FINANCIAL ACCOUNTING (BBA2B02)

STUDY

MATERIAL

CORE COURSE

FOR

CONTENTS

Module 1

INTRODUCTION TO ACCOUNTING

Meaning and Definition of Accounting

Accounting has rightly been termed as the language of the business. It records, classifies, analyses and communicates all the business transactions that have taken place during a particular period. It is a system of recording and reporting business transactions in financial terms, to interested parties. According to American Institute of Certified Public Accountants, ***"Accounting is the art of recording, classifying and summarizing in a significant manner in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof"***. Thus accounting is the art of recording, classifying, summarizing, analyzing and interpreting the financial transactions and communicating the results thereof to the interested person.

Features or Characteristics or Nature of Accounting

Following are the features of accounting:-

(1) Accounting is an art.
(2) Accounting is a science.
(3) Recording of business transactions.
(4) Classifying business transactions.
(5) Summarizing the classified data
(6) Analysis and interpret the summarized data
(7) Communicating information to the interested parties.
(8) Records transaction and events which are financial character.

Objectives of Accounting or Functions of Accounting

The following are the main objectives:

1. To keep systematic records.
2. To ascertain the operational profit or loss.
3. To ascertain the financial position of the business.
4. To make information available to various users.
5. To protect business properties.
6. To facilitate rational decision making.
7. To ascertain the cost of production and selling price.
8. To control expenditure of business.
9. To satisfy the requirements of law.
10. To calculate the amount due to and due from others.

Importance of Accounting (Uses or Advantages)

Accounting brings the following advantages:

1. It serves as a historical record.
2. It facilitates the preparation of financial statements.
3. It supplies information to interested persons
4. It helps the management in taking important business decisions.
5. It facilitates comparative study of the performance of business over different periods.
6. It provides evidence in case of disputes.
7. It helps to forecast the future.
8. It provides information for judging the efficiency of business
9. It is useful in getting loans.
10. It helps in valuation of good will.
11. It helps in controlling expenses.
12. It helps in controlling employees.
13. It helps in prevention and detection of errors and frauds.

Scope of Financial Accounting

Following activities are included within the framework of financial accounting:

(1) Book-keeping
(2) Financial Statements
(3) Analysis and interpretation of financial statements.
(4) Financial reporting
(5) Accounting principles
(6) Accounting standards.

Limitations of Accounting

Accounting suffers from the following limitations:

1. It is historical in nature.
2. Transactions of non-monetary nature will not be recorded in accounting.
3. Information recorded in accounts is influenced by the personal judgment of the accountant.
4. In accounting valueless assets are also shown.
5. In accounting price changes are not considered.
6. It is not an exact science.
7. Use of different accounting methods reduces the reliability of accounts.
8. Account records show only actual cost figures.

Accounting Concepts or Principles

Accounting concepts are those assumptions, principles or conditions on which the accounting system is based. Principles are set of rules to be followed in accounting. The following are important accounting concepts or principles:

1. **Business Entity Concept**: According to these concepts, a business is treated as separate Entity distinct from its owner. This means that in accounting the business and owner must be treated separately. Thus, when one person invests amount in to the business, it will be deemed to the liability of the business. The concept of separate entity is applicable to all form of business.

2. **Going Concern Concept: A**ccording to this, it is assumed that business will exist for a long time. There is no intention to liquidate the business in the immediate future.

3. **Money Measurement concept:** Accounting records only those transactions which are expressed in monetary terms. Transactions which cannot be expressed in money do not find place in the books of accounts.

4. **Cost Concept:** According to this concept, all transactions are recorded in the books of accounts at actual price involved.

5. **Dual Aspect Concept:** according to this concept, every transaction has two aspects. These two aspects are receiving aspect and giving aspect. These two aspects have to be recorded. The basis of this principle is that for every debit, there is an equal and corresponding credit.

6. **Realization Concept:** According to this principle revenue is said to be realized when goods or services are sold to be a customer. It emphasizes the fact that the mere receipt of an order for goods or services cannot be taken for the realization of revenue. So advanced payment received from a customer cannot be considered as revenue earned.

7. **Matching Concept:** According to this concept, cost of a business of a particular period is compared with the revenue of that period in order to ascertain net profit or net loss.

8. **Accounting Period Concept:** According to this assumption, the life of a business is divided in to different periods for preparing financial statements. Generally business concern adopt twelve months period for measuring the income of the concern. This time interval is known as accounting period.

Accounting Conventions

Accounting conventions are the customs and traditions which guide the accountant while preparing accounting statements. Some of the accounting conventions are:-

(1) **Convention of Consistency** – This convention follows that the basis followed in several accounting periods should be consistent. This means the methods adopted in one accounting year should not be changed in another year. Then only comparison of results is possible.

(2) **Convention of Conservatism** – This is a convention of playing safe, which is followed while preparing the financial statements. The idea of this convention is to consider all possible losses and to ignore all probable profits.

(3) **Convention of Materiality** – Materiality means relevance or importance or significance. It is generally accepted in the accounting circle that the accounting statements and records must reveal all material facts.

(4) **Convention of Full disclosure** – The accounting convention of full disclosure implies that accounts must be honestly prepared and all material information must be disclosed therein.

Accounting Standards

Accounting standards are considered as a guide for maintaining and preparing accounts. They are the rules that ensure uniformity of preparation, presentation and reporting of accounting information.

Accounting standards may be defined as the accounting principles and rules which are to be followed for various accounting treatments while preparing financial statements on uniform basis and which will reveal the same meaning to all the interested groups.

Need for Accounting Standards (Objects of Accounting Standards)

The need for accounting standards arises from limitations of financial statements. The need for accounting standards arises due to the following reasons.

1. To communicate uniform results to external users as well as internal users for decision making.
2. To serve as a tools for information systems catering the needs of management, owners, creditors, Government etc.
3. To facilitate inter firm, intra firm comparison.
4. To make the financial statement more reliable comparable and understandable.

Accounting Standard Board of India (ASB)

The Institute of Chartered Accountant of India, set up, Accounting Standard Board. The primary duty of ASB is to formulate the accounting standard for India. During the formulation of accounting standards, the ASB considered the applicable laws, usage, customs and the business environment existing in our country. The ASB will give due consideration to International Accounting Standards (IASs) issued by the International Accounting Standard Committee and tries to integrate them to the extent possible.

The body consists of the following members: Company Law Board, CBDT, Central Board of Excise and Customs, SEBI, Comptroller and Auditor General of accounts, UGC, Educational and Professional institutions, and councils of the institutes and representatives of Industry.

The following are the objectives and functions of the ASB:

(1) To suggest areas in which accounting standards need to be developed.
(2) To formulate accounting standards.
(3) To review the accounting standards at periodical intervals.
(4) To provide guidance on accounting standards.
(5) To carry out other functions relating to accounting standards.

Accounting Standards in India

ASB of India has issued 32 accounting standards so far. They are as follows

AS 1: Disclosure of accounting policies
AS 2: Valuation of inventories
AS 3: Cash flow statements
AS 4: Contingencies and events occurring after the B/S date
AS 5: Prior period and extra ordinary items and change in accounting policies
AS 6: Depreciation accounting
AS 7: Accounting for construction contracts
AS 8: Accounting for research and development
AS 9: Revenue recognition
AS 10: Accounting for fixed assets
AS 11: Accounting for effects of changes in foreign exchange rates
AS 12: Accounting for govt. grants
AS 13: Accounting for investments
AS 14: Accounting for amalgamation
AS 15; Accounting for retirement benefits in the financial statements of employers
AS 16: Borrowing cost
AS 17: Segment reporting
AS 18: Related party disclosures
AS 19: Leases
AS 20: Earning per share
AS 21: Consolidated financial statement
AS 22: Taxes on income
AS 23: Accounting for investment in associates in consolidated financial statement
AS 24: Discontinuing operations
AS 25: Interim financial reporting
AS 26: Intangible assets
AS 27: Financial reporting of interest in joint ventures
AS 28: Impairment of assets.
AS 29: Provisions, contingent liabilities and contingent assets
AS 30: Financial instruments-recognition and measurements
AS 31: Financial instruments-presentation
AS 32: Financial instruments disclosure

Accounting Process

Accounting process begins when a financial transactions takes place. Firstly day to day transactions are recorded in the journal or subsidiary books. From the journal the transactions move further to ledger. Here entries are posted in the appropriate accounts, and then accounts are balanced to get the effect of debit and credit. These balance moves to a statement called trial balance. From the trial balance, we can prepare trading and profit and loss accounts and balance sheet. The different stages through which the transactions move from journal to final accounts are collectively known as accounting cycles or accounting process.

Journal and Ledger

A book of original entry in which transactions are recorded in the order of their occurrence is called journal. Journal is a primary record of business transactions. Recording of transactions in the journal is known as journalizing and recorded transactions are called journal entries Ledger is a book, which contains various accounts it is said to be secondary books of account. It is a collection of all accounts debited or credited in journal. Ledger is defined as “a book in which all the personal, real, and nominal accounts of business are kept for permanent records so that up to date statement of an account can be easily known”.

Rules of accounting

Accounts are classified in to three namely real accounts, personal accounts and nominal accounts. There are separate rules for each type of accounts they are as follows

1. Real accounts

An account relating to an asset or property is called real account. Cash, furniture, plant and machinery etc., are examples of real accounts the debit, credit rule applicable to real account is:

Debit what comes in
Credit what goes out

2. Personal accounts

It includes the account of person with whom the business deals. These accounts are classified in to three categories

a) **Natural personal accounts** – the term natural persons mean persons who are creation of god. For e.g.;- Raja’s accounts, Gupta’s accounts etc.,

b) **Artificial personal accounts** - these accounts includes accounts of corporate bodies or institutions

c) **Representative personal account**-these are accounts which represents certain person or group of persons. For example salary due, rent outstanding etc., the rule of personal account is

Debit the receiver
Credit the giver

3) Nominal accounts

Accounts relating to expenses and losses and incomes and gains are called nominal accounts. Salary accounts, commission account etc., are examples.

Debit all expenses and losses
Credit all incomes and gains

Posting

The term posting means transferring the debit and credit items from the journal to their respective accounts in the ledger. It is the process of recording the transaction from journal to ledger.

The following rules should be observed while posting transactions in the ledger from the journal:

a) separate account should be opened in the ledger for posting transactions relating to different accounts recorded in the journal

b) The concerned account, which has been debited in the journal should also be debited in the ledger

c) The concerned account, which has been credited in the journal should also be credited in the ledger

Sub-Division of Journal

The journal is sub-divided into many subsidiary books called special journals. The journal in which transaction of a similar nature is recorded is known as special journal or day book. The special journals are ruled differently on the basis of the nature of transactions to be recorded. Transactions that cannot be recorded in any of the special journals are recorded in a journal called journal proper or miscellaneous journal.

Advantages of Special Journals

1. **Division of work:** since there are so many subsidiary books, the accounting work may be divided amongst a number of clerks.
2. **Specialization:** when the same work is allotted to a period of time he acquires full knowledge of it and becomes efficient thus the accounting works will be done more efficiently.
3. **Save in time:** the trader can save time and labor by avoiding repetitions
4. **Availability of information:** since separate subsidiary book is kept for each class of transactions, information relating to that will be readily available.
5. **Facility in checking:** checking is facilitated in subsidiary books which will prevent errors and frauds

Important special journals

The journal is sub divided in to the following subsidiary books

1. Cash Book: For recording all cash transactions
2. Purchases Book: For recording credit purchases of goods
3. Sales Book: For recording credit sales
4. Purchase Returns Books: For recording the goods returned by the trader to the suppliers
5. Sales Returns Book: For recording the goods returned to the trader by his customer
6. Bills Receivable Books: For recording all bills received by the trader from his customer
7. Bills Payable Book: For recording all the bills given (accepted) to suppliers

8. Journal Proper: For all transactions that do not find a place in any of the above books

Trial Balance

Trial balance is a statement containing the various ledger balances on a particular date. This statement is prepared to check the correctness of ledger posting and balancing of accounts. If the total of the debit balances is equal to the credit balances. It is implied that posting and balancing of accounts are correct

Features of Trial Balance

1. It is prepared on a specific date
2. It is not a part of double entry and not an account
3. It is a statement of balance of all accounts or totals of ledger accounts
4. Total of the debit and credit columns of the trial balance must tally
5. If the debit and credit columns are equal it is presumed that accounts are arithmetically accurate
6. Difference in the debit and credit columns indicate that some mistakes have been committed
7. Tallying of trial balance is not a conclusive proof of accuracy of books of accounts; it serves to prove only the arithmetical accuracy of books

Objectives of Trial Balance

The following are the objectives of preparing trial balance.

1. To ascertain the arithmetical accuracy of the ledger accounts
2. To help in locating errors
3. To help in the preparation of final accounts

Specimen of trial balance is given below:

Trial Balance as on ……….

Account code	Name of the account	Debit (Amount in ₹)	Credit (Amount in ₹)
	Cash in hand	xxx	
	Cash at bank	xxx	
	Sundry debtors	xxx	
	Sundry creditors		xxx
	Sales		xxx
	Sales returns	xxx	
	Purchases	xxx	
	Purchase returns		xxx
	Drawing	xxx	
	Capital		xxx

	Bills receivable	xxx	
	Bills payable		xxx
	Stock of goods	xxx	
	Bank loan/overdraft		xxx
	Carriage inwards	xxx	
	Carriage outwards	xxx	
	Rent paid	xxx	
	Interest paid	xxx	
	Salary paid	xxx	
	Discount received		xxx
	Commission received		xxx
	Plant and machinery	xxx	
	Buildings	xxx	
	Furniture	xxx	
	Vehicles	xxx	
	Goodwill	xxx	
	Provisions		xxx
	Outstanding expenses		xxx
	Prepaid expenses	xxx	
	Accrued income	xxx	
	Pre received income		xxx
	Reserve accounts		xxx
	Advance from customers		xxx
		XXXX	XXXX

Module II

FINAL ACCOUNTS OF PROPRIETARY CONCERNS

Preparation of Final Accounts of a Sole Proprietor

Final account means accounts which are prepared at the final stage to give the financial position of the business. It consists of trading account profit and loss account and balance sheet.

Trading Account

Trading account gives the overall result of trading, that is purchasing and selling of goods. The result of trading accounting may be gross profit or gross loss. If the sale proceeds exceed the cost of goods sold the difference is gross profit. Opening stock, purchases, direct expenses, are debited and sales and closing stock are credited to this account.

Specimen of Trading Account is given below:

Trading account for the year ended……….

To Opening stock	xxx	By Sales xxxx	
To Purchases xxxx		Less returns xx	
Less returns xxx		--------	xxxx
-------------	xxxx	By Closing stock	xxx
To Direct expenses:		By Gross loss (if loss)	xxx
Carriage inward	xxx		
Freight	xxx		
Octroi	xxx		
Dock dues	xxx		
Excise duty	xxx		
Royalty	xxx		
Motive power	xx		
Coal, gas, water	xxx		
Factory expenses	xxx		
To Gross Profit (if profit)	xxx		
	xxxxx		xxxxx

Profit and Loss Account

Profit and loss account is prepared to ascertain the net profit or net loss of the business for an accounting period. The amount of gross profit is shown on the credit side. Indirect expenses, operating expenses and losses are shown on the debit side of this account and all incomes and gains are shown on the credit side. If credit side is more than debit side, the difference is net profit.

A Specimen of Profit and Loss account is given below:

Profit and Loss account for the year ended….

To Gross loss b/d	Xxxx	By Gross profit b/d	Xxx
To Salaries	Xxx	By Rent received	Xxx
To Rent, rates & taxes	Xxx	By Discount received	Xxx
To Printing & stationary	Xxx	By Commission received	Xxx
To Postage	Xxx	By Interest	Xxx
To Audit fees	Xxx	By Other incomes (if any)	xxx
To General expenses	Xxx	By Net loss (if loss)	
To Repair	Xxx		
To Fire Insurance premium	Xxx		
To Legal expenses	Xxx		
To Office expenses	Xxx		
To Interest on loan	Xxx		
To Bad debts	Xxx		
To Discount allowed	Xxx		
To Commission	Xxx		
To Advertising	Xxx		
To Travelling expenses	Xxx		
To Depreciation	Xxx		
To Sundry expenses	Xxx		
To Establishment expenses	Xxx		
To Loss on sale of assets	Xxx		
To Carriage outward	Xxx		
To Net profit	xxx		
	xxxx		xxxx

Manufacturing Account

Manufacturing account is an account prepared by manufacturing concerns to ascertain cost of goods manufactured during a period. All the expenses relating to manufacturing activity are debited. The total represents cost of manufactures, which is transferred to trading account. A specimen of manufacturing account is given below:

Manufacturing account for the year ended….

To Opening Work in progress	Xxxx	By Closing work in progress	Xxxx
To Raw material consumed:		By Sale of scrap	Xxx
Opening stock of raw material xxx		By Cost of goods manufactured	xxxx
Add Purchase (less return) xxx		(balance, transfer to	
Less closing stock of raw material xx		trading account)	
-----	Xxxx		
To Direct wages	Xxx		
To Carriage inward	Xxx		
To Freight	Xxx		
To Factory expenses	Xxx		
To Works manager's salary	Xxx		
To Consumable stores	Xxx		
To Depreciation of plant	Xxx		
To Repairs of plant	Xxx		
To Coal, gas, water	Xxx		
To Motive power	Xxx		
	Xxxx		xxxxx

Balance Sheet

Balance sheet is a statement showing the assets and liabilities of a business on a particular date. It reveals the financial position of a business. Hence it is also known as position statement. In the words of Francis R Stead, 'balance sheet is a screen picture of financial position of a going business at a certain moment.

Specimen of Balance Sheet is given below:

Balance Sheet as at ……

Liabilities		₹	Assets	₹
Current liabilities:			Current Assets:	
Bills payable		xxxx	Cash in hand	xxxx
Creditors		xxxx	Cash at bank	xxxx
Bank over draft		xxxx	Debtors	xxxx
Outstanding expenses		xxx	Bills receivable	xxxx
Income received in advance		xxx	Marketable securities	xxxx
Long term liabilities:			Prepaid expenses	xxx
Loan		xxx	Accrued incomes	xxx
Capital	xxxxx		Closing stock	xxxx
Add: Net Profit	xxxx		Long term investments	xxxx
	xxxxx		Fixed assets:	
Less: Drawings	xxx	xxxxx	Furniture	xxxxx
			Vehicles	xxxx
			Patent	xxxx
			Loose tools	xxxx
			Plant	xxxxx
			Land and building	xxxxx
			Goodwill	xxxx
		xxxxx		xxxxx

Opening, Closing and Adjusting Entries

Opening entries are passed at the beginning of an accounting period. When a businessman starts business with cash and other form of assets, it becomes essential to open the necessary ledger accounts. This is made by passing entries through journal proper.

At the end of every accounting period, all revenue items are closed by transferring to trading and profit and loss account, such entries are known as closing entries. Thus closing are those entries passed at the end of the accounting year to close the accounts relating to incomes, expense, gains and losses.

In the mercantile system of accounting, various adjustments had to be made to accounts of incomes and expenses, so as to show correct figure for the current year. These entries are passed for adjusting the incomes, expenses etc., are called adjusting entries

When a sum of money from one account to another account has to transferred it is done by a means of an entry called transfer entry.

Treatment of Certain Items

Closing Stock

If it is given in the adjustment it is shown on the credit side of the trading account and also shown on the assets side of the balance sheet. If it is given in the trial balance, it should be shown only in the balance sheet.

Outstanding Expenses

These are those expenses which remains unpaid at the end of the accounting period. If it is given in the adjustment, it should be added to the concerned expenses on the debit side of the trading account or profit or loss account and it should also be shown in the balance sheet as liability. If it is given in the trial balance, it should be shown in the balance sheet as liabilities.

Prepaid Expenses

Prepaid expenses are payments made in the current year but related to the next accounting year. Prepaid expenses are also known as expenses paid in advance or unexpired expenses. If it is given in the adjustment, it should deducted from the concerned expenses on the debit side of trading accounting or profit and loss account and it should also be shown on the asset side of balance sheet. If it is given in the trial balance, it should be taken only in the balance sheet as asset

Accrued Income

This is the income earned but not received by the end of the accounting year. This is also known as outstanding incomes. If it is given in the adjustment, it should be added to the concerned income on the credit side of the profit and loss account and it should also be shown on the asset side of balance sheet. If it is given in the trial balance, it should be shown only in the balance sheet on the asset side.

Income Received in Advance

It means income which has been received by business before it been earned by the business. It relate to the next accounting period. It is also known as unearned income or income received in advance. If it is given in the adjustment it's should be deducted from the concerned income on the credit side of the profit and loss account and it should also be shown on the liability side of balance sheet. If it is given in the trial balance it should be shown only in the balance sheet on the liability side.

Depreciation

If it is given in the adjustment, it should be shown on the debit side of the profit and loss account and deducted from the concerned asset on the balance sheet. If it is given in trial balance, depreciation should be taken only on the debit side of profit and loss account.

Bad Debts

When an amount due from debtors is found irrecoverable it is called bad debt .it is a loss the business. If it is given in the adjustment it should be taken on the debit side of the profit and loss account by adding to the bad debt already given in the trial balance and it should also be deducted from debtors on the asset side.

Provision for Bad Debts

The provision given in the trial balance is the provision created in last year; it is taken on credit side of profit and loss account. If there is bad debt and provision required are given, it should be adjusted against the opening provisions. The treatment is as follows.

Bad debt (given in the trial balance)	xxxx
Add: Further bad debt (given in the adjustment)	xxx
Provision required (given in the adjustment)	xxx
	-------
	xxxx
Less: Existing provision (given in the trial balance)	xxx

Amount shown on the debit side of the P&L account	xxx

If the existing provision is more than the bad debt and new provisions, then the balance should be shown on the credit side of profit and loss account. Bad debts and new provisions given in the adjustments are also deducted from the debtors account on the asset side of the balance sheet.

Loss of Stock by Fire

In case goods are not insured the total loss should be shown on the credit side of the trading account. The same amount should be shown on the debit side of the profit and loss account. If goods are insured and insurance company admitted the claim, the total loss should be credited to the trading account, amount claim not admitted by the insurance company is debited to P&L account and claim admitted is shown on the asset side of balance sheet.

