Auditing Course Material

Part 20 of 61 (Chapters 1901-2000)

8. Activity Ratios

Payable Turnover is an activity ratio that measures how quickly a company pays off its suppliers and creditors over a specific period. This ratio shows the frequency with which a company fulfills its payable obligations, indicating the efficiency of its cash outflows toward accounts payable. It is also called Accounts Payable Turnover Ratio, Creditors Turnover Ratio or Trade Payables Turnover.

$$\text{Payable Turnover} = \frac{\text{Cost of Goods Sold (COGS)}}{\text{Average Accounts Payable}}$$

where:

- *Cost of Goods Sold (COGS)* represents the direct costs of producing goods sold by the company.
- *Average Accounts Payable* is calculated by averaging the beginning and ending accounts payable for the period.

Example
Suppose a company has:
Cost of Goods Sold (COGS) = ₹10,00,000
Beginning Accounts Payable = ₹2,00,000
Ending Accounts Payable = ₹1,50,000

First, calculate Average Accounts Payable and then calculate Payable Turnover:

$$\text{Payable Turnover} = \frac{10,00,000}{1,75,000} = 5.7$$

Where,

$$\text{Average Accounts Payable} = \frac{2,00,000 + 1,50,000}{2} = ₹\ 1,75,000$$

This result means the company pays off its accounts payable about 5.7 times in the period.

Interpretation

- **High Payable Turnover:** A high ratio suggests the company pays its suppliers promptly, which can be good for maintaining positive relationships with suppliers. However, it may also indicate a lack of cash flexibility if the company is paying too quickly.
- **Low Payable Turnover:** A low ratio indicates slower payments to suppliers, which may suggest efficient cash flow management or, alternatively, potential issues with liquidity.

Days Payable Outstanding (DPO)

Days Payable Outstanding (DPO) measures the average number of days a company takes to pay its suppliers after receiving goods or services. It provides a time-focused view of how long the company holds onto its cash before settling its obligations, impacting cash flow and liquidity. It is also called Average Payment Period, Days Payables Outstanding or Creditors Collection Period.

$$\text{Days Payable Outstanding (DPO)} = \frac{365}{\text{Payable Turnover}}$$

Or, alternatively,

$$\text{DPO} = \frac{\text{Average Accounts Payable}}{\text{Cost of Goods Sold (COGS)}} \times 365$$

Example
Using the previous example:
Payable Turnover = 5.7

Calculate DPO:

$$\text{DPO} = \frac{365}{5.7} = 64 \text{ days}$$

This result means the company takes, on average, 64 days to pay its suppliers.

Interpretation

- **Low DPO:** A low DPO indicates the company is paying its suppliers quickly, which may reflect good supplier relationships but could also reduce cash flexibility.
- **High DPO:** A high DPO suggests the company is taking longer to pay its suppliers, potentially indicating strategic cash flow management to hold onto cash longer or delays due to cash constraints.

Usefulness

The Payable Turnover helps assess a company's efficiency in meeting short-term obligations, ensuring suppliers are paid timely without impacting liquidity. DPO complements Payable Turnover by providing the average time a company takes to pay its suppliers, giving a clearer picture of cash management practices.

8. Activity Ratios

XYZ Ltd. provides the following financial data:

Income Statement Information:
Net Sales (Revenue) = ₹15,00,000

Balance Sheet Information:
Total Assets (Beginning of Year) = ₹8,00,000
Total Assets (End of Year) = ₹12,00,000
Fixed Assets (Beginning of Year) = ₹4,00,000
Fixed Assets (End of Year) = ₹6,00,000
Current Assets (Beginning of Year) = ₹3,00,000
Current Assets (End of Year) = ₹5,00,000
Current Liabilities (Beginning of Year) = ₹1,50,000
Current Liabilities (End of Year) = ₹2,50,000

Using this data, calculate the following turnover ratios:
1. Total Assets Turnover
2. Fixed Assets Turnover
3. Working Capital Turnover

Solution:

Step 1: Calculate the Average Values

To compute these ratios, we need the average values for Total Assets, Fixed Assets, Current Assets, and Current Liabilities.

(a) Average Total Assets

$$\text{Average Total Assets} = \frac{\text{Beginning Total Assets} + \text{Ending Total Assets}}{2}$$

$$= \frac{8,00,000 + 12,00,000}{2} = 10,00,000$$

(b) Average Fixed Assets

$$\text{Average Fixed Assets} = \frac{\text{Beginning Fixed Assets} + \text{Ending Fixed Assets}}{2}$$

$$= \frac{4,00,000 + 6,00,000}{2} = 5,00,000$$

(c) Average Working Capital

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

Calculate Beginning Working Capital and Ending Working Capital.

$$\text{Beginning Working Capital} = 3{,}00{,}000 - 1{,}50{,}000 = 1{,}50{,}000$$

$$\text{Ending Working Capital} = 5{,}00{,}000 - 2{,}50{,}000 = 2{,}50{,}000$$

Now, Calculate Average Working Capital

$$\text{Average Working Capital} = \frac{1{,}50{,}000 + 2{,}50{,}000}{2} = 2{,}00{,}000$$

Step 2: Calculate Turnover Ratios

1. Total Assets Turnover

The Total Assets Turnover ratio measures how efficiently a company uses its total assets to generate sales.

$$\text{Total Assets Turnover} = \frac{\text{Net Sales}}{\text{Average Total Assets}}$$

Using values,

$$\text{Total Assets Turnover} = \frac{15{,}00{,}000}{10{,}00{,}000} = 1.5$$

Interpretation: A Total Assets Turnover of 1.5 means that XYZ Ltd. generates ₹1.5 in sales for every ₹1 invested in total assets, indicating good overall asset utilization.

2. Fixed Assets Turnover

The Fixed Assets Turnover ratio measures how efficiently a company uses its fixed assets to generate sales.

$$\text{Fixed Assets Turnover} = \frac{\text{Net Sales}}{\text{Average Fixed Assets}}$$

Using values,

$$\text{Fixed Assets Turnover} = \frac{15{,}00{,}000}{5{,}00{,}000} = 3.0$$

Interpretation: A Fixed Assets Turnover of 3.0 indicates that XYZ Ltd. generates ₹3 in sales for every ₹1 invested in fixed assets, reflecting effective utilization of its long-term assets, like property and equipment.

3. Working Capital Turnover

The Working Capital Turnover ratio measures how efficiently a company uses its working capital to support sales.

$$\text{Working Capital Turnover} = \frac{\text{Net Sales}}{\text{Average Working Capital}}$$

Using values,

$$\text{Working Capital Turnover} = \frac{15,00,000}{2,00,000} = 7.5$$

Interpretation: A Working Capital Turnover of 7.5 means that XYZ Ltd. generates ₹7.5 in sales for every ₹1 of working capital, indicating effective use of short-term assets and liabilities in generating revenue.

8. Activity Ratios

ABC Ltd. Financial Data (for the year ending Dec 31, 2025)
ABC Ltd. provides the following financial data:

Income Statement Information:
Net Sales (Revenue) = ₹12,00,000
Cost of Goods Sold (COGS) = ₹8,00,000

Balance Sheet Information:
Inventory (Beginning of Year) = ₹1,50,000
Inventory (End of Year) = ₹1,00,000
Accounts Receivable (Beginning of Year) = ₹1,20,000
Accounts Receivable (End of Year) = ₹1,80,000
Accounts Payable (Beginning of Year) = ₹80,000
Accounts Payable (End of Year) = ₹1,20,000

Using this data, calculate the following ratios:
1. Inventory Turnover
2. Days Inventory Outstanding (DIO)
3. Receivable Turnover
4. Days Sales Outstanding (DSO)
5. Payable Turnover
6. Days Payable Outstanding (DPO)

Solution:

Step 1: Calculate the Average Values

To calculate these ratios, we first need the average values for Inventory, Accounts Receivable, and Accounts Payable.

(a) Average Inventory

$$\text{Average Inventory} = \frac{\text{Beginning Inventory} + \text{Ending Inventory}}{2}$$

$$= \frac{1,50,000 + 1,00,000}{2} = 1,25,000$$

(b) Average Accounts Receivable

$$\text{Average Accounts Receivable} = \frac{\text{Beginning Accounts Receivable} + \text{Ending Accounts Receivable}}{2}$$

$$= \frac{1,20,000 + 1,80,000}{2} = 1,50,000$$

(c) Average Accounts Payable

$$\text{Average Accounts Payable} = \frac{\text{Beginning Accounts Payable} + \text{Ending Accounts Payable}}{2}$$

$$= \frac{80{,}000 + 1{,}20{,}000}{2} = 1{,}00{,}000$$

Step 2: Calculate Ratios

1. Inventory Turnover

The Inventory Turnover ratio measures how many times a company's inventory is sold and replaced over a period.

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold (COGS)}}{\text{Average Inventory}}$$

Using Values,

$$\text{Inventory Turnover} = \frac{8{,}00{,}000}{1{,}25{,}000} = 6.4$$

Interpretation: An Inventory Turnover of 6.4 means that ABC Ltd. cycles through its inventory 6.4 times a year, indicating efficient inventory management.

2. Days Inventory Outstanding (DIO)

Days Inventory Outstanding (DIO) measures the average number of days inventory is held before it is sold.

$$\text{DIO} = \frac{365}{\text{Inventory Turnover}}$$

Using Values,

$$\text{DIO} = \frac{365}{6.4} \approx 57.03 \text{ days}$$

Interpretation: A DIO of approximately 57 days indicates that, on average, ABC Ltd. holds its inventory for 57 days before it is sold.

3. Receivable Turnover

The Receivable Turnover ratio measures how efficiently a company collects cash from its credit sales.

$$\text{Receivable Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

Using values,

$$\text{Receivable Turnover} = \frac{12,00,000}{1,50,000} = 8$$

Interpretation: A Receivable Turnover of 8 means that ABC Ltd. collects its receivables 8 times a year, indicating efficient collection practices.

4. Days Sales Outstanding (DSO)

Days Sales Outstanding (DSO) measures the average number of days it takes for a company to collect payment after a sale on credit.

$$DSO = \frac{365}{\text{Receivable Turnover}}$$

$$DSO = \frac{365}{8} \approx 45.63 \text{ days}$$

Interpretation: A DSO of approximately 46 days indicates that, on average, it takes ABC Ltd. 46 days to collect payments after a sale.

5. Payable Turnover

The Payable Turnover ratio measures how quickly a company pays off its suppliers.

$$\text{Payable Turnover} = \frac{\text{Cost of Goods Sold (COGS)}}{\text{Average Accounts Payable}}$$

$$\text{Payable Turnover} = \frac{8,00,000}{1,00,000} = 8$$

Interpretation: A Payable Turnover of 8 means that ABC Ltd. pays off its accounts payable 8 times a year, indicating regular payments to suppliers.

6. Days Payable Outstanding (DPO)

Days Payable Outstanding (DPO) measures the average number of days it takes for a company to pay its suppliers.

$$DPO = \frac{365}{\text{Payable Turnover}}$$

$$DPO = \frac{365}{8} \approx 45.63 \text{ days}$$

Interpretation: A DPO of approximately 46 days indicates that, on average, ABC Ltd. takes 46 days to pay its suppliers.

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9. Limitations of Ratio analysis

While ratio analysis is a valuable tool for assessing financial performance, it has several limitations:

- **Historical Data Dependency:** Ratios are based on historical financial data, which may not reflect current conditions or future performance, especially in rapidly changing industries.
- **Lack of Context:** Ratios alone don't provide context for unusual numbers or trends. They require additional analysis and comparison with industry standards to be meaningful.
- **Inflation and Accounting Policies:** Different accounting policies (e.g., depreciation methods) and inflation effects can distort ratios, making comparisons across companies or time periods less reliable.
- **Limited Qualitative Insight:** Ratios offer quantitative analysis but don't capture qualitative factors such as management quality, employee morale, or brand reputation, which can also impact financial performance.
- **Single-Period Snapshot:** Ratios provide a snapshot of a specific period, which may overlook seasonal fluctuations or one-time events, giving an incomplete picture of financial health.
- **Potential for Misinterpretation:** Ratios can be misinterpreted if analyzed in isolation or without industry benchmarks, leading to inaccurate conclusions about a company's performance.

Despite these limitations, ratio analysis remains useful when combined with other financial and qualitative analyses to provide a comprehensive view of a company's financial standing.

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1. Introduction

The sole proprietorship has its limitations such as limited capital, limited managerial ability and limited risk-bearing capacity. Hence, when a business expands or when it is to be set up on a scale, which needs more capital and involves more risk, two or more persons join hands to run it. They agree to share the capital, the management, the risk, and profits of the business. Such mutual economic relationship based on a written or an oral agreement amongst these persons is termed as 'partnership'. The persons who have entered into partnership are individually known as 'partners' and collectively as 'firm' and the name under which their business is carried on is called the firm's name.

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.

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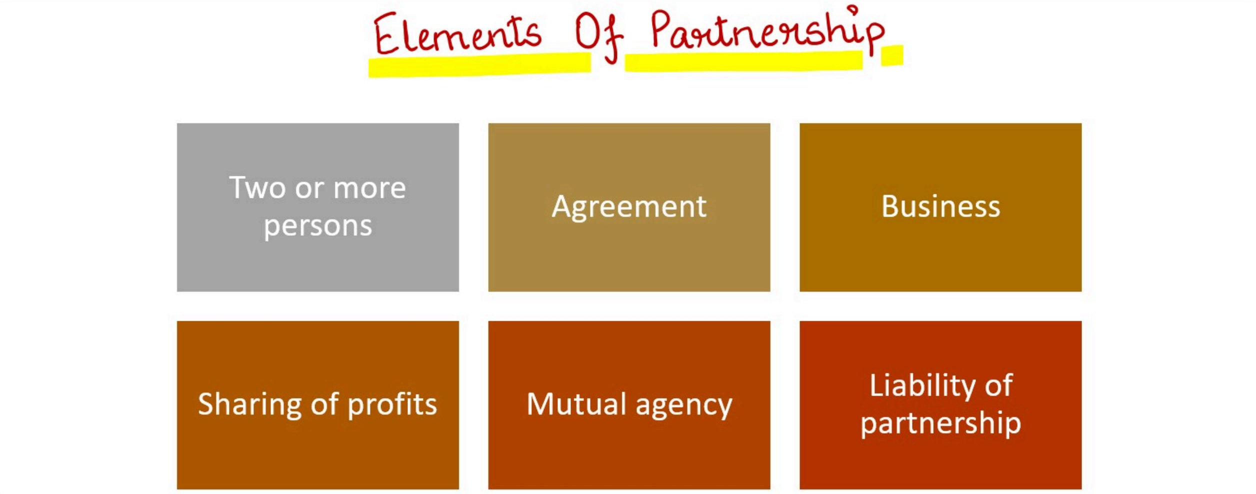
1. Introduction

The essential elements of Partnership are discussed below.



1. **Two or more Persons:** There must be at least two partners in a partnership firm. The Partnership Act is silent about the maximum number of members, but, according to section 464 of the Companies Act, 2013, the number of partners in any association shall not exceed 100. However, the Rule 10 given under the Companies (Miscellaneous) Rules, 2014 restricts the present limit to 50. Thus, in effect, a partnership firm cannot have more than 50 members.
2. **Agreement:** A partnership is an agreement between partners. The agreement may be written, or it may be verbal also.
3. **Business:** Partnership is formed for doing business that is legal.
4. **Sharing of Profits:** Profit and loss of the partnership firm will be divided among the partners in their profit-sharing ratio.
5. **Mutual Agency:** The business of the partnership firm may be carried by all the partners or any of them acting for all. This statement has two important implications. First, every partner is entitled to participate in the conduct of the affairs of its business. Second, that there exists a relationship of mutual agency between all the partners. Each partner carrying on the business is the principal as well as the agent for all the other partners.
6. **Liability of Partnership:** Each partner is liable jointly with all the other partners and severally to the third party for all the acts of the firm done while he is a partner. Not only that, the liability of a partner for acts of the firm is also unlimited. This implies that his private assets can be used to pay off the firm's debts.

2. Partnership Deed

A partnership is formed by an agreement. This agreement may be expressed (i.e., oral or in writing) or implied. 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 term of a partnership as agreed among the partners is called a *partnership deed*. The deed is required to be duly stamped as per the Indian Stamp Act, 1889 and duly signed by all the partners. The clauses of the partnership deed can be altered with the consent of all the partners.

The partnership deed contains various provisions relating to various matters such as:

- Name of the firm, address, and its main business.
- Names and addresses of all partners.
- Nature and place of business.
- Date of commencement of partnership.
- Duration of partnership.
- Amount of capital of each partner.
- Profit-sharing ratio.
- Interest on capital.
- Interest on drawings.
- Interest on a loan advanced by a partner to the firm.
- Salary or commission payable to any partner.
- Method of valuation of goodwill and other assets and liabilities in case of admission or retirement or death of a partner.
- Settlement of accounts in case of retirement/death of a partner and dissolution of the firm.

In case, there is no partnership deed in place, then the following rules shall be applicable, as per the Indian Partnership Act, 1932.

Profit-sharing Ratio	Equal, Irrespective of capital contribution.
Interest on Capital	No Interest on Capital is to be allowed to any Partner
Interest on Drawings	No interest on Drawings is to be charged to any partner
Salary or Commission to a Partner	Not allowed to any partner
Interest on loan by a Partner	Interest is allowed @ 6% per annum

Apart from the above, the Indian Partnership Act specifies that subject to a contract between the partners:

i. If a partner derives any profit for him/ her self from any transaction of the firm or from the use of the property or business connection of the firm or the firm name, he/she shall account for the profit and pay it to the firm.
ii. If a partner carries on any business of the same nature as that of the firm, he/she shall account for and pay to the firm, all profits made by him/her in that business.

2. Partnership Deed

Amrita, Lalita, and Charu are partners in a firm without a Partnership Deed.

1. Amrita, has contributed more capital than other partners and demands interest on capital at 10% per annum but Lalita and Charu do not agree with her.
2. Lalita devotes herself full-time into the business and demands a salary of ₨. 5,000 p.m. but Amrita and Charu do not agree with her.
3. Charu demands an interest of 12% per annum (market rate) on the loan amount of Rs. 50,000 extended by her to the firm.
4. Amrita has withdrawn Rs. 10,000 from the firm for his personal use. Lalita and Charu demand that interest on drawings should be charged @ 10% per annum.
5. Profit before considering any of the above claims was Rs. 50,000 at the end of the first year of the business. Amrita demands a share of profit in the capital ratio.
6. Lalita wants to introduce his son Inder as a partner. Charu objects to his proposal.

State with reasons how will the above matters be resolved?

Solution:

The partners do not have a Partnership Deed. Therefore, provisions of the Indian Partnership Act, 1932 will apply to resolve the matters:

1. Interest on capital is not payable to the partner. Therefore, Amrita will not get interest on the capital.
2. Remuneration is not payable to the partner. Therefore, Lalita will not get the salary.
3. Interest on Loan by Partner is payable @ 6% p.a. Therefore, Charu will is entitled get interest 3,000 (i.e., 50,000 × $\frac{6}{10}$).
4. Interest on Amrita's Drawings will not be charged.
5. Profit after Interest on Loan by Charu, i.e., Rs. 47,000 (Rs. 50,000 – Rs. 3,000) is to be distributed equally. Interest on a loan to a partner is treated as a charge against profit.
6. A person cannot be introduced as a partner without the consent of all the partners. Therefore, Inder cannot be admitted into partnership because Charu objects to it.

