FINANCIAL ACCOUNTING – XII

UNIT 1: FUNDAMENTALS OF PARTNERSHIP

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Collect the partnership deed or agreement of partnership of any firm and read their contents.</td></tr>
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		of profits to a partner, Fixed and Fluctuating capital accounts.	distribution of profit among partners in case of guarantee of minimum share to partner, 3. Prepare partners' capital accounts in case of fixed and fluctuating capital accounts both.	preparing P&L Appropriation Account and Partners' Capital Accounts
	SESSION 3: GOODWILL VALUATION AND TREATMENT OF JOINT LIFE POLICY			
	1. Need and Valuation Of Goodwill	1.Explain the meaning of goodwill 2.Identify various factors that affect the goodwill of a firm. 3. Explain the various methods of valuation of goodwill	1. Discuss the important factors and methods of valuation of goodwill	**Interactive Lecture:** Acquaint students with the various methods generally used for valuation of goodwill.
	2. Treatment of Joint Life Policy	1. State the journal entries for treatment of Joint Life Policy	1. Pass journal entries for treatment of Joint Life Policy in the books of firm.	**Interactive Lecture:** Discuss journal entries for treatment of Joint Life Policy

UNIT 1: FUNDAMENTALS OF PARTNERSHIP

Learning Objectives

After studying this unit, the students will be able to:

1. Understand the concept of Partnership and Partnership Deed,
2. Apply the provisions of Partnership Act, 1932 in the absence of partnership deed,
3. Make computation of Interest on capital and Drawings,
4. Prepare Partners' Fixed and fluctuating capital Accounts,
5. Distribute profit among partners and prepare Profit and Loss Appropriation Account,
6. Explain the valuation of Goodwill,
7. Explain the treatment of Joint Life Policy,
8. Make the accounting treatment of past adjustment, and
9. Explain the meaning of certain keywords.

SESSION 1: INTRODUCTION TO PARTNERSHIP

Meaning of Partnership

Partnership is a contractual relationship between two or more persons who agree to pool talent and money for a joint business venturewith a view to profit, each incurring liability for losses and the right to share in the profits.It is the name of legal relationship between or among persons who have entered into a contract.

The persons who own the partnership business are individually called 'partners' and collectively they are called as 'firm' or 'partnership firm'. The name under which partnership business is carried on is called 'Firm Name'.

Thus partnership is a business entity in which two or more co-owners contribute resources, share in profits and losses, and are individually liable for the entity's actions.

Section 4 of the Indian Partnership Act 1932 defines partnership as the 'relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all'**.**

Partnership is thus invisibilitywhich binds the partners together and firm is the visible form of those partners who are thus bound together.

Essential Characteristics of Partnership

A partnership firm has no separate legal entity, apart from the partners constituting it. Thus, the essential features of partnership are:

1. **Existence of business:** Partnership is formed to carry on some type of lawful business. Business here means any activity leading to earn profit.If persons join together and

agreed to do charitable work or for formation of any club for entertainment would not be treated as partnership due to absence of the business.

2. **Association of persons:**Partnership is an association of at least two or more personsand all such persons must be competent to contract.The maximum number of persons/partners in any association/partnership may be upto such number as may be prescribed but not exceeding one hundred. This restriction will not apply to an association or partnership constituted by professionals like lawyers, chartered accountants, company secretaries, etc. and joint family business which are governed by their special laws.
3. **Contractual relationship:**There should be a contractual relationship between the persons forming partnership. Persons competent to contract voluntarily enter into an agreement either written or oral to becomethe partners.They have to mutually agree and jointly decide to go for any business activity as per agreed terms and conditions.
4. **Profit and Loss Sharing:**Business is carried on to share profit and not to incur losses. The profits generated by the firm are distributed among the partners on an agreeable proportion. Loss if any has also to be borne by them on that agreed ratio.
5. **Agency:** Partnership contract is based on principle of agency. The business is carried on by all or any one of them acting on behalf of all other partners.While dealing with firm's transactions, each partner is entitled to represent the firm and other partners. In this way, a partner is an agent of the firm and of the other partners.
6. **Utmost good faith:** The partners should have utmost good faith in each other. They should be fair and honest. They should present true accounts and must disclose true information to one another.
7. **Unlimited liability:**Every partner has an unlimited liability in respect of debts of the firm like sole proprietorship. If the assets of the firm are insufficient to meet the Firms' obligations, then private property of the partners can be used to meet those obligations.
8. **Restriction on transfer of ownership:** A partner cannot transfer his share in business to any outsider without the consent of other partners because the partnership agreement is based on contract among individuals.

Partnership Deed

A partnership is formed by an agreement. This agreement may be in writing or oral. Though the law does not expressly require that the partnership agreement should be in writing, it is desirable to have it in writing in order to avoid any dispute with regard to the terms of the partnership. The document which contains the terms of a partnership as agreed among the partners is called "partnership deed". The Partnership Deed is to be duly stamped as per the Indian Stamp Act, and duly signed by all the partners.

Contents of Partnership Deed

Some of the important clauses to be included in a partnership deed are as follows:

1. Name of the Firm And Its Address
2. Name and Address of Partners
3. Nature Of Firm's Business
4. Date of Commencement of Partnership
5. Duration of Partnership
6. Partners' Capitals
7. Interest on Capital
8. Drawing and Interest on them
9. Profit and Loss Sharing Ratio
10. Partners' Salary and Commission, if Payable
11. Rights and Duties of Partners Regarding Conduct Of Business
12. Rules and Procedure in Case of Admission and Retirement of Partners, Death of A Partner.
13. The Procedure of Keeping Accounts and their Audit
14. Method of the Final Settlement of Accounts in Case of Dissolution of Partnership.
15. Method of Appointing Arbitrators and their Rights in Case of Disputes.

Provisions governing Accounting Treatment in the Absence of Partnership Deed

In the absence of Partnership deed, following provisions govern the accounting treatment of certain items:

Item	Provision/Treatment
1. Salary/Commission to a partner	According to Section 13(a) of the Indian Partnership Act, a partner is not entitled to receive remuneration for taking part in the conduct of the business.
2. Sharing of Profits & Losses	As per Section 13(b) of the Indian Partnership Act, the partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm
3. Interest on Capital	No Interest is to be allowed on capital in the absence of Partnership deed.As per Section 13(c) of the Indian Partnership Act if a partner is entitled to interest on the capital subscribed by him such interest shall be payable only out of profits.
4. Interest on Drawings	No interest is to be charged on drawings in the absence of partnership deed.
5. Interest on Advances/ Loans by partner	According to Section 13(d) of the Indian Partnership Act, a partner making, for the purposes of the business, any payment or advance beyond the amount of capital he has agreed to subscribe, is entitled to interest thereon at the rate of six per cent.

Knowledge Assessment – I

Choose the appropriate answer:

1. What is the minimum number of partners required to commence a partnership business?
    a) 20
    b) 10
    c) 2
    d) 4
2. Partnership type of business is formed by the mutual agreement of partners. What kind of agreement is it?
    a) Oral Agreement
    b) Written Agreement
    c) Oral or Written Agreement
    d) None of the above
3. In the general form of partnership, liabilities of partners are:
    a) Limited
    b) Unlimited
    c) Limited to Business Capital
4. The written agreement of partnership is most commonly referred to as:
    a) Agreement
    b) Partnership Deed
    c) Partnership Contract
    d) Partnership Act
5. When no partnership agreement exists between partners, what will be the profit sharing ratio between the partners?
    a) Equal
    b) Unequal
    c) Depend on Partner's Capital
    d) Depend on experience of the partner
6. Which of the following is NOT generally the characteristic of a partnership business?
    a) Limited Life
    b) Ease of formation
    c) Limited Liability
    d) Mutual agency
7. Which of the following is the disadvantage of Partnership as compared to Sole proprietorship?
    a) Losses will be shared
    b) Business debts will be shared
    c) Responsibilities of Managing the business
    d) Profits of the business will be shared
8. In the absence of partnership deed, partnership firm will pay interest on loan at the rate of:
    a) 8%
    b) 9%
    c) 6%
    d) 12%

Answers

1. c, 2. c, 3. b, 4. b, 5. a, 6. c, 7. d, 8. c

SESSION 2: PREPARATION OF FINAL ACCOUNTS OF FIRM

Final Accounts

Transactions of the partnership firm are recorded according to the Double Entry System of accounting. For recording the transactions, the procedure followed is similar to that of the Sole Proprietorship. While preparing the financial accounts of firm, following important points need to be taken care of:

1. **Capital Accounts:** Separate Capital Account needs to be prepared for each partner. Suppose W, X, Y and Z are four partners in a firm, there will be four capital accounts, one each for W, X, Y and Z.
2. **Profit and Loss appropriation account:** After making the Trading and Profit and Loss account of a Partnership firm, the next step is to divide the profits or losses among the partners and to make other appropriations like interest on capital, salary, commission etc. For this purpose, another account is prepared i.e. Profit and Loss Appropriation account. This account is prepared to show the division of profit and other appropriations among partners like salary, commission, interest on capital, interest on drawings etc. A specimen of this account is as under.

Profit and Loss Appropriation Account

Particulars	Rs.	Particulars	Rs.
To Profit and Loss A/c(loss transferred from Profit & Loss A/c) To Salaries of Partners To Commission to Partners To Interest on Partners' Capitals To Profit transferred to Partners' capital or current account		By Profit and Loss account(Profit transferred from P & L account) By Interest on Drawings By Loss transferred to Partners' capital or current accounts	

The amount of profit to be distributed is arrived at after making the following adjustments:

a) **Interest on Capital:** Interest will be given to each partner on their contributed capital after making adjustments for capital introduced and withdrawals made out of the capital. The following are the accounting entries for interest on capital:

For allowing Interest on Capital:

Interest on Capital A/c Dr.

To Partner's Capital A/c

To close Interest on Capital A/c:

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c

Alternatively, only one entry can be passed in place of above two entries

Profit and Loss Appropriation A/c Dr.

To Partner's Capital A/c

Illustration 1

Priya and Shreya are partners in a firm sharing profits and losses in the ratio of 3:2. Interest on capital is allowed at 10% p.a. Balance Sheet at the end of 31.12. 2014 of the firm are as follows:

Balance Sheet
as on 31 December, 2014

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Capital accounts:		Sundry Assets	70,000
Priya	40,000	Drawings of Priya	10,000
Shreya	30,000		
Profit & Loss Appropriation Account	10,000		
	80,000		80,000

During the year, Priya withdrew Rs. 10,000 and Shreya withdrew Rs. 8,000. Profits for the year 2014 before charging interest on capital amounted to Rs. 17,000. You are required to calculate interest on capital due to partners, prepare a Profit & Loss Appropriation A/c, Capital accounts of Partners and Revised Balance Sheet of the firm, presuming that no adjustments for interest on capital have so far been made.

Solution:

For calculating interest on capital, it isnecessary to calculate the partners' capital in the beginning of the year. In the Balance Sheet, capitals of the partners at the end of the accounting year have been given. Drawing made by Priya is appearing in the Balance sheet, this means it is not deducted from her capital. A part of the profit earned in the year i.e. Rs. 7,000 (17,000-10,000) has already been credited to partners in the ratio of 3:2So for calculating partners' capital at the beginning of the year, it is necessary to make adjustments for above items as given below:

(Figures in Rs.)

Particulars	**Amount**
Priya's Capital as on 31.12.2014	40,000
Less Profit credited during the year	4,200
Capital as on 1.01.2014	35,800
Interest on Priya's Capital @ 10%	3,580
Shreya's Capital as on 31.12.2014	30,000
Add: Drawings made during the year	8,000
	38,000
Less: Profit credited during the year	2,800
Capital as on 1.01.2014	35,200
Interest on Shreya's Capital @ 10%	3,520

Profit & loss Appropriation A/c

For the year ending 31st December, 2014

Dr. Cr.

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Interest on Capital		By Profit during the year	17,000
Priya 3,580			
Shreya 3,520	7,100		
To Net Profit Transferred to Partners' Capital A/cs Priya 5,940 Shreya 3,960	9,900		
	17,000		17,000

Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	**Priya**	**Shreya**	**Particulars**	**Priya**	**Shreya**
To Drawings	10,000	8,000	By Balance b/d	35,800	35,200
To Balance c/d	35,320	34,680	By Interest on Capital	3,580	3,520
			By Share of Profit	5,940	3,960
	45,320	42,680		45,320	42,680

Revised Balance Sheet of the firm

as on 31.12.2014

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Capital Accounts:		Sundry Assets	70,000
Priya	35,320		
Shreya	34,680		
	70,000		70,000

b) Interest on Drawings: Whenever partners withdraw money from the partnership firm for their personal purpose, it is termed as drawings. The partnership agreement may provide for charging interest on such drawings. Interest on capital is computed on the basis of the period for which the money remained with the partners during the accounting year. Interest on drawing is an income of the partnership firm and is credited to profit and loss appropriation account.

The following are the accounting entries for interest on Drawings:

For charging Interest on Drawings

Partner's Capital A/c Dr.

To Interest on Drawings A/c

To close Interest on Drawing A/c :

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

Alternatively, only one entry can be passed in place of above two entries:

Partner's Capital A/c Dr.

To Profit and Loss Appropriation A/c

Calculation of Interest on Drawings

The drawings are usually made by the partners at regular intervals. Thus, the interest on drawings is calculated with reference to the time period involved. It can be worked out by any one of the following methods:

A. When dates of drawings are not given:

(i) *Average period method*: If the dates of drawings are not given, then interest on drawings is calculated on the average basis on the total amount of drawings made during the accounting period for 6 months period. It is based on the assumption that the amounts were drawn evenly throughout the accounting year.

Interest on drawings = Total drawings × Rate/100 × 6/12

(ii) *Average rate of interest method or when drawings are made irrespective of the time period:* Sometimes the average rate of interest is given in the question, in such a case; it is assumed that the rate of interest is already half on the basis of 6 months. Thus, time will not be considered.

Interest on drawings = Total drawings × Average Rate/100

B. When dates of drawings are given:

(i) Product Method: When different amounts are withdrawn at different intervals, the interest will be calculated with the help of product method. In this, each amount of drawings is multiplied with number of days or months (from the date of drawings to the date of final accounts) to find out the product and then products are totaled. Interest is calculated on total product at the rate of interest for one month or one day.

Interest on drawings = Total of Product × Rate/100 × 1/365 or 1/12

(ii) Monthly/quarterly drawings method: If uniform amount is withdrawn at each time and the interval between two withdrawals also is uniform. In such a case interest on drawings is calculated with monthly drawings method. Time period in this method is calculated as follows:

In that case there will be following cases:

When drawings are for 12 months period

- At the beginning of each month = Total drawings × Rate/100 × 6.5/12
- At the end of every month = Total drawings × Rate/100 × 5.5/12
- At the middle of every month = Total drawings × Rate/100 × 6/12

When drawings are for 6 months period

- At the beginning of each month = Total drawings × Rate/100 × 3.5/12
- At the end of every month = Total drawings × Rate/100 × 2.5/12
- At the middle of every month = Total drawings × Rate/100 × 3/12

When drawings are made quarterly during the period

- At the beginning of each quarter = Total drawings × Rate/100 × 7.5/12
- At the end of every quarter = Total drawings × Rate/100 ×4.5/12

Illustration 2

In a partnership firm, partners are charged interest on drawings at 15% p.a. During the year ended 31^{st} December 2014 a partner drew as follows:

February 1 Rs.1,000

May 1	Rs.2,500
June 30	Rs.1,000
October 31	Rs.3,000
December 31	Rs.1,000

What is the interest chargeable to the partner?

Solution:

Product Method

When drawings are made in uneven amount at different dates, interest on drawings can be calculated by 'Product Method' as follows:

Date	Amount (Rs.)	Period in months	Product (Rs.)
February 1	1,000	11	11,000
May 1	2,500	8	20,000
June 30	1,000	6	6,000
October 31	3,000	2	6,000
December 31	1,000	0	0
	Total		**43,000**

$$\text{Interest on drawings} = \frac{43{,}000 \times 15 \times 1}{100 \times 12} = \text{Rs. } 537.50$$

Interest can also be computed using Product Method on daily balances. Product is determined by multiplying amount with the number of days interest is computed product total for one day.

c) Salaries to partners: Partnership agreement can also provide for payment of salaries to those partners who actively take part in the business of the firm.

The following are the accounting entries for salaries to partners:

To allow Salary /Commission:

Partner's Salary /Commission A/c Dr.

To Partner's Capital A/c

To Close Salary / Commission A/c :

Profit and Loss Appropriation A/c Dr.

To Partner's Salary / Commission A/c

Alternatively, only one entry can be passed in place of above two entries

Profit and Loss Appropriation A/c Dr.

To Partner's Capital A/c

d) Distribution of profits: In the absence of any agreement regarding profit sharing, the profits and losses areshared equally among the partners. Partners may agree to share the profits and losses in the ratio of their capitals. In case of partners'capital remains fixed, there is no problem in distribution of profits according to capital proportion. But in case of frequent drawings and additions of capital, it will be appropriate to calculate the weighted average ratio.

Following is the accounting entry for distribution of profit among partners:

Profit and Loss Appropriation A/c Dr.

To Partner's Capital A/c

Illustration 3

On 1.01.2014 Rohit and Shobhit started a business with capitals of 40,000 and Rs. 80,000 respectively. They agreed to share the profits and losses in the ratio of their capitals. They earned a profit of Rs. 40,000 in that year. Following are the details of additional capital introduced or withdrawn by the partners during the year 2014:

Date	Capital Introduced		Capital Withdrawn	
	Rohit	Shobhit	Rohit	Shobhit
1.04.2014	5,000			10,000
1.06.2014		6,000	8,000	
1.11.2014		5,000	3,000	

Solution:

Computation of Total capital employed by Rohit for One Month

Capital	Months for which capital remained in the business	Product
40,000	3	1,20,000
45,000	2	90,000
37,000	5	1,85,000
34,000	2	68,000
		4,65,000

Computation of Total capital employed by Shobhit for One Month

Capital	Months for which capital remained in the business	Product
80,000	3	1,60,000
70,000	2	1,40,000
76,000	5	3,80,000
81,000	2	1,62,000
		8,42,000

On the basis of capitals, profits are to be shared in the ratio of 465 : 842.

The profit of Rs. 40,000 will be shared as follows:

Rohit: $\frac{40{,}000 \times 465}{1307}$ = Rs. 14,231

Shobhit: $\frac{40{,}000 \times 842}{1307}$ = Rs. 25,769

Guarantee of Profit to a Partner: Sometimes a partner is guaranteed his minimum share of profits. This guarantee can be given by any of the following:

1) Any one of the partners,
2) Some of the partners in a fixed ratio,
3) All of the other partners in a fixed ratio.

If the profit share of the partner to whom guarantee has been given is less than the guaranteed amount, then the excess paid to him is charged to the partner(s) who have given the guarantee. If the ratio in which the deficiency to be borne by the other partners is not given it is charged from them in their profit sharing ratio.

Illustration 4

There are three partners in a firm named Rohan, Sohan and Mohan sharing profits in the ratio of 2:2:1. According to partnership deed, Mohan has to get a minimum profit of 7,000 irrespective of profits of the firm. Any excess payable to Mohan will be borne by Rohan. Prepare the profit and loss appropriation account showing the distribution of profits among the partners in case the profits for the year 2014 are (i) Rs. 30,000 and (ii) Rs. 45,000.

Solution:

(i) In case the profit is Rs.30,000:

Mohan's guaranteed share is Rs. 7,000 while he would get Rs. 6,000 in absence of any guarantee. The excess of the guaranteed amount over his normal share of profit will be borne by Rohan. Sohan will remain unaffected and get his normal share of profit.

Profit and Loss Appropriation Account

For the year ending 31st December, 2014

Dr. **Cr.**

Particulars		Amount (Rs.)	Particulars	Amount (Rs.)
To Profit transferred to Capital Account:			By Net Profit for the year	30,000
Rohan2/5	12,000			
Less:Given to Mohan	1,000	11,000		
Sohan 2/5		12,000		
Mohan1/5	6,000			
Add:Received from Rohan	1,000	7,000		
		30,000		30,000

(ii) In case the profits are Rs.45,000

In this case, Mohan is getting Rs. 9,000 as his share of profit, this is more than his guaranteed share. Hence,Rohan will not have to make any sacrifice.

Profit and Loss Appropriation Account

For the year ending 31st December, 2014.

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Profit transferred to Capital Account:		By Net Profit for the year	45,000
Rohan 2/5	18,000		
Sohan 2/5	18,000		
Mohan 1/5	9,000		
	45,000		45,000

Adjustments after Closing Accounts

When the accounts have been closed, sometimes, adjustments are to be made in respect of:
(i) Omissions and errors in records
(ii) Changes in the interest rate,
(iii) Making changes in accounting system or
(iv) Changesin profit sharing ratio etc. from retrospective effect.
In such cases, adjustments will have to be in the partners' capital accounts directly or through Profit & Loss Adjustment Account.

Illustration 5

On 31 St December 2014 after the close of the accounts, the capital accounts of Kapil, Rajat and Vishal stood in the books of the firm at Rs. 40,000; Rs. 30,000; and Rs. 20,000 respectively. It was subsequently discovered that interest at 5% p.a. on partnerscapitals at the beginning of the year and interest on drawings of partners were left out of considerations.
The interest on drawings amounted to KapilRs. 250; RajatRs. 180; Vishal Rs.100. The profit for the year in arriving at the above figures of capitals amounted to Rs. 60,000 and partners drawings had been KapilRs, 10.000; Rajat Rs.7, 500 and Vishal Rs.4, 500. The partners shared profit and losses as Kapil one half, Rajat one-third and Vishal one sixth respectively.
You are required to give the necessary journal entry to rectify the above omissions:

Solution:

Calculation of Opening Capitals

(Figures in Rs.)

Particulars	Kapil	Rajat	Vishal
	Rs.	Rs.	Rs.
Capital (31st December 2014)	40,000	30,000	20,000
Add: Drawings	10,000	7,500	4,500
	50,000	**37,500**	**24,500**
Less: Profit already credited	30,000	20,000	10,000
Capital (1st January 2014)	20,000	17,500	14,500

Adjustment of Capitals

(Figures in Rs.)

Items	Kapil		Rajat		Vishal		Firm	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Interest on Capitals	-	1,000	-	875	-	725	2,600	
Interest on Drawings	250	-	180	-	100	-	-	530
Distribution of Loss	1035	-	690	-	345	-	-	2070
	1,285	1,000	870	875	445	725	2600	2600
Credit/Debit to be given	285			5		280		

Adjustment Entry should therefore be:

Kapil's Capital A/c	Dr.	285
To Rajat's Capital A/c		5
To Vishal's Capital A/c		280

Fixed and Fluctuating Capitals

Since partnership has two or more than two partners, separate capital account for each partner has to be maintained. Usually every partner contributes something in cash or in kind in firm to provide funds for the running of a business. The sum of the contributions represents the capital of the firm. The partnership deed usually mentions the method of maintaining capital accounts of partners. There are two methods by which capital accounts are maintained:

- Fixed Capital system and
- Fluctuating Capital system.

Fixed Capital system:

When the partners agree to keep their capital at their original figures, year after year, they are said to have fixed capitals. In Fixed Capital system, two accounts need to be prepared for each partner:

- Partner's Capital Account: Firstly, it is credited with the original amount of capital introduced by partner in the firm. Subsequently, it is to be credited with additional capital introduced by partner and debited when partner withdraws capital.
- Partner's Current Account: Under the fixed capital, separate CURRENT ACCOUNT of each partner is opened.This current account will be credited at the end of every year with his:

  (a) Share of profits,

  (b) Interest on capital and

(c) Salary or any other remuneration;

and debited with his

(a) Drawings

(b) Interest on Drawings and

(c) Share of loss, if any.

The current account may show credit and debit balance at the end of the year. If they show Credit balances, they appear on the liability side of the Balance Sheet of the firm along with Fixed Capitals. If the Current Accounts show Debit balances, they appear on the asset side of the Balance Sheet. A debit balance of the current account implies that the concerned member has overdrawn his Current account and owes that amount to the firm. A credit balance of the current account represents the amount which a partner is entitled to draw but has not actually drawn. In some cases, interest is allowed on the credit balance and charged to the debit balance; if so entries are passed through respective partners'current accounts.

Fluctuating Capital System:

Fluctuating Capital is one which changes from year to year. There is only one account for each partner in case of fluctuating capital system. All entries relating to introduction of fresh capital, interest on capital, salary, commission, share of profit etc. are credited to the capital account and similarly capital account is debited with drawings, interest on drawing, losses etc. All entries for all items are passed through his capital accounts; as such, the amounts of his capital at the end of the year will be different from what it was at the beginning of the year. The balance of the capital goes on fluctuating year after year and is known as Fluctuating Capital.

Illustration 6

Vinay and Manas started a partnership firm on 1st January 2014 with capitals of Rs. 50,000 and Rs. 40,000 respectively. On 30th June, 2014 Manas made a further contribution of Rs. 10,000 towards his capital. Drawings during the year come to Rs. 4.000 by Vinay and Rs. 5,000 by Manas. 6% interest is to be charged on capitals and no interest is to be charged on drawings. Manas is to be allowed a salary of Rs. 500 p.m. The profit for the year comes to Rs. 32,000 before charging salary and interest on capitals.

Show the Profit and Loss Appropriation Account and the partners'accounts under fixed capital method and Fluctuating Capital Method:

Solution:

Profit and Loss Appropriation Account

For the year ended 31st December 2014

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Interest on Capital:		By Net Profit	32,000
Vinay: 6% on Rs. 50,000 for a year	3,000		
Manas:6%onRs40,000 for a year 2,400 6% on Rs. 10,000 300 for six months	2,700		
To Salary: Manas	6,000		
To Net Profit:			
Vinay	10,150		
Manas	10,150		
	32,000		32,000

When Capitals are Fixed:

Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Date	**Particulars**	**Vinay**	**Manas**	**Date**	**Particulars**	**Vinay**	**Manas**
2014 Dec. 31	To balance c/d	50,000	50,000	2014 Jan. 1	By Cash	50,000	10,000
				June 30	By Cash	-	10,000
		50,000	50,000			50,000	50,000

Current Accounts

(Figures in Rs.)

Dr. **Cr.**

Date	**Particulars**	**Vinay**	**Manas**	**Date**	**Particulars**	**Vinay**	**Manas**
2014	To Drawings	4,000	5,000	2014	By Interest	3,000	2,700
	To balance c/d	9,150	13,850		By Salary	-	6,000
					By Net Profit	10,150	10,150
		13,150	18,850			13,150	18,850

When Capitals are Fluctuating:

(Figures in Rs.)

Dr. **Cr.**

Date	**Particulars**	**Vinay**	**Manas**	**Date**	**Particulars**	**Vinay**	**Manas**
2014	To Drawings	4,000	5,000	2014 Jan. 1	By Cash	50,000	40,000
Dec. 31	To balance c/d	59,150	63,850	June 30	By Cash	-	10,000
				Dec. 31	By Interest	3,000	2,700
					By Salary	-	6,000
					By Net profit	10,150	10,150
		13,150	18,850			63,150	68,850

Knowledge Assessment - II

Fill in the Blanks:

1. Interest on Drawings is ______________ to Partner’s Current Account when capital Accounts are fluctuating
2. Salary to partner is ____________ to Profit and Loss Appropriation Account.
3. Under fluctuating method of capital, interest on capital is credited to ____________ Account.
4. Under Fixed method of capital, partner’s capital Account and ________________ Account are prepared.
5. Interest on Capital is debited to _________________ Account.
6. Interest on drawings calculated on the basis of _______________ for which the money remained outstanding from the partners during the course of accounting year.
7. When drawings are of uneven amounts and made at uneven time intervals, then it is convenient to calculate interest thereon according to ______________ method.
8. In case of guarantee of profit to a partner, the partner to whom guarantee has been given will get the ______________ share of profit, while the other will have to share the remaining profits as per their agreement.

Answers

1. credited, 2. debited, 3. partner’s capital, 4. partner’s Current, 5. Profit and LossAppropriation, 6. period, 7. product, 8. guaranteed

SESSION 3: GOODWILL VALUATION AND TREATMENT OF JOINT LIFE POLICY

Goodwill

A business builds up some reputation after it has continued for some time. If the reputation is good, the firm will come to acquire a fixed clientele in the sense that a number of customers will automatically make their purchases from the firm.Goodwill is the benefit and merit of good name and reputation. Goodwill refers to a measure of the capacity of a business to earn excess profit. Thus, goodwill may also be defined as "value of the reputation of business". Goodwill is considered as an intangible and valuable asset of the business. Its tangible effect is extra profit which firm earns and other firms not possessing equal reputation do not earn.

Factors affecting the Value of Goodwill

- **Favourable Location:** If the firm is located in a prominent place that attracts more customers, the goodwill tends to be high for that business.

- **Nature of Business:** A firm dealing in goods having stable demand is able to earn more profits and this increase the goodwill of the business.

- **Time Factor:** The comparatively old firm will enjoy more commercial reputation than the other one since the old one is better known to its customers although both of them may have the same locational advantages.

- **Capital Requirements:** A business which requires lesser amount of capital with high rate of earning will have more goodwill than one with high capital requirement.

- **Efficiency of Management:** A well-managed firm enjoys the advantages of high productivity through proper planned production, distribution and services. The efficient management may also help to increase the value of goodwill by increasing profits

- **Trend of Profit:** Value of goodwill may also be affected due to the fluctuation in the amount of profit (i.e. on the basis of rate of return). If the trend of profit is always rising, no doubt value of goodwill will be high, and vice versa.

Need for Valuation of Goodwill:

Valuation of goodwill is required in the following circumstances:

(i) On Admission of a partner
(ii) On Retirement of a partner
(iii) On Death of a partner
(iv) Change in profit sharing ratio
(v) Amalgamation of two or more firms
(vi) Dissolution of partnership

Valuation of Goodwill

There are three methods of valuation of goodwill of the firm;

1. Average Profits Method

2. Super Profits Method

3. Capitalisation Method

1. Average Profits Method: This is the simplest and the most commonly used method of the valuation of goodwill. Under this method, goodwill is calculated on the basis of the average of the profits of the past few years. The average is then multiplied by the agreed number of years.

Goodwill = Average Profits xNumber of years of Purchase

The following adjustments should be made in the profits of the firm before calculating the average profits:

- Any abnormal profits should be deducted from the net profits of that year.
- Any abnormal loss should be added back to the net profits of that year.
- Non-operating incomes e.g.Income from investments etc. should be deducted from the net profit of that year.

Illustration 7

Vipin agreed to purchase Abhishek's business. The profits disclosed by Abhishek's business for last four years were as follows:

2010: Rs. 50,000(including an abnormal gain of Rs. 10,000)

2011: Rs.55,000 (including an income from investments outside the business worth Rs. 5,000)

2012: Rs. 45,000 (after charging an abnormal loss of Rs. 5000)

2013: Rs. 66,000 (excluding Rs. 6,000 as insurance premium on firm's property – now to be insured)

Calculate the value of firm's goodwill on the basis of three years' purchase of Average Profits of last four years.

Solution:

Calculation of Average profits

(Figures in Rs.)

Profit for 2010 (Rs.50,000 – Rs.10,000)	40,000
Profit for 2011 (Rs.55,000 – Rs.5,000)	50,000
Profit for 2012 (Rs.45,000 + Rs.5,000)	50,000
Profit for 2013 (Rs.66,000 – Rs.6,000)	60,000
Total profits for four years	2,00,000

Average profit = $\frac{2,00,000}{4}$ = 50,000

Goodwill at 3 Years' purchase of Average profits = 50,000 x 3 = Rs.1,50,000

2. Super profits method:

Super Profits are the profits earned above the normal profits. Under this method,goodwill is calculated on the basis of Super Profits i.e. the excess of actual profits over the average profits.

Steps for calculating Goodwill under this method are given below:

i) Normal Profits = Capital Investedx Normal rate of return

ii) Super Profits = Actual Profits – Normal Profits

iii) Goodwill = Super Profits x No. of years purchased

Illustration 8

The capital employed as shown by the books of ABC Ltd is Rs.5,00,000 and the normal rate of return is 10 %. Goodwill is to be calculated on the basis of 3 years' purchase of super profits of the last four years. Profits for the last four years are:

Year	Profit
2010	Rs.1,00,000
2011	Rs.1,22,500
2012	Rs.74,500
2013	Rs.54,000

Solution:

Total profits for the last four years = 1,00,000 + 1,22,500+ 74,500 + 54,000 = Rs.3,51,000

Average Profits = 3,51,000 / 4 = Rs.87,750

Normal Profits = 5,00,000x 10/100 = Rs.50,000

Super Profits = Average Profits − Normal Profits = 87,750 – 50,000 = $ 37,750

Goodwill = 37,750 × 3 = Rs. 1,13,250

3. Capitalisation Method:

Under this method we calculate the average profits and then assess the capital needed for earning such average profits on the basis of normal rate of return. Such capital is called capitalised value of average profits. The formula is:-

Capitalised Value of Average Profits = Average Profits x (100 / Normal Rate of Return)

Capital Employed = Assets – Liabilities

Goodwill = Capitalised Value of Average Profits – Capital Employed

Illustration 9

ABC Ltd earns Rs.40,000 as its average profits. The normal rate of return is 10%. Total assets of the firm are Rs.10,00,000 and its total external liabilities are Rs.5,00,000. Calculate the amount of goodwill:

Solution:

Total capitalized value of the firm = 40,000 × 100/10 = Rs.4,00,000

Capital Employed = 10,00,000– 5,00,000 = Rs.5,00,000

Goodwill = 5,00,000 – 4,00,000 = Rs.1,00,000

Joint Life Policy

Partners may take out a joint life insurance policy on the lives of all the partners. It enables the firm to make payment to the executors/representatives of deceased partner, without upsetting the working capital of the firm. The amount of policy is payable to the firm in the event of death of a partner or on maturity of policy, whichever is earlier.

Accounting Treatment of premium and Joint life Policy:

A. **The premium paid may be taken as a revenue expenditure:**

In such a case, following accounting entries will be passed:

a) *On payment of premium*

Joint Life Policy Insurance Premium A/c Dr.

To Bank

b) *On charging from P&L A/c*

P & L A/c Dr.

To Joint Life Policy Insurance Premium A/c

c) *On maturity of the policy*

Insurance Company/ Bank A/c Dr.

To Partners' Capital A/c (individually)

d) *On receipt of amount from Insurance company*

Bank A/c Dr.

To Insurance Company's A/c

B. **The premium paid may be taken as a capital expenditure:**

In such a case, Joint life Policy is shown at surrender value in the Balance Sheet. Surrender value is the amount that the insurer will be ready to pay on the basis of number of premiums paid. Following accounting entries will be passed in this case:

a) *On payment of premium*

Joint Life Policy A/c Dr.

To Bank

b) *On transfer of balance exceeding surrender value*

P & L A/c Dr.

To Joint Life Policy A/c

c) *On maturity of the policy*

Insurance Company/ Bank A/c Dr.

To Partners' Capital A/c (individually)

d) *On receipt of amount from Insurance company*

Bank A/c Dr.

To Insurance Company's A/c

e) *On transfer of the balance in Joint Life Policy Account*

Joint Life Policy A/c Dr.

To All partners' capital A/c

C. **Creation of Joint Life policy reserve Account:**

An amount equal to premium is debited to Profit & loss Appropriation account and credited to Joint Life Policy reserve account. The Joint life policy and Joint Life Policy reserve account are mutually adjusted to leave in each account a balance equal to surrender value of the policy. Following accounting entries will be passed in this case:

a) *On payment of premium*

Joint Life Policy A/c Dr.

To Bank

b) *On appropriation of reserve*

P &L Appropriation A/c Dr.

To Joint Life Policy Reserve A/c

c) *On maturity of the policy*

Insurance Company/ Bank A/c Dr.

To Partners' Capital A/c (individually)

d) *On receipt of amount from Insurance company*

Bank A/c Dr.

To Insurance Company's A/c

e) *On transfer of the balance in Joint Life Policy Account*

Joint Life Policy A/c Dr.

To All partners' capital A/c

f) *On transfer of the balance in Joint Life Policy Reserve Account*

Joint life Policy Reserve A/c Dr.
To Joint Life Policy A/c

Change in Profit Sharing Ratio

Existing partners, sometimes decide to change their Profit sharing ratio. This change may result in gain to a few partners and loss to others. The partners who are going to gain due to this change in the profit sharing ratio should compensate the sacrificing partner/partners.

Illustration 10

Shashank and Prashant are sharing profits in the ratio of 3:2. The following is their Balance Sheet ason 31st December, 2014:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors	20,000	Plant	55,000
Capital: Shashank	40,000	Buildings	20,000
Prashant	25,000	Cash	10,000
	85,000		85,000

The goodwill of the firm has been valued at Rs.15,000 and Buildings at Rs.35,000 on 31st December, 2014. The partners decide to share profits equally with effect from 1st January, 2015. You are required to pass the adjustment entry or entries necessary on account of such change in the share of profits.

Solution:

There are two options in this case:

(i) Crediting the partners with the increase in the value of the assets in the old ratio and then writing off such increase in the new ratio.

(ii) Passing only one adjustment entry with the amount of profit or loss.

First Option:

Journal

Date	Particulars	Dr.	Cr.
	Goodwill A/c Dr.	15,000	
	Building A/c Dr.	5,000	
	To Shashank's Capital A/c		12,000
	To Prashant's Capital A/c		8,000
	(Being the amount of goodwill and appreciation in the value of building credited to partners in the old ratio.)		

	Shashank's Capital A/c Dr.	10,000	
	Prashant's Capital A/c Dr.	10,000	
	To Goodwill A/c		15,000
	To Building A/c		5,000
	(Being the amount of goodwill and appreciation in the value of building written off in the new ratio.)		

Second option:

On account of change in the profit sharing ratio,Shashank's loss has been 1/10 while Prashant's gain has been 1/10. Thus Shashank should be compensated by Rs.2,000 (i.e. 1/10 of 20,000) by Prashant. The Journal entry therefore should be:

Journal

Date	Particulars	Dr.	Cr.
	Prashant's Capital A/c Dr.	2,000	
	To Shashank's Capital A/c		2,000
	(Being adjustment required on account of goodwill and revaluation of building.)		

Knowledge Assessment - III

State whether the following statements are True or False:

1. Joint Life policy is the insurance policy covering the lives of partners jointly.
2. Surrender value of the Joint Life Policy is the realizable value of policy on the death of a partner.
3. Goodwill is an intangible asset.
4. For goodwill valuation, normal business profits of existing business is considered.
5. For the purpose of goodwill valuation, normal business profit means profits as assessed by income tax officer.
6. Goodwill exists continually with existence of successful business and identified on transfer of ownership in business.
7. Precise value of goodwill is known only when business is sold as whole by negotiation.
8. Normal business profits for goodwill valuation are otherwise of non-trading incomes and expenses.

Answers

1. True, 2. False, 3.True, 4.True, 5.False, 6.True, 7.True, 8. True

KEYWORDS

1. **Partnership:** The contractual relation between persons who have agreed to share the profits of business carried on by all or any one of them acting for all.

2. **Partnership Deed:** A written document containing the important terms of partnership as agreed by all partners.
3. **Goodwill:** An intangible asset arising from business reputation i.e. connections, trade and customers.

SUMMARY

- If Partnership deed is silent in respect of certain aspects, the relevant provisions of the Indian Partnership Act, 1932 become applicable. The partners share profits equally, no partner is entitled to remuneration, no interest on capital is allowed and no interest on drawings is charged. However, if any partner has given some loan to the firm, he is entitled to interest on such amount @ 6% per annum.
- The partners' capital accounts may be maintained according to fluctuating capital method or fixed capital method. Under fluctuating capital method all the transactions relating to a partner are recorded in his capital account itself. But under fixed capital method, the two accounts are prepared, Partners' capital account and partners' current account.
- The distribution of profits among the partners is shown through a Profit and Loss Appropriation Account which is merely an extension of the Profit and Loss Account.
- Sometimes, a partner may be guaranteed a minimum amount by way of his share in profits. If, in any year, the share of profits as calculated according to his profit sharing ratio is less than the guaranteed amount, the deficiency is made good by the guaranteeing partners' in the agreed ratio which usually is the profit sharing ratio. If, however, such guarantee has been given by any of them, he or they alone shall bear the amount of deficiency.
- If, after the final accounts have been prepared, some omission or commissions are found in respect of the interest on capital, interest on drawings, partner's salary, commission, etc. the necessary adjustment can be made in the partner's capital accounts through the Profit and Loss Adjustment Account.
- There are three methods of calculating value of goodwill viz., purchase of average profits method, purchase of super profits method and capitalization method.
- When the partners decide to change their profit sharing ratio, some partners will gain while others will lose. Hence, the gaining partner has to compensate the partner who makes the sacrifice by paying (or through necessary adjustment in their respective capital accounts) the proportionate amount of goodwill.

EXERCISE QUESTIONS:

Short Answer Questions

1. Define partnership.
2. Explain Partnership Deed.
3. What do you understand by 'partners' and 'firm'?

4. List any four characteristics of partnership.
5. Define Goodwill.
6. Explain four main features of partnership.
7. In the absence of partnership deed, what rules do you apply for solving accounting problems of partnership.
8. List any two items appearing on the debit side of the partner's current account.

Long Answer Questions

1. How is profit and loss appropriation account prepared?
2. How will you calculate interest on the drawings of equal amounts
    a) on the first day of every month of a calendar year?
    b) on the last day of every month of a calendar year?
    c) on 15^{th} day of every month of a calendar year?
3. Distinguish between fixed and fluctuating capital accounts.
4. State at least five important points from accounting point of view which must be incorporated in the partnership deed.
5. What is partnership? State the chief characteristics of a partnership? Describe the main provisions of the Partnership Act that are relevant to partnership accounts.
6. List the items which usually appear on the debit side of a partner's capital account, if the capitals are (i) Fixed, (ii) Fluctuating.
7. Define goodwill. Describe various methods of valuing goodwill
8. Distinguish between:
    a) Fixed and Fluctuating methods of capital.
    b) Average Profits and Super Profits method.

Numerical Questions

1. Rohan and Mohan started business on 1^{st} January 2013. They introduced capital worth Rs.20,000 and Rs.30,000in their respective accounts. Their partnership deed provides the following:
    (i) Profits and losses shall be shared in the ratio of 2:3.
    (ii) Partners shall be entitled to interest on capital @6%p.a.
    (iii)Interest on drawings shall be charged at 8% p.a.

    During the year ended 31^{st} December 2013, the firm made a profit of Rs. 19,280 before adjustment of interest on capital and drawings. The partners withdrew during the year Rs.3,000 each at the end of every quarter commencing from 31 March 2013.

    You are required to open a Profit and Loss Adjustment Account and show the entries for interest and distribution of profit. Also show the Capital Account of Partners for the year.

    *(**Answer:** Net Profit to Rohan Rs.6,800; Mohan Rs.10,200, Balance in Capital Accounts: Rohan Rs.15,640; Mohan Rs.29,640)*

2. Anil, Sunil &Vipinare partners in a firm, the balances on their capital accounts stood at Rs.30,000, Rs.25,000 and Rs.20,000 respectively. In arriving at these figures, the profits for the year ended 31st December, 2014 Rs.24,000 has already been credited to partners in the proportion in which they share profits. Their drawing were Anil: Rs. 5,000, Sunil: Rs.4,000 and Vipin: Rs.3,000 in 2014. Subsequently the following omissions were noticed and it was decided to bring them into account:
   (i) Interest on Capital @10%p.a.
   (ii) Interest on Drawing Anil: Rs.250, Sunil: Rs.200 and Vipin: Rs.150.

   Make the necessary correction through Profit and Loss adjustment account and through a journal entry.

   *(**Answer:**Debit Vipin by Rs.550 and Credit Anil by Rs.550)*

3. From the following information calculate the value of goodwill on the basis of 3 years' purchase of super profits of the business:
   (i) Capital Employed Rs.50,000
   (ii) Trading Profits: 2010 Profit Rs. 12,300; 2011 Profit Rs.15,000; 2012 Loss Rs.2,000; 2013 Profit Rs.21,000
   (iii) Normal rate of return 20%
   (iv) Remuneration for alternative employment to the proprietor if not engaged in the business Rs.5,000

   *(**Answer:** Rs.3,300)*

4. Rohan, Rohit and Vipin are equal partners in a firm. From the following information calculate interest on drawings @ 5% p.a.
   a) Rohan drew @ 4000 @ the end of every month for six month ended on June 30, 2014.
   b) Rohit drew @ 4000 @ in the beginning of every month for six month ended on June 30, 2014.
   c) Vipin drew @ 4000 @ in the middle of every month for six month ended on June 30, 2014.

   *(**Answer:**Rohan: Rs.250, Rohit: Rs.350, Vipin: Rs.300)*

5. Shweta, Jiveta and Jasika were partners in a firm. On January 1st 2014 their capitals stood at Rs. 1,00,000, Rs. 50,000 and 50,000 respectively. As per the provisions of their partnership deed:
   a) Jasika was entitled for a salary of Rs10,000 per annum.
   b) Partners were entitled to interest on capital @5% p.a.
   c) Profits were to be shared in the ratio of partners' capital.
   d) The net profit of the year 2014 were distributed equally without providing for the above terms.

   Pass an adjustment entry to rectify the above errors.

   *(**Answer:**Debit Jiveta by 8,000, Credit Shweta by 6,000 and Jasika by 2,000)*

6. On January 1st, 2013 an existing firm had assets of Rs. 1,50,000 including cash of Rs. 10,000. The partner's capital accounts shared a balance of Rs. 1,20,000 and the reserve contributed the rest. If the normal rate of return is 10% and the goodwill of the firm is valued at Rs 48,000 at four year's purchase of super profits, find the average profits of the firm.

*(**Answer:** Average profits: Rs. 27,000)*

7. Arvind and Govind are two partners in a firm. From the following information, calculate the value of goodwill.

   (i) At three years purchase of average profits.
   (ii) On the basis of capitalisation of super profits
   (iii) On the basis of capitalisation of average profits

   Information :

   a) Average capital employed in the business Rs. 5,00,000
   b) Net trading results of the firm for the past years Profit 2010 – Rs. 1,47,600, Loss 2011 – Rs 1,48,100, Profit 2012– Rs 4,48,700
   c) Rate of interest expected from the capital having regard to the risk involved – 10%
   d) Remuneration to each partner for his service Rs. 500 p.m
   e) Assets (excluding goodwill) Rs 7,54,762
   f) Liabilities Rs. 31,329

*(**Answer:**(i) Rs.4,12,200, (ii) Rs.8,74,000,(iii) Rs.650567)*

8. A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less then Rs. 25,000. Total profits of the firm were Rs. 90,000.

   Calculate share of profits for each partner when:

   (i) Guarantee is given by firm.
   (ii) Guarantee is given by A
   (iii) Guarantee is given by A and B equally.

*(**Answer:** (i) A: Rs.39,000, B: Rs.26,000, C: Rs. 25,000 (ii) A: Rs.35,000, B: 30,000, C: Rs.25,000, (iii) A: Rs.40,000, B:Rs.25,000, C:Rs.25,000)*

UNIT 2:RECONSTITUTION OF PARTNERSHIP FIRMS - I

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Classroom or Company’s premises</td><td colspan="4">SESSION 1: INTRODUCTION TO ADMISSION</td></tr>
<tr><td>Learning Outcome</td><td>Knowledge Evaluation</td><td>Performance Evaluation</td><td>Teaching and Training Method</td></tr>
<tr><td>1. Reasons for admission of a new partner</td><td>1. Explain the reasons of admitting a new partner.</td><td>1. Elucidate the reasons of admission of a new partner</td><td>Interactive Lecture: Discussion related to the reasons of admission of a new partner</td></tr>
<tr><td>2. Calculation of new profit sharing ratio</td><td>1. Explain the different ways of calculating new profit sharing ratio and sacrificing ratio under different situations.</td><td>1. Discuss the methods of computation of new profit sharing ratio.</td><td>Interactive Lecture: Explanation as to different methods of calculated newprofit sharing ratio.</td></tr>
<tr><td colspan="4">SESSION 2: ACCOUNTING TREATMENT OF GOODWILL</td></tr>
<tr><td>1. Treatment of Goodwill</td><td>1. Explain the different situations relating to treatment of goodwill when new partner brings his/her share of goodwill in cash at the timeof admission of a new partner.
2. Explain the procedure of treating the goodwill when new partner does not bring amount of goodwill in cash.</td><td>1. Pass journal entries for accounting treatment of goodwill when new partner brings his/her share of goodwill in cash.</td><td>Interactive Lecture:
1. Discussion of the journal entries and procedure of treatment of goodwill at the timeof admissionof a new partner</td></tr>
<tr><td colspan="4">SESSION 3: PREPARATION OF FINAL ACCOUNTS AT THE TIME OF ADMISSION OF A PARTNER</td></tr>
<tr><td>1. Revaluation of assets and liabilities of the firm</td><td>1. Explain the procedure of preparing P&L Adjustment Account.</td><td>1. Express the methodology of revaluation of assets and liabilities of a firm.</td><td>Interactive Lecture: Discuss the method of preparing P&L Adjustment Account.</td></tr>
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	2. Distribution of accumulated profits and losses	1. Explain how to distribute accumulated profits and losses among the partners	1. Pass journal entries for treatment of accumulated profits and losses	**Interactive Lecture:** Discussion relating to journal entries and procedure of distribution accumulated profits, reservesand accumulated losses at the timeof admissionof a new partner
	3. Adjustment of Partners' capital	1.Explain how to adjust partners' capital on admission of new partner	1.Discuss the adjustment of Partners' capital.	**Interactive Lecture:** Acquaint students with the adjustment of Partners' capital

Reconstitution of Partnership Firms - I

Learning Objectives

After studying this unit, the students will be able to:

1. State the meaning of admission of a partner,
2. Calculate new profit sharing ratio and sacrificing ratio,
3. Describe accounting treatment of goodwill,
4. Explain the need for revaluation of assets and reassessment of liabilities,
5. Illustrate the accounting treatment of changes arising from revaluationof assets and reassessment of liabilities,
6. Describe accounting treatment of undistributed profits and reserves,
7. Explain the treatment of various adjustments in partners' capitals,
8. Prepare Revaluation Account, Partners' Capital Accounts and balance sheet of the reconstituted firm, and
9. Explain the meaning of certain keywords.

SESSION 1: INTRODUCTION TO ADMISSION

Reconstitution of Partnership Firms

Partnership is the agreement between the partnerswho have agreed to share theprofits of a business carried on by all or any of them acting for all.Any change in the existing agreement between the partners results into reconstitution of partnership firm. A partnership firm is said to be reconstituted in the following circumstances:

- Admission of a partner
- Change in the profit sharing ratio amongst partners
- Retirement of a partner
- Death of a partner
- Amalgamation of partnership firms

In the present chapter, accounting treatment related to admission of partner is being explained in detail.

Admission of a Partner

Due to lack of sufficient capital or managerial help or both, it becomes difficult to run the partnership business. In this case a firm may decide to admit a new partner into the firm. But according to Indian Partnership Act 1932, no partner can be admitted into the firm without the consent of all the existing partners. A person who is admitted as a partner into the firm is not liable for any act of the firmdone before his/her admission. A partner is admitted for any one or more of the following reasons:

- For acquiring more capital in the business.
- To have more managerial skill, a competent and experienced person is needed.

- To expand and boost up the business.
- To increase the goodwill by admitting a well-reputed person into the business.
- For reducing competition.

Adjustments required in case of Admission of a Partner
On admission of a new partner, the partnership firm is reconstituted with a new agreement and the following adjustments become necessary:

- Calculation of New Profit Sharing Ratio
- Treatment of Goodwill
- Revaluation of Assets And Liabilities of A Firm
- Distribution of Accumulated Profits And Reserves
- Adjustment of Partners' Capitals

Calculation of New Profit Sharing ratio

When in a partnership firm a new partner is admitted, he will be given a portion of the profit of the firm. As the incoming partner is entitled to get some profit share, the profit share of old partners will be reduced.Existing partners have to surrender some of their share in favour of the new partner. The ratio in which they agree to sacrifice their share of profits in favour of incoming partner is called sacrificing ratio. So there will be a requirement to find out the NEW PROFIT SHARING RATIO of the firm, without which the profit cannot be divided among partners, including the new partner.

The following are thecases which require calculationof the new Profit and Loss sharing ratio:

(1) When only the share of the new partner is given, then it is assumed that the remaining profit willbe shared by the old partners in their old profit sharing ratio.

(2) When the share of the new partner is purchased out of the share of profit of the old partners, then the old partner forgoes a portion of the profit, which goes to the new partner.

(3) The old partners may sacrifice their share of profits for the new partner in their existing profit sharing ratio.

(4) New partner's share of profit is out of the profit of all partners in the equal ratio.

In all the cases, profit and loss sharing ratio is completely changed.

Illustration 1

Rahul and Shashank are partners in a business sharing profits and losses in the ratio of 2: 1. They admit Gaurav into the firm.

Find out the new profit and loss sharing ratio in the following cases:

(i) When Gaurav is given 1 /4th share in profit.
(ii) When Gaurav is given 1 /4th share in profits out of Rahul's share.
(iii) When Gaurav is given 1 /4th share in profits from Rahul and Shashank in the ratio of 1:1.
(iv) When Gaurav is given 1 /4th share of profits from Rahul and Shashank in their profit and loss sharing ratio.

Solution:

(i) Let the total share of profit be 1.
The newcomer Gaurav is given 1 /4th share in the profit
Balance of share in Profit = 1 – 1/4 = 3/4.
3/4th share of profit is shared by Rahul and Shashank in 3: 2 ratio
Therefore Rahul's new share of profit = 3/4 x 2/3 = 2/4
Shashank's new share of profit = 3/4 x 1/3 = 1/4
New profit sharing among Rahul, Shashank and Gaurav = 2/4: 1/4: 1/4 (or) 2:1:1

(ii) Let the total share of profit be 1.
Gaurav's share of profit = 1/6
Gaurav's share of profit is borne by Rahul. So, Rahul's new profit sharing proportion = 2/3 – 1/4 = 5/12
Shashank's profit sharing ratio remains the same.
New profit sharing among Rahul, Shashank and Gaurav = 5/12: 1/3: 1/4 = 5/12: 4/12: 3/12 (or) 5:4:3

(iii) Let the total share of profit be 1.
Gaurav's share of profit = 1/4or 6/24
Rahul and Shashank sacrifice equally i.e. 1/4 x 1/2= 1/8
So, Rahul's new share of profit = 2/3 – 1/8 = 13/24
Shashank's new share of profit = 1/3 – 1/8 = 5/24
Therefore, new profit sharing = 13: 5: 6

(iv) Let the total profit share be 1.
Gaurav gets 1/4th share in the profit and is sacrificed by Rahul and Shashank in 2: 1 ratio:
Rahul has to sacrifice 2/3 of 1/4 = 2/12
Shashank has to sacrifice 1/3 of 1/4 = 1/12
Rahul's new profit sharing proportion = 2/3 – 2/12= 6/12

Shashank’s new profit sharing proportion = 1/3 – 1/12 = 3/12
C will get 1/4 (3/12)
New profit sharing proportion =6:3:3 (or) 2:1:1

(i) and (iv) give equal answers. That is, when Gaurav is given 1/4th share of the profit and nothing else is mentioned in the problem. This means the existing partners sacrifices in their oldratio. In other words, the remaining profit i.e. 3/4th share is shared by old partners in their old profit sharing ratio i.e. 2: 1. That is,
Rahul’s share = 3/4 x 2/3 = 2/4
Shashank’s share = 3/4 x 1/3 = 1/4

Knowledge Assessment - I

State whether the following statements are True or False:

1. The ratio in which partners surrender their profits is known as new profit sharing ratio.
2. Sacrificing ratio is calculated by deducting new profit sharing ratio from existing profit sharing ratio.
3. The new ratio of existing partners is calculated by dividing remaining share of the profit in their old profit sharing ratio.
4. No partner can be admitted into partnership firm without the consent of all other partners.
5. When only the share of the new partner is given, then it is assumed that the remaining profit would be shared by the old partners in their old profit sharing ratio.
6. The partnership firm isreconstituted on the admission and retirement of a partner.
7. On admission of a new partner, new profit sharing ratio of the firm needs to be calculated without which the profit cannot be divided among partners, including the new partner.

Answers

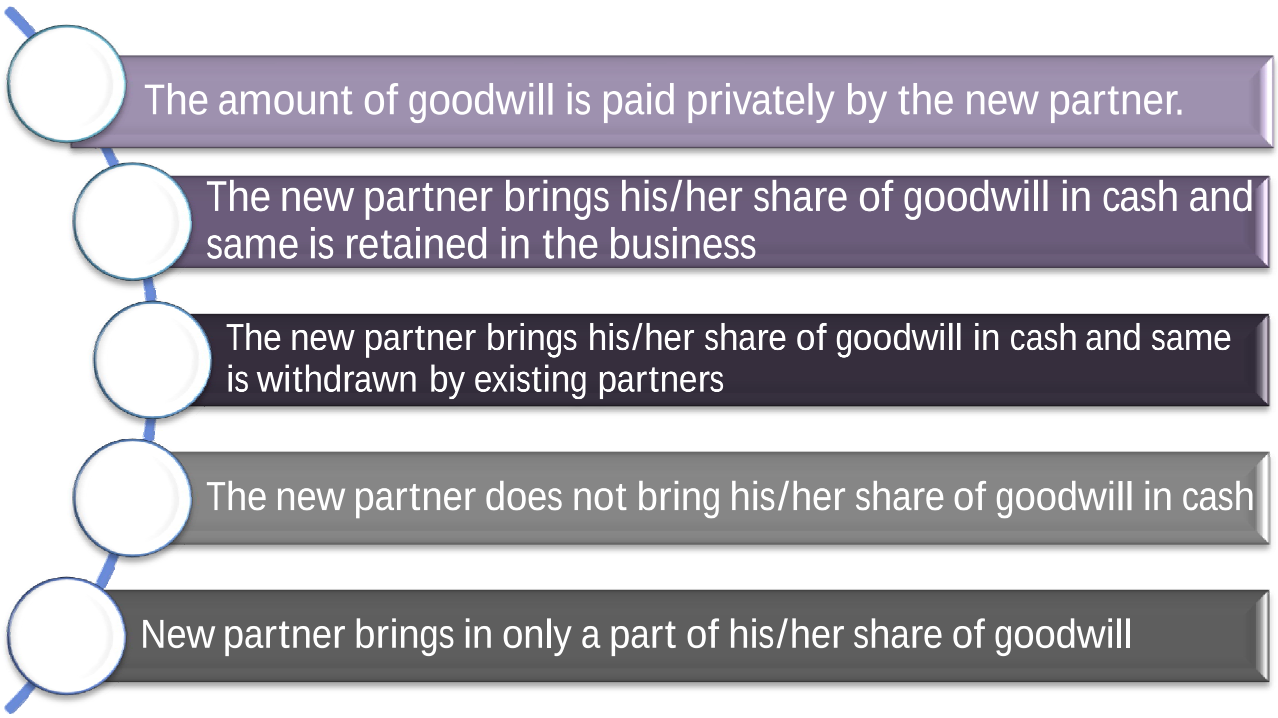
1. False, 2. True, 3.True, 4.True, 5.True, 6.True, 7. True

SESSION 2: ACCOUNTING TREATMENT OF GOODWILL

Treatment of Goodwill

When a new partner is admitted in a partnership firm, the old partner sacrifices someof their shares for that partner, so it is the duty of new partner to compensate old partners for the sacrifice made by them. Compensation is made by giving goodwill in cash or in any other way to old partners.

There are following different situations relating to treatment of goodwill at the timeof admission of a new partner.



Case I: The amount of goodwill is paid privately by the new partner

In this case new partner gives his share of goodwill to old partners personally, so there is no need to record it in the books of the firm and no journal entry is required.

Case II: The new partner brings his/her share of goodwill in cash and the amount of goodwill is retained in the Business:

In this case, new partner bring his share of goodwill in cash form in the firm and it is taken by old partner in their sacrifice ratio. If there is any goodwill account in thebalance sheet of existing partner, it will be written off inexisting ratio among the partners. For this following journal entrieswill be passed:

1. *Existing goodwill appearing in the books will be written off in the existing profit sharing ratio:*
   Old Partner’s Capital A/c (individually) Dr.
   To Goodwill A/c
   (*for goodwill written off in old ratio*)

2. *New partner brings amount of goodwill and capital in cash.*
   Cash/Bank A/c Dr.
   To Goodwill A/c
   (for the amount of goodwill brought in by new partner)

3. *Amount of goodwill transferred to old partners in the sacrificing ratio.*
   Goodwill A/c Dr.
   To Old Partners'Capital A/c
   (for the amount of goodwill transferred to old partners' capital accounts in sacrificing ratio)

Case III: The new partner brings his/her share of goodwill in cash and the amount of goodwill is withdrawn by old partners:

Sometimes, the amount of goodwill brought in by new partner is withdrawn by old partners. In this case in addition to above three journal entries explained in the previous case, one more journal entry is required to be passed:

Old Partners' capital A/c Dr.
To cash/bank a/c
(*for the amount of goodwill withdrawn by old partners*)

In some cases partners withdraw only ½ or ¼ amount of goodwill, then entry should be passed with the withdrawn amount only.

Illustration 2

Radha and Tanvi are partners in a firm sharing profit in the ratio 5 : 3. They admitted Garvit as a new partner for 1/4th share in the profit. Garvitbrings Rs. 60,000 for her share of goodwill and Rs.2,40,000 for capital. Amount of goodwill brought in by Garvit is withdrawn by old partners. Make journal entries in the books of the firm after the admission of Garvit. The new profit sharing ratio will be 2 : 1 : 1.

Solution :

Journal

Date	Particulars	Dr.	Cr.
	Bank A/c Dr.	3,00,000	
	To Goodwill A/c		60,000
	To Garvit's Capital A/c		2,40,000
	(*for cash brought by Garvit for his share of goodwill and capital*)		

	Goodwill A/c Dr.	60,000	
	To Radha's Capital A/c		30,000
	To Tanvi's Capital A/c		30,000
	(*for Goodwill transferred to existing partners capital account in their sacrificing ratio)*		
	Radha's Capital A/c Dr.	30,000	
	Tanvi's Capital A/c Dr.	30,000	
	To Bank A/c		60,000
	(*for amount of Goodwill is withdrawn by them)*		

Working Note:

Calculation of sacrificing ratio [existing ratio – new ratio]

Radha's sacrificing ratio: 5/8 – 2/4 = 1/8

Tanvi's sacrificing ratio: 3/8 – 1/4 = 1/8

Sacrificing ratio of Radha and Tanvi: 1 : 1

Case IV: When the new partner does not bring his/her share of goodwill in cash

When goodwill of the firm is evaluated and new partner does not bring his share of goodwill in cash, then goodwill should be adjusted through partners' capital accounts. For this purpose new partner's capital account is debited from his/her share of goodwill and old partners' capital accounts are credited in sacrificing ratio. Following journal entry is required to be passed.

New partner's capital A/c Dr. (from his/her share of goodwill)
To Old Partners' Capital A/c (In sacrificing ratio)
(for new partner's capital account is debited from his/her share of goodwill and old partners' capital accounts are credited in sacrificing ratio.)

Goodwill appears in the books of the firm and new partner does not bring his/her share of goodwill in cash:

If the goodwill account appears in the books of the firm, and the new partner is not able to bring goodwill in cash. In this case, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their existing profit sharing ratio.

Illustration 3

Akhil and Nikhil are partners sharing profit in the ratio of 2 : 3. They agree to admit Neha for 1/5 share in future profit. Neha brings Rs. 3,50,000 as capital and enable to bring her share of goodwill in cash, the goodwill of the firm to be valued at Rs. 2,10,000. At the time of admission goodwill existed in the books of the firm at Rs.90,000. Make necessary journal entries in the books of the firm.

Solution:

Journal

Date	Particulars	Dr.	Cr.
	Akhil's Capital A/c Dr.	36,000	
	Nikhil's Capital A/c Dr.	54,000	
	To Goodwill A/c		90,000
	(for Goodwill written off before Neha'sadmission)		
	Bank A/c Dr.	3,50,000	
	To Neha's Capital a/c		3,50,000
	(for Cash brought by Nehafor her capital)		
	Neha's Capital A/c Dr.	42,000	
	To Akhil's Capital A/c		16,800
	To Nikhil's Capital A/c		25,200
	(for existing partners capital A/c credited for goodwill on Neha's admission in sacrificing ratio)		

Working Note:

Akhil and Nikhil sacrifice their profit in favour of Neha in their existing profit sharing ratio i.e. 2: 3. Therefore, the sacrificing ratio is 3 : 2.

Value of Goodwill = Rs.2,10,000

Neha's share in Profit = 1/5

Neha's share of Goodwill = Rs. 2,10,000 × 1/5 = Rs. 42,000

Case V: When new partner brings in only a part of his/her share of goodwill

When new partner is not able to bring the full amount of his/her share ofgoodwill in cash and brings only a part of cash. In this case, the amount of goodwill brought by him is credited to goodwill account. At the time of goodwill transferred to capital account of existing partner's, new partner's capital account is debited with his unpaid share of goodwill besides debiting goodwill account with the amount of goodwill is paid by him. The Following journal entries are passed in this regard:

Cash/Bank A/c Dr.
To Goodwill A/c
(for part amount of goodwill brought by new partner)

Goodwill A/c Dr.
New Partner's Capital A/c Dr.
To Existing Partner's Capital A/c [individually in sacrificing ratio]
(for credit given to sacrificing partner by new partner's in full share of goodwill)

Illustration 4
Sarika and Deepika are partners sharing profit in the ratio of 5 : 3. They admit Rajeev into the firm for 1/5share in profit which he takes 1/ 15 from Sarikaand 2/ 15 from Deepika. Rajeev brings Rs.12,000 as goodwill out of his share of Rs. 15,000. No goodwill account appears in the books of the firm. Make necessary journal entries in the books of the firm.
Solution:

Journal

Date	Particulars	Dr.	Cr.
	Bank A/c Dr.	12,000	
	To Goodwill A/c		12,000
	(for part of the share of goodwill brought in by Rajeev)		
	Goodwill A/c Dr.	12,000	
	Rajeev's capital A/c Dr.	3,000	
	To Sarika's Capital A/c		5,000
	To Deepika's Capital A/c		10,000
	(for Goodwill credited to Sarika and Deepika in their sacrificing ratio i.e 1 : 2)		

Knowledge Assessment - II

Fill in the Blanks:

1. When Goodwill is paid_______________, no entry will be made
2. At the time of admission the goodwill appearing in the books is ______________.
3. At the time of admission the amount of goodwill brought by the new partner is _____________ to Capital A/c existing partners' capital.
4. When new partner is not able to bring goodwill in cash, then new partner's capital account is___________ with his/her share of goodwill.
5. When new partner bring his share of goodwill in cash form in the firm then it is taken by old partner in their ____________ ratio.
6. On admission of a partner, the amount of goodwill existing in the books is written off by debiting the capital account of existing partners in their ________ profit sharing ratio.
7. When goodwill of the firm is evaluated and new partner does not bring his share of goodwill in cash, then goodwill should be adjusted through___________________.
8. When amount of goodwill brought in by new partner is withdrawn by old partners then old partners' capital account is debited and __________ account is credited.

Answers

1. privately, 2. Written off, 3. transferred, 4. Debited, 5.Sacrificing, 6.Existing, 7. Partners' capital accounts, 8. Bank

SESSION3: PREPARATION OF FINAL ACCOUNTS AT THE TIME OF ADMISSION OF A PARTNER

Revaluation of Assets and Liabilities:

When a new partner is admitted, the existing assets and liabilities are to be revalued. The existing partners sometimes revalue the assets and liabilities to avoid any undue gain or loss to the incoming partner

The revaluation can be done in two ways:

(1) When assets and liabilities are revalued, the revised values are shown in the books of accounts.

(2) When the assets and liabilities are revalued, revised values are not to be shown in the books of accounts.

When Assets and Liabilities Revalued and the Revised Values are shown in the Books of Accounts:

The assets and liabilities are valued and the decrease and increase are brought into a separate account known as Profit and Loss Adjustment Account (also known as Revaluation Account)which is a nominal account. The following Journal entries are to be passed which are categorized into three groups:

(a) For profit items

For any increase in the valuation of assets;
Assets A/c Dr.
To Revaluation A/c
For any decrease in the values of liabilities:
Liabilities A/c Dr.
To Revaluation A/c

(b) For Loss items

For any decrease in the valuation of assets:
Revaluation A/c Dr.
To Assets A/c
For any increase in the values of liabilities:
Revaluation A/c Dr.
To Liabilities A/c

(c) For transferring the profit or loss on Revaluation account

For profit on Revaluation account

Revaluation A/c Dr.

To Old Partners' Capital A/c

For any Loss on Revaluation account

Old Partners' Capital A/c

To Revaluation A/c

When the assets and liabilities are revalued, revised values are not to be shown in the books of accounts.

Memorandum Profit and Loss Adjustment account will be opened in the books of the firm. The increase in the value of assets or decrease in the value of liabilities will be credited to this account. The decrease in the value of assets or increase in the value of liabilities will be debited to this account. Following two entries will be passed:

(i) *For crediting the profit on revaluation to old Partner's capital accounts:*

Memorandum P&L Adjustment A/c Dr.

To Old Partners' Capital Accounts

In case of loss entry will be reversed

(ii) *For writing off the profit on revaluation to all partners' capital accounts including the new partner:*

Partners' Capital Accounts Dr.

To Memorandum P&L Adjustment A/c

In case of loss entry will be reversed

Illustration 5

Following is the Balance Sheet of Avinash and Bhuvan who are sharing profits in the ratio of 3:2

Balance Sheet
as on 31 December, 2014

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Sundry Creditors	20,000	Cash	10,000
Capital accounts:		Sundry Debtors	20,000
Avinash	40,000	Buildings	40,000
Bhuvan	20,000	Plant	10,000
	80,000		80,000

Chandar is admitted as a partner with effect from 1 january, 2014, the new profit sharing ratio being 2:2:1. The following information has been given to you:

(i) Chandar will bring Rs.20,000 as capital

(ii) The value of firm's goodwill is Rs.10,000.