Managers Commission

Commission is shown on the debit side of P&L account. It should also be shown on the liability side of the balance sheet (if it is given in the adjustment). It is calculated as follows.

a) Fixed percentage of net profit before charging such commission
   Commission is calculated as follows

$$\frac{\text{Net profit x rate of commission}}{100}$$

b) Fixed percentage of net profit after charging such commission
   Commission is calculated as follows

$$\frac{\text{Net Profit x Rate of commission}}{\text{100 + Rate of commission}}$$

Illustration 1:

Mr. A, who is a sole trader, following is the trial balance as on 31-Dec 2018

Cash at bank	61,590	Sales	9,36,200
Cash in hand	11,800	12% Bank Loan	80,000
Drawings	20,000	Capital	1,60,000
Bill receivable	39,600	Bills payable	5,200
Salary	44,000	Discount Received	2,400
Investment (Market Value Rs. 28000)	24,000	Sundry creditors	1,26,200
Stock on 1-1-2018	1,27,360	Income from Investment	1,980
Land and Building	80,000	Purchase Return	7,400
Travelling Expenses	13,800		
Motor Van	32,000		
Furniture	16,000		
Telegram	1,600		
Sundry Debtors	1,28,000		
Discount Allowed	3,600		
Sundry Expense	37,240		
Stationary	3,200		
Bank Loan Interest	6,000		
Establishment	9,190		
Advertisement	2,000		
Sales Return	5,000		
Purchase	6,53,400		
	13,19,380		13,19,380

Additional information

1. Closing stock is valued at 2,40,000
2. Maintain a reserve of 10% of debtors as reserve for debtors
3. Provide a reserve of 5% on sundry debtors as reserve for discount and 5% on sundry creditors
4. Stock worth Rs 20,000 destroyed by fire on 25-11-2018 in respect of which the insurance company admitted the claim only Rs 15,000
5. The manager of the business is entitled to get a commission of 10% of net profit after calculating such commission
6. Charge depreciation 2.5% on land and building, 10% on furniture, 20% on motor van
7. Salary paid in advance 3000.

Prepare a trading and profit and loss account on 31 Dec 2018 and balance sheet on that date.

Solution

Trading and profit and loss account for the year ended 31 Dec 2018

Particulars		Amount in ₹	Particulars		Amount in ₹
Opening stock		1,27,360	Sales	936200	
Purchase	653400		Less: return	5000	931200
Less return	7400	6,46,000	Loss of stock on fire		20000
Gross profit		4,17,840	Closing stock		240000
		11,91,200			11,91,200
Salary	44000		Gross profit b\d		417840
Less prepaid	3000	41000	Income from investment		1980
Establishment expenses		9190	Discount received		2400
stationary		3200	Reserve or discount on creditors		6310
Telegram		1600			
Travelling expenses		13800			
Sundry expenses		37240			
Loss by fire		5000			
Interest on bank loan	6000				
Add outstanding	3600	9600			
Advertisement		2000			
Discount		3,600			
Provision for doubtful debts		12,800			
Provision for discount		5760			
Depreciation					
Land and Building	2000				
Furniture	1600				
Motor van	6400	10000			
Manager's Commission		24885			
Net Profit		248855			
		428530			428530

Working note:

Net profit after charging commission = 2, 73,740

Commission = 2, 73,740 × 10 / 110 = 24,885

Balance sheet as at 31st December 2018

Liabilities			Assets		
Sundry creditors	1, 26,200		Cash in hand		11,800
Less provision	63,10		Cash at bank		61,590
	-------------	1,19,890	Bills receivable		39,600
Bills payable		5,200	Sundry debtors	1,28,000	
Interest on bank loan		3,600	Less provision	12,800	
Commission payable		24,885		------------	
Bank loan		80,000		1,15,200	
Capital	1,60,000		Less provision For discount	5, 760	
Add net profit	2,48,855			-------------	1,09,440

	4,08,855		Closing stock		2,40,000
Less drawings	20,000		Salary prepaid		3,000
	------------	3,88,855	Insurance claim		15,000
			Investment		24,000
			Furniture	16,000	
			Less depreciation	1,600	
				-------------	14,400
			Motor Van	32, 000	
			Less depreciation	6,400	
				------------	25,600
			Land and building	80,000	
			Less depreciation	2,000	
				---------	78,000
		6,22,430			6,22,430

Illustration 2

The following balances are extracted from the books of accounts of Raman on 31-dec 2018

Purchases	40000	Sales	70185
Purchases return	1410	Stock (1-1-18)	5730
Capital	50500	Drawing	8800
Bad debts	700	Bad debt reserve (1-1-18)	1620
Carriage inwards	1155	Office expenses	670

Postage and stationary	330	Bills receivable	620
Discount (Cr)	115	Wages	3140
Sales return	2120	Rent received	1050
Building	13000	Cash in hand	1105
Cash at bank	6200	Salary	4500
Office furniture	1800	Postage	410
Commission paid	435	Sundry creditors	9490
Sundry debtors	31035	Sundry expenses	8470
Building (new)	3500	Rates and insurance	650

Prepare trading and profit and loss account for the year ended 31-dec 2018 and prepare balance sheet on that date considering the following:

1) Insurance unexpired ₹120
2) Provide interest on capital @ 5%
3) Rent not received ₹100
4) Depreciate on old building @ 2.5%, new @ 2% and office furniture @ 5%
5) Write off further bad debts ₹285
6) Increase the provision for bad debts @ 6% on debtors
7) Salary outstanding ₹285
8) Stock on 31-12-2018 valued @ ₹7145

Solution

Trading & Profit and Loss Account of Raman For the year ending 31-dec-2018

Particulars		₹	Particulars		₹
To Opening stock		5,730	By Sales	70185	
Purchase	40000		Less: return	2120	68065
Less return	1410	38,590	Closing stock		7145
Wages		3,140			
Carriage inwards		1,155			
Gross profit		26,595			
		75,210			75,210
Salary	4500		Gross profit b\d		26595
Add: Outstanding	285	4785	Discount received		115
Office expenses		670	Rent	1050	
Rates and Insurance	650		Add: Outstanding	100	1150

Less: Prepaid	120	530		
Printing and Stationary		330		
Sundry expenses		8470		
Postage		410		
Depreciation:				
Building (Old)	325			
New	70			
Office furniture	90	485		
Provision for bad and doubtful debts :				
Bad debts	700			
Additional bad debt	285			
Add: New provision	1835			
	2830			
Less: Existing provision	1620	1210		
Commission		435		
Interest on capital		2525		
Net Profit transferred to balance sheet		8010		
		27860		27860

Balance sheet as at 31- dec-2018

Liabilities		₹	Assets		₹
Sundry Creditors		9490	Cash in hand		1105
Capital	50500		Cash at bank		6200
Add: Net profit	8010		Bills receivable		620
	58510		Sundry debtors	31035	
Add: Interest on capital	2525		Less: Bad debts	285	
	61035			30750	
Less: Drawings	8800	52235	Less: New provision	1845	28905
Outstanding salary		285	Closing stock		7145
			Office furniture	1800	
			Less: Depreciation	90	1710
			Interest accrued		100
			Unexpired insurance		120
			Buildings:		
			Old	13000	
			New	3500	
				16500	
			Less: Depreciation	395	16105
		62010			62010

Illustration 3

From the following trial balance of Mr. Arthur on 31 Dec 2018, prepare trading and profit and loss account for the year ending 31st December 2018, and a balance sheet on that date:

Arthurs drawings	10550	Arthurs capital	119400
Bills receivable	9500	loan @ 6% p.a	20000
Plant and machinery	28800	commission received	5640
Sundry debtors (including Madan for Dishonored cheque ₹1000)	62000	sales	356430
		Sundry creditors	59630
Wages (manufacturing)	40970		
Return inwards	2780		
Purchases	256590		
Rent and taxes	5620		
Stock on 1st Jan 2018	89680		
Salaries	11000		
Travelling expenses	1880		
Insurance	400		
Cash	530		
Bank	18970		
Repairs and renewals	3370		
Interest on loan	1000		
Interest and discount	4870		
Bad debts	3520		
Fixtures and fittings	8970		
	561100		561100

The following adjustments are to be made:

a) Stock in trade in hands on 31 Dec 2018 ₹128960
b) Write off half of Madan's cheque
c) Create a provision of 5% on debtors.
d) Manufacturing wages include ₹1200 for erection of new machinery
e) Depreciate plant and machinery by 5% and furniture and fixtures by 10% p.a
f) Commission not earned but received amounts to ₹600

Solution **Trading and profit and loss account for 31st Dec 2018**

Particulars		₹	Particulars		₹
To Opening stock		89,680	By Sales	355430	
Purchase		256590	Less: return	2780	353650
Wages	40970		Closing stock		128960
Less: Plant and machine	1200	39,770			
Gross profit		96,570			
		4,82,610			4,82,610
Salary		11000	Gross profit b\d		96570
Rent and taxes		5620	Commission	5640	
Travelling expenses		1880	Less: not earned	600	5040
Insurance		400			
Repairs		3370			
Interest on loan	1000				
Add: Outstanding	200	1200			
Interest and discount		4870			
Bad debts	3620				
Add: Dishonoured cheque of Madan	500	4120			
Depreciation:					
Plant	1500				
Fixtures	897	2,397			
Provision for bad and doubtful debts (5% on 61000)		3,050			
Net Profit transferred to balance sheet		63703			
		101610			27860

Balance sheet of Mr. Arthur

Liabilities		₹	Assets		₹
Arthurs Capital:			Plant	30000	
Balance	119400		Less: Depreciation	1500	28500
Add: Profit	63703		Fixtures and fittings	8970	
	183103		Less: Depreciation	897	8073
Less: Drawings	10550	172553	Closing Stock		128960
			Bills Receivable		9500

Loan		20000	Debtors	62000	
Creditors		59630	Less: Dishonour (50%)	500	
Outstanding:			Less: Provision	3050	58450
For interest on loan	200		Bank		18970
For commission received in advance	600	800	Cash		530
		252983			252983

Illustration 4

The following is the trial balance of Mr. Ramlal as at 31st Dec 2018

	Dr	Cr
Ramlal's capital	-	86690
Stock as on 1st Jan 2011	46800	-
Sales	-	389600
Return inwards	8600	-
Purchases	321700	-
Return outwards	-	5800
Freight and carriage	18600	-
Rent and taxes	5700	-
Salary and wages	9300	-
Sundry debtors	24000	-
Sundry creditors	-	14800
Bank loan @ 6% p.a	-	20000
Bank interest	9000	-
Printing and advertisement	14600	-
Misc income	-	250
Cash at bank	8000	-
Discount earned	-	4190
Furniture and fittings	5000	-
Discount allowed	1800	-
General expenses	11450	-
Insurance	1300	-
Postage and telegram	2330	-
Cash in hand	380	-
Travelling expenses	870	-
Drawings	40000	-
	521330	521330

The following adjustment should also be made:

a) Included amongst the debtors is ₹3000 due from Abraham and included amongst creditors ₹1000 due to him

b) Provision for bad and doubtful debts be created at 5% and reserve for discount 2% on sundry debtors

c) Depreciation on furniture and fittings at 10%.shall be written off

d) Personal purchases amounting to ₹600 has been included in the purchase day book

e) Interest on bank loan shall be provided for the whole year

f) A quarter of the amount of printing and advertising is to be carried forward to the next year.

g) Credit purchase invoice amounting to ₹400 had been omitted from the books

h) Stock on 31-12-2018 was ₹78600

Prepare trading and profit and loss account for the year ended 31-12-2018 and balance sheet as on 31 Dec 2018

Solution

Trading and profit and loss account of Sri Ramlal.

Particulars		₹	Particulars		₹
To Opening stock		46,800	By Sales	389600	
Purchase	321700		Less: return	8600	381000
Add: omitted invoice	400		Closing stock		78600
	322100				
Less: Returns	5800				
	316300				
Less: Drawings	600	3,15,700			
Freight and carriage		18,600			
Gross profit		78,500			
		4,59,600			4,59,600
Salaries and wages		9300	Gross profit b\d		78500
Rent and taxes		5700	Misc. income		250
Bank interest	900		Discount		4190
Add: Due	300	1200			
Printing and Stationary	14600				
Less: Prepaid	3650	10950			
Discount allowed		1800			
General expense		11450			
Insurance		1,300			
Postage and telegram		2,330			

Travelling expenses	870		
Provision for bad debts	1,150		
Reserve for discount on debtors	437		
Depreciation on furniture	500		
Net Profit transferred to balancesheet	35953		
	82940		82940

Balance sheet as at 31 Dec 2018

Liabilities		₹	Assets		₹
Capital	86690		Furniture and fittings	5000	
Add: Net profit	35953		Less: Depreciation	500	4500
	122643		Sundry debtors	24000	
Less: Drawings			Less: Amount due from A	1000	
Cash	40000		Less: Reserve for bad debts	1150	
Goods	600	82043		21850	
			Add: Reserve for discount	437	21413
Sundry Creditors	14800		Stock		78600
Less: Amount due to A	600	14200	Printing and Stationary		3650
Bank Loan		20000	Cash in hand		380
Bank interest due		300	Cash at bank		8000
		116543			116543

Preparation of Final Accounts of Partnership Concerns

Definition and Features of Partnership Accounts

The Indian Partnership Act defines partnership as the relationship between persons who have agreed to share the profit or loss of a business carried on by all or any of them acting for all. Such persons are individually known as partners and they do business in the name of their firm. Generally, partners agree among themselves as regards terms and conditions on which the business of the firm will be carried on. But often they carry on business on the basis of a verbal agreement.

The essential features of partnership are:

1. Association of two or more persons;
2. An agreement entered by all persons concerned;
3. Expenses of a business;
4. The carrying on of business by all or any of them acting for all;
5. Sharing of profits and losses of the business at an agreed ratio.

So a partnership is run by a mutual written agreement called partnership deed which may be either registered or unregistered but for the sake of settlement of future disputes among the partners, it is better to have a registered partnership deed.

1. The partnership deed generally details out the following clauses:
2. Name of the firm and nature of the partnership business;
3. Commencement and tenure of the business;
4. Amount of capital to be contributed by each partner;
5. The ratio for sharing profit and loss of the partnership business among the partners;
6. Arrangement of drawings by partners, making limit thereon and interest if any, to be charged on drawings;
7. Salary to be given to the partners;
8. Interest, if any, to be allowed on capital contributed by the partners;
9. Rent to be paid to the partners whose premises are used for the purpose of business;
10. Process of appropriation in case of any dispute among the partners;
11. Procedure for maintenance of accounts and audit thereof;
12. Valuation of goodwill in case of admission of new partners, retirement of existing partners and death of a partner;
13. Procedure for settlement of partners’ claims in case of retirement or death.
14. Procedure for dissolution of partnership, etc.

If any situation or circumstances is not either covered in the partnership deed or adequately explained, such situation or circumstance should be settled by applying the provisions of the Partnership Act, 1932.

The partners are supposed to have the power to act in certain matters and not to have such powers in others.

Partners' Capital and Current Accounts

From the point of view of accounting, maintenance of the partners' capital accounts and current accounts are very important. The relevant accounting transactions and events are:

- Initial contribution by partners towards capital of the firm.
- Fresh capital contributed by partners.
- Interest entitlements (if agreed in the partnership deed) on capital so contributed;
- Amount withdrawn by the partners from time to time;
- Interest liability of partners on such drawings (if agreed in the partnership deed);
- Salary to partners for services rendered to run the partnership business;
- Rent of premises let out to partnership by the partners;
- Share of profit or loss of the partnership business.

How to account for all such transactions and events in the partnership accounts should be understood properly.

There are two methods of accounting –

i) Fixed capital method and

ii) Fluctuating capital method.

In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts. Unless a decision is taken to change it, initial capital account balance is not changed.

In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

Illustration 1

A and B start business on 1st January, 2018, with capitals of ₹30,000 and ₹20,000. According to the Partnership Deed, B is entitled to a salary of ₹500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3.

During 2018 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹25,000. During the year A withdrew ₹8,000 and B withdrew ₹10,000 for domestic purposes. Show the capital accounts of the partners following fluctuating capital method.

Solution

A's Capital Account					
Dr.					Cr.
Date	Particulars	₹	Date	Particulars	₹
2018			2018		
31-Dec	To Cash (Drawings)	8000	01-Jan	By Cash	30000
	To Balance c/d	33800	31-Dec	By Profit and Loss A/c (Interest)	1800
				By Profit and Loss A/c (5/8 Profit)	10000
		41800			41800
			2019		
			01-Jan	By Balance b/d	33800

B's Capital Account					
Dr.					Cr.
Date	Particulars	₹	Date	Particulars	₹
2018			2018		
31-Dec	To Cash (Drawings)	10000	01-Jan	By Cash	20000
	To Balance c/d	23200	31-Dec	By Profit and Loss A/c	
				Salary	6000
				Interest	1200
				By Profit and Loss A/c (3/8 Profit)	6000
		33200			33200
			2019		
			01-Jan	By Balance b/d	23200

Illustration 2

Ram and Rahim started business with capital of ₹50,000 and ₹30,000 on 1st January, 2018. Rahim is entitled to a salary of ₹ 400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year Ram withdrew ₹8,000 and Rahim withdrew ₹10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹30,000. Assuming the capitals to be fixed, prepare the Capital and Current Accounts of the partners.

Solution

Ram's Capital Account					
Dr					Cr
Date	Particulars	₹	Date	Particulars	₹
2018			2018		
31-Dec	To Balance c/d	50000	01-Jan	By Cash	50000
			2019		
			01-Jan	By Balance b/d	50000

Rahim's Capital Account					
Dr					Cr
Date	Particulars	₹	Date	Particulars	₹
2018			2018		
31-Dec	To Balance c/d	30000	01-Jan	By Cash	30000
			2019		
			01-Jan	By Balance b/d	30000

Ram's Current Account					
Dr					Cr
Date	Particulars	₹	Date	Particulars	₹
2018			2018		
31-Dec	To Cash (Drawings)	8000	31-Dec	By Profit and Loss A/c (Interest)	3000
	To Profit and Loss A/c (Interest on Drawings)	240	31-Dec	By Profit and Loss A/c (1/2 Profit)	10470
	To Balance c/d	5230			
		13470			13470
			2019		
			01-Jan	By Balance b/d	5230

Rahim's Current Account					
Dr					Cr
Date	Particulars	₹	Date	Particulars	₹
2018			2018		
31-Dec	To Cash (Drawings)	10000	31-Dec	By Profit and Loss A/c	
	To Profit and Loss A/c (Interest on Drawings)	300		Salary	4800

				Interest	1800
				By Profit and Loss A/c	
	To Balance c/d	6770	31-Dec	(1/2 Profit)	10470
		17070			17070
			2019		
			01-Jan	By Balance b/d	6770

Profit and Loss Appropriation Account

- Profit and Loss Appropriation Account is prepared by a partnership firm to distribute the net profit among the partners in accordance with the partnership deed.
- Any interest on drawing is added to the net profit and thereafter out of such total profit, interest on partners' capital, salaries, commission, rent etc. are distributed as per agreement.
- The balance of profit is distributed among the partners at the profit sharing ratio.

Illustration 3

X, Y & Z are in partnership. Y and Z are entitled to 15% commission on net profit to be shared equally for the special service rendered by them to the partnership. However, all the partners are entitled to 8% interest on fixed capital of ₹5,00,000 each. The business is run at the premises of Mr. X who is further entitled to get a monthly rent of ₹2,000 to be adjusted against his current account. They share profits and losses equally. Net profit during the year 2018 was ₹7,00,000.

During the year they were discussing to change the profit sharing ratio because X could not attend to business work. Finally they decided to increase interest on capital to 12% p.a. with effect from 1-10-2018 and to change the profit sharing ratio to 1:2:2 with effect from the same date. With that Y and Z would not get any commission. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account						
Particulars			₹	Particulars		₹
To	Commission			By	Net Profit	700000
	Y	39375				
	Z	39375	78750			
To	Interest					
	X	45000				
	Y	45000				
	Z	45000	135000			
To	Rent - X		24000			
To	Current Accounts					
	X	137550				

	Y	162350				
	Z	162350	462250			
			700000			700000

Working Notes:

1. Interest

Interest	*Jan-Sept. 2018*	*Oct-Dec 2018*	Total
	8%	*12%*	
	₹	₹	₹
X	30,000	15000	**45,000**
Y	30,000	15000	**45,000**
Z	30,000	15000	**45,000**
	90000	**45000**	**135000**

2. Commission = ¾ of (15% on ₹7,00,000) = ₹78,750
3. Share of Profit

	Jan-Sept. 2018	*Oct-Dec 2018*	Total ₹
Net Profit	525000	175000	700000
Less: Commission	78750	-	78750
Less: Interest	90000	45000	135000
Less: Rent	18000	6000	24000
Profit available for distribution in the profit sharing ratio	338250	124000	462250
X	112750	24800	137550
Y	112750	49600	162350
Z	112750	49600	162350

Treatment of Goodwill in Partnership Accounts

Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits. The implication of the above is that there is always a certain normal rate of profits earned by similar firms in the same locality. The excess profit earned by a firm may be due to its locational advantage, better customer service, possession of a unique patent right, personal reputation of the partners or for similar other reasons. The necessity for valuation of goodwill in a firm arises in the following cases:

(a) When the profit sharing ratio amongst the partners is changed;
(b) When a new partner is admitted;
(c) When a partner retires or dies, and
(d) When the business is dissolved or sold.

There are four methods for valuation of goodwill:

(1) Average profit basis,
(2) Super profit basis,
(3) Annuity basis, and
(4) Capitalisation basis.

Methods for Goodwill Valuation

1. **Average Profit Basis:** In this case the profits of the past few years are averaged and adjusted for any expected change in future. For averaging the past profit, either simple average or weighted average may be employed depending upon the circumstances. If there exists clear increasing or decreasing trend of profits, it is better to give more weight to the profits of the recent years than those of earlier years. But, if there is no clear trend of profit, it is better to go by simple average.