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3. Capital Accounts of Partners

All transactions relating to partners of the firm are recorded in the books of the firm through their capital accounts. This includes the amount of money brought in as capital, withdrawal of capital, the share of profit, interest on capital, interest on drawings, partner's salary, commission to partners, etc. There are 2 methods by which the capital accounts of partners can be maintained.

i. Fixed Capital Method
ii. Fluctuating Capital Method.

The difference between the two lies in whether the transactions other than the addition/withdrawal of capital are recorded in the capital accounts of the partners. Just like any other business, books of accounts are maintained in the firm. In a partnership firm, capital account of each partner is maintained separately.

Let us discuss the methods that are used for maintaining partners' capital account one by one.

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3. Capital Accounts of Partners

In this method, the capital of the partners will be fixed in the books of accounts. To maintain the fixed balance of capital, a separate account, i.e., the partner's current account is opened. Interest on capital, interest on drawings, salary, profit, and loss, etc. are shown in the current account. The column of "Amount in Rs." can have further sub-columns like Partner A, Partner B, and so on.

Dr. Partner's Current Account Cr.

Date	Particulars	J.F	Amount in Rs.	Date	Particulars	J.F.	Amount in Rs.
	To Balance b/d (in case of debit opening balance) To Drawings To Interest on Drawings To Profit and Loss Appropriation A/c (for share of loss) To Balance c/d (in case of credit opening balance)				By Balance b/d (in case of credit opening balance) By Salary By Commission By Interest on Capital By Profit and Loss Appropriation A/c (for a share of profit) By Balance c/d (in case of debit closing balance)		

Dr. Partner's Capital Account Cr.

Date	Particulars	J.F	Amount in Rs.	Date	Particulars	J.F.	Amount in Rs.
	To Bank A/c (permanent withdrawal of capital) balance c/d (Closing Balance)				By Balance b/d (Opening Balance) By Bank A/c (Fresh capital introduced)		

3. Capital Accounts of Partners

Under the fluctuating capital method, only one account, i.e. capital account is maintained for each partner. All the adjustments, such as share of profit and loss, interest on capital, drawings, interest on drawings, salary, or commission to partners, etc. are recorded directly in the capital accounts of the partners. This causes the balance in the capital account to fluctuate from time to time. That's the reason why this method is called fluctuating capital method. The column of "Amount in Rs." can have further sub-columns like Partner A, Partner B, and so on.

Dr.		**Partner's Capital Account**				**Cr.**	
Date	**Particulars**	**J.F**	**Amount in Rs.**	**Date**	**Particulars**	**J.F.**	**Amount in Rs.**
	To Drawings Interest on Drawings To Profit and Loss Appropriation A/c (For Share of Loss)				By Balance b/d By Bank A/c (Fresh capital introduced) By Salaries By Interest on Capital By Profit and Loss Appropriation A/c (For Share of Profit)		

3. Capital Accounts of Partners

The difference between the two methods is mentioned below:

Basis	**Fixed Capital Method**	**Fluctuating Capital Method**
Number of Accounts	Under this method, two separate accounts are maintained for each partner (i.e., Capital Account and Current Account).	Under this method, one account is maintained for each partner (i.e., Capital Account).
Adjustments	All adjustments for drawings, salary, interest on capital, etc. are made in the current account and not in the capital account of the partners.	All adjustments for drawings, salary, interest on capital, etc. are made in the capital account of the partners.
Fixed Balance	The capital account balance remains unchanged unless there is an addition to or withdrawal of capital.	The balance of the capital account fluctuates from year to year.
Credit Balance	The capital account of the partners always shows a credit balance.	The capital account of partners may sometimes show a debit balance and sometimes a credit balance.

4. Distribution of Profits among Partners

The profits and losses of the firm are distributed among the partners in an agreed ratio. However, if the partnership deed is silent, the firm's profits and losses are to be shared equally by all the partners. In the case of a sole proprietorship, the profit or loss, as ascertained by the profit and loss account is transferred to the capital account of the proprietor.

In the case of a partnership, however, certain adjustments such as interest on drawings, interest on capital, salary to partners, and commission to partners are required to be made. For this purpose, it is customary to prepare a Profit and Loss Appropriation Account of the firm and ascertain the final figure of profit and loss to be distributed among the partners, in their profit-sharing ratio.

4. Distribution of Profits among Partners

Akhil and Bharat are partners sharing profits and losses in ratio 2:3 with capitals of Rs. 2,00,000 and Rs.1,00,000. On 1st October 2019, Akhil and Bharat gave loans of Rs. 4,00,000 and Rs. 2,00,000 respectively to the firms. There is no agreement as to payment of interest on the loan by a partner.

Determine the amount of profit or loss for the year ended 31^{st} March 2020 to be distributed between the partners in each of the following cases:
Case 1. If the Profit before interest for the year amounted to Rs 25,000.
Case 2. If the Profit before interest for the year amounted to Rs 15,000.
Case 3. If the Loss before interest for the year amounted to Rs 25,000.

Solution:

When there is no agreement for payment of interest on the loan among partners, interest @ 6% p.a. is allowed on loan by a partner as per the Indian Partnership Act, 1932.

Case 1. Distributable Profit/Loss

Case 1. Distributable Profit / loss
= Profit before interest − interest on loan by partners
= 25000 − 18000
= 7000

Working Note :
⇒ Interest on loan by Akhil

$$= 4,00,000 \times \frac{6}{100} \times \frac{6}{12} = 12000$$

⇒ Interest on loan by Bharat

$$= 2,00,000 \times \frac{6}{100} \times \frac{6}{12} = 6000$$

Total interest on loan by partners = Rs 18000

Case 2. Distributable Profit/Loss
= Profit before Interest - Interest on Loan by Partners = Rs. 15,000 - 18,000 = Rs. 3,000 (Loss).

Note: Interest on loan by a partner being a charge against profit is paid or credited to Loan by Partners Account even if profit is less than the amount of interest on the loan. The resulting loss is distributed between partners in the profit-sharing ratio.

Case 3. Distributable Profit/Loss
= Loss before Interest + Interest on Loan by Partners = Rs. 25,000 + 18,000 = Rs. 43,000 (Loss).

Note: If there is already a loss, the amount of interest on loan will add to the loss and then the total loss will be distributed among the partners in the profit-sharing ratio.

5. Profit and Loss Appropriation Account

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. It shows how the profits are appropriated or distributed among the partners. All adjustments in respect of partner's salary, partner's commission, interest on capital, interest on drawings, etc. are made through this account. The net profit/net loss as per the Profit and Loss Account is transferred to this account. The Pro-forma of Profit and Loss Appropriation Account is given below.

Dr. Pro-Forma Profit and Loss Appropriation Account Cr.

Date	Particulars	J.F	Amount in Rs.	Date	Particulars	J.F.	Amount in Rs.
	To Profit and Loss A/c (If there is Loss) To Interest on Capital To Salary to Partner To Commission to Partner To Interest on Partner's Loan To Partner's Capital A/c (Distribution of Profits)				By Profit and Loss A/c (If there is Profit) By Interest on Drawings By Partner's Capital A/c (Distribution of Loss)		

5. Profit and Loss Appropriation Account

Amit and Swati started business on 1st April 2019 with capital of Rs. 3,00,000 and Rs. 2,00,000 respectively. According to the Partnership Deed, Swati is to get the salary of Rs. 5,000 per month, Amit is to get 10% commission on Profit after allowing salary to Swati. Interest is to be allowed on capitals @ 6% p.a. Profit-sharing ratio between the two partners is 3: 2. Amit had given a loan of Rs. 1,00,000 to the firm on 1st April 2019. Interest on the loan was allowed @ 8% p.a. Swati was given a loan of Rs. 2,00,000 on which interest of Rs. 11,000 was charged. The manager was to be allowed a commission of Rs. 3,000. During the year, the firm earned a profit of Rs. 2,50,000 before providing for above adjustment.

Pass Journal entries for distribution of profit and prepare Profit and Loss Appropriation Account. The firm closes its books of account on 31st March every year.

Solution:

Profit and Loss Appropriation Account

Particulars	**Amount (Rs).**	**Particulars**	**Amount Rs.)**
To Salary—Swati's Capital A/c	60,000	By Profit and Loss Adjustment A/c (Net Profit after adjusting for omitted items.)	2,50,000
To Commission—Amit 's Capital A/c	19,000		
To Interest on Capital—Amit's Capital A/c	18,000		
To Interest on Capital— Swati's Capital A/c	12,000		
To Profit transferred to:			
Amit's Capital A/c (3/5) Rs. 84,600			
Swati's Capital A/c (2/5) Rs. 56,400	1,41,000		
	2,50,000		**2,50,000**

Working note:

Dr.		**Profit and Loss Adjustment A/c**	**Cr.**
Particulars	**Amount (Rs.)**	**Particulars**	**Amount (Rs.)**
Interest on Loan (Amit)	8,000	Profit and Loss A/c	2,50,000
Manager's commission	3000	Interest on Loan (received by Swati)	11,000
Net Profit to be transferred to profit and loss appropriation A/c	2,50,000		
	2,61,0000		**2,61,000**

If items that are in nature of charge against profit have been omitted while calculating the profit for the current year, a Profit and Loss Adjustment A/c is prepared to find the amount of profit to be transferred to Profit and Loss Appropriation A/c i.e., to be distributed among partner.

Journal entries in the books of firm are as follows:

Date	Particulars	L. F.	Debit	Credit
31st March, 2020	Profit and Loss A/c... Dr		2,50,000	
	To Profit and Loss Appropriation A/c (Being transfer of net profit to Profit and Loss Appropriation Account)			2,50,000
	Swati's Salary A/c ...Dr		60,000	
	To Swati's Capital A/c (Being Salary due to Swati, Rs. 5000 × 12)			60,000
	Amit's Commission A/c ... Dr.		19,000	
	To Amit's Capital A/c (Being Commission due to Amit ((Rs. 2,50,000 - Rs. 60,000) × 10%)			19, 000
	Profit and Loss Appropriation A/c... Dr.		79,000	
	To Swati's Salary A/c			60,000
	To Amit's Commission A/c(Being salary and commission to Partners transferred to Profit and Loss Appropriation Account)			19,000
	Interest on Capital A/c... Dr.		30,000	
	To Amit's Capital A/c			18,000
	To Swati's Capital A/c (Being Interest on capitals allowed to partners @ 6% p.a.)			12,000
	Profit and Loss Appropriation A/c ...Dr.		30,000	
	To Interest on Capital A/c (Being Interest on capitals transferred to Profit and Loss Appropriation Account)			30,000
	Profit and Loss Appropriation A/c ...Dr.		1,41,000	
	To Amit's Capital A/c (1,41,000 x 3/5)			84,600
	To Swati's Capital A/c (1,41,000 x 2/5) (Being Distribution of profit among the partners)			56,400

5. Profit and Loss Appropriation Account

It is also a possibility that the total amount of appropriation as per the deed is more than the amount of profit available for appropriation. In this situation, profit available for distribution among partners is distributed in the ratio of appropriation to be made. The ratio of appropriation is determined as follows:

i. Determine the amount payable as the appropriation to each partner as per the Partnership Deed (ignoring the profit available for distribution among partners). For example, salary payable, commission payable and interest on capital, etc., payable to each partner is determined.
ii. Total the amount of appropriation (as per Step (i) above) for each partner separately.
iii. Ratio of the Appropriations (as per Step (ii) above) is the ratio in which profit is appropriated. It should be kept in mind that no item like salary, commission, interest on capital, etc has priority over other items of appropriation.

5. Profit and Loss Appropriation Account

Rohan and Amit are partners in a firm sharing profit and loss in ratio 2:1. As per Partnership Deed, the partners are to get a salary of Rs. 1,00,000 and Rs. 1,20,000 p.a. respectively, and interest on capital @ 10% p.a. which is Rs. 20,000 and Rs. 40,000 respectively. Net profit for the year Rs. 2,10,000. Show the distribution of Profit among partners.

Solution:

The total amount of appropriation is Rs.2,80,000 (i.e., Rs. 1,00,000 + Rs. 1,20,000 + Rs. 20,000 + Rs. 40,000 = Rs. 3,00,000), which is more than the net profit for the year. In this case, we will calculate the total amount payable to each partner and distribute the profit available in the ratio of the total amount payable to each partner.

	Rohan (Rs.)	**Amit (Rs.)**
Salary	1,00,000	1,20,000
Interest on capital	20,000	40,000
Total	1,20,000	1,60,000
Ratio	3:4	

So, the profit will be appropriated in the ratio of 3:4. Thus, Rs. 90,000 (i.e., $\frac{3}{7}$ of Rs. 2,10,000) and Rs. 1,20,000 (i.e., $\frac{4}{7}$ of Rs. 2,10,000) being the total of appropriations for Rohan and Amit.

6. Interest on Capital

No interest is allowed on partners' capitals unless it is expressly agreed among the partners. The Interest on capital is calculated with due allowance for any addition or withdrawal of capital during the accounting period.

Let us understand it with some examples.

Mohini, Rashmi, and Navin entered a partnership, bringing in Rs. 3,00,000, Rs. 2,00,000 and Rs. 1,00,000 respectively into the business. They decided to share profits and losses equally and agreed that interest on capital will be provided to the partners @10% per annum. There was no addition or withdrawal of capital by any partner during the year. The interest on capital works out to Rs. 30,000 (10% on Rs. 3,00,000) for Mohini, Rs. 20,000 (10% on 2,00,000) for Rashmi, and Rs. 10,000 (10% on 1,00,000) for Navin.

Take another case of Mansoor and Reshma who are partners in a firm and their capital accounts showed the balance of Rs. 2,00,000 and Rs. 1,50,000 respectively on April 1, 2016. Mansoor introduced additional capital of Rs. 1,00,000 on August 1, 2016, and Reshma brought in further capital of Rs. 1,50,000 on October 1, 2016. Interest is to be allowed @ 6% p.a. on the capitals. It shall be calculated as follows:

For Mansoor, $2,00,000 \times \frac{6}{100} + 1,00,000 \times \frac{6}{100} \times \frac{8}{12} = \underline{16000}$

For Reshma, $1,50,000 \times \frac{6}{100} + 1,50,000 \times \frac{6}{100} \times \frac{6}{12} = \underline{13500}$

7. Interest on Drawings

No interest is to be charged on the drawings if there is no express agreement among the partners about it. However, if the partnership deed provides for it, the interest is charged at an agreed rate, for the period money remained outstanding from the partner's capital A/c during an accounting year. Charging interest on drawings discourages excessive amounts of drawings by the partners. Interest on drawings is calculated by two methods.

1. Direct method
2. Indirect method (Sum of Product Method)

---

7. Interest on Drawings

It has further 2 subcases, single drawing, and multiple drawings at regular intervals.

(i) **When a single drawing is made during the year:** Interest is calculated on drawings for the period from the date of drawings to the closing date of the accounting year. The following formula is used to compute the interest on drawings:

Interest on Drawings = Amount of Drawings × Rate of Interest × Period of interest

For example, Mr. X is a partner who withdrew Rs. 20,000 on 1st April 2018. Interest on drawings is charged at 10% per annum. Calculate interest on drawings on 31st December 2018.

Interest on Drawings = Amount of Drawings × Rate of interest × Period of interest

$$= 20{,}000 \times \frac{10}{100} \times \frac{9}{12}$$

$$= \underline{1500}$$

(ii) **When multiple drawings are done at regular intervals:** Many a time, a fixed amount of money is withdrawn by the partners, at equal time intervals, say each month. quarter, half-yearly

While calculating the time, attention must be paid to whether the fixed amount was withdrawn at the beginning of the given period, middle, or at the end. Then interest is to be calculated for an average period.

$$\text{Average Period} = \frac{\text{Number of months left after first drawing} + \text{Number of months left after last drawing}}{2}$$

---

7. Interest on Drawings

Calculate average period and the interest on drawings, when Aashish withdrew Rs. 10,000 from the firm for his personal use during the year ending March 31, 2017 @ 8% p.a. at the following intervals.

(a) Drawings are made on the first day of every month.
(b) Drawings are made in the middle of every month.
(c) Drawings are made at the end of every month.
(d) Drawings are made on the first day of every quarter.
(e) Drawings are made in the middle of every quarter.
(f) Drawings are made on the last day of every quarter.
(g) Drawings are made at the beginning of each month for 6 months only.
(h) Drawings are made at the middle of each month for 6 months only.
(i) Drawings are made at the end of each month for 6 months only.

Solution:

(a) Drawings are made on the first day of every month.

(a) Drawings are made on the first day of every month.

$$\text{Average Period} = \frac{12 \text{ (Months left after first drawing)} + 1 \text{ (Months left after last drawing)}}{2}$$

$$= \frac{13}{2} = 6\tfrac{1}{2}$$

Interest on Drawing

$$= 1,20,000 \times \frac{6.5}{12} \times \frac{8}{100}$$

$$= 5200$$

[Total Drawings = 10,000 × 12 = 1,20,000]

(b) Drawings are made in the middle of every month.

(b) Drawings are made in the middle of every month

$$\text{Average Period} = \frac{11.5 + .5}{2} = 6$$

$$\text{Interest on Drawing} = 1,20,000 \times \frac{6}{12} \times \frac{8}{100}$$

$$= 4800$$

(c) Drawings are made at the end of every month.

(c) Drawings are made at the end of every month

Average Period $= \frac{11+0}{2} = 5\frac{1}{2}$

Interest on Drawing $= 1,20,000 \times \frac{5.5}{12} \times \frac{8}{100}$

$= 4400$

(d) Drawings are made on the first day of every quarter.

(d) Drawings are made on the first of every quarter.

Average Period $= \frac{12+3}{2} = 7.5$

Interest on Drawing $= 40,000 \times \frac{7.5}{12} \times \frac{8}{100}$

$= 2000$

[Total Drawings $= 10,000 \times 4 = 40,000$]

(e) Drawings are made in the middle of every quarter.

(e) Drawings are made in the middle of every quarter.

Average Period $= \frac{10.5+1.5}{2} = 6$

Interest on Drawing $= 40,000 \times \frac{6}{12} \times \frac{8}{100} = 1600$

(f) Drawings are made on the last day of every quarter.

(f) Drawings are made on the last day of every quarter.

Average Period $= \frac{9+0}{2} = 4.5$

Interest on Drawings $= 40,000 \times \frac{4.5}{12} \times \frac{8}{100}$

$= 1200$

(g) Drawings are made at the beginning of each month for 6 months only.

(g) Drawings are made in the beginning of each month for 6 months only

Average Period $= \frac{6+1}{2} = 3.5$

Interest on Drawings $= 60,000 \times \frac{3.5}{12} \times \frac{8}{100}$

$= 1400$

[Total Drawings $= 10,000 \times 6 = 60,000$]

(h) Drawings are made at the middle of each month for 6 months only.

(h) Drawings are made in the middle of each month for 6 months only.

$$\text{Average Period} = \frac{5.5 + .5}{2} = 3$$

$$\text{Interest on Drawings} = 60,000 \times \frac{3}{12} \times \frac{8}{100}$$

$$= 1200$$

(i) Drawings are made at the end of each month for 6 months only.