(iii) An amount of Rs.4,000 owing to Rohan for purchase of goods has been omitted from the list of sundry creditors.

(iv) Building is to be revalued at Rs.60,000 and Plant Rs.14,000.

You are required to pass the necessary Journal entries and prepare the Balance Sheet of the new firm when:

(a) Assets and Liabilities have to be shown in the books at the revised values.
(b) Assets and Liabilities have to continue in the books at the old values.

Solution:

(a) When new values have to be recorded in the books

Journal

Date	Particulars	Dr.	Cr.
	Bank A/c Dr.	20,000	
	To Chandar's Capital A/c		20,000
	(for capital brought in by Chandar)		
	Goodwill A/c Dr.	10,000	
	To Avinash's Capital A/c		6,000
	To Bhuvan's Capital A/c		4,000
	(for Goodwill account raised on Chandar's admission)		
	P&L Adjustment A/c Dr.	4,000	
	To Sundry Creditors		4,000
	(for a liability omitted now recorded.)		
	Plant A/c Dr.	4,000	
	Buildings A/c Dr.	20,000	
	To P&L Adjustment A/c		24,000
	(for increase in the value of assets recorded)		
	P&L Adjustment A/c Dr.	20,000	
	To Avinash's Capital A/c		12,000
	To Bhuvan's Capital A/c		8,000
	(for profit on revaluation credited to partners)		

Balance Sheet
as on January 1, 2014

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Sundry Creditors	24,000	Cash	30,000
Capital accounts:		Sundry Debtors	20,000
Avinash	58,000	Buildings	60,000
Bhuvan	32,000	Plant	14,000
Chandar	20,000	Goodwill	10,000
	1,34,000		1,34,000

Working notes:

P&L Adjustment Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Sundry Creditors	4,000	By Plant A/c	4,000
To Profit:		By Buildings A/c	20,000
Avinash Capital A/c	12,000		
Bhuvan Capital A/c	8,000		
	24,000		24,000

Partners' Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	**Avinash**	**Bhuvan**	**Chandar**	**Particulars**	**Avinash**	**Bhuvan**	**Chandar**
To Balance c/d	58,000	32,000	20,000	By Balance b/d	40,000	20,000	
				By Goodwill	6,000	4,000	
				By P&L Adjustment A/c	12,000	8,000	
				By Cash			20,000
	58,000	32,000	20,000		58,000	32,000	20,000

(b) When new values have not to be recorded in the books

Journal

Date	Particulars	Dr.	Cr.
	Bank A/c Dr.	20,000	
	To Chandar's Capital A/c		20,000
	(*for capital brought in by Chandar)*		
	Goodwill A/c Dr.	10,000	
	To Avinash's Capital A/c		6,000
	To Bhuvan's Capital A/c		4,000
	(*for Goodwill account raised on Chandar's admission)*		
	Avinash's Capital A/c Dr.	4,000	
	Bhuvan's Capital A/c Dr.	4,000	
	Chandar's Capital A/c Dr.	2,000	
	To Goodwill A/c		10,000
	(*for Goodwill account written off)*		
	Memorandum P&L Adjustment A/c Dr.	20,000	
	To Avinash's Capital A/c		12,000
	To Bhuvan's Capital A/c		8,000
	(for profit on revaluation credited to partners)		

	Avinash's Capital A/c Dr.	8,000	
	Bhuvan's Capital A/c Dr.	8,000	
	Chandar's Capital A/c Dr.	4,000	
	To Memorandum P&L Adjustment A/c		20,000
	(for profit on revaluation written off)		

Partners' Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	Avinash	Bhuvan	Chandar	Particulars	Avinash	Bhuvan	Chandar
To Goodwill	4,000	4,000	2,000	By Balance b/d	40,000	20,000	
To Memorandum P&L Adjustment A/c	8,000	8,000	4,000	By Goodwill	6,000	4,000	
To Balance c/d	46,000	20,000	14,000	By Memorandum P&L Adjustment A/c	12,000	8,000	
				By Cash			20,000
	58,000	32,000	20,000		58,000	32,000	20,000

Balance Sheet
as on January 1, 2014

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	20,000	Cash	30,000
Capital accounts:		Sundry Debtors	20,000
Avinash	46,000	Buildings	40,000
Bhuvan	20,000	Plant	10,000
Chandar	14,000		
	1,00,000		1,00,000

Working Notes:

Memorandum P&L Adjustment Account

(Figures in Rs.)

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Sundry Creditors	4,000	By Plant A/c	4,000
To Profit:		By Buildings A/c	20,000
Avinash Capital A/c	12,000		
Bhuvan Capital A/c	8,000		
	24,000		24,000
To Reversal of entry (increase in the value of assets)	24,000	By Reversal of entry (increase in the value of liabilities)	4,000
		By Avinash Capital A/c	8,000
		By Bhuvan Capital A/c	8,000
		By Chandar Capital A/c	4,000
	24,000		24,000

Distribution of Accumulated Profits and Reserves

Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner, is credited in the existing partner's capital account in existing profit sharing ratio. If there is any loss, the same will be debited to the existing partner in the existing ratio. The following journal entries are passed in this regard:

(i) For distribution of undistributed profit and reserve among old partners in old profit sharing ratio:

Reserves A/c Dr

Profit & Loss A/c(Profit) Dr.

To Old Partner's Capital Accounts (individually in old ratio)

(ii) In case partners decided to leave the Reserves and P&L Account undisturbed, one more entry reversing the amount credited may be passed:

All Partners' Capital Accounts(in new ratio) Dr.

To Profit and Loss A/c

To Reserves A/c

Illustration 6

Aman and Raman are partners sharing profit in the ratio of 2:3. They admit Mohan as as new partner for 1/5 shares in profits. On that date the balance sheet of the firm shows a balance of Rs.20,000 in general reserve and Profit and Loss A/c balance of Rs.15,000. Pass the necessary journal entries when:

(i) Old P&L A/c and General Reserve balances are not to appear in the new firm's books.

(ii) Old P&L A/c and General Reserve balances are to appear in the new firm's books.

Solution:

(i) When Old P&L A/c and General Reserve balances are not to appear in the new firm's books.

Journal

Date	Particulars		Dr.	Cr.
	P&L A/c	Dr.	15,000	
	General Reserve A/c	Dr.	20,000	
	To Aman's Capital A/c			14,000
	To Raman's Capital A/c			21,000
	(for the amount of P&l A/c and General reserve distributed among the partners)			

(i) When Old P&L A/c and General Reserve balances are to appear in the new firm's books.

Journal

Date	Particulars		Dr.	Cr.
	P&L A/c	Dr.	15,000	
	General Reserve A/c	Dr.	20,000	
	To Aman's Capital A/c			14,000
	To Raman's Capital A/c			21,000
	(for the amount of P&l A/c and General reserve distributed among the partners)			
	Aman's Capital A/c	Dr.	11,200	
	Raman's Capital A/c	Dr.	16,800	
	Mohan's Capital A/c	Dr.	7,000	
	To P&L A/c			15,000
	To General Reserve A/c			20,000
	(for the amount credited to partners written off)			

Adjustment of Partners' Capital

Adjustment of Partners' Capital can be any of the following:

A. Calculation of New Partner's Capital on the basis of Old Partners' Capital
B. Adjustment of Old Partners' Capital on the basis of New Partner's Capital

These cases are further explained with the help of illustrations.

Illustration 7

Anup and Swarup are partners sharing profits and losses equally. Their original capitals were Rs.20,000 and Rs.15,000 respectively. They admit Chand as their new partner with 1/5 share in profits. The revaluation of assets and liabilities show a profit of Rs.8,000. Goodwill has been valued at Rs.15,000. Chand is required to bring proportionate capital. How much capital should Chand bring?

Solution:

Calculation of present capital of Anup and Swarup

Particulars	Anup	Swarup
Original Capital	20,000	15,000
Profit on Revaluation	4,000	4,000
Goodwill	7,500	7,500
Total	31,500	26,500

The total Capital of Anup and Swarup together Rs.58,000(31,500+26,500). This is their capital for 4/5 share in profits. Thus total firm's capital should be 58,000 x 5/4 = Rs.72,500. Therefore Chand should bring Rs.14,500(1/5 of Rs.72,500) as his capital.

In case it is desired that capitals of the partners should be in their profit sharing ratio, the capital of Anup and Swarup may also be adjusted without changing the total capital of the firm. So according to this capitals of Anup and Swarup should br Rs.29,000 each. This means Swaupshoud bring Rs.25,00 and Anup should be paid Rs.25,00.

Illustration 8

Sahil and Prashant are partners in a firm sharing profits and losses in the ratio of 2:3. Sahil's and Rahul's capitals are 25,000 and 40,000 respectively. They admitted Rahul as new partner. The new profit sharing ratio is 2:2:1. Rohan is required to bring Rs. 20,000 as his capital. The profit on revaluation of assets and liabilities is Rs.5,000. It is agreed that capitals of partners should be in the new profit sharing ratio. Any excess or deficit amount should be transferred to their current accounts. Pass necessary Journal entries.

Solution:

Calculation of present capital of Sahil and Prashant

Particulars	Sahil	Prashant
Original Capital	35,000	40,000
Profit on Revaluation	2,000	3,000
Total	37,000	43,000
Capital Should be	40,000	40,000
Excess or deficit	-3,000	+3,000

Journal

Date	Particulars	Dr.	Cr.
	Sahil's Current A/c Dr.	3,000	
	To Sahil's Capital A/c		3,000
	(for deficit in capital transferred to current account)		
	Prashant's Capital A/c Dr.	3,000	
	To Prashant's Current A/c		3,000
	(for excess capital transferred to current account)		

Knowledge Assessment - III

Fill in the Blanks:

1. The increase in the value of assets or decrease in the value of liabilities will be credited to _______________account.
2. Any accumulated profit or reserve appearing in the balance sheet at the time of admission of a new partner is ______________ in the existing partner's capital account in existing profit sharing ratio.
3. Sometime, at the time of admission, the partners' agreed that their capitalsare adjusted to the ____________ to their profit sharing ratio.
4. Revaluation account is ________________ for the decrease in the value of assets or increase in the value of liabilities.
5. _____________________ Account will be opened when the assets and liabilities are revalued, revised values are not to be shown in the books of accounts.
6. When a new partner is admitted, the existing assets and liabilities are to be______________.
7. In case it is desired that capitals of the partners should be in their profit sharing ratio, the capital of Old partners may also be adjusted without changing the _______________of the firm.
8. _______________ is the another name for Revaluation Account.

Answers

1. revaluation, 2. credited, 3. proportionate, 4. Debited, 5. Memorandum Profit and Loss Adjustment, 6. revalued, 7. total capital, 8. Profit and Loss Adjustment

KEYWORDS

1. **Sacrificing ratio:** It is the ratio in which existing partners lose on admission of a new partner.
2. **Revaluation account/ P&L Adjustment account:** This account records any increase or decrease in the values of assets and liabilities as agreed by all partners of the firm on reconstitution of partnership firm.
3. **Memorandum revaluation account:** It is similar to revaluation account except that it is only a memorandum record of increase or decrease in the value of assets and liabilities on reconstitution of partnership firm. The assets and liabilities continue to appear at their old values in the Balance Sheet of the firm.

SUMMARY

- There are variousmatters related to goodwill, revaluation of assets and liabilities, reservesand other accumulated profits and losses and the capitals of the old partners (if agreed) which need adjustments in the books of firm at the time of admission of a new partner.
- The problem of determining the newprofit sharing ratio arises when new partner is admitted in the business. Given the new partner's share inprofits and the ratio, in which he acquires it from the old partners, the newshare of each old partner shall be worked out by deducting his share of sacrificefrom his old share in profits. The ratio in which the old partners have agreedto sacrifice their shares in profit in favour of the new partner is called thesacrificing ratio. It is usually same as the old profit sharing ratio. In some cases, based on the agreement it can be different also.
- The amount that the new partnerpays for goodwill is called goodwill premium. There are various ways for the treatment of goodwill atthe time of admission of a partner. The amount of premium brought in by thenew partner is shared by old partners in the ratio of sacrifice. In case the newpartner fails to bring his share of premium for goodwill in cash than thecapital account of the new partner is debited for his share of premium ofgoodwill and the old partners’ capital accounts are credited in their sacrificingratio.
- At thetime of admission of a partner, the assets and liabilities are revalued or someasset or liability is found unrecorded, necessary adjustments are made throughthe Revaluation Account. Any gain or loss arising from such exercise shall bedistributed among the old partner's in their old profit sharing ratio.
- If, at the time ofadmission of a partner, any reserve and accumulated profits or losses exist inbooks of the firm, these should be transferred to old partner's capital/currentaccounts in their old profit sharing ratio.
- If partnersdecided that their capital should be proportionate to their new profit sharing ratio, then the new partner's capital is used as a base for determining thenew capitals of the old partners and necessary adjustment made throughcash or by transfer to partner's current accounts. Other basis also may beavailable for determining capitals of the partners after admission of the newpartner like sharing the total capital to be in the firm immediately after admission of the new partner.

EXERCISE QUESTIONS:

Short Answer Questions

1. Explain the meaning of sacrificing ratio.
2. Identify the matters that need adjustments on the admission of a new partner.
3. Why partners determine new profit sharing ratio even for old partnerswhen a new partner is admitted?

4. If some goodwill already appears in books and the new partner brings inhis/her share of goodwill in cash, how old partners deal with existing amount ofgoodwill?
5. Explain the accounting treatment of goodwill when at the time of admission, the new partner cannot bring his share of goodwill in cash.

Long Answer Questions:

1. What is meant by admission of a Partner? What is the purpose of admission of a Partner?
2. Explain the accounting treatment of Goodwill at the time of admission of a Partner.
3. Why assets and liabilities are revalued on admission of a partner? Give imaginary entries covering such revaluation.
4. If there is a change in the profit sharing ratio of the existing partners, is it necessary to revalue the assets and liabilities? Give reasons for your answer.
5. Distinguish between Revaluation account and Memorandum Revaluation Account.

Numerical Questions

1. Rajat and Saleem are partners sharing profits and losses in the ratio of 7:3. Rajat surrenders 2/10th from his share and Saleem surrenders 1/10th from his share in favor of Kareena, a new partner. Calculate new profitsharing ratio and sacrificing ratio**.**

   (**Answer:** New Profit Sharing ratio 5:2:3, Sacrificing ratio= 2:1)

2. Abhishek and Aakash are partners in a business sharing profit and losses in the ratio of 3:7. They admit Aditya as a partner. Abhishek sacrificed 1/3 of his share and Aakashsacrified 1/7 of his share in favour of Aditya. Calculate the new profit sharing ratio.

   (**Answer:** New ratio 1:3:1)

3. Rahul and Nanda are partners in a firm sharing profits and losses in the ratio of 5:3. Sahil is admitted in the firm for 1/5 share of profits. He is to bring in Rs. 20,000 as capital and Rs. 4,000 as his share of goodwill. Give the necessary journal entries, (a) When the amount of goodwill is retained in the business. (b) When the amount of goodwill is fully withdrawn. (c) When 50% of the amount of goodwill is fully withdrawn.

4. The following is the Balance Sheet of Ayush and Baldev as on 31st December, 2014, who share profits and losses in the ratio of 3:2.

Balance Sheet
as on December31, 2014

Liabilities	Amount	Assets	Amount
Sundry Creditors	40,000	Cash at Bank	25,000
Capital accounts:		Sundry Debtors	9,000
Ayush	30,000	Stock	20,000

Baldev	10,000	Furniture	6,000
		Premises	20,000
	80,000		80,000

They decided to admit Krishan into partnership on the following terms:

a) Goodwill of Rs.30,000 to be created.
b) Depriciate furniture by 10%
c) Stock has to be valued at rs.18,000
d) Provision for doubtful debts at 10% be created on Sundry debtors.
e) Premises have to be revalued higher by 255
f) Krishan shall bring rs.10,000 for ¼ share in profits.

Prepare revaluation account, Partners' capital accounts and Balance Sheet after admission of Krishan.

*(**Answer:** Revaluation profit Rs.1,500, Balance Sheet total Rs.1,21,500)*

5. Anmol and Kushal are partners sharing profits and losses equally. The position of their firm as on 31st December, 2014 is as follows:

Balance Sheet
as on December 31, 2014

Liabilities	Amount	Assets	Amount
Sundry Creditors	15,000	Machinery	50,000
Capital accounts:		Sundry Debtors	10,000
Anmol	35,000	Stock	15,000
Kushal	35,000	Bills Receivable	5,000
		Cash at Bank	5,000
	80,000		85,000

They admit Shashwat as an equal partner on 1.01.2015. Goodwill is valued at Rs.30,000. Stock to be valued at Rs.25,000; Machinery at Rs.60,000. Shashwat is to bring Rs.15,000 as his capital and the necessary cash towards his share of goodwill. Goodwill account will not remain in the books.

You are required to prepare Revaluation account, Partners' capital accounts.

*(**Answer:** Revaluation Profit Rs.20,000, Closing bbalances of capital accounts Anmol: Rs. 45,000, KushalRs. 45,000 and ShashwatRs. 15,000)*

6. Anil and Bimal are partners in a firm sharing profits and losses in the ratio 3:1. They admit Karan for a ¼ share on 31st March 2014 when their Balance Sheet was as follows:

Liabilities	Amount	Assets	Amount
Employees Provident Fund	17,000	Stock	30,000
Workmen's Compensation Fund	6,000	Sundry Debtors 50,000	

Investment Fluctuation Reserve	4,100	Less Provision For doubtful debts 2,000	48,000
Capital accounts:		Investments	7,000
Anil	54,000	Cash	61,00
Bimal	35,000	Goodwill	40,000
	1,16,100		1,16,100

The following adjustments were agreed upon:

(a) Karan brings in `16,000 as goodwill and proportionate capital.

(b) Bad debts amounted to `3,000.

(c) Market value of investment is `4,500.

(d) Liability on account of workmen's compensation reserve amounted to `2,000.

Prepare Revaluation A/c and Partner's Capital A/cs.

*(**Answer:** Loss on Revaluation: Rs. 1,000; Capital account balances: Anil:Rs.39,450Bimal: Rs.30,150 Karan: Rs.23,200.)*

7. Gaurav and Gagan sharing profits in the ratio of 3:2 respectively. Their Balance Sheet as on 31st December, 2014 is as follows:

Balance Sheet
as on December 31, 2014

Liabilities		Amount	Assets	Amount
Sundry Creditors		25,000	Cash at Bank	5,000
General Reserve		50,000	Debtors	40,000
Capital accounts:			Stock	1,00,000
Gaurav	1,80,000		Furniture	20,000
Gagan	80,000	2,60,000	Land and buildings	5,000
				1,70,000
		3,35,000		3,35,000

They admit Gopal into partnership on 1st January, 2015 on the following terms:

(i) That Gopal pays Rs.1,00,000 as his capital for one-fifth share in the future profits.

(ii) That a goodwill account be raised in the books of the new firm at its value of Rs.1,00,000.

(iii) That stock and furniture be reduced by 10% and a provision for doubtful debts be created at 5% on debtors.

(iv) That the value of land and buildings be appreciated by 20%.

(v) That the capital accounts of all partners be readjusted on the basis of their profit sharing arrangement through partners' current accounts.

Prepare Revaluation Account and Balance Sheet.

*(**Answer:** Revaluation Profit rs.20,000; Balance Sheet total Rs.5,67,000)*

UNIT 3: RECONSTITUTION OF PARTNERSHIP FIRMS - II

<table>
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<tr><td rowspan="9">Location:

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<tr><td>Learning Outcome</td><td>Knowledge Evaluation</td><td>Performance Evaluation</td><td>Teaching and Training Method</td></tr>
<tr><td>1.Conditions under which partner can retire from the firm</td><td>1.Explain the different conditions of retirement of a partner</td><td>1.Elucidate the reasons of retirement of a partner</td><td>Interactive Lecture: Discussion as to the conditions of retirement of a partner</td></tr>
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<tr><td>3.Payment to retiring partner</td><td>1.State thedifferent ways of treating the amount due to the outgoing partner:</td><td>1. Analyse the mode of settling the final amount due to retiring partner</td><td>Interactive Lecture: Explain the ways in which amount due to retiring partner will be paid.</td></tr>
<tr><td colspan="4">SESSION 2: DEATH OF A PARTNER</td></tr>
<tr><td>1. Accounting adjustments required in case of death of a partner</td><td>1. Explain the procedure of preparing final Account after death of a partner.</td><td>1.Elucidate the preparation of final accounts of a firm after death of a partner</td><td>Interactive Lecture: Discussion as to accounting adjustments and preparation of final accounts of firm after death of a partner</td></tr>
<tr><td colspan="4">SESSION 3: AMALGAMATION OF PARTNERSHIP FIRMS</td></tr>
<tr><td>1. Journal entries in case of Amalgamation of Partnership Firms</td><td>1. State the journal entries for closing the books of accounts at the time of amalgamation of firms and opening accounts in the books of new firm.</td><td>1. Pass journal entries for closing books of accounts of amalgamated firms and opening accounts in the new firm.</td><td>Interactive Lecture: Discussion of journal entriesfor amalgamation of partnership firms.</td></tr>
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RECONSTITUTION OF PARTNERSHIP FIRMS- II

(Retirement, Death and Amalgamation)

Learning Objectives

After studying this unit, the students will be able to:

1. State the circumstances under which a partner may retire from the firm,
2. calculate new profit sharing ratio and gaining ratio,
3. make adjustments relating to goodwill, accumulated reserves and undistributed profits at the time of retirement/death of a partner,
4. prepare the revaluation account relating to retirement/death of a partner,
5. illustrate the various methods of settling the claim of retiring partner and the related accounting treatment,
6. ascertain profit up to the date of death of a partner,
7. Understand the concept of Amalgamation of Partnership Firms,
8. Pass necessary journal entries in the books of amalgamating / old firms and also in the books of amalgmated / new firm, and
9. explain the meaning of certain keywords.

SESSION 1: RETIREMENT OF A PARTNER

Retirement of a partner

A partner(s) may retire from the firm due to various reasons like old age, better opportunity, ill health, conflict between the partners and so on. According to section 32(1) of the Partnership Act every partner has the right to retire with the consent of all other partners and in the case of partnership at will, by giving notice to that effect to all the other partners.

Asper section 36(1) of the Partnership Act, an outgoing partner may carry on business competing with that of the firm and he may advertise such business, but without using the firm name or representing himself as carrying on the business of the firm and soliciting the customers who were dealing with the firm before he ceased to be a partner.

A retiring partner will not be liable for liabilities incurred by the firm after his/her retirement. However, he/she must give a public notice to that effect. Such a public notice is not necessary in case partner is not actively participating in the activities of the business i.e. in case of sleeping or dormant partner.

The retirement of partner can take place on any of the following grounds:

- With the consent of all the partners.
- In accordance with the partnership agreement which has already been signed.
- By giving the written notice to all other partners, if the partnership is at will.

Adjustments required in case of Retirement of a Partner

On retirement of a partner, the partnership firm is reconstituted with a new agreement and the following adjustments become necessary:

- Calculation of New Profit Sharing Ratio
- Treatment of Goodwill
- Revaluation of Assets And Liabilities of A Firm
- Distribution of Accumulated Profits And Reserves
- Payment to Retiring Partner

Calculation of New Profit Sharing Ratio

When a partner retires from the firm, his/her share in the firm is given to the remaining partners. Afterretirement of partner, if the new profit sharing ratio is not given, then old partners will continue to share in the old ratio. The share of the retiring partner will be shared by old partners in their old ratio. The ratio in which they share retiring partner's share is termed as gaining ratio. Thus, gaining ratio is calculated by deducting old ratio from new ratio i.e. Gaining ratio = New profit sharing ratio - Old profit sharing ratio

Sometimes continuing partners may agree to share the retiring partner share in an agreed ratio.

Illustration 1

Anil, Basu and Suraj were partners in a firm sharing profits and losses in the ratio of 3:2:1. Suraj decided to retire from the firm. Find the new ratio of Anil and Basu in the following situations when:

a) ratio is not given
b) Suraj's share is taken by Anil and basu in the ratio of 1 : 2
c) Basu take over the share of Suraj

Solution:

a) New profit sharing ratio of Anil and Basu is 3 : 2

b)Suraj's Share = 1/6
Anil gets = 1/3 of 1/6 = 1/3 × 1/6 = 1/18
Anil's new share = 3/6 + 1/18 = 10/18 or 5/9
Basu gets = 2/3 of 1/6 = 2/3 × 1/6 = 2/18
Basu's new share = 2/6 + 2/18 = 8/18 or 4/9
New profit sharing ratio of Anil and Basu is 5 : 4.

c)Basu takes over Suraj's share fully.
Suraj's share = 1/6
Basu gets = 1/6

Basu's new share = 2/6 + 1/6 = 3/6 or 1/2
New profit sharing ratio of Anil and Basu is 3 : 3 or 1:1
Only Basu gains.

Treatment of Goodwill:

Goodwill earned by the firm is the result of efforts of all partners including the retiring partner Therefore retiring partner needs to be compensated for his/her share of goodwill.
Treatment of goodwill is explained under two different situations:

- ***When Goodwill already appears in the books of the firm.***
- ***When Goodwill does not appear in the books of the firm.***

When Goodwill already appears in the books

If at the time of retirement of a partner, goodwill already appears in the Balance Sheet of the firm, then it can be treated in the following ways:

- If goodwill appears at proper value in the books of firm, then no adjustment is required in case of retirement of any partner.
- If goodwill appears at less than the actual value of the goodwill, then the goodwill account is debited with the difference amount and all partners' capital accounts are credited in their profit sharing ratio including the retiring partner.
- If goodwill appears at higher than the actual value of the goodwill in the books, then the excess goodwill needs to be written off by debiting all partners' capital accounts in their profit sharing ratio including the retiring partner and crediting goodwill account with the difference amount.

Illustration 2

Vikas, Kamal and Neeraj are partners in a firm sharing profits and losses in the ratio of 2:2:1. Neeraj retires and on the date of retirement, the goodwill is valued at Rs.20,000. Pass necessary journal entries in the following cases:

a) When goodwill is appearing in the books at Rs. 10,000.
b) When goodwill is appearing in the books at Rs. 25,000.

Solution:

Journal

Date	Particulars	Dr.	Cr.
a)	Goodwill A/c Dr.	10,000	
	To Vikas's Capital A/c		4,000
	To Kamal's Capital A/c		4,000
	To Neeraj's Capital A/c		2,000
	(for adjustment of goodwill on retirement of Neeraj)		
b)	Vikas's Capital A/c Dr.	2,000	
	Kamal's Capital A/c Dr.	2,000	
	Neeraj's Capital A/c Dr.	1,000	
	To Goodwill A/c		5,000
	(for excess value of goodwill written off on retirement of Neeraj)		

When Goodwill does not appear in the books of the firm

There are four cases for treatment of goodwill in this situation and these are shown in the figure:

Goodwill raised at full value & retained in the books of the firm

- In this case, goodwill account will be debited and all partners' capital accounts including retiring partner's capital account are credited in old profit sharing ratio.

Goodwill raised at full value and written off immediately

- In this situation, firstly goodwill account will be debited and all partners' accounts including retiring partner are credited in old profit sharing ratio.
- Secondly, goodwill written off by debiting remaining partners' capital accounts in their new profit sharing ratio and crediting goodwill account with its full value

Goodwill raised to the extent of retiring partner's share and written off

- In this the goodwill account is raised only to the extent of retired partner’s share by debiting goodwill account with the proportionate amount and credited only to the retired partner’s capital account.
- Thereafter, the remaining partners capital accounts are debited in their gaining ratio and goodwill account credited to write it off.

No Goodwill raised in the books of the firm

- If partners' decide that no goodwill account will be raised in the books, then retiring partner’s capital account is credited with his/her share of goodwill and remaining partner’s capital accounts are debited in their gaining ratio.

Illustration 3

Anu, Bimal and Jatin are partners with a profit sharing ratio of 4:3:2. Bimal retires and the goodwill is valued at Rs.21,600. Goodwill is yet to be accounted in the books of the firm. Anu and Jatin decided to share future profits in the ratio of 3:2. Necessary entries to be recorded under the following circumstances:

a) When goodwill account is raised but written off;
b) When only Bimal's goodwill account is raised and written off and
c) When only Bimal's share of goodwill is adjusted through the Capital Account of Anu and Jatin.

Solution:

Date	Particulars	Dr.	Cr.
a) (i)	Goodwill A/c Dr.	21,600	
	To Anu's Capital A/c		96,00
	To Bimal's Capital A/c		72,00
	To Jatin's Capital A/c		48,00
	(for goodwill raised at full value)		
(ii)	Anu's Capital A/c Dr.	12,960	
	Jatin's Capital A/c Dr.	8,640	
	To Goodwill A/c		
	(for goodwill written off)		
b) (i)	Goodwill A/c Dr.	7,200	
	To Bimal's Capital A/c		7,200
	(for B's share of goodwill raised)		
	Anu's Capital A/c Dr.	3,360	
(ii)	Jatin's Capital A/c Dr.	3,840	
	To Goodwill A/c		7,200
	(for bimal's share of goodwill written off by Anu and Jatin in gaining ratio of 7:8))		
c)	Anu's Capital A/c Dr.	3,360	
	Jatin's Capital A/c Dr.	3,840	
	To Bimal's Capital A/c		7,200
	(forBimal's share of goodwill is adjusted through the Capital Account of Anu and Jatin.)		

Working Notes:

1. Bimal's share of goodwill = 21,600 x 3/9 = Rs.7,200
2. Calculation of gaining ratio:
   Anu's new share = 3/5
   Anu's old share = 4/9
   Anu's gain= 3/5 – 4/9 = 7/45
   Jatin's new share = 2/5
   Jatin's old share = 2/9
   Jatin's gain = 2/5 -2/9 = 8/45
   So Gaining ratio of Anu and Jatin = 7:8

Revaluation of Assets and Liabilities

On retirement, the partner has the right to share the profit or loss on the increase or decrease in value of assets and liabilities of the firm during the retirement period. To find out the profit or loss, a revaluation account is opened as in the case of admission of a partner. If there is an increase in the value of any asset then concerned asset account will be debited and revaluation account will be credited. In the same way, if there is decrease in the value of any asset then concerned asset will be credited and revaluation account will be debited. Similarly, if there is an increase in the value of liabilities, revaluation account is debited and concerned liability account is credited and vice versa.The profit or loss on revaluation is to be divided among all the partners including remaining and outgoing partners in their old profit sharing ratio.

After the revaluation, the assets and liabilities will appear in the balance sheet either at original value (book value) or at revised value. If assets and liabilities are to be recorded at unchanged value then a memorandum revaluation account as explained in the unit of Reconstitution of Partnership firm I will have to be prepared.

Illustration 4

Deepak, Lalit and Nimish are partners sharing profits and losses in the ratio of 3:1:1. Their Balance Sheet is as follows:

Balance Sheet
as on 31 December, 2014

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Sundry Creditors	20,000	Cash	10,000
Capital accounts:		Sundry Debtors	20,000
Deepak	40,000	Buildings	40,000
Lalit	20,000	Plant	25,000
Nimish	15,000		
	95,000		95,000

Nimish retires on this date. The following arrangement is agreed upon:

(i) The value of the firm's goodwill is Rs.20,000. Nimish's share is to be adjusted in the accounts of Deepak and Lalit.

(ii) The assets are revalued as follows:

Buildings Rs.45,000
Plant Rs.32,000

(iii) A provision for bad debts is to be created @10% of debtors.

(iv) Theamount due to Nimish is to be transferred to his loan account.

You are required to prepare the Profit & Loss Adjustment Account, Capital Accounts of the Partners and Balance Sheet of the new firm when:

(a) Assets and Liabilities have to be shown in the books at the revised values.
(b) Assets and Liabilities have to continue in the books at the old values.

Solution

(a) When assets are to be shown at new values:

P&L Adjustment Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Provision for bad debts	2,000	By Plant A/c	7,000
To Profit:		By Buildings A/c	5,000
Deepak Capital A/c	6,000		
Lalit Capital A/c	2,000		
Nimish Capital A/c	2,000		
	12,000		12,000

Partners' Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	**Deepak**	**Lalit**	**Nimish**	**Particulars**	**Deepak**	**Lalit**	**Nimish**
To Nimish's Capital A/c	3,000	1,000		By Balance b/d	40,000	20,000	15,000
To Nimish's Loan A/c			21,000	By P&L Adjustment A/c	6,000	2,000	2,000
To Balance c/d	43,000	21,000		By Deepak's Capital A/c			3,000
				By Lalit's Capital A/c			1,000
	46,000	22,000	21,000		46,000	22,000	21,000

Balance Sheet
as on 1st January, 2015

Liabilities	**Amount (Rs.)**	**Assets**		**Amount (Rs.)**
Sundry Creditors	20,000	Cash		10,000
Loan from Nimish	21,000	Sundry Debtors	20,000	
Capital accounts:		Less Provision	2,000	18,000
Deepak	43,000	Buildings		45,000
Lalit	21,000	Plant		32,000
	1,05,000			1,05,000

(b) When assets are to be shown at old values

Memorandum P&L Adjustment Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Provision for bad debts	2,000	By Plant A/c	7,000
To Profit:		By Buildings A/c	5,000
Deepak Capital A/c	6,000		
Lalit Capital A/c	2,000		
Nimish Capital A/c	2,000		
	12,000		12,000
To Reversal of entry (increase in the value of assets)	12,000	By Reversal of entry (decrease in the value of assets)	2,000
		By Deepak Capital A/c	7,500
		By Lalit Capital A/c	2,500
	12,000		12,000

Partners' Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	**Deepak**	**Lalit**	**Nimish**	**Particulars**	**Deepak**	**Lalit**	**Nimish**
To Nimish's Capital A/c	3,000	1,000		By Balance b/d	40,000	20,000	15,000
To Memorandum P&L Adjustment A/c	7,500	2,500		By Memorandum P&L Adjustment A/c	6,000	2,000	2,000
To Nimish's Loan A/c			21,000	By Deepak's Capital A/c			3,000
To Balance c/d	35,500	18,500		By Lalit's Capital A/c			1,000
	46,000	22,000	21,000		46,000	22,000	21,000

Balance Sheet
as on 1st January, 2015

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Sundry Creditors	20,000	Cash	10,000
Loan from Nimish	21,000	Sundry Debtors	20,000
Capital accounts:		Buildings	40,000
Deepak	35,500	Plant	25,000
Lalit	18,500		
	95,000		95,000

Distribution of Undistributed Profits and Losses

If some accumulated profits or losses in the forms of any reserve or credit balance of profit and loss account or debit balance of profit and loss etc. account appears in the books of the firm then on retirement of the partner all such amounts should be distributed among all the partners including outgoing and remaining partners in their oldprofit sharing ratio. Sometimes, only the share of outgoing partners is transferred to his/her capital account and balance is shown in the balance sheet. This can be done with the consent ofremaining partners.

Illustration 5

Amit, Rama and Chandar are partners in a firm sharing profits and losses in the ratio of 2:2:1. Chandar retires from the business. The General Reserve stands at Rs.10,000 on the date of Chandar's retirement. You are required to pass the necessary journal entry for the distribution of General Reserve if

a) The General Reserve is not allowed to be kept in the books.
b) The General Reserve is kept only at an amount remaining after giving Chandar his share.
c) The General Reserve is allowed to kept at the full value.

Solution:

Date	Particulars	Dr.	Cr.
a)	General Reserve A/c Dr.	10,000	
	To Amit's Capital A/c		4,000
	To Rama's Capital A/c		4,000
	To Chandar's Capital A/c		2,000
	(*for General Reserve distributed among the partners)*		
b)	General Reserve A/c Dr.	2,000	
	To Chandar's Capital A/c		2,000
	(for Chandar's share of General reserve credited to his account)		
c)	Amit's Capital A/c Dr.	1,000	
	Rama's Capital A/c Dr.	1,000	
	To Chandar's Capital A/c		2,000
	(for remaining partners' capital account adjusted for chandar's share of General reserve)		

Payment to Retiring Partner

The net amount due to retiring partner will be paid as per the terms of the agreement between the partners.Following are the different ways of treating the due amount to the outgoing partner:

A. ***If the due amount is paid off immediately:***

Retiring Partner's Capital A/c Dr.

To Bank A/c

B***. If the remaining partners purchase the share of retiring partner in some agreed ratio or in the profit sharing ratio:***

Retiring Partner's Capital A/c Dr.

To Remaining Partners' Capital A/c

C***. If remaining partners bring cash in the business and there after the retiring partner is paid off:***

When old partners bring cash:

Bank A/c Dr.

To Remaining Partners' Capital A/c

When outgoing partner is paid off:

Retiring Partner's Capital A/c Dr.

To Bank A/c

D. ***With mutual agreement the amount due to the outgoing partner may be transferred to a loan account to be paid in instalments with or without interest:***

When due amount is transferred to loan account:

Retiring Partner's Capital A/c Dr.

To Retiring Partner's Loan A/c

If interest has to be paid and due:

Interest A/c Dr.

To Retiring Partner's Loan A/c

Payment of the instalment:

Retiring Partner's Loan A/c Dr.

To Bank A/c

Note: The last two entries will be repeated till all instalments are paid.

Illustration 6

Rahul, Raj and Dev are partners sharing profit in the ratio of 3 : 2 : l. Their balance sheet as on December 31st 2014 is as under:

Balance Sheet
as on 31 December, 2014

Liabilities	**Amount (Rs.)**	**Assets**		**Amount (Rs.)**
Sundry Creditors	1,00,000	Buildings		1,60,000
Bills payable	32,000	Plant		1,50,000
General Reserve	18,000	Motor car		60,000
Capital accounts:		Stock		1,00,000
Rahul	1,60,000	SundryDebtors	73,000	
Raj	1,20,000	Less:Provisionfor	3,000	70,000

		Bad debts	
Dev	1,20,000	Cash at Bank	10,000
	5,50,000		5,50,000

Raj retires on that date on the following terms:

(a) The Goodwill of the firm is valued at Rs.90,000.

(b) Stock and Building to be appreciated by 10%.

(c) Plant is depreciated by 10%

(d) Provision for Bad debts is increased upto Rs.5,000.

(e) Raj's share of goodwill adjusted through remaining partners' capital account,

The amount due to Raj is paid out of the fund brought in by Rahul and Dev for that purpose in their new profit sharing ratio. Raj is paid full amount.

Prepare Revaluation Account and Partner's Capital account.

Solution

P&L Adjustment Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Provision for bad debts	2,000	By Stock A/c	10,000
To Plant	15,000	By Buildings A/c	16,000
To Profit:			
Rahul Capital A/c	4,500		
Raj Capital A/c	3,000		
Dev Capital A/c	1,500		
	26,000		26,000

Partners' Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	**Rahul**	**Raj**	**Dev**	**Particulars**	**Rahul**	**Raj**	**Dev**
To Raj's Capital A/c	22,500	7,500		By Balance b/d	1,60,000	1,20,000	1,20,000
To Bank		1,59,000		By P&L Adjustment A/c	4,500	3,000	1,500
				By General Reserve A/c	9,000	6,000	3,000
To Balance c/d	2,92,750		1,64,250	By Rahul's Capital A/c		22,500	
				By Dev's Capital A/c		7,500	
				By Bank	1,19,250		39,750
	2,92,750	1,59,000	1,64,250		2,92,750	1,59,000	1,64,250

Working Notes:

Raj's share of goodwill

90,000 × 2/6 = 30,000

Adjusted through the remaining partners capital account:

Rahul's Capital A/c	Dr.	22,500	
Dev's Capital A/c	Dr.	7,500	
To Raj's Capital A/c			30,000

(Raj's share of goodwill debited to remaining partners' capital A/c)

Illustration 7

The total amount due to the Retiring partner, Bhavyam is Rs. 1,20,000. It is to be paid in three equal annual instalments with interest @10% p.a. The first instalment is to be paid after the expiry of one year from the date of retirement. PrepareBhavyam's loan account.

Solution:

Bhavyam's Loan Account

Dr. **Cr.**

Date	**Particulars**	**Amount (Rs.)**	**Date**	**Particulars**	**Amount (Rs.)**
1st Year	To Bank (40,000 + 12,000)	52,000		By Bavyam's capital A/c	1,20,000
	To Balance c/d	80,000		By Interest	12,000
		1,32,000			1,32,000
2nd Year	To Bank (40,000 + 8,000)	48,000		By Balance b/d	80,000
	To Balance c/d	40,000		By Interest	8,000
		88,000			88,000
3rd Year	To Bank (40,000 + 8,000)	44,000		By Balance b/d	40,000
				By Interest	4,000
		44,000			44,000

Knowledge Assessment - I

State whether the following statements are True or False:

1. The retiring partner's capital account is debited with his/her share ofgoodwill and remaining partner's capital account is credited in theirgaining ratio.
2. The profit or loss on revaluation is to be divided among the remaining partners in their new profit sharing ratio.
3. Afterretirement of partner, if the new profit sharing ratio is not given, then old partners will continue to share in the old ratio. The share of the retiring partner will be shared by old partners in their old ratio.
4. Revaluation account is prepared to record the change in the value of assetsor liabilities.
5. The ratio in which retiring partner's share is distributed amongst continuing partners is known as gaining ratio.
6. When the remaining partners purchase the share of the retiring partner in specified ratio, then the new ratio is calculated by deducting the share purchased by them from their old share.
7. In case goodwill account is written off, the capital account of all partners is credited.
8. The retiring partner is entitled to his/her share of goodwill at the time of retirement because the goodwill is the result of past efforts of all partners including the retiring one.
9. The net amount due to retiring partner will be paid as per the terms of the agreement between the partners.
10. On retirement of a partner, when due amount to retiring partner is transferred to loan loan account then retiring partner's loan A/c will be credited.
11. With mutual agreement, the amount due to the outgoing partner may be transferred to a loan account to be paid in instalments.

Answers

1. False, 2. False, 3.True, 4.True, 5.True, 6.False, 7.False, 8.True, 9.True, 10. True, 11.True

SESSION 2: DEATH OF A PARTNEER

Death of aPartner

The problems arising on the death of a partner that requires some adjustments are similar to those arising on retirement. Retirement can be anticipated and planned. Thus, the date of retirement coincides with the date of closing of the firm's books of accounts.

According to section 35 of the Partnership Act, a partnership firm may not be dissolved by the death of a partner. The death may occur at any time during the course of trading period. In the event of death of a partner, the Legal Representatives of the Deceased Partner will be entitled to receive from the firm, the amount due on account of the following:

1. Capital Account of the deceased partner as per the last Balance Sheet of the firm.
2. Interest on capital, if any, to the date of death of the partner.
3. Share in the goodwill of the firm.
4. Share in the revaluation of assets and liabilities.

5. Share in the accumulated reserves.
6. Share in the undistributed profits.
7. Share in the profit of the firm from the last Balance Sheet to the date of his death.
8. Share in the Joint Life Policy.
9. Salary, if any, due to him till the date of his death.

Further, the amount due to the deceased partner is reduced by:

1. Drawings,
2. Interest on Drawings and
3. Undistributed losses, if any, should be transferred to the loan account in the name of his Executor's Account.

Then, the amount may be paid immediately or by instalments. If payment is made by instalments, it will carry interest @ 6% p.a.

Calculation of profit upto the date of death of a partner.

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death. Such profit is ascertained by any of the following methods:

(i) Time Basis

(ii) Turnover or Sales Basis

(i) Time Basis

In this case, it is assumed that profit has been earned uniformly throughout the year. Deceased partner share is ascertained out of the profit earned from the beginning of the accounting year till the date of death of a partner.

Illustration 8

Dakshay, Dev and Kapil are partners sharing profits in the ratio of 2:2:1. Kapil dies on 1st April 2014. The profit for the accounting year ending on 31st December, 2014 amount to Rs.2,40,000. Calculate the share of the deceased partner in profits of the firm.

Solution:

Profit of the year is Rs. 2,40,000

Profit from 1st January to 1st April, 2014 i.e. for 3 months= 2,40,000 x 3/12 = Rs.60,000

Kapil's share will be 60,000 x 1/5 = Rs. 12,000

(ii) Turnover or Sales Basis

In this method, we have to take into consideration the profit and the total sales of the last year. Thereafter the profit upto the date of death is estimated on the basis of the sale of the last year. Profit is assumed to be earned uniformly at the same rate.

Illustration 9

Akul, Sumit and Nakul are sharing profits in the ratio of 2:2:1. Nakul dies on March 31, 2014. Sales for the year 2014 amounts to Rs.6,00,000 out of which Rs.2,00,000 amounted between the period from January1, 2014 to March 31, 2014. The profit for the year amounted to Rs.60,000. Calculate the share of the deceased partner in profits of the firm.

Solution:

The profit upto the death on the basis of turnover:

$$60,000 \times \frac{2,00,000}{6,00,000} = 20,000$$

Nakul's share will be 20,000 x 1/5 = Rs. 4,000

Illustration 10

Mayank, Arnav and Sahil are partners in a firm sharing profits in the ratio 5 : 3 : 2. On 31st December 2014 their Balance Sheet was as under:

Balance Sheet
as on 31 December, 2014

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	52,000	Buildings	1,60,000
General Reserve	25,000	Plant	1,50,000
Capital accounts:		Stock	37,000
Mayank	1,20,000	Sundry Debtors	25,000
Arnav	1,05,000	Cash at Bank	40,000
Sahil	1,10,000		
	4,12,000		4,12,000

Mayank died on 1 July 2015. It was agreed between his executor and the remaining partners that:

(i) Goodwill to be valued at 2½ years purchase of the average profits of the last Four years, which were: 2011 Rs. 75,000; 2012 Rs.65,000; 2013 Rs.70,000 and 2014 Rs.80,000.

(ii) Building is valued at Rs.1,80,000; Plant at Rs.1,36,000 and Stock at Rs.48,000.

(iii) Profit for the year 2015be taken as having accrued at the same rate as that of the previous year.

(iv) Interest on capital is provided at 9% p.a.

(v) On 1 July 2015 his drawings account showed a balance of Rs.20,000.

(vi) Rs.37,025 are to be paid immediately to his executor and the balance is transferred to his Executors Loan Account.

Prepare Mayank's Capital Account and Mayank's Executor's Account as on 1stJuly 2015.

Solution:

Valuation of Goodwill:

Total Profit = Rs.75,000 + Rs.65,000 + Rs.70,000 + Rs.80,000= Rs.2,90,000

Average Profit = 2,90,000/4 = Rs.72,500

Hence, Goodwill at 2½ year's purchase = Rs.72,500 × 2½ = Rs.1,81,250

Mayank's share of goodwill = 1,81,250 × 5/10 = Rs.90,625

It is adjusted into the Capital Accounts of Arnav and Sahil in the gaining ratio of 3 : 2 i.e. Rs.54,375 and Rs.36250 respectively.

(ii) Share of Profit payable to Mayank [upto the date of death]

= Rs.80,000 × 6/12 × 5/10

= Rs.20,000

(iii) Mayank's Share of Reserve Fund = Rs.25,000 × 5/10

= Rs.12,500

(iv) Interest on Mayank's Capital = 1,20,000 × 9/100 × 6/12

= Rs.5,400

Revaluation Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Plant	14,000	By Stock A/c	11,000
To Profit:		By Buildings A/c	20,000
Mayank Capital A/c	8,500		
Arnav Capital A/c	5,100		
Sahil Capital A/c	3,400		
	31,000		31,000

Mayank's Capital Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Drawings	20,000	By Balance b/d	1,20,000
To Mayank's Executor A/c	2,37,025	By Reserve Fund	12,500
		By Arnav's capital A/c	54,375
		By Sahil's capital A/c	36,250
		By Revaluation	8,500
		By P&L suspense	20,000
		By Interest on capital	5,400
	2,57,025		2,57,025

Mayank's Executor Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Bank	37,025	By Mayank's Capital a/c	2,37,025
To Mayank's Executor Loan A/c	2,00,000		
	2,37,025		2,37,025

Knowledge Assessment - II

Fill in the blanks with appropriate words:

1. In the event of death of a partner, _______________of the Deceased Partner will be entitled to receive from the firm the amount due to Deceased partner.
2. The amount due to the deceased partner is reduced by amount of drawings, _______________ and share in undistributed losses of the firm.
3. Time basis and ____________ basis are the two methods for ascertainment of the profits of the deceased partner in case of death.
4. Under time method for ascertainment of profit in case of death of a partner, it is assumed that profit has been earned ___________ throughout the year.
5. Retirement can be anticipated and plannedbut _____________ cannot be.
6. In the event of death of a partner, the accumulated profits and losses are shared by partners in the _____________ ratio
7. According to section 35 of the Partnership Act, a partnership firm may not be ___________ by the death of a partner.

Answers

1.the Legal Representatives, 2. Interest on drawings, 3.turnover, 4. uniformly, 5. death, 6. old, 7. dissolved,

SESSION 3: AMALGAMATION OF PARTNERSHIP FIRMS

Amalgamation of Partnership Firms

Amalgamation of partnership firms means merger of two or more partnership firms with one another to form a new partnership firm. When two or more existing partnership firms,carrying on same type of business, come together end their separate entity and form a new firm it is called as amalgamation of partnership firms.

Journal Entries in the Books of Old Firms (Closing Entries):

i) For Revaluation of Assets and Liabilities: Assets and Liabilities of the old firms may be revalued at the time of amalgamation. There may be increase or decrease in the values of assets and liabilities which shows profit or loss. To record this profit or loss, a Profit & Loss Adjustment Account or Revaluation Account is to be opened. The net profit or loss on this account is to be transferred to Partner's Capital A/c in the old profit sharing ratio. For this purpose following journal entries are to be passed.

a) *For increase in the value of asset and decrease in the value of Liability*
Assets / Liabilities A/c Dr.
To Profit & Loss Adjustment A/c

b) *For decrease in the value of asset and increase in the value of liability*
Profit & Loss Adjustment A/c Dr.
To Assets / Liabilities A/c

c) *For closing the Profit & Loss Adjustment A/c and transferring profit.*
Profit & Loss Adjustment A/c Dr.
To Partners' Capital A/c
(If there is a loss, a reverse entry will be passed)

ii) For Creation of Goodwill : If there is no goodwill account in the books of the old firm and if it is to be created the following entry will be passed,
Goodwill A/c Dr.
To Partners' Capital Accounts
(Goodwill is to be transferred in the old profit sharing ratio)

iii) For closing Reserves and Profit Accounts: The balance on these accounts is to be transferred to Partiner's Capital Accounts in the old profit sharing ratio.
Reserves A/c Dr.
Profit & Loss A/c (Cr. Balance) Dr.
To Partners' Capital A/c
(If there is a loss, a reverse entry will be passed)

v) For closing Assets and Liabilities accounts which are not taken over by the New Firm:
Those assets and liabilities which are not taken over by the new firm will be either soldaway/ paid off by the old firm or transferred to Partners' Capital Accounts in the capital ratio. The profit or loss on such transaction will be transferred to P & L Adjustment A/c or directly to Partners' Capital Accounts in the old profit sharing ratio. For this purpose following journal entries are to be passed.

a) If an asset is sold away for cash
Cash / Bank A/c Dr.
To Particular Asset A/c

b) If an asset is taken over by the partner / partners
Partner/s Capital A/c Dr.
To Asset A/c

c) If a liability is paid off
Particular Liability A/c Dr.
To Cash / Bank A/c

d) If a liability is taken over by the partner/ partners
Particular Liability A/c Dr.
To Partner/s Capital A/c

vi) For closing Assets and Liabilities which are taken over by the New Firm : The accounts of assets and liabilities which are taken over by the new firm will be closed by transferring them to the New Firm A/c at agreed values.

a) For closing Assets
New Firm A/c Dr.
To Assets A/c

b) For closing Liabilities
Liabilities A/c Dr.
To New Firm A/c

vii) *For closing Partners' Capital Accounts:*
Partners' Capital Accounts of the old firm are to be closed with the net balance by transferring them to the New Firm A/c
Partner's Capital A/c Dr.
To New Firm A/c

Journal Entries in the Books of the New Firm (Opening Entries):

i) For Assets, Liabilities and Capitals of the Partners of the old firm taken over by the New Firm:
Assets A/c Dr. (at agreed values)
To Labilities A/c (at agreed values)
To Partner's Capital A/cs (at transferred balance)

ii) For Adjustment of Goodwill : The goodwill transferred from the old firm to the new firm may be maintained as it is or may be written off or may be reduced by the New Firm. If the goodwill is written off or reduced, the entry will be as follows :
All Partners' Capital A/csDr.
To Goodwill A/c

(All partner's capital A/c are debited in the new profit sharing ratio)

iii) For Adjustment of Capitals : If the capitals of the partners in the new firm are changed as per the new profit sharing ratio or as per the agreement, there is a need to pass journal entries for the adjustment of capitals.

a) For cash brought in for adjustment of shortage of capital

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

For cash paid for adjustment of excess capital

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

Illustration 11

Akul and Bharat, who were partners and Chandar and Dev who were partners, decided to amalgamate as on January 1, 2015 under the name ABCD Trading Company. Their Balance Sheets on December 31, 2014 were as follows:

Akul and Bharat Balance Sheet
as on 31 December, 2014

Liabilities	Amount	Assets	Amount
Sundry Creditors	20,000	Stock	30,000
Reserve	20,000	Sundry Debtors	12,000
Capital accounts:		Buildings	28,000
Akul	30,000	Investments	20,000
Bharat	20,000		
	90,000		90,000

Chandar and Dev Balance Sheet
as on 31 December, 2014

Liabilities	Amount	Assets	Amount
Sundry Creditors	30,000	Stock	58,000
Bank loan	18,000	Sundry Debtors	30,000
Capital accounts:		Goodwill	20,000
Cahndar	30,000		
Dev	30,000		
	1,08,000		1,08,000

Akul and Bharat shared profits in proportion to their capitals; while Chandar and Dev shared profits equally. The terms of amalgamation are:

(i) Akul, Bharat, Chandar and Dev to be partners in the new firm and to share profits and losses in the same ratio as their capitals in the new firm after all adjustments have been made.

(ii) The buildings owned by Akul and Bharat to be taken over by the new firm at a valuation of Rs. 36,000. However, the new firm does not take over their investments.

(iii) The Goodwill appearing in the Balance Sheet of Chandar and Dev was worthless.

(iv) After the above adjustments have been made,Chandar and Dev each to bring Rs. 7,000 as additional capital.

On the assumption that the above adjustments were duly completed on 1st January, 2014, show the necessary journal entries that are required to close the books of old firms and open the books of new firm and prepare its Balance Sheet.

Solution:

Books of Akul and Bharat

Date	Particulars	Dr.	Cr.
	Buildings A/c Dr.	8,000	
	To P&L Adjustment A/c		8,000
	(for Building revalued)		
	Reserve A/c Dr.	20,000	
	P&L Adjustment A/c Dr.	8,000	
	To Akul's Capital a/c		16,800
	To Bharat's Capital A/c		11,200
	(for profit on revaluation and reserve distributed)		
	ABCD Trading Company Dr.	78,000	
	To Buildings		36,000
	To Stock		30,000
	To sundry debtors		12,000
	(for assets taken over)		
	Sundry Creditors Dr.	20,000	
	To ABCD Trading Company		20,000
	(for creditors taken over)		
	Akul's Capital A/c Dr.	12,000	
	Bharat's Capital A/c Dr.	8,000	
	To Investments		20,000
	(for investments not taken over transferred to partners' capital accounts in the ratio of their capitals)		
	Akul's Capital A/c Dr.	34,800	
	Bharat's Capital A/c Dr.	23,200	
	To ABCD Trading Company		58,000
	(for capital account balances transferred)		

Books of Chandar and Dev

Date	Particulars	Dr.	Cr.
	P&L Adjustment A/c Dr.	20,000	
	To Goodwill		20,000
	(for Building revalued)		
	Chandar's Capital A/c Dr.	10,000	
	Dev'sCapital A/c Dr.	10,000	
	To P&L Adjustment A/c		20,000
	(for loss on revaluation distributed)		
	ABCD Trading Company Dr.	88,000	
	To Stock		58,000

	To Sundry Debtors		30,000
	(for assets taken over)		
	Bank Loan Dr.	18,000	
	Sundry Creditors Dr.	30,000	
	To ABCD Trading Company		48,000
	(for liabilities taken over)		
	Chandar's Capital A/c Dr.	20,000	
	Dev's Capital A/c Dr.	20,000	
	To ABCD Trading Company		40,000
	(for capital account balances transferred)		

Books of ABCD Trading Company

Date	Particulars	Dr.	Cr.
	Buildings Dr.	36,000	
	Stock Dr.	30,000	
	Sundry Debtors Dr.	12,000	
	To Sundry Creditors		20,000
	To Akul's Capital a/c		34,800
	To Bharat's Capital A/c		23,200
	(for business taken over from Akul and Bharat)		
	Stock Dr.	58,000	
	Sundry Debtors Dr.	30,000	
	To Sundry Creditors		30,000
	To Bank Loan		18,000
	To Chandar's Capital a/c		20,000
	To Dev's Capital A/c		20,000
	(for business taken over from Chandar and Dev)		
	Bank A/c Dr.	14,000	
	To Chandar's Capital a/c		7,000
	To Dev's Capital A/c		7,000
	(for additional capital brought in by Chandar and Dev)		

Balance Sheet
as on 1st January , 2015

Liabilities	Amount	Assets	Amount
Bank Loan	18,000	Bank	14,000
Sundry Creditors	50,000	Stock	88,000
Capital accounts:		Sundry Debtors	42,000
Akul	34,800	Buildings	36,000
Bharat	23,200		
Chandar	27,000		
Dev	27,000		
	1,80,000		1,80,000

Knowledge Assessment - III

State whether the following statements are True or False:

1. In the event of amalgamation, the goodwill of each firm is credited to the partners' capitals of the respective firm in their capital ratio.
2. The assets and liabilities not taken over by the new firm are transferred to Partner's Capital Accounts.
3. Theaccounts of assets and liabilities which are taken over by the new firm will be closed by transferring them to the New Firm A/c at agreed values
4. Partners' Capital accounts of the old firm are to be closed with the net balance by transferring them to the New Firm account.
5. If an asset is taken over by any partner, then Partner's Capital account is debited and asset account is credited.
6. The net profit or loss on P&L Adjustment account is tobe transferred to Partner's Capital A/c in the capital ratio
7. On amalgamation of partnership firms, the balance on Reserve account is to be transferred to Partners' Capital Accounts in the old profit sharing ratio.
8. The goodwill transferred from the old firm to the new firm may be maintained as it is or may be written off or may be reduced by the New Firm.

Answers

1. False, 2. True, 3.True, 4.True, 5.True, 6.False, 7.True, 8. True

1. **New Profit sharing ratio:** New profit sharing ratio is the ratio in which the remaining partner will share future profits after the retirement or death of any partner.
2. **Gaining ratio:** It is the ratio in which the continuing partners gain on retirement or death of a partner.
3. **Amalgamation of Firms:** It means merger of two or more partnership firms with one another to form a new partnership firm.

SUMMARY

- For treatment of goodwill in case of retirement and death of a partner, the basic rule is that gaining partner(s) compensate the sacrificing partner to the extent of their gain for the respective share of goodwill. If goodwill already appears in the books, it will be written off by debiting all partners' capital account in their old profit sharing ratio.
- At the time of retirement/death of a partner,there may be some assets which are not shown at their current values and there may be certain liabilities which have been shown at avalue different from the actual obligation to be met by the firm.Besides this, there may be unrecorded assets and liabilities which have to berecorded. For these purposes, a P&L Adjustment or Revaluation Account is prepared.
- The reserves or accumulated profits or losses belongto all the partners of a firm therefore these should be transferred to capital account of all partners.

- Retiring partner or deceased partner may be paid in lump sum or instalments with interest.

EXERCISE QUESTIONS:

Short Answer Questions

1. What is meant by retirement of a partner?
2. What do you mean by gaining ratio?
3. Explain the accounting treatment of goodwill on retirement of a partner.
4. Explain the various matters that need adjustments at the time of retirement of a partner.
5. Distinguish between sacrificing ratio and gaining ratio.
6. Name the methods of computing the share in profits in the event of death of a partner.
7. How can a partner retire from the firm?
8. Why is it necessary to distribute Reserves Accumulated, Profits and Losses at the time of retirement or death of a partner?

Long Answer Questions

1. Explain the modes of payment to a retiring partner.
2. How will you compute the amount payable to a deceased partner?
3. Explain the treatment of goodwill at the time of retirement or on the event of death of a partner?
4. How is the share of profit of a deceased partner calculated from the date of last balance sheet to the date of death?
5. State the journal entries that are to be passed in the event of amalgamation in the books of the firms to be amalgamated and new firm.

Numerical Questions

1. Aditya, Deepak and Mohit are partners sharing profits and losses in the ratio of 3:2:1. Deepak retires and remaining partners decide to take Deepak's share equally. Calculate the new ratio of Aditya and Mohit

   *(**Answer:** New ratio Aditya and Mohan 2:1)*

2. Anu, Bishu, and Lalit are partners sharing profits and losses in the ratio of 2 : 1 : 2 respectively. Lalit retires and Anu and Bishu decide to share the profits and losses equally in future. Calculate the gaining ratio.

   *(**Answer:**Gaining Ratio Anu and Bishu 1:3)*

3. Deepak, Himanshu and Jatin are partners sharing profit equally. Jatin retires and the goodwill of the firm is valued at Rs 1,08,000. No goodwill account appears in the books of the firm. Deepak and Himanshu share future profit in the ratio of 3 : 2. Make necessary journal entry for goodwill.

   *(**Answer:** Debit Deepak by 28,800 and Himanshu by 7,200, credit Jatin by 36,000)*

4. Parth, Ramesh and Mayank are partners in a firm .they shared profits and losses in the ratio of 3:2:1. On 1st January 2015, Ramesh retired and on that date balance Sheet of the firm was as under:

Balance Sheet
as on 1st January , 2015

Liabilities	Amount	Assets	Amount
Bills Payable	50,000	Land and Buildings	2,50,000
Sundry Creditors	1,60,000	Stock	1,80,000
Capital accounts:		Sundry Debtors	1,00,000
Parth	3,40,000	Plant and Machinery	3,00,000
Ramesh	2,20,000	Investments	50,000
Mayank	1,90,000	Bills Receivable	20,000
		Cash at Bank	60,000
	9,60,000		9,60,000

a) Parth and Mayank decided to share future profits and losses in the ratio of 5:3.
b) Goodwill of the firm was valued at two yesrs' purchase based on the average of last three years' profit. The profit of the last years were as under:

2014	Profit	Rs.2,48,000
2013	Loss	Rs.36,000
2012	Profit	Rs. 1,48,000

It was decided that Ramesh's share of goodwill be adjusted in the capital accounts of Parth and Mayank.
c) Stock and Land & buildings are to be depreciated by 10% and plant and machinery to be increased by 10%.
d) 5% is to be provided for doubtful debts on Sundry Debtors and provision is to be made for Rs.12,000 for outstanding legal expenses.
e) The amount due to Ramesh was transferred to his Loan account.

You are required to prepare P&L Adjustment Account, Partners' Capital accounts and Balance Sheet of the firm after the retirement of rajesh.

*(**Answer:** Revaluation loss Rs.30,000; Ramesh's loan Rs.2,90,000; Parth's capital Rs.2,95,000; Mayank's capital Rs.1,35,000; Balance Sheet Total Rs.9,42,000]*

5. The Balance Sheet of Akhil, Satyam and Lakshay who were sharing profits in the ratio of 5 : 3 : 2, is given below as on March 31, 2015.

Balance Sheet
as on 31st March , 2015

Liabilities	Amount	Assets	Amount
Reserve Fund	1,80,000	Land	4,00,000
Sundry Creditors	1,24,000	Buildings	3,80,000
Outstanding Expense	16,000	Stock	1,85,000
Capital accounts:		Sundry Debtors	1,72,000
Akhil	7,20,000	Plant and Machinery	4,65,000
Satyam	4,15,000	Furniture and fittings	77,000
Lakshay	3,45,000	Cash at Bank	1,21,000
	17,40,000		17,40,000

Satyam retires on the above date and the following adjustments are agreed upon hisretirement.

a) Stock was valued at Rs. 1,72,000.
b) Furniture and fittings were valued at Rs. 80,000.
c) An amount of Rs. 10,000 due from Mr. Deepak, a debtor, was doubtful and aprovision for the same was required.
d) Goodwill of the firm was valued at Rs. 2,00,000 but it was decided not to show goodwill in the books of accounts.
e) Satyam was paid Rs. 40,000 immediately on retirement and the balance wastransferred to his loan account.
f) Akhil and Lakshay were to share future profits in the ratio of 3:2.

Prepare Revaluation Account, Capital Account and Balance Sheet of the reconstituted firm.

*(**Answer:** Revaluation loss Rs.20,000; Satyam's loan Rs.4,83,000; Akhil's capital Rs.7,80,000; Lakshay's capital Rs.3,37,000; Balance Sheet Total Rs.9,42,000)*

6. Following is the Balance Sheet of Adarsh, Karan and Manish who are sharing profits in the ratio 2:1:2 as on 31st March 2015.

Balance Sheet
as on 31st March , 2015

Liabilities	Amount	Assets	Amount
Sundry Creditors	38,000	Building	2,40,000
Bills Payable	2,000	Stock	65,000
Capital accounts:		Sundry Debtors	30,000
Adarsh	1,44,000	Cash at bank	5,000
Karan	92,000	Profit and Loss Account	60,000
Manish	1,24,000		
	4,00,000		4,00,000

Adarsh died on 30th September 2015. He had withdrawn 44,000 from his capital on July 1, 2015.According to the partnership agreement, he was entitled to interest on capital @8% p.a. His share ofprofit till the date of death was to be calculated on the basis of the average profits of the last three years.Goodwill was to be calculated on the basis of three times the average profits of the last four years. Theprofits for the years ended 2012-13, 2013-14 and 2014-15 were Rs. 30,000, Rs. 70,000 and Rs. 80,000respectively.

Prepare Adarsh's account to be rendered to her executors

*(**Answer:** Amount transferred to Adarsh's executors account Rs.1,22,880)*

7. Anil, Bhuvan and Neeraj are partners in a firm sharing profits in proportion of 1/2, 1/6 and 1/3 respectively. The Balance Sheet as on April 1, 2014 was as follows:

Balance Sheet
as on 31st March , 2015

Liabilities	Amount	Assets	Amount
Sundry Creditors	18,000	Freehold Premises	40,000
Employee Provident Fund	12,000	Stock	22,000

Capital accounts:		Debtors 20,000	
Anil	30,000	Less: Provision for Doubtful debts 1,000	19,000
Bhuvan	30,000	Machinery	30,000
Neeraj	28,000	Furniture	12,000
	1,30,000		1,30,000

Neeraj retires from the business and the partners agree that:

(a) Machinery is to be depreciated by 10%.

(b) Provision for bad debts is to be increased to Rs.1,500.

(c) Furniture was taken over by Neeraj for Rs.14,000.

(d) Goodwill is valued at Rs.21,000 on Neeraj's retirement.

(e) The continuing partners' have decided to adjust their capitals in their new profit sharing ratio after retirement of Neeraj. Surplus or deficit if any, in their capital accounts will be adjusted through their current accounts.

Prepare Revaluation A/c and Partners' Capital A/c's.

*(**Answer:** Revaluation loss Rs.1,500; Neeraj's loan Rs.24,500; Anil's capital Rs.45,000; Bhuvan's capital Rs.15,000)*

8.The following were the Balance Sheets of two firms M/s L and M and M/s Q and R.

Balance Sheet
as on 31st December , 2014

Liabilities	L &M	Q & R	Assets	L &M	Q & R
Sundry Creditors	20,000	25,000	Premises	40,000	
Mr. L's loan	5,000		Stock	20,400	18,300
Capital accounts:			Sundry Debtors	15,000	20,000
L	40,000		Office Furniture	4,000	5,000
M	20,000		Investments		15,000
Q		24,000	Cash at Bank	5,600	6,700
R		16,000			
	85,000	65,000		85,000	65,000

The two firms decided to amalgamate their business as from 1st January, 2015 under the name LQR traders. For this purpose, it was agreed that Mrs.L's Loan should be repaid andthe Investment of M/s. Q&R be not taken over by the new firm.

Goodwill of L&M was fixed at Rs. 8000 and that of R & S at Rs. 10000. Premises wererevalued at Rs. 50000, but the stock of L&M was found overvalued by Rs. 4000. The stock of Q&R was undervalued by Rs. 2000. A reserve for bad debts was created at 5% of both firms.

The total capital of LQR Traders was to be 80000 and it was shared by the L, M, Q&R in their new profit sharing ratio which was 3 : 2 : 3 : 2 respectively.

Pass necessary journal entries to close the books of M/s L& M and M/s Q&R also passopening entries in the books of Bharat Traders. Prepare necessary accounts in the books of allthe firms.