   Let us suppose profits of a partnership firm for the last five years were ₹30000, ₹40000, ₹ 50000, ₹60000 and ₹70,000. In this case, a clear increasing trend is noticed and therefore, average profit may be arrived at by assigning appropriate weight as shown below:

Year	Profit ₹	Weight	Weighted Profit
1	30000	1	30000
2	40000	2	80000
3	50000	3	150000
4	60000	4	240000
5	70000	5	350000
		15	850000

   So Weighted Average Profit = ₹850000 / 15 = ₹56,667

   If goodwill is valued at three years' purchase of profit, then in this case the value of goodwill is ₹56,667 × 3 = ₹1,70,000.

   However, if any such trend is not visible from the figures of past profits, then one should take simple average profit and calculate goodwill accordingly. Let us suppose, profits of a partnership firm for five years were ₹ 30,000, ₹ 25,000, ₹ 20,000, ₹ 30,000 and ₹ 28,000. In this case, there is no clear increasing or decreasing trend of profit. So average profit comes to ₹26,600 (arrived at by taking simple average). If the goodwill is valued by taking three years' purchase of profit, value of goodwill becomes ₹ 79,800.

2. **Super Profit Basis:** In case of average profit basis, goodwill is calculated on the basis of average profit multiplied by certain number of years. The implication is that such profit will be maintained for so many numbers of years and the partner(s) who gains in terms of profit sharing ratio should contribute for such gains in profit to the partners who make the sacrifice. On the other hand, super profit means, excess profit that can be earned by a firm over and above the normal profit usually earned by similar firms under similar circumstances. Under this method, the partner who gains in terms of profit sharing ratio has to contribute only for excess profit because he can earn normal profit by joining any partnership. Under super profit method, what excess profit a partnership firm can earn is to be determined first. The steps to be followed are given below:

   (a) Identify the capital employed by the partnership firm;

(b) Identify the average profit earned by the partnership firm based on past few years' figures;
(c) Determine normal rate of return prevailing in the locality for similar firms;
(d) Apply normal rate of return on capital employed to arrive at normal profit;
(e) Deduct normal profit from the average profit of the firm. If the average profit of the firm is more than the normal profit, there exists super profit and goodwill.

Let us suppose total capital employed by a partnership firm was ₹ 1,00,000 and its average profit was ₹25,000. Normal rate of return is 22% in case of similar firms working under similar conditions. So normal profit is ₹22,000 and average profit is ₹25,000. The partnership firm earns ₹3,000 super profit.

Goodwill is generally valued by multiplying the amount of super profit by certain number of years depending upon the expectation about the maintenance of such super profit in future. If it is expected that the super profit can be maintained for another five years in future, then value of goodwill may be taken as ₹3,000 × 5 = ₹15,000.

2. **Annuity Method:** In the super profit method explained above, time value of money is not considered. Although it was expected that super profit would be earned in five future years, still no devaluation was done on the value of money for the time difference. In fact when money will be received in different points of time, its values should be different depending upon the rate of interest. If 15% rate of interest is considered appropriate, then discounted value of super profit to be earned in different future years will be as follows:

Year	Super Profit ₹	Discount Factor @ 15%	Discounted Value of Super Profit
1	3000	0.8696	2608.80
2	3000	0.7561	2268.30
3	3000	0.6575	1972.50
4	3000	0.5718	1715.40
5	3000	0.4972	1491.60
			10056.60

So under the annuity method, discounted value of super profit becomes ₹10,056.60 and not ₹ 15,000 as was done under super profit method.

The word annuity is used to mean identical annual amount of super profit, so for discounting it is possible to refer to annuity table. As per the annuity table, present value of Re.1 to be received at the end of each year for 5 years @ 15% interest p.a. is 3.3522. So value of goodwill under annuity method is ₹3000 × 3.3522 = ₹10,056.60.

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

(a) Determine the normal rate of return,
(b) Find out the average profit of the partnership firm for which goodwill is to be determined,

(c) Determine the capital employed by the partnership firm for which goodwill is to be determined,

(d) Find out normal value of the business by dividing average profit by normal rate of return.

(e) Deduct average capital employed from the normal value of the business to arrive at goodwill.

Let us suppose capital employed by a partnership firm is ₹100000, its average profit is ₹ 20,000, Normal rate of return is 15%.

Normal Value of business = 20,000 x 100 / 15
= ₹1,33,333

Value of goodwill = ₹1,33,333 – ₹1,00,000 = ₹33,333

Illustration 4

Lee and Lawson are in equal partnership. They agreed to take Hicks as one-fourth partner. For this it was decided to find out the value of goodwill. M/s Lee and Lawson earned profits during 2015-2018 as follows:

Year	2015	2016	2017	2018
Profit	120000	125000	130000	150000

On 31.12.2018 capital employed by M/s Lee and Lawson was ₹5,00,000. Rate of normal profit is 20%.

Find out the value of goodwill following various methods.

Solution

Year	Profit ₹	Weight	Weighted Profit
2015	120000	1	120000
2016	125000	2	250000
2017	130000	3	390000
2018	150000	4	600000
		10	1360000

Weighted Average Profit = ₹136000

Method 1 – Average Profit Basis

Assumption: Goodwill is valued at 3 year's purchase

Value of goodwill: 136000 × 3 = ₹408000

Method 2 – Super Profit Basis

Average Profit	=	136000
Normal Profit (20% on ₹500000)	=	100000
		36000

Assumption: Goodwill is valued at 3 year's purchase

Value of goodwill: 36000 × 3 = ₹108000

Method 3 – Annuity Basis

Assumptions:

a) Interest rate is equivalent to normal profit rate i.e., 20% p.a
b) Goodwill is valued at 3 year's purchase
   Value of goodwill: 36000 × 2.1065 = ₹75834

Method 4 – Capitalisation Basis

Normal value of capital employed:

136000 × 100/20	=	₹680000
Capital employed in M/s Lee and Lawson	=	₹500000
Goodwill	=	₹180000

Change in Profit Sharing Ratio

Sometimes, change in profit sharing ratio takes place without any change in the number of partners (i.e. admission, retirement or death) of the firm.

When such a change takes place, one or more partners purchase interest in the business from the other partner(s). Therefore, the aggregate amount of gain by one or more partner(s) is equal to the aggregate amount of sacrifices made by the other partner(s). The required adjustments in regard to the profit-sharing ratio, revaluation of assets and liabilities, treatment of goodwill or reserves or partners' capitals are same as what is done in case of admission or retirement or death of a partner.

The only exception is that neither a partner is coming into the business nor a partner is going out. Sometimes a single entry is passed through partners' capital accounts in gaining/sacrificing ratio, when such changes are not to be incorporated in the balance sheet, as is passed for adjustment of goodwill.

Illustration 5

P, Q and R are partners sharing profits and losses in the ratio of 3:2:1. The goodwill of the firm is valued at ₹12,000. They have decided to change the profit-sharing ratio to 2:2:1. Pass Journal Entries.

Solution

In the books of the firm

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Q's Capital A/c (Refer Working Note)	Dr.	800	
	R's Capital A/c	Dr.	400	
	To P's Capital A/c			1200

	(Being the adjustment for goodwill through the Partners' Capital Accounts)		

Working Note:

Calculation of share of sacrifice/gain

	P	Q	R
Old ratio (3:2:1)	$\frac{3}{6}$	$\frac{2}{6}$	$\frac{1}{6}$
New ratio (2:2:1)	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
	(Sacrifice) $\frac{1}{10}$	(Gain) $\frac{2}{30}$	(Gain) $\frac{1}{30}$
	12000 × 1/10	12000 × 2/30	12000 × 1/30

Illustration 6

The following is the Balance sheet of Anil and Bimal, who are equal partners as on 31.12.2018:

Liabilities		₹	Assets	₹
Capital Accounts: Anil		12,000	Sundry Assets	28,000
	Bimal	6,000		
Reserves		6,000		
Creditors		4,000		
		28,000		28,000

From 1.1.2019, the partners decided to share profits and losses in the ratio of 2:1. For this purpose, the goodwill of the firm is valued at ₹6,000 which will not be shown in the Balance Sheet. Pass necessary Journal Entries and re-draft the Balance Sheet.

Solution **Journal Entry in the books of the firm**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Reserves A/c	Dr.	6000	
	To Anil's Capital A/c			3000
	To Bimal's Capital A/c			3000
	(Being reserve transferred to the Partners' Capital Accounts in the old ratio before change in the constitution)			
	Anil's Capital A/c (Refer W.N.)	Dr.	1000	

	To Bimal's Capital A/c *(Being the adjustment for goodwill made through the Partners' Capital Accounts)*		1000

Balance Sheet of Anil and Bimal as at 1.1.2019

Liabilities	Rs.	Assets	Rs.
Capital Accounts:			
Anil: ₹(12,000+3,000-1,000)	14,000	Sundry Assets	28,000
Bimal: ₹(6,000+3,000+1,000)	10,000		
Creditors	4000		
	28000		28000

Working Note:

Calculation of share of sacrifice/gain

		Anil	Bimal	
Old ratio (1:1)		$\frac{1}{2}$	$\frac{1}{2}$	
New ratio (2:1)		$\frac{2}{3}$	$\frac{1}{3}$	
	(Gain)	$\frac{1}{6}$	$\frac{1}{6}$	(Sacrifice)
		6000 × 1/6	6000 × 1/6	

Illustration 7

Any and Many are partners sharing profits as to ¾ and ¼ and their capitals are ₹90,000 and ₹30,000 respectively. It is decided that with effect from 1st April, 2008 the profit-sharing ratio will be: Any 5/8 and Many 3/8. The Deed states that goodwill is to be valued at 2 years' purchase of three years' profits and that capitals of the two partners should be proportionate to the profit-sharing ratio. The profits for the years ended 31st March, 2006, 31st March, 2007 and 31st March, 2008 were ₹42,000, ₹39,000 and ₹45,000 respectively. Make necessary journal entries.

Solution		₹
Value of Goodwill: Total profits for 3 years -	2005-06	42,000
	2006-07	39,000
	2007-08	<u>45,000</u>
	Total	<u>126000</u>
Average profit		42,000

Goodwill at 2 years' purchase 84,000

Calculation of share of sacrifice/gain

	Any	Many
Old ratio (3:1)	$\frac{3}{4}$	$\frac{1}{4}$
New ratio (5:3)	$\frac{5}{8}$	$\frac{3}{8}$
	(Sacrifice) $\frac{1}{8}$	(Gain) $\frac{1}{8}$
	84,000 x 1/8 = 10,500	84,000 x 1/8=10,500

New capital required after the change in ratio-

			₹
Total Capital	(90,000 + 30,000)		120000
Any's capital	120000 × 5/8 =	75,000	
Many's capital	120000 × 3/8 =	45,000	

Journal Entries

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Many's Capital Account Dr. To Any's Capital Account [The value of 1/8 share of goodwill (total value ₹84000) which Many acquires Any] *(Being reserve transferred to the Partners' Capital Accounts in the old ratio before change in the constitution)*		10500	10500
	Bank Account Dr. To Many's Capital Account [The sum required to make up Many's capital upto ₹45000 after the debit of ₹10500, i.e., ₹45000 (30000-10500)]		25500	25500
	Any's Capital Account Dr. To Bank Account		25500	25500

	[The sum to be returned to Any to bring his capital down to ₹75000 i.e., (90000 + 10500-75000)]		

Admission of a 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 that purpose. This account is debited with all reduction in the value of assets and increase in liabilities. The difference in 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:

1.	Revaluation Account Dr To the assets (Individually which shows a decrease) To the Liability (Individually which have to be increased)	with the reduction in the value of the assets with the increase in the liabilities.
2	Assets Account (Individually) Dr. Liabilities Account (Individually) Dr. To Revaluation Account	with the increase in the value of the assets with the reduction in the amount of liabilities
3	Revaluation Account Dr. To Capital A/c's of the old partners capital ratio or Capital A/c's of the old partners Dr. To Revaluation Account	with the profit in the old profit sharing ratio with the loss in old profit sharing ratio

Illustration 8

Messers Dalal, Banerji and Mallick is a firm sharing profits and losses in the ratio 2:2:1. Their Balance Sheet as on 31st March, 2018 is as below:

Liabilities		₹	*Assets*	₹
Sundry Creditors		*12,850*	*Land and Buildings*	*25,000*
Outstanding Liabilities		*1,500*	*Furniture*	*6,500*
General Reserve		*6,500*	*Stock of goods*	*11,750*
Capital Account :			*Sundry Debtors*	*5,500*
Mr. Dalal	*12,000*		*Cash in hand*	*140*
Mr. Banerji	*12,000*		*Cash at Bank*	*960*
Mr. Malick	*5,000*	*29,000*		

	49,850		*49,850*

The partners have agreed to take Mr. Mistri as a parner with effect from 1st April, 2018 on the following terms:

(1) Mr. Mistri shall bring ₹5,000 towards his capital.
(2) The value of stock should be increased by ₹2,500 and Furniture should be depreciated by 10%.
(3) Reserve for bad and doubtful debts should be provided at 10% of the debtors.
(4) The value of land and buildings should be enhanced by 20% and the value of the goodwill be fixed at ₹15,000.
(5) The value of the goodwill be fixed at ₹15,000.
(6) General Reserve will be transferred to the partner's Capital Accounts.
(7) The new profit sharing ratio shall be: Mr. Dalal 5/15, Mr. Banerji 5/15,Mr. Mallick 3/15 and Mr. Mistri 2/15.
(8) The goodwill account shall be written back to the Partner's account in accordance with the new profit sharing proportion.

The outstanding liabilities include ₹1,000 due to Mr. Sen which has been paid by Mr. Dalal. Necessary entries were not made in the books. Prepare (i) Revaluation Account, and (ii) The Capital Accounts of the partners, and (iii) the Balance Sheet of the firm as newly constituted (Journal entries are not required)

Solution **Revaluation Account**

2018			₹	2018		₹
Apr-01	To Provision for bad and doubtful debts		550	Apr-01	By Stock in trade	2500
	To Furniture and fittings		650		By Land and Buildings	5000
	To Capital Accounts Profit on revaluation transferred					
	Dalal	2520				
	Banerji	2520				
	Mallick	1260	6300			
			7500			7500

Capital Accounts of Partners

Dr. Cr.

Particulars	Dalal ₹	Banerji ₹	Mallick ₹	Mistri ₹	Particulars	Dalal ₹	Banerji ₹	Mallick ₹	Mistri ₹
To Dalal & Banerji	-	-	-	2000	By Balance b/d	12000	12000	5000	-

To Balance c/d	19120	18120	7560	3000	By General Reserve	2600	2600	1300	-
					By Cash	-	-	-	5000
					By Mistri	1000	1000	-	-
					By Outstanding liabilities	1000	-	-	-
					By Revaluation A/c	2520	2520	1260	-
	19120	18120	7560	5000		19120	18120	7560	5000

Balance Sheet of M/s Dalal, Banerji, Mallick and Mistri as at 1-4-2018

Liabilities		₹	Assets		₹
Sundry creditors		12850	Land and Buildings		30000
Outstanding Liabilities		500	Furniture		5850
Capital Accounts of Partners:			Stock of goods		14250
Mr. Dalal	19120		Sundry debtors	5500	
Mr. Banerji	18120		Less: Provision	550	4950
Mr. Mallick	7560		Cash in hand		140
Mr. Mistri	3000	47800	Cash at bank		5960
		61150			61150

Retirement of a Partner

1. On retirement of a partner, it is required to revalue assets and liabilities just as in the case of admission of a partner.
2. If there is revaluation profit, then such profit should be distributed amongst the existing partners including the retiring partner at the existing profit sharing ratio.
3. If there is loss on revaluation such is also to be distributed to all the partners including the retiring partner at the existing profit sharing ratio.
4. To arrive at profit or loss on revaluation of assets and liabilities, a Revaluation Account or Profit and Loss Adjustment Account is opened.
5. Revaluation Account or Profit and Loss Adjustment Account is closed automatically by transfer of profit or loss balance to the Partners' Capital Accounts.
6. If it is decided that revalued figures of assets and liabilities will not appear in the balance sheet of the continuing partners, then a journal entry should be passed only counting the amount payable or chargeable to the retiring partner which the continuing partners will share at the ratio of gain.

On the retirement of a partner, any undistributed profit or reserve standing at the Balance Sheet is to be credited to the Partners' Capital Accounts in the old profit sharing ratio. Alternatively, only the retiring partner's share may be transferred to his Capital Account if the others continue at the same profit sharing ratio.

For example, A, B and C were in partnership sharing profits and losses at the ratio of 5:3:2. A retired and B and C agreed to share profit and loss at the ratio 3:2. Reserve balance was ₹10,000. In this case either of the following journal entries can be passed:

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Reserves A/c	Dr.	10000	
	To A's Capital A/c			5000
	To B's Capital A/c			3000
	To C's Capital A/c			2000
	(Transfer of reserve A/c to partners' capital A/c's in 5:3:2 ratio on A's retirement)			
	Or			
	Reserves A/c	Dr.	5000	
	To A's Capital A/c			5000
	(Transfer of A's share of reserve to his Capital Account on his retirement)			

Note that alternative (2) has the same implications because B and C continued at the same ratio 3:2 as they did before A's retirement.

Take another example: X, Y, and Z were equal partners. Z decided to retire. X and Y decided to continue in the ratio 3:2. Reserve standing at the date of retirement of Z was ₹9,000. In this case adjustment of Z's share was not sufficient since the relationship between X and Y was also changed.

X's gain: 3/5 – 1/3 = 4/15
Y's gain: 2/5 – 1/3 = 1/15
Gaining Ratio: X : Y
4 : 1

This is different from 1:1. So alternative (1) is to be followed in this case.

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Reserves A/c	Dr.	9000	
	To X's Capital A/c			3000
	To Y's Capital A/c			3000
	To Z's Capital A/c			3000
	(Transfer of Reserve on Z's retirement)			
If the continuing partners want to show reserve in the Balance Sheet, the journal entry will be:				
	X's Capital A/c	Dr.	2400	
	Y's Capital A/c	Dr.	600	
	To Z's Capital A/c			3000
	(Adjustment entry for Z's share of reserve)			

Final Payment to Retiring Partner

The following adjustments are necessary in the Capital A/c's:

1. Transfer of reserve
2. Transfer of goodwill
3. Transfer of profit/loss on revaluation.

After adjustment of the above mentioned items, the Capital Account balance standing to the credit of the retiring partner represents amount to be paid to him.

The continuing partners may discharge the whole claim at the time of retirement. Then the journal entry will appear as follows:

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

Sometimes the retiring partner agrees to retain some portion of his claim in the partnership as loan. The journal entry will be as follows:

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

Illustration 9

Fairbrother, Greatbatch and Kristen were partners sharing profit and losses at the 2:2:1. Kristen wants to retire on 31-12-2018. Given below the Balance Sheet of the partnership as well as other information:

Balance Sheet as on 31-12-2018

Liabilities	₹	Assets	₹
Capital A/cs.		Sundry Fixed Assets	1,50,000
Fairbrother	1,20,000	Stock	50,000
Greatbatch	80,000	Debtors	50,000
Kristen	60,000	Bills Receivable	20,000
Reserve	10,000	Bank	50,000
Sundry creditors	50,000		
	3,20,000		3,20,000

Fairbrother and Greatbatch agree to share profits and losses at the ratio of 3:2 in future. Value of goodwill is taken to be ₹50,000. Sundry Fixed Assets are revalued upward by ₹30,000 and stock by ₹ 10,000. Bills Receivable dishonoured ₹ 5,000 on 31-12-2018 but not recorded in the books. Dishonour of bill was due to insolvency of the customer. Fairbrother and Greatbatch agree to bring sufficient cash to discharge claim of Kristen and to make their capital proportionate. Also they wanted to maintain ₹75,000 bank balance for working capital. However they did not want to show goodwill in the books of accounts. Pass necessary journal entries and draft the Balance Sheet of M/s Fairbrother and Greatbatch.

Solution **Journal Entries**

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Reserve A/c	Dr.	10000	
	To F's Capital A/c			4000

	To G's Capital A/c To K's Capital A/c (Transfer of Reserve to Partners' Capital A/cs on K's retirement)	30000	4000 2000
	Stock A/c Dr. To Profit and Loss Adjustment A/c (Increase in the value of Sundry Fixed Assets and Stock recorded)	10000	40000
	Profit and Loss Adjustment A/c Dr. To Bills Receivable A/c (Loss arising out of dishonoured bill recorded)	5000	5000
	Profit and Loss Adjustment A/c Dr. To F's Capital A/c To G's Capital A/c To K's Capital A/c (Profit on revaluation transferred to Partners' Capital A/cs on K's retirement)	35000	14000 14000 7000
	F's Capital A/c Dr. To K's Capital A/c (Adjusting off the value of goodwill in the profit sacrificing ratio of partners)	10000	10000
	Bank A/c Dr. To F's Capital A/c To G's Capital A/c (Cash brought in by F and G as per agreement)	104000	70000 34000
	K's Capital A/c Dr. To Bank A/c (Payment made to K on retirement)	79000	79000

Balance Sheet (After K's retirement)

Liabilities	₹	Assets	₹
Sundry creditors	12850	Sundry Fixed Assets	180000
Capital Accounts of Partners:		Stock	60000
F	198000	Sundry debtors	50000
G	132000	Bill Receivable	15000
		Bank	75000
	320000		320000

Working Notes:

1. **Partner's Capital A/c's**

Dr. Cr.