(i) Drawings are made at the end of each month for 6 months only.

$$\text{Average Period} = \frac{5 + 0}{2} = 2.5$$

$$\text{Interest on Drawing} = 60,000 \times \frac{2.5}{12} \times \frac{8}{100}$$

$$= 1000$$

---

7. Interest on Drawings

If the partner withdraws varying amounts at different unequal time intervals, then we use **Sum of Product Method** to calculate, the interest on drawings. The Sum of Product method is a variation of the direct method and makes calculation of interest on drawings easier. The formula used under this method is provided below.

$$\text{Interest on Drawings} = \text{Total of Products} \times \frac{\text{Rate of interest}}{100} \times \frac{1}{12} \text{ or } \frac{1}{365}$$

where, Total no. of products = Amount of Drawings X duration of months from the end of the year

If the date of withdrawal of drawings is not specified, then we multiply the amount of interest by \(\frac{6}{12} \) to arrive at average.

---

7. Interest on Drawings

Arun is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018, he drew as follows:

Date	Amount (in Rs.)
March 1	6,000
June 1	4,000
September 1	5,000
December 1	2,000

Calculate the amount of interest on drawings using (i) Direct Method and (ii) Sum of Product Method

Solution:

(i) Calculation of interest on drawings using Direct Method

We know, Interest on drawings = Amount of drawings × Rate of interest × Period of interest

To calculate interest on drawings using the direct method, interest will have to be calculated for each drawing from the date of drawing to the closing date of the accounting period.

Date of Drawings	Calculation	Amount
Interest on drawing made on March 1		Rs. 600
Interest on drawing made on June 1		Rs. 280
Interest on drawing made on September 1		Rs. 200
Interest on drawing made on December 1		Rs. 20
Total Interest on Drawings		**Rs. 1100**

(ii) Calculation of interest on drawings using Sum of Product Method

Date of Drawings	Amount Withdrawn (Rs.)	Period up to 31^{st} December (months)	Product = Number of months till 31^{st} December × Amount Withdrawn (Rs.)
March 1	Rs. 6000	10	Rs. 60,000
June 1	Rs. 4000	7	Rs. 28,000
September 1	Rs. 5000	4	Rs. 20,000
December 1	Rs. 2000	1	Rs. 2,000
Sum of Product			**Rs. 1,10,000**

Interest on Drawings = Sum of Product × Rate of Interest × $\frac{1}{12}$

$$= 1,10,000 \times \frac{12}{100} \times \frac{1}{12}$$

$$= 1100$$

Notes:

a. If the date of drawings is not given, then interest on total drawings for the year is calculated on 6 months on an average basis.
b. If the date of drawings is not given and Accounting Period is less than 6 months, then interest on total drawings is calculated for half of the Accounting Period.
c. When the rate of interest on drawings is given without the word “per annum” or “p.a.”, interest on drawings should be charged without considering the time factor.

8. Guarantee of profit to the partners

Sometimes a partner is admitted into the firm with a guarantee of a certain minimum amount by way of his share of profits of the firm. Such assurance may be given by all the old partners in a certain ratio or by any of the old partners, individually to the new partner. The minimum guaranteed amount shall be paid to such a new partner when his share of profit as per the profit-sharing ratio is less than the guaranteed amount.

8. Guarantee of profit to the partners

Megha, Ritu, and Swati are partners in a firm sharing profit and losses in the ratio of 2:3:1 Swati is guaranteed a minimum profit of Rs. 25,000 as her share in the firm's profits. The firm earned a profit of Rs. 1,20,000 during the year. Calculate the share of deficiency to be borne by partners.

Solution:

Ans.

Megha's share in profit $= \frac{2}{6} \times 1,20,000$

$= 40,000$

Ritu's share in profit $= \frac{3}{6} \times 1,20,000$

$= 60,000$

Swati's share in profit $= \frac{1}{6} \times 1,20,000$

$= 20,000$

The share of Swati is Rs 5000 less than the guaranteed amount. This shall be borne by the guaranteeing partners, that are Megha and Ritu in their profit-sharing ratio, which in this case is 2:3

Megha's share in the deficiency $= \frac{2}{5} \times 5000$

$= 2000$

Ritu's share in the deficiency $= \frac{3}{5} \times 5000$

$= 3000$

The total profit of the firm will be distributed among the partners as follows:

Megha's share of profit = 40,000 (original share) − 2000 (deficiency)

= 38000

Ritu's share of profit = 60,000 − 3000

= 57000

Swati's share of profit = 20,000 + 2000 + 3000

= 25000

Note:

If only one partner gives the guarantee, say in the above case, only Ritu gives the guarantee then the whole amount of deficiency (Rs. 5,000) will be borne by her only. In that case, profit distribution will be:

Megha's share = Rs. 40,000,
Ritu 's share = Rs. 55,000 (Rs. 60,000 – Rs. 5,000)
Swati's share = Rs. 25,000 (Rs. 20,000 + Rs. 5,000).

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9. Treatment of past adjustments

If, after the final accounts have been prepared, some omissions are noticed, say in respect of the interest on capital, interest on drawings, partner's salary, commission, etc., necessary adjustments can be made in the partner's capital accounts through the Profit and Loss Adjustment Account, to rectify the same.

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10. Preparation of final accounts of a partnership firm

There is not much difference in the final accounts of a sole proprietary concern and that of a partnership firm except that in the case of a partnership firm an additional account called Profit and Loss Appropriation Account is prepared to show the distribution of profit and loss among the partners.

The following accounts are prepared under partnership firm:

- Trading and Profit and Loss Account
- Profit and Loss Adjustment Account (only in case of omission or rectification of past adjustment)
- Profit and Loss Appropriation Account
- Partner's Capital Account/ Partner's Current Account
- Balance Sheet

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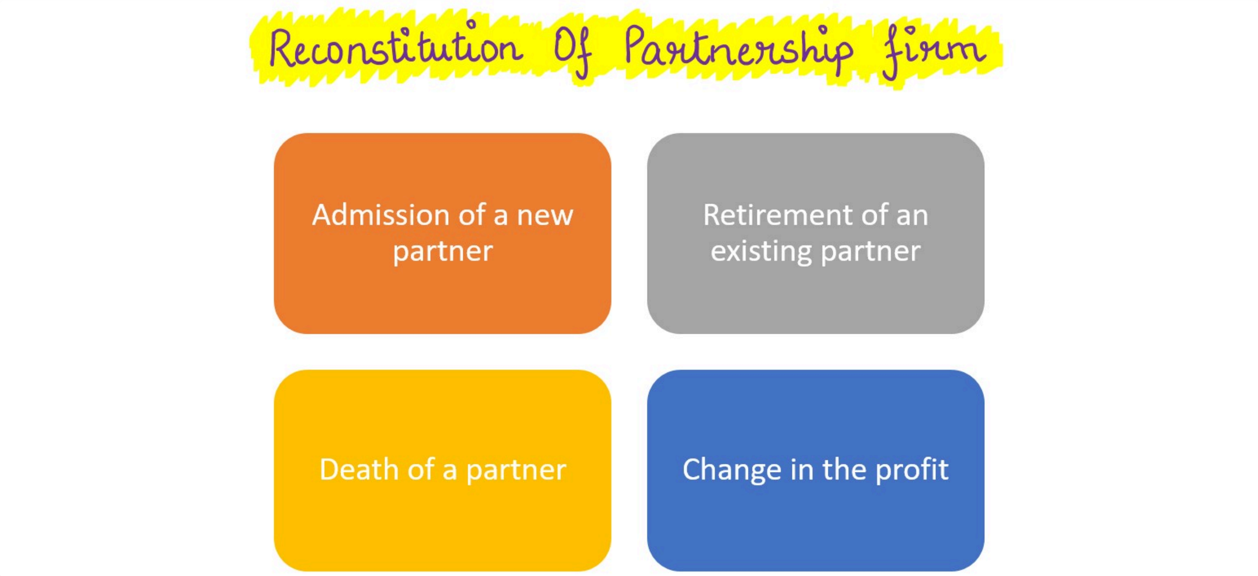
11. Reconstitution of a partnership firm

Reconstitution of a partnership firm usually takes place in any of the following ways as listed below.



i. **Admission of a new partner:** A new partner may be admitted when the firm needs additional capital or managerial help. According to the provisions of the Partnership Act, 1932, unless it is otherwise provided in the partnership deed, a new partner can be admitted only when the existing partners unanimously agree to it.
ii. **Retirement of an existing partner:** It means withdrawal by a partner from the business of the firm which may be due to his bad health, old age, or change in business interests. In fact, a partner can retire at any time if the partnership is at will.
iii. **Death of a partner:** Partnership may also stand reconstituted on the death of a partner if the remaining partners decide to continue the business of the firm as usual.
iv. **Change in the profit-sharing ratio among the existing partners:** Sometimes, the partners of a firm may decide to change their existing profit-sharing ratio. This may happen on account of a change in the existing partners' role in the firm.

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12. Accounting for Reserves, Accumulated Profits and Losses

If at the time of reconstitution of a partnership, reserves, accumulated profits, and losses exist in the books of the firm, they are transferred to the Partners' Capital Accounts (if capitals are fluctuating) or Current Accounts (if capitals are fixed) in their old profit-sharing ratio because reserves, accumulated (undistributed) profits and losses as on the date of reconstitution of a partnership were earned before such reconstitution.

These are discussed next.

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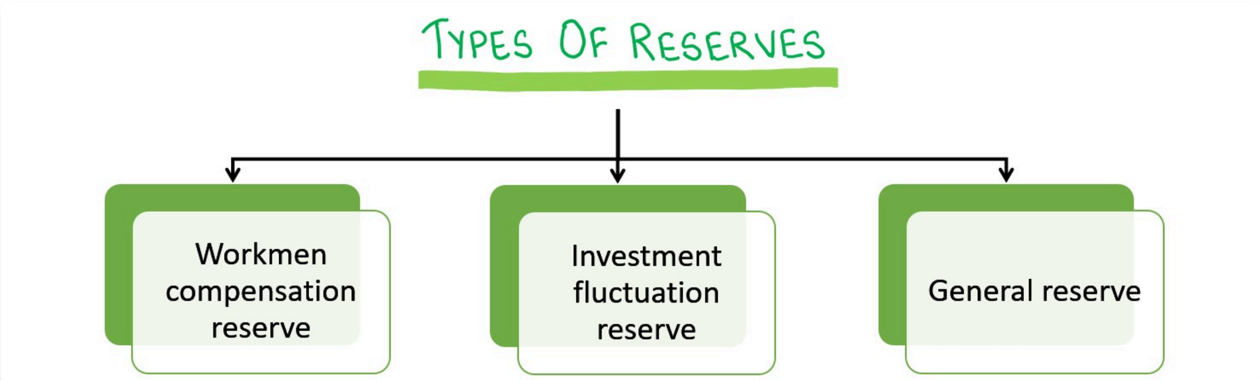
12. Accounting for Reserves, Accumulated Profits and Losses

Journal entries for transfer of Reserve/Profits

Particulars	L.F	Debit	Credit
Reserve A/c … Dr.			
Profit and loss A/c (credit balance) … Dr.			
Workmen compensation Reserve A/c ..Dr.			
Investment Fluctuation Reserve A/c … Dr.			
To Partner’s current A/c or Partner’s capital A/cs			

The treatment of three common types of reserves is discussed below.



Workmen Compensation Reserve: It is a reserve set aside out of profit to meet possible liability (Claim) on account of compensation of employees if it arises. There may be the following 3 types of situations.

- In case there is no claim exist on account of workmen compensation reserve at the time of change in Profit sharing ratio. Then it will be transferred to the partner’s capital A/c in the profit-sharing ratio.
- In case the amount of claim is less than the amount in reserve A/c, the claim amount shall be deducted from workmen compensation reserve A/c and credited to workmen compensation claim A/c (liability) and the remaining amount should be transferred to the partner’s capital A/c in the profit-sharing ratio.
- In case the amount of claim is more than the amount in the reserve, then the excess claim amount will be debited from the partner’s capital in their profit-sharing ratio.

Investment Fluctuation Reserve: Investments are recorded in the books of a firm. However, their market value maybe equal to lower or higher than its book value. This reserve is set aside out of profit to meet the fall in, the market value of the investment. There may be the following 3 types of situations.

- In case when the market value is equal to book value, then the reserve will be credited to the partner’s capital A/c.
- In case when the market value of the investment is lower than book value, then the shortage is transferred from Investment fluctuation reserve to Investment A/c and if any remaining amount is left, it is credited to the partner’s capital A/c. If the fall is more than the amount available in the reserves, then the difference that couldn’t be compensated by reserve is transferred to revaluation A/c.
- In case the Market value is higher than the book value, then the excess amount is shown on the credit side of Revaluation and the amount in reserve is transferred to Partner’s capital A/c.

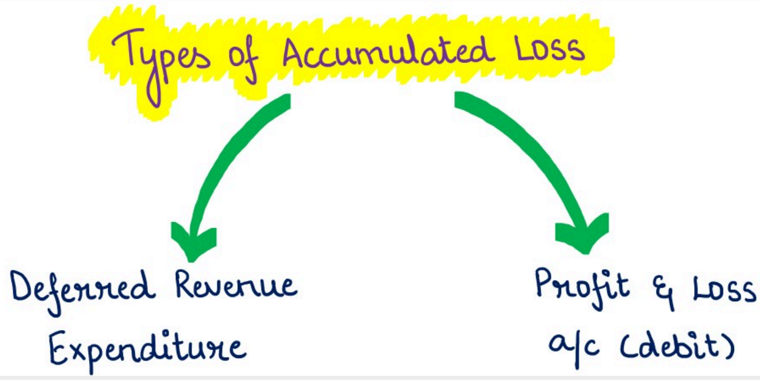
General Reserve: If any amount is reflected in the Balance Sheet as general reserve, it must be distributed among the partners in their profit-sharing ratio.

12. Accounting for Reserves, Accumulated Profits and Losses

Journal entries for transfer of Accumulated losses:

Particulars	L.F.	Debit	Credit
Partner's Capital/ partner's current A/cs ... Dr.			
To Profit and Loss A/c			
To Deferred Revenue Expenditure A/c			

Treatment of two common types of accumulated loss are discussed below:



i. **Deferred Revenue Expenditure:** It is an expenditure that does not bring any asset into existence, but its benefit is expected to last more than one accounting period. It is written off during the period it's expected to give benefits. For example, advertisement suspense Account. At the time of reconstitution of partnership, it is to be written off by debiting partner's Capital A/c.

ii. **Profit and Loss A/c (debit):** If there is any amount reflected as profit and loss A/c (debit) in the balance sheet, it is considered an accumulated loss and must be debited to partner's capital A/c or current A/c in their profit sharing ratio.

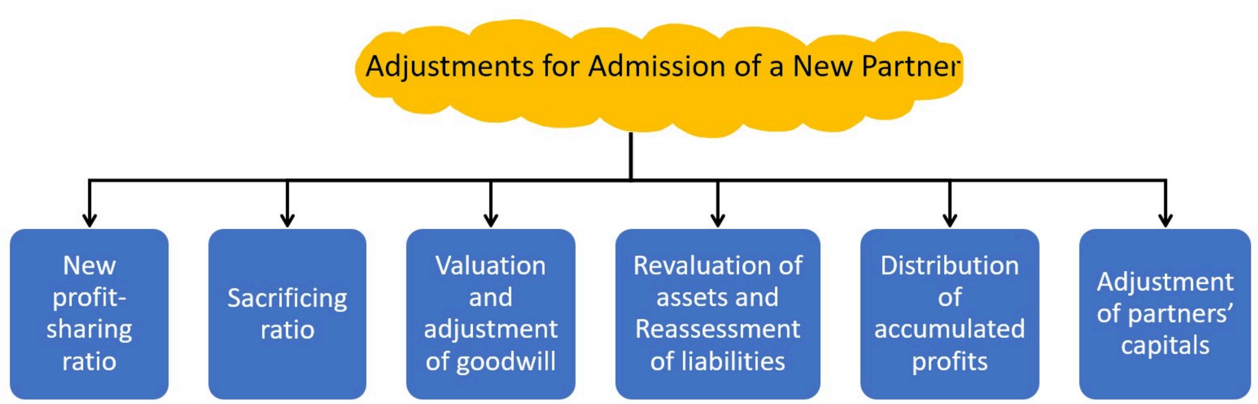
13. Admission of New Partner

According to the Partnership Act, 1932, a new partner can be admitted into the firm only with the consent of all the existing partners unless otherwise agreed upon. With the admission of a new partner, the partnership firm is reconstituted, and a new agreement is entered into to carry on the business of the firm. A newly admitted partner acquires two main rights in the firm, as given below.

1. Right to share the assets of the partnership firm
2. Right to share the profits of the partnership firm.

For the right to acquire a share in the assets and profits of the partnership firm, the partner brings an agreed amount of capital either in cash or in kind. Moreover, in the case of an established firm, which may be earning more profits than the normal rate of return on its capital, the new partner is required to contribute some additional amount known as "premium or goodwill". This is done to compensate the existing partners for the loss of their share in the super-profits of the firm.

Adjustment for Admission of a New Partner includes the following calculations:



- New profit-sharing ratio.
- Sacrificing ratio.
- Valuation and adjustment of goodwill.
- Revaluation of assets and Reassessment of liabilities.
- Distribution of accumulated profits (reserves).
- Adjustment of partners' capitals.

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13. Admission of New Partner

At the time of admission of the new partner, there is a need to calculate the new profit-sharing ratio of the firm. On admission of a new partner, the profit-sharing ratio among the old partners will change keeping in view their respective contributions to the incoming partner.

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13. Admission of New Partner

The ratio in which the old partners agree to sacrifice their share of profit in favour of the incoming partner is called sacrificing ratio. The sacrifice by a partner is equal to:

Old Share of Profit – New Share of Profit

13. Admission of New Partner

X and Y are partners in firm sharing profits in the ratios of 2:1. Z is admitted for \(\frac{1}{3} \)rd share of profit. What will be the new profit-sharing ratio of X, Y, and Z and sacrificing ratio of X and Y?

Solution:

Ans.

Let the total profit be 1

'Z' is admitted with share $= \frac{1}{3}$

Remaining share $= 1 - \frac{1}{3} = \frac{2}{3}$

X's share $= \frac{2}{3} \times \frac{2}{3} = \frac{4}{9}$

Y's share $= \frac{1}{3} \times \frac{2}{3} = \frac{2}{9}$

Z's share $= \frac{1}{3}$ or $\frac{3}{9}$

Thus, the new ratio among X, Y and Z is 4:2:3

Sacrificing Ratio = Old Ratio – New Ratio

For X $= \frac{2}{3} - \frac{4}{9} = \frac{2}{9}$

For Y $= \frac{1}{3} - \frac{2}{9} = \frac{1}{9}$

Therefore, sacrificing ratio $= \frac{2}{9} : \frac{1}{9} = 2:1$

13. Admission of New Partner

X and Y sharing profits in the ratio of 7:3, admit Z for $\frac{3}{7}^{th}$ share in the new firm, which he takes $\frac{2}{7}^{th}$ from X and $\frac{1}{7}^{th}$ from Y. What will be the new profit-sharing ratio of X, Y, and Z and sacrificing ratio of old partners?

Solution:

Ans.

X's old share $= \frac{7}{10}$

X's sacrifice for Z $= \frac{2}{7}$

X's new share $= \frac{7}{10} - \frac{2}{7} = \frac{29}{70}$

Y's old share $= \frac{3}{10}$

Y's sacrifice for Z $= \frac{1}{7}$

Y's new share $= \frac{3}{10} - \frac{1}{7} = \frac{11}{70}$

Z's share $= \frac{3}{7} = \frac{30}{70}$

New Profit sharing Ratio among X, Y, Z is 29 : 11 : 30

Sacrificing Ratio $\frac{2}{7} : \frac{1}{7} = 2:1$

13. Admission of New Partner

X and Y are partners sharing profits and losses in the ratio 2:1. They admit Z into the firm. X sacrifices 1/4 th of his share and Y sacrifices 3/4th of his share in favour of Z. Calculate their new profit-sharing ratio and sacrificing ratio of old partners.

