowing for the terms of the Partnership Deed came to Rs.30,000. Assuming the capitals to be fixed, prepare the profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

Illustration 9

A and B are partners, sharing profits and losses in the ratio of 3:2. They admit C with 1/6th share in profits and guaranteed that is share of profit will not be less than Rs. 2,50,00,000. Total profits for the year ended 31st march, 2020 where Rs. 9,00,00,000. Calculate share of profits for each partner when:

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

Illustration 10

A, B and C are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capitals were ₹ 15,00,000, ₹ 30,00,000, and ₹ 60,00,000 respectively. For the year 2019 interest on capital was credited to them @ 12% instead of 10%. Pass the necessary adjustment entry.

Illustration 11

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

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

	Weak	Able	Lazy
	Rs.	Rs.	Rs.
Capital (1.1.2019)	75,000	40,000	30,000
Current Account (1.1.2019)	10,000	5,000	(Dr.) 5,000
Drawings	15,000	10,000	10,000

The draft accounts for 2019 showed a net profit of Rs. 60,000 before taking into account interest on capitals and drawings and subject to following rectification of errors:

1. Life insurance premium of weak amounting to Rs. 750 paid by the firm on 30th June, 2019 has been charged to Miscellaneous Expenditure A/c.
2. Repairs of Machinery amounting to Rs.10,000 has been debited to Plant Account and Depreciation thereon charged @20%.
3. Travelling expenses of Rs.3,000 of Able for a pleasure trip to U.K. Paid by the firm on 30th June, 2019 has been debited to Travelling expenses Account.

Illustration 12

Ram and Rahim are in partnership sharing profits and losses in the ratio of 3:2. As Ram, on Account of his advancing years, feels he cannot work as hard as before, the chief clerk of the firm, Ratan is admitted as a partner with effect from 1st January, 2019, and becomes entitled to 1/10th of net profits and nothing else, the mutual ratio between Ram and Rahim remaining unaltered.

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

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

The net profit for the year ended December 31, 2019 is Rs. 1,10,000. Show the distribution of net profit amongst the partners.

Illustration 13

X and Y are partners. As per terms of agreement interest is allowed on capital at 8% p.a. and charge on drawing at 10% p.a. X withdrew Rs. 40,000 pm at the end of each month and Y withdrew Rs. 1,20,000 at the end of each quarter. You are required to fill missing figures in following accounts:

Profit and Loss Appropriation Account for the year ended March 31, 2020

Particulars		Rs.	Particulars		Rs.
To…….?			By Profit and Loss A/c (net profit)		?
To Interest on Capital A/c			By Interest on Drawings A/c		?
X	1,60,000		X	?	
Y	?	2,88,000	Y	?	
To Profit transferred to Capital A/c					
X (2/3)	?				
Y (1/3)	2,80,000	?			
		?			?

Partner's Capital Account

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

Illustration 14 (PYP DEC 2021 5 MARKS)

A, B and C are partners in a firm. On 1st April, 2019, their fixed capital stood at Rs. 50,000, Rs. 25,000 and Rs. 25,000 respectively.

As per the provision of partnership deed:

1. C was entitled for a salary of Rs. 5,000 p.a.
2. All the partners were entitled to interest on capital at 5% p.a.
3. Profits and losses were to be shared in the ratio of Capitals of the partners.

Net profit for the year ended 31st March, 2020 of Rs. 33,000 and 31st March, 2021 of Rs. 45,000, was divided equally without providing for the above adjustments.

You are required to pass an adjustment journal entry to rectify the above errors.

Illustration 15 (RTP MAY 2021)

Rose, Lilly, and Lotus start business with capital of ₹ 2,00,000/-, ₹ 3,00,000/- and ₹ 4,00,000 on 1st April 2019. Lotus is entitled to a salary of ₹ 50,000 per annum. Interest is allowed on capitals at 12% p.a. and is charged on drawings at 12% per annum. Profits are to be distributed in the ratio 1:2:3 after the above-mentioned adjustments. Rose was given guarantee of minimum profit of ₹ 50,000 by Lotus. Partners drawings during the year were Rose ₹ 40,000/- Lilly ₹ 30,000/- Lotus ₹ 20,000/-. Lotus had paid ₹ 10,000/- as tuition fees of his son on 31st March 2020, which was wrongly debited to salaries account. The profit for the year 2019-20 before allowing interest on capital and charging interest on drawings and salary paid to Lotus was ₹ 3,34,600/-. Assuming the capitals to be fixed, prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

CHAPTER - 17
PARTNERSHIP – VALUATION OF GOODWILL

--------------------------- Bird's Eye View------------------------

- ❑ Goodwill – Meaning
- ❑ Nature of Goodwill
- ❑ Factors Affecting Goodwill
- ❑ Need For Valuation of Goodwill
- ❑ **Methods of Valuation of Goodwill** – Average Profit Method, Super Profit Method, Annuity Method, Capitalization Method.

GOODWILL – MEANING

1. Goodwill is the value of reputation of a firm in respect of the profits expected in future over and above the normal profits earned by other similar firms belonging to the same industry. Such excess of future profits over the normal profits is known as super profits. Thus, goodwill exists only when the firm earns super profits.
2. Any firm that earns only normal profits or is incurring losses has no goodwill.
3. If time value of money is considered, goodwill can be defined as the present value of anticipated super profits.

NATURE OF GOODWILL

1. Goodwill is regarded as an intangible asset and not a fictitious asset.
2. Goodwill is a valuable asset if the firm is earning profits and is a valueless asset if the firm is incurring losses
3. However, in the periods of temporary recession, the goodwill of the firm which is incurring
   least losses as compared to other similar firms may be a valuable asset.

FACTORS AFFECTING GOODWILL

1. Nature of Business
2. Favorable Location
3. Efficiency of Management
4. Market Situation
5. Special Advantages
6. Technical know how
7. Quality of Products

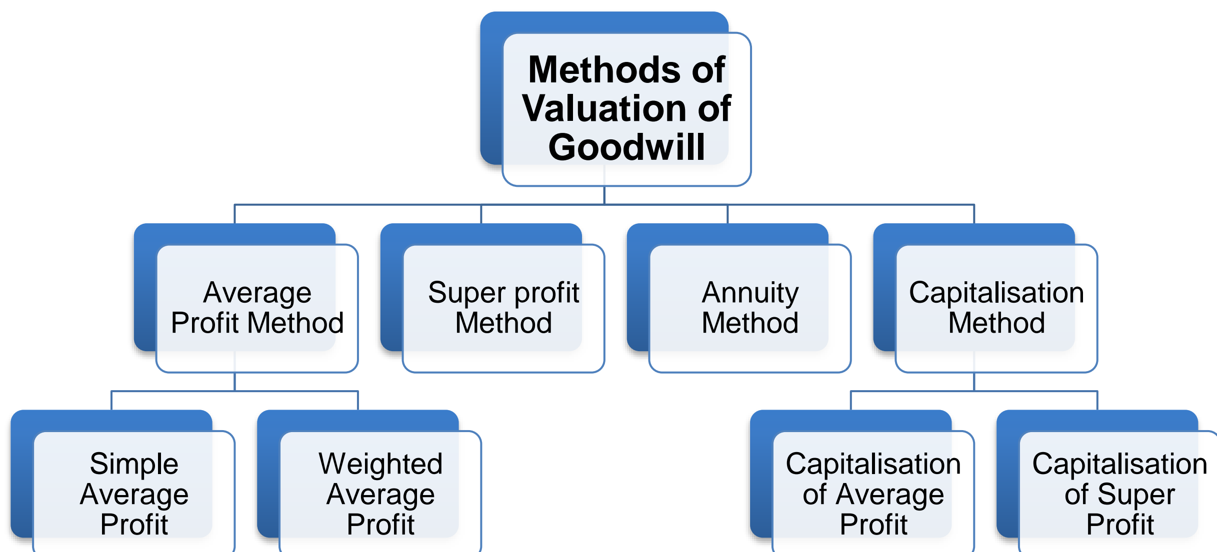
8. After Sales Service
9. Producing/ Providing customers satisfying products

NEED FOR VALUATION OF GOODWILL

1. When there is a change in profit- sharing ratio amongst the existing partners
2. When a new partner is admitted
3. When a partner retires
4. When a partner dies
5. When the firm is sold as going concern
6. When the firm is amalgamated with another firm.

METHODS OF VALUATION OF GOODWILL

1. Average Profit Method
2. Super Profit Method
3. Annuity Method
4. Capitalization Method



AVERAGE PROFIT METHOD

1. Under this method goodwill is valued on the basis of certain number of years' purchase of the average annual profits of the past years. While calculating past profits any abnormal gain is excluded by deducting from past profits and any abnormal loss is excluded by adding to the past profits. Thus

   Goodwill = Average Annual Profit X Number of Year's Purchase.

2. For ascertaining Average Annual Profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits

of the recent years than those of earlier years. But if there is no clear trend of profit, it is better to go by simple average.

3. This method of goodwill is not usually followed in practice, as the goodwill is really attached with the profit, over and above the normal level of profit. Under this method there will be a value attached to the goodwill, even though an enterprise is not earning normal or expected profits.

Illustration 1

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

Illustration 2

Calculate the value of goodwill as on 1st Jan. 2017 on the basis of three years purchases of the Average Profits of the last five year's profits. The profits & losses for the years were 2011 Rs 30000, 2012 loss Rs 40000, 2013 Rs 92000, 2014 Rs 55000, 2015 Rs 70000, 2016 Rs 90000.

Illustration 3

If in Illustration 1 Profit on sale of a fixed asset during 2012 amounted to Rs 2000, during 2014 amounted to Rs 5000, Loss on sale of a fixed asset during 2016 amounted to Rs 5000.

Calculate the Value of Goodwill.

Illustration 4

The following were the profits of a firm for the last three years.

31st March	Profit (Rs)
2011	500000 (including an abnormal gain of Rs 150000)
2012	400000 (after charging an abnormal loss of Rs 200000)
2013	600000(excluding Rs 200000 payable on the insurance of plant and machinery)

Required - Calculate the value of firm's goodwill on the basis of four years purchase of the average profits for the last three years.

SUPER PROFIT METHOD

1. Goodwill under this method is ascertained by multiplying the super profits by certain number of year's purchase. While calculating past profits any abnormal gain is excluded by deducting from past profits and any abnormal loss is excluded by adding to the past profits. Thus
   Goodwill = Annual Super Profit X Number of Year's Purchase.
   Annual Super Profit = Average Annual Profit – Normal/Expected Annual Profit
   Normal/Expected Annual Profit = Average Capital Employed * Normal Rate of Return (%)
2. If future maintainable profit is less than the normal expected profit, there is no super profit, hence no goodwill.

Illustration 5

A firm of A, B and C has a total capital investment of Rs 4,50,000. The firm earned net profits during the last four years as: 1. Rs 70,000; 2. Rs 80,000; 3. Rs 1,20,000; 4. Rs 1,00,000. The reasonable expected return is 15 per cent having regard to the risk involved. Find out the value of goodwill of the business if it is based on 3 years purchase of the average super profits of the past four years.

Illustration 6

The profits and losses for the last years are – 2011 profit 10000, 2012 Loss Rs 17000, 2013 Profit 50000, 2014 Profit Rs 75000. The average Capital employed in the business is Rs 200000, the rate of interest expected from capital invested is 10%. The remuneration of partners is estimated to be Rs 6000 p.a. calculate the value of goodwill on the basis of 2 years purchases of Super Profits based on the average of 3 years.

ANNUITY METHOD

Under this method, time value of money is considered. Time value of money is the difference between value of money at to (i.e. present date) and value of money at T1 (i.e. future date). Suppose it is expected that the super profits would be available to the firm for 5 years in this case, the value of super profits to be received in different 5 years would be different depending upon the rate of interest. Since there is a time gap between payment for goodwill at present date and the receipts of super profits at some future date, this method suggests to calculate the present value of future super profits.

Goodwill = Present value of goodwill arrived at under the Super Profits Method

Illustration 7

The expected profits of a firm for the next 5 years are as follows:

Year	**I**	**II**	III	IV	V
Profit (Rs)	100000	200000	300000	400000	500000

The total assets of the firm are Rs 2000000 and outside liabilities are Rs 1100000. The present value factor at 10% follows:

Year	**I**	**II**	**III**	**IV**	**V**
PVF	0.9091	0.8264	0.7513	0.6830	0.6209

Required - Calculate the value of goodwill

CAPITALISATION METHOD

The goodwill under this method is ascertained by capitalizing either the **Super profits** or **Average profits.**

Capitalization of Average Profits Method

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

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

In Short,

Goodwill = Value of Business – Capital Employed /Net Assets
Value of Business = Average Profit/ Normal rate of Return (%)
Net Assets = All Assets other than Goodwill – Outsiders Liability

Capitalization of Super Profits Method

The Goodwill under Capitalization of Super Profits method can be calculated with the help of following formulae

Goodwill = Super Profit/ Normal rate of Return (%)

Illustration 8

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

Illustration 9

A firm earns profits of Rs 100000. The Normal Rate of Return in a similar type of business is 10%. The value of total assets (excluding goodwill) and total outsiders liabilities as on the date of valuation of goodwill are Rs 1100000 and Rs 280000 respectively. Calculate the value of goodwill according to Capitalization of Super Profits Method.

Illustration 10

Calculate the value of Goodwill according to Capitalization of Average Profits Method in the previous Illustration

Illustration 11

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

		₹
1. Capital Invested		1,50,000
2. Trading results: 2016 2017 2018 2019	 Profit Profit Loss Profit	 40,000 36,000 6,000 50,000
3. Market Rate of interest on investment	10%	
4. Rate of risk return on capital invested in business	2%	
5. Remuneration from alternative Employment of the proprietor (if not engaged in business)	₹ 6,000 Per annum	

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

Illustration 12 (RTP MAY 2018)

J and K are partners in a firm. Their capital are J ₹ 3,00,000 and K ₹ 2,00,000. During the year ended 31st March, 2017 the firm earned a profit of ₹1,50,000. Assuming that the normal rate of return is 20%, calculate the value of goodwill on the firm:

1. By Capitalization Method; and
2. By Super Profit Method if the goodwill is valued at 2 years' purchase of Super Profit.

Illustration 13 (RTP NOV 2018)

Vasudevan, Sunderarajan and Agrawal are in partnership sharing profit and losses at the ratio of 2:5:3. The Balance Sheet of the partnership as on 31.12.2017 was as follows:

Balance Sheet of M/s Vasudevan, Sunderarajan & Agrawal

Liabilities	₹	Assets	₹
Capital A/c		Sundry fixed assets	5,00,000
Vasudevan	85,000	Inventory	1,00,000
Sunderarajan	3,15,000	Trade receivables	50,000
Agrawal	2,25,000	Bank	5,000
Trade Payables	30,000		
	6,55,000		**6,55,000**

The partnership earned profit ₹ 2,00,000 in 2017 and the partners withdrew 1,50,000 during the year. Normal rate of return 30%.

You are required to calculate the value of goodwill on the basis of 5 years' purchase of super profit. For this purpose calculate super profit using average capital employed.

CHAPTER - 18
PARTNERSHIP – ADMISSION OF PARTNER

--------------------------- **Bird's Eye View**------------------------

- ❑ Admission of Partner – Meaning
- ❑ Adjustments Required at the Time of Admission of Partner
- ❑ Ascertainment of New Profit-Sharing ratio & Sacrificing Ratio
- ❑ Treatment of Goodwill
- ❑ Hidden Goodwill
- ❑ Revaluation of Assets & Liabilities
- ❑ Treatment of Reserves Appearing in Balance Sheet

ADMISSION OF PARTNER – MEANING

Admission of a partner is one of the modes of reconstituting the firm under which old partnership comes to an end and a new one between all partners (including incoming partner) comes into existence.

ADJUSTMENTS REQUIRED AT THE TIME OF ADMISSION OF NEW PARTNER

1. Adjustment in Profit Sharing Ratio
2. Adjustment of Goodwill,
3. Adjustment of Profit/loss arising from the Revaluation of Assets and Liabilities
4. Adjustment of Accumulated Profits, Reserves and Losses,
5. Adjustment of Capitals (if agreed).

ASCERTAINMENT OF NEW PROFIT-SHARING RATIO & SACRIFICING RATIO

New Profit-Sharing Ratio

The ratio in which all partners (including incoming partners) share the future profits and losses is known as the new profit-sharing ratio.

The determination of new profit-sharing ratio depends upon the ratio in which the incoming partner acquires his share from the old partners. An incoming partner may acquires his share.

a) From the old partners in their old profit-sharing ratio;

b) From the old partners in some agreed ratio (other than old profit-sharing ratio)

c) From one or more of old partners (but not from all partners).

Sacrificing Ratio

The ratio in which the old partners have agreed to sacrifice their shares in profit in favor of new partner is called the sacrificing ratio. The ratio is calculated by taking out the difference between old profit share and the new profit share.

Thus, Sacrificing Ratio = Old Profit-Sharing Ratio - New Profit-Sharing Ratio

Note - Unless agreed otherwise it is presumed that the old partners sacrifice in their old profit-sharing ratio.

Illustration 1

A and B are partners sharing profits in the ratio 3 : 2. They admit C for 1/3 share in future profits. Calculate the new ratio.

Illustration 2

A and B are partners sharing profits in the ratio 3:2. They admit C for 1/3 share in future profits which he gets 1/9 from A and 2/9 from B. Calculate the new ratio.

Illustration 3

A and B are partners sharing profits in the ratio 3:2. They admit C as the new partner. A surrender $1/3^{rd}$ of his share and B surrenders $2/3^{rd}$ of his share in favour of C. Calculate the new ratio.

Illustration 4

A and B are partners sharing profits in the ratio 3:2. They admit C for $1/5^{th}$ shares in profits which he acquires entirely from A. Calculate the new ratio.

Illustration 5

A and B are partners sharing profits in the ratio 3:2. They admit C for $1/5^{th}$ share which he acquires entirely from A and B in the ratio of 1:2. Calculate the new ratio.

Illustration 6

X and Y are partners in a firm sharing profits and losses in the ratio 5:3. They admit Z into partnership. The new ratio 3:2:1. Calculate the sacrificing ratio.

Illustration 7

A and B are partners sharing profits and losses at the ratio 3:2. They take C as a new partner. Calculate the new profit-sharing ratio if-

i) C purchases 1/10 share from A
ii) A and B agrees to sacrifice $1/10^{th}$ share to C in the ratio of 2:3
iii) Simply gets $1/10^{th}$ share of profit.

TREATMENT OF GOODWILL

When the existing partners of a firm decide to admit a new partner, new partner will gain in future profits while others will lose. The new partner who gains by acquiring a right to share future profits must compensate the partner or partners who has or have made the sacrifice. The compensation is made by bringing his share of goodwill of a firm.

Points To Remember in Regards to Treatment of Goodwill

1. As Per Accounting Standards, it is Not Recommended to raise Goodwill Account but to Show the Adjustment of Goodwill Through partner's Capital A/c.
2. The Goodwill Should be recorded in The Books only when some Consideration in Money or Money's worth is paid for It. Thus, Only Purchased goodwill Should be recorded in books of the Firm.

The following are the situations through which the Goodwill to be brought in by the incoming partner is dealt with –

1. Private Settlement of Goodwill.
2. Incoming partner brings in his share of firm's Goodwill in cash.
3. Incoming partner brings in his share of firm's Goodwill in Kind.
4. Incoming partner does not bring his share of Firm's Goodwill in cash. (Adjusted Through Capital Accounts)
5. Incoming partner brings only part of his share of Firm's Goodwill in cash.

Private Settlement of Goodwill

When the incoming partner pays his share of Goodwill privately to the sacrificing partners outside the business, no entry is passed in the books of the firm.

Incoming partner brings in his share of firm's Goodwill in cash.

Bringing Share of Goodwill in Cash & Crediting to Sacrificing Partners

Cash/Bank A/c…...Dr
    To Sacrificing Partners capital A/c
    (In SR)

Goodwill Withdrawn by Sacrificing partners

Sacrificing Partner's capital A/c……. Dr
    To Cash/ Bank A/c

Incoming partner brings in his share of firm's Goodwill in Kind

Recording of Assets brought in Against Goodwill

Assets A/c…...Dr
    To Capital A/c (Bal Fig)
    To Sacrificing Partners Capital A/c
    (Amount of G/W In SR)

Incoming partner does not bring his share of Firm's Goodwill in cash.

Adjustment of Goodwill Through Partner's capital Accounts

Gaining Partner's Capital A/c…...Dr (In GR)
To Sacrificing Partners Capital A/c (In SR)

Incoming partner brings only part of his share of Firm's Goodwill in cash.

Bringing Share of Goodwill in Cash & Crediting to Sacrificing Partners with Full Amount of Goodwill

Cash/Bank A/c…...Dr
Gaining Partner's capital A/c…. Dr
To Sacrificing Partners Capital A/c
(In SR)

Goodwill Withdrawn by Sacrificing partners

Sacrificing Partner's Capital A/c……. Dr
To Cash/ Bank A/c

Illustration 8

The following is the Balance sheet of Yellow and Green as at 31st December, 2019:

Liabilities	Rs.	Assets	Rs.
Trade Payables	20,000	Cash at Bank	10,000
Capital:		Sundry Assets	55,000
Yellow	25,000		
Green	20,000		
	65,000		**65,000**

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

	Rs.		Rs.
2012	9,000	2014	12,000
2013	14,000	2015	13,000

The new profit-sharing ratio is 6:5:5.
Give Journal entries and Balance sheet under below situations

1. If Goodwill is Paid Privately
2. If Goodwill is Brought in Cash

3. If Goodwill is Brought in Cash & Withdrawn by Partners
4. If Goodwill is Adjusted Through Partners Capital A/c

Illustration 9

Cu and Au were in partnership sharing profits and losses in the ratio 5:3. On 1st April 2020, they decided to admit Ag the partnership on the following terms:

1. Ag will bring 2,00,000/- as capital for 1/4 share.
2. New profit sharing ratio shall be 2:1:1 among Cu, Au and Ag.
3. Cu was entitled to salary of ₹ 2,000/- p.m., it was revised to ₹ 3,000 p.m. from 1st October 2018.
4. Interest on capital was paid at 8% p.a.
5. Capitals as on 31st March 2020 were Cu ₹ 4,00,000 Au ₹ 3,00,000, which had remained unchanged since last four years.
6. Goodwill was to be valued on the basis of 3 years purchase of average adjusted weighted average profits of past 4 years. The profits of previous four years, before charging interest on capital and salary to Cu were as follows:

Year	Profit
2016-17	2,10,000
2017-18	2,60,000
2018-19	2,10,000
2019-20	3,05,000

These profits were subject to following rectification

(a) A machine costing ₹ 40,000 purchased on 1st October 2018 was wrongly charged to revenue. The machinery was depreciated at 20% p.a. on w.d.v. method
(b) Stock on 31st March 2018 was overvalued by 20,000/-
(c) There was a loss by fire amounting to 10,000/- in the year 2016-17 which was not considered in trading account but correctly debited in the PL ac for that year.
(d) Debtors as on 31st March 2020 included bad debts of ₹ 5,800/-

7. Ag shall bring his share of goodwill in cash.

You are required to calculate amount of goodwill Ag is supposed to bring and journal entry for the same.

HIDDEN GOODWILL

If on admission, the new partner introduces capital in excess of his proportionate share in the total capital of the firm, the excess capital introduced is treated as his contribution towards goodwill. **The hidden Goodwill can be calculated as follows –**

Sr. No.	Particulars	Amount
A	Incoming Partner's Capital X Reciprocal of Share of Incoming Partner	XXX
B	Total Capital after taking into consideration the capital brought in by Incoming Partner	XXX
C	Value of Hidden Goodwill (A-B)	XXX

Journal Entry
Incoming Partner's Capital A/c………...Dr
(His share of Goodwill)
To Sacrificing Partners A/c
(Sacrificing Ratio)

Illustration 10
A and B are partners with capitals of Rs. 7,000 each. They admit C as a partner with 1/4th share in the profits of the firm. C brings Rs. 8,000 as his share of capital. Give the necessary journal entry to record goodwill.

Illustration 11
A and B are in partnership sharing profits and losses equally. The Balance sheet M/s. A and B as on 31.12.2019, was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital Accounts:		Sundry Fixed assets	60,000
A	45,000	Inventories	30,000
B	45,000	Bank	20,000
Trade payables	20,000		
	1,10,000		1,10,000

On 1.1.2020 they agreed to take C as 1/3rd partner to increase the capital base to Rs. 1,35,000. C agrees to pay Rs. 60,000. Show necessary journal entries and prepare partner's capital Accounts.

REVALUATION OF ASSETS AND LIABILITIES

At the time of admission of a partner, the assets and liabilities are revalued so that the profit or loss arising on account of such revaluation up to the date of admission of a new partner may be ascertained and adjusted in the old partners' Capital Accounts in their old profits ratio since it belongs to old partners and not to new partner.

Revaluation Account
1. Revaluation Accounts is a nominal Account.
2. The purpose of Revaluation Account is to ascertain the profit / loss arising on account of revaluation of assets and liabilities.
3. Revaluation Account is **credited** with increase in the value of assets and decrease in the amount of liabilities (it is a gain) and is **debited** with any decrease in the value of assets and increase in the amount of liabilities. (it is a loss). Unrecorded assets are recorded through the Revaluation Account as increase in assets. Unrecorded liabilities are recorded through the Revaluation Account as increase in liabilities.
4. The balance of Revaluation Account shows the net effect on account of revaluation which is transferred to the partners' Capital Accounts in their old profit-sharing ratio.

When the changed Valuation of Assets and Liabilities is to be recorded in the books

Sr. No.	Transaction	Journal Entry
1	Increase in Value of an Asset / Creation of New Asset	Respective Asset A/c ………Dr To Revaluation A/c
2	Decrease in Value of an Asset / Write-off of Asset	Revaluation A/c……………Dr To Respective Asset A/c
3	Increase in Value of Liability / Provision of Liability	Revaluation A/c……………Dr To Respective Liability
4	Decrease in Value of Liability / Write Back of Excess Provision	Respective Liability A/c……. Dr To Revaluation A/c
5	Profit on Revaluation	Revaluation A/c…………...Dr To Old Partner's Capital A/c's (Old Profit-Sharing Ratio)
6	Loss on Revaluation	Old Partner's Capital A/c's…………Dr (Old Profit-Sharing Ratio) To Revaluation A/c

When the changed values of assets and liabilities are not to be altered

In this case Profit or revaluation is found out by preparing a memorandum statement and then the profit or loss on revaluation is adjusted in capital accounts of the partners

Sr. No.	Transaction	Journal Entry
1	**Profit on Revaluation**	Gaining Partners Capital A/c's………. Dr (Gaining Ratio) To Sacrificing Partners Capital A/c (Sacrificing Ratio)
2	**Loss on Revaluation**	Sacrificing Partners Capital A/c……...Dr To Gaining Partners Capital A/c's (Sacrificing Ratio/Gaining Ratio)

TREATMENT OF RESERVES & ACCUMULATED PROFITS/LOSSES

If, at the time of admission of a partner, any reserves or accumulated profits/ losses exists in the books of the firm, these should be transferred to old partners' Capital Accounts in their old profit-sharing ratio since the reserves, accumulated profits/ losses

up to the date of admission of a new partner belong to the old partners and not to the new partner.

Illustration 12

The following is the balance sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January, 2020:

Liabilities	Rs.	Assets	Rs.
Trade Payable	15,000	Buildings	18,000
Ram's Capital	20,000	Plant and Machinery	15,000
Mohan's Capital	25,000	Inventories	12,000
		Trade Receivables	10,000
		Bank	5,000
	60,000		**60,000**

On this date Shyam was admitted on the following:

1. He is to pay Rs. 25,000 as his capital and Rs. 10,000 as his share of goodwill for one fifth share in profits.
2. The new profits sharing ratio will be 5:3:2
3. The assets are to be revalued as under:

	Rs.
Building	25,000
Plant and Machinery	12,000
Inventories	12,000
Trade Receivables (because of Doubtful debts)	9,500

4. It was found that there was a liability for Rs. 1,500 for goods received but not recorded in books.

Give Journal entries to record the above. Also, give the balance sheet of the partnership firm after Shyam's admission.

Illustration 13

A and B are partners sharing profits and losses in the ratio of 3:2. Their balance sheet as on 31.3.2020 March, 2012 is as follows:

Liabilities	Rs.	Assets	Rs.
Trade payables	50,000	Freehold premises	2,00,000
A's Capital	2,00,000	Plant	40,000
B's Capital	1,00,000	Furniture	20,000
		Office equipment	25,000
		Inventories	30,000

		Trade receivables	25,000
		Bank	10,000
	3,50,000		**3,50,000**

On 1.4.2020 they admit C the following terms:

1. C will bring Rs. 50,000 as a capital and Rs. 10,000 for goodwill for 1/5 share;
2. Provision for doubtful debts is to be made on trade receivables @ 2%.
3. Inventory to be written down by 10%.
4. Freehold premises is to be revalued at Rs. 2,40,000, plant at Rs. 35,000, furniture Rs. 25,000 and office equipment Rs. 27,500.
5. Partners agreed that the value of the assets and liabilities remain the same and, as such, there should not be any change in their book values as a result of the above-mentioned adjustments.

You are required to make necessary adjustment in the capital accounts of the partners and show the balance sheet of the new firm.

Illustration 14

A and B are partners in a firm, sharing profits and losses in the ratio of 3:2. The balance sheet of A and B as on 1.1.2020 was as follows:

Liabilities	Rs.	Amount (Rs.)	Assets	Rs.	Amount (Rs.)
Trade Payable		17,000	Building		26,000
Bank Overdraft		9,000	Furniture		5,800
Capital Accounts:			Inventories		21,400
A	44,000		Trade Receivables	35,000	
B	36,000	80,000	Less: Provision	-200	34,800
			Investment		2,500
			Cash		15,500
		1,06,000			**1,06,000**

'C' was admitted to the firm on the above date on the following terms:

1. C was admitted for 1/6 share in the future profits and to introduce a capital of Rs. 25,000.
2. The new profit-sharing ratio of A, B and C will be 3:2:1 respectively.
3. 'C' is unable to bring cash for his share of goodwill, they decide to calculate goodwill on the basis of C's share in profits and the capital contribution made by him to the firm.
4. Furniture is to be written down by Rs. 870 and Inventory to be depreciated by 5%. A Provision is required for trade receivables @ 5% for bad debts. A provision would also be made for outstanding wages for Rs. 1,560. The value of buildings having appreciated be brought up to Rs. 29,200. the value of investments is increased by Rs. 450.

5. It is found that the trade payables included a sum of Rs. 1,400 which is not to be paid off.

Prepare the following:
a) Revaluation Account
b) Partner's capital Accounts.

Illustration 15
Dalal, Banerji and Mallick are partners in a firm sharing profits and Losses in the ratio 2:2:1. Their balance sheet as on 31st March, 2020 is as below:

Liabilities	Rs.	Amount (Rs.)	Assets	Rs.	Amount (Rs.)
Trade Payables		12,850	Land & Buildings		25,000
Outstanding Liabilities		1,500	Furniture		6,500
General Reserve		6,500	Inventory of goods		11,750
Capital Account:			Trade Receivables		5,500
Mr. Dalal	12,000		Cash in Hand		140
Mr. Banerji	12,000		Cash at Bank		960
Mr. Mallick	5,000	29,000			
		49,850			**49,850**

The partners have agreed to take Mr. Mistri as a partner with effect from 1st April, 2020 on the following terms:
1. Mr. Mistri shall bring Rs. 5,000 towards his capital.
2. The value of inventory should be increased by Rs. 2,500 and Furniture should be depreciated by 10%.
3. Reserve for bad and doubtful debts should be provided at 10% of the trade receivables.
4. The value of Land and Buildings should be enhanced by 20%.
5. The value of the goodwill be fixed at Rs. 15,000.
6. General Reserve will be transferred to the partner's Capital Accounts.
7. The new Profit-sharing ratio shall be: Mr. Dalal 5/15, Mr. Banerji 5/15, Mallick 3/15 and Mr. Mistri 2/15.
8. The outstanding liabilities include Rs. 1,000 due to Mr. Sen which has been paid by Mr. Dalal, Necessary entries were not made in the books.