*(**Answer:** Total of Balance Sheet Rs.1,46,950)*

UNIT 4 :DISSOLUTION OF PARTNERSHIP

Unit Code:	**UNIT TITLE: DISSOLUTION OF PARTNERSHIP**			
	Duration:			
Location: Classroom or Company's premises	**SESSION 1: INTRODUCTION TO DISSOLUTION**			
	Learning Outcome	**Knowledge Evaluation**	**Performance Evaluation**	**Teaching and Training Method**
	1.Difference between dissolution of partnership and dissolution of partnership firm	1.Explain the difference between dissolution of partnership and that of firm	1.Differentiate between liquidation of partnership and partnership firm	**Interactive Lecture:** Acquaint students with the difference between dissolution of partnership and dissolution of partnership firm
	2. Reasons for Dissolution of partnership	1.State the reasons which can result in dissolution of partnership	1.Elucidate the causes of liquidation of partnership	**Interactive Lecture:** Discuss the reasons which can dissolve a partnership
	3.Modes of dissolution of partnership firm	1. Elucidate the different modes of dissolution of partnership firm	1.Identify the situations when the court will intervene and when it will not for dissolution of firm	**Interactive Lecture:** Explain the ways in which dissolution of firm can take place
	SESSION 2: ACCOUNTING TREATMENT OF DISSOLUTION OF FIRM			
	1. Mode of settlement of accounts between partners	1. Express the methodology of settlement of accounts after dissolution	1. Analyse the mode of settling losses and deficiencies	**Interactive Lecture:** Explain the ways in which the losses and deficiencies will be settled
	2. Accounting entries in case of dissolution and preparation of RealisationAccount	1. State the journal entries for closing the books of accounts at the time of dissolution 2.Explain preparation of RealisationAccount	1. Pass journal entries for closing books of accounts. 2. Prepare RealisationAccount	**Interactive Lecture:** Discuss journal entries and preparation of RealisationAccount.

	SESSION 3: REALISATION ACCOUNTvs REVALUATION ACCOUNT AND TREATMENT OF INSOLVENCY OF PARTNER(S)			
	1. Difference between Realization and Revaluation Accounts	1.State the main points of difference between Realization and Revaluation Accounts	1.Analyse the difference between Realization and Revaluation Accounts	**Interactive Lecture:** Discussion how Realisation Account is different from Revaluation Account
	2. Treatment in case of insolvency of partner	1.Explain the procedure of treating the insolvency of partners	1.Analyse the treatment of losses as per Garner v Murray rule	**Interactive Lecture:** Discuss the method of dealing with losses in case of insolvency of partner(s)

UNIT 4 : DISSOLUTION OF PARTNERSHIP

Learning Objectives

After reading this unit, the students will be able to:

1. distinguish between dissolution of partnership and dissolution of partnership firm,
2. explain reasons of dissolution of partnership,
3. highlight the modes of dissolution wherein the court may or may not intervene,
4. explain the procedure of settlement of accounts,
5. describe the accounts to be prepared for completing liquidation process,
6. explain the journal entries to be passed for various transactions relating to dissolution,
7. differentiate between Revaluation Account and RealisationAccount,
8. explain the treatment of insolvency of partners and
9. explain the meaning of certain keywords

SESSION 1: INTRODUCTION TO DISSOLUTION

Partnership firms generally do not exist infinitely. Due to certain reasons like irreconcilable disagreement between partners, insolvency, expiry of a fixed period, breach of agreement, etc., the existence of partnership firm comes to an end. This process of ending partnership or business is termed as dissolution.

DIFFERENCE BETWEEN DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF PARTNERSHIP FIRM

Dissolution officially ends a business owner's future responsibility for repayment of debt, payment of taxes and other commitments.But, it is important to understand that dissolution does not necessarily bring a business to an end. It can also change the relation of the partners. Thus, dissolution can imply dissolution of firm or dissolution of partnership. The difference between both is given as follows:

Dissolution of Partnership usually results in change in relations of partners. For example, at the time of admission of C to partnership firm of A and B, the partnership between A and B stands dissolved and a new partnership between A, B and C comes into existence.

Dissolution of partnership firm causes closure of business and winding up of the affairs of the company permanently. The assets are sold off and liabilities repaid, any balance remaining is distributed amongst the partners.

The difference between the two can be shown in a tabular manner as follows:

S. No.	Dissolution Of Partnership	Dissolution Of Firm
1	Ends the old partnershipagreement and causes reconstruction of the firm due to admission, retirement and death of a partner.	Closes the business, disposes off the assets of the firm and liabilities are paid off and remaining amount is distributed amongst the partners.
2	Results in change in the exiting agreement between the partners	Results in liquidation of partnership between all the partners of the firm.
3	The firm usually carries on its business	The firm does not continue its business
4	Books of accounts need not necessarily be closed	Books of accounts have to be closed compulsory.
5	Dissolution of partnership does not mean the dissolution of firm.	Dissolution of firm means the dissolution of partnership also
6	It is voluntary, i.e. by mutual consent.	It can be voluntary as well as compulsory in nature
7	Assets and liabilities are revalued and new balance sheet is drawn	Assets are sold and liabilities are paid-off.

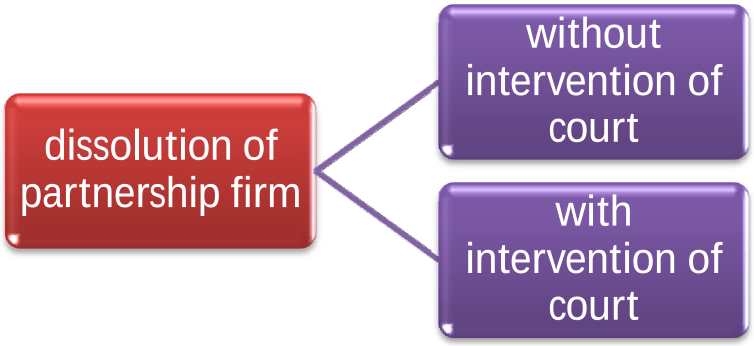
REASONS FOR DISSOLUTION OF PARTNERSHIP

Partnership can be dissolved because of the following reasons:

1. Change in profit-sharing ratio of the exiting partners
2. Admission of a new partner
3. Retirement of a partner
4. Expulsion of a partner
5. Death of a partner
6. Insolvency of a partner
7. Expiry of the period of partnership

MODES OF DISSOLUTION OF PARTNERSHIP FIRM

Dissolution of partnership firm can be with or without the intervention of the court.



DISSOLUTION WITHOUT THE INTERVENTION OF COURT:-

Partnership firm may be dissolved without the intervention of court in the following ways:

1. By Agreement

A partnership firm can be dissolved any time with the mutual consent of all the partners irrespective of whether the partnership is at will or for a fixed duration. A partnership can be dissolved in accordance with the terms of the Partnership Deed or otherwise.

2. Compulsory Dissolution:-The occurrence of any of the following can compulsorily dissolve partnership firm:

(i) Insolvency of all or all but one partners

(ii) Business becoming unlawful or illegitimate

3. Dissolution on the happening of contingent event

In absence of any contract to the contrary, a firm may be dissolved on the happening of any of the following contingent event

(i) On the expiry of fixed period or the term for which the firm was constituted

(ii) On achievement of specific task or completion of the project for which the firm was constituted

(iii) On the death of a partner

(iv) On the insolvency of a partner

(v) On the resignation of a partner

4. Dissolution by notice

In case of partnership at will, partnership firm can stand dissolved in the event of a written notice of dissolution given by a partner duly signed by him to the other partners. A notice once given cannot be withdrawn without the consent of other partners. In absence of specification of date in the notice, dissolution will be considered from the date of communication of notice to last of eh partners.

DISSOLUTION BY INTERVENTION OF COURT

In the following cases, on application or instance by a partner, the court may intervene and order for the dissolution of the firm:-

(i) Insanity of Partner

Lunacy of a partner, permanent or noti.e. partner having unsound mind does not itself dissolve the partnership but it will be a ground for dissolution at the instance of other partners.

(ii) Permanent Incapacity of Partner

In case a partner, other than the one suing, has become permanently incapable of discharging his duties and obligations then court may order for the dissolution of firm. Also, where a partner is imprisoned for a long period of time the court may dissolve the partnership.

(iii) Misconduct of Partner

If any partner other than partner suing is responsible for any loss to the firm, which amounts to misconduct and prejudicially affects the carrying on of business, then the court may order for the dissolution of the firm.

(iv) Constant breach of agreement by partner

The court may order for the dissolution of the firm if the partner, other than the suing partner, is found guilty of willfully or persistently committing breach of agreement regarding the conduct of business or the management of the affairs of the firm and it becomes impossible to continue the business with such partner.

(v) Transfer of Interest

When any of the partner other than the suing partner, transfers whole of his share to the third party permanently or has allowed his share to be discharged or sold by the court, the court may intervene.

(vi) Continuous Losses

The court may order for dissolution if the firm is continuously suffering losses and there is no more capital available for the future growth of the firm.

(vii) Just and Equitable

The court may order for dissolution on any other ground which court think is just, fair and equitable. e.g. loss of total confidence between the partners.

LIABILITY FOR ACTS OF PARTNERS AFTER DISSOLUTION

Despite dissolution, the partners continue to be liable to third parties for acts done even thereafter unless public notice of dissolution is given. But, a deceased or insolvent or dormant partner shall not be liable for acts done after he has ceased to be partner. A public notice in their case is not required.

RIGHTS OF PARTNERS TO HAVE BUSINESS WOUND UP AFTER DISSOLUTION

On the dissolution of a firm every partner or his representative is entitled, as against all the other partners or their representatives, to have the property of the firm applied in payment of the debts and liabilities of the firm, and to have the surplus distributed among the partners or their representatives according to their rights.

Knowledge Assessment - I

State whether the following statements are true or false:

1. Dissolution officially ends a business owner's future commitments to repay.

2. Dissolution of a partnership is different from dissolution of a firm.

3. Admission of partner results in dissolution of the partnership firm.

4. Dissolution of partnership results in dissolution of firm.

5. A firm is compulsorily dissolved when a partner decides to retire.

6. Lunacy of a partner leads to automatic dissolution of the firm.

7. In case of misconduct of partner, the court may order dissolution of firm at the instance of a partner.

8. Despite dissolution, an insolvent partner shall continue to be liable to third parties for acts done even thereafter unless public notice of dissolution is given.

Answers

1. True, 2. True, 3. False, 4. False, 5. False, 6. False, 7. True, 8. False

SESSION 2: ACCOUNTING TREATMENT OF DISSOLUTION OF FIRM

MODE OF SETTLEMENT OF ACCOUNTS BETWEEN PARTNERS

Once the partnership ceases to exist, it becomes important to wind up its operations by disposing off all assets by either takeover by the partners or by selling them off and settling all claims of creditors from the proceeds therefrom. Section 48 of The Partnership Act, 1932 states that,in settling the accounts of a firm after dissolution,subject to agreement by the partners, the following rules shallbe observed:

(a) Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits;

(b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order :

(i) in paying the debts of the firm to third parties;

(ii) in paying to each partner rateably what is due to him from the firm for advances as distinguished from capital;

(iii) in paying to each partner rateably what is due to him on account of capital; and

(iv) the residue, if any, shall be divided among the partners in the proportions in which they were entitled to share profits.

PAYMENT OF FIRM'S DEBTS AND OF SEPARATE DEBTS

In case of joint debts due from the firm, and also separate debts due from any partner, Section 49 states that the property of the firm shall be applied,firstly, in payment of the debts of the firm, and, if there is any surplus, then the share of each partner shall be applied in payment of his separate debts or paid to him. The separate property of any partner shall be applied first in the payment of his separate debts, and the surplus (if any) in payment of the debts of the firm.

TREATMENT OF GOODWILL AFTER DISSOLUTION

Also, Section 55 states that in settling the accounts of a firm after dissolution, the goodwill shall, subject to contract between the partners, be included in the assets, and it may be sold either separately or along with other property of the firm. In case of sale of goodwill, a partner may make an agreement withthe buyer that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits. He may carry on a business competing with that of the buyer and he may advertise such business, but, subject to agreement between him and the buyer, he may not

(a) use the firm-name,
(b) represent himself as carrying on the business of the firm, or
(c) solicit the custom of persons who were dealing with the firm before its dissolution

ACCOUNTS TO BE PREPARED IN CASE OF LIQUIDATION

When a company goes into liquidation, there are three main accounts which need to be prepared for accumulation of all figures of assets and liabilities of the firm and completion of the dissolution process. The following should be prepared:

1. Realisation Account
2. Partner's Capital Accounts
3. Bank Account or Cash Account

ACCOUNTING ENTRIES

As the first step to accounting for dissolution, all assets and liabilities accounts are closed and the respective balances transferred to Realisation Account. The journal entries to be passed are as follows:

i) For transfer of assets

Realisation Account Dr.

To Asset Account

Note: Each asset, except cash and bank, is credited with its book value individually and their respective provisions or reserves will also be transferred to RealisationAccount.Provision for doubtful debts, Investment fluctuation fund etc. are credited to Realization Account and ignored thereafter. These are internal provisions having no claim against the firm and therefore these amounts will merge into realization profit or loss and finally get transferred to Capital Accounts of partners.

For example, Joint Life Policy appears on assets side while its corresponding Joint Life Policy Reserve appears on the liabilities side of the Balance Sheet. Their accounting entries at the time of dissolution will be:

a) Realisation Account Dr.

To Joint Life Policy Account

b) Joint Life Policy Reserve Account Dr.

To RealisationAccount

ii) For Transfer of liabilities

Liability Account Dr.

To Realisation Account

Note: All liabilities, except partner's loan, are debited at their book value, individually.

iii) For transfer of reserves and accumulated, undistributed profits

General Reserve Dr.

P & L Account Dr.

To Partner's Capital Accounts

Note: Accumulated profits such as General Reserves, Credit Balance of Profit and Loss Account etc. are transferred to Partner's Capital Accounts in their profit sharing ratio.

iv) Forrealization of assets, whether recorded or unrecorded

CashAccount or Bank Account Dr

To Realisation Account

v) For paying off Liabilities

Realisation Account Dr.

To CashAccount or Bank Account

vi) For asset taken over by a partner, whether recorded or not

Partner's Capital Account Dr.

To Realisation Account

vii) For Liability taken up by the partner, whether recorded or not

Realisation Account Dr.

To Partner's Capital Account

viii) Unrecorded Liability settled by the firm

Realisation Account Dr.

To Cash Account or Bank Account

ix) unrecorded asset taken over by a creditor

Creditor's Account Dr.

To RealisationAccount

(For transfer of creditor to RealisationAccount)

RealisationAccount Dr.

To Bank Account

(For payment of creditor in excess of his liability over the cost of the unrecorded asset)

x) For payment of Realisation expense

Realisation Account Dr.

To Cash Account

xi) For paying off partner's loan

Partner's Loan Account Dr.

To Cash Account or Bank Account

xii) For profit on realization

RealisationAccount Dr.

To Partner's Capital Account

Note: The entry will be reversed in case of realization loss.

xiii) For cash brought in by partner on account of a 'debit balance' in his account

Cash Account or Bank Account Dr.

To Partner's Capital Account

Note: The above entry will be reversed in case of 'credit balance' in the partner's account.

ACCOUNTING ENTRIES IN CASE A PARTNER TAKES ON THE RESPONSIBILITY OF REALISATION

All partners by mutual consent may decide that one of them will be the incharge of the dissolution process. He will be responsible for the realization of all assets and payment of liabilities, for which he may be entitled to a pre-decided amount of remuneration. The partner may or may not agree to meet the realization expenses. The accounting entries in both the cases are as follows:

i) When partner in charge of realization has not to meet realization expenses

Besides the usual accounting entries, as discussed above, the following entries for remuneration etc. due to the partner 'incharge' of realization will be made:

1. For remuneration due:

Realisation Account Dr.

To Partner's Capital Account

2. For Realisation expenses incurred by the partner:

Realisation Account Dr.

To Partner's Capital Account

(ii) When partner in charge of realization has to meet realisation expenses.

In case the partner has agreed to bear all expenses on realization in consideration of the remuneration to be received by him on realization work, no entry will be required in the firm's books for realization expenses incurred by the partner incharge of realization. However, if in such a case the firm has paid the realisation expenses on behalf of the parner in-charge, the following entry will be passed in the firm's books:

Partner's Capital Account Dr.

To Bank/Cash Account

The accounts of the partners will be settled in the usual manner.

Note: It can also be possible that a firm follows fixed capital system, meaning thereby, that two accounts viz. Capital Account and Current Account for each partner are being maintained. In such a case, the transfer of accumulated profits, General reserve, net profit as shown in balance of Profit and Loss Account, etc. in addition to the realization loss, will be transferred to the current accounts of the partners in their profit sharing ratio. Also, payments made to a partner or payment by partner to third party will be passed through his respective Current

Account. Thereafter, the balances in the current accounts will be transferred to the Capital Accounts of the partners.

Knowledge Assessment – II

Choose the appropriate answer:

1. The order of utilization of the following in meeting losses including deficiencies of capital.
    a. Profit, capital and finally amount brought in by partners
    b. Amount brought in by partners, profit, capital
    c. Capital, profit and finally amount brought in by partners
    d. None of the above
2. The assets and amount brought by partner in lieu of deficiency of capital is used firstly to repay
    a. debts of the firm to third parties
    b. advances of partners,
    c. capital of partner
    d. distributed amongst partners in profit sharing ratio
3. The separate property of any partner shall be applied first in the payment of
    a. his separate debts
    b. debts of other partners
    c. the debts of the firm
    d. none of the above
4. Unrecorded liability paid at the time of dissolution should be debited to
    a. Realisation Account
    b. Revaluation Account
    c. Liability Account
    d. Partner's capital Account
5. Provision for doubtful debts appearing at the time of dissolution should be transferred to
    a. Debtors Account
    b. Realisation Account
    c. Cash Account
    d. None of the above
6. When realization expenses are borne by the partner, they are credited to
    a. Realisation Account
    b. Cash Account
    c. Profit & Loss Account
    d. Partner's Capital Account
7. At the time of dissolution, all assets of the firm are transferred to Realisation Account at
    a. Market value
    b. Realisable value
    c. Book value
    d. None of the above
8. On dissolution of the firm, Realisation Account is debited with:
    a. Cash received from sale of assets
    b. All assets to be realized
    c. All liabilities of the firm
    d. Assets taken over by any of the partners

Answers

1. a, 2. a, 3. a, 4. a, 5.b, 6.d, 7.c, 8.b

Illustration 1

Shanti and Satya were partners in a firm sharing profits in the ratio of 4 : l. On 31st March, 2015 their Balance Sheet was as follows :

Balance Sheet of Shanti and Satya as on 31stMarch, 2015

(Figures in Rs.)

Liabilities	Amount	Assets	Amount
Creditors	45,000	Bank	55,000
Workmen Compensation Fund	40,000	Debtors	60,000
Satya's Current Account	65,000	Stock	85,000
Capital's:		Furniture	1,00,000
- Shanti	2,00,000	Machinery	1,30,000
- Satya	1,00,000	Shanti' s Current Account	20,000
	450,000		450,000

On the above date the firm was dissolved :

(1) Shanti took over 40% of the stock at 10% less than its book value and the remaining stock was sold for Rs. 40,000. Furniture realized Rs. 80,000

(2) An unrecorded investment was sold for Rs. 20,000. Machinery was sold at a loss of Rs. 60,000.

(3) Debtors realized Rs. 55,000.

(4) There was an outstanding bill for repairs for which Rs. 19,000 were paid.

Prepare Realisation Account.

Solution

RealisationAccount

Dr. **Cr.**

Particulars	Amount (Rs.)	**Particulars**	Amount (Rs.)
To Debtors	60,000	By Creditors	45,000
To Stock	85,000	By Shanti's Current/ Capital Account	30,600
To furniture	1,00,000	By Bank Account	
To Machinery	1,30,000	- Stock 40,000	
To Bank Account		- Furniture 80,000	
- Outstanding bill 19,000		- Investment 20,000	

- Creditors 45,000	64,000	- Machinery 70,000	
		- Debtors 55,000	2,65,000
		By loss transferred to	
		- Shanti's Current /Capital Account	78,720
		- Satya's Current / Capital Account	19, 680
	4,39,000		**4,39,000**

Illustration 2

Ritu, Deepika and Vinny enter into a partnership contract with profit sharing ratio of 5:3:1. The Balance Sheet as on 31st March, 2015 is given as follows:

Balance Sheet

as on 31st March, 2015

(Figures in Rs.)

Liabilities	**Amount**	**Assets**	**Amount**
Bills Payable	40,000	Buildings	40,000
Loan from Bank	30,000	Plant and Machinery	40,000
Reserve Fund	9,000	Stock	19,000
Capital		Debtors 42,000	
- Ritu 44,000		Less: Provision for Bad Debt 2,000	40,000
- Deepika 36,000		Bank	40,000
- Vinny 20,000	1,00,000		
	1,79,000		1,79,000

Due to some problems, the partners decided to dissolve the firm. The assets realized as follows:

Stock – Rs.23,400, Debtors – 50%, Fixed Assets – 10% less than their book value

Bills Payable were settled for Rs.32,000. There was outstanding bill of repairs Rs.800, which was paid off. Realisation expenses of Rs.1,250 were also paid. Prepare Realization Account, Bank Account and Partners'Capital Account.

Solution

REALISATION ACCOUNT

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Building	40,000	By Bills Payable	40,000
To P & M	40,000	By Loan from Bank	30,000
To Stock	19,000	By Provision for bad debt	2,000
To Debtors	42,000	By Bank (Stock)	23,400
To Bank (Bills Payable)	32,000	By Bank (Debtors)	21,000
To Bank (Loan)	30,000	By Bank (Fixed Assets)	72,000
To Bank (outstanding bill-repairs)	800	By Partners' CapitalAccount	
To Bank (RealisationExpenses)	1,250	- Ritu 9,250	
		- Deepika 5,550	
		- Vinny 1,850	16,650
	2,05,050		2,05,050

BANK ACCOUNT

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Balance b/d	40,000	By Realisation (Bills Payable)	32,000
To Realisation (Stock)	23,400	By Realisation (Loan)	30,000
To Realisation (Debtors)	21,000	By Realisation (Expense)	1,250
To Realisation (Fixed Assets)	72,000	By Realisation (Repairs)	800
		By CapitalAccount	
		- Ritu39,750	
		- Deepika 33,450	
		- Vinny 19,150	92,350
	1,56,400		1,56,400

PARTNERS' CAPITAL ACCOUNT

Dr. **Cr.**

(Figures in Rs.)

Particulars	Ritu	Deepika	Vinny	Particulars	Ritu	Deepika	Vinny
To RealisationAccount (loss)	9,250	5,550	1,850	By Balance b/d	44,000	36,000	20,000
To Bank	39,750	33,450	19,150	By Reserve fund	5,000	3,000	1,000
	49,000	39,000	21,000		49,000	39,000	21,000

SESSION 3: REALISATION ACCOUNT Vs REVALUATION ACCOUNT AND TREATMENT OF INSOLVENCY OF PARTNER(S)

DIFFERENCE BETWEEN REALISATION ACCOUNT AND REVALUATION ACCOUNT

The revaluation account has been discussed in previous chapters. But, the students need to understand that the revaluation account and realization account are different from each other. Although, both are nominalaccounts, but the revaluation account is prepared to take into account the effects of fluctuations in asset and liabilitiesdue to reconstitution of partnership firm viz. admission, retirement or death of partners. Realization account is prepared at the time of dissolution of the firm to dispose of the assets and liabilities. The main points of difference are as follows:

Basis	Revaluation Account	RealisationAccount
Meaning	It records increase or decrease in the value of assets and liabilities	It records the book value and the realised value of assets and liabilities
Time of Preparation	It is prepared at the time ofreconstitution of firm, viz. admission, retirement or death of a partner	It is prepared at the time ofdissolution of the firm
Purpose	It is prepared to find out profit/loss on revaluation of assets and liabilities	It is prepared to find out profit/loss on realisation of assets and liabilities
Transfer of Profit & Loss	Profit/Loss is transferred only to old partners' capital accounts	Profit/Loss is transferred to all Partners' Capital Accounts

PREPARATION OF MEMORANDUM BALANCE SHEET

Sometimes, the information required for preparation of Balance Sheet is not complete. In such a situation, the preparation of a Memorandum Balance Sheet helps to ascertain the missing figures.

Illustration 3

Abhishek, Babita and Chandan started business on 1st April 2014 with capital of Rs.1,00,000, Rs.80,000 and Rs.60,000 respectively sharing profits and losses in the ratio of 4:3:3 for the year ended 31st March 2015. The firm suffered a loss of Rs.50,000. Each of the partner withdrew Rs.10,000 during the year and the firm was dissolved. The creditors of the firm stood at Rs.24,000 on that day and cash in hand was Rs.4,000. The assets realized Rs.3,00,000 and creators were paid Rs.23,500 in full settlement of that claim. Prepare Realization Account and show working.

Solution

REALISATION ACCOUNT

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Sundry Assets Account	1,80,000	By CreditorsAccount	24,000
To Cash Account	23,500	By Cash Account	3,00,000
To Capital Account			
- Abhishek48,200			
- Babita36,150			
- Chandan36,150	1,20,500		
	3,24,000		**3,24,000**

Working Notes:

1. **Statement showing calculation of capital as on 31st March 2015.**

(Figures in Rs.)

	Abhishek	Babita	Chandan
Capital (01.04.2014)	1,00,000	80,000	60,000
Less: Loss (50,000)	20,000	15,000	15,000
	80,000	**65,000**	**45,000**
Drawings	10,000	10,000	10,000
Capital as on 31st March 2015	**70,000**	**55,000**	**35,000**

2. MEMORANDUM BALANCE SHEET as on 31.03.2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital		Cash	40,000
- Abhishek 70,000		Sundry Assets (Balancing figure)	1,80,000
- Babita 55,000			
- Chandan 35,000	1,60,000		
Creditors	24,000		
	1,84,000		1,84,000

INSOLVENCY OF PARTNER(S)

Apart from amounts owed by third parties to the firm, a partner may also owe some money to the firm, which he needs to pay back. But, if he becomes insolvent, he may not be in a position to pay back the amount owed by him to the firm in full. The amount not paid by the partner is the loss to the firm, which is borne by the solvent partners on the basis of rules as decided in case of Garner vs. Murray:

1. The solvent partners should bring in their share of loss on realization in cash.
2. The loss on account of insolvency of partner should be borne by the solvent partners in the ratio of their capitals after bringing in cash such loss on realization, i.e. ratio of capital standing in Balance Sheet just before the date of dissolution of partnership firm

Note: the capital in this case will be ascertained after making all adjustments with respect to reserves, drawings, unrecorded assets/liabilities, etc. on the date of Balance Sheet, just before the date of dissolution. Also, a solvent partner having debit balance in his account just before the dissolution of partnership firm, is not required to bear the loss on account of insolvency of another partner.

In case all partners become insolvent, the loss on account of insolvency of partners will have to be borne by the creditors. The creditors may be transferred to the Realisation Account. The amount available may be paid to them through Realisation Account. Any balance remaining unpaid to them represents their sacrifice because of insolvency of all partners.

Knowledge Assessment – III

State which of the following statements is True or False:

1. Realisation account and revaluation account do not serve the same purpose.
2. Both realisation account and revaluation account are nominal accounts.
3. Revaluation account is prepared at the time of dissolution while realization account at the time of reconstitution of the firm.
4. Realisation account records the fluctuations in the assets and liabilities of the firm.
5. The profit on realization is transferred to solvent partner's capital accounts only.
6. Preparation of Memorandum Balance Sheet is compulsory in all cases.
7. Preparation of a Memorandum Balance Sheet helps to ascertain the missing figures in case of incomplete information.
8. The amount of loss to the firm on account of insolvency of a partner is borne by the solvent partners in the firm.
9. A solvent partner having debit balance in his account just before the dissolution of partnership firm, is not required to bear the loss on account of insolvency of another partner.
10. If all partners become insolvent, the creditors bear the losses of the firm.

Answers

1.True, 2. True, 3.False, 4.False, 5.False, 6.False, 7.True, 8.True, 9.True, 10. True

Illustration 4

Arya, Bishan, Gaurav and Vishal are partners in a partnership firm with equal profit sharing ratio. On 31st December, 2015, Vishal become insolvent. The following is the Balance Sheet of the firm as on date:

Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	50,000	Sundry Assets	2,50,000
General Reserve	50,000	Gaurav's Capital Account	50,000
Arya's Capital Account	1,50,000	Vishal's Capital Account	50,000
Bishan's Capital Account	1,00,000		
	3,50,000		3,50,000

The assets of the firm realisedRs. 2,00,000 and creditors were settled with full repayment. You have been asked to close the books of accounts as per Garner v Murray rule.

Solution

RealisationAccount

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Sundry Assets	2,50,000	By Sundry Creditors	50,000
To Bank (payment to creditors)	50,000	By Bank (assets realised)	2,00,000
		By Loss on Realisation	
		Arya's Capital Account 12,500	
		Bishan's Capital Account 12,500	
		Gaurav's Capital Account 12,500	
		Vishal's Capital Account 12,500	50,000
	3,00,000		3,00,000

Bank Account

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To RealisationAccount	2,00,000	By Arya's Capital Account	1,30,000
To Arya's Capital Account	12,500	By Bishan's Capital Account	92,050
To Bishan's Capital Account	12,500	By Sundry Creditors	50,000
To Gaurav's Capital Account	12,500		
To Vishal's Capital Account	37,500		
	2,75,000		2,75,000

Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	Arya	Bishan	Gaurav	Vishal	Particulars	Arya	Bishan	Gaurav	Vishal
To balance b/d	-	-	50,000	50,000	By balance b/d	1,50,000	1,00,000	--	--
To RealisationAccount	12,500	12,500	12,500	12,500	By General Reserve	12,500	12,500	12,500	12,500
To Vishal's Capital	29,550	20,450			By Bank	12,500	12,500	12,500	

Account					(Loss on Realisation)				
To Bank	1,32,950	92,050			By Arya's Capital Account				29,550
					By Bishan's Capital Account				20,450
					By Bank			37,500	
	1,75,000	1,25,000	62,500	62,500		1,75,000	1,25,000	62,500	62,500

Working Notes:

Vishal's deficiency will be borne by Arya and Bishan. Gaurav does not need to bear the deficiency due to the debit balance in his capital account. The ratio for division of losses is ascertained as under:

(Figures in Rs.)

	Arya	Bishan
Capital	1,50,000	1,00,000
Add: Reserve	12,500	12,500
Realisation loss brought in cash	12,500	12,500
	1,75,000	1,25,000
Less: Loss on Realisation	12,500	12,500
Real Capital (for sharing deficiency of Vishal)	1,62,500	1,12,500
Share of Vishal's Deficiency (Rs. 50,000)	29,550	20,450

Illustration 5

The following is the Balance Sheet of Charu, Dinesh and Ritika as on 31st March, 2015.

Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors	2,00,000	Cash	31,200
Loan	1,00,000	Stock	1,56,300
Capital Account		Debtors	47,200
Charu	80,000	Furniture	95,300
Dinesh	60,000	Profit & Loss Account	1,20,000
Ritika	10,000		
	4,50,000		4,50,000

All partners became insolvent and the firm was dissolved. Assets realized as follows:

Stock: Rs. 1,09,000, Furniture: Rs. 40,000, Debtors: Rs. 41,000.

Realisation expenses of Rs. 2,200 were incurred. Of all the three partners, only Charu's private estate showed a surplus of Rs. 6,000. You are required to close the books.

Solution

RealisationAccount

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Stock	1,56,300	By Cash (Assets)	1,90,000
To Debtors	47,200	By Charu's Capital Account	37,000
To Furniture	95,300	By Dinesh's Capital Account	37,000
To Cash (expenses)	2,200	By Ritika's Capital Account	37,000
	3,01,000		3,01,000

Cash Account

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To balance b/d	31,200	By RealisationAccount (expenses)	2,200
To RealisationAccount (assets)	1,90,000	By Loan	75,000
To Charu's Capital Account	6,000	By Creditors	1,50,000
	2,27,200		2,27,200

Loan Account

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Cash Account	75,000	By balance b/d	1,00,000
To Deficiency Account	25,000		
	1,00,000		1,00,000

Sundry Creditors

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Cash Account	1,50,000	By balance b/d	2,00,000
To Deficiency Account	50,000		
	2,00,000		2,00,000

Deficiency Account

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Dinesh's Capital Account	17,000	By Loan Account	25,000
To Ritika's Capital Account	67,000	By Creditors Account	50,000
		By Charu's Capital Account	9,000
	84,000		84,000

Capital Accounts

(Figures in Rs.)

Dr. **Cr.**

Particulars	Charu	Dinesh	Ritika	Particulars	Charu	Dinesh	Ritika
To RealisationAccount	37,000	37,000	37,000	By balance b/d	80,000	60,000	10,000
To Profit & Loss Account	40,000	40,000	40,000	By Cash	6,000	--	--
To Deficiency Account	9,000	--	--	By Deficiency Account	--	17,000	67,000
	86,000	77,000	77,000		86,000	77,000	77,000

Alternatively, creditors may be transferred to RealisationAccount and the books closed therefrom.

KEYWORDS

1. **Dissolution:** The process of ending a business owner's future responsibility for repayment of debt, payment of taxes and other commitments, officially is termed as dissolution.

2. **Dissolution Of Partnership:** It ends the old partnership agreement and causes reconstruction of the firm due to admission, retirement and death of a partner.
3. **Dissolution Of Firm:** in dissolution of partnership firm the business is closed down, the assets of the firm are disposed off and liabilities are paid off and remaining amount is distributed amongst the partners.
4. **Insolvency of a partner:**A partner is said to be insolvent when he is not able to repay his debts in full.

SUMMARY

- Dissolution of partnership and dissolution of partnership firm are different from each other. Dissolution of Partnership usually results in change in relations of partners at the time of reconstitution of firm while dissolution of partnership firm causes closure of business and winding up of the affairs of the company permanently
- Dissolution of partnership can be because of admission, retirement, death, insolvency or expiry of period of partnership.
- Dissolution of partnership firm can be with or without the intervention of court. The court does not intervene if dissolution is by mutual agreement, Insolvency of all or all but one partners, business becoming unlawful or illegitimate, on the happening of some contingent event or by notice.
- The intervention of court takes place at the instance of a partner in case of Insanity of Partner, Permanent Incapacity of Partner, Misconduct of Partner, Constant breach of agreement by partner, Transfer of Interest, Continuous Losses to the firm or other Just and Equitable reasons.
- Losses, including deficiencies of capital, are first met out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits.
- The assets of the firm are utilized for payment of outside debt, advances of partners, capital of partners and any balance thereafter amongst the partners in their profit sharing ratio. This division is done in the said order only.
- Realisation account, partner's capital accounts and bank or cash account are usually prepared to close the books at the time of dissolution.
- All partners by mutual consent may decide that one of them will be the incharge of the dissolution process, for which he may be entitled to a pre-decided amount of remuneration.
- Realisation account and revaluation account are different from each other in the sense that realization account is prepared at the time of dissolution for disposing off assets and payment of liabilities while revaluation is prepared at the time of reconstitution of firm to record fluctuation in values of assets and liabilities.
- In case of insolvency of partner, the amount not so paid by him to the firm is considered loss which is borne by the solvent partners as per Garner v Murray rule.

EXERCISE QUESTIONS

Short Answer Questions

1. What do you understand by the term dissolution.
2. Explain dissolution of partnership firm.
3. Why does a partnership dissolve.
4. State the ways of dissolution of firm without intervention of court.
5. Are partners liable even after dissolution?
6. What is the method of repaying joint debts and separate debts.
7. Can a partner become incharge of dissolution?
8. Define insolvency of a partner.

Long Answer Questions

1. "Dissolution of partnership and dissolution of firm are generally used synonymously". Do you agree. Justify your answer.
2. Explain in detail the possible causes of dissolution of partnership.
3. What are the different modes of dissolution of firm. Explain in detail.
4. Discuss the course of settlement of accounts between partners.
5. What is the treatment of goodwill after dissolution as per the Indian Partnership Act, 1932.
6. Give the journal entries necessary to liquidate a firm along with their narration.
7. What change in dissolution treatment takes place if a partner becomes in-charge of dissolution.
8. Differentiate between realization account and revaluation account.
9. Explain the treatment of losses in case of insolvency of a partner.

Numerical Questions

1. Aditya, Mohak and Raghav commenced business in the form of partnership with profit sharing ratio of 4:3:3 on 1st January, 2013 with capital amounting to Rs. 10,00,000, Rs. 8,00,000 and Rs. 6,00,000 respectively. They decided to pay 5% p.a. interest on capital and withdraw Rs. 1,00,000 per partner per year. The profits during the year 2013 and

2014 were Rs. 4,00,000 and Rs. 5,00,000 respectively, before allowing interest on capitals. But, the partners usually had arguments and to resolve them, they decided to dissolve it on 31st December, 2014. Creditors on date were s. 2,40,000. The assets realized Rs. 26,00,000 net. Prepare the necessary accounts to close the books of the firm.

(Answer: *Assets at the time of dissolution were Rs. 29,40,000. Loss on realization Rs. 3,40,000, Aditya receives Rs. 10,29,100, Mohak gets Rs. 7,75,700 and Raghav gets Rs. 5,55200.)*

2. Radhe, Krishna and Gopi entered into a partnership with profit sharing ratio of 3:2:1. Their Balance Sheet as on 31st December, 2014 was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry creditors	1,54,000	Cash at bank	35,000
Bills payable	36,000	Stock	1,98,000
Radhe's Loan Account	1,00,000	Debtors 1,50,000	
Reserve Fund	1,20,000	Less: Provision 10,000	1,40,000
Capital Accounts:		Joint Life Policy	40,000
Radhe 2,00,000		Plant and Machinery	4,37,000
Krishna 1,60,000			
Gopi 80,000	4,40,000		
	8,50,000		8,50,000

The firm was dissolved on January 1, 2015. JLP was taken over by Radhe at Rs. 50,000. Stock realized Rs. 1,80,000. Debtors realized Rs. 1,45,000. Plant and machinery was sold for Rs. 3,60,000. Liabilities were paid in full. In addition. One bill for Rs. 7,000 under discount was dishonoured and had to be taken up by the firm.
Give journal entries and the necessary ledger accounts to close the books of the firm.

(Answer: *Loss on realization: Rs. 87,000, Radhe receives Rs. 1,66,500, Krishna Rs. 1,71,000 and Gopi gets Rs. 85,500)*

3. Kumar, Shyam and Ratan were partners in a firm sharing profits in the ratio of 5 : 3 : 2 respectively. They decided to dissolve the firm with effect from 01-04-2015. On that date the Balance Sheet of the firm was as follows :

Balance Sheet as at 01.04.2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capitals :		Plant	80,000
- Kumar	68,000	Furniture	45,000
- Shyam	50,000	Motor van	25,000
- Ratan	27,000	Stock	30,000
Creditors	1,20,000	Debtors	71,000

		Cash	14,000
	2,65,000		2,65,000

The dissolution resulted in the following :

(i) Plant of Rs. 40,000 was taken over by Kumar at an agreed value of Rs. 45,000 and remaining plant realisedRs. 50,000.

(ii) Furniture realisedRs. 40,000.

(iii) Motor van was taken over by Shyam for Rs. 30,000.

(iv) DebtorsrealisedRs. 1,000 less.

(v) Creditors for Rs. 20,000 were untraceable and the remaining creditors were paid in full.

(vi) Realisation expenses amounted to Rs. 5,000.

Prepare the Realisation Account, Capital Accounts of Partners and Cash Account of the firm.

***(Answer:** Loss on realization:Rs. 1,000, Cash paid to Kumar Rs. 22,500, ShyamRs. 19,700 and RatanRs. 26,800)*

4. A, B and C were partners sharing profits in the ratio of 3:1:1. Their Balance Sheet as on March 31st 2015, the date on which they dissolve their firm, was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capitals:		Sundry Assets	17,000
- A - 27,500		Stock	7,800
- B - 10,000		Debtors 24,200	
- C - 7.000	44,500	Less: Provision for doubtful debts 1.200	23,000
Loan	1,500	Bills Receivables	1,000
Creditors	6,000	Cash	3,200
	52,000		52,000

It was agreed that:

(a) A to take over Bills Receivables at Rs. 800, debtors amounting to Rs.20,000 at 17,200 and the creditors of Rs. 6,000 were to be paid by him at this figure.

(b) B is to take over all stock for Rs. 7,000 and some sundry assets at Rs. 7,200 (being 10% less than the book value)

(c) C to take over remaining sundry assets at 90% of the book value and assume the responsibility of discharge of loan together with accrued interest of Rs. 300.

(d) The expenses of realization were Rs. 270.

The remaining debtors were sold to a debt collecting agency at 50% of the Book value. Prepare RealisationAccount, Partners Capital Accounts and Cash Account.

***(Answer:** Loss on realization: Rs. 6970, Cash paid to A Rs. 11,318, cash brought in by B Rs. 5,594 and C Rs. 694)*

Q5. A, B and C share profits in the ratio of 5:3:2. They decide to dissolve the firm. The Balance Sheet on date of dissolution is as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital Accounts		Bank	70,000
- A	2,00,000	Debtors	50,000
- B	1,50,000	Stock	60,000
- C	1,50,000	Furniture	25,000
Current Accounts		Patents	35,000
- A	30,000	Machinery	1,00,000
- B	20,000	Building	3,20,000
Profit and Loss Account	50,000	Current Account – C	10,000
Trade Creditors	70,000		
	6,70,000		6,70,000

Additional Information:

1. Realisation expenses were to be fully borne by A for which he is entitled to Rs. 10,000. Actual realization expenses paid out of firm's bank account amounted to Rs. 12,000.
2. B took over stock for Rs. 55,000 and C took over building for Rs. 4,00,000.
3. Other assets realized as follows:

Debtors Rs. 48,000, Furniture Rs. 17,000, Machinery Rs. 80,000

4. Patents didn't realize anything and trade creditors were settled in full for Rs. 65,000.
5. Accounts of partners were settled after realizing assets and paying outside liabilities.

Prepare Realisation Account, Partner's Current Accounts, Capital Accounts and Bank Account.

(Answer: *Profit on RealisationRs. 5,000, Amount transferred from current accounts to capital accounts: A: 18,500(Cr.), B: Rs. 3,99,000(Cr.). C: Rs. 55,500(Dr.), cash brought in by C: Rs. 2,49,000, cash paid to A: Rs. 2,55,000, B: Rs. 1,31,500)*

Q6. Ashish and Anish are in partnership sharing profits and losses in the ratio of 4:3 respectively. They decided to dissolve the partnership firm on 31st December, 2014. As on date, Ashish's capital was Rs. 1,25,030 and Anish's capital Rs. 2,070; the creditors amounted to Rs. 23,150 and cash at bank Rs. 4,520. The remaining assets realized Rs. 1,24,910 and the expenses of dissolution were Rs. 1,860. Both Ashish and Anish were solvent. Prepare the necessary accounts to close the books of the firm.

(Answer: *Sundry Assets on the basis of Memorandum Balance Sheet Rs. 1,45,730, Realisation Loss transferred to Ashish's Capital AccountRs. 12,960, Anish's Capital AccountRs. 9,720, amount brought in by Anish: Rs. 7,650, amount paid to AshishRs. 1,12,070)*

Q7. Annu, Tannu and Mannu shared profits in the ratio of 2:2:1. On 31st December, 2014, they decided to dissolve the firm and their Balance Sheet was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors	50,000	Cash	30,000
Bills payable	30,000	Debtors	50,000
Provident Fund	20,000	Stock	36,000
Investment Fluctuation Fund	8,000	Investments	20,000
Commission received in Advance	12,000	Plant	90,000
Capital Accounts			
Annu 50,000			
Tannu 60,000			
Mannu30,000	1,40,000		
	2,60,000		2,60,000

Annu was appointed to realize the assets, for which he was entitled to receive 5% commission on the sale of assets (except cash). It was decided that he will bear all expenses of realization. The assets realized as follows:

Stock Rs. 36,000, debtors Rs. 45,000, investments 80% of the book value; plant Rs. 65,500.

Expenses of realization amounted to Rs. 5,500. Commission received in advance was returned to the customers after deducting Rs. 4,000. The firm had to pay Rs. 8,000 for outstanding wages. This liability was not provided for in the above Balance Sheet. Also, Rs. 20,000 had to be paid for provident fund.

***(Answer:** Loss on realization: AnnuRs. 15,050, TannuRs. 15,050, MannuRs. 7,525, cash brought in by AnnuRs. 1,33,025, cash paid to TannuRs. 31,350 and MannuRs. 15,675)*

UNIT 5-JOINT STOCK COMPANY

UNIT CODE-5	**UNIT TITLE: JOINT STOCK COMPANY**			
Location: Class Room	**Duration:**			
	SESSION 1: MEANING AND DEFINITION OF A COMPANY			
	Learning Outcome	**Knowledge Evaluation**	**Performance Evaluation**	**Teaching & Training Method**
	1. Define the meaning of company	1. Describe the meaning of company	1. Elucidate the implication of the word company	**Interactive Lecture:** Discuss the concept and meaning of company
	2.Essential characterstics of a company	2. Define the various charactersticsof a company	2. Describe the different features of a company	**Interactive Lecture:** Explain the various attributes of the company
	SESSION 2: TYPES OF COMPANIES			
	1. One Person Company	1. Define one person company	1. Identify the connotation of one person company	**Interactive Lecture:** Explain the type of companies according to Companies Act 2013.
	2 Private Company	2.Define private company	2.Identify features of private company	**Interactive Lecture:** Explain the attributes of a private company.
	3. Public Company.	3. Describe the term public company.	3. Understand the meaning of a public company.	**Interactive Lecture:** Evaluate the various aspects of a public company.

	SESSION 3: FORMATION OF A COMPANY			
	1. Promotion	1. Explain the process of promotion of a company.	1. Define the promoter and his role in promotion of a company	**Interactive Lecture:** Explain role of promoter in promotion of a company
	2. Incorporation	2.Enumerate the process of Incorporation of a company.	2. Explain the procedure to get a company incorporated in India.	**Interactive Lecture:** Describe the documents to be filed before incorporation.
	3.Capital Subscription	3.Describe the term capital subscription.	3. Enumerate the minimum capital that needs to be subscribed.	**Interactive Lecture:**Explain capital subscription and conditions to met for incorporation.

JOINT STOCK COMPANY

Learning Objectives

After reading the unit, the student will be able to:

- understand themeaning and definition of a company;
- explain the essential characteristics of company;
- understand the kinds of companies ;
- explain the difference between partnership and joint stock company;
- appreciate the difference between private and public companies;
- understand the procedure of formation of company and
- understandthe meaning of certain keywords.

SESSION I MEANING OF A COMPANY

A company form of business organization is different from other forms such as partnership or sole proprietor firms as it is separate legal entity .In this form of organization, ownership is divorced from management. The shareholders contribute towards the finances of the company but all of them do not and cannot participate in the management of the company. In order to manage the day to day affairs of the company, the shareholders elect board of directors who manage on behalf of the shareholders.In India, the companies are governed by provisions of Companies Act,1956 which has been replaced by the Companies Act, 2013.The Ministry of Corporate Affairs (MCA) recently issuedthe Companies (Amendment) Act, 2015 (Amended law)thereby amending certain sections of the Companies Act, 2013. A company means association of persons formed for economic gain of its members. According to thelaw, any association of persons for any common object can be registered as a company. The object need not be the economic gain of its member's example a company can be formed for the purpose of charity, research, advancement of knowledge etc.

According to Justice Lindley "A company is an association of many persons who contribute money or money's worth to a common stock and employ it for a common purpose. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs, are members".

According to Section 2(20) of the Companies Act, 2013 "A company means a company incorporated under this Act or any previous Company Law."

ESSENTIAL CHARACTERSTICS OF A COMPANY

The following are the essential characteristics of a company:

1. **Voluntary Association:** A company is a voluntary association of persons i.e., it can neither compel a person to become its member nor force them to give up their membership. It is personal choice of persons and their objective to make profit motivates them to become members of a company.

2. **Independent Legal Entity:**A company is a legal entity quite distinct and separate from its members.It can hold and deal with any type of property of which it is the owner-in anyway it likes ;can enter into contracts ,open a bank account in its own name ,sue and be sued by its members as well as outsiders. The scope of its activities and the working of the company are regulated by its Memorandum of Association, Articles of Association and provisions of Companies Act.

3. **Perpetual Legal Existence:** A company has perpetual succession .The mode of incorporation, dissolution of a company and the right of members to transfer shares freely guarantees the continuity of the existence of the company quite independent of the life of the members .The existence of the company can be terminated only by the law. Hence, members may come and go but the company can go on forever.

4. **Common Seal:** A company being an artificial entity, acts through other natural persons known as the directors. They act as agents to the company but not of its members. All the acts of the company are authorized by its common seal. The common seal is the official signature of the company. A document not bearing the common seal of the company will not be binding on the company.
   As per Companies (Amendment) Act, 2015, a company may not have its common seal. However, if the company does not have the common seal, theauthorizationof any document shall be made by two directors or by a director and the Company Secretary, if appointed by the company.

5. **Limited Liability:**The liability of the members of the company is generally limited to the extent of unpaid value of the share held by them. In case of a guarantee company, the members are liable to contribute a specified agreed sum to the assets of the company in the event of the company being wound up if its assets fall short of its liabilities.

6. **Transferability of Shares:** The shares of Joint Stock Company are freely transferable .However, in case of private companies, they are transferable subject to the restrictions put by the company's Article of Association.

7. **Management and Ownership:**The company is not run by all the members but by representatives elected by the members called Directors. This makes the management and ownership of the company separate.

Knowledge Assessment-I

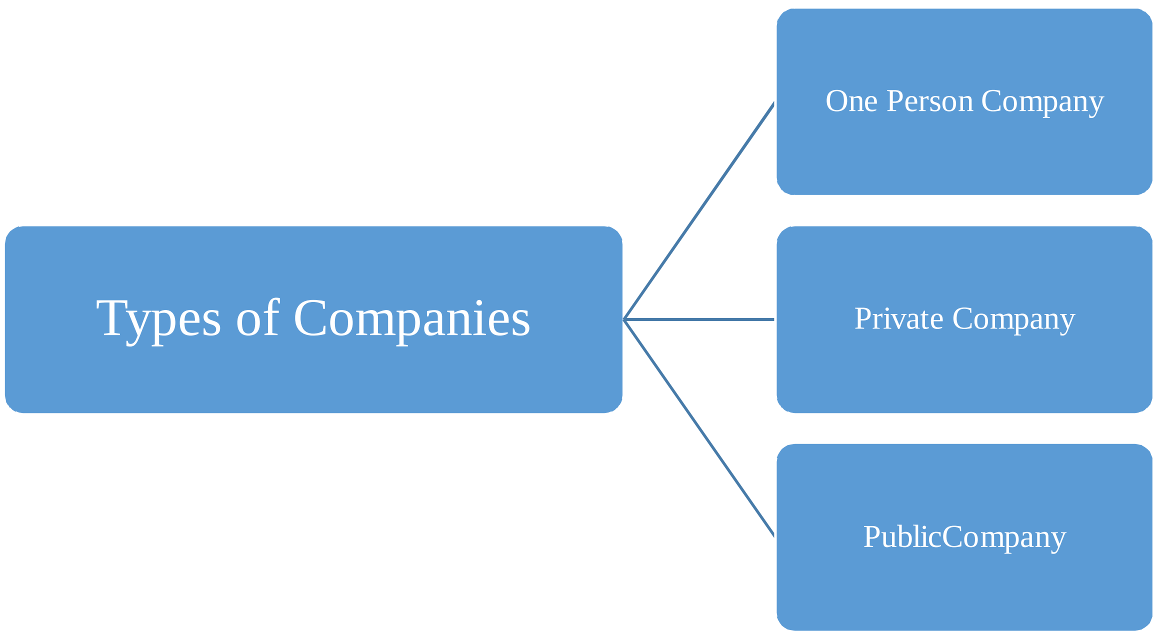
Fill in the blanks with appropriate words

1. A company is a _____________ quite distinct and separate from its members
2. The existence of the company can be terminated only by the ___________.
3. A company has ______________succession
4. The ____________is the official signature of the company.
5. If the company does not have the common seal, the authorization of any document shall be made by two directors or by a director and the ______________, if appointed by the company
6. The shares of Joint Stock Company are freely ____________
7. The _____________of the members of the company is generally limited to the extent of unpaid value of the share held by them.
8. A company is a ______________association of persons.

(**Answers:**1.legal entity 2.law 3. perpetual 4. common seal 4. liability 5.Company Secretary6.transferable7. liability 8.voluntary)

SESSION II KINDS OF COMPANIES

According to Companies Amendment Act, 2013,there are three types of companies:



ONE PERSON COMPANY

According to section 2(62) of the Companies Act, 2013 “one person company” means a company which has only one person as member.

The Companies Act, 2013 providesthat:

(a) Only a natural person who is an Indian citizen and resident in India is eligible to incorporate a OnePerson Company and as a nominee for the sole member of a OnePersonCompany.
(b) One personcannot form not more than one OPCor become nominee in more than one such company.
(c) A minor cannot become member or nominee of the One PersonCompany or can hold share with beneficial interest.

(d) Such Company cannot carry out Non-Banking Financial Investmentactivities including investment in securities of anybody corporate.
(e) The paid up capital of such a company fifty lakh rupees or its average annualturnover is two crore rupees.

PRIVATE COMPANY

According to Section 2(68), a private company is company that has minimum paid up capital as may be prescribed by its Articles:

i. Restricts the right to transfer the shares ;if any ;
ii. Limits the number of members to 200 not including
    a) Persons who are in the employment of the company and
    b) Persons who have been formally in the employment of the company who are members of the company while in that employment and have continued to be members after the employment ceased;
iii. Prohibits invitation to the public to subscribe for any shares or debentures of the company; and
iv. Prohibits invitation or acceptance of deposits from persons other than its members,directors or other relatives.

PUBLIC COMPANY Sec 2(71)

According to Sec 2(71), A public company is a company which:

i. Is not a private company;
ii. Has minimum paid up capital as may be prescribed ;and

Provided ,that a company which is a subsidiary of a company ,not being a private company ,shall be deemed to be a public company for the purpose of this Act even when such subsidiary company continues to be a private company in its articles [Sec2(71)].

It is to be noted that a private company can be registered with only two members (except one person company) while public company needs at least 7 members .Where two or more members hold shares jointly ,they shall be considered as a single member.

The name of the Public company ends with words “Limited”

A public company can raise funds by issue of its shares to public for subscription. A company both Private and Public, may be

(a) Limited Liability Company,
(b) Unlimited Liability Company and
(c) Company limited by Guarantee

Limited Liability Company :- According to Section 2(22) of Companies Act 2013, a limited liability company having liability of its members limited by the memorandum to the amount, if any, unpaid on shares respectively held by them is termed as a “A Company Limited by Shares”.

Unlimited LiabilityCompany: - According to Section 2 (92) of the Companies Act 2013, it is a company where the liability of its members is unlimited. This implies that in the event of liquidation or winding up of the Company, the debts shall be met from private property of the members.

Company Limited by Guarantee:- According to Section 2 (21) of the Companies Act 2013, it is the company having the liability of its members limited by the memorandum to such an amount as the members may respectively undertake to contribute to the Assets of the company in the event of its winding up.

DIFFERENCE BETWEEN COMPANY AND PARTNERSHIP

S.No	Basis	Company	Partnership
1.	Definition	A joint stock company is a voluntary association of persons with a corporate body, limitedliability, perpetual succession and common seal .It is a legal entity distinct and separate from its members.	Partnership is relationship between persons who have agreed to share the profits of the business carried on by all or any one of them acting for all. Sharing of profits, existence of an agreement whether express or implied and mutual agency between partners are essential characteristics of partnership.
2.	Mode of creation	It is formed by registration in pursuance of provisions of the Companies Act .There are elaborate legal formalities.	It is formed by the mutual consent of all partners expressed in an agreement, which may be express or implied .Registration of a partnership firm is desirable but not compulsory by law.
3.	Legal Status	It is a legal entity with perpetual succession and common seal.	In partnership there is no perpetual succession
4.	Creation	Created by Law	Created by Contract
5.	Liability	In case of joint stock company the liability of shareholders is limited (except in case of unlimited companies) to the extent of face value of shares or to the extent of guarantee	In case of partnership the liability of partners is unlimited .
6.	Managem ent	The affairs of a company are managed by its directors. Its members have no right to take part in the day to day management.	Every partner of a firm has a right to participate in the management of the business unless the partnership deed provides

			otherwise.
7.	Legal Status	A company has a separate legal status distinct from its shareholders.	Partnership firm has no legal existence distinct from its partners.
8.	Transfer of Interest	Shares in a public company are freely transferable from one person to another person. In private company the right to transfer shares is restricted	A partner cannot transfer his interest to others without the consent of other partners. Partner may transfer his share but the assignee does not become a partner. He is only entitled to share of profits.
9.	Insolvency /Death	Insolvency or death of a shareholder does not affect the existence of a company.	A partnership ceases to exist if any partner retires, dies or is declared insolvent.
10	Winding up	A company comes to an end only when it is wound up as per the order of the National Company Law Tribunal, or in a legal manner or its name being struck off by the Registrar.	A firm is dissolved by an agreement or by the order of court. It is also automatically dissolved on the insolvency, retirement or death of a partner.
11	Audit	Audit of accounts of a company is compulsory	Audit is discretionary in case of a partnership firm.
12	Authority of Members	A shareholder is not an agent of a company and has no power to bind the company by his acts.	A partner is an agent of a firm. He can enter into contracts with outsiders and incur liabilities so long as he acts in the ordinary course of firm's business.

DISTINCTION BETWEEN PRIVATE AND PUBLIC LIMITED COMPANIES

Following are the main points of difference between a Public Company and a Private Company:-

1. **Maximum number of members:**There is no limit on the maximum number of member of a public company, but a private company cannot have more than two hundred members excluding past and present employees.
2. **Minimum Paid-up Capital :**The minimum paid up capital in case of both private and public company may be prescribed differently by the Ministry of Corporate Affairs ,as per Companies(Amendment) Act ,2015.The earlier limit of minimum paid-up capital of

Rs. 1,00,000 for private company and Rs. 5,00,000 for public company as per CompaniesAct ,2013 has been withdrawn.

3. **Transferability of shares :** There is complete restriction on the transferability of the shares of a private company through its Articles of Association , whereas there is no restriction on the transferability of the shares of a public company
4. **Invitation to public:**A public company by issuing a prospectus may invite public to subscribe to its shares whereas a private company cannot extend such invitation to the public.
5. **Legal Formalities :**The legal formalities to be observed in case of public companies are much more than those in case of private company.

Knowledge Assessment-II

State whether the following statements are (T) or (F)

1. Only a natural person who is an Indian citizen and resident in India is eligible to incorporate a One Person Company .
2. A minor can become member or nominee of the One Person Company or can hold share with beneficial interest.
3. The minimum paid up capital in case of both private and public company may be prescribed differently by the Ministry of Corporate Affairs.
4. Audit of accounts of a company is not compulsory.
5. Insolvency or death of a shareholder affects the existence of a company.
6. A company comes to an end only when it is wound up according to the provisions of the Companies Act.
7. A company is a legal entity with perpetual succession.
8. The minimum number of person required to form a public company is five, whereas in a private company their number is only two.
9. The legal formalities to be observed in case of private companies are much more than those in case of public company.

(**Answers :**1.(True)2.(False)3.(True)4.(False)5.(False)6.(True)7.(True)8.(False)9.(False))

SESSION III FORMATION OF COMPANY

A company may be formed either to take over existing business or to carry on new business.Whatever may be the objective, the procedure of formation of company from the time the idea is conceived till the company is actually formed and commences business can be divided into three principal stages:

i. Promotion
ii. Incorporation
iii. Commencement of Business

PROMOTION

The stage of conceiving the idea and working on it is termed as promotion.The person involved in this task is termed as promoter.The promoter may work up the idea with the help of his own resources, influence or competence or he may,if necessary, take the help of technical experts to find out the economic and technical feasibility of the project that he has in his mind.

INCORPORATION

It is the incorporation that brings a company into existence as a separate corporate entity .The following preliminary steps have to be taken by the promoter in this regard.According to Companies Act 2013, the following procedure has to be followed for incorporation of company:

(a) Ascertainment of availability of the proposed name of the company from the Registrar of companies
(b) The various documents are to be filed with digital signatures of Managing Director, Director, Manager or Secretary of the company.
(c) As per Section 153 of the Companies Act 2013, every individual intending to be appointed as director of the company shall make an application for allotment of Director Identification number .Therefore before filling the form INC1 for the availability of name for the company, all the directors of the proposed company must obtain DIN.
(d) Subsequent to the availability of name the MOA and AOA are drafted .They are to be drafted with utmost care as they represent the charter or internal rules of the company. The memorandum (MOA) should be drafted keeping in mind the provisions of section 4 of The Companies Act, 2013 and objects should not be contrary to those as per Form No. INC-1.
(a) In case the company proposes to raise capital by issue of shares or debentures to the general public, a draft prospectus has to be submitted to the Securities Exchange Board of India (SEBI).

(b) Appointment of underwriters, brokers, solicitors, auditorsetc. who shall represent company's interest in different aspects have to be appointed.

On being satisfied, the Registrar will register the Memorandum, Articles and other documents and issue a certificate termed as "Certificate of Incorporation".

COMMENCEMENT OF BUSINESS

Under Companies Act 2013, the date of incorporation of a company cannot be the date of commencement of business. As per Companies Act 2013, before commencement of business orexercising any borrowing powers, the director of acompany having share capital was required to filewith the Registrar of Companies a declaration thatevery subscriber to the Memorandum has paid thevalue of shares committed by him/her and that thepaid-up share capital of the company is not less thanthe amount prescribed.The Section 11 of Companies Act 2013 has been omitted andthe requirement of filing a declaration before commencement of business has been done away with as per the Companies (Amendment) Act, 2015.

ALLOTMENT OF SHARES

The application for shares is offer from the people to purchase shares and the prospectus issued by the company is an invitation to the general public to apply for the company's shares. The communication of acceptance of this offer by an allotment order notice leads to a valid contract between the shareholder and the company.

Allotment of shares is done by the resolution of the board of director's .In case of over-subscription, the directors follow the guidelines given by the stock exchange in consultation with the SEBI's representative.

According to the guidelines provided by the SEBI in the event of over-subscription:

(a) Applicants will be categorized according to the number of shares applied for;
(b) The total number of shares to be allotted to each category as a whole shall be arrived on a proportionate basis.

The Companies Act does not impose any restrictions upon a private company to allot its shares .However public company offering shares or debentures to the public for subscription can proceed with the allotment of shares only after complying with the following requirements:

1. Minimum Subscription: The amount fixed as minimum subscription must have been subscribed for .The amount of minimum subscription of share capital which must be raised, shall be fixed either by the directors or by the persons who have signed the memorandum.It is to be exclusive of any amount payable otherwise than in cash .According to Companies Act 2013, no allotment of any security of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as minimum amount has been subscribed and the sums payable on application for the

amount so stated have been paid to and received by the company by cheque or other instrument.

2. Application money: A sum of at least 5% of the nominal value of shares or such other percentage as may be specified by Securities Exchange Board of India (SEBI),must have been received in cash by the company as the application money.
3. Money to be deposited in scheduled bank: All the money received from the applicants for the shares should be kept deposited in a scheduled bank and should be utilized for adjustment against allotment of securities where the securities have been permitted to be dealt with the stock exchange and repayment of the money within the time specified by SEBI where the company is unable to allot securities.

As per the Companies(Prospectus and Allotment of Securities)Rules ,2014,if minimum subscription is not received within specified period ,application money shall be repaid within 15 days from closure of issue .If not so repaid within such period ,directors of the company who are officers in default shall be jointly and severally liable to repay the money with interest @15% per annum. Application money to be refunded shall be credited only to the bank account from which subscription was remitted.

Knowledge Assessment-III

Fill in the blanks with appropriate words

1. The stage of _____________ the idea and working on it is termed as promotion.
2. The one who promotes a company using his own resources ,influence or competence is known as ______________ of a company.
3. If ____________________ is not received within specified period, application money shall be repaid within 15 days from closure of issue.
4. Companies both public and private that do not have share capital can commence its business activities immediately after obtaining the certificate of ______________.
5. Allotment of shares is done by the resolution of the ___________________ .
6. The ____________ money should not be less than at least 5% of the nominal value of shares or such other percentage as may be specified by Securities Exchange Board of India (SEBI).
7. According to Companies Act 2013, the date of ____________of a company and the date of commencement of business is not different.
8. If __________ subscription is not received within the period specified then the application money shall be refunded within 15 days from closure of issue .

(**Answers:**1.Conceiving,2.Promoter,3.minimum subscription, 4.Incorporation,5.board of directors,6application , 7.incorporation,8.minimum)

KEY WORDS

- A company means a company incorporated under this Act or any previous Company Law.
- One Person Company: One person company means a company which has only one person as member.
- Dormant company: The 2013 Act states that a company can be classified as dormant when it is formed and registered under this 2013 Act for a future project or to hold an asset or intellectual property and has no significant accounting transaction.
- Private Company: Restricts the right to transfer the shares, limits the number of members ,no requirement of minimum paid up capital, prohibits invitation to the public to subscribe to any securities of the company.
- Public Company:A public company means a company which is not a private company.
- Limited LiablityCompany :According company having liablity of its members limited by the memorandum to the amount, if any, unpaid on shares respectively .
- Unlimited LiablityCompany :It is a company where the liablity of its members is unlimited. Company Limited by Guarantee:- It is the company having the liablity of its members limited by the memorandum to such an amount as the members may respectively undertake to contribute to the Assets of the company in the event of its winding up.

SUMMARY

- A company means association of persons formed for economic gain of its members.
- The essential characteristics of a company are voluntary association, independent legal entity, perpetual legal existence, common seal, limited liability, transferability of shares, management and ownership.
- There are three types of companies namely one person company, private company and public company .
- A company may be formed either to take over existing business or to carry on new business. Whatever may be the objective, the procedure of formation of company from the time the idea is conceived till the company is actually formed can be divided into three principal stages namely promotion, incorporationand commencement of business.

EXERCISE QUESTIONS

Short Answer Questions

1. Explain limited liability companies
2. What do you mean by unlimited liability companies
3. Explain the term preliminary expenses
4. Explain the one person company
5. What do you mean by a private company

Long Answer Questions

1. Define company and state its essential characteristics.
2. Explain the documents that have to be filed with the Registrar of companies for getting a company incorporated.
3. Explain the process of allotment of shares.
4. Differentiate between:
   (a) Private Company and public company
   (b) Certificate of Incorporation
   (c) Company and Partnership
5. Write short notes on :
   (a) One Person Company
   (b) Private company
   (c) Limited liability companies
   (d) Dormant Companies
   (e) Small Companies

UNIT 6 - SHARES AND SHARE CAPITAL

UNIT CODE-6	**UNIT TITLE: SHARES AND SHARE CAPITAL**			
Location: Class Room	**Duration:**			
	Learning Outcome	**Knowledge Evaluation**	**Performance Evaluation**	**Teaching & Training Method**
	SESSION 1: MEANING OF SHARES			
	1. Share Capital of a Company	1. Describe the meaning of shares	1. Identify definition of shares as per the Companies Act 2013.	**Interactive Lecture:** Discuss the concept and meaning of shares.
	2.Types of Shares	2. Define Equity Shares and Preference Shares.	2. Classify the shares based on different perspectives.	**Interactive Lecture:** Explain the various basis on which the shares are classified.
	3.Classification of Preference Shares	3. Explain the different types of preference shares.	3. Discuss different types of preference shares.	**Interactive Lecture:**Explain the categories of preference shares
	SESSION 2: CLASSIFICATION OF SHARE CAPITAL			
	1. Classification of Shares as per Schedule III of Companies Act 2013.	1.Discussthe classification of shares.	1. Explain the order of share capital in the Balance Sheet.	**Interactive Lecture:**Elucidate the ways in which shares can be issued.
	2. Difference between capital reserve and reserve capital.	2.Discuss the treatment for capital reserve and reserve capital.	2. Explain accounting treatment for capital reserve and reserve capital.	**Interactive Lecture:**Discuss the importance and use of capital reserve and reserve capital.

	SESSION 3: ISSUE OF SHARES			
	1.Issue of Shares	1. Discuss the issue of shares for cash or otherwise .	1. Explain accounting treatment for issue of shares for cash or consideration.	**Interactive Lecture:**Describe the journal entries for issue of shares for cash or consideration.
	2. Issue of shares on different terms	2.Discuss the issue of shares at par, premium or discount .	2. Explain journal entries for issue of shares at different terms .	**Interactive Lecture:**Explain accounting treatment regarding issue of shares for different terms.
	3.Oversubscription and undersubscription of shares .	3. Enumerate the difference between oversubscription and undersubscription.	3. Discuss the journal entries for the oversubscription and under subscription.	**Interactive Lecture:** Explain the concept of oversubscription and under subscription.
	4.Calls in Arrear and Calls in Advance	4.Enumerate the difference between Calls in Arrear and Calls in Advance	4. Discuss the journal entries for Calls in Arrear and Calls in Advance	**Interactive Lecture:**Explain the concept of Calls in Arrear and Calls in Advance
SESSION 4: FORFEITURE OF SHARES				
	1.Concept of forfeiture	1. Different terms for forfeiture of shares issued at different terms	1. Journal entries for forfeiture of shares	**Interactive Lecture:** Explain the treatment of forfeiture of shares
	2. Reissue of forfeited shares	2.Discuss the reissue of shares at different terms.	2. Explain journal entries for reissue of forfeited shares	**Interactive Lecture:** Explain the concept of and journal entries for reissue of forfeited shares

SHARES AND SHARE CAPITAL

Learning Objectives

After reading this unit , the students will be able to:

- understand the meaning of shares, share capital and their kinds.
- enumerate the circumstances under which shares can be issued at par or premium,
- identify the circumstances under which shares can be forfeited,
- identify the purpose for which Share Premium Reserve can be used ,
- understand when the forfeited shares can be reissued ,
- terms for reissue of forfeited shares and
- explain the meaning of key words.

SESSION I MEANING OF SHARES

Companies Act defines a share as 'share in the share capital of a company and includes stock'[Sec2 (84)].This is not an exhaustive definition. According to Farwell a share is the interest of a shareholder in the company measured by a sum of money,for the purpose of liability in the first place and interest in the second and also consists of series of mutual covenants entered into by all the shareholders interse in accordance with the provisions of the Companies Act and the Articles of Association." Thus, a share is not a sum of money but is an interest measured in sum of money ,and made up of various rights ,contained in the contract,including the right to a sum of money of a more or less amount.