Solution:

Ans. X's old share $= \frac{2}{3}$

share sacrificed in favor of Z $= \frac{2}{3} \times \frac{1}{4} = \frac{1}{6}$

X's new share $= \frac{2}{3} - \frac{1}{6} = \frac{3}{6}$ or $\frac{6}{12}$

share surrendered in favor of Z $= \frac{1}{3} \times \frac{3}{4} = \frac{1}{4}$

Y's new share $= \frac{1}{3} - \frac{1}{4} = \frac{1}{12}$

Z's share $= \frac{1}{6} + \frac{1}{4} = \frac{5}{12}$

Sacrificing Ratio = Old ratio − New ratio

X's sacrifice $= \frac{2}{3} - \frac{6}{12} = \frac{24-18}{36} = \frac{6}{36}$

Y's sacrifice $= \frac{1}{3} - \frac{1}{12} = \frac{12-3}{36} = \frac{9}{36}$

$= \frac{6}{36} : \frac{9}{36} = 2:3$

Sacrificing Ratio $= 2:3$

13. Admission of New Partner

X and Y are partners sharing profits and losses in the ratio 2:1. They admit Z into the firm. As per the new agreement X, Y, Z decides to share the future profits or losses equally. Calculate sacrificing ratio.

Solution:

Ans:

Old ratio is 2:1

New ratio is 1:1:1

Sacrificing Ratio = Old Ratio – New Ratio

X's sacrifice $= \frac{2}{3} - \frac{1}{3} = \frac{1}{3}$

Y's sacrifice $= \frac{1}{3} - \frac{1}{3} = 0$

Hence, only X has sacrificed his share for Z.

---

13. Admission of New Partner

Rohit and Mohit are partners in firm sharing profits in the ratio of 5:3. They admit Bijoy as a new partner for 1/7 share in the profit. The new profit-sharing ratio will be 4:2:1. Calculate the sacrificing ratio of Rohit and Mohit.

Solution:

Ans.

Rohit's old share $= \frac{5}{8}$, Rohit's new share $= \frac{4}{7}$

Rohit's sacrifice $= \frac{5}{8} - \frac{4}{7} = \frac{3}{56}$

Mohit's old share $= \frac{3}{8}$, Mohit's new share $= \frac{2}{7}$

Mohit's sacrifice $= \frac{3}{8} - \frac{2}{7} = \frac{5}{56}$

Thus, the sacrificing Ratio between Rohit and Mohit will be 3:5

13. Admission of New Partner

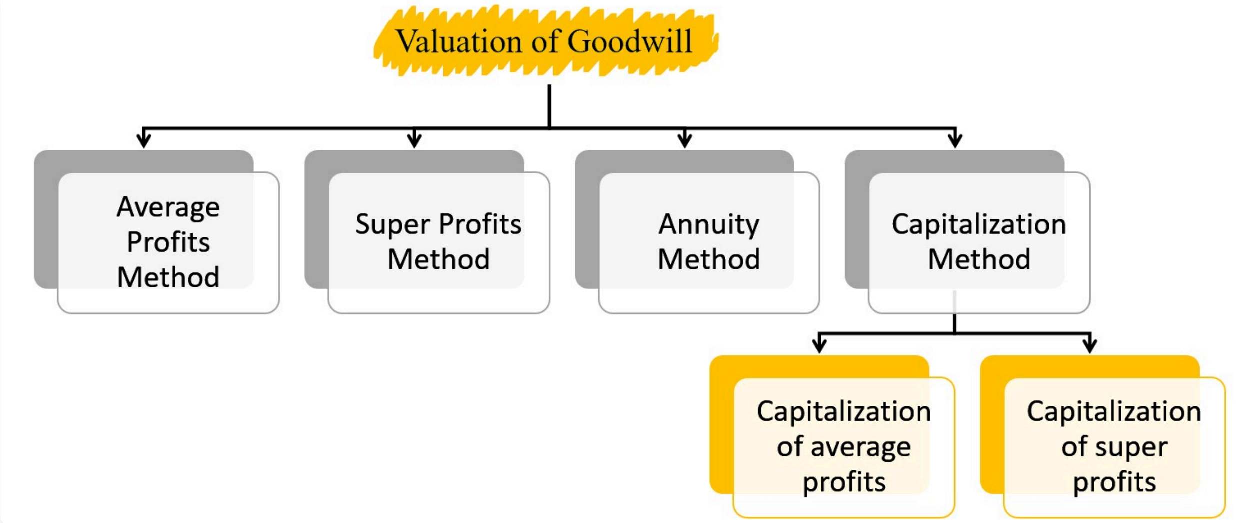
Over a period, a well-established business develops an advantage of good name, reputation, and wide business connections. This helps the business to earn more profits as compared to a newly set up business. In accounting, the monetary value of such advantage is known as "goodwill". It is regarded as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in the future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in a position of being able to earn super profits as compared to the profit earned by other firms in the same industry.

In simple words, goodwill can be defined as the present value of a firm's anticipated excess earnings or as the capitalized value attached to the differential profit capacity of a business. Thus, goodwill exists only when the firm earns super-profits. Any firm that earns normal profits or is incurring losses, has no goodwill.

The main factors affecting the value of goodwill are explained below.

1. **Nature of business:** A firm that produces high-value-added products or having a stable demand is able to earn more profits and therefore, has more goodwill.
2. **Location:** If the business is centrally located or is at a place having heavy customer traffic, the goodwill tends to be high.
3. **Efficiency of management:** A well-managed concern usually enjoys the advantage of high productivity and cost-efficiency. This leads to higher profits and so the value of goodwill will also be high.
4. **Market situation:** The monopoly condition or limited competition enables the concern to earn high profits which leads to the higher value of goodwill.
5. **Special advantages:** The firm that enjoys special advantages like import licenses, low rate and assured supply of electricity, long-term contracts for the supply of materials, well-known collaborators, patents, trademarks, etc. enjoy the higher value of goodwill.

Evaluation of Goodwill



Since goodwill is an intangible asset, it is very difficult to accurately calculate its value, hence it is calculated through various methods. The important methods of valuation of goodwill are listed and explained below.

1. Average Profits Method
2. Super Profits Method
3. Annuity Method
4. Capitalisation Method

1. Average Profit Method: Under this method, the goodwill is valued at an agreed number of 'years' purchase of the average profits of the past few years. The goodwill is calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.

Goodwill = Average Profit × Years of purchase

For example, if the past average profits of a business work out at Rs. 20,000 and it is expected that such profits are likely to continue for another 3 years, the value of goodwill will be Rs. 60,000 (Rs. 20,000 × 3).

Illustration 1

X Ltd. agreed to purchase the business of a sole trader. For that purpose, goodwill is to be valued at 3 years' purchase of average profits of last 5 years.

Profits for 5 years are Rs. 24,000, Rs. 20,000, Rs. 22,000 Rs. 24000, Rs. 26000

Solution:

Ans. Average profits $= \dfrac{24000 + 20{,}000 + 22000 + 24{,}000 + 26{,}000}{5}$

$= \dfrac{1{,}16{,}000}{5}$

$= 23{,}200$

Goodwill = Average Profit × Years of purchase

$= 23{,}200 \times 3$

$= 69{,}600$

The above illustration is based on the simple average. Sometimes, if there exists an increasing or decreasing trend, it is considered better to give a higher weightage to the profits of the recent years than those of the earlier years. This is called the

weighted average profits method.

2. Super profit Method: The basic assumption in the average profits (simple or weighted) method of calculating goodwill is that if a new business is set up, it will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases an existing business, has to pay in the form of goodwill, a sum equal to the total profits he is likely to receive for the first few years.

But it is contended that the buyer's real benefit does not lie in total profits; it is limited to such amounts of profits that are more than the normal return on capital employed in a similar business. Therefore, it is desirable to value, goodwill based on the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super-profits. To calculate super profits, we first need to calculate normal profits. Normal profit is the profit that the other firms in the industry are earning. The formula to calculate normal profit is given below:

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

Suppose, an existing firm earns Rs. 18,000 on the capital of Rs. 1,50,000 and the normal rate of return is 10%. The Normal profit will work out at Rs. 15,000 (1,50,000 × $\frac{10}{100}$). The super-profits in this case will be Rs. 3,000 (Rs. 18,000 – 15,000).

The goodwill under the super profit method is ascertained by multiplying the super-profits by a certain number of years of purchase. If in the above example, it is expected that the benefit of super-profits is likely to be available for 5 years in the future, the goodwill will be valued at Rs. 15,000 (3,000 × 5).

Thus, the steps involved under this method are:

1. Calculate the average profit,
2. Calculate the normal profit on the capital employed based on the normal rate of return,
3. Calculate the super-profits by deducting normal profit from the average profits, and
4. Calculate goodwill by multiplying the super-profits by the given number of years of purchase.

Illustration 2

The books of a business showed that the capital employed on December 31, 2015, is Rs. 5,00,000, and the profits for the last five years were: 2011 - Rs. 40,000; 2012 - Rs. 50,000; 2013 - Rs. 55,000; 2014 - Rs.70,000 and 2015 - Rs. 85,000. You are required to find out the value of goodwill based on 3 years of purchase of the super-profits of the business, given that the normal rate of return is 10%.

Solution:

Year	Profit in Rs.
2011	40,000
2012	50,000
2013	55,000
2014	70,000
2015	85,000
Total	**3,00,000**

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

$$= \frac{5,00,000 \times 10}{100}$$

$$= 50,000$$

$$\text{Average Profits} = \frac{3,00,000}{5} = 60,000$$

$$\text{Super Profit} = 60,000 - 50,000 = 10,000$$

$$\text{Goodwill} = 10,000 \times 3 = 30,000$$

3. Annuity Method: The time value of money is not considered in Super Profit method, but the same is covered under the Annuity Method. Under this method, a suitable discounting factor is determined, and super profit is then discounted using this discounting factor. Under the Annuity Method, if the value of Annuity is not given, it can be calculated using the following formula:

$$A = \frac{1+\left(1+\frac{r}{100}\right)^{-n}}{r/100}$$

where,

A = Present value of Annuity of Rupee 1

r = Normal Rate of Return

n = Number of years

Value of Goodwill = Average Super profit × Present value of Annuity for Rupee 1 at a given rate of interest

4. Capitalisation Method: Under this method, the goodwill can be calculated in two ways:

CAPITALISATION METHOD

By capitalising average profits

By capitalising super profits

(a) Capitalisation of Average Profits: Under this method, the value of goodwill is ascertained by deducting the actual capital employed (net assets) in the business from the capitalized value of the average profits on the basis of the normal rate of return. This involves the following steps:

i. Ascertain the average profits based on the past few years' performances.
ii. Capitalize the average profits based on the normal rate of return to ascertain the capitalized value of average profits as follows:

$$= \frac{\text{Average profits} \times 100}{\text{Normal Rate of Return}}$$

iii. Ascertain the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill).
iv. Compute the value of goodwill by deducting net assets from the capitalized value of average profits, i.e. (ii) – (iii).

Illustration 3

A business has earned an average profit of Rs. 1,00,000 during the last few years and the normal rate of return in a similar business is 10%. Ascertain the value of goodwill by the capitalization of average profits method, given that the value of net assets of the business is Rs. 8,20,000.

Solution:

$$\text{Capitalised value of Average Profits} = \frac{\text{Average Profits} \times 100}{\text{Normal Rate of Return}}$$

$$= \frac{100{,}000 \times 100}{10}$$

$$= 10{,}00{,}000$$

$$\text{Goodwill} = \text{Capitalised value of Average Profits} - \text{Net Assets}$$

$$= 10{,}00{,}000 - 8{,}20{,}000$$

$$= 1{,}80{,}000$$

(b) Capitalisation of Super Profits: Goodwill can also be ascertained by capitalizing on the super profit directly. Under this method, there is no need to work out the capitalized value of average profits. It involves the following steps:

i. Calculate capital employed of the firm, which is equal to total assets minus outside liabilities.
ii. Calculate normal profits on capital employed.
iii. Calculate average profit for past years, as specified.
iv. Calculate super-profits by deducting normal profits from average profits.
v. Multiply the super-profits by the required rate of return multiplied.

$$\text{Goodwill} = \frac{\text{Super Profits} \times 100}{\text{Normal Rate of Return}}$$

In other words, goodwill is the capitalized value of super-profits. The amount of goodwill worked out by this method will be the same as calculated by capitalizing on the average profits.

For example, using the data given in the previous illustration, where the average profits are Rs.1,00,000 and the normal profits are Rs. 82,000 (10% of Rs. 8,20,000), the super-profits worked out at Rs. 18,000 (Rs. 1,00,000 – Rs. 82,000), the goodwill will be calculated as follows.

$$18000 \times \frac{100}{10} = 180{,}000$$

Treatment of Goodwill

Goodwill is an intangible asset that enables the firm to earn profit over and above the normal profit, i.e., super profit, as compared to the profit earned by other firms in the industry. The firm earns this super profit because of the efforts of the existing partners in the past. Therefore, at the time of admission of a new partner, the new partner who acquires his share in the future profits of the firm should compensate the sacrificing partners by paying them an amount termed as goodwill or premium for goodwill. Goodwill is a way of compensating the existing partners for the sacrifice they make in favour of a new partner.

Note: AS-26, "Intangible Assets" prescribes that goodwill should be recorded in the books only after consideration in money or money's worth has been paid for, i.e., only the goodwill that is purchased should be recorded in the books. Thus, in case of admission, or retirement/death of a partner or in case of change in the profit-sharing ratio among partners, goodwill should not be raised in the books of the firm, because no consideration in money or money's worth is paid for it. If any partner brings any premium over and above his capital contribution at the time of his admission, such premium should be distributed among the existing partners in their sacrificing ratios.

If goodwill is evaluated at the time of change in the constitution of the firm (by way of admission/retirement/death/change in the profit-sharing ratio), goodwill should not be brought in books since it is inherent goodwill. The value of goodwill should be adjusted through partners' capital accounts.

From the accounting point of view, there may be different situations related to the treatment of goodwill and these are discussed below.

i) Goodwill (Premium for goodwill) paid privately: When goodwill or premium for goodwill is paid privately, i.e., outside the business, by the new or incoming partner to the old partners, "No Journal Entry" is recorded in the Books of Accounts.

ii) Goodwill/Premium for Goodwill brought in cash by the new or incoming partner and retained in the business: When the new or incoming partner brings cash for his share of goodwill, it is transferred to the Capital Accounts of the sacrificing partners. In other words, the amount of goodwill brought in by the new partner is shared by the sacrificing partners in their sacrificing ratio. The Journal Entries to be passed in this case are discussed below.

Transaction/Event	Journal Entry
1. To write off Goodwill already appearing in the Balance Sheet (if any).	Old Partners' Capital Accounts ...Dr. To Goodwill Account (in old profit-sharing ratio)
2. When the new partner brings his amount of Premium for Goodwill in cash	Cash/Bank Account ...Dr. To Premium for Goodwill Account
3. To distribute the premium for goodwill among the old partners in sacrificing ratio	The premium for Goodwill Account ...Dr. To Sacrificing Partners' Capital Account (Individually in sacrificing ratio)

Note: (a) If any Goodwill already exists in the Books of the Firm, then such Goodwill has to be written off by debiting the Old Partner's Capital Accounts in their old profit-sharing ratio and crediting Goodwill Account.

(b) If any old partner also gains at the time of admission of a new partner, then such old partner's Capital Account must be debited with the proportionate amount of goodwill corresponding to the proportion of share gained.

(iii) Goodwill/Premium for Goodwill brought in Kind: New or incoming partner may bring his share of Goodwill/Premium for Goodwill in the form of assets. In this case, the value of Assets brought in is debited and Goodwill/Premium for Goodwill Account is credited for his share of Goodwill. Therefore, Premium for Goodwill is transferred to the Capital Accounts of the sacrificing partners in their sacrificing ratio. The Journal Entries to be passed in this case are discussed as follows:

Transaction/Event	Journal Entry
1. When the new partner brings his amount of Premium for Goodwill in Kind.	Assets Account ...Dr. To Premium for Goodwill Account
2. To distribute the premium for goodwill among the old partners in sacrificing ratio.	Premium for Goodwill Account ...Dr. To Sacrificing Partners' Capital Account (Individually in sacrificing ratio)

(iv) Goodwill/Premium for Goodwill brought by a new or incoming partner is withdrawn by Old Partners fully or partly: Premium for Goodwill brought by the new or incoming partner is shared by the sacrificing partners in the sacrificing ratio. The sacrificing partners may decide to withdraw such Premium for Goodwill fully or partly. The Journal Entries when sacrificing partners withdraw such Premium for Goodwill are discussed below.

Transaction/Event	Journal Entry
1. When the new partner brings his amount of Premium for Goodwill in cash	Cash/Bank Account ...Dr. To Premium for Goodwill Account
2. To distribute the premium for goodwill among the old partners in sacrificing ratio	Premium for Goodwill Account ...Dr. To Sacrificing Partners' Capital Account (Individually in sacrificing ratio)
3. For withdrawal of Premium for Goodwill by the sacrificing partners, fully or partly	Sacrificing Partners' Capital Account ...Dr. To Cash/Bank Account (with the amount withdrawn)

(v) When only a part of the Goodwill/Premium for Goodwill is brought in by the new or the incoming partner in cash: New or incoming partner may not be able to bring the full amount of his share of Goodwill/Premium for Goodwill in cash, i.e., he brings in only a part of his share of Goodwill/Premium for Goodwill. In this case, the Premium for Goodwill Account is credited for Premium brought in by the new partner. At the time of recording the transfer entry, the new or incoming partner's Capital/Current Account is debited with his unpaid share of Premium for Goodwill besides debiting Premium for Goodwill Account with the amount of premium paid by him. In this manner, the incoming partner's Capital Account will show a debit and to that extent, his capital will stand reduced. The Journal Entries to be passed in this case are discussed below.

Transaction/Event	**Journal Entry**
1. For Premium for Goodwill brought in cash by the incoming partner	Cash/Bank Account ...Dr. To Premium for Goodwill Account
2. To distribute the premium for goodwill among the old partners in sacrificing ratio	Premium for Goodwill Account ...Dr. Incoming Partner's Capital Account ...Dr. To Sacrificing Partners' Capital Account (Individually in sacrificing ratio)

(vi) When new or incoming partner is not able to bring his share of Goodwill/premium for Goodwill in cash: If the new partner does not bring his share of goodwill in cash, his Capital Account is debited for his share of goodwill and the sacrificing partners' Capital Accounts are credited in their sacrificing ratio. The Journal Entries to be passed in this case are discussed below.