Prepare: 1. Revaluation Account, 2. The capital Accounts of the partners, 3. Balance sheet of the firm after admission of Mr. Mistri.

Illustration 16
A and B are in partnership sharing profits and losses in the proportion of three-fourth and one-fourth respectively. Their Balance Sheet on 31st march, 2020 was as follows:
Cash Rs. 1,000; Trade receivables Rs. 25,000; Inventory Rs. 22,000; Plant and machinery

Rs. 4,000; Trade payables Rs. 12,000; Bank Overdraft Rs. 15,000; A's Capital Rs. 15,000; B's Capital Rs. 10,000

On 1st April, 2020 they admitted C into partnership on the following terms:

(a) C to purchase one-third of the Goodwill for Rs. 2,000 and provide Rs. 10,000 as capital. Goodwill not to appear in books.

(b) Future profits and losses are to be shared by A, B and C equally.

(c) Plant and Machinery is to be reduced by 10% and Rs. 500 is to be provided for estimated bad debts. Stock is to be taken at a valuation of Rs. 24,940.

(d) By bringing in or withdrawing cash and capital of A, and B are to be made proportionate to that of C on their profit-sharing basis.

Set our entries relating to the above arrangement in the firm's journal, give partner's Capital Account in tabular form.

Illustration 17

A and B are partners of X & Co. sharing profits and Losses in 3:2 ratio between themselves. On 31st March, 2020, the balance sheet of the firm was as follows:

Balance sheet of X & Co. as at 31.3.2020

Liabilities	Rs.	Amount (Rs.)	Assets	Rs.	Amount (Rs.)
Capital Accounts:			Plant and Machinery		20,000
A	37,000		Furniture and Fittings		5,000
B	28,000	65,000	Inventories		15,000
Trade Payables		5,000	Trade Receivables		20,000
			Cash in hand		10,000
		70,000			**70,000**

X agrees to join the business on the following conditions as and from 1.4.2020:

a) He will introduce Rs. 25,000 as his capital and Pay Rs. 15,000 to the partners as premium for goodwill for 1/3rd share of the future profits of the firm.

b) A revaluation of assets of the firm will be made by reducing the value of plant and machinery to Rs. 15,000, Inventory by 10%, Furniture and Fitting by Rs. 1,000 and by making a provision of bad and doubtful debts at Rs. 750 on trade receivables.

Prepare profit and Loss adjustment account, capital accounts of partners including the incoming partner X assuming that the relative ratios of old partners will be equal proportion after admission.

Illustration 18

Leena and Meena were in partnership business sharing profits and losses in the ratio of 2:3Their Balance Sheet as on 31st March, 2020 was as follows:

Liabilities	Rs	Assets	Rs
Capital Accounts:		Building	60,000
Leena	60,000	Plant	45,000
Meena	1,40,000	Furniture	23,500
General Reserve	40,000	Debtors	38,400

Creditors Bills Payable	42,600 17,400	Bills Receivable Stock Bank	12,500 42,600 78,000
	3,00,000		**3,00,000**

On 1st April, 2020, they decided to admit Neena into the partnership giving her a 1/5th share in future profits. She brings in 80,000 as her share of capital. Goodwill was valued at ₹1,00,000 at the time of admission of Neena. The partners decided to revalue the Assets as follows:
Plant ₹40,000, Debtors ₹38,000, Stock ₹42,000, Building ₹90,000, Furniture ₹20,000, Bills Receivable ₹12,000.

You are required to show the following accounts in the books of the firm: -
(a) Profit & Loss Adjustment Account
(b) Partners' Capital Accounts
(c) The Balance Sheet of the new firm.

Illustration 19
Alpha and Beeta were partners in a firm namely Meta-Chem sharing profits and losses equally.

Balance sheet of Meta-Chem as on 31st March 2020

Liabilities	**Rs.**	**Assets**	**Rs.**
Capital:		Factory Building	4,78,000
Alpha 3,00,000		Plant & Machinery	3,41,000
Beeta 2,00,000	5,00,000	Office Furniture	55,850
General Reserve	1,80,000	Inventory	77,740
Workmen compensation fund	60,000	Trade Receivables	1,43,210
Term loan from IDFC bank	2,78,000	Bank	44,200
Trade payables	1,22,000		
	11,40,000		**11,40,000**

They agreed to admit Gyama as partner from 1st April 2020 on the following terms:
1. He shall have one-sixth share in future profits.
2. New profit-sharing ratio would be 3:2:1.
3. He shall bring Rs. 2,50,000 as his capital.
4. Godwill of the firm is valued at Rs. 3,00,000
5. Factory building is to be appreciated by 20% and inventory is revalued at Rs. 70,000.
6. Machinery to be appreciated by 20% and office furniture to be revalued at Rs. 50,000.
7. Of the trade receivables Rs. 3,210 are bad and 5% be provided for bad and doubtful debts.
8. There is no actual liability towards workman.

You are required to prepare:
1. Revaluation account.
2. Partner's capital account.
3. Bank account.
4. Balance sheet after admission.

Illustration 20

The following was the balance sheet of A, B and C who are equal partners on January 1, 2020

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bills payable	3,000	Cash	1,000
Creditors	6,000	Debtors	10,000
Capital Accounts:		Stock	12,000
A	20,000	Furniture	5,000
B	15,000	Buildings	25,000
C	10,000	Bills receivable	1,000
	54,000		**54,000**

They agree to take D into partnership and give him a ¼ share in the profits on the following terms:

1. That D should bring in Rs. 6,000 for goodwill and Rs. 10,000 as Capital;
2. That one-half of the goodwill shall be withdrawn by old partners;
3. That stock and Furniture be depreciated by 10%;
4. That a Liability of Rs. 1,300 be created against bills discounted;
5. That the building be valued at Rs. 40,000;
6. That the values of Liabilities and assets other than cash are not to be altered.

Give the necessary entries to give effect to the above arrangement; prepare revaluation account and opening balance sheet of the firm as newly constituted.

Illustration 21

Gopal and Govind are partners sharing profits and Losses in the ratio 60:40. The firms' balance sheet as on 31.03.2020 was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital Accounts:		Fixed assets	3,00,000
Gopal	1,20,000	Investments	50,000
Govind	80,000	Current Assets	2,00,000
Long Term Loan	2,00,000	Loans and Advances	1,00,000
Current Liabilities	2,50,000		
	6,50,000		**6,50,000**

Due to financial difficulties, they have decided to admit Guru as partner in the firm from 01.04.2020 on the following terms:

Guru will be paid 40% of profits.

Guru will bring in cash Rs. 1,00,000 as capital. It is agreed that goodwill of the firm will be valued at 2 year's purchase of 3 year's normal average profits of the firm and Guru

will bring in cash his share of goodwill. It was also decided that the partners will not withdraw their share of goodwill nor will the goodwill appear in the books of accounts.

The profits of the previous three years were as follows:
For the year ended 31.3.2018: Profit Rs. 20,000 (Includes insurance claim received of Rs. 40,000).
For the year ended 31.3.2019: Loss Rs. 80,000 (Includes Voluntary retirement compensation paid Rs. 1,10,000).
For the year ended 31.3.2020: profit of Rs. 1,05,000 (Includes a profit of Rs. 25,000 on sale of assets).

It was decided to revalue the assets on 31.3.2020 as follows:

	Rs.
Fixed assets (net)	4,00,000
Investments	Nil
Current Assets	1,80,000
Loans and Advances	1,00,000

The new profit-sharing ratio after the admission of Guru was 35:25:40.

Pass journal entries on admission, show goodwill calculation, and prepare revaluation account, partner's capital accounts and balance sheet as on 01.04.2020 after the admission of Guru.

Illustration 22 (RTP MAY 2021)
Ramu and Mamu were partners in a firm sharing profits and losses in the ratio 3:2
Their Balance Sheet as on 31st March, 2020 was as follows:

Liabilities	Rs	Assets	Rs
Capital:		Land & Building	1,50,000
Ramu	2,10,000	Machinery	1,80,000
Mamu	1,90,000	Furniture	44,000
General Reserve	60,000	Trade Receivables	42,800
Loan from LFC bank	25,000	Inventory	65,200
Trade Payables	21,000	Bank	24,000
	5,06,000		5,06,000

Damu was admitted as partner from 1st April, 2020 on the following terms:
1. He shall bring 1,50,000 as capital and goodwill.
2. He shall get 1/5th share in future profits, to be acquired equally from Ramu and Mamu.
3. Goodwill of the firm to be valued at ₹ 2,50,000. It was agreed that goodwill shall not appear in the books of accounts.
4. Land & Building is to be appreciated by 50% and inventory is revalued at 60,000
5. Machinery to be depreciated by 20%. Debtors of debts and a Reserve for doubtful debts should be 2,800 are to be written off as bad created @ 5% of debtors.
6. Furniture to be reduced to ₹40,000.
7. after admission of Damu, capitals of the partners' to be adjusted in their new profit sharing ratio, taking Damu's capital as base.

You are required to prepare:

1. Revaluation account
2. Partners' capital accounts.
3. Cash and bank account.
4. Balance Sheet after admission

CHAPTER - 19
PARTNERSHIP – RETIREMENT OF PARTNER

---------------------------- **Bird's Eye View**-------------------------

- ❑ Retirement of Partner – Meaning
- ❑ How Can a Partner Retire
- ❑ Adjustments Required at the Time of Retirement of Partner
- ❑ Ascertainment of New Profit-Sharing ratio & Gaining Ratio
- ❑ Treatment of Goodwill
- ❑ Hidden Goodwill
- ❑ Revaluation of Assets & Liabilities
- ❑ Treatment of Reserves Appearing in Balance Sheet
- ❑ Capital adjustment
- ❑ Disposal of Amount Due to Retiring Partner
- ❑ Sec. 37 of Indian Partnership Act ,1932

RETIREMENT OF PARTNER – MEANING

Retirement of a partner is one of the modes of reconstitution of the firm under which an old partnership comes to end and a new one between the continuing partners. '(i.e. partners other than the outgoing partner) comes into existence. However, the firm continues its business.

HOW CAN A PARTNER MAY RETIRE

A Partner may retire –
1. With the consent of all other partners (whether implied or expressed); or
2. In accordance with an express agreement by the partners; or
3. By giving notice in writing, to all other partners of his intention to retire in case of partnership at will [Sec 32(1)]

ADJUSTMENTS REQUIRED AT THE TIME OF RETIREMENT OF NEW PARTNER

The various matter that need adjustment at time of Retirement of Partner are given below-
1. Adjustment in Profit Sharing Ratio
2. Adjustment of Goodwill,

3. Adjustment of Profit/loss arising from the Revaluation of Assets and Liabilities
4. Adjustment of Accumulated Profits, Reserves and Losses,
5. Adjustment of Capitals (if agreed).

ASCERTAINMENT OF NEW PROFIT-SHARING RATIO & GAINING RATIO

New Profit-Sharing Ratio
The ratio in which the continuing partners (i.e. partners other than outgoing one) decide to share the future profits and losses, is known as new profit-sharing ratio.
Note - Unless agreed otherwise, it is presumed that the continuing partners acquire the outgoing partner's share in their old profit-sharing ratio so that the continuing partners to share profits in the old ratio.

Gaining ratio
The ratio in which the continuing partners acquire the outgoing (retired or deceased) partner's share is called as gaining ratio. The ratio is calculated by taking out the difference between new profit share and old profit share.
Thus, Gaining ratio = New Profit Share – Old Profit Share
Note - Unless, agreed otherwise it is presumed that, the continuing partners gain in their old profit-sharing ratio.

TREATMENT OF GOODWILL

When an existing partner of a firm decides to retire from the firm, the continuing partners(s) will gain in future profits. The continuing partner who gains by acquiring an additional right to share future profits must compensate the outgoing partner who sacrifices by foregoing his right to share future profits. The amount of compensation will be equal to the proportionate amount of firm's goodwill**. Thus,**
Outgoing Partner's Share of Goodwill = Value of Firm's Goodwill x Share of Profit Sacrificed

Credit for Outgoing Partner 's full share of Goodwill to Outgoing Partner by Debiting Continuing Partners

Gaining Partner's Capital A/c…...Dr (In GR)
To Sacrificing Partner's Capital/Outgoing partner's Capital A/c (In SR)

HIDDEN GOODWILL

If the firm has agreed to settle the account of retiring/ deceased partner by paying him a lump sum amount, then amount paid to him in excess of his capital share in reserves/ revaluation account etc. Shall be treated as his share of goodwill.
For Example - X, Y and Z are partners. Z retires, his capital account after making adjustment for reserves and profit on revaluation exists at Rs 1,00,000. X and Y have agreed to pay him Rs 1,50,000 in full settlement of his claim. It implies that Rs 50,000 is Z's share in the goodwill of the firm. This will be treated by debiting Rs 50,000 in the capital account of X and Y in their gaining ratio and crediting Z's capital account.

REVALUATION OF ASSETS AND LIABILITIES

At the time of retirement of a partner, the assets and liabilities are revalued so that the due share of an outgoing partner in the profit/ loss arising from such revaluation may be ascertained and adjusted in his Capital Account.
For Journal Entries refer previous chapter

TREATMENT OF RESERVES & ACCUMULATED PROFITS/LOSSES

If, at the time of retirement of a partner, any reserves, accumulated profits, or losses exist in the books of the firm, these should be transferred to the capital Accounts of all the partners (including outgoing partner) in their old profit-sharing ratio so that the due share of an outgoing partner in the reserves, accumulated profits/ losses up to the date of retirement gets adjusted in his Capital Accounts

ADJUSTMENT OF CAPITAL

The adjustment of capital shall be done in a same way as provided in the chapter of Admission of Partner

DISPOSAL OF AMOUNT DUE TO THE RETIRING PARTNER

Amount due to retiring partner is arrived at after considering balances in capital and current account, share of profit up to the date of retirement, goodwill, profit/ loss on revaluation, drawings, interest on capital/ drawings etc.

The dues of the retiring partner may be settled -

i. Out of existing funds/ assets available with the firm
ii. Out of additional capital contribution to be brought in by the contributing partners
iii. Out of capital contribution of the new partner
iv. In lumpsum value after sometime (along with interest at an agreed rate)
v. In installment (along with interest at agreed rate)

SECTION 37 OF THE INDIAN PARTNERSHIP ACT, 1932

In case the account of the retiring partner is not settled immediately and there is no agreement to guide the rights of outgoing partner, Sec. 37 of the Partnership Act applies. As per this section, when any member of the firm ceases to be partner and the continuing partners carry on the firm’s business with property of the retired partner without any final settlement, then in absence of any contract to the contrary**, the outgoing partner is entitled at the option of himself to such share of profits made since then as may be attributable to the use of his property or to interest at 6% p.a. thereon.**

Illustration 1

Alok, Bhaskar and Chetan are partners sharing in the ratio 3:2:1. Calculate new ratio if:
a) If Alok retires.

b) If Bhaskar retires.
c) If Chetan retires.

Illustration 2

Aarav, Banta, and Chunmun are partners sharing in the ratio 3:2:1. Aarav retires and his share is taken over by the remaining partners as follow
Banta takes $2/6^{th}$ from Aarav.
Chunmun takes $1/6^{th}$ from Aarav.
Calculate new ratio.

Illustration 3

Deepu, Tasha, and Honey are partners sharing profits in the ratio 3:2:1. Tasha retires and his share was acquired by Deepu and Honey in the ratio 2:1. Calculate new ratio.

Illustration 4

Calculate Gaining ratio in Following Cases;

1. A, B and C are partners sharing profits and losses in the ratio of 1/2, 3/10 and 1/5 respectively. B retires from the firm and A & C decide to share future profits and losses in the ratio of 3:2.
2. W, A, B and C are partners sharing profits and losses in the ratio of 1/3, 1/6, 1/3 and 1/6 respectively. B retires and W, A and C decide to share future profits and losses equally.
3. A, B and C are partners sharing profits and losses in the ratio of 25:15:9. B retires and it is decided that profit sharing ratio between A & C will be the same as existing between B and C.
4. A, B and C are partners sharing profits and losses in the ratio of 4/9, 1/3 and 2/9. B retires and surrenders 1/9th of his share in favour of A and remaining in favour of C.

Illustration 5

Antoo, Bantoo and Chintoo were in partnership sharing profits and losses 3:4:3 respectively. The accounts of the firm are made up to 31st March every year. The partnership provided, interalia, that: On the retirement of a partner the goodwill was to be valued at three years' purchase of average profits of the past four years up to the date of the retirement after deducting interest @12%p.a. on capital employed and remuneration of Rs. 2,000 p.m. to each partner. On 1st April 2020, Antoo retired and it was agreed on his retirement to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet. It was agreed that the capital employed would be Rs. 6,50,000. Bantoo and Chintoo were to continue the partnership, sharing profits and losses equally after the retirement of Antoo. The following were the amounts of profits of earlier years before charging salary to partners and interest on capital employed.

Year	**Profit**
2016-17	2,60,000
2017-18	2,75,000
2018-19	2,65,000
2019-20	2,80,000

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

Illustration 6

A and B are partners in a business sharing profits and Losses A-3/5th and B-2/5th. Their balance sheet as on 1st January, 2020 is given below:

Liabilities		Amount (Rs.)	Assets		Amount (Rs.)
Capital Accounts			Plant and Machinery		20,000
A	20,000		Inventories		16,000
B	15,000	35,000	Trade receivables		15,000
Reserve Account		15,000	Balance at Bank		6,000
Trade Payable		7,500	Cash in hand		500
		57,500			**57,500**

B retires from the business owing to illness and A takes it over. The following revaluation was made:

1. The goodwill of the firm is valued at Rs. 25,000.
2. Depreciate Plant & Machinery by 7.5% and Inventories by 15%.
3. Doubtful debts provision is raised against trade receivables at 5% and a discount reserve against trade payables at 2%.

Required: Journalise the above transactions in the books of the firm and close the partner's capital account as on 1st January 2020. Give also the opening balance sheet of A.

Illustration 7

F, G and K were partners sharing profits and Losses at the 2:2:1. K wants to retire on 31.12.2019. Given below is the Balance sheet of the partnership as well as other information:

Balance sheet as on 31.12.2019

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital Accounts		Sundry fixed assets	1,50,000
F	1,20,000	Inventories	50,000
G	80,000	Trade Receivables (including Bills receivables 20,000)	70,000
K	60,000	Bank	50,000
Reserve	10,000		
Trade payables	50,000		
	3,20,000		**3,20,000**

F & G agree to share profits and Losses at the ratio of 3:2 in future. Value of goodwill is taken to be Rs. 50,000. Sundry fixed assets are revalued upward by Rs. 30,000 and Inventories by Rs. 10,000. Bills receivable dishonoured Rs. 5,000 on 31.12.2019 but not recorded in the books. Dishonor of bill was due to insolvency of the customer. F and G agree to bring sufficient cash to discharge claim of K and to make their capital proportionate. Also, they wanted to maintain Rs. 75,000 bank balance for working capital.

Required: Pass necessary journal entries and draft the balance sheet of M/s F & G. Also prepare capital account of partners and draft the balance sheet of M/s F & G after K's retirement.

Illustration 8

A, B and C were in partnership sharing profits in the proportions of 5:4:3. The Balance Sheet of the firm as on 31st March, 2020 was as under:

Liabilities	Rs.	Assets	Rs.
Capital:		Fixtures	8,200
A	1,35,930	Inventories	1,57,300
B	95,120	Trade Receivables	93,500
C	61,170	Cash	74,910
Trade payables	41,690		
	3,33,910		**3,33,910**

A had been suffering from ill-health and gave notice that he wished to retire. An agreement was, therefore, entered into as on 31st March, 2020, the terms of which were as follows:

(i) The Profit and Loss Account for the year ended 31st March, 2020 which showed a net profit of Rs. 48,000 was to be re-opened. 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, 2019 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 valued by an independent valuer. The valuations arising out of the above agreement were goodwill Rs. 56,800 and fixture Rs. 10,980. A provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book values.

B and C agreed, as between themselves, to continue the business, sharing profits in the ratio of 3:2 and decided to retain the Fixtures on the books at the revised value, and to increase the provision for doubtful debts to 6%.

Required: Submit the journal entries necessary to give effect to the above arrangements and to draw up the capital account of the partners after carrying out all adjusting entries as stated above.

Illustration 9

K, L and M are partners sharing Profits and Losses in the ratio 5:3:2. Due to illness, L wanted to retire from the firm on 31.3.2020 and admit his son N in his place.

Balance Sheet of K, L and M as on 31.3.2020

Liabilities		Rs.	Assets	Rs.
Capital:			Furniture	20,000
K	40,000		Sundry Debtors	50,000

L	60,000		Stock in Trade	50,000
M	30,000	1,30,000	Cash and Bank Bal	80,000
Reserve		50,000		
Trade payables		20,000		
		2,00,000		**2,00,000**

On retirement of 'L' assets were revalued: Furniture Rs.10,000, Stock in Trade Rs.30,000. 50% of the amount due to 'L' was paid off in cash and the balance was retained in the firm as capital of N. On admission of the new partner, goodwill was valued at Rs. 50,000. Partners are being paid off their extra balance to make capital proportionate by keeping N's capital as base.

You are Required to give: i) Necessary Journal Entries ii) Balance Sheet of M/s K, M, N as on 01.04.2020 iii) Capital accounts of partners.

Illustration 10

Dowell & Co. is a partnership firm with partners Mr. A, Mr. B and Mr. C, sharing profits and losses in the ratio of 10:6:4. The Balance Sheet of the firm as at 31st March, 2020 is as under:

Liabilities		**Rs.**	**Assets**	**Rs.**
Capital:			Land	10,000
Mr. A	80,000		Buildings	2,00,000
Mr. B	20,000		Plant & Machinery	1,30,000
Mr. C	30,000	1,30,000	Furniture	43,000
Reserves (un-appropriated profit)		20,000	Investments	12,000
Long Term Debt		3,00,000	Inventories	1,30,000
Bank Overdraft		44,000	Debtors	1,39,000
Trade Payables		1,70,000		
		6,64,000		**6,64,000**

It was mutually agreed that Mr. B will retire from partnership and in his place Mr. D will be admitted as a partner with effect from 1st April, 2020. For this purpose, the following adjustments are to be made:

1. Goodwill is to be valued at Rs. 1 lakh but the same will not appear as an asset in the books of the reconstituted firm.
2. Buildings and Plant and Machinery are to be depreciated by 5% and 20% respectively. Investments are to be taken over by the retiring partner at Rs. 15,000. Provision of 20% is to be made on trade receivables to cover doubtful debts.
3. In the reconstituted firm, the total capital will be Rs. 2 lakhs which will be contributed by Mr. A, Mr. C and Mr. D in their new profit-sharing ratio, which is 2:2:1.
   i) The surplus funds, if any, will be used for repaying the Bank Overdraft.
   ii) The amount due to the retiring partner shall be transferred to his loan account.

Prepare:

(a) Revaluation A/c;
(b) Partner's Capital Accounts;
(c) Bank Account; and
(d) Balance Sheet of the reconstituted firm as on 1st April,2020.

Illustration 11

M/s X is a partnership firm with the partners A, B and C sharing profits and Losses in the ratio of 3:2:5. Their Balance sheet of the firm as on 30th June 2020, was as under:

Balance sheet of M/s. X
As on 30.06.2020

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
A's Capital A/c	1,04,000	Land	1,00,000
B's Capital A/c	76,000	Building	2,00,000
C's Capital A/c	1,40,000	Plant and Machinery	3,80,000
Long term Loan	4,00,000	Investments	22,000
Bank Overdraft	44,000	Inventories	1,16,000
Trade Payables	1,93,000	Trade Receivables	1,39,000
	9,57,000		**9,57,000**

It was mutually agreed that B will retire from partnership and his place D will be admitted as a partner with effect from 1st July, 2020. For this purpose, the following adjustments are to made:

1. Goodwill of the firm is to be valued at Rs. 2 Lakhs due to the firm's locational advantage but the same will not appear as an asset in the books of reconstituted firm.
2. Buildings and Plant and machinery are to be valued at 90% and 85% of the respective balance sheet values. Investments are to be taken over by the retiring partner at Rs. 25,000. Trade Receivables are considered good only upto 90% of balance sheet figure. Balance be considered bad.
3. In the reconstituted firm, the total capital will be Rs. 3 Lakhs, which will be contributed by A, C and D in their new profit-sharing ratio, which is 3:4:3.
4. The amount due to retiring partner shall be transferred to his loan account.

Required:
Prepare Revaluation account and Partner's Capital Account.

Illustration 12

Aarav, Nirav, and Purav are partners sharing profits and losses in the ratio of 3:2:1. Their Balance Sheet as on 31st March, 2020 was as follows:

Balance Sheet as on 31st March, 2020

Liabilities	₹	Assets	₹
Capital: Aarav	80,000	Building	50,000
Nirav	50,000	Machinery	67,500
Purav	35,000	Debtors	65,000
General Reserve	60,000	Stock	80,000
Trade Creditors	50,000	Bank	12,500
	2,75,000		**2,75,000**

Purav retired from the business on 1st April 2020 on the following terms:

1. Goodwill was to be valued at 2 years purchase of average profit of past 3 years.
   31st March, 2018 39,000

31st March, 2019 50,000
31st March, 2020 55,000
2. Goodwill was not to be raised in the books of accounts.
3. Provision for Doubtful Debts was to be created on debtors at 5%. Machinery is to be depreciated by 10% and stock is revalued at ₹ 71,000.
4. Building to be appreciated by 20%.
5. Aarav and Nirav to bring in additional capital of ₹ 35,000 and ₹ 25,000 respectively.
6. Balance payable to Purav must be paid immediately.

You are required to prepare:
a) Revaluation account
b) Partners capital accounts.
c) Bank account.
d) Balance Sheet after retirement.

Illustration 13
Satyam, Shivam & Sundaram are partners of M/s. Great Stationers sharing profits and losses in the ratio of 1:1:2. On 31st March, 2020 their Balance Sheet was as under:

Liabilities	₹	Assets	₹
Capital: Satyam	1,95,000	Building	2,50,000
Shivam	1,48,000	Plant	1,60,000
Sunderam	1,12,000	Investments	85,000
General Reserve	80,000	Stock	45,280
Loan from Satyam	94,000	Trade Receivables	68000
Sundry Creditors	75,000	Bank	95,720
	7,04,000		**7,04,000**

On 1st April 2020 Shivam retired on the following terms:
1. Goodwill is to be valued at ₹ 1,20,000 but the same will not appear as an asset in the books of the reconstituted firm.
2. Buildings is to be appreciated by 20% and Plant is to be depreciated by 10%.
3. Investments are to be taken over by the Satyam in full settlement of his loan.
4. Provision of 5% is to be made on trade receivables to cover doubtful debts.
5. In the reconstituted firm, the total capital will be ₹ 3,00,000/- which will be contributed by Satyam and Sunderam in their new profit-sharing ratio, which is 2:3.
6. The amount due to retiring partner shall be transferred to his loan account.

You are required to give journal entries to record above adjustments and also prepare Balance Sheet thereafter.

Illustration 14
A, B, C were in partnership sharing profits and losses in the ratio of 3:2:1. The Balance Sheet of the firm as on 31.03.2020 was as under:

Liabilities		Rs.	Assets	Rs.
Capital Accounts:			Fixtures	30,000
A	1,50,000		Stock	1,70,000
B	1,00,000		Sundry Debtors	90,000
C	50,000	3,00,000	Cash	50,000

Sundry Creditors		40,000		
		3,40,000		**3,40,000**

A on account of ill health, gave notice that he wished to retire from the firm. A retirement agreement was, therefore, entered as on 31.3.2020, the terms of which were as follows:

(a) The Profit and Loss account for the year ended 31.3.2020, which showed a net profit of Rs. 42,000 was to be re-opened. B was to be credited with Rs. 6,000 as bonus, in consideration of the extra work, which had devolved upon him during the year. The profit-sharing basis was to be revised and the revised ratio to be 2:3:1 as and from 1st April, 2019.

(b) Goodwill was to be valued at two year's purchase of the simple average profits of five years. Profits for these five years ending on 31st March were as under:

Year	**Rs.**
31.03.2016	15,000
31.03.2017	23,000
31.03.2018	25,000
31.03.2018	35,000
31.03.2020	42,000

(c) Fixtures are to be valued at Rs. 39,800 and a provision of 2% was to be made for doubtful debts and the remaining assets were to be taken at their book value.

(d) That the amount payable to A shall be paid by B.

B and C agreed, as between themselves, to continue the business, sharing profits and losses in the ratio of 3:1 and decided to retain fixtures in the books at the revised value and increase the provision for doubtful debts to 6%. Total capital of the firm will be Rs. 3 lakhs as before to be maintained in the new ratio as between B and C.

You are required to give the necessary entries to give effect to the above arrangements.

Prepare Capital Account of Partners. Cash Account and Balance Sheet of B and C after giving effect to the above arrangements on the retirement of A.

CHAPTER – 20
PARTNERSHIP – DEATH OF PARTNER

---------------------------- **Bird's Eye View**-------------------------

- ❑ Difference Between Retirement of Partner & Death of Partner
- ❑ Joint Life Policy – Meaning & Accounting Treatment
- ❑ Several Life Policy – Meaning & Accounting Treatment
- ❑ Determination of Deceased/Retiring Partner's Share in Profits
- ❑ Treatment of Goodwill
- ❑ Disposal of Amount Due to deceased Partner

DIFFERENCE BETWEEN RETIREMENT OF A PARTNER AND DEATH OF PARTNER

The basic differences between two situations are –

(a) That the retirement of a partner may be planned to be effective from a particular date whereas the death of a partner may occur anytime during the year;

(b) That the payment of the amount due is made to the retiring partner in case of retirement of a partner whereas the payment of the amount due is made to the legal representatives of a deceased partner in case of death of a partner**.**

JOINT LIFE POLICY – MEANING & ACCOUNTING TREATMENT

Joint Life Policy

1. Joint Life Policy is an assurance policy covering the lives of the partner jointly.
2. The main objective behind taking out a joint life policy is to make provision for payment of the amount due to the executors of a deceased partner so that the working capital of the firm may not be adversely affected to that extent.
3. Joint Life Policy matures on the expiry of the term of the policy or the death of any partner (covered under the policy) whichever is earlier.

Accounting Treatment of Joint Life Policy

The premium paid may be treated either as an expense or as an investment. The various methods of recording a joint life policy are as under:

1. Ordinary Business Expense Method
2. Surrender Value Method
3. Joint Life Policy Reserve Method

JLP- Ordinary Business Expense Method

1. Under this method, the premium paid is treated as an ordinary business expense.
2. Joint life policy does not appear as an asset in the Balance Sheet of the firm.

The Journal Entries under this method are –

Sr. No.	Case	Accounting Entry
1	On Payment of Premium	Joint Life Policy Premium A/c……Dr To Bank A/c
2	On Closing the Joint Life Policy premium A/c at the end of the Year	Profit & Loss A/c………. Dr To Joint Life Policy Premium A/c
3	On Claim (Including Bonus) Becoming Due	Insurance Company's A/c………Dr To All Partner's Capital A/c's (in PSR)
4	On Receipt of amount Due from the insurance Company	Bank A/c…………. Dr To Insurance Company's A/c

JLP- Surrender Value Method

1. Under this method, the premium paid is treated as an investment in joint Life Policy.
2. Joint Life Policy appears in the Balance Sheet as an asset at its surrender value.
3. Surrender value is amount payable by the insurance company on the surrender of a policy by the firm before the date of maturity.