Particulars	F ₹	G ₹	K ₹	Particulars	F ₹	G ₹	K ₹
To K	10000	-	-	By Balance b/d	120000	80000	60000
To Balance c/d	128000	98000	79000	By E	-	-	10000
				By Profit and Loss Adj. A/c	14000	14000	7000
				By Reserve	4000	4000	2000
	138000	98000	79000		138000	98000	79000
To Bank	-	-	79000	By Balance b/d	128000	98000	79000
To Balance c/d	198000	132000	-	By Bank	70000	34000	-
	198000	132000	79000		198000	132000	79000

2. **Total capital**

Sundry Fixed Assets (₹150000+30000)	180000
Stock (₹50000+10000)	60000
Sundry debtors	50000
Bill Receivable	15000
Bank	75000
	380000
Less: Sundry Creditors	50000
	330000
F's Share (₹3,30,000 × 3/5)	198000
G's Share (₹3,30,000 × 2/5)	132000

3. **Bank A/c**

	₹		₹
To Balance b/d	50000	By K's Capital A/c	79000
To F's Capital A/c	70000	By Balance c/d	75000
To G's Capital A/c	34000		
	154000		154000

Often the retiring partner's claim is not fully paid but kept in the business as loan. As per arrangement such loan is repaid by instalments alongwith agreed interest. Sometimes joint life policy is taken to meet the claim of the retiring partner

Death of a Partner

The problems arising on the death of a partner are similar to those arising on retirement. Assets and liabilities have to be revalued and the resultant profit or loss has to be transferred to the Capital Accounts of all partners including the deceased partner.

Goodwill is dealt with exactly in the way already discussed in the case of retirement. The only additional point is that as death may occur on any day, the representatives of the deceased partner will be entitled to the partner's share of profit from the beginning of the year to the date of death. After ascertaining the amount due to the deceased partner, it should be credited to his Executor's Account.

The amount due to the deceased partner carries interest at the mutually agreed upon rate. In the absence of agreement, the representatives of the deceased partner can receive, at their option, interest at the rate of 6% per annum or the share of profit earned for the amount due to the deceased partner.

The basic distinction between retirement and death of a partner relates to finalisation of amount payable to the Executor of the deceased partner. Although revaluation of goodwill is done in the same way as it has been done in case of retirement, in addition, the executor of the deceased partner is entitled to share of profit upto the date of death.

For example, A, B and C are in partnership sharing profits and losses at the ratio of 2:2:1. A died on 15th April, 2018. The firm closes its books of account as on 31st December every year. So the executor of A is entitled for 3½ months profit. If A's share is immediately paid off, then profit for 2017 can be taken as base for calculating 3½ months profit in 2018. If M/s. A, B & C earned ₹96,000 in 2007, then 3½ months profit is ₹28,000. A's share comes to ₹28,000 × 2/5 i.e., ₹11,200.

Journal entry is:

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Profit and Loss Suspense A/c Dr. To A's Capital A/c (Share of A in 3½ months profit in 2018 is transferred to his Capital Account on death)		11200	11200

Right of Outgoing Partner in Certain Cases to Share Subsequent Profits

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 six per cent per annum on the amount of his share in the property of the firm:

Provided that where by contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section. This way, the outgoing partner has the option to receive, interest at the rate of 6% p.a. or the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary.

It may be noted that the outgoing partner is not bound to make election until the share of the profit that would be payable to him has been ascertained.

Illustration 10

Rohan, Sohan and Mohan were partners sharing profits and losses in the ratio of 2:2:1. Their Balance Sheet as on 1-1-2018 stood as follows:

Liabilities	₹	₹	Assets	₹
Capital Accounts:			Fixed Assets	1,00,000
Rohan	50,000		Stock	25,000
Sohan	40,000		Debtors	35,000
Mohan	30,000	1,20,000	Cash and bank	10,000
Reserves		10,000		
Creditors		40,000		
		1,70,000		1,70,000

On 1st July, 2018 Mohan died. His representatives agreed that:

(i) Goodwill of the firm be valued at ₹50,000;
(ii) Fixed Assets be written down by ₹10,000; and
(iii) In lieu of profits, Mohan should be paid at the rate of 25% per annum on his capital as on 1-1-2018.

Current years (2018) profit after charging depreciation of ₹9,500 (₹5,000 related to the 1st half) was ₹ 40,500. The year-end figures of Stock, Debtors and Creditors and Cash and Bank Balances were respectively ₹23,000, ₹19,000, ₹35,000 and ₹4,377. The particulars regarding their drawings are given below:

	Upto 1-7-2018	April 1-7-2018
	₹	₹
Rohan	4,125	5,000
Sohan	4,125	5,000
Mohan		1,750

Prepare the balance sheet of the firm as on 31st December, 2018.

Solution

a)	Profit after Depreciation	40500
	Add : Depreciation	9500

	Profit before Depreciation	50000
b)	Profit for the 1st half (assumed : evenly spread)	25000
	Less : Depreciation with respect to 1st half	5000
	Post Depreciation profit	20000
c)	Profit for the 2nd half	25000
	Less : Depreciation for the 2nd half	4500
	2nd half profit after Depreciation	20500

d) Profit and Loss Appropriation A/c (for the first half)

		₹		₹
To Interest on Mohan's Capital (30000 × 25% for 6 months)		3750	By Profit	20000
To Rohan	8125			
To Sohan	8125	16250		
		20000		20000

e) Capital Account as on 1-7-2018

Particulars	Rohan ₹	Sohan ₹	Mohan ₹	Particulars	Rohan ₹	Sohan ₹	Mohan ₹
To Revaluation Loss of Fixed Assets	4000	4000	2000	By Balance b/d	50000	40000	30000
To Drawings	4125	4125	1750	By Reserve	4000	4000	2000
To Mohan	5000	5000	-	By Rohan & Sohan	-	-	10000
To Executors A/c	-	-	42000	By Profit and Loss Adj. A/c	8125	8125	3750
To Balance c/d	49000	39000					
	62125	52125	45750		62125	52125	45750

f) Application of Section 37 of the Partnership Act

Either

(i) Interest of 42,000 × $\frac{6}{100} \times \frac{6}{12}$ = ₹1260

or

(ii) Profit earned out of unsettled capital

$$20{,}500 \times \frac{42000}{(49000 + 39000 + 42000)} = ₹6623$$

g) In the absence of specific agreement amongst partners on the above subject matter, the representatives of the deceased partner can receive at their option, interest at the rate of 6% p.a. or the share of profit earned for the amount due to the decease partner.

In the above case, it would be rational to assume that the representatives would opt for ₹6,623.

h) Profit and Loss Appropriation A/c for the second half

Particulars		₹	Particulars	₹
To Executors A/c		6623	By Net Profit	20500
To Rohan	6938			
To Sohan	6939	13877		
		154000		154000

i) Capital Accounts as on 31-12-2018

Particulars	Rohan ₹	Sohan ₹	Particulars	Rohan ₹	Sohan ₹
To Drawings	5000	5000	By Balance b/d	49000	39000
To Balance c/d	50938	40939	By Profit and Loss Appropriation A/c	6938	6939
	55938	45939		55938	45939

j) Executors Account

To Bank	48623	By Mohan's Capital A/c	42000
		By Profit and Loss Appropriation A/c	6623
	48623		48623

k) Balance Sheet as on 31-12-2018

Liabilities		₹	Assets		₹
Capital Accounts of Partners:			Fixed Assets	100000	
Rohan	50938		Less: Written down	10000	
Sohan	40939	91877		90000	
			Less: Depreciation	9500	80500
Creditors		35000	Debtors		19000
			Stock		23000
			Cash and Bank		4377
		126877			126877

Module III HIRE PURCHASE AND INSTALMENT SYSTEM

Hire Purchase system

It is a system of purchase under which the buyers enters into agreement with the seller to pay the price in installments. The buyer gets the possession of goods immediately on paying the down payment but does not get ownership. He becomes the owner only after the last installment is paid. Under this system the buyer fails to pay any installment, the seller has the right to tack back the goods.

Difference between Hire Purchase and Sale

The main difference between hire purchase agreement and sale are given below:

1. Under the sales ownership is transferred at the time of purchase. But under hire purchase ownership is transferred only after payment of the last installment
2. In the case of sale payment of price is generally made in lump sum. In the case of hire purchase payment of price is always made installment
3. In the case of sales buyer can dispose of the goods in any way he likes. But a buyer under hire purchase agreement has no such right before he becomes the owner on payment of the installment.
4. In the case of sale on credit the seller can sue the buyer for the payment of the price outstanding. Bur a seller under hire purchase system can take back the goods in case of default by the buyer in payment of any installment
5. In case of sale, the buyer's position is like that of an owner. But the position of an under hire purchase is like that of a bailee in respect of the goods until he becomes the owner.
6. In case of sale on immediate cash, the price does not include any interest. But under hire purchase the installment includes interest.

Accounting for hire purchase transactions in the books of hire purchaser

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

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

When asset is recorded at full cash price

Under this method the asset is recorded at the full price. Thus this method treats the hire purchaser as owner of the asset.

Accounting entries in the books hire purchaser as follows:

1) When the asset is acquired on hire purchase

    Asset account A/c Dr.

        To hire vendor a/c (cash price)

2) When down payment is made

    Hire vendor a/c Dr.

To cash a/c

3) When interest becomes due

Interest a/c Dr.
To hire vendor a/c

4) When installment is paid

Hire vendor a/c Dr.
To cash a/c

5) When depreciation is charged on asset

Depreciation a/c Dr.
To asset a/c

6) For closing interest

P & L a/c Dr.
To interest a/c

7) For closing depreciation

P & L a/c Dr.
To Depreciation a/c

In the books of hire vendor

Accounting entries are as follows:

1) When the asset is sold

Hire purchase a/c Dr.
To hire purchase sales a/c

2) When down payment received

Cash a/c Dr.
To hire purchase a/c

3) When interest become due

Hire purchase a/c Dr.
To interest a/c

4) When installment received

Cash A/c Dr.
To hire purchaser a/c

5) For closing interest

Interest a/c Dr.
To P & L a/c

Illustration 1

On 1st Jan. 2014, A Ltd purchased from B Ltd five tracks under hire purchase system. ₹50000 being paid on delivery and the balance in five installments of ₹75000 each payable annually on 31st Dec. The vendor charges 5% p.a interest on yearly balances. The cash price of five trucks was ₹

375000. Show how this transaction should be recorded in the books of A ltd, if A Ltd writes off depreciation at 10% p.a on the written down value.

In the books of A Ltd

Trucks Account

Date	Particulars	₹	Date	Particulars	₹
2014 Jan 1	To B Ltd	375000	2014 Dec 31	By Depreciation	37500
				By Balance c/d	337500
		375000			375000
2015 Jan 1	To Balance b/d	337500	2015 Dec 31	By Depreciation	33750
				By Balance c/d	303750
		337500			337500
2016 Jan 1	To Balance b/d	303750	2016 Dec 31	By Depreciation	30380
				By Balance c/d	273370
		303750			303750
2017 Jan 1	To Balance b/d	273370	2017 Dec 31	By Depreciation	27340
				By Balance c/d	246030
		273370			273370
2018 Jan 1	To Balance b/d	246030	2018 Dec 31	By Depreciation	24600
				By Balance c/d	221430
		246030			246030
2019 Jan 1	To Balance b/d	221430			

B Ltd Account

2014 Jan 1	To Cash	50000	2014 Jan 1	By Trucks	375000
	To Cash	75000	Dec-31	By Interest	16250
Dec-31	To Balance c/d	266250			
		391250			391250
2015 Dec 31	To Cash	75000	2015 Jan 1	By Balance b/d	266250
	To Balance c/d	204560	Dec-31	By Interest	13310
		279560			279560
2016 Dec 31	To Cash	75000	2016 Jan 1	By Balance b/d	204560
	To Balance c/d	139790	Dec-31	By Interest	10230
		214790			214790
2017 Dec 31	To Cash	75000	2017 Jan 1	By Balance b/d	139790
	To Balance c/d	71780	Dec-31	By Interest	6990
		146780			146780
2018 Dec 31	To Cash	75000	2018 Jan 1	By Balance b/d	71780
			Dec-31	By Interest	3220
		75000			75000

Interest account

2014 Dec 31	To B Ltd	16250	2014 Dec 31	By P & L A/c	16250
2015 Dec 31	To B Ltd	13310	2015 Dec 31	By P & L A/c	13310
2016 Dec 31	To B Ltd	10230	2016 Dec 31	By P & L A/c	10230
2017 Dec 31	To B Ltd	6990	2017 Dec 31	By P & L A/c	6990
2018 Dec 31	To B Ltd	3220	2018 Dec 31	By P & L A/c	3220

Calculation of Interest

1. Calculation of interest when cash price and rate of interest and amount of installment are given – total interest is the difference between hire purchase price and cash price. Interest for each year is calculated on the amount of outstanding cash price
2. Calculation of interest when cash price and amount of installment are given. In the case , total interest apportioned to each year on the ratio of installment price outstanding
3. When rate of interest and installment are given but total cash price is not given. In this method, interest is calculated from the last year firstly and then previous year and at last fist year. For this purpose. Rate of interest must be converted on cash to on installment.

Illustration 2

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

Solution

Year	Instalment	Interest paid	Cash price
1st year down payment	800	No interest	800
First year end	400	400+254+667*5/105=63	337
Second year	300	330+667*5/105=46	254
Third year end	700	700*5/105=33	667
			2058

Default and re-possession

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

1. When seller takes back the possession of complete goods
2. When seller takes possession of only part of the total assets sold or when seller takes back the possession of complete goods

In the case accounting treatment is as follows:

In the books of purchaser:

1) All entries are passed as usual up to the date of default.
2) Buyer closes the account of seller by passing the entry:

Hire vendor account Dr

To assets account

3) Any balance left in asset account is closed by transferring to P & L account.

In the books of seller

1) All entries are passed as usual up to the date of default.
2) Seller closes the purchaser account by passing:

Re possessed goods account Dr.

To hire purchaser

3) Re possessed goods account or goods returned account is debited with all expenses incurred and re sale price is credited and if any balance, it is transferred to P & L account.

When seller takes possession of the total assets sold

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

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

Illustration 3

A Machinery is sold on hire purchase. The terms of payment is four annual installment of ₹ 6000 at the end of each year commencing from the date of agreement. Interest is charged @ 20% and is included in the annual payment of ₹6000

Show machinery account and hire vendors account in the books of the purchaser who defaulted in the payment of the third yearly payment where upon the vendors re-possessed the machinery. The purchaser provides depreciation on the machinery @ 10% p.a on written down value method. All workings should form part of your answer

Solution **Calculation of Cash Price**

No. of Instalment	Amount due after payment of instalment	Amount of instalment	Total amount	Interest 20/120	Opening Balance
	₹	₹	₹	₹	₹
1	-	6000	6000	1000	5000
2	5000	6000	11000	1833	9167
3	9167	6000	15167	2528	12639
4	12639	6000	18639	3106	15533

Cash price of the machinery is Rs. 15533

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
Year I	To Hire Vendor a/c	15533	Year I	By Depreciation	1553
				By Balance c/d	13980
		15533			15533
Year II	To Balance b/d	13980	Year II	By Depreciation	1398
				By Balance c/d	12582
		13980			13980
Year III	To Balance b/d	12582	Year III	By Depreciation	1258
				By Hire Vendor a/c	11000
				By Profit and Loss a/c (Loss in default)	324
		12582			12582

Hire Vendor Account

Year I	To Bank a/c	6000	Year I	By Machinery a/c	15533
	To Balance c/d	12639		By Interest	3106
		18639			18639
Year II	To Bank a/c	6000	Year II	By Balance b/d	12639
	To Balance c/d	9167		By Interest	2528
		15167			15167
Year III	To Machinery a/c (Transfer)	11000	Year III	By Balance b/d	9167
				By Interest	1833
		11000			11000

Illustration 4

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

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

Solution **In the books of P – Truck Account**

Year I	To Hire Vendor a/c	56000	Year I	By Depreciation	5600
				By Balance c/d	50400

		56000			56000
Year II	To Balance b/d	50400	Year II	By Depreciation	5040
				By Hire Vendor a/c	29453
				By Profit and Loss a/c (balancing figure)	15907
		50400			50400

Hire Vendor Account

Year I Jan 1	To Bank a/c	15000	Year I Jan 1	By Trucks a/c	56000
Dec-31	To Bank a/c	15000	Dec-31	By Interest	2050
Dec-31	To Balance c/d	28050			
		58050			58050
Year II Dec 31	To Trucks a/c	29453	Year II Jan 1	By Balance b/d	28050
			Dec-31	By Interest	1403
		29453			29453

In the books of Hire Vendor
P's Account

Year I Jan 1	To Hire Sales a/c	56000	Year I Jan 1	By Bank a/c	15000
Dec-31	To Interest a/c	2050	Dec-31	By Bank a/c	15000
				By Balance c/d	28050
		58050			58050
Year II Jan 1	To Balance b/d	28050	Year II Dec 31	By Goods repossessed a/c	29453
Dec-31	To Interest a/c	1403			
		29453			29453

Goods Repossessed Account

Year II Dec 31	To P a/c	29453	Year II Dec 31	By Sales	30110
	To Cash (Expenses)	357			
	To P & L a/c	300			
		30110			30110

Profit and Loss Account

			Year II Dec 31	By Goods repossessed a/c	300

Illustration 5

Roman transport co. purchased five trucks from Ramos Auto Ltd., on the January, 2016 on hire purchase system. The cash price of each truck is ₹120000. The mode of payments was as follows:

(i) 15% of cash price down

(ii) 25% of cash price at the end of each year for 4 year

Roman transport co. writes off 15% depreciation annually on diminishing balance. The payment due to 31st December 2016 could not be made. Ramos Auto Ltd. agree to leave three Trucks with the buyer on the conditions that the value of the other two Trucks would be adjusted against the amount due, the trucks being valued at cost less 25% depreciation on diminishing balance.

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

Solution

In the books of Roman Transport Co. – Truck Account

2016 Jan 1	To Ramos Auto Ltd.	600000	2016 Dec 31	By Depreciation	90000
				By Balance c/d	510000
		600000			600000
2017 Jan 1	To Balance b/d	510000	2017 Dec 31	By Depreciation	76500
				By Ramos Auto Ltd.	135000
				By Profit and Loss a/c (loss on default)	38400
				By Balance c/d	260100
		510000			510000
2018 Jan 1	To Balance b/d	510000			

Ramos Auto Ltd. Account

2016 Jan 1	To Bank a/c (15% of 600000)	90000	2016 Jan 1	By Trucks a/c	600000
Dec-31	To Bank a/c	150000	Dec-31	By Interest	36000
Dec-31	To Balance c/d	396000			
		636000			636000
2017 Dec 31	To Trucks a/c	135000	2017 Jan 1	By Balance b/d	396000
	To Balance c/d	288000	Dec-31	By Interest	27000
		423000			423000

<u>Working note:</u>

Calculation of value of 2 Trucks taken up Ramos Auto Ltd.

	₹
Cost of 2 Trucks	240000
Less: Depreciation @ 25% for 2016	60000
	180000
Less: Depreciation @ 25% for 2017	45000
Value on 31-12-2017	135000

Calculation of value of 3 trucks retained by Roman Transport Co.

	₹
Cost of 3 Trucks	360000
Less: Depreciation @ 15% for 2016	54000
	306000
Less: Depreciation @ 15% for 2017	45900
Value on 31-12-2017	260100

Illustration 6

P purchased 4 cars of ₹14000 each on hire purchase system the hire purchase price for all the 4 cars was ₹60000 to be paid ₹15000 down and 3 instalment of ₹15000 each at the end of each year interest is charged @ 5% p.a, buyer depreciates cars @10% p.a on straight line method.

After having paid down payment and first instalment, buyer could not pay 2nd instalment and seller took possession of three cars at an agreed value to be calculated after depreciating cars at 20% p.a on written down value method one car was left with the buyer. Seller after spending ₹1200 on repairs sold away all the three cars to X for ₹35000 open ledger accounts in the books of both parties

Solution

Calculation of value of asset taken by the seller

Number of cars taken by the seller	3	
Cost Price	3 × 14000	₹42,000
Less: Depreciation		
1st Year	8400	
2nd Year	6720	15120
Value of assets taken		₹ 26,880
Value of car left with buyer		
Number of car	1	
Cost Price		14000
Less: Depreciation		
1st Year	1400	
2nd Year	1400	2800
value of asset left		11200

In the books of P – Asset Account

Year I	To Hire Vendor a/c	56000	Year I	By Depreciation	5600
				By Balance c/d	50400
		56000			56000
Year II	To Balance b/d	50400	Year II	By Depreciation	5600
				By Hire Vendor a/c	26880
				By Profit and Loss a/c (balancing figure)	6720

				By Balance c/d	11200
		50400			50400

Hire Vendor Account

Year I Jan 1	To Bank a/c	15000	Year I Jan 1	By Trucks a/c	56000
Dec-31	To Bank a/c	15000	Dec-31	By Interest	2050
Dec-31	To Balance c/d	28050			
		58050			58050
Year II Dec 31	To Trucks a/c	26880	Year II Jan 1	By Balance b/d	28050
	To Balance c/d	2573	Dec-31	By Interest	1403
		29453			29453

In the books of Hire Vendor

P's Account

Year I Jan 1	To Hire Sales a/c	56000	Year I Jan 1	By Cash a/c	15000
Dec-31	To Interest a/c	2050	Dec-31	By Cash a/c	15000
				By Balance c/d	28050
		58050			58050
Year II Jan 1	To Balance b/d	28050	Year II Dec 31	By Goods repossessed a/c	26880
Dec-31	To Interest a/c	1403		By Balance c/d	2573
		29453			29453

Goods Repossessed Account

Year II Dec 31	To P a/c	26880	Year II Dec 31	By Cash Sales	35000
	To Cash (Repairs)	1200			
	To P & L a/c	6920			
		35000			35000

INSTALMENT SYSTEM

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

Books of buyer:

Buyer debits asset account with full cash price, credits vendor's account with full instalment price and debits interest suspense account with the difference between full cash price and full instalment price. Interest is debited to interest suspense account (not interest account) because it includes interest in respect of a number of years. Every year interest account is debited and interest suspense account is credited with the interest of current year. Interest account, at the end of the year, is closed by transferring to profit and loss account. The balance of vendor account should be shown in the balance sheet after deducting amount in interest suspense account. Vendor is paid the instalment due to him and entry for the depreciation is passed in the usual way.

Books of Seller:

The seller debits the purchaser with the full amount (instalment price) payable by him and credits sales account by the full cash price and credits interest suspense account by the difference between the total instalment price and total cash price. Seller, like the buyer, also transfers the amount of interest due from the interest suspense account interest account every year. Interest account is closed by transferring to profit and loss account and the purchaser account should be shown in the balance sheet after deducting amount in interest suspense account. On receiving the instalment the vendor debits cash/bank account and credits purchaser's account.