13. Admission of New Partner

When a new partner is admitted into the partnership, assets are revalued, and liabilities are reassessed. A Revaluation Account (or Profit and Loss Adjustment Account) is opened for this purpose. This account is debited with all reduction in the value of assets and increase in liabilities and credited with an increase in the value of assets and decrease in the value of liabilities. The difference in the two sides of the account will show profit or loss. This is transferred to the Capital Accounts of old partners in the old profit-sharing ratio. The entries to be passed are:

Particulars	**L.F**	**Debit**	**Credit**
Revaluation Account ... Dr. To Assets Account To Liabilities Accounts		With the reduction in the value of the assets	Decrease in value of asset/ increase in the liabilities.
Assets Account (Individually) ...Dr. Liabilities Accounts ...Dr. To Revaluation Account		Increase in the value of an asset or Decrease in the value of a liability	Increase in value of asset/decrease in value of the liability.
Revaluation Account ...Dr. To Capital A/cs of the old partners		Revaluation profit	Revaluation Profit distributed as per old profit-sharing ratio.
Or			
Capital A/cs of the old partners ...Dr. To Revaluation Account			Revaluation loss distributed as per old profit-sharing ratio.

13. Admission of New Partner

Following is the Balance Sheet of Ram and Mohan, who share profits in the ratio of 3:2 as on 1st January 2020:

Liabilities	Amount	Assets	Amount
Trade payables	15,000	Buildings	18,000
Ram's Capital	20,000	Plant and Machinery	15,000
Mohan's Capital	25,000	Inventories	12,000
		Trade receivables	10,000
		Bank	5,000
	60,000		**60,000**

On this date, Abhinav was admitted into the business on the following terms:

1. The new profits sharing ratio will be 5:3:2.
2. The assets are to be revalued as under:

- Building Rs. 25,000
- Plant and Machinery Rs. 12,000
- Inventories Rs. 12,000
- Trade receivables (because of doubtful debts) Rs. 9,500

3. It was found that there was a liability of Rs. 1,500 for goods received but not recorded in books. Prepare Revaluation A/c and journal entry for distribution of Revaluation profit/loss.

Solution: Revaluation Account

Particulars	Amount (in Rs.)	Particulars	Amount (in Rs.)
Plant and Machinery A/c	3,000	Building A/c	7,000
Provision for Doubtful Debts	500		
Trade Payables A/c	1,500		
Profit on Revaluation (Balancing figure)	2,000		
	7,000		**7,000**

Explanation: In revaluation Account only the difference between the book value and revalued account is considered, for example the book value of building is Rs. 18,000 and is revalued at Rs. 25,000, hence a difference of Rs, 7,000 is present which is an appreciation and therefore credited to Revaluation A/c and similarly those items that have shown a decrease in value are debited to Revaluation A/c.

Journal Entries in the books of Ram and Mohan (amount in Rs.)

Particulars	Amount (in Rs.)	Particulars	Amount (in Rs.)
Plant and Machinery A/c	3,000	Building A/c	7,000
Provision for Doubtful Debts	500		
Trade Payables A/c	1,500		
Profit on Revaluation (Balancing figure)	2,000		
	7,000		**7,000**

13. Admission of New Partner

Sometimes, at the time of admission, the partners agree that their capitals should also be adjusted to be proportionate to their profit-sharing ratio. In such a situation, if the capital of the new partner is given, the same can be used as a base for calculating the new capital of the old partners. The capitals, thus ascertained should be compared with their old capitals after all adjustments relating to goodwill, reserves and revaluation of assets and liabilities, etc. have been made, and then the partner whose capital falls short will bring in the necessary amount to cover the shortage and the partners who has a surplus, will withdraw the excess amount of capital.

By bringing in an additional amount or withdrawal of excess amount, the final capital of each partner can be brought up to the required level. It may be noted that subject to agreement among the partners, surplus or deficiency in each old partners' capital accounts can also be taken care of simply by transfer to their respective current accounts.

13. Admission of New Partner

Sometimes, the partners of a firm decide to change their existing profit-sharing ratio without any admission or retirement of a partner. This results in a gain of additional share in future profits of the firm for some partners while a loss of a part thereof for other partners.

Any change, in the profit-sharing ratio, like admission of a partner, may also involve adjustments in respect of revaluation of assets and liabilities, transfer of accumulated profits and losses to partners' capital accounts in the old profit sharing ratio, and adjustment of partners' capitals, if specified, so as to make them proportionate to the new profit sharing ratio. All this is done in the same way as in the case of the admission of a partner.

14. Retirement and Death of a Partner

A partner may retire from the partnership firm because of old age, illness, etc. Generally, the business of the partnership firm may not come to an end when one of the partners retires. Other partners may continue to run the business of the firm. Readjustment takes place in case of retirement of a partner likewise the case of admission of a partner. Whenever a partner retires, the continuing partners make gains in terms of the share of profit of the retiring partner. Therefore, the remaining partners arrange for the amount to be paid to discharge the claims of the retiring partners.

As per provisions of Section 37 of the Indian Partnership Act., "Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of 6 % per annum on the amount of his share in the property of the firm.

The sum due to the retiring partner (in case of retirement) and to the legal representatives/executors (in case of death) includes:

- the credit balance of his capital account.
- the credit balance of his current account (if any).
- his share of goodwill.
- his share of accumulated profits (reserves).
- his share in the gain of revaluation of assets and liabilities.
- his share of profits up to the date of retirement/death.
- interest on his capital, if involved, up to the date of retirement/death; and
- salary/commission, if any, due to him up to the date of retirement/death.

Similarly, there can be deductions like:

- debit balance of his current account (if any).
- his share of goodwill to be written off, if necessary.
- his share of accumulated losses.
- his share of loss on revaluation of assets and liabilities.
- his share of loss up to the date of retirement/death.
- his drawings up to the date of retirement/death.
- interest on drawings, if involved, up to the date of retirement/death.

Thus, as in the case of admission, the various accounting aspects involved in the retirement or death of a partner are as follows:

- ascertainment of new profit-sharing ratio and gaining ratio
- treatment of goodwill
- revaluation and adjustment of assets and liabilities
- distribution and ascertainment of accumulated profits and losses
- adjustment of capital, if required

Let us discuss them one by one.

14. Retirement and Death of a Partner

Usually, the continuing partners acquire the share of retiring or deceased partners in the old profit sharing ratio, and there is no need to compute the new profit sharing ratio among them, as it will be the same as the old profit sharing ratio among them.

For example, Asha, Deepti, and Nisha are partners in the firm, sharing profits and losses in the ratio of 3:2:1. If Deepti retires, the new profit sharing ratio between Asha and Nisha will be 3:1, unless they decide otherwise (this is shown in the next illustration).

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14. Retirement and Death of a Partner

Naveen, Suresh, and Tarun are partners sharing profits and losses in the ratio of 5:3:2. Suresh retires from the firm and his share was acquired by Naveen and Tarun, in the ratio of 2:1. Calculate the new share of profit.

Solution:

Ans. New share of Continuing Partner = Old share + Acquired share from the outgoing partner

Gaining Ratio is 2:1

Share acquired by Naveen $= \frac{2}{3}$ of $\frac{3}{10} = \frac{2}{3} \times \frac{3}{10} = \frac{2}{10}$

Share acquired by Tarun $= \frac{1}{3}$ of $\frac{3}{10} = \frac{1}{3} \times \frac{3}{10} = \frac{1}{10}$

Share of Naveen $= \frac{5}{10} + \frac{2}{10} = \frac{7}{10}$

Share of Tarun $= \frac{2}{10} + \frac{1}{10} = \frac{3}{10}$

Thus, the new profit sharing ratio of Naveen and Tarun will be 7:3

The ratio in which the continuing partners have acquired the share from the retiring/deceased partner is called the *gaining ratio.*

Gaining share of Continuing Partner = New share – Old share

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14. Retirement and Death of a Partner

Amit, Dinesh, and Gagan are partners sharing profits in the ratio of 5:3:2. Then Dinesh retires. Amit and Gagan decide to share the profits of the new firm in the ratio of 3:2. Find the gaining ratio.

Solution:

Amit's gaining share $= \frac{3}{5} - \frac{5}{10} = \frac{1}{10}$

Gagan's gaining share $= \frac{2}{5} - \frac{2}{10} = \frac{2}{10}$

Thus, the gaining ratio of Amit : Gagan = 1:2

that implies that Amit gains $\frac{1}{3}$ and Gagan gains $\frac{2}{3}$ of Dinesh's share of profit.

14. Retirement and Death of a Partner

At the time of retirement or the death of a partner, adjustment is necessary for goodwill. Value of goodwill is calculated as per the Partnership Deed. The retiring or deceased partner is entitled to his share of goodwill at the time of retirement/death because the goodwill has been earned by the firm with the efforts of all the existing partners. The retiring/deceased partner shall be compensated for his share of goodwill by the continuing partners (who have gained due to acquisition of a share of profit from the retiring/deceased partner) in their gaining ratio. This compensation paid is known as goodwill.

Based on the above, the following approach is suggested to adjust for goodwill:

Step 1: Write off the existing book value of goodwill (if any) appearing in the Balance Sheet by passing the following Journal Entry:

All Partner's Capital Account ...Dr. (in old profit-sharing ratio)
To Goodwill Account (with the existing value of goodwill)
(Being the existing goodwill written off in old ratio.)

Step 2: Give credit for outgoing partner's (i.e., retiring or deceased partner) share of goodwill by passing the following Journal Entry:

Continuing Partners' Capital Accounts ...Dr. (in gaining ratio)
To Outgoing Partner's Capital Account (with Outgoing Partner's share of goodwill)
(Being the adjustment made for goodwill on retirement/ death of a partner)

Note: If any of the Continuing partners has also sacrificed a part of his share on profits of the firm on retirement or death of a partner, his Capital Account is also credited along with the retiring/deceased Partner's Capital Account with his proportion of sacrifice and the Continuing partners' Capital Accounts are debited who have gained on retirement/death of a partner by recording the following Journal Entry:

Continuing Gaining Partners' Capital Accounts ...Dr. (who have gained)
To Retiring/Deceased Partner's Capital Account (with Outgoing Partner's share of goodwill)
To Continuing Sacrificing Partners' Capital Accounts
(Being the adjustment made for goodwill on retirement/ death of a partner)

Hidden Goodwill

The retiring or deceased partner's account must be settled, if the firm agrees to it, by paying him a lump sum amount. The amount paid to him in excess of what is due to him should be based on the balance in his capital account after making necessary adjustments in respect of accumulated profits and losses and revaluation of assets and liabilities, etc., shall be treated as his share of goodwill (known as hidden goodwill).

14. Retirement and Death of a Partner

As learnt in case of admission of a partner, a Revaluation Account is prepared in order to ascertain net gain (loss) on revaluation of assets and/or liabilities and bringing unrecorded items into the firm's books, and the same is transferred to the capital account of all partners including retiring/deceased partners in their old profit sharing ratio.

14. Retirement and Death of a Partner

Sometimes, the Balance Sheet of a firm may show accumulated profits in the form of general reserve, reserve fund, and/or accumulated losses in the form of profit and loss account debit balance. The retiring/deceased partner is entitled to his/her share in the accumulated profits and is also liable to share the accumulated losses if any. These accumulated profits or losses belong to all the partners and should be transferred to the capital accounts of all partners in their old profit-sharing ratio.

Disposal of the amount due to Retiring Partner

The outgoing partner's account is settled as per the terms of partnership deed i.e., in lump-sum immediately or in various instalments with or without interest as agreed or partly in cash immediately and partly in instalment at the agreed intervals. In the absence of any agreement, Section 37 of the Indian Partnership Act, 1932 is applicable, which states that the outgoing partner has an option to receive interest @ 6% p.a. till the date of payment or such share of profits which has been earned with his/her money (i.e., based on capital ratio).

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14. Retirement and Death of a Partner

At the time of retirement or the death of a partner, the remaining partners may decide to adjust their capital contributions in their profit-sharing ratio. In such a situation, the sum of balances in the capitals of continuing partners may be treated as the total capital of the new firm, unless specified otherwise. Then, to ascertain the new capital of the continuing partners, the total capital of the firm is divided amongst the remaining partners as per the new profit sharing ratio, and the excess or deficiency of capital in the individual capital account's may be worked out.

It may be noted that the accounting treatment for disposal of the amount due to retiring partner and deceased partner is similar with a difference that in case of death of a partner, the amount credited to him/her is transferred to his Executors' Account and the payment has to be made to him/her.

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15. Liability of a Retiring Partner

The obligations of the partner that are binding even after retirement are as follows:

1. Retiring partner or the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death though, as between the partners they are responsible to pay only their respective share of liabilities [Section 42(2) of the Partnership Act].
2. Retiring partner may also be held liable for debts contracted after his retirement unless a notice of retirement is published as contemplated by the Law [Section 32(2) of the Partnership Act]; and
3. The estate of a deceased or a bankrupt partner cannot be held liable for debts contracted by the firm after the death or bankruptcy. [Sections 34(2) and 35 of the Partnership Act]

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16. Death of a Partner

The accounting treatment in the event of death of a partner is like that in the case of retirement of a partner. However, in the case of the death of a partner, his claim is transferred to his executors and settled in the same manner as that of the retired partner.

However, there is one major difference that, while retirement normally takes place at the end of an accounting period, the death of a partner may occur at any time. Hence, in case of death of a partner, his claim shall also include his share of profit or loss, interest on capital, interest on drawings (if any) from the date of the last Balance Sheet till the date of his death. Of these, the main problem relates to the calculation of profit for the intervening period (i.e., the period from the date of the last balance sheet and the date of the partner's death). Since, it is considered cumbersome to close the books and prepare the final account, for the period, therefore deceased partner's share of profit may be calculated on the basis of last year's profit (or the average of past few years) or on the basis of sales.

Calculation of profit up to the date of death of a partner

Such Profit is calculated through the Profit & Loss Suspense account. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

If the death of a partner occurs during the year, the representatives of the deceased partner are entitled to his/her share of profits earned till the date of his/her death.

Such profit is ascertained by any of the following two methods explained below:

1. **Time Basis:** In this case, it is assumed that profit has been earned uniformly throughout the year. For example, the total profit of the previous year is Rs. 1,25,000 and a partner dies on 30th June 2020, thus, the profit of 3 months is Rs. 31, 250 i.e. 1, 25,000 × $\frac{3}{12}$. If the deceased partner took share of profit, his/her share of profit till the date of death is Rs. 6,250 i.e. Rs. 31,250 × $\frac{1}{5}$.
2. **Turnover or Sales Basis:** In this method, we must take into consideration the profit and the total sales of the last year. Thereafter the profit up to the date of death is estimated based on the sales of the last year. Profit is assumed to be earned uniformly at the same rate.

17. Illustration

Arun, Tarun, and Neha are partners sharing profits in the ratio of 3:2:1. Neha dies on 31^{st} May 2020. Sales for the year 2019-2020 amounted to Rs. 4,00,000 and the profit on sales is Rs. 60,000. Accounts are closed on 31^{st} March every year. Sales from 1^{st} April 2020 to 31^{st} May 2020 is Rs. 1,00,000.

Calculate the deceased partner's share in the profit up to the date of death.

Solution:

Ans. Sales amounted for the year = 4,00,000 and profit is 60,000

Sales upto the date of death = 1,00,000

If the sales are 1,00,000 the profit $= \frac{60,000}{400,000} \times 1,00,000$

$= 15000$

Neha's share $= 15000 \times \frac{1}{6}$

$= 2500$

Rate of profit $= \frac{60,000}{400,000} \times 100$

$= 15\%$

Sales up to the date of death = 1,00,000

Profit $= 1,00,000 \times \frac{15}{100}$

$= 15000$

The above adjustments are made in the capital account of the deceased partner and then the balance in the capital account is transferred to an account opened in the name of his/her executor. The payment of the amount of the deceased partner depends on the agreement. In the absence of an agreement, the legal representative of a deceased partner is entitled to interest @ 6% p.a. on the amount due from the date of death till the date of final payment.

18. Dissolution and Insolvency

We have learnt about the reconstitution of a partnership firm which takes place on account of admission, retirement, or death of a partner. In such a situation, while the existing partnership is dissolved, the firm may continue under the same name if the partners so decide. In other words, it results in the dissolution of a partnership but not that of the firm.

According to Section 39 of the Partnership Act, 1932, the dissolution of a partnership between all the partners of a firm is called the dissolution of the firm. This means that the Act recognizes the difference in the breaking of relationship between all the partners of a firm and between some of the partners, and it is the breaking or discontinuance of relationship between all the partners which is termed as the dissolution of the partnership firm. This brings an end to the existence of the firm, and no business is transacted after dissolution except the activities related to the closing of the firm. The affairs of the firm are to be wound up by selling the firm's assets and paying its liabilities and discharging the claims of the partners.

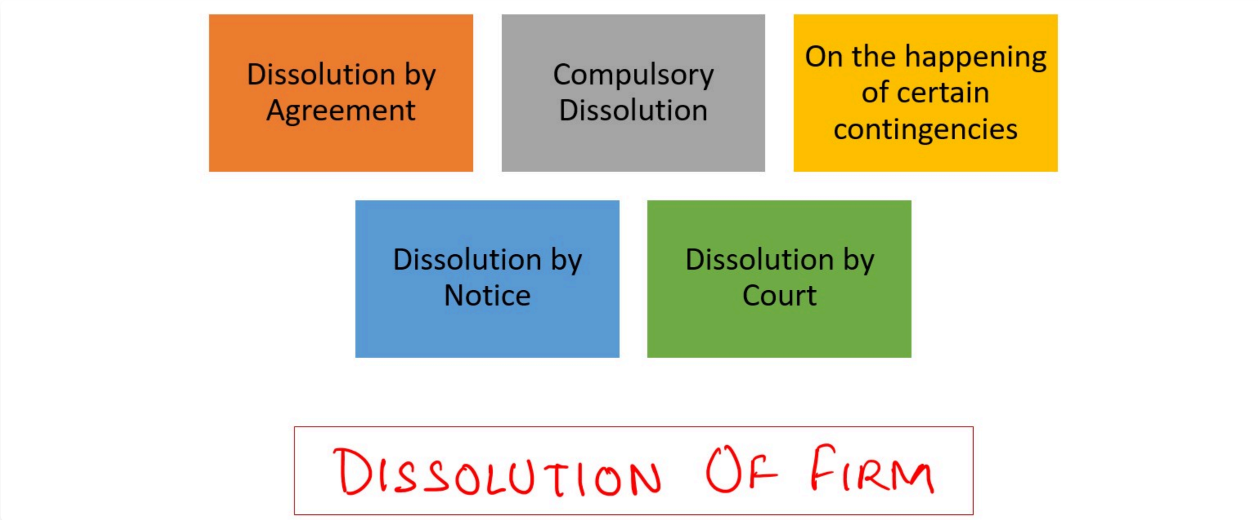
The difference between Dissolution of Partnership and Dissolution of Firm is given below.

Basis	**Dissolution of Partnership**	**Dissolution of Firm**
1. Termination of business	The business is not terminated.	The business is terminated.
2. Settlement of assets and liabilities	Assets and liabilities are revalued, and a new balance sheet is drawn.	Assets are sold and liabilities are paid off.
3. Court's intervention	The court does not intervene because the partnership is dissolved by mutual agreement.	A firm can be dissolved by the court's order.
4. Economic relationship	The economic relationship between the partners continues though in a changed form.	The economic relationship between the partners comes to an end.
5. Closure of books	It is not required because the business is not terminated.	The books of account are closed.
6. Other dissolution	It may or may not involve the dissolution of the firm.	It necessarily involves dissolution of the partnership.

Dissolution of a partnership firm may take place without the intervention of a court or by the order of a court. It may be noted that dissolution of the firm necessarily brings in the dissolution of the partnership.

18. Dissolution and Insolvency

Dissolution of a firm takes place in any of the following ways, as explained below.



(i) **Dissolution by Agreement** among partners through consent or agreement.