The Journal Entries under this method are –

Sr. No.	Case	Accounting Entry
1	On Payment of Premium	Joint Life Policy A/c……Dr To Bank A/c
2	On Transfer of the Balance in Excess of Surrender Value	Profit & Loss A/c………. Dr To Joint Life Policy A/c
3	On Claim (Including Bonus) Becoming Due	Insurance Company's A/c………Dr To Joint Life Policy A/c
4	On Receipt of amount Due from the insurance Company	Bank A/c…………. Dr To Insurance Company's A/c
5	On Transfer of the Balance in Joint Life Policy A/c	Joint Life Policy A/c……Dr To All Partner's Capital A/c's (in PSR)

JPL- Joint Life Policy Reserve Method

1. Under this method, Joint Life Policy is treated as an asset.
2. At the same time a Joint Life Policy Reserve created out of the profits is also maintained.
3. The Joint Life Policy A/c will appear on the assets side and the Joint Life Policy Reserve A/c will appear on the liabilities side of the Balance Sheet at the surrender value of the Joint Life Policy.
4. No transfer is made from Profit & Loss Appropriation A/c to Joint Life Policy Reserve A/c if the Joint Life Policy matures before the end of the accounting year.

The Journal Entries under this method are –

Sr. No.	Case	Accounting Entry
1	On Payment of Premium	Joint Life Policy A/c……Dr To Bank A/c
2	On Appropriation of Reserve	P & L Appropriation A/c………. Dr To Joint Life Policy reserve A/c
3	On Transfer of the Balance in Excess of Surrender Value	Joint Life Policy reserve A/c……Dr To Joint Life Policy A/c
4	On Claim (Including Bonus) Becoming Due	Insurance Company's A/c………Dr To Joint Life Policy A/c
5	On Receipt of amount Due from the insurance Company	Bank A/c…………. Dr To Insurance Company's A/c
6	On Transfer of the Balance in Joint Life Policy Reserve A/c	Joint Life Policy Reserve A/c……Dr To Joint Life Policy A/c
7	On Transfer of Balance in Joint Life Policy A/c	Joint Life Policy A/c……Dr To All Partner's Capital A/c's (in PSR)

Illustration 1

A and B sharing profits and losses in the ratio of 2:3 took out a joint Life Policy on 1st January, 2011 for Rs 10,000 for 10 years. The premium for the whole years is Rs 1,000. B died on 1st March 2014 and claim (including Bonus) Rs 12,100 was received on 1st May 2014. The books of the firm are closed on 31st December, each year. The surrender values of the policy at the end of 2011, 2012, 2013 and 2014 were nil, Rs 200, Rs 600 and Rs 1,200 respectively. Give the necessary journal entries under each of the following alternative methods of recording a joint Life Policy:

a) Ordinary Business Expense Method
b) Surrender Value Method
c) Joint Life Policy Reserve Method

Illustration 2

Red, White, and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2016 for *50,000, a premium of ₹3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2016 nil; 2017 900; 2018 2,000; 2019 3,600.

Black retires on 15th April, 2020.

Required

Prepare ledger accounts assuming no Joint Life Policy Account is maintained.

Illustration 3

Red, White, and Black shared profits and losses in the ratio of 5:3:2. They took out a joint life Policy in 2016 for *50,000, a premium of ₹3,000 being paid annually on 10th June. The surrender value of the policy on 31st December of various years was as follows: 2016 nil; 2017 900; 2018 2,000; 2019 3,600.

Black retires on 15th April, 2020.

Required

Prepare ledger accounts assuming no Joint Life Policy Account is maintained on surrender value basis.

Illustration 4

A, B and C are in partnership sharing profits and losses at the ratio of 5:3: 2. The balance sheet of the firm on 31.12.2019 was as follows:

Balance Sheet

Liabilities	₹	Assets	₹
Capital A/c:		Sundry Fixed	80,000
A	50,000	Assets	50,000
B	40,000	Inventories	30,000
C	30,000	Trade Receivables	20,000
Bank Loan	40,000	Joint Life Policy	10,000
Trade Payables	30,000	Bank	
	1,90,000		1,90,000

On 1.1.2020, a want to retire, B and C agreed to continue at 2:1. Joint Life Policy was taken on 1.1.2014 for 1,00,000 and its surrender value as on 31.12.2019 was 25,000. For the purpose of A's retirement goodwill was raised for 1,00,000. Sundry Fixed Assets was revalued for ₹1,10,000. But B and C did not prefer to show such increase in assets in the Balance Sheet. Also, they agreed to bring necessary cash to discharge 50% of the A's claim, to make the bank balance ₹25,000 and to make their capital proportionate.

Required:

Prepare necessary journal entries.

Illustration 5

On 31st March, 2020, the balance sheet of M/s Ram, Rahul and Rohit sharing profits and losses in proportion to their capital, stood as follows:

Liabilities	**₹**	**₹**	**Asset**	**₹**
Capital Accounts:			Land and Buildings	2,00,000

Ram	3,00,000		Machinery	2,00,000
Rahul	2,00,000		Closing Stock	1,00,000
Rohit	1,00,000	6,00,000	Sundry Debtors	2,00,000
Sundry Creditors		2,00,000	Cash and Bank	
			Balances	1,00,000
		8,00,000		8,00,000

On 31st March, 2020, Ram desired to retire from the firm and the remaining partners decided to carry on. It was agreed to revalue the assets and liabilities on that date on the following basis: -

1. Land and Buildings be appreciated by 30%
2. Machinery be depreciated by 20%.
3. Closing stock to be valued at Rs.80,000.
4. Provision for bad debts be made at 5%.
5. Old credit balances of Sundry Creditors Rs.10,000 be written back.
6. Joint Life Policy of the partners surrendered and cash obtained Rs.60,000.
7. Goodwill of the entire firm be valued at Rs.1,80,000 and Ram's share of the Goodwill be adjusted in the accounts of Rahul and Rohit who share the future profits equally. No Goodwill Account being raised.
8. The total capital of the firm is to be the same as before retirement. Individual capital be in their profit-sharing ratio.
9. Amount due to A 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: - Rahul & Rohit, Loan Account of Ram, Cash Account and Balance Sheet as on 1.4.2020 of M/s. Rahul & Rohit.

SEVERAL LIFE POLICY – MEANING & ACCOUNTING TREATMENT

Individual Life Policy is an assurance policy covering the life of a partner individually. If the firm had insured the partners' lives severally and charged the premium to Profit & Loss Account, the executors of a deceased partner are entitled to claim a share in.

(a) The claim receivable from the insurance company in respect of matured policy and
(b) The surrender values of unmatured individual life policies of other partners.

<u>Illustration 6</u>

X, Y and Z were sharing profits and losses in the ratio of ½: 1/3: 1/6 respectively. The firm had insured the partners' lives severally, X for Rs 10000, Y for 7500 and Z for Rs 5000. The premiums were charged to Profit & Loss Account. The surrender value of each such policy as on 31st March, 2017 is 50% of the sum assured. Y and Z decide to share the profits and losses equally in future. X dies on 31.03.2017. Give the necessary journal entries.

<u>Illustration 7</u>

X, Y and Z were sharing profits and losses in the ratio of ½: 1/3: 1/6 respectively. The firm had insured the partners' lives severally. The surrender values of the life policies appearing in the balance sheet as a 31st March, 2017 were – X for Rs 5000, Y for Rs

3750 and Z for Rs 2500. The surrender values represent 50% of the sum assured in each case. Y and Z decide to share equally in the future. X dies on 31.03.2017. Given the necessary journal entries

DETERMINATION OF DECEASED/ RETIRING PARTNER'S SHARE IN PROFITS

The calculation of outgoing partner share in profits earned from the date of last balance sheet to date of death/ retirement, involves the following two steps:

Step 1

Determination of profits of the firm from the date of last balance sheet to the date of death/ retirement –

Subject to agreement, such profit may be determined *either* on time basis *or* on sales basis using previous year's profits or average profits of the past years.

a) On Time Basis –

Profit from the Date sheet
Of Last Balance Sheet to months
Date of Death/Retirement = No. of days or months from the date of last balance to the date of death/ retirement ÷ 365 Days or 12

X

Previous Year's profits or Average profits of a given number of past years

b) On sales Basis –

Profit from the Date of Last of
Balance Sheet to Date of Average Sales of Retirement/Death = Sales from the date of Last Balance Sheet to the Date Retirement/Death ÷ Previous Year's Sales or a number of past years

X

Previous Year's profits or Average profits of a given number of past years

Step 2

Calculation of Outgoing Partner's share in profits-

Outgoing partner's share in profits = Profit Calculated in Step 1 x Share of Outgoing/Deceased Partner.

Illustration 8

X, Y and Z were partners sharing profits & Losses in the ratio of 3:2:1 respectively. X died on 31st March, 2016. Calculate his share of profit during the accounting year 2016, in each of the following alternative's cases:

Case a) if the partnership deed provided that the share of profit till the date of death be estimated at the sum calculated on the average of the last three completed year's profits. The book showed the profits for the calendar years as under:

2011- Rs 5,000; 2012 – Rs 5,000; Rs 2013 Rs 8,000; 2014- Rs 7,600 & 2015- Rs 9,000

Case b) if the partnership deed provided that the share of profit till the date of death be estimated at the sum calculated on the sales till the date of death by applying the ratio of net profit to sales for the last accounting year. Sales from 1.1.2016 to 31.3.2016 amounted to Rs 30,000. Sales and net profit for the year 2015 amounted to Rs 3,60,000 and Rs 54,000 respectively.

Illustration 9

A, B & C were partners sharing profits & losses in the ratio of 3:2:1 respectively. B died on 31st March 2012. The profits from 1.1.2012 to 31.3.2012 amounted to Rs 4,500. A and C decided to share the future profits in the ratio of 3:2 respectively with effect from 1.4.2012. Give the necessary journal entry to record the B's share of profit to the date of death.

TREATMENT OF GOODWILL

When an existing partner dies, the continuing partners(s) shall exist in firms & will gain in future profits. The continuing partner who gains by acquiring an additional right to share future profits must compensate the deceased partner. The amount of compensation will be equal to the proportionate amount of firm's goodwill. Thus,

Credit for Deceased Partner's full share of Goodwill to Deceased Partner by Debiting Continuing Partners

Gaining Partner's Capital A/c…...Dr (In GR)

To Sacrificing Partner's Capital/Deceased partner's Capital A/c (In SR)

Illustration 10

Wise, Clever and Dull were trading in partnership sharing profits and Losses 4:3:3 respectively. The accounts of the firm are made upto 31st December every year.

The partnership provided, interalia, that:

On the death of a partner the goodwill was to be valued at three year's purchase of average profits of the three years upto the date of the death after deducting interest @8 percent on capital employed and fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2019, wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be Rs.15,000 per annum and that the capital employed would be Rs.1,56,000. Clever and dull were to continue the partnership, sharing profits and Losses equally after the death of Wise.

The Following were the amounts of profits of earlier years before charging interest on capital employed.

	Rs.
2016	67,200
2017	75,600
2018	72,000
2019	62,400

You are required to compute the value of goodwill and show the adjustment there of in the books of the firm.

DISPOSAL OF AMOUNT DUE TO DECEASED PARTNER

The amount payable to deceased partner calculated after giving credit for profit up to the date of death, Profit on revaluation, Reserves, his share of goodwill shall be paid to his legal heirs/ executor. If, however the amount due to the deceased partner is not paid then sec. 37 of Indian partnership Act applies.

Illustration 11

The Balance sheet of Seed, Plant and Flower as at 31st December, 2019 was as under:

Liabilities	Rs.	Rs.	Assets	Rs.
Trade Payables		20,000	Fixed Assets	40,000
General Reserve		5,000	Debtors	10,000
Capital:			Bills Receivable	4,000
Seed	25,000		Inventories	16,000
Plant	15,000		Cash at Bank	10,000
Flower	15,000	55,000		
		80,000		80,000

The profit-sharing ratio was: Seed 5/10, Plant 3/10, and Flower 2/10. On 1st May, 2020 Plant died. It was agreed that:

1. Goodwill should be valued at 3 years purchase of the average profits for 4 years. The profits were:

2016	Rs.10,000	2018	Rs.12,000
2017	Rs.13,000	2019	Rs.15,000

2. The deceased partner to be given share of profits upto the date of death on the basis of the previous year.
3. Fixed Assets were to be depreciated by 10%. A bill for Rs.1,000 was found to be worthless. These are not to affect goodwill.
4. A sum of Rs.7,750 was to be paid immediately, the balance was to remain as a loan with the firm at 9% p.a. as interest.

   Seed and Flower agreed to share profits and Losses in future in the ratio of 3:2.

   Give necessary journal entries.

Illustration 12

The Following is the Balance sheet of M/s. ABC Bros as at 31st December, 2019.

Balance sheet as at 31st December, 2019

Liabilities	Rs.	Assets		Rs.
Capital:		Machinery		5,000
A	4,100	Furniture		2,800
B	4,100	Fixture		2,100
C	4,500	Cash		1,500
General Reserve	1,500	Inventories		950
Trade Payables	2,350	Trade Receivables	4,500	
		Less: Provision for Doubtful Debts	-300	4,200
	16,550			16,550

C died on 3rd January, 2020 and the following agreement was to be put into effect.

1. Assets were to revalued: Machinery to Rs.5,850; Furniture to Rs.2,300; Inventory to Rs.750.
2. Goodwill was valued at Rs.3,000 and was to be credited with his share, without using Goodwill Account.
3. Rs.1,000 was to be paid away to the executors of the dead partner on 5th January, 2020.

Required to show:

1. The Journal Entry for Goodwill adjustment.
2. The Revaluation Account and Capital Accounts of the partners.
3. Which account would be debited and which account credited if the provision for doubtful debts in the Balance sheet was to be found unnecessary to maintain at the death of C.

Illustration 13

The partnership agreement of a firm consisting of three partners- A, B and C (who share profits on proportion of ½, ¼ and ¼ and whose fixed capitals are Rs.10,000; Rs.6,000 and Rs.4,000 respectively) provides as follows:

1. That partners be allowed interest at 10% p.a. on their fixed capitals, but not interest be allowed on undrawn profits or charged on drawings.
2. That upon the death of a partner, the goodwill of the firm be valued at two year's purchase of the average net profits (after charging interest on capital) for the three years to 31st December preceding the death of a partner.
3. That an insurance policy of Rs.10,000 each to be taken in individual names of each partner, the premium is to be charged against the profit of the firm.
4. Upon the death of a partner, he is to be credited with his share of the profits, interest on capitals etc. calculated upon 31st December following his death.
5. That the share of the partnership policy and Goodwill be credited to a deceased partner as on 31st December following his death.
6. That the partnership books be closed annually on 31st December.

A died-on 30th September 2019, the amount standing to the credit of his current account on 31st December, 2018 was Rs. 450 and from that date to the date of death he had withdrawn Rs. 3000 from the business.

An unrecorded liability of Rs. 2,000 was discovered on 30th September, 2019. It was decided to record it and be immediately paid off.

The trading result of the firm (before charging interest on capital) had been as follows: 2016
Profit Rs. 9,640; 2017 Profit Rs. 6,720; 2018 Loss Rs. 640; 2019 Profit Rs. 3,670.

Assuming the surrender value of policy to be 20 percent of the sum assured.

Required:
Prepare an account showing the amount due to A's legal representative as on 31st December, 2019.

Illustration 14

B and N were partners. The partnership dead provides inter alia:
1. That the accounts be balanced on 31st December each year.
2. That the Profits be divided as follows:
   B: One-half; N: One-third; and Carried to Reserve Account: One-sixth
3. That in the event of death of partner, his executor will be entitled to the following:
   a) The capital to his credit at the date of death;
   b) His proportion of profit to date of death Based on the average profits of the last three completed years;
   c) His share Goodwill Based on three year's purchases of the average profits for the three preceding completed Years.

Trail Balance on 31st December, 2019

Particulars	Dr. (Rs.)	Cr. (Rs.)
B's Capital		90,000
N's Capital		60,000
Reserve		30,000
Bills receivable	50,000	
Investments	40,000	
Cash	1,10,000	
Trade Payables		20,000
Total	**2,00,000**	**2,00,000**

The profits for the three years were 2017: Rs.42,000; 2018: Rs.39,000 and 2019: Rs.45,000. N died on 1st May, 2020. Show the calculation of N (i) Share of profits; (ii) Share of Goodwill; (iii) Draw up N's Executors Account as would appear in the firm's ledger transferring the amount to the Loan Account.

Illustration 15

The following was the balance sheet of Om & Co. in which X, Y, Z were partners sharing profits and Losses in the ratio of 1:2:2 as on 31.3.2019. Mr. Z died on 31st December, 2019. His account has to be settled under the following terms.

Balance sheet of Om & Co. as on 31.3.2019

Liabilities	Rs.	Rs.	Assets	Rs.	Rs.
Trade Payables		20,000	Building		1,20,000
Bank Loan		50,000	Computers		80,000
General Reserve		30,000	Inventories		20,000
Capital Accounts:			Trade Receivables		20,000
X	40,000		Cash at Bank		50,000
Y	80,000		Investments		10,000
Z	80,000	2,00,000			
		3,00,000			3,00,000

Goodwill is to be calculated at the rate of two years purchase on the basis of average of three year's profits and losses. The profit and Losses for the three years were detailed as below:

Year Ending On	Profit/Loss
31.3.2019	30,000
31.3.2018	20,000
31.3.2017	(10,000) Loss

Profit for the period from 1.4.2019 to 31.12.2019 shall be ascertained proportionately on the basis of average profit and Losses of the preceding three years.

During the year ending on 31.3.2019 a car costing Rs.40,000 was purchased on 1.4.2018 and debited to travelling expenses account on which depreciation is to be calculated at 20% p.a. at written down value method. This asset is to be brought into account at the depreciated value.
Other values of assets were agreed as follows:

Inventory at Rs.16,000, building at Rs.1,40,000, Computers at Rs.50,000; Investments at Rs.6,000. Trade receivables were considered good.

Required:

1. Calculate goodwill and Z's share in profit of the firm for the period 1.4.2019 to 31.12.2019.
2. Prepare revaluation account assuming that other items of assets and Liabilities remained the same.
3. Prepare partner's capital accounts and balance sheet of the firm Om & Co. as on 31.12.2019.

Illustration 16

Diya, Riya, & Kiya are partners of M/s. DRK Fabrics sharing profits and losses in the ratio of 2:1:2. On 31st March 2020 their Balance Sheet was as under:

Liabilities	Rs.	Assets	Rs.
Capitals:		Land & Building	1,65,000
Diya	1,50,000	Furniture	75,000
Riya	1,80,000	Joint life Policy	60,000
Kiya	70,000	Inventory	88,740
General Reserve	1,40,000	Trade Receivable	96,750
Trade payables	60,000	Bank	1,14,510
	6,00,000		**6,00,000**

Kiya died on 30th September, 2020.
The partnership deed provides as follows:

a) That partners be allowed interest at 12% p.a. on their capitals, but no interest be charged on drawings.
b) Upon the death of a partner, the goodwill of the firm be valued at one years' purchase of the average net profits (after charging interest on capital) for the four years to 31st March preceding the death of a partner. The profits of the firm before charging interest on capitals were
   2016-17 1,62,000
   2017-18 1,99,000
   2018-19 1,87,000
   2019-20 1,96,000

Average capital during preceding four years may be assumed as Rs. 3,00,000

c) Profits till the date of death to be ascertained on the basis of average profit of previous four years.
d) Upon the death of a partner, she is to be credited with her share of the profits, interest on capitals etc. calculated till the date of death

After the death of Kiya

1. ₹ 2,00,000 was received from insurance company against Joint life Policy.
2. Land & Building was appreciated by 20%, Furniture to be depreciated by 10%, inventoryto be revalued at ₹ 80,000. Bad debts amounted ₹ 1760.
3. Amount payable to Kiya was paid in cash.

You are required to prepare

1. Revaluation A/c
2. Partners' Capital A/c
3. Balance Sheet as on 30th September 2022, assuming other Assets and liabilitiesremaining the same.

Illustration 17

Peter, Paul, and Prince were partners sharing profits and Losses in the ratio 2:1:1. It was provided in the partnership deed that in the event of retirement/death of partner he/his legal representatives would be paid: -

1. The balance in the capital account
2. His share of goodwill of the firm valued at two years purchase of normal average profits (after charging interest in fixed capital) for the last three years to 31st December preceding the retirement or death.
3. His share of profits from the beginning of the accounting year of to the date of retirement or death, which shall be taken on proportionate basis of profits of the previous year as increased by 25%.
4. Interest on fixed capital at 10% p.a. though payable to the partners will not be payable in the year of death or retirement.
5. All the asset are to be revalued on the date of retirement or death and the profit and Loss be debited/ credited to the capital Accounts in the profit-sharing ratio.

Peter died on 30th September, 2019. 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, 2019 were Peter Rs.10,000, Paul Rs.5,000 and Prince Rs.5,000. The Balance in the current Account as on 1st January, 2019 were Peter Rs.20,000, Paul Rs.10,000 and Prince Rs.7,000. Drawings of Peter till 30th September, 2019 were Rs.10,000. The profits of the firm before charging interest on capital for the calendar years 2016, 2017 and 2018 were Rs.1,00,000, Rs.1,20,000 and Rs.1,50,000 respectively. The profits include the following abnormal items of credit: -

Particulars	2016 (Rs.)	2017 (Rs.)	2018 (Rs.)
Profit on sale of assets	5,000	7,000	10,000
Insurance claim received	3,000	-	12,000

The firm has taken out a Joint life Policy for 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 policies were 30% of the face value. On 30th June, 2019 the firm received notice from insurance company that the insurance premium in respect of fire policy had been undercharged to the extent of Rs.6,000 in the year 2018 and the firm has to pay immediately. The revaluation of the assets indicates 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, 2019 along with necessary workings.

CHAPTER - 21
PARTNERSHIP – CHANGE IN PSR

---------------------------- Bird's Eye View-------------------------

- Change In PSR – Meaning
- Sacrificing Partner - Meaning
- Gaining Partner - Meaning
- Calculation of Sacrifice or Gain of Partners
- Adjustment For Goodwill
- Adjustment For Reserves & Accumulated Profit & Losses
- Adjustment For Revaluation of Assets & Reassessment of Liabilities

CHANGE IN PSR – MEANING

Sometimes, existing partners decide to change their profit-sharing ratio as a result of change in capital contribution of partners, due to ill health or old age of partner. It may result in active participation of one partner in relation to other partners. Due to change in their profit sharing, some partners will gain in future while other partners will lose in future. The gaining partners should compensate the losing partners unless otherwise agreed upon. The change in the profit-sharing ratio means that one partner is purchasing from another partner a share of the profits which previously belonged to the former.

SACRIFICING PARTNER – MEANING

The partners whose share of profit has reduced due to change in profit sharing ratio are called sacrificing partners. The reduced share of profit is called sacrificing share.

GAINING PARTNER – MEANING

The partners whose share of profit has increased due to change in profit sharing ratio are called gaining partners. The increased share of profit is called gaining share.

CALCULATION OF SACRIFICE/GAIN OF PARTNERS

The sacrifice made by a partner or gain received by a partner is computed by deducting the new share of partner from the old share of partner. If the difference is positive, there is sacrifice made by partner and in case the difference is negative, there is a gain received by a partner. In terms of formula

Sacrifice (or gain) share = Old share – New share

ADJUSTMENT OF GOODWILL

If the partners of the existing firm decide to change their profit-sharing ratio, the gaining partner must compensate the sacrificing partner by paying proportionate amount of goodwill. In other words, the gaining partner should pay the sacrificing partner that share of goodwill which is equal to the share gained by him.

ADJUSTMENT FOR RESERVES & ACCUMULATED PROFIT & LOSSES

If in case of change in profit sharing ratio, the reserves and accumulated profits or losses appears in the balance sheet and the partners decide to leave the reserves and accumulated profit undistributed, it will be necessary to make an adjustment entry for the same. This is, because at present the partners are entitled to share such reserves and profits in the old profit-sharing ratio whereas in future, they will be entitled to share such reserves and profits in the new profit-sharing ratio. Hence, the gaining partner must compensate the sacrificing partner with that share of reserves and profits which is proportionate to the share gained by him.

ADJUSTMENT FOR REVALUATION OF ASSETS AND REASSESSMENT OF LIABILITIES

Assets and liabilities of a firm may also be revalued at the time of change in profit sharing ratio of existing partners. The reason is that the realizable value of assets and liabilities may be different from those shown in the balance sheet. It becomes necessary because the change in the value of assets and liabilities belongs to the period before change in profit sharing ratio and hence profit or loss on revaluation must be shared by the partners in their old profit-sharing ratio. For this purpose, there are two alternatives viz.

If revised values are to be recorded in the books: It has been discussed in the chapter of 'Admission of a Partner.'

If revised values are not to be recorded in the books: In this case, the gaining partner must compensate the sacrificing partner with that share of profit on revaluation of assets and liabilities which is proportionate to the share gained by him.

We can say that sacrifice made by partners or gain received by partners will be adjusted through their capital accounts by making a single journal entry. It is also called capital

adjustment on change of profit-sharing ratio. In such a case a single journal entry is passed through capital transfer.

The Journal Entry for Adjustment Shall be –
Gaining Partner's capital A/c………Dr
To Sacrificing Partner's capital A/c

Illustration 1
A and B were partners in a firm sharing profit in 3: 2 With effect from 1st January, 2011 they agreed to share profits equally. For this purpose, the goodwill of the firm was valued at Rs. 30,000. Pass the necessary journal entry for the treatment of goodwill.

Illustration 2
A, B and C were partners in a firm sharing profit 3:3:2 ratios. They decided to share profits equally w.e.f. 1.4.2012. On that date, the profit and loss account showed the credit balance of Rs. 24,000. Instead of closing the profit and loss account, it was decided to pass an adjustment entry reflecting the change in the profit-sharing ratio. You are therefore, required to pass the necessary journal entry to give effect to the same.

Illustration 3
Hari and Ravi are partners in a firm sharing profits in the ratio of 5:3. On 31.3.2003 their Balance sheet showed a General Reserve of Rs. 80,000. On that date they decided to admit Mohan as a new partner. The new profit-sharing ratio between Hari, Ravi and Mohan will be 5:3:2. Pass the necessary journal entry in the books under the following circumstances:

a) When they want to transfer the General Reserve in their capital accounts.
b) When they do not want to transfer General Reserve in their capital accounts and prefer to pass an adjustment entry for the same.

Illustration 4
A, B and C are partners in a firm sharing profits and losses in the ratio of 2:2:1 and from today onwards, they decided to share future profits and losses equally. What single journal entry shall be passed for following items?
a) General reserve appearing in the balance sheet at Rs. 60,000?
b) Goodwill is valued at Rs. 30,000?
c) Revaluation of assets and liabilities show a profit of Rs. 30,000?

Illustration 5
A, B & C are equal partners. They wanted to change the profit-sharing ratio into 4:3:2. Make necessary journal entries. Goodwill of the firm is valued at Rs. 90,000.

Illustration 6

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

Illustration 7 (MTP NOV 2019 20 MARKS)

A, B and C are partners in a firm sharing profits and losses as 8:5:3. Their Balance Sheet as at 31st December, 2018 was as follows:

	Rs.		Rs.
Sundry Creditors	1,50,000	Cash	40,000
General Reserve	80,000	Bills Receivable	50,000
Partner's Loan Accounts:		Sundry Debtors	60,000
A	40,000	Stock	1,20,000
B	30,000	Fixed Assets	2,80,000
Partner's Capital Accounts:			
A	1,00,000		
B	80,000		
C	70,000		
	5,50,000		**5,50,000**

From 1st January, 2019 they agreed to alter their profit-sharing ratio as 5:6:5. It is also decided that:

a) The fixed assets should be valued at Rs.3,31,000;
b) A provision of 5% on sundry debtors be made for doubtful debts;
c) The goodwill of the firm at this date be valued at three year's purchase of the average net profits of the last five years before charging insurance premium; and
d) The Stock be reduced to Rs.1,12,000.

There is a joint life insurance policy for Rs.2,00,000 for which an annual premium of Rs.10,000 is paid, the premium being charged to Profit and Loss Account. The surrender value of the policy on 31st December, 2018 was Rs.78,000.

The net profits of the firm for the last five years were Rs.14,000, Rs.17,000, Rs.20,000, Rs.22,000 and Rs.27,000.

Goodwill and the surrender value of the joint life policy was not to appear in the books.

Draft Journal Entries necessary to adjust the capital accounts of the partners and prepare the revised Balance Sheet.

CHAPTER –22

DISSOLUTION OF PARTNERSHIP FIRMS AND LLP

---------------------------- **Bird's Eye View**-------------------------

- Circumstances Leading to Dissolution of Partnership
- Circumstances Leading to Dissolution of Partnership Firm
- Distinguish Between Dissolution of Partnership & Dissolution of Partnership Firm
- Dissolution Of Firm Before the Expiry of Fixed Term
- Settlement of Accounts on Dissolution
- Accounting Entries on Dissolution of Firm
- Treatment of Goodwill on Dissolution of Firm
- Consequences of insolvency of Partner
- Treatment of Loss Arising from Insolvency of a Partner
- Insolvency of All partners
- Piecemeal Payments (Maximum loss Method, Highest Relative Capital Method)
- Winding up of LLP

CICUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:

(a) the expiry of the term for which it was formed;

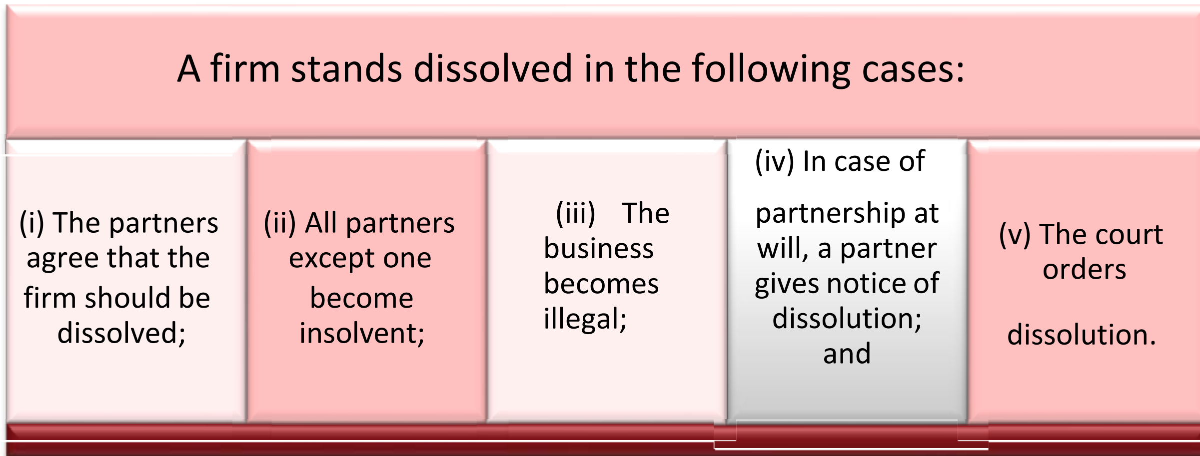
(b) completion of the venture for which it was entered into;

(c) death of a partner;

(d) insolvency of a partner.

However, the partners or remaining partners (in case of death or insolvency) may continue to do the business. In such a case there will be a new partnership but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

CICUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP FIRM



The court has the optionto order dissolution of a firm in the following circumstances:

a) Where a partner has become of unsound mind;
b) Where a partner suffers from permanent incapacity;
c) Where a partner is guilty of misconduct of the business;
d) Where a partner persistently disregards the partnershipagreement;
e) Where a partner transfers his interest or share to a thirdparty;
f) Where the business cannot be carried on except at a loss;and
g) Where it appears to be just and equitable.

DISTINCTION BETWEEN DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF FIRM

Dissolution of Partnership	Dissolution of Partnership Firm
Dissolution of a partnership refers to the discontinuance of the relation between thepartners of the firm.	Dissolution of the firm implies that the entire firm ceases to exist, including the relation among all the partners.
There can be change in profit sharing ratio or admission/death/retirement of a partner.	Dissolution of partnership firm occurs.
In event of dissolution of the partnership, the business continues as usual, but the partnership is reconstituted.	In event of the dissolution of the firm, thebusiness ceases to end.
There is no intervention by the court.	Court has the inherent power to intervene. By its order, a firm can be dissolved.