A share may be said to be a bundle of rights as well as liabilities .It secures to its owner the right to receive a proportionate part of the profits if any,and proportionate part of the assets of the company upon liquidation .On the other hand, the shareholder may also be required to pay the full value in winding up.

Share Capital of a Company: - It is the amount that the company can raise or has raised by the issue of shares. The entire capital of the company is divided into units and each such unit is known as shares. Only companies limited by shares have share capital.

TYPE OF SHARE CAPITAL (SECTION 43):

The share capital of companies limited by share shall be of two kinds, namely;

(a) Equity Share Capital;

(b) Preference Share Capital.

Equity Share Capital:

Equity share capital means all the share capital which is not preference share capital. Equity share capital may be divided into;

(i) Equity share capital with voting right; or

(ii) Equity share capital with differential rights.

This differential rightsmay be difference pertaining to the dividend, voting rights or otherwise according to and within the limits of the rules. The difference could also be related to managing control, power to appoint director etc.

Preference Share Capital:

Preference share capital of the issued share capital of the company which carries or would carry a preference right with respect to –

(a) Payment of dividend, either as a fixed amount or an amount calculated at a fixed rate. Which may be either be free of or subject to income tax; and

(b) Repayment of amount of share capital or share capital deemed to be paid up, whether or not, there is preferential right specified in the memorandum or article of the company.

Preference Share Capital:

Preference shares are the shares that have two preferential rights i) Preferential right to dividend which may be a fixed amount or calculated at a fixed rate, which may be free or subject to income tax. ii) Preferential right to return the capital at the time of winding up of companies.

Classes of Preference Shares: - Preference shares can be classified with reference to

1) Dividends
2) Participation in Profits
3) Convertibility and
4) Redemption

With Reference to Dividend

Cumulative Preference Shares*:*When the dividend oncumulative preference shares arenot paid, they are treated as arrears and are carried forward to subsequent years. Such accumulated arrears of dividend are paid before anything is paid to any other class of shares. Such preference shares are known as cumulative preference shares. Preference shares are always cumulative unless otherwise expressly stated in the articles.

Non-cumulative Preference Shares: Non-cumulative preference shares are those type of preference shares, which have the right to dividend out of the profits of current year only. The dividend on such shares is not allowed to accumulate .They do not carry the right to receive arrears of dividend. If a company fails to pay dividend in a particular year then the right to claim dividend will lapse.

With respect to participation in surplus

Participating Preference Shares:Participating preference shares are those preference shares, which have fixed rate of dividend along with the right to participate in surplus profit of the company after paying the dividend to the equity shareholders are called participating preference shares.

Non-participating Preference Shares: Non-participating preference sharesare those preference shares, which have which have fixed rate of dividend but no right to participate on the surplus profit or surplus on liquidation of the company, are called non-participating preference shares.

With reference to convertibility

Convertible Preference Shares: Convertible preference sharesare those preference shares, which can be converted into equity shares at the option of the holders after a fixed period according to the terms and conditions of their issue, are known as convertible preference shares.

Non-convertible Preference Shares: Non-convertible preference shares are thosepreference shares, which do not carry the right of conversion are called non-convertible preference shares.

With reference to redemption

Redeemable Preference Shares: Redeemable preference shares are those preference shares that are redeemable during the life time of the company. However ,as per Companies Act,2013 ,a company can issue only such preference shares which are redeemable within 20 years from the date of issue ,except those issued for infrastructure projects ,which may be redeemable for a period exceeding 20 years.

Non-redeemable Preference Shares: Non-redeemable preference shares are those preference shares, which cannot be redeemed during the life time of the company, are known as non-redeemable preference shares. The amount for such shares is paid only at the time of liquidation of the company. The Companies Act 2013 does not permit issue of Non-Redeemable preference shares.

Knowledge Assessment I

Fill the blanks with the appropriate answers

1. Preference shares are those shares which have ______________ over other classes of shares in respect of dividend at a fixed rate or a fixed amount before any dividend on equity shares.
2. The preference shares, that have right to participate in surplus profit of the company are called ____________ preference shares.
3. The sum total of the____________ of shares of a company is called its share capital.
4. A company cannot issue ____________ preference shares .
5. Those preference shares, which cannot be ______________ during the life time of the company, are known as non-redeemable preference shares.
6. All the share capital which is not preference share capital is ____________ share capital .
7. A company may________ its Equity or undertake capital reduction.
8. _______________can be converted into equity .
9. A company can issue preference shares which are redeemable for a period exceeding 20 years from the date of issue in the case of _______________.

(**Answers. 1-** preferential rights, 2- participating, 3- nominal value, 4-non redeemable 5-redeemed,6-equity 7. buy back 8- Preference shares 9- infrastructure projects)

SESSION II CLASSIFICATION OF SHARE CAPITAL

The sum total of the nominal value of shares of a company is called its share capital. The sharecapital of a company may be of two kinds:

Preference Share Capital: Preference Share Capital is the sum total of the nominal value of preference share of a company.

Equity Share Capital: Equity Share Capital is the sum total of the nominal value of equity share of a company.

Classification of Share Capital

According to Schedule III of Companies Act 2013, the share capital of a company can be divided into the following different categories:

1. ***AuthorizedShare capital***: According to section 2(8) of Companies Act 2013, the maximum amount of capital, as authorized by Memorandum of Association, which a company is authorized to raise from the public by the issue of shares, is known as authorized capital. It is a capital which is in accordance with the instrument of incorporation, therefore it is also known as registered capital or nominal capital.

2. ***Issued Share Capital:***According to Section 2 (50) of Companies Act 2013, the portion of authorized capital, which is offered to the public for subscription, including shares offered to the vendor for consideration other than cash. It includes any bonus shares, shares subscribed by signatory to the memorandum of the association and shares taken by Directors as qualifying shares .

3. ***Subscribed Share Capital:***According to Section 2 (86) of Companies Act 2013, subscribed share capital is that part of issued capital, which is subscribed by the public and allotted .Subscribed Capital is classified under two headsi) Subscribed and fully paid up, ii) Subscribed and not fully paid up.

i) *Subscribed and fully paid up:* 'Subscribed and fully paid up' are shown as in the notes to accounts on share capital when the entire nominal value has been called and received by the company. For example R ltd issued 1,00,000 equity shares of Rs.10 each and called up Rs.10 as well as received Rs.10,then it implies that shares are subscribed and fully paid up.

ii) *Subscribed and not fully paid up:*'Subscribed and not fully paid up'is that part of capital which the company has called up (the entire nominal value of the share)but not received it or the company has not called the entire nominal value of the share.

Case I

The company has called up the entire nominal value of the share but not received it

For example: Anne Ltd has issued 1,00,000 equity shares of Rs.10 each and has called the entire nominal value of the share i.e.,Rs.10and received amount on all shares except a final call of Rs.3 .It shall be shown as Subscribed and not fully paid up. Share capital is shown in Notes to Accounts on Share Capital under Subscribed Capital as follows:

Subscribed and not fully paidup	*Rs.*	
10,000 Equity shares of Rs.10 each	1,00,000	
Less: Calls in Arrear	30,000	70,000
		9,70,000

Case II

The company has not called the entire nominal value of the share.
For example Torrent Ltd issues 1,00,000 shares of Rs.10 each and has called up only Rs.8,then it shall be shown as 'Subscribed but not fully paid up'.Share capital is shown in Notes to Accounts on Share Capital under Subscribed Capital as follows:

Subscribed but not fully paid up	
1,00,000 equity shares of Rs.10 each ,Rs.8 called up	Rs.8,00,000

It might happen that the company has not called the entire nominal value and also has not received the entire called up amount. Suppose it does not receive the amount called on first call on 5,000 equity shares @Rs.2 per share.

Subscribed and not fully paidup	*Rs.*
10,000 Equity shares of Rs.10 each	1,00,000
Less Calls in Arrear	10,000
	90,000

4. ***Paid-up Share Capital:***According to Section 2 (64) of Companies Act 2013, it is that part of called up capital, which is actually paid by the shareholders. Therefore, it is known as real capital of the company. The amount received or credited in excess of nominal or face value of shares is credited to Securities Premium Reserve account.

5. ***Reserve Share Capital:***It is that part of subscribed capital which is uncalled.It is that portion which has been reserved by the company by passing a special resolution to be called only in the event of its liquidation. It is shown as subscribed but not fully paid up share capital. Unlimited companies must have reserve capital.

Issue of different classes of Shares :- When a company has issued different classes of shares, the details of each class of share shall be shown distinctively in the Balance Sheet.

For example:

Notes to Accounts

Particulars	Rs	Year ended 31st March 2014
Share Capital Authorised Capital 10,000 Equity shares of Rs 10 each 1,000 Preference shares of Rs 100 each		 1,00,000 1,00,000
		2,00,000
Issued Capital 9,000 Equity shares of Rs 10 each 900 Preference shares of Rs 100 each		 90,000 90,000
		1,80,000
Subscribed Capital **Subscribed and fully paid** 8,000 Equity shares of Rs 10 each 900 Preference shares of Rs 100 each		 80,000 90,000
		1,70,000
Subscribed bot not fully paid 1,000 equity shares of Rs 10 each *Less*: calls in arrears (1000 X3) 30 Preference shares of Rs 100 *Less*: Calls in arrears (20 X 10)	 10,000 3,000 3,000 200	 7,000 2,800

According to section 2 (15) of the Companies Act 2013, called up capital is such part of the capital which has been called for payment and Paid up capital is the amount that the shareholder has paid which the company has received against the amount called. For example, if the shareholder has paid Rs. 3 against the called amount of Rs 5then the paid up capital is Rs 3. It is the money credited and paid up and is equivalent to the amount that is received by the company as paid up with regards to the shares issued and also includes any amount credited as paid up in respect of the shares of the company, but it does not include any other amounts received in respect of such shares by whatever name called.

Format of Companies Balance Sheet .

The format of Balance Sheet as prescribed in Schedule III of Companies Act 2013 is

Balance Sheet of XYZ Ltd as on XXXX

Particulars	**Note No**	**Figures at the end of current reporting period in Rs**	**Figures at the end of previous reporting period in Rs**
I Equity and Liabilities			
1. Shareholders' Funds a) Share Capital b) Reserves & Surplus c) Money received against shares warrants			
2. Share Application money pending allotment			
3. Non- Current Liabilities a) Long Term borrowings b) Deferred tax Liabilities c) Other long term liabilities d) Long term provisions			
4. Current Liabilities a) Short term borrowings b) Trade payables c) Current liabilities d) Short term provisions			
Total		XXXX	XXXX
II Assets			
1. Non- Current Assets a) Fixed Assets i)Tangible Assets ii) Intangible Assets iii) Capital work in progress iv) Intangible Assets under development b) Non- Current Investments c) Deferred Tax assets (Net) d) Long Term Loans and advances e) Other Non- Current Assets			
2. Current Assets a) Current Investment b) Inventories c) Trade Receivables			

d) Cash and Cash equivalents e) Short term loans and advances f) Other current Assets			
Total		XXX	XXXX

Schedule III of Companies Act 2013 gives the details of items of Balance Sheet that are to be given in notes to the accounts and number be put against the item in the Balance Sheet.

Disclosure of Share Capital in Companies Balance Sheet

Share Capital is shown in the company's Balance Sheet as follows

Particulars	Note No.	Rs
I Equity and Liabilities		
1. Shareholders' Funds d) Share Capital e) Reserves & Surplus f) Money received against shares warrants	1	

Notes to Accounts

Share Capital	
Authorised Capital	
--Equity shares of Rs–each --Preference shares of Rs – each	
Issued Capital	
--Equity shares of Rs --each --Preference shares of Rs – each	
Subscribed Capital	
Subscribed and fully paid	
--Equity shares of Rs --each --Preference shares of Rs – each	
Subscribed but not fully paid	
--Equity shares of Rs–each Less: Calls in arrears Add: Forfeited Shares Amount to be shown in Balance sheet	

Illustration 1

GAMA Limited is registered with a capital of 2,00,000 equity shares of Rs 10 each. 1,50,000 equity shares were offered for subscription to public. Application was received for 1,50,000 shares. All calls were made and amount duly received except final call of Rs 2 on 20,000 shares. Show the share capital in the Balance Sheet of the company.

Solution:

Particulars	Note no.	Rs
I Equity and liablities		
1. Shareholders Funds i) Share Capital	1	9,60,000

Notes to Accounts

Share Capital		Rs
Authorised Capital 2,00,000 Equity shares of Rs 10 each		20,00,000
Issued Capital 1,50,000 Equity shares of Rs 10 each		15,00,000
Subscribed Capital Subscribed and fully paid 1,20,000 equity shares of Rs 10 each		12,00,000
Subscribed but not fully paid 30,000 Equity shares of Rs 10 each	3,00,000	
Less Calls in arrears	60,000	2,40,000
Amount to be shown in Balance sheet		
		9,60,000

Difference between Capital Reserve and Reserve Capital:

Capital Reserve is created out of capital profits whereas reserve capital is that part of authorized capital of a company which is not called up by the company. The basic differences between the two are as follows:

Capital Reserve	Reserve Capital
Capital Reserve is created out of capital profits.	Reserve Capital is that part of authorized capital of a company which is not called up by the company.
There is no special resolution required for creating capital reserve.	Special resolution required for creating Reserve Capital

Capital Reserve can be used by company at any time for purchasing long term assets by the company.	Reserve Capital can be used by the company only in case of liquidation of the company.
Capital Reserve is shown on the liabilities side of the balance sheet.	Reserve Capital is not shown in the balance sheet of the company.
Capital Reserve can be used by the company to write off capital losses.	Reserve Capital cannot be used by the company to write off capital losses.

- Capital reserve can be used by the company to write off capital losses while Reserve capital cannot be used for that purpose

Knowledge Assessment II

Fill the blanks with the appropriate answers

1. The maximum amount of capital that is authorized by Memorandum of Association is known as authorized capital.
2. Capital reserve is shown on the ______________ of the balance sheet .
3. The part of subscribed capital which is uncalled is known as ____________.
4. Calls in Arrear is the amount which is not received by the company, against the amount called towards __________________.
5. Reserve Capital can be used by the company only in case of ___________ the company .
6. The part of called up capital, which is paid by the shareholders is known as ___________.
7. Capital Reserve can be used by the company to write off ___________.

(**Answers:** 1. authorized capital 2. liabilities side 3.reserve capital4.share capital 5.liquidation 6. Paid up capital, capital losses)

SESSION III ISSUE OF SHARES

According to Companies Act 2013, the company can issue shares only if it has met the prescribed legal compliances. There can be public issue of shares as well as private placement of shares. The public issue of shares implies offer made by the company to the general public for subscription of the shares offered.

The process in which the shares are issued to selected group of persons privately is known as private placement of shares. It is made by Private Company.

When the shares are issued to the public, it is important to observe that

1) Calls are made as provided in the Articles of Association of the Company
2) In case the company doesn't have its own Articles of Association, then Table F of the Companies Act 2013 shall be followed, which has the following provisions
   a) Period of 1 month must elapse between two calls
   b) The amount of calls should not be more than 25% of the face value of share
   c) Notice of 14 day's period should be given to the shareholders to pay the amount
   d) Calls should be made on uniform basis for all the shares within the same class.

Accounting Entries

Shares may be issued by a joint stock company for two different considerations :

1. For cash
2. For consideration other than cash

Issue of shares for cash: Companies generally issue shares for cash.The company may call the sharemoney either in one instalment or in two or more instalments. But companyalways collects this money through its bankers.However,as per SEBI's guidelines,the application money demanded should not be less than 25% of the issue price of the share in case of a public issue.

Issue price may be payable either:

- In lump sum
- In instalments

In Lump sum : If the shares are issued in lump sum they are payable in one installment

.

On receipt of Application money the Journal entry would be as follows :

Bank A/c Dr

To Share Application A/c

(Being application money received on ….shares of Rs…each)

The persons to whom the shares will be allotted will be issued letters termed as "Letter of Allotment" to that effect .They will also be required to pay allotment money as per terms of prospectus .The Journal entry would be as follows :

On transferring the Application Money

Share Application A/c Dr

To Share Capital A/c

(Being the application money transferred to share capital A/c as per board's resolution no---- dated--------)

Illustration 2

XYZ offered to public on 1stMarch, 2015 ,5,000 equity shares of Rs.10 each at par payable along with application .Applications are received for all the shares by 31th March 2015 and the shares were allotted on 15th April 2015.

Pass necessary journal entries.

Solution :

In the books of XYZ

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Date	Particulars	L.F	Dr.(Rs.)	Cr.(Rs.)
2015 March 31	Bank A/c Dr To Share Application A/c (Being application money received on 5,000shares of Rs10each)		50,000	 50,000
April 15	Share Application A/c Dr To Share Capital A/c (Being the shares allotted and application money transferred to share capital account)		50,000	 50,000

In Instalments : The first instalment is received on application which is transferred to share capital account .The second instalment is received on the allotment known as the allotment money and the remaining amount may be called up which is known as call money.If the call money is required at the time of first call itself, such a call is called First and Final call.

The journal entries are:

(a) On making Ist call

Share First Call A/c Dr

To Share Capital A/c.

(Call money due on …. share @ Rs … per share)

(b) On receipt of money of Ist call

Bank A/c Dr

To Share First Call A/c

(Being money received on first call)

(c) On making IIndcall

Share Second and Final Call A/c Dr

To Share Capital A/c.

(Call money due on …. share @ Rs … per share)

(d) On receipt of money of IInd call

Bank A/c Dr

To Share Second and Final Call A/c

(Being money received on second call)

Illustration 3:

Flex Industries Ltd. issued 10,000 shares of Rs. 10 each on 1st April, 2014. The amount payable on these shares was as under: Rs3 per share on application. Rs 5 per share on allotment. Rs2 per share on call. Make journal entries and preparerelevant accounts in the books ofcompany.

Solution :

Journal Entries

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Share Application A/c (Application money received @ Rs3 per share)		30,000	30,000
	Share Application A/cDr To Share Capital A/c (Share application money for 10,000 shares transferred to share capital A/c)		30,000	30,000
	Share Allotment A/c Dr To Share Capital A/c (Allotment money made due on 10,000 shares @ Rs5/- per share)		50,000	50,000
	Bank A/c Dr To Share Allotment A/c. (Allotment money received on 10,000 shares @Rs5 per share.)		50,000	50,000
	Share First & Final call A/c. Dr To Share Capital A/c (Call money on 10,000 shares @ Rs2 per share made due)		20,000	20,000
	Bank A/cDr To Share First & Final call A/c. (Call money received on 10,000shares @ Rs2 per share)		20,000	20,000

Dr. **Bank Account** **Cr.**

Date	Particulars	L.F	Amount (Rs.)	Date	Particulars	L.F	Amount (Rs.)
	To Share Application A/c		30,000		By Balance c/d		1,00,000
	To Share Allotment A/c		50,000				
	To Share First and Final call A/c		20,000				

			1,00,000				1,00,000
	To Balance b/d		1,00,000				

Dr. **Share Capital Account** **Cr.**

Date	Particulars	L.F	Amount (Rs.)	Date	Particulars	L.F	Amount (Rs.)
	To Balance c/d		1,00,000		By Share Application A/c		30,000
					By Share Allotment A/c		50,000
					By Share First and Final call A/c		20,000
							1,00,000
					By Balance b/d		1,00,000

Dr. **Share Application Account** **Cr.**

Date	Particulars	L.F	Amount (Rs.)	Date	Particulars	L.F	Amount (Rs.)
	To Share Capital A/c		30,000		By Bank A/c		30,000
			30,000				30,000

Dr. **Share Allotment Account** **Cr.**

Date	Particulars	L.F	Amount (Rs.)	Date	Particulars	L.F	Amount (Rs.)
	To Share Capital A/c		50,000		By Bank A/c		50,000
			50,000				50,000

Dr. Share First and Final Call Account Cr.

Date	Particulars	L.F	Amount (Rs.)	Date	Particulars	L.F	Amount (Rs.)
	To Share Capital A/c		20,000		By Bank A/c		20,000
			20,000				20,000

Terms of Issue

Section 53 of Companies Act 2013 prohibits issue of shares at discount except when sweat equity shares are issued.

Issue at par: When the issue price of the share is equal to its nominal value then the shares are issued at par.

Illustration 4:

Sona Steering Industries Ltd. issued 10,000 shares of Rs. 10 each on 1st April, 2014. The amount payable on these shares was as under: Rs5 per share on application. Rs 3 per share on allotment. Rs2 per share on call. Make journal entries and preparerelevant accounts in the books ofcompany.

Solution :

Journal Entries

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Share Application A/c (Application money received @ Rs5 per share)		50,000	50,000
	Share Application A/cDr To Share Capital A/c (Share application money for 10,000 shares transferred to share capital A/c)		50,000	50,000
	Share Allotment A/c Dr To Share Capital A/c (Allotment money made due on 10,000 shares @ Rs3/- per share)		30,000	30,000
	Bank A/c Dr		30,000	

	To Share Allotment A/c. (Allotment money received on 10,000 shares @Rs3 per share.)			30,000
	Share First & Final call A/c. Dr To Share Capital A/c (Call money on 10,000 shares @ Rs2 per share made due)		20,000	20,000
	Bank A/cDr To Share First & Final call A/c. (Call money received on 10,000shares @ Rs2 per share)		20,000	20,000

Issue of Shares at premium:

When the shares are issued at a price higher than thenominal value of the shares whether for cash or consideration other than cash then it is called as shares issued at apremium. The power to issue shares at a premium need not be given in the Articles of Association.The amount of premium is decided by the Board ofDirectors as per the guidelines issued by SEBI. According to Section 52 (1) of the Companies Act 2013, the sharepremium collected by the company is to be transferred to a separate account called as“Share Premium Reserve Account” or Share Premium Account

Although Securities Premium isa profit to the company, it is not a revenue profit, it is treated ascapital profit, which can be utilized only for the following purposes–

(a) Issue of fully paid bonus shares to the existing shareholders.
(b) Writing off the preliminary expenses of the company.
(c) Writing off the expenses of issue or the commission paid or discount allowed on any issue of shares / debentures.
(d) Providing the premium payable on redemption of preference shares or debentures.
(e) In Purchasing its own shares

Journal Entries:

The journal entries for shares issued at a premium are as follows:

1. **For Premium Amount called with Application money**

Bank A/c Dr.

To Share Application A/c

(Amount received on application for —shares @ Rs. — per share including premium)

Share Application A/c Dr.

To Share Capital A/c

To Securities Premium ReserveA/c

(Transfer of application money to sharecapital and securities premium account)

2. **Premium Amount called with Allotment Money**

(a) Share Allotment A/c Dr.

To Share Capital A/c

To Securities Premium ReserveA/c

(Amount due on allotment of shares @Rs. — per share including premium)

(b) Bank A/c Dr.

To Share Allotment A/c

(Allotment money received including premium)

The Securities Premium Reserve account is credited with the amount of premium on the allotted shares .The amount of premium collected shall not be refunded.

Illustration 5:

XYZ company offers 10,000 shares of Rs.10 each to the public for subscription @ Rs.12 per share. The premium is paid on application .All the shares were duly allotted.

Pass the necessary Journal entries for the same

Solution:

In the books of XYZ

JOURNAL

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Share Application A/c (Application money received on 10,000 shares @ Rs12 per share)		1,20,000	 1,20,000
	Share Application A/cDr To Share Premium Reserve A/c To Share Capital A/c (Being equity shares allotted and		1,20,000	 20,000 1,00,000

	amount of premium transferred to Share Premium Reserve A/c)			

Particulars	Note no.	Rs
I Equity and Liablities		
1. Shareholder's Funds (a) Share Capital (b) Reserve and Surplus	 1 2	 1,00,000 20,000
Total		1,20,000
II Assets		
1. Current Assets Cash and cash equivalent	 3	 1,20,000

Notes to Accounts

1. Share Capital **Authorised Capital** ------- Equity shares of Rs 10 each Issued Capital 10,000 Equity shares of Rs 10 each **Subscribed Capital** **Subscribed and fully paid** 10,000 equity shares of Rs 10 each	Rs ---------- 1,00,000 1,00,000
2. Reserve and Surplus Securities Premium Reserve	20,000
3. Cash and Cash Equivalent Cash at Bank	20,000
	1,20,000

OVERSUBSCRIPTION OF SHARES

The shares are oversubscribed when the number of shares applied is more than the number of shares offered for subscription .The company has three alternatives to allot shares

i) Reject the excess applications and refund the money

The company may reject the applications for shares which are in excess of the shares offered for issue. In this case the application money received from these applicants is refunded to them in full. The journal entry made is as follows:

Share Application A/c   Dr

To Bank A/c

(Being refund of application money on _________shares @ Rs.__ per share)

ii) Partial Allotment

It means allotment is made to each applicant or some applications on a proportionate basis .For example ,a company offers 10,000 shares to the public and applications are received for 15,000 shares. No allotment is made to applicants for 3,000 shares and rest are allotted on pro rata basis .It means applicants for 12,000 shares have been allotted 10,000 shares or every applicant of this group has been allotted five shares for six applied .In such a case there will be problem of excess application money received . The excess application money may be adjusted towards sums due on allotment. The following journal entry is made :

Shares Application A/c   Dr

To Share Allotment A/c

(Excess application money adjusted towards sums due on allotment)

If the question is silent or specifies that the excess application money is to be adjusted towards allotment and calls then the excess amount is transferred to the Allotment and Calls in Advance account and the balance is refunded. If the question specifically tells that the money is adjusted against allotment and the balance is refunded, then the balance is refunded and not adjusted against calls .

UNDERSUBSCRIPTION OF SHARES

The shares are under subscribed when the number of shares applied is less than the number of shares offered for subscription. A company may not receive applications for all the shares offered by it to the public. For example, it might have offered 8,000 shares to the public but applications might have been received only for 6,000 shares .Such a situation is called under subscription. In such a case entries for application , allotment and calls will be made only for 6,000 shares.

Illustration 6:

A company offers 20,000 shares of Rs.10 each to the public for subscription .The money is payable as follows :

Rs.4 on application, Rs.3 on allotment and Rs. 3 on first and final call

The company receives application for 25,000 shares .The directors decided to allot 20,000 shares on pro-rata basis and surplus application money was utilized for allotment. Pass journal entries assuming that the amounts due were received

Solution:

Journal Entries

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Share Application A/c (Application money received @ Rs4 per share)		1,00,000	 1,00,000
	Share Application A/cDr To Share Capital A/c To Share Allotment A/c (Being transfer of application money to Share Capital account and excess money to allotment account)		1,00,000	 80,000 20,000
	Share Allotment A/cDr To Share Capital A/c (Allotment money made due @ Rs 3 per share)		60,000	 60,000
	Bank A/c Dr To Share Allotment A/c (Allotment money received @Rs 3 per share.)		40,000	 40,000
	Share First & Final call A/cDr To Share Capital A/c (Call money on @ Rs3 per share made due)		60,000	 60,000
	Bank A/cDr To Share First & Final call A/c (Call money received @ Rs3 per share)		60,000	 60,000

Illustration7:

Meena Ltd. issued 60,000 shares @Rs.10 each at a premium of Rs.2 per share payable as Rs.3 on application,Rs.5(including premium)on allotment and the balance on first and final call. Applications were received for 1,02,000 shares .The directors resolved to allot as follows :

A:Applicants of 60,000 shares 30,000 shares

B: Applicants of 40,000 shares 30,000 shares

C:Applicants of 2,000 shares Nil

Nikhil who had applied for 1,000 shares in Category A,andVish who was allotted 600 shares in Category B failed to pay the allotment money

Solution:

Calculation of amount received on allotment:

Particulars	Amount(Rs.)	Amount(Rs.)
Total allotment money due (60,000 shares ×Rs.5)		3,00,000
Less Allotment money not paid by Nikhil *$_1$	1,000	
Allotment money not paid by Vish*$_2$	2,400	3,400
		2,96,600
Less Excess application money adjusted on allotment(40,000 shares × Rs.3)		1,20,000
Amount received allotment		1,76,600

Working Notes :

***$_1$ Calculation of Amount due on allotment but not paid by Nikhil:**

Number of shares allotted to Nikhil=(30,000/60,000)×1,000=500 shares

Application money paid by Nikhil=1,000 ×Rs.3= Rs. 3,000

Application money required =500× Rs.3= Rs.1,500

Surplus money adjusted towards allotment   Rs.3,000 –Rs.1,500= Rs.1,500

Allotment money due =500×Rs.5=Rs.2,500

Allotment money not paid by Nikhil= Rs.2,500- Rs.1,500=Rs.1,000

***$_2$ Calculation of Amount due on allotment but not paid by Vish :**

Shares applied by Vish =4/3×600 =800 shares

Application money paid by Vish =800×Rs.3= Rs.2,400

Application money required =600 × Rs.3=Rs.1,800

Surplus application money=Rs.2,400-Rs.1,800= Rs.600

Allotment money due=600× Rs.5= Rs.3,000

Allotment money not paid byVish= Rs.3,000-Rs.600= Rs.2,400

Illustration 8:

Petromax Ltd. issued 60,000 shares of Rs.10 each payable as Rs.2 on application Rs.4 and balance when required .Applications were received for 92,000 shares and allotment was done as under:

A: Applicants of 40,000 shares   Full

B: Applicants of 50,000 shares 40%

C: Applicantsof 2,000 shares Nil

Rs.1,72,000was realized on account of allotment money (excluding the amount carried from application money).Show Journal entries.

Solution:

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Share Application A/c (Application money received)		1,84,000	 1,84,000
	Share Application A/cDr To Bank A/c (2,000×Rs.2) To Share Allotment A/c (30,000×Rs.2) To Share Capital A/c (60,000×Rs.2) (Being application money adjusted)		1,84,000	4,000 60,000 1,20,000
	Share Allotment A/cDr To Share Capital A/c (Being money due on allotment)		2,40,000	 2,40,000
	Bank A/c(Note 2) Dr To Share Allotment A/c. (Being receipt of allotment except on 2,000 shares)		1,72,000	 1,72,000

Working Notes

		Rs.
1.	Application money received on 50,000 shares	1,00,000
	Less: application money due on shares allotted	
	(40% of 50,000=20,000 shares × Rs.2)	40,000
	Excess application money adjusted towards allotment	60,000
2.	Calculation of Amount received on Allotment later on :	
	Total allotment money due	2,40,000
	Less: allotment money received on application	60,000
		1,80,000
	Less: Allotment money received on 2,000 shares	8,000
	Allotment money received	1,72,000

CALLS IN ARREAR

If the calls that become due are not paid by any one or more of the shareholders, the unpaid amount becomes arrears due from them. Such arrears are transferred to an account termed as Calls-in-Arrears A/c. The company may provide in its Articles for charging interest from the defaulting shareholder. In case the articles are silent then Table F of Companies Act ,2013, shall be followed which prescribes that ,the company is authorised to charge interest on Calls-in-Arrears @ 10% p.a. for the period between date of non-receipt of the due amount and the date of actual receipt of the due amount.

The following jounal entry is made to record Calls-in-Arrears:

Calls-in-Arrears A/c Dr

To Share ___Call A/c

(Call money not received on …. shares)

When the unpaid balance is received later on the following journal entry is made:

Bank A/c Dr

To Calls in Arrears A/c

(Amount due on allotment/ call remaining unpaid now received on…… shares.)

The company may charge interest on the amount of calls in arrears at a given rate from the date of amount due till it is paid journal entry will be

Bank A/c Dr

To Interest on calls in arrears A/c

Illustration 9

X Ltd. made its first call of Rs 10 per share on 1st July 2014. Pratiksha holding 300 shares failed to pay the call money. She could pay the money only on 31st December, 2014. Company charged interest @12% per annum.

Make necessary journal entry for the interest charged by the company.

Solution

Amount of interest due = $3,000 \times \frac{12}{100} \times \frac{6}{12} = 180$

Journal Entries

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Interest on calls in Arrear A/c (Being receipt of calls in arrear)		180	 180

CALLS IN ADVANCE

If the application money that is received on partially accepted applications is greater than the amount required for adjustment towards allotment money, the excess money shall be refunded to the investors. However, if the Articles of the company soauthorise, the directors may retain the excess money as calls-in-advance to be adjusted against the calls as and when they become due. The company pays interest at the rate stated in its Articles of Associations on the money received in advance. In the absence of interest clause in the Articles of Association, provisions of Table F of the Companies Act, 2013 apply and the Company is liable to pay interest @ 12% on Calls–in-Advance.

The amount received in advance shall be credited to “Calls in Advance Account “and shown as Equity and Liabilities part of the Balance Sheet under the head Current Liabilities and sub head Other Current Liabilities in the Balance Sheet. The following journal entry is made:

Bank A/c Dr

To Call-in-advance A/c

(The amount of calls money received in advance)

This money is adjusted when the respective call is made due

Call-in-advance A/c Dr

To First Call A/c

(with amount due on ___calls on all shares including those on which calls have been received in advance)

Bank A/c Dr(with amount actually received)

Calls in Advance A/c Dr(with the amount of calls received in advance)

To _____Call A/c

Illustration 10

A company offers 2,00,000 shares to the public .The amount payable is as follows :

On application Rs.3 per share on first call Rs.3 per share

On allotment Rs.2 per share on final call Rs.2 per share

The amount on allotment was duly received . All calls were duly made and paid except:

10,000 equity shares failed to pay the first call on their equity shares and a holder of 6,000 shares paid the entire balance on his holding .

Pass necessary Journal entries to record the above transactions in the books of accounts of the company and show how the share capital will appear in the balance sheet of the company if the company did not demand the final call.

Solution :

Journal Entries

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr To Share Application A/c (Application money received on 2,00,000 shares @ Rs 3 per share)		6,00,000	 6,00,000
	Share Application A/c Dr To Share Capital A/c (Being transfer of application money to Share Capital Account)		6,00,000	6,00,000
	Share Allotment A/c Dr To Share Capital A/c (Being money due on allotment)		4,00,000	 4,00,000
	Bank A/c Dr To Share Allotment A/c. (Being receipt of allotment and money on calls in advance)		4,00,000	 4,00,000
	Share First call A/c. Dr To Share Capital A/c (Being money due on the first call)		6,00,000	 6,00,000
	Bank A/c Dr Calls in Arrear A/c Dr To Share First Call A/c. To Calls in Advance (Being the receipt of money on first call and calls in arrear)		5,82,000 30,000	 6,00,000 12,000

___________ CO.LTD

Balance Sheet (extracts) as on-----

	Note	Current Year(Rs.)
I.Equity and Liabilities		
1. Shareholder's funds		
Share Capital	1	15,70,000
2. Current Liabilities		
Other Current Liabilities	2	12,000
Total		
II.Assets		15,82,000
I. Current Assets		
Cash and cash equivalents	3	15,82,000
Total		15,82,000

Notes to Accounts

		Rs.
1. Share Capital		
AuthorisedCapital		
-------- Equity Shares of Rs.10 each		
Issued Capital		
2,00,000 Equity shares of Rs.10 each		20,00,000
Subscribed Capital		
Subscribed but not fully paid up		
2,00,000 Equity shares of Rs.10 each ,Rs.8 called up	16,00,000	
Less Calls in Arrear	30,000	15,70,000
2. Other Current Liabities		
Calls in Advance		12,000
3. Cash and Cash Equivalent		
Cash at Bank		15,82,000

Shares issued for consideration other than cash:A company may issue shares for consideration other than cash . Such shares may be issued to the vendors or promoters of the company or as sweat equity shares. Shares issued for consideration other than cash are required to be disclosed in the Balance Sheet. It is disclosed under “Subscribed Share Capital” in the Notes to Accounts on “Share Capital”.

A company may purchase a running business and pay to the vendors purchase consideration in the form of shares .The difference if any ,between the purchase consideration and the net assets acquired by the company is debited to the Goodwill Account or credited to the Capital Reserve Account as the case may be .

The accounting entry in this case would be :

(a) On purchase of Assets

Sundry Assets A/c Dr.
To Vendor A/c

(b) On Purchase of business

Sundry Assets A/cDr.
Goodwill A/c Dr.
To Sundry Liabilities A/c
To Vendor A/c
To Capital Reserve A/c

(c) On issue of Shares at par

Vendor A/c Dr.
To Share Capital A/c

(d) If shares are issued at premium

Vendor A/c Dr
To Share Capital A/c
To Securities Premium Reserve A/c

Number of shares to be issued = $\frac{\text{Purchase Consideration}}{\text{Issue Price of Share}}$

Illustration 11:

A company issued 5,000 fully paid up shares of Rs.100 each for purchase of the following assets and liabilities from Madan Brothers

Land and buildings	Rs.3,00,000
Plant	Rs.2,00,000
Stock-in-trade	Rs.2,25,000
Sundry Creditors	Rs.50,000

You are required to pass the necessary Journal entries.

Solution:

JOURNAL

Date	Particulars	Dr.(Rs.)	Cr. (Rs.)
	Land and Buildings A/c Dr. Plant A/c Dr. Stock-in-trade A/c Dr. To Sundry Creditors A/c To Madan Brothers A/c To Capital Reserve A/c (Being purchase of business)	3,00,000 2,00,000 2,25,000	 50,000 5,00,000 1,75,000
	Madan Brothers A/c Dr. To Share Capital A/c (being issue of 5,000 shares of Rs.100 each as payment of the price of the business)	5,00,000	 5,00,000

Issue of shares to the promoters : A company may allot fully paid shares to the promoters or any other person for providing technical information, engineering services ,plan outlay, drawings ,etc. such amount may be debited to Incorporation Expenses Account. The accounting entries in such case could be :

Incorporation Expenses A/c Dr.

To Share Capital A/c

Illustration 12:

A company purchased a running business from M/s Hari Ram for a sum of Rs.1,00,000 payable as Rs.80,000 in fully paid up shares of Rs.10 each and balance in cash .The assets and liabilities consisted of the following :

Plant and Machinery	Rs.20,000	Stock	Rs.20,000
Building	Rs.20,000	Cash	Rs.5,000
Sundry Debtors	Rs.10,000	Sundry Creditors	Rs.10,000

Simultaneously, the company also decided to remunerate promoters for getting the formalities completed for the formation of the company and providing technical services after that, by issuing fully paid shares of Rs.10,000 and Rs.20,000 respectively.

You are required to pass the necessary Journal entries.

Solution:

JOURNAL

Date	*Particulars*	*Dr.(Rs.)*	*Cr. (Rs.)*
	Plant and Machinery A/c Dr.	20,000	
	Building A/c Dr.	20,000	
	Sundry Debtors A/c Dr.	10,000	
	Stock A/c Dr.	20,000	
	Cash A/c Dr.	5,000	
	Goodwill A/c Dr.	35,000	
	To Sundry Creditors A/c		10,000
	To Hari Ram A/c		1,00,000
	(Being purchase of business)		
	Hari Ram A/c Dr.	1,00,000	
	To Share Capital A/c		80,000
	To Cash A/c		20,000
	(being payment of the price of the business to Hari Ram)		
	Incorporation Expenses A/c Dr.	30,000	
	To Share Capital A/c		30,000
	(Being issue of fully paid shares to the promoters for formation and technical services)		

Knowledge Assessment III

State whether the following statement is (T) or (F)

1. The company can issue shares only when all the prescribed legal compliances have been met.
2. The Memorandum of Association states the rate of interest to be paid on the money received in advance.
3. The Incorporation Expenses Account may be debited by the amount of fully paid shares allotted to the promoters.
4. The calls in arrear are the calls that become due but are not paid by shareholders .
5. The shares are oversubscribed when the number of shares applied by the shareholders is equal to the number of shares offered for subscription
6. Partial Allotment means allotment to the shareholders is made on a proportionate basis
7. The difference between the purchase consideration and the net assets acquired by the company is credited to the Goodwill Account
8. The sharepremium collected by the company is to be transferred to a separate account called as"Share Premium Reserve Account " or Share Premium Account

(**Answers**:1.(True), 2(False), 3.(True) ,4.(True),5.(False),6.(True), 7.(False) 8.(True))

SESSION IV FORFEITURE OF SHARES

If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited. Forfeiture of shares may be said to be the compulsory termination of membership which leads to reduction of share capital .The company before forfeiture must give at least clear 14 days' notice to the defaulting shareholder unless he pays the amount due together with the interest ,if any, by the specified date the shares shall be forfeited .
The forfeited shares account is added to capital under Subscribed Share Capital in the Note to Accounts on "Share Capital"

Forfeiture of Shares Issued at Par:

Forfeiture of shares results in reduction of share capital and therefore the share capital account should be debited with the amount called up on these shares so far .The various unpaid calls account should be cancelled and ,therefore, they should be credited and the balance representing the amount received on the shares forfeited should be credited to a new account termed as ‘Forfeited Shares Account’.

Share Capital A/c Dr (with called up amount)
To Forfeited Shares A/c (with amount already received)
To Share Allotment (with amount due but not paid)
To Share Call (with amount due but not paid)

.**Illustration 13:**
A company forfeits 100 shares of Rs.10 each fully called up on which the shareholders has failed to pay the allotment money of Rs.2 per share and call money of Rs.3 per share.

Solution:

Journal Entries **Dr.** **Cr.**

Date	Particulars	Amount (Rs.)	
	Share Capital A/c Dr.	1,000	
	To Share Allotment A/c		200
	To Share Call A/c		300
	To Share Forfeited A/c		500

Forfeiture of shares issued at premium There can be two situations:

(a) **When the amount of Share premium has been received :**The amount of Securities Premium is not debited when the shares are forfeited due to restrictions enforced by Section 52(2)of the Companies Act ,2013.

Journal entry for the same:

Share Capital A/c Dr(with amount called up less premium)
To Unpaid Calls A/c
To Forfeited Shares A/c(Amount received less premium)

(b) **When the amount of Share premium has not been received :**The amount of premium that had been credited to Securities Premium Reserve Account but not received is debited in case of forfeiture of shares .

Journal entry for the same:

Share Capital A/c Dr(with amount called up less premium)

Securities Premium A/c Dr(amount of premium called up but notreceived)

To Unpaid Calls A/c
To Forfeited Shares A/c

Illustration 14:

Sanjeev Industries Ltd issued 1,00,000 equity shares of Rs.10 each at a premium of Rs.2 per share payable ,Rs.3 per share on application ,Rs.5 per share on allotment ,Rs.2 per share on first call and balance on second call .Ms.Renu was allotted 500 shares .Give journal entries in case

i) MsRenu paid application and allotment money when due but could not pay first and second call .Her shares were forfeited .
ii) Ms.Renu could not pay the allotment and first call money .Her shares were forfeited after the first call .

Solution :

JOURNAL OF XYZ LTD

Date	Particulars	L.F	Dr(Rs.)	Cr(Rs.)
i)	Equity Share Capital A/c(500 ×Rs.10) Dr To Share Forfeited A/c(500× Rs. 6) To Share First Call A/c(500× Rs.2) To Share Second Call A/c(500× Rs.2) (Being 500 shares forfeited for non payment of first and second calls)		5,000	 3,000 1,000 1,000
ii)	Equity Share Capital A/c (500× Rs.8) Dr Securities Premium Reserve A/c Dr To Share Forfeited A/c(500× Rs.3) To Share Allotment(500× Rs.5) To Share First Call(500× Rs.2) (Being 500 shares forfeited for non payment of allotment and first call)		4,000 1,000	 1,500 2,500 1,000

REISSUE OF FORFEITED SHARES

Forfeited shares can be reissued by the company at their convenience .They can be reissued at par,premium or discount .However,in case they are reissued at discount ,the amount of discount cannot exceed the amount that has been forfeited on these shares.

Shares reissued at par:

The journal entry would be :

Bank A/c Dr
To Share Capital A/c

Shares reissued at discount :

Bank A/c Dr(with the amount received on reissue)
Forfeited Shares A/c * Dr(with the discount allowed on reissue)
To Share Capital A/c (with the amount credited as paid up)

*Such amount is calculated as under :
Number of shares reissued ×(Paid up value-Reissue price per share)

Shares reissued at premium:

If the forfeited shares are reissued at premium ,the excess of reissue price over paid up value is credited to Securities Premium Reserve Account.

Bank A/c Dr
To Share Capital A/c
To Securities Premium Reserve A/c

Transfer of Balance in Forfeited Shares Account :

i) **All forfeited shares are reissued :** If after reissue of all the forfeited shares ,balance in the forfeited shares account is transferred to Capital Reserve.
Forfeited Shares A/c Dr
To Capital Reserve

ii) When all forfeited shares are not reissued : If part of shares are reissued ,the amount of discount cannot be more than the amount received on forfeited shares that are reissued.
Suppose 2,000 shares have been forfeited on which Rs.10,000 were received .If out of 2,000 shares ,only 1,000 are reissued then the share forefeitedaccount in respect of such shares would be Rs.5,000.It is to be observed that the discount on such reissued shares cannot be more than Rs5,000.If the discount allowed on reissued shares is Rs.3,000 then Rs 2,000(5,000-3,000) shall be transferred to Capital Reserve being Capital Profit. The amount on the forfeited shares not issued shall remain in the Forfeited Shares Account .This amount is added and shown under Subscribed Share Capital and shown as Shareholders funds in the Balance Sheet.

The profit on reissue of shares is calculated as follows
$= (\frac{\text{Total amount forfeited}}{Number\ of\ shares\ forfeited} \times No\ of\ shares\ reissued) -$(Reissue Discount or amount with which forfeited shares account was debited at the time of re issue of such shares)

Illustration 15:

Give Journal entries to record the forfeiture and reissue of shares and open Share forfeited Account in the books of the company.
L Ltd forfeited 500 shares @ Rs.10 each issued at a premium of Rs.5 per share for non-payment of allotment money of Rs.8 per share (including share premium of Rs.5 per share)and

first and final call of Rs.5 per share .Out of these ,50 shares were subsequently reissued at Rs.15 per shares.

Solution:

Date	Particulars	L.F	Dr(Rs.)	Cr(Rs.)
1.	Equity Share Capital A/c (500 ×Rs.10) Dr Securities Premium Reserve(500×Rs.5) Dr To Share Forfeited A/c(500× Rs2) To Share Allotment A/c(500× Rs.8) To Share First and Final Call A/c(500×Rs.5) (Being 500 shares forfeited for non-payment of allotment and first call)		5,000 2,500	 1,000 4,000 2,500
2.	Bank A/c (50×Rs.15) Dr To Equity Share Capital A/c(50×Rs.10) ToSecurities Premium Reserve A/c(50×Rs.5) (Being forfeited shares reissued @Rs.15 per share)		750	 500 250
3.	Forfeited Shares A/c Dr To Capital Reserve (Being profit on reissue transferred to Capital Reserve)		100	 100

Note:Calculation of amount transferred to Capital Reserve

Rs 1,000 × 50/500=Rs 100

Illustration 16:

A company forfeits 100 shares of Rs.10 each on which Rs.300 had been received .The company can allow a maximum discount of Rs.300 on these shares .In case these shares are reissued for Rs.900 fully paid ,pass the necessary journal entries

Solution:

S.No.	Particulars	L.F	Dr.Amount (Rs.)	Cr.Amount (Rs.)
	Bank A/c Dr Forfeited Shares A/c Dr To Share Capital A/c (being forfeited shares reissued)		900 100	 1,000
	Forfeited Shares A/c Dr To Capital Reserve (being profit on reissue of forfeited shares being transferred to capital reserve)		200	 200

In case only a part of the forfeited shares have been reissued then proportionate profit on reissue of forfeited shares will be transferred to capital reserve.

For example if in the above case only 60 shares are reissued at Rs.9 per share ,the amount to be transferred to Capital Reserve will be[(Rs.300×60/100)- Rs.60]= Rs.120

Knowledge Assessment IV

Fill in the blanks with appropriate words

1. If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be ____________.
2. As per Companies Act 2013 , shares cannot be____________ at discount .
3. Forfeited shares can be issued at discount but the amount of discount cannot ___________ the amount that has been forfeited on these shares.
4. If the forfeited shares are reissued at premium ,the excess of reissue price over paid up value is credited to ________________________.
5. If the discount allowed on reissued shares should be transferred to Capital Reserve as it represents _________________.
6. Forfeiture of shares leads to the ________ of share capital.
7. In case the calls are unpaid, such unpaid calls account should be cancelled and the balance should be credited to a new account called ___________________.

(**Answers:**1. forfeited 2. reissued 3. exceed 4. Securities Premium Reserve Account 5. Capital Profit 6. reduction 7.Forfeited Shares Account)

KEY WORDS

- **Share Capital of a Company** :- It is the amount that the company can raise or has raised by the issue of shares.
- **Preference Shares** :- Accordingly to section 43 (b) Preference shares are the shares that have two preferential rights i) preferential right to Dividend which may be a fixed amount or calculated at a fixed rate, which may be free or subject to Income Tax. ii) Preferential right to return the capital at the time of Winding up of companies.
- **Equity shares:** Shares which are not preference shares, are termed as equity shares. These shares do not carry any preferential right.
- **Reserve Share Capital:** It is that part of subscribed capital which is uncalled. This is that portion which has been reserved by the company by passing a special resolution to be called only in the event of its liquidation. It is shown as subscribed but not fully paid up share capital. Unlimited companies must have reserve capital ,
- **Issue of Shares at premium:** When the shares are issued at a price higher than the nominal value of the shares whether for cash or consideration other than cash,then it is called as shares issued at a premium.
- **Oversubscription of Shares:** The shares are oversubscribed when the number of shares applied is more than the number of shares offered for subscription .
- **Undersubscription of Shares :**The shares are under subscribed when the number of shares applied is less than the number of shares offered for subscription.
- **Calls In Arrear:** If the calls that become due are not paid by any one or more of the shareholders, the unpaid amount becomes arrears due from them.
- **Calls In Advance:** If the application money that is received on partially accepted applications is greater than the amount required for adjustment towards allotment money, the excess money shall be refunded to the investors.
- **Forfeiture of Shares:** If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited. Forfeiture of shares may be said to be the compulsory termination of membership which leads to reduction of share capital

SUMMARY

- A share may be said to be a bundle of rights as well as liabilities .It secures to its owner the right to receive a proportionate part of the profits if any, and proportionate part of the assets of the company upon liquidation .
- Accordingly to Companies Act 2013, the share capital can be divided into two types namely Preference Shares and Equity shares. The Preference Shares have preferential rights, preferential right to dividend and preferential right to return the capital at the

time of winding up of companies. The preference shares can be classified with reference to dividends, participation in profits, convertibility and redemption .The shares that are not preference shares are termed as equity shares. These shares do not carry any preferential right.

- The shares may be oversubscribed or undersubscribed . If the calls that become due are not paid by any one or more of the shareholders, the unpaid amount becomes arrears due from them. Such arrears are transferred to an account termed as calls-in-arrears. If a shareholder fails to pay the allotment money and/or calls made on him, his shares are liable to be forfeited by the company.
- Forfeiture of shares may be said to be the compulsory termination of membership which leads to reduction of share capital. The shares forfeited may have been issued at par or premium. The forfeited shares may be reissued at par , premium or discount but the amount of discount cannot exceed the amount that has been forfeited on these shares.

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EXERCISE QUESTIONS

Short Answer Questions

1. What is public company?
2. What is a private company.
3. Explain the term Preference Shares .
4. What is Redeemable Preference Shares?
5. What are Convertible Preference Shares?
6. What do you mean by Capital reserve ?
7. When can shares be Forfeited?
8. What is meant by Calls in Arrears?
9. What do you mean by Securities Premium Reserve ?
10. What are the uses of securities premium?
11. What is meant by Calls in Advance?
12. Write a brief note on “Minimum Subscription”.

Long Answer Questions

1. Distinguish between Equity and Preference share capital
2. Explain the main categories in which the Share capital is divided ?
3. Explain the process of issue of the forfeited shares
4. How is the share capital shown in the Balance Sheet of the company?
5. When can the shares of a company be issued at discount?
6. Can forfeited shares be issued at discount? If so at what terms?
7. Discuss the process for the allotment of shares of a company in case of over subscription.
8. What is a ‘Preference Share’? Describe the different types of preference shares.
9. Describe the provisions of law relating to ‘Calls in Arrears’ and ‘Calls in Advance’.

10. Explain the terms ‘Over subscription’ and ‘Under subscription’. How are they dealt with in accounting records?
11. Describe the purposes for which a company can use the amount of Securities Premium.
12. State clearly the conditions under which a company can issue shares at a discount.
13. Explain the term ‘Forfeiture of Shares’ and give the accounting treatment on forfeiture.

Numerical Questions

1. Oxy Ltd. offered 50,000 equity shares of Rs.10 each to the public for subscription. The shares were payable as under:
Rs.3 per share on application
Rs. 2 per share on allotment
Rs.2 per share on First call
Rs. 3 per share on Second and final call.
The shares were fully subscribed for and the money was duly received.
Show the journal and cash book entries.

2. P Ltd issued 20000 shares of Rs 10 each payable as Rs 2 per share on application, Rs 5 (including premium of Rs 2 per share) on allotment, Rs 3 per share on first call and the balance on Final Call. All the money were received except the first call money on 400 shares; which was received later on with final call.
Make necessary journal entries.

(**Answer:** Calls in arrear =Rs.1,200)

3. Jaya Ltd. Issued 60,000 shares @Rs.10 each at a premium of Rs.2 per share payable as Rs.3 on application,Rs.5(including premium)on allotment and the balance on first and final call. Applications were received for 82,000 shares .The Directors resolved to allot as follows :

A:Applicants of 30,000 shares	20,000 shares
B: Applicants of 50,000 shares	40,000 shares
C:Applicants of 2,000 shares	Nil

Ramesh who had applied for 900 shares in Category A,and Suresh who was allotted 600 shares in Category B failed to pay the allotment money .

(**Answer:**Amount unpaid by Ramesh=Rs.2,100, Amount unpaid by Suresh=Rs.2,550,Amount of money received on allotment =Rs.2,35,350)

4. WNX Ltd. issued 10,000, 12% Preference Shares of 100 each at a premium of 10 per share payable as follows:

On Application	Rs.30
On Allotment	Rs.30 (including premium)
On First Call	Rs.25
On Final Call	Rs.25

The application were received for 12,000 shares and the directors allotted 10,000 shares and rejected 2,000 shares with the money received thereon refunded. The allotment money was duly received while the first call money was received on 9,000 shares and the final call money on 8,000 shares. Show the cash book and journal entries and prepare the balance sheet of the company.

5. Ranbaxy Ltd. purchased the business of Comet Ltd. for 2,70,000 payable in fully paid shares. Rocket Ltd. allotted equity shares of 10 each fully paid in satisfaction of the claim by Comet Ltd. Show the necessary journal entries in the books of Ranbaxy Ltd. assuming that:

i. Such shares are issued at par,

ii. Such shares are issued at premium of 20% and

(**Answer:** No. shares to be allotted at a premium of 20%= 22,500)

6. Maruti Cars Ltd. issued 100000 shares of Rs 10 each at a premium of Rs 5 per share, payable as:

On application Rs. 4 (including Rs 2 premium) per share

On allotment Rs 8 (including Rs 3 premium) per share

On call Rs. 3 per share

Applications were received for 100000 shares and allotment was made to all. Make journal entries.

(Answer: Share Premium =Rs.3,00,000)

7. DN Ltd. issued 50,000 shares of Rs 10 each at a discount of 10% payable as

On application Rs. 2 per share

On allotment Rs3 per share

On First call Rs. 2 per share

On Final Call Rs.2 per share

Applications were received for 70,000 shares and it was decided that:

Refuse allotment to the applicants for 10,000 shares , Allot 20,000 shares to Mohan who had applied for similar number ,Allot the remaining on pro-rata basis.

8. Mohan failed to pay allotment money and Sohan who belonged to Category'C'and was allotted 3,000 shares paid both calls with allotment. Calculate amount received on allotment

(**Answer:** Amount received on Allotment =Rs.82,000)

9. The directors of a company forfeited 300 shares of Rs.10 each issued at a premium of Rs.3 per share, for the non payment of the first call money of Rs.3 per share .The final call of Rs.2 per share has not been made .Half the forfeited shares were reissued at Rs.1,000 fully paid . (**Answer**: Capital Reserve =Rs.750)

10. GaganLtd forfeited 1,500 shares of Rs.10 each for the non payment of the first call money of Rs.2 per share .The final call of Rs.1 per share has not been made .The forfeited shares were reissued at Rs.21,000 as fully paid up .Pass necessary journal entries in the books of the company for forfeiture and reissue of shares .

(**Answer:** Capital Reserve =Rs.10,500)

11. CAPEX Ltd. forfeited 1,000 equity shares of 10 each issued at par for non-payment of the first call of 2 per share and the final call of 3 per share. Give journal entry for the forfeiture.

*(***Answer:**Shares Forfeited A/c=Rs.5,000***)***

12. EXIM Ltd. forfeited 1,500 Equity Shares of 10 each, issued at a premium of 5 per share for non-payment of allotment money of 8 per share (including share premium 5 per share) the first call of 2 per share and the final call of 3 per share. Give the journal entry for the forfeiture.

(**Answer :**Shares Forfeited A/c= Rs.3,000)

UNIT 7 DEBENTURES

<table>
<tr><td>UNIT CODE-VII</td><td colspan="4">UNIT TITLE: DEBENTURES</td></tr>
<tr><td rowspan="3">Location:
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<tr><td colspan="4">SESSION 1: MEANING AND CLASSIFICATION OF DEBENTURES</td></tr>
<tr><td></td><td>1. Meaning of Debenture.

2.Features of Debentures.

3.Types of Debentures

4.Difference between shares and debentures

5. Disclosure in the Balance Sheet</td><td>1. Describe the meaning of debentures.

2. Define features of debentures.

3. Classify the debentures as per different perspectives .

4. Explain the basis of differencebetween shares and debentures.

5. Describe the treatment of debenture both as current liability and non- current liability.</td><td>1. Define the term Debentures .

2.Elucidate the basic features of debentures

3. Categorize the debentures on different basis such as security, redemption, convertibility transferability etc.

4. Discuss the dissimilarity between the shares and the debentures.

5. Discuss the treatment of debenture in the Balance Sheet.</td><td>Interactive Lecture: Deliberate uponthe concept and meaning of Debentures

Interactive Lecture: Explain the various features of debentures.

Interactive Lecture: Explain the various basis on which the debentures are classified .

Interactive Lecture: Elucidate the distinction between shares and debentures.
Interactive Lecture: Enumerate the heads under which the debenture will appear based upon the date of redemption.</td></tr>
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	SESSION 2: ISSUE OF DEBENTURES			
	1.Issue of Debentures for cash	1.Explain the accounting treatment for issue of debenturesfor cash	1. Discuss the terms of issue of debentures whether at par, premium or discount.	**Interactive Lecture:** Explain the accounting treatment for debentures to be issued under different circumstances for cash.
	2.Issue of debentures for consideration other than cash	2.Describe the accounting treatment for Debenture issued for consideration other than cash	2. Explain treatment of debentures issued at par ,premium or discount for consideration other than cash	**Interactive Lecture:** Explain the way in which the debenture premium or discount on issue of debentures will be treated .
	3. Debentures issuedas collateral security.	3. Explain the journal entries for Debenture issued as collateral security.	3. Identify the accounting treatment for debentures issued at par ,premium or discount for debentures issued as collateral.	**Interactive Lecture:** Elucidate the accounting journal entries for debentures issued as collateral.
	4.Issue and redemption of debentures on different terms .	4. Describe the accounting treatment for different terms of issue and redemption of debentures.	4. Explain the journal entries for the dissimilar terms of issue and redemption.	**Interactive Lecture:** Explain the accounting treatment through journal entries for the issue and redemption of debentures .
	5.Treatment for interest on debentures	5.Explain the accounting treatment for interest on debentures	5. Elucidiate the accounting journal entries for interest on debentures.	**Interactive Lecture:** Describe the journal entries for interest on debentures .

ISSUE OF DEBENTURES

Learning Objectives

After reading the unit, the students will be able to:

- understand meaning of debentures
- enumerate the features of debentures
- describe different types of debentures
- understand the difference between shares and debentures
- explain the disclosure of debenture in the balance sheet
- understand the accounting treatment for debentures issued for cash
- enumerate accounting treatment for issue of debentures for consideration other than cash
- describe the accounting treatment for debentures issued as collateral security.
- explain the different terms for issue and redemption of debentures
- understand the accounting treatment for interest on debentures and
- explain the meaning of certain keywords.

SESSION –I MEANING OF DEBENTURES

When the company has an intention to raise loan amount from the public it issues debentures .A debenture is a document issued under the seal of the company where the debenture holder is the creditor of the company. It is an acknowledgement of the loan received by the company equal to the nominal value of the debenture.It not only bears the date of repayment but also rate and mode of payment of Interest.

As per Sec.2(30) of the Companies Act ,2013,"Debenture" includes debenture stock, bonds or any other instrument of the company evidencing a debt, whether constituting a charge on the assets of the company or not. A company can issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Such an option has to be approved by a special resolution passed at a general meeting. No company shall issue any debentures carrying any voting rights.

FEATURES OF DEBENTURES

1. An acknowledgement of debt
2. It may or may not be secured
3. They carry fixed interest rates
4. They represent long term borrowing of the company

TYPES OF DEBENTURES

Debenture can be classified as under:

1. **From security point of view:**

   Secured or Mortgage debentures: Debentures thatare secured by a charge on the whole or part of assets of the company arecalled mortgage debentures. The holders of secured debentures are given priority in repayment depending on the order in which they have been issued. The date of redemption of such secured debentures shall not exceed 10 years from the date of issue. If a company is engaged in the setting up of infrastructure projects ,it may issue secured debentures for a period exceeding 10 years but not exceeding 30 years .Debentures issued earlier will have priority over debentures issued later on. In India, debentures must be secured. Secureddebentures can be of two types:
   (a) **First mortgage debentures:** The holders of such debentureshave a first claim over other debentures as regards proceeds of property mortgaged.
   (b) **Second mortgage debentures:** The holders of such debentures are paid only after the claims of the first debentures are met.

   Unsecured debentures: These debentures do not carry charge on assets of the company. The holders of such debentures which do not carry anysecurity with regard to the repayment of principal amount or interest arecalled unsecured debentures. These are called Naked or Unsecured Debentures. Issues of these types of debentures are not permitted in India as per law.

2. **On the basis of redemption**

   Redeemable debentures: The principal amount of such debenturesis paid off to the debenture holders on the expiry of specified period.These are the debentures which areissued for a fixed period. Redeemable debentures can be reissued even after they have been redeemed until they have been cancelled. Such debentures can be redeemed by annual drawings or by purchasing fromthe open market.

   Non-redeemable debentures: These are the debentures whichare not redeemed in the life time of the company. Such debenturesare paid back only when the company goes into liquidation.Irredeemable debentures are not issued in India.

3. **On the basis of Transferability:**

Registered debentures: They are made in the name of specific persons, who are registered as debenture holders in the books of the company. These are the debentures that areregistered with the company. The names of debenture holders and amount on these debentures are recorded in the register of the company. The amount on these debentures is payable only to those whose name appears inthe register of the company.

Bearer debentures: Bearer debentures are treated as negotiable instruments and aretransferrable merely by delivery. The names of debenture holders are notrecorded in a register of the company.

4. **On the basis of convertibility**

Convertible debentures: These are the debentures that can beconverted into shares of the company as per the terms of their issue.

Non-convertible debentures: The debentures that are not convertible into shares of the company are called Non-convertible debentures.

5. **From Coupon Rate Point of view**

Specific Coupon Rate Debentures: These debentures are issued witha specified rate of interest, which is called the coupon rate. The specifiedrate may either be fixed or floating.

Zero Coupon Rate Debentures: Rate of interest is not specified on these debentures. Such debenturesare issued at substantial discount and the difference between thenominal value and the issue price is treated as the amount of interestassociated with the duration of the debentures .

DIFFERENCE BETWEEN SHARES AND DEBENTURES

Basis	**Debentures**	**Shares**
Ownership	The debentures represent the debt taken by the company and hence debenture holders are creditors of the company	Shares represent the capital of the company and hence shareholders are owners of the company
Voting Rights	According to the Companies Act 2013, no company shall issue any debentures carrying any voting rights.	Shareholders have right to vote and attend the general meetings of the company.
Return	Debenture holders get interest at a fixed rate.	Shareholders get dividend as declared by the board of directors in the Annual General Meeting .
Issue at discount	Debentures can be issued at discount.	Shares cannot be issued at discount except Sweat Equity Shares .
Risk	Debentures do not carry any risk with respect to the payment of interest or	The shareholders face risk with respect to the payment of dividend.

	redemption.	
Winding up	The debenture holders have priority for the payment at the time of winding up of the company.	Shareholders are paid after all the liabilities have been met.
Convertibility	Debentures can be converted into shares .	Shares cannot be converted into any other security.

DISCLOSURE IN THE BALANCE SHEET

Debentures are shown in the "Equity and Liabilities"side of the Balance Sheet. They may be either a current liability or a Non-Current Liability depending on their redemption period.

1. **Debentures as Non-Current Liability**

When the debentures are due for redemption after 12 months from the reporting date or after the period of operating cycle,they are shown in the Balance Sheet under the head "Non Current Liabilities" and sub head 'Long term borrowings'

2. **Debentures as Current Liability**

In case the debentures are redeemable within a period of 12 months from the date of issue or within the period of operating cycle, then they are shown under the head of Current Liabilities and sub head 'Short term borrowings'.

Knowledge Assessment-I

Fill the blanks with the appropriate answers:

1. Debentures that are secured by a charge on the whole or part of assets of the company are called ____________.
2. If a company is engaged in ______________ ,it may issue secured debentures for a period exceeding 10 years but not exceeding 30 years.
3. ______________ are the debentures that can be converted into shares of the company as per the terms of their issue.
4. When the debentures are issued with specified rate of interest, such an interest rate is called the ______________.
5. The debentures represent the debt taken by the company and hence debenture holders are _____________ of the company.
6. The debenture holders have _____________ for the payment at the time of winding up of the company.
7. Debentures are shown in the ___________________ side of the Balance Sheet.

(**Answers:**1.secured debentures 2. infrastructure projects 3.Convertible debentures 4.coupon rate 5.creditors6.priority 7. Equity and Liabilities

SESSION –II ISSUE OF DEBENTURES

The issue of debentures implies issue of a certificate by the company which is an acknowledgment of debt taken by the company. The procedure of issuing debentures by a company is similar to that of the issue of shares. The debentures can be issued at (i) par, (ii) premium, or (iii) discount.

Issue of Debenture takes various forms which are as under:

1. Debentures issued for cash
2. Debentures issued for consideration other than cash
3. Debentures issued as collateral security.

I. ACCOUNTING TREATMENT OF ISSUE OF DEBENTURES FOR CASH

The debentures may be issued at par or premium or discount. If the debenture is issued at premium then the amount of premium received will be credited to Securities Premium Reserve account as specified in the Companies Act, 2013. If the debentures are issued at discountthen such discount on issue of debentures shall be debited to the account Discount on issue of Debentures Account.

The following are the journal entries for debentures issued at par .

1. **Debentures issued for cash at par :**

(i) For the receipt of application money

Bank A/c Dr.
To Debentures Application A/c
(Being application money received for Debentures)

(ii) On allotment of debentures

Debentures Application A/c Dr.

To Debentures A/c

(Being application money transferred to debentureaccount on allotment)

(iii)For the amount due on allotment

Debentures Allotment A/c Dr.

To Debentures A/c

(Being allotment money made due)

(iv)Receipt of money due on allotment
Bank A/c Dr.

To Debentures Allotment A/c

(Being the receipt of debenture allotment money)

(v) When First call is made
Debentures first call A/c Dr.
To Debentures A/c
(Being First and Final call money made due on debentures)

(vi)At the time of receipt of Debentures First call money
Bank A/c Dr.
To Debentures First call A/c

(Being the receipt of amount due on call)

(vii) When Second and final call is made

Debentures First and Final call A/c Dr.

To Debentures A/c

(Being Second and Final call money made due on debentures)

(viii) At the time when Debentures Second and Final call money is received

Bank A/c Dr.

To Debentures Second and Final call A/c

(Being the receipt of amount due on call)

Note:
The rate of interest payable on debentures is to be prefixed with the “Debenture Account”

(ix) For payment of Interest on Debentures

Debenture Interest A/c Dr.

To Bank A/c

To Tax Deducted at Source

Illustration 1

ShayneeLtd. issued 10,000, 5% Debentures of Rs.100 each payable asfollows

Rs.20 on Application

Rs.30 on Allotment

Rs.50 on First and Final call

All the debentures were applied for and allotted. All the calls were dulyreceived. Make necessary journal entries in the books of the company.

Solution:

In the books of Shynee Ltd.

JOURNAL

Date	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)

	Bank A/c Dr. To Debentures Application A/c (Being application money received for10,000 debentures)		2,00,000	 2,00,000
	Debentures Application A/c Dr. To 5% Debentures A/c (Being application money transferred toDebentures A/c on allotment)		2,00,000	 2,00,000
	Debentures Allotment A/c Dr. To 5% Debentures A/c (Being allotment money due on 10,000debentures @ Rs 30 per debenture)		3,00,000	 3,00,000
	Bank A/c Dr. To Debentures Allotment A/c (Being allotment money received)		3,00,000	 3,00,000
	Debentures First and Final call A/cDr. To 5% Debentures A/c (Being debentures first and final call money made due @ Rs.50 per debenture)		5,00,000	 5,00,000
	Bank A/cDr. To Debentures First and Final call A/c (Being receipt of Debentures first and finalcall money)		5,00,000	 5,00,000

2. **Debentures issued at premium :**

When the debentures are issued at a valuewhich is more thantheir nominal value, they are said to be issued at premium. For example, a debenture ofRs 100 is issued at Rs 110. This excess amount of Rs 10 is the amountof premium. The premium on the issue of debentures is credited to the Securities Premium Reserve Account and shown in the Equity and Liability part of the Balance Sheet as Reserves and Surplus under Share-holders funds. Section 52(2) of Companies Act ,2013 specifies the utilization of Securities Premium Reserve Account . The securities premium account may be applied by the company –

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares; or

(b) in writing off the preliminary expenses of the company; or

(c) in writing off the expenses of, or the commission paid or discount allowed on any issues of shares or debentures of the company; or

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under Section 68.