(ii) **Compulsory Dissolution:** A firm is dissolved compulsorily:

a. when all the partners or all but one partner, become insolvent, rendering them incompetent to sign a contract.
b. when the business of the firm becomes illegal; or
c. when some event has taken place, which makes it unlawful for the partners to carry on the business.

(iii) **On the happening of certain contingencies:** Subject to contract between the partners, a firm is dissolved:

a. if constituted for a fixed term, by the expiry of that term.
b. if constituted to carry out one or more ventures, by the completion thereof.
c. by the death of a partner.
d. by the adjudication of a partner as an insolvent.

(iv) **Dissolution by Notice:** In case of partnership at will, the firm may be dissolved, if any one of the partners gives a notice in writing to the other partners, signifying his intention of seeking dissolution of the firm.

(v) **Dissolution by Court:** At the suit of a partner, the court may order a partnership firm to be dissolved on any of the following grounds:

a. when a partner becomes insane.
b. when a partner becomes permanently incapable of performing his duties.
c. when a partner is guilty of misconduct.
d. when a partner persistently commits a breach of partnership agreement.
e. when a partner has transferred the whole of his interest in the firm to a third party.
f. when the business of the firm cannot be carried on except at a loss; or
g. when, on any ground, the court regards dissolution to be just and equitable.

18. Dissolution and Insolvency

When the firm is dissolved, its books of account are to be closed and the profit or loss arising on the realization of its assets and discharge of liabilities is to be computed. For this purpose, a Realisation Account is prepared to ascertain the net effect (profit or loss) of realization of assets and payment of liabilities which is transferred to partner's capital accounts in their profit-sharing ratio. Realization Account is a Nominal Account, as it is prepared to find out profit/ loss on realization.

Hence, all assets (other than cash in hand, bank balance, and fictitious assets, if any), and all external liabilities are transferred to this account. It also records the sale of assets, and payment of liabilities, and realization expenses. The balance in this account is termed as profit or loss on realization which is transferred to partners' capital accounts in their profit-sharing ratio. The Pro-forma of Realisation Account is provided below:

Dr. Pro-forma of Realisation Account Cr.

Particulars	Amount in Rs.	Particulars	Amount in Rs.
To Assets: Land and Building Plant and Machinery Furniture and Fittings Bills Receivables Sundry Debtors To Cash/Bank A/c (Payment of Liabilities) To Cash/Bank A/c (Payment of Unrecorded Liabilities) To Partner's Capital A/c (Liability taken over by partner) To Partner's Capital A/c (Profit on Realisation transferred to Partners' Capital Account in their Profit-Sharing Ratio)		By Liabilities: Sundry Creditors Bills Payable Bank Overdraft Outstanding Expenses Provision for Doubtful Debts By Cash/Bank A/c (Sale of Assets) By Partner's Capital A/c (Assets taken over by the Partner) By Partner's Capital A/c (Loss on Realisation transferred to Partners' Capital Account in their Profit-Sharing Ratio)	

Important points to consider while preparing Realisation Account are as follows:

- Liabilities to outsiders must be transferred to the Realization Account. In case, the amount paid in respect of the liabilities is in cash, it should be debited to the Realization Account and Cash Account is credited. If liability is taken over by a partner, the Realization Account should be debited and the Partners' Capital A/cs is credited at the figure agreed upon.
- The balance of the Realization Account will represent either the profit or loss on realization. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realization Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.
- Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.
- The balance of the cash account at the end will be exactly equal to the balance of the capital account, provided they have credit balance. Hence, credit cash, and debit the partners' capital account with the amount payable to them to close their accounts.
- If any of the assets are taken over by a partner at a value mutually agreed to by the partners, debit the Partner's Capital Account and credit Realization Account with the price of the asset taken over.
- Pay off the liabilities at book value if no other information provided regarding their realization and assets assumed to fetch no value if no realization amount is provided.
- If liability is being set off by giving an asset, then no journal entry is passed.
- If an unrecorded asset fetches an amount on realization, the amount is debited to cash/bank A/c.
- Sundry debtors are transferred at gross value and the provision for doubtful debts is transferred to the credit side of the Realisation Account along with liabilities. The same thing will apply to fixed assets, if the provision for the depreciation account

is maintained.

- All external liability accounts including provisions, if any, are closed by transferring them to the credit of the Realisation account.

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18. Dissolution and Insolvency

In case of dissolution of a firm, the firm ceases to conduct business and must settle its accounts. For this purpose, it disposes of all its assets for satisfying all the claims against it. In this context, it should be noted that, subject to agreement among the partners, the following rules as provided in Section 48 of the Partnership Act, 1932, shall apply.

(i) **Treatment of Losses:** Losses, including deficiencies of capital, shall be paid:

a. first out of profits,
b. next out of the capital of partners, and
c. lastly, if necessary, by the partners individually in their profit-sharing ratio.

(ii) **Application of Assets:** The assets of the firm, including any sum contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order:

a. In paying the debts of the firm to the third parties.
b. In paying each partner proportionately what is due to him/her from the firm for advances as distinguished from capital (i.e. partner's loan).
c. In paying to each partner proportionately what is due to him on account of capital; and
d. The residue, if any, shall be divided among the partners in their profit-sharing ratio.

Note: If there are any realization expenses, they will be paid first, and then other liabilities will be settled.

Thus, the amount realized from assets along with a contribution from partners, if required, shall be utilized first to pay off the outside liabilities of the firm such as creditors, loans, bank overdraft, bill payables, etc. (it may be noted that secured loans have precedence over the unsecured loans); the balance should be applied to repay loans and advances made by the partners to the firm (in case the balance amount is not adequate enough to pay off such loans and advances, they are to be paid proportionately); and surplus, if any is to be utilized in settlement of the capital account balances, after adjusting all profits and losses.

Where both the debts of the firm and private debts of a partner co-exist, the following rules, as stated in Section 49 of the Act, shall apply:

a. The property of the firm shall be applied first in the payment of debts of the firm and then the surplus, if any, shall be divided among the partners as per their claims, which can be utilized for payment of their private liabilities.
b. The private property of any partner shall be applied first in payment of his private debts and the surplus, if any, may be utilized for payment of the firm's debts, in case the firm's liabilities exceed the firm's assets. It may be noted that the private property of the partner does not include the personal properties of his wife and children. Thus, if the assets of the firm are not adequate to pay off the firm's liabilities, the partners have to contribute out of their net private assets (private assets minus private liabilities).

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19. Insolvency of a Partner

When a partner is unable to contribute towards the deficiency of his capital account (the account finally showing a debit balance), he/she is said to be insolvent, and the sum not recoverable is treated as a capital loss for the firm. Such a capital loss is to be borne by the remaining solvent partners in accordance with the principle laid down in the *Garner vs. Murray case*, which states that the solvent partners have to bear such loss in the ratio of their capitals as on the date of dissolution.

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19. Insolvency of a Partner

If a partner goes insolvent, then following are the consequences:

a. The partner adjudicated as insolvent ceases to be a partner.
b. He ceases to be a partner on the date on which the order of adjudication is made.
c. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.
d. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication.
e. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

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19. Insolvency of a Partner

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

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

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

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19. Insolvency of a Partner

The partners are free to have either fixed or fluctuating capitals. If they are maintaining capitals at fixed amounts, then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary, etc. are done through Current Accounts, which may have debit or credit balances, and insolvency loss is distributed in the ratio of fixed capitals.

But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts, then the Balance Sheet of the business shall not exhibit Current Accounts of the partners, and the capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and on drawings to the date of dissolution but before adjusting profit or loss on Realisation Account.

If some partner is having a debit balance in his Capital Account and is not insolvent, then he cannot be called upon to bear the loss on account of the insolvency of other partners.

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19. Insolvency of a Partner

When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent.

If all the partners are insolvent, then the creditors cannot be paid in full. All the cash available, together with whatever can be recovered from the private estates of the partners, will be paid to the creditors after the expenses of realization are met.

The Realisation Account should be prepared in the usual course but creditors should not be transferred to this account nor will pay to creditors be debited to this account; the loss on realization should be transferred to the capital accounts of partners in the profit-sharing ratio.

The available cash should then be paid to the creditors. The amount remaining unpaid should be transferred to the Deficiency Account to which account, the balances of partners’ capital accounts should also be transferred. Thus, the books will be closed.

Piecemeal Payments

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

i. **Maximum Loss Method:** Each instalment realized is considered to be the final payment i.e., outstanding assets and claims are considered worthless and partners’ accounts are adjusted on that basis each time when a distribution is made, following either Garner vs. Murray Rule or the profit-sharing ratio rule.
ii. **Highest Relative Capital Method:** According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called the proportionate capital method. For determining the amount by which the capital of each partner is more than his relative capital, partners’ capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called their hypothetical capitals.

The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

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1. Introduction

The never-ending human desire to grow and grow further has given rise to the expansion of business activities, which in turn has necessitated the need to increase the scale of operations so as to provide goods and services to the ever-increasing needs of the growing population of consumers. Large amount of money, modern technology, large human contribution etc. is required for it, which is not possible to arrange under partnership or proprietorship. To overcome this difficulty, the concept of 'Company' or 'Corporation' came into existence.

Corporate Accounting is a special branch of accounting which deals with the accounting for companies, preparation of their final accounts and cash flow statements, analysis and interpretation of companies' financial results and accounting for specific events like amalgamation, absorption, preparation of Consolidated Balance Sheets.

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2. Company Form of Business Organization

A company (or a joint stock company) is an entity incorporated by a group of persons through the process of law for a undertaking (usually) a business. It is an artificial person and is separate from its members.

As per Section 2(20) of the Companies Act 2013, the Company means a company incorporated under this Act or any previous Company Law.

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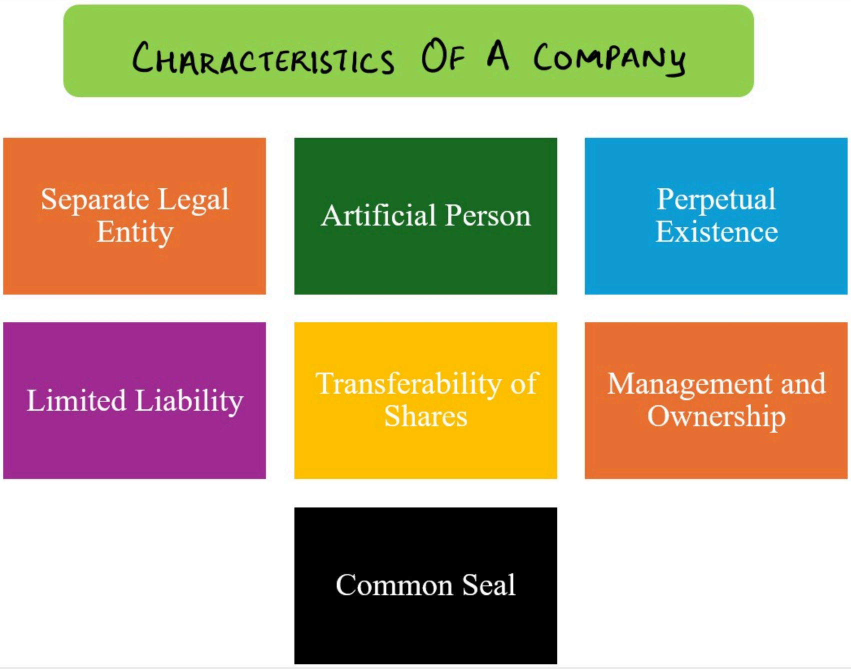
2. Company Form of Business Organization

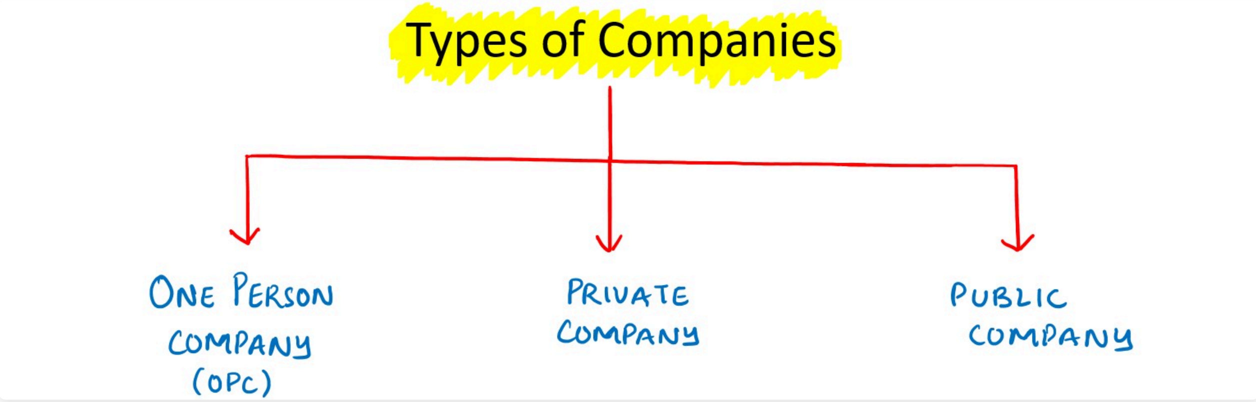
A company has certain distinct features from other forms of business organisation. These are as follows:



- **Separate Legal Entity:** A company is an artificial person having a legal entity separate from its shareholders.
- **Artificial Person:** In the eyes of law it is an artificial person, it can own property and enter into contracts, conduct business, sue or be sued for its debt and actions.
- **Perpetual Existence:** A company has a perpetual succession, i.e., its existence is not affected by death, lunacy or bankruptcy of its members or shareholders. The life of the company only comes to an end only through the winding up process of law.
- **Limited liability:** Liability of its members is limited to the value of shares subscribed by the members.
- **Transferability of the Shares:** Shares of a company are freely transferable, except in case of private companies.
- **Management and Ownership:** A company is not managed by all the members but by elected representatives called directors. Thus, management and ownership are separate.
- **Common seal:** A company may have its common seal. All the important documents of the company should have this seal affixed to it.

2. Company Form of Business Organization

The companies can be categorized into 3 types. Let us look at each of them, one by one.



One Person Company (OPC)

As per Section 2(62) of the Companies Act, 2013 “One Person Company means a company which has only one person as a member”. Rule 3 of Companies (Incorporation) Rules, 2014 further prescribes that:

- Only a natural person being an Indian citizen and resident of India can form a one-person company or can be a nominee for sole member of OPC.
- It cannot be formed for charitable purposes.
- It cannot carry out non-banking financial investment activities including investment in securities of anybody corporate.
- Its paid-up share Capital is not more than Rs. 50 lakhs.
- Its average annual turnover of 3 years should not exceed Rs. 2 crores.
- A One Person Company should have at least 1 director but not more than 15 directors.

Private Company

A private company is one which has a minimum prescribed paid up share capital and by its Articles of Association and it must affix Private Limited at the end of its name. Some of the features of a Private Company are follows:

- It restricts the right to transfer shares.
- It must have at least 2 members.
- The maximum number of members cannot be more than 200.
- It forbids any invitations to the public to subscribe for any securities of the company.
- It has at least 2 directors and maximum of 15 directors.

Public Company

A Public company is one which has an extension to it names as Limited. Some of the features of a Public Company are as follows:

- The members can freely transfer their shares.
- It must have at least 7 members.
- There is no limit to maximum number of members.
- It can issue prospectus for inviting application from public for issue of securities.
- It has at least 3 directors and maximum of 15 directors.

3. Share Capital of a Company

A company, being an artificial person, cannot generate its own capital which is necessarily to be collected from several persons. These persons are known as 'shareholders' and the amount contributed by them is called 'share capital'. Since the number of shareholders is very large, a separate capital account cannot be opened for each one of them. Hence, innumerable streams of capital contribution merge their identities in a common capital account called as **Share Capital Account**.

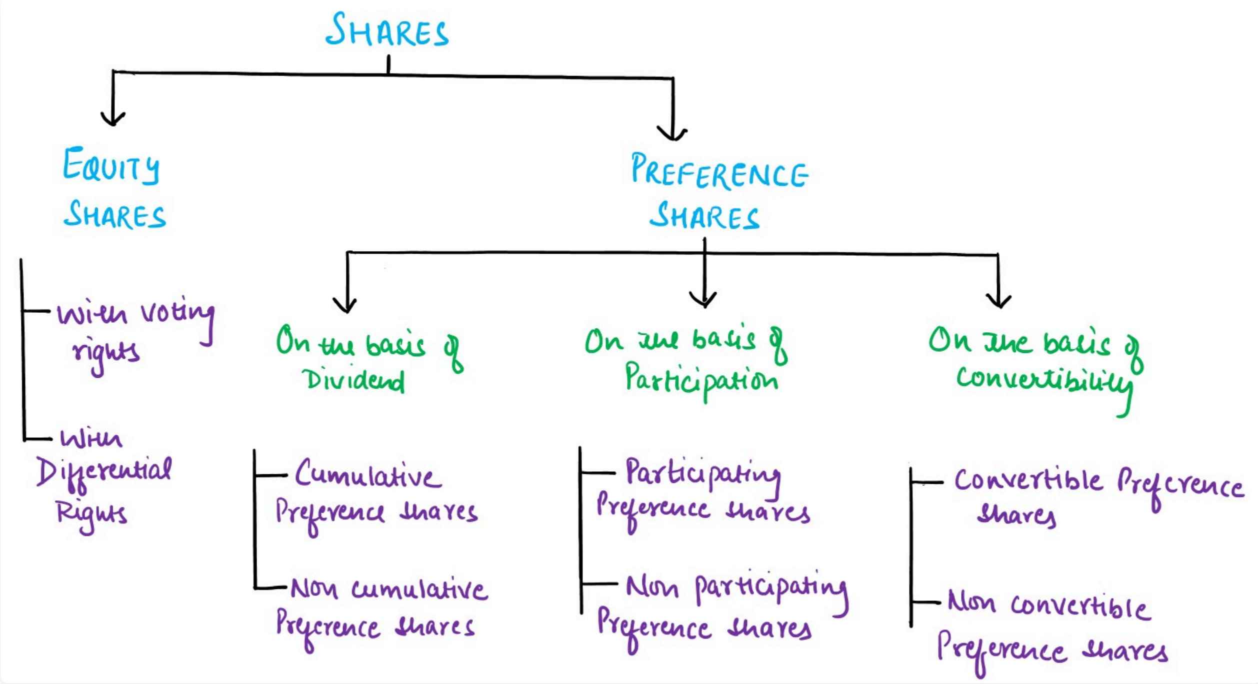
From accounting point of view, the share capital of the company can be classified, as given in the table.

Types of Capital	**Meaning**
Authorized Capital	It is the maximum limit of capital which the company is authorized to raise.
Issued Capital	It is that part of authorized capital which the company has issued to the public.
Subscribed Capital	It is that part of the issued capital which is subscribed by the public.
Called-Up Capital	It is that amount of the shares subscribed that are demanded from the public by the company.
Paid-Up Capital	It is that portion of the called-up capital which has been received from the shareholders. When the shareholders have paid the entire call amount, the called-up capital is the same to the paid-up capital. If any of the shareholders has not paid amount on calls, such an amount may be called as *calls in arrears*. Therefore, paid up capital is equal to the called-up capital *minus* call in arrears.
Uncalled Capital	It is that portion of the subscribed capital which has not yet been called up. The company may collect this amount any time when it needs further funds.
Reserve Capital	The Company may decide by passing a special resolution that a portion of the uncalled amount shall not be called up by the company except in case of winding up or liquidation. This is called reserve capital.