Economic relationships among partners mayremain same or change.	Economic relationship among partners comes to an end.
Assets and liabilities are revalued. New balance sheet is prepared.	Assets are sold and realized. Liabilities arepaid off.
Revaluation account is prepared.	Realization account is prepared.
Assets and liabilities are revalued after winding up of the existing partnership.	Assets and liabilities are settled on winding up of a firm.
Books of accounts are not closed.	Books of accounts are closed.

DISSOLUTION OF FIRM BEFORE THE EXPIRY OF FIXED TERM

A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund of premium or of such part as may be reasonable, if the firm is dissolved before the term has expired.

No claim in thisrespect will arise if:

1. the firm is dissolved due to the death of a partner;
2. the dissolution is mainly due to the partner's (claiming refund) own misconduct; and
3. the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it.

SETTLEMENT OF ACCOUNTS ON DISSOLUTION

On the dissolution of a partnership, firstly, the assets of the firm, including goodwill, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards, the capital contributed by partners is repaid and, if there is still a surplus, it is distributed among the partners in their profit-sharing ratio.

Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm leftover are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in section 48 of the Partnership Act, upon dissolution of the partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

a) Losses including deficiencies of capital are paid, first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.
b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order:
    i. in paying the debts of the firm to third parties;
    ii. in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital;

iii. in paying to each partner what is due to him on account of capital; and
iv. the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

ACCOUNTING ENTRIES ON DISSOLUTION OF FIRM

i. Transfer of book value of assets:
Realisation A/c...............Dr.
    To Respective Assets A/c

ii. Transfer of third-party liabilities / provisions
Respective Liability/Provision A/c......... Dr.
    To Realisation A/c

iii. Sale/Disposal / Realisation of Assets
Cash/Bank A/c................... Dr.
    To Realisation A/c

iv. Asset taken over by the partner at an agreed value
Partner's Capital A/c.................... Dr.
    To Realisation A/c

v. Expenses of dissolution
Realisation A/c.......... Dr.
    To cash/bank A/c

vi. Discharge of third-party Liabilities
Realisation A/c............ Dr.
    To Cash/Bank A/c

vii. Partner agreeing to discharge a liability
Realisation A/c................... Dr.
    To Respective Partners Capital A/c

viii. Profit/loss on realisation
PROFIT: Realisation A/c............ Dr.
    To Partners' Capital A/c
    (in profit sharing ratio)

LOSS: Partners' capital A/c............ Dr.
    To Realisation A/c
    (in profit sharing ratio)

ix. Discharge of partner's loan / advance

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

x. Transfer of accumulated Profits, Reserve etc.
Reserve A/c.............. Dr.
Profit and Loss A/c.............. Dr.
To Partners' Capital A/c
(in profit sharing ratio)

xi. Settlement of Partners' Accounts
DEBIT BALANCE: Cash / Bank A/c........Dr.
To Respective Partner's Capital A/c

CREDIT BALANCE: Partners' Capital A/c......... Dr.
To Cash/Bank A/c

Specimen of Realization Account

Particulars	₹	Particulars	₹
To Sundry Assets (Excluding Cash/Bank, Debit Balance of P&L A/c, Partners' Current, Capital, and Loan A/cs)		By Sundry Liabilities (Excluding Credit Balance of P&L A/c, Partners' Current, Capital, and Loan A/c)	
To Bank/Cash (expenses for realization)		By Provision on Assets	
To Bank/Cash A/c (Amount paid for liabilities and unrecorded liabilities)		By Bank/Cash A/c (Amount realized from assets andunrecorded assets)	
To Partners' Capital A/cs (Expenses or Liabilities paid by partners)		By Partners' Capital A/cs (Assets taken over by partners)	
To Partners' Capital A/cs (Profit on realization distributed among partners in profit sharing ratio)		By Partners' Capital A/cs (Loss on realization distributed among partners in profit sharing ratio)	

TREATMENT OF GOODWILL ON DISSOLUTION OF FIRM

1. If Goodwill appears in the Balance Sheet, it is considered as purchased Goodwill and is treated like any other asset and is transferred to realization account.
2. If Goodwill does not appear in the balance sheet, no entry is required for this.
3. If something is realized or Goodwill is purchased by any one of the partners, then either Cash Account is debited or Partner's Capital A/c is debited and Realization Account is credited.

Illustration 1

X, Y, and Z are partners of the firm XYZ and Co., sharing Profits and Losses in the ratio of 4: 3: 2. Following is the Balance Sheet of the firm as on 31st March, 2022:

Balance Sheet as on 31st March, 2022

Liabilities	₹	Assets	₹
Partners' Capitals:		Fixed Assets	5,00,000
X	4,00,000	Stock in trade	3,00,000
Y	3,00,000	Sundry debtors	5,00,000
Z	2,00,000	Cash in hand	10,000
General Reserve	90,000		
Sundry Creditors	3,20,000		
	13,10,000		**13,10,000**

Partners of the firm decided to dissolve the firm on the above-said date.

Fixed assets realized ₹ 5,20,000 and book debts ₹ 4,40,000.

Stocks were valued at ₹ 2,50,000 and it was taken over by partner Y.

Creditors allowed discount of 5% and the expenses of realization amounted to ₹ 6,000.

You are required to prepare:

(i) Realization account;
(ii) Partners capital account; and
(iii) Cash account.

Illustration 2

P, Q, and R are partners sharing profits and losses as to 2:2:1. Their Balance Sheet as on 31st March, 2022 is as follows:

Liabilities		₹	Assets	₹
Capital accounts			Plant and Machinery	1,08,000
P	1,20,000		Fixtures	24,000
Q	48,000		Stock	60,000
R	24,000	1,92,000	Sundry debtors	48,000
Reserve Fund		60,000	Cash	60,000
Creditors		48,000		
		3,00,000		**3,00,000**

They decided to dissolve the business. The following are the amounts realized:

Particulars	₹
Plant and Machinery	1,02,000
Fixtures	18,000
Stock	84,000
Sundry debtors	44,400

Creditors allowed a discount of 5% and realization expenses amounted to ₹ 1,500. There was an unrecorded asset of ₹ 6,000 which was taken over by Q at ₹ 4,800. An amount of ₹ 4,200 due for GST had come to notice during the course of realization and this was also paid.

You are required to prepare:

(i) Realization account.
(ii) Partners' capital accounts.
(iii) Cash account.

Illustration 3

Amit, Sumit, and Kumar are partners sharing profit and losses in the ratio 2:2:1. The partners decided to dissolve the partnership on 31st March 2022 when their Balance Sheet was as under:

Liabilities	Amount	Assets		Amount
Capital Accounts:		Land & Building		1,35,000
Amit	55,200	Plant & Machinery		45,000
Sumit	55,200	Furniture		25,500
General Reserve	61,500	Investments		15,000
Kumar's Loan A/c	15,000	Book Debts	60,000	
Loan from D	1,20,000	Less: Prov. for bad debts	(6,000)	54,000
Trade Creditors	30,000	Stock		36,000
Bills Payable	12,000	Bank		13,500
Outstanding Salary	7,500	Capital Withdrawn:		
		Kumar		32,400
	3,56,400			**3,56,400**

The following information is given to you:

(i) Realization expenses amounted to ₹ 18,000 out of which ₹ 3,000 was borne by Amit.

(ii) A creditor agreed to takeover furniture of book value ₹ 12,000 at ₹ 10,800. The rest of the creditors were paid off at a discount of 6.25%.

(iii) The other assets realized as follows:

Furniture	- Remaining taken over by Kumar at 90% of book value
Stock	- Realized 120% of book value
Book Debts	- ₹ 12,000 of debts proved bad, remaining were fully realized
Land & Building	- Realized ₹ 1,65,000
Investments	-Taken over by Amit at 15% discount

(iv) For half of his loan, D accepted Plant & Machinery and ₹ 7,500 cash. The remaining amount was paid at a discount of 10%.

(v) Bills payable were due on an average basis of one month after 31st March 2022, but they were paid immediately on 31st March @ 6% discount "per annum".

Prepare the Realization Account, Bank Account and Partners' Capital Accounts in the books ofPartnership firm.

CONSEQUENCES OF INSOLVENCY OF A PARTNER

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realized. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well-known case of *Garner* vs. *Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

If a partner goes insolvent then the following are the consequences:			
1. The partner adjudicated as insolvent ceases to be a partner on the date on which the order of adjudication is made.	2. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.	3. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and	4. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

TREATMENT OF LOSS ARISING FROM A INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm, he is said to be insolvent and the share of loss is to be borne by other solvent partners following the decision in the English case of Garner vs. Murray.

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realization of assets to be borne by all partners (including insolvent partner) in the profit-sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to Garner vs. Murray rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per the deed should be applied.

Capital Ratio on Insolvency

- ❖ The partners are free to have either fixed or fluctuating capitals in the firm.
- ❖ If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.
- ❖ But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business should not exhibit Current Accounts of the partners and capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and drawings to the date of dissolution but before adjusting profit or loss on Realization Account.
- ❖ If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear the loss on account of the insolvency of other partner.

INSOLVENCY OF ALL PARTNERS

- ❖ When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances, it is better not to transfer the amount of creditors to Realization Account. The balance of the creditors' accounts is

transferred to Deficiency Account.

- Creditors may be paid the amount available including the amount contributed by the partners.

- The unsatisfied portion of the creditor account is transferred to the Capital Accounts of the partners in the profit-sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

Illustration 4

P, Q, and R were partners sharing profits and losses in the ratio of 3:2:1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2022 is as follows;

Liabilities		**₹**	**Assets**	**₹**
Fixed Capital			Fixed Assets:	
P	20,000		Trademark	40,000
Q	20,000		Freehold Property	8,000
R	10,000	50,000	Plant and Equipment	12,800
Current Accounts:			Motor Vehicle	700
P	500		Current Assets	
Q	9,000	9,500	Stock	3,900
Loan from P		8,000	Trade Debtors 2,000	
Trade Creditors		12,400	Less: Provision (100)	1,900
			Cash at Bank	200
			Miscellaneous losses	
			R's Current Account	400
			Profit and Loss Account	12,000
		79,900		**79,900**

On 1st July, 2022 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of ₹ 500 but no cash passed specifically in respect of this transaction. Sale of other assets realized the following amounts:

	₹
Trademark	Nil
Freehold Property	7,000
Plant and Equipment	5,000

Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid ₹ 11,700 in full settlement of their debts. The costs of dissolution amounted to ₹ 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 ofthe amount due.

Required

(a) Cash and Bank Account,

(b) Realization Account, and

(c) Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

Illustration 5

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on31st March, 2021 when the firm was dissolved:

Liabilities	₹	Assets	₹
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1,000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		5,550

The assets realized as under:

Particulars	₹
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realization amounted to ₹ 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of ₹ 200 only.

Show necessary ledger accounts to close the books of the firm.

Illustration 6

A, B, C, and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on31st March 2022 when their balance sheet was as under:

Liabilities	₹	**Assets**	₹
Creditors	15,700	Bank	535
Employees Provident Fund	6,300	Debtors	15,850
Capital Accounts:		Stock	25,200
A 40,000		Prepaid Expenses	800
B 20,000	60,000	Plant & Machinery	20,000
		Patents	8,000
		C's Capital A/c	3,200
		D's Capital A/c	8,415
	82,000		**82,000**

Following information is given to you: -

1. One of the creditors took some of the patents whose book value was ₹ 5,000 at a valuation of ₹ 3,200. Balance of the creditors were paid at a discount of ₹ 400.

2 There was a joint life policy of ₹ 20,000 (not mentioned in the balance sheet) and thiswas surrendered for ₹ 4,500.

3 The remaining assets were realized at the following values: - Debtors ₹ 10,800; Stock ₹ 15,600; Plant and Machinery ₹ 12,000; and Patents at 60% of their book-values. Expenses of realization amounted to ₹ 1,500.

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firm'sclaim against his estate. Prepare necessary ledger accounts.

Illustration 7

M/s X, Y, and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively,had the following Balance Sheet as on December 31, 2022:

Liabilities		₹	₹	**Assets**	₹	₹
Capital:	X	29,200		Fixed Assets		40,000
	Y	10,800		Stock		25,000
	Z	10,000	50,000	Book Debts	25,000	

Z's Loan		5,000	Less: Provision	(5,000)	20,000
Loan from Mrs. X		10,000	Cash		1,000
Sundry Trade Creditors		25,000	Advance to Y		4,000
		90,000			**90,000**

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to ₹ 4,000 have been purchased in November, 2022 and had been received but the purchase was not recorded inbooks.

Fixed assets realized ₹ 20,000; Stock ₹ 21,000 and Book Debt ₹ 20,500. Similarly, the creditors allowed a discount of 2% on average. The expenses of realization come to ₹ 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in Garner vs. Murray.

Illustration 8

'Thin,' 'Short' and 'Fat' were in partnership sharing profits and losses in the ratio of 2:2:1.On 30th September, 2022 their Balance Sheet was as follows:

Liabilities		₹	Assets	₹
Capital Accounts:			Premises	50,000
Thin	80,000		Fixtures	1,25,000
Short	50,000		Plant	32,500
Fat	20,000	1,50,000	Stock	43,200
Current Accounts:			Debtors	54,780
Thin	29,700			
Short	11,300			
Fat (Dr.)	(14,500)	26,500		
Sundry Creditors		84,650		
Bank Overdraft		44,330		
		3,05,480		**3,05,480**

'Thin' decides to retire on 30th September, 2022 and as 'Fat' appears to be short of private assets, 'Short' decides that he does not wish to take over Thin's share of

partnership, so all three partners decide to dissolve the partnership with effect from 30th September,2022. It then transpires that ‘Fat’ has no private assets whatsoever.

The premises are sold for ₹ 60,000 and the plant for ₹ 1,07,500. The fixtures realize

₹ 20,000 and the stock is acquired by another firm at a book value less 5%. Debtorsrealize ₹ 45,900. Realization expenses amount to ₹ 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership booksfollowing the rules in Garner vs. Murray:

(i) Realization Account;
(ii) Partners’ Current Accounts;
(iii) Partners’ Capital Accounts showing the closing of the firm’s books.

PIECEMEAL PAYMENTS

Generally, the assets sold upon dissolution of partnership are realized only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

1. Maximum Loss Method
2. Highest relative Capital Method

MAXIMUM LOSS METHOD

Each installment realized is considered to be the final payment *i.e.,* outstanding assets and claims are considered worthless and partners’ accounts are adjusted on that basis each time when a distribution is made, following either *Garner* vs. *Murray* Rule or the profit-sharing ratio rule.

Illustration 9

A, B, and C are partners sharing profits and losses in the ratio of 5:3:2. Their capitals were ₹ 9,600, ₹ 6,000, and ₹ 8,400 respectively.

After paying creditors, the liabilities and assets of the firm were:

Liabilities	₹	Assets	₹
Liability for interest on loans from:		Investments	1,000
Spouses of partners	2,000	Furniture	2,000
Partners	1,000	Machinery	1,200
		Stock	4,000

The assets realized in full in the order in which they are listed above. B is insolvent.

You are required to prepare a statement showing the distribution of cash as and when available, applying the maximum possible loss procedure.

Illustration 10

The following is the Balance Sheet of A, B, C on 31st December, 2022 when they decided to dissolve the partnership.

Liabilities	₹	Assets	₹
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts:			
A	15,000		
B	18,000		
C	9,000		
	49,000		**49,000**

The assets realized the following sums in installments:

I	1,000
II	3,000
III	3,900
IV	6,000
V	20100
	34,000

The expenses of realization were expected to be ₹ 500 but ultimately amounted to ₹ 400 only. Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

HIGHEST RELATIVE CAPITAL METHOD

- According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

- For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit- sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him.

- By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained.

- The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

Illustration 11

A partnership firm was dissolved on 30th June, 2022. Its Balance Sheet on the date of dissolution was as follows:

Liabilities	₹	Assets	₹
Capitals:		Cash	10,800
A 76,000		Sundry Assets	1,89,200
B 48,000			
C 36,000	1,60,000		
Loan A/c – B	10,000		
Sundry Creditors	30,000		
	2,00,000		**2,00,000**

The assets were realized in instalments and the payments were made on the proportionate capital basis. Creditors were paid ₹ 29,000 in full settlement of their account. Expenses of realization were estimated to be ₹ 5,400 but actual amount spent was ₹ 4,000. This amount was paid on 15th September. Draw up a statement showing distribution of cash, which was realized as follows:

	₹
On 5th July, 2022	25,200
On 30th August, 2022	60,000
On 15th September, 2022	80,000

The partners shared profits and losses in the ratio of 2: 2: 1. Prepare a statement showingdistribution of cash amongst the partners by 'Highest Relative Capital' method.

WINDING UP OF A LLP

The winding up of a LLP may be either voluntary or by the Tribunal and LLP, so wound up may be dissolved.

Winding up of a LLP may be initiated by Tribunal if:

- The LLP wishes to wind up;
- The LLP has less than 2 partners for more than 6 months;
- The LLP is unable to pay its debts;
- The LLP has not acted in the interest of the sovereignty and the integrity of India;
- The LLP has failed to submit with the statements of accounts and solvency or the LLP annual returns for more than five consecutive financial years with the Registrar;
- The Tribunal thinks that it is Just and Equitable that the LLP should be wound up.

The Central Government may make rules for the provisions in relation to winding up and dissolution of LLP.

Illustration 12

P and Q were partners sharing profits equally in LLP. Their Balance Sheet as on March 31, 2022was as follows:

Balance Sheet as on 31st March, 2022

Equity and Liabilities		**₹**	**Assets**	**₹**
Capitals:			Bank	30,000
P	1,00,000		Debtors	25,000
Q	50,000	1,50,000	Stock	35,000
Creditors		20,000	Furniture	40,000
Q's current account		10,000	Machinery	60,000
Reserves		15,000	P's current account	10,000
Bank overdraft		5,000		
		2,00,000		**2,00,000**

The firm was dissolved on the above date:

P took over 50% of the stock at 10% less on its book value, and the remaining stock was sold at a gain of 15%. Furniture and Machinery realized for ₹ 30,000 and ₹

50,000 respectively; there was an unrecorded investment which was sold for ₹ 25,000; Debtors realized 90% only and ₹ 1,245 were recovered for bad debts written off last year. There was an outstanding bill for repairs which had to be paid for ₹ 2,000.

You are required to prepare Realization Account, Partners' capital accounts (including transfer of current account balances) and Bank Account in the books of the firm.

CHAPTER - 23
INTRODUCTION TO COMPANY ACCOUNTS
&
ACCOUNTING FOR SHARES

---------------------------- **Bird's Eye View**-------------------------

- Company - Meaning
- Characteristics of Company
- Types of Companies
- Maintenance of Books of Accounts & Schedule III
- Share Capital – Meaning
- Categories of Share Capital
- Types of Shares – Equity & Preference
- Types of Preference Shares
- Procedure For Issue of Shares
- Subscription of Shares – Full, Under & Oversubscription
- Issue of Shares at Premium
- Issue of Shares at Discount
- Accounting Entries for Issue of Shares
- Calls in Arrears & Calls in Advance
- Interest on Calls in Arrears & Calls in Advance
- Forfeiture of Shares – Meaning
- Accounting Entries for Forfeiture of Shares
- Re-issue of Forfeited Shares
- Issue of Shares Other Than Cash

COMPANY – MEANING

A Company is an incorporated association which is an artificial person created by law, having a corporate and legal personality distinct and separate from its members, perpetual succession and a common seal.

CHARACTERSTICS OF COMPANY

1. Incorporated Association
2. Separate legal entity
3. Perpetual existence
4. Common seal
5. Limited liability
6. Distinction between Ownership and management
7. Not a Citizen
8. Transferability of Shares
9. Maintenance of Books
10. Periodic Audit
11. Right of Access to information

TYPES OF COMPANY

GOVERNMENT COMPANY

According to Section 2(45) of the Companies Act, 2013 "A Government company" means any company in which not less than 51% of the paid-up capital is held by the central Government, or by any state Government or Governments or partly by the central government and partly by one or more state government and includes a company which is a subsidiary company of such a government company.

FOREIGN COMPANY

According to Section 2 (42) of the Companies Act, 2013, "Foreign company" means any company or body corporate incorporated outside India which –

a) Has a place of business in India whether by itself or through an agent physically or through electronic mode; and
b) Conducts any business activity in India in any other manner.

PRIVATE COMPANY

Section 2(68) of the Companies Act, 2013 defines 'Private Company' as a company by its article: -

i) Restricts the rights of to transfer its shares;
ii) Except in case of one Person Company, limits the number of its members to two hundred. Provided that where two or more persons hold one or more shares in company jointly, they shall, for the purpose of this sub-clause, be treated as a single member.
   Provided further that-
   A) Person who are in the employment of the company; and
   B) Person who, having been formerly in the employment the company, were members of the company while in that employment and have continued to be members after employment ceased, shall not be included in the number of members, and
iii) Prohibits any invitation to the public to subscribe for any securities of the company. Shares of private company are not listed of Stock Exchange.

PUBLIC COMPANY
Section 2(71) of the Companies Act, 2013 defines Public Company as a company which is not a private company; Provided that a company which is subsidiary of a company, not being a private company, shall be deemed to be public company for the purpose of this Act even where such subsidiary company continues to be a private company in its articles

ONE PERSON COMPANY
Section 2(62) of the companies Act, 2013 defines "One Person Company" as a company which has only one person as a member;

SMALL COMPANY
Section 2(85) of the companies Act, 2013 defines "Small Company" means a company other than a public company, -
a) paid-up share capital of which does not exceed Four crores or such higher amount as may be prescribed which shall not be more than Ten crore rupees or
b) Turnover of which as per its last profit and loss account does not exceed Forty crore rupees or such higher amount as may be prescribed which shall not be more than Hundred crore rupees.

LISTED COMPANY & UNLISTED COMPANY
As per Section 2(52) of the Companies Act, 2013, "Listed company" means a company which has any of its securities listed on any recognized stock exchange.
The company, whose shares are not listed on any recognized stock exchange, is called "Unlisted Company"
In case of private companies, shares are not listed in any stock exchange.

UNLIMITED COMPANY
Section 2(92) of the Companies Act, 2013 defines "Unlimited company" means a company not having any limit on the liability of its members

COMPANY LIMITED BY SHARES
As per Section 2(22) of the companies Act, 2013,"Company limited by shares" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them

COMPANY LIMITED BY GUARANTEE
As per Section 2(21) of the Companies Act, 2013 "company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up.

HOLDING COMPANY
According to section 2(46) of the Companies Act, 2013, Holding company in relation to one or more other companies, means a company of which such companies are subsidiary companies.

SUBSIDIARY COMPANY

Section 2(87) of the Companies Act, 2013 defines "subsidiary company" as a company in which the holding company.

(i) Controls the composition of the Board of Directors; or

(ii) Exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.

A company shall be deemed to be a subsidiary company of the holding company even if there is indirect control through the subsidiary company (i.e.). The control over the composition of a subsidiary company's Board of Directors means exercise of some power to appoint or remove all or a majority of the directors of the subsidiary company

MAINTAINANCE OF BOOKS OF ACCOUNT

As per Section 128 of the Companies Act, 2013, every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement. For every financial year which give a true and fair view of the state of the affaire of the company, including that of its branch office an offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting

Provided further that company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

PREPARATION OF FINACIAL STATEMENTS

Under Section 129 of the Companies Act, 2013, the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the notified accounting standards and shall be in the form or forms as may be provided for different class or classes of companies, as prescribed in schedule III. The board of Directors of the company shall lay financial statement at every annual general meeting of company.

Financial Statement as per section 2(40) of the Companies Act, 2013 inter-alia include-.

1. A balance sheet as the end of financial year;
2 A profit and loss account prepared in the case of a company carrying on any activity and not for Profit Company an income and expenditure account prepared for the financial year;
3 Cash flow statement for the financial year;
4 A statement of changes in equity, if applicable; and
5 Any explanatory note annexed to, or forming part of, any document referred to in sub-clause (1) to sub clause (4).

Provided that the financial statement, with respect to One Person Company, small company and dormant company, may not include the cash flow statement.

Requisites of financial statements

It shall give a true and fair view of the state of affairs of the company as at the end of the financial year.

Provision applicable

1) Specific act is applicable for instance for
   a. Insurance company
   b. Banking company or
   c. Any company engaged in generation on supply of electricity or
   d. Any other class of company for which a form of balance sheet or profit and loss account has been prescribed under the act governing such class of company
2) In case of all other companies
   Balance sheet as Performa set out in part 1 of schedule III and statement of profit and loss as per par II of schedule III

Compliance with accounting standards

As per section 129 of the companies act, it is mandatory to comply with accounting standards notified by the central government from time to time.

Schedule III of the companies act, 2013

As per section 129 of the companies act, 2013 financial statement shall give a true and fair view of the state of affairs of the company or companies and comply with the accounting standards notified under section 133 and shall be in the form of form as may be provided for different class or classes of companies in schedule III under the Act

SHARE CAPITAL – MEANING

Total capital of the company is divided into small units of a fixed amount. Each unit is called Share. "Share means a share in the share capital of company.' The total capital raised by the issue of shares is called "Share Capital." The share capital is always shown at Face Value.

CATEGORIES OF SHARE CAPITAL

Authorized Share Capital

A company estimates its maximum capital requirements. This amount of capital is mentioned in 'Capital Clause' of the 'Memorandum of Association' registered with the Registrar of Companies. It puts a limit on the amount of Capital, which a company is authorized to raise during its lifetimes and it is called 'Authorized Capital.' It is also referred to as 'Registered Capital' or 'Nominal Capital'. It is shown in the balance sheet at face value.

Issued & Un-Issued Capital

A company need not issue total authorized capital. Whatever portion of the share capital is issued by the company, it is called 'Issued Capital'. It is also shown in the balance sheet at nominal value.

The remaining portion of the authorized capital which is not issued either in cash or consideration may be termed as **'Un-issued Capital'.** It is not shown in the balance sheet.

Subscribed & Unsubscribed Share Capital

It is that part of the issued share capital, which is subscribed by the Public i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.

The portion of the issued capital which is not subscribe by the public is called **"Un-Subscribed Capital"**

Called-up & Uncalled Share Capital

Companies generally receive the issue price of shares in installments. The portion of the issue price of shares which a company has demanded or called from shareholder is known as 'called-up Capital' and the balance, which the company has decided to demand in future may be referred to as Uncalled Capital.

Paid up Capital & Calls in Arrears'

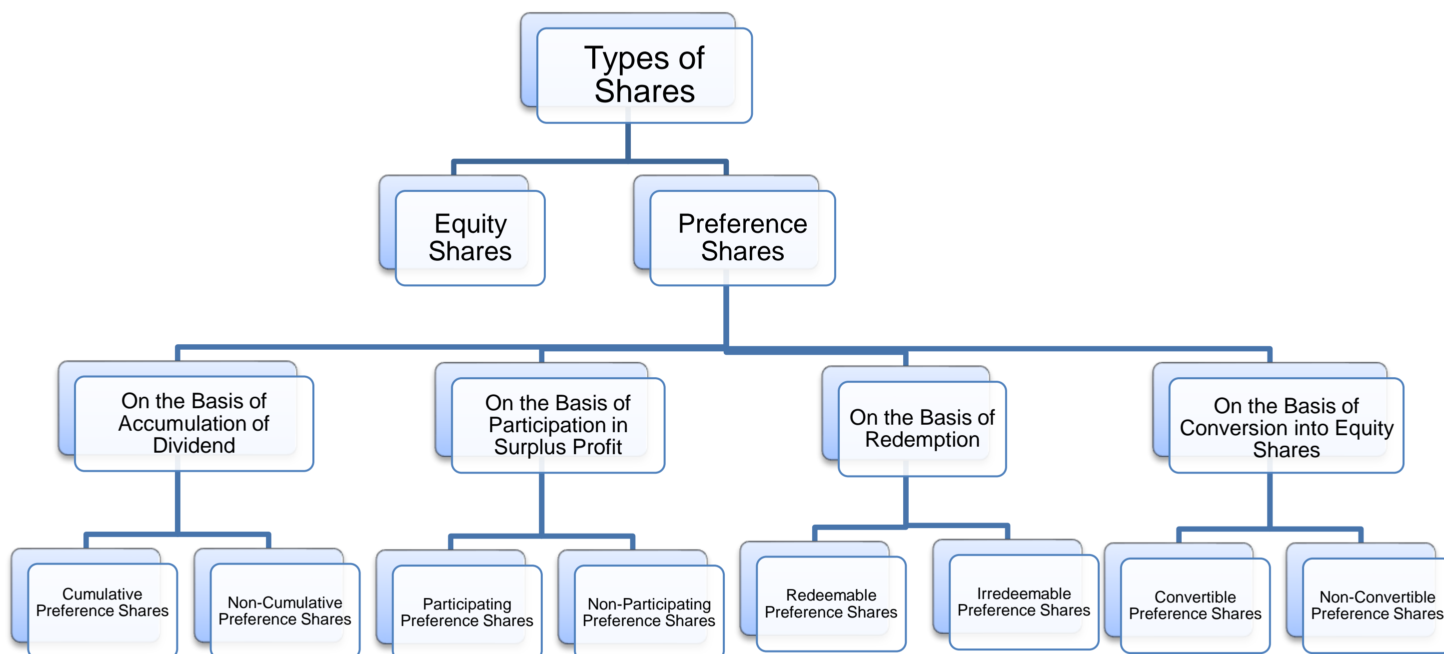
It is the portion of called up capital which is paid by the shareholders. Whenever a particular amount is called by the company and the shareholder(s) fails to pay the amount fully or partially, it is known as **'Unpaid calls or installments (or calls) in Arrears.'** Thus, installments in arrears mean the amount not paid although it has been demanded by the company as payment towards the issue price of shares. To calculate paid-up capital, the amount of installments in arrears is deducted from called up capital.

Reserve Share Capital

As per Section 65 of the Companies Act, 2013, a company may decide by passing a special resolution that a certain portion of its subscribed uncalled capital shall not be called up except in the event of winding up of the company. Portion of the uncalled capital which a company has decided to call only in case of liquidation of the company is called Reserve Capital.

Reserve Capital is different from Capital reserve, Capital reserves are part of "Reserves & Surplus" and refer to those reserves which are not available for declaration of Dividend. Thus, reserve Capital which is portion of uncalled capital to be called up in the Event of winding up of a company is entirely different in nature from capital reserve which is created out of capital profits only.

TYPES OF SHARES



EQUITY SHARES

1. Equity shares are those shares, which are not preference shares. It means that they do not enjoy any preferential rights in the matter of payment of dividend or repayment of capital.

2. The rate of dividend on equity shares is recommended by the Board of Directors and may vary from year to year. Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders.

3. These shares carry voting rights. Companies Act, 2013 permits issue of equity share capital with differential rights as to dividend, voting or otherwise.

PREFERENCE SHARES

1. According to section 43 of the Companies Act, 2013, persons holding at a preference Shares, called preference shareholders, are assured of a preferential dividend at a fixed rate during the life of the company.

2. They also carry a preferential right over other shareholders and are to be paid first in case of winding up of the company. Thus, they enjoy preferential rights in the matter of:
   a) Payment of dividend, and
   b) Repayment of capital

Generally, holders of these shares do not get voting rights. Companies use this mode of financing as it is cheaper than debt. Dividend is generally cumulative in nature and not be paid every year in case of deficiency of profits. The companies act, 2013 prohibits the issue of any preference share which is irredeemable. Preference shares are cumulative, Non-Participating, Non-Convertible & Redeemable in nature unless expressly stated otherwise

TYPES OF PREFERENCE SHARES

Cumulative Preference Shares

1. A cumulative preference share is one that carries the right to a fixed amount of dividend or dividend at fixed rate. Such a dividend is payable even out of future profit if current year's profits are insufficient for the purpose. This means that dividend on these shares accumulates unless it is paid in full and, therefore, the shares are called Cumulative Preference Shares.
2. The arrears of dividend are then shown in the balance sheet as a contingent liability.
3. In India, a preference share is always Non cumulative unless otherwise stated.
4. In case, The Dividend remains in arrears for a period of not less than two years, Holders of such shares will be entitled to take part and vote on every resolution on every matter in the general body meeting of the shareholders

Non- Cumulative Preference Shares

A non-cumulative preference share carries with it the right to a fixed amount of dividend. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that year expires. It implies that holder of such a share is not entitled to arrears of dividend in future.