Statement showing differences between Hire Purchase and Instalment System

	Basis of Distinction	Hire Purchase	Instalment System
1.	Governing Act	It is governed by Hire Purchase Act, 1972.	It is governed by the Sale of Goods Act, 1930.
2.	Nature of Contract	It is an agreement of hiring.	It is an agreement of sale.
3.	Passing of Title (ownership)	The title to goods passes on last payment.	The title to goods passes immediately as in the case of usual sale.
4.	Right to Return goods	The hirer may return goods without further payment except for accrued instalments.	Unless seller defaults, goods are not returnable.

5.	Seller's right to repossess	The seller may take possession of the goods if hirer is in default.	The seller can sue for price if the buyer is in default. He cannot take possession of the goods.
6.	Right of Disposal	Hirer cannot hire out sell, pledge or assign entitling transferee to retain possession as against the hire vendor.	The buyer may dispose off the goods and give good title to the bona fide purchaser.
7.	Responsibility for Risk of Loss.	The hirer is not responsible for risk of loss of goods if he has taken reasonable precaution because the ownership has not yet transferred.	The buyer is responsible for risk of loss of goods because of the ownership has transferred.
8.	Name of Parties involved	The parties involved are called Hirer and Hire vendor.	The parties involved are called buyer and seller.
9.	Component other than cash price.	Component other than Cash Price included in installment is called Hire charges.	Component other than Cash Price included in Installment is called Interest.

MODULE IV

BRANCH ACCOUNTS

A branch is a segment of a business. It is a chain of shops functioning in different localities under the control of the head office. The system of operating business at several places through one's own establishment s is called branch organization. Branch accounts are accounts relating to different branches and are used to ascertain the trading result of each branch separately.

Need or Objectives of Branch Account

The various objects of maintaining branch account are:-

(1) To ascertain profit or loss of each branch.
(2) To ascertain the financial position of each branch.
(3) To help in controlling branches.
(4) To assess the progress and performance of each branch.
(5) To ascertain the requirements of stock and cash for each branch.
(6) To ascertain whether the branch should be expanded or closed.

Types of Branches

Branches may be divided into

(1) Dependent branches (branch not keeping full system of accounting)
(2) Independent branches (branch keeping full system of accounting)
(3) Foreign branches.

Dependent Branches

Dependent branches are branches, which don't maintain its own set of books. All records have to be maintained by the head office. The following are the features of such a branch:

1) These branches sells only such goods, which are supplied by the head office
2) The head pays all branch expenses
3) The branch manager out of petty cash book pays some petty expenses.
4) Such banks are instructed to deposit daily cash proceeds in to bank account opened in the name of head office
5) Sales are generally made on cash basis but some branches are authorized to make credit sales also.
6) Branches keep only some memorandum records
7) There are four methods of accounting for dependent branches namely
    a. Debtors system
    b. Stock and debtors system
    c. Final account system
    d. Wholesale branch system

Debtors System

Under this method, head office opens only one account for each branch called branch account. Its purpose is to ascertain the profit or loss made by each branch. Such branch account is nominal in nature

Accounting entries are

1) To record opening balances of branches assets
   Branch account Dr
   To branch stock a/c
   To branch debtors a/c
   To branch petty cash
   To branch other assets
2) To record opening balances of branch liabilities
   Branch liabilities a/c Dr
   To Branch account
3) When goods sent to the branch
   Branch a/c Dr
   To goods sent to branch a/c
4) For expenses paid by head office
   Branch a/c Dr
   To bank a/c
5) For remittance sent by the branch
   Bank a/c Dr
   To branch a/c
6) For the branch assets at close Branch asset a/c Dr
   To branch a/c
7) For the branch liabilities at close
   Branch a/c Dr
   To branch liabilities
8) For transfer of profit of the branch
   Branch a/c Dr
   To general profit and loss a/c

Specimen of a branch account is given below

<u>Format of Branch Account</u>

Particulars	₹	Particulars	₹
To Balance b/d		By Bank A/c (Cash remitted)	
Cash		By Return to H.O.	

Stock Debtors Petty Cash Fixed Assets Prepaid Expenses		By Balance c/d Cash Stock Debtors	
To Goods sent to Branch		Petty Cash	
To Bank A/c Salaries Rent Sundry Expenses		FixedAssets PrepaidExpenses	
To Profit & Loss A/c – Profit (if credit side is larger)		By Profit and Loss A/c – Loss (if debit side is larger)	

Treatment of items in branch account

(1) Branch expenses paid by branch from out of petty cash: - These need not be shown in the branch account. The opening balance of petty cash will appear on the debit side of profit and loss account. The cheque sent by the head office to the branch for petty expenses will also appear on the debit side. The closing balance of petty cash (i.e. opening+ amount sent by head office-petty expenses) will appear on the credit side.

If petty cash is maintained on the imp rest system, actual expenses incurred will be reimbursed and appear on the debit side of branch account as to bank account

(2) Depreciation on fixed assets: - It is not shown in the branch account. The asset is shown on the credit side after deducting the amount of depreciation.

(3) Bad debts, discount allowed etc.,: - These need not be shown in the branch account but appear on the credit side of debtors account.

(4) Sales returns from branch debtors: - it will not appear on the branch account but appear on the credit side of debtors account.

(5) Purchase of fixed assets by the branch: - The fixed assets purchased by the branch should be treated as closing branch fixed asset and should be credited to the branch account. If it is purchased for cash, it should also be deducted from the remittance on the credit side of the branch account. If it is purchased on credit, it should also be treated as a closing branch liability and appear on the credit side of branch account.

(6) Sale of fixed assets: - The effect of this is to reduce the value of branch assets at close and increase the remittance from the branch in case the sale is for cash. If the sale is for credit it will increase the debtors balance instead of increase in remittance.

Illustration 1

The Vijayalakshmi Trading Company Ltd Bangalore has a branch at Mangalore. The head office pays all expenses except petty expenses which were met by the branch. All cash received by the branch was remitted to the head office daily. The following are the transactions between head office and branch during the year ending 31st December 2018.

		₹
Stock at branch 1st January 2018		7,000
Branch debtors on 1st January 2018		2,000
Petty cash on 1st January 2018		200
Goods sent to branch during the year		30,000
Cash sales		40,000
Credit sales		20,000
Cash received from the debtors		16,000
Goods returned by the branch		1,000
Returns from customers		1,500
Cheque sent to branch for expenses:		
Salary	3,000	
Rent	1000	
Petty cash	500	4,500
Stock at branch on 31st December 2018		4,000
Branch debtors on 31st December 2018		4,500
Petty cash at branch on 31st December 2018		300

Prepare the Mangalore Branch account in the Bangalore office books.

Solution:

Mangalore branch account

To branch stock		7,000	By goods sent to branch (returns)	1,000
To branch debtors		2,000	By bank (remittance)	56000
To branch petty cash		200	By branch stock	4000
To goods sent to branch		30,000	By branch debtors	4500
To bank:			By branch petty cash	300
Salary	3000			
Rent	1000			
Petty Cash	500	4,500		
To general profit and loss a/c		22,100		
		65,800		65,800

Illustration 2

Active Associates, Mysore, is having its branch in Mercara. Goods are invoiced to branch at cost. Branch has been instructed to send all cash daily to the head office. All expenses of the branch are paid by the head office except petty expenses, which are met by the branch. From the following particulars prepare branch account in the books of Active Associates, Mysore.

Balances on 1st January 2018:	₹
Stock in hand at branch	12,000
Sundry debtors at branch	9,000
Petty cash in hand at branch	400
Office furniture at branch	1,200
Outstanding salaries of the branch	200
Insurance of the branch prepaid up to 31st March 2018	200
Transactions during the year ended 31st December 2018:	
Goods sent to branch	64,000
Goods returned by the branch	800
Goods returned by customers	480
Cash received from debtors	30,000
Cash sales	50,000
Credit Sales	30,000
Discount allowed to debtors	300
Payment for the branch made by the head office:	
Salaries	2,000
Rent paid	1,800
Insurance for one year paid up to 1st April 2019	800
Petty expenses paid by the branch	280
Balances on 31st December 2018:	
Stock at branch	10,000
Rent still owing	100

Write off 10% depreciation on office furniture.

Solution

Mercara Branch account

To branch stock	12000	By outstanding salaries (opening)	200
To branch debtors	9000	By goods sent to branch (returns)	800
To branch petty cash	400	By bank (remittance) (50000+30000)	80000
To branch furniture	1200	By branch stock (closing)	10000

To branch prepaid insurance		200	By branch debtors (closing)	8220
To goods sent to branch		64000	By branch petty cash (closing) (400- 280)	120
To bank:			By branch furniture (closing)	1080
Salaries	2,000		By branch prepaid insurance (closing) 800x 3/12	200
Rent	1,800			
Insurance	800	4600		
To outstanding rent (closing)		100		
To general profit & loss		9120		
		100620		100620

Branch debtor's account

To balance (opening)	9,000	By cash	30,000
To sales (credit)	30,000	By returns	480
		By discount	300
		By balance (closing)	8,220
	39,000		39,000

Invoice Price Method

Sometimes the head office may send goods at a price higher than the cost price. This inflated price is generally termed as invoice price. The difference between the invoice and the cost price is the loading. In this case three additional entries are also to be passed in addition to the usual entries.

1) To remove loading on opening stock

    Stock reserve account Dr

        To branch account

2) To remove loading in goods sent to branch

    Goods sent to branch a/c Dr

        To branch a/c

3) To remove loading on closing stock

    Branch account Dr

        To stock reserve

Illustration 3

The Bundy shoes limited are having its branch at Ajmer. Goods are invoiced to branch at shoes at 20% profit on sale. Branch has been instructed to send all cash daily to the head office. All expenses are paid by the head office, except petty expenses which are met by the branch manager. From the following particulars prepare branch accounts in the books of Bundy Shoes Ltd.

Stock on 1st Jan 2018 (invoice price)	15000

Sundry debtors on Jan 1st	9000
Cash in hand on 1st Jan	400
Office furniture on 1st Jan	1200
Goods invoiced from the head office (invoice price)	80000
Goods returned to head office	1000
Goods returned by debtors	400
Cash received from debtors	30000
Cash sales	50000
Credit sales	30000
Discount allowed to debtors	30
Expenses paid by the head office Rent Salary Stationery	 1200 2400 300
Petty expenses paid by the manager Depreciation is to be provided on branch furniture At 10% p.a	280
Stock on 31st December 20018 at invoice price	14000

Solution

Branch account

To balance			By bank remittances(cash sales+ amount received from debtors)	80000
Stock		15000	By balance:	
Debtors		9000	Stock	14000
Cash		400	Debtors	8570
Furniture		1200	Cash	120
To goods sent to branch	80000		Furniture	1080
Less returns	1000	79000	Stock reserve (Loading on op. stock = 15000 × 20/100)	3000
To bank			Goods sent to branch (Loading on branch stock = 79000 × 20/100)	15800
Rent	1200			
Salary	2400			
Stationary	300	3900		
To Stock reserve (Loading on closing stock = 14000×20/100)		2800		
To profit		11270		
		122570		122570

Debtors account

To balance (opening)	9,000	By cash	30,000
To sales (credit)	30,000	By returns	400
		By discount	30
		By balance (closing)	8,570
	39,000		39,000

Illustration 4:

A head office in Mumbai sends goods to its branch at Bangalore marked 20% above cost. From the following particulars show how the Bangalore branch account will appear in the head office books.

		Rs.
Balances on 1st July 2018 at the branch:		
Stock at invoice price		3,600
Debtors		6,000
Petty cash		60
Goods supplied to the branch		60,000
Remittance from the branch:		
Cash sales	12,000	
Amount received from debtors	42,000	54,000
Cheque sent to the branch:		
Salary	1,800	
Rent and taxes	300	
Petty cash	220	2,320
Stock at branch on 31st December 2018		6,000
Debtors at branch on 31st December 2018		9,600
Petty cash at the branch on 31st December 2018		40

Solution

Mangalore Branch Account

To branch stock account (opening)		3600	By bank (remittance) (12000 + 42000)	54000
To branch debtors (opening)		6000	By branch stock (closing)	6000
To branch petty cash (opening)		60	By branch debtors (closing)	9600
To goods sent to branch		60000	By branch petty cash (closing)	40
To bank			By stock reserve (loading on opening stock) (3600x20/120)	600
Salary	1800		By goods sent to branch (loading on goods sent) 60000x20/120	10000
Rent	300			
Petty cash	220	2320		

To stock reserve (loading on closing stock) (6000x20/120)	1000		
To general profit and loss	7260		
	80240		80240

Note: Petty expenses met by the petty cashier = 220

Stock and Debtors System

In case of this system, the head office maintenance a number of accounts for branch transactions in place of in branch account. The various accounts are:

1. Branch stock account
2. Branch debtors account
3. Branch expenses account
4. Branch adjustment account
5. Branch profit and loss account
6. Branch cash account
7. Branch fixed asset account
8. Goods sent to branch account

Accounting entries are as follows:

1) When goods sent to branch at invoice price
   Branch stock a/c Dr
   To goods sent to branch a/c

2) For cash sales
   Cash a/c Dr
   To branch stock a/c

3) For credit sales
   Branch debtors a/c Dr
   To branch stock

4) For bad debts and allowances allowed to debtors
   Cash a/c Dr
   To branch debtors

5) Cash paid by branch debtors and remitted to head office
   Cash a/c Dr
   To branch debtors

6) For removing loading on goods sent Goods sent to branch a/c
   To branch adjustment a/c

7) For removing loading on closing stock
   Branch adjustment a/c Dr

To stock reserve a/c

8) Expenses paid by head office
Branch expenses a/c Dr
To cash a/c
9) Transfer branch expenses
Branch adjustment a/c Dr
To branch expenses a/c

10) For net profit disclosed by branch adjustment
Branch adjustment a/c Dr
To general profit and loss a/c

Illustration 5

A opened as branch in Bangalore on 1st January 2018. Goods were invoiced at selling price which is cost plus 25%. From the following particulars relating to the year 2018. You are required to prepare accounts under stock and debtors system.

Goods sent to branch	300000
Sales:	
Cash	100000
Credit	140000
Goods returned by customer	3000
Cash received from customer	80000
Discount allowed	1000
Cash remitted to branch	
Rent	1500
Branch salaries	6000
Sundry expenses	1000
Defective goods written off	1000
Goods returned by branch	12000
Stock at the end	50000

Solution

Branch Stock Account

Particulars	₹	Particulars	₹
To Goods sent to branch a/c	300000	By Branch cash a/c - Cash Sales	100000
To Branch debtors - goods returned	3000	By Branch cash a/c - Credit Sales	140000
		By Goods sent to branch - Returned	12000
		By Branch Adjustment a/c - Defective	1000
		By Balance c/d	50000
	303000		303000
To Balance b/d	50000		

Branch Debtors Account

Particulars	₹	Particulars	₹
To Branch Stock - Credit Sales	140000	By Cash Received	80000
		By Return from debtors	3000
		By Branch expenses	1000
		By Balance c/d	56000
	140000		140000
To Balance b/d	56000		

Branch Expenses Account

Particulars	₹	Particulars	₹
To Cash:		By Branch Adjustment - Transfer	9500
Salaries	6000		
Rent	1500		
Sundry expenses	1000		
Branch debtors	1000		
	9500		9500

Branch Adjustment Account

Particulars	₹	Particulars	₹
To Branch expenses	9500	By Goods sent to branch - Loading	60000
To Branch stock	1000		
To Stock Reserve – Loading	10000		
To Goods sent to branch - Loading in returns	2400		
To Branch P & L a/c	37100		
	60000		60000

Goods sent to Branch Account

To Branch stock	12000	By Branch stock	300000
To Branch Adjustment a/c	60000	By Branch Adjustment	2400
To Trading a/c – Transfer	230400		
	302400		302400

Final Account system

Under this system head office opens

(1) Branch trading and profit and loss account

(2) Branch account. It is personal account in nature.

Illustration 6

A merchant at Mangalore has a branch at Mysore to which he charges goods at cost plus 25%. The Mysore branch keeps its own sales ledger and transmits all cash received to the head office every day. All expenses are paid from the head office.

The transactions for the branch were as follows:

Stock on 1-1-2018	22,000
Debtors on 1-1-2018	200
Petty cash on 1-1-2018	200
Sales (cash)	5,300
Goods sent to branch	40,000
Collection on ledger account	42,000
Goods returned to Head office	600
Bad debts	600
Allowance to customers	500
Returns inward	1,000
Cheques sent to branch:	
Rent	1,200
Wages	400
Salary and other expenses	1,800
Stock 31-12-2018	26,000
Debtors on 31-12-2018	4,000
Petty cash 31-12-2018 including miscellaneous income of ₹50 not remitted	250

Prepare branch trading and profit and loss account for the year ended 31-12-2018 and also prepare the branch account.

Solution

Mysore branch Trading and Profit and Loss account for the *year ended 31- 12- 2018*

To opening stock – at cost (22000x100/125)		17600	By Sales:		
To goods supplied by the head office – at cost (40000x100/125)	32000		Credit Sales	47900	
Less returns at cost	480	31520	Cash Sales	5300	
To wages		400		53200	
			Less returns	1000	52200
To gross profit		23480	Closing stock – at cost (26,000x25/125)		20800
		73000			73000
To salaries		1800	By Gross Profit b/d		23480

To rent	1200	By miscellaneous income	50
To bad debts	600		
To allowance	500		
To net profit	19430		
	23530		23530

Branch debtors' account

To Balance (opening)	200	By cash	42000
		By sales return	1000
		By discount	600
		By allowance	500
To Sales (Credit, balancing figure)	47900	By balance (closing)	4000
	48100		48100

Mysore branch account (personal account)

To branch stock (opening)	17,600	By goods sent to branch	480
To branch debtors (opening)	200	By bank	47300
To branch petty cash (opening)	200	By balance (balancing figure)	25050
To goods sent to branch	32000		
To bank	3,400		
To general profit and loss	19,430		
	72,830		72830

Whole Sale Branch System

This system is adopted when the head office supplies goods to the branch at a price which it supplies to wholesalers. Thus under this system, branch is treated at par with wholesale branch.

Illustration 7

A head office invoices goods to its branches at 20% less than the list price which is cost+100% goods are sold to customers at list price. From the following particulars ascertain the profit made by the head office and branch.

	Head office	Branch

Stock in the beginning (at invoice price for branch)	30000	1600
Purchases during the year	256000	-------
Goods sent to branch	40000	-------
Sales	180000	36000
Expenses	32000	5000

Solution

Let cost price be	100
List price (retail price) 100+100%	200
Invoice price (200-20%)	160

Trading Account

	Head Office (₹)	Branch (₹)		Head Office (₹)	Branch (₹)
To stock	30000	1600	By sales	180000	36000
Purchases	256000	Nil	Goods sent to branch	40000	Nil
Goods from HO	Nil	40000	Closing stock	171000	12800
Gross profit	105000	7200			
	391000	48800		391000	48800
Expenses	32000	5000	Gross profit	105000	7200
Stock reserve(closing) 12800x40/160	3200	Nil	Stock reserve (opening) (1600x40/160)	400	Nil
Net profit	70200	2200			
	105400	7200		105400	7200

Working Note

1. Calculation of closing stock at H.O

	₹
Opening stock at cost	30000
Add purchases	256000
	286000
Less cost of goods sold (18000x100/200)	90000
	196000
Less cost of goods sent to branch (40000x100/160)	25000
Closing stock at HO	171000

2. Calculation of closing stock at branch

	₹
Opening stock at invoice price	1600
Add goods received from HO at invoice price	40000
	41600
Less goods sold at branch (36000x160/200)	28800
Closing stock at branch at invoice price	12800

Independent Branches

Independent branch means a branch which maintains its own set of books. In this system, branches are treated as separate independent units. Features of such branches may be summarized as below

1) They keep a full system of accounting and trial balance can be extracted from the ledger
2) In the branch books, there will be a head of accounts and in the books of head office there will be a branch account
3) The branch does not confine its trading to the goods sent by the head office
4) There is no need for the branch to remit all cash. It can retain the cash out of which it can make the payment

Accounting entries are as follows:

Transaction	Head office books	Branch books
Goods supplied by head office	Branch a/c Dr: To goods sent to branch	Goods received from head office a/c Dr: To head office a/c
Cash remittance from head office to branch	Branch a/c Dr: To bank	Bank a/c Dr: To head office
Cash remittance from branch to head office	Bank a/c Dr: To branch a/c	Head office a/c Dr: To bank a/c
Remittance sent by branch but not received by head office	----------------------	Remittance in transit a/c Dr: To head office a/c
Asset purchased by the branch but asset a/c is to be kept in head office	Branch asset a/c Dr: To branch	Head office a/c Dr: To bank/liability
Depreciation with respect to the above asset	Branch a/c Dr: Top branch asset	Depreciation a/c Dr: To head office

Head office expenses chargeable to branch	Branch a/c Dr: To P&L a/c	Head office expenses a/c Dr: To head office
Inter branch transactions	Receiving branch a/c Dr: To supplying branch	**Receiving branch**: Goods from head office a/c Dr: To head office **Supplying branch**: Head office a/c Dr: To goods sent to head office

Module V

ISSUE OF SHARES

Introduction

Funds provided by the owner(s) into a business are recorded as capital. Capital of the business depends upon the form of business organisation. Proprietor provides capital in a sole-proprietorship business. In case of a partnership, there is more than one proprietor, called partners. Partners introduce capital in a partnership firm. As the maximum number of members in a partnership firm is restricted, therefore only limited capital can be provided in such form of businesses. Moreover, the liability of the proprietor(s) is unlimited in case of non-corporate business, namely, sole-proprietorship and partnership.