Note : In case nothing is mentioned ,then the amount of premium is to be assumed to be called at the time of allotment .

Journal entry for amount due on allotment:

Debentures Allotment A/c Dr.

To Debentures Account

To Securities Premium Reserve A/c

(Being the amount due on allotment including the premium of Rs.__)

Illustration 2

A company has issued 50,000 10% Debentures of Rs.100 each at a premiumof 20% payable as

Rs.50 on application

Rs.70 on allotment (including premium)

All the debentures were subscribed for and money was duly received. Makejournal entries.

Solution:

JOURNAL

Date	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
	Bank A/c Dr. To Debentures Application A/c (Being application money received for50,000 debentures)		25,00,000	25,00,000
	Debentures Application A/c Dr. To 5% Debentures A/c (Being application money transferred toDebentures A/c on allotment)		25,00,000	25,00,000
	Debentures Allotment A/c Dr. To 5% Debentures A/c To Securities Premium Reserve A/c (Being allotment money due)		35,00,000	25,00,000 10,00,000
	Bank A/c Dr. To Debentures Allotment A/c (Being allotment money received)		35,00,000	35,00,000

BALANCE SHEET AS ON 31ST March ________

Particulars	Note no	Rs
I Equity and Liabilities		
1) Shareholders Fund Reserves & Surplus	1	 10,00,000
2) Non-Current Liabilities Long Term borrowing	2	 50,00,000
Total	Total	60,00,000
II Assets		
Current Assets Cash and Cash equivalents	 3	 60,00,000
Total		60,00,000

Notes to Accounts

1) Reserves and Surplus Securities Premium Reserve	 10,00,000
2) Long Term Borrowings 50,000 5% Debentures of Rs100 each	 50,00,000
3) Cash and Cash equivalent Cash at Bank	 60,00,000

3. Debentures issued at discount :

The Articles of Association of the Company must provide for discount on issue of debentures. The Discount on issue of Debentures is a capital loss and it can be written off either against the Securities Premium Reserve Account as per Section 52 (2), or from the Statement of Profit and Loss Account. It has to be written off within the life of the debentures. However, the unamortized discount on issue of debentures which is to be written off within 12 months of the date of balance sheet or within the period of operating cycle is shown under the head Current Assets under the sub head 'Other Current Assets'. The balance unamortized amount yet to be written off over the life of debentures is shown under the head "Non Current Assets" under the sub head 'Other Non Current Assets '.

Journal entry for issue of debentures at discount

Debentures Allotment A/c Dr.

Discount on issue of debentures A/c Dr.

To Debentures A/c

(Being the allotment money due along with the amount ofdiscount per debenture)

Securities Premium Reserve A/c Dr.

Statement of Profit and Loss A/c Dr.

To Discount on Issue of Debentures

(the discount on the issue of debenture being written off)

Illustration 3

A company has issued 1,000 9% debentures of Rs. 100 each at a discountof 10% payable as

Rs.50 on application

Rs.40 on allotment. The debentures are redeemable after 5 years .

Make necessary journal entries

Solution:

JOURNAL

Date	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
	Bank A/c Dr. To Debentures Application A/c (Being application money received for 50,000 debentures)		50,000	 50,000
	Debentures Application A/c Dr. To 5% Debentures A/c (Being application money transferred toDebentures A/c on allotment)		50,000	 50,000
	Debentures Allotment A/c Dr. Discount on issue of debentures A/c Dr. To Debentures A/c (Being the allotment money due along with the amount ofdiscount per debenture)		40,000 10,000	 50,000
	Bank A/c Dr. To Debentures Allotment A/c (Being allotment money received)		40,000	 40,000

BALANCE SHEET AS ON 31ST March ________

Particulars	Note no	Rs
I Equity and Liabilities		
Non-Current Liabilities Long Term borrowing	 1	 1,00,000
Total	Total	1,00,000
II Assets		
1. Non Current Assets Other Non Current Assets*	 2	 8,000

2. Current Assets (a) Cash and Cash equivalents (b) Other Current Assets *	 3 4	 90,000 2,000
Total		60,00,000

Notes to Accounts

1. Long Term Borrowings 1000 5% Debentures of Rs100 each	 1,00,000
2. Other Non Current Assets Discount on Issue of Debentures (Unamortized)	 8,000
3. Cash and Cash equivalent Cash at Bank	 90,000
4. Other Current Assets Discount on Issue of Debentures (Unamortized)	 2,000

*Discount on issue of Issue of Debentures is shown as “Other Non CurrentAssets”and“Other Current Assets”

Discount on issue of debentures Rs.10,000

Less : Unamortized Discount on issue of Debentures to be

written off within 12 months from the date of Balance Sheet (10,000×1/5) Rs. 2,000

Amount of unamortized discount to be shown as Other Non-Current Assets Rs.8,000

Illustration 4

Greta Ltd ; issued 6,000 12% debentures of Rs. 100 each at a discount of 10% payable as follows:

Rs. 40 on application; Rs. 30 on allotment (discount to be adjusted with allotment) and Rs. 20 on first and final call. The issue was fully subscribed and all money was received in full. Give journal entries and the ledger accounts for the same.

Solution:

JOURNAL

Date	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
	Bank A/c Dr. To Debentures Application A/c (Being application money received for 6,000 debentures)		2,40,000	 2,40,000

	Debentures Application A/c Dr. To 12% Debentures A/c (Being application money transferred toDebentures A/c on allotment)		2,40,000	 2,40,000
	Debentures Allotment A/c (6,000×30) Dr. Discount on Issue of Debentures A/c Dr. To 12%Debentures A/c (Being the allotment money due along with the amount ofdiscount per debenture)		1,80,000 60,000	 2,40,000
	Bank A/c Dr. To Debentures Allotment A/c (Being allotment money received)		1,80,000	 1,80,000
	Debenture Final Call A/c Dr. To 12% Debentures A/c (Being first and final call due @Rs.20 per debenture)		1,20,000	 1,20,000
	Bank A/c Dr. To Debentures First and Final Call A/c (Being final call received)		1,20,000	 1,20,000

In the books of Greta Ltd

Dr. **12% DEBENTURE ACCOUNT** Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Balance c/d	6,00,000	By Debenture Application A/c By Debenture Allotment A/c By Discount on Issue of Debentures A/c By Debenture First and Final Call A/c	2,40,000 1,80,000 60,000 1,20,000
	6,00,000		**6,00,000**

Dr. **DISCOUNT ON ISSUE OF DEBENTURES ACCOUNT** Cr

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To 12% Debentures A/c	60,000	By Balance c/d	60,000
	60,000		**60,000**

Dr. **BANK ACCOUNT** Cr

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Debenture Application A/c To Debenture Allotment A/c To Debenture First and Final Call A/c	2,40,000 1,80,000 1,20,000	By Balance c/d	5,40,000
	5,40,000		**5,40,000**

II. ISSUE OF DEBENTURES FOR CONSIDERATION OTHER THAN CASH

The company may issue debentures for the payment of the purchase of some assets which may be tangible or intangible(plant and machinery, tools ,goodwill ,copyrights, patents etc.)to the vendors.Such an issue of debenture is known as issue of debentures forconsideration other than cash. Debentures can be issued to vendors at par,at premium and at discount.

Accounting Treatment:

1. **When purchase consideration is equal to the value of net assets**

   Sundry Assets A/c Dr.

   To Sundry Liabilities A/c

   To Vendors A/c

   (Being purchase of assets)

2. **When purchase consideration is more than the value of net assets**

   Sundry Assets A/c Dr.
   Goodwill A/c Dr.(balancing figure)
   To Sundry Liabilities A/c
   To Vendors A/c

3. **When purchase consideration is less than the value of net assets**

   Sundry Assets A/c Dr.
   To Sundry Liabilities A/c
   To Capital Reserve A/c (balancing figure)

   To Vendors A/c

For Allotment of debentures to Vendor

(i) At par

Vendors' A/c Dr.

To Debentures A/c

(Being issue of debentures at par to vendors)

(ii) At discount

Vendors' A/c Dr.

Discount on Issue of Debentures A/c Dr.

To Debentures A/c

(Being the issue of debentures to vendors at a discount ofRs._per debenture)

(iii)At premium

Vendors' A/c Dr

To Debentures A/c

To Securities Premium Reserve A/c

(Being issue of debentures to vendors at a premiumof Rs.__per debenture)

Note : Number of Debentures Issued = $\frac{\text{Purchase Consideration}}{\text{Issue Price of each Debenture}}$

Illustration 5

Saviour Gems Ltd. purchased machinery for Rs 1,80,000 and issued 9% Debentures of Rs 100 each to the vendors. Make journal entries if thedebentures were issued

(a) At par

(b) At a premium of Rs.20

(c) At a discount of Rs. 10

Solution:

In the books of Saviour Gems Ltd.

JOURNAL

Situations	Particulars	L.F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
(i) At par	Machinery A/c Dr To Vendors A/c (Being the machine purchased)		1,80,000	 1,80,000
	Vendors A/c Dr To 9% Debentures A/c		1,80,000	 1,80,000

	(1800 debentures of Rs 100 each issued at par to vendors)			
(ii) At Premium	Vendors A/c Dr To 9% Debentures A/c To Securities Premium Reserve A/c (1500 debentures issued at a premium of Rs 10 per debenture)		1,80,000	 1,50,000 30,000
(iii) At Discount	Vendors A/c Dr Discount on Issue of Debentures A/c Dr To 9% Debentures A/c (Issue of 2,000 9% debentures of Rs 100 each ata discount of Rs 10 per debenture)		1,80,000 20,000	 2,00,000

Working notes

Debentures Issued at Premium

Amount due = Rs. 1,80,000

Value of debenture including Rs.20 for premium = Rs 120

No. of debentures to be issued =Rs 1,80,000 / Rs. 120 = 1,500

∴ Debenture amount (Nominal value) = 1500 × 100 = Rs 1,50,000

Securities Premium Amount = 1,500 × Rs. 20 = Rs30,000

Debentures Issued at Discount

If debentures are issued at a discount of Rs.10

Amount due to vendor = Rs 1,80,000

Value of one debenture at a discount of Rs 10 = Rs 90

No. of debentures to be issued = Rs 1,80,000 ÷ Rs 90 = 2,000

Debentures amount (Nominal value) = 2,000 × Rs 100 = Rs 2,00,000

Discount on issue of Debentures = 2000 × Rs 10 = Rs 20,000

ISSUE OF DEBENTURES AS COLLATERAL SECURITY

A company may give debentures as an additional security beside the property of the company which is the principal security in case it borrows money. Such anissue of debentures is known as 'issue of debentures as collateral security'.Collateral security means security given in addition to the principal security.The lender shall have a right over such debentures only in the case of failure in the payment of loan by the company. In case the company pays back the amount of loan taken ,then the debentures will be returned backto the company. No interest shall be paid on the debentures issued as collateralsecurity because company pays interest on loan.In the accounting books of the company, issue of debentures as collateralsecurity can be credited in two ways.

First Method : Since no liability is created, no entry is made in the books of accounts

Second Method: Although no liability is created but entry is made in the books of accounts

First Method

Since no liability is created by suchissue, no entry is made in the books of accounts. However, on the liability side of the balance sheet, below the item of loan,a note to the effect that it has been secured by issue of debentures as a collateralsecurity is appended. For example, X Company has issued 5%, 50,000debentures of Rs 100 each for a loan of Rs50,00,000 taken from a bank. Thisfact may be shown in the balance sheet as under:

Balance Sheet as on 31 December 2014

Particulars	NoteNo.	Amount (Rs)
I. **Equity and Liabilities** 1. Non-current Liabilities Long-term borrowings	1	50,00,000

Notes to Accounts

Particulars	Amount (Rs)
1**. Long-term borrowings** Bank Loan (Secured by issue of 50,000, 5% debentures of Rs 10 each as Collateral Security)	50,00,000

Second Method

The issue of debentures as a collateral security may be recorded by means ofjournal entry as follows:

Debenture Suspense A/c Dr. 50,00,000

To 5% Debentures A/c 50,00,000

On repayment of the bank loan, the entry will be reversed and the Debenture Suspense A/c will appear as a deduction from the debentureson the liability side of the balance sheet.

5% Debenture A/c Dr. 50,00,000

To Debenture Suspense A/c 50,00,000

Balance Sheet as on 31 December 2014

Particulars	NoteNo.	Amount (Rs)
I. Equity and Liabilities 1. Non-current Liabilities Long-term borrowings	1	50,00,000

Notes to Accounts

Particulars		Amount (Rs)
1. Long-term borrowings		50,00,000
Bank Loan5%, 50,000 debentures ofRs 100 each	50,00,000	
Less: Debenture suspense	<u>50,00,000</u>	--------------
		50,00,000

Illustration 6

A company took a loan of Rs 20,00,000 from HDFC Bank and issued10% debentures of Rs 22,00,000 of Rs 100 each as a collateral security. Explainhow you will deal with the issue of debentures in the books of the company.

Solution

Particulars	NoteNo.	Amount (Rs)
I. Equity and Liabilities 1. Non-current Liabilities Long-term borrowings	1	20,00,000

Notes to Accounts

Particulars	Amount (Rs)
1. Long-term borrowings Bank Loan (22,000, 10% debentures ofRs 100 each)	20,00,000
	20,00,000

DIFFERENT TERMS FOR ISSUE OF DEBENTURES

A company may issue debentures at different terms .The terms may not only lead to issue but also redemption of debentures .

(i) Issued at par redeemable at par

Bank A/c Dr

To Debentures Account

(Being issue of debentures at par)

(ii) Issued at discount and redeemable at par

Bank A/c Dr

Discount on Issue of Debentures A/c Dr

To Debentures A/c

(Being issue of debentures of Rs_ at a discount of Rs ___)

(iii)Issued at premium redeemable at par

Bank A/c Dr

To Debentures A/c

To Securities Premium Reserve A/c

(Being issue of ... debentures of Rs .... at a premium of Rs ....)

(iv)Issued at par, redeemable at premium

Bank A/c Dr

Loss on Issue of Debentures A/c Dr

To Debentures A/c

To Premium on Redemption of Debenture A/c

(Being issue of ______debentures of Rs____a redeemable at a premium of Rs _____)

(v) Issued at discount and redeemable at premium

Bank A/c Dr

Discount on Issue of Debentures A/c Dr

Loss on Issue of Debentures A/c Dr

To Debentures A/c

To Premium on Redemption of Debenture A/c

(Being issue of ______ debentures of Rs___ at a discount ofRs__ redeemable at a premium of Rs __)

Illustration 7

Make journal entries if 200 debentures of Rs 500 each have been issuedas :

(i) Issued at Rs 500, redeemable at Rs 500

(ii) Issue at Rs 450; redeemable at Rs 500

(iii) Issued at Rs 550; redeemable at Rs 500

(iv) issued at Rs 500; redeemable at Rs 550

(v) Issued at Rs 450; redeemable at Rs 550

Solution:

JOURNAL

Situation	Particulars	L. F	Dr. Amount (Rs.)	Cr. Amount (Rs.)
(i)	Bank A/c Dr. To Debentures A/c (Issue of 200 debentures @ of Rs 500 each)		1,00,000	 1,00,000
(ii)	Bank A/c Dr. Discount on Issue of Debentures A/c Dr. To Debentures A/c (Issue of 200 debentures of Rs 50each at Rs 450)		90,000 10,000	 1,00,000
(iii)	Bank A/c Dr. To Debentures A/c To Securities Premium Reserve A/c (Issue of 200 debentures of Rs.500each at Rs.550)		1,10,000	 1,00,000 10,000
(iv)	Bank A/c Dr. Loss on Issue of Debentures A/c Dr. To Debentures A/c To Premium on Redemption of Debentures A/c (Issue of 200 debentures of Rs.500 eachat Rs.500 repayable at Rs.550)		1,00,000 10,000	 100,000 10,000
(v)	Bank A/c Dr. Discount on Issue of Debentures A/c Dr. Loss on Issue of Debentures A/c Dr. To Debentures A/c To Premium on Redemption of Debentures A/c (Issue of 200 Debentures of Rs 500each at Rs 450repayable at Rs 550)		90,000 10,000 10,000	 1,00,000 10,000

According AS-16(Borrowing Cost) discount or loss on issue of debentures should be amortized over the years of benefit i.e 3-5 years .It is to be written off from Capital Reserve, Securities Premium Reserve Account or from Statement of Profit and Loss Account.

The journal entry for writing off the loss will be:

Capital Reserve A/c Dr.

Securities Premium Reserve A/c Dr.

Statement of Profit and Loss A/c Dr.

To Loss (Discount) on Issue of Debentures A/c

It is to be noted that writing off the loss on issue of debenture is not a legal necessity. However, sound principles require that such loss should be written off as soon as possible before the debentures are redeemed.

TREATMENT FOR INTEREST ON DEBENTURES

The interest on debentures is computed at a fixed rate on its face value .Such an interest on debentures may be paid annually, half yearly or quarterly as per the terms of the issue .The interest on debentures is a charge against profits of the company and may be subject to the tax deducted at source (TDS).In case the interest is accrued but not yet paid it shall be shown under Current Liabilities and sub head ‘Other Current Liabilities’

Journal Entries:

(i) When interest is due :

Debenture Interest A/c Dr

To Debentureholders A/c

(ii) When Interest is due and Tax is deducted at source

Debenture Interest A/c Dr

To Debentureholders A/c

To TDS

(iii)At the time of payment of interest

Debentureholders A/c Dr

To Cash/Bank A/c

Knowledge Assessment-II

Fill in the blanks with the appropriate answers

1. The debentures that are issued at value which is greater than their ___________, are said to be issued at premium.
2. The ____________received on the issue of debentures is credited to the Securities Premium Reserve Account
3. The Articles of Association of the company must provide for ____________on issue of debentures.
4. The company may issue debentures for the payment for the purchase of some assets which may tangible or _____________.
5. Collateral security means security given in ______________ to the principal security.
6. The _____________ on debentures is a charge against profits of the company and may be subject to the tax deducted at source (TDS).
7. The interest that is ___________ but not yet paid shall be shown under Current Liabilities and sub head 'Other Current Liabilities'
8. The interest shall not be paid on the debentures issued as _____________security because company pays interest on loan.

(Answers :1. nominal value **2.**premium **3.**discount **4.**intangible **5.**addition **6.**interest **7.**accrued **8.**collateral)

KEYWORDS

Debentures : Debentures includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

Secured or Mortgage debentures: Debentures thatare secured by a charge on the whole or part of assets of the company arecalled mortgage debentures.

Unsecured debentures: These debentures do not carry charge on assets of the company.

Redeemable debentures: The principal amount of such debenturesis paid off to the debenture holders on the expiry of specified period.

Non-redeemable debentures: These are the debentures whichare not redeemed in the life time of the company.

Registered debentures: They are made in the name of specific persons, who are registered as debenture holders in the books of the company. These are the debentures that areregistered with the company.

Bearer debentures: Bearer debentures are treated as negotiable instruments and aretransferrable merely by delivery.

Convertible debentures: These are the debentures that can be converted into shares of the company as per the terms of their issue.

Non-convertible debentures: The debentures that are not convertible into shares of the company are called Non-convertible debentures.

Specific Coupon Rate Debentures: These debentures are issued witha specified rate of interest, which is called the coupon rate. The specifiedrate may either be fixed or floating.

Zero Coupon Rate Debentures: Rate of interest is not specified on these debentures. Such debenturesare issued at substantial discount and the difference between thenominal value and the issue price istreated as the amount of interestassociated with the duration of the debentures .

SUMMARY

- A debenture is a document issued under the seal of the company where the debenture holder is the creditor of the company. It is an acknowledgement of the loan received by the company equal to the nominal value of the debenture. It not only bears the date of repayment but also rate and mode of payment of Interest. The debentures can be classified on the basis of security, redemption, transferability, convertibility, coupon rate point of view.
- The procedure of issue of debentures by a company is similar to that of the issue of shares. However legal restrictions regarding use of premium money or issuing at discount applicable in the case of shares, are not applicable to the debentures. The Debentures can be issued for cash, for consideration other than cash or as a collateral security. Further, debentures may be issued at par, at premium, or at discount.
- The debentures are issued at premium if the issue price is more than its nominal value and they are issued at discount if the issue price is less than nominal value .The premium received is credited to the Securities Premium Reserve Account whereasthe discount on issue of debentures is capital loss and it can be written off either against the Securities Premium Reserve Account or from the Statement of Profit and Loss Account.

EXERCISE QUESTIONS

Short Answer Questions

1. What do you mean by Debenture?
2. Explain the term Registered Debenture?
3. Define Secured Debenture ?
4. What is meant by Convertible debentures ?
5. Explain Irredeemable debentures?

Long Answer Questions

1. What is meant by issue of debenture for consideration other than cash? What accounting journal entries must be passed?
2. Explain the characteristics of debentures
3. Explain the meaning and accounting treatment of debentures issued as collateral security.
4. Explain any three types of Debentures
5. Explain the treatment for interest on debentures.

Numerical Questions

1. Gamma Ltd. issued 2,000 10% debentures of Rs 100 each at premium of 10% payable as Rs 40 on application and balance on allotment. Debentures are redeemable at par after 5 years all the money due on allotment was called and duly received. Record necessary entries when premium money is included in allotment money
2. Zytee Ltd. purchased machinery worth Rs 4,00,000 from Ryan Ltd. Rs 50,000 were paid immediately and the balance was paid by issue of Rs3, 60,000, 10% Debentures in ZyteeLtd. Record the necessary journal entries for recording the transactions in the books of Zytee Ltd.

3. Flex Ltd. issued 30,00,000, 6% debentures of Rs 100 each at a discount of 5%, redeemable at a premium of 5% after three years The amount was payable as follows: On application Rs 50 per debenture, Rs.45 on allotment, Record the necessary journal entries for issue of debentures.

4. Give Journal entries in each of the following cases if the face value of a Debenture is Rs.100:
   (a) A debenture issued at Rs.105 repayable at Rs.100
   (b) A debenture issued at Rs.100 repayable at Rs.105
   (c) A debenture issued at Rs.110 repayable at Rs.105

5. X Ltd obtained a loan of Rs.4,00,000 from IDBI Bank. The company issued 5,000, 9% debentures of Rs.100 each as a collateral security for the same.Show how these items will be presented in the Balance Sheet of the company.

6. Devi Ltd on 1st April 2006 acquired assets of the value of Rs.6,00,000 and liabilities of Rs.70, 000from P&Co; at an agreed value of Rs.5,50,000. Devi Ltd issued 12% debentures of Rs.100 each at a premium of 10% in full satisfaction of purchase consideration. Pass necessary Journal entries .

7. Pass the necessary journal entries for issue and redemption of Debentures in the following cases :

(i) 10,000, 10% Debentures of Rs.120 each issued at 5% premium, repayable at par.

(ii) 20,000, 9% Debentures of Rs.200 each issued at 20% premium, repayable at 30% premium.

8. SehrawatLtd.purchased machinery worth Rs.8,00,000 and the purchase consideration was paid by issuing 12% debentures of the face value of Rs.100 at a discount of 20%.Pass necessary journal entries .

   (Answer: Face value of debentures issued =Rs.10,00,000)
9. X Ltd. issued Rs.20,00,000 debentures of Rs.100 each at a premium of 10%,payable 25% on application (including premium)and balance on allotment .The debentures were duly taken up by the public and money was received .Pass the necessary journal entries for the same .

UNIT :8 – COMPANY FINAL ACCOUNTS

<table>
<tr><td rowspan="2">Unit Code:</td><td colspan="4">UNIT TITLE: COMPANY FINAL ACCOUNTS</td></tr>
<tr><td colspan="4">Duration:</td></tr>
<tr><td rowspan="7">Location:

Classroom or Company’s premises</td><td colspan="4">SESSION 1: INTRODUCTION TO COMPANY FINAL ACCOUNTS</td></tr>
<tr><td>Learning Outcome</td><td>Knowledge Evaluation</td><td>Performance Evaluation</td><td>Teaching and Training Method</td></tr>
<tr><td>1.Meaning of books of accounts</td><td>1.Explain the components of books of accounts</td><td>1.Classify the components of books of accounts</td><td>Interactive Lecture:
Basic Overview of books of accounts</td></tr>
<tr><td>2. Constituents of Company Final Accounts</td><td>Define the various Constituents of Company Final Accounts</td><td>1.Identify the various components of Final accounts as prepared by companies</td><td>Interactive Lecture:
Discussion of company final accounts
Activity:
Collect the final accounts of a company as given in the annual report</td></tr>
<tr><td>3.Format of Balance Sheet</td><td>1.Explain the Format of preparing the Balance Sheet of a company and the associated general instructions</td><td>1.Identify various items to be included under major heads and sub-heads of Balance Sheet</td><td>Interactive Lecture:
Discussion of format of Balance Sheet</td></tr>
<tr><td colspan="4">SESSION 2: INTRODUCTION TO STATEMENT OF PROFIT AND LOSS</td></tr>
<tr><td>1. Basic format of Statement of Profit and Loss</td><td>1. Explain the items in the format of Statement of Profit and Loss</td><td>1.Classify various items under heads and sub heads of Statement of Profit and Loss</td><td>Interactive Lecture:
Acquaint with the Statement of Profit and Loss.</td></tr>
</table>

UNIT – 8: COMPANY FINAL ACCOUNTS

Learning Objectives:

After reading this unit, the students will be able to:

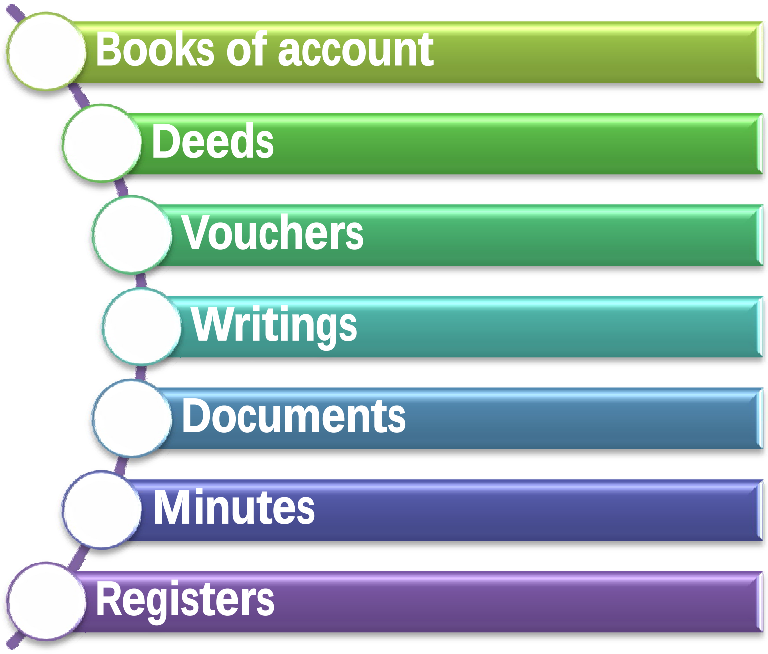
1. understand the concept of books of accounts,
2. explain the components of company final accounts,
3. comprehend the basic requirements to be considered for preparation of statement of Profit and loss,
4. express the components under the main headings of the format of the balance sheet of a company and
5. Explain the meanings of certain keywords.

SESSION 1: INTRODUCTION TO COMPANY FINAL ACCOUNTS

The companies now-a-days are increasing their operations by leaps and bounds. With this rise in expansion, the number of transactions taking place daily is also increasing beyond imagination. It is not possible for any person to remember all the transactions and calculate the amount of profit earned or loss incurred. To overcome, this problem, the entire life of the company is divided into time periods of one year, generally termed as financial year.*Financial year has been specified in Sec. 2(14) of the Companies Act, 2013, which states that in relation to any company or body corporate, a financial year can only be from April to March and where it is incorporated on or after 1st January of a year, the period ending on 31st day of March of the following year, in respect where financial statement of the company or body corporate is made.* This division of the period helps to record the transactions in a chronological order and at the end of the period helps to prepare books of accounts so as to facilitate calculation of the profitability as well as financial position of the company.

BOOKS OF ACCOUNTS

According to Sec. 2(12) of Companies Act, 2013, “book and paper” and “book or paper” includes books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form.



Further, books of accounts include records maintained in respect of—
(*i*) All money received and expended by a company
(*ii*) All sales and purchases of goods and services by the company;
(*iii*) The assets and liabilities of the company

INTRODUCTION TO COMPANY FINAL ACCOUNTS

A basic set of company final accounts also referred to as financial statements in relation to a company include

(*i*) aBalance Sheet as at the end of the financial year;
(*ii*) aProfit And Loss Account, or in the case of a company carrying on anyactivity not for profit, an Income And Expenditure account for the financial year;
(*iii*) Cash Flow Statement for the financial year;and
(*iv)* any explanatory note as annexure to the above stated points

The financial statement, with respect to One Person Company,small company and dormant company, may not include the cash flow statement.
The financial statements are prepared with the purpose of a true and fair view of the state of affairsof the company including compliance with the relevant, applicable accounting standards.

FORMATS OF FINANCIAL STATEMENTS

Before we go through the formats of Balance Sheet and Statement of Profit and Loss of a company, let us first have an understanding of some of the general instructions or important provisions governing the preparation and presentation of the final accounts of the company.

1. A financial year for a company is for a period of 12 months ending 31st March every year.
2. The financial statements are prepared in accordance with the relevant, applicable accounting standards.
3. In case of deviation from such standards, the disclosure of the deviation and the financial effect therefrom are mandatory.
4. If the company defaults in the above provision, then the managing director, whole time director CFO or any other person charged by Board with this duty and in case of absence of any such officers, all directors shall be punishable with imprisonment upto one year or fine of ranging between Rs. 50,000 and Rs. 5,00,000, or both.
5. The financial statements need to be audited and the auditor's statement is required to be attached with the financial statements.
6. The financial statements, shall be approved by the Board of Directors before they are signed on behalf of the Board at least by the chairperson of the company or by two directors out of which one shall be managing director, the Chief Financial Officer and the Company Secretary of the company, wherever they are appointed.
7. A report by the Board of Directors including the following has to be attached to statements for a general meeting
   (a) The extract of the annual return containing particulars as per Section 92
   (b) Number of meetings of the Board;
   (c) A statement on declaration given by independent directors;
   (d) Explanations or comments by the Board on every qualification, reservation or adverse remark or disclaimer made-
      (i) by the auditor in his report; and
      (ii) by the company secretary in practice in his secretarial audit report.
   (e) The amounts, if any, which it proposes to carry to any reserves;
   (f) The amount, if any, which it recommends should be paid by way of dividend;

8. A copy of Financial Statements must be sent not less than 21 days before the date of the annual general meeting where they are to be adopted, to every member of the company, every debenture-holder and every trustee for the debenture-holders.

The format of Balance Sheet as has been given by **Schedule III, Part - I**of the Companies Act, 2013 is as follows:

PART I - BALANCE SHEET

Name of the Company…………………….

Balance Sheet as at ………………………

(Rupees in………..)

Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) **Shareholders' funds**			
(*a*) Share capital			
(*b*) Reserves and surplus			
(*c*) Money received against share warrants			
(2) **Share application money pending allotment**			
(3) **Non-current liabilities**			
(*a*) Long-term borrowings			
(*b*) Deferred tax liabilities (Net)			
(*c*) Other Long term liabilities			
(*d*) Long-term provisions			
(4) **Current liabilities**			
(*a*) Short-term borrowings			
(*b*) Trade payables			
(*c*) Other current liabilities			
(*d*) Short-term provisions			
TOTAL			
II. ASSETS			
Non-current assets			
(1) (*a*) Fixed assets			
(*i*) Tangible assets			
(*ii*) Intangible assets			
(*iii*) Capital work-in-progress			
(*iv*) Intangible assets under development			
(*b*) Non-current investments			
(*c*) Deferred tax assets (net)			
(*d*) Long-term loans and advances			
(*e*) Other non-current assets			

(2) **Current assets**

(*a*) Current investments

(*b*) Inventories

(*c*) Trade receivables

(*d*) Cash and cash equivalents

(*e*) Short-term loans and advances

(*f*) Other current assets

TOTAL

See accompanying notes to the Financial Statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1.

CRITERIA FOR AN ASSET TO BE CLASSIFIED AS CURRENT	CRITERIA FOR A LIABILITY TO BE CLASSIFIED AS CURRENT
Expected to be realised in, or is intended for sale or consumption in, thecompany's normal operating cycle	Expected to be settled in the company's normal operating cycle;
Held primarily for the purpose of being traded	Held primarily for the purpose of being traded;
Expected to be realised within twelve months after the reporting date; or	Due to be settled within twelve months after the reporting date; or
It is cash or cash equivalent unless it is restricted from being exchanged orused to settle a liability for at least twelve months after the reporting date.	The company does not have an unconditional right to defer settlement of theliability for at least twelve months after the reporting date. Terms of a liability thatcould, at the option of the counterparty, result in its settlement by the issue of equityinstruments do not affect its classification.
All other assets and liabilities not fulfilling the above criteria shall be classified as non-current.	

2. An operating cycle is the time between the acquisition of assets for processing andtheir realisation in cash or cash equivalents. Where the normal operating cycle cannot beidentified, it is assumed to have duration of twelve months.
3. A receivable shall be classified as a "trade receivable" and a payable as a "trade payable" if theyare in respect of the amountdue on account of goods sold or services rendered and goods purchased or services received, respectivelyin the normal course of business.

A company shall disclose the following in the notes to accounts.

A. Share Capital

For each class of share capital (different classes of preference shares to betreated separately):

(*a*) the number and amount of shares authorised;

(*b*) the number of shares issued, subscribed and fully paid, and subscribedbut not fully paid;

(*c*) par value per share;

(*d*) a reconciliation of the number of shares outstanding at the beginningand at the end of the reporting period;

(*e*) the rights, preferences and restrictions attaching to each class of sharesincluding restrictions on the distribution of dividends and the repayment ofcapital;

(*f*) shares in respect of each class in the company held by its holdingcompany or its ultimate holding company including shares held by or bysubsidiaries or associates of the holding company or the ultimate holdingcompany in aggregate;

(*g*) shares in the company held by each shareholder holding more than5 per cent shares specifying the number of shares held;

(*h*) shares reserved for issue under options and contracts/commitmentsfor the sale of shares/disinvestment, including the terms and amounts;

(*i*) for the period of five years immediately preceding the date as at whichthe Balance Sheet is prepared:

- Aggregate number and class of shares allotted as fully paid-uppursuant to contract(s) without payment being received in cash.
- Aggregate number and class of shares allotted as fully paid-upby way of bonus shares.
- Aggregate number and class of shares bought back.

(*j*) terms of any securities convertible into equity/preference shares issuedalong with the earliest date of conversion in descending order starting from thefarthest such date;

(*k*) calls unpaid (showing aggregate value of calls unpaid by directors andofficers);

(*l*) forfeited shares (amount originally paid-up).

B. Reserves and Surplus

(*i*) Reserves and Surplus shall be classified as:

(*a*) Capital Reserves;

(*b*) Capital Redemption Reserve;

(*c*) Securities Premium Reserve;

(*d*) Debenture Redemption Reserve;

(*e*) Revaluation Reserve;

(*f*) Share Options Outstanding Account;

(*g*) Other Reserves–(specify the nature and purpose of each reserve andthe amount in respect thereof);

(*h*) Surplus *i.e.*, balance in Statement of Profit and Loss disclosingallocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc.;

(Additions and deductions since last balance sheet to be shown undereach of the specified heads);

(*ii*) A reserve specifically represented by earmarked investments shall be termedas a “fund”.

(*iii*) Debit balance of statement of profit and loss shall be shown as a negativefigure under the head “Surplus”. Similarly, the balance of “Reserves and Surplus”,after adjusting negative balance of surplus, if any, shall be shown under the head“Reserves and Surplus” even if the resulting figure is in the negative.

C. Long-Term Borrowings

(*i*) Long-term borrowings shall be classified as:

(*a*) Bonds/debentures;

(*b*) Term loans:

(A) from banks.

(B) from other parties.

(*c*) Deferred payment liabilities;

(*d*) Deposits;

(*e*) Loans and advances from related parties;

(*f*) Long term maturities of finance lease obligations;

(*g*) Other loans and advances (specify nature).

(*ii*) Borrowings shall further be sub-classified as secured and unsecured. Natureof security shall be specified separately in each case.

(*iii*) Where loans have been guaranteed by directors or others, the aggregateamount of such loans under each head shall be disclosed.

(*iv*) Bonds/debentures (along with the rate of interest and particulars ofredemption or conversion, as the case may be) shall be stated in descending order ofmaturity or conversion, starting from farthest redemption or conversion date, as thecase may be. Where bonds/debentures are redeemable by instalments, the date ofmaturity for this purpose must be reckoned as the date on which the first instalmentbecomes due.

(*v*) Particulars of any redeemed bonds/debentures which the company has powerto reissue shall be disclosed.

(*vi*) Terms of repayment of term loans and other loans shall be stated.

(*vii*) Period and amount of continuing default as on the balance sheet date inrepayment of loans and interest, shall be specified separately in each case.

D. Other Long-term Liabilities

Other Long-term Liabilities shall be classified as:

(*a*) Trade payables;

(*b*) Others.

E. Long-term provisions

The amounts shall be classified as:

(*a*) Provision for employee benefits;

(*b*) Others (specify nature).

F. Short-term borrowings

(*i*) Short-term borrowings shall be classified as:

(*a*) Loans repayable on demand;

(A) from banks.

(B) from other parties.

(*b*) Loans and advances from related parties;

(*c*) Deposits;

(*d*) Other loans and advances (specify nature).

(*ii*) Borrowings shall further be sub-classified as secured and unsecured. Natureof security shall be specified separately in each case.

(*iii*) Where loans have been guaranteed by directors or others, the aggregateamount of such loans under each head shall be disclosed.

(*iv*) Period and amount of default as on the balance sheet date in repayment ofloans and interest, shall be specified separately in each case.

G. Other current liabilities

The amounts shall be classified as:

(*a*) Current maturities of long-term debt;

(*b*) Current maturities of finance lease obligations;

(*c*) Interest accrued but not due on borrowings;

(*d*) Interest accrued and due on borrowings;

(*e*) Income received in advance;

(*f*) Unpaid dividends;

(*g*) Application money received for allotment of securities and due forrefund and interest accrued thereon. Share application money includes advancestowards allotment of share capital. The terms and conditions including the numberof shares proposed to be issued, the amount of premium, if any, and the periodbefore which shares shall be allotted shall be disclosed. It shall also be disclosedwhether the company has sufficient authorised capital to cover the share capitalamount resulting from allotment of shares out of such share application money.

Further, the period for which the share application money has been pendingbeyond the period for allotment as mentioned in the document inviting applicationfor shares along with the reason for such share application money being pendingshall be disclosed. Share application money not exceeding the issued capitaland to the extent not refundable shall be shown under the head Equity and shareapplication money to the extent refundable, *i.e.*, the amount in excess ofsubscription or in case the requirements of minimum subscription are not met,shall be separately shown under “Other current liabilities”;

(*h*) Unpaid matured deposits and interest accrued thereon;

(*i*) Unpaid matured debentures and interest accrued thereon;

(*j*) Other payables (specify nature)***.{Calls in advance and interest accrued thereon may be included here)***

H. Short-term provisions

The amounts shall be classified as:

(*a*) Provision for employee benefits.

(*b*) Others (specify nature).

I. Tangible assets

(*i*) Classification shall be given as:

(*a*) Land;

(*b*) Buildings;

(*c*) Plant and Equipment;

(*d*) Furniture and Fixtures;

(*e*) Vehicles;

(*f*) Office equipment;

(*g*) Others (specify nature).

(*ii*) Assets under lease shall be separately specified under each class of asset.

(*iii*) A reconciliation of the gross and net carrying amounts of each class ofassets at the beginning and end of the reporting period showing additions, disposals,acquisitions through business combinations and other adjustments and the relateddepreciation and impairment losses/reversals shall be disclosed separately.

(*iv*) Where sums have been written-off on a reduction of capital or revaluation ofassets or where sums have been added on revaluation of assets, every balance sheetsubsequent to date of such write-off, or addition shall show the reduced or increasedfigures as applicable and shall by way of a note also show the amount of the reductionor increase as applicable together with the date thereof for the first five years subsequentto the date of such reduction or increase.

J. Intangible assets

(*i*) Classification shall be given as:

(*a*) Goodwill;

(*b*) Brands /trademarks;

(*c*) Computer software;

(*d*) Mastheads and publishing titles;

(*e*) Mining rights;

(*f*) Copyrights, and patents and other intellectual property rights, servicesand operating rights;

(*g*) Recipes, formulae, models, designs and prototypes;

(*h*) Licences and franchise;

(*i*) Others (specify nature).

(*ii*) A reconciliation of the gross and net carrying amounts of each class ofassets at the beginning and end of the reporting period showing additions, disposals,acquisitions through business combinations and other adjustments and the relatedamortization and impairment losses/reversals shall be disclosed separately.

(*iii*) Where sums have been written-off on a reduction of capital or revaluationof assets or where sums have been added on revaluation of assets, every balancesheet subsequent to date of such write-off, or addition shall show the reduced orincreased figures as applicable and shall by way of a note also show the amount of thereduction or increase as applicable together with the date thereof for the first five yearssubsequent to the date of such reduction or increase.

K. Non-current investments

(*i*) Non-current investments shall be classified as trade investments and otherinvestments and further classified as:

(*a*) Investment property;

(*b*) Investments in Equity Instruments;

(*c*) Investments in preference shares;

(*d*) Investments in Government or trust securities;

(*e*) Investments in debentures or bonds;

(*f*) Investments in Mutual Funds;

(*g*) Investments in partnership firms;

(*h*) Other non-current investments (specify nature).

Under each classification, details shall be given of names of the bodies corporateindicating separately whether such bodies are (*i*) subsidiaries, (*ii*) associates,(*iii*) joint ventures, or (*iv*) controlled special purpose entities in whom investmentshave been made and the nature and extent of the investment so made in each suchbody corporate (showing separately investments which are partly-paid). In regard toinvestments in the capital of partnership firms, the names of the firms (with the namesof all their partners, total capital and the shares of each partner) shall be given.

(*ii*) Investments carried at other than at cost should be separately stated specifyingthe basis for valuation thereof;

(*iii*) The following shall also be disclosed:

(*a*) Aggregate amount of quoted investments and market value thereof;

(*b*) Aggregate amount of unquoted investments;

(*c*) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(*i*) Long-term loans and advances shall be classified as:

(*a*) Capital Advances;

(*b*) Security Deposits;

(*c*) Loans and advances to related parties (giving details thereof);
(*d*) Other loans and advances (specify nature).

(*ii*) The above shall also be separately sub-classified as:
(*a*) Secured, considered good;
(*b*) Unsecured, considered good;
(*c*) Doubtful.

(*iii*) Allowance for bad and doubtful loans and advances shall be disclosedunder the relevant heads separately.

(*iv*) Loans and advances due by directors or other officers of the company orany of them either severally or jointly with any other persons or amounts due by firmsor private companies respectively in which any director is a partner or a director or amember should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

(*i*) Long-term Trade Receivables (including trade receivables on deferredcredit terms);

(*ii*) Others (specify nature);

- Long term Trade Receivables, shall be sub-classified as:

(*A*) Secured, considered good;

(*B*) Unsecured, considered good;

(*C*) Doubtful.

- Allowance for bad and doubtful debts shall be disclosed underthe relevant heads separately.
- Debts due by directors or other officers of the company or any ofthem either severally or jointly with any other person or debts due by firmsor private companies respectively in which any director is a partner or adirector or a member should be separately stated.

N. Current Investments

(*i*) Current investments shall be classified as:
(*a*) Investments in Equity Instruments;
(*b*) Investment in Preference Shares;
(*c*) Investments in Government or trust securities;
(*d*) Investments in debentures or bonds;
(*e*) Investments in Mutual Funds;
(*f*) Investments in partnership firms;
(*g*) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate[indicating separately whether such bodies are: (*i*) subsidiaries, (*ii*) associates,(*iii*) joint ventures, or (*iv*) controlled special purpose entities] in whom investmentshave been made and the nature and extent of the investment so made in each suchbody corporate (showing separately investments which are partly paid). In regard toinvestments in the capital of partnership firms, the names of the firms (with the namesof all their partners, total capital and the shares of each partner) shall be given.

(*ii*) The following shall also be disclosed:

(*a*) The basis of valuation of individual investments;

(*b*) Aggregate amount of quoted investments and market value thereof;

(*c*) Aggregate amount of unquoted investments;

(*d*) Aggregate provision made for diminution in value of investments.

O. Inventories

(*i*) Inventories shall be classified as:

(*a*) Raw materials;

(*b*) Work-in-progress;

(*c*) Finished goods;

(*d*) Stock-in-trade (in respect of goods acquired for trading);

(*e*) Stores and spares;

(*f*) Loose tools;

(*g*) Others (specify nature).

(*ii*) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(*iii*) Mode of valuation shall be stated.

P. Trade Receivables

(*i*) Aggregate amount of Trade Receivables outstanding for a period exceedingsix months from the date they are due for payment should be separately stated.

(*ii*) Trade receivables shall be sub-classified as:

(*a*) Secured, considered good;

(*b*) Unsecured, considered good;

(*c*) Doubtful.

(*iii*) Allowance for bad and doubtful debts shall be disclosed under the relevantheads separately.

(*iv*) Debts due by directors or other officers of the company or any of themeither severally or jointly with any other person or debts due by firms or privatecompanies respectively in which any director is a partner or a director or a membershould be separately stated.

Q. Cash and cash equivalents

(*i*) Cash and cash equivalents shall be classified as:

(*a*) Balances with banks;

(*b*) Cheques, drafts on hand;

(*c*) Cash on hand;

(*d*) Others (specify nature).

(*ii*) Earmarked balances with banks (for example, for unpaid dividend) shall beseparately stated.

(*iii*) Balances with banks to the extent held as margin money or security againstthe borrowings, guarantees, other commitments shall be disclosed separately.

(*iv*) Repatriation restrictions, if any, in respect of cash and bank balances shallbe separately stated.

(*v*) Bank deposits with more than twelve months maturity shall be disclosedseparately.

R. Short-term loans and advances

(*i*) Short-term loans and advances shall be classified as:

(*a*) Loans and advances to related parties (giving details thereof);

(*b*) Others (specify nature).

(*ii*) The above shall also be sub-classified as:

(*a*) Secured, considered good;

(*b*) Unsecured, considered good;

(*c*) Doubtful.

(*iii*) Allowance for bad and doubtful loans and advances shall be disclosedunder the relevant heads separately.

(*iv*) Loans and advances due by directors or other officers of the company orany of them either severally or jointly with any other person or amounts due by firmsor private companies respectively in which any director is a partner or a director or amember shall be separately stated.

S. Other current assets (specify nature)

This is an all-inclusive heading, which incorporates current assets that do not fitinto any other asset categories.

Unamortised expenses like discount on issue of shares, debentures, ancillary borrowing costs, etc. will appear under the head "Other Current / Non-Current Assets", depending upon whether the amount will be amortised in the next 12 months or thereafter.However, preliminary expenses should be written off from Profit and Loss Account in the period they are incurred, unless capitalized in the cost of the project. They cannot be carried forward as the concept of "deferred expenditure" does not exist anymore.

T. Contingent liabilities and commitments (to the extent not provided for)

(*i*) Contingent liabilities shall be classified as:

(*a*) Claims against the company not acknowledged as debt;

(*b*) Guarantees;

(*c*) Other money for which the company is contingently liable.

(*ii*) Commitments shall be classified as:

(*a*) Estimated amount of contracts remaining to be executed on capitalaccount and not provided for;

(*b*) Uncalled liability on shares and other investments partly paid;

(*c*) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preferenceshareholders for the period and the related amount per share shall be disclosedseparately. Arrears of fixed cumulative dividends on preference shares shall also bedisclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, thewhole or part of the amount has not been used for the specific purpose at the balancesheet date, there shall be indicated by way of note how such unutilised amounts havebeen used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets andnon-current investments do not have a value on realisation in the ordinary course ofbusiness at least equal to the amount at which they are stated, the fact that the Boardis of that opinion, shall be stated.

Knowledge Assessment – I

State whether the following statements are True or False.

1. Financial year can be of period exceeding 12 months also.
2. Documents maintained in electronic form are also covered in the definition of books.
3. Amount of money received does not from part of books of accounts
4. It is mandatory for a one person company to prepare Cash Flow Statement.
5. Only major deviations from compliance with accounting standards need to be disclosed in the financial statements.
6. Secured trade receivables which are considered good can be included under the head of cash and cash equivalents.
7. Short term provisions are included under Current Liabilities.
8. If an asset is expected to be realised within twelve months after the reporting date, then it is classified as Current.
9. Capital Reserves and Capital Redemption Reserves form part of “Reserves and Surplus”
10. Loans and advances from related parties can be included under Long Term Borrowings as well as short term borrowings depending on the period of loan.

Answers

1. False, 2. True, 3.False, 4.False, 5.False, 6.False, 7.True, 8.True, 9.True, 10. True

Illustration 1

State under which major headings the following items will be presented in the Balance Sheet of a company as per Schedule III of the Companies Act, 2013:

(i) Long-term borrowings

(ii) Trade Payables

(iii) Provision for tax
(iv) Securities Premium Reserve
(v) Patents
(vi) Accrued Incomes

Solution:

S.No.	Items	Major Headings	Sub-headings
1.	Long-term borrowings	Non-current Liabilities	-
2.	Trade Payables	Current Liabilities	-
3.	Provision for Tax	Current Liabilities	Short term Provisions
4.	Securities Premium Reserve	Shareholders' Funds	Reserves and Surplus
5.	Patents	Non-current Assets	Intangible Assets
6.	Accrued Incomes	Current Assets	Other Current Assets

Illustration 2

State under which major headings the following items will be presented in the Balance Sheet of a company as per Schedule III of the Companies Act, 2013.

(i) Trade Marks
(ii) Capital Redemption Reserve
(iii) Income received in advance
(iv) Stores and Spares
(v) Office Equipment
(vi) Current Investments

Solution

S.No.	Items	Major Head	Sub-Heading
1.	Trade Marks	Non-Current Assets	Fixed Assets – Intangible Assets
2.	Capital Redemption Reserve	Shareholder's Funds	Reserves and Surplus
3.	Income received in advance	Current Liabilities	Other Current Liabilities
4.	Stores and Spares	Current Assets	Inventories
5.	Office Equipment	Non-current Assets	Fixed Assets – Tangible Assets
6.	Current Investments	Current Assets	-

Illustration 3
Under what heads and sub-heads will the following items appear in the Balance Sheet of a company as per Schedule III of the Companies Act, 2013:
(i) Stores and Spares;
(ii) Proposed Dividend;
(iii) Computer Software.

(iv) Loose Tools
(v) Provision for employees' benefits
(vi) Unpaid dividend

Solution

S. No.	**Items**	**Major Head**	**Sub-Head**
1.	Stores and Spares	Current Assets	Inventories
2	Proposed Dividend	Current Liabilities	Short-term Provisions
3.	Computer Software	Non-Current Assets	Fixed Assets: Intangible Assets
4.	Loose Tools	Current Assets	Inventories
5.	Provision for Employees' benefits	Non-Current Liabilities OR Current Liabilities	Long-term provisions OR Short-term Provisions
		Depending upon the nature, i.e. it will be classified as current if a company does not have an unconditional right as on Balance Sheet date to defer its settlement for 12 months after reporting date, otherwise it will be classified as non-current.	
6.	Unpaid Dividend	Current Liabilities	Other Current Liabilities

SESSION 2: INTRODUCTION TO STATEMENT OF PROFIT AND LOSS

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company……………………

Profit and loss statement for the year ended ………………………

(Rupees in…………)

	Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of the previous reporting period**
	1	2	3	4
I	Revenue from operations		xxx	xxx
II	Other income		xxx	xxx
III	Total Revenue (I + II)		xxx	xxx
IV	Expenses: Cost of materials consumed Purchases of Stock-in-Trade		 xxx xxx	 xxx xxx

	Changes in inventories of finished goods, work-in-progress and Stock-in-Trade		xxx	xxx
	Employee benefits expense		xxx	xxx
	Finance costs		xxx	xxx
	Depreciation and Amortization expense		xxx	xxx
	Other expenses		xxx	xxx
	Total expenses		xxx	xxx
V	*Profit before exceptional and extraordinary items and tax (III - IV)*		*xxx*	*xxx*
VI	*Exceptional items*		*xxx*	*xxx*
VII	*Profit before extraordinary items and tax (V - VI)*		*xxx*	*xxx*
VIII	*Extraordinary items*		*xxx*	*xxx*
IX	Profit before tax (VII- VIII)		xxx	xxx
X	Tax expense: (1) Current tax (2) Deferred tax		 xxx xxx	 xxx xxx
XI	*Profit (Loss) for the period from continuing operations (VII-VIII)*		*xxx*	*xxx*
XII	*Profit/(loss) from discontinuing operations*		*xxx*	*xxx*
XIII	*Tax expense of discontinuing operations*		*xxx*	*xxx*
XIV	*Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)*		*xxx*	*xxx*
XV	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI	Earnings per equity share: *(1) Basic* *(2) Diluted*		 xxx xxx	 xxx xxx

See accompanying notes to the financial statements.

(NOTE: THE ITEMS IN ITALICS ARE OUTSIDE THE PURVIEW OF CLASS XII SYLLABUS AND CAN THUS BE OMITTED IN THE CALCULATION OF PROFIT AS WELL AS EPS)

Although, the items in italics are not required as per Board, the definitions of these items have been given below for the purpose of knowledge of the students.

EXCEPTIONAL ITEMS

AS-5 "Net Profit or Loss for the period, Prior period items and changes in Accounting Policies" has a reference to such items as may be referred to as exceptional in nature.

"When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Circumstances which may give rise to the separate disclosure of items of income and expense include: the write-down of inventories to net realisable value as well as the reversal of such write-downs; a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;"

- disposals of items of fixed assets;
- disposals of long-term investments;
- legislative changes having retrospective application;
- litigation settlements; and
- other reversals of provisions.

In case the company has more than one such item of income / expense of the above nature, the aggregate of such items should be disclosed on the face of the Statement of Profit and Loss. Details of the all individual items should be disclosed in the Notes.

EXTRAORDINARY ITEMS:

AS 5 "Net Profit or Loss for the period, Prior period items and changes in Accounting Policies" defines 'extraordinary items' as:

'Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

TAX EXPENSE:

This is to be disclosed on the face of the Statement to Profit and Loss and bifurcated into:

(1) Current tax and

(2) Deferred tax

Current tax

The term ‘Current tax’ has been defined under AS-22 “Accounting for Taxes” on Income as the amount of income tax determined to be payable (recoverable) in respect of the taxable income (tax loss) for a period. Hence, details of all taxes on income payable under the applicable taxation laws should be disclosed here. Presentation for Minimum Alternate Tax (MAT) credit should be made as prescribed by the ICAI Guidance Note on “Accounting for Credit Available in Respect of Minimum Alternative tax under the Income-tax Act, 1961’. The disclosure in this regard should be made as under :

Current tax (MAT)	XX
Less : MAT credit entitlement	(XX)
Net Current tax	XX

Any interest on shortfall in payment of advance income-tax is in the nature of finance cost and hence should not be clubbed with the Current tax. The same should be classified as Interest expense under finance costs. However, such amount should be separately disclosed. Any penalties levied under Income tax laws should not be classified as Current tax. Penalties which are compensatory in nature should be treated as interest and disclosed in the manner explained above. Other tax penalties should be classified under Other expenses. Wealth tax payable by a company on assets liable for wealth tax should not be included within current tax since the same is not a tax on income. Accordingly, wealth tax should be included in Rates and taxes under other expenses. Excess/Short provision of tax relating to earlier years should be separately disclosed.

Deferred Tax

Any charge/credit for deferred taxes needs to be disclosed separately on the face of the Statement of Profit and Loss. AS 22 “Accounting for Taxes on Income” defines ‘Deferred tax’ as the tax effect of timing differences. Timing differences are defined as “differences between taxable income and accounting income for a period that originate in one period and are capable of reversal in one or more subsequent periods.”

PROFIT / (LOSS) FOR THE PERIOD FROM DISCONTINUING OPERATIONS

The term ’Discontinuing operations’ is defined in AS 24 “Discontinuing operations” as a component of an enterprise:

a. that the enterprise, pursuant to a single plan, is:

(i) disposing of substantially in its entirety, such as by selling the component in a single transaction or by demerger or spin-off of ownership of the component to the enterprise's shareholders; or

(ii) disposing of piecemeal, such as by selling off the component's assets and settling its liabilities individually; or

(iii) terminating through abandonment; and

b. that represents a separate major line of business or geographical area of operations; and

c. that can be distinguished operationally and for financial reporting purposes.

TAX EXPENSE OF DISCONTINUING OPERATIONS

In case there are any taxes payable / tax credits available on profits / losses of discontinuing operations, the same needs to be disclosed as a separate line item on the Statement of Profit and Loss.

Excluding the above items, the format of Statement of Profit and Loss applicable for the students is given as follows:

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company……………………..

Profit and loss statement for the year ended ………………………

(Rupees in…………)

	Particulars	**Note No.**	**Figures as at the end of current reporting period**	**Figures as at the end of the previous reporting period**
	1	2	3	4
I	Revenue from operations		xxx	xxx
II	Other income		xxx	xxx
III	Total Revenue (I + II)		xxx	xxx
IV	Expenses:			
	Cost of materials consumed		xxx	xxx
	Purchases of Stock-in-Trade		xxx	xxx
	Changes in inventories of finished goods, work-in-progress and Stock-in-Trade		xxx	xxx
	Employee benefits expense		xxx	xxx
	Finance costs		xxx	xxx
	Depreciation and Amortization		xxx	xxx

	expense Other expenses Total expenses		xxx xxx	xxx xxx
V	Profit before tax (III- IV)		xxx	xxx
VI	Tax expense:		xxx	xxx
VII	Profit (Loss) for the period (V - VI)		xxx	xxx
VIII	Earnings per equity share		xxx	xxx

See accompanying notes to the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. (*A*) In respect of a company other than a finance company, revenue from operationsshall disclose separately in the notes revenue from—

(*a*) Sale of products;

(*b*) Sale of services;

(*c*) Other operating revenues;

Less:

(*d*) Excise duty.

(*B*) In respect of a finance company, revenue from operations shall include revenuefrom—

(*a*) Interest; and

(*b*) Other financial services.

Revenue under each of the above heads shall be disclosed separately by way of notesto accounts to the extent applicable.

2. Finance Costs

Finance costs shall be classified as:

(*a*) Interest expense;

(*b*) Other borrowing costs;

(*c*) Applicable net gain/loss on foreign currency transactions and translation.

3. Other income

Other income shall be classified as:

(*a*) Interest Income (in case of a company other than a finance company);

(*b*) Dividend Income;

(*c*) Net gain/loss on sale of investments;

(*d*) Other non-operating income (net of expenses directly attributableto such income).

4. Additional Information

A Company shall disclose by way of notes additional information regarding aggregateexpenditure and income on the following items:—

(*i*) (*a*) Employee Benefits Expense [showing separately (*i*) salaries and wages,(*ii*) contribution to provident and other funds, (*iii*) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (*iv*) staff welfare expenses].

(*b*) Depreciation and amortisation expense;

(*c*) Any item of income or expenditure which exceeds one per cent of the revenuefrom operations or Rs.1,00,000, whichever is higher;

(*d*) Interest Income;

(*e*) Interest expense;

(*f*) Dividend income;

(*g*) Net gain/loss on sale of investments;

(*h*) Adjustments to the carrying amount of investments;

(*i*) Net gain or loss on foreign currency transaction and translation (other thanconsidered as finance cost);

(*j*) Payments to the auditor as (*a*) auditor; (*b*) for taxation matters; (*c*) for companylaw matters; (*d*) for management services; (*e*) for other services; and (*f*) forreimbursement of expenses;

(*k*) In case of Companies covered under section 135, amount of expenditureincurred on corporate social responsibility activities;

(*l*) Details of items of exceptional and extraordinary nature;

(*m*) Prior period items;

(*ii*) (*a*) In the case of manufacturing companies,—

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(*b*) In the case of trading companies, purchases in respect of goods traded in bythe company under broad heads.

(*c*) In the case of companies rendering or supplying services, gross incomederived from services rendered or supplied under broad heads.

(*d*) In the case of a company, which falls under more than one of the categoriesmentioned in (*a*), (*b*) and (*c*) above, it shall be sufficient compliance with the requirementsherein if purchases, sales and consumption of raw material and the gross income fromservices rendered is shown under broad heads.

(*e*) In the case of other companies, gross income derived under broad heads.

(*iii*) In the case of all concerns having works in progress, works-in-progressunder broad heads.

(*iv*) (*a*) The aggregate, if material, of any amounts set aside or proposed to be setaside, to reserve, but not including provisions made to meet any specific liability,contingency or commitment known to exist at the date as to which the balance sheet ismade up.

(*b*) The aggregate, if material, of any amounts withdrawn from such reserves.

(*v*) (*a*) The aggregate, if material, of the amounts set aside to provisions made formeeting specific liabilities, contingencies or commitments.

(*b*) The aggregate, if material, of the amounts withdrawn from such provisions,as no longer required.

(*vi*) Expenditure incurred on each of the following items, separately for eachitem:—

(*a*) Consumption of stores and spare parts;

(*b*) Power and fuel;

(*c*) Rent;

(*d*) Repairs to buildings;

(*e*) Repairs to machinery;

(*f*) Insurance;

(*g*) Rates and taxes, excluding, taxes on income;

(*h*) Miscellaneous expenses,

(*vii*) (*a*) Dividends from subsidiary companies.

(*b*) Provisions for losses of subsidiary companies.

Note:- Broad heads shall be decided taking into account the concept of materiality andpresentation of true and fair view of financial statements.

Knowledge Assessment – II

State whether the following statements are True or False.

1. Sale of services forms part of revenue from operations in Statement of Profit and Loss.
2. Excise duty has to be deducted from operating revenues.
3. Borrowing cost like interest expense is shown as Finance Cost.
4. In case of a finance company, interest income will be classified as Other Income.
5. Revenue from financial services is considered as revenue from operations for a finance company.
6. Gain from sale of investments is disclosed under other income for a manufacturing concern.
7. Broad heads for inclusion of various items shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

Answers

1. True, 2. True, 3.True, 4.False, 5.True, 6.True, 7. True

1. **Financial Year:** Financial year is a period of 12 months ending 31^{st} March every year.

2. **Books:** Books include documents maintained on paper and/or in electronic form.
3. **Operating Cycle:** The operating cycle is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents.
4. **Trade Receivable:** A receivable shall be classified as a "trade receivable" if it is in respect of the amountdue on account of goods sold or services in the normal course of business.

SUMMARY

- All sales, purchases, assets, liabilities, amount received and expended are included in books of accounts.
- Company final accounts or financial statements include Balance Sheet, Statement of Profit and Loss Account, Cash Flow Statement, Statement of Changes in Equity and explanatory notes.
- In case of deviation from relevant, applicable accounting standards in preparation of financial statements, the disclosure of such deviation and the financial effect therefrom are mandatory.
- The formats of Balance Sheet and Statement of Profit and Loss have been given by Schedule III – Part I and Part II, respectively,of the Companies Act, 2013.

EXERCISE QUESTIONS

Short Answer Questions

1. Mention the major headings under which the assets of a company are to be shown in the Balance Sheet as per Schedule III Part I of the Companies Act, 2013.
2. State the major headings under which the liabilities of a company are to be displayed as per Schedule III Part I of the Companies Act, 2013.
3. Name the sub-heads under the head 'Non-current assets' in the Balance Sheet under Schedule- III of the Companies Act, 2013.
4. What are the sub-heads under the head 'Non-current assets' in the Balance Sheet.
5. What is the criteria for an asset to be classified as a current asset.

Long Answer Questions

1. Give the main heads under which the various items appear in case of vertical form of a company's balance sheet.
2. Prepare a proforma Balance Sheet of a company using hypothetical figures.
3. State the major headings with sub-headingsof the liabilities side of a company's balance sheet.

4. What are the various items covered under the heading "Shareholders' Funds".
5. State the heads under which various assets of a company are to be presented as per the requirements of the Companies Act, 2013.
6. Explain the presentation of a Contingent Liability in the Balance sheet.
7. State the items which are shown under the heading 'Reserves and Surplus' in the Balance sheet of a company as per Schedule III, Part I of the Companies Act, 2013.
8. Draw a basic proforma of a Statement of Profit and Loss.
9. What are the items included under the heading "Revenue from Operations" in case of a manufacturing company.

Numerical Questions

1.How will you disclose the following items while preparing the Balance Sheet of a company?

(i) Debit Balance of Statement of Profit and Loss
(ii) Building under construction
(iii) Loose tools

(Answer.*(i). Shareholders' Funds, (ii).Non-Current Assets, (iii). Current Assets)*

2. Under which heads and sub-heads will the following items appear in the Balance Sheet of a company as per Schedule III, of the Companies Act, 2013:

(i) Subsidy Reserves;
(ii) Mining Rights;
(iii) Provision for doubtful debts.

(Answer.*(i). Shareholders' Funds, (ii).Non-Current Assets, (iii). Current Assets(as a negative item))*

3. Under which major sub-heading the following items will be placed in the Balance Sheet of a Company as per Schedule III, of the Companies Act, 2013:

(i) Accrued Incomes
(ii) Loose Tools
(iii) Provision for employees benefits
(iv) Unpaid dividend
(v) Short-term loans
(vi) Long-term loans

(Answer.*(i). Current Assets, (ii).Current Assets, (iii). Non-Current Liabilities, (iv). Other Current Liabilities, (v) Current Liabilities, (vi). Non-Current Liabilities)*

4. Under which sub-heading will the following items be placed in the Balance Sheet of a company as per revised Schedule-VI, Part-I of the Companies Act, 1956:

(i) Capital Reserves

(ii) Bonds

(iii) Loans repayable on demand

(iv) Vehicles

(v) Goodwill

(vi) Loose tools

(Answer.*(i). Shareholders' Funds, (ii).Non-Current Liabilities, (iii). Current Liabilities, (iv). Non-Current Assets, (v) Non-Current Assets, (vi). Current Assets)*

5. Re-arrange the following items under appropriate heads:

(a) Live Stock, (b) Loose tools, (c) Goodwill, (d) Trade marks, (e) Bills Receivable, (f) Debtors, (g) Land, (h) Leasehold, (i) Stock-in-trade, (j) Stores and spare parts, (k) Furniture, (l) Vehicles, (m) Advance to subsidiary, (n) Cash with Bank, (o) Cash in hand, (p) Work-in-progress, (q) Plant, (r) Interest accrued.

6. State the headings under which you will disclose the following items in the Balance Sheet of the company:

(a) Stock

(b) Discount on issue of debentures not yet written off

(c) Bills Payable

(d) Preliminary Expenses

(e) Application money received for allotment of securities and due for refund

(f) Securities Premium

(Answer.*(a) Current Assets, (b) Other Non-Current Assets (to the extent not written off), (c) Current Liabilities, (d) Write off from Profit and Loss A/c {Can give a note under the head Reserves and Surplus as a deduction from Profit and Loss A/c}, (e) Other Current Liabilities, (f) Shareholder's Funds)*

7.An accountant has joined a company recently. He has asked you to help him in disclosing the following in the Balance Sheet of the company.

(a) Authorised Capital

(b) Capital Reserve

(c) Secured Debentures

(d) Provision for Tax

(e) Unpaid matured debentures and interest thereon

(Answer.*(a) Shareholder's Funds – Note, (b) Shareholder's Funds – (Reserves and Surplus), (c) Non-Current Liabilities- Long Term Borrowings, (d) Current Liabilities- Short Term Provisions, (e) Current Liabilities – Other Current Liabilities)*

8. From the following details, calculate the amount of current assets to be disclosed in the company's Balance Sheet as per Schedule III.

Cash	96,000
Trade Receivables	1,00,000
Stock in trade	1,20,000
Trade Payables	1,20,000
Land	40,000
Investments	80,000
Interest Accrued on Investments	10,000
Loose Tools	20,000

*(**Answer.**Rs. 3,46,000)*

UNIT 9: FINANCIAL STATEMENTS: ANALYSIS AND INTERPRETATION

Unit Code:9	**UNIT TITLE: FINANCIAL STATEMENTS: ANALYSIS AND INTERPRETATION**			
	Duration:			
Location: Classroom or Company's premises	**SESSION1: BASIC OVERVIEW OF FINANCIAL STATEMENTS**			
	Learning Outcome	**Knowledge Evaluation**	**Performance Evaluation**	**Teaching and Training Method**
	1.Meaning and Types of Financial Statements	1.Explain the meaning of financial statements 2.Identify the different types of financial statements 3.Explain the meaning and significance of each of the financial statements	1.Classify mandatory and optional financial statements 2.Differentiate between the various financial statements	**Interactive Lecture:** Introduction of different financial statements **Activity:** Collect financial statements of a company in a particular industry
	2.Nature of Financial Statements	1.Describe the nature of financial statements	1.Identify the character of the financial statements	**Interactive Lecture:** Discussion of nature of financial statements **Activity:** Match the nature and purpose of financial statements studied in theory with the collected financial statements of a company
	3.Limitations of Financial Statements	1.Explain the limitations of financial statements	1.Assess the shortcomings of financial statements	**Interactive Lecture:** Discussion of limitations of financial statements
	SESSION 2: INTRODUCTION TO ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS			
	1. Analysis and Interpretation of Financial Statements	1. Explain the purpose of analysis and interpretation 2. Clarify the difference between analysis and interpretation	1.Justify the analysis and interpretation of financial statements	**Interactive Lecture:** Acquaint with the concept of analysis and interpretation of financial statements
	2. Steps involved in the Financial Statement Analysis	1.Enumerate the steps involved in the analysis of financial statements	1.Evaluate the steps of analyzing financial statements	**Interactive Lecture:** Discussion of steps involved in analyzing financial statements

	3. Methodical Classification	1.Explain preparation of income statement and Balance Sheet in vertical form	1.Classify the main heads and the items involved in the preparation of financial statements in vertical form	**Interactive Lecture:** Discuss the methodical classification of financial statements
	SESSION 3: TOOLS OF ANALYSIS			
	1. Tools of financial analysis	1.Explain the tools generally used for analysis	1.Identify the tools used for analysis	**Interactive Lecture:** Give a brief overview of the tools of financial analysis **Activity:** Prepare the financial statements in vertical form for a period of more than one year for comparison
	SESSION 4: RATIO ANALYSIS AND ITS CLASSIFICATION			
	1. Ratio Analysis	1.Explain the meaning of accounting ratios and ratio analysis 2.Categorize accounting ratios	1.Compute accounting ratios 2.Interpret the computed ratios	**Interactive Lecture:** Discuss the concept of ratio analysis and the different ratios according to the respective classification **Activity:** Compute ratios from the figures in the financial statements of the identified company
	2.Advantages and Limitations of Ratio Analysis	1.Discuss the utility of ratio analysis as a tool for financial analysis 2.Explain the criticisms of ratio analysis	1.Critically appraise ratio analysis	**Interactive Lecture:** Discuss the Advantages and Limitations of Ratio Analysis

(Note: The location would depend upon the topic under discussion, wherein it will be the classroom for the theoretical interactions and the student will be required to visit the office of a company to collect financial statements and other records, if not available on the website of the company.)