Participating Preference Shares

1. Notwithstanding the right to a fixed dividend, this category of preference share confers on the holder the right to participate in the surplus profits, if any, after the equity shareholders have been paid dividend at a stipulated rate.
2. Similarly, in the event of winding up of the company, this type of share carries the right to receive a pre-determined proportion of surplus as well once the equity shareholders have been paid off.

Non- Participating Preference Shares

1. A share on which only a fixed rate of dividend is paid every year, without any accompanying additional rights in profits and in the surplus on winding-up, is called 'Non-participating Preference Shares.
2. Unless otherwise specified, the preference shares are generally non-participating.

Redeemable Preference Shares

1. These are shares that a company may issue on the conditions that the company will repay after the fixed period or even earlier at company's discretion.
2. The repayment on these shares is called redemption and is governed by Section 55 of The Companies Act, 2013.
3. In India, companies can now issue only this category of preference shares.

Irredeemable Preference Shares

The preference shares, which do not carry with them the arrangement regarding redemption, are called Non-redeemable Preference Shares. According to Section 55, no company limited by shares shall issue irredeemable preference shares or preference shares redeemable after the expiry of 20 years from the date of issue.
However, a company may issue preference shares redeemable after 20 years for such infrastructure projects as may be specified, under the companies act, 2013

Convertible Preference Shares

These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.

Non-Convertible Preference Shares

When the holder of a preference share has not been conferred the right to get his holding converted into equity share, it is called Non-convertible Preference Shares. Preference shares are non-convertible unless otherwise stated.

PROCEDURE FOR ISSUE OF SHARES IN CASH

The following chart shows the procedure to issue shares

Important Points as regards to Issue of Shares

1. As per guidelines of Securities Exchange Board of India, a company must receive a minimum of 90% subscription against the entire issue before making any allotment of shares or debentures to the public.
2. If the Company does not receive the minimum subscription of 90% of the issues, the entire subscription shall be refunded to the applicants within 15 days after the date of closure of issue in case of non-underwritten issue & within 7 days after date of closure of issue in case of underwritten issue.
3. Subsequent installments, if any, to be called by the company are known as 'calls.' The Companies Act, 2013, requires that the period of at least one month between two calls.
4. As per Section 39 of the Companies Act 2013, application money must be at least 5% of the face value of share. However, as per SEBI Guidelines, the minimum

application money to be paid by an applicant along with the application money shall not be less than 25% of the issue price. According to Section 24, matters related to issue and transfer of securities will be administered by the SEBI and not by the Company Law Board.

FULL SUBSCRIPTION

Issue is fully subscribed if the number of shares offered for subscription and the number of shares actually subscribed by the public are same.

UNDER SUBSCRIPTION

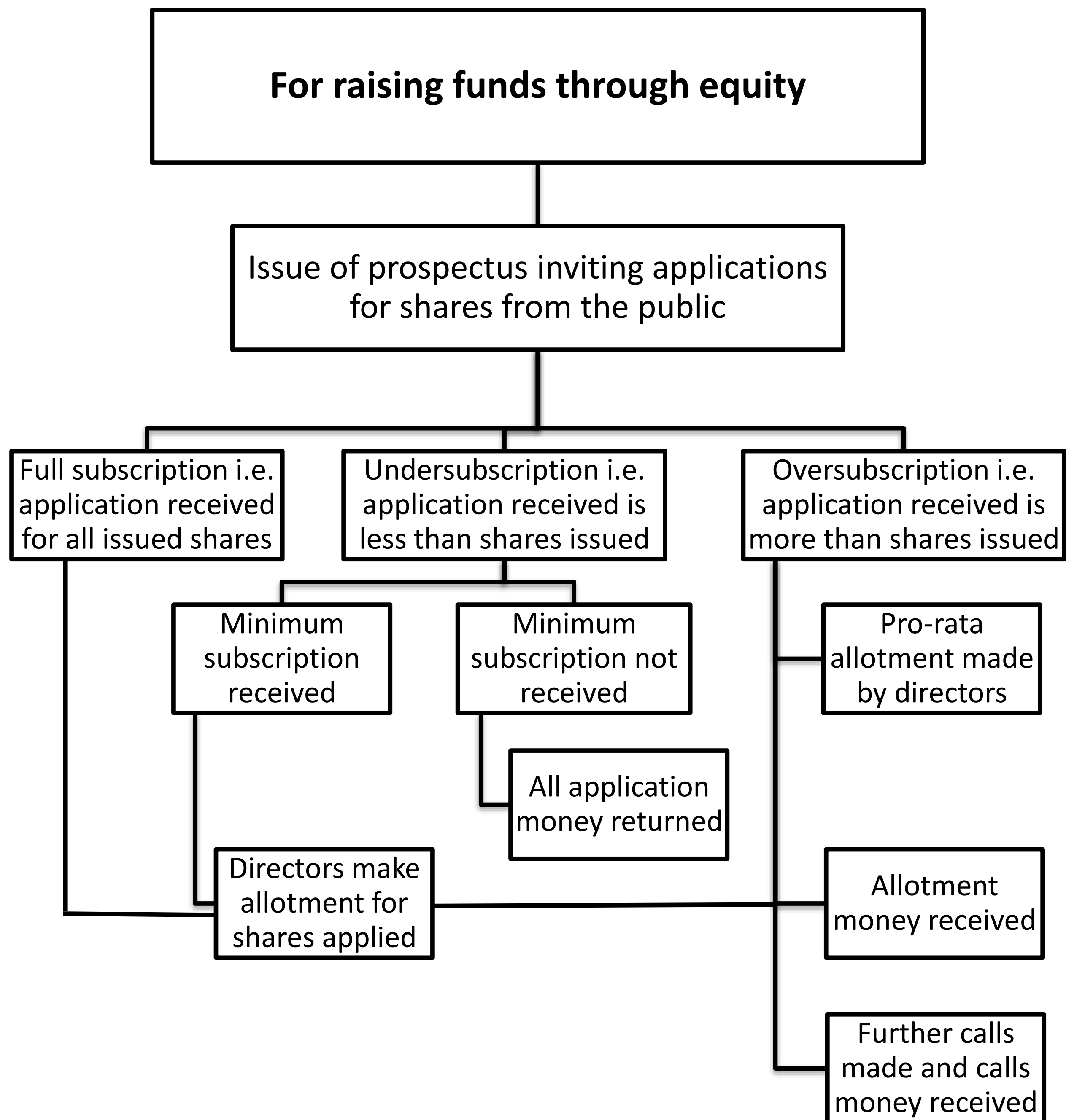
It means the number of shares offered for subscription is more than the number of shares subscribed by the public. It must be remembered that shares can be allotted, in this case, only when the minimum subscription is received.

OVERSUBSCRIPTION AND PRO-RATA ALLOTMENT:

1. Over subscription is the application money received for more than the number of shares offered to the public by a company.
2. It usually occurs in the case of good issues and depends on many other factors like investors' confidence in the company, general economic conditions, pricing of the issue etc. when the shares are oversubscribed, the company cannot satisfy all the applicants.
3. It means that a decision is to be made on how the shares are going to be allotted. Shares can be allotted to the applicants by a company in following manner –
   a) Reject some applications in full
   b) Allotment of some applications in full
   c) Allot shares to the applicants on Pro-rata basis

Example for Pro-rata allotment - a company offers to the public 10,000 shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis, applicants for 12,000 shares are to be allotted 10,000 shares that is in the ratio of 6:5 ratio meaning any applicant who has applied for 6 shares will be allotted 5 shares.

SUBSCRIPTION OF SHARES



ISSUE OF SHARES AT PREMIUM

When shares are issued at price higher than the face value they are said to be issued at premium.

Thus, Premium = Issue Price – Face Value

There are no restrictions on issue of shares at a premium but there are restrictions on its utilization of securities premium. Securities Premium is not a divisible profit, but a capital profit.

The 'Securities Premium' can be utilized by the company (according to Sec. 52.) for

a) Issuing fully paid bonus shares

b) Writing off the preliminary expenses
c) Writing off the expenses of, or the commission paid or discount allowed on issue of shares or debentures.
d) Providing for premium payable on redemption of preference shares or debentures.
e) For purchase of own shares or other securities

ISSUE OF SHARES AT DISCOUNT

Shares are said to be issued at a discount, if issue as at an amount less than the nominal or par value of shares. The excess of the nominal value over the issue price represents discount on the issue of shares. For example, when a shares of the nominal value of Rs. 100 is issued at Rs.98, it is said to have been issued at a discount of 2 per cent.

According to section 53 of the companies act, 2013 a company cannot issue shares at a discount expect in the case of issue of sweet equity shares (issued to employees and directors).

Thus, any issue of shares at discount shall be void.

ACCOUNTING ENTRIES FOR ISSUE OF SHARES

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Share Application A/c
2	**Allotment of Shares** **Issue of Shares at Par**	Share Application A/c……...Dr Share Allotment A/c………Dr To Share Capital A/c
	Issue of Shares at Premium	Share Application A/c……...Dr Share Allotment A/c………Dr To Share Capital A/c To Securities Premium A/c
3	**Refund of Application Money**	Share Application A/c……...Dr To Bank A/c
4	**Appropriation of Excess application money towards allotment money due**	Share Application A/c……...Dr To Share Allotment A/c

5	**Appropriation of Excess application money towards call in advance**	Share Application A/c……...Dr To Calls in Advance
6	**Allotment Money Received**	Bank A/c…………. Dr To Share Allotment A/c
7	**Call Money Due**	Share Call A/c………Dr To Share Capital A/c
8	**Call Money Due if Premium Included in Call Money**	Share Call A/c………Dr To Share Capital A/c To Securities Premium A/c
9	**Call Money Received**	Bank A/c…………. Dr Calls in Advance A/c………. Dr To Share Call A/c

CALLS IN ARREARS

Sometimes shareholders fail to pay the amount or calls. The total unpaid amount on one or more installments is known as Calls-in-Arrears or Unpaid Calls. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

For recording 'Calls-in-Arrears', the following journal entry is recorded:

Calls-in-Arrears A/c……...Dr [Amount of unpaid Calls]
To Share Allotment A/c (If Allotment money is still due)
To Share Calls A/c (If any call is due)

CALLS-IN-ADVANCE

Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as Calls-in-advances. This amount is credited in Calls-in-Advance Account.

The following entries are recorded in case of Calls in Advance

Bank A/c………...Dr
To Call-in-Advance A/c
(When the amount of call is received in advance)

Calls-in-Advance A/c……...Dr [Call amount due]
To Particular Call A/c

(Adjustment entry when call is made)

INTEREST ON CALLS-IN-ARREARS AND CALLS-IN-ADVANCE

Interest on Calls in Arrears	Interest on Calls in Advance
It is payable by shareholders to company on the calls due but remaining unpaid. As per Table F maximum prescribed rate is 10%. Period considered: From the date call money was due to the date money is finally received. Directors have a right to waive off such interest in individual cases at their own discretion. It is a nominal account in nature and is credited to statement of profit and loss as an income.	It is payable by the Company to Shareholders on the call money received in advance but not yet due. As per Table F maximum prescribed rate is 12%. Period considered: From the date money was received to the day call was finally made due. Shareholders are not entitled for any dividend on calls in advance. It is a nominal account in nature with interest being an expense for the company.

FORFIETURE OF SHARES

1. The terms 'forfeit' actually means taking away of property on breach of a condition.
2. It is very common that one or more shareholders fails to pay their allotment and / or calls on the due dates. Failure to pay call of money results in forfeiture of shares. Forfeiture of share is the action taken by a company to cancel the shares.
3. When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him. The shareholder then has no further claim on the company.
4. The fully paid shares can also be forfeited for realization of debts of the shareholders if the articles specifically provide it.

ACCOUNTING ENTRIES FOR FORFIETURE

Sr. No.	Case	Accounting Entry
1	**If Shares were Issued at Par**	Share Capital A/c……. Dr To Forfeited Shares A/c (Amt paid by Shareholder) To Share Allotment A/c (Amt due on Share Allotment)

		To Share first/Second Call A/c (Amt due on respective Calls)
2	**If Shares Were Issued at premium and Premium amount Received**	Share Capital A/c……. Dr To Forfeited Shares A/c (Amt paid by Shareholder other than premium) To Share Allotment A/c (Amt due on Share Allotment) To Share first/Second Call A/c (Amt due on respective Calls)
3	**If Shares Were Issued at Premium and Premium amount not Received**	Share Capital A/c……. Dr Securities Premium A/c. Dr (By the amount earlier credited) To Forfeited Shares A/c (Amt paid by shareholder) To Share Allotment A/c (Amt due on Share Allotment) To Share first/Second Call A/c (Amt due on respective Calls)

REISSUE OF FORFITED SHARES

1. A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only.
2. Reissue of forfeited shares is not allotment of shares but only a sale.
3. These shares can be re-issued at any price so long as the total amount received (from the original allotted and the second purchaser) for those shares is not less than the amount in arrears on those shares.

Journal Entry

1. Bank A/c…. Dr (Actual Amount Received)
   Forfeited Shares A/c……...Dr (Loss on Reissue)
   To Share Capital A/c (FV of Share)

2. Forfeited Shares A/c……...Dr
   To Capital Reserve (Profit on Re-issue)

Points for consideration

1. Loss on re-issue should not exceed the forfeited amount
2. If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.
3. The forfeited amount on shares not yet reissued should be shown under the heading 'share capital.'
4. When only a portion of the forfeited shares are re-issued, then the profit made on reissue of such shares must be transferred to Capital Reserve.

5. When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account"
6. If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.
7. If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.

ISSUE OF SHARES OTHER THAN IN CASH

When the company purchases some assets (Including Services), instead of making the payment to the supplier in the form of cash, it issues its fully paid shares, such issue of shares is called as the issue of shares for consideration other than cash.

Sr. No.	Case	Accounting Entry
1	**Purchase of Business / Assets**	Respective Assets A/c………. Dr To Respective Liability A/c To Vendor A/c
2	**Allotment of Shares** **Issue of Shares at Par**	Vendor A/c………. Dr To Share Capital A/c
	Issue of Shares at Premium	Vendor A/c………. Dr To Share Capital A/c To Securities Premium A/c
3	**Issue of Shares to Promoter**	Goodwill A/c/Preliminary Expenses A/c……...Dr To Share Capital A/c

BALANCE SHEET OF A COMPANY

	Particulars	Notes No.	Figures as at end of the current reporting period	Figures as at end of the previous reporting period
	EQUITY AND LIABILITIES			
1	**Shareholders' funds**			
	a. Share capital (A)		xxx	xxx
	b. Reserves and Surplus (B)		xxx	xxx
	c. Money received against share warrants		xxx	xxx

2	**Share application money pending allotment**			
3	**Non-current liabilities**			
	a. Long-term borrowings (C)		xxx	xxx
	b. Deferred tax liabilities (Net)		xxx	xxx
	c. Other long-term liabilities		xxx	xxx
	d. Long-term provisions (D)		xxx	xxx
4	**Current liabilities**			
	a. Short-term borrowings (E)		xxx	xxx
	b. Trade Payables (A) total outstanding dues of micro enterprises and small enterprises; and (B) total outstanding dues of creditors other than micro enterprises and small enterprises.]		xxx xxx	xxx xxx
	c. Other current liabilities (F)		xxx	xxx
	d. Short-term provisions		xxx	xxx
	Total		**xxx**	**xxx**

	ASSETS			
1	**Non-current assets**			
	a. i. Property, Plant and Equipment		xxx	xxx
	ii. Intangible assets (H)		xxx	xxx
	iii. Capital Work-in-progress		xxx	xxx
	iv. Intangible assets under development		xxx	xxx
	b. Non-current investments (I)		xxx	xxx
	c. Deferred tax assets (Net)		xxx	xxx
	d. Long-term loans and advances (J)		xxx	xxx
	e. Other non-current assets		xxx	xxx
2	**Current assets**			
	a. Current investments (K)		xxx	xxx
	b. Inventories (L)		xxx	xxx
	c. Trade receivables		xxx	xxx
	d. Cash and cash equivalents (M)		xxx	xxx
	e. Short-term loans and advances		xxx	xxx
	f. Other current assets		xxx	xxx
	Total		**xxx**	**xxx**

A. SHARE CAPITAL

For each class of share capital following points is to be kept in mind:

1. The number and amount of shares authorised.
2. The number of shares which are issued, subscribed, and fully paid and which are issued, subscribed but not fully paid.
3. The par value per share.

4. Shares outstanding at the beginning and at the end of the reporting period should be reconciled.
5. Calls unpaid.
6. Forfeited shares.

B. RESERVES AND SURPLUS

Reserves and surplus can be distributed among the following sub-heads:

1. Capital reserves
2. Capital redemption reserves
3. Securities Premium
4. Debenture Redemption reserve
5. Revaluation reserve
6. Surplus; the balance as per profit and loss statement
7. Other reserves (specify the nature and purpose)

C. LONG TERM BORROWINGS

Long term borrowings can be classified under the following sub-heads:

1. Bonds/Debentures
2. Term loans
3. Deferred payment liabilities
4. Deposits
5. Long term maturities of finance lease obligations
6. Loans and advances from related parties
7. Other loans and advances (specify nature)

D. LONG TERM PROVISIONS

This can be classified as follows:

1. Employee benefits provision like gratuity, provident fund etc.
2. Other provisions (specify the nature)

E. SHORT TERM BORROWINGS

Short term borrowings can be classified among the following sub-heads:

1. Loans repayable on demand
2. Loans and advances from related parties
3. Deposits
4. Other loans and advances (specify the nature)

F. OTHER CURRENT LIABILITIES

Some of the other current liabilities can be grouped as under:

1. Interest accrued but not/and due on borrowings
2. Income received in advance
3. Unpaid dividends
4. Application money received for allotment of securities and due for refund and interest accrued thereon

5. Other current liabilities (specify the nature)

G. TANGIBLE ASSETS

Tangible assets can be classified as follows:

1. Land
2. Buildings
3. Plant and Equipments
4. Furniture and Fixtures
5. Vehicles
6. Office Equipments
7. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

H. INTANGIBLE ASSETS

Intangible assets can be classified as follows:

1. Goodwill
2. Brands/trademarks
3. Computer software
4. Mining rights
5. Publishing titles
6. Copyrights, patents and other intellectual property rights, services and operating rights.
7. License and franchise
8. Recipes, models, designs, formulae and prototypes
9. Others (specify the nature)

A detailed report showing additions, disposals, acquisitions through business combinations and other adjustments and amount related to depreciation, impairment losses, revaluation etc. should be provided for each class of asset.

I. NON-CURRENT INVESTMENTS

Investments can be classified as under:

1. Investments in property
2. Investments in equity instruments
3. Investments in preference shares
4. Investments in governments or trust securities
5. Investments in debentures or bonds
6. Investments in mutual funds
7. Investments in partnership firms
8. Other non-current investments (specify the nature)

J. LONG TERM LOANS AND ADVANCES

It can be classified under the following sub-groups:

1. Capital advances
2. Security deposits

3. Loans and advances to related parties
4. Other loans and advances (specify nature)

The above shall also be sub-classified as follows:

1. Secured, considered goods
2. Unsecured, considered goods
3. Doubtful

K. CURRENT INVESTMENTS

It can be classified as follows:

1. Investments in equity instruments
2. Investments in preference shares
3. Investments in government or trust securities
4. Investments in bonds or debentures
5. Investments in mutual funds
6. Investments in partnership firms
7. Other investments (specify the nature)

L. INVENTORIES

Inventories can be classified as:

1. Raw materials
2. Work-in-progress
3. Stores and spares
4. Finished goods Loose tools
5. Stock in trade
6. Goods in transit
7. Others (specify the nature)

M. CASH & CASH EQUIVALENT

The Above Head can be classified as:

1. Balance With Banks
2. Cheques, Drafts in Hand
3. Cash in hand
4. Others (Specify Nature)

Illustration 1

A company had an authorised capital of ₹10,00,000 divided into 1,00,000 equity shares of ₹ 10 each. It decided to issue 60,000 shares for subscription and received applications for 70,000 shares. It allotted 60,000 shares and rejected remaining applications. Upto 31-3-2020, it has demanded or called ₹ 9 per share. All shareholders have duly paid the amount called, except one shareholder, holding 5,000 shares who has paid only ₹ 7 per share.

Prepare a balance sheet assuming there are no other details.

Illustration 2

A company invited applications for 10,000 equity shares of ₹ 50 each payable on application ₹ 15, on Allotment ₹ 20, on first and final call ₹ 15. Applications are received for 10,000 shares and all the applicants are allotted the number of shares they have applied for and instalment money was duly received by the company. Show Journal entries in the books of the company.

Illustration 3

On 1st April, 2020, A Ltd. issued 43,000 shares of ₹ 100 each payable as follows:
₹ 20 on application;
₹ 30 on allotment;
₹ 25 on 1st October, 2020; and
₹ 25 on 1st February, 2021.
By 20th May, 40,000 shares were applied for and all applications were accepted. Allotment was made on 1st June. All sums due on allotment were received on 15th July; those on 1st call were received on 20th October. Journalise the transactions when accounts were closed on 31st March, 2021.

Illustration 4

Pant Ltd. invited applications for 50,000 equity shares at ₹ 50 each, which are payable as on application ₹ 20, on allotment ₹ 10 and on first and final call ₹ 20. The company received applications for 60,000 shares. The directors accepted application for 50,000 shares and rejected the rest. Show Journal entries if company refunded the application money to rejected applicants and allotment money was received for 45,000 shares.

Illustration 5

The Delhi Artware Ltd. issued 50,000 equity shares of ₹ 100 each and 1,00,000 preference shares of ₹ 100 each. The Share Capital was to be collected as under:

	Equity Shares (₹)	Preference Shares (₹)
On Application	25	20
On Allotment	20	30
First Call	30	20
Final Call	25	30

All these shares were subscribed. Final call was received on 42,000 equity shares and 88,000 preference shares. Prepare the cash book and journalise the remaining transactions in the books of the company.

Illustration 6

On 1st October, 2020 Pioneer Equipment Limited received applications for 2,50,000 Equity Shares of ₹ 100 each to be issued at a premium of 25 per cent payable as:

On Application	₹ 25
On Allotment	₹ 75 (including premium)
Balance Amount on Shares	as and when required

The shares were allotted by the Company on October 20, 2020 and the allotment money was duly received on October 31, 2020.

Record journal entries in the books of the company to record the transactions in connection with the issue of shares.

Illustration 7

JHP Limited is a company with an authorised share capital of ₹ 10,00,000 in equity shares of ₹ 10 each, of which 6,00,000 shares had been issued and fully paid on 30th June, 2020. The company proposed to make a further issue of 1,00,000 of these ₹ 10 shares at a price of ₹ 14 each, the arrangements for payment being:

1. ₹ 2 per share payable on application, to be received by 1st July, 2020;
2. Allotment to be made on 10th July, 2020 and a further ₹ 5 per share (including the premium) to be payable;
3. The final call for the balance to be made, and the money received by 30th April, 2021.

Applications were received for 3,55,000 shares and were dealt with as follows:

1. Applicants for 5,000 shares received allotment in full;
2. Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment;
3. Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and
4. The money due on final call was received on the due date.

You are required to record these transactions (including cash items) in the Journal of JHP Limited.

Illustration 8

Shreya's Ltd. did not receive the first call on 10,000 equity shares @ ₹ 3 per share which was due on 1.7.2020. This amount was received on 1.4.2021.
Open Calls in arrears account and journalise the entries in the books of the company on 1.7.2020 and 1.4.2021.

Illustration 9

Rashmi Limited issued at par 1,00,000 Equity shares of ₹ 10 each payable ₹ 2.50 on application; ₹ 3 on allotment; ₹ 2 on first call and balance on the final call. All the shares were fully subscribed. Mr Nair who held 10,000 shares paid full remaining amount on first call itself. The final call which was made after 3 months from first call was fully paid except a shareholder having 1000 shares who paid his due amount after 2 months along with interest on calls in arrears. Company also paid interest on calls in advance to Mr Nair. Give journal entries to record these transactions.

Illustration 10

A Ltd forfeited 30,000 equity shares of ₹ 10 fully called-up, held by Mr X for non-payment of final call @ ₹ 4 each. However, he paid application money @ ₹ 2 per share

and allotment money @ ₹ 4 per share. These shares were originally issued at par. Give Journal Entry for the forfeiture.

Illustration 11

X Ltd forfeited 20,000 equity shares of ₹ 10 each, ₹ 8 called-up, for non-payment of first call money @ ₹ 2 each. Application money @ ₹ 2 per share and allotment money @ ₹ 4 per share have already been received by the company. Give Journal Entry for the forfeiture (assume that all money due is transferred to Calls-in-Arrears Account).

Illustration 12

X Ltd. forfeited 5,000 equity shares of ₹ 100 each fully called-up which were issued at a premium of 20%. Amount payable on shares were: on application ₹ 20; on allotment ₹ 50 (including premium); on First and Final call ₹ 50. Only application money was paid by the shareholders in respect of these shares. Pass Journal Entries for the forfeiture.

Illustration 13

Mr Shami has applied for 1,000 shares of Company XYZ Ltd. paying application money @ ₹ 2 per share but has been allotted only 600 shares. The shares have a face value of ₹ 10 and a premium of ₹ 2 per share, which are payable as: on Allotment- ₹ 5 (including premium) and on final call ₹ 5. Now in case Mr Shami doesn't pay allotment money and final call and his shares are forfeited , Give Journal Entry on Forfieture.

Illustration 14

Mr Long who was the holder of 2,000 preference shares of ₹ 100 each, on which ₹ 75 per share has been called up could not pay his dues on Allotment and first call each at ₹ 25 per share. The Directors forfeited the above shares and reissued 1500 of such shares to Mr Short at ₹ 65 per share paid-up as ₹ 75 per share.
Give Journal Entries to record the above forfeiture and re-issue in the books of the company.

Illustration 15

Beautiful Co. Ltd issued 30,000 equity shares of ₹ 10 each payable as ₹ 3 per share on Application, ₹ 5 per share (including ₹ 2 as premium) on Allotment and ₹ 4 per share on Call. All the shares were subscribed. Money due on all shares was fully received except from Ram, holding 500 shares, who failed to pay the Allotment and Call money and Shyam, holding 1,000 shares, who failed to pay the Call Money. All those 1,500 shares were forfeited. Of the shares forfeited, 1,250 shares (including whole of Ram's shares) were subsequently re-issued to Jadu as fully paid up at a discount of ₹ 2 per share.
Pass the necessary entries in the Journal of the company to record the forfeiture and re-issue of the share. Also prepare the Balance Sheet of the company.

Illustration 16

A holds 2,000 shares of ₹ 10 each on which he has paid ₹ 2 as application money. B holds 4,000 shares of ₹ 10 each on which he has paid ₹ 2 per share as application money and ₹ 3 per share as allotment money. C holds 3,000 shares of ₹ 10 each and has paid ₹ 2 on application, ₹ 3 on allotment and ₹ 3 for the first call. They all fail to pay their arrears on the second and final call and the directors, therefore, forfeited their shares. The shares are re-issued subsequently for 12 per share fully paid-up. Journalise the transactions relating to the forfeiture and re-issue.

Illustration 17

X Co. Ltd. was incorporated with an authorized share capital of 90,000 equity shares of ₹ 10 each. The company purchased land and buildings from Y Co. Ltd for ₹ 4,00,000 payable in fully paid-up shares of the company. The balance of the shares were issued to the public, which were fully subscribed and paid for.
You are required to pass Journal Entries and to prepare the Balance Sheet.

Illustration 18

X Ltd. invited applications for 10 lakhs shares of ₹ 100 each payable as follows:

	₹
On Application	20
On Allotment (on 1st May, 2020)	30
On First Call (on 1st Oct., 2020)	30
On Final Call (on 1st Feb., 2021)	20

All the shares were applied for and allotted. A shareholder holding 20,000 shares paid the whole of the amount due along with allotment. Journalise the transactions, assuming all sums due were received. Interest was paid to the shareholder concerned on 1st February, 2021.

Illustration 19

A limited Company, with an authorized capital of ₹ 20,00,000 divided into shares of ₹ 100 each, issued for subscription 10,000 shares payable at ₹ 25 per share on application, ₹ 30 per share on allotment, ₹ 20 per share on first call three months after allotment and the balance as and when required.
The subscription list closed on January 31, 2020 when application money on 10,000 shares was duly received and allotment was made on March 1, 2020. All amounts due were received within one month of the date they were called.
The allotment amount was received in full but, when the first call was made, one shareholder failed to pay the amount on 1,000 shares held by him and another shareholder with 500 shares paid the entire amount on his shares.
Give journal entries in the books of the Company to record these share capital transactions.

Illustration 20

B Ltd. issued 20,000 equity shares of ₹ 100 each at a premium of ₹ 20 per share payable as follows: on application ₹ 50; on allotment ₹ 50 (including premium); on final call ₹ 20. Applications were received for 24,000 shares. Letters of regret were issued to applicants for 4,000 shares and shares were allotted to all the other applicants. Mr A, the holder of 150 shares, failed to pay the allotment and call money, the shares were forfeited. Show the Journal Entries and Cash Book in the books of B Ltd.

Illustration 21 (PYP NOV 2020)

ABC Limited issued 20,000 equity shares of ₹ 10 each payable as:
₹ 2 per share on application

₹ 3 per share on allotment
₹ 4 per share on first call
₹ 1 per share on final call
All the shares were subscribed. Money due on all shares was fully received except for Mr Bird, holding 300 shares, who failed to pay first call and final call money. All these 300 shares were forfeited. The forfeited shares of Mr Bird were subsequently re-issued to Mr John.as fully paid up at a discount of ₹ 2 per share.
Pass the necessary Journal Entries to record the above transactions in the books of ABC Limited.

Illustration 22 (PYP JUL 2021)
X Limited invited applications for issuing 75,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share. The total amount was payable as follows:
- ₹ 9 per share (including premium) on application and allotment
- Balance on the First and Final Call

Applications for 3,00,000 equity shares were received. Applications for 2,00,000 equity shares were rejected and money refunded. Shares were allotted on pro-rata basis to the remaining applicants. The first and final call was made. The amount was duly received except on 1,500 shares applied by Mr Raj. His shares were forfeited. The forfeited shares were re-issued at a discount of ₹ 4/- per share.
Pass necessary journal entries for the above transactions in the books of X Limited.

Illustration 23 (MTP DEC 2021 SERIES 2)

Hament applies for 2,000 shares of Rs. 10 each at a premium of Rs. 2.50 per share. He was allotted 1,000 shares. After having paid Rs. 3 per share on application, he did not pay the allotment money of Rs. 4.50 per share (including premium) and on his subsequent failure to pay the first call of Rs. 2 per share, his share were forfeited. These shares were reissued at Rs. 8 per share, his shares were forfeited.
At the time of re-issue of forfeited shares of Mr Hament, final call money amount all other shareholders were duly called up.
You are required to pass journal entries to record forfeiture and reissue of shares.

Illustration 24 (PYP DEC 2021)
Fashion Garments Ltd invited applications for issuing 10,000 Equity Shares of Rs. 10 each. The amount was payable as follows:

1. On Application - Rs. 1 per share
2. On Allotment - Rs. 2 per share
3. On First call - Rs. 3 per share
4. On Second and Final call - Rs. 4 per share

The issue was fully subscribed. Ram to whom 100 shares were allotted, failed to pay the allotment money and his shares were forfeited immediately after the allotment. Shyam to whom 150 shares were allotted, failed to pay the First call. His shares were also forfeited after first call. Afterwards the second and final call was made. Mohan to whom 50 shares were allotted failed to pay the second and final call. His shares were also forfeited. All the forfeited shares were re-issued at Rs. 9 per share fully paid up.
Pass necessary Journal entries in the books of Fashion Garments Ltd.