Capital funding process for different types of business forms can be summarised as follows:

Business Organisation	**Ownership**	**Type of Capital**	**Liability of Owners**
Sole - Proprietorship	Proprietor- He alone is the owner of business	Capital	Unlimited
Partnership	Partners	Partners' Capital	Unlimited
Company	Shareholders	Share Capital	Limited to issue price of shares held

With the onset of industrial revolution, requirement of capital investment soared to a new height and the attached risk of failure increased due to pace of technological developments. Non-corporate entities could not cope with the pressure of increased capital and degree of risk involved. This led to the emergence of corporate form of organisation.

Share Capital

Total capital of the company is divided into a number of small indivisible units of a fixed amount and each such unit is called a share. The fixed value of a share, printed on the share certificate, is called nominal/ par/face value of a share. However, a company can issue shares at a price different from the face value of a share. The liability of holder of shares (called shareholders) is limited to the issue price of shares acquired by them.

The total capital of the company is divided into shares, the capital of the company is called 'Share Capital'. At the time of issue of shares, every Company is required to follow SEBI Regulations. Share capital of a company is divided into following categories:

(i) *Authorised Share Capital or Nominal Capital:* A company estimates its maximum capital requirements. This amount of capital is mentioned in 'Capital Clause' of the 'Memorandum of Association' registered with the Registrar of Companies. It puts a limit on the amount of capital, which a company is authorised to raise during its lifetime and is called 'Authorised Capital'. It is shown in the balance sheet at face value.

(ii) *Issued Share Capital:* A company need not issue total authorised capital. Whatever portion of the share capital is issued by the company, it is called 'Issued Capital'. Issued capital means and includes the nominal value of shares issued by the company for:

1. Cash, and
2. Consideration other than cash to: (i) Promoters of a company; and (ii) Others.

It is also shown in the balance sheet at nominal value.

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

(iii) *Subscribed Share Capital:* It is that part of the issued share capital, which is subscribed by the public i.e., applied by the public and allotted by the company. It also includes the face value of shares issued by the company for consideration other than cash.

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

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

Call-in-advance is that portion of capital which is yet to be called by the company but has already been paid by shareholder.

In balance sheet, called-up and paid-up capital are shown together.

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

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

1. Authorised Capital = Issued Capital + Unissued Capital.
2. Subscribed Capital can be equal to or greater than or less than Issued Capital resulting in 3 situations respectively: Fully Subscribed; Over Subscribed and Under Subscribed.
3. Called up Capital = Paid up Capital + Calls in arrears if any – Calls in advance if any

Types of Shares

Share issued by a company can be divided into following categories:

(i) Preference Shares: According to Section 43 of the Companies Act, 2013 persons holding preference shares, called preference shareholders, are assured of a preferential dividend at a fixed rate during the life of the company. They also carry a preferential right over other shareholders to be paid first in case of winding up of the company. Thus, they enjoy preferential rights in the matter of: a) Payment of dividend, and b) Repayment of capital.

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

Types of Preference Shares

Preference shares can be of various types, which are as follows:

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

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

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

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

(e) **Redeemable Preference Shares:** These are shares that a company may issue on the condition that the company will repay after the fixed period or even earlier at company’s discretion. The repayment on these shares is called redemption and is governed by Section 55 of the Companies Act, 2013.

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

(g) **Convertible Preference Shares:** These shares give the right to the holder to get them converted into equity shares at their option according to the terms and conditions of their issue.

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

Note: Unless mentioned otherwise Preference Shares are Non-Cumulative, Non-Participating, Non-Convertible and Redeemable in nature.

(ii) Equity Shares: Equity shares are those shares, which are not preference shares. It means that they do not enjoy any preferential rights in the matter of payment of dividend or repayment of capital. The rate of dividend on equity shares is recommended by the Board of Directors and may vary from year to year. Rate of dividend depends upon the dividend policy and the availability of profits after satisfying the rights of preference shareholders. These shares carry voting rights. Companies Act, 2013 permits issue of equity share capital with differential rights as to dividend, voting or otherwise in accordance with prescribed rules.

The shares can be issued by a company either

(1) for cash or

(2) for consideration other than cash.

Issue of Shares for Cash

To issue shares, private companies depend upon 'Private Placement' of shares. Public companies issue a 'Prospectus' and invite general public to subscribe for shares. To discuss accounting treatment, we shall concentrate on public companies who invite general public to subscribe for equity shares. Similar accounting treatment is applicable in other cases. However, for journal entries in case of issue of preference shares, the word 'Equity' is replaced with the word 'Preference'.

A public company issues a prospectus inviting general public to subscribe for its shares. On the basis of prospectus, applications are deposited in a scheduled bank by the interested parties along with the amount payable at the time of application, in cash. First installment paid along with application is called 'Application Money'. As per Section 39 of the Companies Act, 2013. Application money must be at least 5% of the nominal value of shares. After the closing date of the issue (the last date for filing applications), company decides about allotment of shares in consultation with the SEBI and stock exchange concerned. According to the Companies Act, 2013, a company cannot proceed to allot shares unless minimum subscription is received by the company.

Minimum Subscription: A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company. The amount of minimum subscription to be disclosed in prospectus by the Board of Directors taking into account the following:

(a) Preliminary expenses of the company,
(b) Commission payable on issue of shares,
(c) Cost of fixed assets purchased or to be purchased,
(d) Working capital requirements of the company, and
(e) Any other expenditure for the day to day operation of the business.

As per guidelines of the Securities Exchange Board of India (SEBI), the minimum subscription to be received in an issue shall not be less than ninety per cent of the offer through offer document [Provided that in the case of an initial public offer, the minimum subscription to be received shall be subject to allotment of minimum number of specified securities, as prescribed by Securities Contracts (Regulation) Rules, 1957]. If the Company does not receive the minimum subscription of 90% of the issue, all application moneys received shall be refunded to the applicants forthwith, but not later than:

(a) fifteen days of the closure of the issue, in case of a non-underwritten issue; and
(b) seventy days of the closure of the issue, in the case of an underwritten issue where minimum subscription including devolvement obligations paid by the underwriters is not received within sixty days of the closure of the issue.

The company reserves the right to reject or accept an application fully or partially. Successful applicants become shareholders of the company and are required to pay the second instalment which is known as ‘Allotment Money’ and unsuccessful applicants get back their money. However, in case of delay in refunding the money, the Company becomes liable to pay interest on the amount of refund. Subsequent instalments, if any, to be called by the company are known as ‘Calls’.

As per Section 39 of the Companies Act, 2013, application money must be at least 5% of the face value of shares. However, as per SEBI Regulations, the minimum application moneys to be paid by an applicant along with the application money shall not be less than 25% of the issue price. According to Section 24 of the Companies Act, 2013 matters related to issue and transfer of securities will be administered by the SEBI and not by the Company Law Board.

The issue price of shares is generally received by the company in instalments and these instalments are known as under:

First instalment	…………..	Application Money
Second Instalment	…………..	Allotment Money
Third Instalment	…………..	First Call Money
Fourth Instalment	…………..	Second Call Money and so on.
Last Instalment		Final Call Money

Journal Entries for Issue of Shares for Cash

Upon the issue of share capital by a company, the undermentioned entries are made in the financial books:

(1) On receipt of the application money

Bank Account	Dr.	(With the actual amount received.)
To Share Application Account		
(Being application money received)		

(2) On allotment of share

Share Allotment Account	Dr.	(With the amount due on allotment.)
Share Application Account	Dr.	(With the application amount received on allotted shares)
To Share Capital Account		(With the amount due on allotment and application.)
(Being the sum due on allotment and application money transferred to capital account)		

(3) On receipt of allotment money

Bank Account	Dr.	(With the amount actually received on allotment.)
To Share Allotment Account		
(Being money received on allotment)		

Sometimes separate Application and Allotment Accounts are not prepared and entries relating to application and allotment monies are passed through a combined Application and Allotment Account.

On receipt of Application Money:

Bank A/c Dr

To Share Application and Allotment A/c

On allotment of shares:

Share Application & Allotment A/c Dr (With total application and allotment amount)

To Share Capital A/c

On Allotment money being received

Bank A/c Dr

To Share Application & Allotment A/c

4. *On a call being made*

   Share Call Account Dr. (With the amount due on the call.)

   To Share Capital Account

   (Being share call made due at Rs....)

5. *On receipt of call money*

   Bank Account Dr. (With the due amount actually received on call)

   To Share Call Account

   (Being share call money received)

Subscription of Shares

Accounting for issue of shares depends upon the type of subscription. Whenever a company decides to issue shares to public, it invites applications for subscription by issuing a prospectus. It is not necessary that company receives applications for the number of shares to be issued by it. There are three possibilities:

Full Subscription

Issue is fully subscribed if the number of shares offered for subscription and the number of shares actually subscribed by the public are same. To start discussion on accounting treatment for issue of shares, let us assume that the issue is fully subscribed.

Illustration 1

A company invited applications for 10,000 equity shares of ₹50 each payable on application ₹15, on Allotment ₹20, on first and final call ₹15. Applications are received for 10,000 shares and all the applicants are allotted the number of shares they have applied for and installment money was duly received by the company. Show Journal entries in the books of the company.

SOLUTION

Journal entries in the books of a company

For application money received: Amount received along with application is accounted as follows:

Bank A/c Dr. (Application money on allotted share i.e., 10,000 × 15 = 1,50,000)

To Equity Share Application A/c

At the time of allotment: Application money received from successful applicants become part of share capital and is transferred to share capital as under:

Equity Share Application A/c Dr. (Application money on allotted share i.e., 10,000 × 15 = Rs. 1,50,000)

To Equity Share Capital A/c

To record amount due on allotment: When the decision is taken to allot shares, allotment money on allotted shares falls due and is recorded as follows:

Equity Share Allotment A/c Dr. (Allotment money due at the allotted share i.e., 10,000 × Rs. 20 = Rs. 2,00,000)

To Equity Share Capital A/c

For allotment money received: Allotment money received from shareholders is recorded as follows:

Bank A/c Dr. (Allotment money received from shareholders i.e., 10,000 × Rs. 20 = Rs. 2,00,000)

To Equity Share Allotment A/c

When decision to demand first call is made: After allotment of share, when the Board of Directors decide to demand the next instalment from shareholders, first call money falls due and is accounted for, as under:

Equity Share First Call A/c Dr. (No. of shares × first call money per share i.e., 10,000 × Rs. 15 = Rs. 1,50,000)

To Equity Share Capital A/c

On receiving first and final call money: The journal entry passed to record the money received on account of first call is as under:

Bank A/c Dr. (Amount actually received on account of first call i.e., 10,000 × Rs. 15 = Rs. 1,50,000)

To Equity First Call A/c

Under Subscription

It means the number of shares offered for subscription is more than the number of shares subscribed by the public. In this case, the journal entries as discussed above are passed but with one change i.e., calculation of application, allotment and for that matter, the call money is based on number of shares actually applied and allotted. It must be remembered that shares can be allotted, in this case, only when the minimum subscription is received.

Illustration 2

On 1st April, 2017, A Ltd. issued 43,000 shares of ₹100 each payable as follows:

₹20 on application;

₹30 on allotment;

₹25 on 1st October, 2017; and ₹ 25 on 1st February, 2018.

By 20th May, 40,000 shares were applied for and all applications were accepted. Allotment was made on 1st June. All sums due on allotment were received on 15th July; those on 1st call were received on 20th October. Journalise the transactions when accounts were closed on 31st March, 2018.

Solution

A Ltd.

Journal

2017		₹	₹
May 20	Bank Account Dr. To Share Application A/c (Application money on 40,000 shares at ₹20 per share received.)	8,00,000	8,00,000
June 1	Share Application A/c Dr. To Share Capital A/c (The amount transferred to Capital Account on 40,000 shares at ₹20 on application. Directors' resolution no...... dated ......)	8,00,000	8,00,000
	Share Allotment A/c Dr. To Share Capital A/c (Being share allotment made due at ₹30 per share. Directors' resolution no...... dated ......)	12,00,000	12,00,000
July 15	Bank Account Dr. To Share Allotment A/c (The sums due on allotment received.)	12,00,000	12,00,000
Oct. 1	Share First Call Account Dr. To Share Capital Account (Amount due from members in respect of first call-on 40,000 shares at ₹25 as per Directors, resolution no... dated...)	10,00,000	10,00,000
Oct. 20	Bank Account Dr. To Share First Call Account (Receipt of the amounts due on first call.)	10,00,000	10,00,000
2018 Feb. 1	Share Second and Final Call A/c Dr. To Share Capital A/c (Amount due on 40,000 share at ₹25 per share on second and final call, as per Directors resolution no... dated...)	10,00,000	10,00,000
Mar. 31	Bank Account Dr.	10,00,000	

	To Share Second & Final Call A/c (Amount received against the final call on 40,000 shares at ₹25 per share.)		10,00,000

Over Subscription

In actual practice, issue of shares is either under or over-subscribed. If an issue is over-subscribed, some applications may be rejected and application money refunded and in respect of others, only a part of the shares applied for may be allotted and the excess amount received can be utilised towards allotment or call money which has fallen due or will soon fall due for payment. The entries are:

(1) On refund of application money to applicants to whom shares have not been allotted:

Share Application A/c Dr.
To Bank Account
(Being application money refunded)

(2) When only a part of shares applied for are allotted.

Share Application A/c Dr.
To Share Allotment* A/c (With the application money accepted for allotment)
To Share Calls-in-Advance* A/c (With the amount received in advance)
To Bank A/c (With any excess amount to be refunded)
(Being application money adjusted)
*Credited to Share Capital A/c subsequently.

Illustration 3

Pant Ltd. invited applications for 50,000 equity shares at ₹50 each, which are payable as on application ₹20, on allotment ₹10 and on first and final call ₹20. The company received applications for 60,000 shares. The directors accepted application for 50,000 shares and rejected the rest. Show Journal entries if company refunded the application money to rejected applicants and allotment money was received for 45,000 shares.

Solution

Pant Ltd.
Journal

	₹	₹
Bank A/c Dr.	12,00,000	
To Equity Share Application A/c		12,00,000
(Being the application money received for 60,000 shares at ₹20 per share)		
Equity Share Application A/c Dr.	12,00,000	
To Equity Share Capital A/c		10,00,000

To Bank A/c (Being share allotment made for 50,000 shares and excess refunded.)		2,00,000
Equity Share Allotment A/c Dr. To Equity Share Capital A/c (Being allotment amount due on 50,000 equity shares at ₹10 per share as per Directors' resolution no... dated...)	5,00,000	5,00,000
Bank A/c Dr. Calls in Arrears A/c Dr. To Equity Share Allotment A/c (Being allotment money received for 45,000 shares at ₹10 per share.)	4,50,000 50,000	5,00,000

Shares Issued at Discount

Shares are regarded to be issued at a discount, if issue is at an amount less than the nominal or par value of shares. The excess of the nominal value over the issue price represents discount on the issue of shares. For example, when a share of the nominal value of ₹100 is issued at ₹98, it is said to have been issued at a discount of 2 per cent.

According to Section 53 of the Companies Act, 2013, a Company cannot issue shares at a discount except in the case of issue of sweat equity shares (issued to employees and directors). Thus any issue of shares at discount shall be void.

Shares Issued at Premium

When a company issues its securities at a price more than the face value, it is said to be an issue at a premium. Premium is the excess of issue price over face value of the security. It is quite common for the financially strong, and well-managed companies to issue their shares at a premium, i.e. at an amount more than the nominal or par value of shares. Thus, where a share of the nominal value of ₹ 100 is issued at ₹105, it is said to have been issued at a premium of 5 per cent.

When the issue is at a premium, the amount of premium may technically be called at any stage of share capital transactions. However, premium is generally called with the amount due on allotment, sometimes with the application of money and rarely with the call money.

Accounting Treatment

When shares are issued at a premium, the premium amount is credited to a separate account called *"Securities Premium Account"* because it is not a part of share capital. Rather, it represents a gain of a capital nature to the company.

Being a credit balance, Securities premium Account is shown under the heading, "Reserves and Surplus". However, 'Reserves and Surplus' is shown as 'shareholders' funds in the Balance Sheet as per Schedule III. According to Section 52 of the Companies Act, 2013, Securities Premium Account may be used by the company:

(a) Towards issue of un-issued shares of the company to be issued to members of the company as fully paid bonus securities.

(b) To write off preliminary expenses of the company.

(c) To write off the expenses of, or commission paid, or discount allowed on any of the securities or debentures of the company.

(d) To provide for premium on the redemption of redeemable preference shares or debentures of the company.

(e) For the purchase of own shares or other securities.

Note: It may be noted that certain class of Companies as prescribed under Section 133 of the Companies Act, 2013, whose financial statements comply with the accounting standards prescribed for them, can't apply the securities premium account for the purposes (b) and (d) mentioned above.

When shares are issued at a premium, the journal entries are as follows:

(a) Premium amount called with Application money

(i) Bank A/c	Dr.	[Total Application money + Premium Amount]
To Share Application A/c		[Amount received]
(Money received on applications for_____Shares @ Rs. ________per share including premium)		
(ii) Share Application A/c	Dr.	[No. of Shares Applied for x Application Amount per share]
To Securities Premium A/c		[No. of Shares allotted x Premium Amount per share]
To Share Capital A/c		[No. of Shares allotted x Nominal value per share for capital]

(b) <u>Premium Amount called with Allotment Money</u>

(i) Share Allotment A/c	Dr.	[No. of Shares Allotted x Allotment and Premium Money per share]
To Share Capital A/c		[No. of Shares Allotted x Allotment Amount per

	share]
To Securities Premium A/c	[No. of Share Allotted x Premium Amount per share]
(Amount due on allotment of shares @ Rs._____per share including premium)	
(ii) Bank A/c Dr.	
To Share Allotment A/c	
(Money received including premium consequent upon allotment).	

Illustration 4

On 1st October, 2017 Pioneer Equipment Limited received applications for 2,50,000 Equity Shares of ₹100 each to be issued at a premium of 25 per cent payable as :

On Application	*₹25*
On Allotment	*₹75 (including Premium)*
Balance Amount on Shares	*As and when required*

The shares were allotted by the Company on October 20, 2017 and the allotment money was duly received on October 31, 2017.

Record journal entries in the books of the company to record the transactions in connection with the issue of shares.

Solution

Pioneer Equipment Limited

Journal

Date 2017	**Particulars**	**L.F.**	**Debit Amount** (₹ '000)	**Credit Amount** (₹ '000)
Oct. 1	Bank A/c Dr.		6,250	
	To Equity Share Application A/c			6,250
	(Money received on applications for 2,50,000 shares @ ₹25 per share)			
Oct. 20	Equity Share Application A/c Dr.		6,250	

	To Equity Share Capital A/c			6,250
	(Transfer of application money on allotment to share capital)			
Oct. 20	Equity Share Allotment A/c Dr.		18,750	
	To Equity Share Capital A/c			12,500
	To Securities Premium A/c			6,250
	(Amount due on allotment of 2,50,000 shares @ ₹75 per share including premium)			
Oct. 31	Bank A/c Dr.		18750	
	To Equity Share Allotment A/c			18,750
	(Money received including premium consequent upon allotment)			

Note: Bifurcation of Allotment amount

Security premium per share = 25% x ₹100

= ₹25

Money received on allotment per share = ₹75

	Premium	Capital
Per share	₹25	₹50
No. of Shares (in '000)	250	250
Total Amount (in '000)	₹6250	₹12500

Over Subscription and Pro-Rata Allotment

Over subscription is the application money received for more than the number of shares offered to the public by a company. It usually occurs in the case of good issues and depends on many other factors like investors' confidence in the company, general economic conditions, pricing of the issue etc. When the shares are oversubscribed, the company cannot satisfy all the applicants. It means that a decision is to be made on how the shares are going to be allotted. Shares can be allotted to the applicants by a company in any manner it thinks proper. The company may reject some applicants in full, i.e., no shares are allotted to some applicants and application money is refunded. Usually, multiple applications by the same persons are not considered. Allotment may be given to the rest of the applicants in full, i.e., for the number of shares they have applied for. A third alternative is that a company may allot shares to the applicants on pro-rata basis. 'Pro-rata allotment' means allotment in proportion of shares applied for.

For example, a company offers to the public 10,000 shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis, applicants for 12,000 shares are to be allotted 10,000 shares, i.e., on the 12,000 : 10,000 or 6:5 ratio. Any applicant who has applied for 6 shares will be allotted 5 shares.

Accounting Entries

(a) For rejected applications:

Share Application Account Dr.
To Bank Account
(Being application money refunded for rejected applications as per Board's Resolution No….dated….)

(b) For pro-rata allotment:

Share Application Account Dr.
To Share Allotment Account
(Being excess application money adjusted against allotment money as per Board's Resolution No….dated….)

Illustration 5

JHP Limited is a company with an authorised share capital of ₹10,00,000 in equity shares of ₹ 10 each, of which 6,00,000 shares had been issued and fully paid on 30th June, 2016. The company proposed to make a further issue of 1,00,000 of these ₹ 10 shares at a price of ₹ 14 each, the arrangements for payment being:

(a) ₹2 per share payable on application, to be received by 1st July, 2016;

(b) Allotment to be made on 10th July, 2016 and a further ₹5 per share (including the premium) to be payable;

(c) The final call for the balance to be made, and the money received by 30th April, 2017.

Applications were received for 3,55,000 shares and were dealt with as follows:

(i) Applicants for 5,000 shares received allotment in full;

(ii) Applicants for 30,000 shares received an allotment of one share for every two applied for; no money was returned to these applicants, the surplus on application being used to reduce the amount due on allotment;

(iii) Applicants for 3,20,000 shares received an allotment of one share for every four applied for; the money due on allotment was retained by the company, the excess being returned to the applicants; and (iv) the money due on final call was received on the due date.

You are required to record these transactions (including cash items) in the Journal of JHP Limited.