UNIT: 9 - FINANCIAL STATEMENTS: ANALYSIS AND INTERPRETATION

Learning Objectives:

After reading thisunit,the studentswill be able to:

1. understand the meaning, nature and types of financial statements,
2. explain types of financial statements and their limitations,
3. define purpose of analysis and interpretation and difference thereof,
4. explain the steps involved in financial statement analysis,
5. understand tools used for financial analysis,
6. comprehend the concept and objectives of ratio analysis,
7. identify advantages and drawbacks of ratio analysis,
8. cognize the classification of ratios, their calculation and interpretation and
9. explain the meaning of certain keywords

SESSION1: BASIC OVERVIEW OF FINANCIAL STATEMENTS

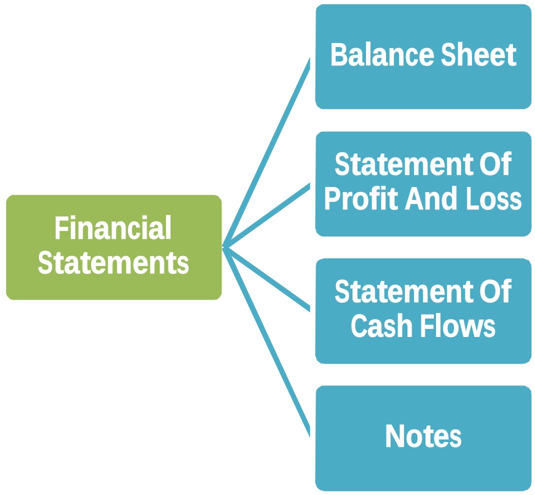
MEANING OF FINANCIAL STATEMENTS

The accounting process involves recording, classifying and summarizing various business transactions and ends with the preparation of financial statements which help in communicating the financial results to the stakeholders. Financial Statements represent a formal and organised documentation of the financial activities of an entity. Relevant financial information is presented in a structured manner to quantify the financial strength, performance and liquidity of a company. These statements are prepared in accordance with the principles, policies and procedures of the company in addition to the applicable accounting standards. The financial statements act as the source of information for inferences regarding the profitability and financial position, thus facilitating decision making by the management and the other stakeholders. Therefore, the financial statements should be understandable, relevant, reliable and comparable. The primary objective of financial statements is to provide relevant information about the performance, profitability and financial position of an enterprise to facilitate decision making by varied users and stakeholders. The purpose may vary from one stakeholder to the other.

TYPES OF FINANCIAL STATEMENTS

According to John N. Myer, “The financial statements provide a summary of accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period.”

The types of financial statements to be prepared by companies can be represented as follows:



A complete set of basic financial statements comprises of:

(a) a **Balance Sheet**: It is a statement reporting the company's financial status on a particular date, listing everything that the company owns, i.e assets and everything that the company owes to the owners and outsiders, i.e. owner's equity and liabilities, respectively. It is usually prepared as at the end of the period and includes statement of changes in equity which is presented as a part of the balance sheet

(b) a **Statement Of Profit And Loss:** Also, referred to as Income Statement, itsummarises revenues, expenses, and profits/losses of a company over a period of time, usually between two Balance Sheet dates. A profit and loss statement provides information on the results of the operations of the enterprise for a specified accounting period, including the income and the costs associated

(c) a **Statement Of Cash Flows:** Also, referred to as Cash Flow Statement, itdiscloses the company's cash flow activities, particularly its operating, investing and financing activities for the specified period;

(d) **Notes**, comprising a summary of significant accounting policies and other explanatory information

NATURE OF FINANCIAL STATEMENTS

The financial statements record the information regarding the operations of an enterprise, measured and expressed in monetary terms, in a chronological order. These statements reflect facts recorded on the basis of personal judgments and in accordance with the accounting principles. The nature of financial statements can be discussed as follows:

1. ***Recorded Facts***: Financial statements include the facts relating to the business transactions recorded in the books of accounts.
2. ***Accounting Convention***: The preparation of financial statements is influenced by certain accounting conventions, like the usage of materiality convention while dealing with small items like pens, pencils, etc.
3. ***Accounting Assumption Or Concepts***: Financial statements are prepared on the basis of certain accounting concepts like going concern concept, cost concept, etc..

4. ***Personal Judgment***: Although, the preparation of financial statements is based on the various accounting concepts and conventions, but their application, in most of the cases, depends on personal judgment and estimates. For example, the fixed assets are recorded at cost less depreciation but the choice of method of depreciation is based on personal judgment.

LIMITATIONS OF FINANCIAL STATEMENTS

Although, financial statements reflect the financial performance and position of the company, they are not free from limitations. Some of the drawbacks of financial statements are enumerated as follows:

1. They are based on historical costs but the current value of the assets changes with time which is not reflected in the financial statements.
2. The statements also do not take into account the impact of price level changes or change in the value of rupee. Therefore, profitability of two different periods is not comparable.
3. Only the monetary transactions are recorded, thus, ignoring the non – monetary factors like efficiency, loyalty, commitment and integrity.
4. Human judgment and interpretation plays a major role in deciding about the policies of the company which is error-free. It also increases chances of manipulation of figures as per the needs of the management.
5. The statements do not give an accurate position of the enterprise. The value of fixed assets reflected in the Balance Sheet neither represents the value at which the asset will be sold nor the value of its replacement. Similarly, items like preliminary expenses, goodwill, discount on issue of shares do not realize anything at the time of liquidation although they are shown as assets in the Balance Sheet.

Knowledge Assessment- I

Fill in the blanks with appropriate word(s):

1. Financial statements reflect ______________ transactions.
2. Balance sheet shows the ____________ _______________ of the company.
3. A statement of Profit and Loss shows the ____________ of the business.
4. Statement of Cash Flows is also referred to as __________ ____________ ___________.
5. The financial transactions are recorded in a _______________ order.
6. The financial statements do not show the current value of assets as they are based on ________ _____ concept.
7. Manipulation in the statements can arise because of involvement of ________ ____________.
8. The financial position of the company as on a particular date is shown by __________ ________.

Answers

1. monetary, 2. financial position, 3. profitability, 4. Cash Flow Statement, 5. chronological, 6. historical cost, 7. personal judgment, 8. Balance Sheet

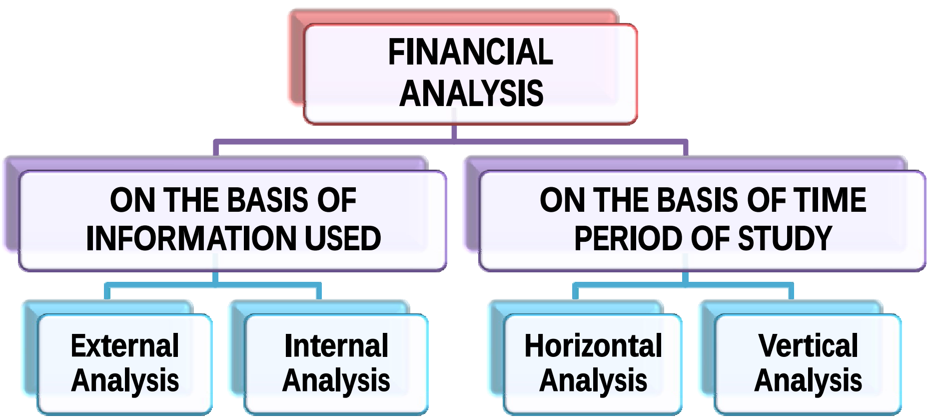
SESSION 2: INTRODUCTION TO ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

ANALYSIS AND INTERPRETATION OF FINANCIAL STATEMENTS

Financial statements, on their own, have limited usage. Analysis and interpretation help in evaluating the profitability and assessing the financial position of the company. Although, the term analysis is generally used to include both analysis and interpretation, but the two terms differ from each other. ‘Analysis’ refers to simple and systematic classification of the statistics in the financial statements while ‘interpretation’ clarifies the meaning and implication of the analysed data.

TYPES OF FINANCIAL ANALYSIS

Financial statements are analyzed by different parties for varied purposes. The financial analysis can be classified as follows:



1. **On the basis of Information used:**
   - **A) External Analysis** is conducted byoutside parties like existing and potential investors, suppliers, lenders, credit agencies, customers and government agencies, who do not have access to the internal records of the company. they depend on the published financial information and any other additional information supplied by the management.
   - **B) Internal Analysis** is undertaken by executives, employees and other people of the management, who have access to the internal records and policies, depending upon the purpose of the analysis.
2. **On the basis of time period of study:**
   - **A) Horizontal Analysis,** also referred to as Dynamic Analysis, represents the review and analysis of the past consecutive Balance Sheets, Income Statements or Statements of Cash Flow for two or more years. The comparison is made with a pre-decided base year. It facilitates the understanding of trend and direction of the performance of the organization.

B) **Vertical Analysis,** also known as Static Analysis,is restricted to the analysis of financial statements of one particular period on a specific date. Each of the variables given in the financial statements is expressed as a percentage of a base figure in the same statement. For example, different costs expressed as percentage of sales. This analysis helps in understanding the structural relationship of different items in the financial statements as well as in comparing the financial performance of various departments of a company or several companies under a certain group.

STEPS INVOLVED IN FINANCIAL ANALYSIS

Financial statement analysis can be conducted as per the following stages:

1. Determine the purpose and context of financial analysis
2. Collect necessary data for the analysis from different sources
3. Classify the gathered data methodically
4. Compare and evaluate the organized data using various tools of financial analysis
5. Communicate the results derived to the concerned personnel.
6. Follow up or Review, if necessary, in case of revisions or updation of information

On the basis of the above steps, it can be observed that it is important to learn the methodical classification of data and understand the various tools of financial analysis for the purpose of interpretation.

METHODICAL CLASSIFICATION

As against the traditional practice of preparing the financial statements in T-form or the two columnar form, the vertical form or the single column form is gaining prominence as it facilitates comparison by showing figures of different firms as well as different years simultaneously.

Income Statement

for the year ending……..

	Particulars		**Rs.**	**Rs.**
	Sales			………..
Less:	Sales Returns		………..	
	Sales Tax/Excise		………..	………..
	Net Sales for the year	(1)		………..
Less:	Cost of Sales	(2)		
	Raw Materials consumed		………..	
	Direct wages		………..	
	Manufacturing expenses		………..	
Add:	Opening stock of finished goods		………..	
Less:	Closing stock of finished goods		………..	………..
	Gross Profit (1) – (2)	(3)		………..
Less:	Operating Expenses:	(4)		

	Administration expenses		……….	
	Selling and distribution expenses		……….	……….
	Net Operating profit (3) – (4)	(5)		……….
Add:	Non-trading income (such as dividends, interest received, etc.)		……….	
Less:	Non-trading expenses (like discount on shares written off)		……….	……….
	Income or Earnings before Interest and Tax (EBIT)	(6)		……….
Less:	Interest on debentures	(7)		……….
	Net Income or Earnings before Tax (EBT)	(8)		……….
Less:	Tax	(9)		……….
	Income or Profit after Tax (PAT)	(10)		……….

Balance Sheet

as on …………………

		Rs.
Cash in hand		……….
Cash at bank		……….
Bills receivable		……….
Book debts (less provision for bad debts)		……….
Marketable trade investments		……….
Liquid assets	(1)	……….
Inventories (stock of raw materials, finished goods, etc.)		……….
Prepaid expenses		……….
Current assets	(2)	……….
Bills payable		……….
Trade creditors		……….
Outstanding expenses		……….
Bank overdraft		……….
Other liabilities payable within a year		……….
Current Liabilities	(3)	……….
Provision for tax		……….
Proposed dividends		……….
Other provisions		……….
Provisions	(4)	……….
Current liabilities and provisions (3) + (4)	(5)	……….
Net working capital (2) – (5)	(6)	……….
Goodwill at cost (if it has been paid for and has value)		……….
Land and Building		……….
Plant and Machinery		……….
Loose Tools		……….
Furniture and Fixtures		……….
Investments in Subsidiaries		……….
Patents, Copyrights, etc. (provided they have a value)		……….
Fixed assets	(7)	……….

Capital employed (6) + (7)	(8)	………..
Other Assets:	(9)	………..
Investment in government securities, unquoted investments, etc.		………..
Other investments (non-trading)		………..
Company's Net Assets (8) + (9)	(10)	………..
Debentures		………..
Other Long Term Loans (payable after a year)		………..
Long Term Loans	(11)	………..
Shareholder's Net Worth (1) – (11)	(12)	………..
(or Tangible Net Worth)		
Preference Share Capital	(13)	………..
Equity Shareholder's Net Worth (12) – (13)	(14)	………..
Equity Shareholder's Net Worth is represented as:		
Equity Share Capital	………..	
Forfeited Shares	………..	
Reserves	………..	
Surplus	………..	
Equity Shareholder's Claims	………..	………..
Less: Accumulated Losses	………..	
Miscellaneous Expenditure (such as preliminary expenses, discount on issue of shares or dentures not written off)	………..	
Equity Shareholder's Net Worth	………..	………..

Knowledge Assessment- II

State whether the following statements are True or False:

1. Both the Income Statement and Balance Sheet show the financial position of the firm at the end of the year.
2. Methodical presentation of financial statements helps in calculation of various ratios.
3. Balance Sheet must be prepared in the horizontal format only.
4. Horizontal Analysis is also termed as Static Analysis.
5. External analysis refers to analysis of the external environment in which the company operates.
6. Analysis and interpretation are synonyms.
7. Internal Analysis includes scrutinizing the effectiveness of the employees.

Answers

1. False, 2. True, 3. False, 4. False, 5. False, 6. False, 7. False

SESSION 3: TOOLS OF ANALYSIS

TOOLS OF ANALYSIS

The preparation of financial statements is not sufficient. A quantitative analysis of the financial information contained in these statements is important to evaluate the operating and financial performance of a company. Various techniques such as ratio analysis, comparative statements, trend analysis, common size statements, funds flow statement, cash flow statement can be used to assess financial statements and take appropriate decisions. Ratio analysis is one of the most common tools used to analyze a business' financial standing because it is easy to understand and simple to compute, which has been explained in detail later in the chapter. The different tools of analysis are as follows:

1. Comparative Statements
2. Common Size Statements
3. Trend Analysis
4. Ratio Analysis
5. Funds Flow Statement
6. Cash Flow Statement

COMPARATIVE FINANCIAL STATEMENTS

The financial performance and position of the company can be compared for different periods by preparing the comparative financial statements. The change can be presented in aggregate terms or in proportionate terms to have a better understanding of the results. The presentation of comparative financial statements in annual reports enhances the usefulness of such reports. The comparative financial statements comprise of the following:

1. Comparative Income Statement
2. Comparative Balance Sheet

The following format can be used to prepare the comparative statements.

Particulars	First Year	Second Year	Absolute Increase (+) or Decrease (-)	Percentage Increase (+) or Decrease (-)
Column 1	2	3	4	5
	Rs.	Rs.	Rs.	%

Illustration 1

The Income Statement and Balance Sheet for the two years, 2014 and 2015 are given as follows. Prepare the Comparative Income Statement and Comparative Balance Sheet.

Income Statements for the years 2014 and 2015

(Figures in Rs. ’000)

Particulars	**2014**	**2015**	**Particulars**	**2014**	**2015**
Cost of goods sold	600	750	Net Sales	800	1000
General expenses	20	20			
Selling expenses	30	40			
Net profit	150	190			
	800	1000		800	1000

Balance Sheets as on March 31

(Figures in Rs. ’000)

Liabilities	**2014**	**2015**	**Assets**	**2014**	**2015**
Capital	700	700	Land	100	100
Reserves	200	245	Building	300	270
Secured Loans	100	150	Plant	300	270
Creditors	200	275	Furniture	100	140
Outstanding Expenses	100	150	Debtors	200	300
			Stock	200	300
			Cash	100	140
	1300	1520		1300	1520

Solution

Comparative Income Statement

For the year ending 31st March 2014 and 31st March 2015

(Figures in Rs. ’000)

Particulars	**2014**	**2015**	**Change in 2015**	**% change in 2015**
Net sales	800	1000	200	+ 25
Less: Cost of Goods Sold	600	750	150	+ 25
Gross Profit (1)	200	250	50	+ 25
Less: General Expenses	20	20	-	-
Selling Expenses	30	40	10	+ 33.33
Total Expenses (2)	50	60	10	+ 20
Net Profit (3 = 1-2)	150	190	40	+ 26.67

Comparative Balance Sheet

as on 31st March 2014 and 31st March 2015

(Figures in Rs. ’000)

Particulars	**2014**	**2015**	**Change in 2015**	**% change in 2015**
Land	100	100	-	-
Building	300	270	-30	-10
Plant	300	270	-30	-10
Furniture	100	140	40	+40
Total Fixed Assets (1)	800	780	-20	-2.5
Cash	100	140	40	+40
Debtors	200	300	100	+50
Stock	200	300	100	+50
Total Current Assets (2)	500	740	240	+48
Creditors	200	275	75	+37.50
Outstanding Expenses	100	150	50	+50
Total Liabilities (3)	300	425	125	+41.70
Net Working Capital (2 – 3)	200	315	115	+57.50
Total Assets ((1+2)	1300	1520	220	+16.92
Capital	700	700	-	-
Reserves	200	245	45	+22.50
Proprietor’s Funds (4)	900	945	45	+5
Secured Loans (5)	100	150	50	+50
Capital employed (4+5)	1000	1095	95	+9.5
Total Assets (1+2)	1300	1520	220	+16.90
Capital + Total Liabilities	1300	1520	220	+16.90

Illustration 2

Convert the following Income Statement into a comparative income statement and interpret the results.

(Figures in Rs. ’000)

Particulars	**2014**	**2015**
	Rs.	**Rs.**
Gross Sales	30,600	36,720
Less: Sales Return	600	700
Net Sales	30,000	36,020
Less: Cost of Goods Sold	18,200	20,250
Gross Profit	**11,800**	**15,770**
Less: Operating Expenses –		
Administration Expenses	3,000	3,400
Selling Expenses	6,000	6,600

Total Operating Expenses	**9,000**	**10,000**
Profit from Operations	2,800	5,770
Add: Non-Operating Income	300	400
	3,100	**6,170**
Less: Non-Operating Expenses	400	600
Net Profit before Tax	2,700	5,570
Less: Tax @ 50%	1,350	2,785
Net Profit after Tax	1,350	2,785

Solution

(Figures in Rs. '000)

Particulars	**2014**	**2015**	**Absolute Increase (+) or Decrease (-)**	**Percentage Increase (+) or Decrease (-)**
Column 1	2	3	4	5
	Rs.	Rs.	Rs.	Rs.
Gross Sales	30,600	36,720	+6,120	+20.00
Less: Sales Return	600	700	+100	+16.67
Net Sales	30,000	36,020	+6,020	+20.07
Less: Cost of Goods Sold	18,200	20,250	+2,050	+11.26
Gross Profit (A)	**11,800**	**15,770**	+3,970	+33.64
Less: Operating Expenses –				
Administration Expenses	3,000	3,400	+400	+13.33
Selling Expenses	6,000	6,600	+600	+10.00
Total Operating Expenses (B)	**9,000**	**10,000**	+1,000	+11.11
Operating Profit	2,800	5,770	+2,970	+106.07
Add: Non-Operating Income	300	400	+100	+33.33
	3,100	**6,170**		
Less: Non-Operating Expenses	400	600	+200	+50.00
Net Profit before Tax	2,700	5,570	+2,870	+106.30
Less: Tax @ 50%	1,350	2,785	+1,435	+106.30
Net Profit after Tax	1,350	2,785	+1,435	+106.30

Interpretation

1. The company has made efforts to reduce the cost which is evident from the fact that the cost of goods sold has not increased in the same ratio as the amount sales.

2. The gross profit has increased in 2005 as compared to 2004 considerably, 33.64% with an increase 20% in sales;

3. The company has also concentrated on reducing the operating cost; hence, the percentage of operating profit has also considerably increased, i.e. 106.07%.

Thus, the overall performance of the company has immensely improved in the year 2015.

COMMON SIZE STATEMENT

The relationship of different items of the financial statements with a common base figure is represented in a common size statement. It is also referred to as component percentage statement. For example, a common size balance sheet shows the percentage of each asset to the total assets, of each liability to the total liabilities and of items of expenditure to the net sales. It helps in analyzing changes and trends over time.

Common size statements can be prepared using the following steps:

1. List out absolute figures in rupees at two points of time

2. Choose a common base (as 100). For example, Sales revenue total may be taken as base (100) in case of income statement, and total assets or total liabilities (100) in case of balance sheet.

3. Calculate percentages of each item to the total.

Particulars	First Year	Percentage	Second Year	Percentage
Column 1	2	3	4	5
	Rs.	%.	Rs.	%

Illustration 3

Prepare Common Size Statement from the following information extracted from the Income Statement of a company:

	Year 3	Year 2	Year 1
	Rs.	Rs.	Rs.
Sales	12,00,000	9,00,000	10,00,000
Cost of goods sold	(5,50,000)	(4,70,000)	(4,80,000)
Operating expenses:			
Marketing expense	(70,000)	(70,000)	(60,000)
R&D expense	(1,50,000)	(40,000)	(1,00,000)
Administrative expense	(2,00,000)	(2,20,000)	((2,00,000)
Operating income	2,30,000	1,00,000	1,60,000
Interest expense	(30,000)	(50,000)	(30,000)
Income before taxes	2,00,000	50,000	1,30,000
Income tax expense	(80,000)	(20,000)	(50,000)
Net income	1,20,000	30,000	80,000

Solution

	Year 3		Year 2		Year 1	
	Rs.	%	**Rs.**	%	**Rs.**	%
Sales	12,00,000	100.0	9,00,000	100.0	10,00,000	100.0
Cost of goods sold	(5,50,000)	45.8	(4,70,000)	52.2	(4,80,000)	48.0
Operating expenses:						
Marketing expense	(70,000)	5.8	(70,000)	7.8	(60,000)	6.0
R&D expense	(1,50,000)	12.5	(40,000)	4.4	(1,00,000)	10.0
Administrative expense	(2,00,000)	16.7	(2,20,000)	24.4(	(2,00,000)	20.0
Operating income	2,30,000	19.2	1,00,000	11.1%	1,60,000	16.0
Interest expense	(30,000)	2.5	(50,000)	5.6	(30,000)	3.0
Income before taxes	2,00,000	16.7	50,000	5.6%	1,30,000	13.0
Income tax expense	(80,000)	6.7	(20,000)	2.2	(50,000)	5.0
Net income	1,20,000	10.0	30,000	3.3%	80,000	8.0

Interpretation

1. Although, the sales has increased in absolute terms from Rs. 10,00,000 in Year 1 to Rs. 12,00,000 in Year 3, but the cost of goods sold has decreased as a percentage of sales, albeit increasing in absolute terms.
2. Operating income decreased in year 2 but has considerably increased in year 3.
3. Net income before taxes has increased in the third year inspite of a sharp downfall in year 2.
4. The net income has increased by 6.7% in year 3 as compared to year 2.

Illustration 4

Prepare Common Size Balance Sheet from the following information of Amazing International.

	2015	2014
	Rs.	Rs.
Current assets		
Cash	12,000	9,000
Accounts receivable	48,000	36,000
Inventory	36,000	27,000
Total current assets	96,000	72,000
Total fixed assets	62,000	55,000
Total Assets	1,58,000	1,27,000
Current liabilities		
Accounts payable	24,000	18,000
Accrued expenses	4,800	3,600

Short-term debt	8,000	6,000
Total current liabilities	36,800	27,600
Long-term debt	90,200	77,400
Total liabilities	1,27,000	1,05,000
Shareholders' equity	31,000	22,000
Total liabilities and equity	1,58,000	1,27,000

Solution

Amazing International
Statement of Financial Position

Particulars	**2015**	**2014**	**(%) as of 2015**	**(%) as of 2014**
	(Rs.)	(Rs.)	%	%
CURRENT ASSETS				
Cash	12,000	9,000	7.6%	7.1%
Accounts Receivable	48,000	36,000	30.4%	28.3%
Inventory	36,000	27,000	22.8%	21.3%
Total Current Assets	96,000	72,000	60.8%	56.7%
Total Fixed Assets	62,000	55,000	39.2%	43.3%
Total Assets	1,58,000	1,27,000	100.0%	100.0%
CURRENT LIABILITIES				
Accounts Payable	24,000	18,000	15.2%	14.2%
Accrued Expenses	4,800	3,600	3.0%	2.8%
Short-term Debt	8,000	6,000	5.1%	4.7%
Total Current Liabilities	36,800	27,600	23.3%	21.7%
Long-term Debt	90,200	77,400	57.1%	60.9%
Total Liabilities	1,27,000	1,05,000	80.4%	82.7%
Shareholders' Equity	31,000	22,000	19.6%	17.3%
Total Liabilities And Equity	1,58,000	1,27,000	100.0%	100.0%

Interpretation

1. Accounts receivable form a major part of the current assets in both the years, with the percentage increasing slightly in 2015.
2. The second major component is inventory with a marginal increase in 2015.

3. The company is debt driven as can be seen from the major chunk of long term debt in the total liabilities and equity

TREND PERCENTAGES

This method requires computation of relationship (in percentage terms) of each item in the financial statement of a particular year to the same item in the base year. The base year is usually the earliest year but it depends upon the personal judgement and requirement of the company's executives to take any other year as base year. These percentages can also be taken as Index numbers which reveal relative fluctuations in the financial data in consequence of passage of time. It enhances the conciseness and comprehension of large amount of data, thus, providing important information at a glance. Generally trend analysis is done for a reasonably long period. It is important to take care that the accounting procedures and conventions used for collecting data and preparation of financial statements should be similar; otherwise the figures will not be comparable.

Illustration 5

Calculate the trend percentages from the following figures of sales, stock and profit of Aks Ltd., taking 2001 as the base year and interpret them.

(Rs. in crores)

Year	Sales	Stock	Profit before tax
	(Rs.)	(Rs.)	(Rs.)
2011	1,88,100	70,900	32,100
2012	2,34,000	78,100	43,500
2013	2,65,500	81,600	45,800
2014	3,02,100	94,400	52,700
2015	3,76,800	1,15,400	62,700

Solution

Trend Percentages (base year 2011 = 100)

(Rs. in crores)

Year	Sales	Trend %	Stock	Trend %	Profit before tax	Trend %
	(Rs.)		(Rs.)		(Rs.)	
2011	1,88,100	100	70,900	100	32,100	100
2012	2,34,000	124	78,100	110	43,500	136
2013	2,65,500	141	81,600	115	45,800	143
2014	3,02,100	161	94,400	133	52,700	164
2015	3,76,800	200	1,15,400	163	62,700	195

Interpretation :

1. The sales have continuously increased in all the years in different proportions. The percentage in 2015 is 200 as compared to 100 in 2011 i.e. a 100% increase. The increase in sales is quite satisfactory.

2. The figures of stock have also increased over a period of five years. The increase in stock is more in 2014 and 2015 as compared to earlier years.

3. Profit has substantially increased. The profits have increased in greater proportion than sales which implies that the company has been able to reduce their cost of goods sold and control the operating expenses.

Illustration 6

From the following data relating to the liabilities side of balance sheet of X Ltd., for the period March 31, 2012 to 2015, calculate the trend percentages taking 2012 as the base year.

(Rs. in crores)

Liabilities	**2012**	**2013**	**2014**	**2015**
Equity Share Capital	100	100	120	150
General Reserve	80	100	120	150
12% Debentures	40	50	50	50
Bank Overdraft	30	40	55	50
Bills Payable	10	12	8	14
Sundry Creditors	30	40	50	60
Outstanding Liabilities	5	7.5	12.5	15

Solution

Trend Percentages

(Rs. in crores)

Liabilities	**2012**	**Trend %**	**2013**	**Trend %**	**2014**	**Trend %**	**2015**	**Trend %**
	(Rs.)		(Rs.)		(Rs.)		(Rs.)	
Shareholder's Funds								
Equity Share Capital	100	100	100	100	120	120	150	150
General Reserve	80	100	100	125	120	150	150	187.5
	180	200	200	111.11	240	133.33	300	166.67

Long Term Debts								
12% Debentures	40	100	50	125	50	125	50	125
	40	100	50	125	50	125	50	125
Current Liabilities								
Bank Overdraft	30	100	40	133.33	55	183.33	50	166.67
Bills Payable	10	100	12	120	8	80	14	140
Sundry Creditors	30	100	40	133.33	50	166.67	60	200
Outstanding Liabilities	5	100	7.5	150	12.5	250	15	300
	75	100	99.5	132.67	125.5	167.33	139	185.33
Total (Liabilities)	295	100	349.5	118.47	415.5	140.85	489	165.76

Interpretation:

1. Shareholders' funds have increased over the period because of retention of profits in the business in the form of reserves, and the share capital has also increased.

2. The increase in current liabilities is more than that of long term debt. This may be due to expansion of business and/or availability of greater credit activities.

RATIO ANALYSIS

Accounting ratios, as a tool of financial analysis, are quite helpful in decision making as they measure the comparative significance of the individual items of the income and position statements in relative terms. Various ratios facilitate the assessment of the profitability, solvency and efficiency of an enterprise. Ratio analysis has been discussed in detail in the later part of the chapter.

FUNDS FLOW ANALYSIS

Funds Flow Analysis reveals the changes in the working capital position of the company. It shows the various sources of acquisition of funds as well as their application. With this insight, the management can prepare the estimates of the working capital flows.

CASH FLOW STATEMENT

As opposed to Funds Flow Analysis, Cash Flow Analysis considers the transactions effecting cash and cash equivalents only. It is more useful in evaluating the liquidity position of the company.

Both, Funds Flow Analysis and Cash Flow Analysis have been discussed at length in the forthcoming chapters.

Knowledge Assessment- III

State whether the following statements are True or False:

1. Funds Flow Analysis reveals changes in working capital position.
2. Trend Percentage Analysis helps in Dynamic Analysis.
3. Ratio Analysis is the only important technique of analysis of financial statement.
4. Financial analysis helps an analyst to arrive at a decision.
5. Common size statements and financial ratios are the two tools employed in vertical analysis.
6. In a Common size statement each item is expressed as a percentage of some common base.
7. Financial analysis is used only by the creditors.
8. Ratio analysis establishes relationship between two financial statements.

Answers

1. True, 2. True, 3. False, 4. True, 5. True, 6. True, 7. False, 8. True

SESSION 4: RATIO ANALYSIS AND ITS CLASSIFICATION

RATIO ANALYSIS

Ratio analysis is the process of calculating and interpreting financial ratios for the purpose of decision making. Ratio analysis is not an end in itself, it is a means to better comprehend the financial position of the firm. This technique should preferably be used only as a gateway in financial analysis, to acquire an indication of a firm's performance and to find areas for further consideration.

MEANING OF RATIO

A ratio is a simple mathematical expression of the relationship between two variables. In simple language, ratio is one number expressed in terms of another and can be calculated by dividing one number with the other. For example, the current assets of a firm as on a specific date are Rs. 10,00,000 and the current liabilities are Rs. 5,00,000, then the ratio of current assets to current liabilities can be calculated by dividing current assets by current liabilities, 10,00,000 / 5,00,000 = 2. The ratios can be expressed in percentage terms or as proportion.

Financial ratios help to summarise large quantities of financial data to make qualitative judgment about the firm’s financial performance. However, no conclusion can be drawn from a single ratio. The analysis is possible by studying the ratios in relation to one another and comparing the calculated ratios against set benchmarks. Ratios can be used to compare the current performance as against previous years and with other companies working in the same industry to check whether the company is improving or deteriorating. Ratios look at the relationships between individual values and relate them to how a company has performed in the past and might perform in the future. Also, a study of the trend helps to obtain a quick indication of a firm's financial performance in several key areas in addition to an idea of comparative valuations.

IMPORTANCE OF RATIO ANALYSIS

- analysing financial statements
- simplifying compelx accouting figures and establish relationships
- facilitatiing inter and intra firm comparison
- analysing past performance of the firm
- making future projections
- judging operating efficiency of the business
- identifying areas of improvement

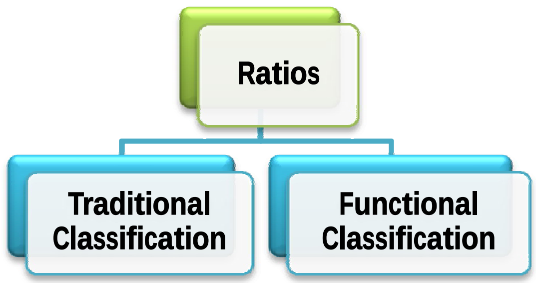
LIMITATIONS OF RATIO ANALYSIS

Although, ratio analysis is a quick, simple and useful tool of analyzing the financial position and performance of the company, they are not free from drawbacks. The major limitations are:

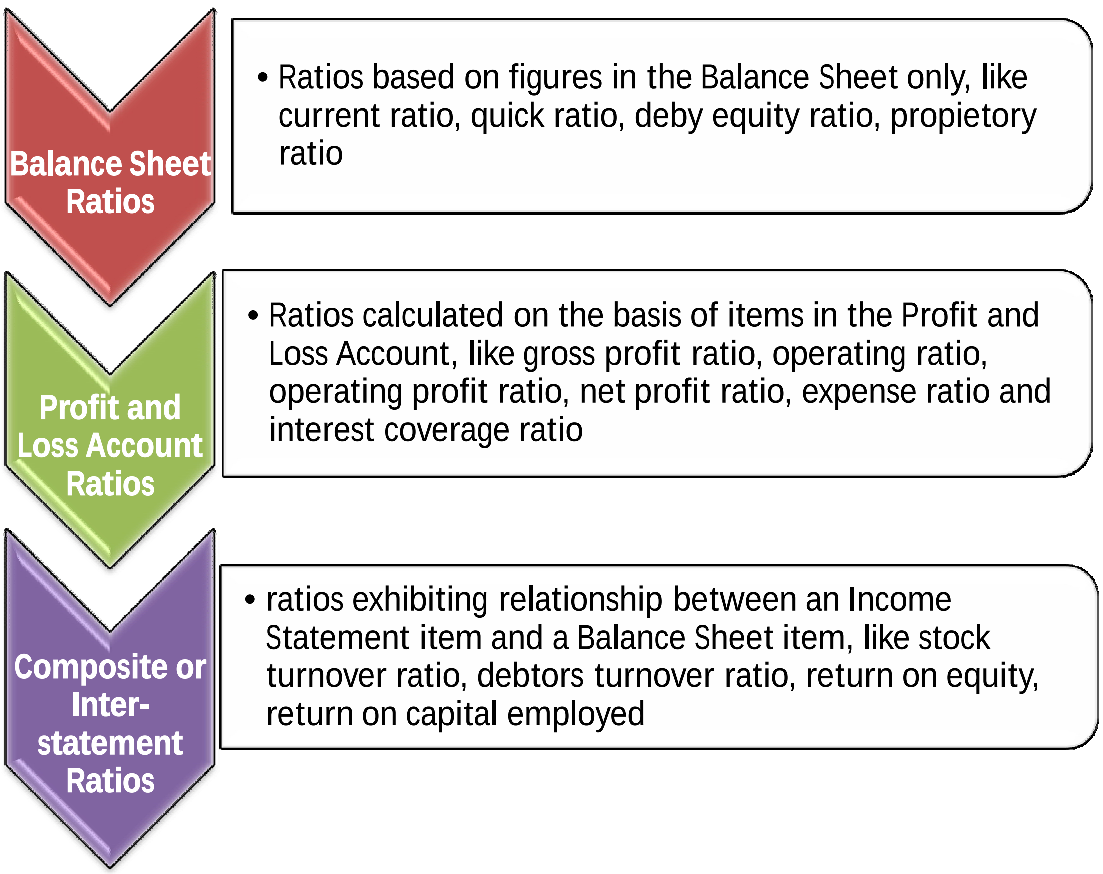
1. Due to lack of pre-defined and accepted standards of ratios, interpretation becomes difficult
2. The ratios become misleading if there is change in the accounting policies and procedures.
3. Ratios reflect past performance and need not necessarily be a true indicator of the future.
4. The presence of personal bias leads to different interpretation of ratios by different people.
5. Ratios only provide clues and not conclusions, thus, cannot be relied upon solely.
6. The qualitative aspect of the company and its functioning is ignored.
7. Companies in an industry and across industries differ in their nature, size and accounting procedures making comparison of ratios difficult.
8. The economy is inflationary in nature but ratios tend to ignore the price level changes.

CLASSIFICATION OF RATIOS

The accounting ratios can broadly be classified as follows:



The traditional classification is as under:



Although, accounting ratios are calculated by taking data from financial statements but classification of ratios on the basis of financial statements is rarely used in practice. The alternative functional classification can be depicted as follows:

LIQUIDITY RATIOS

- These ratios measure the ability of the business to pay the amount due to stakeholders in the short term as and when they become due.
- Eg. Current Ratio, Quick Ratio

SOLVENCY RATIOS

- Solvency Ratios help to determine the long term financial stability of the firm, i.e. the ability of the business to pay off its long term obligations
- Eg. Debt Equity Ratio, Debt ratio, Proprietary ratio, Total Assets to Debt Ratio, Interest Coverage Ratio

ACTIVITY / TURNOVER RATIOS

- These ratios measure the efficiency of employment of the firm's resources, i.e. the rate at which the assets are converted into sales
- Eg. Stock Turn-over, Debtors Turnover, Creditors Turnover, Investment (Net Assets) Turnover, Fixed Assets Turnover, Working Capital Turnover

PROFITABILITY RATIOS

- Profitability ratios help in analysing the earning capacity of the business in addition to overall performance and effectiveness
- Eg. Gross Profit Ratio, Operating Ratio, Operating Profit Ratio, Net profit Ratio, Return on Investment, Return on Net Worth, Earnings per Share, Dividend Payout Ratio, Price Earning Ratio.

LIQUIDITY RATIOS

Also referred to as ‘working capital ratios’ or ‘short term solvency ratios’, these ratios help to know whether the company has adequate working capital to meet its short term obligations thereby ensuring the smooth functioning of day-to-day operations of the business. The ratios under this categorization are as follows:

RATIO	PURPOSE	FORMULA	SIGNIFICANCE /INTERPRETATION
CURRENT RATIO	Measures a firm's ability to pay off its short-term liabilities with its current assets	$= \frac{\text{Current Assets}}{\text{Current Liabilities}}$	• Shows the proportion of current assets of a business in relation to its current liabilities. • Preferred ratio is 2:1 but it varies from industry to industry
QUICK RATIO/ ACID-TEST RATIO/ LIQUID RATIO	Ascertains whether a firm has sufficient short-term assets to pay-off its immediate liabilities without selling inventory.	$= \frac{\text{Quick Assets or Liquid Assets}}{\text{Current Liabilities}}$ Where Quick Assets = (Current Assets – Stock - Prepaid Expenses)	• Indicates the proportion of liquid assets to the current liabilities • Ideal ratio is 1:1, higher can be preferred but lower ratio is not advisable
ABSOLUTE LIQUIDITY RATIO	Shows the relationship between absolute liquid or super quick assets and current liabilities	$= \frac{\text{Cash + Bank + Marketable Securities}}{\text{Current Liabilities}}$	• Relates absolute liquid assets to current liabilities • 50% or 0.5:1 ratio is desired
DEFENSIVE INTERVAL RATIO	Examines firm's ability to meet projected daily expenditure from operations	$= \frac{\text{Quick Assets}}{\text{Projected daily cash requirements(PDCR)}}$ Where, PDCR = $\frac{\text{Projected cash operating expenses (i.e. cost of goods sold + cash expenses)}}{\text{Number of days in a year}}$	• Measures the number of days for which the company's quick assets can finance its daily cash expenditures assuming no access to non-current (long-term) assets • Higher the ratio, the better it is

Illustration 7

Calculate liquidity ratios from the following information :

Total Current Assets	Rs 1,80,000
Stock (included in current assets)	Rs 60,000
Prepaid Expenses	Rs 6,000
Current Liabilities	Rs 1,20,000

Solution :

A). Current ratio = Current Assets / Current liabilities

= Rs 1,80,000 / Rs 1,20 000

= 3 : 2 or 1.5 : 1

B. Liquid ratio = (Current Assets – Stock - Prepaid Expenses) / Current liabilities

= (1,80,000 – 60,000 – 6,000) / 1,20,000 = 0.95

Illustration 8

The Balance Sheet of Glassworks Ltd. as at 31st March, 2015 is given below:

(Figures in Rs. Crores)

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Share Capital	10	Goodwill	6
Reserves and Surplus	3	Fixed Assets	12.60
P&L Account	2.50	Investments (short-term)	1
Secured Loans	8	Stock	3.60
Creditors	2.50	Debtors	2.40
Bank Overdraft	1.50	Advances	0.50
Provision for Taxation	0.50	Cash in Hand	0.90
		Cash at Bank	1
	28		**28**

Calculate liquidity ratios.

Solution

(a) Current Ratio = Current Assets / Current Liabilities

= 9.4/4.5 = 2.09

As compared to the ideal 2:1, a ratio of 2.09 indicates better liquidity position of the company.

(b) Liquid Ratio = Liquid Assets / Current Liabilities

= 5.8 /4.5= 1.29

Alternatively, the bank overdraft can be deducted from current liabilities to calculate quick liabilities. The answer in this case will be:

= 5.8/ 3 = 1.93

(c) Absolute Liquidity Ratio = Absolute Liquid Assets / Current Liabilities

= 2.9 / 4.5 = 0.64

Interpretation

The current ratio is higher than the ideal ratio of 2: 1, liquid ratio is greater than the ideal 1:1 and the absolute liquid ratio is more than the required 0.5 :1. These ratios indicate a favorable liquid position of the company.

Working Notes

1. **Computation of Current Assets, Liquid Assets and Absolute Liquid Assets**

(Figures in Rs. Crores)

Particulars	Current Assets	Liquid Assets	Absolute Liquid Assets
Stock	3.6	-	-
Debtors	2.4	2.4	-
Advances	0.5	0.5	-
Cash in hand	0.9	0.9	0.9
Cash at bank	1	1	1
Investments (short term)	1	1	1
	9.4	**5.8**	**2.9**

2. **Calculation of Current Liabilities**

(Figures in Rs. Crores)

Particulars	Rs.
Creditors	2.50
Bank Overdraft	1.50
Provision for Taxation	0.50
	4.5

Illustration 9

The following figures have been taken from the balance sheet of Annie Ltd.:

Share Capital	Rs 304,000
Cash In Hand And At Bank	Rs 60,000
Fixed Assets	Rs 226,000
Creditors	Rs 40,000
5% Debentures	Rs 48,000
Bill Payables	Rs 8,000
Debtors	Rs 36,000
Stock	Rs 104,000
General Reserve	Rs 16,000
Profit and Loss Account	Rs 10,000

Calculate (i) Current Ratio and (ii) Liquid Ratio.

Solution:

A). Current Ratio = Current Assets / Current Liabilities

where Current Assets = Cash In Hand And At Bank + Debtors + Stock

= Rs 60,000 + Rs 36,000 + Rs 1,04,000

= Rs 2,00,000

Current Liabilities = Creditors + Bill Payable

= Rs. 40,000 + Rs 8,000

= 48,000

Current Ratio = Rs 2,00,000 / Rs 48,000

= 4.26 : 1

(ii) Quick Ratio = Quick Assets / Current Liabilites

where Quick Assets = Current Assets – Stock

= Rs 2,00,000 – Rs 1,04,000

= Rs 96,000

Quick Ratio = Rs 96,000 / Rs 48,000

= 2 : 1

Illustration 10

Cash operating expenditure of Rs. 1,82,500 has been projected for a company with Rs. 40,000 quick assets. Determine the defensive interval ratio.

Solution

Projected Daily Cash Requirement = 1,82,500 / number of days in a year

= 1,82,500 / 365

= Rs. 500

Defensive Interval Ratio = Quick Assets / Projected Daily Cash Requirement

= 40,000 / 500

= 80 days

A high defensive interval ratio indicates safety of short term liquidity, thus the quick assets in this case are sufficient to meet operating expenses for 80 days.

Illustration 11

Explain the effect of payment of Rs. 10,000 to creditors on the current ratio if cash and creditors before payment are Rs. 1,50,000 and Rs. 75,000 respectively.

Solution

Current Ratio = Current Assets / Current liabilities

Before payment of Rs 10,000 to creditors

= Cash / Creditors

= Rs 1,50,000 / Rs 75,000

= 2 : 1

After payment of Rs 10,000 to creditors

Current Ratio = Cash / Creditors

= (Rs 1,50,000 – Rs 10,000) / (Rs 75,000 – Rs 10,000)

= 2.15 : 1

Hence, it can be observed that the current ratio has increased from 2 : 1 to 2.15 : 1

SOLVENCY RATIOS

As against liquidity ratios, solvency ratios represent an enterprise's capacity to meet its long-term financial commitments. It is generally said that the lower a company's solvency ratio, the greater is the probability that it will default on its debt obligations. The following table shows the ratios covered under this head:

RATIO	PURPOSE	FORMULA	SIGNIFICANCE /INTERPRETATION
DEBT EQUITY RATIO	Measures the riskiness of a company's financial structure by comparing a company's total debt to total equity.	$= \dfrac{\text{Total Long Term Debt}}{\text{Shareholder's Funds (or Equity)}}$	• Reveals the relative proportion of shareholders' equity and debt used to finance a company's assets • Higher debt to equity ratio indicates that more debt financing is used than investor financing (i.e from shareholders).

DEBT RATIO	Computes a firm's total liabilities as a percentage of its total assets and shows a company's ability to pay off its liabilities with its assets	$= \dfrac{\text{Total Debt}}{\text{Total Assets (or Capital Employed)}}$	• Shows the proportion of a company's assets that are financed by debt. • The higher the ratio, the greater is the financial risk
PROPRIETARY RATIO	Evaluates the soundness of the capital structure of a company and shows the contribution of shareholder's in total capital of the company	$= \dfrac{\text{Shareholder's Funds}}{\text{Capital Employed (or Net Assets)}}$	• Reflects the proportion of shareholders' funds to total assets • A low ratio indicates excessive use of debt or trade payables, instead of equity to support its operations, thus increasing risk of bankruptcy and vice-versa
INTEREST COVERAGE RATIO	Measures company's ability to meet its interest payments on outstanding debt	$= \dfrac{\text{Earning Before Interest and Tax (EBIT)}}{\text{Interest}}$	• Ascertains the number of times a company could make the interest payments on its debt with its EBIT • A low ratio is a strong indicator that a company may default on its loan payments and vice-versa
CAPITAL GEARING RATIO	Analyzes capital structure i.e relationship between the funds provided by common stockholders and the funds provided by those who receive a periodic interest or dividend at a fixed rate.	$= \dfrac{\text{Funds bearing fixed interest or fixed dividends}}{\text{Total capital employed or equity shareholder's funds}}$	• A company is said to be low geared if the larger portion of the capital is composed of common stockholders' equity (i.e. a low ratio), while it is highly geared if the larger portion of the capital is composed of fixed interest/dividend bearing funds (i.e a high ratio)
PREFERENCE DIVIDEND COVERAGE RATIO	States the organization's capability of paying dividends to shareholders from the profits earned during an accounting period	$= \dfrac{\text{Profit After Tax}}{\text{Preference Dividend}}$	• A high coverage ratio represents a healthy company, indicating that the company can easily pay off its preferred dividend requirements.

Illustration 12

The following is the balance sheet of a company:

Balance Sheet

(In Rs. Lakhs)

Liabilities	**Amount (Rs.)**	**Assets**	**Amount (Rs.)**
Equity Share Capital	80	Plant and Machinery	50
Preference Share Capital	20	Land and Building	40
Reserves	11	Motor Car	15
Debentures	15	Furniture	5
Current liabilities	14	Stock	10
		Debtors	9
		Cash and Bank	10
		Discount on Issue of Shares	1
	140		**140**

You are required to calculate

a) Debt equity ratio
b) Debt ratio
c) Proprietary ratio

Solution

The Balance Sheet, for the sake of convenience, can be redrafted as follows:

Balance Sheet

Sources of Funds:		
Shareholders' Funds:		
Equity Share Capital	Rs. 80,00,000	
Preference Share Capital	Rs. 20,00,000	
Reserves	Rs. 11,00,000	
Discount on Issue of Shares	Rs. (1,00,000)	Rs. 1,10,00,000
Long-term debt		
Debentures	Rs. 15,00,000	Rs. 15,00,000
Capital Employed		**Rs. 1,25,00,000**
Application of funds:		
Fixed Assets :		
Plant and Machinery	Rs. 50,00,000	
Land and Building	Rs. 40,00,000	
Motor Car	Rs. 15,00,000	
Furniture	Rs. 5,00,000	
Total Fixed Assets:		Rs. 1,10,00,000
Current Assets:		

Stock	Rs. 10,00,000	
Debtors	Rs. 9,00,000	
Cash and Bank	Rs. 10,00,000	
Total Current assets	Rs. 29,00,000	
Less Current Liabilities:	Rs. 14,00,000	
Net Current Assets		Rs. 15,00,000
Total Application of funds (Net Assets)		**Rs. 1,25,00,000**

Debt Equity Ratio = Long-Term Debt / Equity

= Rs. 15,00,000/Rs. 1,10,00,000

= 0.136

Debt Ratio = Long-term Debt/Capital Employed

= Rs. 15,00,000/Rs. 1,25,00,000

= 0.12

Proprietary Ratio = Shareholders Funds/Capital Employed

= Rs. 1,10,00,000/Rs. 1,25,00,000 = 0.88

Alternatively, the debt ratio and proprietary ratio can be based on total assets (Rs. 1,39,00,000),

Then these shall work out as follows:

Debt Ratio = Total Debt/Total Assets

= Rs. 29,00,000/Rs. 1,39,00,000

= 0.209

Proprietary Ratio = Shareholders Funds/Total Assets

= Rs. 1,10,00,000/Rs. 1,39,00,000

= 0.791

Illustration 13

The following capital structure hs been extracted from the Balance Sheet of Ahuja Ltd.

Particulars	**Rs.**
Equity Share Capital	30,00,000
Reserves	10,00,000
10% Debentures	40,00,000

12% Preference Shares Capital	20,00,000
Capital employed	1,00,00,000

Calculate gearing ratio if the company earns a profit of Rs. 20,00,000 before interest and tax and tax rate of 50%.

Solution

The capital gearing ratio can be calculated as follows:

= (Funds bearing fixed interest/dividend) / Total capital employed

= 60,00,000 / 1,00,00,000

= 0.6 or 60%

Illustration 14

A company has EBIT of Rs. 15 crores with the following borrowings for the current year:

(Rs. Crores)

15% Term Loan	50
Working Capital:	
20% Bank Loan	33
Public Deposit @ 14%	15

The sales of the company are growing and to support this, the company proposes to obtain additional borrowing of Rs. 25 crores. The increase in EBIT is expected to be 20%. Compute the change in interest coverage ratio after the additional borrowing.

Solution

(i) Computation of present Interest Coverage Ratio

Present EBIT = Rs. 15 crores

(Rs. Crores)

Term Loan @ 15%	7.50
Bank loan @ 20%	6.60
Public deposit @ 14%	2.10
Present interest charges	16.20

Present Interest Coverage Ratio = EBIT / Interest Charges

= 15 / 16.20

= 0.93

(ii) Computation of Revised Interest Coverage Ratio

Revised EBIT (120% of Rs. 15 crores) = Rs. 18 crores

(Rs. Crores)

Existing charges	16.20
Add: Additional Charges (20% of additional borrowings)	5.00
Proposed interest charges	21.20

Revised Interest Coverage Ratio = Revised EBIT / Proposed Interest Charges

= 18 / 21.20

= 0.85

The interest coverage ratio is adversely affected as can be seen in the decrease of 8% due to increase in sales.

Illustration 15

Fun Toys reported a debt equity ratio of 1.75 times at the end of 2014. If the firm's total debt at the year-end was Rs. 25 crores, then how much equity does Fun Toys have?

Solution

Debt Equity Ratio = Total Debt / Total Equity

1.75 = 25 crores / Total Equity

Total Equity = 25 crores / 1.75 = 14.29 crores

Illustration 16

A company is considering investment in one of the two firms, Dues Ltd. and Common Stock Ltd., both of which operate in the same industry. Dues Ltd. finances 25 crores in assets with 24 crores in debt and 1 crore in equity, while Common Stock Ltd. finances 25 crores in assets with 1 crores in debt and 24 crore in equity. Calculate debt ratio and debt equity ratio for the two firms.

Solution

Particulars	**Dues Ltd.**	**Common Stock Ltd.**
Debt Ratio	= 24 crores / 25 crores = 0.96 or 96%	= 1 crore / 25 crores = 0.04 or 4%
Debt Equity Ratio	= 24 crores / 1 crore = 24 times	= 1 crore / 24 crores = 0.042 times

ACTIVITY RATIOS

Activity ratios, also termed as turnover ratios and efficiency ratios, help to evaluate the efficiency with which the firm manages and utilizes its assets. These ratios indicate the speed with which the assets are converted into sales or the rate of rotation of capital employed in the business. The higher the rate, the better is the profitability.

RATIO	PURPOSE	FORMULA	SIGNIFICANCE /INTERPRETATION
STOCK TURNOVER / INVENTORY TURNOVER	Indicates the efficiency of the firm in producing and selling its product.	$= \frac{\text{Cost of goods sold}}{\text{Average inventory}}$	• Measures how many times average inventory is "turned" or sold during a period
DEBTORS' TURNOVER / DEBTORS' VELOCITY	Quantifies the effectiveness of the company in extending credit as well as in collecting debts	$= \frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$	• Appraises the number of times a business can collect its average accounts receivable during the year • Higher ratio indicates better management of credit.
DEBT COLLECTION PERIOD RATIO	Indicates the extent to which the debts have been collected in time	$= \frac{\text{Months (or days) in a year}}{\text{Debtors' Turnover}}$	• An increase in time period (i.e. a higher ratio) exhibits blockage of funds in debtors
CREDITORS' TURNOVER / CREDITORS' VELOCITY	Includes trade creditors and bills payable. It signifies the promptness with which the payments for credit purchases are made by the company	$= \frac{\text{Credit purchases}}{\text{Average Accounts Payable}}$	• Higher creditors' turnover ratio indicates that there are less accounts payable in comparison to credit purchases, i.e. the company does not delay the payment to creditors, thus increasing the credit worthiness of the company
DEBT PAYMENT PERIOD ENJOYED RATIO (Average Age of Payable)	Represents average credit period enjoyed from creditors	$= = \frac{\text{Months (or days) in a year}}{\text{Creditors' Turnover}}$	• The lower the ratio, the higher is the promptness of payment to creditors
INVESTMENT (NET ASSETS) TURNOVER or CAPITAL EMPLOYED TURNOVER	Reflects relationship between sales and capital employed in the business	$= \frac{\text{Sales}}{\text{Capital Employed or Net Assets}}$	• Higher ratio indicates better liquidity and profitability in addition to better utilization of net assets

FIXED ASSETS TURNOVER	Determines the company's ability to generate net sales from fixed-asset investments	$= \frac{\text{Sales}}{\text{Net Fixed Assets}}$	• Higher fixed-asset turnover ratio specifies that the company has been more effective in using the investment in fixed assets to generate revenues
WORKING CAPITAL TURNOVER	Indicates whether or not the working capital has been effectively utilized in making sales	$= \frac{\text{Net Sales}}{\text{Working Capital}}$	• The higher the ratio, the better is the operational efficiency of the company

Illustration 17

An extract from Gupta & Co. reveals the following:

(Figures in Rs.)

Inventory as on 1st July, 2014	23,500
Purchases	2,23,000
Inventory as on 30 June 2015	21,500
Sales (all credit)	8,21,250
Accounts Receivable balance as on 30 June 2015	1,57,500

Calculate:

(a) Inventory turnover ratio
(b) Accounts recievable turnover ratio
(c) Collection Period

Solution

(a) Inventory Turnover Ratio = Cost Of Goods Sold / Average Inventory

Where, Cost of Goods Sold = opening stock + purchases – closing stock

= 23,500 + 2,23,000 – 21,500 = Rs.2,25,000

And Average Inventory = (Opening stock + closing stock) / 2

= (23,500 + 21,500) / 2

= Rs. 22,500

Inventory Turnover Ratio = Rs.2,25,000 / Rs. 22,500

= 10 times

(b) Accounts Receivable Turnover Ratio = Credit Sales / Average Accounts Receivable

= 8,21,250 / 1,57,500

= 5.214

(c) Collection Period = Days in a year / Debtors' turnover ratio
= 365 / 5.124
= 71.23 days
= 72 days approx.

Illustration 18

Calculate creditors turnover ratio and average payment period from the following information:

Particulars	**Rs.**
Total Purchases	4,00,000
Cash Purchases (included in above)	50,000
Purchases Returns	20,000
Creditors at the end	60,000
Bills payable at the end	20,000

Solution

Creditors Turnover Ratio = Credit purchases / average trade creditors

= (Total Purchases – Cash Purchases – Purchase Returns) / (closing creditors + closing Bills payable)

= (4,00,000 – 50,000 – 20,000) / (60,000 + 20,000)

= 3,30,000 / 80,000

= 4.13 times

Average payment period = 365 / Creditors Turnover Ratio

= 365 / 4.13

= 88 days (approx.)

Illustration 19

What will be the working capital ratio if:

Particulars	Rs.
Cash	1,00,000
Bills Receivable	50,000
Sundry Debtors	2,50,000

Stock	2,00,000
Sundry creditors	3,00,000
Cost of sales	15,00,000

Solution

Working Capital Turnover Ratio = Cost of sales / net working capital

Where Net Working Capital = Curent Assets – Current Liabilities

= Cash + Bills Recievable + Sundry Debtors + Stock – Sundry Creditors

= 1,00,000 + 50,000 + 2,50,000 + 2,00,000 – 3,00,000

= 3,00,000

Working Capital Turnover Ratio = 15,00,000 / 3,00,000

= 5 times

Illustration 20

Piper pipes Ltd. ahs provided the following information:

Stock Turnover Ratio	6 times
Gross Profit Ratio	20% on sales
Sales	3,00,000
Closing stock is Rs. 10,000 more than the opening stock	
Opening Creditors	Rs. 20,000
Closing Creditors	Rs. 30,000
Trade Debtors At The End	Rs. 60,000
Net Working Capital	Rs. 50,000

Calculate:

a) Average stock
b) Purchases
c) Creditors turnover ratio
d) Average payment period
e) Average collection period
f) Working capital turnover ratio

Solution

Cost Of Goods Sold = Sales – Gross Profit

= 3,00,000 – 20% of profit

= Rs. 2,40,000

Stock Turnover Ratio = Cost Of Goods Sold / Avaerage Stock

6 = 2,40,000 / Average Stock

Average Stock = 2,40,000 / 6 = Rs. 40,000 ………………………………………. (a)

Average Stock = (Opening Stock + Closing Stock) / 2

40,000 = {Opening Stock + (10,000 + Opening Stock)} / 2

Opening stock = Rs. 35,000

Closing stock = Rs. 45,000

Cost Of Goods Sold = Opening Stock + Purchases – Closing Stock

Purchases = Cost Of Goods Sold + Closing Stock – Opening Stock

= 2,40,000 + 45,000 – 35,000

Purchases = Rs. 2,50,000…………………………………………………………(b)

Creditors Turnover Ratio = Credit Purchases / Average Trade Creditors

Average Trade Creditors = (Opening Creditors + Closing Creditors) / 2

= (20,000 + 30,000) / 2

= Rs. 25,000

Assuming all purchases to be credit purchases

Creditors Turnover Ratio = 2,50,000 / 25,000

Creditors Turnover Ratio = 10 Times…………………………………………………(c)

Average Payment Period = 365 / Creditors Turnover Ratio

= 365 / 10

Average Payment Period = 36.5 days or 37 days (approx.)………………………(d)

Debtors Turnover Ratio = Credit Sales / Average Trade Debtors

= 3,00,000 / 60,000 = 5 times

Average Collection Period = 365 / Debtors Turnover Ratio

= 365 / 5

Average Collection Period = 73 days……………………………………………..(e)

Working Capital Turnover Ratio = Cost Of Goods Sold / Net Working Capital

= 2,40,000 / 50,000

Working Capital Turnover Ratio = 4.8 Times………………………………….(f)

PROFITABILITY RATIOS

Profitability ratios represent financial metrics for assessment of the ability of the business to generate earnings in comparison to its expenses and other relevant costs incurred during a specific period of time. They analyse the earning capacity of the business and underline the effectiveness with which the profitability of a company is being managed.

RATIO	PURPOSE	FORMULA	SIGNIFICANCE /INTERPRETATION
GROSS PROFIT RATIO	Indicates gross margin or mark-up on products sold, i.e. the average spread between cost of goods sold and the revenue	$= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$	• Compares gross profit of the firm with the net sales • Reveals the extent to which the selling price of the product may reduce without losses ensuing from operations to the firm
NET PROFIT RATIO	Relates sales to net profit after operational as well as non-operational expenses and incomes	$= \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$	• Establishes relationship between net profit after tax and net sales of the firm • Indicates proportion of sales revenue available to the owners • Also, shows the extent to which sales revenue can decrease or the cost can increase without losses to the owners
OPERATING RATIO	Displays the efficiency of a company's management by comparing operating expense to net sales	$= \frac{\text{Operating cost}}{\text{Net Sales}} \times 100$	• The smaller the ratio, the greater the organization's ability to generate profit if revenues decrease

OPERATING PROFIT RATIO	Measures what proportion of a company's revenue is left over, after deducting direct costs and overhead and before taxes and other indirect costs such as interest.	= $\frac{\text{Operating Profit (EBIT)}}{\text{Net Sales}}$ x 100 OR = 100 – Operating Ratio	• Shows whether the fixed costs are too high for the production or sales volume. • Higher the ratio, the better it is
EXPENSE RATIO (used for administrative expenses ratio, selling and distribution expenses ratio, etc.)	Establishes percentage relationship between various expense items and sales	= $\frac{\text{Expenses}}{\text{Net Sales}}$ x 100	• a quick indicator of rising or decreasing costs or rising or declining sales • measures the operating expenses of a business with the net sales
RETURN ON INVESTMENT / RETURN ON CAPITAL EMPLOYED	Analyses the profitability of the company from the point of view of total funds employed in the business	= $\frac{\text{Operating Profit}}{\text{Capital Employed}}$ x 100	• used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments • used as indicator to compare different investments
RETURN ON NET WORTH / RETURNON SHAREHOLDERS' FUNDS	Also known as Return on Equity Measures the profitability of a company by revealing how much profit is generated with the shareholders' investment	= $\frac{\text{Profit after Tax}}{\text{Shareholders' Funds}}$ x 100	• Expressed as a percentage of net income over shareholders' funds • Useful for comparing the profitability of a company to that of other firms in the same industry
EARNINGS PER SHARE	Represents the proportion of a company's profit allocated to each outstanding equity 9share	= $\frac{\text{Net Profit after tax and preference dividend}}{\text{Number of Equity Shares}}$	• Indicates the amount of money each share of stock would receive if all of the profits were distributed to the outstanding shares at the end of the year

DIVIDEND PER SHARE	Signifies the amount of dividend that an equity shareholder will receive for each share held	= Dividend paid / Number of Equity Shares	• Helps in determining the amount retained by the company for future prospective investments • Depends on the dividend distribution policy of the company
DIVIDEND PAYOUT RATIO	Represents the amount of dividends paid to equity shareholders relative to the amount of total net income of a company	= Dividend per Share x100 / Earnings Per Share	• Shows the proportion of earnings per share paid out as dividend • If the entire EPS is paid out then dividend payout ratio will be 100%
PRICE EARNING RATIO	Compares a company's current share price to its per-share earnings	= Market Price / Earnings per Share	• Shows what the market is willing to pay for a stock based on its current earnings • A high P/E suggests that investors are expecting higher earnings growth in the future

NOTE: Capital employed = Total long term sources of funds

It can be calculated on the basis of basic accounting equation in any of the following manners:

Shareholder's Funds + LongTerm Debt + Current Liabilities = Fixed Assets + Current Assets

Shareholder's Funds + LongTerm Debt = Fixed Assets + Current Assets - Current Liabilities

Shareholder's Funds + LongTerm Debt = Fixed Assets + Working capital

Illustration 21

From the following information, calculate operating profit ratio and operating ratio.

Particulars	**Rs.**	**Particulars**	**Rs.**
Sales Less Returns	4,00,000	Selling Expenses	25,000
Gross Profit	1,40,000	Income From Investment	1,000
Administration Expenses	35,000	Loss On Account Of Fire	2,000

Solution:

Operating Profit = Gross Profit - Administration And Selling Expenses

= 1,40,000 - (35,000 + 25,000)

= 1,40,000 - 60,000

= Rs. 80,000

Operating Profit Ratio = (80, 000 / 4,00,000) × 100

= 20 %

Operating Ratio = (Cost Of Goods Sold + Operating Expenses) / Net Sales

= [{(Net Sales–Gross Profit) + (Administration Expenses+Selling Expenses)}/ Net Sales] X 100

= [{(4,00,000 – 1,40,000) + (35,000 + 25,000)} / 4,00,000] x 100

= 80%

The same can be alternatively be calculated as follows:

=100 – Operating Profit Ratio

= 100 – 20

= 80%

Illustration 22

Compute the cost of goods sold ratio, administrative expenses ratio and selling expenses ratio from the following information:

Net sales	Rs. 75,00,000
Cost of goods sold	Rs. 52,00,000
Administrative expenses	Rs. 3,00,000
Sales expenses	Rs. 4,50,000

Solution:

1. Cost of goods sold ratio = (Cost Of Goods Sold /Net Sales) × 100

= (Rs. 52,00,000/ 75,00,000) × 100

= 69.33%

2. Administrative expenses ratio = (Administrative expenses /Net sales) × 100

= (3,00,000/ 75,00,000) × 100

= 4%

3. Selling expenses ratio = (Selling expenses /Net sales) × 100

= (4,50,000/ 75,00,000) × 100

= 6%

Illustration 23

The following details have been extracted from the financial statements of a company:

Share Capital :		Current Liabilities	Rs. 2,00,000
Equity(Rs.10)	Rs. 8,00,000	Discount on Shares	Rs. 10,000
12% Preference Shares	Rs. 2,00,000	Fixed Assets	Rs. 19,00,000
General Reserve	Rs. 3,78,000	Current Assets	Rs. 4,68,000
10% Debentures	Rs. 8,00,000		

You are required to calculate Return On Investment, Return on Shareholders' Funds, EPS, Book value per share and P/E ratio if the market price of the share is Rs. 34, the net profit after tax was Rs. 3,00,000, and the tax had amounted to Rs. 1,00,000.

Solution

Profit before interest and tax = Rs. 3,00,000 + Debenture interest + Tax

= Rs. 3,00,000 + Rs. 80,000 + Rs. 1,00,000

= Rs.4,80,000

Capital Employed = Equity Share Capital + Preference Share Capital + Reserves + Debentures – Discount on Shares

= Rs. 8,00,000 + Rs. 2,00,000 + Rs. 3,78,000 + Rs. 8,00,000 – Rs. 10,000

= Rs. 21,68,000

Return on Investment = (Profit before Interest and Tax/ Capital Employed) × 100

= (Rs. 4,80,000/Rs. 21,68,000) × 100

= 22.14%

Return on Shareholders's Fund = Profit after Tax/ Shareholder's Fund × 100

= Rs. 3,00,000/Rs. 13,68,000 × 100

= 13.84%

EPS = Profit available for equity shareholders/ No. of Equity Shares

= Rs. 2,76,000/ 80,000 = Rs. 3.45

Profit available to equity = Profit after Tax – Preference Dividend shareholders

= Rs. 3,00,000 – Rs. 24,000 = Rs. 2,76,000

P/E Ratio = Market price of a share/ Earnings per share

= 34/3.45

= 9.855 Times

Book Value per share = Equity Shareholders' funds / No. of Equity Shares

= Rs. 11,68,000/80,000 shares

= Rs. 14.6

Illustration 24

From the following information, calculate Return on Investment and Total Assets to Debt Ratio.

Fixed Assets Rs. 75,00,000, Current Assets Rs. 40,00,000, Current Liabilities Rs. 27,00,000, 12% Debentures Rs. 80,00,000 and Net Profit before Interest, Tax and Dividend Rs. 14,50,000.