CHAPTER - 24
ISSUE OF DEBENTURES

---------------------------- **Bird's Eye View**------------------------

- ❑ Debentures – Meaning
- ❑ Features of Debentures
- ❑ Distinction Between Shares & Debentures
- ❑ Types of Debentures
- ❑ Debentures Issued at Par & Redeemable at Par
- ❑ Debentures Issued at Premium but Redeemable at Par
- ❑ Debentures Issued at Discount but Redeemable at Par
- ❑ Debentures Issued at Par but Redeemable at Premium
- ❑ Debentures Issued at Discount but Redeemable at Premium
- ❑ Debentures Issued at premium & Redeemable at Premium
- ❑ Debentures as Collateral Security
- ❑ Debentures in Consideration Other than in Cash
- ❑ Treatment of Discount/Loss on Issue of Debentures
- ❑ Interest on Debentures

DEBENTURES – MEANING

The word debenture represent amount lent to the company on which the company will have to pay a fixed amount of return. The word debenture is not defined precisely in the companies Act, 2013. **However, 'debenture' includes debenture stock, bonds & any other securities of the company, whether constituting a charge on the assets of the company or not.**

A debenture can be defined as a bond issued by the company under its common seal, accepting the debt & containing the provision as the regards repayment of principle & interests.

DEBENTURES – FEATURES

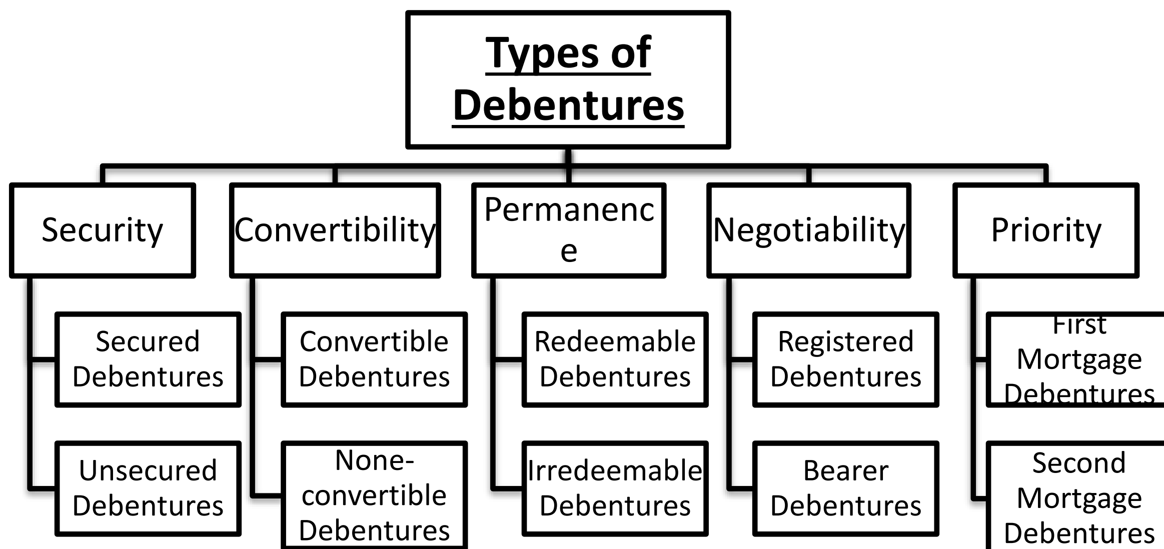
1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security which falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.

4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

DISTINCTION BETWEEN SHARES AND DEBENTURES

Sr. No.	SHARES	DEBENTURES
1	Shareholders are the owners of the company.	Debenture holders are the creditors of the company.
2	Shareholders have voting rights.	Debenture holders do not have voting rights.
3	Reward is the payment of dividend.	Reward is the payment of Interest.
4	Dividend on Shares is appropriation of Profits.	Interest on Debentures is Charge against profits.
5	Dividend on Shares is paid at a variable rate.	Interest on Debentures is paid at a pre-determined fixed rate.
6	Shares cannot be converted into debentures.	Debentures can be converted into shares.
7	Shares can be forfeited for non-payment of allotment and call money.	Debentures cannot be forfeited for non-payment of call money.
8	Payment of share capital is made after the repayment of Debentures.	Payment of debentures is made before the payment of share capital.

TYPES OF DEBENTURES



Secured Debentures

1. These debentures are secured by a charge upon some or all assets of the company.
2. There are two types of charges: (i) Fixed charge; and (ii) Floating charge.

3. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders. A floating charge generally covers all the assets of the company including future one.

Unsecured or "Naked" Debentures

These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

Convertible Debentures

1. These are debentures which will be converted into equity share (either at par or premium) after a certain period of time from the date of its issue.
2. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.

Non-Convertible Debentures

These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

Redeemable Debentures

These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

Irredeemable Debentures

These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation.

Registered Debentures

1. These debentures are payable to registered holder whose name, address and particulars of holdings is recorded in the Register of Debenture holders.
2. They are not easily transferable. The provisions of the Companies Act, 2013 are to be complied with for effecting transfer of these debentures.
3. Debentures interest is paid to the order of registered holders as expressed in the warrant issued by the company.

Bearer Debentures

1. These debentures are transferable by delivery. These are negotiable instruments payable to the bearer.
2. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity.

First Mortgage Debentures

These debentures are payable first out of the property charged.

Second Mortgage Debentures

These debentures are payable after satisfying the first mortgage debentures.

ISSUE OF DEBENTURES

The issue of Debentures can be categorized into the Following –
1. Debentures Issued at Par & Redeemable at Par.
2. Debentures Issued at Premium & Redeemable at Par.
3. Debentures Issued at Discount & Redeemed at Par
4. Debenture Issued at Par & Redeemable at Premium
5. Debenture Issued at Discount & Redeemable at premium
6. Debenture Issued at Premium & Redeemable at premium.

DEBENTURES ARE ISSUED AT PAR AND REDEEMABLE AT PAR

1. Debentures are said to have been issued at par when the issue price is equal to the face value.
2. Debentures are said to be redeemable at par when the redeemable value is equal to face value.
3. Example – An issue of debenture of Rs. 100 at Rs. 100 redeemable at 100.

Accounting Entries

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Debenture Application A/c
2	**Allotment of Debentures**	Debenture Application A/c……...Dr Debenture Allotment A/c……...Dr To …. % Debentures A/c
3	**Allotment Money Received**	Bank A/c………… Dr To Debenture Allotment A/c
4	**Call Money Due**	Debenture Call A/c………Dr To …. % Debentures
5	**Call Money Received**	Bank A/c………… Dr To Debenture Call A/c

Illustration 1

Amol Ltd. issued 40,00,000, 9% debentures of ₹50 each, payable on application as per term mentioned in the prospectus and redeemable at par any time after 3 years from the date of issue. Record necessary entries for issue of debentures in the books of Amol Ltd.

DEBENTURES ARE ISSUED AT PREMIUM AND REDEEMABLE AT PAR

1. Debentures are said to have been issued at premium but redeemable at par when the issue price is more than the face value but redeemable value is equal to face value.

2. Example – An issue of debenture of Rs. 100 at Rs. 110 and redeemable at 100.

Accounting Entries

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Debenture Application A/c
2	**Allotment of Debentures**	Debenture Application A/c……...Dr Debenture Allotment A/c……...Dr To …. % Debentures A/c To Securities Premium A/c
3	**Allotment Money Received**	Bank A/c…………. Dr To Debenture Allotment A/c
4	**Call Money Due**	Debenture Call A/c………Dr To …. % Debentures
5	**Call Money Received**	Bank A/c…………. Dr To Debenture Call A/c

Illustration 2

Koinal Chemicals Ltd. issued 15,00,000, 10% debenture of ₹50 each at premium of 10%, payable as ₹20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in application money.

DEBENTURES ARE ISSUED AT DISCOUNT AND REDEEMABLE AT PAR

1. Debentures are said to have been issued at discount but redeemable at par when the issue price is less than the face value but redeemable value is equal to face value.
2. Example – An issue of debenture of Rs. 100 at Rs. 90 and redeemable at 100

Accounting Entries

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Debenture Application A/c
2	**Allotment of Debentures**	Debenture Application A/c……...Dr Debenture Allotment A/c……...Dr Discount on Issue of Debenture A/c…... Dr. To Debenture A/c
3	**Allotment Money Received**	Bank A/c…………. Dr To Debenture Allotment A/c

4	**Call Money Due**	Debenture Call A/c………Dr To …. % Debentures
5	**Call Money Received**	Bank A/c………… Dr To Debenture Call A/c

Illustration 3

Atul Ltd. issued 1,00,00,000, 8% debenture of ₹100 each at a discount of 10% redeemable at par at the end of 10th year. Money was payable as follows:
₹ 30 on application
₹ 60 on allotment
Record necessary journal entries regarding issue of debenture.

DEBENTURES ARE ISSUED AT PAR AND REDEEMABLE AT PREMIUM

1. Debentures are said to have been issued at par but redeemable at premium when the issue price is equal to face value but redeemable value is more than the face value.
2. Example – An issue of debenture of Rs. 100 at Rs. 100 and redeemable at 110.
3. The difference between the redeemable value and issue value is treated as loss on issue of debentures at the time of allotment of debentures.
   Loss on Issue of debentures in above example shall be Rs. 10.
4. The amount of premium payable on redemption of debentures is credited to a separate account called "Debenture Redemption Premium A/c". The said account shall appear on the liability side of the balance sheet till the debentures are redeemed.

Accounting Entries

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Debenture Application A/c
2	**Allotment of Debentures**	Debenture Application A/c……...Dr Debenture Allotment A/c……...Dr Loss on Issue of Debenture A/c…... Dr. (Premium payable on redemption) To Debenture A/c To Debenture Redemption Premium A/c (Premium payable on redemption)
3	**Allotment Money Received**	Bank A/c………… Dr To Debenture Allotment A/c
4	**Call Money Due**	Debenture Call A/c………Dr To …. % Debentures
5	**Call Money Received**	Bank A/c………… Dr To Debenture Call A/c

Illustration 4

Modern Equipment's Ltd. issued 4,00,000, 12% debentures of ₹ 100 payable as follows:

On application ₹ 30

On allotment ₹ 70

The debenture were fully subscribed and all the money was duly received. As per the terms of issue, debentures are redeemable at ₹ 110 per debenture. Record necessary entries regarding issue of debentures.

DEBENTURES ARE ISSUED AT DISCOUNT AND REDEEMABLE AT PREMIUM

1. Debentures are said to have been issued at discount but redeemable at premium when the issue price is less than the face value but redeemable value is more than the face value.
2. Example – An issue of debenture of Rs. 100 at Rs.90 and redeemable at 110.
3. The difference between the redeemable value and issue value is treated as loss on issue of debentures at the time of allotment of debentures.
   Loss on Issue of debentures in above example shall be Rs. 20.
4. The amount of premium payable on redemption of debentures is credited to a separate account called "Debenture Redemption Premium A/c". The said account shall appear on the liability side of the balance sheet till the debentures are redeemed.

Accounting Entries

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Debenture Application A/c
2	**Allotment of Debentures**	Debenture Application A/c……...Dr Debenture Allotment A/c……...Dr Loss on Issue of Debenture A/c…... Dr. (Discount allowed + Premium payable on redemption) To Debenture A/c To Debenture Redemption Premium A/c (Premium payable on redemption)
3	**Allotment Money Received**	Bank A/c…………. Dr To Debenture Allotment A/c
4	**Call Money Due**	Debenture Call A/c………Dr To …. % Debentures
5	**Call Money Received**	Bank A/c…………. Dr To Debenture Call A/c

Illustration 5

Aggrotech Ltd. issued 150 lakh 9% debentures of ₹100 each at a discount of 6%, redeemable at a premium of 5% after 3 years payable as: ₹50 on application and ₹44 on allotment. Record necessary journal entries for issue of debentures.

DEBENTURES ARE ISSUED AT PREMIUM AND REDEEMABLE AT PREMIUM

1. Debentures are said to have been issued at premium and redeemable at premium when both the issue price and redeemable value is more than the face value.
2. Example – An issue of debenture of Rs. 100 at Rs.105 and redeemable at 110.
3. The difference between the redeemable value and face value is treated as loss on issue of debentures at the time of allotment of debentures.
   Loss on Issue of debentures in above example shall be Rs. 10.
4. The amount of premium payable on redemption of debentures is credited to a separate account called "Debenture Redemption Premium A/c". The said account shall appear on the liability side of the balance sheet till the debentures are redeemed.

Accounting Entries

Sr. No.	Case	Accounting Entry
1	**Application Money Received**	Bank A/c……. Dr To Debenture Application A/c
2	**Allotment of Debentures**	Debenture Application A/c……...Dr Debenture Allotment A/c……...Dr Loss on Issue of Debenture A/c…... Dr. (Premium payable on redemption) To …...%Debenture A/c To Securities Premium A/c (Premium on Issue) To Debenture Redemption Premium A/c (Premium payable on redemption)
3	**Allotment Money Received**	Bank A/c…………. Dr To Debenture Allotment A/c
4	**Call Money Due**	Debenture Call A/c………Dr To …. % Debentures
5	**Call Money Received**	Bank A/c…………. Dr To Debenture Call A/c

Illustration 6

X Ltd. Issued 10000, 12% Debentures of Rs 100 each at 6% premium, redeemable at 6% premium after 5 years, payable as Rs 60 on application and the balance on allotment. The debentures were fully subscribed and all money was duly received.

Required: Prepare Journal

Illustration 7
Country Crafts Ltd. issued 1,00,000, 8% debentures of ₹ 100 each at premium of 5% payable fully on
application and redeemable at premium of ₹ 10 Pass necessary journal entries at the time of issue.

Illustration 8
Simmons Ltd. issued 1,00,000, 12% Debentures of ₹100 each at par payable in full on application by 1st April, Application were received for 1,10,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date.
You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

Illustration 9
X Ltd. issued 1,00,000 12% Debentures of ₹100 each at a discount of 10% payable in full on application by 31st May, 2020. Applications were received for 1,20,000 debentures. Debentures were allotted on 9th June, 2020. Excess monies were refunded on the same date. Pass necessary Journal Entries. Also show necessary ledger accounts.

Illustration 10
Koinal Chemicals Ltd. issued 20,00,000, 10% debentures of ₹50 each at premium of 10%, payable as ₹20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in allotment money.

Illustration 11
Kapil Ltd. issued 50,000, 12% Debentures of ₹100 each at a premium of 10% payable in full on application by 1st March, 2020. The issue was fully subscribed and debentures were allotted on 9th March, 2020.
Pass necessary Journal Entries (including cash transactions).

ISSUE OF DEBENTURES AS A COLLATERAL SECURITY

1. Collateral security means secondary or supporting security for a loan, which can be realized by the lender in the event of the original loan not being repaid on the due date.
2. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.
3. Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.

4. The holder of such debentures (given as a collateral security) is entitled to interest only on the amount of loan, but not on the debentures.
5. There are two methods of showings these type of debentures in the accounts of a company.

Method 1

Under this method, no entry is made in the books of account of the company at the time of making issue of such debentures. In the 'Notes to Account' of Balance Sheet, the fact of the debentures being issued and outstanding is shown by a note under the liability secured.

Method 2

Under this method, the following entry is made to record the issue of such debentures:
Debentures Suspense Account……...Dr.
To Debentures Account
The Debentures Suspense Account will appear on the assets side of the Balance sheet and Debentures on the liabilities side of the Balance Sheet. When the loan is repaid, the entry is reversed in order to cancel it.

Illustration 12

X Ltd. Obtains a Loan from IDBI of Rs.1,00,00,000, giving as collateral security of Rs.1,50,00,000 (of Rs.10 each), 14%, First Mortgage Debentures. Give Journal Entry and relevant disclosures in Balance Sheet.

ISSUE OF DEBENTURES IN CONSIDERATION OTHER THAN CASH

Just like Shares, debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc.

Sr. No.	Case	Accounting Entry
1	**Purchase of Business / Acquisition of Assets**	Sundry Assets A/c………Dr To Sundry Liabilities A/c To Vendor's A/c
2	**Issue of Debentures in Consideration**	Vendor's A/c……...Dr To …. % Debentures A/c

Illustration 13

X Ltd. Took over the assets of Rs 6,60,000 and liabilities of Rs 80,000 of Y Ltd. For an agreed purchase consideration of Rs 6,00,000 payable 10% in cash and the balance by the issue of 15% Debentures of Rs 100 each, Shown the necessary journal entries in the books of X Ltd., assuming that—
Case (a) Such Debenture are issued at par;
Case (b) Such Debenture are issued at 20% premium; and
Case (c) Such Debentures are issued at 10% discount;

Illustration 14

X company Limited issued 10,000 14% Debentures of the nominal value of 50,00,000 as follows –

a) To sundry persons for cash at 90% of nominal value of Rs. 25,00,000

b) To a vendor for purchase of fixed assets worth Rs. 10,00,000- 12,50,000 nominal value

c) To the banker as Collateral security for a loan of Rs 10,00,000- 12,50,000 nominal value.

Pass necessary journal entries

TREATMENT OF DISCOUNT/LOSS ON ISSUE OF DEBENTURES

1. The discount on issue of debentures is amortized over a period between the issuance date and redemption date.
2. It should be written-off in the following manner depending upon the terms of redemption:
   a) If the debentures are redeemable after a certain period of time, say at the end of 5 or 10 year, the total amount of discount should be written-off equally throughout the life of the debentures (applying the straight-line method). The main advantage of this method is that it spreads the burden of discount equally over the year.
   b) If the debentures are redeemable at different dates, the total amount of discount should be written-off in the ratio of benefit derived from debentures loan in any particular year (applying the sum of the year's digit method). This is suitable when debentures are redeemed by unequal installments.
   c) If the debentures are irredeemable, the discount should be written-off gradually over a long period.
3. Loss on issue of debentures is also a capital loss and should be written-off in a similar manner as discount on debentures issued.
4. In the balances sheet both the items are shown as non-current/ current assets depending upon the period for which it has to be written off.

Illustration 15

HDC Ltd. issues 1,00,000, 12% Debentures of ₹100 each at ₹94 on 1st January, 2020. Under the terms of issue, the debentures are redeemable at the end of 5 years from the date of issue. Calculate the amount of discount to be written-off in each of the 5 years.

Illustration 16

On 1.04.2011, X Ltd. Issued Rs. 1,00,000 15% Debentures of Rs 100 each at 94% redeemable at par as follows:

Year-end	Nominal value of Total Debentures to be Redeemed
2	10%
3	20 %
4	30%
5	40%

Required

Calculate the amount of discount to be written off each year assuming that the company closes its accounts on financial year basis.

Illustration 17
HDC Ltd. issues 2,00,000, 12% Debentures of ₹10 each at ₹9.40 on 1st January, 2020. Under the terms of issue, 1/5th of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 2020. Calculate the amount of discount to be written-off from 2020 to 2024.

Illustration 18
On 01.01.2011 A Ltd. Issued 500, 15% Debentures of Rs 100 each, at a discount of 10% redeemable at a premium of 10%. Show the 'Loss on Issue of Debentures A/c; if (i) such debentures are redeemable after 4 years, and (ii) such debentures are redeemable by equal annual drawings in 4 years A Ltd. Follows calendar year as it accounting year.

INTEREST ON DEBENTURES

1. Interest Payable on Debenture is treated as a charge against the profits of the company.
2. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures.
3. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates applicable under tax rules from time to time. The companies will deposit the tax so deducted with income tax authorities.

Sr. No.	Case	Accounting Entry
1	**Making Interest Due**	Interest a/c...........Dr To Debenture holders A/c
2	**Making Payment of Interest and Deduction of Tax at Source**	Debenture holders A/c.........Dr To TDS Payable A/c To Bank A/c
3	**Making Payment of Tax Deducted at Source**	TDS Payable A/c............ Dr To Bank A/c
4	**Transfer of Interest to Profit & Loss A/c**	Profit & Loss A/c......Dr To Interest A/c

Illustration 19
A company issued 12% debentures of the face value of ₹10,00,000 at 10% discount on 1-1-2017. Debenture interest after deducting tax at source @ 10% was payable on 30th June and 31st of December every year. All the debentures were to be redeemed after the expiry of five year period at 5% premium.
Pass journal entries for the accounting year 2020.

Illustration 20

On 1st April 2020 Sheru Ltd. issued 1,00,000 12% debentures of ₹100 each at a discount of 5%, redeemable on 31 March 2025. Issue was oversubscribed by 20,000 debentures, who were refunded their money. Interest is paid annually on 31 March. You are required to prepare:

(i) Journal Entries at the time of issue of debentures.

(ii) Discount on issue of Debenture Account

(iii) Interest account and Debenture holder Account assuming TDS is deducted @ 10%.

Illustration 21 (MTP DEC 2021 SERIES 1)

On 1st April, 2020, Sky Ltd. took over assets of ₹ 4,50,000 and liabilities of ₹ 60,000 of Universe Ltd. for the purchase consideration of ₹ 4,40,000. It paid the purchase consideration by issuing 8% debentures of ₹ 100 each at 10% premium. On the same date it issued another 3,000, 8% debentures of ₹ 100 at discount of 10% redeemable at the premium of 5% after 5 years. According to the terms of the issue ₹ 30 is payable on application and the balance on the allotment of debenture.

You are required to pass journal entries in the books of Sky Ltd. for financial year 2020-21.

CHAPTER - 25
ACCOUNTING FOR BONUS ISSUE AND RIGHT ISSUE

---------------------------- **Bird's Eye View**-------------------------

- ❑ Introduction To Bonus Issue
- ❑ Provisions in Regards To Bonus Issue
- ❑ Journal Entries for Bonus Issue
- ❑ Effects of Bonus Issue
- ❑ Introduction To Right Issue
- ❑ Provisions in Regards To Right Issue
- ❑ Exceptions to The Rights of Existing Equity Shareholders
- ❑ Book Value Per Share
- ❑ Right of Renunciation
- ❑ Journal Entries for Right Issue
- ❑ Advantages of Right Issue
- ❑ Disadvantages of Right Issue
- ❑ Effects of Right Issue

INTRODUCTION TO BONUS ISSUE

- ❖ A bonus share may be defined as issue of shares at no cost to current shareholders in a company, based upon the number of shares that the shareholder already owns. In other words, no new funds are raised with a bonus issue.

- ❖ While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant.

- ❖ Bonus issue is also known as 'capitalisation of profits.' Capitalisation of profits refers to the process of converting profits or reserves into paid up capital. A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to the members.

- ❖ If the subscribed and paid-up capital exceeds the authorised share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution

authorising the issue of bonus shares is also required to be filed with the Registrar of Companies.

EXAMPLE 1

Alpha Company announced bonus issue to its shareholders in the ratio of 2:3 i.e. 2 shares for every 3 shares held. Shareholder X has 6,000 shares before announcement of bonus issue. How much shares would he have after bonus issue?

PROVISIONS IN REGARDS TO BONUS ISSUE

1. Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to Sub-section (1) of Section 63, a company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—
   i. its free reserves;
   ii. the securities premium account; or
   iii. the capital redemption reserve account:

2. Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

3. Sub-section (2) of Section 63 provides that no company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (1), unless—
   a) It is authorised by its articles;
   b) It has, on the recommendation of the Board, been authorised in the general meeting of the company;
   c) It has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;
   d) It has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;
   e) The partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up.
   f) It complies with such conditions as may be prescribed

4. The company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same.

5. Sub-section (3) of the Section also provides that the bonus shares shall not be issued in lieu of dividend.

6. As per Para 39 (i) of Table F under Schedule I to the Companies Act, 2013, a company in general meeting may, upon the recommendation of the Board, resolve—
   a) that it is desirable to capitalise any part of the amount for the time being standing to the credit of any of the company's reserve accounts, or to the credit of the profit and loss account, or otherwise available for distribution; and
   b) That such sum be accordingly set free for distribution in the specified manner amongst the members who would have been entitled thereto, if distributed by way of dividend and in the same proportions.
   c) The sum aforesaid shall not be paid in cash but shall be applied, either in or towards— (a) paying up any amounts for the time being unpaid on any shares held by such members respectively; (b) paying up in full, unissued shares of the company to be allotted and distributed, credited as fully paid-up, to and amongst such members in the proportions aforesaid; partly in the way specified in (a) and partly in that specified in (b) above;

7. A securities premium account and a capital redemption reserve account may only be applied in the paying up of **unissued shares to be issued to members** of the company as fully paid bonus shares. In other words, it can be said that **free reserves may be used for paying up amounts unpaid on shares held by existing shareholders** (though securities premium account and capital redemption reserve cannot be used).

8. As per Section 2(43) of the Companies Act, 2013, "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend. Provided that—
   I. any amount representing unrealised gains, notional gains, or revaluation of assets, whether shown as a reserve or otherwise, or
   II. any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

9. As per SEBI Regulations, such securities premium should be realized in cash, whereas under the Companies Act, 2013, there is no such requirement. In accordance with Section 52, securities premium may arise on account of issue of shares other than by way of cash. Thus, for unlisted companies, securities premium (not realized in cash) may be used for issue of bonus shares, whereas the same cannot be used in case of listed companies.

JOURNAL ENTRIES FOR BONUS ISSUE

Upon the sanction of an issue of bonus shares of Fully Paid Shares

1. Capital Redemption Reserve Account Dr.
   Securities Premium Account Dr.
   General Reserve Account Dr.
   Profit & Loss Account Dr.
   To Bonus to Shareholders Account.

2. Bonus to Shareholders Account Dr.
   To Share Capital Account.

Upon the sanction of bonus by converting partly paid shares into fully paid shares

1. **Conversion of partly paid Shares into Fully Paid Shares**

   General Reserve Account Dr.
   Profit & Loss Account Dr.
   To Bonus to Shareholders Account

2. **On making the final call due**

   Share Final Call Account Dr.
   To Share Capital Account.

3. **On adjustment of final call**

Bonus to Shareholders Account Dr.
To Share Final Call Account

EFFECTS OF BONUS ISSUE

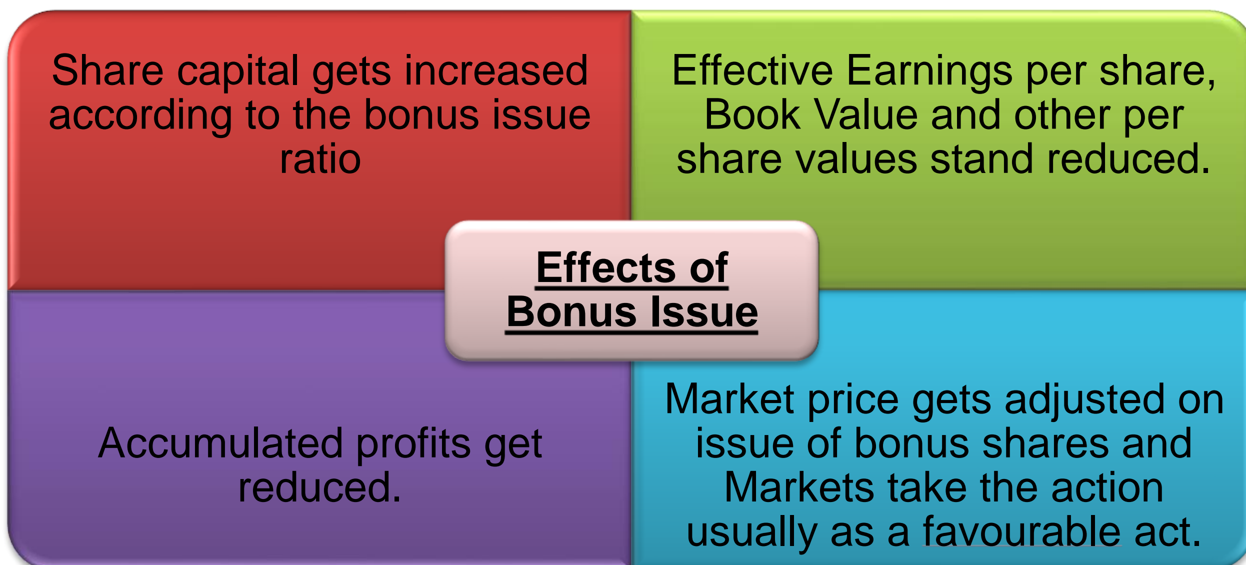


Illustration 1
Following items appear in the trial balance of Bharat Ltd. (a listed company) as on 31st March, 2022:

	₹
40,000 Equity shares of ₹ 10 each	4,00,000
Capital Redemption Reserve	55,000
Securities Premium (collected in cash)	30,000
General Reserve	1,05,000
Surplus i.e. credit balance of Profit and Loss Account	50,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reductionin free reserves. Pass necessary journal entries.

Illustration 2
Following items appear in the Trial Balance of Saral Ltd. as on 31st March, 2022:

Particulars	**Amount**
4,500 Equity Shares of ₹ 100 each	4,50,000
Securities Premium (collected in cash)	40,000

Capital Redemption Reserve	70,000
General Reserve	1,05,000
Profit and Loss Account (Cr. Balance)	65,000

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 3 shares held. Company decided that there should be the minimum reduction in free reserves. Pass necessary Journal Entries in the books Saral Ltd.

Illustration 3

Pass Journal Entries in the following circumstances:

1. A Limited company with subscribed capital of ₹ 5,00,000 consisting of 50,000 Equity shares of ₹ 10 each; called up capital ₹ 7.50 per share. A bonus of ₹ 1,25,000 declared out of General Reserve to be applied in making the existing shares fully paid up.

2. A Limited company having fully paid-up capital of ₹ 50,00,000 consisting of Equity shares of ₹ 10 each, had General Reserve of ₹ 9,00,000. It was resolved to capitalize ₹ 5,00,000 out of General Reserve by issuing 50,000 fully paid bonus shares of ₹ 10 each, each shareholder to get one such share for every ten shares held by him in the company.

Illustration 4

Following notes pertain to the Balance Sheet of Solid Ltd. as at 31st March, 2022:

	₹
Authorized capital:	
10,000 12% Preference shares of ₹ 10 each	1,00,000
1,00,000 Equity shares of ₹ 10 each	10,00,000
	11,00,000
Issued and Subscribed capital:	
8,000 12% Preference shares of ₹ 10 each fully paid	80,000
90,000 Equity shares of ₹ 10 each, ₹ 8 paid up	7,20,000
Reserves and Surplus:	
General reserve	1,60,000
Revaluation reserve	35,000
Securities premium (collected in cash)	20,000
Profit and Loss Account	2,05,000
Secured Loan:	
12% Debentures @ ₹ 100 each	5,00,000

On 1st April, 2022 the Company has made final call @ ₹ 2 each on 90,000 equity shares. The call money was received by 20th April, 2022. Thereafter the company decided to capitalize

its reserves by way of bonus at the rate of one share for every four shares held. Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue assuming that the company has passed necessary resolution at its generalbody meeting for increasing the authorized capital.

Illustration 5

The following notes pertain to Brite Ltd.'s Balance Sheet as at 31st March, 2022:

Notes	₹ in Lakhs
(1) Share Capital	
Authorized:	
20 crore shares of ₹ 10 each	20,000
Issued and Subscribed:	
10 crore Equity Shares of ₹ 10 each	10,000
2 crore 11% Cumulative Preference Shares of ₹ 10 each	2,000
Total	12,000
Called and paid up:	
10 crore Equity Shares of ₹ 10 each, ₹ 8 per share called and paid up	8,000
2 crore 11% Cumulative Preference Shares of ₹ 10 each, fully called and paid up	2,000
Total	10,000
(2) Reserves and Surplus:	
Capital Redemption Reserve	1,485
Securities Premium (collected in cash)	2,000
General Reserve	1,040
Surplus i.e. credit balance of Profit & Loss Account	273
Total	4,798

On 2nd April 2022, the company made the final call on equity shares @ ₹ 2 per share. The entire money was received in the month of April, 2022.