Solution

Journal of JHP Limited

Date 2016	Particulars	₹	₹
July 1	Bank A/c (Note 1 – Column 3) Dr. To Equity Share Application A/c (Being application money received on 3,55,000 shares @ ₹ 2 per share)	7,10,000	7,10,000
July 10	Equity Share Application A/c Dr. To Equity Share Capital A/c To Equity Share Allotment A/c (Note 1 Column 5) To Bank A/c (Note 1 – Column 6) (Being application money on 1,00,000 shares transferred to Equity Share Capital Account; on 2,15,000 shares adjusted with allotment and on 40,000 shares refunded as per Board's Resolution No…..dated…)	7,10,000	 2,00,000 4,30,000 80,000
	Equity Share Allotment A/c Dr. To Equity Share Capital A/c To Securities Premium a/c (Being allotment money due on 1,00,000 shares @ ₹5 each including premium at ₹4 each)	5,00,000	 1,00,000 4,00,000
	Bank A/c (Note 1 – Column 8) Dr. To Equity Share Allotment A/c (Being balance allotment money received)	70,000	70,000
2017	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being final call money due on 1,00,000 shares @ ₹7 per share as per Board's Resolution No…..dated….)	7,00,000	7,00,000
April 30	Bank A/c Dr. To Equity Share Final Call A/c (Being final call money on 1,00,000 shares @ ₹7 each received)	7,00,000	7,00,000

Working Notes:

Calculation for Adjustment and Refund

Category	No. of Shares Applied for	No. of Shares Allotted	Amount Received on Application	Amount Required on Application	Amount adjusted on Allotment	Refund [3 - 4 + 5]	Amount due on Allotment	Amount received on Allotment
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(i)	5,000	5,000	10,000	10,000	Nil	Nil	25,000	25,000
(ii)	30,000	15,000	60,000	30,000	30,000	Nil	75,000	45,000
(iii)	3,20,000	80,000	6,40,000	1,60,000	4,00,000	80,000	4,00,000	Nil
TOTAL	**3,55,000**	**1,00,000**	**7,10,000**	**2,00,000**	**4,30,000**	**80,000**	**5,00,000**	**70,000**

Also,

(i) Amount Received on Application (3) = No. of shares applied for (1) x Rs. 2

(ii) Amount Required on Application (4) = No. of shares allotted (2) x Rs. 2

Calls-in-Arrears

Sometimes shareholders fail to pay the amount due on allotment or calls. The total unpaid amount on one or more instalments is known as *Calls-in-Arrears* or *Unpaid Calls*. Such amount represents the uncollected amount of capital from the shareholders; hence, it is shown by way of deduction from 'called-up capital' to arrive at paid-up value of the share capital.

For recording 'Calls-in-Arrears', the following journal entry is recorded:

Calls-in-Arrears A/c	Dr.	[Amount of Unpaid Calls]
Bank A/c	Dr.	[Amount received]
To Share Allotment A/c		[Total allotment money due]
To Share Calls A/c		[Total Call money due]

(Being call money/ allotment money received on .... shares at Rs..... per share.)

Calls-in-Advance

Some shareholders may sometimes pay a part, or whole, of the amount not yet called up, such amount is known as Calls-in-advance. According to Table F, interest at a rate not exceeding 12 per cent p.a. is to be paid on such advance call money. This amount is credited in Calls-in-Advance Account. The following entry is recorded:

Bank A/c	Dr.	[Call amount received in advance]
To Call-in-Advance A/c		

When calls become actually due, calls-in-advance account is adjusted at the time of the call. For this the following journal entry is recorded:

Calls-in-Advance A/c Dr. [Call amount received in advance]
Bank A/c Dr. [Remaining call money received, if any]
To Particular Call A/c [Call money due]
(Being call in advance adjusted and call money due received)

Interest on Calls-In-Arrears and Calls-In-Advance

Interest on calls in arrears is recoverable and that in respect of calls in advance is payable, according to provisions in this regard in the articles of the company, at the rates mentioned therein or those to be fixed by the directors, within the limits prescribed by the Articles. Table F prescribes 10% and 12% p.a. as the maximum rates respectively for calls in arrears and those in advance.

Journal entries for calls-in-arrears are as follows:

(i) For interest receivable on calls-in-arrears

Shareholders' A/c Dr.
To Interest on calls-in-arrears A/c

(Being interest on calls in arrears at the rate of ...% made due)

(ii) For receipt of interest

Bank A/c Dr.
To Shareholders' A/c
(Being interest money received)

The accounting treatment of interest on Calls-in-Advance is as follows:

(i) Interest Due

Interest on Calls-in-Advance A/c Dr. [Amount of interest due for payment]
To Shareholder's A/c

(Being interest on calls in advance made due)

(ii) Payment of Interest

Shareholder's A/c Dr. [Amount of interest paid]
To Bank A/c
(Being interest paid on calls-in-advance)

Illustration 6

Rashmi Limited issued at par 1,00,000 Equity shares of ₹ 10 each payable ₹ 2.50 on application; ₹3 on allotment; ₹2 on first call and balance on the final call. All the shares were fully *subscribed. Mr. Nair who held 10,000 shares paid full remaining amount on first call itself. The final call which was made after 3 months from first call was fully paid except a shareholder having 1000 shares who paid his due amount after 2 months along with interest on calls in arrears. Company also paid interest on calls in advance to Mr. Nair. Give journal entries to record these transactions.*

Solution

Journal Entries in the Books of Rashmi Limited

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c	Dr.	250000	
	To Equity Share Application A/c			250000
	(Money received on applications for 100000 shares @ ₹2.50/share)			
	Equity Share Application A/c	Dr.	250000	
	To Equity Share Capital A/c			250000
	(Transfer of application money on 1,00,000 shares to share capital)			
	Equity Share Allotment A/c	Dr.	300000	
	To Equity Share Capital A/c			300000
	(Amount due on the allotment of 1,00,000 shares @ ₹ 3 per share)			
	Bank A/c	Dr.	300000	
	To Equity Share Allotment A/c			300000
	(Allotment money received)			
	Equity Share First Call A/c	Dr.	200000	
	To Equity Share Capital A/c			200000
	(Being first call made due on 1,00,000 shares at ₹2 per share)			
	Bank A/c	Dr.	225000	
	To Equity Share First Call A/c			200000
	To Calls in Advance A/c			25000
	(Being first call money received along with calls in advance on 10,000 shares at ₹2.50 per share)			
	Equity Share Final Call A/c	Dr.	250000	
	To Equity Share Capital A/c			250000
	(Being final call made due on 1,00,000 shares at ₹2.50 each)			
	Bank A/c	Dr.	222500	
	Calls in Advance A/c	Dr.	25000	
	Calls in Arrears A/c	Dr.	2500	
	To Equity Final Call A/c			250000

	(Being final call received for 89,000 shares and calls in advance for 10,000 shares adjusted)		
	Interest on Calls in Advance A/c Dr. To Shareholders A/c (Being interest made due on calls in advance of ₹25,000 at the rate of 12% p.a.)	750	 750
	Shareholders A/c Dr. To Bank A/c (Being payment of interest made to shareholder)	750	 750
	Shareholders A/c Dr. To Interest on Calls in Arrears A/c (Being interest on calls in arrears made due at the rate of 10%)	41.67	 41.67
	Bank A/c Dr. To Calls in Arrears A/c To Shareholders A/c (Being money received from shareholder for calls in arrears and interest thereupon)	2541.67	 2500 41.67

Forfeiture of Shares

The term 'forfeit' actually means taking away of property on breach of a condition. It is very common that one or more shareholders fail to pay their allotment and/or calls on the due dates. Failure to pay call money results in forfeiture of shares. Forfeiture of shares is the action taken by a company to cancel the shares. The directors are usually empowered by the Articles of Association to forfeit those shares by serving proper notice to the defaulting shareholder(s). When shares are forfeited, the title of such shareholder is extinguished but the amount paid to date is not refunded to him. The shareholder then has no further claim on the company. The power of forfeiture must be exercised strictly having regard to the rules and regulations provided in the Articles of Association and it should be bonafide in the interests of the company.

The Articles of a company usually authorise the Directors to forfeit shares of a member on account of nonpayment of a call or interest thereon after serving him a prior notice as prescribed by the Articles. Directors also have the right to cancel such forfeiture before the forfeited shares are re-allotted.

Accounting Entries

At the time of passing entry for forfeiture of shares, students must be careful about the following matters:

(i) Amount called-up (i.e., amount credited to capital) in respect of forfeited shares.

(ii) Amount already received in respect of those shares.

(iii) Amount due but has not been received in respect of those shares.

We know that shares can be issued at par or at a premium. Accounting entries for forfeiture will vary according to situations.

Forfeiture of Shares which were issued at Par

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. Allotment or Calls Account will be credited with the amount due but not paid by the shareholder(s). (Alternatively, Calls-in-Arrears Account can be credited for all amount due, if it was transferred to Calls-in-Arrears Account). *Forfeited Shares Account or Shares Forfeiture Account* will be credited with the amount already received in respect of those shares.

Share Capital Account	Dr.	[No. of shares x called-up value per share]
To Forfeited Shares Account		[Amount already received on forfeited shares]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]

Where all amounts due on allotment, first call and final call have been transferred to Calls-in-Arrears Account, the entry will be:

Share Capital Account	Dr.	[No. of shares x called-up value per share]
To Calls-in-Arrears Account		[Total amount due, but not paid]
To Forfeited Shares Account		[Amount received]

Illustration 7

X Ltd forfeited 20,000 equity shares of ₹10 each, ₹8 called-up, for non-payment of first call money @ ₹2 each. Application money @ ₹2 per share and allotment money @ ₹4 per share have already been received by the company. Give Journal Entry for the forfeiture (assume that all money due is transferred to Calls-in-Arrears Account).

Solution

In the books of X Ltd

Date	Journal Particulars	₹	₹
	Equity Share Capital A/c (20,000 x ₹8) Dr.	1,60,000	
	To Calls-in-Arrears A/c (20,000 x ₹2)		40,000
	To Forfeited Shares A/c (20,000 x ₹6)		1,20,000
	(Being the forfeiture of 20,000 equity shares of ₹10 each, ₹8 called-up for non-payment of first call money @ ₹2 each)		

Forfeiture of Shares which were issued at a Premium

In this case, Share Capital Account will be debited with the called-up value of shares forfeited. If the premium on such shares has not been paid by the shareholder, the Securities Premium Account will be debited to cancel it (if it was credited earlier). Allotment, Calls and Forfeited Accounts will be credited in the usual manner.

If the premium has already received by the company, it cannot be cancelled even if the shares are forfeited in the future.

If premium not received

Share Capital A/c	Dr.	[Called-up value]
Securities Premium A/c	Dr.	[Amount of Security premium not received]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

If premium received

Share Capital A/c	Dr.	[Called-up value]
To Share Allotment Account		[If amount due, but not paid]
To Share First Call Account		[If amount due, but not paid]
To Share Final Call Account		[If amount due, but not paid]
To Forfeited Shares Account		[Amount received on forfeited shares]

Illustration 8

X Ltd. forfeited 5,000 equity shares of ₹ 100 each fully called-up which were issued at a premium of 20%. Amount payable on shares were: on application ₹20; on allotment ₹50 (including premium); on First and Final call ₹ 50. Only application money was paid by the shareholders in respect of these shares. Pass Journal Entries for the forfeiture.

Solution

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Equity Share Capital A/c (5,000 x ₹100)	Dr.	500000	
	Securities Premium A/c (See Note)	Dr.	100000	
	To Equity Share Allotment A/c (5,000 x ₹50)			250000
	To Equity Share First and Final Call A/c (5000 x ₹50)			250000
	To Forfeited Shares A/c (5000 x ₹20)			100000

	(Being the forfeiture of 5,000 equity shares of ₹100 each fully called-up, issued at a premium of 20%, for nonpayment of allotment and call money as per Board's Resolution)		

Note: Share premium @ ₹20 on 5,000 shares has not been received by the company. Therefore, at the time of forfeiture, Securities Premium Account will be debited to cancel it (because Securities Premium Account was credited at the time of allotment).

Forfeiture of Fully Paid-Up Shares

Forfeiture for non-payment of calls, premium, or the unpaid portion of the face value of the shares is one of the many causes for which a share may be forfeited. But fully paid-up shares may be forfeited for realization of debts of the shareholder if the Articles specifically provide it.

Re-Issue of Forfeited Shares

A forfeited share is merely a share available to the company for sale and remains vested in the company for that purpose only. Reissue of forfeited shares is not allotment of shares but only a sale. The share, after forfeiture, in the hands of the company is subject to an obligation to dispose it off. In practice, forfeited shares are disposed off by auction. These shares can be re-issued at any price so long as the total amount received (from the original allottee and the second purchaser) for those shares is not less than the amount in arrears on those shares.

Accounting Entries:

(a) Bank Account Dr. [Actual amount received]
Forfeited Shares Account Dr. [Loss on re-issue]
To Share Capital Account
(Being the re-issue of….shares @ Rs…. each as per Board's Resolution No…. dated.)

(b) Forfeited Shares Account Dr.
To Capital Reserve Account
(Being the profit on re-issue, transferred to capital reserve).

Points for Consideration

In connection with re-issue, the following points are important:

1. Loss on re-issue should not exceed the forfeited amount.
2. If the loss on re-issue is less than the amount forfeited, the surplus should be transferred to Capital Reserve.
3. The forfeited amount on shares (amount originally paid-up) not yet reissued should be shown under the heading 'share capital.'
4. When only a portion of the forfeited shares are re-issued, then the profit made on re-issue of such portion of shares only must be transferred to Capital Reserve.
5. When the shares are re-issued at a loss, such loss is to be debited to "Forfeited Shares Account".

6. If the shares are re-issued at a price which is more than the face value of the shares, the excess amount will be credited to Securities Premium Account.
7. If the re-issued amount and forfeited amount (taken together) exceeds the face value of the shares re-issued, it is not necessary to transfer such amount to Securities Premium Account.

Calculation of Profit on Re-Issue of Forfeited Shares

Illustration 9

Mr. Long who was the holder of 2,000 preference shares of ₹100 each, on which ₹75 per share has been called up could not pay his dues on Allotment and First call each at ₹25 per share. The Directors forfeited the above shares and reissued 1500 of such shares to Mr. Short at ₹65 per share paid-up as ₹75 per share.

Give Journal Entries to record the above forfeiture and re-issue in the books of the company.

Solution

Journal Entries in the Books of Mr. Long

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Preference Share Capital A/c (2,000 x ₹75)	Dr.	150000	
	To Preference Share Allotment A/c			50000
	To Preference Share First Call A/c			50000
	To Forfeited Share A/c			50000
	(Being the forfeiture of 2,000 preference shares ₹75 each being called up for non-payment of allotment and first call money as per Board's Resolution No.... dated.....)			
	Bank A/c (1,500 x ₹65)	Dr.	97500	
	Forfeited Shares A/c (1,500 x ₹10)	Dr.	15000	
	To Preference Share Capital A/c			112500
	(Being re-issue of 1500 shares at ₹65 per share paid-up as ₹75 as per Board's Resolution No…..dated….)			
	Forfeited Shares A/c	Dr.	22500	
	To Capital Reserve A/c (Note 1)			22500
	(Being profit on re-issue transferred to Capital/Reserve)			

Working Note:

Calculation of amount to be transferred to Capital Reserve

Forfeited amount per share = ₹50,000/2000 = ₹ 25

Loss on re-issue = ₹75 – ₹65 =

₹10

Surplus per share re-issued = ₹15

Transferred to capital Reserve ₹15 x 1500 = ₹22,500

Issue of Shares for Consideration other than Cash

Public limited companies, generally, issue their shares for cash and use such cash to buy the various types of assets needed in the business. Sometimes, however, a company may issue shares in a direct exchange for land, buildings or other assets. Shares may also be issued in payment for services rendered by promoters, lawyers in the formation of the company. These shares should be shown separately under the heading ‘Share Capital’.

Within specified time of allotment, the company must produce before the Registrar a written contract of sale of service in respect of which shares have been allotted.

Accounting Entries

When assets are purchased in exchange of shares
Assets Account Dr.
To Share Capital Account

Illustration 10

X Co. Ltd. was incorporated with an authorized share capital of 90,000 equity shares of ₹ 10 each. The company purchased land and buildings from Y Co. Ltd for Rs. 4,00,000 payable in fully paid-up shares of the company. The balance of the shares were issued to the public, which were fully subscribed and paid for.

You are required to pass Journal Entries and to prepare the Balance Sheet.

Solution

Journal

Date	Particulars	₹	₹
	Land and Buildings A/c Dr.	4,00,000	
	To Y Co. Ltd A/c		4,00,000
	(Being the land and buildings purchased from Y Co. Ltd as per agreement dated…).		
	Y.Co. Ltd A/c Dr.	4,00,000	
	To Equity Share Capital A/c		4,00,000
	(Being 40,000 shares of ₹10 each issued to Y Co. Ltd. on purchase of land and building)		
	Bank A/c Dr.	5,00,000	

	To Equity Share Application and Allotment A/c (Being the issue of 50,000 shares of ₹10 each as per Board's Resolution No…..dated…)		5,00,000
	Equity Share Application and Allotment A/c Dr. To Equity Share Capital A/c (Being shares allotted for application money received.)	5,00,000	 5,00,000

Balance Sheet of X Company Limited as at….

	Particulars	Notes No	₹
	EQUITY AND LIABILITIES		
	Shareholders' funds		
	Share capital	1	900000
	Total		900000
	ASSETS		
1	**Non-current assets**		
	Fixed and Tangible Assets	2	400000
2	**Current assets**		
	Cash and cash equivalents	3	500000
	Total		900000

Notes to accounts

		₹
1.	**Share Capital**	
	Equity share capital	
	Authorised share capital	
	90,000 Equity shares of ₹10 each	9,00,000
	Issued share capital	
	90,000 Equity shares of ₹10 each	9,00,000
	Subscribed Share Capital	
	90,000 Equity Shares of ₹10 each	9,00,000
	Called up and Paid up Capital	9,00,000
	90,000 Equity Shares of ₹10 each	
	(Out of the above 40,000 shares have been allotted as fully paid up pursuant to contract(s) without payment being received in cash)	

2.	**Tangible Assets** Land and Building	4,00,000
3.	**Cash and cash equivalents** Balances with banks	5,00,000

ISSUE OF BONUS SHARES

Introduction

A bonus share may be defined as issue of shares at no cost to current shareholders in a company, based upon the number of shares that the shareholder already owns. In other words, no new funds are raised with a bonus issue. While the issue of bonus shares increases the total number of shares issued and owned, it does not increase the net worth of the company. Although the total number of issued shares increases, the ratio of number of shares held by each shareholder remains constant.

Bonus issue is also known as 'capitalisation of profits'. Capitalisation of profits refers to the process of converting profits or reserves into paid up capital. A company may capitalise its profits or reserves which otherwise are available for distribution as dividends among the members by issuing fully paid bonus shares to the members. If the subscribed and paid-up capital exceeds the authorized share capital as a result of bonus issue, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital. A return of bonus issue along with a copy of resolution authorizing the issue of bonus shares is also required to be filed with the Registrar of Companies.

Provisions of the Companies Act, 2013

Section 63 of the Companies Act, 2013 deals with the issue of bonus shares. According to Sub-section (1) of Section 63, a company may issue fully paid-up bonus sharesto its members, in any manner whatsoever, out of—

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account:

SEBI Regulations

A listed company, while issuing bonus shares to its members, has to comply with the following requirements under the SEBI (Issue of Capitaland Disclosure Requirements) Regulations, 2009:

Regulation 92- Conditions for Bonus Issue

Subject to the provisions of the Companies Act, 2013 or any other applicable law for the time being in force, a listed company may issue bonus shares to its members if:

(a) it is authorised by its articles of association for issue of bonus shares, capitalisation of reserves, etc.:

Provided that if there is no such provision in the articles of association, the issuer shall pass are solution at its general body meeting making provisions in the articles of associations for capitalisation of reserve;

(b) it has not defaulted in payment of interestor principal in respect of fixed deposits or debt securities issued by it;

(c) it has sufficient reason to believethat it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity and bonus;

(d) the partly paid shares, if any outstanding on the date of allotment, are made fully paid up

Journal Entries

(A) (1) Upon the sanction of an issue of bonus shares

a) Debit Capital Redemption Reserve Account
Debit Securities Premium Account
Debit General Reserve Account
Debit Profit & Loss Account

b) Credit Bonus to Shareholders Account

(2) Upon issue of bonus shares

a) Debit Bonus to Shareholders Account

b) Credit Share Capital Account.

(B) (1) Upon the sanction of bonus by converting partly paid shares into fully paid shares

a) Debit General Reserve Account
Debit Profit & Loss Account

b) Credit Bonus to Shareholders Account

(2) On making the final call due

a) Debit Share Final Call Account

b) Credit Share Capital Account.

(3) On adjustment of final call

a) Debit Bonus to Shareholders Account

b) Credit Share Final Call Account

Illustration 11

Following items appear in the trial balance of Bharat Ltd. (a listed company) as on 31st March, 2018:

	₹
40,000 Equity shares of ₹10 each	*4,00,000*
Capital Redemption Reserve	*55,000*
Securities Premium (collected in cash)	*30,000*

General Reserve	*1,05,000*
Surplus i.e. credit balance of Profit and Loss Account	*50,000*

The company decided to issue to equity shareholders bonus shares at the rate of 1 share for every 4 shares held and for this purpose, it decided that there should be the minimum reduction in free reserves. Pass necessary journal entries.

Solution

Journal Entries in the books of Bharat Ltd.

		Dr.	Cr.
		₹	₹
Capital Redemption Reserve A/c	Dr.	55,000	
Securities Premium A/c	Dr.	30,000	
General Reserve A/c (b.f.)	Dr.	15,000	
To Bonus to Shareholders A/c			1,00,000
(Bonus issue of one share for every four shares held, by utilising various reserves as per Board's resolution dated…….)			
Bonus to Shareholders A/c	Dr.	1,00,000	
To Equity Share Capital A/c (Capitalisation of profit)			1,00,000

Illustration 12

Following is the extract of the Balance Sheet of Preet Ltd. as at 31st March, 2018

Authorised capital :	₹
15,000 12% Preference shares of ₹10 each	*1,50,000*
1,50,000 Equity shares of ₹10 each	*15,00,000* *16,50,000*
Issued and Subscribed capital: *12,000 12% Preference shares of ₹10 each fully paid*	*1,20,000*
1,35,000 Equity shares of Rs. 10 each, ₹8 paid up	*10,80,000*
Reserves and surplus: *General Reserve*	*1,80,000*
Capital Redemption Reserve	*60,000*
Securities premium (collected in cash)	*37,500*
Profit and Loss Account	*3,00,000*

On 1st April, 2018, the Company has made final call @ ₹2 each on 1,35,000 equity shares. The call money was received by 20th April, 2018. Thereafter, the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held.