Solution

Return on Investment = [(Net Profit before Interest, Tax and Dividend) / Capital Employed]x 100

Net Profit before Interest, Tax and Dividend = 14,50,000

Capital Employed = Fixed Assets + Current Assets – Current Liabilities

= 75,00,000 + 40,00,000 - 27,00,000

= Rs. 88,00,000

Return on Investment = (14,50,000 / 88,00,000) x 100 = 16.48%

Total Assets to Debt Ratio = (Total Assets / Total Debt)

= (75,00,000 + 40,00,000) / 80,00,000

= 1.4375

Illustration 25

In 2014, Banjo Beats Ltd. announced ROA of 8.56%, ROE of 14.5% and profit margin of 20.5%. The firm had total assets of Rs. 16.5 crores at the year-end. Calculate net income available to equity shareholders, equity and net sales of Banjo Beats Ltd.

Solution

Return on Assets (ROA) = Net Income available to equity shareholders / Total Assets

0.0856 = Net Income available to equity shareholders / 16.5 crores

Net Income available to equity shareholders = 16.5 crores x 0.0856 = Rs. 1.4124 crores

Return on Equity = Net Income available to equity shareholders / Equity

0.145 = 1.4124 crores / Equity

Equity = Rs. 9.74 crores

Profit Margin = Net Income available to equity shareholders / Sales

0.205 = 1.4124 crores /Sales

Sales = Rs. 6.89 crores (approx..)

Illustration 26

Computronix Ltd. has provided you with the following details. You are required to compute

(i) Net Profit Ratio
(ii) Return On Assets
(iii) Return on Equity
(iv) Dividend Payout Ratio

Information:

Net Sales	Rs. 12.5 crores
EBIT	Rs. 5.6 crores
Net Income available to equity shareholders	Rs. 3.2 crores
Equity Dividends	Rs. 1.2 crores
Total Assets	Rs. 52.5 crores
Equity (2 crore shares outstanding)	Rs. 21 crores

Solution

(i) Net Profit Ratio = Net Profit / Net Sales

= [(3.2 crores – 1.2 crores) / 12.5 crores] x 100

= 16%

(ii) Return on Assets = Net Income available to equity shareholders / Total Assets

= 3.2 crores / 52.5 crores

= 0.06095 or 6.095%

(iii) Return on Equity = Net Income available to equity shareholders / Equity

= 3.2 crores / 21 crores

= 0.1524 or 15.24%

(iv) Dividend Payout Ratio = Equity Dividends / Net Income available to equity shareholders

= 1.2 crores / 3.2 crores

= 37.50%

FINANCIAL RATIOS OF ITC for a period of four financial years from 2011 to 2014

	Mar '14	Mar '13	Mar '12	Mar '11
LIQUIDITY RATIOS				
Current Ratio	1.25	1.22	1.12	1.09
Quick Ratio	0.68	0.66	0.56	0.53
SOLVENCY RATIOS				
Debt Equity Ratio	--	--	--	0.01
Debt Coverage Ratios				
Interest Cover	4,292.22	124.56	115.19	107.29
Total Debt to Owners Fund	0.00	0.00	0.00	0.01
Financial Charges Coverage Ratio	4,597.28	133.76	124.15	116.88
ACTIVITY RATIOS				
Inventory Turnover Ratio	4.52	4.53	4.47	4.07
Debtors Turnover Ratio	19.97	27.82	26.91	24.61
Investments Turnover Ratio	4.52	4.53	4.47	4.07
Fixed Assets Turnover Ratio	1.83	1.80	1.82	1.72
Total Assets Turnover Ratio	1.27	1.35	1.35	1.35
Asset Turnover Ratio	1.37	1.45	1.44	1.42
PROFITABILITY RATIOS				
Gross Profit Margin(%)	34.76	32.88	32.37	31.48
Operating Profit Ratio (%)	37.47	35.54	35.15	34.54
Net Profit Margin(%)	25.57	24.05	23.70	22.63
Return On Capital Employed(%)	48.21	48.29	47.69	45.88
Return On Net Worth(%)	33.51	33.36	32.88	31.36
Earnings Per Share	11.05	9.39	7.88	6.45
Book Value Per Share	32.95	28.14	23.97	20.55
Dividend Payout Ratio	54.31	55.92	57.09	69.04

Knowledge Assessment- IV

Choose the correct answer from the given options:

1. Net Profit Ratio signifies:
   a) Operational Profitability
   b) Liquidity Position
   c) Long Term Solvency
   d) Profit for Lenders
2. Inventory Turnover measures the relationship of inventory with:
   a) Average Sales
   b) Cost of goods sold
   c) Total Purchases
   d) Total Assets
3. Which of the following does not help to increase Current Ratio?
   a) Issue of Debentures to buy stock
   b) Issue of debentures to pay creditors
   c) Sale of investment to pay creditors
   d) Avail bank overdraft to buy machine
4. Debt to Total Assets Ratio can be improved by:
   a) Borrowing more
   b) Issue of Debentures
   c) Issue of Equity Shares
   d) Redemption of Debt
5. If the Current Ratio is 1.5:1 and Current Assets are Rs. 15,00,000, then what are the Current Liabilities?
   a) 22,50,000
   b) 10,00,000
   c) 25,00,000
   d) 15,00,000
6. Return on Investment can be improved upon by:
   a) Increasing turnover
   b) Reducing Expenses
   c) Increasing Capital Utilisation
   d) All of the above

7. Suppliers and creditors are interested in
   a) Profitability position
   b) Liquidity position
   c) Market Share position
   d) Debt position
8. With 8% Return on Total Assets of Rs. 50,00,000 and Net Profit Ratio of 5%, the sales of the firm are:
   a) Rs. 4,00,000
   b) Rs. 2,50,000
   c) Rs. 80,00,000
   d) Rs. 83,33,333
9. Which of the following statements is correct?
   a) A higher Receivable Turnover is not desirable
   b) Interest Coverage Ratio depends upon tax rate
   c) Increase in Net Profit Ratio means increase in sales
   d) Lower Debt Equity Ratio means lower financial risk
10. A constant Gross Profit Ratio accompanied by a decreasing Net Profit Ratio can be because of:
    a) Increase in cost of goods sold
    b) Increase in expense
    c) Increase in dividend
    d) Decrease in sales

Answers

1. a, 2. b, 3. d, 4. d, 5. b, 6. d, 7. b, 8. c, 9. d, 10. b

Illustration 27

The following information has been obtained from the financial statements of a company:

(In Rs. Crores)

Particulars	**Year 1**	**Year 2**
Cash	200	160
Sundry Debtors	320	400
Short-term Investments	200	320
Stock	1840	2160
Prepaid expenses	28	12
Total current assets	2588	3052
Total assets	5600	6400
Current liabilities	640	800
Loans	1600	1600
Capital	2000	2000
Retained Earnings	468	812

Statement of Profit for the current year

(In Rs. Crores)

Sales	4000
Less: Cost of Goods sold	2800
Less: Interest	160
Net Profit	1040
Less: Taxes @50%	520
Profit after Taxes	520
Profit distributed	220

On the basis of the above information, evaluate the financial position of the company w.r.t.:

(i) Liquidity
(ii) Leverage
(iii) Profitability
(iv) Activity

Solution

Computation of ratios

Liquidity Ratios		
a) Current Ratio	= Current Assets/ Current Liabilities	= 3052/800 = 3.81
b) Acid Test Ratio	= Liquid Assets / Current Liabilities	= (3052 – 2172) / 800 = 1.1
Leverage Ratios		
a) Debt Equity Ratio	= Long term debts / Equity Funds	= 1600 / 2812 = 0.57
b) Interest Coverage Ratio	= EBIT / Interest	= 1200 / 160 = 7.5 times
Profitability Ratios		
a) Gross Profit Ratio	= (Gross Profit / Net Sales) x 100	= (1200 / 4000) x 100 = 30%
b) Net Profit Ratio	= (Net Profit / Net Sales) x 100	= (520 / 4000) x 100 = 13%
c) Return on Total Assets	= (Profit after Tax / Total Assets) x 100	= (520 / 6400) x 100 = 8.12%
d) Return on Capital Employed	= [{PAT + Interest (1-t)} / Total Capital Employed] x 100	= {(520+80) / 4412} x 100 = 13.60%
e) Return on Equity Funds	= (Profit After Tax / Equity Fund) x 100	= (520 / 2812) x 100 = 18.50%
Activity Ratios		
a) Debtors Turnover	= sales / average debtors	= 4000/ 360 = 11.1 times

b) Stock turnover	= cost of goods sold / average stock	= 2800 / 2000 = 1.4 times
c) Total assets turnover	= sales / average assets	= 4000/ 6000 = 0.67 times

Illustration 28

The debt equity ratio of Soapera Ltd. is 1:2. Which of the following would increase, decrease or not change the debt equity ratio?

(i) Further issue of equity shares
(ii) Cash received from debtors
(iii) Sale of goods on cash basis
(iv) Redemption of debentures
(v) Purchase of goods on credit

Solution

(i) Further issue of equity shares will decrease the debt equity ratio as the denominator (i.e. equity)will increase with the additional amount of equity with numerator (i.e. debt) remaining constant.
(ii) Cash received from debtors affects the current assets which is neither a part of debt nor a part of equity. Thus, this increase in cash will not affect the debt equity ratio.
(iii) Similarly, sale of goods on cash basis will affect the current assets only, thus bringing about no change in the debt equity ratio.
(iv) Redemption of debentures will decrease the debt component with the amount being repaid. This will decrease the debt equity ratio as the numerator (i.e. debt) decreases while the denominator (i.e. equity) remains constant.
(v) Purchase of goods on credit increases the current liabilities, leaving the debt equity ratio unchanged.

Illustration 29

Ardent Ltd. has sales of Rs. 30 crores. The EBIT as a percentage of sales is 12%. The capital employed of the company comprises of Rs. 10 crores of equity, Rs. 2 crore of 13% preference shares and Rs. 6 crore of 15% debt. The company's profit is subject to 40% tax. Calculate Return on Equity.

Solution

EBIT = 12% of sales = 12% of Rs. 30 crores

= Rs. 3.6 crores

Particulars	Amount
EBIT	3.6 crores
Less: Interest	0.90 crores
Profit Before Tax	2.70 crores
Less: Tax @ 40%	1.08 crores
Profit after tax	1.62 crores
Less: Preference Dividend	0.26 crores
Return for Equity	1.36 crores

Return on Equity = [(PAT – Preference Dividend) / Equity] x 100

= (1.36 crores / 10 crores) x 100

= 13.6 %

Illustration 30

Calculate the relevant profitability ratios with the following information:

Opening Stock: Rs. 30,000

Stock at the end of year : Rs.20,000

Annual Sales: Rs. 50,000

Annual Purchases: Rs.10,000

Total expenses: Rs.5,000

Capital at start: Rs. 62,000

Closing Capital: Rs. 18,000

Solution

(1) Gross profit ratio= (Gross profit / Net sales) x 100 %

= (30,000 / 50,000) x 100%

= 60%

(2) Net profit ratio = (Net profit / Net sales) x 100 %

= (25,000 / 50,000) x 100%

= 50%

(3) Return on capital employed = (Profit before interest / Capital employed) x 100 %

= (25,000 / 40,000) x 100%

= 62.5%

Working Notes:

Gross profit = Sales - Cost of goods sold

= 50,000 - 20,000

= Rs. 30,000

Cost of goods sold = Opening Stock + Purchases –Closing Stock

= 30,000 + 10,000 - 20,000

= Rs. 20,000

Net profit = Gross profit - Total expenses

= 30,000 - 5,000

= Rs. 25,000

Average capital employed = (Opening Capital + Closing Capital) / 2

= (62,000 + 18,000) / 2

= Rs. 40,000

Illustration 31

(a) A firm has the following current assets

Cash Rs. 1,05,000, inventories Rs. 5,60,000and debtors Rs. 4,20,000.

If the current ratio of the firm is 2:1, calculate its current liabilities.

(b) A company has closing inventory worth of Rs. 1,50,000 and cost of goodssold Rs. 9,75,000. If the company's turnover ratio is 5, determine the opening balance of inventory.

Solution

(a) Computation of Current Assets

(Figures in Rs.)

Cash	1,05,000
Stock	5,60,000
Debtors	4,20,000
Total current assets	10,85,000

Current Ratio = Current Assets / Current Liabilities

2 = 10,85,000 / Current Liabilties

Current liabilities = 10,85,000 / 2

Current liabilities = Rs. 5,42,500

(b) Stock Turnover Ratio = Cost of goods sold / average inventory
Where, Average inventory = (opening stock + closing stock) / 2
= (opening stock + 1,50,000) / 2

5 = 9,75,000 / [(opening stock + 1,50,000) / 2]

5 = 19,50,000 / (opening stock + 1,50,000)

5(Opening stock + 1,50,000) = 19,50,000

5 × Opening stock + 7,50,000=19,50,000

Opening stock = (19,50,000–7,50,000) / 5

Opening stock = Rs. 2,40,000

Illustration 32

The following is the Comparative Statement of a company for the two years ending 2014 and 2015.

(Figures in Rs.'000)

	2014	2015		2014	2015
Equity share capital	3,00	4,00	Goodwill	200	200
Reserves	150	280	Land & Building	300	400
8% Debentures	200	300	Plant and Machinery	250	350
Mortgage Loan	400	258	Patents	50	50
Sundry Creditors	50	70	Stock	150	200
Bills payable	25	35	Sundry debtors	100	80
Bank overdraft	40	60	Bills receivable	80	90
Outstanding expenses	10	15	Marketable securities	18	20
Tax liability	15	20	Cash balance	40	45

			Prepaid expenses	2	3
	1190	1438		1190	1438
			Sales	500	600
			Purchases	300	405

Calculate:

(a) Current Ratio
(b) Quick Ratio
(c) Inventory Turnover Ratio
(d) Debtors Turnover Ratio
(e) Average Collection period
(f) Creditors turnover ratio
(g) Average payment period
(h) Working capital turnover ratio

Solution

(Figures in Rs.'000)

Particulars	2014	2015
Stock	150	200
Sundry debtors	100	80
Bills receivable	80	90
Marketable securities	18	20
Cash balance	40	45
Prepaid expenses	2	3
Total Current Assets……….(a)	**390**	**438**
Sundry Creditors	50	70
Bills payable	25	35
Bank overdraft	40	60
Outstanding expenses	10	15
Tax liability	15	20
Total Current Liabilities ……..(b)	**140**	**200**
Working capital (c) = (a) – (b)	250	238
COMPUTATION OF RATIOS		
Current Ratio = Current Assets/ Current Liabilities = (a) / (b)	= 390 / 140 = 2.785	= 438 / 200 = 2.19
Quick Assets = Current Assets – Stock – Prepaid Expenses	= 390 – 150 – 2 = 2.38	= 438 – 200 – 3 = 2.35
Acid Test Ratio = Quick Assets / Current Liabilities	= 238 / 140 = 1.7	= 235 / 200 = 1.175

Inventory Turnover Ratio = Sales / Average Inventory	= 500 / 150 = 3.33 times	= 600 / {(150+200)/2} = 600 / 175 = 3.43 times
Debtors Turnover Ratio = Credit Sales / Average Trade Debtors	= 500 / 180 = 2.78 times	= 600 / {(180+170)/2} = 600 / 175 = 3.43 times
Average Collection Period = 365 / Debtors Turnover Ratio	= 365 / 2.78 = 131. 29 days = 131 days (approx..)	365 / 3.43 = 106.41 days = 106 days (approx..)
Creditors Turnover Ratio = Credit Purchases / Average Trade Creditors	= 300 / (50 + 25) = 4 times	= 405 / {(75+105)/2} = 4.5 times
Average Payment Period = 365 / Creditors Turnover Ratio	= 365 / 4 = 91 days	= 365 / 4.5 = 81 days
Working Capital Turnover Ratio = Cost Of Sales / Average Working Capital	= 500 / 250 = 2 times	= 600 / {(250+238)/2} = 2.46 times

KEYWORDS

1. **Financial Statements:**The financial statements provide a summary of accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period.
2. **Balance Sheet**: It is a statement reporting the company’s financial status on a particular date, listing assets, owner’s equity and liabilities.
3. **Statement Of Profit And Loss:** A profit and loss statement provides information on the results of the operations of the enterprise for a specified accounting period, including the income and the costs associated.
4. **Statement Of Cash Flows:** Itdiscloses the company's cash flow activities, particularly its operating, investing and financing activities for the specified period.
5. **Analysis of financial statements**: Analysis refers to simple and systematic classification of the statistics in the financial statements.
6. **Interpretationof financial statements:**Interpretation clarifies the meaning and implication of the analysed data.
7. **Comparative Financial Statements:** Comparative Financial Statements are statements used to compare the financial performance and position of the company, both, in aggregate and proportionate terms.
8. **Common Size Statement:** Common Size Statement is a statement which shows the relationship of different items of the financial statements with a common base figure.
9. **Trend Percentages:** This method requires computation of relationship (in percentage terms) of each item in the financial statement of a particular year to the same item in the base year.

10. **Ratio:**A ratio is a simple mathematical expression of the relationship between two variables.
11. **Ratio analysis**: Ratio analysis is the process of calculating and interpreting financial ratios for the purpose of decision making.

SUMMARY

- The financial statements, prepared in accordance with accounting principles and policies, facilitate decision making by providing information for inferences regarding the profitability and financial position.
- A complete set of financial statements comprises of Balance Sheet, Statement of Profit And Loss, Statement Of Cash Flows and Notes to accounts.
- Financial analysis can be classified on the basis of information used and on the basis of period of study.
- Horizontal Analysis or Dynamic Analysis, represents the review and analysis of the financial statements for two or more years, while Vertical Analysis, also known as Static Analysis, is restricted to the analysis of financial statements of one particular period on a specific date.
- Commonly used tools of financial analysis are ratio analysis, comparative statements, trend analysis, common size statements, funds flow statement and cash flow statement.
- Ratios can commonly be categorized under four main heads: liquidity ratios, solvency ratios, activity ratios and profitability ratios.

EXERCISE QUESTIONS

Short Answer Questions

1. What are financial statements.
2. Enumerate the different types of financial statements.
3. Differentiate between analysis and interpretation.
4. List the techniques of financial statement analysis.
5. Compare horizontal analysis and vertical analysis.
6. What is trend analysis.
7. State the objectives of financial statement analysis.
8. What will be operating profit ratio if operating ratio is 81.38%..
9. How will inventory turnover ratio be different in case of perishable goods as compared to consumer durables.
10. Examine the difference between current ratio and acid test ratio.
11. Which accounting ratio will be useful in indicating the inability to pay back loan from financial institutions.
12. The stock turnover ratio of a company is 3 times. State giving reasons, whether the ratio improves, declines or does not change because of increase in value of closing stock by Rs. 5,000.
13. Why is Analysis of Financial Statements important to creditors.

Long Answer Questions

1. "Analysis without interpretation is meaningless and interpretation in absence of analysis is impossible." Discuss.
2. Discuss the different techniques of financial analysis and explain the limitations of financial statement analysis.
3. What is Common size Balance Sheet and Income Statement? Explain the technique of preparing the common size Balance Sheet.
4. Explain the usefulness of trend percentages in analysis and interpretation of financial statements.
5. "Ratio Analysis is only a technique for making judgments and not a substitute fr judgments." Comment.
6. Discuss the primary emphasis of the various analysts viz. managers, equity investors, long term creditors and short term creditors in evaluating ratios.
7. Discuss the various ratios required to study the solvency position of the company.
8. The current ratio is a better measure of overall liquidity only when a firm's inventory cannot easily be converted into cash. If inventory is liquid, the quick ratio is a preferred measure." Comment.
9. What is profitability? How is it measured? Which accounting ratios serve as an indicator of profitability. Explain their computation with a hypothetical example.
10. Discuss the application of ratio analysis in interpretation of financial statements and in financial analysis. Explain the limitations of ratio analysis.

Numerical Questions

1. From the following information, prepare a Comparative Income Statement of V Ltd.:

(Figures in Rs.)

Particulars	2014	2015
Sales	15,00,000	18,00,000
Cost of goods sold	11,00,000	14,00,000
Indirect Expenses	20% of Gross Profit	25% of Gross Profit
Income Tax	50%	50%

*(**Answer:** Net Profit After Tax: 2014: 1,60,000, 2015 1,50,000, Absolute change (10,000), % change (6.25%))*

2. From the following information, prepare a Comparative Statement:

(Figures in Rs.)

Particulars	2014	2015
Sales	10,00,000	12,50,000
Cost of goods sold	6,00,000	7,50,000
Operating Expenses	40,000	50,000

Interest on investments @ Rs. 50,000 and taxes payable @50%.

*(**Answer:** Net Profit After Tax: 2014: 2,40,000, 2015 2,85,000, Absolute change 45,000, % change 18.75%)*

3. From the following information, calculate the following ratios:
   (i) Net Profit Ratio
   (ii) Debt Equity Ratio
   (iii) Quick Ratio

   Information:

Particulars	Rs.
Paid up capital	20,00,000
Capital reserve	2,00,000
9% Debentures	8,00,000
Net Sales	14,00,000
Gross Profit	8,00,000
Indirect Expenses	2,00,000
Current Assets	4,00,000
Current Liabilities	3,00,000
Opening Stock	50,000

Closing stock is 20% more than the opening stock.

***(Answer:** Net Profit Ratio: 42.86 **%,**Debt – Equity Ratio: 4:11, Quick Ratio :17: 15 or 1.13 :1)*

4. (a) Net profit after interest but before tax is Rs. 1,40,000.,
   15% long term debts: Rs. 4,00,000,
   Shareholder's funds: Rs. 2,40,000
   Tax rate: 50%,
   Calculate return on capital employed.

(b) Opening Stock: Rs. 60,000
Closing stock: Rs. 1,00,000
Stock turnover ratio: 8 times
Selling price 25% above cost
Calculate the Gross Profit Ratio.

(c) From the following information, compute Debt Equity Ratio.

Particulars	Rs.
Long term borrowings	2,00,000
Long term provisions	1,00,000
Current liabilities	50,000
Non-current assets	3,60,000
Current assets	90,000

(d) The current ratio of A Ltd. is 2:1. State with reasons which of the following transactions would increase, decrease or not change theratio.
   (i) Included in trade payables was a bills payable of Rs. 9,000 which was met on maturity.
   (ii) Company issued 1,00,000 equity shares of Rs. 10 each to the vendors of machinery purchased.

***(Answer:** (a) ROCE: 31.25%, (b) GP Ratio: 20%,(c) Debt Equity ratio: 3:1, (d) (i) Increase,(ii) No Change)*

5. The motto of Y Ltd., an advertising company is ‘Service with Dignity’. Its management and work force is hard-working, honest and motivated. The net profit of the company doubled during the year ended 31-3-2014. Encouraged by its performance, company decided to give one month extra salary to all its employees. Following is the Comparative Statement of Profit and Loss of the company for the years ended 31st March 2013 and 31st March 2014:

Y Ltd.

Comparative Statement of Profit and Loss

Particulars	2012-2013 Rs.	2013-2014 Rs.	Absolute Change Rs.	% Change
Revenue from operations	20,00,000	30,00,000	10,00,000	50
Less: Employee Benefit Expenses	12,00,000	14,00,000	2,00,000	16.67
Profit Before Tax	8,00,000	16,00,000	8,00,000	100
Tax Rate @ 25%	2,00,000	4,00,000	2,00,000	100
Profit after Tax	6,00,000	12,00,000	6,00,000	100

(a) Calculate Net Profit Ratio for the years ending 31st March, 2013 and 2014.

(b) Identify any two values which Y Ltd. is trying to propagate.

(Answer: (a) *Net Profit Ratio for 2013:30%, 2014: 40%, (b) (i) Accountability, (ii) Equality, (iii) Nation Building (iv) Gratitude towards Employees)*

6. Calculate following ratios from the following information:
(i) Current ratio (ii) Acid test ratio (iii) Operating Ratio (iv) Gross Profit Ratio

Current Assets Rs. 35,000, Current Liabilities Rs. 17,500, Stock Rs. 15,000, Operating Expenses Rs. 20,000, Sales Rs. 60,000, Cost of Goods Sold Rs. 30,000

(Answer: *Current Ratio 2:1; Liquid Ratio 1.14:1; Operating Ratio 83.3%; Gross Profit Ratio 50%)*

7. Compute Gross Profit Ratio, Working Capital Turnover Ratio, Debt Equity Ratio and Proprietary Ratio from thefollowing information:

Paid-up Capital Rs. 5, 00,000, Current Assets Rs. 4, 00,000, Net Sales Rs. 10, 00,000, 13% Debentures Rs. 2, 00,000, Current Liability Rs. 2, 80,000, Cost of Goods Sold
Rs. 6,00,000

(Answer: *Gross Profit Ratio 40%; Working Capital Ratio 8.33 times; Debt Equity Ratio 2:5; Proprietary Ratio 25:49)*

8. A trading firm's average stock is Rs. 20,000 (cost). If the stock turnover ratio is 8 times and the firm sells goods ata profit of 20% on sale, ascertain the profit of the firm.

(Answer: *Profit Rs. 40,000)*

9. Calculate the financial ratios if the following information is provided:

Capital employed	Rs. 170 lakhs
Equity capital and Reserves	Rs. 100 lakhs
Debentures	Rs. 50 lakhs
Cash credit from banks	Rs. 20 lakhs
Working Capital	Rs. 85 lakhs
Stock	Rs. 30 lakhs
Stores	Rs. 14 lakhs
Debtors	Rs. 35 lakhs
Advances, deposits, etc.	Rs. 6 lakhs
Annual sale	Rs. 80 lakhs

(Answer. *Current Ratio 4.25:1, Liquidity Ratio 2.05:1, Debt Equity Ratio 0.7:1, Proprietary Ratio 0.59:1, Fixed Assets to Proprietor's Fund 0.85:1, Fixed Assets Ratio 0.57:1)*

10. The management of a company has provided the following particulars.
    (a) Inventory turnover ratio is 6 times
    (b) Closing debtors are outstanding for a period of 2 months.
    (c) The creditors at the end of the year are outstanding for 73 days.
    (d) Ratio of cost of goods sold to Proprietors' funds is 2:1 and to Fixed Assets is 4:1.
    (e) Ratio of gross profit to sales is 20%
    (f) Closing stock is greater than the opening stock by Rs. 20,000.
    (g) The gross profit for the year is Rs. 2,40,000
    (h) Reserves and surplus of Rs. 80,000 appear in the Balance Sheet.

    You are required to ascertain:
    (i) Proprietor's funds
    (ii) Fixed Assets
    (iii) Closing Debtors
    (iv) Closing Creditors
    (v) Closing Stock
    (vi) Share Capital
    (vii) Cash and bank

(Answer. *Proprietor's Funds Rs. 4,80,000, Fixed Assets Rs. 2,40,000, Closing Debtors Rs. 2,00,000, Closing Creditors Rs. 1,96,000, Closing Stock Rs. 1,70,000, Share Capital Rs. 4,00,000, Cash and bank Rs. 66,000)*

11. The ratios relating to Metropolis Ltd. are given as follows:
Gross Profit Ratio 15%, Stock Velocity 6 months, Debtors Velocity 3 months, Creditors Velocity 3 months, Gross Profit Rs. 60,000, Closing Stock is equal to Opening Stock. Find out Sales, Closing Stock, Sundry Debtors, Sundry Creditors

***(Answer.** Sales [4,00,000], Closing Stock [1, 70,000], Sundry Debtors [1, 00,000] Sundry Creditors [85, 000])*

12. Your company had the following details for last year:
PBT is 24.46 lakhs, Tax Rate 60%, Proposed Dividend 20%.
Capital of the company is:
30, 000 equity shares each of Rs. 100, 9% Preference shares Rs. 10 lakhs , Reserve in the beginning of the year Rs. 22 lakhs.
Find out: EPS, Book Value per share, PE Ratio, Dividend Payment Ratio.

***(Answer.** EPS Rs. 29.61, Book Value per share Rs. 182.95, PE Ratio 14.8%, Dividend Payment Ratio 67.54%)*

UNIT 10 :FUNDS FLOW STATEMENT

<table>
<tr><td rowspan="2">Unit Code:</td><td colspan="4">UNIT TITLE: FUNDS FLOW STATEMENT</td></tr>
<tr><td colspan="4">Duration:</td></tr>
<tr><td rowspan="10">Location:

Classroom or Company's premises</td><td colspan="4">SESSION 1: INTRODUCTION TO FUNDS FLOW STATEMENT</td></tr>
<tr><td>Learning Outcome</td><td>Knowledge Evaluation</td><td>Performance Evaluation</td><td>Teaching and Training Method</td></tr>
<tr><td>1.Concept of funds and flow of funds</td><td>1.Comprehend the concept of funds as against cash
2.Explain the meaning of flows, inflow as well as outflow</td><td>1.Differentiate between funds in the narrow sense and broad sense
2.Classify transactions leading to flow of funds, both increase and decrease</td><td>Interactive Lecture: Introduction of funds, flow of funds</td></tr>
<tr><td>2. Meaning of Funds Flow Statement</td><td>1. Explain the meaning of funds flow statement
2. Describe the sources and applications of funds</td><td>1.Elucidate the concept of funds flow statement
2.Differentiate between sources and applications of funds</td><td>Interactive Lecture: Discussion of meaning of funds flow statement
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	preparation of FFS	of FFS preparation	FFS	preparation of FFS
	2. Schedule of Changes in Working Capital	1.Explain the preparation of Schedule of Changes in Working Capital	1.Compute net increase or decrease in working capital	**Interactive Lecture:** Discuss the methodical preparation of Schedule of Changes in Working Capital
	3. Computation of Funds From Operations	1.Discuss the process of calculating Funds From Operations	1. Calculate Funds From Operations	**Interactive Lecture:** Discuss the preparation of Funds From Operations
	4. Preparation of Funds Flow Statement	1.Elucidate the preparation of FFS	1. Analyse the format of Funds Flow Statement	**Interactive Lecture:** Discuss the preparation of Funds Flow Statement **Activity:** Prepare Funds Flow Statement

UNIT 10 :FUNDS FLOW STATEMENT

Learning Objectives

After reading this unit, the students will be able to:

1. understand themeaning of funds and flow of funds,
2. comprehend the concept of funds flow statement,
3. explain the utility of Funds Flow Statement,
4. differentiate between Funds Flow Statement, Income Statement and Balance Sheet,
5. highlight the limitations of Funds Flow Statement,
6. understand the steps involved in the preparation of Funds Flow Statement,
7. describe the treatment of provision for tax and proposed dividend and
8. explain the meaning of certain keywords.

SESSION 1: INTRODUCTION TO FUNDS FLOW STATEMENT

Trading performance, operational efficiency, profitability in addition to the financial position can be ascertained using the Statement of Profit and Loss and Balance Sheet. Thus, they have a limited role to play as the transactions recorded and analysed pertain to one year only. It is important to highlight the changes in financial position of a business involving two balance sheet dates. The financial statements do not provide adequate information about the flow of funds, both inflow and outflow. This information is recorded in Funds Flow Statement, which is then efficiently and effectively used for decision making.

INTRODUCTION TO THE TERM 'FUNDS'

The term "funds" is most commonly used synonymously with cash in the narrow sense. In this case, funds flow statement and cash flow statement will give the same result. In the broader sense, the term 'fund' refers to working capital. However, there are two concepts of working capital, ie. gross concept and net concept. The gross concept includes the firm's total investment in its current assets, while in the net concept,working capital is the excess of current assets over current liabilities, i.e.:

Net Working Capital = Current Assets -Current Liabilities

In funds flow statement, net working capital is used for the purpose of preparation of the Statement,as the net concept is closely related to the operating cycle of the business.

CONCEPT OF “FLOW” OF FUNDS

Although, all financial transactions have a final effect on the balance sheet, but not necessarily do they affect the net working capital of the firm as well. To understand the change in funds, it is important to identify those transactions which cause a change in funds. This change or movement of funds during the normal working course of business is referred to as "flow" of funds. The flow may result in either an increase (inflow) or decrease (outflow) of funds i.e. net working capital. For example, the issue of shares increases the amount of capital of the company, thus resulting in inflow or increase in the fund. Similarly, if a company purchases a building to be used as office premises, then this transaction will result in an outflow of funds or a decrease in the funds.

The transactions which result in flow of funds usually involve one current account and the other non-current account. Some examples can be enumerated as follows:

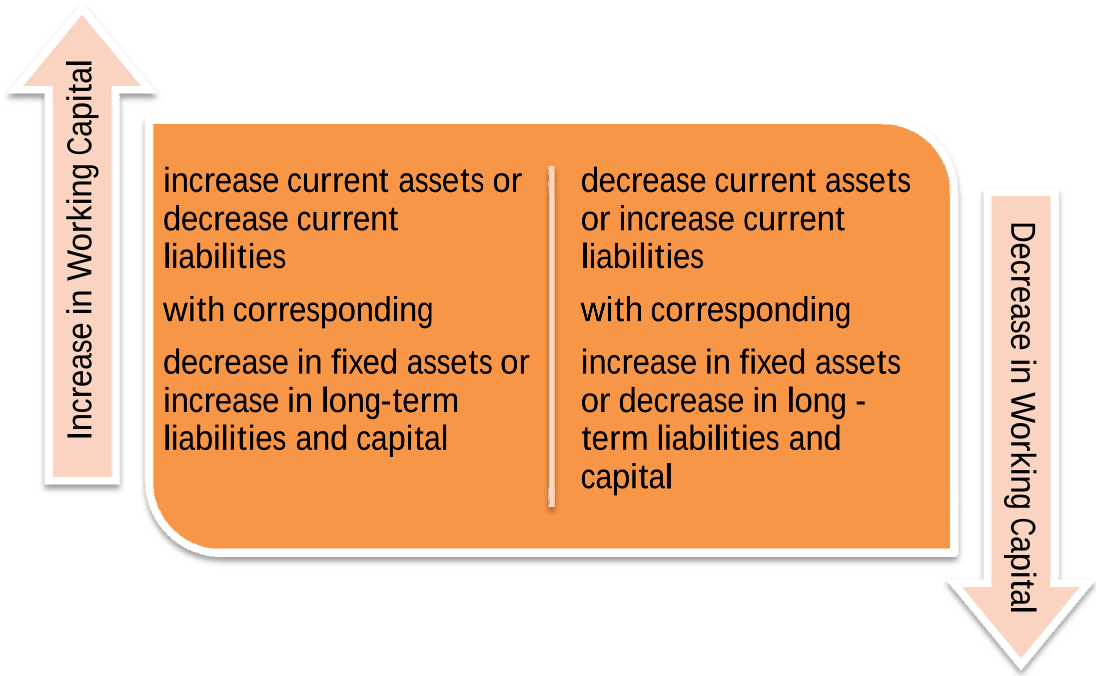
1.Transactions involving current liabilities and non-current liabilities & owner’s equity, like creditors paid off by giving debentures, or by issue of shares

2.Transactions involving current liabilities and non-current assets like claim of creditors satisfied by transferring building to their account

3.Transactions involving current assets and non-current assets like purchase of machinery for cash

4.Transactions involving current assets and non-current liabilities and owner's equity like redemption of debentures by paying cash or issue of shares for cash

To summarise,



No Flow Of Funds

In addition to the above, there can be transactions which do not bring about a change in the funds, i.e neither an inflow nor an outflow. For example, stock sold on credit would result in a decrease in stock and an increase in debtors, thus resulting in no flow of funds.Similarly, transfer to General Reserve will result in decrease of profit from P&L Appropriation Account and increase in General Reserve Account, thus resulting in no flow of funds. Such transaction will involve:

1) Current assets and current liabilities like payment of cash to creditors
2) Non-Current assets and non-current liabilities & owner's equity like purchase of building against debentures or by issue of shares

FUNDS FLOW STATEMENT

Funds Flow Statement is a statement which records the above stated flow of funds. It is an important financial tool, which analyzes the changes in financial position of a firm showing the sources and applications of its funds.It records all the cross transactions i.e. transactions involving a current account and a non-current account which bring about a change in the fund or working capital. The cross transactions presented in the funds flow statement are grouped as follows:

SOURCES OF FUNDS	APPLICATIONS OF FUNDS
• Transactions which bring about an increase (inflow)in the available fund	• Transactions which bring about a decrease (outflow) in the available fund

Knowledge Assessment - 1

State whether the following statements are true or false:

1. Funds and cash are always used synonymously.
2. Gross concept of funds refers to net working capital.
3. Flow of funds is always positive i.e. increase.
4. All financial transactions will definitely have either a positive or a negative flow of funds.
5. A transaction involving two current assets will not result in flow of funds.
6. A transaction involving a current asset and a non-current asset will have affect the Funds Flow Statement.
7. Funds Flow Statement records all sources and applications of funds.
8. Application of funds refers to uses of funds.

Answers

1. False, 2. False, 3. False, 4. False, 5. True, 6. True, 7. True, 8. True

SESSION 2: BASIC OVERVIEW OF UTILITY AND LIMITATIONS OF FUNDS FLOW STATEMENT

UTILITY OF FUNDS FLOW STATEMENT

The preparation of Fund Flow Statement facilitates financial analysis so as to provide a better understanding of changes in the distribution of resources between two Balance Sheet dates. Some of the uses of Funds Flow Statement are given as follows:

(1) Acts as an instrument for allocation of resources.
(2) Highlights the different sources and applications or uses of funds between the two accounting period.
(3) Proves to be an effective tool for measuring changes in working capital.
(4) Explains the financial consequences of business operations.
(5) Shows the financial strength and weakness of a concern and helps to take corrective action in case of deviation.
(6) Acts as an instrument for the investors facilitating effective decision-making regarding investment by providing information about overall credit worthiness, sources of repayment, funds generated through normal business operations and past utilization of funds.

DIFFERENCE BETWEEN FUNDS FLOW STATEMENT AND INCOME STATEMENT

The basic functions of Funds Flow Statement and Income Statement differ from each other. The main points of difference can be highlighted as follows:

FUNDS FLOW STATEMENT	INCOME STATEMENT
Ascertains the different sources and uses of funds during the particular period	Reveals the net profit earned or net loss incurred at the end of a particular period
Deals with movement of funds	Discloses the final result of business activities
Matches funds raised with funds applied	Matches income with expenditure
Based on financial statements of two consecutive years	Prepared from nominal accounts of a particular accounting period
No standard format required for preparation	Format specified by Schedule III Part 2 of Companies Act, 2013.

Prepared at the discretion of management, not a statutory obligation	Mandatorily prepared as per rules specified
considers both capital and revenue nature of income and expenditure	considers only revenue nature of income and expenditure
Income statement required for preparation of Funds Flow Statement	No such requirement of Funds Flow Statement
Can be prepared anytime during the year	Prepared only at the end of accounting period

The above-said differences show thatfunds flow statement and income statement differ from each other and thus, cannot substitute one another. Rather, they are complementary to each other.

DIFFERENCE BETWEEN FUNDS FLOW STATEMENT AND BALANCE SHEET

The differences between Funds Flow Statement and Balance Sheet can be highlighted as follows:

FUNDS FLOW STATEMENT	**BALANCE SHEET**
Highlights total sources and applications of funds during the year	Reveals the assets owned and liabilities owed by the company on a particular date
Prepared on the basis of Profit & Loss account and Balance sheet of two consecutive years	Prepared on the basis of Trial Balance.
Reveals the changes in values of fixed assets and their effect on flow of funds	Explains the financial position of the company
Mainly useful for internal financial management	Useful not only for management but also shareholders, creditors, government agencies, and other stakeholders

LIMITATIONS OF FUNDS FLOW STATEMENT

Funds Flow Statement suffers from certain drawbacks. The same have been enumerated as follows:

1. Being historical in nature, does not estimate sources and applications of funds in the near future.
2. Does not disclose major policy changes with respect to investment or the structural changes in financial relationship in a firm
3. Does not focus on transactions involved in non-fund items

4. Ignores transactions involved between current accounts or non-current accounts.
5. No additional information provided to the management as conventional financial statements are simply rearranged and presented.
6. Not much relevant as a study of changes in cash is more important than that of funds.
7. Carries over defects in financial statements. Thus, it is not fool proof.

Knowledge Assessment – II

Fill in the blanks with appropriate words:

1. Funds Flow Statement highlights ______________ and ____________ of funds.
2. One of the advantages of Funds Flow Statement is that it facilitates evaluation of change in _______ capital.
3. Income Statement and Funds Flow Statement are _________ to each other.
4. Funds Flow Statement deals with __________ of funds.
5. It is the _______ of management to prepare Funds Flow Statement.
6. FFS considers both ________ and _______ nature of income and expenditure.
7. Funds Flow Statement is based on financial statements of ____ consecutive years.
8. _______ items are not disclosed in FFS.

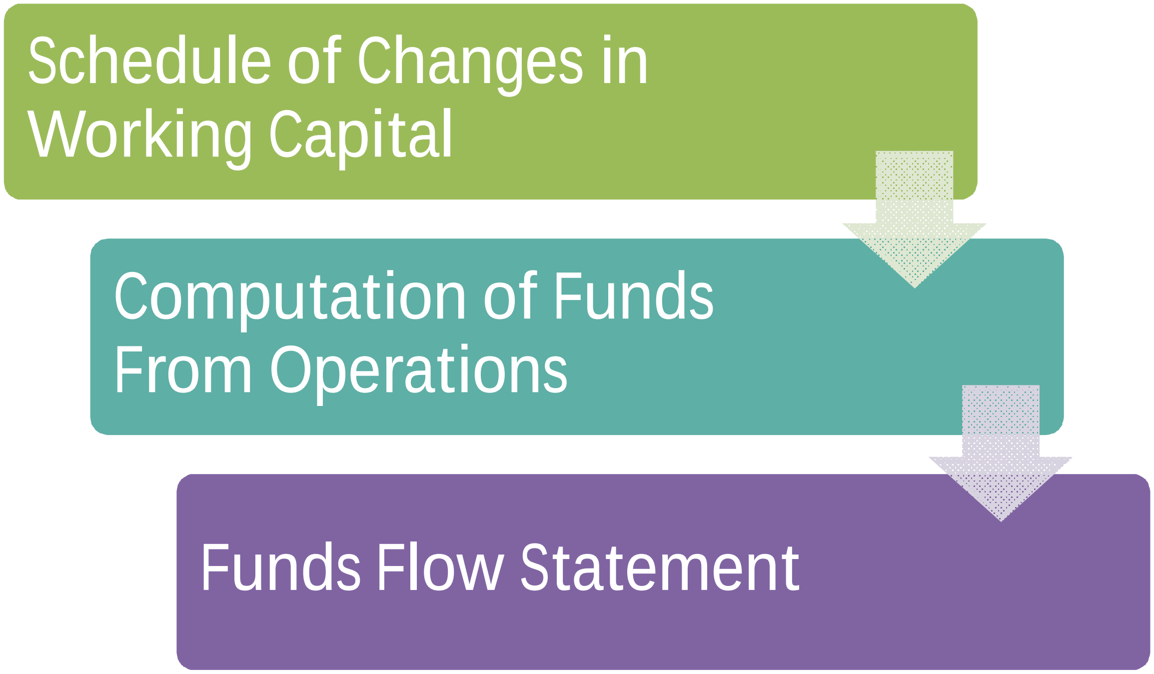
Answers

1. Sources, applications, 2. Working 3. Complementary, 4. Movement, 5. Discretion, 6. Capital, revenue, 7. Two, 8. Non-fund

SESSION 3: PREPARATION OF FUNDS FLOW STATEMENT

PREPARATION OF FUNDS FLOW STATEMENT

The steps involved in the process of preparation of Funds Flow Statement are as follows:



STEP 1: PREPARATION OF SCHEDULE OF CHANGES IN WORKING CAPITAL

The schedule of changes in working capital is prepared by comparing the current assets and current liabilities of two given periods. The format for the same is given below:

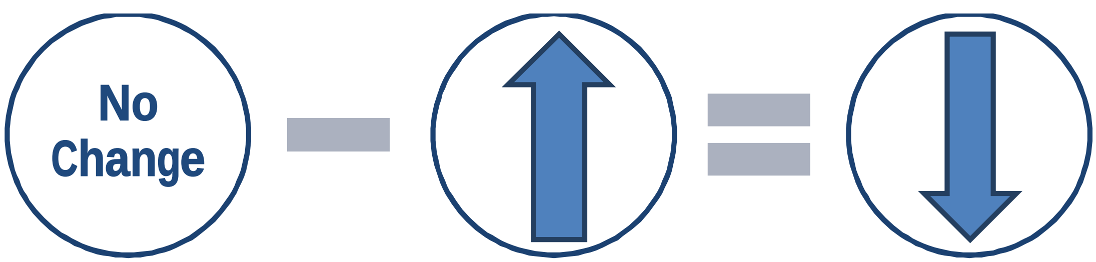
Items	*As on Year 1*	*As on Year 2*	*Change*	
			Increase	*Decrease*
Current Assets:				
Cash Balance				
Bank Balance				
Marketable Securities				
Accounts Receivable				
Stock in Trade				
Prepaid Expenses				
Current Liabilities				
Bank Overdraft				
Outstanding Expenses				
Accounts Payable				
Net Increase / Decrease in Working Capital				

Rules for preparing the Schedule:

(i) Increase in current asset results in increase in working capital

(ii) decrease in current asset results in decrease in working capital

(iii) increasein current liabilities decreases working capital



(iv) decrease in current liabilities results in increase in working capital

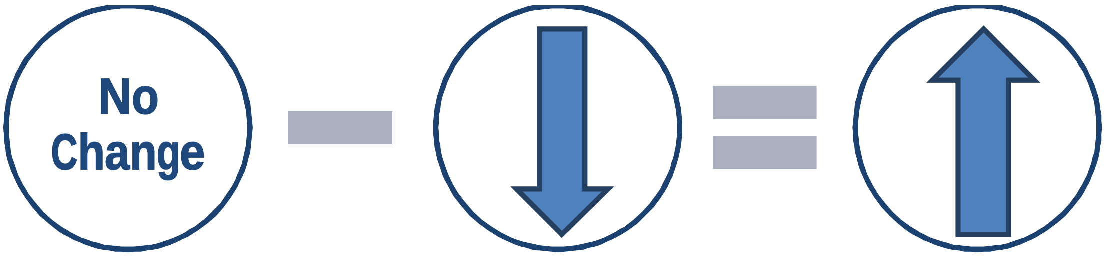


Illustration 1

From the following information extracted from the Balance Sheets of Sunny Weather Ltd., prepare a statement of changes in working capital:

(Figures in Rs.)

Liabilities	2014	2015	Assets	2014	2015
Capital	40,000	50,000	Cash	6,000	9,400
Profit & Loss Account	2,000	4,600	Debtors	24,000	23,000
Creditors	14,000	9,000	Land	10,000	13,200
			Stock	16,000	18,000
	56,000	63,600		56,000	63,600

Solution

STATEMENT OF CHANGES IN WORKING CAPITAL

(Figures in Rs.)

Items	***2014***	***2015***	***Change***	
			Increase	***Decrease***
Current Assets:				
Cash Balance	6,000	9,400	3,400	-
Debtors	24,000	23,000	-	1,000
Stock	16,000	18,000	2,000	-
Current Liabilities:				
Creditors	14,000	9,000	5,000	-
Total			10,400	1,000

Net Increase in Working Capital :Rs. 9,400

Illustration 2

India Ltd. has provided the following information. You are required to prepare schedule of changes in working capital.

(Figures in Rs.)

Liabilities	2015	2014	Assets	2015	2014
Share Capital	3,00,000	2,50,000	Land	54,000	30,000
Profit & Loss Account	1,50,000	1,20,000	Long-term investments	20,000	30,000
Creditors	90,000	1,00,000	Goodwill	10,000	20,000
Bills Payable	70,000	40,000	Cash	1,40,000	50,000
Short-term Loans	40,000	-	Debtors	1,80,000	1,96,000
			Stock	2,40,000	1,74,000
			Preliminary Expenses	6,000	10,000
	6,50,000	5,10,000		6,50,000	5,10,000

Solution

STATEMENT OF CHANGES IN WORKING CAPITAL

(Figures in Rs.)

Items	***2014***	***2015***	***Change***	
			Increase	***Decrease***
Current Assets:				
Cash	50,000	1,40,000	90,000	
Debtors	1,96,000	1,80,000		16,000
Stock	1,74,000	2,40,000	66,000	
Current Liabilities:				
Trade creditors	1,00,000	90,000	10,000	
Bills Payable	40,000	70,000		30,000
Short-term Loans	-	40,000		40,000
Total			1,66,000	86,000

Net Increase in Working Capital: Rs. 80,000

STEP 2 : COMPUTATION OF FUNDS FROM OPERATIONS

This step is a part of computation of sources in the preparation of Funds Flow Statement. For the sake of convenience to students, it has been taken as a separate step.

"Funds from operations" is a source of funds generated from internal sources. It requires adjustments of certain items to the figure of net profit. It can be prepared horizontally or vertically. Both the 'statement form' and 'account form' formats for the above said computation are given as follows:

STATEMENT FORM

CALCULATION OF FUNDS FROM OPERATIONS

Particulars		Amount (Rs.)
Closing balance of Profit & Loss Account or Reserves & Surplus (if P&L balance is not available) {Value as given in Balance Sheet)		xxx
Add: Items already debited to Profit and Loss Account but do not result in outflow of funds		
Depreciation		xxx
Amortization of fictitious and intangible assets		
- Goodwill	xxx	
- Patents	xxx	
- Trade Marks	xxx	
- Preliminary Expenses	xxx	
- Discount on issue of shares, etc.	xxx	xxx
Appropriation of Retained Earnings		
- Transfer to General Reserve	xxx	
- Transfer to any other reserve	xxx	xxx
Loss on sale of any fixed assets such as		
- Land	xxx	
- Building	xxx	
- Machinery	xxx	
- Furniture	xxx	

- Long term investments, etc.	xxx	xxx
Dividend including - Interim Dividend - Proposed Dividend	 xxx xxx	 xxx
Provision for taxation		xxx
Any other non-fund item debited to Profit and Loss Account		xxx
(a)		**xxx**
Less:Items already credited to Profit and Loss Account but do not result in inflow of funds		
Profit on sale of fixed assets such as - Land - Building - Machinery - Furniture - Long term investments, etc.	 xxx xxx xxx xxx xxx	 xxx
Appreciation in value of fixed asset if credited to P&L Account		xxx
Dividend received		xxx
Excess provision transferred to P&L Account or written off		xxx
Any other non – fund item credited to P&L Account		xxx
Opening balance of Profit & Loss Account or Reserves & Surplus (if P&L balance is not available) {Value as given in Balance Sheet)		Xxx
(b)		**xxx**
Funds from operations / Loss from operations (a – b)		**Xxx**

ACCOUNT FORM

CALCULATION OF FUNDS FROM OPERATIONS

PROFIT AND LOSS ADJUSTMENT ACCOUNT

Dr. **Cr.**

Particulars	**Amount**	**Particulars**	**Amount (Rs.)**
To Depreciation	xxx	By balance b/d (opening balance of P&L Account or Reserves and Surplus as is available in the last year's Balance Sheet)	xxx
To Loss on sale of Fixed Assets / Investments	xxx	By Income from Investment	xxx
To Amortisation of Fictitious and Intangible Assets	xxx	By Profit on sale of Fixed Assets / Investments	xxx
To Provision for Tax	xxx	By Funds From Operations (Balancing Figure)	xxx
To Transfer to General Reserve	xxx		
To Transfer to any other reserve	xxx		
To Proposed Dividend	xxx		
To Interim Dividend paid	xxx		
To balance c/d (closing balance of P&L Account or Reserves and Surplus as is available in the current year's Balance Sheet)	xxx		
To Loss From Operations (balancing figure in case credit side exceeds debit side)	xxx		

Illustration 3

Calculate Funds from Operations from the following information:

(i) Net profit for the year Rs. 65,00,000
(ii) Profit on sale of building Rs. 3,55,000
(iii) Goodwill appears in the books at Rs. 18,00,000 of which 10% has been written off during the year.
(iv) Machinery worth Rs. 80,000 has been sold off Rs. 65,000 during the year.
(v) Transfer to General Reserves Rs. 12,50,000.
(vi) Depreciation at 20% has been provided on furniture of Rs. 65,00,000.

Solution

Calculation of Funds From Operations

Particulars		Amount (Rs.)
Net Profit for the year (given)		65,00,000
Add: Non – fund items debited to P&L Account		
Goodwill written off	1,80,000	
Loss on sale of machinery	15,000	
Transfer to General Reserve	12,50,000	
Depreciation (20% of 65,00,000)	13,00,000	27,45,000
Less: Non – fund items credited to P&L Account		
Profit on sale of building	3,55,000	3,55,000
Funds from operations		88,90,000

Alternately,

ADJUSTED PROFIT AND LOSS ACCOUNT

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Goodwill written off	1,80,000	By Profit on sale of building	3,55,000
To loss on sale of machinery	15,000	By Funds From Operations	88,90,000

To Transfer to General Reserve	12,50,000		
To Depreciation (20% of 65,00,000)	13,00,000		
To Net Profit	65,00,000		
	92,45,000		92,45,000

Illustration 4

From the following Profit and Loss Account, calculate Funds From Operations:

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Salaries	50,000	By Gross Profit b/d	10,000
To Rent	20,000	By Discount	50,000
To Depreciation	10,000	By Interest on Investment	40,000
To Preliminary Expenses	20,000	By Net Loss	50,000
To Loss on Sale of Land	50,000		
	1,50,000		1,50,000

Solution

Calculation of Funds From Operations

Particulars		**Amount (Rs.)**
Net Loss for the year (given)		(50,000)
Add: Non – fund items debited to P&L Account		
Depreciation	10,000	
Preliminary Expenses	20,000	
Loss on Sale of Land	50,000	80,000
Less: Non – fund items credited to P&L Account		
Interest on Investment	40,000	40,000
Loss from operations		(10,000)

Illustration 5

Sandhu Ltd.has reported a profit of Rs. 7,00,000 for the current year after incorporating the following:

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Loss on sale of equipment	90,000	Profit from sale of assets	4,00,000
Premium on redemption of debentures	15,000	Provision for tax	2,20,000
Discount on issue of debentures	20,000	Dividend received	40,000
Depreciation on machinery	2,00,000	Transfer to General Reserve	50,000
Depletion of natural resources	1,00,000	Preliminary expenses	10,000
Interim dividend	2,50,000	Profit on revaluation	25,000
Loss on sale of investment	10,000	Goodwill written off	3,00,000

Calculate Funds from Operations.

Solution

Calculation of Funds From Operations

Particulars		Amount (Rs.)
Net Profit for the year (given)		7,00,000
Add: Non – fund items debited to P&L Account		
Goodwill written off	3,00,000	
Loss on sale of equipment	90,000	
Transfer to General Reserve	50,000	
Depreciation on machinery	2,00,000	
Discount on issue of debentures	20,000	
Depletion of natural resources	1,00,000	
Provision for tax	2,20,000	
Preliminary expenses	10,000	

Premium on redemption of debentures	15,000	
Interim dividend	2,50,000	
Loss on sale of investment	10,000	12,65,000
Less: Non – fund items credited to P&L Account		
Profit on sale of assets	4,00,000	
Profit on revaluation	25,000	
Dividend income	40,000	4,65,000
Funds from operations		15,00,000

Alternately,

ADJUSTED PROFIT AND LOSS ACCOUNT

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Goodwill written off	3,00,000	By Profit on sale of assets	4,00,000
To Loss on sale of equipment	90,000	By Profit on revaluation	25,000
To Transfer to General Reserve	50,000	By Dividend income	40,000
To Depreciation on machinery	2,00,000	By Funds from operations (balancing figure)	15,00,000
To Discount on issue of debentures	20,000		
To Depletion of natural resources	1,00,000		
To Provision for tax	2,20,000		
To Preliminary expenses	10,000		
To Premium on redemption of debentures	15,000		
To Interim dividend	2,50,000		
To Loss on sale of investment	10,000		
	19,65,000		19,65,000

STEP 3 : PREPARTION OF FUNDS FLOW STATEMENT

Funds Flow Statement can be prepared using the following format:

FUNDS FLOW STATEMENT

SOURCES AND APPLICATIONS OF FUNDS	
Sources of Funds	
Funds From Operations	xxx
Issue of Share Capital	xxx
Issue of Debentures	xxx
Long term Borrowings	xxx
Sale of Fixed Assets / Investments	xxx
Non-operating Incomes (like dividend received)	xxx
Sale of Long-term Investments	xxx
Any other source	xxx
Decrease in working capital (as per Schedule of Changes in Working Capital)	xxx
Total	**xxx**
Applications or Uses of Funds	
Loss from Operations	xxx
Redemption of Preference Share Capital	xxx
Redemption of Debentures	xxx
Repayment of long-term loans	xxx
Purchase of fixed assets	xxx
Purchase of long-term investments	xxx
Dividend paid	xxx
Interim dividend paid	xxx
Tax paid	xxx
Any other application	xxx
Decrease in working capital (as per Schedule of Changes in Working Capital)	xxx
Total	**xxx**

The totals of both sides should match.

The same can be prepared in horizontal format also.

Is Depreciation a Source of Funds?

Sometimes, the question arises whether depreciation is considered as a source of funds. s we have already seen, depreciation is taken as an operating expense which is debited to Profit and Loss Account. Thus, depreciation is debited to P&L Account and credited to Fixed Assets Account. since, both are non-current accounts, depreciation is therefore, a non-fund item. It is neither a source nor an application of funds. At the time of calculation of Funds From Operations, depreciation charged on fixed assets is added back.

However, depreciation can be taken as a source in the following cases:

1. The value of closing stock may include depreciation on fixed assets as a part of its total cost by way of charging overheads to inventory.
2. Providing depreciation results in saving of funds as it is charged on assets owned by the company. Otherwise, rent on assets used will have to be paid.
3. Depreciation reduces taxable income and thus, decreasing tax liability.

TREATMENT OF CERTAIN ITEMS

a) PROVISION FOR TAXATION

At the time of preparation of Funds Flow Statement, provision for taxation can be taken as

(i) current liability
(ii) non-current liability

(i) ***AS A CURRENT LIABILITY***

In this case, when provision for taxation is made, the transaction involves Profit and Loss Appropriation Account, which is a fixed liability and provision for taxation is a current liability. This will result in decrease of working capital. Payment of tax liability will not result in a change in current liability as it will involve one current liability (i.e. provision for taxation) and the other current asset (i.e. bank or cash)

(ii) ***AS A NON – CURENT LIABILITY***

In this case, it may be taken as appropriation of profit, thus resulting in no change in working capital, as it will involve two fixed or non-current liabilities, Profit and Loss Appropriation Account and Provision for Taxation account. However, payment of tax will be taken as application of funds as it involves one non-current liability, i.e. provision for taxation and one current asset i.e. bank account.

Note: Provision for taxation may be taken as current or non-current liability but tax payable will be taken as current liability as it is the amount due which has to be paid after tax assessment.

b) PROPOSED DIVIDENDS

Proposed Dividend can also be taken as current liability or non-current liability. The treatment in both the cases will be similar as has been discussed for Provision for Taxation.

Note: Proposed Dividend may be taken as current or non-current liability but dividend payable will be taken as current liability as it is the amount of dividend which has to be paid to the shareholders.

STUDENTS ARE ADVISED TO TAKE, BOTH, PROVISION FOR TAXATION AND PROPOSED DIVIDEND AS CURRENT LIABILITY ONLY IF SO MENTIONED IN THE QUESTION. BY DEFAULT, THEY HAVE TO BE TREATED NON-CURRENT LIABILITIES.

Knowledge Assessment – III

Choose the correct answer from the options given below:

1. The schedule of changes in working capital is prepared by comparing
   a) current assets and current liabilities
   b) non- current assets and non-current liabilities
   c) current assets and non-current liabilities
   d) non-current assets and current liabilities
2. The schedule of changes in working capital shows
   a) Increase in working capital
   b) Decrease in working capital
   c) Both of the above
   d) None of the above
3. Decrease in current asset results in
   a) Increase in working capital
   b) Decrease in working capital
   c) Both of the above
   d) None of the above
4. Funds from operations can be generated from
   a) Internal sources
   b) External sources
   c) Both of the above
   d) None of the above
5. Funds from operations can be calculated
   a) Horizontally only
   b) Vertically only
   c) Both horizontally and vertically
   d) Neither ways
6. Items already debited to Profit and Loss Account but do not result in outflow of funds need to
   a) Be added back
   b) Be deducted
   c) Sometimes added sometimes deducted
   d) Does not affect
7. Depreciation is
   a) Source of fund
   b) Application of fund
   c) Both of the above
   d) None of the above
8. Provision for taxation and proposed dividend, by default, are treated as
   a) Current liability
   b) Current asset
   c) Non-current liability
   d) Non-current asset

Answers

1. a. 2. c. 3. b. 4. a. 5. c. 6. a. 7. d. 8. c

Illustration 6

From the following balance sheets, prepare Funds Flow Statement.

(Figures in Rs.)

Liabilities	2014	2015	Assets	2014	2015
Share capital	2,00,000	2,50,000	Cash	30,000	47,000
Creditors	70,000	45,000	Debtors	1,20,000	1,15,000
Retained Earnings	10,000	23,000	Stock	80,000	90,000
			Land	50,000	66,000
	2,80,000	3,18,000		2,80,000	3,18,000

Solution

Fund Flow Statement

Source of funds	Amount (Rs.)	*Application of fund*	Amount (Rs.)
Issue of shares	50,000	Purchase of Land	16,000
Fund from operation	13,000	Increase in working capital	47,000
	63,000		63,000

Workings:

(i) **Statement of changes in working capital**

(Figures in Rs.)

	2014	*2015*	*Increase*	*Decrease*
Current Assets:				
Cash	30,000	47,000	*17,000*	
Debtors	1,20,000	1,15,000		*5,000*
Stock	80,000	90,000	*10,000*	
Current liabilities:				
Creditors	70,000	45,000	*25,000*	
Total			*52,000*	*5,000*

Net Increase in Working Capital: Rs. 47,000

(ii) Calculation of Funds From Operations

Profit and Loss Adjustment Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To balance c/d	23,000	By Balance b/d	10,000
		By Funds From Operations (balancing figure)	13,000
	23,000		23,000

Illustration 7

The Balance Sheets of Vinyl Ltd. has been given as under. You are required to prepare Funds Flow Statement.

(Figures in Rs.)

Liabilities	2014	2015	Assets	2014	2015
Share capital	20,00,000	20,00,000	Goodwill	2,40,000	2,40,000
General Reserve	2,80,000	3,60,000	Building	8,00,000	7,20,000
Profit And Loss Account	3,20,000	2,60,000	Plant	7,40,000	7,20,000
Creditors	1,60,000	1,08,000	Investments	2,00,000	2,20,000
Bills Payable	24,000	16,000	Stock	6,00,000	4,68,000
Provision for taxation	3,20,000	3,60,000	Bills receivable	40,000	64,000
Provision for doubtful debts	8,000	12,000	Debtors	3,60,000	3,80,000
			Cash and bank balances	1,32,000	3,04,000
	31,12,000	31,16,000		31,12,000	31,16,000

Additional Information:

1. Depreciation provided on plant was Rs. 80,000 and on buildings Rs. 80,000
2. Provision for taxation made during the year Rs. 3,80,000.
3. Interim dividend paid during the year Rs. 1,60,000.

Solution

FUNDS FLOW STATEMENT

Sources	Amount (Rs.)	Applications	Amount (Rs.)
Funds from operations	7,20,000	Purchase of plant	60,000
		Tax paid	3,40,000
		Purchase of investments	20,000
		Interim dividend paid	1,60,000
		Increase in working capital	1,40,000
	7,20,000		7,20,000

Workings:

(i) **Statement of changes in working capital**

(Figures in Rs.)

	2014	*2015*	*Increase*	*Decrease*
Current Assets:				
Stock	6,00,000	4,68,000		1,32,000
Bills receivable	40,000	64,000	24,000	
Debtors	3,60,000	3,80,000	20,000	
Cash and bank balances	1,32,000	3,04,000	1,72,000	
Current liabilities:				
Creditors	1,60,000	1,08,000	52,000	
Bills Payable	24,000	16,000	8,000	
Provision for doubtful debts	8,000	12,000		4,000
Total			2,76,000	1,36,000

Net Increase in Working Capital: Rs. 1,40,000

(ii) Calculation of Funds From Operations

Profit and Loss Adjustment Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Transfer to General Reserve	80,000	By Balance b/d	3,20,000
To Provision for Tax	3,80,000	By Funds From Operations (balancing figure)	7,20,000
To Depreciation on Plant	80,000		
To Depreciation on Buildings	1,60,000		
To Interim Dividends	1,60,000		
To balance c/d	2,60,000		
	10,40,000		10,40,000

Provision for TaxationAccount

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To Income tax (Tax paid)	3,40,000	By Balance b/d	3,20,000
To balance c/d	3,60,000	By Profit and Loss Account	3.80,000
	7,00,000		7,00,000

Plant Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To balance b/d	7,40,000	By Depreciation Account	80,000
To Bank Account (purchase)	60,000	By balance c/d	7,20,000
	8,00,000		8,00,000

Buildings Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To balance b/d	8,00,000	By Depreciation	80,000
		By balance c/d	7,20,000
	8,00,000		8,00,000

Investments Account

Dr. **Cr.**

Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
To balance b/d	2,00,000	By balance c/d	2,20,000
To Bank Account (purchase)	20,000		
	2,20,000		2,20,000

General Reserve Account

Dr. **Cr.**

Particulars	**Amount (Dr.)**	**Particulars**	**Amount (Dr.)**
To balance c/d	3,60,000	By balance b/d	2,80,000
		By Profit & Loss Account	80,000
	3,60,000		3,60,000

Illustration 8

Prepare Statement of Changes in Working Capital and Funds Flow Statement from the following Balance Sheets of DakshinLtd. for 2014 and 2015.

Balance Sheets of DakshinLtd.

Liabilities	**2014Rs.**	**2015Rs.**	**Assets**	**2014Rs.**	**2015Rs.**
Share Capital(Paid-up)			Land & Buildings	12,00,000	10,00,000
11% Cumulative Preference Shares	--	6,00,000	Plant & Machinery	6,00,000	10,00,000
Equity Shares	22,00,000	24,00,000	Sundry Debtors	8,00,000	9,60,000
General Reserve	80,000	80,000	Stock	12,00,000	14,00,000
Profit and Loss Account	40,000	48,000	Bank	48,000	1,40,000
9% Debentures	2,40,000	2,80,000	Cash	12,000	20,000

Provision for Taxation	120,000	1,68,000			
Proposed Dividend	2,00,000	2,32,000			
Current Liabilities	9,80,000	7,12,000			
	38,60,000	45,20,000		38,60,000	45,20,000

Solution

STATEMENT OF CHANGES IN WORKING CAPITAL

	2006 Rs.	2007 Rs.	Increase in W.C Rs.	Decrease in W.C Rs.
Current Assets				
Sundry Debtors	8,00,000	9,60,000	1,60,000	
Stock	12,00,000	14,00,000	2,00,000	
Bank	48,000	1,40,000	92,000	
Cash	12,000	20,000	8,000	
Current Liabilities				
Current Liabilities	9,80,000	7,12,000	2,68,000	
Working Capital(CA-CL)	10,80,000	18,08,000	7,28,000	

Net Increase in Working Capital: Rs. 7,28,000

FUNDS FLOW STATEMENT

Sources	**Amount (Rs.)**	**Applications**	**Amount (Rs.)**
Issue of Preference Shares	6,00,000	Purchase of Plant and Machinery	4,00,000
Issue of Equity Shares	2,00,000	Provision for Taxation (assumed to be paid)	1,20,000
Issue of Debentures	40,000	Proposed Dividend (assumed to be paid)	2,00,000
Sale of Land & Buildings	2,00,000	Net Increase in Working Capital	7,28,000
Funds From Operations	4,08,000		
	14,48,000		14,48,000

Working Notes:

1. Increase in 11% Cumulative Preference Sharesand equity shares indicates issue of new shares.
2. Proposed Dividend and Provision for Taxation have been treated as non-current.
3. New debentures have been issued during the year.

4. Decrease in balance of Land and Buildings shows sale.
5. Similarly, plant and machinery has been purchased.
6. Calculation of Funds From Operations

Adjusted Profit and Loss Account

Particulars	Rs.	Particulars	Rs.
To Provision for Taxation	1,68,000	By Balance b/d	40,000
To Proposed dividend	2,32,000	By Funds from operations	4,08,000
To Balance c/d	48,000	(Balance figures)	
	4,48,000		4,48,000

Illustration 9

The following are the summarised balance sheets of Zify Ltd. on 31st Dec. 2014 and 31st Dec. 2015.