On 1st June 2022, the company decided to issue to equity shareholders bonus shares at the rate of 2 shares for every 5 shares held. Pass journal entries for all the above-mentioned transactions. Also prepare the notes on Share Capital and Reserves and Surplus relevant to the Balance Sheet of the company immediately after the issue of bonus shares.

Illustration 6

Following notes pertain to the Balance Sheet of Preet Ltd. as at 31st March, 2022

	₹
Share capital:	
Authorized capital:	
15,000 12% Preference shares of ₹ 10 each	1,50,000
1,50,000 Equity shares of ₹ 10 each	15,00,000
	16,50,000
Issued and Subscribed capital:	
12,000 12% Preference shares of ₹ 10 each fully paid	1,20,000

1,35,000 Equity shares of ₹ 10 each, ₹ 8 paid up	10,80,000
Reserves and surplus:	
General Reserve	1,80,000
Capital Redemption Reserve	60,000
Securities premium (collected in cash)	37,500
Profit and Loss Account	3,00,000

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 1,35,000 equity shares. The call money was received by 20th April, 2022. Thereafter, the company decided to capitalize its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2022 after bonus issue.

Illustration 7

Following notes pertain to the Balance Sheet of Manoj Ltd. as at 31st March, 2022

Authorized capital:	₹
30,000 12% Preference shares of ₹ 10 each	3,00,000
3,00,000 Equity shares of ₹ 10 each	30,00,000
	33,00,000
Issued and Subscribed capital:	
24,000 12% Preference shares of ₹ 10 each fully paid	2,40,000
2,70,000 Equity shares of ₹ 10 each, ₹ 8 paid up	21,60,000
Reserves and surplus:	
General Reserve	3,60,000
Capital Redemption Reserve	1,20,000
Securities premium (collected in cash)	75,000
Profit and Loss Account	6,00,000

On 1st April, 2022, the Company has made final call @ ₹ 2 each on 2,70,000 equity shares. The call money was received by 20th April, 2022. Thereafter, the company decided to capitalize its reserves by way of bonus at the rate of one share for every four sharesheld.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2022 after bonus issue.

INTRODUCTION TO RIGHT ISSUE

Provisions of section 62(1)(a) of the Companies Act, 2013 govern any company, public or private, which is desirous of raising its subscribed share capital by issue of further shares.

Whenever a company intends to issue new shares, the voting and governance rights of the existing shareholders may be diluted, if they are not allowed to preserve them. It may happen because new shareholders may subscribe to the issued share capital. Companies Act, 2013 allows existing shareholders to preserve their position by offering those newly issued shares at the first instance to them. The existing shareholders are given a right to subscribe these shares, if they like. However, if they do not desire to subscribe these shares, they are even given the right to renounce it in favour of someone else (unless the articles of the company prohibits such a right to renounce)

In nutshell, the existing shareholders have a right to subscribe to any fresh issue of shares by the company in proportion to their existing holding for shares. They have an implicit right to renounce this right in favour of anyone else, or even reject it completely. In other words, the existing shareholders have right of first refusal, i.e., the existing shareholders enjoy a right to either subscribe for these shares or sell their rights or reject the offer.

EXAMPLE 2

Assume a company makes a right issue of 10,000 shares when its existing issued and subscribed capital is 100,000 shares. This enables any shareholder having 10 shares to subscribe to 1 new share. Hence X, an existing shareholder holding 1,000 shares, may subscribe to 100 shares as a matter of right. The existing share percentage of X was 1% (1,000 / 100,000). If X subscribes these shares, his percentage holding in the company will be maintained at 1% (1,100 / 1,10,000). However, if X does not mind his share 0.91% diluting (1,000 / 1,10,000), he may renounce the right in favour of anyone else, say Y. Hence, these 100 shares will be issued to Y, at the insistence of X. X may charge Y for this privilege, which is technically termed as the value of right.

PROVISIONS IN REGARDS TO RIGHT ISSUE

A company desirous of issuing new shares has to offer, as per Section 62(1) (a) of Companies Act 2013, the shares to existing equity shareholders through a letter of offer subject to the *following conditions*, namely:

- The offer shall be made by notice specifying the number of shares offered and limiting a time not being less than fifteen days and not exceeding thirty days from the date of the offer within which the offer, if not accepted, shall be deemed to have been declined;

- Unless the articles of the company otherwise provide, the offer aforesaid shall be deemed to include a right exercisable by the person concerned to renounce the shares offered to him or any of them in favour of any other person; and the notice (referred to in above bullet point) shall contain a statement of this right;

- After the expiry of the time specified in the notice aforesaid, or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the shares offered, the Board of Directors may dispose of them in such manner which is not disadvantageous to the shareholders and the company.

EXCEPTIONS TO RIGHT OF EXISTING SHAREHOLDERS

Section 62 recognizes four situations under which the further shares are to be issued by a company, but they need not be offered to the existing shareholders.

Situation 1
To employees under a scheme of employees' stock option subject to certain specified conditions

Situation 2
To any persons, either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer subject to certain specified conditions.

Situation 3
Sometimes companies borrow money through debentures / loans and give their creditor an option to buy equity shares of a company. An option is a right, but not an obligation, to buy equity shares on a future date (expiry date) at a price agreed in advance (exercise price).
According to Section 62(3), increase of the subscribed capital of a company that caused by the exercise of an option as a term attached to the debentures issued or loan raised by the company to convert such debentures or loans into shares in the company, need not be offered to existing shareholders

Situation 4
It is a special situation where the loan has been obtained from the government, and government in public interest, directs the debentures / loan to be converted into equity shares.

BOOK VALUE OF SHARE

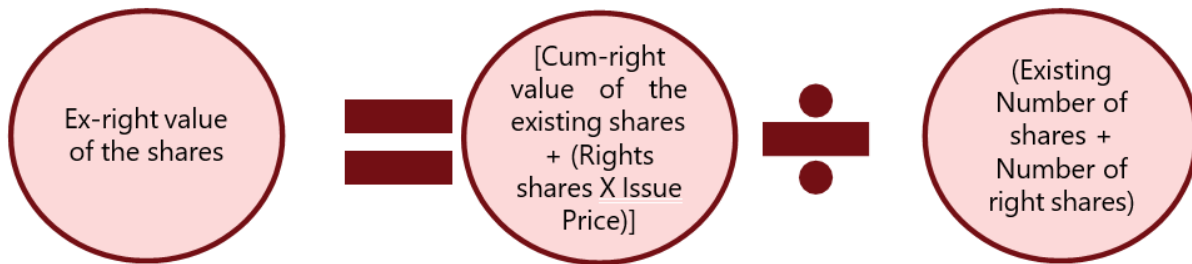
Book value of a share = Net worth (as per books)/ Number of shares
if there are 10,000 shares with net worth of 1,25,000. The book value of one share is (₹ 125,000/ 10,000 shares) ₹ 12.50 per share. However, the market value may differ from the book value of shares. The market value of a company's shares represents the present value of future cash flows expected to be earned from the share in the form of dividends and capital gains from expected future share price appreciation.

The market price, which exists before the rights issue, is termed as Cum-right Market Price of the share. If the company decides to issue further shares, it may affect the market value of the share. 'Theoretically', the value of a company's shares after a rights issue must equal the sum of market capitalisation immediately prior to rights issue and the cash inflows generated from the rights issue.

Normally, the further public issue to the existing shareholders are offered at a discounted price from the market value, to evoke positive response as well as to reward the existing shareholders.

Assume a company having a net worth of ₹ 250,000. 1,000 shares are issued (making it a right issue of 1:10; or 1 new share for 10 existing shares held) at a price of ₹ 14 per share. The existing worth of tangible assets held by the business shall become 264,000 (Existing net worth ₹ 250,000 + Fresh Issue ₹ 14,000). Equity shares shall correspondingly command a valuation of ₹ 264,000.

The market price of the shares after further issue of shares (right issue) is termed as Ex-right Market Price of the shares. Theoretical Ex-Rights Price is a deemed value, which is attributed to a company's share immediately after a rights issue transaction occurs. This price is going to prevail after the further issue of shares is executed.



RIGHT OF RENUNCIATION

1. Right of renunciation refers to the right of the shareholder to surrender his right to buy the securities and transfer such right to any other person.
2. Shareholders that have received right shares have three choices of what to do with the rights. They can act on the rights and buy more shares as per the particulars of the rights issue; they can sell them in the market; or they can pass on taking advantage of their rights (i.e., reject the right offer).
3. The renunciation of the right is valuable and can be monetised by the existing shareholders in well-functioning capital market. The monetised value available to the existing shareholders due to right issue is known as 'value of right.'
4. If a shareholder decides to renounce all or any of the right shares in favour of his nominee, the value of right is restricted to the sale price of the renouncement of a right in favour of the nominee. In case the right issue offer is availed by an existing shareholder, the value of right is determined as given below:
   Value of right = Cum-right value of share – Ex-right value of share

Ex-right value of the shares = [Cum-right value of the existing shares + (Rights shares X Issue Price)] / (Existing Number of shares + Number of right shares)

In our previous example, Ex-right value of share = [₹ 250,000 + (₹ 14 X 1,000 shares)] /10,000 + 1,000 shares = ₹ 24

Value of right = ₹ 25 – ₹ 24 = ₹ 1 per share

EXAMPLE 3

Continuing the previous case, consider an individual shareholder Mr. Narain holding 100 shares of Prosperous Company before rights issue.

Current worth of holding = No. of shares X Cum-right Market Price
= 100 X 25
= ₹ 2,500

a) If Narain exercises his right, he will pay ₹ 14X10 shares = ₹ 140.
   His total investment in the company including right is ₹ 2,640 (₹ 2,500+₹ 140).
   On a per share basis, it is ₹ 2,640 /110 shares = ₹ 24, which is the Ex-right Market value of the share.
b) If Narain does not exercise his right to further issue, his holding's worth will decline to Rs. 24 X 100 shares = Rs 2400. The law allows him to compensate for this dilution of shareholding by renouncing this right in favour of, say, Mr. Murthy.
   Narain can charge Murthy, in well-functioning capital markets, this dilution of Rs. 100 by renouncing his right to acquire 10 shares. Hence Murthy will be charged Rs. 10 per share (` 100 / 10 shares), in return for a confirmed allotment of 10 shares at Rs. 14 each.

For every share to be offered to Murthy, Narain must have ten shares at the back. Hence his holding of 10 shares fetches him right money of 10 or 1 per share held. This is exactly equal to the difference between Cum-right and Ex-right value of the share. It is termed as the Value of Right.

JOURNAL ENTRIES FOR RIGHT ISSUE

The accounting treatment of rights share is the same as that of issue of ordinary shares and the following journal entry will be made:

Bank A/c Dr.
To Equity shares capital A/c

In case rights shares are being offered at a premium, the premium amount is credited to the securities premium account. The accounting entry in Such case Shall be

Bank A/c Dr
To Equity Share Capital A/c
To Securities Premium A/c

ADVANTAGES OF RIGHT ISSUE

1. Right issue enables the existing shareholders to maintain their proportional holding in the company and retain their financial and governance rights. It works as a deterrent to the management, which may like to issue shares to known persons with a view to have a better control over the company's affairs.
2. In well-functioning capital markets, the right issue necessarily leads to dilution in the value of share. However, the existing shareholders are not affected by it because getting new shares at a discounted value from their cum-right value will compensate decrease in the value of shares. The cum-right value is maintained otherwise also, if the existing shareholders renounce their right in favour of a third party.
3. Right issue is a natural hedge against the issue expenses normally incurred by the company in relation to public issue.
4. Right issue has an image enhancement effect, as public and shareholders view it positively.
5. The chance of success of a right issue is better than that of a general public issue and is logistically much easier to handle.

DISADVANTAGES OF RIGHT ISSUE

1. The right issue invariably leads to dilution in the market value of the share of the company.
2. The attractive price of the right issue should be objectively assessed against its true worth to ensure that you get a bargained deal.

EFFECTS OF RIGHT ISSUE

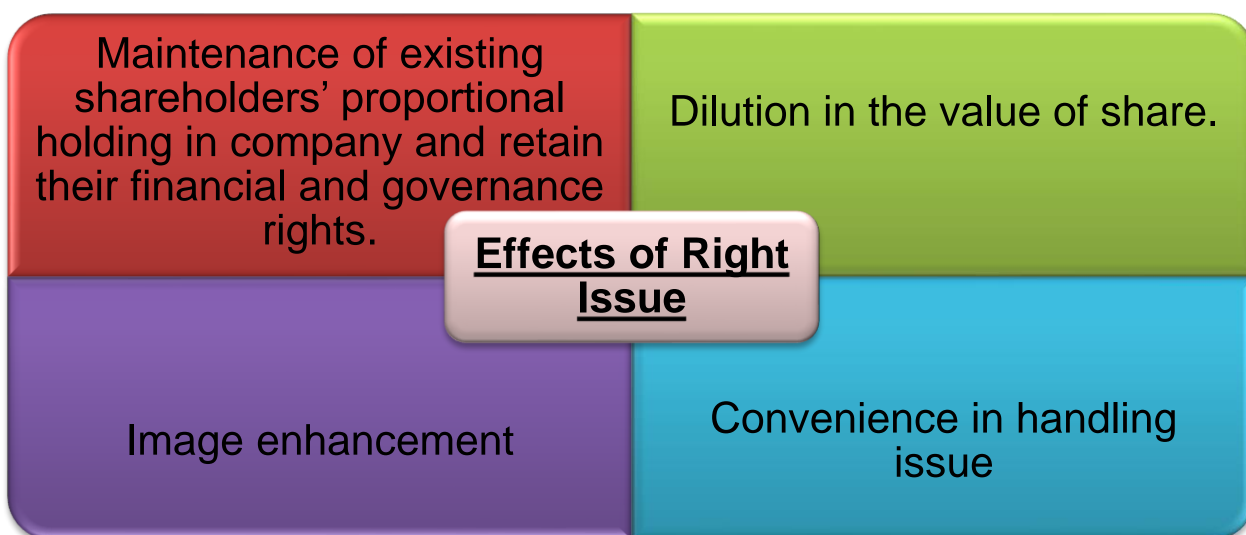


Illustration 8

A company offers new shares of ₹ 100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is ₹ 150. Calculate the value of a right. What should be the ex-right market price of a share?

Illustration 9

A company has decided to increase its existing share capital by making rights issue to its existing shareholders. The company is offering one new share for every two shares held by the shareholder. The market value of the share is ₹ 240 and the company is offering one share of ₹ 120 each. Calculate the value of a right. What should be the ex-right market price of a share?

Illustration 10

A Ltd company having share capital of 25,000 equity shares of ₹10 each decides to issue rights share at the ratio of 1 for every 4 shares held at par value. Assuming all the shareholders accepted the rights issue and all money was duly received, pass journal entries in the books of the company.

Illustration 11

Following notes pertain to the Balance Sheet of Mars Company Limited as at 31st March 2022:

	₹
Authorized capital:	
50,000 12% Preference shares of ₹ 10 each	5,00,000
5,00,000 Equity shares of ₹ 10 each	50,00,000
	55,00,000
Issued and Subscribed capital:	
50,000 12% Preference shares of ₹ 10 each fully paid	5,00,000

4,00,000 Equity shares of ₹ 10 each, ₹ 8 paid up	32,00,000
Reserves and surplus:	
General Reserve	1,60,000
Capital Redemption Reserve	2,40,000
Securities premium (collected in cash)	2,75,000
Revaluation Reserve	1,00,000
Profit and Loss Account	16,00,000

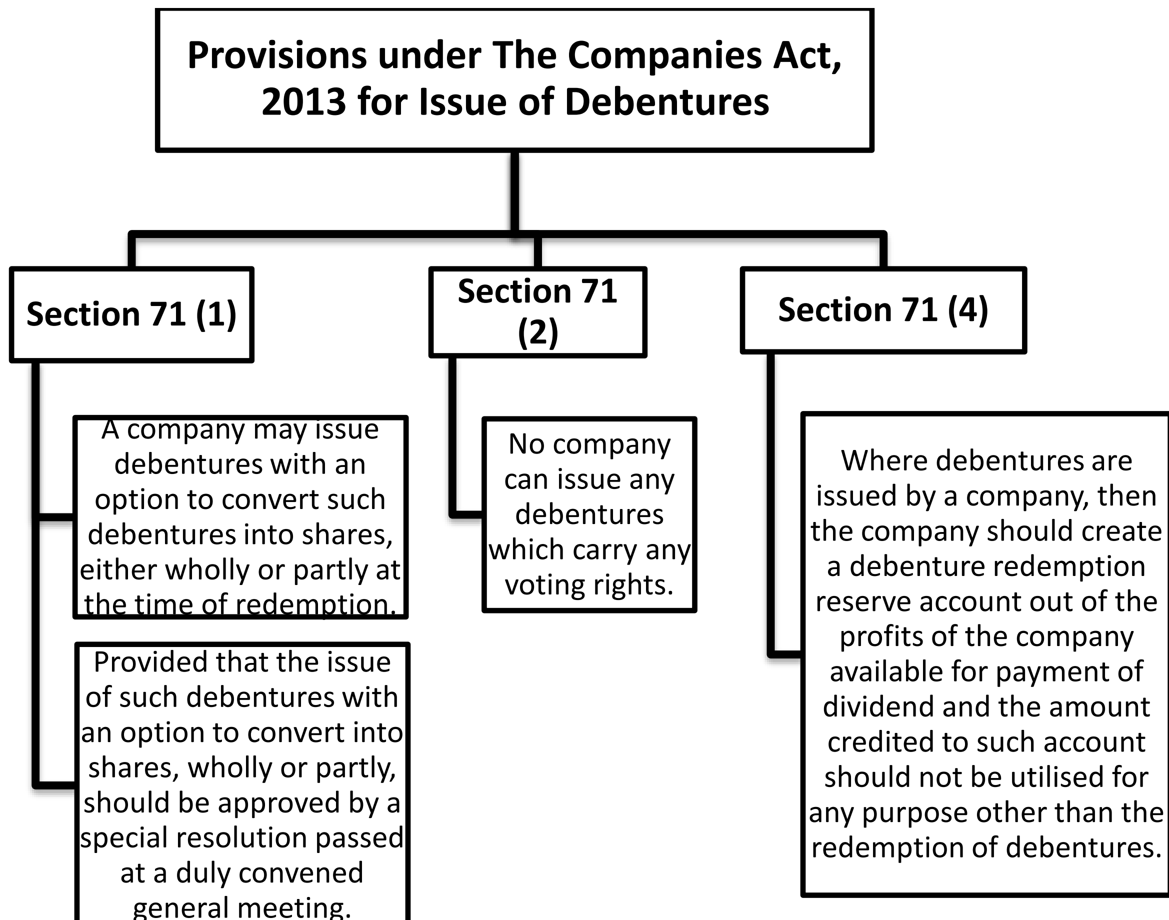
On 1st April, 2022, the Company has made final call @ ₹ 2 each on 4,00,000 equity shares. The call money was received by 25th April, 2022. Thereafter, on 1st May 2022 the company decided to capitalize its reserves by way of bonus at the rate of one share for every four shares held, it decided that there should be minimum reduction in free reserves.
On 1st June 2022, the Company issued Rights shares at the rate of two shares for every five shares held on that date at issue price of ₹ 12 per share. All the rights shares were accepted by the existing shareholders and the money was duly received by 20th June 2022.
Show necessary journal entries in the books of the company for bonus issue and rights issue.

CHAPTER - 26
REDEMPTION OF DEBENTURES

---------------------------- **Bird's Eye View**------------------------

- ❑ Introduction
- ❑ Redemption of Debentures
- ❑ Debenture Redemption Reserve
- ❑ Requirement to Create Debenture Redemption Reserve
- ❑ Balance in Debenture Redemption Reserve (DRR)
- ❑ Adequacy of Debenture Redemption Reserve (DRR)
- ❑ Investment of Debenture Redemption Reserve (DRR) Amount
- ❑ Journal Entries
- ❑ Methods of Redemption of Debentures

INTRODUCTION



REDEMPTION OF DEBENTURES

Debentures are usually redeemable i.e. either redeemed in cash or convertible to equity shares after a time period.
Redeemable debentures may be redeemed:

- after a fixed number of years; or
- any time after a certain number of years has elapsed since their issue; or
- on giving a specified notice; or
- by annual drawing.

A company may also purchase its debentures, as and when convenient, in the open market. When the debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them.

DEBENTURE REDEMPTION RESERVE

A company issuing debentures may be required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilised by the company for any other purpose except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they fall due for payment.

An appropriate amount is transferred from profits every year to Debenture Redemption Reserve and its investment is termed as Debenture Redemption Reserve Investment (or Debenture Redemption Fund). In the last year or at the time of redemption of debentures, Debenture Redemption Reserve Investments are encashed and the amount so obtained is used for the redemption of debentures.

REQUIREMENT TO CREATE DEBENTURE REDEMPTION RESERVE

Section 71 of the Companies Act 2013 covers the requirement of creating a debenture redemption reserve account. Section 71 states as follows:

1. Where a company issues debentures under this section, it should create a debenture redemption reserve account out of its profits which are available for distribution of dividend every year until such debentures are redeemed.
2. The amounts credited to the debenture redemption reserve should not be utilized by the company for any purpose except for the purpose aforesaid.
3. The company should pay interest and redeem the debentures in accordance with the terms and conditions of their issue.
4. Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the Tribunal may, on the application of any or all the holders of debentures or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

BALANCE IN DEBENTURE REDEMPTION RESERVE (DRR)

When the company decides to establish the Debenture Redemption Reserve Account, the amount indicated by the Debenture Redemption Reserves tables is credited to the Debenture Redemption Reserve account and debited to profit and loss account. That shows the intention of the company to set aside sum of money to build up a fund for redeeming debentures. Immediately, the company should also purchase outside investments. The entry for the purpose naturally will be to debit Debenture Redemption Reserve Investments and credit Bank.

If the debentures are purchased within the interest period, the price would be inclusive of interest provided these are purchased "Cum-interest"; but if purchased "Ex-interest", the interest to the date of purchase would be payable to the seller additionally. In order to adjust the effect thereof the amount of interest accrued till the date of purchase, if paid, is debited to the Interest Account against which the interest for the whole period will be credited. As a result, the balance in the account would be left equal to the interest for the period for which the debentures were held by the company.

ADEQUACY OF DEBENTURE REDEMPTION RESERVE (DRR)

As per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, the company shall comply with the requirements with regard to Debenture Redemption Reserve (DRR) and investment or deposit of sum in respect of debentures maturing during the year ending on the 31st day of March of next year (*refer para 6.4 below*), in accordance with the conditions given below—

The Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend; the limits with respect to adequacy of DRR and investment or deposits, as the case may be, shall be as under:

Sr. No.	Debentures issued by	Adequacy of Debenture Redemption Reserve (DRR)
1	All India Financial Institutions (**AIFIs**) regulated by Reserve Bank of India **and Banking Companies for both public** as well as **privately placed debentures**	**No DRR** is required
2	Other Financial Institutions (**FIs**) within the meaning of clause (72) of section 2 of the Companies Act, 2013	**DRR** will be **as applicable to NBFCs** registered with RBI (**as per (3) below**)
3	**For listed companies** (other than AIFIs and Banking Companies as specified in Sr. No. 1 above):	
	a) All **listed NBFCs** (registered with RBI under section 45-IA of the RBI Act,) and **listed HFCs** (Housing Finance Companies registered with National Housing Bank) **for both public** as well	**No DRR** is required

	as **privately placed debentures**	
	b) **Other listed companies for both public** as well as **privately placed debentures**	**No DRR** is required
4	**For unlisted companies** (other than AIFIs and Banking Companies as specified in Sr. No. 1 above	
	a) All **unlisted NBFCs** (registered with RBI under section 45-IA of the RBI (Amendment) Act, 1997) and **unlisted HFCs** (Housing Finance Companies registered with National Housing Bank) for privately placed debentures	**No DRR** is required
	b) **Other unlisted companies**	**DRR** shall be **10% of** the **value of** the **outstanding debentures** issued

INVESTMENT OF DEBENTURE REDEMPTION RESERVE (DRR) AMOUNT

Further, as per Rule 18 (7) of the Companies (Share Capital and Debentures) Amendment Rules, 2019, following companies
a) All listed NBFCs
b) All listed HFCs
c) All other listed companies (other than AIFIs, Banking Companies and Other FIs); and
d) All unlisted companies which are not NBFCs and HFCs
shall on or before the 30th day of April in each year, in respect of debentures issued, deposit or invest, as the case may be, a sum which should not be less than 15% of the amount of its debentures maturing during the year ending on the 31st day of March of next year, in any one or more of the following methods, namely:
a) in deposits with any scheduled bank, free from charge or lien;
b) in unencumbered securities of the Central Government or of any State Government;
c) in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882;
d) in unencumbered bonds issued by any other company which is notified under clause (f) of Section 20 of the Indian Trusts Act, 1882.

- ❖ The amount deposited or invested, as the case may be, above should not be utilised for any purpose other than for the redemption of debentures maturing during the year referred to above.
- ❖ Provided that the amount remaining deposited or invested, as the case may be, shall not at any time fall below 15% of the amount of debentures maturing during the 31st day of March of that year.
- ❖ In case of partly convertible debentures, DRR shall be created in respect of non-convertible portion of debenture issue.
- ❖ The amount credited to DRR shall not be utilised by the company except for the purpose of redemption of debentures.

Note: It should be noted that appropriation to DRR can be made any time before redemption and Investments in specified securities as mentioned above can be done before 30th April for the debentures maturing that year, however, for the sake of simplicity and ease, it is advisable to make the appropriation and investment immediately after the debentures are allotted assuming that the company has sufficient amount of profits (issued if allotment date is not given in the question). Also, in some cases, the date of allotment could be missing, in such cases the appropriation and investments should be done on the first day of that year for which ledgers accounts are to be drafted.

<u>JOURNAL ENTRIES</u>

1. After allotment of debentures

a) For setting aside the fixed amount of profit for redemption
Profit and Loss A/c Dr
To Debenture Redemption Reserve A/c

b) For investing the amount set aside for redemption
Debenture Redemption Reserve Investment A/c Dr
To Bank A/c

c) For receipt of interest on Debenture Redemption Reserve Investments
Bank A/c Dr.
To Interest on Debenture Redemption Reserve Investment A/c

d) For transfer of interest on Debenture Redemption Reserve Investments (DRRI)
Interest on Debenture Redemption Reserve Investment A/c Dr.
To Profit and loss A/c*

Considering the fact that interest is received each year through cash/bank account and it is not re-invested. In the illustrations given in the chapter, the same has been considered and hence interest on DRR investment is not credited to DRR A/c but taken to P&L A/c.

2. At the time of redemption of debentures

a) For encashment of Debenture Redemption Reserve Investments
Bank A/c Dr
To Debenture Redemption Reserve Investment A/c

b) For amount due to debenture holders on redemption
Debentures A/c Dr.
To Debenture holder's A/c

c) For payment to debenture holders
Debenture holder's A/c Dr
To Bank A/c

d) After redemption of debentures, DRR should be transferred to general

reserve
DRR A/c Dr.
To General Reserve

METHODS OF REDEMPTION OF DEBENTURES

Redemption of debentures must be done according to the terms of issue of debentures and any deviation therefrom will be treated as a default by the company.

Redemption by paying off the debt on account of debentures issued can be done in any one of the three methods viz:

By payment in lumpsum
Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period.

By payment in Instalments
Under payment in instalments method, the payment of specified portion of debenture is made in instalments at specified intervals.

Purchase of Debentures in Open Market
Debentures sometimes are purchased in open market. This is not covered in the chapter as it has been specifically excluded from the syllabus at Foundation level.

Illustration 1

The following balances appeared in the books of a company (unlisted company other than AIFI, Banking company, NBFC and HFC) as on December 31, 2021: 6% Mortgage 10,000 debentures of ₹ 100 each; Debenture Redemption Reserve (for redemption of debentures) ₹ 50,000; Investments in deposits with a scheduled bank, free from any charge or lien ₹ 1,50,000 at interest 4% p.a. receivable on 31st December every year. Bank balance with the company is ₹ 9,00,000.
The Interest on debentures had been paid up to December 31, 2021.
On February 28, 2022, the investments were realized at par and the debentures were paid off at 101, together with accrued interest.
Write up the concerned ledger accounts (excluding bank transactions). Ignore taxation.

Illustration 2

The following balances appeared in the books of Paradise Ltd (unlisted company other thanAIFI, Banking Company, NBFC and HFC) as on 1-4-2021:

1. 12 % Debentures ₹ 7,50,000
2. Balance of DRR ₹ 25,000
3. DRR Investment ₹ 1,12,500 represented by 10% ₹ 1,125 Secured Bonds of the Governmentof India of ₹ 100 each.

Annual contribution to the DRR was made on 31st March every year. On 31-3-2022, balance at bank was ₹ 7,50,000 before receipt of interest. The investment were realized at par for redemption of debentures at a premium of 10% on the above date.

You are required to prepare the following accounts for the year ended 31st March, 2022:

1. Debentures Account
2. DRR Account
3. DRR Investment Account
4. Bank Account
5. Debenture Holders Account.

Illustration 3

XYZ Ltd. has issued 1,000, 12% convertible debentures ₹100 each redeemable after a period of five years. According to the terms & conditions of the issue, these debentures were redeemable at a premium of 5%. The debenture holders also had the option at the time of redemption to convert 20% of their holdings into equity shares of ₹ 10 each at a price of ₹ 20 per share and balance in cash. Debenture holders amounting ₹ 20,000 opted to get their debentures converted into equity shares as per terms of the issue. You are required to calculate the number of shares issued and cash paid for redemption of ₹20,000 debenture holders.

Illustration 4

A company had issued 20,000, 13% debentures of ₹ 100 each on 1st April, 2021. The debentures are due for redemption on 1st July, 2022. The terms of issue of debentures provided that they were redeemable at a premium of 5% and also conferred option to the debenture holders to convert 20% of their holding into equity shares (Nominal value ₹ 10) at a price of ₹ 15 per share. Debenture holders holding 2,500 debentures did not exercise the option.

Calculate the number of equity shares to be allotted to the debenture holders exercising the option to the maximum.

Illustration 5

The Balance Sheet of BEE Co. Ltd. (unlisted company other than AIFI, Banking Company, NBFCand HFC) as at 31st March, 2021 is as under:

Particulars	Note No	₹
I. **Equity and liabilities**		
(1) Shareholder's Funds		
a) Share Capital	1	2,00,000
b) Reserves and Surplus	2	1,20,000
(2) Non-current liabilities		
a) Long term borrowings	3	1,20,000
(3) Current Liabilities		
a) Trade payables		1,15,000
Total		**5,50,000**
II. **Assets**		
(1) Non-current assets		
a) Property, Plant and Equipment	4	1,15,000
(2) Current assets		
a) Inventories		1,35,000

b) Trade receivables		75,000
c) Cash and bank balances	5	2,30,000
Total		**5,55,000**

Notes to Accounts

			₹
1.	**Share Capital**		
	Authorized share capital 30,000 shares of ₹10 each fully paid		3,00,000
	Issued and subscribed share capital		
	20,000 shares of ₹10 each fully paid		2,00,000
2.	**Reserve and Surplus**		
	Profit & Loss Account		1,20,000
3.	**Long term borrowings**		
	12% Debentures		1,20,000
4.	**Property, Plant and Equipment**		
	Freehold property		1,15,000
5.	**Cash and bank balances**		
	Cash at bank	2,00,000	
	Cash in hand	30,000	2,30,000

At the Annual General Meeting, it was resolved:

1. To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution). This option was taken up by all the shareholders.
2. To issue one bonus share for every five shares held.
3. To repay the debentures at a premium of 3%.

Give the necessary journal entries for these transactions.

Illustration 6

Libra Limited (a listed company) recently made a public issue in respect of which the following information is available:

1. No. of partly convertible debentures issued - 2,00,000; face value and issue price - ₹ 100 per debenture.
2. Convertible portion per debenture - 60%, date of conversion - on expiry of 6 months from the date of closing of issue.
3. Date of closure of subscription lists - 1.5.2021, date of allotment - 1.6.2021, rate of interest on debenture - 15% payable from the date of allotment, value of equity share for the purpose of conversion - ₹ 60 (Face Value ₹ 10).
4. No. of debentures applied for - 2,00,000.
5. Interest payable on debentures half-yearly on 30th September and 31st March.