Whenever there is an excess or deficit on the called-up amount from the shareholders of the Company, the following accounts are opened:

- **Calls in Arrear:** Some shareholders fail to pay the amount due on allotment and/or calls on the shares held by them. Such unpaid amount on account of one or more instalments is called *calls in arrear* or *unpaid calls*.
- **Calls in Advance:** Sometimes shareholders pay a part or the whole of the amount of the calls not yet made. The amount so received from the shareholders is known as *Calls in Advance*. The amount received in advance is a liability of the company and should be credited to *Calls in Advance Account*. The amount received will be adjusted towards the payment of calls as and when they become due.

The *shares* refer to the units into which the total share capital of a company is divided. Thus, a share is a fractional part of the share capital and forms the basis of ownership interest in a company. The persons who contribute through shares are called **shareholders**. As per Section 86 of the Companies Act 2013, a company can issue 2 types of shares. Let us look at them one by one.



3. Share Capital of a Company

Equity share capital, with reference to any company limited by shares means all share capital that does not come under preference share capital. Equity share capital can further be divided into the following types:

- **With voting rights:** All the equity shareholders have right to take part in the management of the company through their representative board of directors. The shareholders can give their approval by giving votes.
- **With differential rights regarding dividend or voting or any other such rights:** Equity shares, commonly referred to as ordinary shares, represent the form of fractional ownership in which a shareholder, as a fractional owner, undertakes the maximum entrepreneurial risk associated with a business venture. The holder of such shares is the member of the company and has voting rights. They are not entitled to residual income of the company but enjoy the right to control the affairs of business. Where the voting rights on new shares are different from the voting rights on the equity shares already issued, the new shares are known as *Differential Voting Rights Shares (DVRS).*The DVRS do not follow the common rule of one share-one vote, enable promoters to retain control over the company even after many new investors come in, by allowing shares with superior voting rights or lower or fractional voting rights to public investors.

3. Share Capital of a Company

Preference, as the name suggests, with reference to any company limited by shares, refers to that share capital of the issued share capital of the company which would carry a preferential right regarding:

- Payment of dividend (dividend can either be as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income tax)
- Repayment of principal amount, at the time of winding up of the company.

The preference shares can be classified, further sub-divided into following 3 types.

On the basis of dividend

Preference shares can be classified into 2 types on the basis of payment of dividend. These are as follows:

i. **Cumulative Preference Shares:** Cumulative preference shares are the preference shares whose holders are entitled to receive arrears of dividend before any dividend is paid on equity shares.
ii. **Non-cumulative Preference Shares:** Non-cumulative preference shares are the preference shares whose holders do not have the right to receive arrears of dividend. If no dividend is declared in any year due to any reason, they get nothing, nor can they claim unpaid dividend in any subsequent years.

On the basis of participation

Preference shares can be classified into 2 types based on participation, i.e., on the basis that whether or not the holders of such preference shares have a right to participate in the surplus profits of the company.

i. **Participating Preference Shares**: In addition to the fixed preference dividend, such shares carry a right to participate in the surplus profit, if any, after providing dividend at a stipulated rate to equity shareholders.
ii. **Non-Participating Preference Shares**: Such shares get only a fixed rate of dividend every year and do not have a right to participate in the surplus profit, if any.

On the basis of convertibility

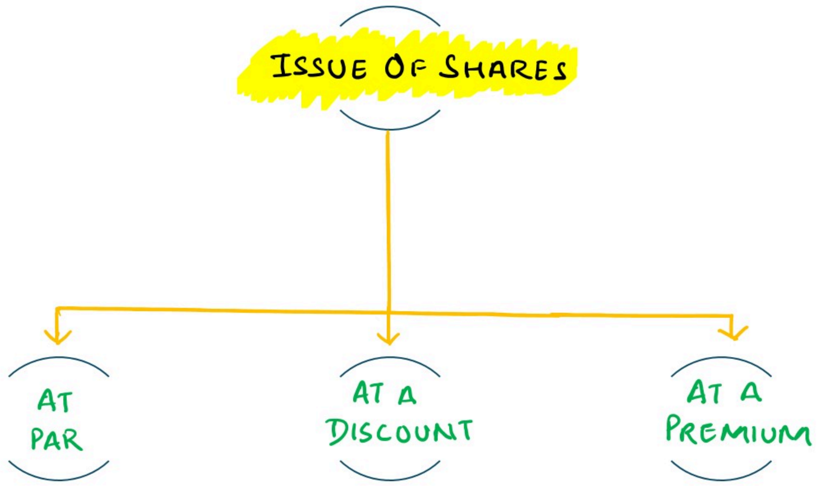
Preference shares can be classified into 2 types based on convertibility, i.e., on the basis that whether or not the holders of such preference shares have an option to convert their preference shares into equity shares.

i. **Convertible Preference Shares:** These are preference shares with a right/option to get converted into equity shares.
ii. **Non-Convertible Preference Shares:** These are preference shares which do not have the right/ option to get converted into equity shares.

4. Issue of Shares

A salient characteristic of the capital of a company is that the amount on its shares can be gradually collected in small instalments spread over a period depending upon its growing financial requirement. The first instalment is collected along with application and is thus, known as **application money**, the second on allotment (termed as *allotment money*), and the remaining instalments are termed as **first call, second call** and so on. The word 'final' is suffixed to the last instalment. However, there in no way to prevent a company from calling the full amount on shares right at the time of application.

The shares of a company may be issued, as per following 3 types:



1. **at Par:** Shares are to be issued at par when their issue price is exactly equal to their nominal value (or face value) according to the terms and conditions of issue. For example, A share of Rs. 10 is issued at Rs. 10.
2. **at a Discount:** When the shares are issued at a price less than the face value of the share, it is known as shares issued at a *discount*. For example, A share of Rs. 10 is issued at Rs. 8, then Rs. 2 less on the face value of the share is the amount of discount.
3. **at a Premium:** When the shares of a company are issued more than its nominal value (face value), the excess amount is called premium. For example, A share of Rs. 10 is issued at Rs. 12, then Rs. 2 excess on face value of share is the amount of premium.

Irrespective of the fact that shares are issued at par, premium or discount, the share capital of a company as stated earlier, may be collected in instalments payable at different stages or in lumpsum.

We will discuss them in detail one by one.

4. Issue of Shares

When company issues share at the face value, then it is said to have issue of shares at par.

Illustration

A company issues 4000 shares of face value Rs 10 at Rs. 10. Pass necessary journal entries. Assuming that all the amount is called up at the time of application.

Solution:

Following Journal Entries shall be passed:

(a)

Bank A/c (40,000 x Rs 10) — Dr.	40,000	
To share Application		40,000

(Being share application amount received for 4000 shares @ Rs. 10.)

(b)

Share Application and Allotment — Dr.	40,000	
To share Capital		40,000

(Being share application amount transferred to Share capital A/c)

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4. Issue of Shares

As per Section 53 of Companies Act 2013, there is prohibition on issue of shares at discount. Any share issued by a company at a discounted price shall be void. However, a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India. Section 54 of the said Act further authorises companies to issue Sweat Equity Shares at Discount.

Note: 'Sweat equity shares' are such equity shares, which are issued by a Company to its directors or employees at a discount or for consideration, other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

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4. Issue of Shares

When a company issues shares at value more than its face value, then it is said to have issue of shares at premium.

Illustration

A company issues 4000 shares of face value Rs 10 at Rs.12, Pass the necessary journal entries for the following. Assuming that all the amount is called up at the time of application.

Solution:

Following Journal Entries shall be passed:

Bank A/c (4000 x Rs. 12) —— Dr.	48000	
To Share Application and Allotment A/c		48000

(Being share application amount received)

Share Application and Allotment	48000	
To share capital (4000 x Rs 10)		40,000
To Securities Premium Reserve A/c (4000 x Rs. 2)		8000

(Being share application amount transferred to Share capital A/c and premium of Rs. 2 on 4000 shares are transferred to Securities Premium A/c)

4. Issue of Shares

As per the Companies Act, 2013, when a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium collected on shares must be credited to a separate account called **Securities Premium Account**. The premium on issue of shares is not to be treated as revenue profits. In fact, it is considered as capital receipt.

There are no restrictions in the Companies Act on the issue of shares at a premium, but there are certain restrictions at the time of its disposal or use.

Restrictions on application of premium amount received are provided under Section 52(2) of the Companies Act, 2013. Accordingly, Securities Premium Account may be applied by the company:

- towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares,
- in writing off the preliminary expenses of the company,
- in writing off the expenses of, or the commission paid, or discount allowed on, any issue of shares or debentures of the company,
- in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- for the purchase of its own shares or other securities under section 68.

It is to be noted that utilization of the amount of Securities Premium Account except in any of the modes specified above, will attract the provisions relating to the reduction of share capital of a company under the Section 66 of the Companies Act, 2013.

The Securities Premium Account must be shown as **Securities premium reserves** separately on the liabilities side of the balance sheet under the head **Reserves & Surplus**.

5. Minimum Subscription

It is the minimum amount which has been mentioned in the prospectus that must be subscribed by the public before an allotment of any security can be made. As per the Companies Act, 2013, the minimum subscription to be subscribed by the public by the date of closure of such issue, is 90% of the total shares issued (offered). If this condition of minimum subscription is not met within the prescribed time, the company is under obligation to refund whatever amount it has received from the public for subscription of its shares.

6. Over Subscription

There are instances when applications for more shares of a company are received than the number offered to the public for subscription. This usually happens in respect of issue of shares of well-managed and financially strong companies and is said to be a case of "Over Subscription". The problem of over subscription is resolved with the allotment of shares. Therefore, from the accounting point of view, it is better to place the situation of over subscription within the total frame of application and allotment.

In such a condition, 3 alternatives are available to the directors to deal with the situation:

1. They can accept some applications in full and totally reject the others.
2. They can make a pro-rata allotment to all.
3. They can adopt a combination of the above two alternatives which happens to be the most common course adopted in practice.

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6. Over Subscription

When the directors decide to fully accept some applications and totally reject the others, the application amount received on rejected applications is fully refunded. Let us understand this with the help of an example.

Illustration

Raman Ltd. invited applications for 20000 shares @ Rs. 10 and received the applications for 25000 shares. The directors rejected the applications for 5000 shares which are more than the required number and refunded their application amount in full. Pass necessary journal entries on application and allotment.

Solution:

Following journal entries shall be passed:

Bank A/c (25000 x Rs 10) —— Dr.	2,50,000	
To Share Application and Allotment A/c		2,50,000

(Being amount received on application for 25000 shares @ Rs. 10 per share)

Share Application and Allotment —— Dr.	2,50,000	
To Share Capital (20,000 x 10)		2,00,000
To Bank A/c (5000 x Rs 10)		50,000

(Being share application amount transferred to share capital and excess is refunded)

---

6. Over Subscription

When the directors opt to make a proportionate allotment to all applicants (called 'pro-rata' allotment), the excess application amount received is normally adjusted towards the amount due on allotment. In case, the excess application amount received is more than the amount due on allotment of shares, such excess amount may either be refunded or credited to calls in advance.

Illustration

Crystal Ltd. invited application for 500000 equity shares of Rs.10 each at a premium of Rs. 5 per share. Which is Payable as follows - Rs. 3 on application Rs. 7 on allotment (including premium) and balance on first and final call, because of favourable conditions issue was oversubscribed and application were received from 700000 shares. Pass journal entries if pro rata allotment is done to all applicants.

Solution:

Following journal entries shall be passed:

Bank A/c (70,000 x Rs 3) —— Dr.	21,00,000	
To share Application A/c		21,00,000

(Application amount received on 700000 shares @ Rs.3 per Share)

Share Application A/c (70,000 x Rs 3)	21,00,000	
To share Capital A/c (50,000 x Rs 3)		15,00,000
To share Allotment A/c (20,000 x Rs 3)		6,00,000

(Transfer of share application amount to share capital A/c and the excess application amount on 2,00,000 shares transferred to share allotment account.)

Share Allotment A/c (50,000 x Rs 7) —— Dr.	35,00,000	
To share Capital (50,000 x Rs 2)		10,00,000
To security Premium (50,000 x Rs 5)		25,00,000

(Amount due on allotment of 500000 shares @ Rs. 7 per share.)

Bank A/c (50,000 x Rs 7) – (Rs 6,00,000) —— Dr.	29,00,000	
To share Allotment A/c		29,00,000

(Allotment amount received after adjusting the amount of Rs. 6,00,000 already received as excess application money.)

6. Over Subscription

When the application for some shares are rejected outrightly; and pro-rata allotment is made to the remaining applicants, the amount on rejected applications is refunded and the excess application amount received from applicants to whom pro-rata allotment has been made is adjusted towards the amount due on allotment for the shares allotted.

Illustration

Jyoti Power Ltd. decided to set up a power plant, for raising funds it decided to issue 20000 shares of Rs. 10 each payable as follows:

- Rs. 4 on application
- Rs. 3 on allotment
- Rs. 3 on first call

Applications were received for 25000 shares and the company decided to allot shares to applicant of 22000 shares on pro rata basis and reject the remaining shares. Pass necessary journal entries.

Solution:

Following journal entries shall be passed:

Bank A/C (25000 x Rs 4)	— Dr.	100,000	
To share Application A/C			100,000

(Amount received on application for 25000 shares @ Rs. 4 per share)

Share Application A/C (25000 x Rs 4)	— Dr.	1,00,000	
To share Capital A/C (20,000 x Rs 4)			80,000
To share Allotment A/C (2000 x Rs 4)			8000
To Bank A/C (3000 x Rs 4)			12000

(Being application amount transferred to share capital A/c, excess application amount of pro-rata allottees is credited to share allotment A/c and the amount on rejected on 3000 applications is refunded.)

Share Allotment A/C (20,000 x Rs. 3)	— Dr.	60,000	
To share Capital A/C			60,000

(Being amount due on the Allotment of 20000 shares @ Rs. 3 per share)

Bank A/C (20,000 x Rs 3) – Rs 8000	— Dr.	52000	
To Share Allotment A/C			52000

(Allotment amount received after adjusting the amount already received as excess application money)

Working Notes

Amount received on application
= Number of shares applied × Instalment amount on application
= 25000 × Rs. 4 = Rs. 1,00,000

Amount required on application
= Number of shares issued × Instalment amount on application
= 20000 × Rs. 4 = Rs. 80,000

Application rejected, amount to be refunded on 3000 shares as only 22000 shares were allotted on pro rata shares
= Numbers of shares rejected × Instalment amount on application
= 3000 × Rs. 4
= Rs. 12,000

Excess amount received on application to be adjusted towards allotment
= Amount received on application – Amount required on application – Amount to be refunded on rejection
= Rs. 1,00,000 – Rs. 80,000 – Rs. 12,000 = Rs. 8,000

6. Over Subscription

When the shares are allotted on a pro-rata basis and one or some of the shareholders of the pro-rata category fail to pay the allotment money, then it is necessary to compute the amount not received on allotment. This can be done by finding out the number of shares allotted to the applicant or the number of shares applied by the applicant.

When shares allotted are given:

$$\text{Number of shares applied} = \frac{\text{Total shares applied}}{\text{Total shares allotted}} \times \text{No. of shares allotted}$$

When shares applied are given:

$$\text{Numbers of shares allotted} = \frac{\text{Total shares allotted}}{\text{Total shares applied}} \times \text{No. of shares applied}$$

6. Over Subscription

MCS Ltd. issued 40000 shares of Rs. 10 each payable at Rs. 2 on application, Rs. 4 on allotment and balance in two equal instalments. Applications were received for 80000 shares and the allotment was made as follows:

i. Applications of 50000 shares were allotted 30000 shares.
ii. Applications of 30000 shares were allotted 10000 shares.

Calculate:

a. The shares applied by Neeraj, who was allotted 600 shares from category (i)
b. The shares allotted to Payal, who applied for 2700 shares and was allotted shares from category (ii).

Solution:

a) By following the simple unitary method, shares applied by Neeraj, who was allotted shares from category (i)

$$= \text{Number of shares allotted} \times \frac{\text{Total shares applied [Category (i)]}}{\text{Total shares allotted [Category (ii)]}}$$

$$= 600 \times \frac{50{,}000}{30{,}000} = 1000$$

b) Again, following the simple unitary method, shares allotted to Payal from category (ii):

$$= \text{Number of shares applied} \times \frac{\text{Total no. of shares allotted [category (ii)]}}{\text{Total no. of shares applied [Category (ii)]}}$$

$$= 2700 \times \frac{10{,}000}{30{,}000} = 900$$

Thus, Neeraj had applied for 1000 shares, against which he had been allotted 600 shares and Payal who had applied for 2700 was allotted 900 shares.

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7. Under Subscription

Under subscription is a situation where number of shares applied for is less than the number for which applications have been invited for subscription. For example, a company offered 200000 shares for subscription to the public, but the applications were received for 190000 shares, only. In such a situation, the allotment will be confirmed to 190000 shares and entries shall be made accordingly. However, it must be ensured that the company has received the minimum subscription (not less than 90% of the offer), otherwise the procedure for issue of shares cannot proceed further and the company will have to refund the entire subscription amount received.

8. Issue of Shares for Consideration other than Cash

On Purchase of Assets from the vendor

Sundry Assets A/c ...Dr. (With the price of individual asset)
To Vendor's A/c (Being asset purchased from the vendor.)

On the issue of shares to the vendor

Vendor's A/c ...Dr. (Amount payable)
To Share Capital A/c (Face value)
To Securities Premium A/c (Premium amount, if shares are issued at a premium)
(Being shares issued to the vendor for payment of assets purchased.)

Note: Shares cannot be issued at a discount.

At the time of Purchase of the Business of the Vendor

When a company purchases the business of another company, it takes over the assets as well as the liabilities of the company at a predetermined price. The following journal entry is passed:

Sundry Assets A/c ...Dr.
To Sundry Liabilities A/c
To Vendors A/c

Notes:

(a) In case where a company may purchase the assets and takeover liabilities of another business, the purchase consideration will be equal to the value of Net Assets (Assets - Liabilities) taken over and the whole amount of the consideration is paid by issue of shares. In case of the whole business being taken over, if the amount of shares issued is more than the amount of the Net Assets taken over, the difference (excess) will be treated as *value of goodwill* and the same shall also be debited while passing the journal entry for the purchase of vendor's business. But, if it is the other way around, i.e., the value of shares issued is less than the value of the Net Assets taken over, the difference will be credited to *Capital Reserve* Account.

(b)

$$\text{Number of shares issued} = \frac{\text{Purchase consideration}}{\text{Issue Price of a share (after adjusting for Premium or discount)}}$$

8. Issue of Shares for Consideration other than Cash

Dee Ltd. purchased a machinery worth Rs. 2,00,000. The payment was done by issue of equity shares of Rs. 10 each. Pass the necessary journal entries.

Solution:

Following journal entries shall be passed:

Machinery A/c —— Dr.	2,00,000	
To Vendor A/c		2,00,000

(Being Machinery purchased)

Vendor A/c —— Dr.	2,00,000	
To share Capital A/c		2,00,000

(Being equity shares issued to vendor. Number of shares issued to vendor = $\frac{2,00,000}{10}= 20,000$)

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8. Issue of Shares for Consideration other than Cash

Rohan Ltd. purchased a running business from Aman Ltd. for a sum of Rs 15,00,000. The payment of Rs. 12,00,000 was made by issue of fully paid equity shares of Rs 10 each and balance by a bank draft. The assets and liabilities consisted of the following plant Rs. 3,50,000; stock Rs. 4,50,000; land and building Rs. 6,00,000; sundry creditors Rs. 1,00,000.