Liabilities	**2014Rs.**	**2015Rs.**	**Assets**	**2014Rs.**	**2015Rs.**
Share Capital	6,00,000	8,00,000	Plant & Machinery(at cost)	4,00,000	6,45,000
Debentures	2,00,000	3,00,000	Land & Building (at cost)	3,00,000	4,00,000
Profit and Loss Account	1,25,000	2,50,000	Stock	3,00,000	3,50,000
Creditors	1,15,000	90,000	Bank	20,000	40,000
Provision for bad and doubtful debts	6,000	3,000	Preliminary Expenses	7,000	6,000
Provision for depreciation			Debtors	69,000	61,000
- On Land & Building	20,000	24,000			
- On Plant & Machinery	30,000	35,000			
	10,96,000	15,02,000		10,96,000	15,02,000

Additional Information:

(i) During the year a part of machinery costing Rs. 70,000(accumulated depreciation thereon Rs. 2,000) was sold for Rs.6,000

(ii) Dividends of Rs. 50,000 were paid during the year

You are required to prepare:

(a) Schedule of Changes in Working Capital

(b) Funds Flow Statement

Solution:

Statement of Changes in Working Capital

	2014Rs.	2015Rs.	Increase in W.C Rs.	Decrease in W.C Rs.
Current Assets:				
Stock	3,00,000	3,50,000	50,000	
Bank	20,000	40,000	20,000	
Debtors	69,000	61,000		8,000
Current Liabilities				
Creditors	1,15,000	90,000	25,000	
Provision for bad and doubtful debts	6,000	3,000	3,000	
Working Capital	2,68,000	3,58,000		

Net Increase in Working Capital :Rs. 90,000

FUNDS FLOW STATEMENT

Sources	Amount (Rs.)	Applications	Amount (Rs.)
Issue of Share Capital	2,00,000	Purchase of Plant & Machinery	3,15,000
Issue of Debentures	1,00,000	Purchase of Land & Building	1,00,000
Sale of Machinery	6,000	Dividends Paid	50,000
Funds From operations	2,49,000	Net Increase in Working Capital	90,000
	5,55,000		5,55,000

Workings:

Provision for Depreciation Plant & Machinery Account

Dr. **Cr.**

Particulars	**Rs.**	Particulars	**Rs.**
To Plant & Machinery Account	2,000	By Balance b/d	30,000
Tobalance c/d	35,000	By Adjusted P/L Account (Dep provided) (balancing figure)	7,000
	37,000		37,000

Provision for Depreciation on Land & Building Account

Dr. **Cr.**

	Rs.		**Rs.**
To Balance c/d	24,000	By Balance b/d	20,000
		By Cash- Issue (balancing figure)	4,000
	24,000		24,000

Plant & Machinery Account

	Rs.		**Rs.**
To Balance b/d	4,00,000	By Cash (sale)	6,000
To Cash- Purchase(balancing figure)	3,15,000	By Provision for Depreciation	2,000
		By Adjusted P&L Account	62,000
		By Balance b/d	6,45,000
	7,15,000		7,15,000

Land and Buildings Account

	Rs.		**Rs.**
To Balance b/d	3,00,000	By Balance c/d	4,00,000
To Cash- Purchase	1,00,000		
	4,00,000		4,00,000

Adjusted Profit & Loss Account

	Rs.		**Rs.**
To Provision for Depreciation		By Balance b/d	1,25,000
- Plant & Machinery	7,000	By Funds from Operations(balancing figure)	2,49,000
- Land & Building	4,000		
To Preliminary Expenses written off	1,000		
To Dividend	50,000		
To Loss on Sale of machinery	62,000		
To Balance c/d	2,50,000		
	3,74,000		3,74,000

KEYWORDS

1. **Funds:**In a narrow sense, funds refer to cash while in broader sense it is classified in gross concept and net concept. Gross concept connotes current assets while net concept implies net working capital.
2. **Flow**: Flow refers to movement of funds during the normal working course of business.
3. **Funds Flow Statement**: It is a statement which analyzes the changes in financial position of a firm showing the sources and applications of its funds.
4. **Cross transactions**: Cross transactions are the transactions which involve a current account and a non-current account,thus, bringing about a change in the fund or working capital.

SUMMARY

1. Flow, during the normal working course of business, can result in an increase (inflow) or decrease (outflow) of funds.
2. The schedule of changes in working capital is a statement which analyses and compares the current assets and current liabilities of two given periods.
3. Funds generated by the regular, normal operations of the company are referred to as Funds from operations.
4. Transactions involving current assets and current liabilities or non-current assets and non-current liabilities & owner's equity, result in no flow of funds.
5. By default, provision for taxation and proposed dividend should be treated as non-current liability but can be taken as current liability if the question states so.
6. The Funds Flow Statement lists out the sources and applications of funds during two consecutive periods.

EXERCISE QUESTIONS

Short Answer Questions

1. Define funds.
2. What do you understand by flow.
3. Can there be no flow of funds?
4. What do you understand by Sources of funds.
5. Give 5 examples of Applications of funds.
6. Define schedule of changes in working capital.
7. Can funds from operations be negative?
8. What is a funds flow statement.

Long Answer Questions

1. State the transactions that result in flow of funds with an example of each.
2. "All financial transactions result in a flow of funds." Do you agree with the statement.State reasons for your answer.
3. Explain the procedure of computing net changes in working capital of a company.
4. How do you calculate the funds from operations. Illustrate.
5. Is depreciation a source of funds? Explain.
6. Explain the steps involved in the preparation of funds flow statement.
7. What is a funds flow statement. Examine its uses and significance for management. Also, highlight its drawbacks.
8. Differentiate between:
   a) Funds Flow Statement and Income Statement
   b) Funds Flow Statement and Balance Sheet
9. What type of transactions will not be reflected in a Funds Flow Statement.

10. Funds Flow Statement and Income Statement are perfect substitutes. Do you agree.State with reasons.

11. What do you understand by funds generated from internal sources and those from external sources.

Numerical Questions

1. From the following details prepare a statement showing changes in working capital during the year.

Balance sheet of Pintex ltd. as on 31st December

Liabilities	2014	2015	Assets	2014	2015
Share capital	5,00,000	6,00,000	Fixed assets	10,00,000	11,20,000
Reserves	1,50,000	1,80,000	Less: Depreciation	3,70,000	4,60,000
Profit and Loss Account	40,000	65,000		6,30,000	6,60,000
Debentures	3,00,000	2,50,000	Stock	2,40,000	3,70,000
Creditors for goods	1,70,000	1,60,000	Book Debts	2,50,000	2,30,000
Provision for tax	60,000	80,000	Cash in hand	80,000	60,000
			Preliminary expenses	20,000	15,000
	12,20,000	13,35,000		12,20,000	13,35,000

*(**Answer:** Net Increase in Working Capital: Rs. 1,00,000)*

2. Prepare a statement of changes in working capital from the following Balance Sheets of Minoti Ltd.

Liabilities	2014	2015	Assets	2014	2015
Share capital	5,00,000	5,00,000	Fixed assets	6,00,000	7,00,000
Debentures	3,00,000	2,50,000	Long-term Investments	2,00,000	1,00,000
Tax Payable	77,000	43,000	Work-in-Progress	80,000	90,000
Accounts Payable	96,000	1,92,000	Stock-in-trade	1,50,000	2,25,000
Interest Payable	37,000	45,000	Accounts Receivable	70,000	1,40,000
Dividend Payable	50,000	35,000	Cash	30,000	10,000
	11,30,000	12,65,000		11,30,000	12,65,000

*(**Answer:** Net Increase in Working Capital: Rs. 80,000)*

3. Brij Company has given the following information. You are required to calculate Funds from Operations.

Profit and Loss Account

Particulars	Amount	Particulars	Amount
Operating expenses	10,00,000	Gross Profit	20,00,000
Depreciation	4,00,000	Profit on sale of plant	2,00,000
Loss on sale of building	1,00,000		
Advertisement Suspense Account	50,000		
Discount to customers	5,000		
Discount on issue of shares	5,000		
Goodwill written off	1,20,000		
Net profit	5,20,000		
	22,00,000		22,00,000

***(Answer:** Funds from Operations: Rs. 99,500)*

4. On the basis of the following information, calculate Funds from Operations.

Liabilities	2014	2015	Assets	2014	2015
Share capital	2,00,000	3,00,000	Land and buildings	2,00,000	1,90,000
General Reserve	60,000	60,000	Plant and Machinery	1,60,000	1,80,000
Profit & Loss Account	40,000	44,000	Stock	1,40,000	2,20,000
6% Debentures	1,60,000	1,60,000	Debtors	40,000	50,000
Creditors	1,30,000	1,16,000	Investments	-	20,000
Provision for tax	10,000	20,000	Cash	20,000	20,000
			Goodwill	40,000	20,000
	6,00,000	7,00,000		6,00,000	7,00,000

Additional Information:

a) During the year, dividend of Rs. 30,000 was paid.
b) Depreciation written off plant and machinery amounted to Rs. 12,000 and no depreciation has been charged on land and buildings.
c) Provision for tax made during the year Rs. 10,000.
d) Profit on sale of machinery Rs. 4,000.

***(Answer:** Funds from Operations: Rs. 72,000)*

5. The Balance Sheets of Suri Ltd. as on Mar. 31, 2014 and Mar. 31, 2015 were as follows:

Liabilities	2014 Rs.	2015 Rs.	Assets	2014 Rs.	2015 Rs.
Share Capital	5,00,000	7,00,000	Land and Building	80,000	1,20,000
General Reserve	50,000	70,000	Plant & Machinery	5,00,000	8,00,000
Profit & Loss Account	1,00,000	1,60,000	Stock	1,00,000	75,000
Sundry Creditors	1,53,000	1,90,000	Sundry Debtors	1,50,000	1,60,000
Bills Payable	40,000	50,000	Cash	20,000	20,000
Outstanding Expenses	7,000	5,000			
	8,50,000	**11,75,000**		**8,50,000**	**11,75,000**

a. Rs. 50,000 depreciation has been charged to Plant & Machinery
b. A piece of machinery costing Rs. 12,000 (Depreciation provided thereon Rs. 7,000) was sold at 60% profit on book value.

Required: - Prepare Funds Flow Statement.

*(**Answer:** Net Decrease in working capital: Rs. 60,000, Funds from Operations Rs. 1,27,000, Total of Funds Flow Statement Rs. 3,95,000)*

6. From the following two Balance Sheetsfor 2014 and 2015, prepare the statement of sources and uses of funds.

	2014	2015
Liabilities		
Share capital	80,000	90,000
Trade creditors	20,000	46,000
Profit & Loss Account	4,60,000	5,00,000
	5,60,000	**6,36,000**
Assets		
Cash	60,000	94,000
Debtors	2,40,000	2,30,000
Stock in trade	1,60,000	1,80,000
Land	1,00,000	1,32,000
	5,60,000	**6,36,000**

*(**Answer:** Net Increase in working capital: Rs. 18,000, Funds from Operations Rs. 40,000, Total of Funds Flow Statement Rs. 50,000)*

7. From the following relating to Panasonic ltd., prepare funds flow statement

Liabilities	**2014**	**2015**	**Assets**	**2014**	**2015**
Share capital	60,00,000	80,00,000	Fixed assets	38,00,000	42,00,000
Reserves	20,00,000	10,00,000	Accounts	21,00,000	30,00,000

			Receivable		
Retained Earnings	6,00,000	12,00,000	Stock	30,00,000	39,00,000
Accounts Payable	9,00,000	27,00,000	Cash in hand	6,00,000	18,00,000
	95,00,000	1,29,00,000		95,00,000	1,29,00,000

Additional information:

a) The company issued bonus shares for Rs.10,00,000 and for cash Rs.10,00,000
b) Depreciation written off during the year Rs.3,00,000

(Answer:** Net Increase in working capital: Rs. 12,00,000, Funds from Operations Rs. 9,00,000, Total of Funds Flow Statement Rs. 19,00,000**)

8. From the following balance sheets of A Ltd on 31st March, 2014 and 2015, you are required to prepare Fund flow statement. The following additional information has also been given

a) Depreciation charged on plant was Rs.4,000 and on building Rs.4,000.
b) Provision for taxation of Rs.19,000 was made during the year
c) Interim Dividend of Rs.8,000 was paid during the year

Liabilities	2014	2015	Assets	2014	2015
Share capital	1,00,000	1,00,000	Goodwill	12,000	12,000
General Reserve	14,000	18,000	Building	40,000	36,000
Profit and Loss Account	16,000	13,000	Plant	37,000	36,000
Sundry Creditors	8,000	5,400	Investments	10,000	11,000
Bills Payable	1,200	800	Stock	30,000	23,400
Provision for Taxation	16,000	18,000	Bills Receivable	2,000	3,200
Provision for doubtful debts	400	600	Debtors	18,000	19,000
			Cash	6,600	15,200
	1,55,600	1,55,800		1,55,600	1,55,800

(Answer:** Net Increase in working capital: Rs. 7,000, Funds from Operations Rs. 36,000, Total of Funds Flow Statement Rs. 36,000**)

UNIT : 11 – CASH FLOW STATEMENT

Unit Code: 11	**UNIT TITLE: CASH FLOW STATEMENT**			
	Duration:			
Location: Classroom or Company's premises	**SESSION 1: INTRODUCTION TO CASH FLOW STATEMENT**			
	Learning Outcome	**Knowledge Evaluation**	**Performance Evaluation**	**Teaching and Training Method**
	1. Meaning of Cash Flow Statement	1. Explain the meaning of cash flow statement 2. Comprehend the concept of cash and cash equivalents 3. Explain the meaning of cash flows	1. Classify the components of cash and cash equivalents 2. Differentiate cash inflows from cash outflows	**Interactive Lecture:** Introduction of cash, cash equivalents, flows and cash flow statement **Activity:** Collect cash flow statement of a company in a particular industry
	2. Classification Of Activities For Preparation Of Cash Flow Statement	1. Describe the various activities under which cash flow statement is prepared	1. Identify the character of the various activities 2. Differentiate between operating, investing and financing activities	**Interactive Lecture:** Discussion of activities into which transaction will be divided for cash flow statement **Activity:** Identify the activities studied with the collected cash flow statement
	2. Computation of cash from operating activities	1. Explain the procedure of computation of cash from operating activities using both the direct method and the indirect method	1. Calculate cash from operating activities using direct method and indirect method	**Interactive Lecture:** Discussion of direct and indirect method of computation of cash from operating activities
	SESSION 2: BASIC OVERVIEW OF UTILITY AND LIMITATIONS OF CASH FLOW STATEMENT INCLUDING TREATMENT OF CERTAIN ITEMS			
	1. Treatment of certain items like extra-ordinary items, interest, taxes,etc.	1. Explain the treatment of items in preparation of cash flow statement	1. Analyse the treatment of interest, dividend, taxes, etc.	**Interactive Lecture:** Acquaint with the concept and treatment of items like interest, dividend, etc.

	2. Difference between cash flow analysis and funds flow analysis	1. Explain the concept of cash flow analysis different from funds flow analysis	1. Evaluate the difference between cash flow analysis and funds flow analysis	**Interactive Lecture:** Discussion of difference between cash flow analysis and funds flow analysis
	3. Utility and limitations of cash flow statement (CFS)	1. Express the advantages of cash flow statement 2. Explain the drawbacks of cash flow statement	1. Analyse the utility and limitations of CFS	**Interactive Lecture:** Discussion of advantages and disadvantages of CFS
	4. Methodical preparation of cash flow statement	1. Explain preparation of investing and financing activities and transactions covered under them	1. Calculate cash from investing activities and cash from financing activities 2. Analyse the inclusion of all three activities for Cash Flow Statement	**Interactive Lecture:** Discuss the methodical preparation of CFS **Activity:** Prepare the CFS on the basis of some given facts and figures

(Note: The location would depend upon the topic under discussion, wherein it will be the classroom for the theoretical interactions and the student will be required to visit the office of a company to collect financial statements and other records, if not available on the website of the company.)

UNIT : 11 - CASH FLOW STATEMENT

***Learning Objectives*:**

After reading thisunit,the students will be able to:

1. understand the meaning of Cash Flow Statement,
2. explain the components of cash and cash equivalents,
3. describe the Sources and applications of cash,
4. explain the classification of activities for preparation of Statement of Cash Flows,
5. differentiate between Funds Flow Statement and Cash Flow Statement,
6. explain the uses of Cash Flow Statement,
7. express the limitations of Cash Flow Statement and
8. explain the meaning of certain keywords.

SESSION 1: INTRODUCTION TO CASH FLOW STATEMENT

The financial statements facilitate decision making by the users, but these economic decisions require an evaluation of the ability of the entity to generate cash in addition to their timing and certainty. To ensure the short-term viability of the company, particularly to meet obligations to trade creditors, repayment of bank loan, distribution of dividend to shareholders, a statement showing inflows and outflows of cash should be prepared.

Accounting Standard-3 (AS-3), issued by The Institute of Chartered Accountants of India (ICAI) revised in 1997, deals with the preparation and presentation of Statement of Cash Flows. The revised AS-3 has made it mandatory for all listed companies to prepare and present a cash flow statement along with other financial statements on annual basis. The application of this standard is not mandatory, but is recommendatory for small and medium enterprises and some specified non-corporate entities. New Indian Accounting Standards, converged with the international standards, have been introduced, of which the new Ind AS – 7 deals with Statement of Cash Flows.

MEANING OF CASH FLOW STATEMENT

Cash Flow Statement, also known as Statement of Cash flows,provides the stakeholders with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows.The statement deals with the provision of information about the historical changes and reasons thereof in cash and cash equivalents of an enterprise by means of a classification of cash flows during the period from operating, investing and financing activities. This aids the management in making plans for the near future.

CASH AND CASH EQUIVALENTS

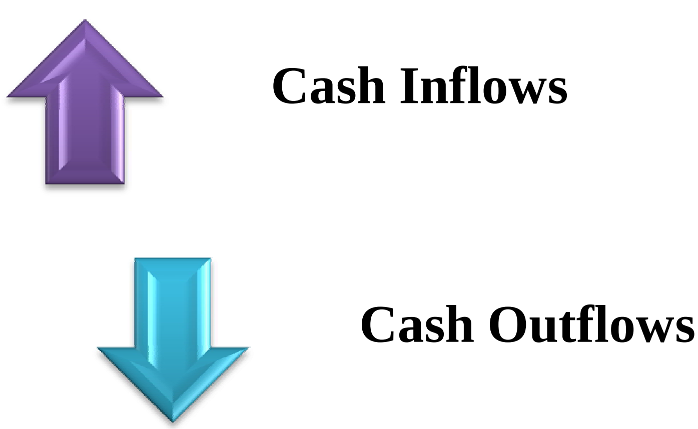
Cash and cash equivalents are the most liquid assets in company's Balance Sheet. As defined by AS- 3 as well asInd AS – 7, cash comprises of cash in hand and demand deposits withbank andcash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash, with an insignificant risk of changes in value. Common examples of cash equivalents are commercial paper, treasury bills, marketable securities, money market holdings, short term government bonds, preferred shares purchased shortly before the redemption date, and like instruments. Thus, for an investment to qualify as cash equivalent, the following should be ensured:

1. They should be held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.
2. It must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value.
3. They should have a short maturity of, preferably, three months or less from the date of acquisition.

CASH FLOWS

Cash flows signify the inflows and outflows of cash and cash equivalents. As per the standard, cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an enterprise rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents.

CASH FLOWS

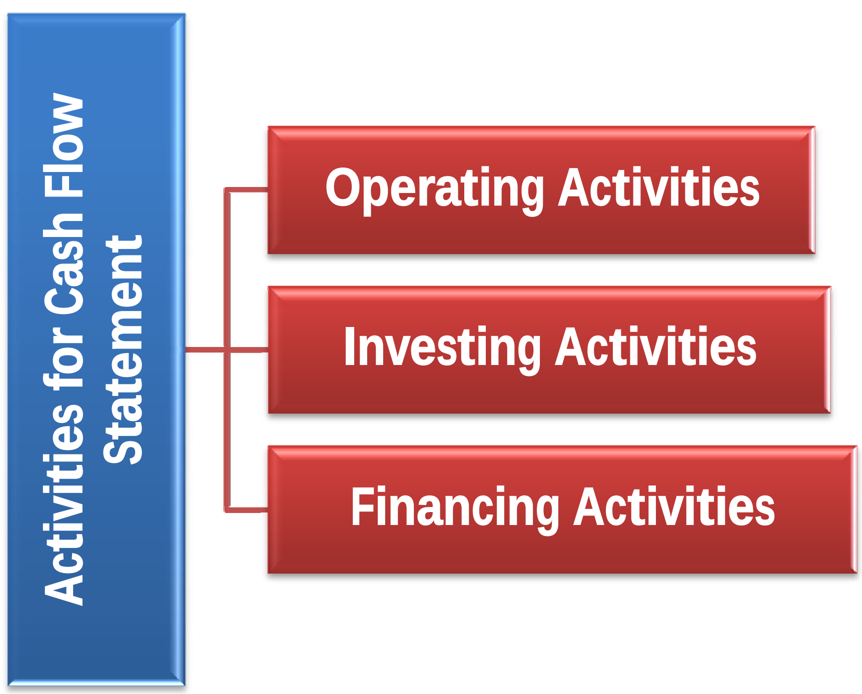


Receipt of cash from a non-cash item is termed as cash inflow. For example, sale of machinery for cash implies receipt of cash or cash inflows. Similarly, payment received from debtors, sale of property for cash, plant or equipment, loans from bank or financial institutions, issue of shares or debentures for cash consideration, dividend on investment in shares and receipt of interest on loan or investment in debentures lead to increase in cash with the company and are, thus, termed as cash inflows.

Transfer of funds by company to another party results in cash outflow. For example, repayment of bank loan is cash outflow. Also, payment of wages and salaries, meeting out expenses, payment to creditors, acquisition of land, building, plant and machinery, purchase of investments, redemption of debentures and such other transactions cause the cash component to decline in the company, and thus, account for the cash outflows.

CLASSIFICATION OF ACTIVITIES FOR PREPARATION OF CASH FLOW STATEMENT

Statement of Cash Flows is prepared under three main categories of activities namely, operating, investing and financing activities. Classification by activity provides information that facilitates assessment of the impact of these activities on the financial position of the company and the amount of its cash and cash equivalents.



Operating Activities

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.The amount of cash flows arising from operating activities indicates the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without resorting to external sources of financing.On the basis of information in the comparative Income Statements and Balance Sheets along with the additional information, the net cash flows generated or used by operating activities can be computed. For example, a company manufacturing kids' garments derives its cash flows from operating activities from transactions like purchase of raw material, the manufacturing expenses, sale of the produced clothes, and the like. Other examples can be:

Cash inflows from operating activities

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenue

Cash outflows from operating activities

- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees
- Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities

Investing Activities

Investing activities include the acquisition and disposal of long-term assets like machinery, furniture, land and building, automobile and other long term investments like investment in shares and debt instruments of other companies, giving long term loan provided the company is not in the business of giving out loans and other such long term investments. Also, the return on these investments is included under this category.

Financing Activities

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. Activities relating to raising and redeeming long term funds, like shares, debentures, long term loans, etc. are included under financing activities. They help to predict claims on future flows by providers of funds, both owned and owed. In addition, the amount of dividend or interest paid on shares and debentures/loans respectively are covered under financing activities.

Although, the transactions covered under these classifications are clear, however, at times some transactions seem to be covered under one category but are actually included in another. For example, the sale of machinery may give rise to a gain or loss which is included in the determination of net profit or loss, thus, as per definition should be included under operating activities. However, the cash flows relating to such transactions are cash flows from investing activities. Let us take another example. A company holds securities for the purpose of trade. Then, as per the above explanation, cash proceeds from sale of such securities should be included under investing activities. However, the main business of the company is dealing or trading in securities, therefore, it is similar to inventory acquired specifically for resale. Thus, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Also, a single transaction may include cash flows that are classified differently. For example, the payment of installment on purchase of car includes both interest and loan component, wherein, the interest element is classified under financing activities and the loan element is classified under investing activities.

COMPUTATION OF CASH FROM OPERATING ACTIVITIES

The Income Statement prepared by a firm gives the net profit earned by the firm on accrual basis, thus, need not necessarily signify cash movement. Therefore, it is important to adjust the net profit figure with the non-cash and non-operating items. The accounting standard AS – 3/Ind-AS7 provides for two methods, direct method and indirect method, to compute cash from operating activities.

NOTE:

1. ***When all transactions are cash transactions, then Cash From Operations = Net Profit as shown in the Income Statement***
2. ***When all transactions are not cash transactions, then cash from operations needs to be computed by making the necessary adjustments as have been discussed hereunder.***

DIRECT METHOD

- **Major classes of gross cash receipts and gross cash payments are disclosed**

INDIRECT METHOD

- **Net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows**

DIRECT METHOD

Under the Direct method, all purchases, expenses and sales, are analysed to calculate the effect of these items on cash. All non-cash expense items such as depreciation, writing off fictitious assets, amortisation of intangible assets are disregarded. In addition, profit or loss on sale of assets and/or investments are ignored.

a) Effect of sales on cash can be computed as follows:

Cash Sales		……………….
Credit Sales (as given in Income Statement)	……………….	
Less: Closing balance of debtors and bills receivable	……………….	
Add: Opening balance of debtors and bills receivable	……………….	
Cash generated from credit sales		……………….
Total cash generated from sales		……………….

b) Cash movement due to purchases can be ascertained as follows:

Cost of goods sold (as given in Income Statement)	……………….
Less: Opening stock	……………….
Add: Closing stock	……………….
Total Purchases	……………….
Add: Opening balance of creditors	……………….
Less: Closing balance of creditors	……………….
Cash Payment for Purchases	……………….

c) Disbursement of cash for expenses can be calculated as follows:

Expenses (as given in Income Statement)	……………….
Add: Outstanding at the beginning of the year	……………….
Less: Outstanding at the end of the year	……………….
Cash Payment for Expenses	……………….

To summarise, cash from operating activities using direct method can be computed as follows:

Cash Flows From Operating Activities		
Cash generated from sales		……………….
Less: Cash Payment for Purchases	……………….	
Less: Cash payment to employees	……………….	
Less: Cash Payment for other Expenses	……………….	
Total disbursements		……………….
Cash generated from operations		……………….
Less: Income tax paid		……………….
Cash flow before extra-ordinary item		……………….
+/- Extra-ordinary items		……………….
Net cash from operating activities		……………….

INDIRECT METHOD

Using the indirect method, the company is required to adjust the net profit (before tax and extra-ordinary items) for

a) **non-cash expenses** such as depreciation, intangible and fictitious assets written off, loss on sale of assets and /or investments by adding back their respective amounts,
b) **non cash and non-operating incomes** such as profit on sale of assets/investments, interest income, dividend received, interest accrued but not received by deducting them,
c) **changes in current assets and current liabilities**

To summarise, cash from operating activities using indirect method can be calculated as follows:

Net profit before tax and extraordinary items	……………….
+ Depreciation	……………….
+ Provision for contingencies	……………….
+ Loss on sale of fixed assets	……………….
+ Loss on disposal of investments	……………….
+ Interest paid	……………….
- Interest received	……………….
- Dividend received	……………….
- Profit on sale of investments	……………….
- Profit on sale of fixed assets	……………….

Operating Profit before working capital changes	………………
+ Decrease in trade and other receivables	………………
+ Decrease in stock	………………
+ Increase in creditors	………………
- Increase in debtors and bills receivables	………………
- Increase in stock	………………
- Decrease in creditors	………………
Cash generated from operations	………………
- Income tax paid	………………
Cash flow before extra-ordinary item	………………
+/- Extra-ordinary items	………………
Net cash from operating activities	………………

Knowledge Assessment - I

1. Principal revenue generating activities of an enterprise arecalled as
   a) Operating activities
   b) Investing activities
   c) Financing activities
   d) None of the above
2. Short term highly liquid investments readily convertible into known amounts of cash and subject to insignificant risk are:
   a) Cash in hand
   b) Investment in shares
   c) Cash at bank
   d) Cash equivalents
3. Cash flows include:
   a) Inflows and outflows of cash
   b) Inflows and outflows of cash equivalents
   c) Both of the above
   d) None of the above
4. Purchase of building by means of issue of shares should be _______ from Cash Flow Statement.
   a) Included
   b) Excluded
   c) Considered investing activities
   d) None of the above
5. Equity dividend received should be classified as:
   a) Operating activities
   b) Investing activities
   c) Financing activities

d) None of the above
6. The purposes of the cash flow statement are to
a) Evaluate management decisions.
b) Determine ability to pay liabilities and dividends.
c) Predict future cash flows.
d) All of the above
7. Which item does not appear on a statement of cash flows prepared by the indirect method?
a) Collections from customers
b) Depreciation
c) Net income
d) Gain on sale of land
8. Operating activities are most closely related to
a) Long-term assets.
b) Current assets and current liabilities.
c) Long-term liabilities and owners' equity.
d) Dividends and treasury stock

Answers
1.a, 2. d, 3.c, 4.b, 5.b, 6.d, 7.a, 8.b

SESSION 2: BASIC OVERVIEW OF UTILITY AND LIMITATIONS OF CASH FLOW STATEMENT INCLUDING TREATMENT OF CERTAIN ITEMS

TREATMENT OF CERTAIN ITEMS

1. ***Extraordinary items***
Cash flows associated with extraordinary items, like loss due to theft or earthquake or flood, are not recurring in natureand should be classified and disclosed separately as arising from operating, investing or financing activities. This is done to enable users to understand their nature and effect on the present and future cash flows of an enterprise.
2. ***Interest and Dividend***
For a company whose main business is lending and borrowing, interest paid, interest received and dividend received are classified as operating activities while dividend paid is the financing activity. In case of a non-financial enterprise, payment of interest and dividend are classified as financing activities whereas receipt of interest and dividends are classified as investing activities.

3. ***Taxes on Incomes and Gains***

   Cash flows arising from taxes on income shall be separately disclosed and shall be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities. For example,

   a) Tax on income should be classified as operating cash flows.
   b) Dividend tax, i.e. tax paid on dividend should be classified as financing activity along with dividend paid.
   c) Capital gains tax paid on sale of fixed assets should be classified under investing activities.

4. ***Non-cash Transactions***

   Transactions that do not require the use of cash or cash equivalents, like acquiring fixed assets from proceeds of issue of equity shares or redemption of debentures by fresh issue of equity, should be excluded from a cash flow statement.

5. ***Bank Overdraft***

   AS- 3 (Revised) has no reference to the treatment of bank overdraft, thus, leading to mixed opinions. One school of thought says that bank overdraft should be subtracted from cash and cash equivalents while the other says that it should be disclosed under cash from financing activities.

   However, Ind AS – 7: Statement of Cash Flows clearly states that:

   "Bank borrowings are generally considered to be financing activities. However, where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn."

   Since, the application of Ind AS is becoming mandatory in phases from 1st April, 2016, the students are advised to treat bank overdraft as a financing activity while preparing Cash Flow Statement, unless they form an essential part of an entity's cash management.

Illustration 1

Calculate cash from operations from the following information:

(Figures in ₹ Crores)

Particulars	**31.3.2014**	**31.3.2015**
Debtors	500	470
Bills Receivable	100	125
Creditors	200	250
Expenses Outstanding	10	12
Expenses Prepaid	8	7
Accrued Income	6	7.50
Income Received in Advance	3	2.50
Net Profit	-	1300
Bills Payable	80	60

Solution

CASH FROM OPERATIONS

(Figures in ₹ Crores)

Particulars		₹	₹
	Profit made during the year		1300
Add:	Decrease in Debtors	30	
	Increase in Creditors	50	
	Increase in Outstanding Expenses	2	
	Decrease in Prepaid Expenses	1	83
			1383
Less:	Increase in Bills Receivable	25	
	Decrease in Bills Payable	20	
	Increase in Accrued Income	1.50	
	Decrease in Income Received in Advance	0.50	47
Cash From Operations			1336

Illustration 2

Excess Ltd has provided the following information. You are required to calculate cash flows from operating activities using

i) direct method
ii) indirect method

Profit and Loss Account
for the year ended on March 31, 2015

(Figures in ₹ Crores)

Particulars	**Amount**	**Particulars**	**Amount**
Cost of Goods Sold	1200	Sales	2200
Gross Profit	1000		
	2200		**2200**
Salary	300	Gross Profit	1000
Insurance Premium	80		
Depreciation	200		
Income Tax	100		
Net Profit	320		
	1000		**1000**

Additional Information:

(Figures in ₹ Crores)

Particulars	**April 1, 2014**	**March 31, 2015**
Debtors	250	300
Bills Receivable	80	60
Creditors	170	150
Stock	220	270
Outstanding Salary	20	30
Prepaid Insurance	50	55
Outstanding Income Tax	30	20

Solution

(i) Cash Flows from Operating Activities using direct method

(Figures in ₹ Crores)

Particulars		
Cash generated from sales		2170
Less: Cash Payment for Purchases	1270	
Less: Cash payment to employees	290	
Less: Cash Payment for other Expenses	85	
Total disbursements		1645
Cash generated from operations		525
Less: Income tax paid		110
Net cash from operating activities		415

Working Notes

a) Effect of sales on cash can be computed as follows:

(Figures in ₹ Crores)

Particulars		
Sales		2200
Less: Closing balance of debtors	300	
Less: Closing balance of bills receivable	60	
Add: Opening balance of debtors	250	
Add: Opening balance of bills receivable	80	
Cash generated from sales		(30)
Total cash generated from sales		2170

b) Cash movement due to purchases can be ascertained as follows:

(Figures in ₹ Crores)

Particulars	
Cost of goods sold (as given in Income Statement)	1200
Less: Opening stock	220
Add: Closing stock	270
Total Purchases	1250
Add: Opening balance of creditors	170
Less: Closing balance of creditors	150
Cash Payment for Purchases	1270

c) Disbursement of cash for expenses can be calculated as follows:

(Figures in ₹ Crores)

Particulars	To employees	For Insurance Premium	Income Tax
Expenses (as given in Income Statement)	300	80	100
Add: Outstanding at the beginning of the year	20	50	30
Less: Outstanding at the end of the year	30	55	20
Cash Payment for Expenses	290	85	110

(ii) Calculation of cash from operating activities using indirect method

(Figures in ₹ Crores)

Particulars	
Net profit before tax and extraordinary items = Net Profit as given in Profit and Loss Account 320 + Income Tax provided in Income Statement 100	420
+ Depreciation	200
= Operating Profit before working capital changes	620
- Increase in sundry debtors	50
- Increase in Stock	50
- Increase in Prepaid Insurance	5
- Decrease in sundry creditors	20
+ Decrease in bills receivable	20
+ Increase in outstanding salaries	10
Cash generated from operations	525
- Income tax paid (100 + 30- 20)	110
Net cash from operating activities	415

Thus, it can be observed from the above calculations that the amount of cash flows from operating activities is the same whether we use direct method or indirect method.

Illustration 3

Shirish has extracted the following information from the financial statements of Zoom Ltd. you are required to calculate cash from operating activities with the help of the given figures:

Particulars	Rs.
Cash sales for the year	14,00,000
Net credit sales for the year	56,00,000
Cash purchases for the year	10,00,000
Net credit purchases for the year	52,00,000
Commission received during the year	40,000
Office and administrative expenses during the year	4,40,000
Provision for income tax made during the year	80,000

Additional Information:

Particulars	Balance as on 1st April, 2014 (Rs.)	Balance as on 31st March, 2015 (Rs.)
Debtors and bills receivable	8,00,000	9,00,000
Creditors and bills payable	15,00,000	3,00,000
Outstanding office and administrative expenses	90,000	30,000
Prepaid office and administrative expenses	50,000	1,30,000
Provision for income tax	1,00,000	1,20,000

Solution

Cash Flows from Operating Activities using direct method

Particulars	Rs.	Rs.
Cash generated from sales		69,00,000
Cash receipt from commission		40,000
Less: Cash Payment for Purchases	74,00,000	
Less: Cash Payment for other Expenses	5,80,000	
Total disbursements		79,80,000
Cash generated from operations		(10,40,000)
Less: Income tax paid		60,000
Net cash from operating activities		(11,00,000)

Working Notes

a) Effect of sales on cash can be computed as follows:

Particulars	Rs.	Rs.
Cash Sales		14,00,000
Net credit sales	56,00,000	
Less: Closing balance of debtors and bills receivable	9,00,000	
Add: Opening balance of debtors and bills receivable	8,00,000	
Cash generated from credit sales		55,00,000
Total cash generated from sales		69,00,000

b) Cash movement due to purchases can be ascertained as follows:

Particulars	Rs.
Cash purchases	10,00,000
Credit purchases	52,00,000
Total Purchases	62,00,000
Add: Opening balance of creditors and bills payable	15,00,000
Less: Closing balance of creditors and bills payable	3,00,000
Cash Payment for Purchases	74,00,000

c) Disbursement of cash for expenses can be calculated as follows:

Particulars	Office and administrative expenses (Rs.)	Income Tax (Rs.)
Expenses	4,40,000	80,000
Add: Outstanding at the beginning of the year	90,000	1,00,000
Less: Outstanding at the end of the year	30,000	1,20,000
Add: Prepaid Expenses at the end of the year	1,30,000	-
Less: Prepaid Expenses at the beginning of the year	50,000	-
Cash Payment for Expenses	5,80,000	60,000

Illustration 4

Anantya Ltd. earned a profit of Rs. 18,00,000 for the year ended 2015 after taking into consideration the following:

Particulars	Rs.
Depreciation on Land and Building	52,000
Transfer to General Reserve	10,000
Depreciation on Plant and Machinery	35,000

Goodwill written off	8,000
Plant worth Rs. 14,000 sold for	10,000
Profit on sale of investments	7,000

The position of current assets and current liabilities is as under:

Particulars	2014 (Rs.)	2015 (Rs.)
Debtors	45,000	35,000
Stock	72,000	80,000
Cash	12,000	21,000
Creditors	56,000	62,000
Outstanding expenses	7,000	5,000
Prepaid expenses	4,000	5,000
Bills Payable	11,000	15,000

You are required to calculate cash flow from operating activities.

Solution

Cash Flows from Operating Activities

Particulars	Rs.
Net profit for the year	18,00,000
Adjustment for non-cash and non-operating items:	
Depreciation on building	52,000
Depreciation on plant and machinery	35,000
Transfer to general reserve	10,000
Goodwill written off	8,000
Loss on sale of plant and machinery	4,000
Profit on sale of investments	(7,000)
Operating profit before working capital changes	19,02,000
Adjustments for changes in working capital	
Decrease in debtors	7,000
Increase in stock	(8,000)
Increase in creditors	6,000
Decrease in outstanding expenses	(2,000)
Increase in prepaid expenses	(1,000)
Increase in bills payable	4,000
Net cash flow from operating activities	**19,08,000**

DIFFERENCE BETWEEN CASH FLOW ANALYSIS AND FUNDS FLOW ANALYSIS

The term ‘funds’ has a wider meaning encompassing the entire gamut of working capital, the changes thereof are recorded in Funds Flow Statement. On a narrower front, the changes in one aspect of funds, i.e. cash are recorded in Cash Flow Statement.

The main points of difference between Cash Flow and Funds Flow are enumerated as follows:

1. Cash Flow Statement records changes in cash position while Funds Flow Statement is concerned with changes in working capital position of the company between two Balance Sheet dates.
2. A Cash Flow Statement, merely being a record of cash receipts and disbursements fails to apprise the stakeholder with the short term solvency position of the enterprise. The same is taken care by Funds Flow Statement.
3. Cash is part of working capital, thus, an improvement in cash position automatically improves the working capital position of the company but the vice versa does not always holds true.
4. On the basis of technique of preparation, an increase in liability or decrease in current asset results in decrease in working capital while the same brings about an increase in cash position of the company.
5. Funds Flow Statement is based on accrual system of accounting while Cash Flow Statement is based on cash basis of accounting.
6. A Cash Flow Statement classifies all cash transactions into operating, financing and investing activities while no such classification is done in Funds Flow Statement which shows just the sources and applications of funds.

The differences can be summarized in a tabular manner as follows:

Basis of Difference	**Funds Flow Statement**	**Cash Flow Statement**
1. Concept	Wider concept, considers working capital	Narrower concept, considers cash
2. Basis of accounting	Based on accrual basis	Based on cash basis
3. Schedule of changes in working capital	Prepared to show changes in current assets and liabilities	No such schedule is prepared.
4. Classification of heads of preparation	Sources and applications of funds	Cash from Operating, financing and investing activities
5. Basis of improvement	Improvement of funds position need not necessarily improve cash position	Improvement of cash position improves the funds position
6. Cash and cash equivalents	Opening and closing balances of cash and cash equivalents are included in schedule of changes in working capital	Opening and closing balances of cash and cash equivalents are shown at the beginning and at the end of the Cash Flow Statement respectively.

UTILITY OF STATEMENT OF CASH FLOWS

A company needs sufficient cash to meet its obligations like payment to creditors, payment of other debts maturing in the near future, expenses incurred, for which a reliable cash flow projection for the immediate future is of great importance. The main advantages of preparation of Cash Flow Statement can be listed as follows:

1. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents.
2. A cash flow statement discloses the movement of cash, highlights the increase or decrease in addition to the reasons thereof, and a comparison with the projections indicates the trend of movement of cash and also the success or failure of cash planning. This helps in taking remedial actions in time which may otherwise go undetected.
3. A cash flow statement is an important financial tool for the management as it helps in short term planning of cash availability and disbursement.
4. A cash flow statement when used along with other financial statements enables users to evaluate changes in net assets of the company, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timings of cash flows in order to adapt to changing circumstances and opportunities.
5. It also helps in efficient cash management by aiding in evaluation of financial policies and cash position.
6. Based on cash basis, it eliminates the effects of using different accounting treatments for the same transactions and events by different companies, thus, enhancing the comparability of the reporting of operating performance.
7. It provides information to management about the requirement of cash and the sources of generation of such amount, i.e. how much can be raised internally and how much needs to be funded from external sources.
8. Information about operating activities as obtained from the Cash Flow Statement helps in determination of policies regarding internal financial management.

LIMITATIONSOF STATEMENT OF CASH FLOWS

Despite the benefits of Statement of Cash Flows, it suffers from the following limitations:

1. Cash Flow Statement is not a substitute for Income Statement. Net cash flow does not necessarily mean net income of the company as it does not take into account the non-cash items.
2. The amount of cash disclosed in the statement need not necessarily disclose the real liquid position as the company, in order to window dress its statements, maypostpone payment of purchases and other expenses.
3. It is not suitable for judging the profitability of the enterprise.

4. It is not a substitute of Funds Flow Statement which shows the changes in flow of funds, i.e. working capital.
5. A comparative study of cash flow statements may give misleading results.

PREPARATION OF CASH FLOW STATEMENT

The classification of activities for the preparation of Statement of Cash Flows, have already been discussed. To summarise, the Cash Flow Statement can be prepared in the following format.

Opening Balance of Cash And Cash Equivalents	……………
Cash From Operating Activities	……………
Cash From Investing Activities	……………
Cash From Financing Activities	……………
Closing Balance Of Cash And Cash Equivalents	……………

Knowledge Assessment – II

State whether the following statements are true or false:

1. Cash Flow Statement records changes in long term solvency position of the company.
2. An improvement in cash position automatically improves the working capital position of the company and vice versa.
3. Funds Flow Statement classifies all transactions into operating, financing and investing activities.
4. A cash flow statement helps in short term planning of cash availability and disbursement.
5. A statement of cash flows helps in judging the profitability of the enterprise.
6. Cash Flow Statement and Funds Flow Statement are used synonymously.
7. Net cash flow does not take into account the non-cash items.

Answers

1. False, 2. False, 3.False, 4.True, 5.False, 6. False, 7. True

Illustration 5

Calculate cash flow from Investing Activities on the basis of the following information provided by Muneesh Ltd.

(Figures in Rs.)

Particulars	Opening Balance	Closing Balance
Building	1,00,000	1,20,000
Accumulated Depreciation	30,000	50,000

During the year, a portion of building costing Rs. 50,000 with accumulated depreciation of Rs. 30,000 was sold for Rs. 26,000.

Solution

Cash Flows from Investing Activities

Sale of Building	26,000
Purchase of Building	(70,000)
Net cash used in Investing Activities	(44,000)

Working Notes

Building Account

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Balance b/d	1,00,000	Cash (proceeds from sale of building)	26,000
Profit and Loss (profit on sale of building)	6,000	Accumulated Depreciation	30,000
Cash (balancing figure–new building purchased)	70,000	Balance c/d	1,20,000
	1,76,000		1,76,000

Accumulated Depreciation Account

Dr. **Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Building	30,000	Balance b/d	50,000
Balance c/d	30,000	Profit and Loss (depreciation provided during the year)	10,000
	60,000		60,000

Illustration 6

Prepare a Cash Flow Statement from the Balance Sheets of Arth Ltd. as on 31st March 2014 and 31st March 2015 are as follows:

(Figures in ₹ '000)

Liabilities	As on 31st March, 2014	As on 31st March, 2015	Assets	As on 31st March, 2014	As on 31st March, 2015
Capital	200	200	Land and Building	140	170
Reserves	96	98	Machinery	214	244
Loans	60	90		354	414
Current Liabilities	72	82	Depreciation	54	72
				300	342
			Cash	8	7.20
			Debtors	70	76.80
			Stock	50	44
	428	470		428	470

The company has paid dividends of ₹ 60,000 during the year.

Solution

Cash flow statement for the year ending 31st March, 2015

(Figures inRs.)

Particulars	Amount	Amount
A. Cash Flows From Operating Activities		
Current year profit before tax 60,000 + (98,000 – 96,000)	62,000	
+ Depreciation	18,000	
	80,000	
+ Increase in current liabilities	10,000	
+ Decrease in stock	6,000	
- Increase in debtors	(6,800)	89,200
B. Cash Flows From Investing Activities		
Purchase of Land and Building	(30,000)	
Purchase of Machinery	(30,000)	
Cash from investing activities		(60,000)
C. Cash Flows From Financing Activities		
Increase in loans	30,000	
Payment of dividend	(60,000)	

Cash from financing activities		(30,000)
Net Decrease in Cash during the year		(800)
Opening cash balance		8,000
Closing Cash Balance		7,200

Illustration 7

The Balance Sheets of Somebody Ltd. as on 31.3.2014 and 31.3.2015 provide the following information. Prepare Cash Flow Statement from the given figures:

(Figures inRs.)

Liabilities	2014	2015	Assets	2014	2015
Equity share capital	2,00,000	5,00,000	Fixed Assets	3,00,000	4,50,000
Profit and Loss	1,25,000	25,000	Stock	1,00,000	1,50,000
10% Debentures	1,00,000	75,000	Debtors	75,000	1,25,000
8% Preference Share Capital	50,000	75,000	Bank	45,000	65,000
General Reserve	45,000	1,15,000			
	5,20,000	**7,90,000**		**5,20,000**	**7,90,000**

During the year, a machinery costing Rs. 70,000 was sold for Rs. 15,000. Dividend of Rs. 24,000 was paid.

Solution

Calculation of Net Profit/ Loss before Tax:

Particulars	Rs.
Profit for the year	(1,00,000)
Add: Transfer to reserve	70,000
Add: Dividend	24,000
	(6,000)

Cash Flow Statement as on 31st March,2015

Particulars	**Rs.**	**Rs.**
A. Cash Flow from Operating Activities :		
Net Loss as per Profit & Loss Account		(6,000)
Adjustments :		
Add : Debenture Interest	10,000	
Add: Loss on sale of machinery	55,000	65,000
Operating Profit before Working Capital Changes		59,000
Adjustments for Working Capital Changes		
Less : Increase in Current Assets		

Stock	(50,000)	
Debtors	(50,000)	(1,00,000)
Net Cash used in Operating Activities		**(41,000)**
B. Cash Flow from Investing Activities		
Sale of Fixed Assets	15,000	
Purchase of Fixed Assets	(2,20,000)	
Net Cash used in Investing Activities		**(2,05,000)**
C. Cash Flow from Financing Activities :		
Issue of Equity Share Capital	3,00,000	
Issue of Preference Share Capital	25,000	
Redemption of Debentures	(25,000)	
Dividend Paid	(24,000)	
Interest on Debentures paid	(10,000)	
Net Cash Flow from Financing Activities		**2,66,000**
Net Increase / Decrease in Cash & Cash Equivalents		20,000
Add : Opening Cash and Cash Equivalents		45,000
Closing Cash and Cash Equivalents		65,000

Illustration 8

The Balance Sheets of Magnificent Ltd. provide the following information:

(Figures inRs.)

Liabilities	2014	2015	Assets	2014	2015
Equity Share Capital	10,00,000	15,00,000	Goodwill	2,00,000	1,80,000
Profit and Loss	6,00,000	7,50,000	Land & Building	8,00,000	6,50,000
Debentures	2,00,000	--	Plant & Machinery	4,00,000	3,60,000
Bank Loan	--	1,00,000	Investments	--	6,00,000
Provision for Taxation	80,000	95,000	Debtors	1,50,000	2,00,000
Creditors	60,000	70,000	Stock	1,00,000	1,80,000
Bills Payable	50,000	30,000	Cash	50,000	70,000
			Bank	2,90,000	3,05,000
	19,90,000	25,45,000		19,90,000	25,45,000

During the year, Land and Building worth Rs.1,50,000 was sold at a profit of 10%. The rate of Depreciation on Plant and Machinery is 10%.Dividend of Rs.1,50,000 was proposed and paid during the year. Income tax paid during the year includes Rs.15,000 on account of Dividend Tax.

Solution

CASH FLOW STATEMENT

Particulars	Rs.	Rs.
I. Cash flows from Operating Activities		
Net Profit before Taxation and Extraordinary Items	2,45,000	
Adjustment for –		
+ Depreciation	40,000	
+ Goodwill written-off	20,000	
+ Proposed Dividend	1,50,000	
– Profit on Sale of Land	(15,000)	
= Operating Profit before working capital charges	4,40,000	
+ Increase in Creditors	10,000	
– Decrease in Bills Payables	(20,000)	
– Increase in Debtors	(50,000)	
– Increase in Stock	(80,000)	
= Cash generated from Operations	3,00,000	
– Income Tax Paid	(65,000)	
A. Cash Inflows from Operations		2,35,000
II. Cash flows from Investing Activities		
Sale of Land and Building	1,65,000	
Purchase of Investment	(6,00,000)	
B. Cash used in Investing Activities		(4,35,000)
III. Cash flows from Financing Activities		
Issue of Equity Share Capital	5,00,000	
Redemption of Debentures	(2,00,000)	
Bank Loan	1,00,000	
Dividend Paid	(1,50,000)	
Dividend Tax Paid	(15,000)	
C. Cash flows from Financing Activities		2,35,000
Net Increase in cash and cash equivalents (A+B+C)		35,000
+ Cash and Cash Equivalents in the beginning		3,40,000
Cash and Cash Equivalent at the end		3,75,000

Working Notes:

(1) Total income tax paid during the year Rs. 80,0000
(–) Dividend tax paid (given) Rs. (15,000)

Income tax paid for operating activities Rs. 65,000

(2) Net profit earned during the year after tax and dividend
= Rs. 7,50,000 – 6,00,000

= Rs.1,50,000

(3) Net profit before tax
= Rs. 1,50,000 + Provision for tax made
= Rs. 1,50,000 + 95,000
= Rs. 2,45,000

Equity Share Capital Account

Dr. **Cr.**

Particulars	J.F.	Amount (Rs.)	Particulars	J.F.	Amount (Rs.)
Balance c/d		15,00,000	Balance b/d		10,00,000
			Cash (New capital raised)		5,00,000
		15,00,000			**15,00,000**

Debenture Account

Dr. **Cr.**

Particulars	J.F.	Amount (Rs.)	Particulars	J.F.	Amount (Rs.)
Cash (Redemption)		20,000	Balance b/d		20,000
		20,000			20,000

Land and Building Account

Dr. **Cr.**

Particulars	J.F.	Amount (Rs.)	Particulars	J.F.	Amount (Rs.)
Balance b/d		8,00,000	Cash		1,65,000
Profit and Loss (Profit on sale)		15,000	Balance c/d		6,50,000
		8,15,000			**8,15,000**

Proposed Dividend Account

Dr. **Cr.**

Particulars	J.F.	Amount (Rs.)	Particulars	J.F.	Amount (Rs.)
Cash		1,50,000	Profit and Loss		1,50,000
		1,50,000			1,50,000

Plant and Machinery Account

Dr. **Cr.**

Particulars	J.F.	Amount (Rs.)	Particulars	J.F.	Amount (Rs.)
Balance b/d		4,00,000	Depreciation		40,000
			Balance c/d		3,60,000
		4,00,000			4,00,000

KEYWORDS

1. **Cash:** Cash comprises cash on hand and demand deposits with banks.
2. **Cash equivalents:** Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
3. **Cash flows:** Cash flows are inflows and outflows of cash and cash equivalents.
4. **Operating activities:** Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
5. **Investing activities:** Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
6. **Financing activities:** Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.
7. **Cash Flow Statement**: The cash flow statement is a statement which reports cash flows during the period classified by operating, investing and financing activities.

SUMMARY

- Accounting Standard-3 (AS-3), or the new Ind AS – 7 deal with Statement of Cash Flows which aims toprovide the stakeholders with a basis to assess the liquidity position of the company.

- Statement of Cash Flows is prepared under three main categories of activities namely, operating, investing and financing activities.
- Investments of long term and the return thereof are included under investing activities.
- Activities relating to raising and redeeming long term funds are covered under financing activities.
- Both direct and indirect methods have been provided for in AS-3 for computation of cash flow from operating activities.
- Non-cash transactions are excluded from preparation of cash flow statement.
- Bank overdraft should be treated under financing activity as per Ind AS – 7.
- Funds Flow Statement deals with changes in working capital position as compared to Cash Flow Statement which covers the flow of cash during two Balance Sheet dates.

EXERCISE QUESTIONS

Short Answer Questions

1. What is meant by Cash Flow Statement?
2. Why is Cash Flow Statement prepared?
3. What is meant by Cash Equivalents?
4. When is interest received considered under financing activities?
5. Dividend received by a finance company will come under which activity while preparing a cash flow statement?
6. State with reason whether the following will result in inflow, outflow or no flow of cash
   a) Purchase of machinery worth Rs. 5,00,000 against issue of 10% debentures
   b) Interest paid on Bank Loan
   c) Sale of Marketable Securities at Par
   d) Payment of cash to creditors
   e) Depreciation charged by company
   f) Declaration of final dividend
   g) Redemption of Debentures
7. What do you understand by investing activities. Give examples.

Long Answer Questions

1. Differentiate between Funds Flow Statement and Cash Flow Statement.
2. Critically examine the significance of cash flow statement for the management and the investors.
3. "A Cash Flow Statement is a good substitute for Income Statement." Do you agree with this statement. State with reasons.
4. Explain the treatment of interest and dividend (both paid and received) in Cash Flow Statement.
5. How are the direct and indirect methods of calculating cash from operating activities different from each other. Explain with the help of an example.

6. State the limitations of Cash Flow Statement.
7. Financing activities require raising finance only. Comment.

Numerical Questions

1. Vishy Ltd. has earned a profit of Rs.10,00,000 after transferring Rs. 3,00,000 to General Reserve and charging depreciation of Rs.2,00,000 on assets. The company has sold machinery for a profit of Rs. 30,000 and has written off Rs. 70,000 on account of goodwill . The other information relating to working capital changes are as follows:

At the end of the year Debtors showed an increase of Rs.60,000; Creditors an increase of Rs.1,00,000; Prepaid Expenses an increase of Rs.2,000; Bills Receivable a decrease of Rs.30,000; Bills Payable a decrease of Rs.40,000 and Outstanding Expenses a decrease of Rs.20,000.

Ascertain the cash flow from the operating activities.

***(Answer:** Cash flow from operating Activities Rs.15,48,000)*

2. Jam Ltd. has reported a profit of Rs. 2,50,000 after appropriations and taking into consideration the following items:

Depreciation on Machinery	20,000
Loss on sale of Furniture	2,000
Goodwill written off	9,000
Provision for Taxation	35,000
Transfer to General Reserve	17,500
Gain on sale of Machinery	8,000

Additional Information:

	31.3.2014	31.3.2015
Trade Receivables	50,000	62,000
Trade payables	45,000	55,000
Inventory	12,000	8,000
Income received in Advance	8,000	--
Outstanding Expenses	6,000	3,000
Prepaid Expenses	--	5,000

Calculate cash from operating activities.

***(Answer:** Cash flow from Operating Activities Rs. 2,76,500)*

3. From the following information calculate the amount of cash flows from Investing Activities:

(Figures in Rs.)

Particulars	31.03.2014	31.03.2015
Plant and Machinery	17,00,000	20,00,000

Long Term Investments	80,000	2,00,000
Land (At cost)	4,00,000	2,00,000

Additional Information

(i) Depreciation charged on Plant and Machinery was 1,00,000

(ii) Plant and Machinery with a book value of 1,20,000 was sold for Rs.80,000

(iii) Land was sold at a gain of 1,20,000.

*(**Answer:** Net Cash used in Investing Activities (2,40,000))*

4. From the following information calculate the amount of cash flows from Investing Activities:

Particulars	**Rs.**
Long Term Investment purchased	27,00,000
Building sold	60,00,000
Land purchased during the year	50,00,000
Machinery purchased	45,00,000
Sale of Long Term Investments	16,00,000
Sale of Machinery	21,00,000
Dividend received on Shares as Investments	3,00,000
Interest received on Debentures held as Investments	11,00,000

*(**Answer:** Net Cash used in Investing Activities (11,00,000))*

5. XYZ Ltd., provided the following information, calculate net cash flows from financing activities**.**

Particulars	**31.03.2011**	**31.03.2012**
Equity Share Capital	50,00,000	60,00,000
12% Debentures	5,00,000	10,00,000

Additional Information:

1. Interest paid on Debentures Rs.60,000
2. Dividend Paid Rs. 2,50,000

*(**Answer:** Cash Flow from Financing Activities Rs. 11,90,000)*

6. From the following Balance Sheets of Vikas Ltd. as on 31.3.2014 and 31.3.2015, prepare a Cash Flow Statement:

(Figures in Rs.)

Liabilities	2014	2015	**Assets**	2014	2015
Share capital	90,000	1,30,000	Furniture	93,400	1,66,000
General Reserve	30,000	55,000	Stock	22,000	26,000
P & L Account	20,000	30,000	Debtors	36,000	39,000
Creditors	17,400	22,000	Cash	4,000	5,000

			Preliminary Expenses	2,000	1,000
	1,57,400	2,37,000		1,57,400	2,37,000

Additional Information:
(i) Depreciation charged on fixed assets for the year 2014 - 2015 was Rs. 20,000.
(ii) Income Tax Rs. 5,000 has been paid in advance during the year.

***(Answer:** Cash Flow from Operating Activities 38,500, Net Cash Used in Investing Activities (51,000), Cash Flow from Financing Activities 13,000)*

7. From the following Balance Sheets, prepare a Cash Flow Statement as per AS-3 (revised).

(Figures in Rs.)

Liabilities	2014	2015	**Assets**	2014	2015
Share capital	12,000	15,000	Furniture	5,000	8,000
P & L Account	5,000	6,000	Stock	6,000	4,000
Creditors	15,000	11 ,000	Debtors	10,000	8,000
			Cash	11,000	12,000
	32,000	**32,000**		**32,000**	**32,000**

A dividend of Rs. 3,000 was paid during the year 2014-15.

***(Answer:** Net Cash flow from operating activities Rs. 4,000, Cash used in investing activities (3,000), cash generated from financing activities Nil)*

8. Following is the Balance Sheet of Wisben Ltd. as on 31st March, 2015.

(Figures in Rs.)

Particulars	2015	2014
I. Equity and Liabilities		
- Shareholder's Funds		
a) Share Capital	7,00,000	6,00,000
b) Reserves and Surplus (Profit and Loss Balance)	2,00,000	1,10,000
- Non-Current Liabilities		
a) Long Term Borrowings	3,00,000	2,00,000
- Current Liabilities		
a) Trade Payables	30,000	25,000
Total	12,30,000	9,35,000
II. Assets		
- Non-Current Assets		
a) Fixed Assets Tangible Assets	 11,00,000	 11,00,000
b) Current Assets Inventories Trade Receivables	 70,000 32,000	 60,000 40,000

Cash and Cash Equivalents	28,000	35,000
Total	12,30,000	9,35,000

Adjustments:

During the year, a piece of machinery of the book value of Rs. 80,000 was sold for Rs. 65,000. Depreciation provided on tangible assets during the year amounted to Rs. 2,00,000.

Prepare a Cash Flow Statement.

(Answer: *Net Cash flow from operating activities Rs. 3,08,000, Cash used in investing activities (5,15,000), cash generated from financing activities 2,00,000)*

9. Prepare a Cash Flow Statement from the following Balance Sheet

(Figures in Rs.)

Particulars	Note No.	31.3.2015	31.3.2014
I – Equity and Liabilities :			
1. **Shareholder's Fund :**			
(a) Share Capital		6,00,000	5,00,000
(b) Reserves and Surplus	1	4,00,000	2,00,000
2. **Current Liabilities :**			
Trade Payables		2,80,000	1,80,000
Total		12,80,000	8,80,000
II – Assets :			
1. Non-Current Assets :			
(a) Fixed Assets :			
Plant and Machinery		5,00,000	3,00,000
2. **Current Assets :**			
(a) Inventories		1,00,000	1,50,000
(b) Trade Receivables		6,00,000	4,00,000
(c) Cash and Cash Equivalents		80,000	30,000
Total		12,80,000	8,80,000

Notes to Accounts

Note No. 1

Particulars	31.3.2015 (Rs.)	31.3.2014 (Rs.)
Reserves and Surplus		
Surplus (Balance in Statement of Profit & Loss)	4,00,000	2,00,000

Additional Information :

(i) An old machinery having book value of Rs. 50,000 was sold for Rs. 60,000.

(ii) Depreciation provided on Machinery during the year was Rs. 30,000.

(Answer: *Net Cash flow from operating activities Rs. 1,70,000, Cash used in investing activities (2,20,000), cash generated from financing activities 1,00,000)*

10. The following are the summarized Balance Sheets of Asthana Ltd. as on 31st March, 2014 and 2015. Prepare cash flow statement from the information provided.

(Figures in Rs.)

Liabilities	2014	2015	Assets	2014	2015
Share Capital	45,00,000	45,00,000	Fixed Assets	40,00,000	32,00,000
General Reserve	30,00,000	31,00,000	Investments	5,00,000	6,00,000
Profit & Loss Account	5,60,000	6,80,000	Stock	24,00,000	21,00,000
Creditors	16,80,000	13,40,000	Debtors	21,00,000	45,50,000
Provision for Taxation	7,50,000	1,00,000	Bank	14,000000000090,000	19,70,000
Loan (short-term)	--	27,00,000			
	1,04,90,000	1,24,20,000		1,04,90,000	1,24,20,000

Additional Information:

(i) Investment costing Rs. 80,000 was sold during the year for a profit of Rs. 5,000.

(ii) Provision for taxation of Rs. 90,000 was made during the year.

(iii) Fixed assets having book value of Rs. 1,00,000 were sold for Rs. 1,20,000.

(iv) The company paid a dividend of Rs. 4,00,000.

(Answer: *Net cash flows from operating activities Rs. 8,55,000, cash flows from investing activities Rs. 25,000, net cash used in financing activities Rs. 4,00,000)*

Annexure 1:

CASH FLOW STATEMENT OF INFOSYS

Consolidated Statements of Cash Flows Year ended March 31, (In Rscrore)	**2015**	**2014**
Operating activities:		
Net profit	12,329	10,648
Adjustments to reconcile net profit to net cash provided by operating activities:		
Depreciation and amortization	1,069	1,374
Income tax expense	4,929	4,062
Income on available-for-sale financial assets and certificates of deposits	(292)	(266)
Effect of exchange rate changes assets and liabilities	97	48
Deferred purchase price	252	188
Reversal of contingent consideration	-	(29)
Provision for doubtful account receivables	171	138
Other adjustments	79	55
Changes in working capital		
Trade receivables	(1,475)	(1,406)

Consolidated Statements of Cash Flows Year ended March 31, (In Rscrore)	2015	2014
Prepayments and other assets	(495)	(364)
Unbilled revenue	(34)	(376)
Trade payables	(17)	31
Client deposits	(13)	4
Unearned revenue	272	(163)
Other liabilities and provisions	631	2,121
Cash generated from operations	**17,503**	**16,065**
Income taxes paid	(6,751)	(3,878)
Net cash provided by operating activities	**10,752**	**12,187**
Investing activities:		
Expenditure on property, plant and equipment net of sale proceeds, including changes in retention money and capital creditors	(2,247)	(2,745)
Loans to employees	(8)	(23)
Deposits placed with corporation	(135)	(224)
Income on available-for-sale financial assets and certificates of deposit	327	204

Consolidated Statements of Cash Flows Year ended March 31, (In Rscrore)	2015	2014
Investment in associate	(94)	-
Payment for acquisition of business, net of cash acquired	(1282)	-
Investment in quoted debt securities	(1)	(936)
Redemption of quoted debt securities	-	2
Investment in certificates of deposit	-	(1,280)
Redemption of certificates of deposit	830	450
Investment in liquid mutual fund units	(23,892)	(22,691)
Redemption of liquid mutual fund units	25,096	22,383
Investment in fixed maturity plan securities	(30)	(143)
Redemption of fixed maturity plan securities	157	-
Net cash provided by / (used in) investing activities	**(1,279)**	**(5,003)**
Financing activities:		
Payment of dividends (including corporate dividend tax)	(4,935)	(3,143)
Net cash used in financing activities	**(4,935)**	**(3,143)**
Effect of exchange rate changes on cash and cash equivalents	(121)	77

Consolidated Statements of Cash Flows Year ended March 31, (In Rscrore)	2015	2014
Net increase/(decrease) in cash and cash equivalents	4,538	4,041
Cash and cash equivalents at the beginning	25,950	21,832
Cash and cash equivalents at the end	**30,367**	**25,950**
Supplementary information:		
Restricted cash balance	364	318

Annexure 2:

CASH FLOW STATEMENT OF TATA MOTORS

(₹ in crores)

		2013-2014		2012-2013
A.	**Cash flows from Operating Activities**			
	Profit after tax		334.52	301.81
	Adjustments for:			
	Depreciation / amortisation	2,070.30		1,817.62
	Lease equalisation adjusted in income	(4.52)		(4.52)
	Loss / (profit) on sale of assets (net) (including assets scrapped / written off)	20.29		2.96
	Profit on sale of investments (net)	(2,052.33)		(43.91)
	Profit on sale of a division	-		(82.25)
	Provision for loan given and cost associated with closure of operations of a subsidiary	202.00		245.00
	Provision for loans and inter corporate deposits (net)	-		5.29
	Provision / (reversal) for diminution in value of investments	17.52		(9.67)
	Tax credit (net)	(1,360.32)		(126.88)
	Interest / dividend (net)	(443.18)		(656.52)
	Exchange differences (net)	276.90		199.39
			(1,273.34)	1,346.51
	Operating Profit before working capital changes		(938.82)	1,648.32
	Adjustments for:			
	Inventories	592.50		129.42
	Trade receivables	601.34		890.28
	Finance receivables	15.00		64.76
	Other current and non-current assets	141.37		(138.30)
	Trade payables and acceptances	1,212.83		(249.93)
	Other current and non-current liabilities	249.25		(381.50)
	Provisions	646.05		188.06
			3,458.34	502.79
	Cash generated from operations		2,519.52	2,151.11
	Income taxes credit / (paid) (net)		(56.06)	107.33
	Net cash from operating activities		2,463.46	2,258.44
B.	**Cash flows from Investing Activities**			
	Payments for fixed assets	(3,105.42)		(2,605.39)
	Proceeds from sale of fixed assets	11.37		16.95
	Proceeds from sale of a division	-		110.00
	Realisation of loans to associates and subsidiaries	297.83		-
	Loans to associates and subsidiaries	(146.28)		(194.36)
	Advance towards investments in subsidiary companies	(135.15)		(16.82)
	Investments in joint venture	(325.00)		-
	Investments in subsidiary companies	(443.18)		(186.12)
	Investments in associate companies	-		(0.01)
	Investments - others	-		(0.84)
	Investments in Mutual Fund (purchased) / sold (net)	445.63		(315.51)
	Decrease in investments in retained interests in securitisation transactions	-		0.63
	Sale / redemption of investments in subsidiary companies	3,978.48		1,378.95
	Redemption of investments in associate companies	-		21.00
	Redemption of investments - others	-		10.75
	(Increase) / decrease in short term inter corporate deposits	(40.00)		43.53
	Deposits of margin money / cash collateral	-		(1.38)
	Realisation of margin money / cash collateral	-		91.25
	Fixed/restricted deposits with scheduled banks made	(530.15)		(205.85)
	Fixed/restricted deposits with scheduled banks realised	760.40		780.00
	Fixed deposits with financial institution made	(200.00)		-
	Fixed deposits with financial institution realized	200.00		-
	Interest received	181.70		404.07
	Dividend received	1,602.68		1,660.65
	Net Cash from Investing Activities		2,552.91	991.50
C.	**Cash flows from Financing Activities**			
	Expenses on Foreign Currency Convertible Notes (FCCN) / Convertible Alternative Reference Securities (CARS) conversion	(0.35)		(0.23)
	Premium on redemption of FCCN / (CARS) (including tax)	-		(886.95)
	Brokerage and other expenses on Non-Convertible Debentures (NCD)	(87.54)		(93.02)
	Premium paid on redemption of NCD	(658.05)		(96.55)
	Proceeds from issue of shares held in abeyance	0.09		0.16
	Repayment of fixed deposits	(362.19)		(1,868.38)
	Proceeds from long-term borrowings	2,310.59		2,562.84
	Repayment of long-term borrowings	(2,232.38)		(3,377.47)
	Proceeds from short-term borrowings	8,548.00		11,873.79
	Repayment of short-term borrowings	(8,679.86)		(10,177.80)
	Net change in other short-term borrowings (with maturity up to three months)	(1,473.41)		1,287.75
	Dividend paid (including dividend distribution tax)	(648.81)		(1,460.41)
	Interest paid [including discounting charges paid, ₹ **373.78 crores** (2012-2013 ₹ 345.06 crores)]	(1,749.90)		(1,809.42)
	Net Cash used in financing activities		(5,033.81)	(4,045.69)
	Net Decrease in cash and cash equivalents (A+B+C)		(17.44)	(795.75)
	Cash and cash equivalents as at April 01, (opening balance)		205.57	919.64
	Exchange fluctuation on foreign currency bank balances		10.55	81.68
	Cash and cash equivalents as at March 31, (closing balance)		198.68	205.57
	Non-cash transactions :			
	Foreign Currency Convertible Notes (FCCN) / Convertible Alternative Reference Securities (CARS) converted to Ordinary shares		413.34	232.83

In terms of our report attached

For **DELOITTE HASKINS & SELLS LLP**
Chartered Accountants

B P SHROFF
Partner

Mumbai, May 29, 2014

CYRUS P MISTRY
Chairman

RAVI KANT
Vice-Chairman

For and on behalf of the Board

N N WADIA
R A MASHELKAR
S BHARGAVA
N MUNJEE
V K JAIRATH
F NAYAR
R SPETH
Directors

R PISHARODY
Executive Director

S B BORWANKAR
Executive Director

C RAMAKRISHNAN
Chief Financial Officer

H K SETHNA
Company Secretary

Mumbai, May 29, 2014