Write relevant journal entries for all transactions arising out of the above during the yearended 31st March, 2022 (including cash and bank entries).

Illustration 7

Case Ltd. (unlisted company other than AIFI, Banking Company, NBFC and HFC) provides the following information as at 31st March, 2022:

Particulars	₹
Shareholder's Funds	
a) Share Capital	
Authorized share capital:	
45,000 equity shares of ₹ 10 each fully paid	4,50,000
Issued and subscribed share capital:	
30,000 equity shares of ₹ 10 each fully paid	3,00,000
b) Reserves and Surplus	
Profit & Loss Account	1,62,000
Debenture Redemption Reserve	18,000
Non-current liabilities	
(a) Long term borrowings 12% Debentures	1,80,000
Current Liabilities	
(a) Trade payables	1,72,500
Non-current assets	
(a) Property, Plant and Equipment (Freehold property)	1,72,500
(b) Non-current Investment: DRR Investment	27,000
Current assets	
(a) Inventories	2,02,500
(b) Trade receivables	1,12,500
(c) Cash and bank balances:	
Cash at bank	2,73,000
Cash in hand	45,000

At the Annual General Meeting on 1.4.2022, it was resolved:

1. To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution). This option was taken up by all the shareholders.
2. To issue one bonus share for every five shares held.
3. To repay the debentures at a premium of 3%.

Give the necessary journal entries for these transactions.

CHAPTER - 27

REDEMPTION OF PREFERENCE SHARES

--------------------------- **Bird's Eye View**------------------------

- Introduction
- Purpose of Issuing Redeemable Preference Shares
- Provisions of Section 55 of Companies Act
- Methods of Redemption of Fully Paid Shares
- Redemption of Preference Shares by Fresh Issue of Equity Shares
- Reasons For Issue of New Shares
- Advantages of Redemption of Preference Shares by Fresh Issue of Equity Shares
- Disadvantages of Redemption of Preference Shares by Fresh Issue of Equity Shares
- Accounting Entries on Redemption of Preference Shares by Fresh Issue of Shares
- Calculation of Minimum Fresh Issue of Shares
- Fresh Issue at Premium & Minimum Fresh Issue
- Minimum Fresh Issue To provide Funds for Redemption
- Redemption of Preference Shares by Capitalization of Undistributed Divisible Profits
- Advantages of Redemption of Preference Shares by Capitalization of Undistributed Divisible Profits
- Disadvantages of Redemption of Preference Shares by Capitalization of Undistributed Divisible Profits
- Accounting Entries for Redemption Of Preference Shares By Capitalization of Undistributed Divisible Profits
- Redemption of Preference Shares by Combination of Fresh Issue & capitalization of undistributed Profits
- Redemption of Partly called up Preference Shares

INTRODUCTION

- Redemption is the process of repaying an obligation, at prearranged amounts and timings. It is a contract specifying the obligation to redeem preference shares within or at the end of a given time period at an agreed price. These shares are issued on the terms that shareholders will at a future date be repaid the amount which they invested in the company (apart from the frequent payments of a specified amount of dividend as return on investment during the tenure of the preference shares).

- The redemption date is the maturity date, which specifies when repayment is scheduled to take place and is usually printed on the preference share certificate.

- Through the process of redemption, a company can also adjust its financial structure, for example, by eliminating preference shares and replacing those with other securities if future growth of the company makes such change advantageous.

PURPOSE OF ISSUING REDEEMABLE PREFERENCE SHARES

1. It is a proper way of raising finance in a dull primary market.
2. A company may face difficulty in raising share capital, as its shares are not traded on the stock exchange. Potential investors who may, hesitate in putting money into shares that cannot easily be sold may be encouraged to invest if the shares are redeemable by the company.
3. The preference shares may be redeemed when there is a surplus of capital and the surplus funds cannot be utilised in the business for profitable use.
4. No dividend is required to be paid, if there is loss or no profit, whereas interest is payable on debentures or loans even in case of loss. In other words, preference dividend declared / paid continues to be regarded as an appropriation of profits (similar treatment is given for equity shares), as against interest on debentures, which is a charge against profits.

In India, the issue and redemption of preference shares is governed by Section 55 of the Companies Act, 2013.

PROVISIONS OF SECTION 55 OF COMPANIES ACT

A company limited by shares if so, authorized by its articles, may issue preference shares which at the option of the company, are liable to be redeemed within a period, normally not exceeding 20 years from the date of their issue.

It should be noted that:

a) no shares can be redeemed except out of divisible or distributable profit, (i.e. out of the profit of the company which would otherwise be available for dividend) **or** out of proceeds of fresh issue of shares made for the purpose of redemption;
b) no such shares can be redeemed unless they are fully paid;
c) in case of such class of companies, as may be prescribed and whose financial statement comply with the accounting standards prescribed for such class of companies under Section 133, the premium, if any, payable on **redemption shall be provided for out of the profits of the company, before the shares are**

redeemed, Provided also that premium, if any, payable on redemption of any preference shares issued on or before the commencement of this Act by any such company shall be provided for **out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.**

d) in case of other companies (not falling under (c) above), the premium, if any payable on redemption shall be provided for out of the profits of the company or out of the company's securities premium account, before such shares are redeemed.

e) where any such shares are proposed to be redeemed out of the profits of the company, there shall, out of the divisible profits, i.e. the profits which would otherwise have been available for dividends, be transferred to a reserve account to be called Capital Redemption Reserve Account, a sum equal to the nominal amount of the shares redeemed.

f) The utilisation of CRR Account is further restricted to issuance of fully paid-up bonus shares only.

METHODS OF REDEMPTION OF FULLY PAID-UP SHARES

❖ Section 55 of the Companies Act, 2013, deals with provisions relating to redemption of preference shares. It ensures that there is no reduction in shareholders' funds due to redemption and, thus, the interest of outsiders is not affected. For this, it requires that either fresh issue of shares is made, or distributable profits are retained and transferred to 'Capital Redemption Reserve Account.'

❖ The rationale behind these provisions is to protect the interest of outsiders to whom the amount is payable before redemption of preference share capital. The interest of outsiders is protected if the nominal value of capital redeemed is substituted, thus, ensuring the same amount of shareholders' fund.

❖ In case of redemption of preference shares out of proceeds of a fresh issue of shares, replacement of capital and tangible assets is obvious.

❖ If redemption is done out of distributable profits, replacement of capital is ensured in an indirect manner by retention of profit by transfer to Capital Redemption Reserve. In this case, the amount which would have otherwise gone to shareholders in the form of dividend is retained in the business and is used for settling the claim of preference shareholders. Thus, there is no additional drain from the net assets of the Company. The transfer of divisible profits to Capital Redemption Reserve makes them non- divisible profits. As Capital Redemption Reserve can be used only for issue of fully paid bonus shares, profits retained in the business ultimately get converted into share capital.

It can be concluded that the 'gap' created in the company's capital by the redemption of redeemable preference shares must be filled in by:

a) The proceeds of a fresh issue of shares; or
b) The capitalisation of undistributed profits (by creating Capital Redemption Reserve); or
c) Combination of (a) and (b) above.

REDEMPTION OF PREFERENCE SHARES BY FRESH ISSUE OF EQUITY SHARES

- One of the methods for redemption of preference shares is to use the proceeds of a fresh issue of shares. A company can issue new shares (equity shares or preference shares) and the proceeds from such new shares can be used for redemption of preference shares.

- A problem arises when a fresh issue is made for the purpose of redemption of preference shares, at a premium. The point to ponder is that whether the proceeds of a fresh issue of shares will include the amount of securities premium for the purpose of redemption of preference shares.

- Companies governed by Section 133 of the Companies Act, 2013 and comply with the Accounting Standards prescribed for them Shall not be able to utilise the balance in securities premium account for the purpose of premium payable on redemption of preference shares.

- Thus, it is to be noted that the proceeds of a fresh issue of shares will not include the amount of securities premium for the purpose of redemption of preference shares.

- The proceeds from issue of debentures cannot be utilised for the purpose.

REASONS FOR ISSUE OF NEW SHARES

A company may prefer issue of new equity shares for the following reasons:

a) When the company has come to realise that the capital is needed permanently and it makes more sense to issue Equity Shares in place of Redeemable Preference Shares as Preference Shares carry a fixed rate of dividend.
b) When the balance of profit, which would otherwise be available for dividend, is insufficient.
c) When the liquidity position of the company is not good enough.

ADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY FRESH ISSUE OF EQUITY SHARES

1. No cash outflow of money – now or later.
2. New equity shares may be valued at a premium.
3. Shareholders retain their equity interest.

DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY FRESH ISSUE OF EQUITY SHARES

1. There will be dilution of future earnings;
2. Share-holding in the company is changed if the fresh issue is made to outsiders. In case the fresh issue is made to existing shareholders in proportion to their

shareholding (i.e., rights issue), the disadvantage of change in shareholding pattern can be mitigated.

ACCOUNTING ENTRIES ON REDEMPTION OF PREFERENCE SHARES THROUGH FRESH ISSUE

1. When new shares are issued at par

Bank Account Dr.
  To Share Capital A/c

2. When new shares are issued at a premium

Bank Account Dr.
  To Share Capital A/c
  To Securities Premium A/c

3. When preference shares are redeemed at par

Redeemable Preference Share A/c Dr.
  To Preference Shareholders A/c

4. When preference shares are redeemed at a premium

Redeemable Preference Share Capital A/c Dr.
Premium on Redemption of Preference Shares A/c Dr.
  To Preference Shareholders A/c

5. When payment is made to preference shareholders

Preference Shareholders A/c Dr.
  To A/c

6. For adjustment of premium on redemption

Profit and Loss A/c Dr.
  To Premium on Redemption of Preference Shares A/c

Illustration 1

Hinduja Company Ltd. had 5,000, 8% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient number of equity shares of ₹ 10 each fully paid up at par. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration 2

C Ltd. had 10,000, 10% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company decided to redeem these preference shares at par, by issue of sufficient number of equity shares of ₹ 10 each at a premium of ₹ 2 per share as fully paid up. You are required to pass necessary Journal Entries including cash transactions in the books of the company.

Illustration 3

G India Ltd. had 9,000 10% redeemable Preference Shares of ₹ 10 each, fully paid up. The company decided to redeem these preference shares at par by the issue of sufficient numberof equity shares of ₹ 9 each fully paid up.

You are required to pass necessary Journal Entries including cash transactions in the books ofthe company.

CALCULATION OF MINIMUM FRESH ISSUE OF SHARES

Minimum Proceeds of Fresh Issue of shares = Nominal value of preference shares to be redeemed – Maximum amount of reserve and surplus available for redemption.

Minimum number of Shares to be issued = Minimum Proceeds of Fresh Issue of shares ÷ FV of share

It is to be noted The No. of Shares to be issued Shall not be in fraction

Illustration 4

The Board of Directors of a Company decided to issue minimum number of equity shares of ₹ 9 to redeem ₹ 5,00,000 preference shares. The maximum amount of divisible profits available for redemption is ₹ 3,00,000. Calculate the number of shares to be issued by the company to ensure that the provisions of Section 55 are not violated. Also determine the number of shares if the company decides to issue shares in multiples of ₹ 50 only.

FRESH ISSUE AT A PREMIUM AND MINIMUM FRESH ISSUE

1. The calculation of minimum number of shares, when fresh issue is at a premium should be handled very carefully Minimum fresh issue cannot be calculated unless one knows the profits available for replacement of preference shares and profit available for replacement cannot be determined unless one knows the portion of profit available for redemption which is required for paying premium on redemption.
2. To tackle this, assume that profits available for redemption is not required for paying premium on redemption of preference shares. In other words, it means that securities premium including premium on fresh issue is comparatively more than premium on redemption.
3. If the above assumption holds good, minimum number of shares can be calculated in a simple manner without use of equation. But, if above condition does not hold good, then an equation is used to determine the minimum number of shares.

MINIMUM FRESH ISSUE TO PROVIDE FUNDS FOR REDEMPTION

1. Besides, ensuring compliance with Section 55, the fresh issue of shares is made to provide funds for making payment to preference shareholders.

2. To calculate minimum number of fresh shares to be issued to provide funds, amount payable to preference shareholders is compared with funds available for redemption and the balance of funds to be raised by fresh issue of shares are calculated.
3. The amount to be raised is divided by the issue price of a share (amount payable by shareholder including premium, if any, on fresh issue) to compute the minimum number of shares to be issued.

REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED DIVISIBLE PROFITS

❖ Another method for redemption of preference shares, as per the Companies Act, is to use the distributable profits in place of issuing new shares. When shares are redeemed by utilising distributable profit, an amount equal to the face value of shares redeemed is transferred to Capital Redemption Reserve Account by debiting the distributable profit.

❖ In this connection, the provisions of the Companies Act state that 'When any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall out of profits which would otherwise have been available for dividend (i.e. out of divisible profits), be transferred to a reserve to be called the Capital Redemption Reserve Account sum equal to the nominal amount of the shares redeemed'.

❖ It is to be noted that Only Divisible Profits can be used to create Capital Redemption Reserve, Non-Divisible Profits cannot be used for this purpose.

Sr. No.	Divisible Profits	Sr. No.	Non-Divisible Profits
1	General reserve	1	Securities Premium
2	Profit and Loss A/c	2	Capital reserve
3	Dividend equalization reserve	3	Profit prior to Incorporation
4	Reserve fund	4	Forfeited shares A/c
5	Excess provision	5	Profit on revaluation of fixed assets
6	Any other revenue reserve	6	Profit on sale of fixed assets (in excess of cost)

ADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED PROFITS

1. No change in the percentage of equity share-holding of the company;
2. Surplus funds can be used.

DISADVANTAGES OF REDEMPTION OF PREFERENCE SHARES BY CAPITALISATION OF UNDISTRIBUTED PROFITS

1. There will be a reduction in liquidity or assets may need to be sold such as investments

ACCOUNTING ENTRIES ON REDEMPTION OF PREFERNCE SHARES THROUGH CAPITALISATION OF UNDISTRIBUTED PROFITS

1. **For transferring nominal amount of shares redeemed to Capital Redemption Reserve Account**

   General Reserve Account Dr.
   Profit and Loss Account Dr.
   any other Divisible Profits Dr.
   To Capital Redemption Reserve Account
   (Being the amount transferred to Capital Redemption Reserve Account as per the requirement of the Act).

2. **When shares are redeemed at par**

   Redeemable Preference Share Capital Account Dr.
   To Preference Shareholders Account
   (Being the amount payable on redemption of preference shares transferred to Preference Shareholders Account)

3. **When shares are redeemed at a premium**

   Redeemable Preference Share Capital Account Dr.
   Premium on Redemption of Preference Shares Account Dr.
   To Preference Shareholders Account
   (Being the amount payable on redemption transferred to Preference Shareholders Account)

4. **When payment is made to preference shareholders**

   Preference Shareholders Account Dr.
   To Bank Account
   (Being the payment to preference shareholders as per terms)

5. **For adjustment of premium of redemption**

   Divisible Profit Account Dr.
   To Premium on Redemption of Preference Shares Account
   (Being the premium on redemption adjusted against Profit and Loss Account)

Illustration 5

The following are the extracts from the Balance Sheet of ABC Ltd. as on 31st December, 2022.

Share capital: 40,000 Equity shares of ₹ 10 each fully paid – ₹ 4,00,000; 1,000 10% Redeemablepreference shares of ₹ 100 each fully paid – ₹ 1,00,000.

Reserve & Surplus: Capital reserve – ₹ 50,000; Securities premium – ₹ 50,000; General reserve –
₹ 75,000; Profit and Loss Account – ₹ 35,000
On 1st January 2023, the Board of Directors decided to redeem the preference shares at par byutilization of reserve.
You are required to pass necessary Journal Entries including cash transactions in the books ofthe company.

REDEMPTION OF PREFERENCE SHARES BY COMBINATION OF FRESH ISSUE AND CAPITALISATION OF UNDISTRIBUTED PROFITS

A company can redeem the preference shares partly from the proceeds from new issue and partly out of profits. In order to fill in the 'gap' between the face value of shares redeemed and the proceeds of new issue, a transfer should be made from distributable profits (Profit & Loss Account, General Reserve and other Free Reserves) to Capital Redemption Reserve Account.
Amount to be Transferred to CRR = FV of Shares to be Redeemed – Proceeds from new Issue (Excluding premium)

Proceeds To be Collected from New Issue = FV of Shares to be Redeemed - Distributable Profits

Illustration 6

C Limited had 3,000, 12% Redeemable Preference Shares of ₹ 100 each, fully paid up. The company had to redeem these shares at a premium of 10%.
It was decided by the company to issue the following:

1. 25,000 Equity Shares of ₹ 10 each at par,
2. 1,000 14% Debentures of ₹ 100 each.

The issue was fully subscribed and all amounts were received in full. The payment was duly made. The company had sufficient profits. Show Journal Entries in the books of the company.

Illustration 7

The capital structure of a company consists of 20,000 Equity Shares of ₹ 10 each fully paid up and 1,000 8% Redeemable Preference Shares of ₹ 100 each fully paid up (issued on 1.4.2021).
Undistributed reserve and surplus stood as: General Reserve ₹ 80,000; Profit and Loss Account ₹ 20,000; Investment Allowance Reserve out of which ₹ 5,000, (not free for distribution as dividend) ₹ 10,000; Securities Premium ₹ 2,000, Cash at bank amounted to ₹ 98,000. Preference shares are to be redeemed at a Premium of 10% and for the purpose of redemption, the directors are empowered to make fresh issue of Equity Shares at par after utilizing the undistributed reserve and surplus, subject to the conditions that a sum of ₹ 20,000 shall be retained in general reserve and which should not be utilized.
Pass Journal Entries to give effect to the above arrangements.

Illustration 8

X Ltd. gives you the following information as at 31st March, 2023:

	Particulars	₹
	EQUITY AND LIABILITIES	
1.	**Shareholders' funds**	
	a. Share capital	2,90,000
	b. Reserves and Surplus	48,000
2.	**Current liabilities**	
	Trade Payables	56,500
	ASSETS	
1.	**Property, Plant and Equipment**	3,45,000
2.	**Non-current investments**	18,500
3.	**Current Assets**	
	Cash and cash equivalents (bank)	31,000

The share capital of the company consists of ₹ 50 each equity shares of ₹ 2,25,000 and ₹ 100 each Preference shares of ₹ 65,000(issued on 1.4.2021). Reserves and Surplus comprises Profit and Loss Account only.

In order to facilitate the redemption of preference shares at a premium of 10%, the Company decided:

1. to sell all the investments for ₹ 15,000.
2. to finance part of redemption from company funds, subject to, leaving a bank balance of ₹12,000
3. to issue minimum equity share of ₹ 50 each share to raise the balance of funds required.

   You are required to pass the necessary Journal Entries to record the above transactions.

REDEMPTION OF PARTLY CALLED UP PREFERENCE SHARES

One of the conditions of redemption is that only fully paid-up preference shares can be redeemed by a company. Hence:

1. If the problem states that it is decided to redeem preference shares which are partly called up, then it is assumed that the final call on these shares is demanded and received before proceeding with redemption of these shares.
2. If information about both fully paid and partly paid preference shares is provided, then, it is presumed that only fully paid shares are to be redeemed and partly paid shares are left intact.
3. The company can forfeit the shares, if the call money is not received by the company in spite of giving opportunity to pay the same via reminders.

Illustration 9

The Balance Sheet of XYZ ltd. as at 31st December, 2021 inter alia includes the following information:

	₹
50,000, 8% Preference Shares of ₹100 each, ₹70 paid up	35,00,000
1,00,000 Equity Shares of ₹100 each fully paid up	1,00,00,000
Securities Premium	5,00,000
Capital Redemption Reserve	20,00,000
General Reserve	50,00,000
Bank	15,00,000

Under the terms of their issue, the preference shares are redeemable on 31st March, 2022 at 5% premium. In order to finance the redemption, the company makes a rights issue of 50,000 equity shares of ₹ 100 each at ₹ 110 per share, ₹ 20 being payable on application, ₹ 35 (including premium) on allotment and the balance on 1st January, 2023. The issue was fully subscribed and allotment made on 1st March, 2022. The money due on allotment were duly received by 31st March, 2022. The preference shares were redeemed after fulfilling the necessary conditions of Section 55 of the Companies Act, 2013.

You are asked to pass the necessary Journal Entries. (Ignore date column)

Illustration 10

With the help of the details in Illustration 9 above and further assuming that the Preference Shareholders holding 2,000 shares fail to make the payment for the Final Call made under Section 55, you are asked to pass the necessary Journal Entries and show the relevant extracts from the balance sheet as on 31st March, 2022 with the corresponding figures as on 31st December, 2021 assuming that the shares in default are forfeited after giving proper notices. (Ignore date column)

Illustration 11

The books of B Ltd. showed the following balance on 31st December, 2023:

30,000 Equity Shares of ₹10 each fully paid; 18,000 12% Redeemable Preference Shares of ₹10 each fully paid; 4,000 10% Redeemable Preference Shares of ₹ 10 each, ₹ 8 paidup (all shares issued on 1st April, 2022).

Undistributed Reserve and Surplus stood as: Profit and Loss Account ₹ 80,000; General Reserve ₹ 1,20,000; Securities Premium Account ₹ 15,000 and Capital Reserve ₹ 21,000.

For redemption, 3,000 equity shares of ₹10 each are issued at 10% premium. At the same time, Preference shares are redeemed on 1st January, 2024 at a premium of ₹2 per share. The whereabouts of the holders of 100 shares of ₹10 each fully paid are not known.

A bonus issue of equity share was made at par, two shares being issued for every five held on that date out of the Capital Redemption Reserve Account. However, equity shares, issued for redemption are not eligible for bonus.

Show the necessary Journal Entries to record the transactions. (Ignore date column)

CHAPTER - 28
ACCOUNTING STANDARDS & ACCOUNTING AS A MEASUREMENT DISCIPLINE

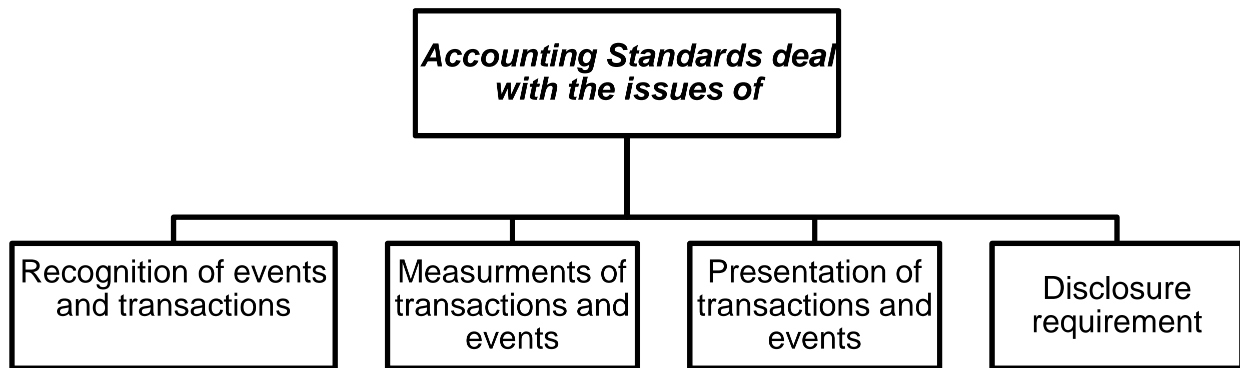
--------------------------- **Bird's Eye View**-------------------------

- Introduction to Accounting Standards
- Objectives of Accounting Standards
- Benefits of Accounting Standards
- Limitation of Accounting Standards
- Process of Formulation of Accounting Standards in India
- Elements of Measurement
- Valuation Principles – Historical Cost, Current Cost, Realizable Value, Present Value
- Accounting Estimates

INTRODUCTION TO ACCOUNTING STANDARD

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true. To ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards (ASS) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable.

Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance.



OBJECTIVES OF ACCOUNTING STANDARDS

The whole idea of accounting standards is centered around harmonization of accounting policies and practices followed by different business entities so that the diverse accounting practices adopted for various aspects of accounting can be standardized. Accounting Standards standardize diverse accounting policies with a view to:

1. Eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements; and

2. Provide a set of standard accounting policies, valuation norms and disclosure requirements.

Accounting standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.

BENEFITS OF ACCOUNTING STANDARDS

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards, the accountant has following benefits:

1. Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.

2. There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.

3. The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it

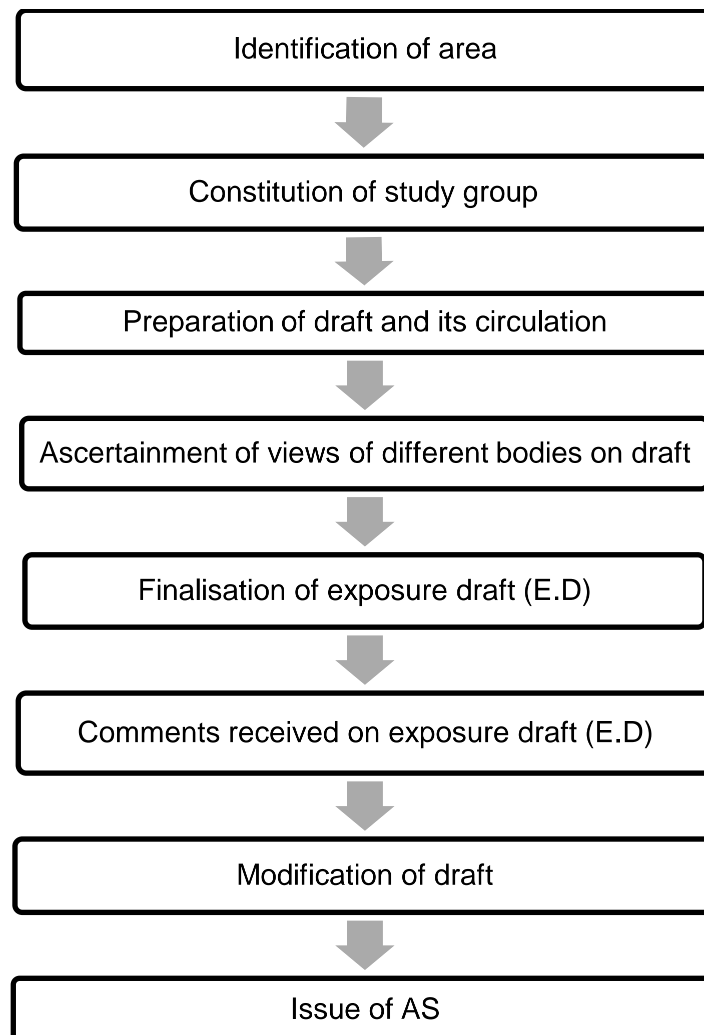
should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

LIMITATIONS OF ACCOUNTING STANDARDS

1. **Difficulties in making choice between different treatments**: Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

2. **Restricted scope**: Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

PROCESS OF FORMULATION OF ACCOUNTING STANDARDS IN INDIA



The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:
1. Identification of broad areas by ASB for formulation of AS.

2. Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.
3. Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
4. Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
5. Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
6. Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
7. Consideration of comments received on the exposure draft and finalization of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
8. Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
9. The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities the accounting standards are issued by The Central Government of India.

VALUATION PRINCIPLES

1. **Historical Cost**: It means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine and spend ₹1,00,000 on its installation, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be ₹ 8,00,000.

   According to this base, assets are recorded at an amount of cash or cash equivalent paid at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

   When a businessman, takes ₹ 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are ₹ 5,00,000 - it is historical cost of the transactions. Take another case regarding payment of income tax liability. You know every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it sometime later, which is technically called assessment year. Then how does he record this liability? As per historical cost base it is to be recorded at an amount expected to be paid to discharge the liability.

2. **Current Cost:** Take that Mr. X purchased a machine on 1st January, 2011 at ₹ 7,00,000. As per historical cost base he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2020, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.2011 ₹ 5,00,000 @ 18% p.a repayable at the end of 15th year together with interest. As on 1.1.2020 the bank announces 1% prepayment penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

   Current cost gives an alternative measurement base. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
   So as per current cost base, the machine value is ₹ 25,00,000 while the value of bank loan is ₹ 5,05,000.

3. **Realizable Value:** Suppose Mr. X found that he can get ₹ 20,00,000 if he would sell the machine purchased, on 1.1.2011 paying ₹ 7,00,000 and which would cost ₹ 25,00,000 in case he would buy it currently. Take also that Mr. X found that he had no money to pay off the bank loan of ₹ 5,00,000 currently.

   As per realizable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Haphazard disposal may yield something less. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents expressed to be paid to satisfy the liabilities in the normal course of business.
   So, the machine should be recorded at ₹ 20,00,000 the realizable value in an orderly sale while the bank loan should be recorded at ₹ 5,00,000 the settlement value in the normal course of business.

4. **Present Value:** Suppose we are talking as on 1.1.2020 - take it as time for reference. Now think the machine purchased by Mr. X can work for another 10 years and is supposed to generate cash @ ₹ 1,00,000 p.a. Also take that bank loan of ₹ 5,00,000 taken by Mr. X is to be repaid as on 31.12.2026. Annual interest is ₹ 90,000.

   As per present value, an asset is carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

   The term 'discount', 'cash inflow' and 'cash outflow' need a little elaboration. ₹ 100 in hand as on 1.1.2020 is not equivalent to 100 in hand as on 31.12.2020. There is a time gap of one year. If Mr. X had ₹ 100 as on 1.1.2020 he could use it at that time. If he received it only on 31.12.2020, he had to sacrifice his use for a year. The value of this sacrifice is called 'time value of money'. Mr. X would sacrifice i.e. he would agree to take money on 31.12.2020 if he had been compensated for the sacrifice. So, a

rational man will never exchange ₹ 100 as on 1.1.2020 with ₹ 100 to be received on 31.12.2020. Then ₹ 100 of 1.1.2020 is not equivalent to ₹ 100 of 31.12.2020. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

ACCOUNTING ESTIMATES

Earlier in this unit we have learned how to measure a transaction, which had already taken place and for which either some value/money has been paid or some valuation principles are to be adopted for their measurement. But there are certain items, which have not occurred therefore cannot be measured using valuation principles still they are necessary to record in the books of account, for example, provision for doubtful debts. For such items, we need some value. In such a situation reasonable estimate based on the existing situation and past experiences are made.

The measurement of certain assets and liabilities is based on estimates of uncertain future events. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. Therefore, the management makes various estimates and assumptions of assets, liabilities, incomes and expenses as on the date of preparation of financial statements. Such estimates are made in connection with the computation of depreciation, amortization and impairment losses as well as, accruals, provisions and employee benefit obligations. Also estimates may be required in determining the bad debts, useful life and residual value of an item of plant and machinery and inventory obsolescence. The process of estimation involves judgments based on the latest information available.

An estimate may require revision if changes occur regarding circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. Change in accounting estimate means difference arises between certain parameters estimated earlier and re-estimated during the current period or actual result achieved during the current period.

Illustration 1

Book value of machinery on 31st March, 2019	₹ 10,00,000
Market value as on 31st March, 2019 if sold	₹ 11,00,000

As on 31st March, 2019, if the company values the machinery at ₹ 11,00,000, which of the following valuation principle is being followed?

(a) Historical Cost.
(b) Present Value.
(c) Realizable Value.

Illustration 2

Mohan purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2019, similar machinery could be purchased for ₹ 20,00,000 but the realizable value of the machinery (purchased on 1.4.2001) was estimated at ₹ 15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹ 12,00,000.

(i) The current cost of the machinery is
(a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 15,00,000.

(ii) The present value of machinery is
(a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 12,00,000.

(iii) The historical cost of machinery is
(a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 15,00,000.

(iv)The realizable value of machinery is
(a) ₹ 10,00,000. (b) ₹ 20,00,000. (c) ₹ 15,00,000.