Solution:

Following journal entries shall be passed in the books of Rohan Limited.

Plant A/c ...Dr. 3,50,000
Stock A/c ...Dr. 4,50,000
Land and building A/c 6,00,000
Goodwill (balancing figure) ...Dr. 2,00,000

To Aman ltd. A/c		15,00,000
to Sundry creditors A/c		1,00,000
(Being business purchased of Aman ltd.)		
Aman ltd. A/c ———— Dr.	15,00,000	
to equity share capital A/c		12,00,000
to Bank A/c		3,00,000
(Being shares issued to Aman ltd.)		

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9. Forfeiture of Shares

It may happen that some shareholders fail to pay one or more instalments, viz. allotment amount and/or call money. In such circumstances, the company may forfeit their shares, i.e. cancel their allotment, and treat the amount already received thereon as forfeited to the company within the framework of the provisions in its articles.

The effect of forfeiture of shares is that the defaulting shareholder loses all his rights in the forfeited shares and ceases to be a member of the company. The name of the shareholder is removed from the Register of Members of the company and the amount already paid by him is forfeited. He is consequently not entitled in future to dividends and rights of membership.

These provisions are usually based on Table A (Table A is the Memorandum of Association of a Company Limited by Shares), which authorise the directors to forfeit the shares for non-payment of calls made. For this purpose, they have to strictly follow the procedure laid down in this regard.

When shares are forfeited, all entries relating to the shares forfeited except those relating to premium, already recorded in the accounting records must be reversed. Accordingly, share capital account is debited with the amount called-up in respect of shares forfeited and crediting the respective 'unpaid calls accounts' or 'calls in arrears account' with the amount already received.Let us discuss the journal entry one by one.

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9. Forfeiture of Shares

Share Capital A/c ...Dr. (Called-up amount, i.e. no. of shares forfeited × the called-up value per share)

To Share Forfeiture A/c (Paid up amount)
To Share Allotment A/c
To Share Calls A/c (individually)
(Being shares forfeited for non-payment of allotment amount and calls made.)

The balance of shares forfeited account is shown as an addition to the total paid-up capital of the company under the head 'Share Capital' under the title 'Equity and Liabilities' of the Balance Sheet till the forfeited shares are reissued.

Let us understand it with the help of an example.

Illustration

Meeta Ltd. forfeited 200 shares of Rs. 10 each, Rs. 5 per share called-up by the company on which Rs. 3 per share had been paid. Directors forfeited these shares immediately. Give journal entries in the books of the company for forfeiture of shares.

Solution:

The following journal entry shall be passed:

Share Capital A/c (200 × Rs 5) — Dr.	1000	
To Share Forfeiture A/c (200 × Rs 3)		600
To Call in arrear A/c (200 × Rs 2)		400

(Being shares forfeited.)

9. Forfeiture of Shares

If shares were initially issued at a premium and the premium amount has been fully realised, but some of the shares are forfeited due to non-payment of call money, the accounting treatment of forfeiture shall be on the same pattern as in the case of shares issued at par. The important point to be noted in this context is that the securities premium account is not to be debited at the time of forfeiture, if the premium has been received in respect of the forfeited shares and the amount of forfeiture shall be excluding premium amount.

In case, however, if the premium amount has not been received, either wholly or partially, in respect of the shares forfeited, the Securities Premium Account will also be debited with the amount of premium not received along with the Share Capital Account at the time of forfeiture. This will usually be the case when even the amount due on allotment has not been received. Thus, the journal entry to record the forfeiture of shares issued at a premium on which premium has not been fully received, will be:

Share Capital A/c ...Dr. (With the amount of called up value of shares forfeited i.e. no. of shares forfeited × called up value per share, excluding premium)
Securities Premium A/c ...Dr. (With the amount of premium amount remaining unpaid on share forfeited)
To Share Forfeiture A/c (With the amount already paid by the shareholders on the share forfeited)
To Share Allotment A/c
and/or
To Share Calls A/c (individually)
(Being shares forfeited for non-payment of allotment and calls made)

Note: If Calls in Arrears Account is maintained, Calls in Arrears Account is credited and not the Share Allotment and/or Share Call/Calls Accounts.

9. Forfeiture of Shares

The directors of a company forfeited 200 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. Pass the necessary journal entry.

Solution:

Since the company has already received the amount of premium following journal entries shall be passed:

Share capital A/C (200 x Rs 8) — Dr. 1600
To share forfeiture A/C (200 x Rs 5) 1000
To share first call A/C (200 x Rs 3) 600

(Being Share Forfeited for Non-Payment of Calls)

Note: Share capital A/c is debited with the called-up amount on these shares i.e. Rs. 8. If the question is silent about when the amount of premium is receivable it is assumed to be received at allotment. Hence in the above question it is received and therefore at the time of allotment it is not be shown.)

9. Forfeiture of Shares

Megha Ltd. forfeited 400 shares of Rs. 10 each issued at a premium Rs. 5 per share on non-payment of allotment and final call money of Rs. 7(including premium). Give journal entries in the books of the company for forfeiture of shares.

Solution:

Following journal entry shall be passed:

Share Capital A/c (400 X Rs 10)	—— Dr.	4000	
Security Premium A/c (400 X Rs 5)	—— Dr.	2000	
To Share Forfeiture A/c (400 X Rs 8)			3200
To share Allotment and final call (400 x 7)			2800

(Being Share Forfeited for Non-Payment of Calls)

Note: Since all the amount is called up by the company, Share Capital A/c is to be debited by Rs. 10 and Securities Premium A/c is to be debited by the amount of premium not received.)

10. Re-issue of Forfeited Shares

The directors can either cancel or re-issue the forfeited shares. In most cases, they reissue such shares which may be reissued at par, at premium or at a discount.

In this context, it may be noted that the amount of discount allowed cannot exceed the amount that had been received on forfeited shares at the time of initial issue, and that the discount allowed on reissue of forfeited shares should be debited to the 'Forfeited Shares Account'. The balance, if any, left in the Share-Forfeited Account relating to reissued Shares, should be treated as capital profit and transferred to Capital Reserve Account.

Illustration 1

A company forfeits 200 shares of Rs. 10 each on which Rs. 600 had been received. Assuming that the company reissues these shares for Rs. 1,800 (@ Rs. 9 per share) as fully paid, Pass the necessary journal entries.

Solution:

Following journal entries shall be passed:

Share capital A/c (200 X Rs10) —— Dr. 2000
To share forfeiture A/c 600
To calls in arrear A/c 1400

(Being 200 shares of Rs. 10 each forfeited for non-payment of calls, refer to note 1 below.)

Bank A/c (200 X Rs 9) —— Dr. 1800
Share forfeiture A/c (200 X Rs 1) —— Dr. 200
To share Capital A/c (200 X Rs 10) 2000

(Being 200 forfeited shares reissued of at Rs. 9 per share as fully paid. refer to note 2 below.)

This shall leave a balance of Rs. 400 in share forfeited account which should be transferred to Capital Reserve Account by recording the following journal entry:

Share forfeiture A/c (Rs 600 – Rs 200) —— Dr. 400
To Capital Reserve 400

(Being Profit on reissue of forfeited shares transferred)

Working Notes

Note 1: The maximum amount of discount allowed on reissue is the amount credited to share forfeiture A/c and the amount not received on these shares is credited to Call in Arrears A/c.

Note 2: Bank A/c will be debited by: Reissue price of share × Number of shares. The Share forfeiture A/c is debited with the amount of discount allowed on reissue of these shares, All share of face value of Rs. 10 is reissued at Rs. 9 as fully paid up therefore, a discount of Rs. 1 is allowed on these shares.

Note 3: Amount transferred to capital reserve account is the difference of debit and credit of forfeiture A/c once the shares are reissued. Amount forfeited on 200 shares = Rs. 600.

Less: Discount on reissue of shares Rs. 200
Amount transferred to Capital Reserve A/c = 600 – 200 = Rs. 400.

Another important point to be noted in this context is that the capital profit arises only in respect of the forfeited share reissued, and not on all forfeited shares. Hence, when a part of the forfeited shares is reissued, the whole balance of share forfeiture account cannot be transferred to the capital reserve. In such a situation, it is only the proportionate amount of balance that relates to the forfeited shares reissued which should be transferred to capital reserve, ensuring that the remaining balance in Share Forfeiture Account is proportionate to the amount forfeited on shares not yet reissued.

Let us understand it with an example.

Illustration 2

A company forfeits 200 shares of Rs. 10 each on which Rs. 600 had been received, it can allow a maximum discount of Rs. 600 on their reissue. Assuming that the company reissues 100 of these shares for Rs. 900 (@ Rs. 9 per share) as fully paid, Pass the necessary journal entries.

Solution:

Following journal entries shall be passed:

Share Capital A/c (200 × Rs 10) —— Dr.	2000	
To share forfeiture A/c		600
To calls in arrear A/c		1400

(Being 200 shares of Rs. 10 each forfeited for non-payment of calls, refer to note 1.)

Bank A/c (100 × Rs 9) —— Dr.	900	
share forfeiture (100 × Rs 1) —— Dr.	100	
To share Capital (100 × Rs 10)		1000

(Being 200 forfeited shares reissued of at Rs. 9 per share as fully paid. refer to note 2 below.)

Share forfeiture A/c (Rs 300 – Rs 100) —— Dr.	200	
To Capital Reserve		200

(Being Profit on reissue of forfeited shares transferred refer to note 3 below.)

Working Notes:

Note 1: The maximum amount of discount allowed on reissue is the amount credited to share forfeiture A/c and the amount not received on these shares is credited to Call in Arrears A/c.

Note 2: Bank A/c will be debited by: Price of reissue of share × Number of shares. The Share forfeiture A/c is debited with the amount of discount allowed on reissue of these shares, The share of face value of Rs. 10 is reissued at Rs. 9 as fully paid up therefore, a discount of Rs. 1 is allowed on these shares. Out of 200 forfeited shares 100 are reissued.

Note 3: We shall calculate the amount forfeited on 100 shares thus corresponding value will be transferred to capital reserve account. It is the difference of debit and credit of forfeiture A/c once the shares are reissued. Amount forfeited on 200 shares = Rs. 600,
Amount forfeited on 100 shares = $\frac{600}{200}$ × 100 = Rs. 300.

Less discount on reissue of shares Rs. 100
Amount transferred to Capital Reserve A/c = 300 – 100 = Rs. 200

11. Liquidation of Companies

Liquidation is the legal procedure by which the company comes to an end. It is a process by which a company is dissolved, its assets are realised and applied in paying off the liabilities of the company. Thus, a company is the creation of law therefore, it can be dissolved only by law.

As per Section 2 (94A) of the Companies Act, 2013, Winding up includes:

a. Winding up under Companies Act, 2013; – Compulsory
b. Liquidation under Insolvency and Bankruptcy Code, 2016 – Voluntary

11. Liquidation of Companies

The company be wound up by the Tribunal in following cases:

- The company has resolved that it will be wound up by the Tribunal. The company is required to pass special resolution.
- The company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with Foreign States, public order, decency or morality.
- The Registrar or any other person authorised by the Central Government by notification under the said Act can make an application to tribunal.
- The company has made a default in filing with the Registrar, its financial statements or annual returns for immediately preceding 5 consecutive financial years.
- The Tribunal is of the opinion that it is just and equitable that the company should be wound up.

The Petition for Winding Up to Tribunal may be made by:

- the company.
- any contributory or contributories, the registrar
- any person authorized by central government in that behalf.
- in case affairs of the company have been conducted in a fraudulent manner, by the central government or a state government.

After knowing about the modes of compulsory winding up of a company, let us now discuss the modes of voluntary winding up.

11. Liquidation of Companies

Earlier there was provision of **voluntary** winding up under Section 304 of the Companies Act, 2013. Now it has been omitted with effect from 1st April 2017. Now the provisions of "voluntary" winding up are available under the Section 59 of the Insolvency & Bankruptcy Code, 2016.

The key provisions of Section 59 of the Insolvency and Bankruptcy Code, 2016 are:

a. A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate voluntary liquidation proceedings.
b. Voluntary liquidation proceedings of a corporate person registered as a company shall meet the following conditions, namely:
1. A declaration from majority of the directors of the company verified by an affidavit.
2. Declaration to be accompanied with the following documents, namely:
a. Audited financial statements and record of business operations of the company for the previous 2 years or from the period since its incorporation, whichever is later.
b. A report of the valuation of the assets of the company.
3. Within 4 weeks of a declaration, there shall be passed a special resolution of the members of the company in a general meeting requiring the company to be liquidated voluntarily and appointing an insolvency professional to act as the liquidator.

1. Corporate Restructuring

Corporate Restructuring is a management practice of partially dismantling and reorganizing a company for the purpose of making it more efficient and therefore more profitable. It is also called Corporate Reconstruction. The Reconstruction is an exercise of restating assets & liabilities by company / entity whose financial position as reflected by its balance sheet is not healthy, but future is promising. This exercise is done to gain the confidence of different stakeholders (creditors, lenders, customers, shareholders, etc.) whose support is required for revival of the operations.

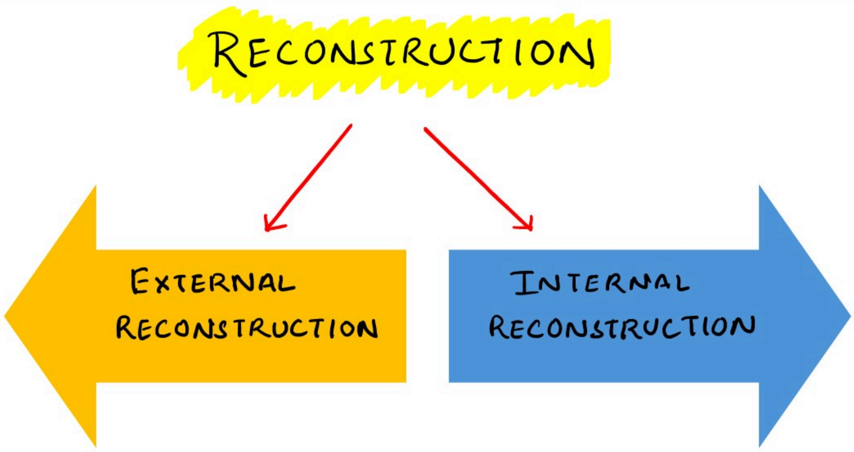
Companies are competing in search of excellence and competitive edge, experimenting with various tools and ideas. Many firms try to turn the business around by cutting jobs, buying companies, selling off or closing unprofitable divisions or even splitting the company up. There are two ways to look at it. One is internal. Maximization of profit is done either by change of manufacturing process, development of new products, or by expanding the existing products. Second is external. Here the company would be able to maximize profit by externally merging with another firm or acquiring another firm. The external strategy of maximizing profit may be in the form of mergers, acquisitions, amalgamations, takeovers, absorption, consolidation, and so on.

To put in simple words the concept of restructuring involves embracing new ways of running an organization and abandoning the old ones. It requires organisations to constantly reconsider their organisational design and structure, organisational systems and procedures, formal statements on organisational philosophy and may also include values, leader norms and reaction to critical incidences, criteria for rewarding, recruitment, selection, promotion and transfer.

With corporate restructuring, the firms want to achieve one or more of the following objectives:

- Induce higher earnings
- Leverage core competencies
- Divestiture and make business alliances
- Ensure clarity in vision, strategy and structure
- Provide proactive leadership
- Empowerment of employees, and
- Reengineering Process

Reconstruction may be internal and external.

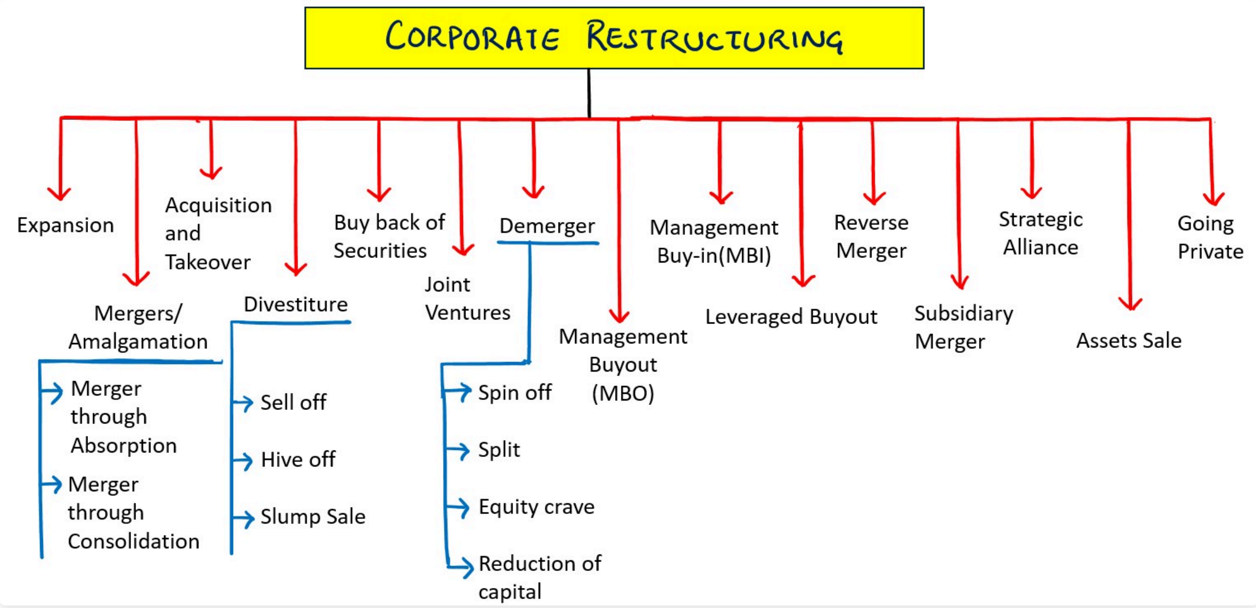


- **External Reconstruction:** When a company is suffering losses for the past several years and facing financial crisis, the company can sell its business to another newly formed company. The new company is formed to take over the assets and liabilities of the old company. This process is called external reconstruction. In other words, external reconstruction refers to the sale of the business of existing company to another company formed for the purpose. In external reconstruction, one company is liquidated, and another new company is formed to purchase the business of existing company. The liquidated company is called *Vendor Company* and the new company is called *Purchasing Company*. Shareholders of vendor company become the shareholders of purchasing company.
- **Internal Reconstruction:** Internal reconstruction means reorganization of capital structure of a company refers to the internal re-organization of the financial structure of a company without forming a new company without liquidating the existing company. It is also termed as re-organization which permits the existing company to be continued. Generally, share capital is reduced to write off the past accumulated losses of the company. The accounting procedure of internal reconstruction is distinct from that of amalgamation, absorption, and external reconstruction. The claim of the shareholders, creditors and

outsiders are adjusted towards the writing off the losses and fictitious assets Thus it includes alteration and reduction of share capital.

2. Approaches of Corporate Restructuring

Let us discuss some of the important methods of corporate restructuring one by one.



2. Approaches of Corporate Restructuring

It is the most common and convenient form of restructuring, which involves only increasing the existing level of capacity and it does not involve any technical expertise. Expansion of business needs more funds to be raised either in the form of equity or debt or both and the funds are used to finance the fixed assets required for manufacturing the expanded level of production. This increases firm's profitability, thereby value of the firm.