Show necessary journal entries in the books of the company and prepare the extract of the balance sheet as on 30th April, 2018 after bonus issue.

Solution

Journal Entries in the Books of Preet Ltd.

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
01-04-2018	Equity Share Final Call A/c	Dr.	270000	
	To Equity Share Capital A/c			270000
	[For final calls of ₹2 per share on 1,35,000 equity shares due]			
20-04-2018	Bank A/c	Dr.	270000	
	To Equity Share Final Call A/c			270000
	[For final call money on 135000 equity shares received]			
	Securities Premium A/c	Dr.	37500	
	Capital Redemption Reserve A/c	Dr.	60000	
	General Reserve A/c	Dr.	180000	
	Profit and Loss A/c	Dr.	60000	
	To Bonus to shareholders A/c			337500
	[For making provision for bonus issue of one share for every four shares held]			
	Bonus to Shareholders A/c	Dr.	337500	
	To Equity Share Capital A/c			337500
	[For issue of bonus shares]			

Extract of Balance Sheet as at 30th April, 2018 (after bonus issue)

	₹
Authorised Capital	
15,000 12% Preference shares of ₹10 each	150000
1,83,750 Equity shares of ₹10 each (refer working note below)	1837500
Issued and subscribed capital	
12,000 12% Preference shares of ₹10 each, fully paid	120000
1,68,750 Equity shares of ₹10 each, fully paid	1687500
(Out of above, 33,750 equity shares @ ₹10 each were issued by way of bonus)	
Reserves and surplus	
Profit and Loss Account	240000

Working Note:

The authorised capital should be increased as per details given below:

Existing authorized Equity share capital	=	15,00,000
Add: Issue of bonus shares to equity shareholders	=	3,37,500
		18,37,500

RIGHT ISSUE

Introduction

Provisions of section 62 (1) (a) govern any company, public or private, desirous of raising its subscribed share capital by issue of further shares. Whenever a company intends to issue new shares, the voting and governance rights of the existing shareholders may be diluted, if they are not allowed to preserve them. It may happen because new shareholders may subscribe to the issued share capital. Companies Act, 2013 allows existing shareholders to preserve their position by offering those newly issued shares at the first instance to them. The existing shareholders are given a right to subscribe these shares, if they like. However, if they do not desire to subscribe these shares, they are even given the right to renounce it in favour of someone else (unless the articles of the company prohibits such a right to renounce).

In nutshell, the existing shareholders have a right tosubscribe to any fresh issue of shares by the company in proportion to their existing holding for shares. They have an implicit right to renounce this right in favour of anyone else, or even reject it completely. In other words, the existing shareholders have right of first refusal, i.e., the existing shareholders enjoy a right to either subscribe for these shares or sell their rights or reject the offer.

Accounting for Right Issue

The accounting treatment of rights share is the same as that of issue of ordinary shares and the following journal entry will be made:

Bank A/c Dr.

To Equity shares capital A/c

In case rights shares are being offered at a premium, the premium amount is credited to the securities premium account.

The accounting entry is usual and is

Bank A/c Dr.

To Equity Share Capital A/c

To Securities Premium A/c

Example:

A company having 100,000 shares of ₹10 each asits issued share capital, and having a market value of ₹ 46, issues rights shares in the ratio of 1:10 atan issue price of ₹ 31.

The entry at the time of subscription of right shares by the existing shareholders will be

Bank A/c	Dr.	3,10,000	
To Equity Share Capital A/c			100,000
To Securities Premium A/c			210,000

Illustration 13

A company offers new shares of ₹100 each at 25% premium to existing shareholders on one for four bases. The cum-right market price of a share is ₹150. Calculate the value of a right. What should be the ex-right market price of a share?

Solution

Ex-right value of the shares = (Cum-right value of the existing shares + Rights shares Issue Price)/ (Existing No. of shares + Rights No. of shares)

= (₹150 × 4 Shares + ₹125 × 1 Share) / (4 + 1) Shares

= ₹725 / 5 Shares

= ₹145 per share.

Value of right = Cum-right value of the share – Ex-right value of the share

= ₹150 – ₹145

= ₹5 per share.

Hence, any one desirous of having a confirmed allotment of one share from the company at ₹125 will have to pay ₹20 (4 shares × ₹5) to an existing shareholder holding 4 shares and willing to renounce his right of buying one share in favour of that person.

ACCOUNTING FOR ISSUE OF DEBENTURES

The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge has been created on any or on the entire assets of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Section 2 (30) of the Companies Act, 2013 defines debentures as “Debenture” includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not. Thus, it is clear from definition that debenture may be Secured Debenture or Unsecured Debenture.

Features of Debentures

1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security where interest falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.
4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

Distinction between Debentures and Shares

Debentures	Shares
1. Debenture holders are the creditors of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company.	2. Shareholders have voting rights and consequently control the total affairs of the company.

3. Debenture interest is paid at a pre- determined fixed rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on equity shares is paid at a variable rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. Dividends are appropriation of profits and these are not deductible in determining taxable profit of the company.
5. There are different kinds of debentures, such as Secured/Unsecured; Redeemable/ Irredeemable; Registered/Bearer; Convertible / Non-convertible, etc.	5. There are only two kinds of shares–Equity Shares and Preference Shares.
6. In the Company's Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Company's Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.
7. Debentures can be converted into other debentures or shares as per the terms of issue of debentures.	7. Shares cannot be converted into other shares in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, debenture holders get back their money as per the terms and conditions of redemption.	9. Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of liquidation, debenture holders are paid-off before the shareholders.	10. At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.

Types of Debentures

The following are the types of debentures issued by a company. They can be classified on the basis of:

(1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.

1. Security

(a) *Secured Debentures:* These debentures are secured by a charge upon some or all assets of the company. There are two types of charges: (i) Fixed charge; and (ii) Floating charge. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders. A floating charge generally covers all the assets of the company including future one.

(b) *Unsecured or "Naked" Debentures:* These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

2. Convertibility

a) *Convertible Debentures:* These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.

b) *Non-Convertible Debentures:* These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

3. Permanence

a) *Redeemable Debentures:* These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

b) *Irredeemable Debentures:* These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation.

4. Negotiability

a) *Registered Debentures:* These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable. The provisions of the Companies Act, 2013 are to be complied with for effecting transfer of these debentures. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.

b) *Bearer Debentures:* These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. Priority

a) *First Mortgage Debentures:* These debentures are payable first out of the property charged.

b) *Second Mortgage Debentures:* These debentures are payable after satisfying the first mortgage debentures.

Issue of Debentures

Accounting entries for issue of redeemable debentures

The issue of redeemable debentures can be categorized into the following:

1. Debentures issued at a par and redeemable at par or at a discount;
2. Debentures issued at a discount and redeemable at par or at discount;
3. Debentures issued at premium and redeemable at par or at discount;
4. Debentures issued at par and redeemable at premium;

5. Debentures issued at a discount and redeemable at premium.
6. Debentures issued at premium and redeemable at premium.

Journal entries in each of the above cases are discussed below:

1. **Debentures issued at par redeemable at par:** When debenture are issued at par, the issue price is equal to par value, in this regard the following entries are recorded:
   (a) For receipt of application money :

   Bank A/c Dr.
   To Debenture Application A/c

   (b) For transfer of application money to debentures account :

   Debenture Application A/c Dr.
   To …% Debenture A/c

2. Debentures issued at Discount and Redeemable at par or at discount: When debentures are issued at discount, issue price will be less than par value. The difference between the two is considered as loss on issue on debentures and is to be written-off over the life of debentures. The entries with regards to issue are given below:

a) For receipt of application money

Bank A/c Dr.
To Debenture Application A/c

b) At the time of making allotment

Debenture Application A/c Dr.
Discount on issue of debentures A/c Dr.
To …% Debentures A/c

3. Debentures Issued at Premium and Redeemable at par or at discount

When debenture are issued at premium, the issue price is more than the par value. The premium is transferred to securities premium account. In this regard, the following journal entries are recorded:

When premium amount is received at the time of application;

(a) For receipt of application money

Bank A/c Dr.
To Debenture Application A/c

(b) For transfer of application of money at the time of allotment

Debenture application A/c Dr.
To …% Debentures A/c
To Securities Premium A/c

When debentures are issued at par or premium value but redeemed at discount, then it means that the company will gain by paying less. This gain will not be recognised in the books at the time of issue of debentures as per the conservatism concept.

4. Debentures issued at par and redeemable at a premium

Where debentures are to be redeemed at premium, an extra entry is to be made at the time of issue and allotment of debentures. This extra entry is to be passed for providing premium payable on redemption. Debenture Redemption Premium Account is a personal account which represents a liability of the company in respect of premium payable on redemption.

In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debentures at the time of allotment of debentures. Following journal entries are recorded in this regard:

(a) For receipt of application money

Bank A/c Dr.

To Debenture application A/c

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c Dr.

To …% Debenture A/c

(ii) Call made consequent upon allotment

Debenture Allotment A/c Dr.

Loss on issue of debenture A/c Dr. [Equal to Debenture Redemption Premium]

To …% Debenture A/c

To Debenture redemption premium A/c

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c Dr.

Loss on issue of debenture A/c Dr.

To …% Debenture A/c

To Debenture redemption premium A/c

5. Debentures Issued at discount and redeemable at premium

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price and the issue price is treated as discount/loss on issue of debentures. Suppose, a 10% debentures of ₹1,000 is issued at a discount of ₹100 and redeemable at a premium of ₹5 per debenture, the amount of loss will be equal to ₹1,005 – ₹900 = ₹105. This is to be treated as loss on issue. It is to be noted that premium on redemption of debentures is also credited by ₹5.

(a) For the receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) At the time of making allotment

i) Transfer of application money to debenture account

Debenture Application A/c Dr.

To % Debentures A/c

ii) Call made consequent upon allotment of debentures at discount and redeemable at premium

Debenture Allotment A/c Dr.

Discount/Loss on issue of debenture A/c Dr. [Amount equal to the discount on issue of debenture plus Premium on redemption]

To …% Debenture A/c

(c) For receipt of call made on allotment

Bank A/c Dr.

To Debenture Allotment A/c

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c Dr.

Discount/Loss on issue of debentures A/c Dr.

To …% Debentures A/c

To Debenture redemption premium A/c

6. Debentures Issued at premium and redeemable at premium

In this situation, the issue price is more than par value and also redemption value is more than par value. The premium received at the time of issue of debentures is credited to Securities premium account and premium paid at the time of redemption is a loss to be provided at the time of issue of debentures. Suppose, a 10% debenture of ₹1,000 is issued at a premium of ₹100 and redeemable at a premium of ₹ 50 per debenture. In the given case ₹ 100 is to be credited to Securities premium account and ₹50 will be the loss to be provided at the time of issue of debentures. It is to be noted that premium on redemption of debentures is also credited by ₹50.

(a) For the receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c Dr.

To % Debentures A/c

(ii) Call made consequent upon allotment of debenture at premium and Redeemable at premium

Debenture Allotment A/c Dr.

Loss on issue of debenture A/c Dr. [Amount equal to the premium on redemption]

To …% Debenture A/c

To Securities Premium A/c [Amount equal to premium on issue]

To Premium on Redemption of Debentures A/c [Amount equal to premium on redemption]

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c Dr.

Loss on issue of Debentures A/c Dr.

To …% Debentures A/c

To Securities Premium A/c

To Premium on redemption of debentures A/c

Accounting for issue of debentures payable in instalments

Just like shares, money payable on debentures may be paid either in full with application or by instalments. Accounting entries will differ to some extent in either case.

Debentures Payable in Full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures, such as 10% Debentures Application Account or 12% Debentures Application Account. These accounts record moneys received from the applicants of debentures. If an issue is over-subscribed, these accounts can be used to record the refund of moneys to the unsuccessful applicants. At the time of allotment of debentures, the amount in Debentures Application Account is transferred to the respective Debentures Account.

Debentures Issued at Par

The debentures which are issued at par are issued at the same price as their nominal value; that is, if a debenture with a nominal value of ₹100 is issued at par, the company receives ₹100. The accounting entries would be as follows:

(a) When cash is received

Bank Account Dr.

To Debentures Application Account

(Being money received on…. debentures @ ₹….each)

(b) When excess money is refunded or adjusted for future calls

Debentures Application Account Dr.

To Bank Account (Amount refunded)

To Debenture Allotment A/c (Amount adjusted for allotment)

(Being excess money…debentures adjusted as per Board's Resolution)

(c) When the debentures are allotted

Debentures Application Account Dr.

To % Debentures Account

(Being the allotment of…debentures of ₹….each as per Board's Resolution)

(d) On Allotment money being called

Debenture Allotment A/c Dr.

To % Debentures Account

(Being Allotment Money Called)

(e) On Allotment money being received

Bank A/c Dr.

To Debenture Allotment A/c

(Being Allotment money received)

(f) On Debenture Call money being called

Debenture Calls A/c Dr.

To % Debentures A/c

(Being Call money made due)

(g) On Debenture Call money being called

Bank A/c Dr.

To Debenture Calls A/c

(Being Call money received)

Illustration 14

Simmons Ltd. issued 1,00,000, 12% Debentures of ₹ 100 each at par payable in full on application by 1st April, Application were received for 1,10,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date.

You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

Solution

In the books of Simmons Limited

Date	Particulars	₹	₹
April 1	Bank A/c Dr.	11,000	
	To 12% Debentures Application A/c		11,000
	(Being money received on 1,10,000 debentures)		
April 7	12% Debentures Application A/c Dr.	1,000	
	To Bank A/c		1,000
	(Being money on 10,000 debentures refunded as per Board's Resolution No…..dated…)		
April 7	12% Debentures Application A/c Dr.	10,000	
	To 12% Debentures A/c		10,000
	(Being the allotment of 1,00,000 debentures of ₹100 each at par, as per Board's Resolution No….dated…)		

Debentures Issued at a Premium

A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value; that is, if a debenture with a nominal value of ₹100 is issued at 10% premium, the company receives at ₹ 110 where the investor gets slightly less interest than stated in the debenture. For example, 12% Debentures of ₹100 issued at a premium of 10%. The investor will get ₹ 12 p.a. for his investment of 110. Therefore, the effective rate of interest on investment is (12/110x 100) = 10.91%.

The accounting entries would be as follows:

(a) When cash is received

Bank Account Dr. [Nominal value plus premium]

To Debentures Application Account

(Being money received on….debentures @ ₹….. each including premium of ₹…..)

(b) When excess money is refunded

Debentures Application Account Dr.

To Bank Account

(Being refund of money on….debentures @ ₹….

each, as per Board's Resolution No…..dated….)

(c) When the debentures are allotted

Debentures Application Account Dr.
To % Debentures Account
To Securities Premium Account
(Being the allotment of….debentures,
premium transferred to Securities
Premium Account, as per Board's
Resolution No….dated….)

Debentures Issued at a Discount

The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate. Like shares, Debentures Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "Discount on Issue of Debentures Account. In the subsequent years, Discount on Issue of Debentures is written-off proportionately by charging to the Statement of Profit and Loss. It is considered a normal practice to amortize discount on issue of debentures over the period of benefit, i.e., normally 3 to 5 years.

The accounting entries would be as follows:

(a) When Cash is received

Bank Account	Dr.	[Actual cash received]
To Debentures Application Account		
(Being money received on….debentures @ Rs. ……each)		

(b) When excess money is refunded

Debentures Application Account	Dr.	
To Bank Account		
(Being excess money on…debentures refunded as per Board's Resolution No…..dated….)		

(c) When the debentures are allotted

Debentures Application Account	Dr.	[Actual cash received]
Discount on Issue of Debentures Account	Dr.	[Discount on debentures]
To% Debentures Account		[Nominal value of debentures]
(Being the allotment of…debentures of Rs ….each @ Rs. …..each as per Board's Resolution No…..dated…)		

<u>Illustration 15</u>

X Ltd. issued 1,00,000 12% Debentures of ₹100 each at a discount of 10% payable in full on application by 31st May, 2017. Applications were received for 1,20,000 debentures. Debentures were *allotted on 9th June, 2017. Excess monies were refunded on the same date. Pass necessary Journal Entries. Also show necessary ledger accounts.*

Solution

In the books of X Limited Journal Entries

Date 2017	Particulars		₹'000	₹'000
May 31	Bank A/c	Dr.	10,800	
	To 12% Debentures Application A/c			10,800
	(Being money received for 1,20,000 debentures @ ₹ 90 each)			
June 9	12% Debentures Application A/c	Dr.	1,800	
	To Bank A/c			1,800
	(Being excess money on 20,000 debentures @ ₹90 refunded as per Board's Resolution No….dated….)		9,000	
June 9	12% Debentures Application A/c	Dr.		
	Discount on Issue of Debentures A/c	Dr.	1,000	
	To 12% Debentures A/c			10,000
	(Being the allotment of 1,00,000 debentures of ₹100 each at a discount of ₹10 per debenture)			

12% Debentures Account

Date	Particulars	₹	Date	Particulars	₹
30.6.2017	To Balance c/d	10,000	9.6.2017	By 12% Debentures Application A/c	9,000
			9.6.2017	By Discount on Issue of Debentures A/c	1,000
		10,000			10,000

12% Debentures Application Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2017	To Bank A/c	1,800	31.5.2017	By Bank A/c	10,800
9.6.2017	To 12% Debentures A/c	9,000			
		10,800			10,800

Discount on Issue of Debentures Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2017		1,000	30.6.2017	By Balance c/d	1,000

	To12% Debentures A/c	1,000		1,000

Issue of Debentures in Consideration other than for Cash

Just like shares, debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc. In this case, the following entries are passed:

(a) Sundry Assets Account Dr. [Assets taken over]

To Sundry Liabilities Account [Liabilities assumed]

To Vendors Account [Purchase consideration]

(Being the assets and liabilities taken over)

(b) Vendors Account Dr.

To Debentures Account

(Being the issue of….debentures to satisfy purchase consideration)

Further it should be noted that these debentures can be issued at par, premium and at discount. In each case the second entry for issue of debentures would be done accordingly. Number of debentures to be issued is calculated as follows:-

1. When debentures are issued at par

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value}}$$

2. When debentures are issued at premium

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value + Premium}}$$

3. When debentures are issued at discount

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value - Discount}}$$

Illustration 16

X Company Limited issued 10,000 14% Debentures of the nominal value of ₹50,00,000 as follows:

(a) To sundry persons for cash at 90% of nominal value of ₹25,00,000.

(b) To a vendor for purchase of fixed assets worth ₹10,00,000 – ₹12,50,000 nominal value.

(c) To the banker as collateral security for a loan of ₹10,00,000 – ₹12,50,000 nominal value.

Pass necessary Journal Entries.

Solution

Journal Entries in the books of X Company Ltd.

Date	Particulars	₹	₹
(a)	Bank A/c Dr.	22,50,000	
	To Debentures Application A/c		22,50,000
	(Being the application money received on 5,000 debentures @ ₹450 each)		
	Debentures Application A/c Dr.	22,50,000	
	Discount on issue of Debentures A/c Dr.	2,50,000	
	To 14% Debentures A/c		25,00,000
	(Being the issue of 5,000 14% Debentures @ 90% as per Board's Resolution No….dated….)		
(b)	Fixed Assets A/c Dr.	10,00,000	
	To Vendor A/c		10,00,000
	(Being the purchase of fixed assets from vendor)		
	Vendor A/c Dr.	10,00,000	
	Discount on Issue of Debentures A/c Dr.	2,50,000	
	To 14% Debentures A/c		12,50,000
	(Being the issue of debentures of ₹12,50,000 to vendor to satisfy his claim)		
(c)	Bank A/c Dr.	10,00,000	
	To Bank Loan A/c (See Note)		10,00,000
	(Being a loan of ₹10,00,000 taken from bank by issuing debentures of ₹12,50,000 as collateral security)		

Note: No entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet the fact that the debentures being issued as collateral security and outstanding are shown under the respective liability.

Interest on Debentures

Interest payable on coupon debenture is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at source at the rates applicable under tax rules from time to time. The companies will deposit the tax so deducted with income tax authorities. Following accounting entries are to be recorded in this regard:

Illustration 17

A company issued 12% debentures of the face value of ₹10,00,000 at 10% discount on 1-1-2017. Debenture interest after deducting tax at source @ 10% was payable on 30th June and 31st of December every year. All the debentures were to be redeemed after the expiry of five year period at 5% premium.

Pass journal entries for the accounting year 2017.

Solution

Journal Entries

			(₹)	(₹)
1-1-2017	Bank A/c	Dr.	9,00,000	
	Discount/Loss on Issue of Debentures A/c	Dr.	1,50,000	
	To 12% Debentures A/c	Dr.		10,00,000
	To Premium on Redemption of Debentures A/c			50,000
	(For issue of debentures at discount redeemable at premium)			
30-6-2017	Debenture Interest A/c	Dr.	60,000	
	To Debenture holders A/c			54,000
	To Tax Deducted at Source A/c			6,000
	(For interest payable)			
	Debenture holders A/c	Dr.	54,000	
	Tax Deducted at Source A/c	Dr.	6,000	
	To Bank A/c			60,000
	(For payment of interest and TDS)			
31-12-2017	Debenture Interest A/c	Dr.	60,000	

	To Debenture holders A/c		54,000
	To Tax Deducted at Source A/c		6,000
	(For interest payable)		
	Debenture holders A/c Dr.	54,000	
	Tax Deducted at Source A/c Dr.	6,000	
	To Bank A/c		60,000
	(For payment of interest and tax)		
	Profit and Loss A/c Dr.	1,20,000	
	To Debenture Interest A/c		1,20,000
	(For transfer of debenture interest to profit and loss account at the end of the year)		
	Profit and Loss A/c Dr.	30,000	
	To Discount/Loss on issue of debenture A/c		30,000
	(For proportionate debenture discount and premium on redemption written off, i.e., 1,50,000 x 1/5)		

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